

Onshore and offshore markets diverging

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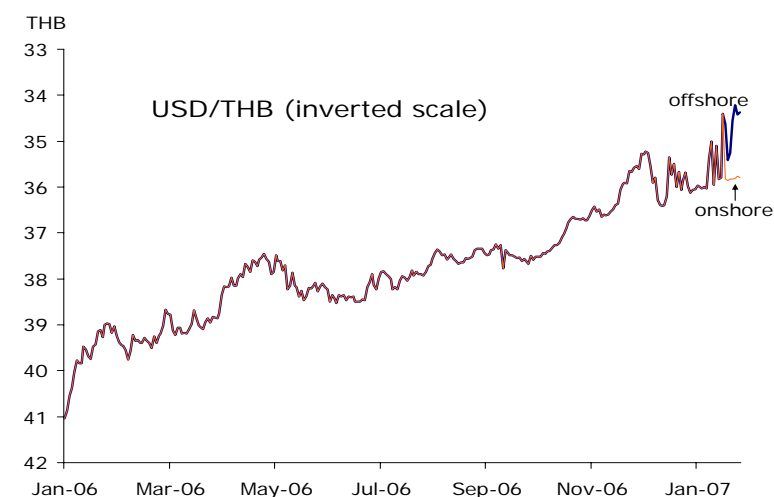
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The imposition of capital controls on 19 December 2006 and subsequent fine-tuning of restrictions has brought about a recent and marked divergence between the onshore traded value of the Thai baht and the offshore value.

Marked divergence between offshore and onshore USD/THB rate



Source: Bloomberg

Prior to the controls, the onshore and offshore markets were in sync reflecting the full convertibility of the THB and the active participation of most banks in the onshore market. In late January 2007, in a further attempt to stem speculation by foreign investors on the baht, the central bank banned Thai banks from executing offshore forward currency contracts with foreign entities. This has effectively created a two-tiered market for the baht and “shut down” the offshore market. Opportunities to arbitrage between these markets are further limited due to the withholding tax that was introduced in the December capital controls. This restriction requires foreigners bringing in non-trade-related funds to deposit 30% of these funds with the central bank for one-year, with only two thirds returned to the foreigner if funds are withdrawn early – an effective 10% withholding tax.

Volatility expected to stay high with capital controls in place



Source: Bloomberg

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Since February 2007, the offshore THB has been decidedly stronger, trading between USD/THB34.0-35.0 while the onshore THB has moved within USD/THB35.0-36.0. The stronger THB in the offshore market largely reflects a thin market, with most THB held and traded onshore. The latest restriction is also exacerbating the already-increased volatility in the THB in both the onshore and offshore markets. Over the past week, the gap between the onshore and offshore price has been around 1.2 pips or 3½%. This wedge is likely to persist as long as capital controls remain in place. Consequently, uncertainty in the evolution of the offshore market will keep volatility high.

The central bank has gone to extensive lengths to curb speculation on the Thai baht. While it is expected to relax its stance on capital controls over time, reducing speculative activity will remain its key focus. In a recent move, the central bank lifted the 30% reserve requirement on same company foreign currency loans provided that the loan is fully hedged for at least a year.

Overall, central bank measures have not prompted us to change our forecast for a stronger THB in the first half of the year. We continue to expect that continued solid global economic conditions and buoyant liquidity will drive strong currency appreciation across Asia. Nevertheless, our THB forecast would have been stronger if not for the recent legislation which has led to investor confusion and has clouded the business environment. Moreover, we do expect that in the second half of 2007 rising political concerns caused by distractions ahead of elections and an uncertain post-transition period will start to weigh on the currency. The military has indicated that elections will be held before end-2007.

Our base case scenario then is for some further appreciation of the baht over the next few months before a softening in the second half of 2007, largely reflecting uncertainty in the run-up to the elections. The onshore USD/THB is expected to head towards 32.50 before a move towards 36.00 by the end of 2007. While these are our core forecasts, we warn readers that considerable volatility around these point-estimates will continue in the current uncertain environment. As mentioned above, the gap between onshore and offshore rates is likely to persist as long as capital controls remain in place.

Thailand : macroeconomic and currency forecasts

	2005	2006e	2007f	2008f
Real GDP growth (% ch)	4.4	4.9	5.0	6.1
Inflation (% , yr avg)	4.5	4.7	3.5	3.0
Fiscal Bal (% GDP)	0.1	-0.8	-2.0	-1.0
Current acc. (% GDP)	-2.1	1.9	0.2	-1.6
FX reserves (US\$ bn)	50.5	65.1	70	75
Policy rate* (% pa, end-period)	4.0	5.0	4.0	4.0
Currency Forecasts (end-period)	Dec 06	Mar 07	Jun 07	Dec 07
USD/THB ⁺	35.73	32.50	34.00	36.00
AUD/THB	28.21	25.03	25.84	26.28

*: Prior to Jan 2007; 14-day repurchase rate. Currently, 1-day repurchase rate
+: onshore rates

Source: Economics@ANZ

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