The international transmission of monetary policy in recent years: Thailand's perspectives

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Abstract

Owing to the extraordinarily accommodative monetary policy of advanced economy central banks, those of emerging market economies have entered uncharted territory. This note reviews the experience of Thailand, a small economy highly exposed to international trade and capital flows, in dealing with monetary policy spillovers during the various phases of the US Fed's QE programmes. The Monetary Policy Committee's policy responses and their rationale highlight the difficult trade-offs faced by monetary policymakers as they seek to maintain economic and financial stability.

Keywords: Thailand, unconventional monetary policies, spillovers, financial stability, policy responses

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Introduction

The post-crisis global financial environment represents uncharted territory for central banks in emerging market economies (EMEs). After unconventional monetary policies were implemented in the major advanced economies (AEs), international monetary policy transmission would no longer depend simply on the interest rate differential between AEs and EMEs. Global liquidity and global risk aversion as a result of major central banks' actions now play an equally important role in the transmission of monetary policy from AEs to EMEs. For many EMEs, particularly those relatively exposed to global financial flows, the changing nature of international monetary policy transmission presents an added complication for domestic monetary policy and exchange rate management.

This note reviews the experience of the Bank of Thailand in dealing with the spillovers from major AEs during the QE1, QE2, QE3, and QE tapering periods. In each episode, special attention is paid to the policy responses and their rationale, highlighting the constraints and trade-offs facing the Bank's Monetary Policy Committee at the time of the relevant policy decisions.

The Bank of Thailand's monetary policy framework

Since May 2000, the Bank of Thailand has conducted its monetary policy under a flexible inflation targeting framework with a managed floating exchange rate. Under this framework, the Monetary Policy Committee takes into consideration not only inflation but also economic growth and financial market conditions, as well as the financial status of households, businesses, and financial institutions. With regard to the exchange rate, the Bank of Thailand has neither level nor trend targets for the Thai baht but, in accordance with its inflation targeting mandate, stands ready to intervene in the case of excess volatility, particularly if this should result from speculative capital flows.

The Thai economy is very open to trade and financial flows. The recovery from the 1997 financial crisis was led by exports of goods and services that in 2013 accounted for nearly three quarters of GDP in nominal terms. The country is also relatively open to international capital flows, with some restrictions on outflows but virtually no restrictions on inflows. Due to its open nature, the economy suffered greatly from the global downturn in 2008–09. The Thai economy, however, managed to recover quickly along with the rest of Asia, as its predominantly bank-based financial sector did not suffer balance-sheet problems as in the West. For this reason, the country was considered among the most attractive destinations by international investors.

Policy responses to international financial spillovers and consequences

Episode 1: QE1 and QE2, December 2008–December 2012[2]

The severity of the economic downturn following the global financial crisis prompted major AE central banks to cut their policy rates to near zero. As interest rate policies were soon found insufficient to counter the large negative aggregate demand shocks, the major central banks turned to a set of unconventional monetary policy measures. Of those measures, a series of quantitative (credit) easing or QE rounds by the US Federal Reserve has taken centre stage. Most of the liquidity injected by the Federal Reserve via its QE programmes have remained in the US banking system in the form of excess reserves. However, some did migrate abroad, and with the resulting yield compression, global investors suddenly found themselves in search of higher returns elsewhere. These factors contributed to excess global liquidity that gravitated towards attractive investment opportunities, quickly withdrawing during periods of instability.

Although the QE programmes started in November 2008, the US monetary policy action did not initially complicate the Bank of Thailand's policy. In the early stages, Thailand's monetary policy was geared towards shoring up its economy, which was hurt by the collapse in global trade. At the end of 2008 and early 2009, the Bank of Thailand cut its policy rate four times for a total of 250 basis points to a record low of 1.25% per annum. During this stage, the baht also fell in value and acted as an automatic stabiliser for the economy. Only when it became clear in the second half of 2009 that Thailand, like the rest of Asia, would emerge as a winner in the new global environment did the excess global liquidity start to interfere with domestic policy decisions.

The changing view of global investors amidst abundant global liquidity prompted the return of capital inflows to Thailand. In 2010, net capital inflows registered a record surplus of nearly USD 25 billion. As a result of both the country's strong growth prospects and the capital inflows, the baht appreciated from around USD/33 baht at the beginning of the year to around USD/30 baht at the end of the year. Monetary policy decisions during this episode appeared immune to these developments. As the Thai economy showed signs of firm recovery, the Monetary Policy Committee began normalising the policy rate in July 2010. Amidst some political and industry opposition that the widening interest rate differential would induce capital inflows and that the resulting baht appreciation would hurt the export sector, the interest rate up-cycle went on almost continuously, peaking at 3.50% per annum. This was just 25 basis points below the level before the global financial crisis had taken a toll on the economy. In fact, it was the severe flooding that almost paralysed the economy in the last quarter of 2011 that halted the Bank of Thailand's hiking cycle.

