Globalisation, financial markets and the operation of monetary policy: the case of Thailand

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Overview

This paper seeks to clarify how monetary policy in Thailand has evolved in response to the challenges posed by globalisation. It explores the role and impact of globalisation and financial integration on Thailand's financial system and its implications for the economy over the last decade. Thailand's economic and financial landscape has changed dramatically over this period to cope with the financial sector restructuring which the country had to undergo during the 1997 crisis, the challenges of the economic and financial environment, including economic and financial reforms, and the global trend towards adoption of international standards and codes on transparency of the conduct of policies. This paper will illustrate the impact of globalisation on Thailand's financial system and the challenges for the Bank of Thailand (BOT) in conducting monetary policy. The paper recounts the events in three phases. The first phase covers Thailand's liberalisation and integration into the global financial markets in the 1990s. The second phase covers the financial crisis of 1997, and the third phase will cover the evolution of the financial system post-crisis under current economic developments. The paper will end with a look at the challenges ahead and ways forward.

1. Introduction

The 1990s saw dramatic changes in the liberalisation and internationalisation of emerging market economies. During this period, Thailand's financial system was gradually integrated into the regional and global system. The price system or the domestic interest rate structure was being set by market forces. Greater foreign participation was permitted while the scope of operation was enlarged and financial infrastructures strengthened. The aim was to ensure that the domestic financial system could effectively serve the needs of the production sector, making Thailand attractive to foreign direct investment and able to attract international capital, which had a lower cost than that from the domestic markets at the time. With a fixed exchange rate system, monetary policy operations revolved around the tasks of managing capital inflows through both foreign direct investment and foreign portfolio investments.

A new milestone in Thailand's economic and financial development was set by the events of the 1997 financial crisis. The Thai authorities had to redefine and review the appropriateness of the strategies current at the time. New mechanisms were put in place to safeguard the economy and financial system against external shocks and volatilities inherent in an open financial system, while at the same time attempting to restore economic and financial stability. This included reforms across sectors, covering social, economic and government reforms, and particularly reforms of the banking system. A dual track approach involving parallel efforts to develop both an export-led strategy and domestic grass-roots economies was adopted to revamp the domestic foundation while at the same time better preparing the country for re-entry into the global market.

At the time of writing, Thailand's economic growth path has been restored, with growth of 6.8% in 2003, inflation not posing an imminent threat and external conditions remaining strong. The new challenge facing us today is how to maintain this economic momentum of growth. On the external side, with the re-emergence of capital flows, the authorities need to remain vigilant and to be effective in the management of this increasing level of capital flows.

The objective of this paper is to capture the impact of globalisation on Thailand's domestic financial system and monetary policy through an analysis of financial and economic developments and the policy responses they elicit. Specifically, the paper attempts to address the following key questions. First, what triggered the changes? Second, and probably more importantly, what are the new challenges that lie ahead? To answer these two questions, this paper carefully examines the evidence surrounding the economic conditions.

2. Evolution of Thailand's monetary/financial landscape: an overview

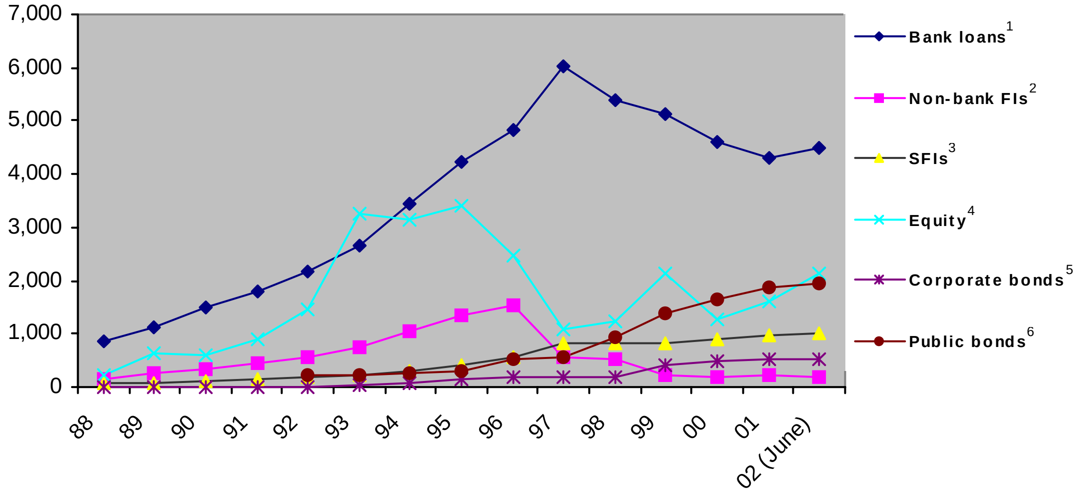
2.1 Phase I: the Asian miracle - the period of the impossible trinity

