Prasarn Trairatvorakul: Thailand's financial challenges in global capital markets

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the Thailand Focus 2012 "Positioning Thailand for the next growth phase", Bangkok, 29 August 2012.

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It's an honor to speak before you today at the Thailand Focus conference. This morning you heard Finance Minister Kittiratt Na Ranong speak on Thailand's competitiveness and fiscal policy. Later on in the conference, other distinguished speakers will discuss Thailand's investment opportunities in greater detail. To complement the picture, I will speak on monetary policy to complete your views on the investment opportunities and prospects of the Thai economy. As international investors, I believe you need to have a firm understanding of the country's policy direction – something that is sorely needed in the current uncertain global economic environment. So today I will share with you my thinking on the monetary policy options going forward in light of my assessment of the global economy and the risks to the Thai economy.

The organizer of this conference, President Charamporn, has kindly asked me to talk about "Financial Challenges in Global Capital Markets". This is an especially relevant topic because, this year, ***the key challenge for Thailand is the challenge of weathering the financial and economic turmoil from the euro crisis***. More than one year ago, I had the honor of giving a talk here. Some of you who were in attendance may recall that I labeled 2011 "the year of rebalancing" for monetary policy. Why "rebalancing?" Because we were steadily raising interest rates toward normal territory amid global and domestic economic recovery. Well, that was one year ago. One year can be a long time, especially for financial markets. And, indeed, things have changed a great deal since then. We had the flood; and the euro crisis. Interest rate hiking was put on hold and rebalancing postponed amid post-flood recovery and reconstruction and especially amid global uncertainty due to the euro. Now we project global economic recovery to be weaker than believed since the financial crisis in 2008.

So if last year was the "year of rebalancing" what is this year? ***For monetary policy, this year is a year of risk and reassessment***. By risk I refer to the possibility that the euro crisis may spread to Asia and Thailand. And by reassessment, I refer to how monetary policy must reconsider rebalancing and carefully re-examine all the options, given how the balance of risks has significantly shifted toward growth and away from inflation.

We are therefore faced with three key questions. First, how will the euro crisis play out? Second, can Thailand grow through the euro crisis? And third, what should monetary policy do?

Let me now turn to the first question. ***How will the euro crisis play out?*** *In my view, the short answer is this. The euro zone will mostly likely remain intact and avoid a liquidity seizure similar to the one seen during the Lehman crisis. However, the euro zone will face a slow and difficult recovery.*

Let me qualify my view by saying that the reality is much more complicated. So let me go quickly over some salient details of the euro crisis and its current impact on Asia. A great deal of uncertainty, much of it induced by lack of policy clarity, surrounds the euro crisis. This is reflected by how global FX markets have been in turmoil as investors fled euro and Asian emerging markets assets for safe havens. The Thai baht was not spared from this turbulence and experienced high volatility and bouts of weakening pressure. However, investors eventually returned to emerging markets in Asia as yields in advanced economies moved lower and Asian fundamentals improved amid slowing inflation pressure. In Thailand, government bonds, in particular, have proven attractive. In fact, foreign participation in both bond and equity is now above pre-Lehman levels. However for equity, the rate of return was slow of late; net inflows were negative last year but are now slightly positive for the second half of this year. Amid all this turbulence, all this back-and-forth, the baht fluctuated in tandem, first depreciating in the first quarter of the year up until July and then appreciating somewhat. This trend was punctuated by bouts of volatility each time euro policy faced implementation difficulties once push comes to shove and member nations have to make the difficult tradeoff between national interests and supra-national interests.

But back to the question of how the euro crisis will play out. No doubt the drama of policy uncertainty will continue. But what will be the end-game? Broadly speaking, we envision two scenarios: an extreme scenario and a baseline scenario.

In the extreme scenario, prolonged political gridlock over policy leads to a liquidity seizure. Failure to ratify the fiscal compact results in handicapped liquidity support efforts on the part of the authorities and heightened market concerns. Rising risk premium leads to explosive debt dynamics, loss of market access and rollover difficulty, which in turn leads to even greater liquidity needs. With the cost of rescue mounting, internal country politics may further delay policy leading to a vicious cycle between rising rescue costs and policy inaction.

There are signs that these risks are very real. For example, last month in late July, Spanish bond yields recently jumped up again over 7 percent, making the country's debt dynamics unstable. There has also been upward pressure on Italian bonds. The ECB came to the rescue by promising to "do whatever it takes to preserve the euro as a stable currency". Markets stabilized and yields came down. The US stock market also picked up. Nevertheless, the risk that yields could erupt again persists, especially if concrete progress in implementing policy does not take place. In the event of a liquidity seizure, there will be considerable spillover into global financial markets. Trade will decline amid the credit crunch that will surely follow. Asia, Thailand included, will not be spared the turmoil.

So that's the extreme scenario.

Now let me go over the baseline scenario. In this scenario, piecemeal policy averts a systemic crisis and leads to a prolonged recovery. In the baseline scenario, progress in implementing policy remains bogged down by internal politics but makes sporadic progress, especially once the possibility of a systemic crisis becomes all too real. This scenario is basically a continuation of the present state of affairs with which you are all familiar. Global capital markets are in flux. And global trade slows down. The recovery process is long and drawn out and the authorities eventually make progress on fiscal integration and banking union.