Instead, the policy response to the surge in capital inflows took the form of massive foreign exchange intervention. Net foreign reserves rose from

[2] This period also included Operation Twist which came after QE2 had ended. See Appendix A for the Fed's QE chronology and details of each operation.

USD 118 billion at the end of 2008 to USD 192 billion at the end of 2010. For much of 2011, net foreign reserves continued to rise, reaching USD 215 billion at the end of August. Although part of this almost doubling in net foreign reserves was due to valuation changes, by and large they came from foreign exchange intervention by the Bank of Thailand.

The rationale for the massive foreign exchange intervention was clear. Judging that too rapid an appreciation of the baht would be detrimental to the recovering economy, the Bank of Thailand decided to intervene in the foreign exchange market. The Bank also hoped that a series of further capital account liberalisation measures, starting with the removal of restrictions on foreign direct investment by Thai companies in October 2010, would relieve pressure on the baht and hence lessen the need to intervene later on. To a certain extent, the Bank was right, as the surge in foreign direct and portfolio investment abroad did balance out the capital account in 2011. The problem, however, was that by the end of 2011, the Bank of Thailand had already amassed a large amount of foreign exchange reserves.

Episode 2: QE3, September 2012–May 2013[3]

In September 2012, the Federal Reserve began the third and final round of QE, also known at the time as QE infinity due to its open-ended nature as opposed to the first two QE rounds. The timing of QE3 coincided with the Thai economy's recovery from the flooding disaster. Boosted by repair and reconstruction demand as well as the government's short-term stimulus (most notably, the tax rebate programme for first-time car buyers, which provided an extraordinary short-term boost to private consumption), the Thai economy recorded a 6.5% growth rate in 2012. Adding to this impressive performance was the prospect of a seven-year, 2 trillion-baht infrastructure investment project. Not surprisingly, foreign capital inflows surged, outweighing the continuously strong foreign investment abroad, and the baht once again came under appreciation pressure.

This time, the Bank of Thailand's response was different. While monetary policy decisions continued to be independent of the baht movement (the interest rate cut in October 2012 was motivated by concerns about the global economy), the Monetary Policy Committee shied away from foreign exchange intervention and allowed the baht to surpass its 2010 level. Although the Monetary Policy Committee eventually became concerned about the pace of appreciation, they seemed to prefer other means as reflected in the 30 April 2013 statement: "The MPC expressed concern over recent volatility and rapid appreciation of the baht, which, at times, has not been justified by economic fundamentals. The committee therefore agreed on the need for a timely implementation of appropriate policy mix as warranted by circumstances, in close coordination with the Ministry of Finance and other agencies." The coordinated policy tool referred to in the statement was understood to be the use of some form of capital flow management measure.

Behind the change of attitude towards foreign exchange intervention was the realisation that the intervention during the QE1–QE2 period, while necessary to buy time for exporters to adjust, was overdone to the point that the mounting costs

[3] Officially, QE3 has not yet ended. For the purpose of this note, we take QE tapering talk as the beginning of the next episode, as it drastically changed the pattern of global capital flows.

were no longer justified. As a result of its sterilised foreign exchange purchases, the Bank of Thailand had to absorb a large amount of liquidity along with significant negative carries. Concerns over the Bank of Thailand's balance sheet losses fed into a public debate, which also made the prospect of additional intervention less appealing. In fact, a board-commissioned study on the Bank's balance sheet improvement released in 2013 had as one of its recommendations the downsizing of the Bank's holdings of foreign reserves.

Returning to the monetary policy front, while policy decisions during this episode were still divorced from exchange rate and balance sheet concerns, they were nonetheless indirectly complicated by the US QE actions through financial stability concerns. It was in the 2012–13 period that the Monetary Policy Committee expressed serious concerns about private credit growth and rising household debt. Beginning in the second half of 2010, private credit registered double-digit growth, and household debt rose sharply to nearly 80% of GDP by the first half of 2013. While these developments were driven largely by post-flood capital replacement and fiscal stimulus packages for domestic consumption, excess global liquidity was also an important contributory factor.

