L. 5. 2. RFD. 197

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

July 15, 1952

Currency Appreciation, Exchange Control and Tariff Increases in Thailand

Yves Maroni

12 pages

NOT FOR PUBLICATION

July 15, 1952

CURRENCY APPRECIATION, EXCHANGE CONTROL and TARIFF INCREASES IN THAILAND

Yves Maroni

Without consulting the International Monetary Fund, the Bank of Thailand on February 28, 1952, reduced its selling rate for sterling from 51 baht to 45 baht to the pound. It was announced at the time that this move was intended to contribute to the lowering of the cost of living. Another objective may have been to speed up the shift in relative importance of dollars and pounds in the country's foreign exchange reserves, which had already been noticeable for some time. A growing fear in Thailand of another devaluation of sterling explains why this objective may have been desired. Moreover, the Bank's policy of selling dollars for only a few well defined purposes made it possible to seek such a result by this method. When, however, the resulting losses of sterling by the Bank of Thailand turned out to be undesirably large, the Government on March 20, introduced exchange control on capital transactions. Because the change in exchange rates apparently was expected to involve a loss in Government revenues from export duties and from other sources, the Government then decided to increase by about 30 per cent, effective April 1, the valuation placed on imports for the purpose of assessing ad valorem duties.

At the time of the appreciation of the currency last February, the Thai exchange system consisted of official rates and of substantially higher free rates. The Bank of Thailand was selling foreign exchange at the official rate of 35 baht to the pound or 12.50 to the dollar to cover most government imports, oil imports, and remittances for students. All of these were considered important enough to warrant preventing their cost in baht from rising to the higher level of the free market exchange rate. The Bank's supply of foreign exchange was derived from the surrender at the official rate of 100 per cent of the export proceeds of rice, 40 per cent of those of tin, and 20 per cent of those of rubber. At the same time, a free market operated openly and the "free" rate of exchange, 21.89 baht to the dollar on February 27, 1952, applied to all payments abroad not eligible for foreign exchange at the official rate, and all receipts from abroad not subject to surrender at the official rate. The existence of partial surrender requirements for the foreign exchange proceeds of tin and rubber exports meant that, in addition to the official rate and the free rate of exchange, there were two mixed rates effective for these two commodities. On February 27, 1952, these were 18.13 baht to the dollar for tin, and 20.01 baht to the dollar for rubber. Moreover, there was a special rate for settlement of accounts with Japan which was set at the beginning of each month and stood at 21.00 baht to the dollar for February 1952. Finally, the Bank of Thailand had authority, given by the International Monetary Fund in April 1951, to sell sterling to the commercial banks for payment for authorized imports at a rate not more than 2 per cent below the average of the commercial banks' selling rate of the previous week. It is this Bank of Thailand selling rate for sterling which was lowered from 51 to 45 baht on February 28.

This paper considers and attempts to evaluate the significance of the effects of the recent appreciation of the currency and of the subsequent exchange control and tariff increases on Thai foreign trade, as well as on the foreign exchange reserves and the balance of payments of Thailand, and on the monetary and fiscal situation and the level of prices in the country.

Effects on foreign trade

By reducing both the baht cost of imports and the baht proceeds of exports, the appreciation of the baht should have the effect of stimulating imports and discouraging exports, other things being equal. This effect, however, is offset by a number of factors, some of which tend to postpone it while others negate it permanently.

