The fallout from Thailand's capital controls

Short-term selling likely to continue, though medium term contagion risk seems slight

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The financial markets have reacted strongly to Monday's announcement of the imposition of capital controls in Thailand. The baht has sold off by more than 2% and the local equity market is down by 16%. The negative market reaction has already prompted a response from the central bank which, overnight, softened controls by exempting equity investments from the new measures.

The actions of the Bank of Thailand are likely to weigh on the Asian financial markets in the near term, for several reasons:

- Fund managers who have lost money in Thailand over the past 24 hours may sell down other Asia positions to raise returns before reporting year-end results;
- Liquidity in the Thai and Asian market may decline as many brokerage houses and banks have suspended trading baht pending clarification of the new rules and regulations;
- Market participants may become wary of the potential for other central banks in Asia to follow suit with capital-restricting measures given the strong rally in Asian financial markets over the past six months; and
- The fact that Thailand kicked off the 1997 Asian crisis in a similar environment of high global liquidity has raised the spectre of a repeat of history in some observers' minds.

We believe the above concerns will prove transitory, and will not affect the Asian markets in 2007 for the following reasons:

- Although there have been clear market losses in Thailand over the past 24 hours, the Thai equity market is now flat for the year and the baht is 12% stronger than it was as of 1 January 2006. Even the baht's gains since the May 2006 sell off have not been fully erased. Thus the "contagion" that might emanate from a forced sell-down of other positions should be rather limited at this stage.
- Liquidity may well decline in the Asian markets and will definitely remain low in the baht in the coming days. This should be a short-term phenomenon for Asia ex-Thailand, however.
- While other central banks have intervened in the FX markets in recent weeks and adopted limited measures to stem currency appreciation, the sell-off in the Thai equity market today is likely to discourage, not encourage, other central banks to take similar action. The Thai stock exchange has already asked BOT to review its new regulations.
- Even if Asian financial markets do sell off significantly in the coming days and weeks, the potential for such a sell-off to represent a significant shock to the real economy is far more limited now than it was in 1996. Nearly all emerging Asian economies are now running significant current account surpluses, so a narrowing of the capital account surplus need not affect trade. Second, in a world of floating (if managed) exchange rates, a sell-off would cause sought-after currency weakness. Finally, the bulk of short-term capital inflows are now into the equity markets and not into commercial bank debt, as was the case in 1997. Thus, the systemic shock suffered by the banking system in Asia in 1997 is unlikely to be repeated in this environment.

Further discussion of Monday's announcement and our view of the expected impact on Thailand's economy is detailed in the note that follows.

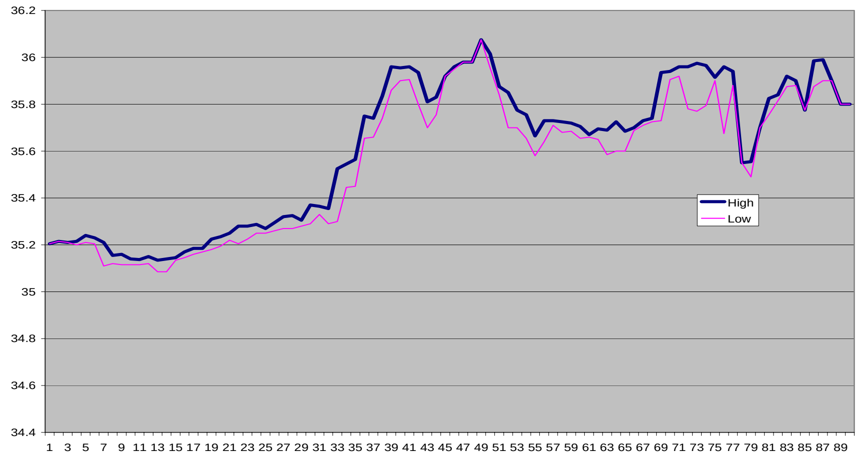
A big surprise...

On Monday, the Bank of Thailand announced new measures aimed at reducing short-term capital inflows and curbing the appreciation of the Thai baht. Financial institutions are required to withhold, for a period of 1 year, 30% of baht purchases of more than US$20,000 except those related to trade in goods and services or repatriation of investments abroad by residents. Foreign direct investments would initially be subject to the new requirement, but a refund would be made following the examination of evidence of legitimacy. Foreign exchange transactions traded before 19 December will be exempt from the reserve requirement. *Please see attached communiqué obtained from the Bank of Thailand website for details.* Overnight, however, in response to heavy selling of local equities, the central bank relaxed its stance, exempting stockmarket purchases from controls. The THB recovered some of its losses after the rules were slackened, moving to USD/THB35.08, but it is now trading lower again at USD/THB35.90. The stock market may recover some of yesterday's losses today.

