

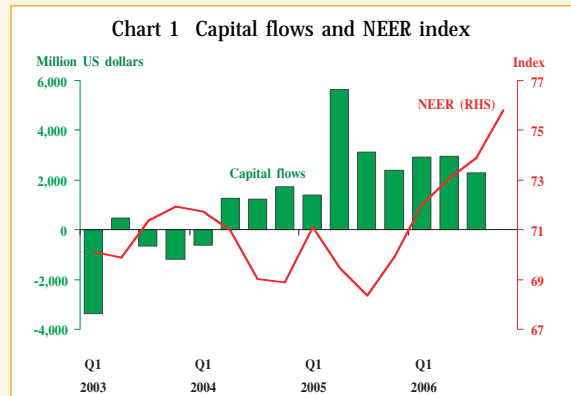
## Reserve requirement on short-term capital inflows

Since 2005, capital inflows have picked up substantially, in line with the large inflows of capital into the East Asian region. Such inflows have been due to strong regional economic fundamentals and the depreciation of the US dollar, as US economic growth is expected to slow down because of the chronic US current account deficit and budget deficit (the twin deficits problem).

The appreciation of the baht, which outpaced that of other regional currencies, implied the loss of competitiveness of Thai exports.

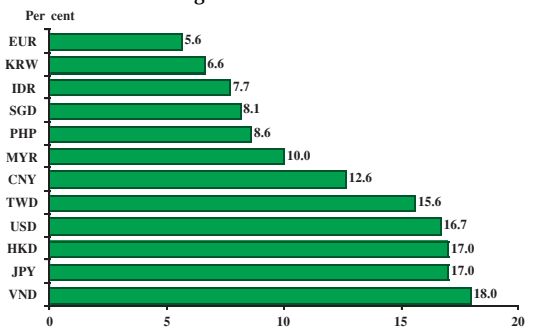
Capital inflows help support domestic investment, including production and exports. However, over the past year, short-term capital inflows for the purpose of currency speculation contributed to the volatility of the baht and led the baht to appreciate more rapidly than economic fundamentals.

The appreciation of the baht due to persistent capital inflows put pressure on the Bank of Thailand's ability to maintain macroeconomic stability conducive to long-term sustainable economic growth. The Nominal Effective Exchange Rate (NEER) index rose persistently and rapidly, contributing to the decline in the competitiveness of the export sector. The export sector is an important economic sector in Thailand, accounting for 56 per cent of GDP. If the baht continued to appreciate further, certain industries would be unable to make necessary adjustments in the short term, especially labour-intensive industries and export-oriented industries with low imported-raw-material content, such as the textile industry as well as food and agriculture-based industries. If such an adjustment problem occurred, it could have an adverse effect on other industries through their interlinkages and eventually on employment and on overall economic stability.



Source: Bank of Thailand

Chart 2 Baht compared to major currencies and other regional currencies



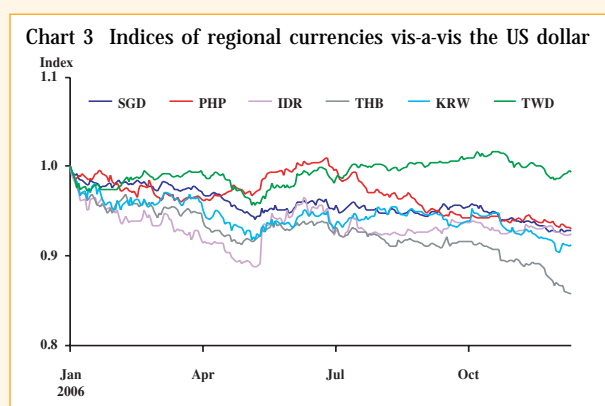
Source: Bank of Thailand

Such measures helped slow down the appreciation of the baht, and provided businesses with the opportunity to expand their production and export bases to countries with lower costs, and also help reduce currency mismatches in the private sector. The relaxation of the restriction on residents' portfolio investments abroad (through institutional investors) should enhance investors' knowledge and experience in managing exchange rate risk, which would provide a foundation for globalization and further capital account liberalization in the future.

The Bank of Thailand has closely monitored the movement of the baht and has adopted a series of measures in order to lessen the pressure on the exchange rate. Such measures included permitting a larger amount of residents' investments abroad, as well as discouraging short-term capital inflows through raising the total permissible outstanding balance in the foreign currency deposit (FCD) accounts of corporate residents, from 10 million US dollars to 50 million US dollars, since May 2006. In addition, since early January 2007, the Ministry of Finance has approved the measures proposed by the Bank of Thailand to relax the restriction on outflows of residents' direct investments and portfolio investments abroad.

Other measures on short-term capital flows that have been implemented since the middle of 2006 could not effectively slow down short-term capital inflows.

Earlier in 2006, the Bank of Thailand made strong efforts to restore the stability of the baht so that the value of the baht would better reflect economic fundamentals and would be in line with the trends of other regional currencies. Nonetheless, the baht continued to appreciate rapidly. The value of the baht in November 2006 appreciated by 12.5 per cent from the value in January 2006. Such movement of the baht was persistent and the magnitude of its appreciation was greater than that of other regional currencies. On 4 December 2006, the Bank of Thailand implemented measures on short-term capital flows which required non-residents to hold securities for longer than 3 months and allowed domestic financial institutions to borrow baht from non-residents without underlying trades or investments in Thailand only for a maturity of longer than 6 months.



Source: Bank of Thailand

inflows, minimum holding period requirements, direct taxes on inflows or outflows, fees for currency exchange, reserve requirement, etc.

Key rationale and principles behind the reserve requirement on short-term capital inflows introduced on 18 December 2006

Comparative analysis of the pros, cons, effectiveness and timeliness of various types of measures demonstrated that if the minimum holding period requirements were to be adopted, despite its effectiveness in discouraging short-term capital flows, it would significantly undermine investor confidence because investors would then be unable to repatriate any of their investments before the end of the holding period, regardless of their needs. Tax measures would take time before they could actually be implemented, and could not be changed in a timely manner. On the other hand, the reserve requirement on short-term capital inflows was regarded as a price-based measure to slow down short-term capital inflows and to enhance the independence of monetary policy. The reserve requirement would lessen the pressure on the exchange rate when the authority needs to adopt tight monetary policy. However, there would be costs associated with such a measure. For instance, if the measure was applied to all types of transfers, it could affect the flow of funds necessary for current transactions (mainly international payments for trade in goods and services). Although the reserve requirement could affect investor confidence, it could be implemented in a very timely manner, and could be flexibly adjusted in accordance with changing circumstances. Therefore, on 18 December 2006, the Bank of Thailand introduced the 30 per cent reserve requirement on short-term capital inflows. Payments for trade in goods and services, foreign direct equity investments, and foreign investments in the stock market have been exempted from such measures. The Bank of Thailand would continue to closely monitor and assess the outlook for short-term capital inflows and the impact of the measures and stands ready to make necessary adjustments in accordance with any changing circumstances ahead.

However, such measures could not effectively slow down short-term capital inflows and were unable to reduce the pressure on the exchange rate. Therefore, during the middle of December 2006, the Bank of Thailand considered additional measures to discourage short-term capital inflows partly based on studies on the experiences of other countries that encountered problems regarding short-term capital inflows in the past, such as Chile, Malaysia, South Korea, Japan, Colombia, and Brazil, in addition to conceptual frameworks and ideas from the academia and as well as the International Monetary Fund (IMF). Among the key measures that could be used to restrict short-term capital inflows were restrictions on the volume of capital