On the export side, three factors appear partially to offset any reduction induced by the appreciation of February 28. First, rice exporters must surrender all of the foreign currency proceeds to the Bank of Thailand at the official rate, and since no change in the official rate or in the surrender requirement is contemplated, the alteration of the Bank's selling rate for sterling will have no effect on rice exports. Second, tin producers have not yet succeeded in exporting as much tin since the war as they did before the war because the recovery of tin production from its postwar low has been lagging. Further recovery of tin output, which might have been expected in the absence of currency appreciation, may now be retarded as a result of the lower baht proceeds of exports. Under these conditions, a contraction of tin output is unlikely and exports of tin may therefore be maintained. Third, teak producers, predominantly foreigners, have recently been told by the Thai Government that upon expiration of current leases further teak concessions will be granted to Thai nationals only. This may well lead some of the foreign lease holders to increase output from their concessions in order to maximize their returns during the remaining period of their leases. Moreover, Thailand is currently the principal exporter of teak, a product used exclusively in shipbuilding, and for which adequate substitutes are apparently lacking. Thai producers may, therefore, succeed in forcing the price up without losing much business. Consequently, the value of teak exports is likely to rise in the long run. Since rice, tin, and teak together account for over 60 per cent of Thailand's exports, this leaves less than 40 per cent of total exports which might suffer a reduction because of the recent currency appreciation. Any net decline in total exports is, therefore, likely to be rather small.

On the import side, the increase in ad valorem duties which became effective April 1 goes a long way to offset any stimulation in imports induced by currency appreciation. In addition, since the appreciation occurred at a time when there were large stocks of imported commodities in the country, the volume of imports will probably not greatly increase until these stocks have been substantially reduced. With the tendency for world prices to decline, there may also be a postponement of the increase in imports, motivated by importers' desires to obtain lower prices later.

On balance, therefore, the effect of the recent appreciation of the baht upon foreign trade is not likely to be as great as might otherwise have been expected. There may be a slight fall in the volume of trade and in the trade surplus itself, which in recent years has been quite large. If any large reduction in the trade surplus occurs or if a deficit appears, other explanations will have to be advanced. One particularly soft spot would seem to be rubber, which in 1950 accounted for around 22 per cent of total exports but now appears to be facing a sharply narrowing market due to intensified competition from synthetic production in the United States. In addition, Thai rubber production in the future is likely to feel the effect of overtapping of trees which has occurred in recent years. This suggests that the country's foreign trade is more likely to be seriously affected by changes in the underlying conditions of demand and supply at home and abroad than by the recent financial measures which in part contradict each other.

Effects on the gold and foreign exchange reserves and the balance of payments

External Reserves before February 28 — Thanks to large and persistent trade surpluses, World Bank loans, and United States military and economic aid, Thailand's gold and foreign exchange reserves grew from the equivalent of $151,000,000 at the end of 1947 to $358,000,000 at the end of 1951, and stood at $377,000,000 at the end of February 1952. The gold holdings of the Bank of Thailand rose from $78,000,000 to $113,000,000 while its foreign exchange (including short-term and long-term holdings) rose from the equivalent of $73,000,000 at the end of 1947 to $245,000,000 at the end of 1951, and stood at $263,000,000 at the end of February 1952. 1/

The significant aspect of the rise in foreign exchange holdings is the increasing ratio of dollar holdings, which, moreover, rose at an increasing rate after April 1951. This resulted, in part, from attempts of the Thai Government, through miscellaneous administrative devices, to increase sales to and reduce purchases from the dollar area and to increase purchases from and reduce sales to the sterling area. From the end of 1947 to the end of 1951, dollar holdings rose from $11,000,000 to $86,000,000, while during the same period sterling holdings increased from the equivalent of $57,000,000 to $159,000,000. Moreover, while dollar holdings had increased moderately from around 15 per cent of total foreign exchange holdings at the end of 1947, to 23.8 per cent at the end of March 1951, they rose more rapidly to 34 per cent of the total at the end of November 1951 and still more sharply to 41.4 per cent at the end of February 1952. Sterling holdings, having reached a peak of $164,000,000 in November 1951, were $10,000,000 less at the end of February 1952.

