Singapore Dollar Avoids The Dire Straits

The city-state model is so successful in Asia you really have to wonder why it has not been tried on a large scale elsewhere. The politics of too many places where a large city's interests have to be balanced against those of a hinterland, including Paris in France, Tokyo in Japan, Vienna in Austria or Mexico City in Mexico (but not Panama City in Florida) are such you have to wonder why both sides simply do not wish each other the best and get on with their separate lives.

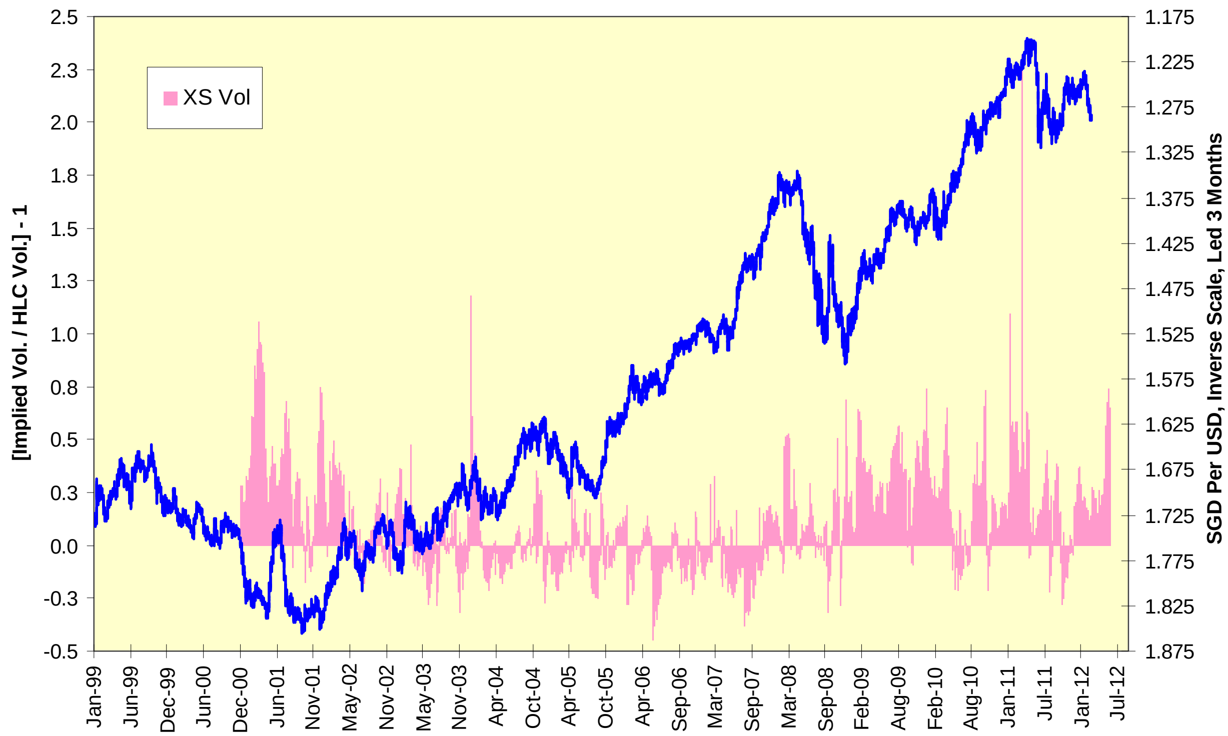
This essentially describes why the islands at the tip of the Malay Peninsula separated therefrom by the Johor Straits and from the Indonesian island of Sumatra by the Singapore and Malacca Straits is an independent entity. The island had been governed separately by the British since 1819 and was home to a thriving hodgepodge of merchants and traders from the region including a very large Chinese contingent that created a free-market laboratory without having the self-awareness of doing so.

