ประสิทธิภาพนโยบายการเงินของไทย และทิศทางในอนาคต

Assessing the Effectiveness of the Thai Monetary Policy : Where do we go from here?

ดร.วิรไท สันติประภพ

กรกฎาคม 2544

ธนาคารแห่งประเทศไทย

SP/06/2001

สัมมนาวิชาการประจำปี 2544

BOT Symposium 2001

ประสิทธิภาพนโยบายการเงินของไทย และทิศทางในอนาคต

Bank of Thailand's Inflation Targeting : Recent Performance and Future Challenges

Dr. Veerathai Santiprabhob[1]

Siam Commercial Bank Public Company Limited

June, 2001

Abstract

Views expressed in this paper are those of the author and do not necessarily reflect those of his institution.

This paper reviews Bank of Thailand (BOT)'s policy stance and performance since its official adoption of inflation targeting in May 2000. The paper argues that the BOT had established a credible inflation targeting framework. Core inflation had persistently turned out below the midpoint of the BOT's target range, and bond yield curves had not reflected any evidence of inflation expectation. However, the BOT had been very passive in responding to adverse external shocks. Looking forward, the paper asks whether the BOT could be more accommodative to growth, while keeping core inflation within its target range, by lowering its policy benchmark interest rate. To avoid potential policy constraints in the long term, the paper argues that the BOT, together with the government, needs to (1) establish necessary legal and institutional foundation for inflation targeting; (2) ensure that fiscal discipline is maintained and FIDF's contingent liabilities are managed in a transparent and accountable manner; and (3) press on with financial sector restructuring. The paper also raises a number of policy-related questions in which the BOT may wish to explain to the public in further details.

Keywords : BOT'S INFLATION TARGETING

Author's E-Mail Address : veeratha@scb.co.th

[1] Vice President, Corporate Planning and Information Department, Siam Commercial Bank, PCL. Comments on the paper can be sent to veerathai@post.harvard.edu. The author is grateful to various BOT staff for helpful information support and discussions.

The environment in which the Bank of Thailand (BOT) conducts its monetary policy has changed dramatically since the economic crisis emerged in 1997. After the baht was floated, the BOT had to abandon anchoring its monetary policy with the nominal exchange rate. Traditional transmission channels of monetary policy were also impaired by financial sector instability resulting from bank runs, rising non-performing loans, capital inadequacy, and extensive closure of financial institutions.

Three years into the economic crisis, the BOT had conducted monetary policy under a few frameworks with a view of responding to concurrent economic conditions. The BOT initially maintained high short-term interest rates to prevent the baht from rapid depreciation and subsequently targeted monetary aggregates within a reserve money-programming framework. When Thailand had exited the IMF program in May 2000, the BOT formally adopted inflation targeting as its main monetary policy framework[2]

The intentions of this paper are to review the BOT's recent performance with inflation targeting and to highlight its future challenges in conducting monetary policy. The first section of the paper attempts to review BOT's monetary policy stance and performance in controlling inflation, influencing inflation expectation, and responding to external shocks that occurred during the year. The second section discusses future difficulties and challenges facing the BOT in pursuing the inflation targeting framework.

It should be noted at the outset that this paper presents *ex post* views of an outsider who may not appreciate all *ex ante* elements influencing BOT's policy decisions. Based on these *ex post* observations, the paper argues that the BOT had established a credible inflation targeting framework. Core inflation had been kept within the target range, and bond yield curves had not reflected any evidence of inflation expectation. However, the BOT had been very passive in responding to adverse external shocks. Looking forward, the paper asks whether the BOT could be more accommodative to growth, while keeping core inflation within its target range, by lowering its policy benchmark interest rate. The paper also argues that, to avoid policy constraints in the long term, the BOT and the government need to: (1) establish legal and institutional foundation for inflation targeting; (2) ensure that fiscal discipline is maintained and FIDF's contingent liabilities are managed in a transparent and accountable manner; and (3) press on with financial sector restructuring. In addition, the paper raises a number of policy questions that the BOT may wish to explain to the public in further details.

---

[2] It should be pointed out that all nine countries surveyed by Blejer (et al.) (2000,p.3) also adopted inflation targeting in the context of moving toward a floating exchange rate regime.

