“Capital Controls” & FX Intervention

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The Current Situation

Targeted capital controls & macro-prudential measures to curtail market volatility

Brazil	Oct-10	IOF increased to 6% for foreign fixed-income investments and implemented a 6% tax on margin deposits for foreign exchange futures transactions from 0.38%. (18th October). Also closed loopholes that allowed investors avoid higher debt inflow tax.
	Dec-10	Unrenumerated Reserve Requirement (RR) on time despoits increased from 15% to 20%. Renumnerated RR on deposits increased from 8% to 12%.
	Mar-11	IOF tax on international bond issuance increased to 6.0% on all maturities up to one year.
Indonesia	Jun-10	One-month holding period introduced for SBIs in June 2010. In April 2011 this was extended to six months effective 13th May 2011. Suspension of SBI issuance with maturities less than 9 months. Introduction of one-month non-transferable term deposit facility.
	Dec-10	Re-introduction of cap on short-term foreign borrowing by banks to 30% of capital, effective March 2011
Thailand	Sep-10	Limit on direct overseas investments removed. Restrictions on lending by Thai institutions to non-residents relaxed and cap on offshore property purchases increased.
	Oct-10	Re-introduction of 15% withholding tax on non-residents' interest earnings and capital gains on government bond puchases. Already in place for domestic residents
South Korea	Jun-10	Limit on resident banks' FX derivatives contracts set at 50% of capital in previous month and for foreign bank branches set at 250% of equity capital in previous month. Cut further to 40% and 200% respectively in May 2011 and effective 1st June.
	Jun-10	Banks FX forward contracts limit for corporate customers reduced from 125% to 100%.
	Dec-10	Re-introduction of 14% withholding tax on interest income on non-resident purchases of government and monetary stabilization bonds effective Jan 2011. Plans for levy on foreign currency non-deposit bank liabilities from 1st August

Push & Pull Factors

Short-term

- QE2 & DM Loose Monetary Policy
- Weak Financial Sector Balance Sheets
- Government Indebtedness
- Higher Nominal Interest Rates
- Relatively Stable Inflation

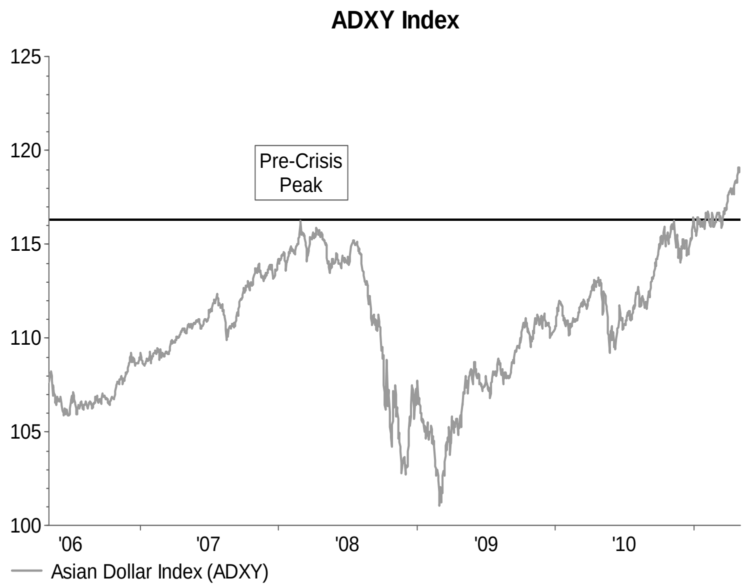
Long-term

- Declining Potential Growth Rates
- Portfolio Diversifaction
- Higher Potential Growth Rates
- Better Developed Financial Markets
- Global Integration Through Trade

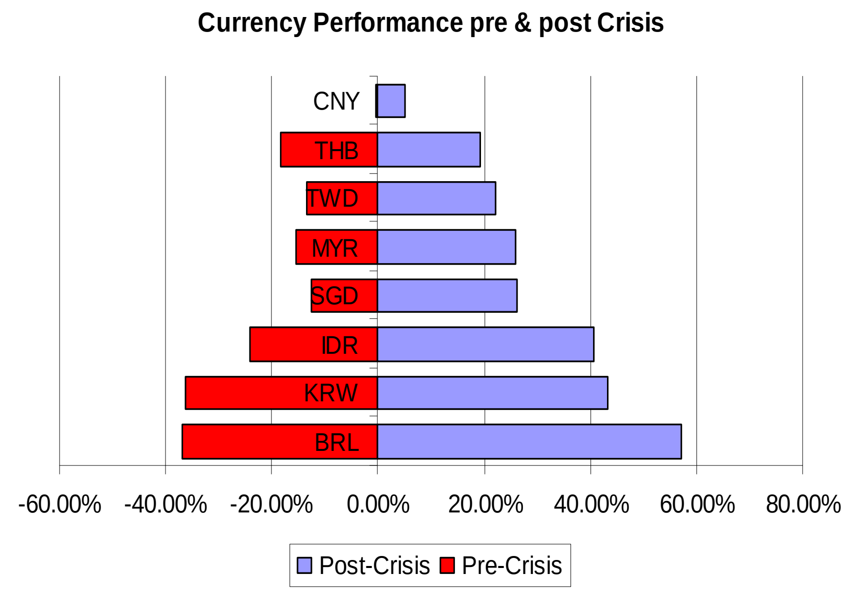
IIF Asia Capital Inflows & Projections, USD bn	
2007	410
2008	120
2009	378
2010 (Actual)	500
2011	484
2012	446

