Preface to the Second Edition

Some two years have passed since the first edition of *Currency Strategy* was published. In that time, the global currency or “FX” market – already the biggest and most important financial market in the world – has grown substantially, both in terms of breadth and depth. Forecasts who had anticipated the demise or at least the decline of the FX market due to challenges such as the Euro and technological innovation have been proved utterly wrong. The FX market has adapted more than successfully to these new challenges and in so doing new investor classes have been created, which seek to harness its power. Currency overlay investors, who have currency hedging benchmarks and seek to manage currency returns separate from the underlying, were certainly around well before 2002. However, the currency overlay industry has to a significant extent come into its own these last few years and is now confirmed as a separate and specific investor base. Similarly, central banks are now seen as an investor base in their own right. This is a significant change from previous times when they managed their own portfolios purely or largely for liquidity purposes and were rarely seen in the market, and in those few cases for the purpose of intervening against the market. Now, they have become part of the market itself. The FX market has finally been recognized for what it is, a separate asset class to fixed income and equity, whose risks have accordingly to be managed separately.

How easy it is to forget now the predictions of earlier years and moreover the attempts by governments and central banks to control or even eliminate the FX market. For a time, it did indeed appear as if the FX market was declining, both in size and use. The Bank of International Settlements’ (BIS) tri-annual survey of 2001 showed a 20% fall in global daily FX turnover to around USD1.2 trillion from USD1.5 trillion in 1998. The advent of the Euro had eliminated 11 currencies and with it the need to manage currency risk *within* an economic trade zone roughly the size of the US economy. The prospect of 10 more countries joining the European Union in 2004 and thereafter into the Euro itself would surely further reduce the need for managing currency risk. Japan had called for an Asian version of the International Monetary Fund to be created and public suggestions were made about a possible Asian trade union to be created at some point, followed by a possible currency union. Some Latin American nations adopted the US dollar and there was even a suggestion that Canada should *de facto* become the 51st state by itself adopting the US dollar. The UK was under increasing pressure to bow to Euro-zone demands to set a timetable for adoption of the Euro, which if implemented would needless to say put such countries as Sweden, Denmark, Norway and Switzerland under pressure to do likewise. The process of currency elimination, and therefore of the need to manage currency risk, seemed at one stage to be almost irreversible.
That is now hard to believe indeed. As the 2004 BIS survey confirmed, the global FX market has bounced back with a vengeance, proof not that it is necessarily the best system but that, like democracy, it is better than most of the rest. Global FX daily turnover as of the 2004 survey was a record high of USD1.9 trillion, a near 60% increase on 2001. It has become the conventional wisdom that currency is a separate asset class that has to be managed separately from “underlying” equity or fixed income. Moreover, currency managers are no longer regarded as “speculators” but as investment managers in their own right. Simply put, currency is a risk and it has to be managed. However, if it is a separate risk to be managed, then one needs a separate and distinct analytical framework with which to analyse and manage this risk.

This is one of the three main themes of Currency Strategy. As readers may no doubt be aware, there is a rich literature on the subject of “FX” or exchange rates. However, much of this is academic, with little apparent practical application. Moreover, there were – and remain – few books aimed at currency market practitioners themselves. Currency Strategy sought to fill that gap, firstly by looking at the traditional exchange rate models – much-loved by academia but seen as practically irrelevant by traders – examining their shortcomings, and trying to suggest modest, but important improvements, that might make them more practical to the end user. As currency is a separate asset class, it needs a separate analytical framework. This I termed “currency economics”, which seeks not only to focus on the currency-related aspects of classical economic theory, but also to marry these with recent innovations in flow, technical and behavioural finance analysis.

Developing a separate analytical framework to manage currency risk is a good starting point, but left there this is clearly not enough. The second theme therefore is that currency market practitioners need to adopt a rigorous and disciplined approach to managing currency risk or currency strategy. This represents their overall framework for managing currency risk. Within this, they should decide not only their analytical parameters for managing currency risk, but also their practical parameters. Within this second theme, currency analysis goes from being theoretical to practical – from “it’s going up” to “buy now!”.