During the 1990s or the so-called period of the Asian miracle, the Thai economy was among the fastest-growing in the world, boasting double digit growth per annum, moderate inflation and a stable exchange rate. The Thai authorities managed the economy with a conservative fiscal policy and a basket-pegged exchange rate system as the anchor of monetary policy. Thailand experienced nine consecutive years of fiscal surplus between 1988 and 1996. The high investment rate in private enterprise investment, accounting for 40% of GDP, was financed by the high saving rates - intermediated almost exclusively via the banking sector - and the massive amount of capital flows which came in the form of both foreign direct investment and foreign portfolio investment.

Graph 1

Landscape of the Thai financial market 1988-2002

End-of-period value, in billions of Thai baht



Note: Data for banks, specialised financial insitutions (SFIs) and non-bank FIs are as of May 2002.

[1] Bills, loans and overdrafts, excluding interbank transactions. [2] Credit extended by finance, finance and securities, and credit foncier companies. [3] Credit extended by GSB, GHB, BAAC, EXIM Bank, IFCT and SIFC. [4] Stock Exchange of Thailand (SET) market capitalisation. [5] Corporate bonds outstanding at par value. [6] Data on outstanding public bonds before 1992 are not available.

Sources: BOT; SET; Thai Bond Dealing Centre.

During this period, the development of the Thai economy relied heavily on bank credits. This reliance on bank lending as a source for funds subsequently led to the underdevelopment of alternative domestic funding instruments, as demonstrated in Graph 1. With economic growth reliant solely on bank lending, there was very little development of the capital market.

Against this backdrop, commercial banks mobilised funds mainly through deposits, which accounted for roughly 80% of domestic banking liabilities. Commercial banks held almost 70% of total financial sector assets, mostly in the form of credits to the household and corporate sectors.

The effectiveness of the interest rate as an instrument for the conduct of monetary policy was limited under the basket-pegged exchange rate system and an open capital account regime. The rule of the impossible trinity implied that interest rates could not be used freely as an instrument of monetary policy. There was reliance on prudential measures such as the reserve requirement to manage short-term capital flows and credit policy, safeguard against excessive capital inflows and ensure a broad-based development of the productive sectors. On a positive note, the regime enabled borrowers to access funds at lower cost and introduced some degree of stability and predictability to the exchange rate level. Increased integration of financial markets brought with it the challenge of managing increased volatility of capital movements and domestic interest rates. This came about as capital flows that entered the country came in the form of short-term bank loans and bills of exchange, all of which were subject to volatility and sharp reversals of flows. The structure of these inflows - mainly short-term loans - came about from a combination of factors, including the fixed exchange rate and the free flow of capital, as well as the availability of funds through the Bangkok International Banking Facilities (BIBF).

However, the extent of bank-based activity and inadequate supervision and regulation contributed significantly to the crisis. The over-reliance on banks combined with their role as intermediaries for the huge capital flows coming into the country overwhelmed the risk management capacity of banks. This fed through to banks' lending policies, leading them to "over-lend" to sectors, which they might not have done under normal circumstances. The suddenness of the reversal of capital flows meant that banks were unable to adjust their operations in time, leading to a liquidity crunch in many banks.

