Pongpen Ruengvirayudh: Managing currency stability

Speech by Ms Pongpen Ruengvirayudh, Deputy Governor for Monetary Stability of the Bank of Thailand, at the SCB Collaboration with Myanmar Banks Dinner Talk, Yangon, 13 August 2015.

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Good evening,

Excellencies, Governor of the Central Bank of Myanmar,

Distinguished guests, Ladies and Gentlemen,

I would like to thank the Siam Commercial Bank for inviting me to give a keynote speech on this occasion. Myanmar and Thailand have a long-standing cultural and economic relationship, particularly in trade and investment. This auspicious event marks yet another crucial step forward in promoting Myanmar-Thailand friendship, especially through financial and banking system. It is my hope that our two nations will continue to mutually benefit from their strong economic bind for many generations to come.

Living in a more volatile and interconnected world

Ladies and Gentlemen,

One of the most important trends over the past decades is the rapid integration of international finance. From the perspective of our ASEAN economies, we have also gone through both regional and global interconnectedness. This is especially apparent for Myanmar, whose pace of integration is among the fastest, with ongoing liberalization on many fronts. Myanmar is thus becoming one of the attractive destinations for foreign investments.

This configuration of financial integration is a double-edged sword. On the one hand, it helps distribute and diversify risk, raising economic efficiency and strengthening system stability. On the other hand, tighter financial linkages imply large and swift transmission of shocks across countries, particularly through a large expansion in gross capital flows with an increased volatility of those flows and exchange rates. The challenges we face in Thailand to large extent also apply to emerging markets as a group. The massive equities and bonds sell-offs in emerging markets during the taper tantrum episode in 2013 were vivid examples of “financial spillovers”. There is no doubt that the benefits of integration into global economic and financial markets outweigh their costs. Therefore, the relevant question is thus how countries should respond to increased capital flows volatility.

This year, we gather here at an important juncture of what seems to be yet another shift in global economic and financial landscape. This may create a challenging environment for small open economies to conduct policy, particularly capital flows and exchange rate policy. ***Given recent economic and financial development, it is clear that the main drivers of ensuing volatility in capital flows and exchange rates are threefold. First,*** policy divergences among advanced economies appear to be on course recently. While the US is expected to raise its policy rate, likely by the end of this year, recovery of the euro area economies and Japan remains unsteady, with ultra-loose monetary policies put in place for a longer period. ***Second,*** uncertainties surrounding Greece’s bailout program have rendered great shifts in market players’ risk on and off sentiments. ***Third,*** growth momentum and prospects in China and some other emerging markets are deteriorating. These changing global dynamics, interacting with market’s reactions to potential US rate hike, may cause volatile ups and downs of financial markets.

I will not discuss these at length. ***Rather, at this juncture, the key question is how to design or adjust policy frameworks to cope better with these financial spillovers while preserving monetary policy independence.*** Undoubtedly, there is no single recipe that fits all central banks. Thus the aim of my talk is to offer a central bank's overall perspectives and Thailand's experiences on policy framework in managing capital flow and exchange rate stability. I will also touch on some beneficial policy cooperation among regional countries.

A brief background of Thailand's monetary policy framework

Let's begin with a broad perspective of Thailand's monetary policy framework. ***The Bank of Thailand (BOT) has been conducting monetary policy under "Flexible Inflation Targeting" framework since May 2000.*** As a pragmatic response to the failure of a pegged exchange rate system, transparency of the policy making process under IT was deemed appropriate for Thailand, particularly after the 1997 Asian Financial Crisis. Under this regime, price stability is the overriding and explicit objective, while economic growth and financial stability are also taken into policy deliberation. The policy interest rate is our main tool in achieving the mandate.

With managed-float exchange rate regime, the Thai baht is generally allowed to be determined by the market. In this regard, flexible exchange rate serves as an automatic stabilizer to cushion against external shocks and economic imbalances in the short-term, and as an important price signal for resource allocations and catalyst for structural changes in the long term.

