

Comments on “Understanding monetary policy in Malaysia and Thailand: objectives, instruments and independence” by Robert Neil McCauley¹

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The paper provides an informative review of Thailand’s current monetary policy framework and demonstrates a good understanding of Thai financial market development. Thus, my comments will focus on some issues raised in the paper regarding Thailand, in order to enhance the completeness of the paper.

Monetary policy goals

The paper states that the two main monetary policy goals of the Bank of Thailand (BOT) are low inflation and stable exchange rates. Even though the BOT’s objectives are often cited so, it is important to emphasise that the overriding goal under the inflation targeting framework is price stability, with a view to enhancing sustainable growth in the long term. Exchange rate stability, however, is now regarded as a desirable condition subsumed under the price stability goal. For an open economy like Thailand, it is undeniable that the exchange rate still bears important influence on domestic prices. Therefore, mild exchange rate volatility complements overall price stability, and the two goals should not be considered as independent.

Exchange rate stability

Under the managed float exchange rate regime, extreme exchange rate movements have occasionally been limited by the central bank’s intervention. Broadly speaking, the BOT does not attempt to influence the exchange rate level, for that should be left to the market based on the true fundamentals of the economy. However, when exchange rate movements become too volatile, for example with sudden shifts in global market sentiments, the BOT may decide to take action but only to slow down the speed of change in order to allow adequate time for the real sector to adjust accordingly.

It is well understood in Thailand that exchange rate intervention may have grave consequences in the long term. Therefore, the central bank has been doing less rather than more market intervention, which is consistent with the message sent out to the public. Over time, as the domestic financial market matures, the public will be better equipped with the tools to protect themselves from exchange rate volatility, and thus the central bank’s role on this front can be expected to diminish even further.

In the paper, the author observes the exchange rate volatilities over two periods and draws the conclusion that the intervention policy under the present BOT governor (June 2001-present) is more active than that under the former governor (May 1998-May 2001). However,

¹ March 2006 version.

² Bank of Thailand. The views expressed are those of the discussant and do not necessarily represent those of the BOT.

exchange rate volatility reflects not only the policy stance but also the prevailing economic and market environment during each period of time. Incidentally, exchange rate volatilities of Indonesia, the Philippines, South Korea and Thailand all diminished substantially in the latter period when compared to the former (Table 1). These regional countries were hit hard by the financial crisis of 1997-1998, and thus the reduction in the exchange rate volatility in the case of Thailand is likely to reflect improved economic fundamentals and confidence, just like in the other countries, rather than the change in the stewardship of the monetary policy governing agency.

Table 1
Historical volatilities of selected Asian currencies

	Jan 1999-May 2001	Jun 2001-Dec 2005
Indonesia - IDR	20.46	9.28
Thailand		
Bilateral THB/USD	7.04	4.03
Effective exchange rate	6.65	3.44
Philippines - PHP	12.81	4.72
South Korea - KRW	9.92	7.41

Note: Volatility is measured as the annualised standard deviation of the daily percentage changes.

Source: Bank of Thailand.

Other goals

The paper mentions that, with both monetary and supervisory responsibilities, the BOT has goals other than those pertaining to monetary policy, namely, financial stability and developmental goals.

Under financial stability, asset prices are alluded to as an area of possible concern of the central bank. In practice, the BOT has no asset price target, explicit or implicit, but it does use asset price information to detect fragilities in the economy. The use of asset price information can serve both monetary and prudential policy, and the choice of policy instrument may vary as the BOT deems suitable. For example, if an asset price bubble reflects overall demand pressure, monetary policy may be tightened along with a stepping up of prudential measures to safeguard macroeconomic stability as well as financial institutions' stability. In some cases, however, the asset price bubble reflects a localised fragility, and the use of monetary policy is likely to be too broad to address the problem even though it pertains to macroeconomic stability. Under such circumstances, the BOT may opt to use prudential measures, instead of tightening monetary policy, for the macroeconomic stability goal. It simply demonstrates how the BOT uses its policy tools flexibly and concertedly, for macroeconomic and financial stability goals in the end serve the same ultimate objective of economic stability in support of long-term growth.

As for the development of the bond market, it should not be viewed as an independent developmental goal. The development of the bond market will help enhance monetary policy transmission and thus, in a broad sense, serves the monetary policy goal. Table 2 illustrates

the development in terms of market depth, with the outstanding value of government bonds³ to GDP increasing substantially from the pre-crisis period (1993-1997) thanks in part to the budget deficits in recent years. Meanwhile, progress has also been made on other fronts, such as the exemption of withholding tax, to provide easier access to all players and enhance the participation of both investors and private issuers.

What would be useful in the study of Thailand's monetary policy is an analysis of whether monetary and prudential roles of the BOT tend to conflict with or support each other on the whole. The analysis may also extend to include developmental goals in the form of credits to special sectors.

Table 2

Development of the government security market

Unit: Billion baht	Average 1993-97	Average 1998-99	Average 2000-05	2005
Government bonds	47.6	507.0	1,046.5	1,360.5
T-bills	0	12.5	135.0	209.0
NGDP	4,070.6	4,631.8	5,840.4	7,104.2
Total outstanding (% GDP)	1.2	11.2	20.2	22.1

Sources: Thai Bond Market Association; National Economic and Social Development Board (NESDB).

