The Vice-Grip of Finance

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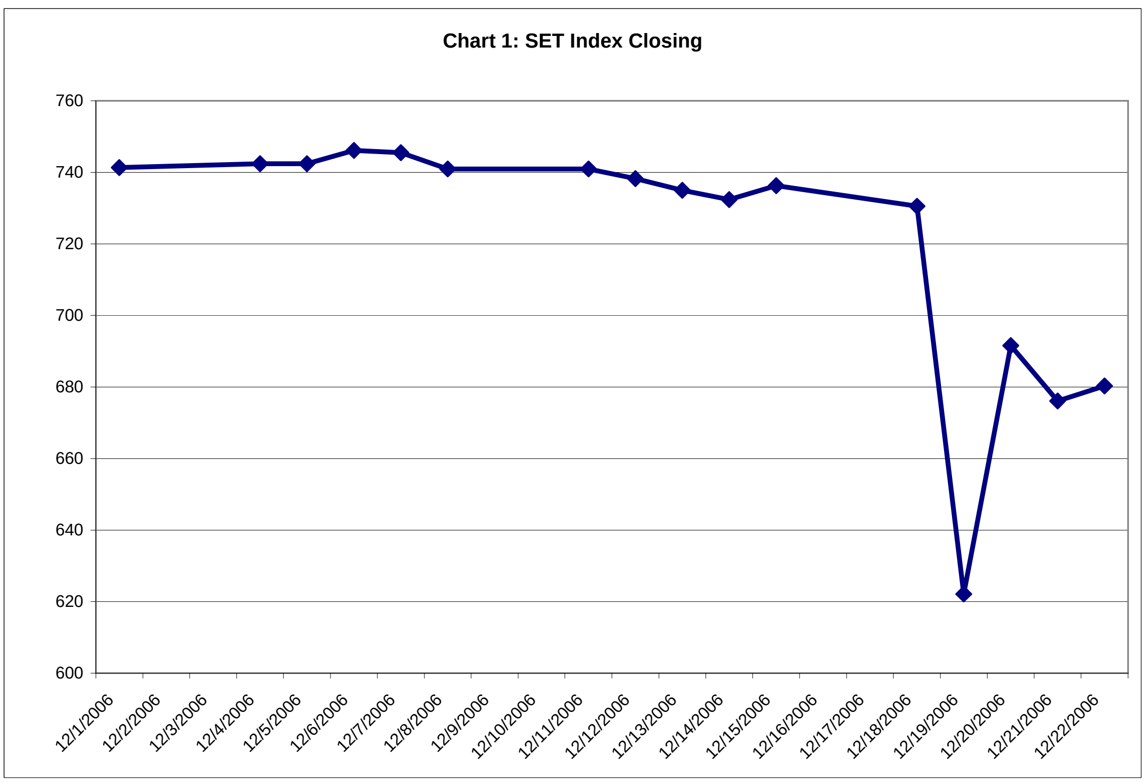
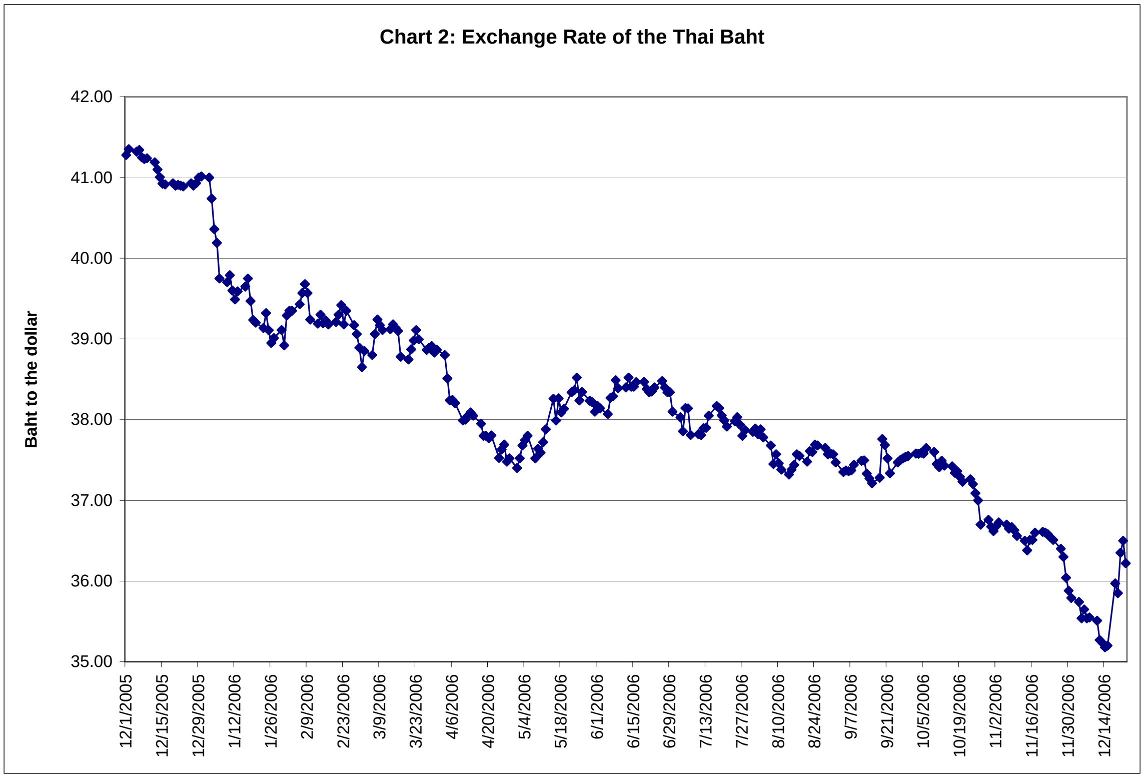
On December 19th a bunch of foreign investors dumped their holdings in the Thai stock market, triggering a collapse of the stock exchange of Thailand (SET) index (Chart 1). The SET index fell 15 per cent in a single day, losing much of the gains it had registered over the previous year.