	Net Inflows - Total sum Q2 09 to Q4 10 % 2010 GDP	Dominant Type of Capital Inflow	NEER % Appreciation since April 2009 to April 2011	Monetary Policy Direction	Inflation - Avg Rate in 6mths to April 2011	Change from Previous 12mths	Bank Credit - Annual Growth April 2011	Change from 10yr average	FX Reserves Increase since Q2 2009 to April 2011	Reserves Increase % GDP
South Korea	2.80%	Portfolio	16.50%		4.10%	1.3	4.70%	-7.3	100.8	9.20%
Thailand	5.00%	'Other Investment'	3.20%		3.80%	0.6	19.00%	11.3	68.7	20.40%
Taiwan	2.50%	'Other Investment'	3.30%		1.30%	0.7	8.90%	4.9	99.4	20.80%
Indonesia	3.60%	Portfolio	18.10%		6.70%	2.2	24.30%	1.5	58.2	7.80%
China	4.60%	FDI	-8.50%		4.90%	2.6	17.90%	-3.5	1091	18.20%
Brazil	10.20%	Portfolio	31.00%		6.10%	1.3	26.40%	6.6	126	7.40%

Why have these countries resorted to capital controls & macro-prudential measures?



Source: Bloomberg



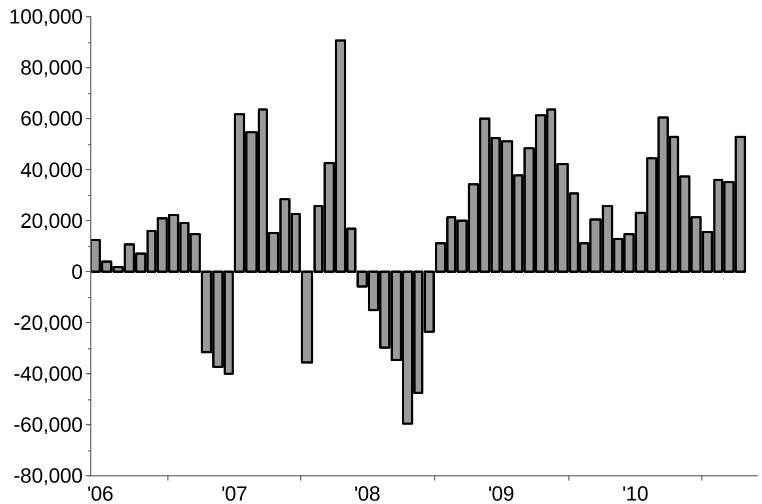
Source: Bloomberg

- Curtail the volume of capital inflows
- Limit currency appreciation
- Change the composition of inflows
- Create conditions to allow monetary policy independence
- Reduce financial market volatility
- Slow the pace of reserve accumulation

Impact of Capital Flow Measures

Pace of FX reserve increase accelerating in Brazil & Asia

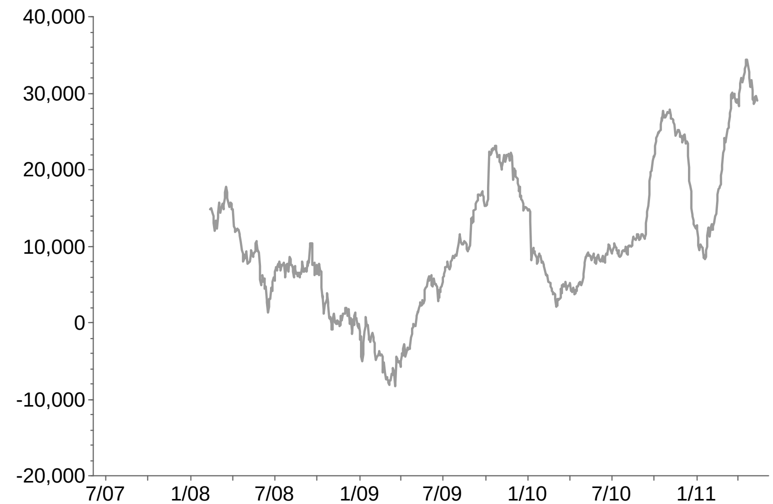
3-Month Asia Reserve Change - KRW, THB, TWD, IDR



(DIFF 1Q) Asia 4 KRW, THB, TWD, IDR, (USD mn)