It may not be initially obvious how excess global liquidity could have influenced Thailand's credit boom. After all, foreign funding made up less than 10% of the banking sector's total liabilities and the sector's fast-growing external borrowings were used mainly to finance the hedging needs of exporters and part of Thailand's direct investment abroad. The rise in banks' short-term external borrowings could be explained by the rise in hedging demand, while the rise in banks' long-term external borrowings could be explained by the rise in investment abroad demand. This was different from the case of the pre-1997 credit boom, which was driven by the on-lending of foreign funds by local financial institutions.

The excess global liquidity deriving from QE and other major central banks' unconventional monetary policy measures contributed to Thailand's latest credit boom via three indirect channels. First, the surge in capital inflows led to a large liquidity surplus in the banking system. Sterilised intervention by the Bank of Thailand led to an enlargement of the banking sector's bond holdings, which could be liquidated at will to meet loan demand. Second, the QE operations have depressed long-term yields in the United States, which along with the fact that much of the QE-induced portfolio inflows went into bonds, put downward pressure on long-term bond yields in Thailand. This was positive for local bond issuance by large corporates, including banks. The first and the second channels both enabled banks to source funds at low cost with ease and thus may be considered supply-side channels. The third channel worked through the demand side. The surge in exporters' hedging needs was, in fact, a response to the baht's appreciation. The stronger baht also made foreign assets more attractive for Thai firms investing abroad and hence further increased the demand for foreign currency funds.

Episode 3: QE tapering, May 2013–present

On 22 May 2013, less than a month after the Monetary Policy Committee released the statement on the exchange rate management framework, talk of the Fed's QE tapering surfaced and capital flows reversed their direction. Although actual QE tapering started in December, capital outflows had already commenced. The capital and financial account ended the year less than USD 1 billion in surplus, compared with a surplus totalling USD 9.3 billion from January to May. The baht also weakened and ended the year at USD/32.86 baht after reaching a record 28.61 in April. In addition, QE tapering talk has led to an increase in the US long-term yields, which in turn has caused the corresponding yields to increase in Thailand. The increase in long-term yields together with the depreciation of the baht has inevitably resulted in higher external funding costs for the Thai economy.

It is important to note, however, that the capital outflows and the weakening baht were not due entirely to the reversal in the pattern of global capital flows following the tapering talk. Thailand's weakening economic prospects also contributed. As the year 2013 progressed, it became increasingly clear that the Thai economy had lost its growth momentum. The economy, which started the year on a high note, with many observers expecting 5% or higher growth for the whole year, ended up with a disappointing 2.9%. For the current year, many forecasters are projecting a growth rate of even less. This reversal of fortune was due to the expiration of temporary government stimulus measures along with the failure of merchandise exports to take advantage of the AE's economic recovery. The political turmoil that began in the last quarter of 2013 was an additional negative factor.

The baht's depreciation removed the incentive to build up any further foreign exchange reserves or to put in place capital flow management measures. This time, it is monetary policy that is complicated by the Fed's monetary policy action. Given the current prospects of the Thai economy, the continuation of accommodative monetary policy is critical. The policy choices in the short to medium term are either to hold or to cut the policy rate. The Monetary Policy Committee minutes for the 22 January 2014 meeting, in which the committee voted four to three to maintain the policy rate, starkly reveals the committee's concern over international financial spillovers. Specifically, the majority view is reflected in the following quotation: "Against the backdrop of higher global financial market volatility stemming from QE tapering and market concerns about the emerging markets, financial stability should be given a high priority in monetary policy considerations, as it would provide a foundation for a sustainable recovery in the period ahead." And it is not that the other three members were not concerned. They just deemed that the risk was manageable because of the "high level of international reserves to cushion potential capital outflows".

Concluding remarks

By reviewing the experience of Thailand in dealing with international financial spillovers, this note highlights the complications generated by the AE's post-crisis monetary policy actions for the monetary policy of EMEs and their exchange rate management. As the Thai experience demonstrates, these complications can at times be difficult to deal with. In the first episode, the Monetary Policy Committee was faced with a difficult policy task, ie determining how far it should intervene, in dealing with the surge in foreign capital inflows and the resultant impact on the baht. The vast amount of accumulated reserves became a policy constraint in the second episode. And, in the final episode, the risk of financial spillovers has interfered directly with monetary policy. In fact, if the Thai economy were to need a substantial rate cut at the time when the Federal Reserve starts its hiking cycle, the financial stability risk for Thailand could become a significant constraint.