A third theme, however, is that currency market practitioners need to be broken down into specific types. Having an overall strategy for managing currency risk is excellent, but this may not necessarily reflect the specific nature of the risk you are managing. The approach that hedge funds have to managing currency risk is – or at least should be! – completely different from that of, say, a corporate treasury. Here too, currency strategy is the starting point. From there, we need to drill down to the specific type of currency market practitioners in order to manage their specific risks appropriately.

As such, Currency Strategy is all about theory, strategy and execution. Ultimately, my aim in writing the book was to fill what I perceived to be a gap in the available literature on the global FX market, preferably in a user-friendly manner for currency market practitioners, and ultimately to provide a more appropriate framework for analysing and managing their specific currency risks. Writing on any subject is, as ever, somewhat of a trial balloon; you hope what you have to say is interesting and worth reading, but you never know for sure until the book leaves the shelves.

It is very gratifying to me therefore that, although the original may have contained many flaws and omissions, the very fact that I am writing this Preface to the Second Edition confirms that the book struck a chord with its intended audience. As ever, I am most grateful to you, the reader, for taking your time – and spending your hard-earned money – to read this work. Like the economic law of demand and supply, without you, this would have never been written.
Preface to the Second Edition

In this second edition I have included several additional sections, including the following:

- Important additions to Chapters 7, 8 and 9, which form the backbone of Part Three: The Real World of the Currency Market Practitioner, and deal respectively with corporations, “real money” and speculators.
- A new chapter – Chapter 11 – which focuses on the latest developments in the emerging markets, particularly in Asia, and how these new markets may impact the global FX market.

The purpose of this Preface is to put the book within the context of global FX market developments since the book was first published. As noted above, the book sought to fill a gap – and for the most part succeeded, given the response. That need remains – hence the reason for this second edition. In Part Three of the first edition I sought to examine in detail what I call the Real World of the Currency Market Practitioner. Theory is fine, but it is practice and execution that differentiates one from another. Part Three is the backbone of the book – what makes it succeed or fail. Here, in this second edition, I have made important new additions to Chapter 7, 8 and 9, dealing respectively with the worlds of corporations, real money and speculators. For the sake of clarity, these are in the form of Additional Sections at the end of each chapter after the Summary, examining the latest developments and techniques in the managing of currency risk for corporate treasury, portfolio managers, traders and hedge funds.

Chapter 7 is the first of three chapters on Managing Currency Risk, focusing on how corporate treasury manages currency risk. The basic building blocks for a corporation to manage currency risk are to identify transaction risk, translation risk and economic risk. From this, and using a “budget” exchange rate, the corporation can devise an overall hedging policy for managing all its main currency risks. However, how a corporation manages these risks is left open to the corporation, depending on their overall hedging policy. It was a key conclusion of the first edition that corporations should base their transaction hedges on their fundamental exchange rate forecasts. They take a view and then they hedge – or not – accordingly. This is very much a linear approach to managing risk. However, there have been important developments in the managing of currency risk by investors, notably regarding the concept of risk appetite, which could undoubtedly help corporations to manage their own risk. Indeed, such an approach may help both with regard to timing and direction. In addition, corporations also deal with one-off event risks such as what has been called “bid-to-award” risk, which involves the question of how to hedge a bid for a specific project. We also look at this concept in the revised Chapter 7.

Chapter 8 is the second of the three chapters on Managing Currency Risk, focusing on how asset managers and currency overlay managers manage currency risk. In it, we looked at the reasons for managing currency risk on either an active or passive basis, the use of currency hedging benchmarks and various examples of active currency management strategies. In this edition we take a look at the recent advances made by the Currency Overlay investor class and the very latest strategies that are being adopted. In particular, there has been a marked increase in quantitative strategies to accompany if not quite replace macro discretionary strategies. These have mirrored to some extent the rise of the systematic trading model community, which we will look at in more detail in Chapter 9.

