

## Comments on Levich and Packer: “Development and functioning of FX markets in Asia and the Pacific”

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The Levich and Packer paper covers a wide range of issues surrounding the foreign exchange markets, with emphasis on the Asian countries. Section 2 outlines how Asian currencies have been transacted in financial markets, using the BIS Triennial Survey. Section 3 focuses on CLS Bank, which is based on a payment-versus-payment (PVP) model. However, the authors point out that, having eliminated Herstatt risk, CLS has itself become a too-big-to-fail institution. Section 4 describes foreign exchange market developments after the global financial crisis of 2008–09. Section 5 focuses on the carry trade strategy and asks whether it is a winning strategy. The paper will interest a wide range of readers, from academics to policymakers and market practitioners.

In Section 2, it is shown that major Asia-Pacific currencies, such as the Japanese yen, Australian dollar, and New Zealand dollar, have increased their shares in global turnovers of currencies according to the BIS Triennial Survey. One interesting fact, still under-appreciated, is that the renminbi is a fast-growing currency in terms of turnover statistics. Its share increased from 0.1% in 2004 to 2.2% in 2014. Although the volume is still low, the increase is very fast. The currency’s offshore turnover volume is, at USD 86.1 billion, the largest among Asian emerging market currencies. Looking forward, the renminbi will increase its share in turnover and other measures for international currencies.

Section 3 deals with risks in foreign exchange transactions. One of the best known is so-called Herstatt risk. For the settlement of any foreign exchange transaction, two banks have to send or receive two different currencies. As central banks are not open 24 hours a day, it is difficult, if not impossible, to make the two payments simultaneously. When Bank Herstatt failed in 1974, some of the transactions failed. In order to eliminate this risk, CLS Bank was established in 1997 and started operations in 2002. It is the sole global multicurrency settlement system and is based on a unique, continuously operating PVP system, with a guaranteed refund system (in the case of a failed transaction of the other leg).

Currently, there are 17 CLS-eligible currencies and some 90.46% of global FX turnover goes through CLS. However, settlement risk continues to obtain in some currency pairs involving emerging market currencies, such as the renminbi, Russian rouble, Thai baht, and Brazilian real. There is a plan to cover those currencies in the future. However, the huge success of CLS comes at a price. As CLS has lowered settlement risk significantly, CLS has itself become a source of systemic risk as a financial institution that is too big to fail. This development in settlement risk is not widely known among academics, even among financial experts. This chapter is a good summary of CLS’s institutional development.

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Section 4 shows the contrast in currency movements between the period after the global financial crisis and the period after the May 2013 “taper tantrum” following the hint that QE3 would end in the United States. In the wake of the global financial crisis, downward pressure was exerted on currencies associated with large current account deficits, smaller foreign exchange reserves, and with larger US investments prior to the crisis. Wide-spread violations of covered interest rate parity were observed. In the wake of the taper tantrum, by contrast, the downward pressure was felt by currencies associated with larger current account surpluses, high foreign exchange reserves and low debt. This was quite a turnabout.

According to the authors, many papers have interpreted this result as consistent with fragile economies having built up less exposure to financial flows, or “hot money” during earlier periods of relatively high rates in EMEs (and quantitative easing by the Federal Reserve). They also cite Eichengreen and Gupta (2003) to the effect that the currencies of countries with larger financial markets depreciated more between April and September 2013, which is indicative that “large markets are more prone to the effects of liquidity retrenchment”.

I am not convinced by this explanation. A more careful analysis of the difference between the two episodes is called for. The global financial crisis originated in the United States, and thus prompted panicky deleveraging by US and European financial institutions. It was interesting that the Japanese yen and the Swiss franc appreciated sharply in the wake of the crisis. Capital outflows from emerging markets were also based on the perceived risk of the emerging market economies – typical of a crisis contagion. By contrast, in 2013, capital outflows from emerging markets were based more on the interest rate differential. Even with their strong fundamentals, the low-interest countries – typically sound economies – were the ones that experienced capital outflows.

The investigation of carry trades in Section 5 is interesting. It is well known in the recent literature that investing in high-interest-rate currencies while borrowing in low-interest-rate currencies yields excess returns – violating the uncovered interest rate parity relationship. However, the result is sensitive to the sample period, and volatility may be high. Graphs 5.1 and 5.2 show the cumulative returns of the carry trade strategies in G10 and EM currencies, respectively. Although large excess returns were produced, these returns seem to be smaller (no increase in cumulative returns) after 2007. This may reflect the interest rate differential between the advanced countries and EM countries, which narrowed in the wake of the global financial crisis.

Table 5.2, summarising the profitability (excess returns) of four factors – carry, trend, value, and volatility – among individual managers shows an interesting result. Those who made losses and exited from the market had large negative excess returns in alpha and in the carry trade component. The difference between “live” fund managers and “dead” fund managers is striking. So it is not just the strategy but how well it is executed that is the key for success.

Japan is a home base for carry trades. Japan’s huge foreign reserves, amounting to USD 1.2 trillion, can be regarded as a form of carry trade. The Ministry of Finance issues short-term government securities (T-bills) in yen to obtain yen liquidity, and then intervenes in the market to obtain US dollars, when it wishes to slow down the yen’s appreciation. The foreign reserves, mostly in the form of US T-bills and T-bonds, have accumulated while Japanese T-bills are rolled over on the liability side.

Hence, this is essentially a carry trade and one that has produced profits, according to Ito (2003).

Many Japanese retail investors are also known to be carry traders. Those who invest in high-interest rate currencies, taking on exposure to the risk of the yen's appreciation, are nicknamed "Mrs Watanabe". Japanese securities firms market high-interest rate bonds denominated in foreign currencies, such as those of Australia and New Zealand, to such retail investors. Indeed, these "uridashi" bonds are so popular that demand for them has soared. As a result, the high-interest rate currencies have appreciated. In December 2005, the RBNZ and Treasury of NZ visited Japan to discourage the marketing of "uridashi" bonds. In January, there was a debate between Finance Minister Michael Cullen, defending the mission to Japan, and Mr John Key, who was critical that pressure was being put on Japan.

Is Mrs Watanabe a naïve investor, ignorant of currency risks? Not necessarily so. First, for carry trades to produce excess returns, uncovered interest rate parity has to be violated, and many papers have now demonstrated that this violation occurs. Second, many Mrs Watanabes are retired workers or their widow(er)s. Their time preference is very high. Large interest payments in the next 10 years, even with a risk of losing principal value, are likely to be more highly valued by 75 year-old investors. For them, carry trades are akin to a reverse mortgage.

The authors argue that returns on carry trades have declined, and they attribute this to market overcrowding. When more traders, lured by success of other traders, adopt the same strategy, or carry trade, then returns will inevitably decline. The first movers, or the innovators, reap the profits, but the followers do not. This is interesting in principle, but the claim seems difficult to actually substantiate.

Markets are evolving all the time, and trading strategies are also advancing. Increasingly, market transactions are driven by algorithmic trading. It's possible that, rather than the humans crowding each other out, it is the rise of the machines that is crowding out the humans.

## References

Ito, T (2003): "Nihon no kawase kainyū no bunseki" (in Japanese: title translates as "An analysis of Japanese foreign interventions"), *Keizai Kenkyū*, vol 54, no 2, pp 97–113.