In retrospect, what could the Bank of Thailand have done differently? An important policy lesson from this note is that policymakers should take a long-term view and explore a set of policy alternatives along with the short-term and long-term consequences. Admittedly, this is easier said than done. But going in this direction should help policymakers establish a better formulated policy mix with fewer unintended consequences.

Appendix A. Fed's QE chronology

Fed's QE chronology

	Period	Length	First Hint / Note	Size	Period
QE1	16 Dec 2008 – 31 Mar 2009	16 months	25 Nov 2008 FOMC statement	600 bn	500: Agency MBS 100: Agency debts
	18 Mar 2009 – 31 Mar 2010		18 Mar 2009 FOMC statement	1,150 bn (additional)	750: Agency MBS 100: Agency debts 300: Treasury
QE2	3 Nov 2010 – 30 Jun 2011	8 months	Hint: 27 Aug 2010 Bernanke's speech at Jackson Hole	600 bn (75 bn a month)	600: Long-term Treasury
Operation twist (OT)	21 Sep 2011 – End 2012	16 months	1) 21 Sep 2011 – Jun 2012 2) 20 Jun 2012 – end 2012 (ext) *Formerly used in 1961	400 bn 267 bn (extension)	buy long-term Treasury (maturity 6-30 yrs) and sell short-term Treasury (maturity <3 yrs) at the equal amounts
QE3 / QE3+	13 Sep 2012 – present	Open-ended	Hint: 1) 22 Aug 2012 FOMC Minute revise down GDP and weak activity 2) 31 Aug 2012 Bernanke's speech at Jackson Hole *QE3+ 12 Dec 2012	Open-ended (85 bn a month)* State-contingent: 1) Unemployment 6.5% 2) Inflation expectation 2-2.5%	40: Agency MBS 45: Treasury

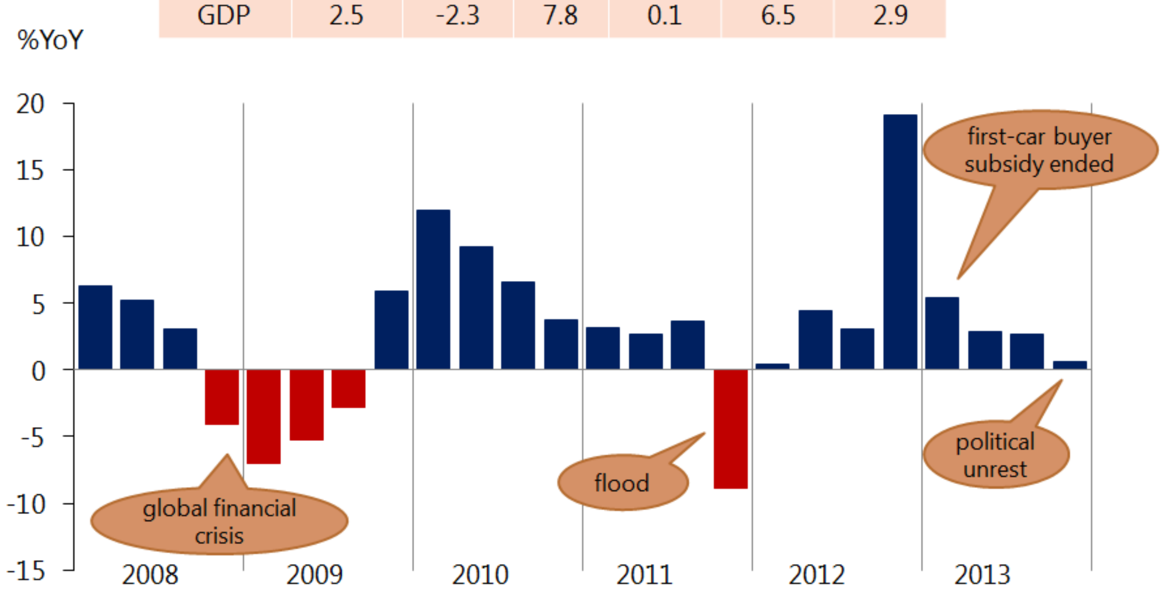
* Size of asset purchases was cut to USD 75 bn and 65 bn, in Jan and Feb 2014, respectively

