Monetary policy in the post-crisis world: the perspective from Thailand

Bank of Thailand

1. Introduction

The uneven global recovery, together with excess liquidity and zero interest rates in advanced economies, has led to a surge in capital inflows to Asia in 2010. A strong and increasingly self-sustained recovery in Asia, amid the protracted moderate recovery in the advanced economies, has resulted in divergent growth prospects, suggesting that some measure of decoupling is under way. To strengthen the recovery, advanced economies have pursued zero interest rate policies and quantitative easing. As a result of increased capital inflows to Asia − a reflection of global excess liquidity, born of loose monetary policy in the advanced economies − emerging Asian currencies have appreciated sharply. In addition, the persistence of global imbalances implies that capital flows will remain a pertinent issue over the medium term, in particular for emerging markets, which may have to bear a disproportionate share of the burden of adjustment should structural impediments persist in the United States, Europe and China.

The Thai economic recovery is increasingly robust, with exports on the rebound and domestic demand momentum on the rise, but downside risks remain. Export growth has been buoyant, recording positive quarter-on-quarter seasonally adjusted growth since the third quarter of 2009, but is expected to moderate somewhat. Domestic demand recorded consecutive positive quarter-on-quarter growth from Q2 2009 to Q3 2010, and will move to the fore as the primary driver of growth. Surveys indicate that many sectors, such as automobiles, electricity and real estate, have plans to increase investment. Overall growth is projected to be 7.3−8.0% for 2010 and 3.0−5.0% for 2011, reflecting the firm recovery that is taking hold. Nevertheless, external downside risks from the global economy remain: European sovereign debt may become untenable, or US unemployment chronic. Internal risks include rising inflation pressure and financial imbalances amid a strong economic recovery and abundant liquidity fuelled by inflows.

The combination of rising inflation and capital inflows arguably constitutes the first serious test of the Bank of Thailand's inflation targeting framework. That framework, adopted in 2000, has successfully weathered numerous shocks − the recent global crisis, the worldwide oil price surge of 2006−08, domestic political unrest, and the bursting of the US information technology bubble. However, the current environment of rising inflation and currency appreciation poses a new challenge, as monetary policy now faces a potential trade-off between price and exchange rate stability. Should monetary policy respond to inflation risk, or focus on exchange rate volatility? In a changing and uncertain global environment, calibrating the proper monetary response that takes both considerations into account is particularly difficult.

2. Challenges

The Bank of Thailand faces three challenges exacerbated by the surge in capital inflows: (i) risks to growth due to rapid currency appreciation; (ii) heightened risks to price and financial stability as inflows contribute to excess liquidity; and (iii) calibrating the appropriate monetary policy response to both risks.

Rapid appreciation of the baht threatens export competitiveness and overall growth. So far this year, the baht has appreciated by about 10% against the US dollar in nominal terms, and by 7.8% against the nominal effective exchange rate, compared to end-2009. Thailand's particularly strong exports, and corresponding current account pressure, were factors behind the appreciation. The appreciation of the baht was above the regional average and particularly rapid in the third quarter of 2010. However, examining the movements of regional currencies over a longer period, eg going back to December 2008, shows that the baht's overall appreciation has been close to the regional average. Nevertheless, as Thailand is a small open economy with a large export sector, excessive exchange rate volatility and excessive appreciation threaten to derail its economic recovery.

Thailand's overall export sector remains resilient to currency appreciation. A Bank of Thailand survey of exporting firms finds that appreciation has been manageable so far. Foreign orders remain high. Exporting firms have increased their use of hedging (by 43% as of September 2010). Some firms have repriced exports and reduced margins in order to remain competitive. Exporting firms with high import content (eg apparel, office, furniture and machinery) were more adversely affected, but managed to retain adequate profit margins. Nevertheless, further rapid appreciation could push exporting firms' resilience to the limit, with potentially deleterious effects on macroeconomic stability and growth.

Artificially low interest rates in advanced economies set the stage for the surge in capital inflows. Quantitative easing and the zero interest rate policies pursued by advanced economies led to turbulence in global foreign exchange markets. Assets across various classes and all maturities became less attractive. Yields on US inflation-linked bonds turned negative. As the Asian recovery took hold, capital rushed to emerging market assets in Asia in search of higher yields, lower risk premia and currency gain, driven by strong fundamentals. The appreciation pressure from capital flows was particularly strong in the third quarter of 2010 because of policy uncertainty in advanced economies and constant revisions of investor expectations and investment portfolios.