Source: Bloomberg

90-Day Change Brazil Reserves

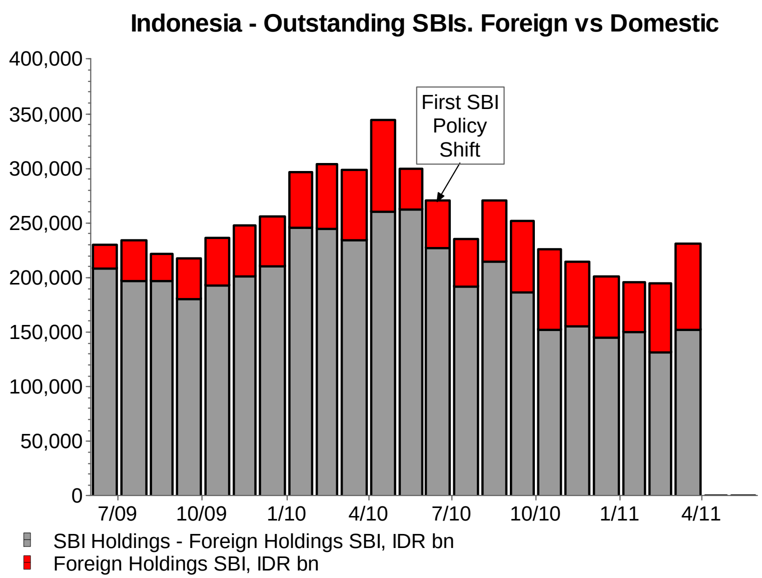


(DIFF 1Q) Brazil Daily Reserves, USD mn

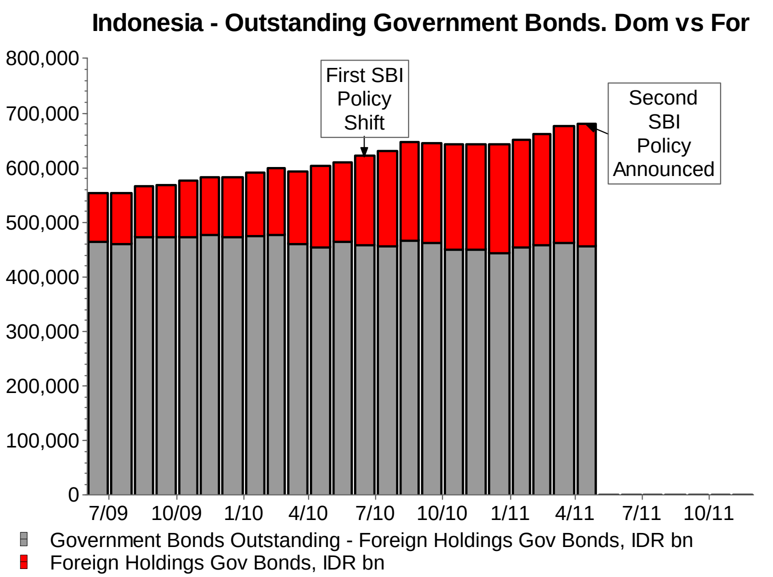
Source: Bloomberg

- For Asia-4 foreign exchange reserves increased USD 53 billion in three months to April 2011. In Brazil, the 3-month increase totalled USD 32 billion, close to a record high. Brazil foreign exchange reserves hit a record USD 330 billion as of the end of May. Asia-4 breached the USD 1.0 trillion level during May.

