

VI. Conclusion

The objective of this study was to test the efficiency of the FOREX market in Thailand during a period of relatively fixed exchange rate regime (June 1995 until June 1997) and a period of floating exchange rate regime (June 1997 – June 1999). The test was based on the economic theories of Forward Rate Unbiasedness (FRU) and Uncovered Interest Parity (UIP).

The test of FRU and UIP represents a joint hypothesis to test the efficiency of the market. The rejection of these theories could be a result of a failure of any one of the following factors: risk neutral, rational expectation, and efficient arbitrage. In other words, whether agents are risk neutral, whether they have rational expectation, and whether they can arbitrage efficiently.

In chapter V, we tested the market efficiency by three methods. First was the test for market efficiency using OLS. The test was performed to see the difference in two exchange rate regimes. The first period considered was at the time the exchange rate was relatively fixed under a basket of currencies (June 1995 – June 1997), while the second period is after the change to a floating exchange rate regime (June 1997 – June 1999). The study tested the hypothesis of FRU and UIP in a period of fixed exchange rate regime first and tested the hypothesis of FRU and UIP during a floating exchange rate regime later. The result showed that the null hypotheses of FRU and UIP are rejected both in a fixed exchange rate system and a floating exchange rate system. This meant the market was inefficient in one-month test under the definition of FRU and UIP within both the periods of a fixed and a floating exchange rate regime. This might due to the relationship of three variables: exchange rate, forward rate and interest rate, which closely link together. Their relations are difficult to reveal because they have feedback effect from one to another. The test

using OLS was unable to include feedback effect in the model. Therefore, this study applied VAR methodology, which is an appropriate methodology, both two-variable and three-variable tests to estimate the model after OLS estimation.

Second was the test of the hypotheses of FRU and UIP with in the same two periods but this stage used the two-variable VAR methodology to test the hypotheses of FRU and UIP. To see the different in two exchange rate regimes, the study performed in the same structure as prior study. First tested for the hypotheses of FRU and UIP during the time the exchange rate was relatively fixed and followed with the test for the hypotheses of FRU and UIP during a floating exchange rate regime later. The result was that it rejected the null hypotheses of FRU and UIP during a fixed exchange rate system but accepted both FRU and UIP hypotheses during a floating exchange rate system.

Third was the test that combined the hypotheses of FRU and UIP into a single model. In this stage the test used the three-variable VAR methodology to estimate the hypotheses of both FRU and UIP in the same model. The study was performed in the same manner as the two-variable VAR methodology, which tested in a period of fixed exchange rate regime before a period of floating exchange rate regime. The result of the three-variable methodology rejected the null hypotheses of both FRU and UIP during a fixed exchange rate system, but accepted the null hypotheses of both FRU and UIP during a floating exchange rate system.

The results from two-variable and three-variable VAR methodologies were identical that they rejected the null hypotheses of FRU and UIP in a fixed exchange rate regime and they accepted both null hypotheses during the period of floating exchange rate regime.

From the close relation of CIP, UIP and FRU mentioned in the former chapter it is known that if two conditions of the theories hold, the other condition would also hold. In the study the null hypotheses of FRU and UIP were rejected during a fixed exchange rate regime, which meant the null hypothesis of CIP also did not hold. Therefore, during a fixed period the FOREX market was inefficient. However, during a floating exchange rate regime the result accepted the null hypotheses of FRU and UIP and therefore the null hypothesis of CIP was also accepted. Hence, the FOREX market during a floating period is more efficient than during a fixed exchange rate regime.

Actually, the Covered Interest Parity (CIP) is widely accepted to hold in reality as banks allow forward rates to be set by interest rate differentials. The mechanism that drives the Covered Interest Parity (CIP) to hold is the arbitrage. The forward premium/discount must be equal to the interest rate differential. If it is not, then arbitrageurs will borrow money from the country that has a lower interest rate and invest or deposit in the country that has higher interest rate and then sell forwards. Following this strategy the arbitrageurs would gain riskless profit. Thus, in the real world or under risk neutrality and rational expectations, this opportunity will not last for long because every one will try to do the same transaction, which will rapidly shift the differentials to their parity and eliminate the riskless profit opportunity. In other words, agents in the FOREX market are unlikely to miss any riskless arbitrage opportunities, therefore, the Covered Interest Parity (CIP) will always hold.

This study concludes that the change from a fixed exchange rate system to a floating exchange rate system changed the Thai FOREX market from inefficient to be more efficient under the economic definition of FRU and UIP. This result from the economic theories of FRU and UIP was also confirmed by the theory of CIP. This implies that after floating the exchange rate system, market

mechanism, or demand and supply, now play an important role in determining the FOREX market price.

Under a floating exchange rate system, demand and supply of both internal and external foreign exchange markets determine the exchange rate. This leads to faster responds of the exchange rate to change in fundamental economic factors. As a result, there will be fewer interventions by the Bank of Thailand, and those interventions will have shorter effect. To intervene in the foreign exchange market, the Bank of Thailand will buy or sell Baht to trade with foreign currencies. This measure will effect the amount of money that circulates in the system and cause a change in interest rates. However, the change in interest rates will eliminate the intended impacts of intervention. If the Bank of Thailand wants to maintain the effects of intervention, the Bank of Thailand has to buy or sell bonds with trading partners from the Open Market Operation (OMO). This will sterilize the effect of the intervention in the foreign exchange market so that it will not have any influence on interest rates. Still the impact from the intervention will not endure if the market does not believe that the government will continue the measure of the intervention.

Therefore, the market mechanism now plays an important role in the Thai FOREX market whereas the intervention from the government authority has less influence on the market.