CONTENTS

I. BOT's recent performance under inflation targeting

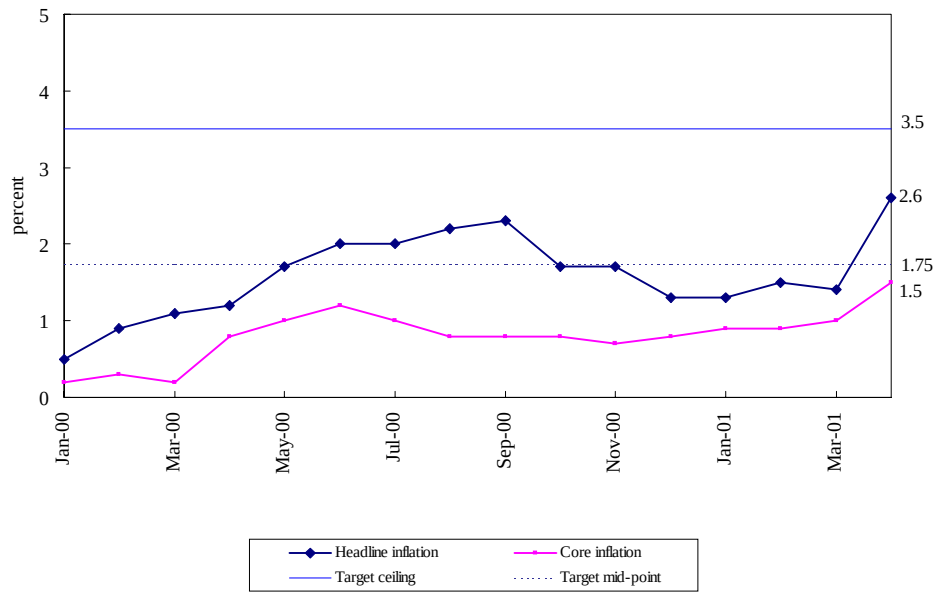
Most economists would agree that it is very difficult to evaluate monetary policy performance within a short period of time if it is possible, particularly when there were a number of uncontrollable factors at play. The BOT's inflation targeting framework has just been in place for just over one year. During that period, the Thai economy only began to recover and the recovery concentrated in a few economic sectors. More importantly, traditional transmission mechanisms of monetary policy were impaired because the financial sector had not been restored to its normal functioning position and the demand for financial assets remained fragile.

Keeping in view the short existence of the BOT's inflation targeting framework, this section of the paper discusses the BOT's policy stance and performance in three key aspects: (1) ability to control inflation; (2) ability to influence inflation expectation; and (3) responses to external shocks.

I.1 Ability to control inflation

The most straight forward question may be asked when evaluating performance of central bank under inflation targeting is whether actual inflation has turned out close to the announced target or within the target range. Since the BOT first announced its inflation target on May 23, 2000, it has committed to maintaining core inflation (excluding changes in prices of raw food and energy) within a range of 0-3.5 percent during 2000-2002. Chart 1 clearly shows that core inflation turned out within the target range throughout the past twelve months.

Chart 1: Inflation



Although that core inflation turned out within the target range helps strengthen the BOT's credibility, it may not be sufficient to conclude that the BOT's inflation targeting was perfect. One also needs to ask: (1) whether the target range is appropriate and (2) whether actual inflation performance was biased toward the ceiling or floor of the announced target range.

Is the BOT's target range appropriate? It would be easier to evaluate the appropriateness of BOT's inflation target if the framework were adopted amid high inflation and the BOT had to tighten monetary policy to lower inflation.[3] On the contrary, the BOT adopted inflation targeting during a period of historically low inflation and the economy only began to recover from an economic crisis. Given the state of the economy, criteria used by the BOT in determining its inflation target can be highly debatable.

As mentioned earlier, the BOT set the target range for its core inflation at 0-3.5 percent. The range's ceiling was based on actual headline inflation of Thailand's main trading partners and competitors during 1990-1999 and their expected inflation of around 2-3 percent during 2000-2001. The BOT indicated that "ensuring that Thailand's inflation

[3] Many emerging countries adopting inflation targeting moved toward the framework when inflation was relatively high. Among others, Chile, Czech Republic, Israel, and Poland moved toward inflation targeting when the inflation was higher than 8 percent (Schaechter, Stone, and Zelmer (2000, p.16)).

rate is in line with those of trading partners enhances export competitiveness, which in turn, leads to the stability of the Thai baht." [4]

This paper does not argue in favor of a higher or lower inflation target, and the range's ceiling of 3.5 percent may turn out to be most appropriate. The paper, however, raises two questions relating to the rationale for the BOT's inflation target.

First, it wonders whether monetary policy should focus on only export competitiveness. Inflation targeting, as opposed to exchange rate targeting, allows monetary policy to focus on domestic considerations and allows the central bank " to use all available informations, and not just one variable, to determine the best setting for monetary policy." [5] Moreover, export competitiveness depends on a number of factors beyond central bank's control and cannot guarantee the stability of the baht. As Thailand had experienced during the past few years, the value of the baht was mainly driven by capital flows and public expectations on key domestic and external imbalances. To this end, one may wonder whether the BOT should focus more on domestic factors and factors influencing capital movements in determining its inflation target. These factors are, for instance, output gap, public debt burden, flows of funds, and interest rate differentials. To approach at an appropriate ceiling of its inflation target, the BOT needs to evaluate effects of all key economic imbalances in a comprehensive macroeconomic model.[6]

And, second, export competitiveness is a forward looking issue. If the BOT feels strongly about setting its inflation target to maintain the country's export competitiveness, it should rely more on expected inflation rather than past performance. As most countries are moving toward inflation targeting and becoming more conservative about inflation, future inflation of Thailand's trading partners will more likely be lower than in the past. Moreover, the BOT needs to take into consideration Thailand's pace of productivity improvement in relation to that of our trading partners as well as expected changes in the trading pattern.

---

[4] BOT's Inflation Report, (July 2000, p.iii.)
[5] Mishkin (1999, p.19).
[6] One could also doubt the floor of the BOT's inflation target, which is set at 0 percent. While zero inflation is desirable from social perspectives, the BOT may need to send a signal that it committed to accommodating the recovery by aiming at a positive level of inflation.

