

How to protect your personal income against the ‘free fall’ of the Euro

In the beginning of 2009 it was possible to buy 49 Thai Baht for 1 Euro, while at the moment you would be doing well if you could get 40 Thai Baht for the same Euro. Whilst for some this is a great development as one can get more Euros for Thai Baht transferred to a Euro savings account, others will see a drop in income as the salary included in their employment contracts is denominated in Euro. In this article I will comment briefly on the reasons for the strengthening of the Thai Baht and will introduce some terminology that is important in order to understand personal currency risk. In the latter part of this article I will show how currency risks can be mitigated.

Currency developments

The Thai Baht has appreciated against the Euro by just under 20% since January 2009. Over the same period and against the US Dollar, the Thai Baht is up 7%. This indicates that the appreciation is due both to the weakening of the Euro and a strengthening of the Thai Baht. The weakness of the Euro has been due to economic factors, specifically the “bail-out” of Greece. Over the same period, demand for Thai Baht has increased due to Thailand’s positive trade balance and the inflow of foreign currency for investments. Even the political turmoil has been of little influence on these developments. As in normal market trading, whenever the demand increases, the price will go up. In an attempt to prevent further strengthening of the Thai Baht, the Bank of Thailand has relaxed its foreign currency controls, allowing more foreign currency outflows. This aims at bringing the inflows and outflows of foreign currency into more of an equilibrium.

Currency risks

Understanding your personal currency risk requires you to look carefully at your personal situation and to identify the type of risk you face. Normally the currency risk for companies is broken down into transaction risk, economic risk and translation risk. For individuals, the key factors are economic risk and transaction risk. Economic risk refers to the impact of exchange rate movements on the present value of uncertain future cash flows. It comprises the impact of exchange rate variation on future income and expenses. Transaction risk refers to the impact of exchange rate changes on the value of “committed”/saved cash flows. These are mostly savings in foreign currencies and possible related liabilities (such as a mortgage, for example). Economic risk is flow oriented, whilst transaction risk is more assets and liabilities oriented. Protecting yourself against foreign currency fluctuations requires some understanding of natural hedging and the functional currency, which will be explained next.

Natural Hedging

Natural hedging is the simplest form of currency risk protection and does not require any exotic financial instrument. The basic principle of natural hedging is to create an equality between the incoming and outgoing cash flows in a certain currency, as well as equality in the currencies of your assets and liabilities. Using this form of protection requires you to analyze your current cash flows as well as your assets and liabilities in the different currencies. If you

discover imbalances in the incoming and outgoing flows or assets and liabilities, you might consider certain changes to limit the currency exposure. In general, the areas an individual needs to consider are as follows:

- Personal income/expenses
- Personal savings (deposits and investments)
- Personal assets (house)
- Personal liabilities (mortgage, personal loans)

Personal functional currency

The functional currency can be defined as the currency of the primary economic environment in which the entity/person operates; normally, this will be the currency of the environment in which an entity/person primarily generates and spends cash. The importance of determining a personal functional currency is to understand the currency risks on the current savings and future spending. For example, if you would like to retire in the Netherlands and spend your savings there, then it would make sense to set your personal functional currency as the Euro. Having your savings in Euro creates a natural hedge against future spending in Euro and will mitigate your currency risk.

Alternatively, and depending on your own currency risk appetite, you might opt to keep your savings in another currency. This might yield a higher interest or other form of income at the cost of a greater currency risk.

Net saving

The net saving is your net disposable income less your final consumption expenditure. Basically it represents the amount you are able to save each year. The currency which should be used for the calculation of your net saving depends on your personal functional currency.

Expatriate contracts

In general, the personal income of expatriates comprises salary, allowances, interest on savings and proceeds from investments. Living in an international environment, your income might be received in one currency, while you might have expenses in another. Expatriates working in Thailand will receive their salaries in Thai Baht as this is required by law. On the other hand, pension contributions might be paid in Euro. It is also possible that your basic salary is based on an international employment contract and is denominated in a different currency, for example the Euro. This would apply to many Dutch expatriates for whom the basic and expatriate allowances are dominated in Euro, but paid in Thai Baht in accordance with the law.

Example

In the table below, we illustrate what the currency effect is on net savings.

An individual is employed by an international company and his contract salary is denominated in Euro. As per Thai law, the salary is paid in Thai Baht in Thailand as the person is living in Thailand. The salary is fixed at € 4,000.- per month and the expenses are fixed at THB 147,000.- per month. The person has defined his personal functional currency as the

Euro. The Thai Baht has appreciated from THB 49 to the Euro in January 2009 to THB 40 to the Euro in August 2010 and this has the following effect on the net savings:

	January 2009			August 2010		
	Euro	X-rate	THB	Euro	X-rate	THB
Net-Salary	4,000	49	196,000	4,000	40	160,000
Expenses			(147,000)			(147,000)
Net savings	1,000	49	49,000	325	40	13,000

The above table shows that the person had net savings of € 1,000.- in January 2009 while in August 2010 the net saving dropped to € 325.-, due to the appreciation of the Thai Baht against the Euro.

The individual would have been better protected by agreeing with his employer that his personal functional currency is the Euro and that his Thai Baht based salary should protect/cover both his personal savings of Euro 1,000.- and his expenses of Thai Baht 147,000.-. If this would have been included in his contract, the appreciation of the Thai Baht would have had the following effect:

	January 2009			August 2010		
	Euro	X-rate	THB	Euro	X-rate	THB
Salary basic			147,000			147,000
Salary for Net Saving	1,000	49	49,000	1,000	40	40,000
Total salary payment			196,000			187,000
Expenses			(147,000)			(147,000)
Net savings	1,000	49	49,000	1,000	40	40,000

By agreeing with the employer that there will be a Thai Baht salary element for covering expenses in Thai Baht and a Euro salary element for net savings in Euro, the person would have created a natural hedge and by doing so, would have kept his

net saving in Euro the same, despite the currency fluctuations.

Long term residents

The above example deals with the situation of an expatriate who will stay in Thailand for a few years and will move on afterwards. The difference between short-term expatriates and long-term residents in terms of currency fluctuation protection is the difference in choice of their personal functional currency. A long term resident might opt for setting his personal functional currency to be Thai Baht, as his future spending will be in Thai Baht. Applying the Thai Baht as the personal currency in the above example would result in the employment contract being completely in Thai Baht. This would have the following effect:

	January 2009			August 2010		
	Euro	X-rate	THB	Euro	X-rate	THB
Net-Salary			196,000			196,000
Expenses			(147,000)			(147,000)
Net savings			49,000			49,000

The long-term resident will have both his salary and net saving in Thai baht. His employment contract will be denominated in Thai Baht. By doing so he has created a natural hedge between his income and both current and future expenses. Due to the natural hedge he is protected against currency fluctuations.

Conclusion

Protecting yourself against currency fluctuations requires a closer look at your own personal finances, your personal situation and your wishes for the future. It is vital, when seeking to protect yourself against currency fluctuation, to determine your own personal functional currency based on a clear analysis of your own income and expenses in the different currencies. Based on this, it should be possible to create and structure a natural hedge for your incoming and outgoing cash flows. The natural hedge is the key to protecting yourself against currency fluctuations.

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