The Baht And I: Time To Thai One On

The fourteenth anniversary of the devaluation of the Thai baht and the onset of what would become known as the Asian crisis is coming upon us in July. By the time the contagion of hot money fleeing Indonesia, the Philippines, (see "Indonesian Rupiah: River Deep, Bali High," and "No Whacks At The Philippines," March and April, 2011, respectively) Malaysia and others then known as the Asian Tigers worked its way through the system, the world was teed up for the Russian default in August 1998, the Long Term Capital Management debacle culminating in what then seemed to be a major bailout in October 1998, and eventually the savaging of the Brazilian real in January 1999.

Ah, those were the days. Men were men, bailouts were bailouts, stock markets surged through the whole thing as the liquidity flooding the system pushed equities higher and *Time* put the trio of Alan Greenspan, Robert Rubin and Larry Summers on its cover as, "The Committee to Save the World." Is it any wonder we had two more bubble-and-bust cycles within the next decade and began working on a third?

The Asian crisis alerted its victims to the dangers of large-scale debt denominated in another currency and to the need to maintain sufficient reserves of foreign exchange to protect against the occasional speculative charge against their currency. Thailand has been able to build its reserves of foreign exchange up to and beyond a safety level; at $167.72 billion at the end of January 2011, it almost 87% greater than the country's September 2010 external debt of $89.94 billion. The country for years has been the world's largest exporter of rice and in a fun factoid; it is the second largest exporter of gypsum, the calcium sulfate rock used in wallboard.

.

A Long-Term Uptrend

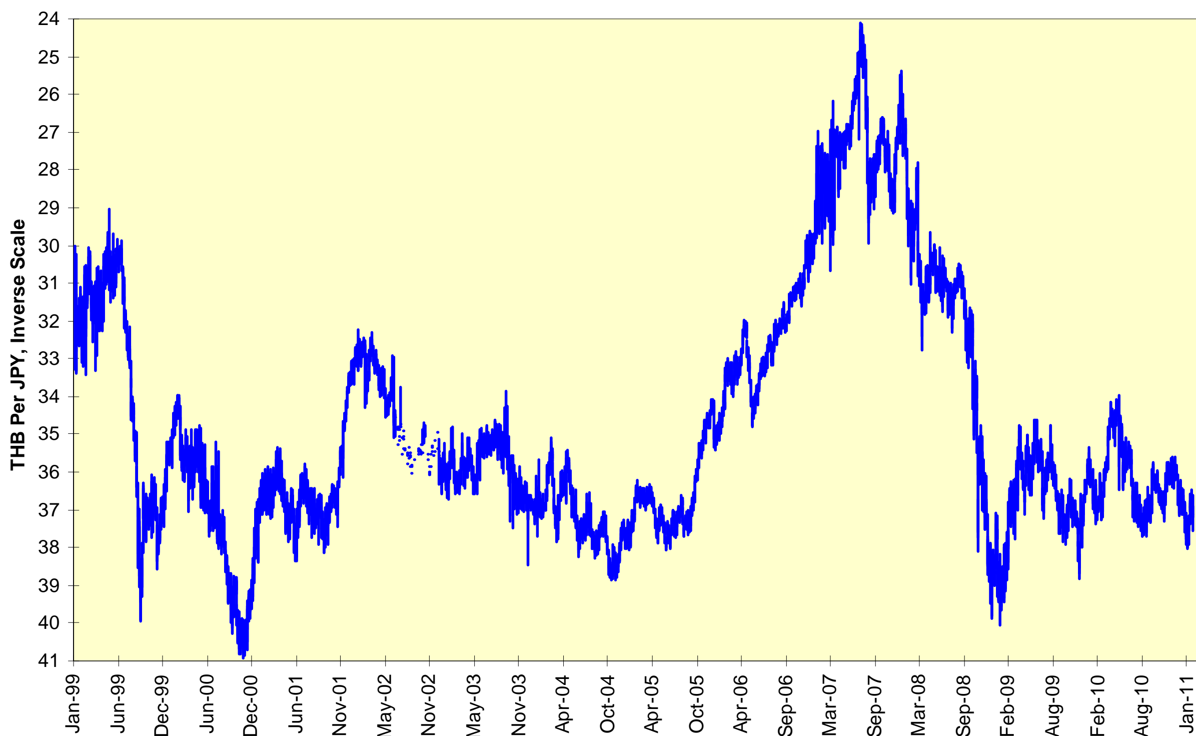
Once the clock struck on the new millennium, defined here as January 1, 2001 and not (sniff) January 1, 2000, the baht entered a long-term uptrend against the dollar, one free from the usual variance and histrionics associated with fairly small currencies. Excess volatility, the ratio of implied volatility on THB forwards to its high-low-close volatility, minus 1.00, has remained tepid except for the last nine months of 2007 for reasons apparent below. As has been the case with other South Asian currencies, option volatility provides few clues as to the THB's course.

