

## How Eastern Europe Got Carried Away

Trading is an easy business. You can buy, you can sell or you can do nothing. Why do we make it so hard? Come to think of it, currency trading is an easy business, too. You can borrow or you can lend, and that is it. And just as the mantra for conventional trading is, “Buy low and sell high,” the mantra for currency carry trading should be, “Borrow cheap and lend dear.”

What can go wrong, besides everything? Let’s put aside the empirical observation carry trades are the only class of currency trades proven to make significant excess returns over time (see “Currency Traders Should Be Humbler,” May 2007) or that the yen carry trade always is present in the autopsy photos of any global financial crisis (see “Looking At The Carry Trade,” June 2007) and turn our attention to that lynchpin of global bank secrecy masquerading as fiscal probity, Switzerland (see “Franc-ly My Dear, I Don’t Give A Carry” and “The Swiss Franc’s Commodity Connections,” September and October 2008, respectively).

As money flooded into Switzerland, Swiss short-term interest rates fell; this must have something to do with supply and demand for funds. As money burns holes in bankers’ pockets and as the emerging markets of Eastern Europe were doing what they were supposed to be doing, emerging, financial electric force fields took over and attracted funds from Swiss banks to Eastern European markets. German and Austrian banks, perhaps getting a little misty-eyed over the past glories of the Hohenzollern and Habsburg monarchies, respectively, joined the lending parade.

Unread Japanese-language copies of “How to Lend in Thailand,” copyright 1996, remained on library shelves throughout the region.

Much of the lending to Eastern Europe was for residential mortgages. While we do not wish to cast aspersions on the sophistication of others, we have learned the hard way in the U.S., the U.K. and elsewhere just how tricky the mortgage market can be in one currency, especially when the mortgages move from plain vanilla to the various exotica seen at the height of the farce. Consider how well American subprime mortgage borrowers would have understood an option ARM based, say, in Canadian dollars; the evidence is overwhelming few understood them in U.S. dollars. Now extrapolate the problem to Poland, Hungary and other countries where CHF-denominated loans and mortgages became popular. Did the borrowers understand the risk they were taking if their domestic currency weakened vis-à-vis the CHF? The answer appears to be, “No, of course not.”

