The Baht, the Bank, and the Blame

Bhanupong

Lecture 24

Sources of data: Bank of Thailand
Yahoo.finance

Outline

- Capital controls
- Why has the baht gained strength rapidly?
- Should the BOT intervene?
- The benefit of market intervention
- Consequences of the rising international reserves
- The way forward

A Pandora's box.

- On 19 September 2006, there was a coup led by General Sodhi-a military junta.
- **On Monday December 19, 2007, three months after the coup, the BOT introduced wholesale capital controls to rein in baht speculation** to curb fierce speculation against the baht with hot money flowing in from overseas.
- A one-year, 30 per cent withholding Unremunerated Reserve Requirement (URR) on many types of capital inflows was imposed to help maintain the competitiveness of Thai exports by restraining the rising value of the baht.
- *A simple plan can lead to more complicated problems later like opening a Pandora's box.*

The first version

- Under the first version of the URR rules, anyone selling more than $20,000-worth of foreign currency, other than for the purposes of trade, would have had to deposit 30% of it with the central bank—at zero interest—for one year, or forfeit one-third of the deposit.
- **Without an understanding of the capital market, the BoT** certainly had the desired effect on the baht, which dropped around 2% on the following Tuesday.

Black Tuesday

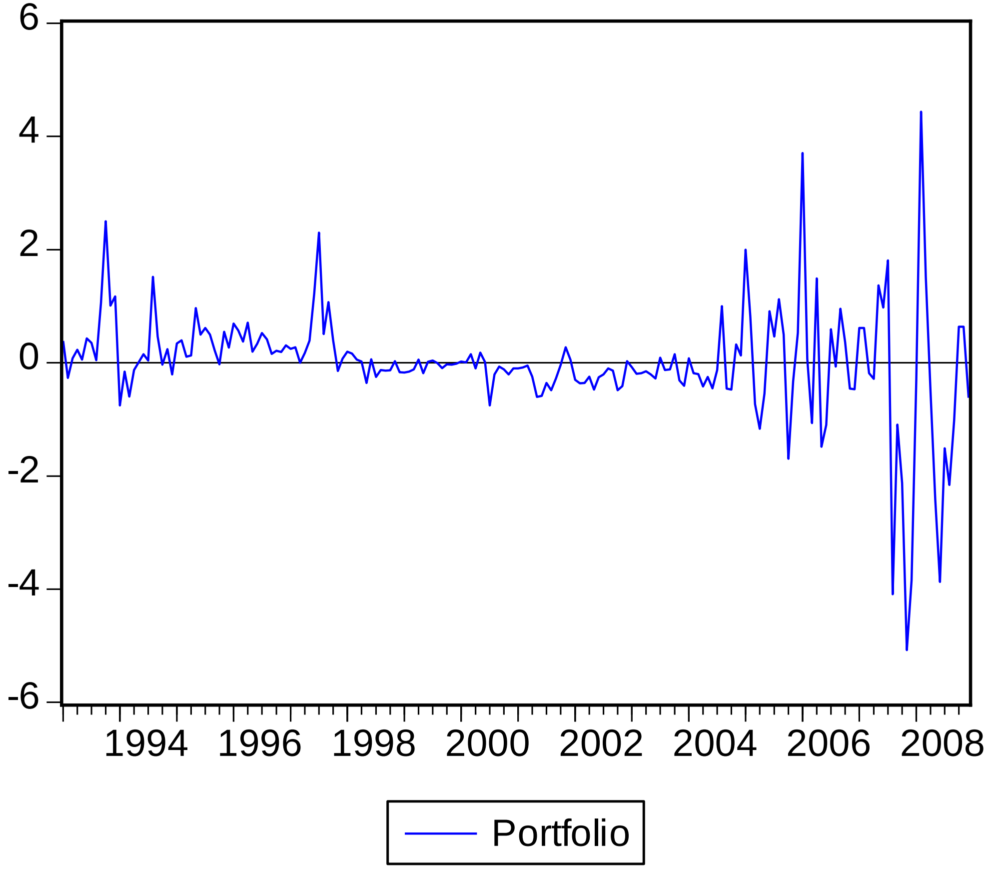
- The stock market crashed the following day - "Black Tuesday" - because of panic selling, as no foreign funds would stay in a country with draconian capital controls.
- Thailand's curbs on currency speculators caused such a slump on its stockmarket, and jitters across Asia, that its authorities have been forced into an embarrassing climbdown.
- Pridiyathorn, Deputy Priminster, quickly halted capital control policy on Tuesday night and admitted record fall of Thai stock market was far beyond expectations.

Bt820-billion blunder

- The Stock Exchange of Thailand recorded the single biggest one-day loss in its history with Bt820 billion in paper wealth lost as the key SET index plunged by 14.8 per cent.
- On Wednesday (Dec 21), Deputy Premier and Finance Minister Pridiyathorn Devakula quickly reversed the government's capital-control policy by exempting the ultra-sensitive stock market from a controversial reserve requirement and tax.
- In a nationally televised announcement, Pridiyathorn admitted foreign investors had been severely hit by the capital reserve and tax measures, resulting in the Thai stock market's free fall.

- Pridiyathorn ***backed off quickly by removing*** the capital controls on ***equity investment*** and leaving only capital controls in the money market in place.
- Although the stock market recovered on Wednesday, the damage to Thailand's credibility was far reaching.
- If Pridiyathorn had failed to back off in time, the stock market would not have had anything left to sell.
- The authorities mismanaged the foreign exchange, causing an unintended stock market crash.

Impact of URR



Theoretical argument

- Monetary authority cannot resist the long-term rend of the exchange rate, which is dictated by the movement of dollar against other leading currencies.
- The massive current account deficit in the US requires either major adjustment in the dollar value or output contraction in the US.
- The Asian currencies eventually must appreciate against the US dollar as it becomes weaker and weaker.

Unconventional measures

- There is no doubt that monetary authority wishes to maintain orderly movement of the baht.
- But the abrupt capital control measure points out to the direction that the Bank of Thailand's wishes to resist the appreciating trend of the baht. This can be done only in the short run—at a very high cost.
- Timing and doses of monetary medicine can be very difficult to administer properly.
- *"Too little and too late" has become "too much and too early"*
- Predictable declining trend of the baht is not the same as the volatility of the exchange rate.
- Volatility of the baht was higher in offshore markets because of its inelastic supply and demand for baht in those markets.

Motivation

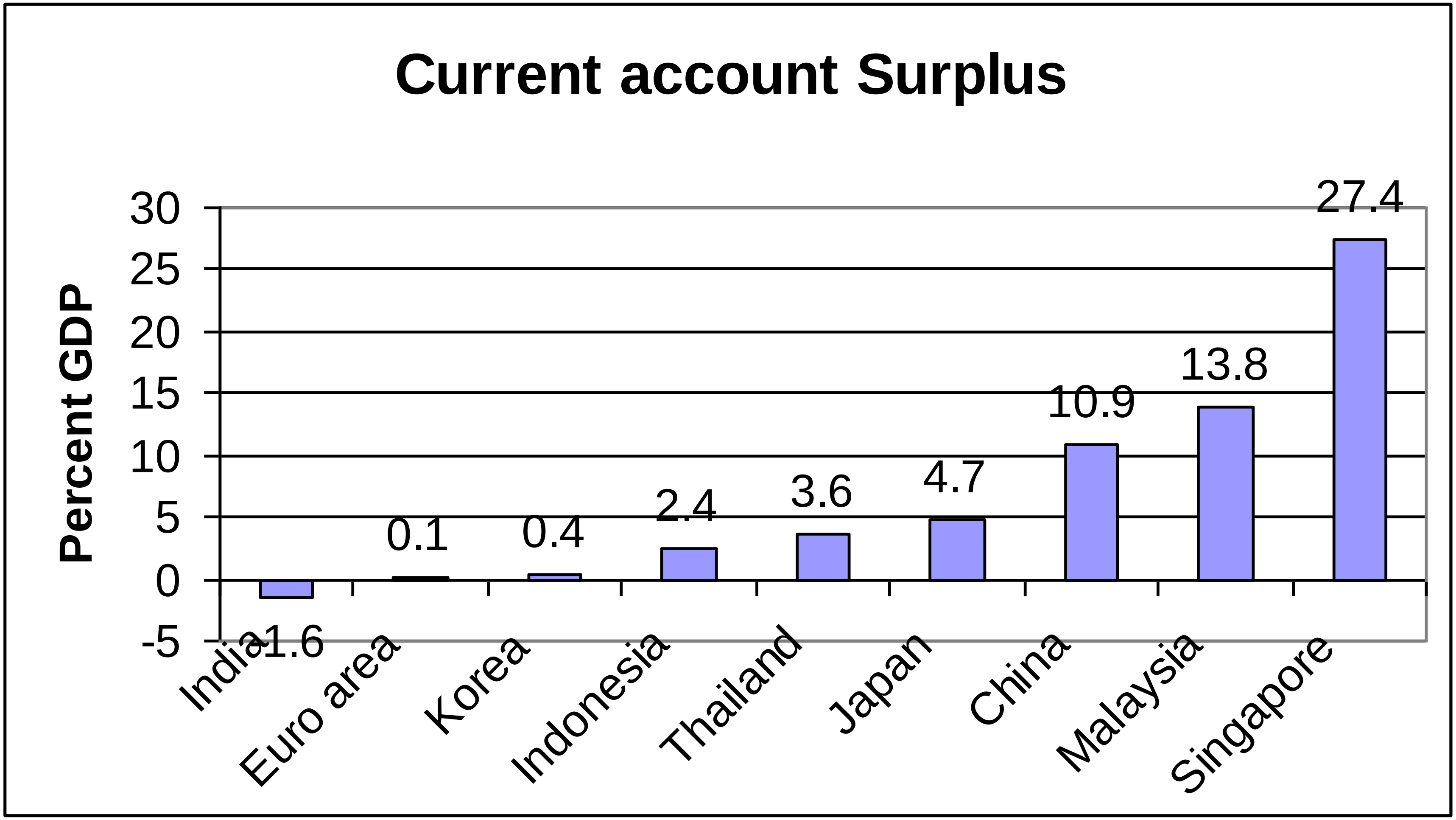
- The argument for the intervention to stop the baht from appreciation is that exports are very important to the Thai economy: 60% of GDP.
- We also have to think about the importance of imports.
- We should look at the net exports!

