

The Polish Zloty (Pronounced “Zloty”)

When the book is closed on human history and they start handing out the hardware at that Big Award Show in the Sky, Poland is going to win the “Lousy Choice of Neighbors” prize by acclamation. This is a place whose one unquestioned natural border is the Baltic Sea in the north and, arguably, the Carpathian Mountains in its otherwise undefined southeast. Other than that, its history includes losing large chunks of land to an expanding Prussia from the west, an expanding Russia from the east, Austria from the south, and during the Thirty Years War to invading Swedes under Gustavus (“Hop on the bus, Gus”) Adolphus.

It disappeared once in the Eighteenth Century after a series of partitions, reemerged as an independent country after the collapse of Imperial Germany and Tsarist Russia in World War I with borders swung far into what is now Russia and with a corridor to the Baltic at Danzig. That lasted twenty years and about three months before Poland was re-partitioned between Nazi Germany and the Soviet Union; this triggered the Second World War in Europe. After the Poles fought bravely and hopelessly in a losing effort, Free Polish soldiers joined the Allied cause and participated in the air war against Germany and in the Italian campaign, most heroically at Monte Cassino. They were rewarded for their efforts by watching France being rewarded a victor’s share and by being re-subjugated to Russian rule with borders shoved almost 200 miles west to the lines of the Oder and Neisse rivers. However, he who laughs last laughs best: The collapse of the Soviet Bloc began with the 1980 Polish dockworkers’ strikes in Gdansk (the former Danzig) under Lech Walesa.

The Once And Future Zloty

The name derives, like that of so many other currencies, from “golden.” It came and went in various forms and valuations with the country itself, but always remained in secondary circulation with official coins of the realm. Once again, it may disappear into the euro at some point after 2015 according to current projections, but given Poland’s history and luck, the euro might disappear two minutes after the official announcement is made. We shall see. Regardless, the currency trades heavily against both the USD and the EUR and has been a borrower of CHF as part of the franc carry trade. As the CHF has been capped against the EUR since September 2011, let’s focus for now on the exchanges into the USD and EUR even though the CHF has traded below the “franc ceiling” regularly since January 2013.

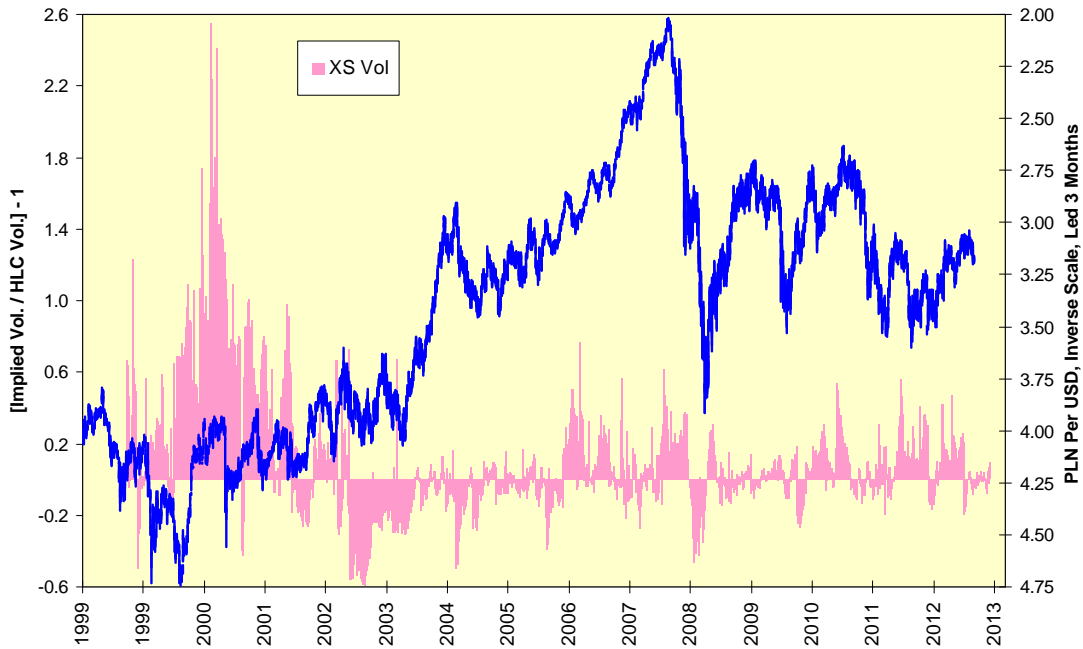
First, the PLN’s history has been much less exciting than the country’s history. The excess volatility, or ratio of the implied volatility for three-month non-deliverable forwards to high-low-close (HLC) volatility, minus 1.00, has been very low in absolute terms since 2004 and was not very large in either direction before 2004. Restated, the demand by USD holder for insurance on the PLN is muted. About all we can say in this regard is the market is slightly more comfortable with a weaker PLN. As a refresher, HLC volatility is defined as:

