# Thirachai Phuvanat naranubala: The role of non-bank financial institutions in relation to monetary policy

Speech by Mr Thirachai Phuvanat naranubala, Deputy Governor of the Bank of Thailand, at the Regional Seminar on Non-Bank Financial Institutions in East Asia Region, Bangkok, 4 September 2002.

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I wish to congratulate the Securities and Exchange Commission of Thailand and The World Bank for organizing such an interesting seminar in Bangkok, and to thank them for inviting me to share my thoughts with you today.

I can see that the topics in the seminar will cover many important aspects of non-bank financial institutions' operations -- ranging from the regulatory and supervisory framework to capital market development as well as the issue of governance. But I am the only person touching on monetary policy aspect.

Monetary policy does affect an important part of your business, which is the bond market. Because the one factor reflected in the bond market yield curve is inflation expectation. Therefore, if the framework and the conduct of monetary policy result in low and predictable inflation, it will help curb volatility of the yield curve and support development of the bond markets. Change in monetary policy stance also directly affect interest rate and hence the bond market. Thus, it pays for you to understand monetary policy.

## Monetary Policy in Thailand

In order for you to do that, I have to start by telling you about how the monetary policy framework has evolved here in Thailand.

Since the end of the Second World War, Thailand employed the regime of fixed exchange rate one way or another.

At the beginning our currency was fixed to the British Pound, and later to the US Dollar - first directly, then later via a basket with a very heavy US Dollar content.

The regime had served us very well. It provided certainty for international trade, and it helped to attract foreign investment. We were able to maintain the parity with the US Dollar for more than 18 years until 1981 when we had our first devaluation.

The pressure on our parity in the early days was slight. Thailand's exports at that time were rice, rubber, tin and teak. Our production costs for those items were among the lowest in the world.

However, beginning from the 1980's, we began to industrialize. Our industrial exports which was only 33 % of the total exports at the end of the 1970's quickly rose to 76 % in 1990 and even further to 86% today.

With industrialization, we began to find that our productivity did not keep up with our major trading partners, particularly the US, and pressure on the parity began to build up. Our domestic costs of production have never been flexible downward. To ask for a wage and salary reduction was unthinkable then - as it is today. Our only choice was to devalue.

The devaluations that occurred were not always smooth. More than once, they brought on political tension, between those in the government who believed in it and those in the opposition, or even the military, who thought otherwise. In one incident, it even caused a change in the central bank governor. Finally, we had to float our currency in 1997.

Since then, we have adopted Inflation Targeting as our monetary policy framework. A core inflation target was announced at between 0 and 3.5 % per annum. The central bank will regularly monitor economic changes and make forecasts. If we see that the rate of inflation has a tendency to exceed the range, we will adopt a tighter monetary policy stance by increasing the policy interest rate, and vice versa if we see it going under the range. The policy rate that we use is the 14 day repurchase rate.

This is completely different, of course, compared to the days of fixed currency regime when interest rates in Thailand would move mostly in tandem with the US rates.

The change in the monetary policy framework therefore affects the financial environment and your businesses a great deal.

**Development of the bond market**

What other change also happened?

One very important change that has occurred in Thailand is the rapid development of the bond market, which took off after the 1997 crisis.

The bond market is an important tool for safety and soundness of the financial institution system. It allows the intermediation process to proceed uninterrupted when the banks are temporarily in difficulty. But more importantly, it helps with liquidity management.

In the case of Thailand, the government throughout the 1980's had been very disciplined in their fiscal policy. They maintained balanced budgets in most years. As a result, no new government bond was issued, as old ones were being retired.

Without a deep and liquid government bond market, growth of corporate bond was also slow. When the crisis erupted, financial institutions that could not seek liquidity from the inter bank market were stuck without liquid instruments in hand. Some of them might have survived had the bond market been more active.

After the crisis, the government had to issue massive amount of bonds to cover losses in the financial system. Today, the Thai bond market is therefore much larger, at 38 % of the GDP. We have a much more active market.

What does an active bond market mean to monetary policy? I will highlight three points.

**First** is the implication on transmission mechanism.

When the central bank wants to change stance in monetary policy, it changes interest rate up or down. But it does not directly change the interest rates along the whole spectrum of the yield curve. It only affects the key policy rate, which in the case of Thailand is the very short-term 14 day rate in the repurchase market.

However, to have an impact on the real economy, there must be a way to transmit this signal all the way to the financial activities that determine economic transactions, such as business capital formation, household consumption and savings.

The traditional channel is through commercial banks. And now we have another channel through the corporate bond market. This channel is poised to grow more rapidly in the future.

The **second** aspect is that central bank also operates in the government bond market in its conduct of monetary policy. It can sell and buy bonds to pump money in or out of the system, through their open market operations.

An efficient, deep and liquid bond market therefore will not only help make the intermediation process competitive and active - but also allow the central bank to transact in the market more effectively.

The **third** aspect is the function of the bond market in managing the capital flows. Emerging market economies when they are successful tend to attract capital inflow very quickly, and in very large quantity. Unfortunately, if things turn bad, the outflow of capital can also be equally quick and in as large a quantity.

How can one better manage this volatile capital flow? To some extent, I think the risks can be mitigated with a well functioning bond market.

If we can make it function as a temporary reservoir to store the incoming water, and more slowly releasing it to the various users of fund within the country, at the right pace for absorption - if the market selection process can be made such that only the projects with really viable, economic prospects are granted the fund - and, if the foreign owners of fund can be persuaded to hold the instruments denominated in borrowers' own currency, thereby shifting the position on the foreign exchange risks from the borrowers to the investors, then the bond market can be a safer channel for capital flows than the commercial banks.

At this point you may disagree that if foreign investors in bonds want out, they will still sell the bonds, causing the prices to be sharply lower anyway. This is true. But price volatility in the bond market is still better than a run on your banks.

Therefore an efficient bond market can help lessen the adverse impact that volatile capital flows may have on the financial institutions. A sound financial system is of course a necessary condition for the conduct of monetary policy.

**The role of non-bank financial institutions**

Let me now turn to the non-bank financial institutions. What can be your roles in relation to monetary policy? I can offer four suggestions.

Number one, you can make yourself an efficient player in the market. The more efficient the competitors, the better the market is.

But in order to compete well, you will have to be well capitalized, well organized with good governance and risk management processes.

Number two, you can help establish market codes and practices that conform to world standards. The market needs rules to ensure smooth trades and dispute resolutions, and to guard against manipulation. The industry has an important role to play in the setting of rules and codes of conduct.

Number three, you can help ensure that the market has a wide variety of products. We should aim for a market that can offer many kinds of contract, to serve those needing to unbundled or rearrange all kinds of risks at competitive prices.

And lastly, you can build for yourselves a good analytical capability. It will prevent herd behavior, and help to stabilize the market.

But more importantly, proper project analysis can ensure that capital is channeled only to the good projects. It can help prevent over expansion of businesses, over diversification and over enthusiasm that inevitably winds up as non-performing loans in the end.

Ladies and gentlemen

The task of the central bank in monetary policy is to ensure that it sets the right policy, and that its policy is transmitted through to the overall economy. The financial system through which their policy is transmitted must also be safe and sound.

Non-bank financial institutions do indeed have vital roles to play here.