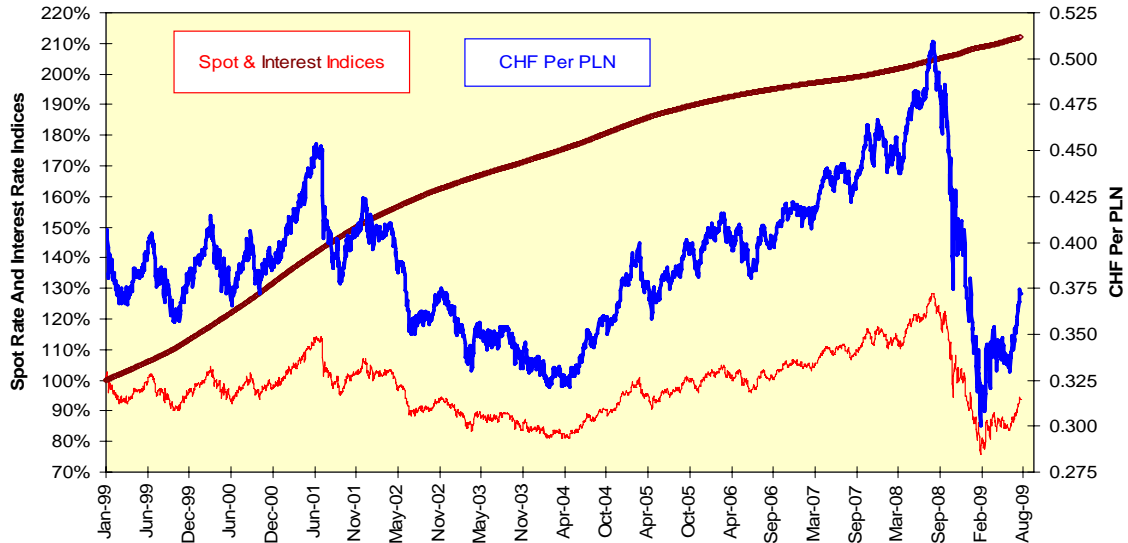
### The Carry Trades

The carry trades between the Swiss franc against the Polish zloty (PLN), Hungarian forint (HUF), Czech koruna (CZK), Turkish lira (TRY) and against the euro will be examined below. Several Eastern European economies peg their currency to the EUR. All carry trades can be decomposed into two components, the interest rate spread and the change in the spot currency rate. This is one reason why governments seeking to “defend” their currency often raise short-term interest rates; the hope is the interest rate differential can offset the losses on the spot rate. The interest rate component of the carry trade between the CHF and TRY in the charts below is quite an eye-opener. These higher short-term interest rates often damage the host economy, but that is a story for another day.

In all cases, the interest rate spread continues to advance in favor of the Eastern European currency. This is unsurprising; three-month Swiss interbank rates are a mere 35.67 basis points at the time of this writing. The collapse of the respective carry trades by February 2009, then, had to have been a function of the changes in the spot rate component of the trade. This is quite visible in the currency cross-rate for each currency. The collapse was arrested and reversed by the Swiss National Bank’s move to quantitative easing on March 12, 2009; not only did this re-open a carry trade, it helped provide a free put option to risk-takers in the region.

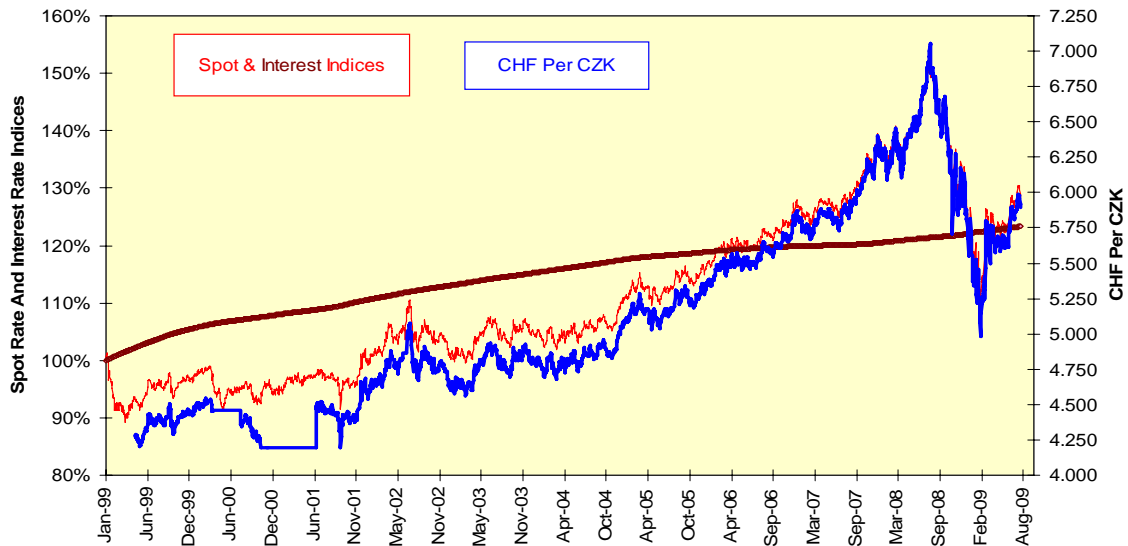
The interest rate component of the PLN carry trade grew steadily through the 2008 financial crisis, but the Polish government was worried more about their economy’s health than about preserving any given PLN-CHF cross-rate. Predictably, the spot rate declined and led to many of the borrowers’ problems by early 2009.

