Prasarn Trairatvorakul: Limitations of monetary policy – the context of Thailand

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the Foreign Correspondents' Club of Thailand (FCCT), Bangkok, 17 June 2013.

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Good evening ladies and gentlemen,

I would like to thank the Foreign Correspondents' Club of Thailand for the invitation. It is my honor and pleasure to be back here again to share with you my views on Thailand's economic outlook and monetary policy. We indeed live in a volatile and uncertain world. Just a few months ago we still talked about a two- or three-speed global economy as a fact of life, with robust growth expected of emerging markets and sluggish recovery to remain with the major economies. Today, with some possibility of an earlier-than-expected tapering off of QE, coinciding with the apparent slowdown in many emerging market economies, the convergence of the world economy is already expected by some. One obvious consequence is the market overreaction to these premature signs of the convergence. The unsettled sentiments over a potential end of cheap money may have contributed to sizeable outflows of capital from emerging markets during the past few weeks. As a consequence, emerging market currencies including the Thai baht depreciated sharply, reversing gains since the beginning of the year.

One lesson from this recent episode is that, expectations can go a long way in influencing people's behavior, and often with implications for policymakers. Specifically, it reminds us how powerful the expectations channel of monetary policy transmission can be. It is therefore of utmost importance that central banks properly manage expectations so as to maximize monetary policy effectiveness and maintain policy credibility. This draws me to the focus of my talk this evening: the limits of monetary policy, namely, what monetary policy can and cannot do. Given unprecedented economic headwinds of various sources, monetary policy around the world has been under immense demand. But these expectations, if unrealistic and not met, could damage central bank credibility, and end up diminishing central banks' influence, with unnecessary costs to the economy. Thus, it is important that central banks establish realistic public expectations on their policy. But before I turn to that topic, let me first review current economic conditions, the outlook for the Thai economy, and recent monetary policy response.

Recent economic developments and monetary policy response

Despite robust economic growth of last year, the Thai economy started out this year with moderation. Growth in the first quarter at 5.3 percent compared to the same period last year was lower than what we had expected. Part of this slowdown may have been a natural reversion to a more normal pace of growth after a strong post-flood acceleration. But that alone may not explain the whole story. Evidently, the recent slowdown in private consumption also owed in part to lower farm income and higher household debts which may have held back consumers' willingness to spend. Meanwhile, uncertainty about global demand may have pulled back private investment especially in the export-oriented sector. On the external front, despite some incipient signs of gradual improvements in the US and Japanese economy, disappointing Chinese and Asian economic performance likely put a drag on the overall Thailand's trading partners' growth and hence continue to weigh on Thai exports.

Looking ahead, however, the medium-term trajectory of the economy should remain intact backed by solid economic fundamentals, including high levels of employment, rising income and robust private sector confidence. Fiscal policy should continue to lend support to the economy especially with the large-scale infrastructure investment expected to phase in from the latter part of this year. This would potentially generate a favorable crowding-in effects on private spending.

As for price and financial stability, inflation eased further due to lower oil and commodity prices, in line with subdued global inflationary pressure. Looking ahead, however, the cost pass-through to prices is expected to increase as domestic demand picks up. At the same time, risks to financial stability remained an ongoing concern with a particular attention given to household debts and some sectors in real estate market.

In light of these recent developments, the MPC judged that downside risks to growth have increased both from domestic demand slowdown and a somewhat slower-than-expected global recovery. Although the view on the medium-term outlook of the Thai economy has not changed, the balance of risks now seemed to tilt towards growth rather than inflation. The MPC therefore decided to cut the policy rate to provide as insurance to the economy in the face of greater downside risks to growth.

With firmly anchored inflation expectations, the Bank of Thailand can today give weight to stabilizing economic developments when setting the interest rate. However, should the outlook for inflation, growth, or financial stability change in the future period, there will be room for maneuver to counteract such developments through monetary policy, as well as other policy tools in an appropriate mix deemed most suitable for achieving the overall macroeconomic stability.

Limitations of monetary policy

Let me now turn to a topic that I would like to highlight today, that is, the limits to what monetary policy can achieve. The global financial crisis has placed far greater demands on monetary policy around the world. In major economies where other macroeconomic policy tools are being impaired, monetary policy was under enormous pressure to support the economy. Central banks responded by expanding dramatically their traditional role as lenders of last resort and came up with innovative, unconventional ways to stretch beyond what monetary policy can normally do. In emerging markets, given large crisis repercussions in terms of excessive capital flows, monetary policy was at times expected to respond to external developments in dealing with global spillovers. Overall, monetary policy has been pushed into situations and actions that were previously unimaginable.

Efforts by many central banks to overstretch its normal capacity may have led the public to expect too much from monetary policy. There is a danger associated with this conviction, if the widening gap between what is expected of central banks and what they can realistically deliver end up undermining central bank credibility. To maintain public trust in the central banks, it is important to clearly lay out what monetary policy can and cannot achieve. I would like to highlight three areas where monetary policy limits in Thailand are particularly binding at present. Understanding these limits would also help explain our monetary policy actions.

