M R Pridiyathorn Devakula: Thailand's Monetary Policy - its obstacles and challenges

An address by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the Seminar on "Where does Thailand stand now?" Bangkok Post – Tradex Economic Forum Bangkok, 26 September 2001.

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Your Excellencies, Distinguished Guests, Ladies and Gentlemen,

The tragic terrorist attack in the United States, and the repercussion on the financial markets all around the world, reinforced what we already witnessed in the 1997 Asian crisis – that the financial world has become closely inter-twined, globalised and integrated. Disturbances in one market readily spread to and affect all the others.

This is the kind of challenge facing policymakers in setting monetary policy these days.

Past Achievements

Ladies and Gentlemen,

Let me briefly review the economic developments.

Thailand has faced a number of difficulties and fought hard in the last four years. We have gone through unprecedented adjustments and improvements on both economic and financial reforms. The Thai economy has gradually recovered. The growth rate of GDP, which was a contraction close to 11% in 1998, has now been maintained in a positive territory for more than two years; 4.2% in 1999, 4.4% 2000 and would highly likely be positive again this year, even though at lower percentage of growth.

Macroeconomic and financial stability has been restored. Inflation has also been stable at a low level of 1.4% in August, whilst foreign reserves have also regained the healthy level at 32.6 billion US$ at end of 2000 and have been maintained at that level up to now. Total external debt has declined from 109 billion US$ at end of 1997 to 73 billion US$ now. Political environment no longer appears as an obstacle towards the recovery path.

As far as the financial sector is concerned, sovereign and commercial banks credit ratings have been stable. Prudential and supervision standards such as rules on loan classification, and asset valuation have steadily moved towards international standards. Commercial banks have also progressively recovered, with an increase in capital adequacy ratio reaching over 14 percent. Thai banks' earning performance showed a steady improvement, with a net operating profit of 7 Billion Baht during the first half of 2001, a significant improvement from 3.6 Billion Baht for the whole of last year. Debt restructuring also progressed well, with the NPL ratio dropping from a high 45% at the end of 1998 to 39% in 1999, 18% in 2000, and reaching around 12% recently, in spite of some re-entry NPLs.

Development for Monetary Policy

Before I go on to discuss obstacles and challenges, let me briefly recap on the changes that have taken place regarding monetary policy since the 1997 crisis.

After Thailand floated our currency in 1997, the Bank of Thailand recognized the need to search for a new and appropriate nominal anchor for monetary policy. We also recognized that the central bank's credibility is crucial in assuring the public on the smooth operation of our economy. The Bank of Thailand decided to adopt inflation targeting as the framework for our monetary policy.

Inflation targeting is not simply setting an inflation target. It is instead an approach that emphasizes (a) a forward looking economic forecasts using the most reliable economic models, (b) transparency in communicating to the public the reasoning for policy stance, and (c) accountability to ensure that promises of price stability are upheld.

We have chosen to target core inflation, a measure which excludes volatile components, namely raw food and energy prices. Our target range has been set between 0 to 3.5 percent until 2002.

When I stepped in as a Governor in June, bearing in mind that our current account surplus was decreasing (due to a reduction of external demand) and international reserves may be affected, a review of the monetary policy was made. It was however agreed that inflation targeting framework should remain for price stability is still very important to prevent the economy from another crisis.

However additional attention was emphasized on certain elements. International reserves which seem to be treated as exogenous factor under the framework have been brought into consideration, with the belief that healthy reserves are needed to maintain investor's confidence amidst the current slowdown of world economy. An increase of repurchase rate (14 days) from 1.5% to 2.5%, with the aim to correct the distorted structure of local interest rates, did help to reduce the gap between local interest rate and LIBOR, making it less attractive for capital outflow.

More important is the emphasis on the managed float concept to limit short-term volatility of Baht exchange rate which did help to lessen the fear that Baht would depreciate further. Whenever Baht swings to the weak position, such fear would lead to the prepayment of US$ loans by private sector or even by states enterprises which were really prepared to do so before I stepped in. It is noteworthy that Baht had stabilized as well as strengthened, which made it possible to stabilize exchange rate as well as accumulating US$ into official reserves.