- The appreciation of the baht is due to three factors:
  (1) Speculative attacks
  (2) Dollar’s weakness against other currencies
  (3) Current and capital account surplus

If the current account is deficit, would there be an appreciation of the baht?

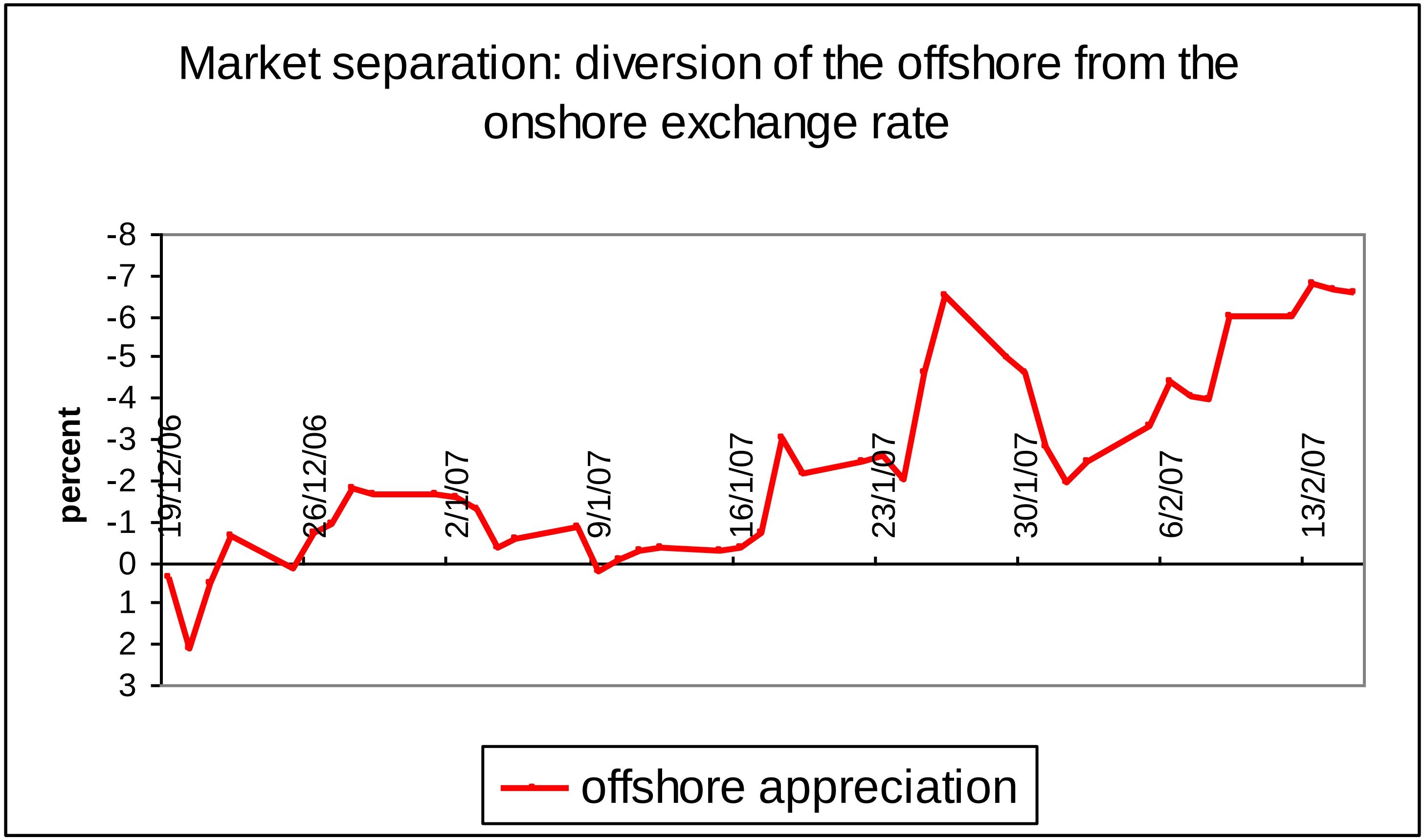
What if the capital account is deficit?

In 2007



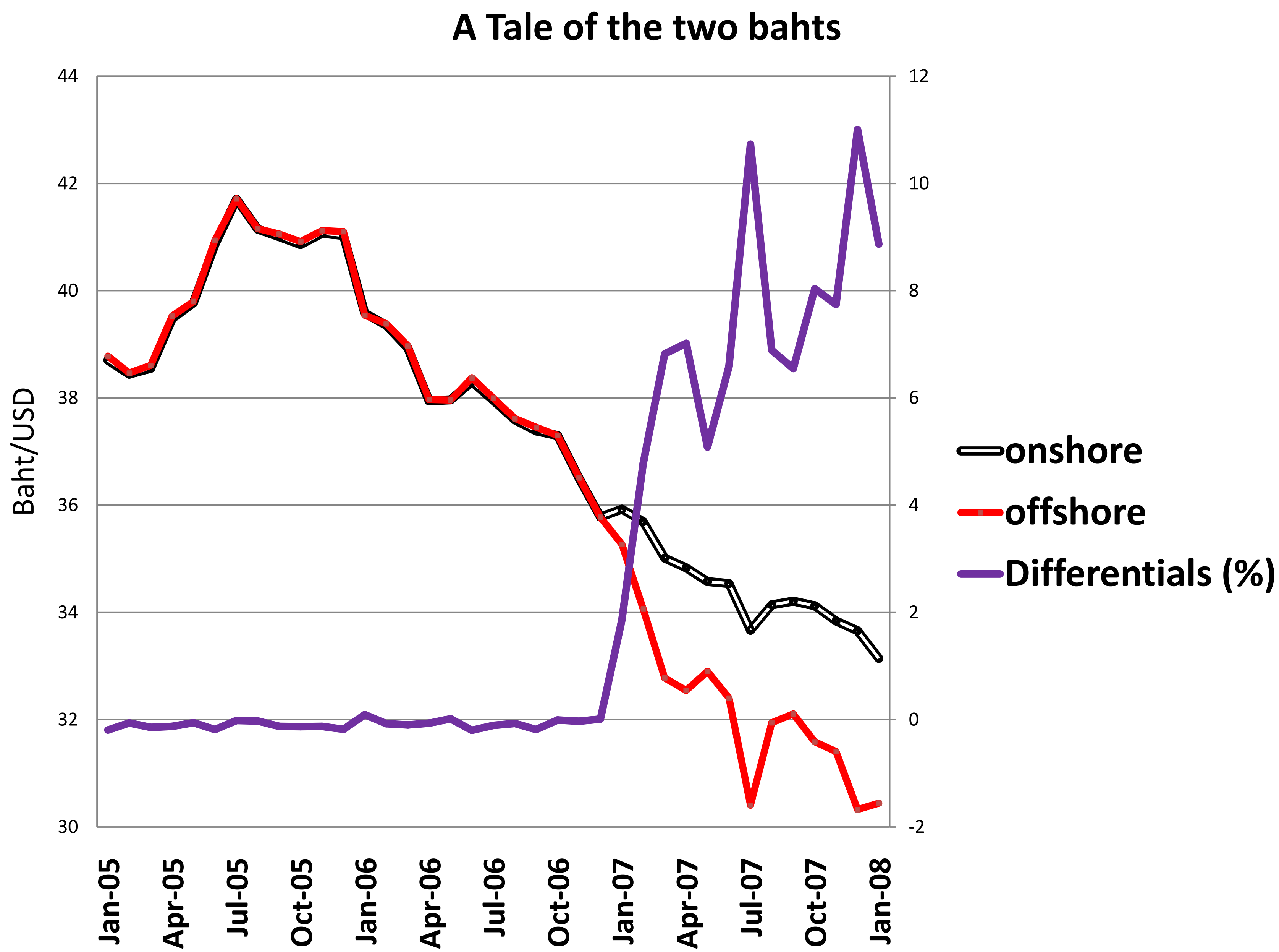
Current account Surplus
Percent GDP
30
25
20
15
10
5
0
-5
-1.6
0.1
0.4
2.4
3.6
4.7
10.9
13.8
27.4
India
Euro area
Korea
Indonesia
Thailand
Japan
China
Malaysia
Singapore