Exchange Rates after February 28 — When the Bank of Thailand sharply cut its selling rate for sterling on February 28, the free rate for sterling fell toward the new Bank selling rate but remained above it and even rose again, reaching as high as 47.97 baht on March 11 and 48.50 baht in mid-April. The free market rate for dollars, which had been 21.89 baht on February 27, also fell but not as much as the rate for sterling and later recovered to 21.21 baht on March 25. The result was that the dollar sterling cross rate in Bangkok, which had previously been rather close to and generally somewhat above the Hong Kong cross rate, fell below it to an extent sufficient to create a profitable

1/ International Financial Statistics, published by International Monetary Fund, June 1952, pp. 108-109.

arbitrage opportunity, causing a very heavy demand for sterling. The Bank's daily sales of sterling, which had averaged below 75,000 pounds, increased fourfold overnight and even exceeded 500,000 pounds on March 7, 11, and 12. It is this drain which no doubt led to the introduction of exchange controls on capital transactions on March 20.

It appears that the political and economic uncertainties aroused by the unorthodoxy of the Government's moves caused an increase in the demand for gold and dollars for hoarding. There was an increase in the price of gold in Bangkok from $44.83 per ounce on February 27 to $46.15 the next day, an increase not paralleled elsewhere in the world at that time. Since the policy of the Bank of Thailand was to refrain from selling dollars in the free market, there was no ready source from which to meet the increased desire to hoard gold and dollars immediately. As a result, the free rate for dollars in Bangkok was prevented from falling to the level corresponding to the free market rate for sterling. The consequent differential between the Bangkok and Hong Kong dollar-sterling cross rates created arbitrage opportunities which tended to force the free rate for sterling substantially above the Bank of Thailand's selling rate. The Bank's policy of selling sterling only for authorized imports permitted the free rate for sterling to diverge from the Bank's selling rate in this manner.

Exchange Control -- The new exchange control regulation, however, did not affect in any way current transactions, and thus left many loopholes through which capital transfers were able to continue. Specifically, the regulation did not prevent Thai exporters, acting in agreement with foreign importers, from avoiding the foreign exchange market altogether (except in so far as compulsory surrender requirements were already in effect) by having payments for exports credited to their accounts abroad. 1/ Nor did it provide adequate machinery to stop evasion of the

---

1/ An attempt has now been made to plug this very large loophole. A regulation, effective May 19, now requires that all foreign currency proceeds of exports be deposited in an authorized bank in Thailand. The Bank of Thailand continues to receive the specified proportions of these proceeds which must be surrendered at the official rate for certain exports. Authorized banks receive the rest at the free rate. The portions to be surrendered at the two rates in the case of rice, tin, and rubber remain unchanged. It is too early to tell how effective this new regulation will be. It may foreshadow further moves in the same direction, especially since the other loopholes mentioned in the text appear to be still open.

prohibition by collusion with foreigners or prevent anyone with imagination from using his ingenuity to devise methods for circumventing the prohibition. Capital transfers remained possible with the help of faked records and dishonest accounting, not only through merchandise transactions, but through service transactions as well. The absence of penalties for violations of the regulation added to its lack of effectiveness and further accounts for the strength displayed by the very active black market in foreign currencies which sprang up overnight and through which additional illegal capital transfers were effected on a large scale.

Consequences — Thus, as was to be expected in view of these loopholes, the drain on the Bank of Thailand's sterling reserves continued unabated through May. The Bank's holdings of short-term sterling, which had been the equivalent of $85,000,000 at the end of February, were $70,000,000 at the end of March, and fell to $56,000,000 at the end of April, and $53,000,000 at the end of May. At the same time, the refusal of the Bank to sell dollars made further accumulation of dollar reserves possible, dollar holdings of the Bank rising moderately from $109,000,000 at the end of February to $116,000,000 at the end of March, and to $124,000,000 at the end of May. Dollar holdings, which had been 41.4 per cent of total foreign exchange holdings at the time of appreciation were 50.8 per cent of the total at the end of May, an even more rapid improvement of their relative position than the already accelerated increase of the previous three months.