Macroeconomic fundamentals, rather than interest rate differentials between economies, are the key drivers of capital flows and currency appreciation; this is borne out by internal econometric analysis of Asian economies' panel data. In addition, a regional cross-country comparison of economies shows that neither interest rate differentials nor interest rate levels are associated with appreciation and suggests that fundamental factors matter more.[1] Interestingly, Thailand shows a relatively low interest rate differential and low interest rate level, but capital flows and currency appreciation have been high nonetheless.

Delayed rebalancing between China, Europe and the United States places a disproportionate burden of adjustment on emerging markets over the medium term. At its peak in 2006, the combined current account surplus of the United States and Europe stood at −2.2% of world GDP. It has fallen slightly following the global crisis. However, the International Monetary Fund projects that this surplus will remain substantial, at −1.5%, over the medium term.[2] As deep-seated structural impediments in the US, Europe and China prevent the orderly reversal of global current account imbalances, the robust and open emerging markets of Asia may face disproportionate pressure on exchange rates and current accounts. The resulting exchange rate volatility may jeopardise the orderly transition from export-led to domestic demand-led growth in Asia.

The surge in capital flows into booming bond and equity markets heightens risks to price and financial stability. Capital inflows today may add further to liquidity, credit growth and inflation

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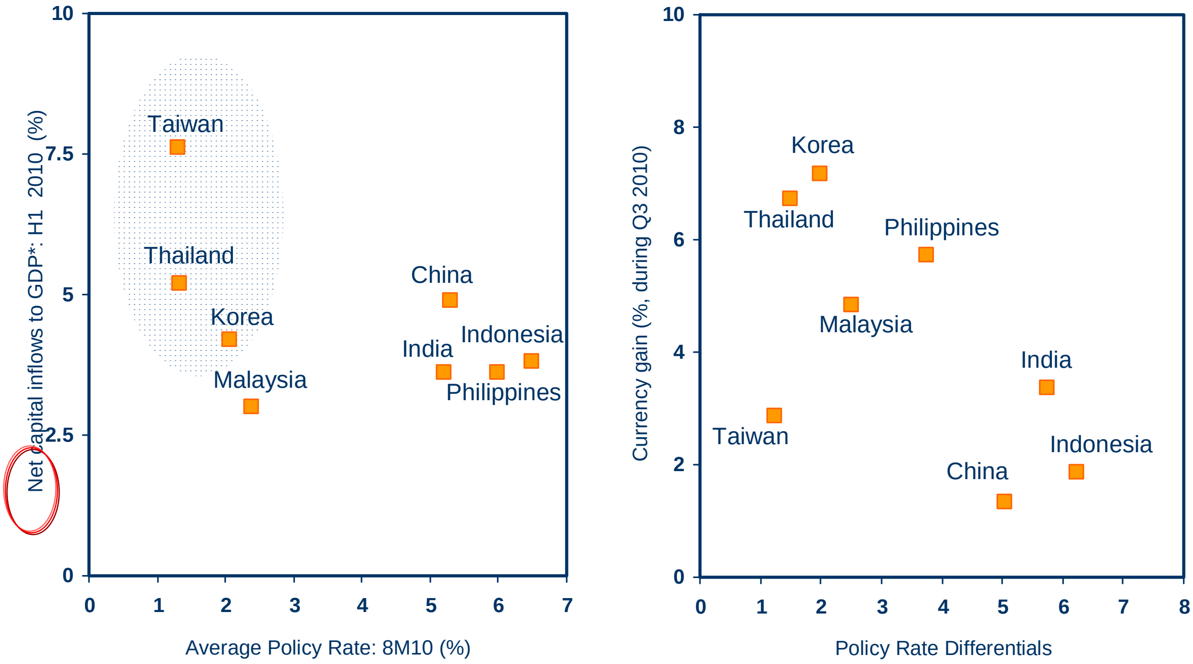
1 However, given that economic and interest cycles are to some extent jointly determined, the problem of endogeneity renders precise economic interpretation difficult.