The island's famous fall to Japan in 1942, replete with the story of the huge shore batteries pointing irretrievably out to sea when the Japanese army was rude enough to arrive by land, was the largest single defeat ever suffered by the British in their long imperial history. Between the end of World War II and the island's separation as an independent republic in 1965, it went through several phases, including union in what was then known as the Federation of Malaya (see "Malaysia On The Jagged Edge," June 2011). Singapore, under its long-time overseas Chinese ruler Lee Kwan Yew, became an exemplar of the Asian model of economic freedom combined with what Americans especially would regard as an authoritarian political system. Only Japan in Asia has a higher per capita GDP.

Two Countries, Two Carries

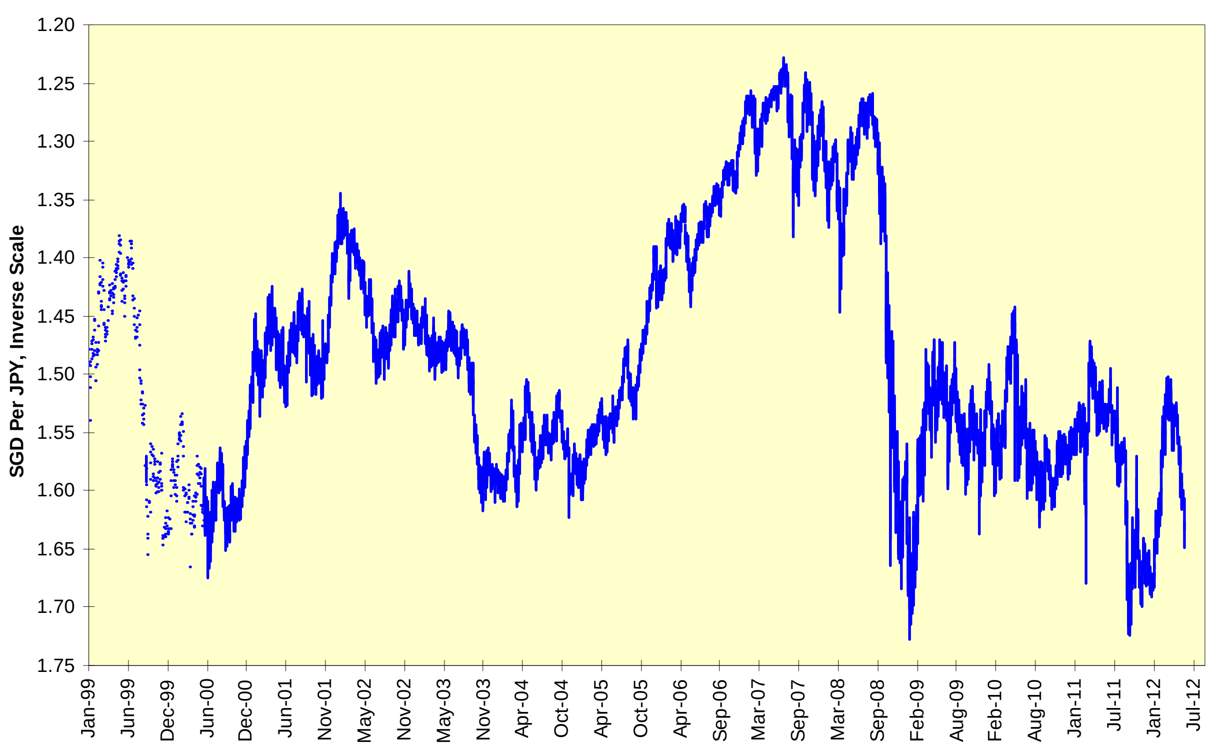
As has been the case for nearly every currency examined in East and South Asia, we have to look at Singapore dollar's relationship against both the U.S. dollar and the Japanese yen. The SGD has been climbing steadily against the USD for more than a decade; the only interruption of note occurred during the financial crisis of 2008-2009. Even so, the options market tends to get nervous about the strong SGD. If we take the excess volatility for the SGD, the ratio of implied volatility on three-month SGD forwards divided by the high-low-close volatility for the SGD, minus 1.00, we see sustained high levels during the 2009-2011 rally. As much of this rally was driven by ultra-low short-term interest rates in the U.S., the high measure of excess volatility really measures anxiety over the sustainability of American policies as much as over any level or trend for the SGD.

