# Coming out of the woods – emerging markets

Anne Louise Gibbins of Chase Manhattan answers some the most frequently asked questions about the emerging markets of Central Europe and South Africa.

In Chase Manhattan's London FX dealing room, we speak daily to a wide variety of clients about emerging markets. Over the past few years, we have dedicated more and more resources to emerging markets to meet the growing demands of our clients. Corporate treasurers represent a fast-growing segment of our emerging markets clientbase and wherever they are based globally, their questions tend to be similar:

- Why is there so much interest in emerging markets?
- How do these currencies trade?
- What sort of volatility should I expect?
- How much will it cost?
- We don't have the time or the head-count available to monitor such a small proportion of our overall exposure… what do we need to watch for and avoid?
- How best can we manage our ongoing risk?

In this article, we will address these frequently-asked questions with reference to the markets that most concern our UK and European treasurers – Central Europe and South Africa. First, however, we answer the most basic question with a little background.

***Why so much interest in these emerging markets?***

The simple answer: investment and the pursuit of market share. Multinational corporates are capitalising on the cheaper, well-educated labour forces and attractive tax incentives these countries offer to set up production facilities. Additionally, there is tremendous demand for imported goods in these regions, so corporates are focused on building market share in these growing domestic markets (Poland alone has a population of 40 million, for example). As multinational corporates have expanded their market share in the Central European region, foreign direct investment (FDI) inflows (defined as the acquisition of more than 15% of a corporation's total share capital) have become compelling. The expectation of eventual EU accession has been one of the driving forces behind this movement.

In Central Europe, FDI flows have dwarfed portfolio flows, causing the currencies particularly to strengthen against the euro. (*see Figure 1*). A clear example of this has been Poland, where the market's expectation of FDI flow on the back of the $4bn TPSA (telecom) privatisation has kept the zloty strong since June. In the Czech Republic this trend has also emerged, with the crown appreciating steadily against the euro since May. In fact, the central bank (CNB) has become so concerned about the crown's strength, that it has intervened on two separate occasions this year to weaken its own currency. The other interesting point to note about these net positive FDI flows (see *Figure* 2) is the extent to which they are financing these countries' current account (c/a) deficits.

*FIGURE 1*

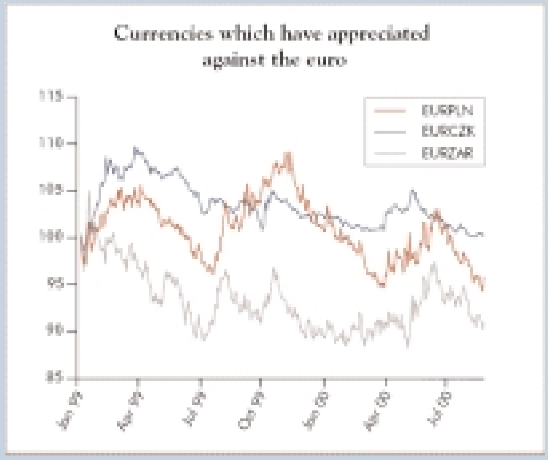


*FIGURE 2*

Net FDI flow US$bn
(Net FDI flow as % of c/a)

| | 1998 | 1999 | 2000CF | 2001CF |
|---|---|---|---|---|
| **PLN** | 5.0 (70%) | 6.3 (50%) | 8.5 (80%) | 5.0 (70%) |
| **CZK** | 2.6 (120%) | 4.9 (460%) | 5.0 (360%) | 3.0 (180%) |
| **HUF** | 1.5 (60%) | 1.7 (80%) | 2.0 (110%) | 2.0 (90%) |

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In the Czech Republic this year, FDI will finance the $1bn c/a deficit more than 3.5 times over. Hungary's $1.7bn c/a deficit is also fully financed, while Poland lags slightly. However, Poland has by far the highest c/a deficit in the region (2,000CF is $11.6bn) which represents 7.5% of GDP. This dependence on external financing is one of the major reasons behind the zloty's continued vulnerability to a major correction and should be an important consideration when deciding how much of your exposure to hedge.

Giancarlo Perasso, Chase Manhattan's Senior Economist for Central Europe, explains further: "Investors see a current account deficit greater than 5% of GDP as an indicator of possible financial vulnerability. In the case of Poland, the threshold is now probably higher because of the high FDI inflows. However, a sizeable share of these inflows is privatisation-related and is bound to decline as the privatisation programme proceeds. Should the c/a deficit remain at current levels, in terms of GDP, the zloty should weaken."

