M R Pridiyathorn Devakula: Maintaining stability with a nuanced approach

Speech by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the Stock Exchange of Thailand, Bangkok, 20 September 2004.

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Distinguished participants, ladies and gentlemen,

Let me begin by thanking the Stock Exchange of Thailand for inviting me here to speak today.

You have already heard from our Minister of Finance a comprehensive framework for sustainable growth in the next five years, with an integrated set of targets for various sectors and various dimensions of the economy. This is a welcome initiative and an important policy development.

The Bank of Thailand's role is to ensure economic and financial stability in order to support continued growth of the economy. From our experience, monetary policy alone is not enough to achieve desirable stability. WE need to involve ourselves in two other areas, i.e. to guard against possible build-ups of financial imbalances and to further strengthen the financial sector.

First of all, I will begin with our assessment of the current economic conditions to assure you that, in spite of the greater risks and challenges that have emerged this year, Thailand's growth momentum continues to remain firm, with economic and financial stability intact.

Key challenges have included increased external pressure from higher oil prices, rising global interest rates, and the potential impact of a slowdown of the Chinese economy.

We have also faced several challenges at home, which include two episodes of the avian flu and a decline in consumer and investor sentiment linked to the situation in the South. But despite these risks and challenges, the Thai economy has managed quite well under the circumstances.

The latest data showed real GDP to have grown by an impressive 6.4 percent for the first half of this year, reflecting the resiliency of our economy, which is still growing at a respectable rate, in spite of many negative external developments.

Favourable conditions for the export of goods and services have allowed a continued surplus of our current account. This has been accompanied by corresponding reductions in external debt which fell from the peak of 112 billion US dollars in June 1997 to 50 billion US dollars in June of this year. Meanwhile, international reserves of 44 billion US dollars in August also provide a level of protection that should help the economy comfortably absorb external shocks. It was mainly an account of the strength of this external position that Thailand's credit rating was upgraded by Standard and Poor's last month.

Ladies and gentlemen,

At this time, the high price of oil is probably the most important external risk to the economy. However, this risk poses varying implications for economic growth and stability.

Our macroeconomic forecasting model shows that the impact of higher oil price on economic growth is likely to be less pronounced compared to its impact on inflation and economic stability. This can be attributed to the fact that the economy still has substantial momentum to support growth. Exports and private investment, in particular, are expected to grow on the back of continued global recovery, a high level of capacity utilization, and conducive financial conditions supported by a turnaround in credit extension of the banking sector.

Moreover, the economy is now in a much better position to weather external shocks, thanks to an improved external position and the strength of domestic demand. In addition, the Government's much improved fiscal position should allow the economy to adjust to higher oil prices without interrupting the growth momentum. It is, therefore, our view that the risks to growth from the higher oil prices should be manageable.

On the other hand, the impact of the higher oil prices on economic stability is expected to be more pronounced. Latest data on headline inflation continue to show signs of price acceleration.

In August, Thailand's headline inflation therefore rose by 3.1 percent year-on-year, while core inflation rose by 0.7 percent year-on-year. With a narrowing of the output gap and reported tightening in some segments of the labour market, we believe that there is considerable pent-up price pressure building up in the system that could eventually translate into higher consumer prices. Our inflation forecast points to a higher probability of rising domestic inflation going forward.

Thus, with growth momentum remaining firm but with prospects for higher inflation, the Monetary Policy Committee saw less need to keep interest rates at low levels. The committee was of the view that monetary policy should be more focused on economic stability, with the adjustment being gradually paced. This was the rationale behind the increase in the policy rate in August.

Ladies and Gentlemen,

Adjustments in the financial markets following the policy rate increase have been orderly. There has been an across the board increase in short-term money market rates as well as a rise in bond yields. But given present excess liquidity in the system, there will be some time lag before the corresponding adjustments in deposit and lending rates take place.

Going forward, especially as the economy's expansion gains further momentum, monetary policy will need to maintain economic stability and to ensure that inflation is kept within the target. It is our intention to do whatever necessary to keep inflation in check and to ensure a continuation of economic stability.

Ladies and gentlemen,

Besides monetary policy, we have also taken measures to safeguard the economy against possible buildups of financial imbalances at the sectoral level. We have learned from the 1997 financial crisis that overshooting asset prices could pose a major risk to the economy. Therefore, to maintain economic arid financial stability, we need to be vigilant in spotting potential financial imbalances, particularly in the real estate and household sectors.

At this time, although monthly value of land transactions has risen back to the previous peak level in 1996 and bank credits extended to real estate developers has picked up, we feel that there is no sign of overheating in this sector yet. Latest land prices have increased only by 14 percent on average, while housing prices for low- and medium-income families rose by less than 10 percent over that of last year. Nonetheless, it is important to keep a watchful eye on developments in the real estate sector, by making sure that bank lending to this sector is prudent. And for our part, there is now greater willingness to use the necessary prudential measures to discourage or forestall any undesirable development.