Options Market Nervous About Stronger SGD



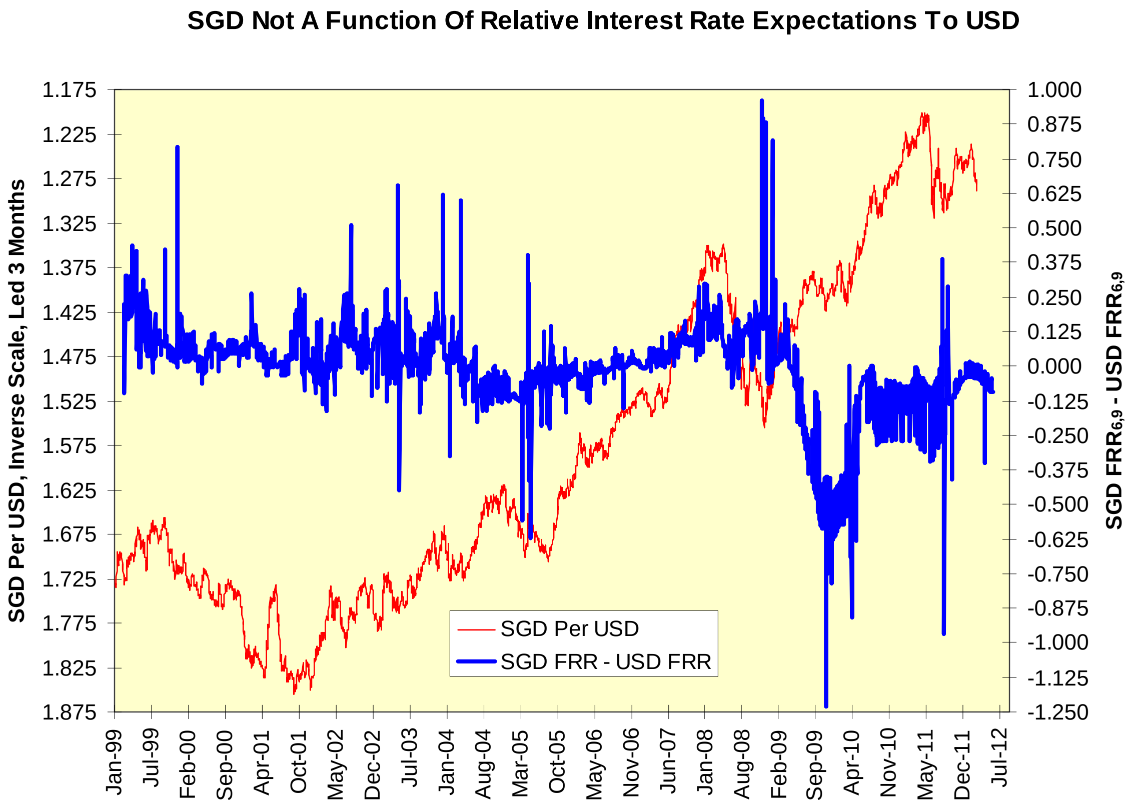
The cross-rate against the JPY has a markedly different history. The SGD strengthened during the hey-day of the yen carry trade in 2005 and 2006, but outside of that episode it has traded in a 1.45 – 1.65 range over the past decade. There is no active option market from which we can construct an excess volatility calculation.