2.2 Phase II: the twin crises

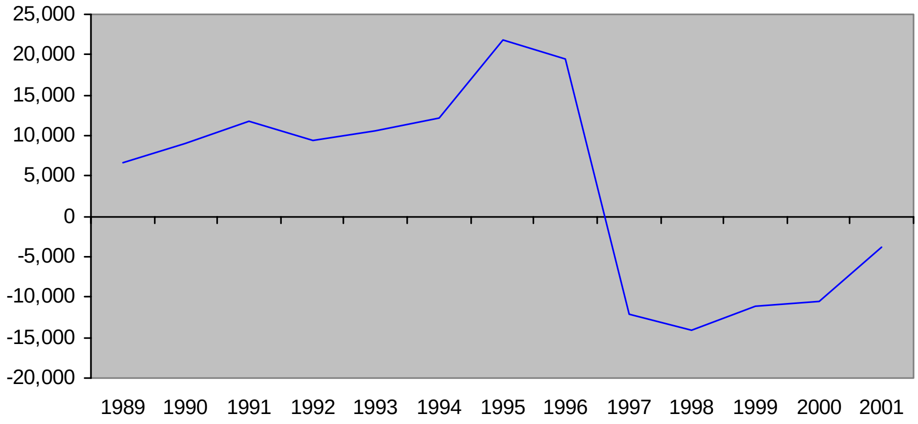
The economic and financial crisis that hit Thailand in 1997 triggered a change in the perspectives and outlook of the authorities. As has been the case in numerous countries, the crisis acted as a catalyst to bring about a rethink and a reorientation in national strategies and policies. The challenge for the BOT, as the country's central banker, was unique. It needed to deal with the crisis in the banking sector as well as the consequences of the sharp devaluation in the currency. This event highlighted Thailand's linkage with the global market.

The challenges that we faced were the sudden stop and reversal of capital flows during the crisis. In 1998, Thailand experienced a sharp reversal in capital flows (Graph 2) accounting for 13.8% of GDP. This was in contrast to the net inflows of some 10% of GDP in 1996. The exchange rate depreciated sharply from around THB 25/USD to a low of THB 56/USD on 13 January 1998. As a result, the banking system, burdened with huge losses and non-performing loans (NPLs) as foreign currency loans contracted by debtors became unserviceable, could no longer act as the engine of financing as in the past.

Graph 2

Thailand's capital flows 1989-2001

In billions of US dollars



As the exchange rate became very volatile, monetary policy had to tighten to stabilise the baht, which had become volatile from the loss of investor confidence not only in Thailand, but in the region as a whole, as the effect of the financial crisis continued to sweep through other countries in the region. The immediate challenge for the authorities was how to restore economic stability.

2.2.1 *Monetary policy adjustment*

Given that a return to a fixed exchange rate was not considered a viable option in the light of the volatility of capital inflows and the unsettling experience from the recent crisis, the BOT recognised the need to find a new anchor.

In the interim period following the adoption of the floating exchange rate system on 2 July 1997 and the IMF programme, a monetary targeting regime was adopted. Under this regime, the Bank targeted domestic money supply using the financial programming approach in order to ensure macroeconomic consistency as well as to reach the ultimate objectives of sustainable growth and price stability. The Bank set the daily and quarterly monetary base targets, on which its daily liquidity management was based. Daily liquidity management was essentially intended to guard against excessive volatility in interest rates and liquidity in the financial system. However, this regime was deemed inappropriate owing to instability in the relationships between money aggregates and macroeconomic objectives reflecting rapid and ongoing changes in the financial system.

Towards the end of the IMF programme in 2000, and after careful consideration, the Bank of Thailand decided to adopt inflation targeting as a nominal anchor for its monetary policy framework.

2.2.2 *Banking sector reform*

The crisis made even clearer the degree of over-reliance of the Thai financial system on commercial banks in financing investment and economic growth, and highlighted the need to reform the domestic banking system. In a sense, Thailand managed to turn the crisis into an opportunity to reform the financial system. With commercial banks flooded with liquidity, demand for low-risk saving instruments also rose sharply to enable banks to invest the excess liquidity.

The crisis in the banking sector meant multiple tasks for the authorities: to stabilise, manage and strengthen the financial system as well as financial institutions. Measures implemented to reform and restructure the financial system included the suspension of operation of 58 finance companies with the Financial Institutions Development Fund (FIDF) as well as the creation of various organisations to deal with problems arising from the suspension, for example the Financial Sector Restructuring Authority (FRA), the Asset Management Corporation (AMC) and the Thai Asset Management Corporation (TAMC), to resolve the outstanding number of NPLs. Moreover, the capital bases of financial institutions were strengthened through a combination of new loan classification and provisioning and private sector led recapitalisation. Standards were tightened to be consistent with international standards and best practices. As a result, banks were required to recapitalise to meet these new standards, and those who failed to do so were taken over by the FIDF. Banks were also required to maintain a minimum capital adequacy ratio at 8.5% in line with the Basel Accord.

