Prasarn Trairatvorakul: Thai monetary policy in the environment of excess global liquidity

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the Thailand Focus 2011 – Enhancing Thailand's Competitiveness over the Next Decades, Bangkok, 28 March 2011.

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Ladies and Gentlemen,

It's an honor to speak before you today at the Thailand Focus conference. Early this morning you heard Prime Minister Abhisit Vejjajiva speak on Thailand's competitiveness; and later Finance Minister Korn Chatikavanij on fiscal policy. To close the circle, I will speak on monetary policy to complete your view on the investment opportunities and prospects of the Thai economy. As international investors, I believe, you want to have a firm understanding of the country's policy environment. This is what I will discuss today – the monetary policy options going forward in light of my assessment of the global economy and the Thai economy.

The assigned title of my talk today is "Thai Monetary Policy in the Environment of Excess Global Liquidity". Let me stress that I have a different opinion on the issue of excess global liquidity than most. Global liquidity is currently problematic in the sense that it is fluid, rather than excessive. Let me discuss why.

First, let me give you my assessment of the global economy. The global economy has entered a phase of fluid global liquidity amid uneven recovery and shifting risk appetite. This phase is characterized by weak recovery in the advanced economies which prompted loose monetary policy and extraordinary monetary measures such as QE2 in the US that have resulted in artificially low interest rates in the advanced economies. These record-low interest rates encouraged investors to seek out higher return in risky emerging market assets, particularly here in Asia. In addition to the push factor of low interest rates and weak recovery in the US and Euro area, strong economic fundamentals in Asia, as reflected in growth and eventual currency gain, served as a pull factor.

As a result, capital became more "fluid" – constantly in search of yield and therefore very sensitive to news and rumors. Such search for risky yield resulted in capital inflows into EME assets last year, as you all know. These inflows contributed to the large appreciation of the Thai baht last year, and indeed other emerging markets.

Here I want to emphasize that the inflows was due to a reallocation in global portfolio, or a change in portfolio choice, if you will. ***There is a misperception that the additional inflow of "fluid" capital stemmed from excess global liquidity.*** Global liquidity had not significantly increased. As a simplification, think of global liquidity as an ocean. The amount of water is finite. But unusual weather can stir otherwise calm waters into a storm. Metaphorically speaking, the new global environment of loose monetary policy and uneven recovery had caused large waves of liquidity to travel from the advanced economies to our shores. Capital inflows helped fuel emerging market growth, contributing even more to the uneven global recovery. Looking a bit further ahead, as the recovery solidifies in the advanced economies and inflation risk rises in emerging markets, diminishing growth differentials will diminish, spurring volatility in capital flows. Choppy waters may be ahead.

So I've given you my view of the current global environment of fluid, if not excess, liquidity. So if excess liquidity is not the main issue, what is? ***On top of the list we have oil prices, Japan crisis and geopolitical risk in the Middle East and how these risks interact with global fluid liquidity.*** Which naturally leads me to the next question – ***what are the global growth scenarios in such a context?***

In our central scenario or most likely scenario, we see continued global growth. The US and Euro area shows signs of a firmer recovery, amid monetary and fiscal stimuli. Latest data show strong consumption and production. But structural obstacles do remain; for example, unemployment and real estate market issues in the US and sovereign debt problems in the Euro area. The growth prospects of Asian economies remain robust, underpinned by strong fundamentals. However, inflation risk is rising, and fast. On the tragic Japan crisis, our current view is that its impact on the global economy should prove temporary. History suggests that Japan will quickly rebuild and recover. And the main engines of global growth still remain. ***The current surge in oil and commodity prices also poses a challenge to global growth***, though, we expect the supply shock to have a limited impact due to several reasons: first, increased oil resiliency, second, real oil prices are still lower than its peak in 2008 and third, many emerging markets administer prices to cushion the blow.

There is a downside risk that this environment of global liquidity amid uneven recovery and geopolitical risk in the Middle East may threaten global growth and stability. This scenario has a low probability of happening. Nevertheless, we should be mindful of it. In this scenario, oil prices will surge upward again and remain high due to strong demand from emerging markets, partly fueled by global liquidity, and supply constraints arising from adverse weather and widespread and protracted unrest in the Middle East. Global recession may result; or worse, global stagflation. The outcome depends on how US and Euro policy makers will respond. ***US and European monetary policymakers are therefore between a rock and a hard place of balancing structural risks to growth and new risks to inflation*.** If US or Euro recovery is still fragile, policymakers may choose to keep interest rates low, prompting stagflation further down the road. The US and Euro policymakers are therefore in a race against time. Their economic stimulus packages must revitalize the economy before the negative side-effects return home to derail the recovery.

