Prasarn Trairatvorakul: Living with capital flows – a delicate balancing act

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Ladies and Gentlemen,

It's an honor to speak before you today in the 5th Annual Euromoney Thailand Investment Forum. Since yesterday, you must have already heard many interesting discussions about Thailand's prospects. Here, I would like to reaffirm that Thailand is indeed on a recovery path. Over a longer horizon, the prospects of ASEAN integration and the rise of Asia are also offering causes for optimism.

As international investors, you naturally would want to participate in Thailand's exciting prospects. Before putting more money into Thailand, however, I suspect that you would want to understand our macro-policy environment. Our recovery has been gaining momentum, and the central bank has been echoing more vigilance regarding inflationary pressures. Meanwhile, the global environment suggests that more capital is likely to flow into our economy. In this ***complex situation***, I believe that you might want to know what the central bank's view and stance are. Since the majority of you are in the capital markets, the focus of my talk today will be related to capital inflows.

Capital inflows have always been and will continue to be welcomed into Thailand. Indeed, capital inflows have been vital for Thailand's development. For the past 30 years, capital inflows have helped finance our country's productive capacities and thus helped raise the standard of living for millions of Thais.

Going forward, more capital is expected to flow into the region for at least two reasons, namely, the growth differential between emerging Asia and advanced economies and the changing nature of global liquidity.

On the first reason, ***the strong growth momentum in Asia is likely to draw in more capital***. This factor is especially strong as advanced economies continue to cope with legacies from the crisis. In contrast, Asia has survived the global crisis relatively well. Recent numbers show that Asia's growth during the past year has been driven by both external and internal demand. For this year, the momentum is expected to continue, while the rapid growth of the middle class in large Asian economies such as China and India makes the prospect of intra-regional demand even more hopeful over the longer horizon.

Another development worth noting is the changing nature of global liquidity, in particular, the ***increase in fluidity*** that is likely to push capital flow into emerging Asia more easily but could also lead to easier capital flow reversals when conditions change. This rise in fluidity of global liquidity seems to have its roots, at least in part, in the macro policies of advanced economies. Specifically, large fiscal debts and quantitative easing in advanced economies help contribute to the rising fluidity.

First, ***large fiscal burdens in many advanced economies*** have altered the risk profile of the supposedly risk-free assets such as their government securities. As the line between traditionally risk-free and riskier assets becomes blurred, investors would be more willing to search for yields and switch back and forth between assets more easily.

Second, although the money used by advanced economies' central banks to purchase securities has ended up mainly in the banking system for the time being, ***quantitative easing*** does help raise investors' risk appetite. On the one hand, QE is likely to make the

recovery of advanced economies a bit firmer through improved consumer and business sentiment. With that, investors' risk-appetite has risen, driving investors to riskier assets, including commodities and emerging market securities. On the other hand, QE drives down yields in advanced economies. The combination of rising risk-appetite and low yields in advanced economies pushes investors to search for higher yields elsewhere and thus makes commodities and emerging market securities more attractive.

Of course, we must note here that despite the altered risk profiles, government securities of advanced economies are likely to remain the ultimate safe haven assets. As such, portions of capital flows could reverse themselves very easily when risk appetite wanes. Experiences have shown that the so-called "risk aversion" episode could coincide with large withdrawals of funds from emerging markets back to advanced economies. These fluctuations in capital flows could potentially pose important challenges for emerging markets.

***While capital inflows are generally beneficial, they are by no means cost-free*.** Potentially, large inflows of capital can lead to exchange rate overshooting, hurting some segments of the real sector that may have trouble adjusting. Moreover, they could seep into speculative activities and drive up asset prices. Especially vulnerable are the real estate and equity markets. As these markets heat up, more capital inflows often find their ways in, creating potential bubbles. Invariably as the bubbles burst, balance sheets of firms, individuals, banks as well as the government will be affected. The burst of these bubbles, when coupled with capital outflows, could have devastating effects. The Asian crisis over a decade ago is a good reminder for us.

Currently, ***the Bank of Thailand has a set of tools at its disposal to help the economy deal effectively with capital inflows***. These tools include (1) the flexible exchange rate and foreign exchange market intervention, (2) macro-prudential measures, and (3) capital account regulations. Together, these tools are indeed powerful, and a careful coordination is required when using them. Let me briefly elaborate on the use of each.

In our framework, a ***flexible exchange rate*** is a core tool, since it can act as an automatic stabilizer towards capital inflows *in general*. As capital pours in, especially if driven by favorable growth potential of the economy, a flexible exchange rate can act as an automatic stabilizer that would help lessen the chance of overheating and dampen pressures on other asset prices which otherwise might turn into a bubble. Exchange rate adjustments in the face of large capital inflows, however, are not without costs. An excessively rapid appreciation of the currency could be disruptive to the real economy, since there often are constraints in the adjustments of the real economy, from labor market frictions to pricing behaviors.

Here we have a challenge and need to balance well. In general, we would allow the currency to appreciate to the extent that the movements are broadly consistent with the economic fundamentals and that they would not cause undue disruptions in the real sector. Let me note here that I think the Thai economy, over the years, has become more capable in coping with exchange rate movements. We see more risk protection via financial market instruments on the part of the private sector. Exporters, in particular, have been able to diversify in terms of product lines and market destinations.