Has the inflation performance been biased toward the target range's ceiling or floor? The BOT, like other central banks new to inflation targeting, set its inflation target in a range rather than using a point target.[7] A range target has provided the BOT with policy flexibility during the transition period, especially when there were uncertainties related to external factors and domestic monetary policy transmission mechanisms. When a range target is wide, inflation performance may need to be evaluated against its midpoint.[8]

Chart 1 shows that core inflation had persistently been below the midpoint of the target range since the BOT formally adopted inflation targeting. Indeed, core inflation was below one percent for almost every month during the past year despite rising oil prices and recurring exchange rate shocks that had directly and indirectly contributed to higher core inflation than originally expected.[9]

As inflation is very crucial for business and financial planning for the private sector and the government alike, Mishkin (2000, p. 9) argues that "… a key requirement for successful inflation targeting regimes in emerging market economies is the recognition that undershooting inflation targets is just as costly as overshooting the targets." Undershooting the inflation target would generate lower than expected returns and higher than expected real wages and real costs of borrowing, which could be detrimental to growth, especially during a fragile recovery. The core inflation, in fact, turned out close to the floor of the BOT's target range in which raises a question of whether the BOT could be more expansionary or whether the target range should be narrowed down to lower inflation expectation in line with actual performance.[10]

---

[7] Among the 13 countries surveyed by Schaechter, Stone, and Zelmer (2000, p.11), only 3 countries use a point inflation target and 2 other countries use a point target with range.

[8] The BOT's target range is wider than those of the 8 countries using a range target as surveyed by Schaechter, Stone, and Zelmer (2000, p.12).

[9] See section I.3 for more information on BOT's responses to external shocks.

[10] Section II.1 discusses options through which the BOT can be more expansionary.

I.2 Ability to influence inflation expectation

To ensure that future inflation falls within the BOT's target range, the BOT needs to keep inflation expectation under control particularly by establishing a credible inflation targeting framework. An expectation of higher inflation will likely induce the public to shift their future consumption and investment forward, thereby leading to higher inflation pressure today. Furthermore, inflation expectation will be incorporated into future wages, prices, and interest rates, all of which are key determinants of future inflation.

In the absence of inflation expectation survey in Thailand, inflation expectation may be implied from yield curve developments over a period of time. Investors normally require higher returns from long-term assets if they expect inflation to rise, thereby shifting yield curves upward or increasing their slope. On the contrary, one would expect yield curves to shift downward or become flat if inflation expectation is subdued.

Yield curves in Thailand which are newly established as long-term government bonds became widely available only after the government's financing needs surged during the crisis, especially to compensate for financial sector restructuring costs. Given the elementary stage and the thinness of the Thai bond market, yield curves have also been influenced by factors other than inflation expectation, e.g., fluctuations in supply of long-term instruments and general confidence in the economy.

Chart 2 shows that period-average yield curves of government and FIDF bonds had shifted downward throughout the last three quarters of 2000 and dipped further in the first quarter of 2001 following the Federal Reserves' decisions to lower the Fed Fund rate and the lowering of interest rates by most domestic banks.[11] However, yield curves recovered slightly in March and April 2001, and shifted up markedly during the last week of May due to uncertainties related to interest rate policy.

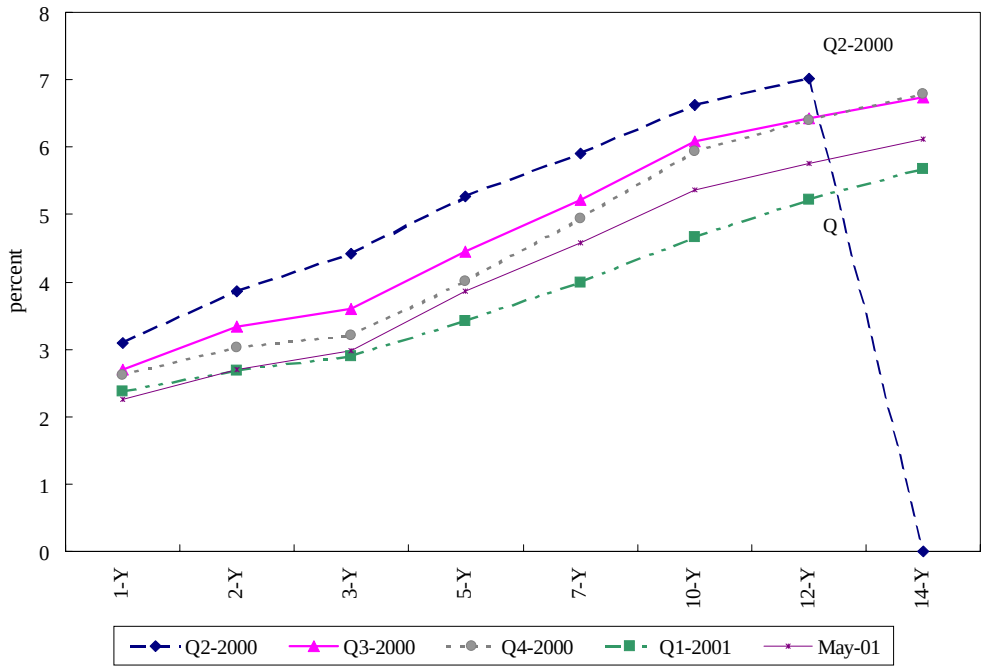
---

[11] The period-average yield curves were calculated using daily information to minimize impact of daily volatility.