Dual exchange rates



Market separation via capital controls

- The fact that the exchange rates in the offshore and offshore markets were different can hardly be considered as the success of the 30% URR policy.
- A separation of the market through high import tariff naturally makes goods in the domestic market have higher prices than imported goods
- But in this case, the commodity is the baht and the tariff rate is the 30% URR.
- This leads to welfare loss caused by distortion of producer and consumer surplus, inducing all sorts of inefficiency through smuggling and black markets.
- And there were costs of foreign exchange intervention.


A Tale of the two bahts
Baht/USD
44
42
40
38
36
34
32
30
12
10
8
6
4
2
0
-2
Jan-05
Apr-05
Jul-05
Oct-05
Jan-06
Apr-06
Jul-06
Oct-06
Jan-07
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Jul-07
Oct-07
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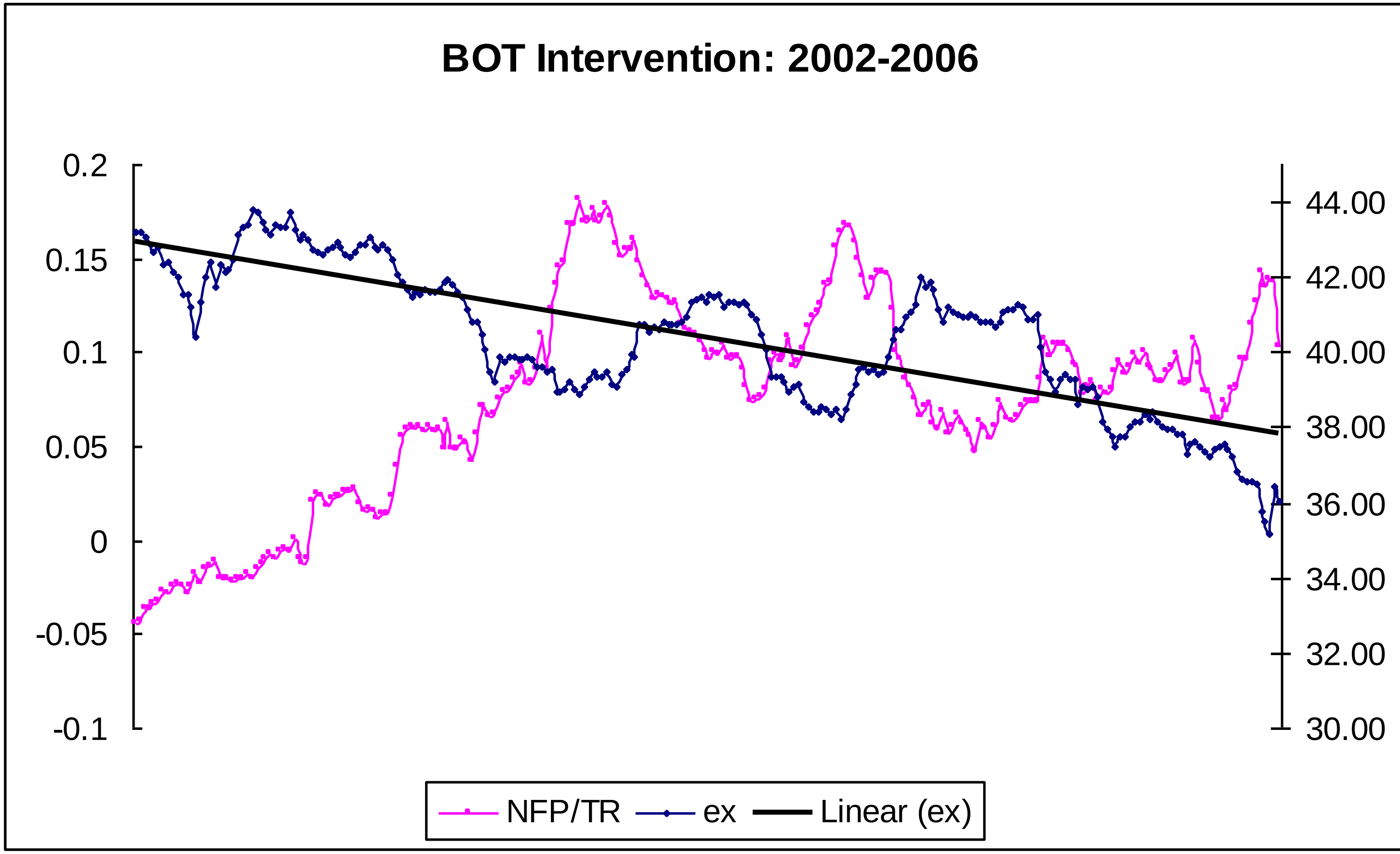
onshore
offshore
Differentials (%)

Size of forward intervention
(Net forward position/Total reserves)



Evaluation

- If we want to look at the effectiveness of the capital controls, we have to look whether the following objective is achieved:
- To reduce the baht volatility or to prevent the baht from going up to 30 baht to the dollar?
- The volatility of the foreign exchange market is brought through transferring the volatility into other markets such as the real sector and capital markets.
- While the volatility of the bilateral rate was reduced but the volatility of the REER was intensified.

- Look at the big picture: investors need cheap imported capital goods.
- Long-term growth is threatened by the loss opportunity of importing capital goods at realistic prices.
- GDP growth in 2007 declined to 4 %.
- The URR contributed to the policy consistency of trade and capital reform.
- This policy can have a detrimental impact on FDI: Vietnam and China has a consistent policy towards capital market reform.
- We heard that the 30% reserve measure was temporary, but one cannot deny its permanent adverse impact on monetary policy credibility and policy risk.

In hindsight

- The BOT committed a policy blunder in 1997 when it attempted to resist the depreciation of the baht.
- And they did it again ten years after.
- Had the BOT allowed the baht to appreciate in 1995 and 1996 during the heavy flows of capital, the baht would have appreciated and cooled down the overheated economy that led to financial crisis in 1997.
- When the yen had hit the four year lows at 120 yen to the dollar, it led to a slowdown in the baht appreciation.
- The high fluctuation of the yen-dollar rate also implies the volatility of the baht-dollar exchange rate.

Rules of engagement

- There are two rules when dealing with currency speculators.
- The first rule is: Don’t try to fight with them.
- The second rule is: Observe the first rule and strictly obey it.
- Foreign exchanges are traded goods, therefore the law of one price would apply in both commodity markets and foreign exchange markets.

When to speculate

- Somehow stabilizing role of the speculators should not be dismissed.
- If the value of the baht does not deviate from the fundamental value, there would be no room for making profit.
- Speculation would stop whenever there is no profit to be made.
- Speculators then reduce price volatility, so why did we try to fight them?
- Speculators are drawn to a one-way bet if they know that they have nothing to lose as the baht continues to appreciate.