Appendix B. Development of selected macroeconomic and financial variables

GDP growth

Figure 1

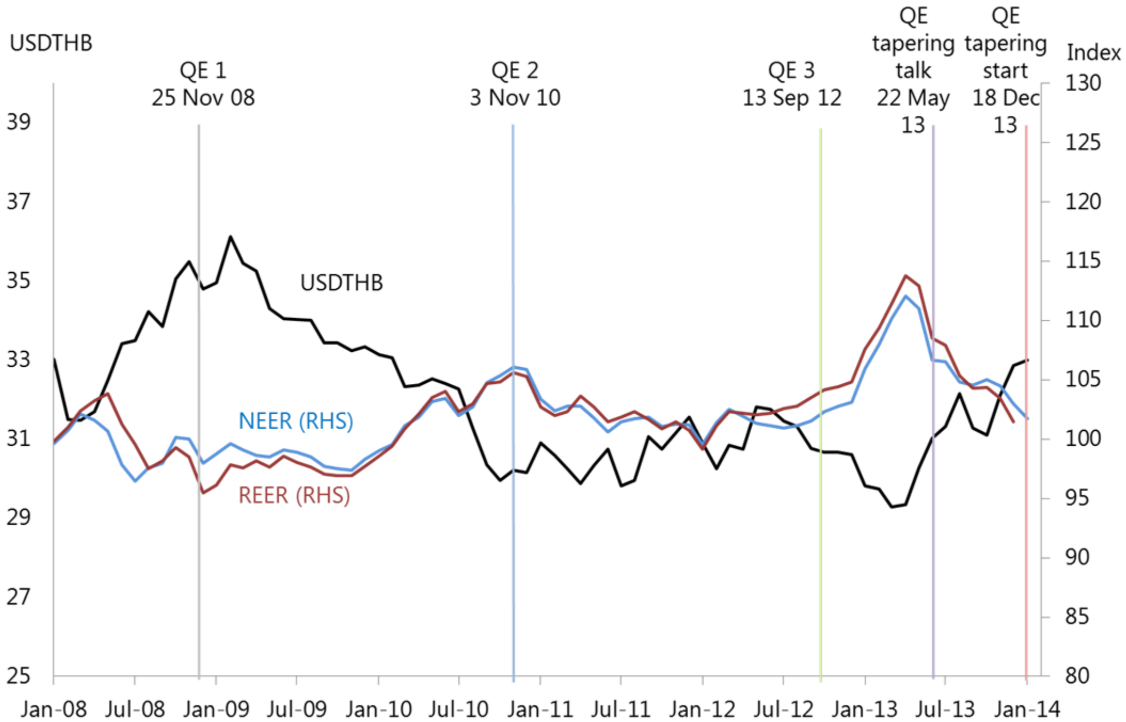
%YoY	2008	2009	2010	2011	2012	2013
GDP	2.5	-2.3	7.8	0.1	6.5	2.9