1. Single instrument, multiple objectives

The first limitation has to do with the fact that multiple objectives cannot be targeted using one instrument, namely, the policy interest rate. This is a key reason why most central banks in the world today typically focus on a single primary objective of price stability, which is crucial to a well-functioning market economy and is what monetary policy has most control over. There are of course other equally important policy objectives, in particular financial stability, as recent global crisis clearly illustrated. The “flexible inflation targeting” is precisely designed to allow the central bank to stabilize not only inflation but also to mitigate the risk of a build-up of financial imbalances. Endowing central banks with more policy tools to achieve this additional objective has gathered a lot of support in international policy forums. The demand for monetary policy does not stop there, however. It has also been suggested that monetary policy should respond directly to capital flows and exchange rate for example. Can a single policy interest rate target all these objectives simultaneously?

Of course, in fortunate coincidences where these objectives do not conflict, there is no dilemma. More often than not, however, the policy choices will involve a trade-off between different objectives. Policymakers will have to weigh carefully the costs and benefits of a policy decision. Given multiple macroeconomic objectives, there is a need for supplementary tools to truly minimize the costs of these tradeoffs.

As the first example, what policy instruments can be employed to address risks to external stability? In many emerging market economies, one often finds problems of exchange rate dominance, namely the risk that exchange rate considerations dominate the conduct of monetary policy and distract central banks from the main goal of price stability. The simplest way to address this problem would be to allow for exchange rate flexibility as the first line of defense. Of course, this does not and should not rule out interventions to limit excessive exchange rate volatility. That is the next line of defense. Should the situation warrant, some type of capital flow management measures can be deployed in exceptional circumstances of sustained and substantial exchange rate overvaluation. However, given their distortive effects and collateral damage it brings upon the economy, any introduction of this type of measures will have to be carefully designed to minimize unintended consequences, especially on productive long-term capital inflows that we highly value.

As for the case of preventing financial imbalances, it is sometimes proposed that for policy rate to have sufficient traction in addressing risks to financial stability, the adjustments may need to be so large as to have a significant adverse impact on economic activity, a price too dear to pay. Thus, with an additional objective of managing credit growth and asset prices in order to avoid financial instability, one really needs another instrument that acts more directly on the source of the problem. That is what “macro-prudential policy” is supposed to achieve.

2. Imperfect foresight

The second limitation of monetary policy lies with the notion that all policymakers have limited capacity to measure economic performance very precisely even in real time, not to mention to forecast the future. Monetary policy is always conducted in an uncertain environment. Unforeseen macroeconomic shocks, imprecisely estimated effects of policy on macroeconomic variables, and noisy measurement render monetary policy design and implementation a challenging task. Our state of knowledge is also far from a perfect understanding of people’s decision making that determine the future evolution of the economy.

The task is even more daunting when the world is going through significant transformation, with unprecedented policy actions all across the globe, and with yet-to-be- known consequences of such actions and their unwinding.

Faced with the uncertainty and the complexity of the environment we are operating in, we need to take a broader perspective and make sure our decisions are robust under different plausible eventualities. At the same time, the Bank of Thailand constantly strives to expand our economic surveillance capability, by collecting up-to-date intelligence on economic and financial conditions through indirect and direct contacts with the market. The insights from direct contact, coupled with the information from surveys like our Business Sentiment Survey sharpen the picture we get from the other available statistics. This is one reason why monetary policy cannot simply follow mechanistic and simplistic rules based solely on any single data.

Nonetheless, uncertainties can never be off the table. In this light, a prudent approach is to move in careful and measured steps. That kind of incremental action in what we perceive to be the right direction is likely to contribute more to economic stability than aggressive attempts to fine tune the economy.

3. Inability to address supply-side impediments

The third limitation of monetary policy I would like to emphasize today is its inability to address supply-side impediments. Through interest rate adjustment, monetary policy can influence aggregate demand in the economy. But monetary policy cannot solve deeper structural problems or lift growth potential of the economy. That needs to come from real progresses that increase productivity and relax supply-side constraints. Sure, demand stimulating can buy time by cushioning the economy from short-term economic shocks. But this may possibly delay necessary adjustments of the economy to longer-term challenges. For example, keeping interest rate too low for too long and keeping exchange rate undervalued, beside encouraging risk taking and storing up financial instability problems for the future, may also temper incentives for businesses to improve efficiencies, and may slow the reallocation of capital and labor to more productive uses.

In the context of Thailand, one of the most important structural issues facing the Thai economy at the moment is that of the labor shortage. Through our business contact and recent surveys, the labor shortage has scored one of the top concerns by both domestic and foreign businesses operating in Thailand. Underlying causes of labor shortage include the demographic change and education and skill mismatch. Clearly, there is little monetary policy can do to solve this supply bottleneck. It can help foster macroeconomic stability conducive to business investment, but most of the efforts to address supply-side impediments still need to come from a broader and more balanced set of economic policies including fiscal, industrial, technology, and labor market policies.

Concluding remarks

Let me end my talk today by saying that, as a central banker, we should be ambitious in making the best use of all available policy tools and in improving our understanding of the economy as well as the shocks driving it. But setting the ambition higher than the capability of monetary policy would likely prove to be counter-productive. It is an old established wisdom that what monetary policy can best deliver is price stability. While we have learned for a great deal about other aspects of macroeconomic stability, there is little disagreement that price stability must remain the central objective of monetary policy in the long run. Abandoning this objective risks de-anchoring price expectations and inducing unnecessary economic volatility. The deployment of supplementary tools can go some way to help relax its limitation, but monetary policy is no panacea.

Ladies and Gentlemen,

Only by understanding both the power and limits of monetary policy, will the economy be able to reap the most benefit out of this policy lever. The Bank of Thailand will continue to do our utmost to strive for overall macroeconomic stability, and the long-term prosperity of Thailand.

Thank you.