As inflation expectation is generally reflected through demand for long-term bonds, this paper attempts to separate demand from supply factors and infer inflation expectation from unexplained demand factors behind yield curve developments. [12] The paper focuses on the period after January 2001 when bond yields were on the rise.

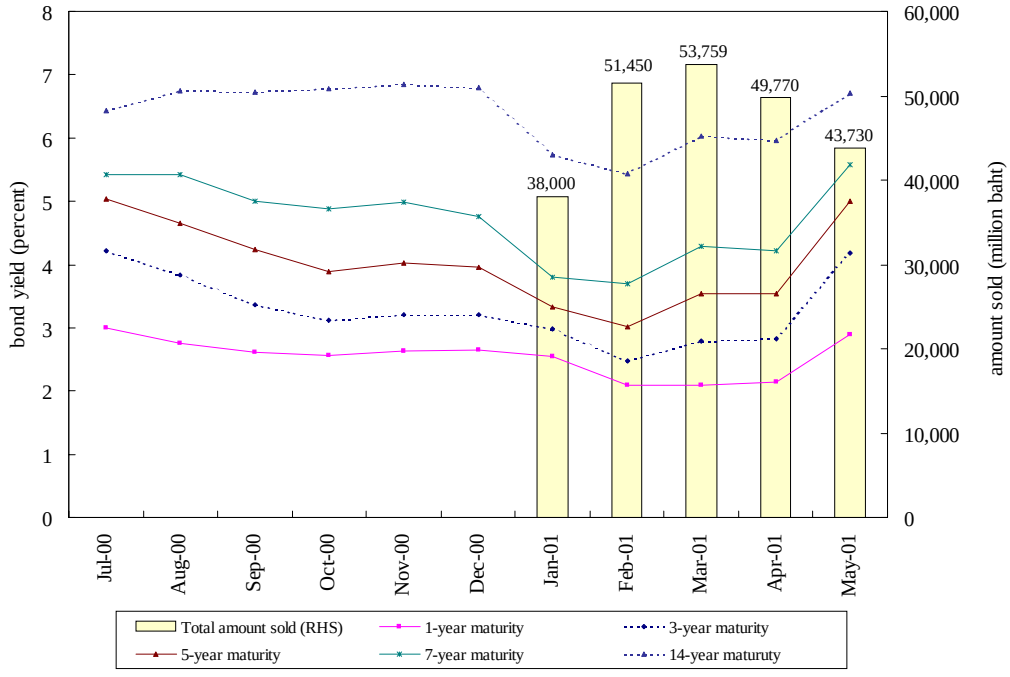
Chart 3 presents bond yields between July 2000 and May 2001 in further details. While yields of 7-year or shorter bonds were declining throughout the second half of 2000, yields of 14-year bonds were rising slightly resulting in a widening gap between long-term and shorter-term rates. Although this gap could imply rising long-term inflation expectation, it was also influenced by government's strategy to shift toward long-term financing. This yield gap had narrowed down in January 2001 and stabilized

Chart 2: Period-Average Yield Curves of Government and FIDF Bonds



[12] Demand for bonds can also be influenced by other factors, including availability of funds for fixed-income investment, liquidity of the secondary market, and availability of alternative investment instruments.

Chart 3: Bond Yields and Amount Sold



since then. In May 2001, it narrowed down further when short-term rates rose sharply in response to uncertainty related to interest rate policy.

Chart 3 also shows that bond yields during February and April 2001 were driven mainly by changes in the amount of new bonds issued. However, it should be noted that the BOT tried to keep yields during this period low by canceling two bond auctions, reducing the amount of bonds sold from the announced amounts, and purchasing bonds directly from an auction.

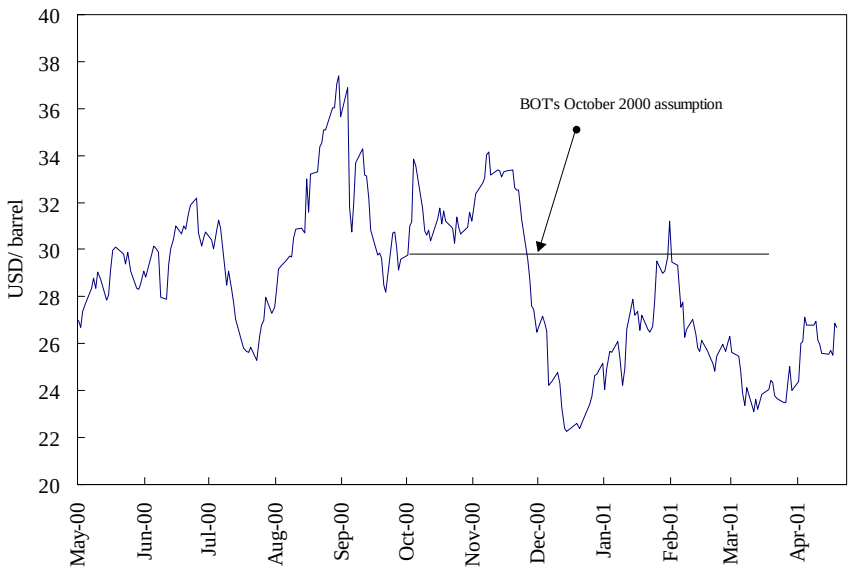
The above chart indicates that yield curves were declining for the most part of 2000 and that rising yields in the first quarter of 2001 mainly reflected movements in the supply of bonds issued, one may conclude that there has been no strong evidence of inflation expectation. Indeed, the credibility of the BOT's inflation targeting framework may have suppressed inflation expectation as reflected in the lowering of yield curves after the framework was adopted.