The increasingly rapid shift in relative importance of dollars and pounds in the country's foreign exchange reserves, however, was accompanied by a reversal of the tendency of total foreign exchange holdings to rise. In the three months following February 28, total foreign exchange holdings, including long-term holdings, declined from the equivalent of $263,000,000 to $244,000,000, and at the end of May were just below their level at the end of December 1951.

Two significant consequences of the continuation of these tendencies must be noted. On the one hand, the declining importance of sterling holdings in the country's foreign exchange reserve, both relatively and absolutely, gradually reduces for Thailand the risk of another devaluation of the pound, and at the same time may imply a greater degree of freedom from inconveniences associated with sterling inconvertibility. On the other hand, the decline in the total foreign exchange holdings reflects a deterioration of the balance of payments position. This deterioration may be attributed in part to the continuing arbitrage operations, to the extent that they may represent a flight of capital, and may be aggravated by the reduction of the trade surplus which, as argued earlier, is likely to result from the recent financial measures. Whatever gain may be associated with the growing importance of dollars in the country's foreign exchange reserve may well be offset by the deterioration of the balance of payments, and, on balance, the position of Thailand in the international financial sphere appears likely to suffer a setback.

Effects on the monetary and fiscal situation and the level of prices

The Bank of Thailand has been earning large sums from the sale on the free market of sterling acquired at the official rate. These profits appear to have been used for the purchase of Treasury bills through the Stabilization Fund, thus ensuring for the Government a steady flow of funds to finance its budget deficits. 1/

Before February 28, the Bank's profits on sterling operations were large enough to enable it to finance the budget deficits, although they were too small to neutralize both the budget deficits and balance of payments surpluses. The budget deficits and the expansion of foreign exchange reserves resulting from balance of payments surpluses led to an equivalent increase in the note issue, which was only partially offset by the withdrawal of notes from circulation when the Bank sold sterling at the free rate. The net result remained inflationary and was reflected in a rising level of prices and a rising cost of living.

The recent measures affect the inflationary tendencies of the country in several respects.

The Government Budget -- The size of the budget deficit may be expected to rise moderately, at least partly because of the appreciation of the baht. Any reduction in exports, and therefore in domestic production, induced by the recent financial measures, automatically entails a fall in Government receipts from export duties and from royalties and other incomes from concessions. This might in part be offset by increased receipts from import duties if imports rise and/or because of the increase in ad valorem duties effective April 1. As pointed out, however, an increase in imports is not probable in the near future, and if one occurs in the long run, it will probably not be very great. Moreover, while the increase in duties may yield larger receipts in the case of imports

---

1/ Total Treasury bills outstanding increased from about 400,000,000 baht at the end of 1948 to about 1.5 billion baht as of the middle of March 1952.

the demand for which is relatively inelastic (e.g., luxury and semi-luxury products), this effect is likely to be cancelled by a decline in receipts from duties on imports the demand for which is relatively elastic. On balance, the recent measures appear likely to result in reduced Government receipts from this important source of revenue. In as much as this comes at a time when the Government has announced plans for increased expenditures, the outcome may well be larger budget deficits than have been experienced in the last few years. It must be remembered, however, that in the past expenditures have regularly been budgeted above what was in fact spent so that the actual deficits were less than had been expected. If this practice is continued, the rise in the budget deficit may not be as large as indicated.

Inflation or deflation? -- In the short run, it remains possible to neutralize the inflationary effect of the moderately increased budget deficit with profits on sterling operations earned by the Bank of Thailand. As shown above, the appreciation of the baht has caused a drain on the sterling holdings of the Bank, so that, even though the profit per pound has been cut drastically by the reduction of the Bank's selling rate for sterling, the vastly increased volume results in an increase in the total profits made by the Bank on sterling operations. Consequently, it is unlikely that there will be any need to supplement the normal resources of the Stabilization Fund for the purpose of financing the deficit. Indeed, now that total foreign exchange reserves are falling, the corresponding net withdrawal of currency from circulation is likely to exceed the budget deficit, and the net result will be a decline in the note issue, with its deflationary consequences.

