INSEAD

Centres of Excellence
Asia Pacific Institute of Finance

November 2007

ACTS-NATIXIS-INSEAD FORUM
Global Investment Flows and the Impact on FX

by Jean Wee, Research Associate, APIF

It was another stimulating night of exchange with our industry partners, with presentations from both INSEAD faculty and industry practicioners, as well as active participation from the floor comprising of senior finance professionals. Held in conjunction with the Association of Corporate Treasurers (Singapore) (ACTS) and NATIXIS, one of Europe's largest listed banks, the networking event was part of APIF's regular link up with industry to maintain communication flow and information exchange between academia and market participants.

Financial market expansion possibly leading to volatility and financial shocks

Professor Hong Zhang, Professor of Finance, INSEAD, kicked off the first of the presentations with an insight into the causes of the recent financial turmoil brought about by the subprime crisis. As with most bubbles, the subprime bubble came about through too much money chasing too few assets, in this case mortgage-backed securities. The important question was: how did this state of things come about? Was it the result of short-term policies like the US' soft-dollar policy and the Greenspan Put (low interest rate policy), or was it a consequence of longer-term trends in motion?

Professor Zhang argued that this wall of liquidity came from the financial wealth created by financial market expansion, a trend that began as early as two decades ago. Financial market/real economy ratios (Market capitalisation/GDP; Debt/GDP) all point to an accelerated expansion of financial markets since the late 1980s. The development of financial markets allowed generation of a wealth effect from securities – unlike the labour market, the financial market enabled people to consume their future earnings in the present, e.g. by cashing out of their businesses through initial public offerings or borrowing on their future stream of income through mortgages.

With enough real investment opportunities, this liquidity can be channeled into new businesses, leading to more efficient allocation of resources and enhanced risk sharing. But when real opportunities are limited, the ensuing vast capital flows create financial imbalances/asset price bubbles, and result in market volatility and financial shocks.

Trend studies show that the increasing financial securities/GDP ratio (i.e. trend for securitizing, be it equities, debt or derivatives) appeared to have no relationship to short-term interest rate or exchange rate policy. Instead, the market-driven phenomenon appeared to be a long-run trend. Professor Zhang believed that the expansion of financial markets and its resultant wealth effect was likely to persist and become even more complex.

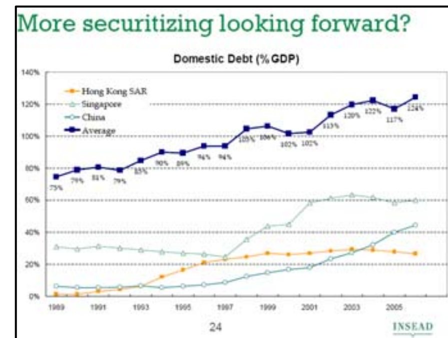
What the persistence of this trend meant for the markets was fourfold. Firstly, in terms of risk and asset classes, the correlation between asset classes would increase and make diversification, the cornerstone of portfolio management, more difficult. Liquidity risk would also rise in significance as a result of vast capital flows. Consequently, alternative assets and emerging markets, which tended to be less correlated to traditional asset classes, might become more important due to their diversification benefits.

Secondly, with respect to the financial service industry, professional management might become more essential due to the difficulty of diversification or hedging by ordinary investors. Even so, for non-professionals who wanted to invest, there might be greater demand for simple instruments like Exchange-Traded Funds (ETFs) rather than the complex and leveraged instruments currently available, given the backlash triggered by the subprime crisis. Also, there could be more regulations on the complexity and expansion of the financial markets as a result of these financial shocks.

Thirdly, the trend for securitizing would impact on evaluation methods, as traditional

methods appeared to be deficient in properly estimating risk and alphas. Investors would need to pay attention to liquidity, dynamic risk exposures, particularly due to capital flows, as well as the value of investments (alphas or net present value), which might be miscalculated due to poor estimations of the changing cost of capital.

Lastly, in terms of foreign exchange (FX) rates, carry trades and currency overlay management might become more vital due to the vast capital flows. Professor Zhang also suggested that securitization and the securitization process in developing countries might have an impact on determining FX trends, giving a "securitization equilibrium". He cited the example of China, where if the rights to use previously zero-value "state-owned" land were auctioned or securitized, particularly to foreigners, this would result in capital inflows, and impact on FX rates. Secondary positive effects on GDP as this land is subsequently developed into productive industry would also result in capital flowing into the country. It might thus be useful to have an index measuring the fraction of real economy that has been traded and securitized. The greater the scope for securitization, as in China and Asia Pacific region, the greater the potential for appreciation.



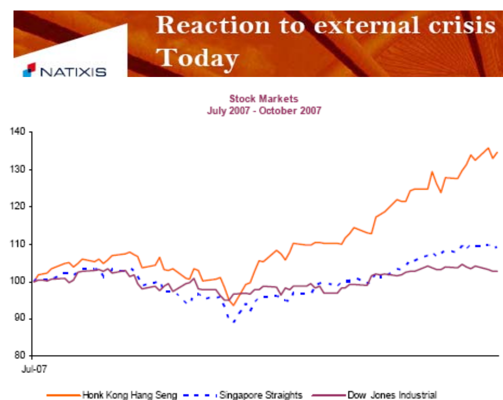
Asian market (FX, bonds, equity) resilience expected to continue despite US woes

Mr Philippe Gernez, Head of Capital Markets, Singapore at NATIXIS, gave the next presentation on his views regarding Asian FX direction. He believed that the consistent appreciation trend of regional Asian currencies, and the accompanying low volatility, would persist, despite continuing news of US subprime difficulties.