### The Swiss Franc - Polish Zloty Carry Trade



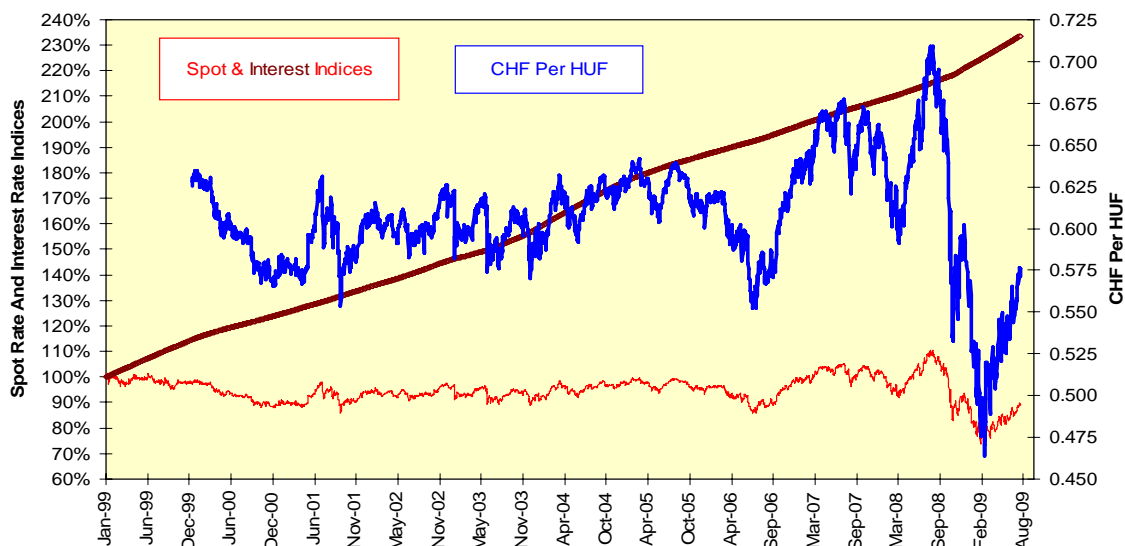
The Czech Republic never had a strong interest rate differential to Switzerland. By late 2007, the cross-rate became almost wholly a function of spot rate differentials with very little interest rate influence; this condition obtains still. The independence of the CZK from high interest rates was one reason why so many Czechs were unbalanced when the CZK tumbled early in 2009.

### The Swiss Franc - Czech Koruna Carry Trade



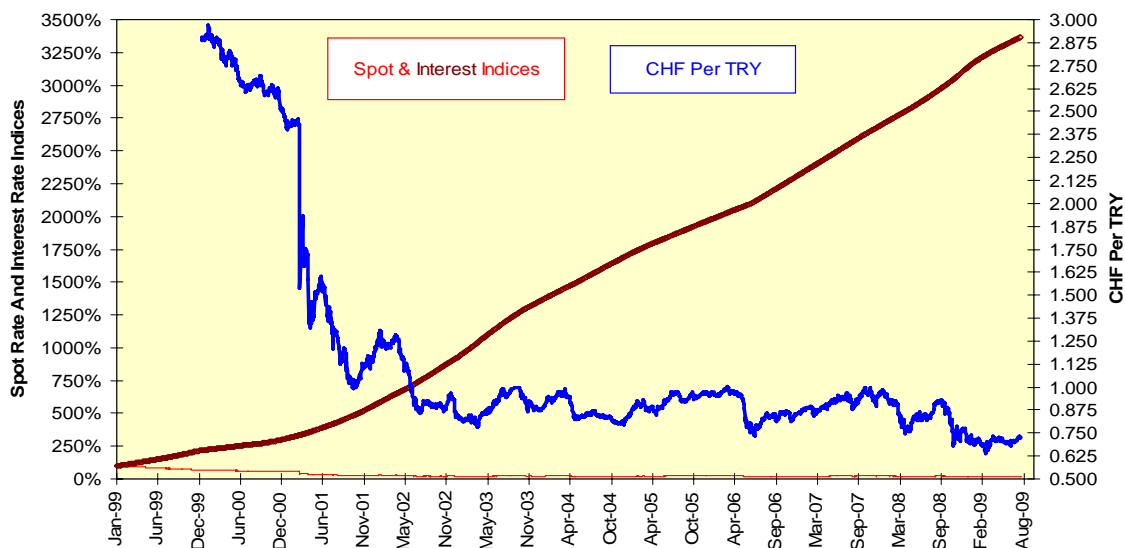
The exact opposite situation applied for the HUF. Here only a modest downturn in the spot rate overwhelmed the interest rate differential and led to an extremely sharp decline in the cross-rate. Hungarian interest rates rose, but they did not rise enough to stabilize the currency. Budapest believed, probably correctly, it was pointless to raise rates to defend an arbitrary level for the forint during a global recession. Only the Swiss move to quantitative easing prevented more Hungarians from leaving in a huff.

