

Contents

Preface to the Second Edition	xi
Acknowledgements	xvii
About the Author	xix
Introduction	1
PART ONE THEORY AND PRACTICE	15
1 Fundamental Analysis: The Strengths and Weaknesses of Traditional Exchange Rate Models	17
1.1 Purchasing Power Parity	17
1.1.1 Reasons for “Misalignments”	19
1.1.2 Tradable and Non-Tradable Goods	20
1.1.3 PPP and Corporate Pricing Strategy	20
Example 1	20
Example 2	22
1.1.4 PPP and the Real Exchange Rate	24
1.2 The Monetary Approach	25
1.2.1 Mundell–Fleming	27
1.2.2 Theory vs. Practice	29
1.2.3 A Multi-Polar rather than a Bi-Polar Investment World	30
1.2.4 Two Legs but not Three	30
1.2.5 Implications for New EU Member States	31
1.3 The Interest Rate Approach	32
1.3.1 Real Interest Rate Differentials and Exchange Rates	34
1.4 The Balance of Payments Approach	34
1.4.1 A Fixed Exchange Rate Regime	35
1.4.2 A Floating Exchange Rate Regime	36
1.4.3 The External Balance and the Real Exchange Rate	37
1.4.4 REER and FEER	38
1.4.5 Terms of Trade	39
1.4.6 Productivity	40

1.5	The Portfolio Balance Approach	42
	Example	42
1.6	Summary	44
2	Currency Economics: A More Focused Framework	47
2.1	Currencies are Different	48
	2.1.1 (In)Efficient Markets	48
	2.1.2 Speculation and Exchange Rates: Cause, Effect and the Cycle	49
	Example	50
	2.1.3 Risk Appetite Indicators and Exchange Rates	53
2.2	Currency Economics	58
	2.2.1 The Standard Accounting Identity for Economic Adjustment	58
	Example 1	59
	Example 2	60
	2.2.2 The J-Curve	62
	Example	63
	2.2.3 The Real Effective Exchange Rate	63
2.3	Summary	64
3	Flow: Tracking the Animal Spirits	65
3.1	Some Examples of Flow Models	69
	3.1.1 Short-Term Flow Models	70
	3.1.2 Medium-Term Flow Models	77
	3.1.3 Option Flow/Sentiment Models	81
3.2	Speculative and Non-Speculative Flows	82
3.3	Summary	84
4	Technical Analysis: The Art of Charting	85
4.1	Origins and Basic Concepts	85
4.2	The Challenge of Technical Analysis	86
4.3	The Art of Charting	87
	4.3.1 Currency Order Dynamics and Technical Levels	87
	4.3.2 The Study of Trends	90
	4.3.3 Psychological Levels	90
4.4	Schools of (Technical) Thought	100
4.5	Technical Analysis and Currency Market Practitioners	102
	PART TWO REGIMES AND CRISES	105
5	Exchange Rate Regimes: Fixed or Floating?	107
5.1	An Emerging World	108
5.2	A Brief History of Emerging Market Exchange Rates	109
	5.2.1 The Rise of Capital Flows	110
	5.2.2 Openness to Trade	111
5.3	Fixed and Pegged Exchange Rate Regimes	111
	5.3.1 The Currency Board	112
	5.3.2 Fear and Floating	112
	5.3.3 The Monetary Anchor of Credibility	113

	Contents	vii
5.4	Exchange Rate Regime Sustainability – A Bi-Polar World?	114
5.5	The Realworld Relevance of the Exchange Rate Regime	116
5.6	Summary	118
6	Model Analysis: Can Currency Crises be Predicted?	119
6.1	A Model for Pegged Exchange Rates	120
6.1.1	Phase I: Capital Inflows and Real Exchange Rate Appreciation	120
6.1.2	Phase II: The Irresistible Force and the Moveable Object	121
6.1.3	Phase III: The Liquidity Rally	123
6.1.4	Phase IV: The Economy Hits Bottom	124
6.1.5	Phase V: The Fundamental Rally	125
6.2	A Model for Freely Floating Exchange Rates	128
6.2.1	Phase I: Capital Inflows and Real Exchange Rate Appreciation	128
6.2.2	Phase II: Speculators Join the Crowd – The Local Currency Continues to Rally	128
6.2.3	Phase III: Fundamental Deterioration – The Local Currency Becomes Volatile	129
6.2.4	Phase IV: Speculative Flow Reverses – The Local Currency Collapses	130
6.3	Summary	133
PART THREE THE REAL WORLD OF THE CURRENCY MARKET PRACTITIONER		135
7	Managing Currency Risk I – The Corporation: Advanced Approaches to Corporate Treasury FX Strategy	137
7.1	Currency Risk	138
7.2	Types of Currency Risk	140
7.2.1	Transaction Risk	140
7.2.2	Translation Risk Example	141
7.2.3	Economic Risk	142
7.3	Managing Currency Risk	143
7.4	Measuring Currency Risk – VaR and Beyond	143
7.5	Core Principles for Managing Currency Risk	144
7.6	Hedging – Management Reluctance and Internal Methods	145
7.7	Key Operational Controls for Treasury	147
7.8	Tools for Managing Currency Risk	147
7.9	Hedging Strategies	148
7.9.1	Hedging Transaction Risk	148
7.9.2	Hedging the Balance Sheet Example	150
7.9.3	Hedging Economic Exposure	151
7.10	Optimization	152
7.11	Hedging Emerging Market Currency Risk	153
7.12	Benchmarks for Currency Risk Management	153
7.13	Budget Rates	154