Moral hazard

- It seems that the Bank of Thailand tries its best to pamper exporters.
- Real competitiveness does not depend on weak currencies. It depends on efficiency and productivity of exporters.
- Country with balance of payments surplus must accept the adjustment mechanism of the exchange rate appreciation.
- Currency appreciation can force exporters to be more efficient rather than depending on weak baht.
- The lesson we learned after the currency crisis in 1997 is that we cannot keep exchange rate overvalued when we suffered huge current account deficit.

Cost of being unrealistic

- We should *not* keep the baht undervalued when we experience current account surplus.
- There are also various costs involving in maintaining unrealistic exchange rates.
- Aside from unnecessary shocks to the financial sector, moral hazard behavior of exporters: they would never learn to protect themselves from currency fluctuations.
- Markets for hedging instruments could not have been developed had the Bank of Thailand continued supporting exporters.
- We cannot force exporters to hedge unless they see that it is for their own benefit.
- Thai exports depend more on world economic activity and their supply flexibility than favorable exchange rates.

Ad Populum Fallacy

- What is good for other countries may not be for Thailand.
- Because capital controls were employed in Malaysia and Chile, it does not mean that Thailand can use similar controls and get similar results.
- Heterogeneity of various countries make the same policy measures obtain different outcomes.
- A misunderstanding to cite Chile as a country that succeeded in using capital controls.
- Dictatorship and capital controls are associated in various countries.

On modeling policy outcome

- We should learn not to trust the model simulation. It turns out that the BOT model underestimated the impact of herd behavior
- How can we model the behaviors that are dictated by “animal spirit”?
- In making any important policy decision with considerable consequences to the whole economy, we should not rely too much on the model.
- After all, there has never been such kind of controls in Thailand; there is no statistical support for such policy predictions—let alone the Lucas’ critique.

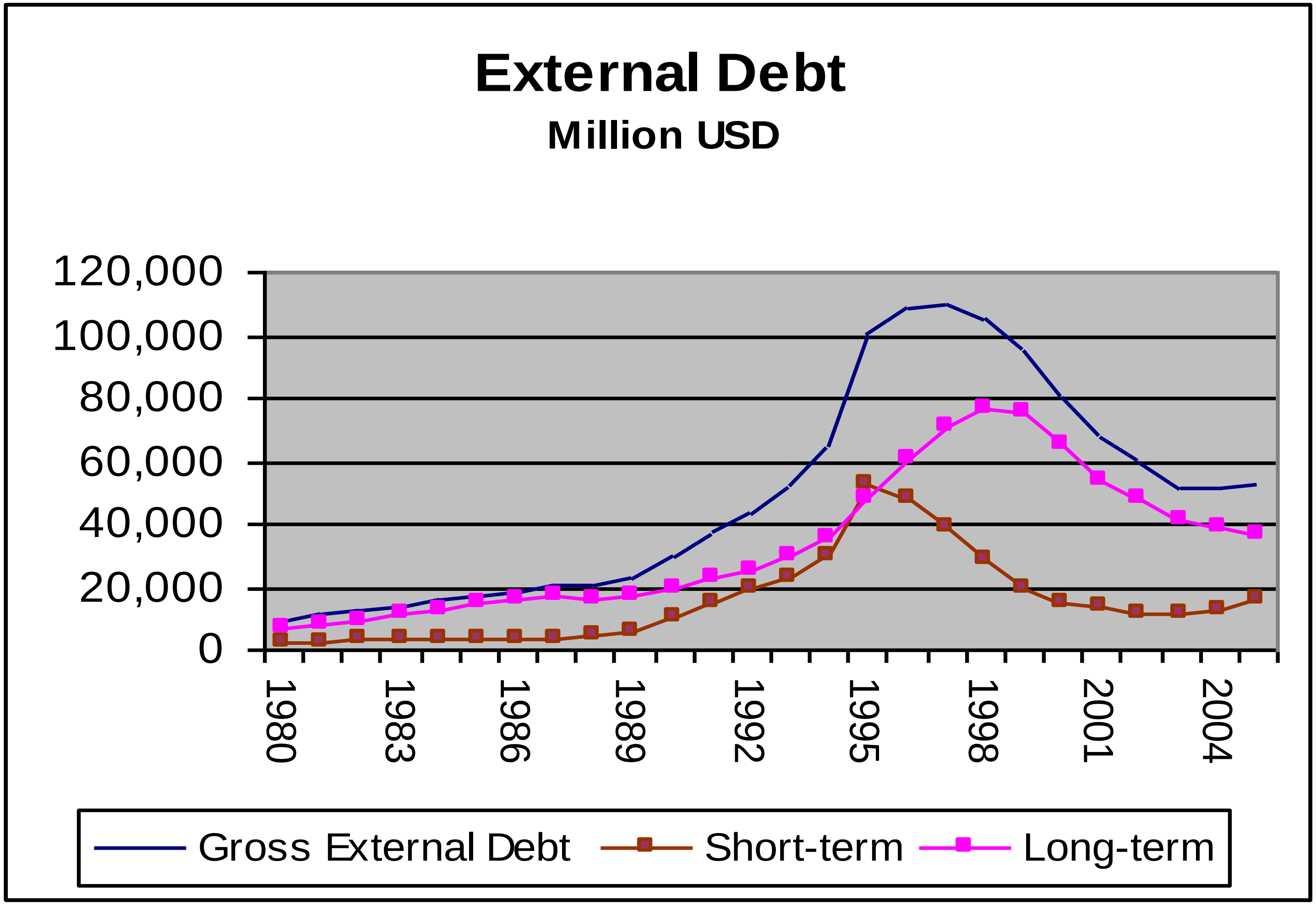
A role model

- If the control worked, other countries would have imitated the BOT’s measures.
- A real test for the effectiveness of the capital control policy is the praise and imitation from other Asian central banks, whose currency are experiencing appreciation.
- The Ringgit had appreciated by 7.8% since the abolishment of the fixed exchange rate.
- Bank Nekara opts to sell the Ringgit to slowdown the appreciation, while domestic producers can cope with rising value of the Ringgit by improving productivity.
- Malaysia, Indonesia, the Philippines, and Singapore, despite currency appreciation, grew above 6% in 2007 as a result of growth in domestic demand.

When do capital controls work?

- **Capital controls are usually employed during financial crisis.**
- They make sense if the country is accumulating excessive short-term liabilities—like the period before the 1997 crisis.

Remember the 1997 crisis



In desperation Thailand even encouraged people to hand over their gold jewellery to be melted down to boost the central banks' reserves

Debt structure and vulnerability

- Capital controls can alter the debt structure.
- However, the short term debt in 2009 was not as high as the pre 1997 crisis.
- The controls may not be able to stem the inflows;
- Consequently, the controls cannot stop the real appreciation of the baht.

Sterilization

- BOT has high cost of mopping up excess liquidity by issuing the BOT's bonds to prevent the rise of the baht.
- Many steps have been taken.
- Each step intensified its grip over the inflows at higher and higher cost to the economy in such a way that the BOT had to backtrack.
- When the renminbi significantly appreciates against the dollar, the pressure on the baht rise will be even stronger.

Leaning against the wind

- Since all measures and options have already been taken, Thailand cannot lean against the wind of the weak dollar.
- Why prolong the painful adjustment?
- Just to give exporters time to adjust?
- How many years would Thai industries require to adjust before the FTAs come into full effect?

The price we pay from sterilization

- BOT obtained about 7 per cent of return from its investment portfolio, mostly consisting of dollars, while interest expenses were averaged 5 per cent from issuing bonds to sterilize liquidity in the economy.
- Although the central bank received a 2-per-cent margin in dollar terms, it took a loss when the margin was converted into baht.
- Since 90 % of BOT profits must be submitted to the MOF, government revenue was affected by the BOT loss.
- "If we had not intervened in the baht, had not bought the dollar, the baht would have continuously appreciated to an unknown level," said the deputy governor. (Feb 2007)
- *A plea to bad consequences—a* form of an illogical argument

The verdict

- It boils down to a crucial question whether the benefit of the controls outweighs its cost.
- For those who firmly believe in non-intervention, doing nothing is far better than doing something (damaging).
- For policy activists, doing any thing at some costs are better than doing nothing.
- We must not underestimate the related costs of intervention
- There is a deadweight loss due to export subsidy—direct transfer is less costly.