### The Swiss Franc - Hungarian Forint Carry Trade



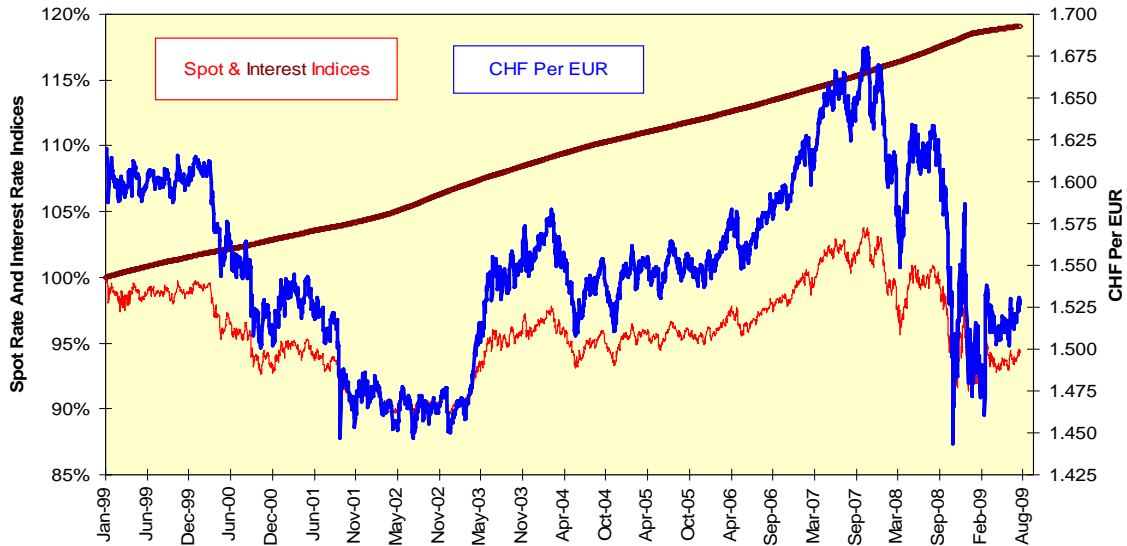
The TRY is and has been almost wholly a prisoner of extremely high interest rates for years now. One of the paradoxes noted in all previous analyses of carry trades, whether from the yen, the U.S. dollar or the Swiss franc is how both Turkey and Argentina have managed to earn positive carry amidst massive declines in their respective currencies' spot rates. While neither country can be held out as a model of prudent management, the lira did manage to remain stable against the CHF by virtue of these high interest rates.

### The Swiss Franc - Turkish Lira Carry Trade



Finally, the picture for the EUR looks much like the one for the PLN. Here a modestly growing interest rate carry was insufficient to offset changes in the spot rate. However, the EUR-CHF cross-rate has been erratic as the European Central Bank has kept oscillating between its mandate to preserve price stability and the desire of its member states for greater monetary stimulus. The lurching back and forth of the EUR against all other major currencies in 2008-2009 has imposed an unnecessary macroeconomic cost on the Eurozone.