These investors chose to exit in large numbers in response to controls on cross-border capital inflows imposed by the government in a bid to reverse a runaway appreciation of the Thai baht. The exchange rate, which stood at 41.28 baht to the dollar at the beginning of December last year, has been on a near-consistent climb since then, to touch a 9-year high of 35.18 at the middle of December 2006 (Chart 2). The reason for this appreciation was a surge in capital inflows into equity securities over the last two years (Chart 3), with gross inflows amounting to between $8 and $12 billion per quarter. Flows of this magnitude were not needed to finance Thailand's balance of payments, which recorded small current account surpluses or small deficits in the most recent quarters.

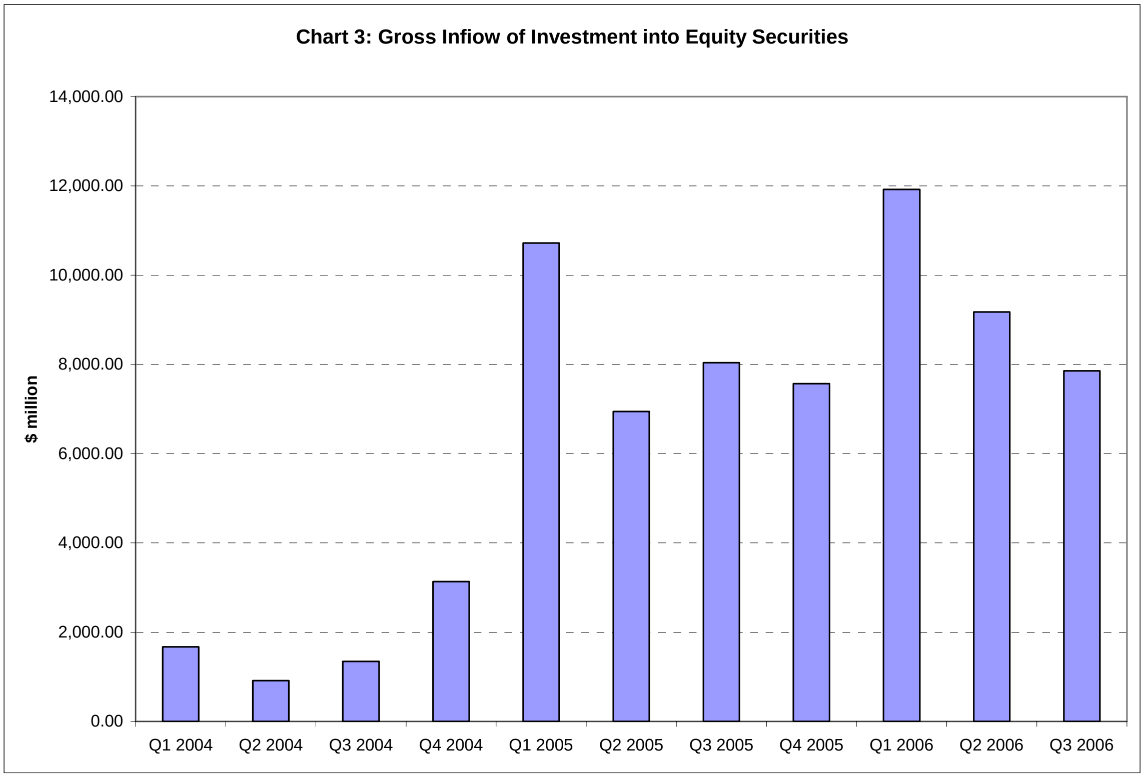




The problem is, of course, that Thailand now has a floating exchange rate, so that any excess supply of dollars results in an appreciation of the currency. Exchange rate management in such situations involves intervention by the central bank to acquire foreign currency and reduce the pressure on the local currency. Clearly, the Bank of Thailand has resorted to this instrument in large measure. As a result, Thailand's international reserves rose by more than $ 11 billion (starting from around $53 billion) in the first 11 months of 2006 (Chart 4).

The dangers of piling up reserves to stabilize the currency are well known. It results in an excessive accumulation of foreign exchange assets with the central bank reducing its control over money supply. Further, it can never completely prevent appreciation. Foreign investors, skeptical of the ability of the central bank to keep the currency down, would make speculative investments to benefit from an appreciation of the currency: convert dollars into baht and make an investment; as and when you choose to exit you not merely record capital gains because of stock value appreciation, but in dollar terms benefit even more when you convert your baht receipts back into dollars, because of appreciation of the baht. As more and more investors troop in to capture these benefits, both the market and the baht appreciate, fuelling further speculative investments.