Indonesia SBI policy step had an impact – but more in composition of inflows



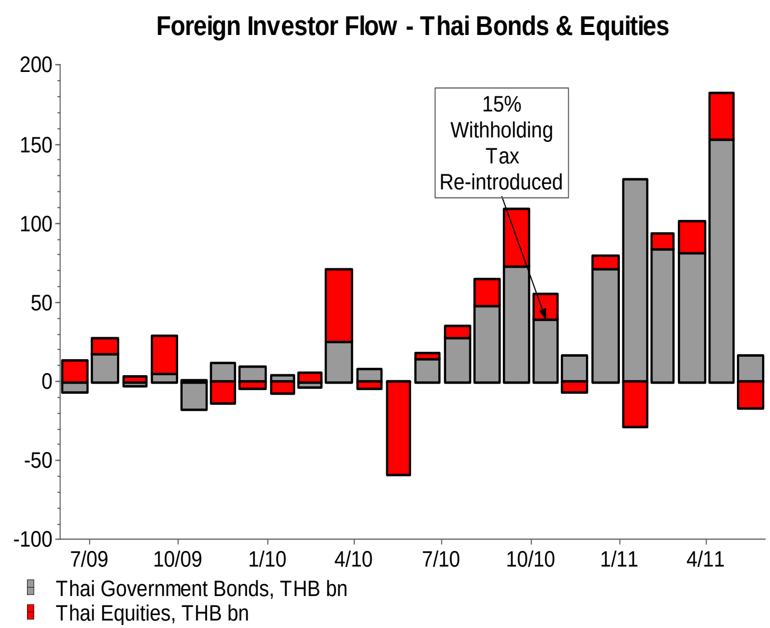
Source: Bank Indonesia



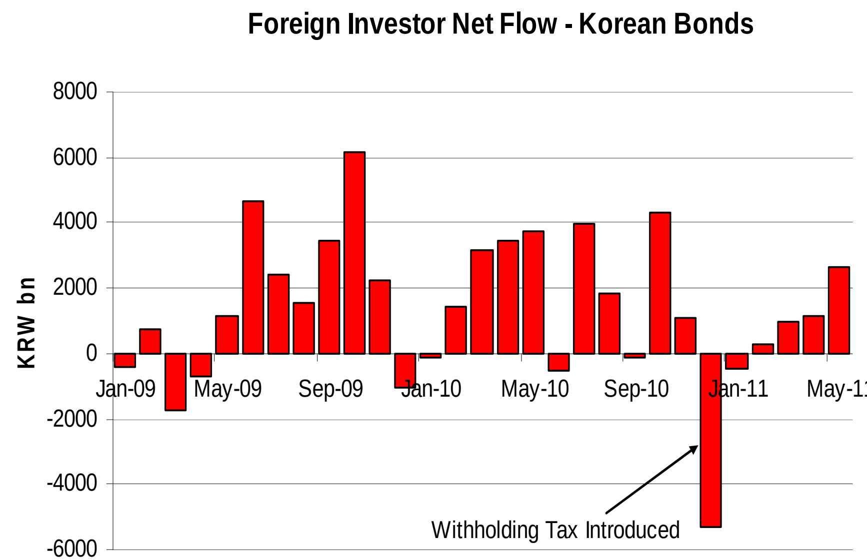
Source: Bank Indonesia

- Global risk aversion in May 2010 resulted in foreign holdings of SBIs falling from USD 9.0 billion in April to USD 4.0 billion in May. In June 2010, the month of the announcement foreign holdings of SBIs increased modestly to USD 4.5 billion. USD/IDR jumped 4.5% in May 2010.

