M R Pridiyathorn Devakula: How the central bank sees monetary policy in the new world economic environment

Speech by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, made at the Shangri-La Hotel, Bangkok, 29 November 2001.

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Your Excellencies
Distinguished Guests
Ladies and Gentlemen,

Introduction

I would like to thank the Thailand Board of Investment, the Department of Export Promotion and Tourism, as well as the Nation Group for inviting me to speak at this conference. I believe that it is important in these times of increased global uncertainty for the Bank of Thailand to share with you and the public our assessment of the current economic situation and outlook, as well as our thinking on the future course of monetary policy. The opportunity to do so today is therefore timely and greatly appreciated.

In short, today I would like to discuss what I see as the challenges facing Thailand in the period ahead and what we, at the Bank of Thailand, are prepared to do to meet those challenges. In so doing, I will briefly review the progress of the past few months, and say a few words on the appropriate policy mix which needs to be implemented to help steer the Thai economy through these difficult times.

The new world environment

Let me begin by outlining two key aspects of the current world economic environment that I think are important. The first one is more fundamental and concerns the closer degree of financial and economic integration between countries. Globalization of the world economy has been driven by a variety of forces including rising trade in goods, increased international capital flows, greater technological spillovers, and growing labor mobility. While these factors have brought about a more efficient allocation of resources across national borders and facilitated higher growth and development across countries, they have also created a world environment in which shocks have become more global in nature and where crisis in one country can easily affect others. The end product of greater international economic interdependencies, especially in financial markets, is therefore the enhancement of the underlying international business cycle linkages.

Which brings me to the second aspect of the world economic environment that I would like to touch on today. This aspect concerns the immediate state of the world economy. The globalization of information technology (IT) production has meant that the correction of the unsustainable boom in IT spending has had a particularly widespread impact on the world economy. All the major industrialized countries are experiencing a synchronized slowdown in their business cycles, adversely affecting countries in the Asian region who rely heavily on exports of high-tech products. These developments have been accompanied by a steep decline in the growth in world trade. Falling commodity prices and increased competition in world markets have also put pressure on the external sector as exporters grapple with both weaker volume and lower prices. Finally, the re-pricing of assets in world equity and bond markets have created unfavorable conditions for raising capital and have, to some extent, held back consumption through the negative wealth effects. Access to world capital markets has become more limited for developing countries and we have observed a major reduction in capital flows into these countries.

Over the past few months, the external environment seems to have deteriorated quite considerably. The events of September 11th and the developments thereafter have put global financial markets on edge while exacerbating the already weak US economy, primarily through the effect on consumer confidence. Global demand continues to stagnate while difficulties in Latin America have heightened market uncertainty, increased investor’s risk aversion and tightened financing to emerging markets. In such a situation, it is important for the Government to come forward and play a major role in stabilizing and supporting the economy. In this light, I believe that the authorities here in Thailand have done a commendable job in providing the economy with timely fiscal support while adhering to fiscal discipline.

Fiscal policy has been expansionary and the decision to increase budget spending this year was warranted. The central government deficit of 159 billion baht (equivalent to 3.2 percent of GDP) for the 2001 fiscal year provided the needed support for economic activity and the budget disbursement rate of 88.4 percent relative to the targeted 89 percent was an improvement from the past.

In regards to monetary policy, the global slowdown and heightened market uncertainty has increased Thailand's external vulnerability prompting the Bank of Thailand to pay increased attention to the issue of external stability; particularly Balance of Payments and International Reserves. Healthy outlook in the country's external financial position is always useful in maintaining investor's confidence in times of greater uncertainty. The one time increase in the 14-day repurchase rate in June to 2.5 percent was partly intended to foster increased support to Thailand's external stability in the face of a more challenging global environment.