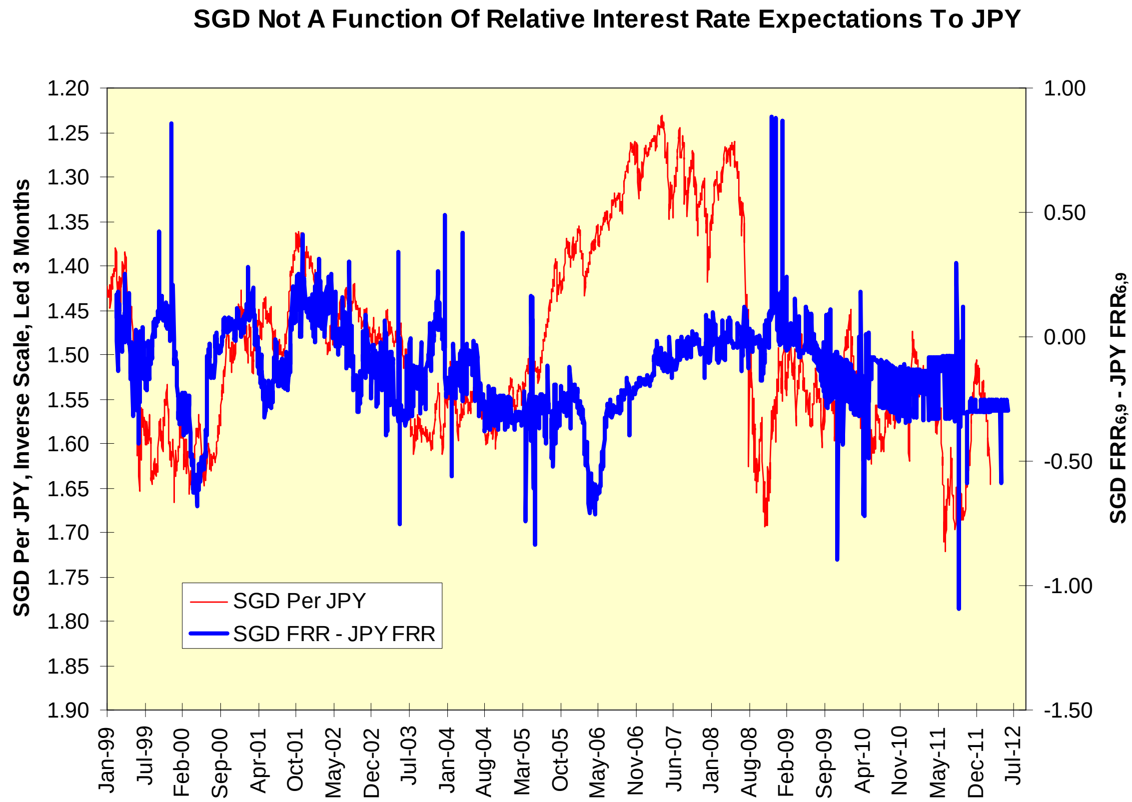
SGD Stable Against Yen



Interest Rate Differentials

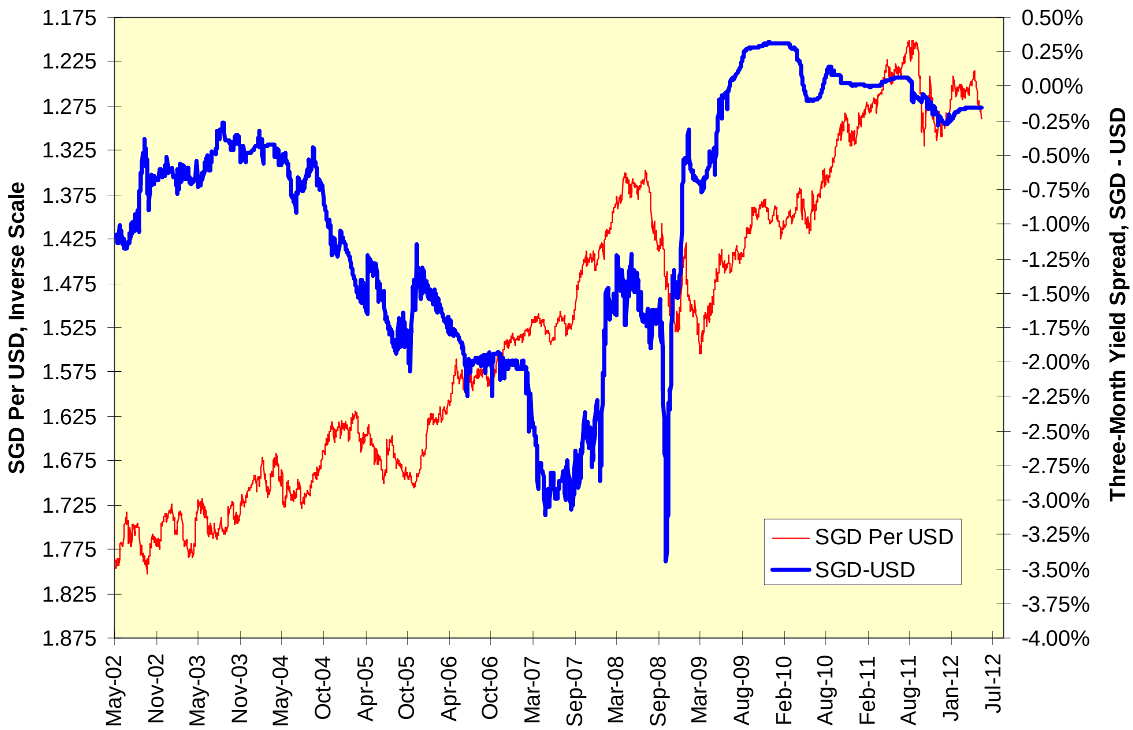
Whatever the course of the SGD against either the dollar or the yen, it has been independent of expected interest rate differentials against the USD since 1999 and against the JPY since 2004. These expected interest rate differentials are the differences between the forward rate ratios between six and nine months ($FRR_{6,9}$) of either the USD or JPY one on hand and of the SGD on the other. The $FRR_{6,9}$ is the forward rate between six and nine months divided by the nine-month rate itself. The more this measure exceeds 1.00, the steeper the money-market yield curve is.