$$\sum_{i=1}^N \left[\frac{.5 * \left(\ln \left(\frac{\max(H, C_{t-1})}{\min(L, C_{t-1})} \right) \right)^2 - .39 * \left(\ln \left(\frac{C}{C_{t-1}} \right) \right)^2}{N} * 260 \right]^{1/2}$$

Where N is the number of days between 4 and 29 that minimizes the function:

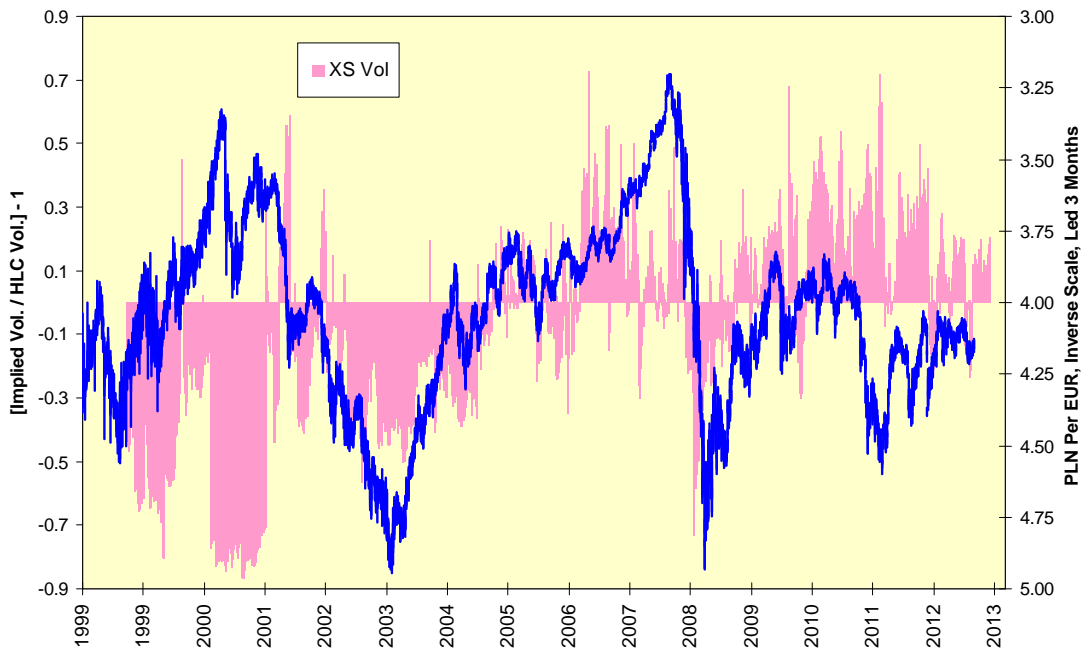
$$\frac{1}{N} * \sum_{i=1}^N \frac{N}{Vol^2} * |(P - MA)| * |\Delta MA|$$

Options Market More Comfortable With Weaker PLN/USD Rate



The excess volatility measure on a EUR basis is more descriptive. Here it rises before the PLN weakens and falls before the PLN strengthens and has been so since 1999. This behavior is a very strong signal of active two-way trade between the two currencies and, tellingly in a world of overt currency-fixing, of a relatively unencumbered trade.