I.3 Responses to external shocks

An analysis of BOT's policy responses to unexpected shocks would help sharpen understanding of the BOT's commitment to inflation targeting. Since May 2000, the Thai economy has experienced two main types of shocks that could be used to evaluate the BOT's commitment to its policy stance: (1) unexpected rise in oil prices during the second half of 2000 (chart 4) and (2) stronger than expected slowdown of the U.S. economy.

Table 1 summarizes assumptions on oil prices and the Fed Fund rate—an important indicator of U.S. economic conditions—that were used by the BOT in making policy decisions.[13] It turned out that the BOT's assumptions had persistently underestimated their outcomes during 2000, and the BOT had to subsequently adjust its assumptions on the Fed Fund rate to reflect worsening conditions. In addition, the BOT expected the oil price shocks to be temporary while the U.S. economic slowdown would be a longer term.

Chart 4: Crude Oil Price



[13] These assumptions were published in the BOT's Inflation Reports.

Table 1 : BOT's Predictions of Core Inflation and GDP Growth and Key Assumptions on the US Economy and Oil Prices

Inflation Report Issuing Date	Predicted Average Core Inflation (%) [1]	Predicted GDP Growth Rate (%) [1]	Assumption on the US Fed Fund Rate	Assumption on Dubai Crude Oil Price (per barrel)	BOT 14-day Repo Rate (%)
Jul-00	2000: 1.0–1.5 *2001: 2.0-3.0*	2000: 4.5-5.5 *2001: 4.0-6.0*	Increase from 6.5% to 7.0% in H2 2000 and maintain until 2002	$25 throughout 2000	1.5
Oct-00	2000: 0.5-1.0 *2001: 1.5-3.0*	2000: 4.5-5.0 *2001: 4.0-5.5*	Increase from 6.5% to 6.75% in Q1 2001 and maintain until 2002	$28-30 during H2 2000 and $26-30 during 2001	1.5
Jan-01	2000: 0.7 *2001: 1.5-2.5* 2002: 1.5-3.0	2000: 4.3 *2001: 3.0-4.5* 2002: 4.5-6.5	Lower from 6.0% to 5.0% in Q1-Q3 2001 and maintain until 2002	$22-26 during 2001 and 2002	1.5
Apr-01	*2001: 1.5-2.0* 2002: 1.5-3.0	*2001: 2.5-4.0* 2002: 4.0-6.0	Lower from 4.5% to 4.0% in Q3 2001 and maintain until Q1 2003	$20-24 during 2001 and 2002	1.5

[1] Indicated by the darkest part of the BOT's fan charts.

Source : BOT's Inflation Reports, various issues.

It should be noted that this paper has no intention to evaluate the accuracy of BOT's assumptions and forecasts. On the other hand, it tries to examine BOT's policy decisions in response to changes in economic assumptions. Despite the fact that the BOT had underestimated the magnitude of these adverse shocks and had to repeatedly adjust its assumptions accordingly, the BOT had not changed its benchmark policy rate, i.e., the 14-day repo rate, before raising it in June 2001.

It appears that the BOT responded to these adverse shocks by slightly expanding its monetary base, especially through the accumulation of net foreign assets (see chart 5).[14] In addition, the BOT had increased the usage of its development credit facilities by 27 percent during May 2000-March 2001 (see chart 6). These credit facilities, however, accounted for only 4 percent of monetary base and 0.04 percent of the total banking system credit outstanding at end March 2001.

Besides expanding the monetary base, the BOT allowed the real effective exchange rate (REER) to depreciate during the second half of 2000 to help strengthen Thailand's competitiveness against its trading partners (see chart 7).[15] Nevertheless, the REER began to appreciate around the beginning of 2001, thereby partially offsetting effects of the initial depreciation.

In summary, the BOT's monetary policy appears to be very passive in responding to adverse shocks. Instead of adjusting its key policy instruments, the BOT chose to revise downward its projections of economic growth and core inflation when it discovered that the shocks had turned out larger than expected. In effect, the BOT focused mainly on keeping core inflation low and allowed these shocks to pass on their adverse effects to real economic activities. This observation is consistent with Cecchetti and Ehrmann (1999)'s cross-section finding that central banks, especially inflation targeting ones, tended to increase their aversion to inflation volatility and, as a result, suffered increases in output volatility.

---

[14] Part of the increase in BOT's net foreign assets was due to the depreciation of the baht.

[15] The REER presented in the chart is the BOT's published series. This series is different from the confidential one used by the BOT in making policy decision and referred to in the Inflation Reports.