On February 9, 2007

- The late Prime Minister Samak Sundaravej said that the controversial capital controls would be abolished when the central bank meets with the new finance minister the following week. (The Nation, Feb 9, 2007)
- Senior director of the BOT said *some crucial information* related to the baht still had not be revealed to the public, which is why people do not realize the need for the 30-percent unremunerated reserve.

Imperfect information

- “The outsiders don't know all the figures. We will illuminate them and clarify the consequences if these measures are revoked," she said.
- "Direct and portfolio investment are not under the measure, so it is not a point foreign investors should worry about. Moreover, we have gradually relaxed the measures," the senior director of BOT explained.
- That was in early February 2007.

Epilogue

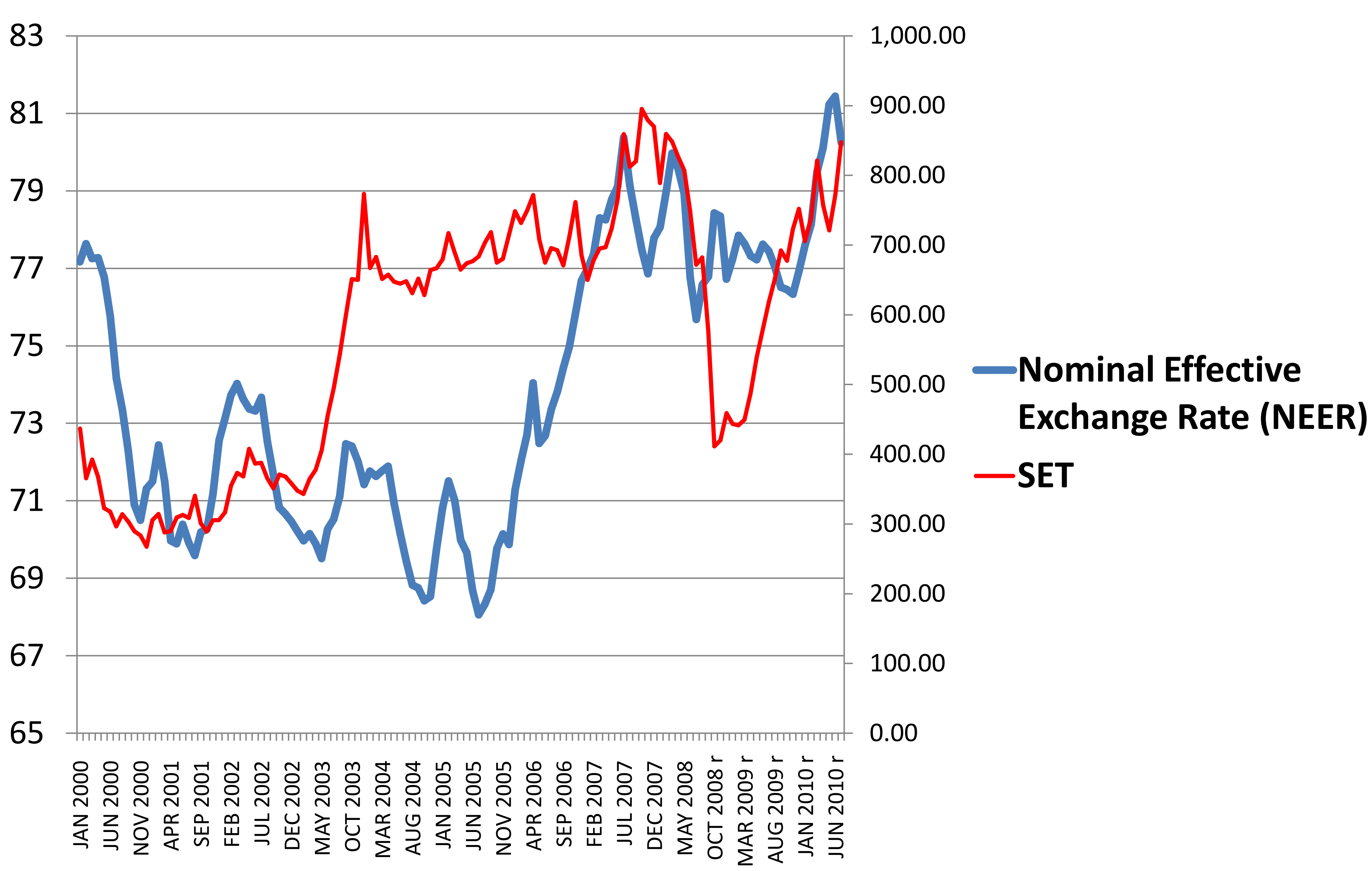
- The BOT governor, at a press conference on March 3, 2007 when the capital control was abandon,
- *“Removal of the controls is justified by several factors, including a strengthening economy and a greater balance in the foreign exchange market”.*
- On that day the baht did not appreciate substantially from Friday February 29.
- The onshore rate was between 31.50-31.60, while the offshore rate was between 31.40 and 31.90; the two rates tended to move closer once again.

Will we see the dollar at 28 baht?

More capital inflows

- Strong inflows into local-currency bond and equity markets, along with current-account surpluses put upward pressure on the baht.

- In July 2010, Thailand welcomed 1.25 million visitors, up 14.9 % year on year, while the hotel occupancy rate stayed at 46.9 % compared with 37.3 % in the previous month.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400.00
300.00
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100.00
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JAN 2000
JUN 2000
NOV 2000
APR 2001
SEP 2001
FEB 2002
JUL 2002
DEC 2002
MAY 2003
OCT 2003
MAR 2004
AUG 2004
JAN 2005
JUN 2005
NOV 2005
APR 2006
SEP 2006
FEB 2007
JUL 2007
DEC 2007
MAY 2008
OCT 2008 r
MAR 2009 r
AUG 2009 r
JAN 2010 r
JUN 2010 r
Nominal Effective Exchange Rate (NEER)
SET

Capital inflows: The bond market

- Foreign investment in the local bond market has picked up sharply in September, according to the president of the Thai Bond Market Association.
- Net foreign inflows have totaled 40 billion baht in September, compared with 70 billion for the entire year to date.
- "The trend reflects the attractive returns offered from local debt and currency movements. It's what investors look for in every market"