*We can see that understanding the current account dynamic and timing of FDI flows are critical for a treasury manager.*

In South Africa, the FDI is such a small proportion of overall flow that there is no real impact on the currency. The rand's historic volatility has been due to its status as a commodity currency, dependence on portfolio flows, and the perception that the reserve bank's lack of FX reserves (due to its net oversold forward position) left it powerless to defend the currency. Francis Beddington, Senior Economist for Africa & Middle East at Chase Manhattan, comments: "South Africa's dependence on portfolio flows makes the rand uniquely vulnerable to changes in global sentiment. In many ways, short rand positions have been used to hedge global emerging markets volatility in times of crisis. This makes the US$/ZAR foreign exchange rate highly volatile."

This volatility is an important consideration for multinational corporates and provides powerful evidence of the benefits of hedging.

### How do these currencies trade?

The Central European region has naturally evolved toward trading versus the euro, reflecting the dominance of the EU trading bloc for these domestic economies and their aspirations to EU membership. Initially, the Czech crown was traded against the dollar, in both the spot and forwards markets, despite the crown then being managed against a trade-weighted basket dominated by DM (65%DM/35%US$). Once the currency was floated, and following the introduction of the euro, we began to see the market liquidity improve versus the euro instead of the dollar. Today, the EUR/CZK pair comprises the majority of the market liquidity.

Since the free float of the Polish zloty in April this year, we have started to see the same effect, with one notable difference: although liquidity in the Polish market is best in the US$/PLN pair, Chase regularly now quotes EUR/PLN spot and forward for offshore corporate clients. Portfolio investors (financial flow) still prefer the greater liquidity offered by the US$/PLN market. The Hungarian forint, the most restricted and illiquid of the region's major currencies, depreciates 0.3% per month versus its currency basket (now 100%EUR, but prior to January, 70%EUR/30%US$) within a ±2.25% band. This currency still offers the most liquidity when traded versus the dollar. While the Czech crown is fully deliverable and the Polish zloty is, for all intents and purposes, fully convertible for offshore entities, the Hungarian forint is not yet fully convertible and restrictions exist.

This Central European trend has been in direct contrast to South Africa. It is investment portfolio flows which drive this market: this year to date, the value of the JSE's average daily share turnover is $314m and between $3-4bn for the bonds. The June average daily turnover on the South African foreign exchange market was $7.5bn, of which $5.9bn was swaps, $400m in forwards, and $1.2bn in spot. These portfolio flows, South Africa's geographical isolation from any other major trading blocs, and the large commodity-based economy, mean that US$/ZAR will remain the main trading pair in the foreseeable future. It is important to note, however, is the recently signed free trade agreement between South Africa and the EU; this agreement covers about 95% of all trade between the EU and South Africa and will be phased in over the next 10 years.

Over time, and once the remaining currency restrictions have been lifted, we would expect to see the increased corporate flows demanding greater EUR/ZAR liquidity.

*Figure 3* demonstrates the average market trading sizes and tenors available across the different products in CZK, PLN, HUF and ZAR.

### What sort of volatility should I expect?

As the Historic Volatility graph (*Figure 4*) highlights, the good news is that the volatility in these emerging markets tends on average to be only marginally higher than that in the G7 currency pairs. The bad news, however, is that these currencies are prone to moments of extreme volatility, which then gives way to relative calm. As international interest has increased, there has been a dramatic rise in non-domestic bank participation in these markets, and this has contributed to a general improvement in trading conditions. It is vital to understand that during times of crisis short-term investment flow can completely reverse, causing significant volatility.

Thankfully, that volatility doesn't

*FIGURE 3*

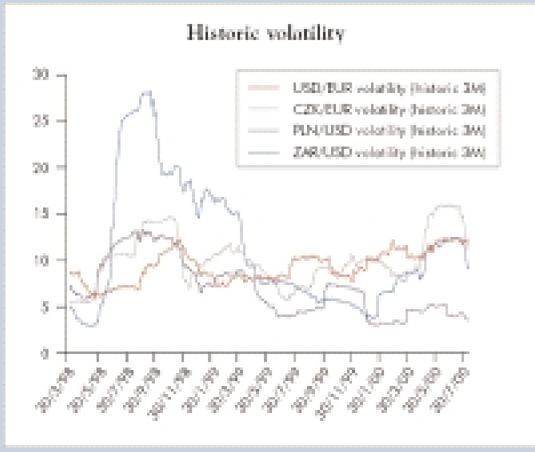
**Emerging markets trading – currency and product liquidity**