Re-introduction of withholding taxes has had only a temporary impact



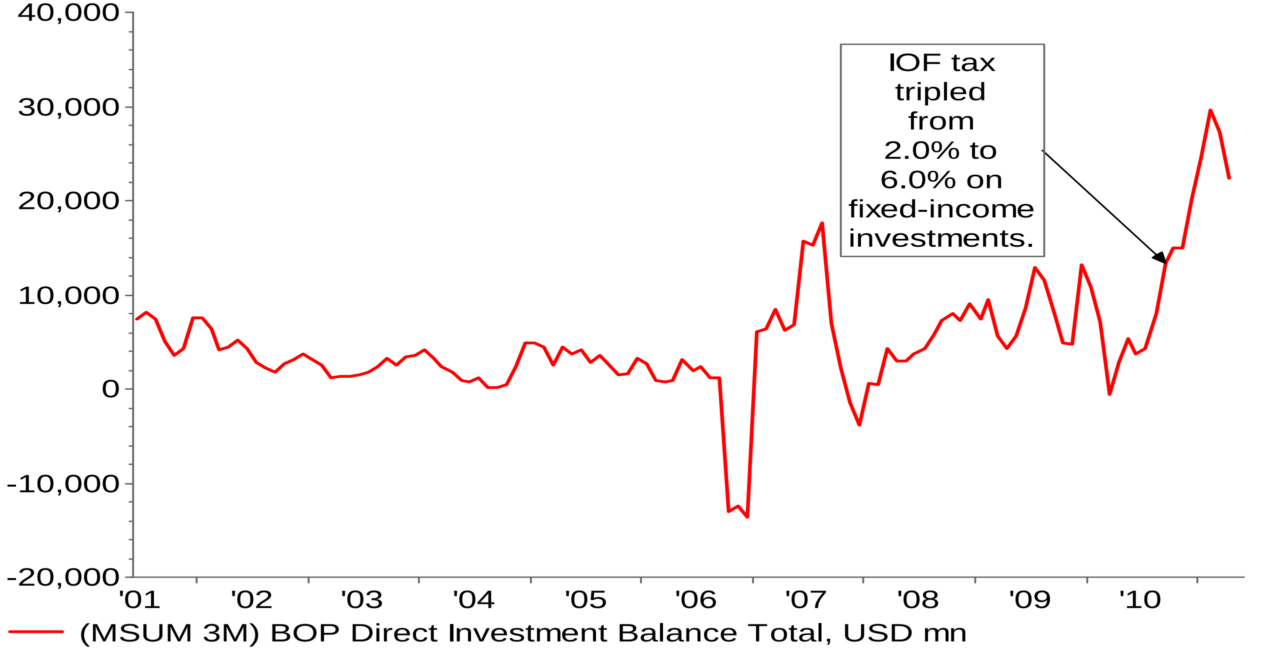
Source: Thai Bond Market Association



Source: Financial Supervisory Service of South Korea

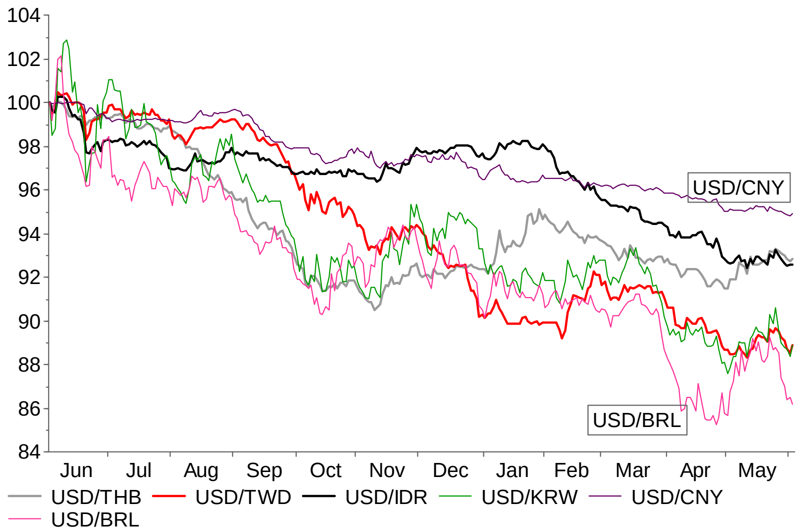
- Inflows to Thailand's bond markets fell in October and November 2010 but have since recovered sharply. USD/THB fell sharply in Oct & Nov 2010 hitting a post-Asian crisis low. Foreign investors sales of Korean bonds hit a record KRW 5.3 trillion (USD 4.7bn) in January 2011. The Korean won strengthened.

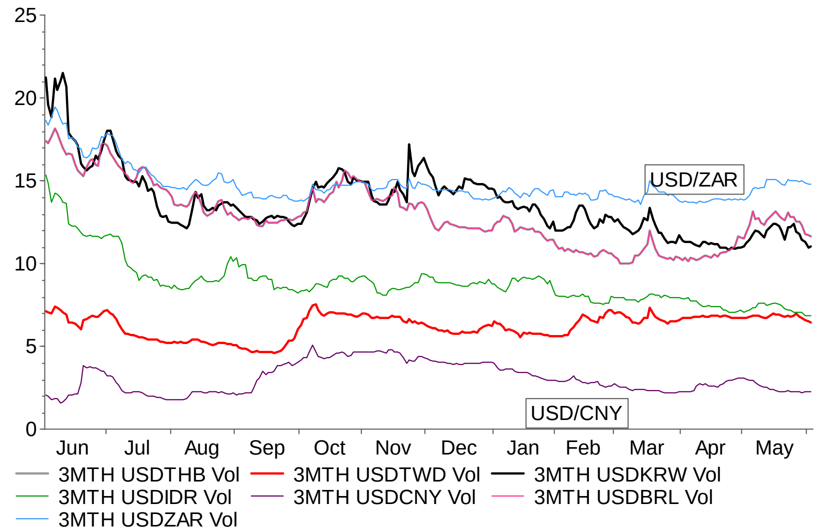
Brazil IOF tax may be encouraging inflows disguised as FDI



- There were net portfolio inflows of USD 63 billion in 2010. However, in the first four months of 2011, foreign investor portfolio inflows totalled just USD 0.5 billion compared to USD 14.3 billion in the same period of 2010. FDI inflows have increased from USD 7.7 billion in the same period of 2010 to USD 23 billion in 2011. USD/BRL jumped 4.9% in October 2010 when IOF tax on bonds was tripled.

FX performance & FX volatility since Capital Flow Measures (CFM)