Chapter 9 is the third and final chapter on Managing Currency Risk, focusing on so-called currency “speculators”. There are many ways to define a “speculator”. For this purpose, we do so purely on an amoral base, focusing on active currency management in the complete absence of any other underlying or attached asset market. In this chapter, we sought to take a detailed look at the world of currency speculators, including interbank dealers, proprietary dealers,
hedge funds, corporate treasury – yes, them too – and currency overlay. There are however other types of currency speculators. We took an initial look at the world of momentum traders. Here, in the second edition, we do so in more detail, examining the rise of the systematic trading model community, which, to be sure, did not just focus on currencies, but has certainly become an increasingly important factor in determining price action within the global FX market as a whole. Because many trading models tend to use similar systems, they tend to turn or “flip” at the same time. Thus, they exacerbate both trend breaks and trend extensions. Either way, they have added to market volatility – something that other market participants in the global FX market ignore at their cost.

Finally, I have added a Chapter 11, entitled Emerging World: New Growth Markets for Global FX, looking at the increasing importance of emerging markets to the global FX markets, particularly those of Asia. The global economy has undergone profound change since the collapse of the Soviet Union and the removal of the Berlin Wall. The markets of what used to be called Eastern Europe have been opened up. Asia has undergone a profound experiment in market liberalization, albeit one that received a temporary if violent setback in 1997 – 1998. Brazil, previously seen as “the country of the future – and it always will be” has benefited dramatically since 2002 from a new administration that has been favourably disposed towards real and significant economic reforms. The thought that Brazil might at some stage become investment grade, previously seen as unthinkable or even laughable, is now widely shared within the emerging market investor community. So-called Emerging Market economies have grown significantly in terms of their global importance. This is particularly true in the case of Asia. Japan has for long been the second largest and most important economy after the United States. To this has now been added China. For now, it is clearly the third largest economy in the world, but at current growth rates it will soon displace Japan in second place and if it keeps growing at its current pace, may even, at some time over the next 20 years, displace the United States itself. India has started to open up in a meaningful way. As a result, both fund managers and corporate investors have taken notice and appear to be undergoing a secular change in the way they look at Indian economic prospects. If the current economic liberalization programme remains on track, and if politics is not allowed to interfere, India may well become one of the largest economies in Asia. South Korea, for its part, is not standing still. It too is responding to the regional change that is being seen across Asia.

The importance of Emerging Markets, and particularly of Asia, is increasingly evident. Asian economies have grown rapidly in recent years. Their balance of payments has improved dramatically and with it FX reserves have exploded. Asian central banks now control over 75% of global reserves, making them potentially the world’s largest currency managers. The concept of “Bretton Woods II” was not around when the first edition of this book was published, but for now has become the conventional wisdom that Asian central banks can and will indefinitely recycle trade and current account surpluses back to the US, thus effectively keeping their currencies pegged to the US dollar. We take a detailed look at the increasing importance of “emerging Asia” within both the global economy and the global FX market and examine whether or not this Bretton Woods II mechanism as it has been described is sustainable. Whether or not that is the case, the emphasis within the global FX market is clearly shifting towards the emerging markets and in particular to Asia, given its increasing importance to the global economy. This appears to be a trend that may last for decades rather than just years.

Africa is also showing potential. Once thought of as a “basket case”, it remains the one last untapped continent. There is much to be optimistic about. The number of wars fought on the African continent has fallen sharply and governments are focused on economic revitalization
programmes. In addition, the HIPC programme of debt relief will for many give the opportunity of a fresh start. The scourge of AIDS, persistent conflicts in specific cases and finally dire poverty remain significant challenges. Nevertheless, the opportunity is enormous. South Africa is an excellent example of what can be achieved as a result of prudent economic management. Growth is consistently strong. Inflation-fighting credibility has resulted in the lowest inflation rate in decades. It will take years for African economies and markets to open up fully, but the potential for active FX markets across the continent is significant.

Just as active and passive currency management, both from a corporate and an investor perspective, has become a dominating focus across the developed markets, so it will spread across the Emerging Markets as domestic markets open up. The global FX market will continue to grow and with it the need to manage currency risk across these markets as a separate and distinct asset class.