

# Key trends in Asia's financial market in 2008 – a corporate treasurer's perspective

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**CURRENCY IS HIGHLY UNPREDICTABLE IN THE WORLD'S FINANCIAL MARKETS. THIS MAY BE WHY CURRENCY FORECASTING IS STILL SO POPULAR (PREDICTING THE UNPREDICTABLE), AND DERIVATIVES FOR HEDGING OR CONTRARIAN TRADING (TAKING OPPOSITE BETS) IS IN SUCH GREAT DEMAND.**

The financial market is not short of theories (or myths), one of which is about correcting trade imbalance via exchange rate realignment and another one is the relation between a strong economy and a strong currency. Since about two decades ago, following the Plaza Accord in 1985, the Japanese yen has become Asia's strongest currency; nevertheless, Japan's trade surplus did not diminish. At the same time, the correction of asset price inflation in Japan resulted in a prolonged adjustment of the financial sector and the real economy. Today the same debate happens for the renminbi. This time, however, history may not repeat itself because:

- 1) China has the ability to determine what level of renminbi is desirable; and
- 2) China as a developing country is only playing a catch-up game in financing its growth.

Understanding the renminbi drivers is important as the future of the currency (exchange rate level and timing of full convertibility) is one of the most important factors that will influence Asia's currency market in 2008, if not in the next decade.

On the other side of the Pacific Ocean, the world financial market has its eyes on the US 'sub-prime' problem. The

US Fed Fund Rate is trending down to avert a credit crisis. Across the Atlantic, Northern Rock caught the Bank of England by surprise and the EU is cautious of continuing



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its tight monetary policy. The old central bank dilemma of inflation vs. growth (reducing unemployment) lingers.

As a result the future direction of the yen, the US dollar and the euro are far from certain. A possible further strengthening of the yen and rising Japanese interest rates have made the 'yen carry trade' increasingly risky. Europe now has a bigger trade imbalance than the US with China and its economic fundamentals, such as higher unemployment, which clouds the judgment that US dollar weakening against the euro is a sure bet.

## Asian currency market outlook: China as the trendsetter

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Alongside the growth of the Chinese economy, Asia has now fully recovered from the Asia Financial Crisis of 1997-1998. Intra-Asia trade has exceeded transpacific trade. Regional supply chain management has reinforced economic integration among nations. Slowdown in US import demand in 2008 will dampen Asia's growth, but only marginally. It may even help to reduce capacity constraints and soften inflation pressure as many Asian economies are now in full employment. Modest growth prospects in the US and Europe will have an effect on FDI flow to Asia. However, capital flow will still be attracted to prosperous industries like private consumption, financial services, infrastructure, logistics, real estate and green investment.

Increased globalisation through trade and capital flows will introduce added volatility in the currency market. Investors and debtors likewise will increasingly be subject to currency exposure; therefore, currency is a risk to manage. Paradoxically, currency is also being sought after as an investment asset class to derive diversification benefit. There are five aspects to focus on in trying to understand the relation of Asian currencies *vis-à-vis* the US dollar, the euro and the pound:

- direction of currency movement;
- relative volatility;
- correlation among currency pairs;

- liquidity of currency trading; and
- development of currency derivatives.

While the fundamentals suggest that Asian currencies will generally strengthen in 2008, the magnitude of each will be different. Of particular interest are the difference in volatility and the degree of correlation among different currency pairs, which provides alternative hedging opportunities to treasurers and carry trade ideas for investors. The Thai baht exhibited higher volatility than other Asian currencies, about double that of the yen and the rupiah. The renminbi (due to 0.5% daily cap) and the Hong Kong dollar (due to the peg) exhibited low volatility against the US dollar. P/Rp/S\$ group, NT\$/W pair and ¥/A\$ pair exhibited relatively higher correlation. The currency derivatives market in Asia is taking shape with cross currency swaps, plain vanilla forwards and options becoming increasingly popular. China has just started to introduce its own version of Chinese language ISDA and Chinese banks are obtaining new derivatives licenses.

Asia is growing as an exporter of capital, underpinned by combined foreign exchange reserves of over US\$4 trillion with China taking the lead with over US\$1.6 trillion. Sovereign wealth funds and other Asia-based institutional investors will be an important source of liquidity in 2008. Cross-border investments into Bear Stearns, Morgan Stanley, Standard Bank and Barclays are the beginning of a new trend.

## The FX market enablers: from IFRS to RTGS

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People, processes and systems are the key enablers to ensure a healthy development of the financial market.