In addition, the restrictions on foreign ownership of Thai financial institutions were temporarily relaxed, allowing foreign investors to acquire major shareholdings for up to 10 years, with the actual holding of shares temporarily grandfathered thereafter (until the ratio is brought down to 49%). Furthermore, on 14 August 1998, the government announced a comprehensive financial restructuring package focusing on four main aspects: (1) accelerated consolidation of banks and finance companies through additional interventions; (2) encouragement of private investment in the banking system; (3) provision of public funds to recapitalise viable financial institutions; and (4) development of a framework to create private asset management companies (AMCs). As a result, the authorities were required to intervene in seven banks and 69 finance companies.

Over the years, NPLs in the Thai financial system have been steadily declining. From a peak of THB 2,729.4 billion in June 1999, NPLs declined to THB 772.6 billion in December 2002, or approximately 15.77% of total loans outstanding. Despite the progress made, the remaining NPLs continue to pose a challenge to financial institutions' balance sheets, and have distracted them from focusing on new lending. In recent years, the performance of financial institutions has continued to improve, with operating profit increasing from THB 45.8 billion in 2001 to THB 77.5 billion in 2002 (Table 1).

Table 1

Performance of financial institutions[1]

In billions of Thai baht
and per cent[2]

Items	1998	1999	2000	2001	2002
1. Interest income	730.20	374.99	334.93	307.98	279.26
2. Interest expense	663.39	312.87	226.86	182.74	149.03
3. Spread	66.81	62.12	108.06	125.25	130.23
4. Non-interest income	58.69	58.17	71.24	73.04	88.12
5. Operating expense	189.42	168.22	155.06	152.47	140.87
6. Operating profit (loss)	(63.92)	(47.94)	24.25	45.82	77.47
7. Provisions	370.90	366.38	130.38	53.07	50.16
8. Income tax	(0.70)	7.03	5.21	4.63	3.11
9. Extraordinary items[3]	0.52	13.62	105.82	99.42	0.08
10. Net profit (loss)	433.60	407.74	(5.53)	87.54	24.28
11. Yield on loan	9.70	5.16	4.99	5.40	4.68
12. Yield on deposit	10.76	4.90	3.27	2.54	2.08
13. Spread	(1.06)	0.26	1.73	2.87	2.60
14. ROA	(5.74)	(6.00)	(0.08)	1.30	0.35

[1] Financial institutions include commercial banks, finance companies and credit foncier companies. [2] Items 1 to 10 are in Thai baht; items 11 to 14 are in per cent. [3] Extraordinary items in 2001 are mostly reversed provisionings.

2.3 Phase III: new challenges

The past two years have seen a remarkable improvement in our domestic economic conditions. Growth has not only been stable, but has advanced at a relatively high rate, with GDP growth for the year 2003 expected to be in the range of 5.75-6.25% at the time of writing. Thai economic growth in 2004 is expected at 5.5-6.5%. The current accommodative monetary and fiscal policies are appropriate for our economic conditions at present. The inflation targeting and the managed floating exchange rate regime in this low interest rate environment are aimed towards supporting and boosting domestic demand, supplementing the strategy of export-led growth adopted earlier.

The present low interest rate, which has hit the bottom of the cycle, poses new challenges and risks, in particular as regards the timing of the tightening cycle. Currently the authorities, including the BOT, are closely monitoring the movement of equity and asset prices. In addition to the domestic front, external stability has also been one of our top priorities. This concern is reflected in the build-up of foreign exchange reserves, which has led to the prepayment of loans from the IMF official financing package in July 2003, as well as close monitoring of movement of the baht and of the balance of payments.