Options Market Leads Baht Weakly

The actual origin of the Thai baht's devaluation in 1997 was the stress it encountered in repaying yen-denominated loans. The cross-rate between the baht and the yen has stayed in a broad but confined range since the January 1999

advent of the euro; once the financial crisis of 2008 began to dissipate, the THB started to gain on the JPY. The period in 2007 when excess volatility for the THB against the USD jumped coincides with the THB's top against the JPY. This indicates traders were hedging the THB-JPY rate with options on THB-USD forwards. You do what you have to do in this world.

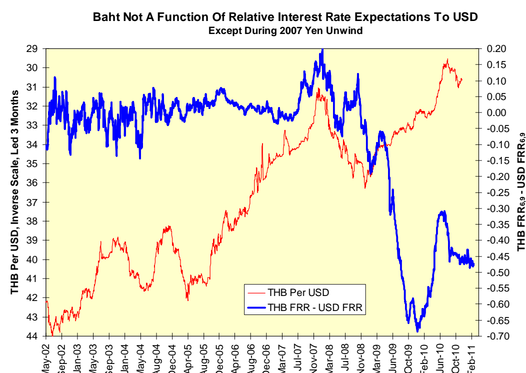
Baht Rebounding Against Yen

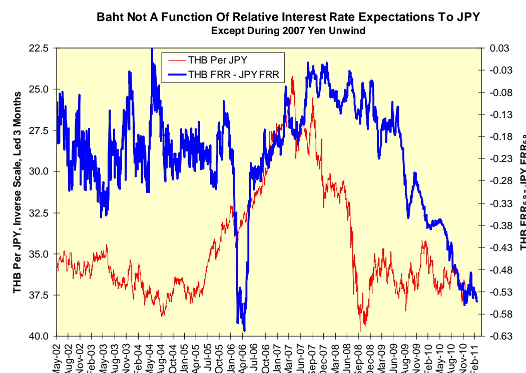


Interest Rates

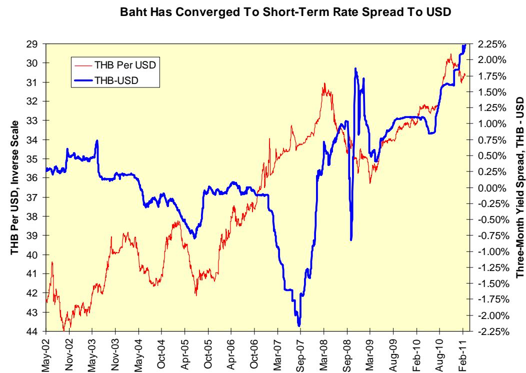
The same late-2007 period comes into play with one of the key variables we have used to analyze nearly all currencies, the interest rate expectation differential as measure the forward rate ratios between six and nine months ($FRR_{6,9}$). This is the rate at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. The more this $FRR_{6,9}$ exceeds 1.00, the steeper the money market yield curve is.

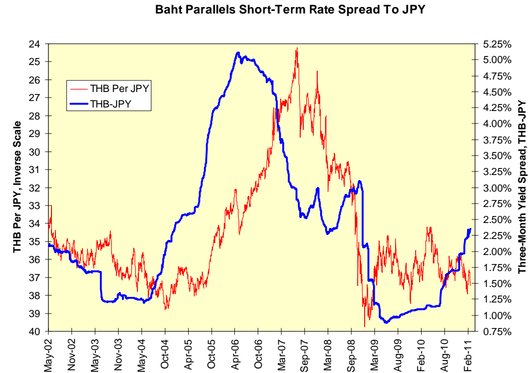
We should expect the differential between the THB $FRR_{6,9}$ and those of both the USD $FRR_{6,9}$ and the JPY $FRR_{6,9}$ to lead the THB by three months, with the normal effect being a greater differential leading to a stronger THB. This does not appear to be a strong relationship for either currency with the exception of the late 2007 period. The mechanism is the same for all markets examined so far; the THB $FRR_{6,9}$ steepened as the market expected higher rates to emerge in Bangkok, the expected interest rate differential expanded and the options market upped its insurance cost for the baht. Outside of this one period of interest rate expectations, the link between interest rate expectations and the exchange rates between the THB and both the USD and JPY has been weak.





