



Managing Payments in Volatile Markets

For Corporate Clients

INDUSTRY INSIGHT



The political unrest and economic instability rumbling across pockets of Northern Africa and the Middle East symbolize the challenges that are simultaneously new and yet strikingly familiar to multinational businesses with long-standing interests in dynamic markets around the world. For cash managers, such events highlight the importance of both vigilantly monitoring political, social and economic trends that can trigger payment and exchange rate risks and establishing a solid strategy for mitigating those risks.

History is dotted with examples of financial upheavals within autocracies, emerging democracies and established democracies alike. This article examines past events and lessons learned that can minimize the potential risks linked to making payments in volatile markets.

Reflecting on Historic Events

A look at past political and economic disruptions provides valuable insights into the potential impact of geopolitical events on payment flows and risks.

UK Withdrawal from the European Rate Mechanism

In the early nineties, the United Kingdom withdrew from the European Rate Mechanism (ERM) because of diametrically opposed economic conditions in the UK and Germany. The UK, like all countries in the ERM, had pegged its currency to the Deutsche mark (DM) and, by extension, its monetary policies to Germany's. When Germany raised its interest rates to attract foreign capital after the reunification of East and West Germany, the UK, which was battling a recession, was caught between a rock and a hard place.

Market speculators realized the UK's dilemma and began selling the pound (GBP) short. When the pound began to slide, the Bank of England intervened by raising interest rates from 10% to 15% on "Black Wednesday", and buying GBP in the market, thus shrinking foreign currency reserves. The maneuvers were unsuccessful and the UK abandoned the ERM. Within weeks, the pound fell 15% against the mark and 25% against the dollar.

Throughout the crisis, the UK government had to weigh liquidity risks related to depleting its foreign currency reserves and companies managing cross-border payments and cash flows had to juggle market risks tied to geopolitical events.

East Asian Currency Crisis

Also, during the nineties a series of events unfolded in Asia as economic downturns and financial policy shifts in the West challenged Asia's fast-growing economies.

Many developing markets in Asia attracted foreign investment with high interest rates leading to an inflow of cash and also driving up the cost of assets and speculative borrowing. To buffer their currencies from exchange rate volatilities, countries such as Korea, Thailand and Indonesia pegged their currencies to the US dollar.

At the same time and in an effort to preserve capital at home, the US and other Western countries raised their interest rates, effectively stemming the flow of investments to Asia.

Korea, Thailand and Indonesia all increased their interest rates and intervened in the markets to support their pegs. Eventually, however, they were forced to abandon their pegs and allow their currencies to float. Subsequently, in the year that followed, the Thai baht depreciated 36%, the Korean won was devalued over 30% and the Indonesian rupee plummeted 80%. Once the panic subsided, however, asset prices and foreign exchange rates found their natural market-driven levels and all three countries resumed impressive growth trends.

Malaysia, whose currency was only partially pegged to the dollar, responded differently. When the Malaysian government perceived speculative trading on the ringgit, it set up currency controls that included resetting the currency's peg and prohibiting offshore trading in it. With trading limited to licensed onshore banks, most global foreign exchange banks suspended trading, complicating cash and payment activities for their corporate clients since payments in the country could only be made through an onshore bank. Only recently have these restrictions been relaxed.

A Comparison with Recent Trends

Earlier this year, a different set of drivers created payment risks in parts of northern Africa and the Middle East. Social and political forces, rather than weaknesses in the financial sector, rocked financial markets in Tunisia, Egypt, the Ivory Coast, Libya and a number of other nations where civil unrest has accompanied calls for regime changes.

In Tunisia and Egypt, protestors fed up with government corruption and high unemployment quickly ousted leaders who had been in place for decades. Unlike Malaysia, the governments did not intervene in financial markets except to close them temporarily because of demonstrations in the streets. As events unfolded there was a sense that the financial markets would eventually return to normal.

In the Ivory Coast, events took a different turn. Incumbent President Gbagbo refused to step down after being defeated in an election last November, opening up a new chapter in regional instability.

In an attempt to eject the unlawful regime, the Central Bank of the West African States, which services the Ivory Coast and seven other countries that share a common currency (XOF), suspended all transactions with the Ivory Coast. The action essentially prohibited the Ivory Coast from participating in the XOF and precluded payments being made into the country. In response, the Gbagbo administration ordered all banks to revert to manual clearing. Rather than submit, foreign banks closed down and the government nationalized all banks. As a result, force majeure was declared and financial assets were frozen.

Risks Associated with Dynamic Markets

Geopolitical risk	Risks related to political change or instability
Market risk	Risks associated with foreign exchange rate movement
Credit risk	Risk that a counterparty will not remit after payment has been made
Systemic risk	Risk of collapse of an entire financial system or market
Liquidity risk	Risk of funds getting trapped in a country
Operational risk	Risk of operational or procedural failures
Settlement risk	The possibility that a counterparty will not pay or that transaction settlement in a transfer system does not take place as expected

Lessons Learned

Across emerging and developed markets alike, political and economic tremors are extremely significant from a payment flow perspective. What's more, as history demonstrates, situations can deteriorate rapidly and payments systems can be impacted materially.

When it comes to making payments in volatile markets, the best defense is a good offense. This includes a three-pronged attack that covers situational, legal and processing-related factors:

- 1 Monitor the Situation:** Situation awareness is the first step towards minimizing payment and foreign exchange risks. Stay abreast of evolving news events and review banking industry and country risk reports and updates. The best and most up-to-date information should come from discussions with your payments and currency trading partners. Global providers such as Citi can provide a distinct advantage because of presence in local markets and day-to-day interactions with settlement systems, central banks and the broad range of public and private sector institutions.
- 2 Review Legal Implications:** Review your provider's contract to clarify its liabilities and responsibilities and yours. Also understand the ramifications of force majeure.
- 3 Pursue Processing-Related Strategies:** While each situation is different, steps can be taken from a processing perspective to mitigate risks. Consult with your FX and payments provider about processing windows and exception arrangements. Make payments early in the week and avoid situations where settlements straddle holidays or weekends. Also discuss with your vendors and other beneficiaries what is happening, the various risks that could impact payment delivery, and potential payment alternatives, such as settling in a different country or currency, for example.

Bottom line, the best strategy for making payments in dynamic and stable markets alike is to align your payments activities with an experienced cross-border provider. That provider should have on-the-ground experts who are attuned to what is happening locally, have the breadth and depth of experience to stay one step ahead of you and can provide the solid insights you need to manage cash flows most effectively during extraordinary situations.

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