| Currency* | FX Spot | FX Forwards: Non Deliverable[1] | FX Forwards: Deliverable | FX Options | FRAs | Swaps: Interest Rate | Swaps: Cross-Currency |
|---|---|---|---|---|---|---|---|
| **PLN Poland** | US$5-100m | NA | 0-12 months, US$20-100m 1-10 years, US$5-50m vs. US$, EUR | 0-5 years US$20-50m | 0-2 years US$25m 3 month equiv. | 1-10 years US$25m vs. Wibor | 1-10 years US$25m |
| **CZK Czech Republic** | US$5-100m | NA | 0-12 months, US$50m+ 1-10 years, US$20m vs, EUR, US$ | 0-5 years US$25-50m | 0-3 years US$30m 3 month equiv. | 1-10 years US$20m vs. Pribor | 1-10 years US$20m |
| **HUF Hungary** | US$1-5m[3] | 0-12 months, US$5-50m 1-10 years, US$1-20m vs. EUR, US$ | NA | Limited liquidity on a case by case basis | NA | Order basis only[2] | 1-10 years US$5m Non-deliv. sett. in EUR, US$[2] |
| **ZAR South Africa** | US$20-30m | NA | 0-12 months, US$25m 1-10 years, US$15m vs. US$ | 0-3 years US$20-100m | 0-2 years US$25m 3 month equiv | 0-10 years US$15m vs. 3 month Jibar | 1-10 years US$15m |

(1) NDF fixing convention – sampled from selected banks.
(2) Normally, with no initial exchange and all subsequent cash flows settled in EUR or US$ at an FX rate fixed according to NDF Methodology above.
(3) For one-off third-party remittances only, must qualify nature of transaction with client prior to trade.
*Further information on all currencies can be provided upon request*

*Source: Chase Manhattan*

FIGURE 4




necessarily mean wider spreads due to commitment of market-makers to provide liquidity. *However, this does mean that the timing of investment and execution of hedges is absolutely critical.* Michele Maffei, Managing Director for Emerging Markets Derivatives Trading, comments: "What is needed is a sound understanding of the economic fundamentals and what is driving the markets as well as sound nerves to invest into weakness and execute hedges into strength."

***How best can we manage our risk?***

First, identify the way the risk impacts the business (see *Figure 5*)…then determine the best product mix to minimise that exposure (see *Figure 6*). We have found that using a mix of these different products achieves optimal results. For foreign investors into a country, the timing of the investment is usually a product of protracted negotiations with the local authorities and usually coincides with strength in the currency as the market prices in the (often high profile) foreign investor's need to purchase local currency. Short-term FX forwards and options enable the investor to effectively postpone the moment when the FX exposure is opened by effectively funding the investment in local currency.

On the other side of the balance sheet, Chase advised and executed risk management solutions for a Polish corporate which was exposed to foreign currency exposure arising from both its recent eurobond debt issue as well as euro commitments to its suppliers for capital equipment. The solution executed was a combination of short-term and long-term hedging products.

Through a series of zero cost EUR/PLN collars, the corporate hedged out the euro payments by:

- limiting its downside exposure to a weaker zloty;
- benefiting from a further rally in the zloty; and
- funding the cost of the hedge by foregoing some further upside potential if the zloty continued to rally.

On the longer-term FX exposure through its eurobond, Chase transacted a US$/PLN cross-currency swap tailored to exactly match the cashflows of its bond. The net result for the corporate was a synthetic PLN fixed rate loan. Not only was the client able to reduce its volatility of earnings, but its perception in the market was enhanced through the implementation of a coherent risk management strategy.

***Moving forward***

In conclusion, it is clear that these Central European states will continue to push ahead with the reforms needed to rejuvenate the last generation's legacy of centralised planning in their move toward EU membership. This transition is bound to keep these nations at the forefront of multinational corporates' investment plans.

At the same time, the rapid growth of volumes in their currency and interest rate markets has made it possible and – more importantly – cost-effective to hedge most market risks. Corporate treasuries cannot afford to ignore the need to put in place hedges for risks in currencies which until now they might have believed to be too illiquid or expensive to hedge. ■

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FIGURE 5

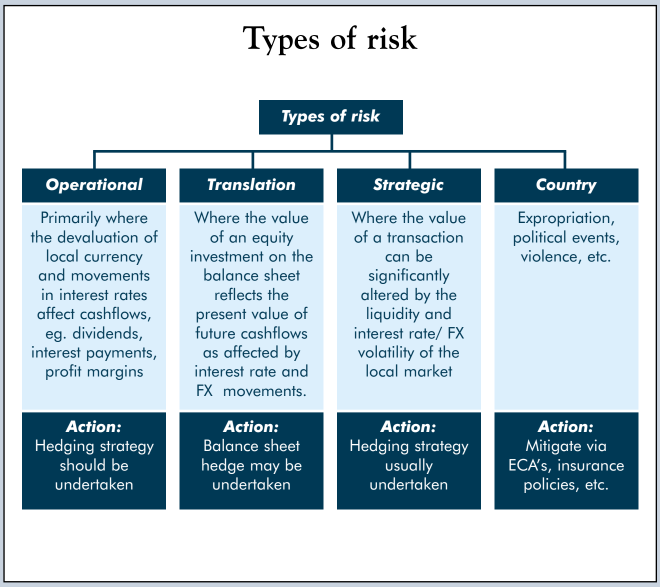


FIGURE 6