In the long run, however, the drain on foreign exchange reserves must slow down. At the rate of depletion experienced in March and April, sterling holdings, including long-term holdings, would be exhausted by the end of this year. Long before this, commercial bank credit is likely to become tighter and merchants may have to suffer losses as some local markets become glutted. As a result, there might be some reduction in the tendency to hoard gold and dollars which would thus reduce the drain on foreign exchange reserves. When the drain on reserves abates, dwindling profits on sterling operations would appear to make continued neutralization of the deficit from this source impossible and to imply a resumption of the tendency of the note issue to rise, with its inflationary consequences.

One consideration having a bearing upon this forecast must finally be mentioned, although its influence may be slight. It is that the reduction in the free rate for dollars, which has accompanied the recent developments, means that the counterpart fund, arising out of the proceeds of the sale in Thailand of goods imported under the MSA program, will now receive fewer bahts than before February 28. Thus, its deflationary effect has been somewhat weakened. However, the importance of the counterpart deposits in Thailand is rather small and this change probably makes little difference in the situation.

Prices — The effect of the recent financial measures on prices may be significant. Import and export prices are determined primarily in world markets rather than in Thailand, and it would seem as though their baht equivalent would have to fall. Exceptions would be rice, which is subject to the official rate of exchange and therefore not affected by the appreciation of the baht on the free market, and imported products subject to ad valorem duties, for which the increase in duties of April 1 offsets any cheapening resulting from currency appreciation. In addition, it was recently decided that oil imports, which were eligible for foreign exchange at the official rate, would now have to be paid for with foreign exchange obtained at the free rate. An increase in their baht cost is, therefore, indicated.

Prices of purely domestic goods may react more nearly according to the prevailing domestic inflationary or deflationary forces, with increased Government expenditures playing an important part in pushing up prices of those goods least dependent upon imports. Domestic products dependent upon those imports whose prices rose should probably become more expensive.

Cost of living items include rice, purely domestic products and certain imported consumer goods (e.g. cotton and oil products). The prices of some of these are likely to rise while prices of the others remain unchanged. In view of the importance of these items, the cost of living may well continue to rise in spite of the appreciation of the baht. Thus, the announced objective of this move, which was to reduce the cost of living, may not be reached. If the cost of living continues to rise, this might result in higher government expenditures and therefore an increased budget deficit. Such a development would strengthen inflationary forces, which at present are more than offset by deflationary influences. It is an added reason why the long run prospect may be inflationary. In the short run, however, the deflationary effect of the drain on reserves upon the note issue may be reflected to some extent in a retardation of price increases or even in a decline in prices which might even affect the cost of living.

Conclusion

The principal results of the recent financial measures in Thailand appear to have been (1) the reversal of the tendency of foreign exchange reserves to rise and the consequent acceleration of the change in the relative importance of dollars and pounds in the foreign exchange reserves, and (2) the monetary and fiscal repercussions which, if they have not decisively altered the inflationary climate of the economy, have nevertheless strengthened the deflationary forces. If these new tendencies are allowed to have their full effect, the outcome may be the eventual replacement of sterling by the dollar as the largest single component of Thailand's foreign exchange reserve. At the same time, the over-all decline in the total amount of foreign exchange held will eventually weaken the country's international position. The deflationary effect of a fall in reserves is probably healthy in as much as it may be expected to offset the inflationary pressure of the rising budget deficits, which present Government policy appears to make inevitable. However, since the reserves are being drawn down primarily by what amounts to a flight of capital, the country is being deprived of the opportunity of using them to finance needed imports of capital goods and other materials required to carry out economic development projects. This means either that these projects will have to be slowed down or postponed or that increased foreign aid will have to be sought, or both. In any case, the progress of Thailand toward higher living standards apparently will receive a setback.