Chart 5: Monetary Base and BOT's Net Foreign Assets

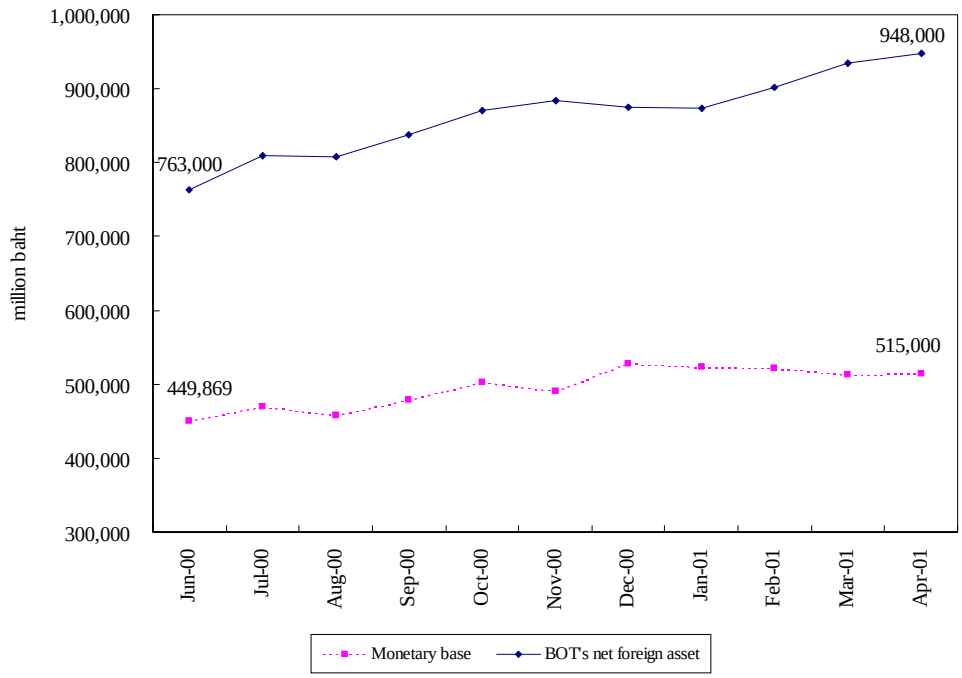


Chart 6: BOT's Development Credit Outstanding

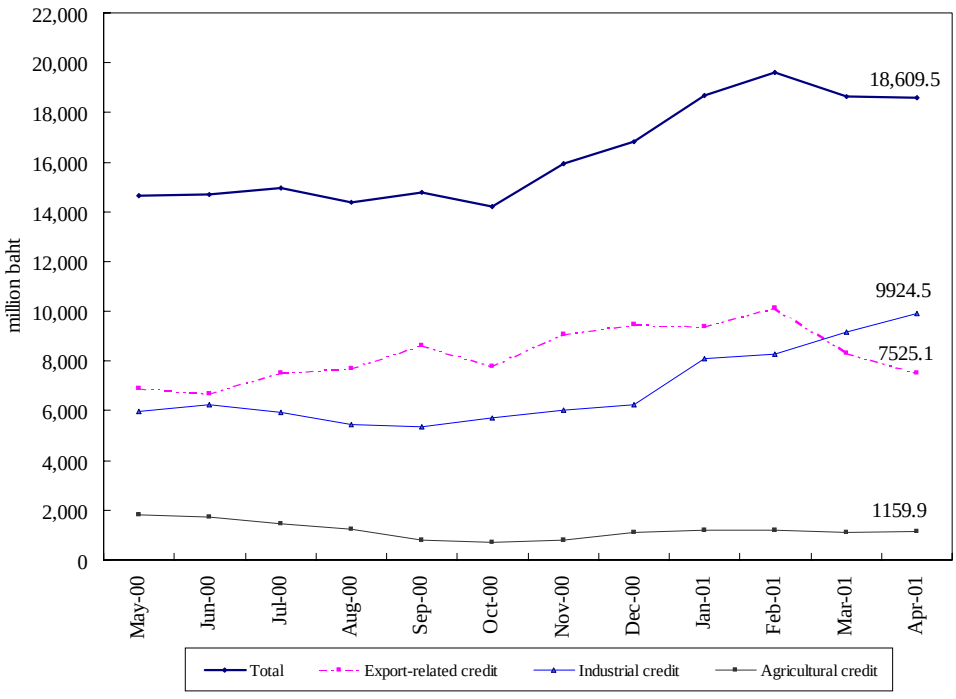
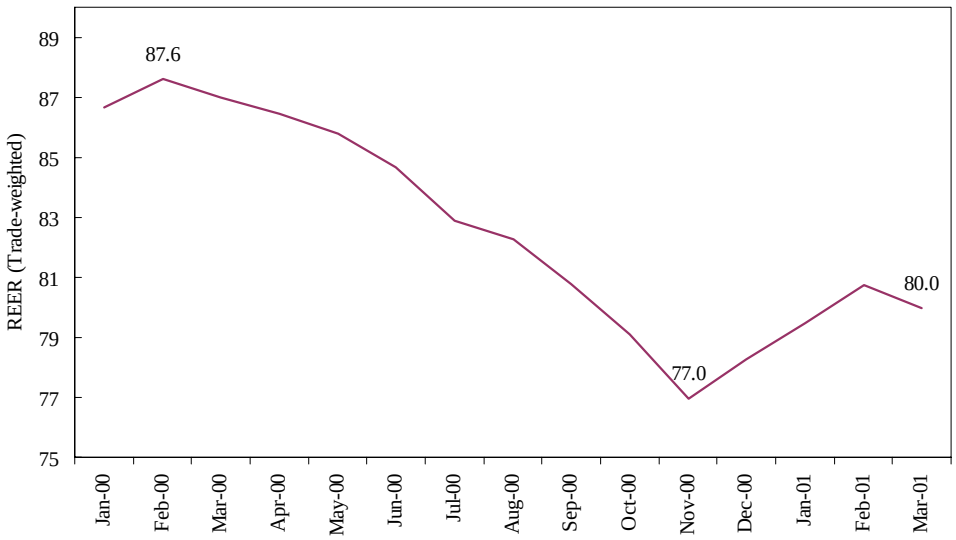


