Pongpen Ruengvirayudh: Thailand's economic challenges and role of monetary policy

Luncheon speech by Ms Pongpen Ruengvirayudh, Deputy Governor of the Bank of Thailand, at the Embassy of the Kingdom of the Netherlands, Bangkok, 1 March 2013.

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Ladies and Gentlemen,

I would like to thank the Netherlands Embassy for inviting me to give a luncheon speech on this occasion. Thailand and the Netherlands have a long-standing cultural and economic relationship, dating back as far as 1605, when the Dutch East India Company set up a trading post in our old capital, Ayutthaya. Today, the Netherlands is Thailand's third biggest trading partner within Europe, accounting for 12.8 percent of total trade volume between the continent and Thailand. In terms of foreign direct investment, the Netherlands is one of the most prominent European investors, with presence spanning key sectors from banking, chemicals, electronics, to wholesale and retail trade. It is my hope that our two nations will continue to mutually benefit from their strong economic bind for many generations to come.

I would like to focus my talk today on the recent economic developments, and the role of monetary policy in addressing some of the present challenges facing the Thai economy. As some of you may already know, monetary policy in Thailand is decided by a committee (MPC) consisting of seven members and four of them are experts from outside the Bank of Thailand. Each of the MPC votes independently to decide on the policy interest rate every six weeks, or so. The MPC generally agrees on the overall economic outlook and areas of challenges, although views about the balance of risks and the appropriate policy response can differ. My discussion today should therefore be taken as a representation of my own view as an MPC member, and needs not reflect the opinions of all other voting members.

Economic outlook

Ladies and Gentlemen,

Last year was in many ways a year of transition. The economy had to recover from the devastating floods that took a heavy toll in late 2011, and at the same time deal with the fragile global economy. Throughout the year, incoming economic data have nonetheless been a series of positive surprises. The recovery gradually gained traction and became increasingly self-sustaining. Production constraints eased and domestic demand was back on track, thanks to the economy's sound underlying fundamentals. Meanwhile, monetary policy continued to be accommodative and supportive to growth. Fiscal spending through flood-relief and stimulus measures also played an important role in providing a boost to the economy. As a consequence, the Thai economy was able to sail through those strong headwinds, and grew robustly at 6.4 percent in 2012.

Projecting forward, the outlook for this year continues to be positive, supported by domestic demand that should remain robust. The underlying economic fundamentals also continue to be favourable. The banking system is underpinned by solid capital base, prudent risk management practice, and strong risk-based supervision. On the macroeconomic front, inflation expectations are firmly anchored, affording monetary policy the space to remain sufficiently accommodative to support growth momentum and mitigate global economic risks. Fiscal stimulus measures, including the first-car tax rebate scheme and the personal income tax cut, should also further help sustain domestic demand. The latest Monetary Policy Report released in January projected growth this year to be 4.9 percent, which will likely be revised up after the strong outturn of last year growth rate as announced by the NESDB.

Challenges and role of monetary policy

Despite this somewhat benign outlook, there remain three important challenges facing the Thai economy, from both domestic and external sources. The first key challenge is on the domestic side. Private sector credits, particularly those in the household sector, have been growing at a high pace, spurred by domestic demand momentum, fiscal stimulus as well as easy financial conditions. International evidence suggests that a prolonged period of rapid credit growth could lead to a build-up of financial imbalances, strain households' debt servicing ability and loan quality, as well as sow a seed for asset price bubbles. While the more adverse scenarios currently remain a remote possibility in Thailand, the MPC is not complacent and has been monitoring risks to financial stability closely. Monetary policy can play an important role in preempting an emergence of such risks, and the MPC will continue to evaluate if and when a specific policy response is warranted.

The second key challenge is on the external front as the global environment remains uncertain. The lingering euro debt crisis and fragile US recovery continue to weigh on global growth. Policymakers are still grappling with deep-rooted long-term problems, and policy response has been met with mixed success. The recent improvement in market sentiments is a welcomed relief and some tail-risk events may have been averted. Nonetheless, a full recovery is not yet in sight, which adds to uncertainty. Given this backdrop, it is important that the Bank of Thailand remains alert, and retains sufficient policy space to act if and when necessary.

