Veerathai Santiprabhob: Monetary policy and financial sector development policy of the Bank of Thailand

Speech by Dr Veerathai Santiprabhob, Governor of the Bank of Thailand, at the Thailand Focus 2015 "Opportunity Growth and Reform", Bangkok, 2 December 2015.

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Chairman of The Stock Exchange of Thailand,

Secretary General of The Securities and Exchange Commission,

President of The Stock Exchange of Thailand, Chairman of Phatra Securities, and President of Asia Pacific Bank of America Merrill Lynch,

Distinguished guests, ladies and gentlemen,

A very good morning to you all.

I would like to thank The Stock Exchange of Thailand, Phatra Securities, and Bank of America Merrill Lynch for the invitation to join this year's Thailand Focus event. I am much honored to be addressing this prestigious group of audience, and especially investor friends of Thailand from abroad.

The title of my talk this morning is "Monetary Policy and Financial Sector Development Policy of the Bank of Thailand". I would like to share with you the Bank of Thailand's roles in supporting the Thai economy as we venture ahead in the volatile world. This year, there would be few among us who failed to notice turbulence in the financial markets worldwide. But what probably matters more is the shifting global economic forces that lie at the heart of such an incident.

In the first part of my talk, I will explore *volatility in the context of a "new normal" world* where we observe, for instance, stagnant growth and low inflation. Then I will discuss the *implications for Thailand*, before moving on to *policy navigation of the Bank of Thailand*.

Financial volatility has manifested itself throughout 2015. Let me briefly recap some of them:

- Only a few months ago, the *Chinese equity* market recorded one-day steepest loss of 8.5 per cent and trillions of dollars were wiped off from the global equity market within a day. The fluctuations in the Shanghai stock index perfectly exemplify the market volatility where from the beginning of this year the index rose by 60 per cent up to June, before collapsing to 10 per cent loss by August.
- There have also been sharp *capital outflows from Emerging Markets*, resulting in large Emerging Market currency depreciations. Indeed, the Institute of International Finance expects that capital flows to Emerging Markets will turn negative for the first time since 1988.
- On the commodity front, *Brent Crude Oil* price plunged below 50 dollars per barrel this year, having peaked at over 110 dollars just one year ago.

Against this backdrop, market participants have been increasingly concerned about investment and business implications. So what brought about heightened volatility in the global markets? I will attempt to answer by highlighting two key sources of volatility.

In the aftermath of the global financial crisis, unconventional monetary policies – most notably successive rounds of Quantitative Easing – were implemented by major advanced economies. This abundant global liquidity contributed largely to strong asset price gains and higher risk appetites. As major central banks pursued their policy of flooding the market with liquidity, risks had been compressed, intentionally or otherwise.

Recently though, despite ample global liquidity, investors have grown worried about the diverging paths of monetary policy among major central banks. That is, the *Federal Reserve* or the Fed is poised to begin its tightening phase while the *European Central Bank*, the Bank of Japan, and the *People's Bank of China* are likely to continue their ongoing monetary easing for a considerable period of time. The implications of diverging monetary policy stance for asset markets have weighed on the minds of investors around the world. As I shall elaborate, it is probably not the excess liquidity *per se* that generates turbulence and volatility, but prospects of the exit – or reversal – that does so.

In the near future, global markets are bracing for the impacts from the Fed "lift-off", leading to growing nervousness in the markets. Although the prospect of an interest rate increase by the Fed has been widely anticipated ever since the taper tantrum in 2013, the *uncertainty over its timing and possible impacts* has in part contributed to episodes of market turbulence this year. After the eventual lift-off – whenever that may be – the markets will turn their attention to the *pace of monetary tightening* – or rate increases. The shift in market expectation over the pace will prompt volatility going forward.

Hopefully I have not spoilt your morning by delving too deeply into volatility. ***But, let me stress this, monetary policy divergence will continue to be an underlying source of volatility in the global and regional financial markets.*** However, issues in financial markets are, by no means, disconnected from the real economy. Indeed, volatility arises from slow recovery, and timid growth outlook for the global economy, the so-called "new normal".

Looking ahead, the global economy is expected to grow only at a subdued pace as some major advanced economies are still grappling with the impacts of the global financial crisis and Emerging Market economies are faced with sluggish exports. Many economists have begun to refer to these conditions as a "new normal" for the global economy where global growth is weak, global merchandise trade shrinks and commodity prices remain low.

An important factor behind this global dynamics may be attributed to China's attempt to rebalance its economy, with more emphasis on domestic consumption, and less on investment and exports. While China is undergoing its economic transition, a slowdown in its growth rate is inevitable. The repercussions of China's transition have been quite evident on the *collapse of commodity prices*, leaving many Emerging Market commodity exporters with current account deficits and massive sharp depreciations.

