

## Exchange rate management under inflation targeting at the Bank of Thailand

The Bank of Thailand (BOT) makes use of inflation targeting as a framework for monetary policy conduct in order to ensure that the Thai economy can grow at its potential over time. In this endeavor, the Monetary Policy Committee (MPC) uses short-term interest rate as an instrument and allows the exchange rate to move in alignment with the ever-changing economic fundamentals, according to the principle of managed floating. The Monetary Policy Committee (MPC) deems such framework for monetary and exchange rate policy suitable and appropriate, as it helps lay out a rule to guide policy decisions in a manner that is consistent over time, which in turn should raise the probability of success in ensuring economic stability and growth over the short and long run.

Central to Thailand's monetary policy success is the principle that policymakers should take into account private sector expectations of future economic growth, inflation, asset price and exchange rate paths, as well as the reaction of the private sector to monetary policy. A clear announcement in advance of an inflation target and the use of such target as a measure of policy success are essential components of rule-based monetary policy in Thailand. It enhances policy transparency and helps guide producers, consumers as well as wage-earners to form accurate expectations over future inflation and interest rate trends. Such accurate forecasts will benefit them in the wage and price setting process. Conversely, if the private sector believes that inflation going forward will be at the target announced by the MPC when it sets wages and prices, inflation would indeed turn out to be at that target. Such policy success will in turn enhance the credibility of the announced target. Once inflation expectations are anchored, the short-term trade-off between growth and inflation will be substantially reduced. The MPC should then have more room for discretion in steering monetary policy to take care of short-term priorities.

How is the exchange rate managed within this monetary policy framework? The MPC manages the exchange rate so that its movement reflects economic fundamentals, which include the rates of inflation and economic growth, the current account as well as developments in major trading partners and competitors. By letting the exchange rate adjust flexibly, the MPC makes full use of its automatic stabilizer property.

Thailand is highly integrated with the world economy. Our international trade and investment patterns are quite diversified. The exchange rate that the MPC manages should reflect that reality. It is not necessarily the rate of exchange between the baht and any currency in particular, but should be the rates of exchange between the baht and a basket of currencies used by our major trade and investment partners, the so-called Thai baht nominal effective exchange rate (NEER).

Under managed floating, the NEER is allowed to adjust flexibly within a certain range, which is chosen to keep the exchange rate from being too weak or too strong at a given time, and either becomes misaligned with economic fundamentals or jeopardizes Thailand's trade and investment. The baht-US dollar exchange rate is also considered to be important, as a majority of firms use US dollar as an invoice currency. As the business sector has increasingly more access to currency risk management expertise and instruments, the BOT steps in to lower short-term baht-US dollar volatility when it is beyond the ability of the private sector to manage such currency risks by itself.

The framework of inflation targeting enables the MPC to make use of exchange rate flexibility in cushioning various shocks that buffet the Thai economy. For instance, in 2007, the US economy was slowing down and Thai exports was at a record high, a combination which exerted pressure on the baht-US dollar exchange rate as well as the NEER to appreciate. As such appreciation pressure was assessed to be consistent with weaker US fundamentals and the displayed ability of Thai businesses to compete internationally, and also that the appreciating baht could automatically offset the effect of rising oil and commodity prices in the world market, which would widely benefit Thai consumers and producers, the MPC saw no reason to resist the appreciation trend. Had the MPC rejected the automatic stabilizer role of the exchange rate and resisted the pressure for the baht to appreciate, the private sector would have had to bear the burden of higher energy costs, inflation and consequently, higher market interest rates. Moreover, fiscal policy would have had to work harder to stimulate the economy.

Estimating the level of the exchange rate that keeps the economy constantly in balance is a next-to-impossible task, as exchange rate dynamics is governed by a highly complex system of relationships. To avoid the risk of having to defend a disequilibrium exchange rate over some length of time and creating a condition for destabilizing currency speculation, a prelude to the devastatingly costly abandonment of fixed exchange rates in many countries in the past, the MPC does not keep the exchange rate in a tight and inflexible range.

In summary, under inflation targeting, the MPC uses short-term interest rate as an instrument and manages the exchange rate in a flexible manner so as to ensure overall economic stability. This way, the Thai economy can systematically adjust to shocks and grow at its potential in a consistent manner.