Source: NESDB

Exchange rates

Figure 2

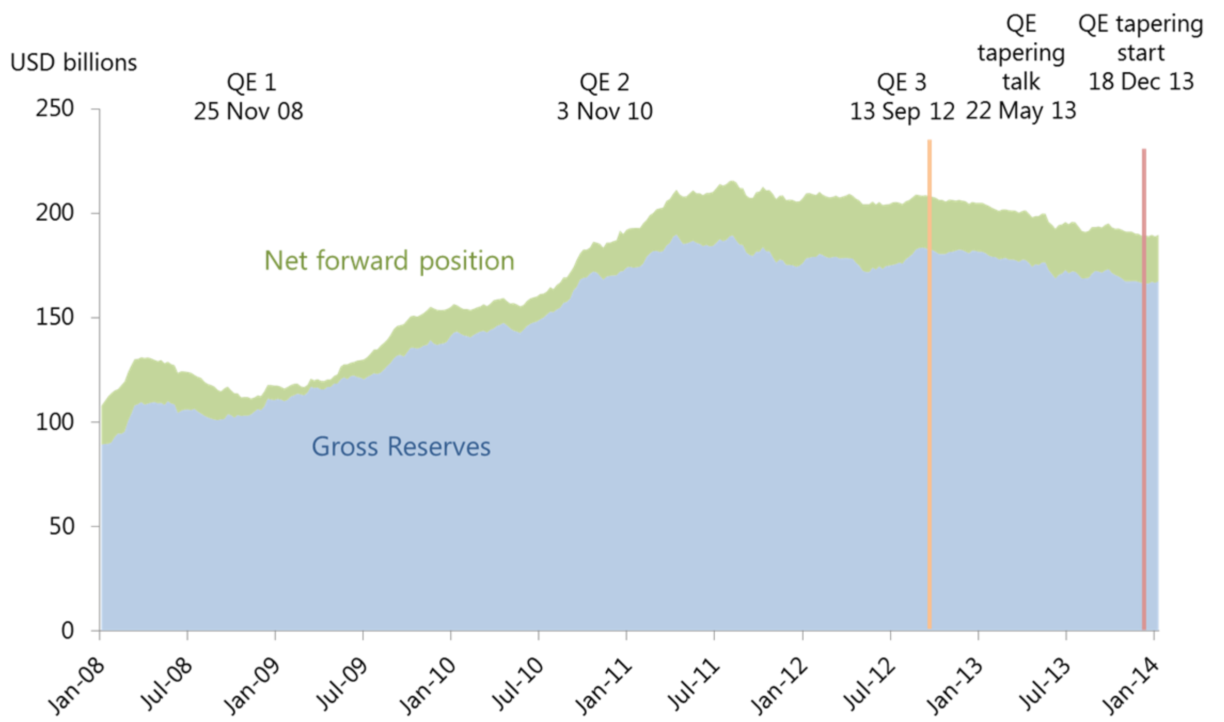


Note: *USDTHB is end of period data.