In Asia there is an acute shortage of talent relative to the high speed of growth in the financial market. Corporate treasury professional bodies and governments are taking steps to fill this gap. Supported by the International Group of Treasury Associations (IGTA), a number of its member associations are promoting the sharing of treasury best practice by forming the Asia Pacific Treasury Forum ('APT forum'). IACCT (China) is a founding member of the forum

and is collaborating with two IGTA members, ACT and AFP, to make available their education materials for Asian market participants. A new Certificate of International Treasury Management on-line course/examination, co-branded between ACT and IACCT (China), is being launched. Hong Kong Monetary Authority also offers good educational programmes through the Treasury Markets Association. To promote treasury best practice, IACCT (China) has formed strategic partnerships with:

- the China Association of CFOs (30,000 members);
- the Hong Kong Chinese Enterprises Association (2,000 members); and
- the Association of Board Secretaries of Shanghai Listed Companies (practically all CFOs of listed companies in China).

The recent Annual China CFO Conference organised by IACCT (China) and CACFO was held recently in Beijing at the Great Hall of the People. To coincide with the 11th IGTA Annual Meeting (30,000 members of over 30 treasury associations) being held in Hong Kong, the first Global Treasurers Summit was organised by IACCT (China) and HKCEA at the Hong Kong Monetary Authority, attended by 38 speakers and over 300 delegates from over 20 countries around the world.

The key process issues are:

- accounting standards;
- centralised risk management processes; and
- internal control compliance.

International financial reporting standards (IFRS) is implemented in most markets. Listed companies in Hong Kong started in 2005. A new set of Chinese accounting standards was promulgated by the Ministry of Finance in 2006, practically in convergence with IFRS and embraces fair value accounting and financial instrument disclosure clauses that match IAS 39 and IAS 7. Listed companies and Chinese banks are required to follow the new standard in 2008.

Enterprise risk management (ERM) is increasingly embraced as part of the corporate governance standard. Added currency volatility will heighten the sense of urgency. Global visibility and netting of currency positions, strategic and tactical hedging strategies and contingency liquidity measures have

to be in place and can only be achieved through a centralised treasury management process. The speed and magnitude of market correction, exemplified in the recent sub-prime crisis, require prompt response and execution.

SOX 404 rules require a secured and automated process to minimise operational risk and fraud. The environment which has a lengthened signoff chain, straight-through-processing (STP) and segregation of front, middle and back office is very different from the traditional paper-based manual set-up where control is based on post-event reconciliation and overnight settlement.

Basel II demands significant investment in an IT system by banks to measure market risk, operational risk and credit risk. Similarly IFRS (fair value accounting) and internal control rules require treasurers to install a treasury management system (TMS) that integrates front, middle and back office functionality, as well as generating the reports that meet hedge accounting rules and allow treasurers to perform effective risk management decisions. Based on a recent survey on TMS carried out by IACCT (China), there is an increasing demand for TMS by treasurers in Hong Kong and China.

In December 2007 HKMA and TMA organised its first Treasury Markets Summit in Beijing. Speakers, on the panel I chaired, were represented from SWIFT – a member of IACCT (China), Bank of Communications and HKMA. Asia is secured and efficient for currency trade settlement as real time gross settlement (RTGS) is in place in most Asian markets and cross-border real time linkage is taking shape (e.g., the Hong Kong/Mainland China link and the Hong Kong/Euroclear link). Efficient cross-border payment and settlement platforms are now available via the regional clearing house automatic transfer system (CHATS) managed by the HKMA.

## Conclusion

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Foreign exchange is a major component of a financial market and is expanding rapidly due to globalisation. According to the latest BIS survey, daily turnover in global currency markets increased from US\$1.87 trillion in 2004 to US\$3.2

trillion in 2007. Trading in financial derivatives linked to currencies soared to US\$2.1 trillion a day, a rise of more than 70% since 2004. Large companies are also taking a more active and sophisticated approach to managing currency exposure. Asia is still small in the world of currency trading on an individual market basis; however it (23.4% of daily turnover) ranks second globally after the UK (34.1%) if the top 13 markets in Asia are combined, followed by the US (16.6%). In 2008 and beyond, Asia will play an increasingly important role in the world's foreign exchange market due to its positive economic fundamentals. Asia's payment, clearing

and settlement platforms are of an international standard, thanks to the concerted efforts of Asian central banks.

However, investment in people, processes and systems among corporations and banks is an area where immense opportunities exist in the private sector. Obtaining the right risk management tools is required for both sound corporate governance practices as well as achieving sustainable growth as part of the social responsibility of the CEO/CFO to create jobs and avoid moral hazards that may cripple the proper functioning of the market economy.