Thailand's equity market has risen by 21% since its mid-2006 trough, with substantial foreign participation. The Thai baht has appreciated by 7.3% over the same period, making it the third-best performing currency after the Turkish lira and NZ dollar. In its communiqué, the BOT stated that the intention of the latest measures is to stem short-term capital inflows and reduce pressures on the baht to appreciate.

This week's announcement followed a string of other announcements dating back to April 2006 that have all been aimed at stemming net capital inflows and currency appreciation. These included raising the amount that mutual funds, insurance firms and other institutions can invest abroad as well as requesting banks and stock brokerages not to sell baht bills of exchange to non-residents. While these measures have assisted in stemming the pace of baht appreciation, strong capital inflows into Asia have continued to put upward pressure on the currency. Interestingly, the Thai equity market rally has not matched that of some of its regional neighbours, such as Indonesia (+34% since mid-06).

USD/THB movement in response to the BOT announcement



**: x-axis refers to 20-min intraday data from 18 December*

...but economic impact likely to be limited

The equity market sell-off is likely to continue, at least in the short term. Although the BOT has made it clear that the new restrictions are on inflows, and not outflows, foreign investors are likely to judge repatriation risk as having risen in this environment. Moreover, domestic equity investors may sell down shares on the likelihood that discouraging foreign portfolio equity investment lowers the possibility for capital gains in the near and medium term.

Whether the announced measures will have a great impact on the baht is less clear. The baht may be somewhat weak in the coming days, but if regional currencies continue to appreciate, it will be difficult for the baht to move in the opposite direction. The baht NDF market may become more active given the significant disincentives to trade the currency onshore.

Overall, we believe that the economic impact from today's measures will be more related to the equity market sell-off and potential decline in foreign investment into Thailand than any currency weakness. Our projections are for the Thai economy to expand at a steady pace of 4.5% in 2007 from 4.2% in 2006. However, should the current policy measures result in administrative delays in investment-related financial transactions, this could impede the pace of foreign investment inflow and undermine medium-term growth prospects especially as the capacity to expand public sector investment is limited by the transitional nature of the current government. Inflation edged up slightly in November to 3.5% YOY but remains below the highs reached in late 2005 and early this year. The Bank of Thailand's key policy rate has been steady at 5% since June 2006 and we expect some easing towards the second half of 2007, in line with a cut in the US Fed funds rate in the second half. A rate cut could come sooner if fuel costs are restrained and the economy slows more sharply, but this is not our base case scenario. Alternatively, the central bank may signal a more accommodative stance sooner to induce a less favourable interest rate differential and hence relieve upward pressure on the baht.

Exporters have been able to withstand the impact of the strong appreciation of the baht with exports having grown at a solid pace of 17% YOY in the first ten months of this year, contributing to a return to a trade surplus of almost US$500 mn compared with a deficit of US$7.3 bn in January-October 2005. Indeed, Thailand's very strong trade position begs the question of why the BOT continually points to the appreciation of the baht as a significant economic issue. The current account has similarly moved into surplus from a deficit of 2.1% of GDP last year. Foreign exchange reserves have climbed steadily and are equivalent to around 5 months of imports.

Economic forecasts

	2005	2006f	2007f
Real GDP growth (%)	4.6	4.2	4.5
Inflation (yr avg, %)	4.6	4.5	3.5
Interest Rate (policy rate, %	4.0	5.0	4.0
Exchange rate (eop)			
THB per USD	41.06	35.50	36.00
THB per AUD	30.11	27.69	26.28

Source: Economics@ANZ

Capital controls have plenty of precedent

While this week's announcement in Thailand was an unwelcome development for the financial markets, capital controls have a long history in Asia. The measures usually result from an increase in perceived short-term – and therefore "speculative" – investment. Capital controls in their modern form were first introduced during World War I as a tax to finance expenditure. Controls reappeared with the Great Depression to stem capital flight as countries pursued expansionary fiscal and monetary policies. The post-WWII Bretton Woods era featured capital controls across many countries, given the predominance of fixed exchange rates. It was only with the breakdown of the gold standard in the 1970s that capital controls in the G7 were eliminated.[1]