Chart 7: Real Effective Exchange Rate



II. Looking forward

In the near term, the BOT will continue to face with important and challenging tasks of nurturing the Thai economic recovery. External economic conditions will likely remain fragile. The financial sector restructuring process is yet to be completed and, as a result, key monetary policy transmission mechanisms will continue to be impaired. Moreover, the economic crisis has left the BOT with a number of policy and operational constraints, especially those resulting from FIDF liabilities. This section discusses BOT's short-term policy challenges and highlights constraints for effective monetary policy implementation in the long term, especially under the inflation targeting framework.

II.1 Short-term policy challenges

The BOT had undoubtedly strengthened the credibility of its inflation targeting framework by keeping core inflation within its target range and suppressing inflation expectation. Its strong commitment to inflation targeting was also confirmed by its passive stance toward adverse shocks. But as the economic recovery remains fragile and external economic conditions are highly uncertain, one may wonder whether the BOT

could be more accommodative to growth while delivering core inflation within its target range. Mishkin (2000, p.9) points out that "support for an independent central bank which is pursuing price stability can erode if the central bank is perceived as focusing *solely* on lowering inflation to the detriment of other objectives such as minimizing output variability."

In theory, a central bank can implement expansionary monetary policy via both direct and indirect monetary instruments. As to indirect instruments, the central bank may increase reserves by purchasing bonds or foreign exchanges from the market. Given excess liquidity in the banking system at present, it would be difficult for the BOT to buy bonds from the secondary market unless it offers attractively high prices. In practice, the BOT can also buy newly issued government bonds, but it is subject to government's financing schedule and, more importantly, risks undermining long-term fiscal discipline. This option is also against the BOT's principle of not financing government deficits as stipulated in the draft of the new BOT Act, which is awaiting resubmission to the parliament. In addition, an increase in short-term liquidity at this time will likely have little impact on growth because of failure in financial intermediaries and low sensitivity of economic activities to short-term interest rates.

The recent decline in Thailand's exports and current account surpluses, together with vulnerability in the regional currency markets, have also made it difficult for the BOT to accumulate foreign exchanges, as it did in the second half of 2000 and the first quarter of 2001. Such an intervention risks triggering a series of depreciation, which would in turn result in higher inflation and encourage capital outflows. Therefore, the BOT will likely have to keep the nominal exchange rate in line with those of other currencies in the region.

As to direct monetary policy instruments, the BOT could increase the usage of its direct credit facilities. However, the focus of its facilities needs to be shifted toward sectors geared for the domestic market because demand for export-related credit will likely be weak until the world economy recovers. At present, around half of the BOT's direct credit outstanding is export related (see chart 6).

If the BOT wishes to accommodate growth further, one may ask whether the BOT has other policy instruments besides reducing its policy benchmark rate. Perhaps, the repo rate should be cut to a level below the one prior to the increase in June 2001.

Although lowering the repo rate would not have much quantitative impact on liquidity in the banking system, it could have strong signaling impact on long-term interest rates, which are more influential to real economic activities than short-term rates. Financial institutions will likely perceive such an action as an indication to lower their interest rate structure, which would help reduce financial costs of the borrowing public, lower NPL carrying cost, facilitate debt restructuring process, and, most importantly, keep financing cost of the government low. [16]

Keeping the government's financing cost low is very crucial to support the currently needed fiscal stimulus. As mentioned earlier, there were a number of incidences during March–June 2001 indicating that the government's financing cost was rising beyond its reservation level. The BOT had to intervene in auctions of government bonds and treasury bills by reducing the amounts of instruments sold, canceling a few auctions, and directly purchasing bonds at one auction. These interventions resulted in market distortions and undermined market efficiency. If the BOT sees the need to keep the government's financing cost low, lowering the whole interest rate structure by reducing its policy benchmark rate would be more desirable than applying discreet interventions at auctions.

To arrive at the appropriate magnitude of the repo-rate reduction, the BOT will need to evaluate its impact on core inflation with a view to ensure that its inflation target will not be compromised. In so doing, the BOT also needs to take into account impact of the government's fiscal programs and their financing needs. Given the contingent nature and uncertain timing of key components of the government's fiscal program, the BOT is indeed in a difficult position to perform such an analysis effectively. Furthermore, operational details of these programs have not yet been finalized, thereby making it difficult to assess their impact on the economy.

It should also be pointed out that a decision to lower the repo rate, if the BOT sees fit, would also demonstrate the BOT's policy and instrument independence, which is crucial for the success of inflation targeting in the long term. In addition, it would help anchor market confidence and stability, and maintain policy risk premium at a low level.