Options Market More Comfortable With Weaker PLN/EUR Rate

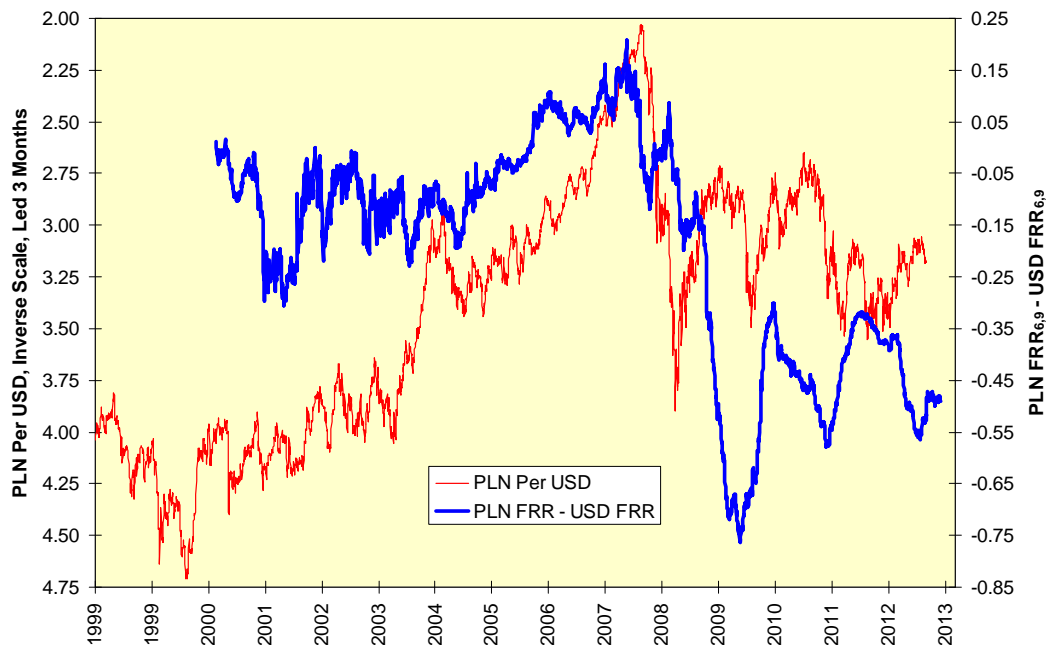


Interest Rates

The PLN has been a well-behaved currency as well in terms of expected interest rate differentials as measured by the difference in forward rate ratios between six and nine months ($FRR_{6,9}$) against the USD and EUR. This did not change much after the reliability of LIBOR came into question after March 2008 (see “Major Currencies And The Great LIBOR Kerfuffle,” June 2013). The general pattern has been for the PLN to firm against the USD as a weak