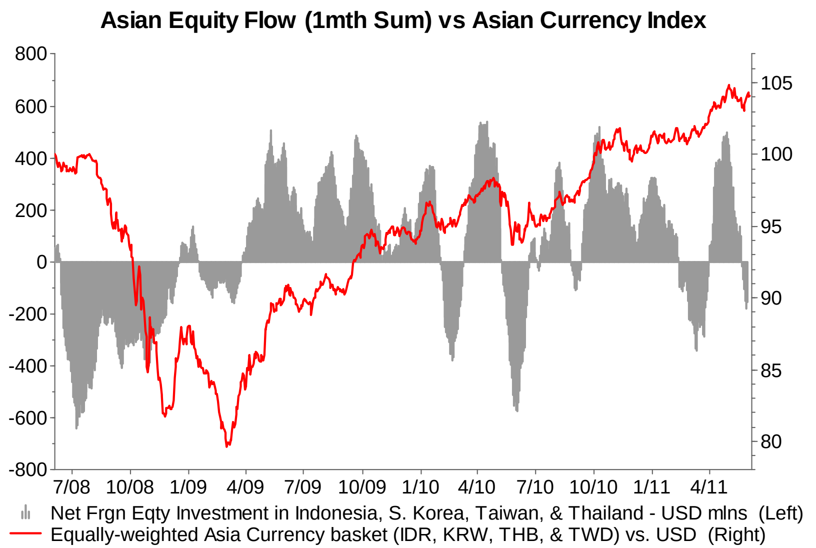


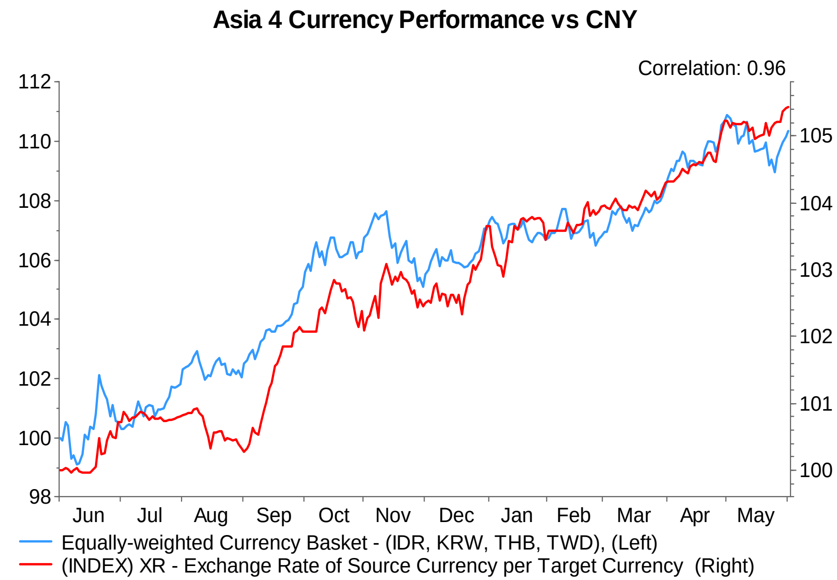


- Each currency rebased from June 2010 shows USD/BRL as being the biggest mover to the downside, dropping 14% over the past year. The Taiwan dollar & Korean won are the best performers in Asia. FX volatility has been relatively stable with CNY volatility the lowest. South Africa which has largely avoided implementing capital flow measures has recorded the greatest level of currency volatility.

Sustainability of Capital Flow Measures

Asia currency performances linked to equity flows and China FX policy

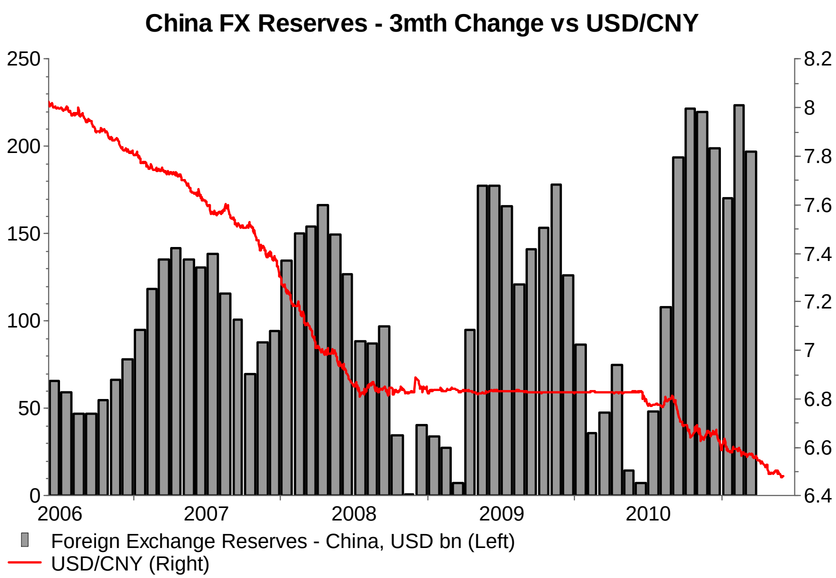




Source: Bloomberg

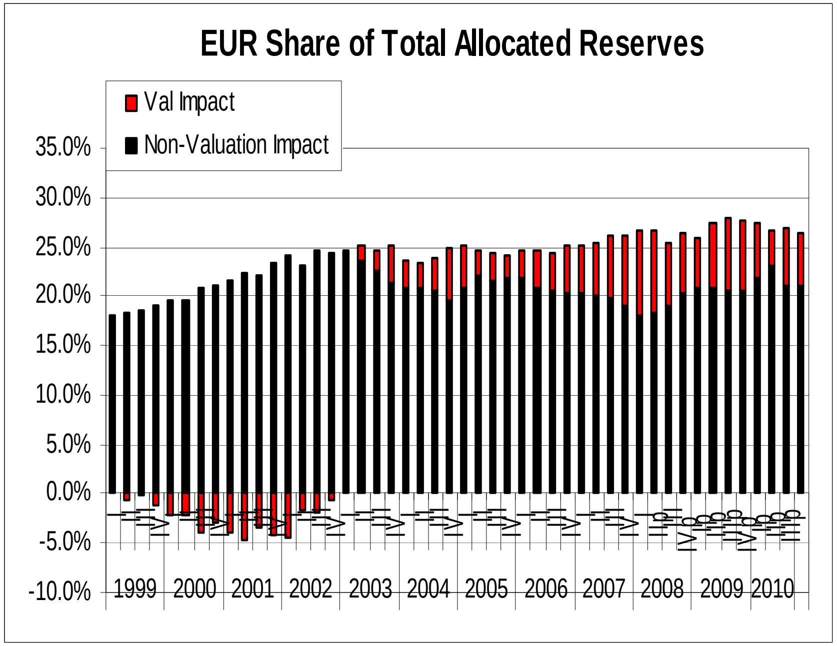
- Strong relative real GDP growth since the financial crisis has drawn foreign investors to Asian equity markets. Capital flow measures by Asian authorities have avoided disrupting equity inflows after the Thai policy error of 2006. Key to foreign exchange and policies on capital flows in Asia will remain FX policy in China.