In such a world, what can the Bank of Thailand do? ***In my view, also shared with many others', monetary policy should be poised, pre-emptive and perceptive taking into account the central scenario***, let me say more concretely what this means.

First, on poise. Last year was the year of transition as the Thai economy moved out of crisis toward recovery. ***This year is the year of regaining poise as the balance of risks shift to inflation amid a selfsustaining recovery.***

A self-sustaining recovery means robust and broad-based growth. Indeed, we have seen expansion across consumption, investment, and exports. Economic performance beat expectations throughout last year. For 2011, we project 3–5 percent growth as the economy returns to its long-term average growth. The surge in oil and commodity prices is projected not to weigh on the growth prospects of the Thai economy, due to falling oil intensity and strong and broad-based growth. The oil price spike this time round is also not as severe as previous episodes. On the recent and unfortunate Japan crisis, we believe it will have a limited impact on the Thai economy. As a share of Thai exports, the Japanese market accounts for only about 10 percent. But of course, there is a risk of a protracted nuclear crisis dampening economic activity with adverse implications for global growth.

In such an economy with strong growth prospects, there is less need for policy to accommodate growth going forward but more need to be concerned about inflation. Strong domestic demand and diminishing excess capacity will surely lead to price pressure as producers compete for scarce resources. And as the recovery goes from strength to strength and inflationary pressure rises, so must the monetary policy stance regain its poise – poised at a neutral rate that is neither too accommodating nor too tight. After all, monetary stimulus can only do so much and excessive stimulus can lead to financial imbalances.

Let me share my view on the surge in oil and commodity prices and, in particular, how we should respond to this challenge. The brief answer is that monetary policy stance continues to be one of regaining poise with increased vigilance over inflation. The long answer is a bit more complex. The first-round supply-side shock of a rise in oil price should be allowed to pass through into domestic prices. Central banks should take care not to over-react to such price changes as they only reflect the welcome process of market re-balancing demand and supply. However, there is a possibility that a supply shock, especially if it is long-lived, may result in second-round inflation. ***By second-round inflation, I mean a persistent and general rise in prices.*** Second-round inflation may materialize if inflation expectations become unanchored and result in a change in price setting behavior fueled by strong domestic demand such that prices rise across the board – something that every central bank must ***pre-empt*** by anchoring expectations to short-circuit the vicious cost-price spiral.

So is second-round inflation a risk in our final assessment? The spike in oil and commodity prices adds to already present inflationary pressure. Monetary policy must therefore be pre-emptive, as well as poised*.** Since last year, domestic demand has been strong. The output gap is projected to close later this year. Capacity utilization has increased and hiring has become more difficult. These indicators point to excess demand that may lead to inflationary pressure. ***On top of that, a sustained and large supply shock amid strong demand is like adding fuel to the fire. It can unhinge inflation expectations. And price controls can only delay the inevitable price pressure. There is therefore an increase in the risk to second-round inflation which necessitates additional monetary response. A downside risk of high oil prices to global growth, and therefore Thai economic growth, also exists. However, in the central scenario, the balance of risks has *clearly* shifted to inflation. Our projections point to a significant risk that core inflation may breach the upper end of the band. ***As such, regaining poise by moving toward the neutral rate will allow us to pre-empt inflation risk.***

By now, you are probably wondering what the neutral rate is. Let me comment briefly on this mysterious topic. First, on the concept – the monetary policy stance is normal or neutral if aggregate output is at its potential output and the monetary policy is not exerting any pressure on growth and inflation but simply promoting their stability. In practice, however, determining the neutral stance of monetary policy is not an exact science. The potential output alone is never observed with precision, as it depends on our labor force productivity, our competitiveness in the global market, our demographic structure, and the degree of distortions caused by public policies and other market failures, to name a few. Uncertainties about these structural determinants make it difficult to ascertain precisely the output potential, and by implications, the neutral interest rate. Finding the neutral rate would depend on incoming information about both the demand outlook and supply-side factors. That said, I would also add that real neutral rate should be in or close to positive territory. Currently the real interest rate is negative.

I have said that this year is the year of regaining poise, but regaining poise in an unbalanced world of fluid global liquidity is not easy. There may be more exchange rate volatility on the back of fluid flows. Hence, the Bank of Thailand has pursued a managed floating exchange rate policy to lessen volatility. Emerging markets in Asia have pursued varying degrees of capital controls. On this point, let me say that my view is that ***capital control measures are options in our toolkit*** but they have to be appropriately designed. The trend has shifted from controlling capital towards more friendly pre-emptive prudential regulation to manage flow types rather than barring overall flows. On a related point, there has been talk that the current environment of ***fluid global liquidity has led to depressed long rates in Asia***, thereby complicating the conduct of monetary policy. This is indeed a possibility. However, capital inflows do not significantly weaken the interest rate tool of the Bank of Thailand. The Bank of Thailand focuses on short-term rates in conducting monetary policy as the Thai economy is bank-based and most short and long-term loans have free-floating interest rates.

