Thailand shows wisdom in restraining the herd
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One of the central lessons of the 1997 Asian crisis is that emerging market countries are prone to receiving excessive foreign-capital inflow, which bids up asset prices and exchange rates, and sets the scene for a painful bursting of the bubble.

These tensions are beginning to reappear.

Emerging capital markets are tiny compared with the combined portfolios of international investors, and a small switch in preferences can easily overwhelm them. The flows are volatile, because a large part is "herd" money with no independent knowledge of the specifics of the receiving country.

A small accretion of information can change the minds of investors who know little. When the herd changes direction, there are big price movements in the shallow capital markets and, more damaging, shifts in the exchange rate. These shifts damage the balance sheets of residents who have borrowed in foreign currency, and give false signals to productive investment.

Despite nearly a decade of debate since the Asian crisis, there is still no satisfactory answer to this conundrum. It has been in abeyance during this period because the memory of the crisis has kept foreign-capital inflows small; domestic investment has been relatively subdued (outside China); interest rates in Asian emerging countries have been low; and governments have been intent on running strong external accounts, accumulating a war-chest of foreign exchange reserves.

Foreign-capital inflow is now back on the agenda. A conference of Asian central banks made this their main talking point in Tokyo last month.

Equity markets in China and Vietnam are showing the classic symptoms of a bubble. Korea is clearly uncomfortable with the level of capital inflow. Most concretely, in December Thailand widened its mandatory deposit requirement on foreign capital, in an effort to discourage short-term inflows.

Of course this measure was unwelcome in financial markets, and other measures and events are also complicating the outcome. But it has taken the steam out of the appreciation of the baht, which was the desired effect.

In the 12 months before the measure, the baht had appreciated 12 per cent against the Chinese yuan, its main external competitor.

The issue is likely to become more acute: international capital is still predominantly flowing "uphill" from the emerging countries to fund the US current account deficit. When this changes, and capital once again flows "downhill", the volumes will be much larger than at present.

Financial markets, while condemning Thailand's efforts to restrain foreign-capital inflow, have no suggestions on how to deal with the intrinsic problem. Market commentators are now suggesting that the right response to a strong exchange rate is to lower interest rates (which are already lower than America's). But lower rates increase the likelihood of an asset bubble, encouraging

more capital inflow through the promise of capital gains and further appreciating the exchange rate.

Instead of revising their policy measure, the Thai authorities might have held their nerve and said "if some capital is so flighty that it is not prepared to stay here for one year (when the effect of the short-term withholding period ceases), then we are better off without it". The main benefits of foreign-capital inflows will come from the more patient longer-term capital, ideally with the technology transfer that comes with foreign direct investment.

The first step in formulating a sensible response is to shift the debate out of the ideological battlefield, into the real world, with all its messy practicalities.

The analysis needs to go beyond the standard academic approach: "Let us assume that markets work perfectly and that everyone is fully informed, including about the future." The argument can't be won by simply condemning capital controls on doctrinal grounds.

There needs to be a recognition that emerging countries like Thailand have substantial productivity potential as they move to "best-practice" techniques.

As a result, they will have high profitability and a higher "natural" rate of interest (the rate associated with stability) than mature countries.

In a world of responsive capital flows, with portfolio managers looking to maximise returns, the scene is set for excessive inflows.

In these circumstances, there is a place for the sort of short-term tax on capital inflows which Thailand introduced, and there are plenty of precedents for such measures.

Such measures are often associated with Chile's 1991 unremunerated reserve requirements on inflows, but they have been used by many other countries (for example, Australia's variable deposit requirements in the 1970s).

During the evolution of financial markets in the now-mature economies, measures designed to limit speculation (for example, limits on short-selling) were common, and only removed when the markets had achieved maturity.

Two decades ago, Nobel Prize-winning economist James Tobin suggested that it might sometimes be a good idea to "throw some sand in the wheels" of financial flows.

Recipient countries should decide which ones are most beneficial, and which ones are potential sources of asset bubbles.

It will sometimes make good sense to discriminate, and if this means less capital inflow and less inflated equity prices, then so be it.

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