Unlike previous financial shocks, when US sneezed and Asia would get a violent cold, Mr Gernez felt that Asian markets, whether FX, credit, or equity, had decoupled from the US. Aside from the initial knee-jerk reaction, Asian exchange rates were back on their appreciating trend, credit spreads had returned back to normal from an initial widening, and equity markets were making new highs. This was in contrast to Europe, which had tracked the US in terms of the deterioration of its credit and equity markets.

This resilience could be explained by a stronger weight of Asian emerging countries in the global economy both in terms of GDP and GDP growth rates, making them more independent of the US; greater central bank ability and willingness to intervene backed by huge war chests of foreign reserves; and general US dollar weakness caused by an easing monetary policy cycle, the need for trade balance (deficit) adjustment, and the on-going credit crunch.

Mr Gernez believed that Asian currencies would continue their appreciation trend as there was a widening growth gap between emerging economies and the developed OECD economies. The construction and real estate weakness in the US, a faltering construction industry in Europe, and slower growth in Japan, all pointed to more attractive investment opportunities in Asia. The willingness by some Asian countries to allow (steady) appreciation to cool excessive growth was another pull factor.



Nonetheless, although strong fundamentals supported continuation of the appreciation trend in Asian currencies in general, he cautioned that there was still a need to discriminate amongst those with a clear trend for appreciation, and those more at risk for a reversal. Those countries with poor trade balances, greater dependence on short-term capital flows, or lower gross savings to support investment, could be at risk (India, the Philippines).

A stimulating Panel Discussion with active participation from the floor

The panel discussion attracted lively participation from the floor, as participants were keen to tap expert opinions on where things were heading, given the current state of uncertainty.

When asked why inflation was still not rearing its ugly head despite there being "too much money" in the system, Professor Zhang replied that it could simply be the way the consumer price index (CPI) was being calculated, as financial asset prices were not included in the basket of goods. He pointed out that, if the created wealth from financial market expansion had gone only to a small group of people, who could only slowly increase their spending on consumables in the

CPI basket, then inflation would not have been noticed immediately. Nonetheless, he believed that there should be some spillover in the long run.

One participant asked about the state of competitive advantage in Europe, given the record high in the EUR/USD. Mr Gernez felt that while EUR strength was negatively affecting export competitiveness in Europe, the stronger EUR was however, cushioning the impact of high oil prices, since oil was priced in USD. Although "old businesses" were beginning to complain about their affected exports, their main source of recourse was through the European Central Bank (ECB), whose mandate, unlike the Fed, did not include promoting growth/employment, but comprised only of protecting against inflation. It was thus unlikely that the ECB would champion any weakening of the EUR in support of European businesses. Futhermore, Mr Gernez pointed out that a stronger EUR was a catalyst for Europe to realign their businesses according to their competitive advantage. The long-term impact would be a re-shaping of the economy to a stronger base, like in Germany, which was already recording trade surpluses. There was therefore no reason to believe that the EUR would not keep on its strengtheing path.

A big concern amongst the participants was China – given its stratospheric rise, what would trigger a reversal? One participant felt that China's growth was built on a very weak insitutional framework, and any fallout from China would be speedily felt everywhere due to the inter-connectivity of the internet. He was concerned whether this would lead to another Asian crisis. Mr Gernez felt that, compared to pre-crisis 1997, Asia's financial sector was much stronger, with much less dependency on USD-denominated debt. Backed by huge FX reserves to defend their currencies, Asian economies would likely be much less affected by any fallout from a China reversal. Professor Zhang commented that given China's vast resources and the amount of securitization still to be done, the China growth story still had legs. But once this stage of growth was done, China might need to reshape its economy to a more standard development path and the inherent institutional changes, a process that would be very complex indeed.

Participants were also concerned that the US subprime problems would eventually pull down Asian economies. People were worried about the effects on the credit quality of Asian financial institutions and corporations, given that "dead bodies" kept floating to the surface. Professor Zhang believed that a lot of the money that invested in subprime papers came from Asia and the oil-producing countries. Compared to previous financial blow-ups, such as the US Savings and Loans crisis, or the October 87 stock market crash, the scale of the subprime problem was by far the largest in US history. Whether this would change investors' fundamental belief in US' growth opportunities remained to be seen. Professor Claudia Zeisberger commented, however, that this year, during the May auction of US Treasuries, China, for the first time, did not participate. It may be a case of the tail wagging the dog – perhaps there was no need to worry about Asia being affected by the US.

Professor Zeisberger also mentioned that there was talk of creating an Asian currency, but Professor Zhang felt that that could be walking on dangerous grounds, given the historical baggage between some of the Asian countries. Professor Zeisberger argued that France and Germany managed to iron out their differences to join the EU and have a common currency, but Mr Gernez pointed out that the unification was only in terms of currency, without a unified political body. That, he said, was the difference, but also a weakness in terms of policy making.

One participant asked, given the amount of available funds in the world, especially with all these sovereign investment funds being set up, what would happen to asset prices (i.e. would they fall?). Professor Zhang reminded everyone that equilibrium did not necessarily mean prices moving in smaller and smaller circles to reach a static point; it could also be destabilizing when prices moved in larger and larger circles to result in greater volatiltiy. It was hard to say which way it would go. Although new capital from countries like China could help stabilize prices for a few years, as the world became more integrated, there would be less of that kind of liquidity, and we could move into the destabilizing state of things.

Finally, there was a general consensus that interest rate tools appeared less effective in Asia compared to FX intervention, particularly in China. Both Professor Zhang and Mr Gernez felt that this was due to the regulated nature of the FX regime in Asia – in China, with a fixed exchange rate, it was not surprising that interest rate tools had little effect.

After such serious exchange, the forum broke up for a relaxing networking reception of wine and food to help digest all the ideas and opinions put forth.

© Copyright 2007 by INSEAD, Asia Pacific Institute of Finance. All Rights Reserved