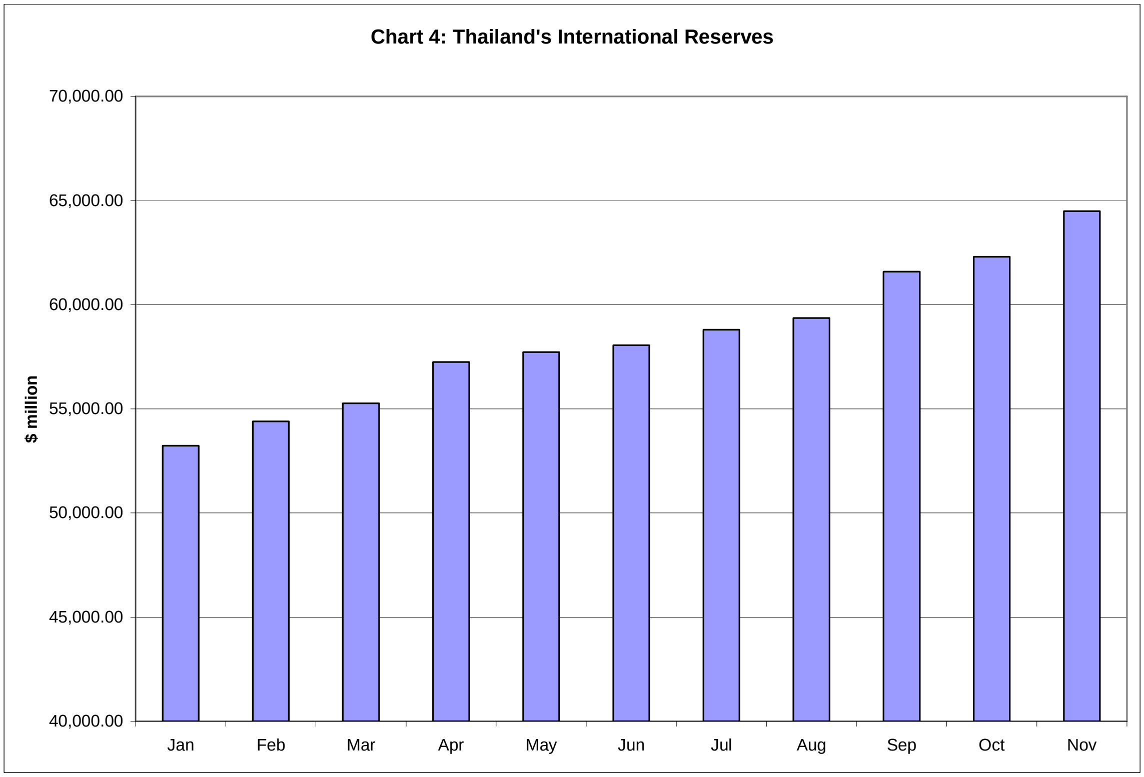
Speaking on radio immediately after the imposition of capital controls, Bank of Thailand Governor Tarisa Watanagase reported that returns on investments in Thailand were around 20 per cent, of which just 5 per cent came from capital gains, whereas 15 per cent came from gains from baht appreciation. The speculation this had triggered had meant that speculative capital inflows had risen to US$950 million per week in December from $300 million in November.



Even though the Bank of Thailand relaxed conditions for residents to transfer money abroad to ease pressure on the baht, the currency appreciated quite sharply as revealed in Chart 2. Fearing that this would hurt exporters adversely, the government and the central bank decided to slow the infow of capital. Implicit in their action was the view that any value of the baht below 35 to the dollar was unacceptable. "We didn't want it to break through that," finance minister Pridiyathorn Devakula reportedly told Reuters. "If you break 35, you see 34, you can also see 33 and 32."

The danger from such appreciation is a loss of export competitiveness. Thai exporters feel threatened by exports from China in particular, where despite small adjustments, the RMB has been kept closely tagged to the dollar. Because of the renminbi's partial peg vis-à-vis the dollar, the Thai baht for example has appreciated by 12 per cent against the former currency.

To prevent the baht from breaking through the 35-to-the-dollar floor, the central bank crafted a cautious set of market-based measures aimed at preventing short-term inflows from investors planning to hold their investments for less than a year in search of speculative returns. The measure amounted to imposing a reserve requirement on all *incremental, short-term* capital flows. As per the policy announced on December 19, 2006, financial institutions were required to withhold (as a no interest deposit) for a year, 30 per cent of foreign currencies bought or exchanged against the baht, except those related to trade in goods and services, or repatriation of investments abroad by residents. After a year, investors can request and obtain a refund of the reserve after submitting evidence of having held their investments for a year. Should an investor wish to sell out and repatriate funds earlier than one year, s/he will be refunded only two-thirds of the amount brought in. What is important to note is that foreign exchange transactions that had occurred prior to December 19, 2006 were exempt from this reserve requirement.



Foreign direct investments or unrequited transfers too were obviously exempt. But this is an area where implementation is complex. Thus, such flows would initially be subject to the reserve requirement but shall be refunded once financial institutions have examined and certified the legitimacy of evidence that they fall in the category of FDI.