So which scenario will be likely? This is the big question mark. There is considerable uncertainty due to the ups and downs of internal politics. But political imperative to maintain the union has always been strong. And a strong union needs a stable common currency and economic growth. Once the crisis becomes imminent and threatens the union, authorities will have no choice but to take decisive action to avert a systemic crisis.

So those are of my views of how the Euro crisis will play out.

Let us move to the second question: can Thailand grow through the Euro crisis? *Yes, long-term sources of growth remain but adjustment pain will be unavoidable.* In a globalized world, nobody is immune from the euro crisis. In fact, there are already signs that Asian exports, Thailand's included, are slowing. Amid a slowing global economy, this drag on growth is unavoidable in the short-term. To grow out of the crisis and survive the shocks from outside, Thailand must look within and unleash domestic engines of growth. Long-term investment in productive infrastructure is one key engine of growth. Another is domestic structural change spurred by two drivers of change in the region. The first driver of change is growth in China and the attendant rise of the Chinese middle class and demand for a broader range of imported goods and services. Chinese exports will also grow in sophistication. The second driver of change is trade liberalization in the region – such as free trade agreements with China and India as well as the ASEAN Economic Community, or

AEC. AEC, in particular, goes beyond free trade and also has the potential to foster not only goods and services integration but also cross-border labor and investment flows. Because of the sheer size of these markets – China, India and AEC – the regional pattern of production will change considerably to cater to new demands while leveraging on new comparative advantages and supply chain synergies. Uncompetitive firms have to either upgrade themselves, or close down and free up labor resources to more competitive firms. This reallocation process implies that the country makes better use of labor resources and achieves higher productivity. Ongoing financial sector reform will also build financial sector resiliency. Thailand's Financial Sector Master Plan, now in its second phase, continues, and focuses on liberalization through increased competition, raising efficiency, and strengthening the financial infrastructure. Our research shows that the gains from structural change can be considerable although adjustment costs, in terms of the reallocation of labor and capital, will also be significant.

Now we arrive at the third and final question. ***Given the euro crisis and Thailand's prospects for growth, what should monetary policy do?*** The dilemma here is how to bridge short-term stabilization with long-term goals of structural change. The challenge for policy is to maintain an overall framework where the trend of increasing economic integration can continue while containing crises. Given our baseline scenario of a prolonged recovery without a liquidity seizure *we lean towards long-term goals* – for example, maintaining capital flow liberalization, financial sector liberalization and market-led exchange rates – but with a readiness for monetary stimulus should a clear need arise. Let me discuss the policy tools at our disposal and how they fit into our overall policy objectives.

On the interest rate, the policy rate has been on hold at 3.00 percent since January this year. At the moment we view it as supportive of growth amid global risks and consistent with our inflation target. However, I must stress that the interest rate is poised to go either way depending on developments in the advanced economies, in particular the euro area and the impact on the overall Thai economy. We recently saw how the impact of the euro crisis is spreading to Asia in the form of a broad-based slow-down in Thai exports. Incoming data will need to be carefully analyzed to determine the severity of the impact on the overall Thai economy.

On the exchange rate, we maintain a managed-float regime. The Thai baht has been quite volatile of late amid concerns over the euro. Nevertheless, it remains broadly in line with economic fundamentals and thus is market determined. The exchange rate should be managed sparingly and only in unusual circumstances of market dysfunction or economic misalignment. By allowing the exchange rate to be market determined, it can serve as an automatic stabilizer in the short-term and as an important price signal and catalyst for structural change in the long-term – an issue I touched on earlier within the context of unleashing domestic engines of growth. Nevertheless, should the euro crisis result in market dysfunction or significant misalignment of the exchange rate, exchange rate intervention to stabilize markets or re-align exchange rates with fundamentals may be warranted.

On macroprudential policy, a framework is needed as the Bank of Thailand's mandate covers both monetary and financial stability. Macroprudential policy focuses on financial stability. Monetary policy focuses primarily on price stability. Macroprudential and interest rate instruments therefore 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 pro-cyclicality, 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 implemented some time ago – 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. At present, the risk of real estate bubbles is not significant but should capital inflows surge again amid strong domestic demand and credit growth in real estate, macro-prudential measures may need to be tightened.

On capital flow liberalization, we are moving to liberalize capital outflows so as to foster more balanced capital flows. This will help to balance fund flows and support exchange rate movements in line with economic fundamentals. In addition, with the rise of the AEC, cross-border investment will facilitate regional competitiveness and realize supply-chain synergies.

Lastly, on financial sector liberalization, ongoing financial sector reform will also build financial sector resiliency to shocks from within and without. 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. We also view an efficient financial sector as supportive of unleashing long-term engines of growth, such as structural change.

Ladies and gentlemen, distinguished guests**,**

At this point, I hope we have concisely and clearly laid out the monetary policy vision for Thailand that can serve as a basis for your investment decisions, reassessment of the risks, and, ultimately, your continued partnership in the Thai economy amid these troubled times of global uncertainty.

On that note, let me conclude my talk here.