The weaker the dollar, the stronger the yen

The euro

Apr 21, 2010 : EURUSD=X 1.3387 THB=X 32.19
0%
-5%
-10%
-15%
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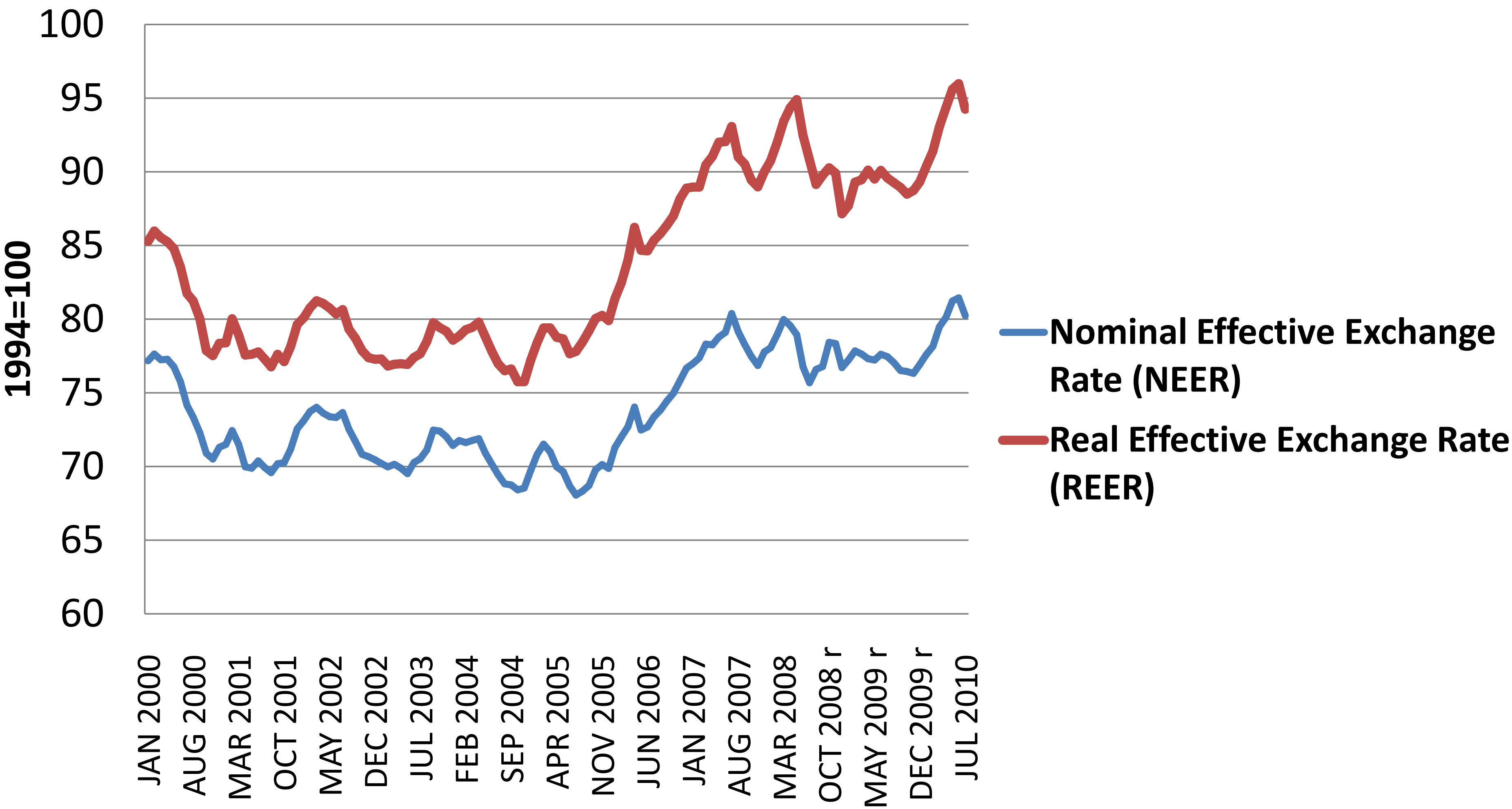
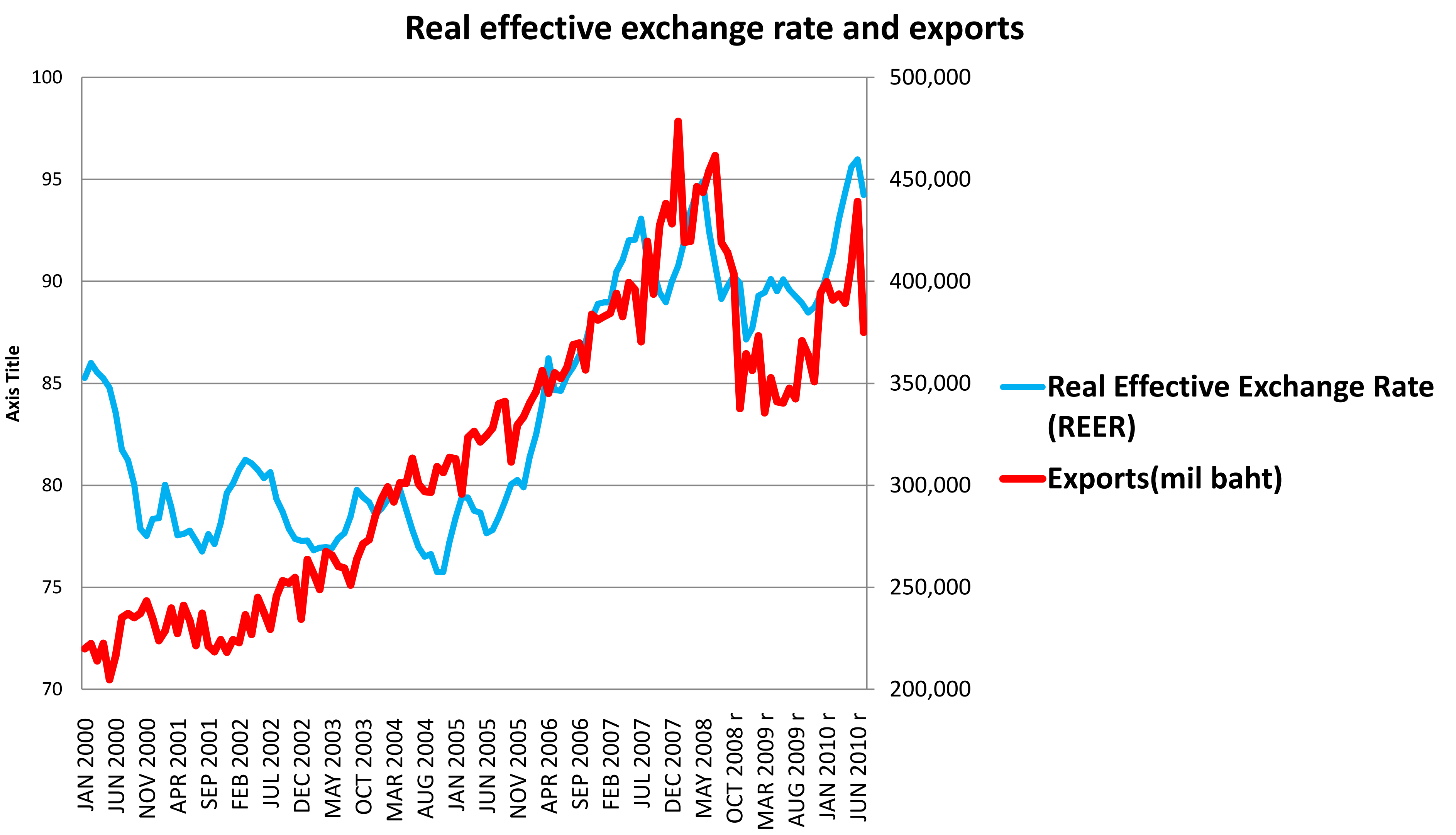
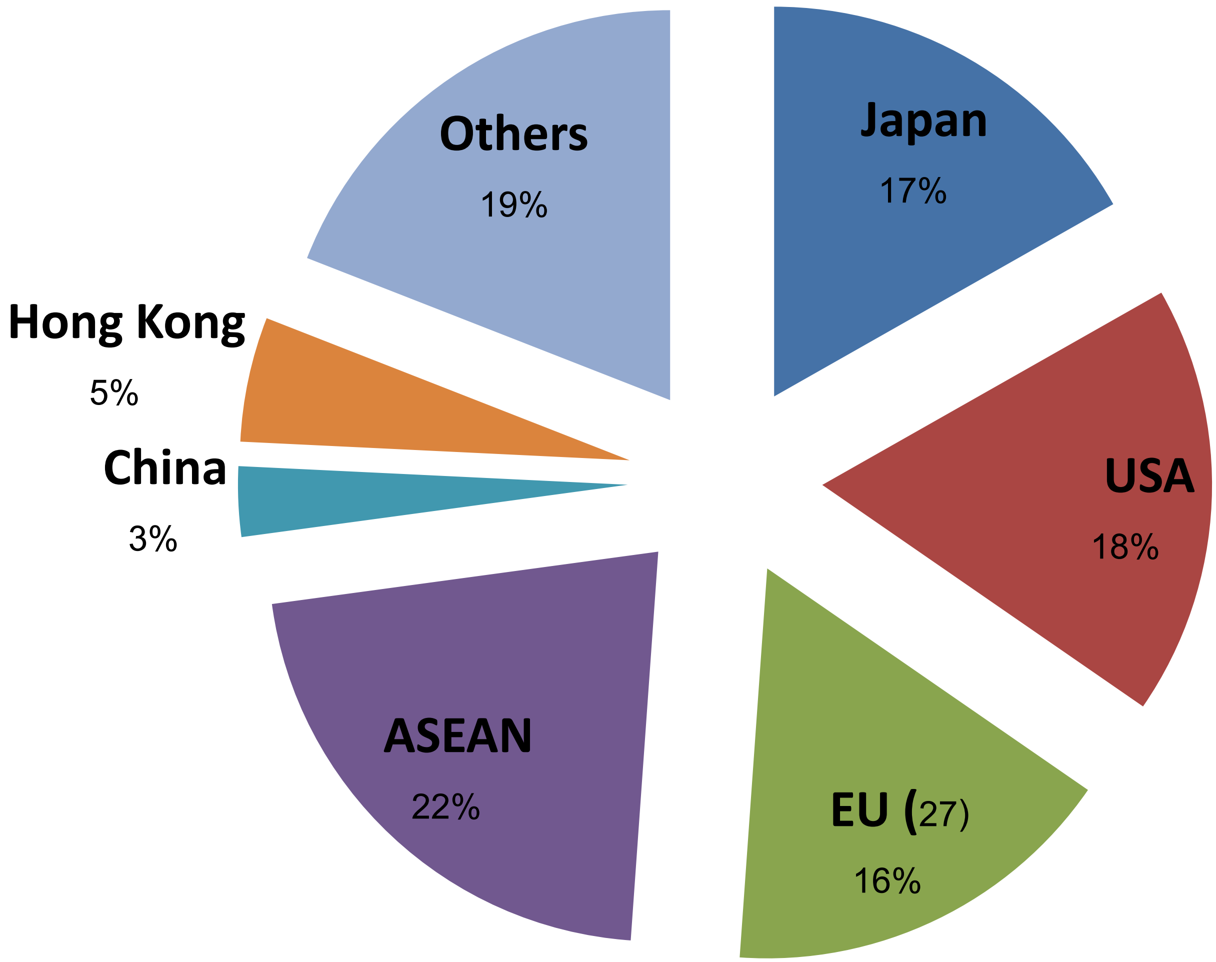
2009
Nov
Dec
2010
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
1D 5D 1M 3M 6M YTD 1Y 2Y 5Y Max
FROM: Sep 17 2009 TO: Sep 17 2010