Clearly, the Bank of Thailand was operating with the expectation that these measures would have no major impact on past investments, while simultaneously limiting purely speculative short-term investments in future. Its expectations were possibly principally based on three grounds. First, there was no quantitative control on the amount of flows, but merely intervention to reduce the returns on speculative short term flows. Such reserve requirement measures—identified as market-based capital controls—had been experimented within other contexts such as Chile, in the past. Second, the penalty being imposed even on speculative flows was small. Tarisa Watanagase reportedly estimates that investors' profits would be trimmed by around 1.5 per cent as a result of the introduction of the reserve measure, which was a small part of the 20 per cent return they were making. Finally, the Bank of Thailand seems to have expected that the measure would bother only new investors, since it was not applicable to transactions completed before December 19, 2006.

In practice, however, there was not just a sharp cutback in incremental investments but a sellout by existing investors. Once we accept that a substantial share of the recent surge in capital inflows was speculative, then the panic exit was to be expected. Speculative investments are made not on the basis of where the value of a stock index or the value of a currency rests, but expectations of where they are headed. The latter expectations, with regard to the direction and extent of future movements, are in turn based on presumptions of how much new liquidity would come into the market. Thus, if controls are placed on new, incremental investment, this does not mean that investors who came in earlier would not respond. Since their investments were made on expectations of future capital inflows, they are bound to adjust their portfolios in the new environment. That is what triggered the exit of investors and the collapse of the market.

This obviously suggests that countries that have been operating with a relatively open capital account and have accumulated a stock of portfolio investment cannot plan capital control measures directed purely at new inflows. If such measures have to be successful they have to place restrictions on outflows as well. In Thailand’s case the failure to do this resulted in an outflow, a collapse of the market and a decision of the central bank to “partially” relax the reserve requirement rule by exempting equity investments from its ambit and promising to do the same for property purchases. However, much as the government and the central bank may protest, this retreat amounts to an almost complete withdrawal of the measures since most of the speculative flows came into these two areas. In sum, the effort to stem the appreciation of the baht has been aborted, leaving the problem unresolved. The only source of hope is that there has been a temporary reversal of baht appreciation. But if capital flows revive, this would be halted.

Clearly Thailand’s rulers are still concerned about the baht. Prime Minister Surayud Chulanont is reported to have said he fully supported the Bank of Thailand's “measures aimed at limiting speculation on the baht as well as its softening of those steps. The policy isn't flip-flopping," he is reported having told the media. "There has been no change in policy. The policy is clear that we don't want to see the baht rise too much, as it would affect the overall economy."

If there is consensus on the policy but it cannot be implemented, the signs are clearly of a loss of policy sovereignty. Thailand, like other developing countries that have liberalised their capital accounts to differing degrees, is finding it difficult to even marginally reverse the extent of liberalization even though the evidence clearly shows that the economy is now being held to ransom by speculators.

The problem, however, is that this is not just a Thai problem, but one faced by most emerging markets, especially those in Asia. The recent increase in liquidity in the international financial system as a result of the high prices and large surpluses that were garnered by oil exporters has, among other things, increased the volume of capital in search of high returns. According to the Financial Times, Emerging Portfolio Research of Boston has estimated that flows to emerging markets have reached $20.8 billion over the year to December, which is an all time record. About $1.65 billion of that money is reported to have entered developing countries in the week ending December 15 alone. This is bound to spur currency appreciation and undermine export competitiveness in other contexts as well. While the US with its gaping trade and current account deficits may see this as a way of partially increasing its exports and reducing imports to and from these countries, the countries concerned themselves will want to shield themselves from excessive currency appreciation not warranted by fundamentals. The answer then would have to be capital controls. But whether there would be a government which is willing to go further than Thailand did to successfully combat speculation is yet to be seen. Meanwhile, financial investors are notching up profits and huge bonuses, and are reportedly still counting.