The third key challenge is that of a recent surge of capital inflows, whose causes are both domestic and global in their origin. On the one hand, the relatively robust growth momentum in Thailand has been a "pull" factor, attracting portfolio inflows from those seeking to benefit from better economic prospects. At the same time, the low interest rate environment and subdued growth in major economies have helped "push" investors to search for higher risk-adjusted returns elsewhere, particularly in emerging economies including Thailand. The exchange rates of these recipient economies have appreciated as a result, leading to concerns in some quarters about the prospect of growth momentum. In Thailand, some have called on the MPC to lower the policy interest rate to ease the pressure on the baht. A few have gone further to question the suitability of inflation targeting regime for Thailand.

Ladies and Gentlemen,

There is little disagreement about the pertinence of capital flows for macroeconomic outlook and stability. Where my view may depart from that of some critics, is in regards to appropriate policy response, and what objectives the Bank of Thailand can and should pursue. The MPC's core objective, as instituted by law and in agreement with the government, is to achieve maximum sustainable growth, in the context of stable prices and sound financial system. Under this mandate, capital flows and exchange rate fluctuations are not the targets in and of themselves, but enter the policy calculations through their effects on the overall macroeconomic outlook. The MPC's recent decisions to keep the policy interest rate unchanged can be rationalized in this light. While all members of the MPC may recognize the risks posed by volatile capital flows, the majority believed that the overall macroeconomic conditions are consistent with the mandate, and no change in policy was warranted. Thus, the current policy framework is sufficiently flexible to allow the Bank of Thailand to address the issue of capital flows. By contrast, if policy interest rate were employed to target capital flows and exchange rate per se, the outcome would likely prove counter-productive in my view. Uncertainty about the effectiveness of such policy use aside, the central bank's commitment to safeguard the overall macroeconomic stability may also be called into question by the public, with potentially serious consequences.

I would like to also point out that a couple of mitigating factors are currently at play, which can help alleviate the adverse impact of capital flow surge. First, the new investment cycle in Thailand may have taken off, led by both the private sector and large public infrastructure projects. Many of these projects have high imported contents, and stand to gain from an exchange rate appreciation. Spells of baht appreciation thus provide an incentive for many firms to implement a long-overdue technological upgrading and import more capital goods in an environment where labor is scarce and no longer cheap. In turn, these imports can help slow down the pace of appreciation and mitigate the adverse effects on export industry. Furthermore, corporations that have expanded their operations overseas or plan to do so will also benefit from stronger baht which can help, to some extent, reduce the overall impact of baht appreciation on their businesses.

With cooperation from all sides, including policymakers and private sector alike, Thailand could seize this opportunity to strengthen the fundamentals of the economy further, and reap long-term benefits that are likely to be greater than short-term costs of adjustment.

Second, it is often overlooked that under flexible exchange rate, adjustments in the currency's value themselves can be an effective buffer for capital flow volatility. In a well-functioning market, a currency that is overvalued relative to its fundamentals would be subject to market discipline that helps slow down further appreciation. Indeed, estimates from both the International Monetary Fund and various investment banks suggest that the current value of Thai baht is consistent with the underlying fundamentals. To promote a deeper foreign exchange market and foster more balanced capital flows, the Bank of Thailand also launched a Capital Account Liberalization Master Plan, which entailed liberalization of Thai investment abroad and a streamline of foreign exchange regulations. There are also continuing efforts to enhance the private sectors' adaptability and foreign exchange risk management. These initiatives should provide an extra layer of cushion to shield businesses against short-term market volatility. They are not, however, a substitute for structural improvement in productivity, which in the long run holds the key to success for the export industry.

Given that the global environment is still subject to uncertainty, capital flows may continue to be volatile, and risks to financial stability warrant close monitoring, it is more important than ever that monetary policy strikes the right balance between providing support to sustain growth momentum while ensuring long-term financial stability. In the judgment of MPC, the current stance of monetary policy remains accommodative, with the real policy rate still in negative territory. As the balance of risks shifts between the need to support growth and the duty to safeguard financial and price stability, monetary policy stance will have to be adjusted accordingly. The Bank of Thailand stands ready to employ the right mix of policy tools under its purview to attain these goals.

Ladies and Gentlemen,

I believe that a balanced and judicious use of monetary policy tool has and will continue to play a critical role for ensuring long-term macroeconomic and financial stability. As always, the Bank of Thailand will strive to create a stable economic environment in which businesses can prosper on a sustainable basis, so that Thailand will continue to be the destination of choice by long-term investors.

Let me close my remark by thanking the Netherlands business community for the substantial contribution to the Thai economy. I hope that the relationship between our two nations will continue to flourish. Thank you.