The increased tendency to hoard gold and dollars, which the recent developments appear to have brought about, is also significant. It illustrates the siphoning of a portion of the world supply of gold and dollars into private channels and its failure to strengthen central bank reserves. While the United Kingdom appears to have suffered most from this tendency, other countries have also been hurt. The Thai experience points to the need for remedial action aimed at restoring confidence in national currencies through the adoption of orthodox policies, including convertibility.

The recent financial measures appear to foreshadow an increasing degree of Government intervention in financial and monetary affairs, a field which has up until recently remained relatively free from controls. Already the surrender requirements for foreign exchange proceeds of exports have been tightened as of May 19 to prevent exporters from depositing these funds in accounts abroad. However, current transactions remain exempt from exchange control and the licensing system which applies to all imports does not apply to all exports. This, and the apparently loose administration of the system, leaves the door wide open for evasion of the exchange control on capital transfers. If the Government decides to halt the drain on foreign exchange reserves without reversing the appreciation of February 28, it will have to tighten exchange control still further as well as strengthen import and export licensing. Such an expansion of centralized controls would certainly create wide opportunities for political pressure and corruption, and would require a large staff of trained personnel to administer the controls effectively. As an indication of the trend to centralized control of economic affairs, all of the members of the board of directors of the Bank of Thailand and the Bank's Governor have been replaced by men who presumably will be more amenable to approving cabinet decisions. Similarly, the membership of the National Economic Council has been revised and is now comprised of the ranking army and naval officers now in control of the Government.

In the light of these circumstances, it is doubtful that the recent financial measures in Thailand are a step in the direction of eliminating the multiple exchange rate system. The introduction and recent tightening of exchange control appears to reflect the desire to maintain the present system, and the prospect that exchange controls and licenses will have to be greatly expanded hardly indicates a movement toward convertibility at a single rate.

Moreover, the elimination of the multiple exchange rate system and the adoption of a single exchange rate, as recommended by the International Monetary Fund in 1950, does not appear to be easier of accomplishment today than before the recent appreciation. Now, as then, the abolition of the spread between the official and the free market rates of exchange would create serious fiscal difficulties. No longer able to rely, as it now does for the purpose of financing its budget deficit, on the profits made by the Bank of Thailand on sales at the free market rate of sterling acquired at the official rate, the Government would have to seek new sources of funds. It would have the alternative of (1) selling Treasury bills directly to the Bank of Thailand without the benefit of the offsetting deflationary effect of sterling operations at a dual rate, or (2) raising taxes, which might include introducing export taxes on rice, rubber, and tin, the commodities now subject to the requirement that export proceeds be surrendered at the official rate. The former is obviously inflationary and, as such, undesirable, while the latter appears to be politically unpalatable. When to this is added the problem of coping with the broken sterling-dollar cross rate associated with sterling inconvertibility.

and the newly created opportunities for political control through an expanding exchange control machinery, the prospects for the replacement of the multiple exchange rate system by a system involving convertibility at a single rate appear less bright than before the recent appreciation.

In the final analysis, it is hard to see in what respects the recent financial and monetary measures represent an improvement over the previous situation. Before February 28, there was a gradual decline in the free market rate, and the Bank of Thailand occasionally adjusted its selling rate for sterling to a level never more than 2 per cent below the average of the commercial banks' selling rates for the preceding week. Continuance of this earlier policy would probably have permitted a gradual shift in the relative importance of dollars and pounds in the foreign exchange reserve which would have been less rapid than the shift now in progress and would at the same time have avoided the large scale arbitrage operations and the consequent excessive drain on reserves now being witnessed. As a result, the use of a portion of these reserves to increase imports of capital goods and other materials needed for the economic development of the country would have remained possible, and this would have created a more healthy climate in which the desired deflation could have been attained. The conclusion appears to be that the recent financial measures in Thailand resulted in an increase in uncertainty and speculation and weakened, rather than strengthened, the country's ability to carry forward a sound development program.