I have discussed how monetary policy should be poised and pre-emptive. ***Lastly, monetary policy must also be perceptive, or at least strive to be so, of medium and longer-term***

issues. Let me highlight three issues: beyond normalization, financial imbalances, and global imbalances.

On the first issue, ***what lies beyond normalization?*** The prospect of further tightening depends on how far the balance of risks will shift to inflation and financial imbalances. A prolonged oil price surge may trigger inflation and tightening in Thailand. The downside risk scenario of high oil prices and global recession or global stagflation may materialize, depending on the complex interplay between uneven global recovery, fluid capital, supply shocks and policymakers' response. The global environment is constantly changing. New information and developments force us to revise our views. In such a world, being poised is particularly important. For being poised allows for a timely response as long as we are aware that we are performing a balancing act on top of the US/Euro balancing act.

On the second issue, ***financial imbalances may foment under the radar and are difficult to detect.*** Granted, I have said that monetary policy should be perceptive. But as you all know there are limits to the far-sightedness of economists or central bankers as the global financial crisis so painfully showed. To paraphrase Mark Twain: "it's not what you know, but what you don't know that gets you." Hence it would be wise to prepare for the worse by building resiliency from within. ***A framework for macroprudential policy is needed.*** Let me remind you that The Bank of Thailand's mandate covers both monetary and financial stability. Monetary policy focuses primarily on price stability. Macroprudential policy should focus on financial stability. We therefore see no conflict between joint use of macroprudential and interest rate instruments as they primarily serve different objectives. Prudential measures constitute the first line of defense against financial imbalances by serving as "sand in the wheel", so as to dampen the financial cycle, weaken procyclicality, and hence reduce the propagation of financial shocks. The interest rate tool, in comparison, is too blunt. However, as the last line of defense, monetary policy can be used to lean against the winds of excessive asset prices. The prudential measure we announced last year – a loan-to-value limit of 90 percent for condominium purchases – is an example. The measure in itself is not particularly binding; it is more significant as a pre-emptive move designed to signal policy resolve in mitigating possible build-up of real estate bubbles. ***Ongoing financial sector reform will also build financial sector resiliency.*** Thailand's financial master plan, now in its second phase, continues, and focuses on liberalization through increased competition, raising efficiency, and strengthening the financial infrastructure.

On the third issue, ***global current account imbalances remain problematic***, as they did before the global crisis. As long as structural problems remain in the US and Euro economies and China retains its present economic policies, it is likely global imbalances will persist into the medium term with the risk of a disruptive correction down the road. Such a correction may be particularly painful for small open economies. Firmer policy coordination between large economies is needed to ensure a smooth resolution of global imbalances.

Ladies and Gentlemen,

I am close to the conclusion of my talk today. I have given you my assessment of the global economy, my thoughts on our policy options going forward, and how ***monetary policy should be poised, pre-emptive and perceptive***.

One theme I emphasized today was the global environment of fluid capital and its attendant risks. ***As a point of departure, let me address how you, as the investor, can thrive in such a world of risk while investing in Thailand.*** There is no easy answer. Different investment strategies face different risks. Investors themselves are the most qualified for evaluating and managing their own risk exposures given their investment opportunities. However, I can tell you that the Bank of Thailand will take care of the risks to the system, by maintaining price stability in the long-run while mitigating economic cycles in the short-run. Our flexible inflation-targeting framework targets core inflation between 0.5 and 3.0 percent while taking into account economic growth. And in this framework, the exchange rate is a managed-float and plays a supporting role as an adjustor against external shocks, leaving room to the interest rate as the main instrument of price stability. The managed-float is based on three elements: volatility, competitiveness, and fundamentals. Volatility is managed so as to limit disruption to the private sector in the short-run. Competitiveness is maintained by containing excessive currency movement relative to the region. And most importantly, fundamentals must be allowed to determine exchange rate movements in the long-run.

But monetary policy alone is not enough to ensure competitiveness in the long-run. For that we must have sound ***fiscal policy*** that supports our national infrastructure with prudent debt management; and ***structural polices*** that address education, productivity, and institutional frameworks. At this point, I hope we have clearly laid out the policy vision for Thailand that can serve as a basis for your investment decisions, risk management, and, ultimately, your continued partnership in the Thai economy.

On that note, let me conclude my talk here, so that you can proceed with the other interesting program that will follow after this.

Thank you.