



CHAPTER 6

CONCLUSION AND POLICY IMPLICATION

6.1 Conclusion

The objective of this study is to test the market efficiency hypothesis (MEH) that whether the current forward exchange rate is an unbiased predictor of the future spot exchange rate (UBFH) in the early Thailand's managed floating exchange rate system . Additionally, this study aimed investigate whether the failure of the MEH are due to the risk premium or expectational errors or both.

By using daily spot and one-month forward exchange rates of Thai Baht per US. Dollar during the period July 2,1997 through February 23 , 1998 (169 observations) obtained from the Data Stream, this thesis found that both spot and one-month forward exchange rates are non-stationary at the levels (spot and forward rate ADF statistic value in absolute term 1.38 and 0.07 is lower than the MacKinnon critical value even at 10% level 2.58) but stationary after taking the first differences (spot and forward rate ADF statistic value in absolute term 9.48 and 8.61 is higher than the MacKinnon critical value).

The results from the cointegration test show they have no long run relationship -the residuals ADF statistic value in absolute term 1.20 is lower than the MacKinnon critical value even at 10% level 2.58 . Along with the test results from correlogram and Q-statistic, show significant serial correlation in the residuals the value with the degree of freedom 85 the Q-statistic value 249.70 is higher than the two tail significant at 95% confident level 112.38. All the results imply that Thailand's foreign exchange market is inefficient.

For the answer behind the rejection the MEH, the results from the rational expectation hypothesis cointegration test show they have long run relationship - the residuals ADF statistic value in absolute term 9.56 is higher than the MacKinnon critical value. Along with the test results from correlogram and Q-

statistic, show significant no serial correlation in the residuals the value with the degree of freedom 84 the Q-statistic value 3.68 is lower than the two tail significant at 95% confident level 111.06. All the results imply that there are rational expectation in Thailand's foreign exchange market.

The another results from the risk premium cointegration test show they have no long run relationship -the residuals ADF statistic value in absolute term 2.40 is lower than the MacKinnon critical value even at 10% level 2.58 . Along with the test results from correlogram and Q-statistic, show significant serial correlation in the residuals the value with the degree of freedom 84 the Q-statistic value 192.09 is higher than the two tail significant at 95% confident level 111.06. All the results imply that Thailand's foreign exchange market has risk premium.

Therefore, the result from both 2 cointegration test, can be concluded that the violation of the market efficiency hypothesis in Thailand is due to the rejection of the ' no risk premium' hypothesis.

Compared with the study in Thailand, the results of this study is similar to Phichet ⁴⁶ that found the expected spot rate follow in line with the rational expectation hypothesis. Again, this study found that risk premium exists in the market while his study tested the factors which influenced the expected risk premium that can imply that there are risk premium in market.

Besides the same result with Parichart⁴⁷ that Thailand's foreign exchange market is inefficient, this study found reason for this inefficiency is due to the violation of the "No Risk Premium" Hypothesis.

⁴⁶ Ibid., p 9.

⁴⁷ Ibid., p 26.



6.2 The Implication and Suggestion

One of the empirical results found that the market participants use the information rationally. When expectations are rational it is generally recognized that the efficiency of economic policy in affection the real economy is reduced, especially when the central bank is expected to balance its position in the market.⁴⁸

For this implication, if exchange rate intervention is not perfectly predictable (no REH) this will add to the risks that confront the speculators. Because they are risk averse these risks generate disincentives to risk bearing and reduces the steady behavior of speculators in the foreign exchange market. On the other hand, if the REH holds, the central banks' intervention will frighten the market and adds to its reluctance which increases the volatility of the exchange rate rather than decrease.

Thailand foreign exchange market is inefficient due to the presence of a risk premium. This result can be interpreted that the market includes a risk premium and set the forward according to $F_{t,n} = E_t S_{t+n} + RP_{t,n}$. Therefore, the forward exchange rate is not the unbiased forecaster of the future spot exchange rate. Specifically, the forward rate over predicted the future spot rate in order to allow the risk premium in Baht.

An exchange risk premium (from holding foreign currency assets) arises from an uncertain price of foreign currency in terms of the domestic currency unit. political and other economic risks are also attributed to foreign currency.⁴⁹

For Thailand, the main source of the exchange risk premium is "country risk" which involves both political and economic factors. Starting from the

⁴⁸ Michael Beenstock. "Ration Expectations and the Effect of Exchange-Rate Intervention on the Exchange Rate", *Journal of International Money and Finance* 2 (1988) : p 319 and 331.

⁴⁹ Keehwan Park. Ibid. p 11.

economic side, it begins from the bubble economy that leads Thai people face with severe problems in 1997. The economic slowdown coupled with the continued fall of stock prices and international reserves with the current account deficit remaining high greatly affected market confidence. After using of managed float exchange rate system on July 2, market confidence continued to erode, especially as major credit rating agencies downgraded the country's foreign currency bonds on several occasions. Besides, controversial debates on the new constitution draft, resignations of finance ministers, and the cabinet reshuffle reflected poorly on political stability, all the economic and politic factors which lead to the high risk premium in the Thailand foreign exchange market.

To develop the efficiency of Thailand foreign exchange market and to eliminate or decrease the cause of high risk premium, one should study from the nation's economic crisis experience, understand the cause of the crisis, and develop the mechanism of country's risk management. One of the Bank of Thailand's economic management problem is lack of the understanding and rational expectation in both global level and nation level. Therefore, the central banks could make the most important financial decisions by meeting the expectations of the public, local financiers, and the foreign business community. The policy must be credible, yet flexible enough to allow for unexpected changes in economic environments and to cope with international trends towards business liberalization.

Although, the Thai financial system may recognize that many fundamental features of the system remain undeveloped ; e.g. currency trading in Thailand is still dominated by major banks. Thailand authorities could quickly develop the foreign exchange market. The introduction of an OTC derivatives market is a challenging task ahead of the establishment of an official derivatives exchange at a later stage. However, a major obstacle encountered by those involved is that the derivative products themselves are difficult to understand, what they are, or how they work. Therefore, the organizations concerned both private and public must work together to promote and educated those involved without delay.

6.3 Limitation of the study and Recommendation for Further Study

Because of the limited daily observations, this study forecasts the expected spot rate from only one independent variable ; the forward exchange rate. For further study, others influenced variables should try to be included to forecast the expected future spot rate.