Instruments

Setting policy interest rates

In setting the policy interest rate, the Monetary Policy Committee (MPC) meets eight times each year to assess recent economic conditions and consider the inflation and economic outlook over the next two years. With the assistance of forecasting tools and the MPC members' views, the risk of core inflation breaching the target range of 0-3.5% (quarterly average) determines the MPC's policy reaction.

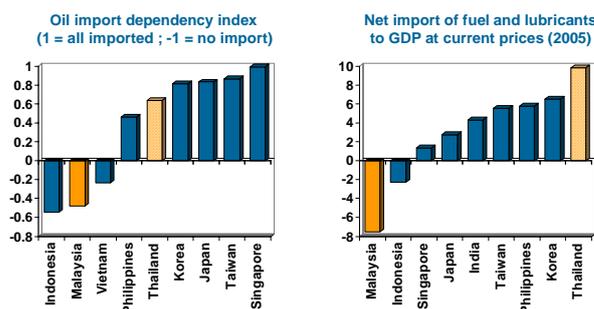
Policy rates: choice, rhythm of decision-making and activism

From past reactions of the MPC, the paper concludes that monetary policy in Thailand is more active than its counterpart in Malaysia. The conclusion is based on the fact that the policy rate in Thailand was raised by 375 basis points between August 2004 and October 2005, while the Central Bank of Malaysia kept its policy rate unchanged between February 2004 and August 2005. Again, this comparison downplays the differences in the underlying structure and environment of the two economies. For example, Malaysia is an oil-exporting economy whereas Thailand is an oil-importing country (Chart 2). That alone should suggest that, even with the same degree of inclination for policy activism, monetary policy in the two countries may have to react differently to an oil price shock. Moreover, Thailand is an inflation targeter but Malaysia is not. That may also suggest a different degree of concern over inflation risk.

³ Calculation is based on securities registered with the BOT.

Chart 2

Oil import dependency comparison



Source: World Bank.

Sources: CEIC, Customs Department, NESDB.

Goals, instruments and higher energy prices

The paper argues that the BOT uses core inflation as the policy target but also gives consideration to headline inflation. I would like to add to the point by saying that having core inflation as the target does not preclude the use of other price information for policy deliberation. The case with headline inflation is a good example. With high oil prices and their subsequent pass-through to the prices of other goods and services, headline inflation tends to lead core inflation more so than it used to. As a result, the MPC monitors headline inflation closely and uses it as an indicator of future pressure on core inflation, of course with the degree of lead varying up to a number of factors including demand pressure.

Independence

Behavioural independence

Although the BOT's charter (the Bank of Thailand Act of 1942) does not guarantee the central bank independence from the power of the government, in practice the BOT has behavioural independence to some degree. However, this may not be reflected by the paper's indicator of choice, namely, the turnover rate of the central bank governor. For example, it is difficult to assess the central bank's behavioural independence from the turnover rate alone given different political setups in Malaysia and Thailand. Moreover, when normalised by the turnover rate of the prime minister, the turnover rate of the central bank governor in Thailand is roughly half that of Malaysia, suggesting that central bank governors in Thailand may be less affected by political changes than in Malaysia once the turnover of the head of government is controlled for (Table 3).

Table 3

Turnover rate of central bank governor

	Thailand	Malaysia
Central bank governor turnover	20 (1942-present)	7 (1959-present)
Prime minister turnover	29 (1942-present)	5 (1957-present)
Central bank governor turnover normalised by PM turnover	0.69	1.4

Sources: Bank of Thailand; Royal Thai Government; Wikipedia.

Balance sheet independence

Although the Bank of Thailand Act of 1942 allows the BOT to finance the government directly through monetisation, the law allowing the government to conduct such business was terminated in 1960.⁴ At the same time, the BOT has not participated in the primary government bond market over the past decade.

Last but not least, one point should be clarified regarding the BOT's assistance to distressed financial institutions through the Financial Institutions Development Fund (FIDF). The paper states that “[I]n one round the government undertook to pay interest coupons on bonds sold to recapitalise the FIDF, while the Bank of Thailand undertook to pay the corpus of the bond out of profits on management of the foreign exchange reserves. Given that the foreign exchange reserves are financed at the margin largely by interest-bearing debt, it might have been better to pay off the bonds out of the profit from the note issue.” As a matter of fact, the BOT is paying off the principal of the fiscalisation bonds out of the annual net profits from both the “General Account” (typical central banking business) and the “Currency Reserve Account”, which is more or less the Note Issue Department's account. It should be emphasised that the key point here is that the FIDF's losses have been resolved, rather than the BOT's balance sheet independence having been compromised, because such an arrangement is equivalent to regular profit remittance from the point of view of the BOT.

⁴ According to the law, drawing overdraft money requires two sets of acts: an act allowing the BOT to grant such loans to the government and the Annual Budget Act allowing the government to overdraw money from the BOT. The latter was terminated under Prime Minister Sarit Dhanarajata in October 1960.