Source: Bank of Thailand and FOMC Press statement

Foreign exchange reserves

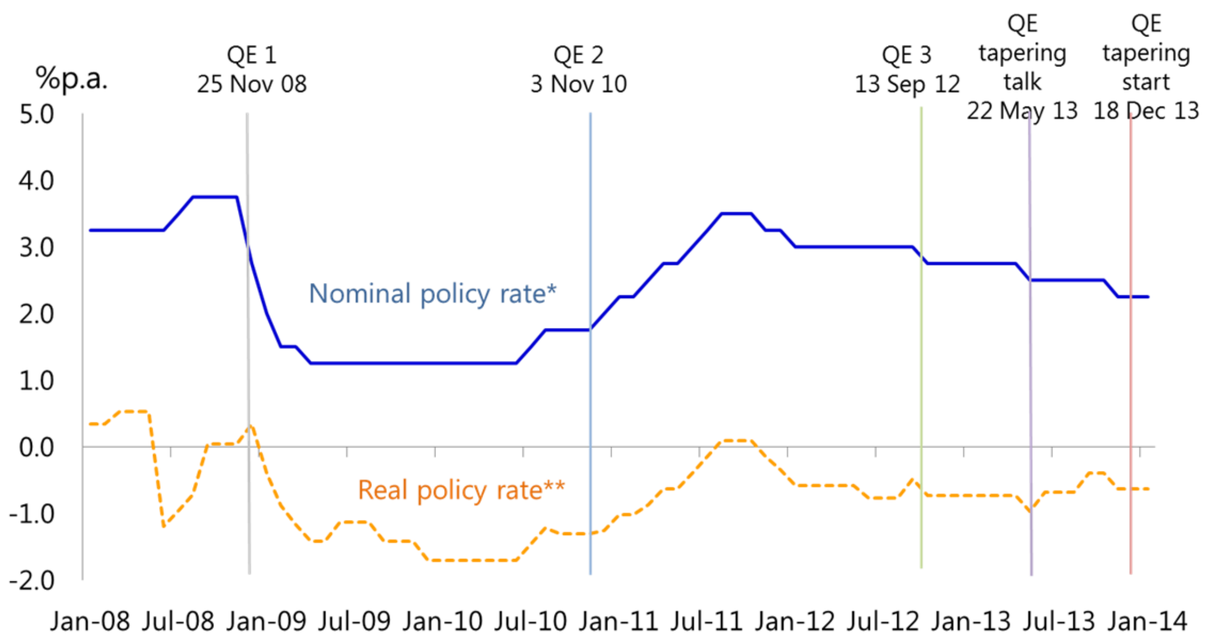
Figure 3



Source: Bank of Thailand and FOMC Press statement

Nominal and real policy rates

Figure 4

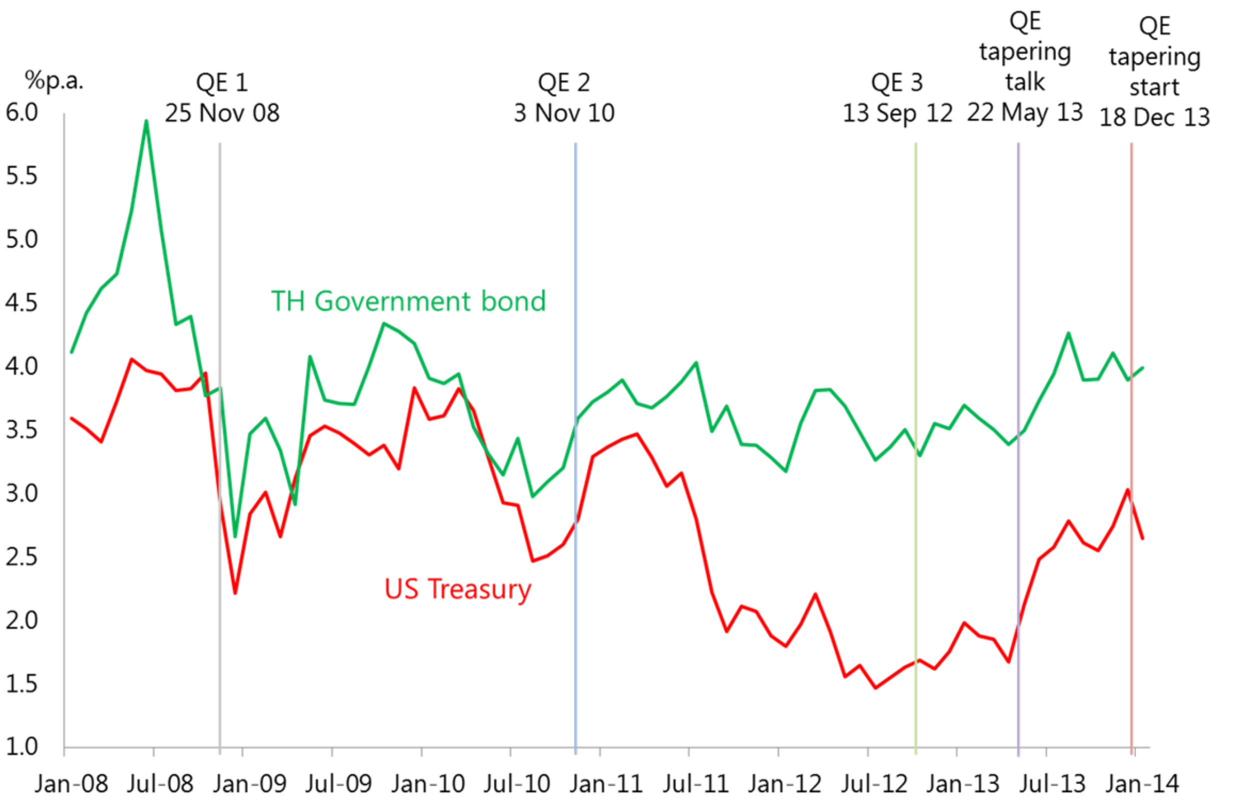


Note: * Nominal policy rate (end-period data) ** Real policy rate is adjusted by estimate of headline inflation 1 year ahead (inflation forecast from Consensus Forecasts)

Source: Bank of Thailand (BOT), Consensus Forecasts and calculated by BOT's staff