2 See IMF, *World Economic Outlook*, October 2010.

pressure, while sowing the seeds of future financial imbalances, particularly in the form of asset bubbles in the real estate and equity markets. And once asset bubbles burst and advanced economies recover, the capital flow "bonanza" may reverse as quickly as it began. Most of the inflows have entered the bond market, reflecting investors' focus on yield and currency gain. Non-resident inflows to the bond market were three times larger than those entering the stock market, and they accelerated significantly in September−October 2010. However, the stock market has also boomed, rising by approximately 44% during the past 12 months and registering a forward price/earnings ratio of about 14%. Although there are no clear signs of an asset bubble in Thailand for the time being, the current Asian experience of incipient asset bubbles suggests that sustained capital flows under conditions of robust economic growth may give rise to financial imbalances.

Figure 1

Currency Appreciation, Capital Inflows, and Interest Rate Differentials



* Net capital inflows equal to foreign direct investment (FDI) + foreign portfolio investment (FPI) + other investment (liabilities); net data.

Sources: Bloomberg, CEIC.

The surge in capital inflows potentially complicates the normalisation of the monetary policy stance and tests the inflation targeting framework. As the economic recovery takes hold at home and abroad, and domestic price pressure rises, the balance of risks has shifted to stability. Accordingly, interest rates should be normalised. However, rate tightening may induce more capital inflows and further currency appreciation, particularly in the current global zero interest rate environment. As a result, the monetary policy trade-off between growth and stability may be especially acute for small open economies, such as Thailand. As noted earlier, however, interest rate differentials appear to have a smaller effect on capital flows and currency appreciation than do economic fundamentals.

3. Policy responses

Interest rate decisions have focused on stability, and not on capital flows or exchange rates as such.

Monetary policy remains focused on price stability. Policy rate normalisation has been ongoing amid the economic recovery and rising inflation pressure. Three rate hikes in 2010 brought the policy rate to 2.00% by the end of the year. Although monetary policy has been complicated by the potential relationship between interest rate differentials and appreciation, the policy rate remains the key instrument in maintaining price stability and anchoring inflation expectations. Regarding the exchange rate, excessive short-run volatility is being managed, while in the long run the exchange rate should be market-determined, as excessive intervention may result in misallocation of investment resources.

Macroprudential policy focuses on financial stability. The Bank of Thailand has recently announced a loan-to-value (LTV) limit as a preventive measure against potential asset bubbles in the real estate sector. The measure caps the LTV for condominiums at 90%, and for single detached houses and townhouses at 95%; otherwise, the 75% risk weight will apply. The measure will take effect in January 2011. It is expected to have only a small effect in the short term. More importantly, it serves as a signal to shape potentially over-exuberant expectations. Macroprudential measures complement, but do not substitute for, monetary tightening, which aims at overall price stability.

A withholding tax on government bonds has been reinstated to level the playing field for investors and lessen appreciation pressure. Thailand's Ministry of Finance reinstated a 15% withholding tax on interest and capital gains on government bonds for foreigners. The tax was waived in 2005 with the goal of boosting foreign participation. In the current environment of capital inflows, the need to maintain the waiver has diminished.

Capital outflow liberalisation has also been pursued as a means of relieving appreciation pressure. To encourage balanced capital flows, in December 2007 the Bank of Thailand eliminated the $100 million limit on overseas investments by Thai listed companies. In August 2009, the central bank relaxed controls further by allowing large Thai companies with a minimum of 5 billion baht ($151 million) in assets to invest directly in foreign securities without going through mutual or private funds. At the same time, it imposed a $50 million ceiling on outstanding investment in foreign securities that can be made by a Thai corporate entity engaging in non-speculative business.

International cooperation is needed to lessen turbulence in global foreign exchange markets. The surge in capital flows is a global phenomenon; it therefore needs a global solution. Asian emerging markets should coordinate the appreciation of regional currencies so as to minimise disruptive adjustment and excessive intervention. In addition, coordination of capital controls and macroprudential measures may be necessary to minimise regulatory arbitrage and to prevent spillovers from disruptive asset price corrections. Advanced economies should take into account the negative externality of zero interest rate policies on the global economy, in terms of both the capital flow volatility inflicted on emerging markets, and the excess global liquidity that may sow the seeds of future financial imbalances. In this respect, a well communicated exit plan may help to stabilise market expectations and thus lessen market volatility. In the medium term, large and advanced economies should take primary responsibility for reversing the persisting global imbalances.