Another pressing issue is how central banks conduct policy in a world of volatile capital flows. More recently, it has been necessary for the BOT to find ways to manage the “return” of a large volume of capital inflows into Thailand, and to prevent them from disrupting economic growth. On 23 July 2003, the Bank announced the relaxation of exchange control regulations, aiming to promote Thai residents’ investment abroad and to offer alternative investment opportunities for residents. This was due mainly to temporary excessive savings, and these limits will be reviewed from time to time to suit the prevailing economic and financial situation. In addition, the BOT eased a number of other rules, including that on the holding of foreign currency deposits, allowing local state enterprises to hedge their foreign currency debts, as well as allowing Thai residents to issue structured products whose returns are linked to external variables, such as exchange rates and foreign assets. On a related issue, on 14 October 2003 the Bank announced additional measures to discourage speculation on the

Thai baht. This included restrictions on non-residents opening nostro accounts in baht with financial institutions in Thailand. While originally intended to facilitate the settlement of international trade and investment transactions, these accounts have also provided avenues for speculative activities. The authorities introduced restrictions on the use of these accounts (ie for settlement only) and a cap on outstanding amounts for accounts (not exceeding THB 300 million per non-resident), as well as ensuring that financial institutions refrain from paying interest on current and savings accounts of non-residents (except for fixed accounts with maturity of at least six months).

To discourage the practice of over-reliance of the Thai financial system on bank intermediation, the Thai authorities have taken steps to develop the domestic capital markets, an issue which ranks high on the economic agenda. A deep and liquid capital market will help facilitate and support the development of the Thai economy as well as sustaining its competitiveness in the global marketplace. Objectives in developing the capital market are to provide an effective source of financing, to create a favourable investment environment with a diverse investor base, to provide a world-class infrastructure with low transaction costs, and to encourage the establishment of strong and qualified institutional intermediaries. At the same time, the authorities aim to promote good corporate governance and any necessary measures that serve the appropriate needs of investors.

There is now regular issuance and trading of government securities, thus providing the market with an efficient and reliable benchmark yield curve. Daily turnover has risen considerably to around THB 11 billion per day at end-August 2003, up by almost 50% from 2002. This is a very significant turnover volume, given that the stock market has long dominated the Thai capital market. To this end, the authorities are working on promoting the essential infrastructure for bond market development, including the development of a private repurchase market and an electronic trading platform for bonds. To encourage investment and active participation by market players, the markets for hedging risk are also being developed, including the long-term interest swap market.

3. Globalisation continued

While the era of globalisation has been around for more than a decade, and has seen developments in information and communications technology unparalleled in modern economic history, for Thailand this is only the beginning. As a small and open economy, it is unavoidable that we will be affected by changes and shocks in the global arena. This was clear during the crisis; many of the triggers for policy changes were a result of global pressure and direction. In the past we have adopted defensive mechanisms to tackle these challenges and problems, but this strategy has proven costly and painful.

Looking forward, we recognise the need to be more active in coping with the shocks and pressures of the global economy. In order to be better prepared for such events, we have also recognised the need to build an early warning system that would alert us to external risks, uncertainties and possible turbulence. In this light, the members of ASEAN and EMEAP have attempted to develop self-help mechanisms as well as credible surveillance and peer review processes. At the regional level, Asian economies have worked together to develop deep and liquid regional bond markets which could provide a predictable source of funding for the government, state-owned enterprises and private firms. Bond markets also offer alternative investment opportunities for savers, and will increase the efficiency of the disintermediation process in Asia. Not only will efficient bond markets in Asia help mitigate the potential risk of double (currency and maturity) mismatches, they will also facilitate intraregional trade and investment and create a closer link among regional financial markets.

Despite the recent positive developments, it is important that the authorities not become complacent in the effort to continue raising standards and improving practices in our financial system. Further questions that arise include: what needs to be done so that we can be ready to meet future challenges? How can we better manage financial integration? Moreover, as a small open economy, to reap the full benefit of globalisation we need collective effort to create stable macroeconomic conditions, well developed financial systems, an effective early warning system and crisis resolution mechanisms. The 1997 crisis showed us that collective action is required to maintain growth and development in the world economy. The changes that Thailand has had to undergo - be they the change in the exchange rate regime, the search for the new anchor and framework for monetary policy, or the financial sector restructuring and massive capitalisation of banks - are but a single dimension, namely, the domestic front. The international front - where there arise the new demands and challenges of regional and global linkages - will open a new chapter for monetary cooperation.