Another crucial driver is the trend of "on-shoring" among major economies – leading to a structural change in the global supply chain – where countries like the US and China seek to source inputs domestically, rather than import intermediate goods from other countries. Thus, even if global growth were to be robust, it is unlikely that Emerging Market export growth would recover quite as strongly.

I would certainly be remiss if I failed to mention another potential risk in Emerging Markets which could have impact on the real economy; that is *a rapid buildup in Emerging Market corporate indebtedness*.

Ultra-loose global monetary policies have made it much easier for firms in Emerging Markets to raise funds – or borrow – especially from abroad. However, in the wake of tighter financial conditions, Emerging Market firms are facing greater difficulty to repay or roll over their debt.

In summary, I have highlighted two key sources of volatility: first, continued excess liquidity amid diverging monetary policies, along with shifting market expectations about the future path of monetary policies; and second, the global economic transition to the "new normal" steady state. The process is ongoing, and will probably take some time – and it may not be smooth – before the new steady state is reached.

Ladies and gentlemen,

Against the backdrop of such a volatile "new normal" world, I will now turn to the implications for Thailand. The impact will be realized on both our financial markets and the real economy. However, as I shall elaborate, the Thai economy has strong buffers that will make it relatively resilient to external shocks.

Let me start by looking at implications for the financial markets and the exchange rate. In line with the trend of regional currencies, the Baht's recent movement has been largely influenced by external factors. Any eminent signals of the Fed's initial hikes, or worse-than-expected data coming out of China, would prompt capital outflows from Emerging Markets, thereby weighing down their currency values. Significant outflows could tighten financing conditions of domestic companies, in terms of both "cost of funds' and "availability of funds". Such interplay of several risk factors is a challenge for business managers and investors alike.

However, international investors, like many of you here, have been increasingly selective in their portfolio decision. They no longer treat Emerging Markets collectively as a single asset class, but have shown to *differentiate* between Emerging Markets. As such, even though Emerging Markets may generally move in the same direction, the actual adjustments across individual markets have been uneven. In this context, the *degree of Thai Baht depreciation* ranks within the middle of the regional movements – and our currency also closely tracks regional peers – while the *level of volatility* is moderate relative to peers. This owes much to Thailand's sound external position which provides cushions from volatility in the global financial markets, shielding the economy from any potential undesirable.

An economy with strong buffers could be likened to a car with good suspension, which could smoothly go through a bumpy road of global financial markets volatility.

In fact, on the external stability front, Thailand performs well across several metrics. The *current account* surplus is expected to top 6 per cent of GDP this year, amounting to more than 26 billion USD. *Public debt* stays rather stable at around 43 per cent of GDP. Our *international reserves* stand at almost 3 times of short-term debt, among the highest in the region. The *non-resident security holdings* in our bond market is lower than 10 per cent, while those in the Stock Exchange of Thailand account for around 30 per cent of market capitalization. Such relatively low levels of non-resident participation, compared to our peers, suggest limited exposure to future capital flight.

Corporate sector's foreign debt also accounts for just 13 per cent of total corporate debt as of mid-2015. ***Moreover, most external debt is concentrated among large corporations.*** These large firms tend to manage their exchange rate exposure well, by utilizing financial hedging instruments. Careful risk management practice among Thai corporates and financial institutions has made them much more resilient to volatile movements of the exchange rate.

The Thai banking system is also resilient, with a high level of capital buffer and stable loan growth, despite some deterioration in loan quality. Banks have closely monitored their customers, and have maintained a high level of *loan loss provision* as a buffer for bad loans. They are also well capitalized, with the *capital adequacy ratio* at 17.3 per cent and *Tier-1 ratio* at 14.4 per cent, among the highest in Asia. This suggests that our banking system has sufficient capital to shoulder unexpected loss, and accommodate credit expansion. In addition, their *profitability* will help enhance their capital base over time.

Last but not least, inflationary pressure is stable due to a substantial fall in oil price from last year. Headline inflation, though currently in negative territory, is expected to gradually rise, and turn positive in 2016. Deflationary risks remain contained as demand continues to expand, and prices of most non-energy items remain stable or trend upwards. Such inflation trajectory is consistent with medium-term expectations of the public and the Bank of Thailand's medium-term inflation target. Overall, the economy and our financial system show a good sign of stability and resiliency.

Let me now turn to implications for the real economy and begin by giving you some positive news, that is, the economy is likely to register stronger growth momentum next year. *Tourism* continues to show good prospects where the number of tourist arrivals is likely to exceed 30 million in 2016. Fiscal stimulus will continue to be a key growth driver. *Public expenditure* is expected to increase by more than 200 billion Baht from this year, providing support to the economic recovery, especially the construction sector. In the private sector, there are signs of *investment expansion* in construction, telecommunications, and alternative energy, among others.