### The Swiss Franc - Euro Carry Trade



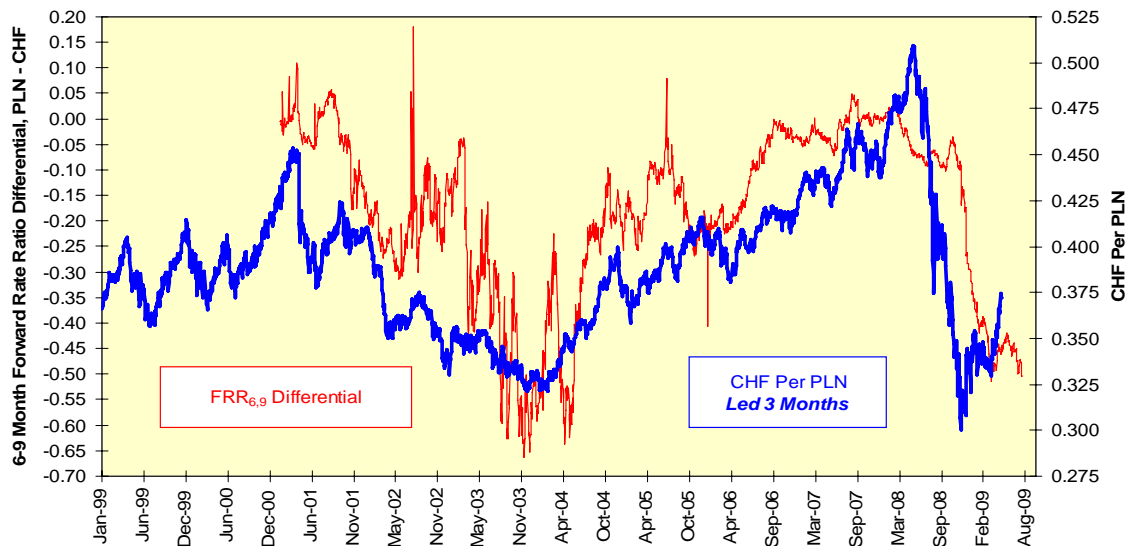
#### When Will Picture Change?

We should not assume an inherent inertia in any spot rate trend or in any interest rate spread; the world would be a fairly ungoverned place were this true.

We can use the relative slopes of the respective interbank money market curves between six and nine months to predict when the cross-rates against the CHF might reverse. As we have done before, we can calculate the forward rate between six and nine months, the rate at which we can lock in borrowing for three months starting six months from now, and divide it by the nine-month rate itself. The forward rate ratios (FRR) can be compared to one another to see which currency's interest rates are expected to rise the most. These FRR differentials lead the cross-rates by three months.

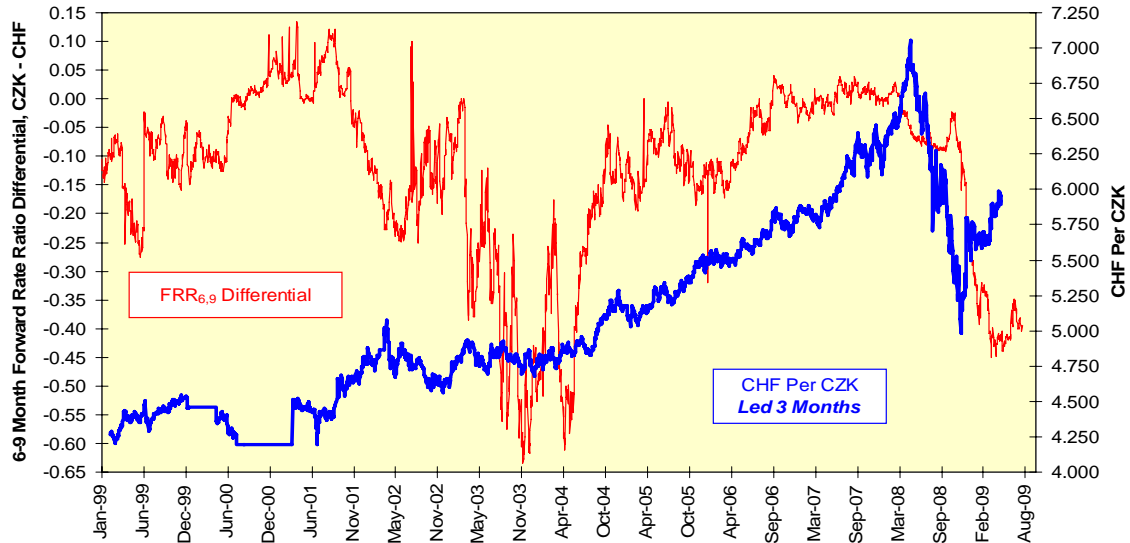
Here the pictures diverge somewhat. In the case of the zloty, the relative interest rate differentials point toward a renewed weakness relative to the franc.