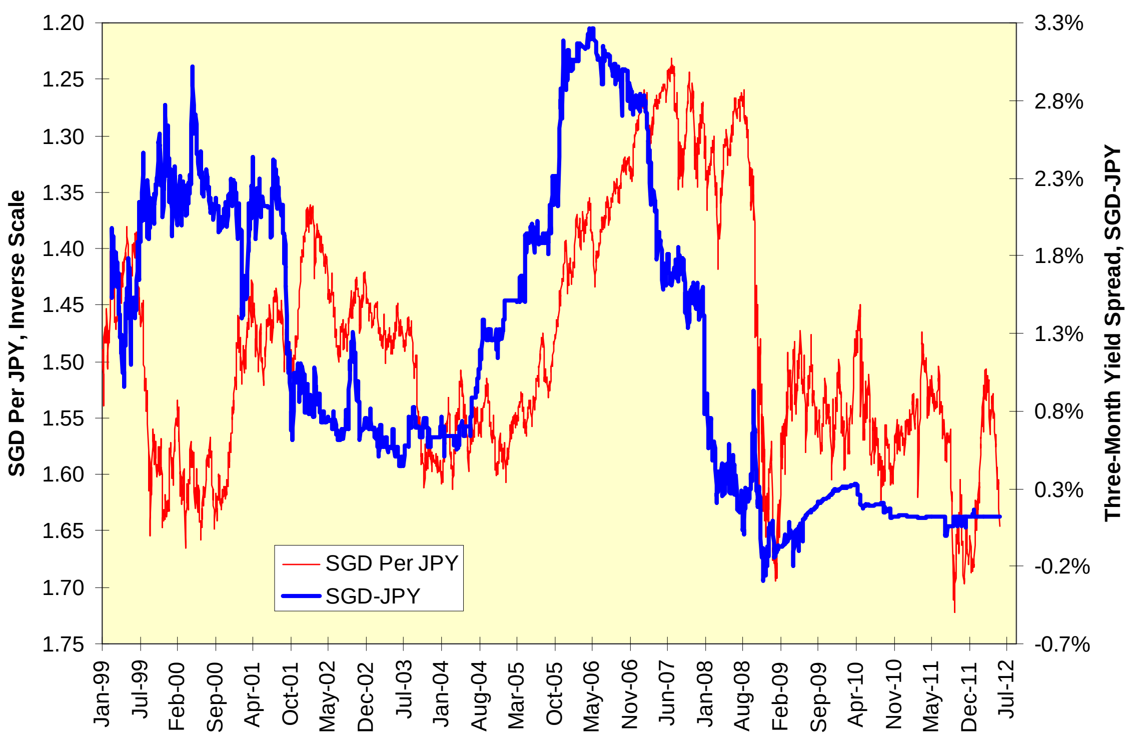


This is a very strong hint the SGD trades independently of standard interest rate arbitrage as normally applied. Does it follow, as so many "minor" currencies do, a straight three-month interest rate spread? The answer is something of a weak, "Yes." The eye sees and the brain interprets patterns where none actually exist, but the convergence between the USD rate and the interest rate spread between Singapore and the U.S. since the U.S. went to quantitative easing in March 2009 is visible, and the three-month rate spread between Singapore and Japan has paralleled the cross-rate for more than a decade.