In some cases, however, exchange rate flexibility and fluctuations can have costly consequences given some economic contexts, particularly in emerging market economies, including Thailand. ***First***, financial markets in these economies are less developed and relatively illiquid compared to advanced economies. This may potentially cause extremely large asset prices and exchange rate movements in response to capital flow volatility. ***Additionally***, the availability of foreign currency hedging instruments, especially to small enterprises, remains limited, amplifying the negative repercussions from exchange rate volatility. ***Moreover***, many emerging market economies, including Thailand, rely on exports as the main engine of growth. Many of their export items often command little bargaining power and hence need to compete on the basis of price. As a result, extreme and sudden exchange rate movements would affect firms' competitiveness. For these reasons, many emerging market economies cannot neglect the implications of exchange rate movements.

This leads us to the next part of my talk this evening.

Managing capital flow and exchange rate stability

Ladies and Gentlemen,

There is no one-size-fits-all measure to deal with capital flow and currency volatility, as well as its impacts on the real economy. Take Thailand as an example. We have adopted multi-dimensional responses to the financial spillovers. The exchange rate management framework focuses on mitigating short-term excessive exchange rate volatility and ensuring alignments with economic fundamentals in the medium to long term. ***Exchange rate flexibility*** constitutes the primary buffer to cushion the effects of capital flow volatility. In the case that resulting movements in exchange rates are deemed excessive and unjustified by fundamentals, ***foreign exchange interventions*** can be undertaken. More controversial, but now increasingly accepted internationally as one of the policy options, are ***capital flow management measures (CFMs),*** aimed at directly curbing international financial flows via regulations and taxes. While there are clear economic rationales for CFMs, given the abundance of market inefficiencies and externalities, many countries tend to regard these measures only as a last resort. As such, reputation costs, asymmetric effects in managing outflows versus inflows, lack of long-term effectiveness, and limited room for calibration are but a few considerations that policy makers need to take into account.

Regarding foreign exchange rate interventions, we are always mindful of its costs and limited effectiveness. In particular, interventions against market views would employ large financial resources while yielding limited success, usually only to delay the pace of exchange rate movements. Active interventions under the inflation targeting framework regime may also have unintended consequences on policy framework credibility, as the central bank's commitment to safeguard the overall macroeconomic stability may be called into question by the public. For this, consistent communications about monetary policy framework and stance would help increase central bank's transparency and public understandings.

From a longer-term perspective, currency should be able to move flexibly in line with economic fundamentals. Active foreign exchange interventions can cause potential distortions. First, financial market development would be hindered. A certain level of exchange rate volatility is often a pre-condition for market development. Without sufficient volatility, there would be no incentive for firms to hedge themselves against currency risks and for financial institutions to start offering currency hedging tools. It should also be noted that heavily managed exchange rate may discourage businesses from upgrading their technology, productivity, and competitiveness, so as to command more bargaining power in the global market and better withstand exchange rate volatility.

Given limitations and side effects of short-term exchange rate management strategies, exchange rate interventions should only be employed to deal with excessive movements or special circumstances when the market needs anchoring. Interventions should also be two-way, not aiming to resist trend movements but to cushion the impact of extreme movements. For normal times, the exchange rate should move flexibly to serve its role as shock absorber for the economy.

Ladies and Gentlemen,

Now, ***policymakers have to strike the right balance between implementing short-term measures and building long-term capacity for the economy to better withstand external shocks.*** To promote economic resilience in the long run, it is important to press ahead with ***reforms that deepen local capital markets***. Deeper and more liquid markets help absorb higher capital flow volatility and large shocks, preventing large swings in price movements. In addition, ***active and widespread use of foreign currency hedging instruments*** is also beneficial to mitigate the negative knock-on effects from exchange rate volatility.

Liberalization of outward investment by domestic investors also helps promote more balanced capital inflows and alleviate upward pressure on the exchange rate. These international asset holdings can provide a buffer when domestic market faces rigorous tests of volatility. Nevertheless, liberalization needs to be well planned, timed, and sequenced in order to ensure that its benefits outweigh costs. The appropriate degree of liberalization for a country at a given time depends on its specific circumstances, notably its financial and institutional development. More stable and long-term flows, particularly direct investment flows, should be liberalized prior to short-term portfolio flows, which are more volatile and sensitive to cyclical factors.

In October 2012, the BOT launched the Capital Account Liberalization Master Plan. This was part and parcel of our longer-term plan to facilitate Thai companies to diversify their investments abroad, especially in neighboring countries. This would encourage private companies to operate their businesses more efficiently by expanding their markets and production bases. In turn, such diversification will help strengthen their competitiveness and absorptive capacity. ***At the other end of the spectrum, limiting leverage in the banking system*** would add more cushions to the economy against external shocks.

