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A Primer On The Chilean "Encaje"

Given all the recent attention to the heightened risks of capital controls in the Emerging Markets, we thought it would be helpful to provide an in-depth analysis of Chile's experience and see what it implies for countries that are now enacting or contemplating similar policies. Because of Chile's resiliency during the Mexican "tequila" crisis and then the Asian crisis, the encaje has garnered much attention since its implementation but the conclusions are mixed. While the mechanics will vary across countries, the measures will in practice act as a tax on foreign inflows.

Chile was one of the first EM countries to attempt to limit or influence inflows of foreign capital. The encaje ("strongbox" in Spanish) was an unremunerated reserve requirement (URR) that was introduced when Chile's success in liberalizing and modernizing its economy led to a surge in foreign investment in the early 1990s that put strong upward pressure on the peso. The goals of the encaje were to 1) limit peso appreciation, 2) limit short-term capital inflows in order to minimize disruptions from speculative hot money, and 3) allow greater independence for monetary policy, as rate hikes to dampen inflation would be overwhelmed by the expansionary effects of greater foreign inflows attracted by the higher interest rates. All three of these concerns are thought be behind recent moves in Brazil and Taiwan to limit or slow foreign inflows. We believe that the longer the EM currency rally continues, more countries are likely to introduce some sort of limits on inflows. Already, Indonesia, Kazakhstan, Russia, and others have admitted that such measures are being studied.

To summarize, starting in June 1991, the Chilean government required a set portion of foreign capital inflows be put into a one-year, non-interest paying deposit with the central bank. The encaje was initially set at 20% of the total inflow and was first applied only to fixed income and foreign loans. What's interesting to us is that the encaje was continually modified, as policy-makers sought to find the right balance and cut off potential loopholes that emerged even though Chile had a strong institutional framework and low levels of corruption. The deposit requirement varied from 10-30% and the penalty for early withdrawal ranged from 1-3%, so it should be no surprise than Brazil is in the process of tweaking its efforts currently. Expect further adjustments in Brazil if they are deemed necessary.

The encaje was eventually eliminated in 1998. During its existence, was the encaje successful in meeting the three goals? Evidence on the experience has been mixed. Most importantly, Chile experienced an almost 30% appreciation in real terms of the peso between 1991-1998, when the encaje was in effect. While some may be tempted to say that the encaje was successful in at least slowing the appreciation, several studies suggest that the controls had no significant effect on the path of the real exchange rate. Much ink has been spilt about the effects of the encaje on Chile's enviable development path, but because many other sweeping economic reforms were taken around the same time, it is impossible to isolate the beneficial effects of the encaje from other factors.

Many studies suggest that the measures did change the maturity of inflows. Several of the best known studies were done by current central bank chief Jose De Gregorio, who concluded that the encaje may have shifted modestly the composition of capital inflows from short-term to longer-term maturities. However, he concluded that there was no significant impact on the real exchange rate. An IMF research review concluded that the encaje, combined with other financial sector reforms, may have allowed the government more monetary policy autonomy and also shifted the composition of foreign investment from short-term "hot money" to longer-term flows.

It is very important to address the notion that such capital controls are costless. We note that small and medium-sized companies in Chile complained that the encaje made it substantially more difficult and costly to obtain financing for investment. One academic study suggested that because of the encaje, smaller firms in Chile experienced significant financial constraints, with these constraints decreasing as firm size increased. This potential cost of inward capital controls could thus be particularly significant in EM, where smaller firms are important sources of job creation and GDP growth. Furthermore, the encaje may have distorted individual firm behavior with regards to the optimal way to raise funding. This may be what was behind the efforts of Brazil to add a tax on ADR creation in addition to the IOF tax , but it has not been explicitly stated by the policy-makers there.

Marc Chandler	212.493.8800
Win Thin	212.493.8361
Meg Browne	212.493.8744
Audrey Childe-Freeman	44.207.614.8791

It is noteworthy that in addition to the encaje, Chilean policy-makers have gradually liberalized controls on capital outflows. For instance, Chilean pension funds (AFPs) have been allowed to invest a greater percentage of assets under management (AUM) overseas. Pension funds were not allowed to hold any foreign assets until 1992, when the limit was first set at 3% of AUM. It was then increased to 9% in 1995 and 12% in 1997, and currently stands at 60%. Raising these limits is one way for the authorities to reduce *net* inflows (by encouraging outflows by domestic agents), and we have seen similar liberalization measures in China and South Africa this year. This trend is unmistakably positive and is likely to continue across the EM space.

The IMF has begrudgingly accepted the use of Chile-style capital controls after the experiences of the Asian crisis showed that full convertibility for EM nations could prove to be too much for them and end up being a destabilizing force. However, IMF officials noted after the recent reinstatement of the Brazilian IOF tax that such measures prove to be porous with limited efficacy towards achieving the desired goals. In the EM space, restricted currencies are now the norm and not the exception, and experience has shown that selected restrictions have not deterred foreign investors from going into countries with strong fundamentals. For instance, the BRICs all have restricted currencies, and yet foreign investors continue to pour money into those countries even though it is clear that none of them are in any hurry to move to full convertibility anytime soon.

Bottom line: Encaje-style controls can at best slow the appreciation pressures on EM currencies, not reverse them. Unfortunately, it appears that this won't stop policy-makers from trying them anyway, but to us, controls are a very blunt instrument that should not be used to try and affect the exchange rate. If a country runs good policies and has solid economic fundamentals, then foreign money will flow in and there's not much that can be done with regards to the exchange rate. Along with strong EM fundamentals, global liquidity is still plentiful and risk appetite remains strong, so it appears that foreign investors will continue to flock to EM. To us, the biggest risk to EM currency strength is not the capital controls, but rather the durability of the current environment that has seen ongoing investor interest in risk trades.

Win Thin
Senior Currency Strategist

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