### Relative Interest Rate Expectations Favor Swiss Franc



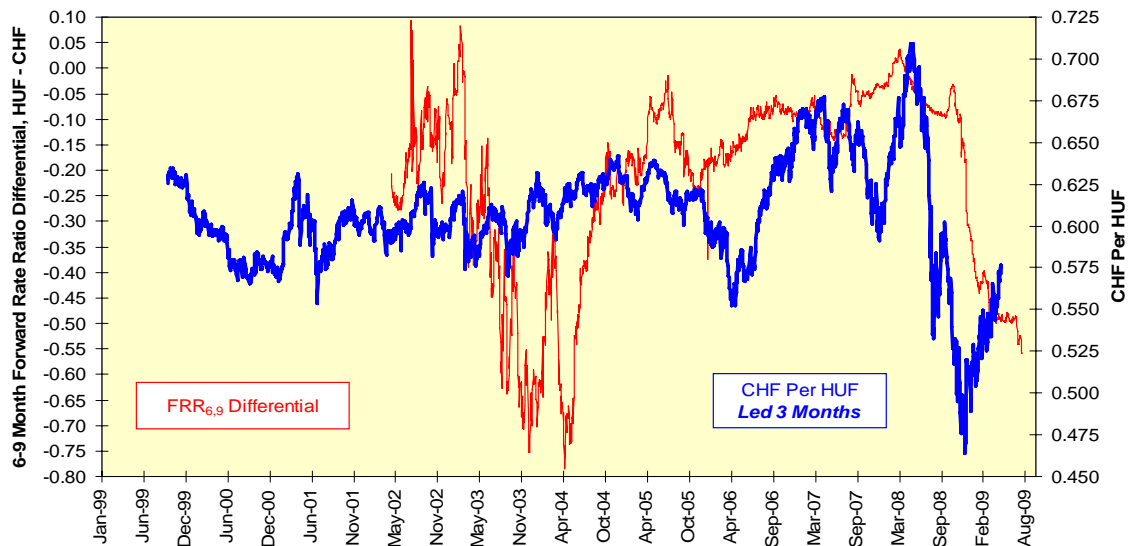
The koruna expected interest rate differentials for the CZK vis-à-vis the CHF have been moving against the koruna even as the CZK spot rate found support in March with the Swiss quantitative easing. Prague clearly does not want to resort to higher interest rates in a recession to defend the koruna at some arbitrary level; we should expect the yield pressure to continue until policies change.

### Relative Interest Rate Expectations Stabilizing



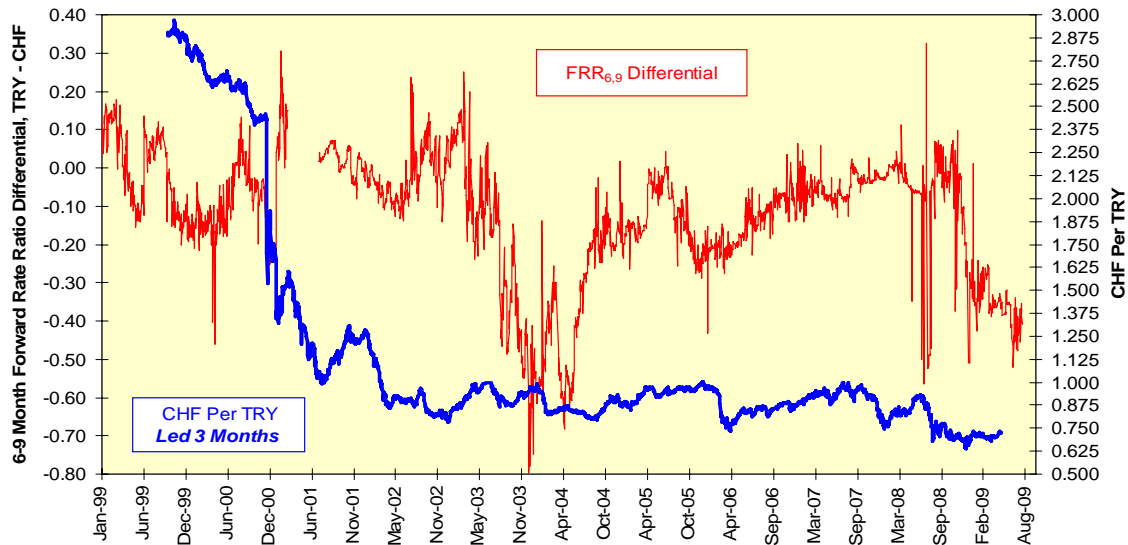
The relative interest rate expectation picture for the HUF is far easier to read: Hungary is not willing to resort to higher interest rates in defense of the forint. Its money market yield curve remains flat. The late-summer strength of the HUF against the CHF should encounter resistance soon.