In the post-Bretton Woods era, capital controls gained relevance for countries in which central banks targeted both low inflation and a stable exchange rate, and thus were therefore mostly seen in developing economies with fixed or managed exchange rates. Capital controls can also help to protect monetary and financial market stability when there are very large net inflows or outflows that may overwhelm domestic financial institutions. Finally, effective capital account regulation can allow the authorities to maintain a "wedge" between domestic and foreign interest rates to promote investment and growth.[2]

Among countries that have implemented capital controls over the past two decades, roughly three groupings can be made. The first is countries that

[1] Neely, "An Introduction to Capital Controls," St Louis Federal Reserve

[2] " Capital Controls: Country Experiences with Their Use and Liberalisation", IMF, May 2000, http://www.imf.org/external/pubs/ft/op/op190/index.htm

introduced capital controls in an effort to reduce capital inflows. The second is countries that brought in capital controls to reduce or control outflows. The final category is countries that feature capital controls as part of a broader array of controls over the economy and economic activity. Thailand first imposed capital controls in 1995-97 to limit inflows prior to the Asian crisis, and subsequently in 1997-1998 to control outflows.

Classification of countries' capital controls

Control inflows	Control outflows	Part of framework of control
Brazil (93-97)	Malaysia (98-06)	China
Chile (91-98)	Romania (96)	India
Colombia (93-98)	Russia (98-99)	Vietnam
Malaysia (94)	Spain (92)	
Thailand (95-97)	Thailand (97-98)	
	Venezuela (94-96)	

The rationale for greater control over capital inflow among the countries listed above varied to some extent, but was generally centred on two themes:

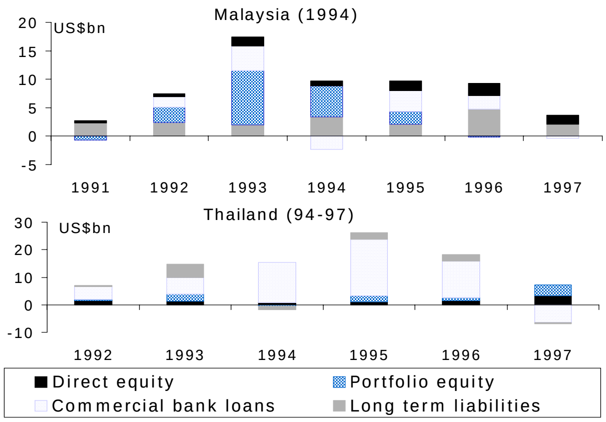
- A desire to limit the inflationary impact of significant capital inflows, where inflows mostly resulted from improved investor confidence following economic reform (Chile, Brazil, Colombia); and/or
- A concern to limit the influx of potentially short-term, "speculative" inflows in light of the connected medium-term risk of a potential rapid outflow (Colombia, Thailand, Malaysia).

Little evidence that capital controls actually work

A number of studies have been conducted on the effectiveness of capital controls, but the studies are inconclusive. The weight of evidence seems to suggest that the controls may provide a limited short-term benefit while possibly exacting a longer-term cost.

Looking in detail at capital flows data for the above 5 listed countries in the period before and after controls on capital inflows were imposed, some trends can be observed (though capital controls are not assumed to be the cause). Across all five countries, net capital inflows fell in the short-term after controls were adopted, but rose in the medium term. Second, the response of FDI to new regulation is uneven. Finally, there does not seem to have been a substantial reduction in short-term capital inflows in the medium term. However, there does seem to be a shift in the composition of short-term flows away from equity investment and toward commercial bank debt.

Net private capital flows after capital account regulation in SE Asia



Source: Institute for International Finance

As the charts above show, the introduction of capital controls in Malaysia in 1994 appears to have reduced portfolio equity investment, but this was replaced by commercial bank loans in 1995; FDI also declined in that year though it increased again in 1996. The imposition of capital controls in Thailand in 1994 seems to have shut down portfolio investment in equities, but capital inflows became heavily skewed toward commercial bank debt.