Although we may see export contraction in 2015, there are resilient spots in certain sectors. *Exports to CLMV economies* have experienced strong growth, and continue to show great potentials from which Thailand could capitalize. In fact, the share of exports to CLMV in our total exports is now on par with the share of our exports to the major trading partners such as the US, Europe, and Japan. Thailand's *exports to the US* are also poised to become firmer as the US economy continues to see improvement in its recovery. Our exports of vehicle parts, electronic-appliance parts and electronics to the US have expanded in the past few months, and are likely to continue their growth momentum in 2016 in line with the US economic recovery.

Nevertheless, some structural limitations still weigh on long-term growth. The recovery of the export sector will continue to be impeded by a shift in the global trade structure. Some of our products such as apparels and garments have seen a continuing decline in competitiveness, while some others are falling out of technological trend.

Simply put, the Thai economy is like a car whose engine is in need of an overhaul. We need structural adjustments in growth drivers to enhance our competitiveness and sustainable economic growth. The private sector needs to invest in new production technology, and improve product quality in response to changes in global demand and consumer preferences. As Mohamed A. El-Erian, then CEO of PIMCO, once said "structural challenges require structural responses".[1]

In this context, we welcome many new initiatives by the government to stimulate public and private investment and upgrade Thailand's value chain. With the introduction of changes in the *Board of Investment*'s criteria for investment privileges, the government has geared up its effort in promoting high value added industries. It also announced *Special Economic Zones* in order to facilitate the growing networks of production, trade, and services initially with our neighboring countries. By expediting growth-enhancing infrastructure development and increasing ease of doing businesses, the government also helps promote crowding-in of private investment.

Fiscal reforms are also in the pipeline in order to boost efficiency of the public spending, revenue collection, and other public administration. Reforms of *state enterprises* will also be vital to upgrading the country's growth potential as they manage strategic assets of the country, and account for a large share of public capital expenditure.

All in all, our car needs an engine overhaul. The government's recent initiatives form an important part to uplift the car's engine. In the meantime, I can assure you that we have a good suspension system to get through a bumpy road of market volatility ahead.

Ladies and gentlemen,

At this juncture – during which Thailand is going through multi-dimensional reforms – the Bank of Thailand will do our part to safeguard stability, support the economic recovery, and facilitate long-term structural reforms.

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1 El-Erian, Mohamed A. "Navigating the New Normal in Industrial Countries." Per Jacobsson Foundation Lecture. 10 Oct. 2010. Web. <https://www.imf.org/external/np/speeches/2010/101010.htm#P12_100>.

There are *three* main elements of our policy navigation that I would like to share with you this morning.

First, the Bank of Thailand will ensure ample liquidity in the system in order to accommodate the economic recovery. As policy normalization by the Fed is imminent, the risk of liquidity withdrawal from Emerging Markets increases. We anticipate limited impact on the overall Thai economy as markets have priced in the Fed's initial hike. Besides, it is widely expected that the Fed fund rates would rise gradually from then on.

As for now, despite the slow economic growth in Thailand, the overall credit to the private sector continues to expand at around 5 per cent. Furthermore, enterprises have issued a sizable amount of corporate bonds, leveraging on lower yields compared to last year. Commercial banks' liquidity position is stable. All these are indications of favorable domestic financing conditions. Should a sudden reversal scenario occurs, the Bank of Thailand would make sure that liquidity will not become an impediment to economic recovery.

The Bank of Thailand will also ensure that "cost of funds" is accommodative to the ongoing recovery. The two pre-emptive cuts in the policy interest rate earlier this year, in response to greater downside risks to growth, have eased domestic cost of funds. In addition, low inflationary pressure gives room for monetary policy to remain accommodative. This would ensure that the overall monetary conditions are conducive to the economic recovery.

Nevertheless, we keep a cautious eye on risks to financial stability, especially under the prolonged low interest rate environment. *Household debt*, although it has stabilized, remains high in relation to GDP. We will continue to monitor and assess the impact of the low interest rate on the *search for yield* and *long-term saving behavior*. We are also vigilant on other pockets of risks which may have destabilizing effects on the economy, such as those in the real estate sector.

Let me now turn to the Bank of Thailand's plan to handle an increased volatility of foreign exchange, which is the second element of our policy navigation.

As a matter of fact, a certain degree of foreign exchange flexibility is desirable for the economy as it allows foreign exchange to act as a shock absorber and facilitates real economic adjustments. With weaker outlook of growth across Emerging Market economies, and the expected Fed's policy rate hike, many Emerging Market currencies, including the Thai Baht, have depreciated. In case of Thailand, with relatively strong external financial position and well-managed foreign exchange risk exposure by public and private sectors alike, the risks from substantial foreign exchange debt exposure are currently contained. In addition, as part of the Capital Account Liberalization Master Plan, the Bank of Thailand announced earlier this year the relaxation of capital flows measures in a bid to promote more balanced fund flows, and greater flexibility in the foreign exchange markets.