SGD Has Converged To Short-Term Rate Spread To USD



SGD Parallels Short-Term Rate Spread To JPY

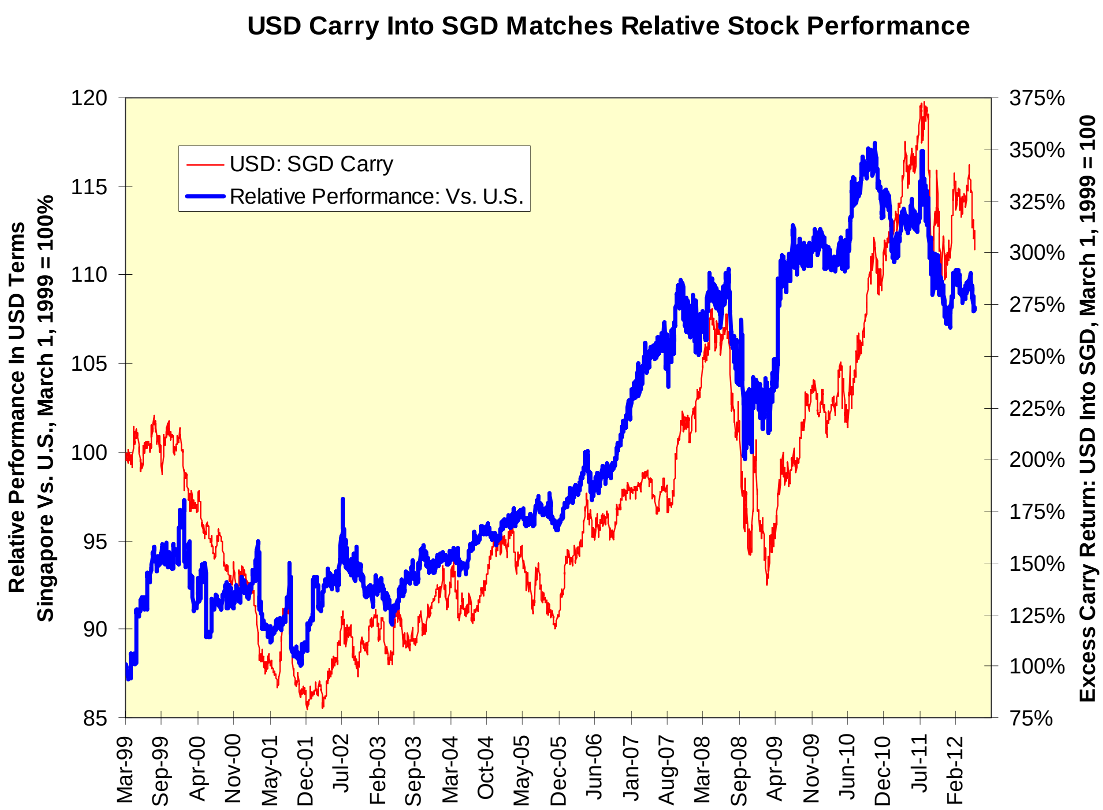


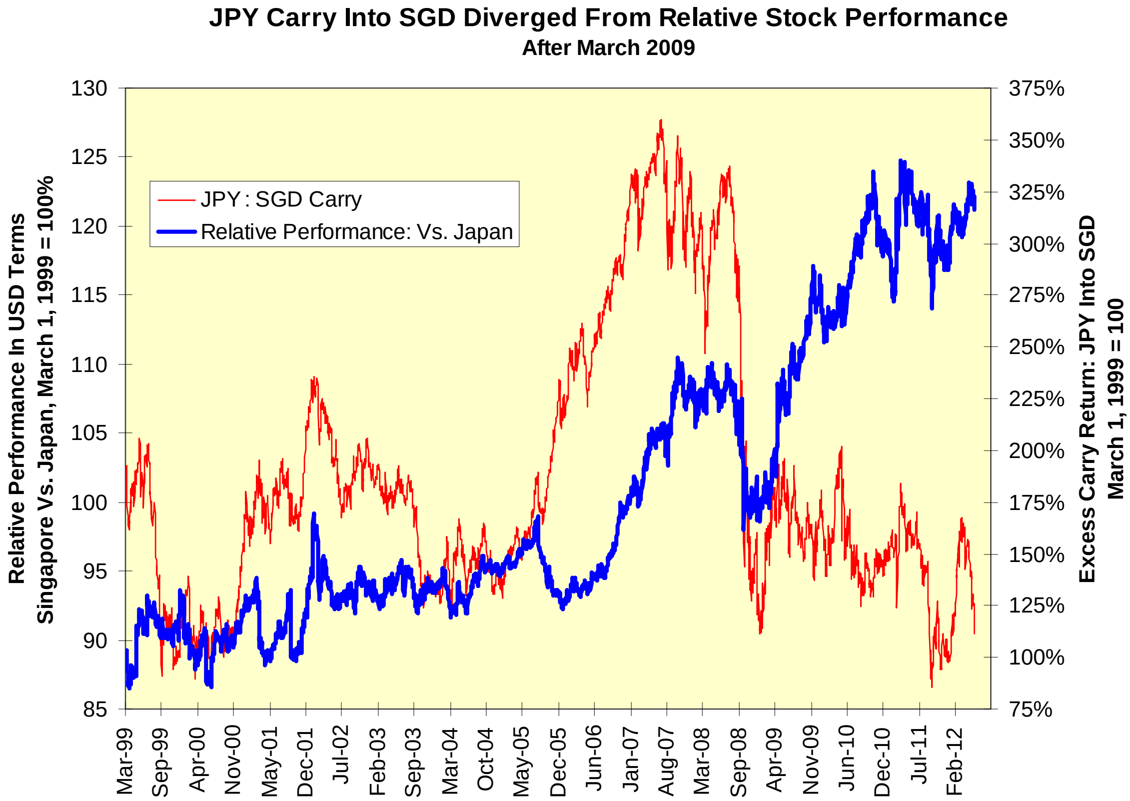
As both Japan and the U.S. have pushed their three-month rates down toward zero percent for long stretches of time, this is equivalent to saying the SGD simply follows the Monetary Authority of Singapore's lead. This is, after all, a free market economy within a political system intolerant of the Frank Sinatra "My Way" school of thought.

Asset Returns

Whenever standard interest rate arbitrage does not drive currency rates and the country in question does not have an export sector dominated by a single commodity or group of commodities, we should look toward relative investment flows. Here the link between the USD and the SGD is far stronger than the link between the JPY and the SGD; this reflects, perhaps, the reduced role of Japanese banks and yen-denominated loans in South Asia following the 1997-1998 crisis.

If we map the excess carry return for borrowing the USD and lending the SGD against the relative performance of the two stock markets in USD terms, we see a general conformity, one that held even through the 2008-2009 financial crisis. Nothing of the sort can be said for the Japanese parallel. Here the excess carry returns oscillated into and out of conformance and diverged for good after the March 2009 global market low. Or, should we say, since Singapore joined the global stock market rally while moribund Japan did not?





What we have in Singapore is a currency befitting its status as a city-state: Independent, marching to the beat of its own interest rate drum, barely swayed by outside developments and able to prosper during that most feared of events in a world filled with competitive devaluators, a long rally. Perhaps they should rename their benchmark Straits Times index the Un-Dire Straits index.