Nomninal and real effective exchange rates

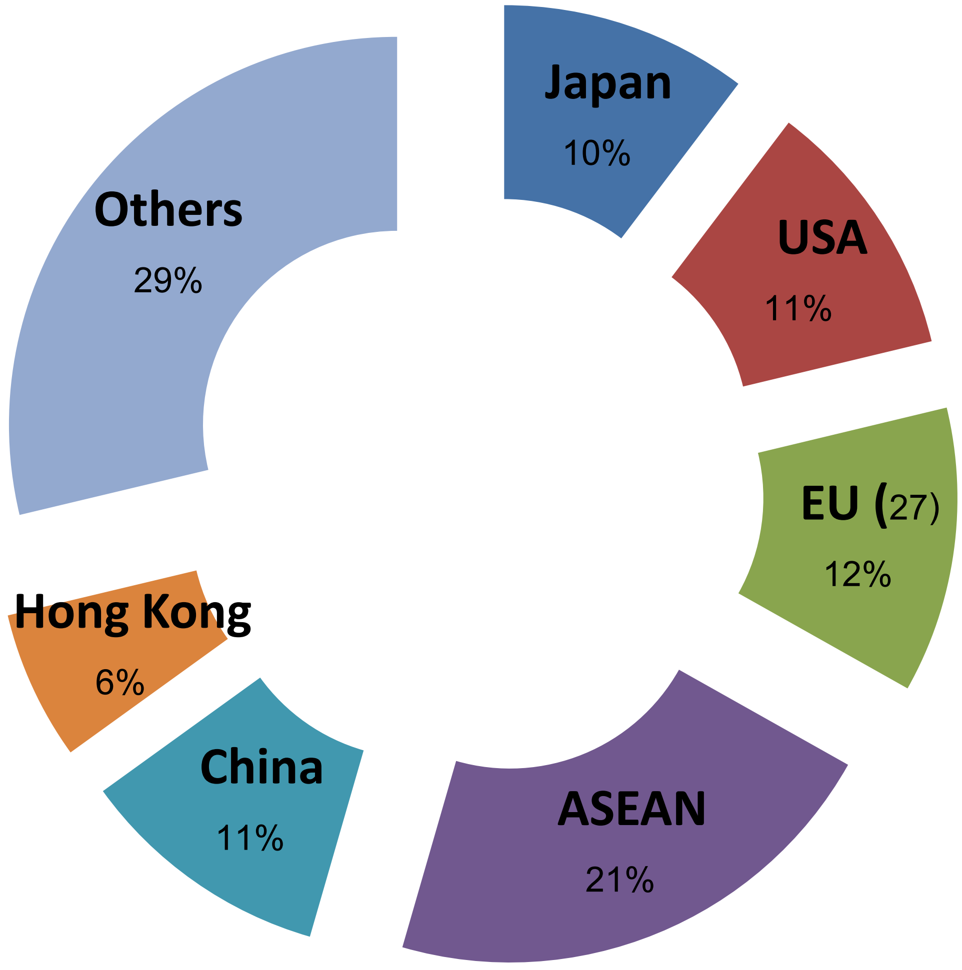



Real effective exchange rate and exports
100
95
90
85
80
75
70
Axis Title
500,000
450,000
400,000
350,000
300,000
250,000
200,000
JAN 2000
JUN 2000
NOV 2000
APR 2001
SEP 2001
FEB 2002
JUL 2002
DEC 2002
MAY 2003
OCT 2003
MAR 2004
AUG 2004
JAN 2005
JUN 2005
NOV 2005
APR 2006
SEP 2006
FEB 2007
JUL 2007
DEC 2007
MAY 2008
OCT 2008 r
MAR 2009 r
AUG 2009 r
JAN 2010 r
JUN 2010 r
Real Effective Exchange Rate (REER)
Exports(mil baht)

Market exports shares: 1995



Export market diversification in 2009



Analyze the asset prices

	Exchange rates (Sep 8, 2010/ year ago)	Stock price indexes ($)	Interest rates (3 months)
Thailand	31/34	35.2	1.4
China	6.79/6.83	-17.5	2.5
Japan	83.9/91.8	0.4	0.19
Singapore	1.34/1.42	8.7	0.5
Malaysia	3.11/3.5	24	2.9

September 2010

	Exchange rate appreciation (%)	Current Account Surplus (%GDP)	Inflation 2010
Thailand	-8.8	4.5	3.6
China	-0.05	4.9	3.0
Japan	-8.6	3.4	-0.8
Singapore	-5.6	14.1	2.6
Malaysia	-11.1	13.3	1.7

The Blame

Bangkok Post: 16/09/2010

- Dej Pathanasethpong, an adviser to the Thai Garment Manufacturers Association, called on the Bank of Thailand and the Finance Ministry to co-ordinate measures to curb the baht's rise.
- "It is the duty of the Finance Ministry to impose measures that foster an environment in which the business sector can perform well. But so far, it seems both the ministry and the central bank **have not done their jobs**."

Federation of Thai Industries

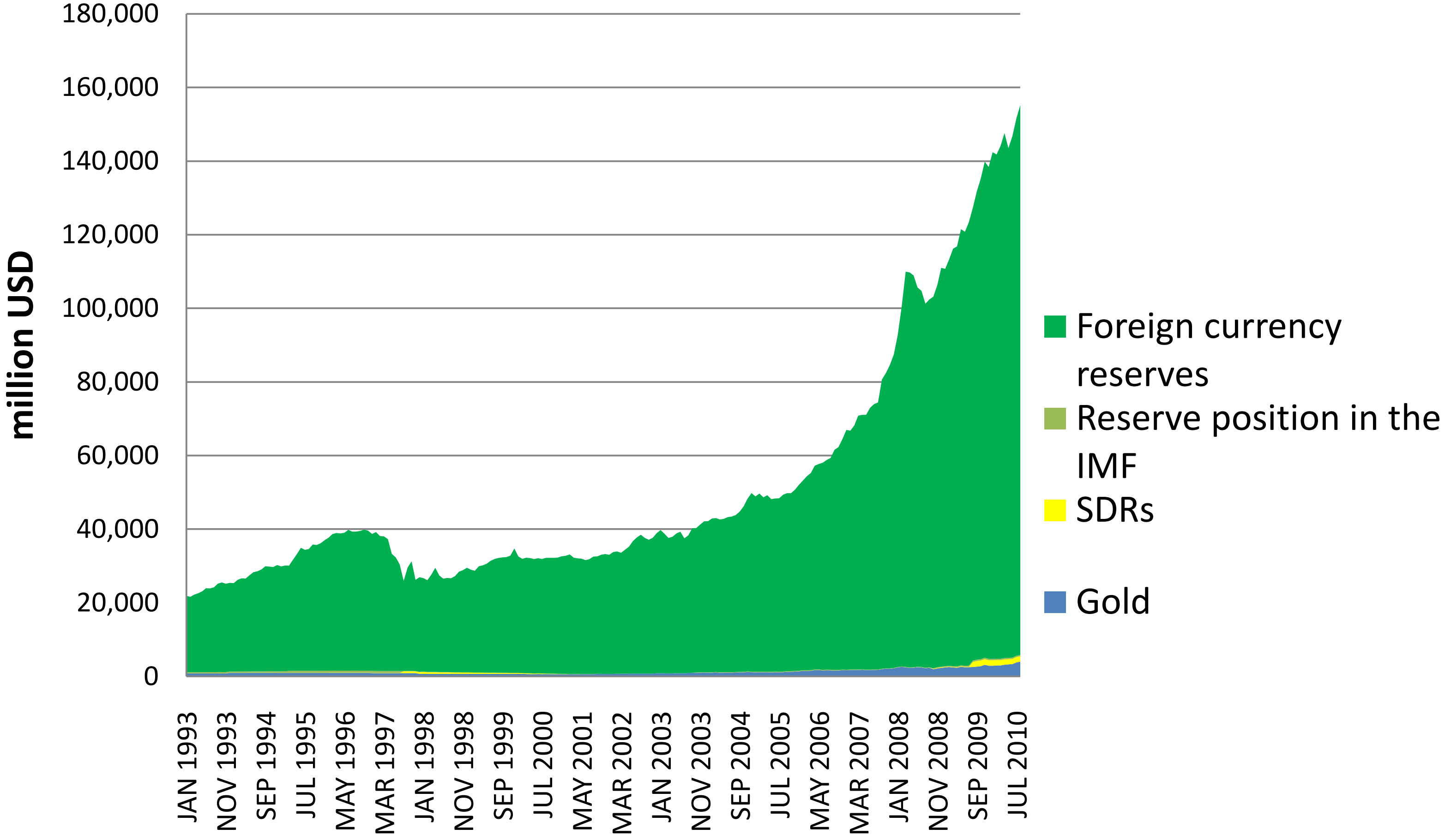
- Manufacturers may cut production if measures are not introduced to soften the "too strong" exchange rate, and this **could result in a contraction of export value in the fourth** quarter, says the Federation of Thai Industries (FTI).
- Chairman Payungsak Chartsutipol said exporters in the agro-industrial, textile and furniture sectors are possibly unable to receive orders from abroad due to severe price competition from regional competitors.