As the global financial markets will continue to be volatile in the near term, the Bank of Thailand thus remains focused on mitigating short-term excessive exchange rate volatility to cushion any impact it would have on the domestic financial conditions, and consequently the real economy.

In the longer term, however, demand-management macroeconomic policy – be it fiscal or monetary – cannot be used to address structural problems successfully. As such, the Bank of Thailand is also geared towards financial sector development in order to facilitate the country's long-term structural reforms. Financial sector development is the third element of our policy navigation.

The Financial Sector Master Plan Phase III will aim for a "competitive, inclusive, connected, and sustainable" financial sector. Our vision is to have a competitive Thai financial sector which can support more diverse needs at a fair and undistorted price, promote regional trades and investments, while maintaining safety and soundness of the economy and the financial system. Today I hope to share with you some of the highlights and key milestones.

Five years from now, I foresee that the Thai financial landscape will look different from today, with more *digital banking* and *electronic payment* transactions, and increased competition from *nonbanks* and *foreign players*. The landscape will also contain innovative fintech companies who provide alternative solutions to both service providers and users such as data analytics, crowd funding, and product or price comparison services. Ultimately, competition will increase financial access, and lower transaction costs to the economy as a whole.

The Bank of Thailand will focus on the development of infrastructures and standards, while ensuring that rules and regulations are clear and supportive of innovation and efficiency. The new Payment Systems Act will unify all relevant regulations currently specified under different laws and enforced by various different agencies.

In addition, ***the Bank of Thailand will support the government's initiatives to promote nation-wide electronic payment system,*** including, for instance, the development of "Any ID" payment infrastructure, and the promotion of debit card usage for payment and transfer of welfare benefits***.***

On connectivity, the establishment of Qualified ASEAN Banks, or QABs, will allow Thai banks to expand regionally, while welcoming foreign banks in the region to conduct businesses in Thailand. Bilateral negotiations with several countries have been planned and I expect some arrangements to be made by the end of next year. The Bank of Thailand will collaborate with other central banks in the region on the promotion of *local currency settlements* for trades and investments. The appointment of cross-currency dealers to act as clearing agents for the Baht and the Ringgit should be done by the first quarter of next year, while negotiations with other countries are ongoing.

We are conscious of the rules and regulations which may hinder the development of regional trades and investments, and we are working carefully to remove obstacles without compromising stability objective.

The joint initiatives by the government and the Bank of Thailand regarding *treasury centers* have generated interest among large companies applying for a license. These treasury centers can purchase or sell foreign currencies and hedging instruments for companies within their groups, thereby aiding in foreign exchange and liquidity risk management. Multinational companies, as well as large Thai corporations with overseas branches, could similarly benefit from lower transaction costs and improved liquidity management. On top of the tax incentives offered by the Board of Investment, *International Headquarters* established in Thailand will be eligible to provide financial management services to their affiliated companies, once granted the treasury center license.

Rules and regulations also need to keep up with innovations in order to ensure safety and reliability of the financial system, and to maintain confidence of the public. To this end, the Bank of Thailand has been given a full responsibility in the *regulation and supervision of the Specialized Financial Institutions or the SFIs*, which amount for around 22 per cent of Thai financial institutions' assets. In performing such roles, the Bank of Thailand will apply the internationally accepted principles and standards taking into account the mission, mandate, and current conditions of each SFI. The ultimate goal is to ensure safety, sustainability and soundness of SFIs' operations, so that they can perform their core duties for the long-term benefit of the Thai society.

Ladies and Gentlemen,

It is clear that the world is currently changing fast. The global economy has now entered the new normal environment. Indeed, we expect to experience greater volatility as the world is in transition to a new steady state.

Looking ahead, we must not fear volatility, but be mindful of associated risks and ways to manage them. So far, with robust cushions, Thailand has fared well from external shocks compared to other Emerging Market economies. This does not mean we can be complacent.

Our country is in need of reforms to address long-term structural problems, similar to having a more powerful engine, enabling us to reach our destination faster. ***Fortunately, though, our economy is currently equipped with strong buffers, similar to a robust suspension system in a car, smoothing our ride through bumpy roads.***

Ladies and Gentlemen,

Let me assure you that the Bank of Thailand will do our part to ensure a stable and resilient macroeconomic landscape. We will accommodate changes, especially those in the financial system, which will put Thailand on a stronger footing and in a more competitive position. I am confident that Thailand will ride forward with the much more powerful engine it deserves.

Thank you very much for your attention.