Financial institutions are now required to report all real estate loans exceeding 100 million baht. Any real estate lending that is deemed too risky would require immediate additional provisioning. This should help ensure that growth of the real sector is driven by quality growth with least amount of bubbles, and that policy is proactive enough to prevent a reoccurrence of the real estate bubble prior to the 1997 crisis. To improve our ability to monitor this sector, we have developed a housing price index in cooperation with a number of agencies including the Government Housing Bank. This housing price data will be important for assessing the underlying conditions in the housing market, and will allow us to monitor any concentrations of risk before they develop in this sector.

As for households, despite a reported rise in household debt by the National Statistical Office, the current level of household debt in Thailand is still much lower than average levels of both industrial and regional economies. While the Thai household debt to GDP ratio stands at 33 percent, the corresponding figures for Australia, Singapore and South Korea are 84, 85, and 63 percent respectively. If we look at the components of household debt, we see that mortgage loans increased by a reasonable rate of 15 percent, while we see an increase of over 30 percent in credit cards loans.

Therefore, as a precaution, the Bank of Thailand has implemented a number of prudential measures to curb possible build-up of imbalances in the credit card loans. In November 2002, we have raised the minimum income levels for credit card qualification. And later on in April 2004 we have raised the rate of minimum monthly payments from 5 percent to 10 percent. These proactive measures so far have yielded desirable and positive results.

Let me now move to the financial sector

Stability of Thailand's financial system, in particular the banking sector, has improved remarkably in the past few years. The 1997 crisis has weakened our financial system. Commercial banks' returns on assets were persistently negative, and NPLs stood at a record high level. Since 2001, the Bank of Thailand has tackled these problems in two steps. First, we aimed to make these financial institutions healthy and profitable so as they could resume their normal function of financial intermediaries. In 2001, the Bank of Thailand issued a few measures and guidelines to enhance banks' profitability; for example, the reduction of provision requirement for a normal loan which is not NPL to a more reasonable level and the classification of NPLs by account was introduced to replace NPLs by name. More important, banks were persuaded to change from the old practice of competing for deposits with higher interests which resulted in lowering the cost to support banks' profits. Moreover, banks also have made substantial progress on productivity and risk management, with restructured work process that has significantly brought down operating costs. As a result, return on assets has improved from negative in 2001 to 0.7 percent in 2003 and the annualized rate of 1.5 percent for the first half of this year.

At the same time, good progress has been made in NPL reduction. The proportion of outstanding NPLs to total loans has reduced from 24.5 percent in 2000 to 12.4 percent at the end of 2003 due to various efforts put to restructure NPLs.

Now, with improved balance sheets and more stable financial standing of all banks, the Bank of Thailand has moved into the second step; and that is to improve the quality of banks' businesses and management.

The Bank of Thailand has recently tightened provisioning rules for NPLs. Up to now, for NPLs outstanding more than 1 year, banks have been required to provide for 100 percent of the amount of loan net of collateral. We will, from the end of this year, require incremental provisioning for remaining amount of loan for NPLs outstanding for more than 2 years. By this new rule, if an NPL still remains outstanding for more than 4 years, provisioning for the entire value of the loan must be set aside. By that time, banks' balance sheets will be very prudent.

More important is the introduction of more prudent criteria to classify NPLs of banks. On top of the record of non-payment, the Bank of Thailand auditors have, since the beginning of 2003, looked at the "ability to repay" based on the potential cash flow as well. All these prudential measures are designed not only to strengthen the Thai financial system, but also to increase its credibility.

Ladies and gentlemen,

To sum up, the Bank of Thailand has taken several measures to ensure monetary and financial stability. The Thai economy has proven to be resilient. This year, despite the many recent challenges, the economy has been able to adjust well to shocks, owing importantly to the strong underlying fundamentals und a continued growth momentum.

Going forward, as economic recovery continues, we need to be alert and be vigilant on the possible risks to economic stability, especially the risk on inflation. To this extent, our recent reorientation of monetary policy stance will serve towards ensuring the needed safeguard of economic stability, whilst not detracting from the underlying growth potential.

And because in an economic cycle upturn, risk of imbalances building up in some sectors of the economy may emerge. Even though there is no current sign of imbalances or bubbles, the Bank of Thailand will need to be alert and be vigilant in looking out for signs of imbalances to prevent economic instability at an early stage. At the same time, we have made significant progress in strengthening our financial institutions. This progress has now allowed us to move forward to the phase of upgrading the efficiency and continued adoption of evolving international standards, which in turn, will serve to enhance financial system competitiveness, stability, und credibility in the period ahead.

Thank you.