Accelerating growth in China's FX reserves as sterilisation costs surpass returns

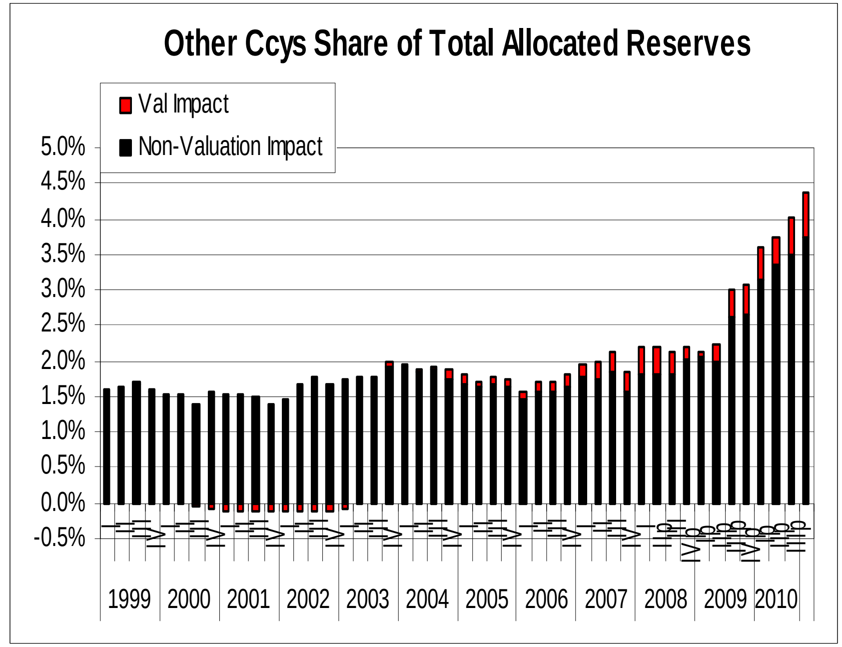


- FX reserve accumulation close to a record in China at USD 197 billion in the three months to March, just below the record USD 224 billion increase in February. The average 3-month increase over the past six months was USD 206 billion. However, over this period sterilisation costs have risen above our estimated return on fixed income investments in foreign exchange reserves.

Rising sterilisation costs relative to returns on reserves encouraging diversification



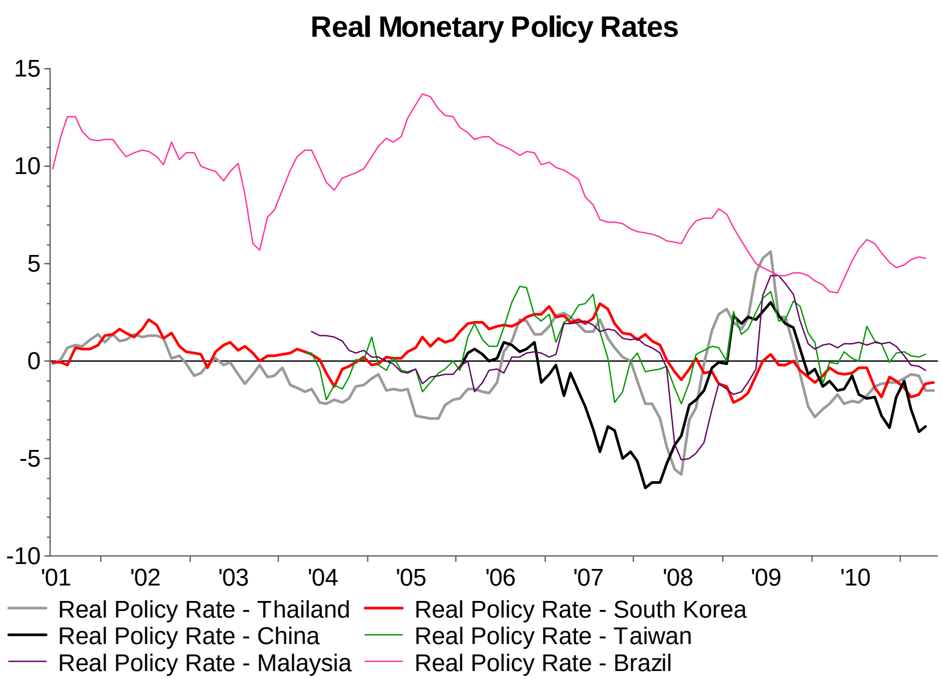
Source: IMF



Source: IMF

- Evidence of diversification clear in the quarterly IMF COFER data. Marked shift into “other currencies” as central banks become more cautious on EUR. Liquidity constraints will limit scale of diversification and central banks likely to accept costs for now.