7.14	The Corporation and Predicting Exchange Rates	155
7.15	Summary	155
	Additional Section for the Second Edition	156
8	Managing Currency Risk II – The Investor: Currency Exposure within the Investment Decision	163
8.1	Investors and Currency Risk	163
8.2	Currency Markets are Different	164
8.3	To Hedge or not to Hedge – That is the Question!	165
8.4	Absolute Returns – Risk Reduction	165
	8.4.1 Passive Currency Management	166
	8.4.2 Risk Reduction	166
	Example	167
8.5	Selecting the Currency Hedging Benchmark	167
	Example	168
8.6	Relative Returns – Adding Alpha	169
	8.6.1 Active Currency Management	169
	8.6.2 Adding “Alpha”	169
	8.6.3 Tracking Error	171
8.7	Examples of Active Currency Management Strategies	172
	8.7.1 Differential Forward Strategy	172
	8.7.2 Trend-Following Strategy	173
	Example	173
	8.7.3 Optimization of the Carry Trade	175
8.8	Emerging Markets and Currency Hedging	176
8.9	Summary	178
	References	178
	Additional Section for the Second Edition	179
9	Managing Currency Risk III – The Speculator: Myths, Realities and How to be a Better Currency Speculator	187
9.1	The Speculator – From Benign to Malign	187
9.2	Size Matters	191
9.3	Myths and Realities	191
9.4	The Speculators – Who they are	192
	9.4.1 Interbank Dealers	192
	9.4.2 Proprietary Dealers	193
	9.4.3 “Hedge” Funds	194
	9.4.4 Corporate Treasurers	195
	9.4.5 Currency Overlay	196
9.5	The Speculators – Why They Do It	197
9.6	The Speculators – What They Do	197
	9.6.1 Macro	198
	9.6.2 Momentum (and Fellow Travellers)	198
	9.6.3 Flow	199
	9.6.4 Technical	199
9.7	Currency Speculation – A Guide	199

	Contents	ix
9.8 Summary		202
Additional Section for the Second Edition		203
10 Applying the Framework		209
10.1 Currency Economics		209
10.2 Flow Analysis		209
10.3 Technical Analysis		210
10.4 Long-Term Valuation		211
10.5 The Signal Grid		211
10.6 Risk Appetite Indicators		211
10.7 Exchange Rate Regimes		212
10.8 Currency Crises and Models		212
10.8.1 CEMC		212
10.8.2 The Speculative Cycle		213
10.9 Managing Currency Risk I – The Corporation		213
10.9.1 Types of Currency Risk		213
10.9.2 Internal Hedging		214
10.9.3 Key Operational Controls for Treasury		214
10.9.4 Optimization		214
10.9.5 Budget Rates		214
10.10 Managing Currency Risk II – The Investor		215
10.10.1 Absolute Returns: Risk Reduction		215
10.10.2 Selecting the Currency Hedging Benchmark		216
10.10.3 Relative Returns: Adding Alpha		216
10.10.4 Tracking Error		217
10.10.5 Differential Forward Strategy		217
10.10.6 Trend-Following Strategy		217
10.10.7 Optimization of the Carry Trade		217
10.11 Managing Currency Risk III – The Speculator		218
10.12 Currency Strategy for Currency Market Practitioners		218
10.12.1 Currency Trading		218
Example		219
10.12.2 Currency Hedging		220
Example		222
10.13 Summary		224
11 Emerging World: New Growth Markets for Global FX		225
11.1 The Growth of Emerging Markets as an Asset Class		225
11.2 Increasing Importance of EM Currencies		227
11.3 Explosive Growth in Asian Currencies		228
11.4 Asian NDF Markets: Growth and Liberalization		230
11.5 Emerging European Currencies		231
11.6 Latin American Currencies		232
11.7 Summary		232
Conclusion		235
Index		239

<http://www.pbookshop.com>