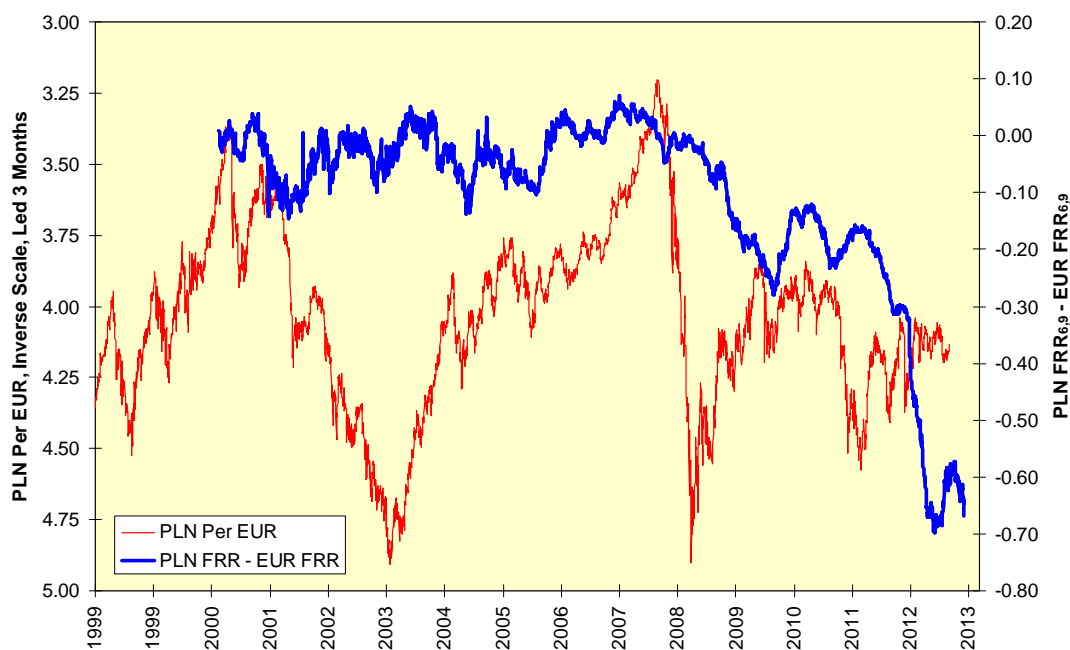
lagging function of the difference between the PLN FRR_{6,9} and USD FRR_{6,9}. Relatively higher expected interest rates boost the PLN, but not greatly so.

PLN A Weak Function Of Relative Interest Rate Expectations To USD



The pattern has been quite different for the expected interest rate differential between the PLN and EUR. This is attributable in large part to the Eurozone's difficulties in selecting one longer-term course for monetary policy and sticking to it. The enormous but discontinuous steepening of the EUR FRR_{6,9} from mid-2010 onwards pushed the differential lower but did not lead to significant weakening of the PLN on the cross-rate. Restated, the euro had its own problems and the zloty was not going along for the ride. Something else was operating.