This is not 1997 "deja-vu all over again"

While it may be tempting to draw hasty conclusions from the fact that Thailand and Malaysia imposed controls on capital inflows in the year before the Asian financial crisis, it is important to recognise that Asia is in far different position now than in 1996. Most obviously, nearly every East Asian economy now has a substantial balance of payments surplus, including in the current account. As such, emerging Asia is in a net creditor position. A reduction in the capital account surplus to Thailand or any other developing Asian economy may cause the current account surplus to adjust upward further, but would not result in the severe balance of payments crisis such that was experienced in 1997.

Current account balance (% GDP)

	2004	2005	2006f	2007f
Australia	-6.2	-6.0	-5.0	-5.1
Cambodia	-10.1	-10.9	-10.6	-10.3
China	4.0	6.7	4.4	4.0
Hong Kong	9.5	9.3	5.6	2.1
India+	-0.1	-2.1	-2.5	-2.5
Indonesia	1.3	0.9	1.4	0.7
Japan	3.8	3.9	4.0	3.5
Korea	4.1	2.4	1.7	1.2
Malaysia	12.5	15.0	11.3	9.8
New Zealand	-6.6	-9.0	-9.8	-9.8
Philippines	2.6	2.4	5.0	4.3
Singapore	26.1	28.5	25.0	22.0
Taiwan	5.8	3.4	3.1	2.5
Thailand	4.1	-2.1	1.0	1.0
Vietnam	-2.0	0.9	1.5	1.7

Risk for similar measures elsewhere in Asia

That does not mean, however, that 2007 will be an easy year. We expect continued upward pressure on emerging Asian currencies along with continued asset price inflation across equities and property (see *International Economics Monthly: 2007 Outlook dated 15 December 2006).* This will test the faith of Asia's central banks in floating FX rates and inflation targeting. Thus, perhaps the greatest "contagion" risk from events in Thailand is that other central banks would impose taxes or other costs on short-term capital flows. The below table shows the countries that have experienced the greatest currency appreciation in the second half of this year. For 2006 as a whole, Korea and Indonesia are also at the top of the league table.

Asia's biggest movers

	Gains v USD since 1 Jan	Gains v USD since 23 Jun
NZD	1.3	13.5
THB	13.1	7.2
PHP	5.9	6.6
SGD	6.9	3.3
MYR	5.7	3.2

The view of other central banks on capital controls will be significantly affected by Thailand's experience in the coming weeks. If the measures are viewed as successful, others may well follow suit. If the Thai equity market suffers while the currency does not, as is our expectation, we believe other central banks will shy away from similarly extreme measures.

Appendix

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The Reserve Requirement on Short-Term Capital Inflows

Dr. Tarisa Watanagase, Governor of the Bank of Thailand (BOT), announced that despite recent measures aiming at discouraging short-term capital inflows and limiting Thai baht speculation, short-term speculative inflows of various forms continue to persist, as evidenced by the volatility of the Thai baht and its rapid pace of appreciation.

The BOT, therefore, decided to implement an unremunerated reserve requirement on short-term capital inflows. Financial institutions are required to withhold 30 percent of foreign currencies bought or exchanged against the Thai baht, except those related to trades in goods and services, or repatriation of investments abroad by residents. The details of the measure and related operational procedures are summarized as follows:

1. After one year, customers whose foreign currencies have been withheld can request for refunds by submitting related evidence to prove that the funds have been in Thailand for at least one year.

2. Once financial institutions have examined and certified the one-year minimum stay period, they shall inform the BOT to return the funds, through them, to their customers.

3. Should any customers wish to repatriate their funds earlier than one year, they would be refunded only two-thirds of the amount.

4. Foreign exchange transactions which have been traded prior to 19 December 2006 are exempt from this reserve requirement.

5. Foreign direct investments or unrequited transfers would initially be subject to the reserve requirement but shall be refunded upon submission of supporting evidence through financial institutions. Once financial institutions have examined and certified the legitimacy of such claims and the BOT deems it appropriate, the BOT shall promptly return the full amount.

6. Financial institutions shall remit the required reserves, in the form of foreign currencies, to the BOT on the 7th of the subsequent month.

7. The earnings received from this measure would be earmarked for public benefits.

In order to regulate foreign short-term capital inflows, several countries have imposed reserve requirements on such inflows during critical times. The BOT views that the present situation warrants the introduction of such measure to prevent speculative pressure on the Thai baht. The BOT will closely monitor and assess the impact of this measure.

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