# Comments on Martin Hohensee and Kyungjik Lee's paper "Survey of hedging markets in Asia"

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Current growth in global derivatives markets makes this a timely and important topic. The authors have chosen well. With a diverse region and an increasing variety of instruments, such a study is not easily undertaken. The paper is structured along different instruments and makes specific assessments which render it easy to read like a good textbook. Rather than addressing the specifics, which were amply discussed, I would like to concentrate more on general market and development issues in the following sections. In particular, the first section concerns market factors while the second section is focused on the regulatory impact and implications. I conclude with a wish list of questions that may allow us to understand the future direction of derivatives in Asia.

## 1. Hedging volumes and market factors

The growth in global derivatives has surpassed that in most other instruments in interest rate space and has increased "spanning" in the global fixed income world. Given the fledgling nature of Asian bond markets and the plain vanilla nature of Asian foreign exchange instruments, it is not surprising that the authors find a great disparity in regional derivatives market development and a general lack of open interest in futures contracts. It was also emphasised that regulatory restrictions, a lack of market sophistication and low turnover in the underlying instruments contributed to the slow pickup in derivatives activity. While these are important factors, I would like to point out two more structural market drivers - correlation and volatility.

Asian interest rates are highly correlated with US Treasuries, which is natural since monetary policy has generally targeted currency levels. Foreign exchange trading volumes have recovered slowly but are still driven by large regional currencies like the yen and the renminbi. Not surprisingly, it is more efficient for large corporations to hedge these major currency drivers (the high correlation across regional currencies makes it cheaper to hedge exposures on a net basis and through the most liquid instrument) rather than independently on a gross basis using less liquid Asian bilateral indirect cross rates. With increasing convergence of monetary and fiscal policies, this trend in correlation looks likely to remain intact.

The second factor, market volatility of both interest rates and currencies, has also diminished since the crisis. A good recent example would be the Chinese renminbi. Before the G7 Dubai meetings, we found that deal flows in the renminbi NDFs and Hong Kong dollar forwards were relatively thin. This changed immediately after the Dubai meetings with a significant pickup in activity with strong flows from both hedgers and speculators. Since then, flows and positions have generally kept pace with volatility.

Also observed, as noted in the paper, is the important role played by the underlying instruments. The recent success of the Korean swap markets arose from an increase in corporate dollar issuance and the subsequent swapbacks into local currencies, which led to further swap trading when cross-currency swap curve spreads widened. But I would disagree with the authors that the potential for derivatives depends primarily on the liquidity of the "underlying". This is evidenced by the success of "non-underlying"-based instruments like

weather derivatives and the recently introduced economic derivatives. What is more important in our view is the acceptance of the underlying reference rate or instrument.

## 2. Regulatory controls and restrictions

Differences in regulatory restrictions also affect the attractiveness of markets. The authors make some comments on the differences in regulatory restrictions but could have gone further in providing some assessment of costs and benefits, not necessarily quantitative, of those regulations. Derivatives markets are generally supported by (but not restricted to) several legs - hedging, speculative flows and arbitrage. Asian capital controls, some of which were put in place to stem speculative flows, also serve to limit arbitrage possibilities and leave hedgers as the main generators of flows. Understandably this makes liquidity difficult to sustain, especially when hedgers tend to be on the same side of the trade (as in the case of Korean corporations issuing dollar bonds and swapping back into won), creating price distortions and reducing hedging efficiency.

Capital account closure is arguably beneficial in times of market stress, but it would be difficult to argue that such closure would be beneficial if extended indefinitely. Rules and regulations serve some market conditions well but do not provide first-best solutions all the time.

Regulatory restrictions give rise to offshore instruments, which tend to circumvent some regimes and thereby to extend market participation. In many cases, the offshore-onshore spreads are indicative of market frictions with asymmetric volumes. This split in liquidity pools certainly does not help in overall trading efficiency and price discovery, creating entrenched clientele segments in the process. With further capital market development, such segmentation will probably be reduced, as witnessed by the elimination of many of the Asian A and B class equity share structures. It would certainly be interesting if the authors could document examples of trade volumes before and after imposition and removal of restrictions. Such an extension would provide an interesting assessment of the impact of specific market rules and regulations.

## 3. Conclusions

The paper is an excellent survey of regional market structures for futures, swaps and credit default swaps. There are good examples, highlighting the areas of success as well as the instruments or countries that have lagged in performance or activity. However, the arguments are rather dispersed, and the paper lacks a cohesive proposal on how we can improve liquidity and participation for derivatives trading in the region. Should we concentrate on a smaller but more focused subset of instruments to pool liquidity? Are markets too fragmented to benefit from any returns to scale? Should more players be involved and who should be targeted? Is there sufficient awareness or should there be more education in the marketplace on the availability and suitability of such instruments for various types of investors and traders? These are questions the answers to which may point to avenues for growth. Ultimately, such growth may fortify the entire asset class.