On this point I would like to further clarify our monetary policy. Some analysts interpreted that the BOT has changed from inflation targeting framework to exchange rate targeting. This is very wrong. If we would target our exchange rate to maintain fixed relation to any currency or group of currencies, we would stand a good chance of losing our official reserves which is really against my firm belief that while global economy as well as our economy are slowing down, healthy international reserves must be maintained to avoid another crisis.

Obstacles and challenges

Ladies and Gentlemen,

I can safely say that we have now a credible framework for our monetary policy. It has proved to be well functioning, inflation is being taken care of, Baht exchange rate has been more stable and provided a better working environment for real sector, and international reserves have not reduced in spite of regular repayments to the IMF. And the framework has up to now been well accepted by the Thai public. But a good and credible policy still has its obstacles and challenges.

Let me now turn to discuss the obstacles and challenges.

The biggest, the most important, and the most worrisome challenge that we face right now is the world economy. A month ago, the world economy was already weak, with the United States uncertain about the timing of a recovery, Japan still having to undergo numerous reforms, and Europe not yet acting the role of the engine of locomotive for the resumption of world growth.

A month ago, East Asian countries were already seeing their exports fast softening, especially in electronic and communication products. These countries were only on the verge of emerging from the depth of the biggest crisis in recent memory. And then disaster struck!

The abominable terrorist attacks in the US would affect some businesses more that others. It will certainly affect some business sectors very hard - airline and hotel industry, insurance, some area of financial services.

The American consumer confidence index by the University of Michigan during the past 4-5 years was always above the 100 point level. It dropped to 91.5 in August. How will the terrorist attack affect this fragile state of mind?

US business investment during the past 4-5 years expanded at the rate of 8-9 % per year. It slowed to only 1.7% in the first half of this year. How will the tragic event that occurred slow this down even further?

The price of Dubai crude, which is the reference price of Thai import cost, before the attack was at the US$ 24-25 per barrel level. After the attack, it briefly touched US$ 29 before turning back. How much will the volatile oil price cool down the world economy?

These are very difficult questions to answer. They are difficult questions to answer under normal circumstances. But when you take into account the fact that the United States soon will undertake operations against the terrorists, and what events may unfold out of that, these questions become many times much more difficult to answer.

I am comforted, however, by the quick actions of financial authorities in all the major countries to try to shore up the situation.

The Federal Reserve acted quickly to set up US$ 90 billion swap facilities with many central banks to facilitate market transactions. Ample liquidity was provided by all countries to market participants. Swift interest rate cuts were implemented in both the USA and Europe.

In Thailand, what can we do in the face of these uncertainties?

I think it is most important, in these times of uncertainty, for the Bank of Thailand to act as the linchpin to the public policy. We have to set the anchor that stabilizes the economy.

It is fortunate that certain elements of our inflation targeting policy has been modified, allowing increased degree of management of the foreign exchange rate which facilitates trade and improves capital flows. The practice which was intended to take care of official reserves while the global economy is slowing down now happens to be the correct policy practice to be further enhanced to cope with addition weaknesses and uncertainties.

More careful management of our international reserves is required so that we can fulfil our debt obligations under the IMF program, and still be left with a strong and healthy level of reserves.

This will be achieved through a vigilant watch on the markets, keeping close dialogue with market participants, gathering intelligence and acting in a timely manner.

Ladies and Gentlemen,

I am here today not to give you a false promise that the BOT could provide policy measures that could lead to the recovery of the Thai economy, but to assure you that our existing policy measures are suitable with the situation and we would do our best not to allow Thailand another crisis of similar cause and magnitude as that of 1997.

While the BOT is assuring a stable environment for private real sector, I will urge the private sector to work harder, to improve their management system and corporate governance, to better learn about their markets, to better control and lower their costs, and to invest in training and technology.

Only by doing so, will they be able to not only survive, but also ready to grow and take advantage of the world recovery when it comes.

Thank you for your attention.