Indeed, since then distortions in the interest rate structure have been corrected, the negative differential between domestic and international interest rates has been reversed, capital outflows seem to have decelerated, the baht has become more stable, our real effective exchange rate continues to be competitive, the level of international reserves remains at a comfortable level, with reserves to short-term debt ratio as high as 140%, and inflationary pressures are well contained-headline inflation for the third quarter stood at 1.5 percent year on year, while core inflation remained well below target at 1.6 percent.

With a firmer position on macroeconomic stability, the economy is expected to grow by around 1.3-1.8 percent this year. However, the economic recovery process remains fragile and is now being undermined by the weakening global environment as well as declining consumer confidence.

Looking to the future: More to be done

Going forward, I believe we are faced with significant challenges. Unfortunately the most pressing concern also happens to be one that we have the least control of, that is the external demand. With uncertainty regarding the timing of economic recovery in the United States, Japan still having to undergo real and arduous reforms, and Europe not yet stepping up as the locomotive engine for the resumption of world growth, prospects for an export led rebound remains clouded. With these regions together constituting over 52 percent of the market share for Thai products, exports in 2001 are expected to fall in value by approximately 6 percent compared to last year. Assuming an economic rebound in the US, Japan, and Europe by mid-2002, exports should grow by around 3-5 percent in 2002. Real GDP growth is projected to be between 1-3 percent in 2002.

Against the backdrop of increased uncertainty and weak external demand, safeguarding our economic recovery will require steady resolve, more reliance on domestic demand, and a supportive set of measures and reform. The main challenge for local authorities is to ensure proper coordination of fiscal and monetary policies as well as the acceleration of structural reforms efforts in the banking and corporate sector to facilitate a pickup in domestic demand, enhance confidence, and bolster foreign investment. Mr. Bosworth did mention yesterday that to resolve the crisis, bad loans must be placed in asset management companies and then AMCs must get rid of them. This is one of the top priority policies of this government. Almost all NPLs of government banks have been transferred to AMCs, and all multi-creditor NPLs of private commercial banks have been transferred to the TAMC. And we will speed up our effort to clear them out. However, please be informed that when similar financial crises occurred in the US in 1982, the US economy was not in as bad a shape as Thailand has experienced in the past four years. At that time, Japan, Europe and the Middle-Eastern economies were strong and contributed certain capital flows into the US economy. But now, under current world economic conditions, where every country has its own problems to solve, we know well that we cannot expect foreign investors to help us clear this NPL mess, so we have to help ourselves. I do not see why we cannot do it. And we will do it.

Back to the economic forecast for next year. One important source of growth in 2002 will be fiscal spending, and the projected central government deficit of 224 billion baht or 4.4 percent of GDP strikes a good balance between improving the economic infrastructure, raising external competitiveness, and fostering economic recovery. It is very important, however, that the fiscal stimulus program meets its spending target.

Safeguarding the recovery would require timely as well as effective disbursements of the 58 billion baht emergency spending plan. The proposed reduction in the corporate tax rate for companies seeking listing in the stock market as well as those already listed, and the postponement of the restoration of the VAT rate until September 2002 will further set the stage for more support in the revival of domestic demand. Additional stimulus will come from the 71.3 billion baht village fund designed to boost investment and facilitate job creation in rural areas. It is important to emphasize that the planed increase in fiscal spending does not compromise the Government's commitment to fiscal discipline. Total public debt will remain below 60 percent of GDP while debt service (principle and interest) will account for less than 16 percent of the budget.

In regards to monetary policy, the inflation targeting framework gives the Bank of Thailand sufficient flexibility to respond quickly to fast changing domestic and external developments. With inflation remaining subdued and likely to remain contained in the range of 1.5-2.5 percent for 2002, the emphasis in the near future will be to strike a proper balance between domestic growth and external stability.