Nevertheless, from time to time there is still a need to dampen the pressures on the exchange rate, and central banks often resort to ***exchange rate intervention***. While such intervention could help contain excess exchange rate volatility, its focus is at the end of the process. In other word, FX intervention is a "passive" mechanism in dealing with capital inflows. By the time of intervention, capital would have already flowed into the economy. Imbalances could have already built up. Furthermore, if market expectations of upside currency gains persist, it could invite even more capital inflows, along with greater pressures on the exchange rate and higher chances of imbalance buildups in the future. For the real economy, it may delay some of the necessary adjustments. Finally, FX intervention is not costless. We have to fund the intervention with local interest rates that are higher than what we would earn from our international reserves.

Experiences have also shown that, even after a large appreciation of the currency, capital inflows could still seep in and fuel speculative activities in markets such as real estate and equity. To help deal with specific pockets of the economy showing signs of potential bubbles, ***macro-prudential measures*** could be used. A recent example is the risk-weights adjustment related to the loan-to-value (LTV) ratio of loans made to property purchases.

While macro-prudential measures aim to help lessen the *effects* of capital that has already flowed into the economy, ***capital account regulations*** can be used to deal directly with the size and type of incoming and outgoing flows. With an aim of creating more balanced capital flows, the Bank of Thailand has continued to liberalize our capital outflows, while on the inflow side we at times resort to tighter regulations when the situation deems necessary.

Implementing a capital account regulation, or less of it, requires a delicate balancing act. For outflow liberalization, on the one hand allowing more Thai resident outflows is beneficial as it helps lessen upward pressure on the currency as well as improve the investment profile of the Thai private sector toward a more diversified and possibly more efficient one. On the other hand, if risk assessment capacity of local investors remains low, too rapid outflow liberalization could make the country's balance sheet more vulnerable rather than more robust. A balancing act is even more difficult when applying *re*-regulation on capital inflows. A measure that is too mild would lack effectiveness, while too drastic a measure would be too costly. For one thing, its distortionary effects would be large; for another, increased policy uncertainty could turn away productive investors and raise the country's risk premium. Aware of these undesirable side effects of controls, we would limit their use to only when absolutely necessary and only on a temporary basis.

On the use of interest rate policy, some may view the policy interest rate as another tool to deal with capital flows, and there have been public debates whether the recent hikes in the policy interest rate by the Bank of Thailand were consistent with our thinking on recent capital flow developments. Specifically, many have argued that the hikes would actually induce more capital inflows that add pressures on the currency. On this issue, let me say the following.

Under inflation targeting, the policy interest rate is used primarily to help maintain price stability to achieve long-term balanced growth of the *domestic* economy. Designating the policy rate to another role, like managing capital flows, would then confuse its primary role, especially when the risk of overheating together with a surge in capital inflows presents policymakers with a dilemma. Thus, our interest rate policy is not meant to deal directly with capital flows. Its side effect on capital flows is, however, not to be ignored. A fine balancing act is also needed when it comes to making interest rate decision given this dilemma.

Perceivably, large interest rate differential may be a push factor for capital flows. However, given relatively small interest rate differentials between Thailand and major economies, we view that a gradual increase in the policy rate should not in and of itself be a cause of further inflows. In fact, we have empirically found that other factors such as growth differential and global risk appetite and liquidity are far more important than interest rate differential in explaining the recent surge of capital inflows to the country. On the other hand, given the pickup in global and domestic demand recovery, the risk of inflation has recently materialized and posed increasing threat to domestic price stability. With all these considerations, we deem that the recent interest rate normalization was necessary and was consistent under our inflation targeting, while its impact on further capital inflows should be minimal.

So let me recap our challenge. Capital inflows are beneficial but they are not cost-free. To help deal with capital inflows and their effects on the macro economy, we have the flexible exchange rate, macro-prudential measures, and various forms of capital account regulations as our tools, while the policy rate is preserved for its primary objective of domestic price stability. Each of the tools has its own advantages and disadvantages. To deal with this challenge, as you may already notice, a balanced use of tools is needed, and that balance could very well evolve over time.

Ladies and Gentlemen,

To live successfully with capital flows will require not only the central bank to do its work properly. For all of us at this Forum, I believe that we can make it easier for Thailand to cope with capital flows, at least partly, through capital market development. An efficient capital market is like a good irrigation system that helps channel flows into productive uses. Such a market, with enough breadth, could also become a shock-absorber towards capital inflows, quantity-wise, and would be a complement to the flexible exchange rate that acts as a "price-wise" shock absorber. A market that has a wide variety of products and instruments, varied types of investors, as well as competitive services will likely be more stable by itself and benefit us all. An efficient capital market is thus one we should aim to strive for.

I hope that I have so far convinced you that living with capital inflows is not easy and will require efforts from the public as well as private sector. Indeed, to successfully live with capital flows is a delicate task, as the title of this speech suggests. On my part, what I want to assure you is that we at the Bank of Thailand are aware of the interrelated issues and always take them into account when making a policy. Tough choices, however, will always have to be made. We will try our best to balance between different stakeholders' needs. For you, as investors, we take to the point that you value policy transparency, and we aim to provide you as such, in addition to macro-stability which is our overriding mandate.

Thank you.