PLN Seldom A Function Of Relative Interest Rate Expectations To EUR

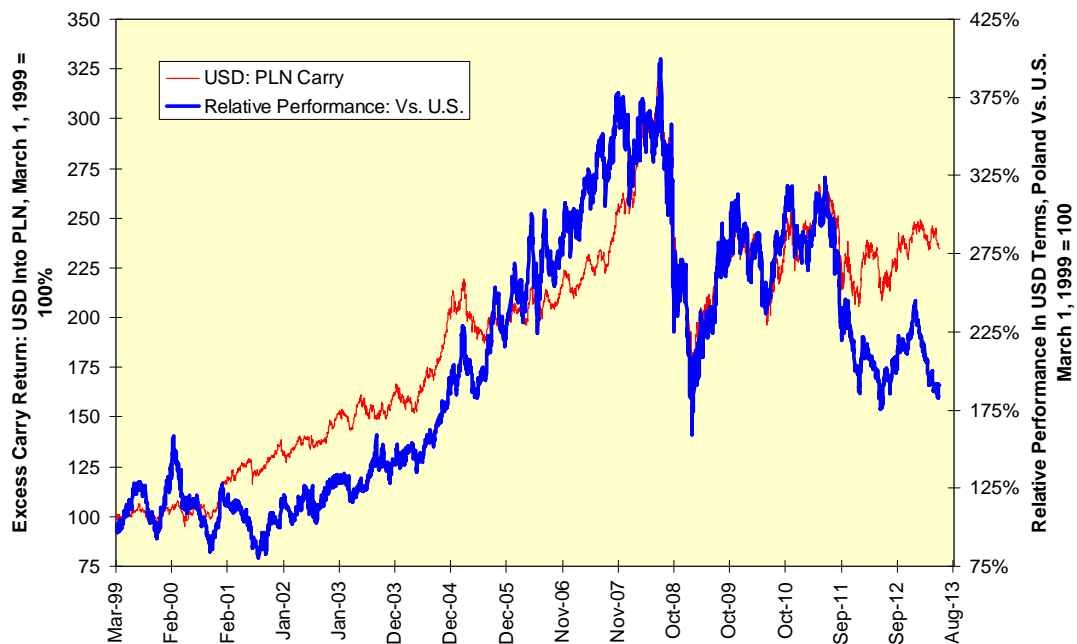


Carry Trades And Relative Asset Returns

The last factor we will look at is one of the more telling, and that is the excess carry returns on borrowing either the USD or EUR – yes, for much of this history the CHF was the currency borrowed most – and lending into the PLN.

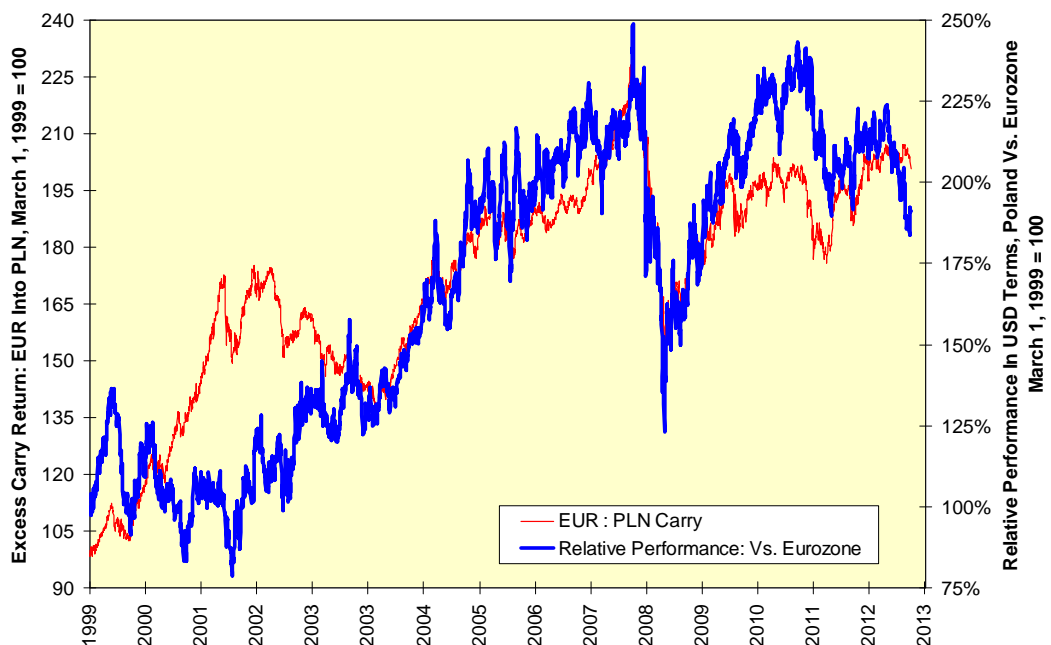
In the case of the dollar carry, the relative performance of Polish equities to American equities mirrored the excess carry return until October 2011. The U.S. stock market strengthened after this date and Polish stocks started to weaken as the Eurozone economy turned softer. Once again, neighbors matter.

USD Carry Into PLN Outpacing Relative Stock Performance



A parallel construct for the EUR carry into the PLN and Polish performance relative to the Eurozone confirms this economic dependence. Here the two measures have been in convergence for more than a decade. A stronger carry into the PLN and relatively stronger Polish stock market performance are largely one and the same.

EUR Carry Into PLN In Convergence With Relative Stock Performance



An external observer might conclude Poland has as much of a happy medium as it is going to get. Its currency can trade against the dollar without having to match the European Central Bank's peripatetic policies and its asset markets can remain linked to the Eurozone's without having to worry about the course of the Federal Reserve's policies. Given its history, Poland should take this deal now and worry about joining the euro later.