10-year US Treasury vs. Thai government bond yields

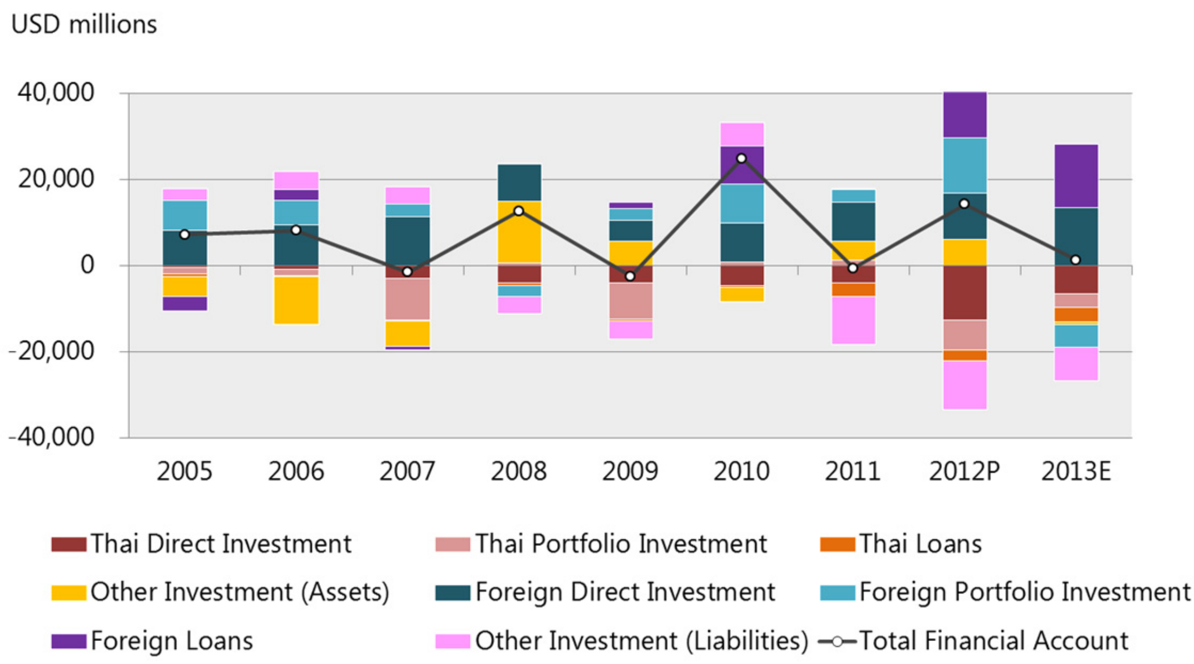
Figure 5



Source: Bloomberg

Net capital flows and components

Figure 6

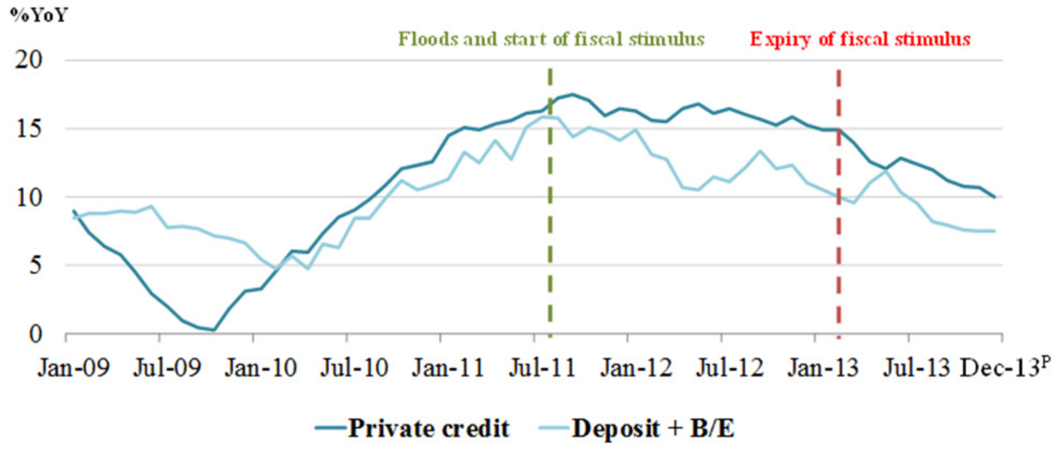


Note: P = Preliminary E = Estimated

Source: Bank of Thailand

Private credit growth

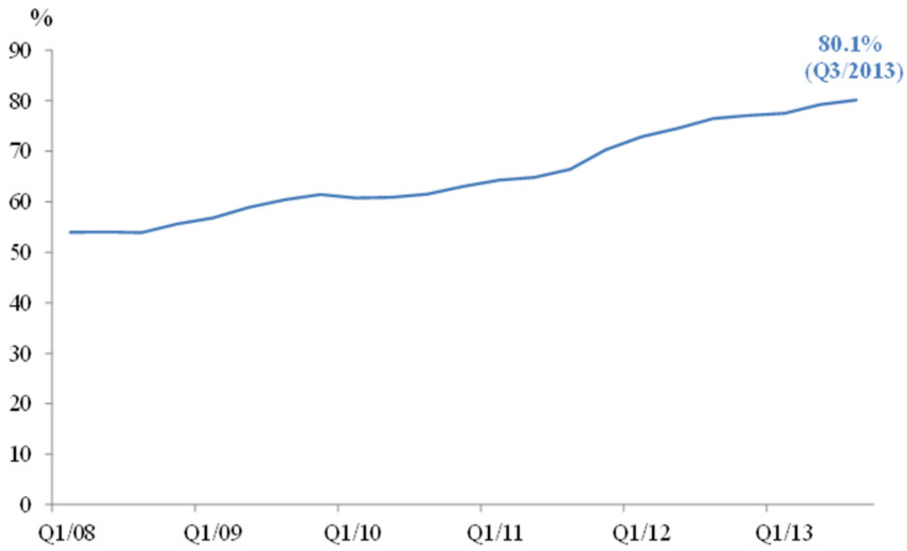
Figure 7



Source: Bank of Thailand

Household debt to GDP

Figure 8



Note: *Loans to households from financial institutions

Source: Bank of Thailand