Last but not least, developing fundamental economic strengths to enhance countries' resiliency to external shocks can work through ***well-diversified export items focusing on high value-added products.*** This would lead to more bargaining power, and hence less sensitive to exchange rate fluctuations. ***Stronger domestic consumer base*** would also help lessen the dependence on external demand.

All reforms I mentioned require concerted efforts from all public and private stakeholders. Policymakers should provide economic environment and infrastructure conducive to reforms. Particularly, financial literacy and risk management awareness should be fostered at all levels and sectors. Financial institutions also play a crucial role in developing financial products to facilitate transactions and risk managements. Businesses should upgrade productivity to enhance industry's resilience to shocks. ***Advanced preparations will surely pay off.***

Lessons learned, challenges ahead, and policy implications

Ladies and Gentlemen,

As we are approaching the end of my talk, let me now share some final thoughts on lessons learned and challenges ahead. First, for countries that want to maintain autonomy on interest rate policy, exchange rate flexibility is a pre-requisite to living with capital flows. Nevertheless, extreme exchange rate fluctuations may cause misalignments. A trade-off between flexibility and stability thus requires policymakers to identify the exchange rate framework suitable for the economy. This can be a daunting task in practice, as the target is often country-specific and subject to dynamic economic developments. Keep in mind that monetary policy can do little to influence real exchange rates in the long term. Attempts to give the exchange rate more weight in monetary policy deliberations will also reduce the autonomy in controlling interest rate, leading to more interest rate volatility. In any case, policymakers need to be more practical and innovative in detecting and assessing impacts of the exchange rate on real economy. An ability to monitor adjustments at the micro or firm levels is also a helpful guide on when and how to manage currency risk.

Second, amidst an increasing global interconnectedness, policymakers should also be mindful of policy externalities on other economies. Policy coordination and information sharing are thus needed for the optimal policy setting. Of course none of this is entirely new for ASEAN countries. One example is the strengthening of regional financial safety net through institutional mechanisms and arrangements such as the development of Chiang Mai Initiative Multilateralization (CMIM), which will increase the region's ability to respond to crises, build confidence, and hence lessen possible market turbulence during times of financial stress. Going forward, further collective actions in the region can help mitigate market volatility and enhance countries' resilience to global shocks. These include promotion of regional currencies as invoice currencies in addition to the US dollar or the Euro, and a bilateral swap agreement as a last resort for foreign currency liquidity.

Last, I would like to stress that ***sound economic fundamentals and policy credibility provide a solid first line of defense, probably the best defense, against capital flow and exchange rate volatility.*** Despite the global nature of volatility, not all emerging market economies suffer equally. Domestic fundamentals are subject to unrelenting scrutiny by the financial market. Countries with stronger macroeconomic fundamentals experience less volatile capital flows and are therefore less disrupted by them. "Fragile five" episode was a case in point for the market to differentiate countries, with high current account deficits and high inflation as the focal point. In most cases, strong macroeconomic fundamentals include both internal and external fronts. Internal front involves improved fiscal discipline, banking system with prudent supervisory and regulatory frameworks, stabilized inflation, well-equipped financial markets, and credible monetary policy framework. External front includes sufficiently flexible exchange rate, adequate foreign reserves, and manageable external debt levels. In addition, well-diversified sources of finance among bank-based, debt and equity markets would be supportive of financial stability.

Concluding remarks

Ladies and Gentlemen,

I have spoken at length, from the subject of global volatility, onto more policy options issue based on central banks' perspectives. ***Let me now wrap up by leaving you with a final remark on these issues.***

In the world of increased financial integration, volatility of capital flow and exchange rate is unavoidable. A sustainable path forward requires going beyond coping with capital flows to living with them. Therefore, public and private stakeholders must remain vigilant of any impacts they may have on real economy. Thailand's approach so far has been to allow the exchange rate to act as an automatic stabilizer, while its extreme movements are carefully managed. At the same time, reforms are actively pursued with the economy's long-term resilience as our ultimate goal. It is also imperative for central banks to continue exploring various policy toolkits to bolster resilience against volatile capital flows and exchange rate in the near future.

Thank you for your attention.