While the current stance of monetary policy under the inflation targeting framework with emphasis on external stability is accommodative and appropriate given current conditions, the Bank of Thailand is constantly monitoring developments and will move decisively should circumstances change. In light of the information currently available, and against the background of the Bank of Thailand's long-run goals of price stability and sustainable economic growth, I believe that the risks at present are weighted mainly toward conditions that may generate economic weakness in the foreseeable future. Such weaknesses could come from further retrenchment of business and consumer confidence, undershooting of fiscal expenditure targets, and slower than expected recovery in the industrialized countries. Whatever risk ultimately materializes, we would make timely and decisive adjustment of our monetary policy. With strong international reserves, at 140% of short-term debt, we can afford to adjust our monetary policy to support growth, if needed.

At this juncture, I would like to stress that the Bank of Thailand remains committed to the open and transparent monetary policy framework that has served us well since May 2000. Let me emphasize that inflation targeting is a framework, not a rule. Just as the case of a real-life anchor, inflation targets keep the economy on the desired growth path in the long run, while permitting it to respond in the short run to unpredictable tides and currents. As long as the inflation rate is within the targeted range, I believe monetary policy is allowed sufficient flexibility to address other challenges currently facing our economy.

Given the supportive policy mix, the recovery process in Thailand should remain on track for next year. However, with monetary policy geared at safeguarding the recovery while keeping sight of external stability, and fiscal discipline imposing limits to further government spending, there is not much room to maneuver on the domestic front. To substantially improve long term profitability, increase investor confidence, and enhance the success of economic recovery, the nation also needs to be unified in the pursuit of real corporate restructuring, improved financial sector discipline and reform, as well as stronger legal framework for the resolution of debt negotiation and restructuring.

Need for closer regional cooperation

In addition, the growth outlook remains dependent, importantly, on a revival in world demand and improved global financial environment. In this respect substantial risks and uncertainties persist, as the world remains vulnerable to further unexpected developments. This is a possibility that we must consider and be prepared for.

We must therefore consider other possibilities in meeting the challenges that may arise in the face of deteriorating external environment. Such alternatives would ideally incorporate increased and closer cooperation among governments at the regional level. This makes good sense since the countries in the Asian region are very open by nature and would all feel the impact of further slackening in world demand. There certainly seems to be some scope for closer coordinated efforts to improve the resilience of our economies to external shocks.

As previously mentioned, one of the major vulnerabilities lies in the area of capital flow, especially for developing countries. In this regard, the regional swap arrangements already signed by a number of countries are a step in the right direction. By strengthening the credibility of central banks, such arrangements have the scope to impart positive impacts in terms of reduced volatility in regional financial markets. In light of the large pool of savings and international reserves the region currently has, there may be room for further initiatives on this front.

In addition, there seems to be scope to better mobilize regional savings and improve intra-regional capital flows. In the past, the savings rates of countries in the Asia-Pacific regions have been very high. But most of these savings were channeled first to the United States and Europe before eventually returning to Asia. I believe that we should look into ways to better channel these regional savings so that they help to cushion our countries from excess volatility of capital flows. I am glad that yesterday Mr. Kuroda proposed the establishment of a co-operation on capital flows and the streamlining of foreign exchange policy among the ASEAN plus three group. Thailand welcomes this move which would not only help reduce excess volatility of capital flows for countries in the region, but also provide exchange rate stability to support intra regional trade, which constitutes about 50% of our exports. We are willing to move forward with ASEAN plus three in this direction. You may take this as an official response, as I have already discussed this issue with our Minister of Finance.

Conclusion

Ladies and gentlemen,

Before ending, I would like to emphasize again that Thailand has gained significant ground since the aftermath of the 1997 crisis. Macroeconomic stability has been restored, progress has been achieved in financial restructuring and strengthening bank supervision, and external vulnerability has been substantially reduced. At this juncture, however, there is no room for complacency. The key challenge facing the authorities is to maintain macroeconomic stability while accelerating the pace of reforms amidst the global slowdown and heightened market uncertainty. Through careful management of domestic policies, greater regional cooperation, as well as consolidation of restructuring efforts, Thailand and the surrounding region should weather the global slowdown and return to a sustainable growth path.

I would like to thank you once again for the opportunity to address this distinguished forum and wish you all the best. Thank you.