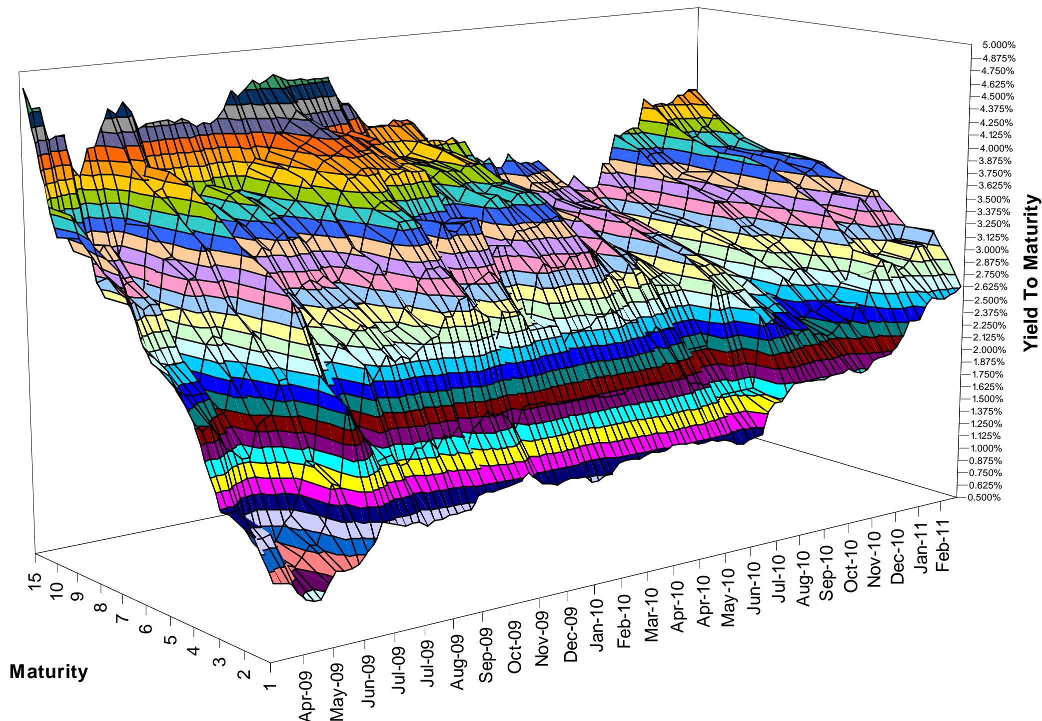
We should ask for the sake of completeness whether we obtain the same results if we use the simple three-month interest rate spread between the THB and both the USD and JPY. As we have seen in a wide range of minor currencies, this spread often is more telling than the forward expectation differential. The answer is straightforward: The simple spread has improved the contribution of relative interest rates to the baht since 2009 for the USD but not for the JPY.



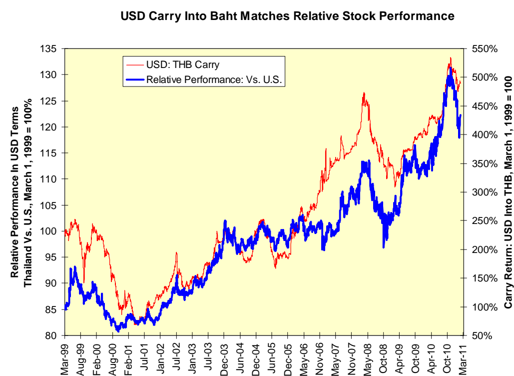


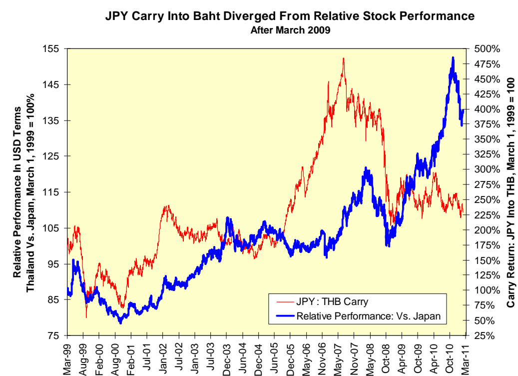
Capital Market Horizons

Can we explain the continuous rise in the THB since the March 2009 global low in terms of shifts in the yield curve at the note horizon? Not really; if this were the case, we most likely would see a flattening of the yield curve at the long end as funds pushed into capital assets. Alternatively, we might expect to see a steepening of the yield curve via the short end driving lower if foreign investors were skittish about the Thai market. Neither is observable.



This leaves relative stock market performance as the last potential market-derived cause of the baht's strength. We can map the total return on the Thai stock market in USD terms to both the U.S. and Japanese markets and overlay the total carry return for borrowing the dollar and the yen and lending in the baht.





The relative performance of the Thai market to the U.S. has been correlated closely to the dollar carry until the actual execution of quantitative easing in November 2010. That led to countervailing hikes in short-term interest rates throughout the region to combat imported inflation, and the relative performance of Thai stocks suffered accordingly.

As we saw last month in the case of the Philippines, the picture is different for comparable measures based on Japanese stocks and the carry from the yen into the baht. Here the two measures diverged sharply after the March 2009 low when the USD started to supplant the JPY as the preferred funding currency for carry trades. In addition, we see the same lesson here as we did in the Filipino case: Once U.S. short-term rates started to decline in late 2007, Thai stocks ceased outperforming Japanese stocks on a USD basis. Once again, the principle low domestic interest rates benefit external borrowers more than internal borrowers is confirmed.

One day interest rates could rise in both the U.S. and Japan and the carry trade will reverse like the tide ebbing. When that happens, it will be as unhappy a day for Thailand as they experienced in July 1997. We never make the same mistake just once anymore, even though it would be quite nice if we learned from one on occasion.