Nearly all Asian countries running excessively loose monetary policy stances



Official Policy Rates

	Current	Average*	Peak
Brazil	12.00%	16.50%	26.50%
Indonesia*	6.75%	6.90%	12.75%
China	6.31%	5.50%	7.47%
South Korea*	3.00%	2.90%	5.25%
Thailand	3.00%	2.50%	5.00%
Taiwan	1.75%	2.25%	3.65%

*10yr period average but for Indonesia 6yr, S Korea 3yr

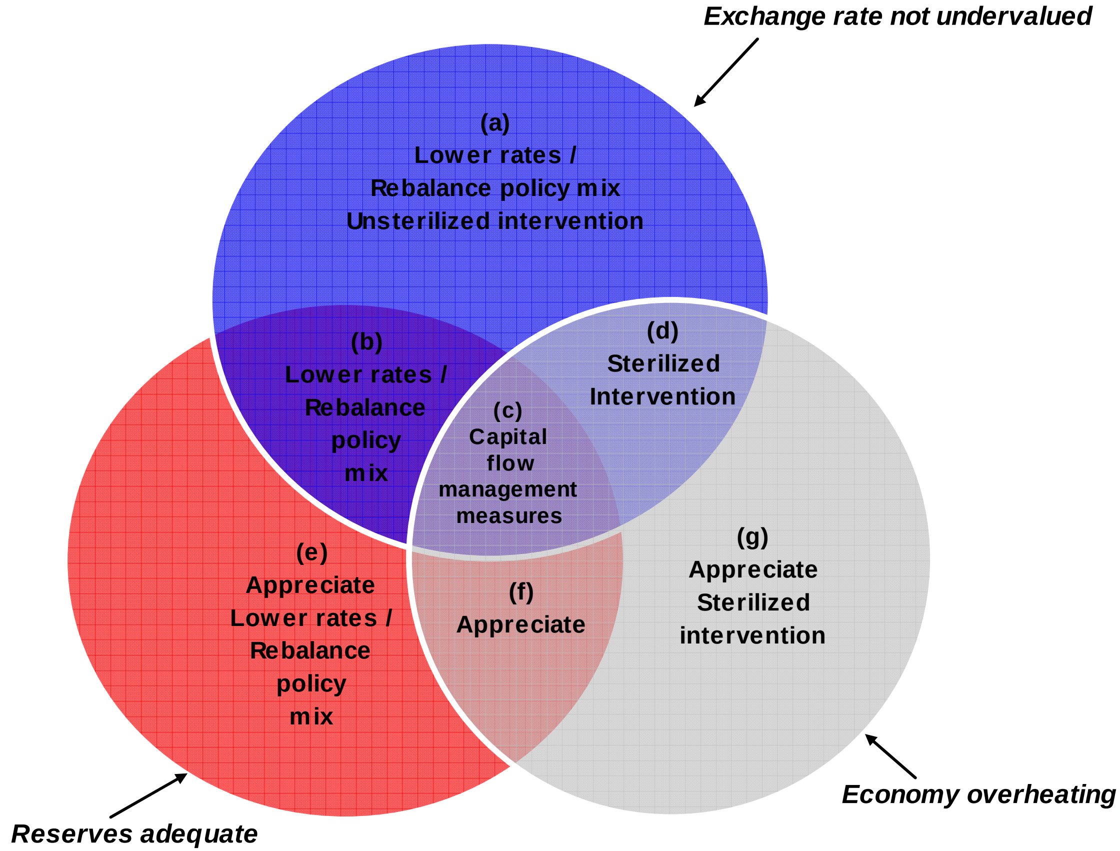
FX valuation will play a key part in international acceptance of CFM.

	% Over/Undervalued vs USD	FEER
BRL	24.96%	15%
IDR	7.46%	1%
KRW	4.17%	3.20%
THB	3.04%	5.90%
TWD	1.40%	-6.50%
SGD	0.96%	-25%
CNY	-6.10%	-16.50%
MYR	-8.20%	-9.20%

Spot Rates as of 0900 BST 6th June 2011

- Valuations derived from FEER estimates from Peterson Institute for International Economics. PPP & long-term deviations from BTMU
- FEER only valuations based on Effective Exchange Rates and as of end April 2011.

IMF offers a template for dealing with capital flows – CFM sometimes justified (zone C)



Source : IMF Paper "Recent Experiences in Managing Capital Inflows – Cross-Cutting Themes and Possible Policy Framework." February 2011

Conclusions

- No solid evidence to suggest significant changes in cross-border flows from capital control & macro-prudential measures. Initial near-term impacts tend to fade overpowered by fundamental ‘push-pull’ factors.

- Steps taken by emerging market countries do not appear geared toward stopping capital but more toward curtailing speculative inflows and reducing the risk of large volatile swings in foreign exchange. South Korea, Indonesia and Brazil have been most active in taking capital flow measures and also suffered the greatest foreign exchange swings pre-post financial crisis.

- Capital flow measures cannot replace macroeconomic policy measures. Building inflationary pressures, if sustained, will require much greater monetary tightening with a risk of more aggressive capital flow measures and intervention to counter currency appreciation. Fiscal policy should also be tightened to alleviate overheating risks.

- The IMF template offers a potential basis for international agreement on the use of capital flow measures. However, that agreement is more likely to be tacit rather than formal.

All Charts and data sourced through Factset, unless otherwise stated.
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