### Relative Interest Rate Expectations Deteriorating



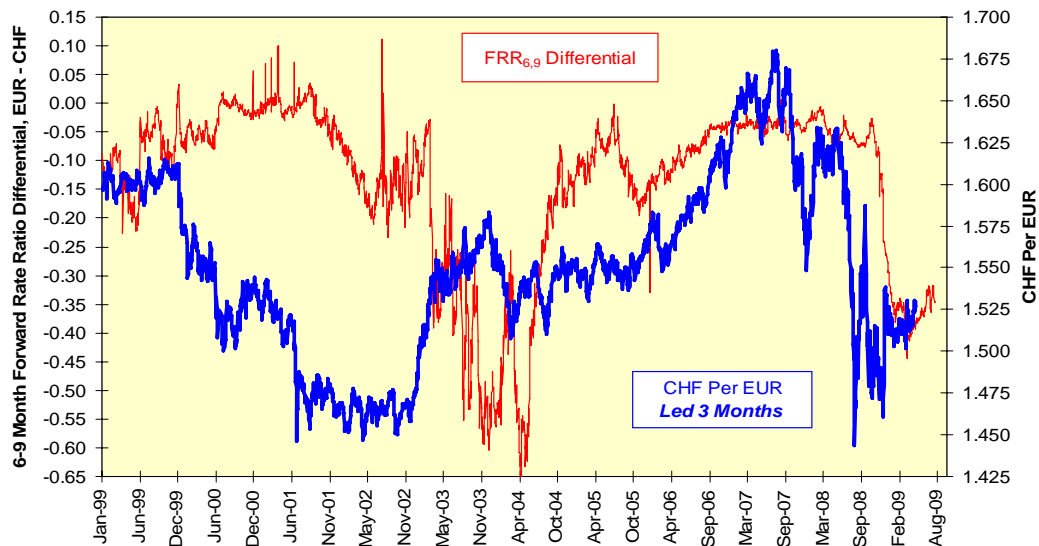
The Turkish case presents a more interesting outlook. While the long-term policy for short-term interest rates in Turkey has been clear, that they are willing to keep high short-term interest rates, the continuous expectation keeps oscillating erratically in a wide band as if Ankara is going to change its ways one day soon.

### Relative Interest Rate Expectations Erratic Within Broad Range



Finally, the relative interest rate outlook for the euro changed significantly in late March 2009. The market started to price in higher interest rate expectations for the EUR relative to the CHF, or perhaps lower interest rate expectations for the CHF relative to the EUR. Either way, this signaled an uptrend for the EUR on the cross-rate.

### Relative Interest Rate Expectations Still Favor Swiss Franc



Two factors can end the Swiss franc carry trade to Eastern Europe, higher short-term rates in Switzerland and a collapse of credit demand and an unwillingness to assume the currency risk of an appreciating CHF in Eastern Europe. Until and unless Switzerland loses its role as a haven for the world's funds on the run, the former is unlikely to happen. The latter is a function of the 2008-2009 recession and of Eastern Europe's collective memory.

We can say the 1997 Asian example held. It did not take long for Eastern Europe to forget about the collapse of the Swiss franc carry trade. It is open for business again. They will promise themselves that they will be more careful next time and then will go out in make the same mistakes again. Just like trading, international banking is a simple business.