The cost of intervention

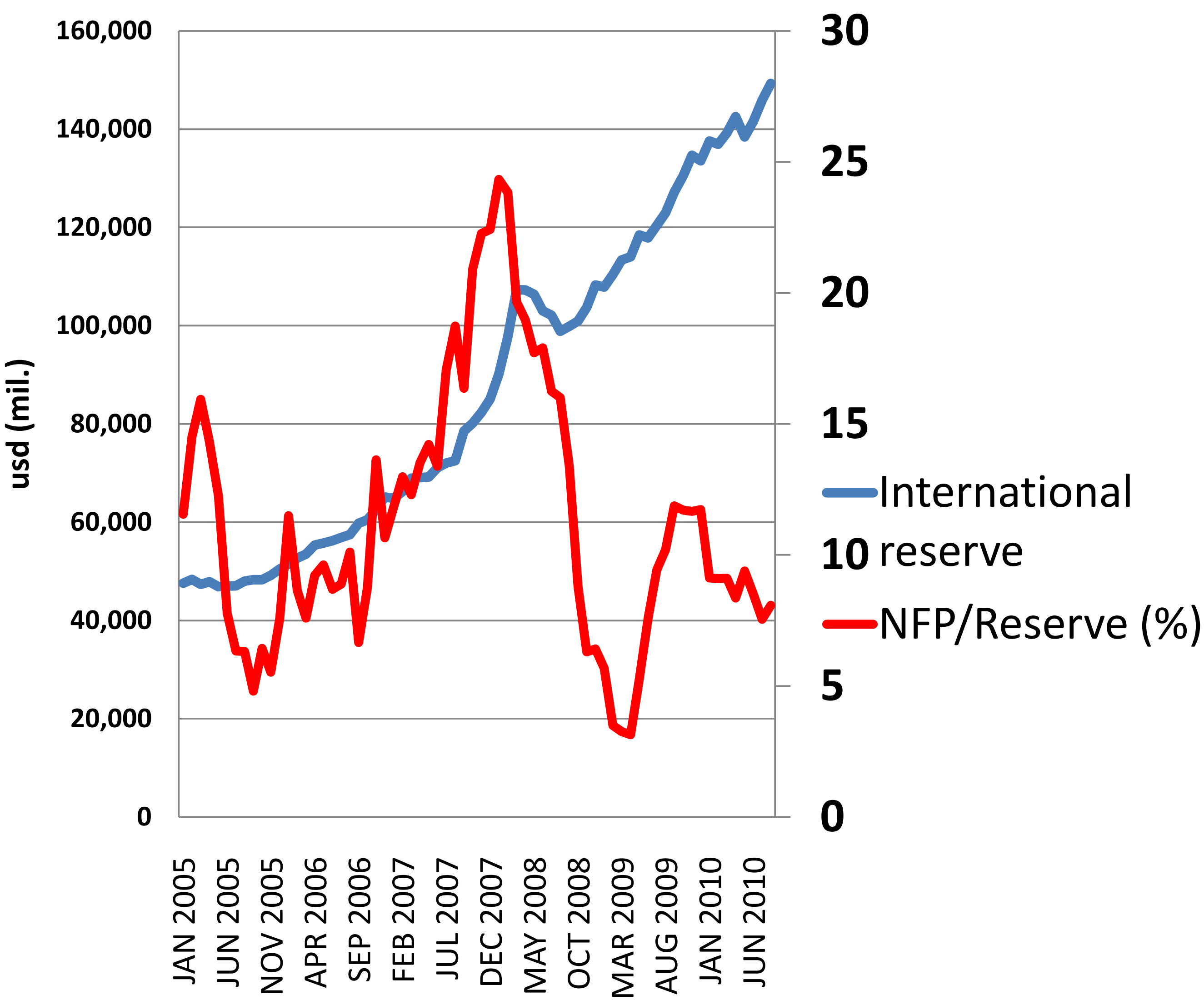
According to the Bank of Thailand, the loss from intervention to prevent the baht from strengthening amount to Bt18 billion in 2009.

The appreciation of the baht causes a loss in value of the total asset by Bt27 billion, resulting in the total operation loss of 7.7 billion, and accumulated loss rose to 82 billion baht.

International Reserves



To intervene or not to intervene



Negative net worth

- **The 2009 balance sheet of the BOT indicates that total assets amount to 3.217 trillion baht, an increase of 729 billion baht as a result of increased international reserve (current account surplus and from buying dollars for intervention in the foreign exchange market)**
- **The liabilities amounted to 3.299 trillion baht, implying negative capital fund of 81.758 billion baht.**

The Bank

- The Bank of Thailand is unlikely to impose measures to block capital inflows in a bid to curb the appreciation of the baht, says the BOT governor.
- Her comments quashed market speculation that the central bank could look to impose capital controls on the baht, which has risen 8% for the year to date against the dollar and is currently trading at a 13-year high.
- It closed yesterday at 30.81/86 to the US dollar, compared with 30.79/82 on Tuesday. (Bangkok Post: 16/09/2010)

O learned BOT

- “Regulators would continue to use existing measures, including dollar purchases in the market, to prevent excessive volatility in the exchange rate”
- "The baht's appreciation has resulted from both internal and external factors. Externally, it has stemmed from the strong economic growth of the region in contrast with weak growth in developed countries,”
- "Internally, capital inflows have increased after local [political] unrest [in the second quarter] caused markets to underperform”.
- “ Our foreign exchange policy has remained unchanged."

New measures and their effectiveness

- Facilitating greater **foreign investment** by companies and individuals;
- Facilitating greater **lending in foreign currencies** by financial institutions;
- Raising maximum limit for **overseas property purchases** to US$10 million from $500,000 now;
- Raising **foreign currency deposit** limit for Thai companies and individuals with domestic banks from the current $500,000;
- Increasing minimum amount requiring mandatory repatriation of export earnings to $50,000 from $20,000 now.
- A 15% tax on interests earned from local bonds held by foreign investors. (See the equation determining capital flows in the previous lecture)

Conclusion

- Distributive impact of exchange rate changes
- Income vs. substitution effects
- Moral hazard
- A blessing in disguise
- Taming the inflationary pressure
- Imported capital goods, productivity, and growth

Discussion questions

- State whether you agree or disagree with the following statements

1. "URR is a powerful too as a last resort to prevent currency appreciation"
2. "Despite rapidly rising level of international reserves, sovereign wealth funds should never be established as their costs outweigh benefits to Thailand"
3. "Tobin tax has stronger impacts than capital control measures"