---

[16] Yields of 3-5 year government bonds dropped around 30-50 basis points in February 2001 following the reduction in interest rates by Thai banks and the lowering of the Federal Reserves' Fed Fund rate.

II.2 Potential policy constraints for the long term

While the BOT has to focus on implementing near-term policy measures in response to concurrent economic conditions, it is unavoidable that the government and the BOT have to establish strong foundations for effective monetary policy implementation in the long term. This section discusses three key areas: (1) strengthening institutional and legal foundations for inflation targeting; (2) assisting the government in maintaining fiscal discipline and minimizing potential distortions from realizing contingent liabilities, especially those of the FIDF; and (3) strengthening financial institutions' conditions. Unless these issues are addressed in a timely and appropriate manner, they may constrain monetary policy implementation and undermine the inflation targeting framework in the long term.

Legal and Institutional foundations for inflation targeting. Economic literatures define inflation targeting as a monetary policy framework that requires, among others: (1) an institutional commitment to price stability as the primary goal of monetary policy; (2) increased policy transparency and accountability; and (3) independence in conducting monetary policy instruments.[17] To this end, "emerging market countries have preferred to have a central bank legal framework in place that yields a high degree of independence *before* introducing inflation targeting."[18]

Since early 1999, the BOT and the Ministry of Finance (MOF) have drafted a new BOT Act, which incorporates the above elements in details. In the draft law, the objectives of the BOT are limited to only maintaining price stability and safeguarding stability of the financial system. The BOT could support government's economic policies only if the BOT's primary objectives are not compromised.

On policy transparency and accountability, the draft law requires that the BOT's Monetary Policy Board (MPB) determines a yearly inflation target, which needs to be approved by the government and publicly disclosed.[19] The draft law also requires

---

[17] Among others, Blejer (et al.) (2000), Mishkin (1999) and (2000), and Schaechter, Stone and Zelmer (2000).

[18] Schaechter, Stone and Zelmer (2000, p.7).

[19] Any amendment to the target also needs to be approved by the government and publicly disclosed.

that the BOT disclose minutes of MPB's meetings within three months of each meeting. In addition, the BOT has to submit to the government and parliament bi-annual monetary policy reports indicating its policy performance and operating approach during the six months prior to the submission.

On BOT's independence, the draft law indicates specific conditions under which the BOT governor, deputy governors, and board members may be removed. Moreover, the draft law allows the BOT to provide financial assistance to the government only in emergency cases and under strict terms.[20]

The passage of the new BOT Act would help establish necessary legal and institutional foundations for inflation targeting and, more importantly, demonstrate a commitment of both the government and the BOT to a clear monetary policy framework. Such a framework will help anchor market confidence and stability, and minimize policy risks.

Fiscal discipline and threats from contingent liabilities. Inflation targeting, even with a strong supportive legal framework, may not be sufficient to ensure fiscal discipline and prevent fiscal dominance. "In the long run, large fiscal deficits will cause an inflation targeting regime to break down: the fiscal deficits will eventually have to be monetized or the public debt eroded by a large devaluation, and high inflation will follow."[21] To avoid a possibility of fiscal dominance in the future, the BOT needs to work closely with the government in designing appropriate fiscal programs as well as strengthen the coordination between monetary and fiscal policy.

In particular, the BOT needs to step up its detailed analysis of the government's fiscal programs, their financing needs, and their contingent liabilities that have been on the rise since the emergence of the economic crisis. [22] The BOT needs to

---

[20] In emergency cases, the MPB could permit the BOT to lend to the government only for expenditure items indicated in the annual budget. The government will have to repay the BOT within one calendar year with market-determined interest.

[21] Mishkin (2000), p. 5.

[22] For instance, these contingent liabilities include loss sharing schemes of the privatized banks, future losses of the Sukumvit Asset Management Company, potential losses from the Thai Asset Management Corporation, future fiscal burden from the 30-baht health care program and the debt moratorium for farmers.

regularly inform the public of such analyses as the public can play an important role in enforcing fiscal discipline. If the BOT is not fully aware of these contingent liabilities and their potential effects, it will not be in a position to conduct monetary policy effectively, especially when it wants to be more proactive in response to external shocks.

It is also equally crucial that FIDF contingent liabilities are dealt with in a transparent and accountable manner. These FIDF liabilities must not be mixed with other contingent liabilities of the government to ensure proper ownership and, as a result, careful monitoring and management. More importantly, the government must be committed to fiscalizing all FIDF losses, for failure in so doing will undermine the BOT's policy independence and future price stability. If the FIDF liabilities will not be taken over by the government and the BOT will have to absorb these losses, the BOT's financial strength will be markedly weakened and its policy credibility undermined.[23] In that case, the BOT will likely be dominated by the government and eventually lose its ability to ensure price stability and fiscal discipline.

Current and future contingent liabilities of the FIDF can also undermine the BOT's "instrument" independence. As the FIDF is the largest player in the short-term repo market, mismanagement of its liabilities could create severe market distortions, which will have to be neutralized by BOT's monetary operations. The FIDF contingent liabilities also contribute to the fragility of the money market, which could be easily disrupted if the FIDF encounters an unexpected shock. To this end, the maturity of FIDF liabilities needs to be well structured although doing so may be beyond the current fiscalization program of the government and result in higher interest expenses.[24] In addition, the BOT needs to prepare contingent plans and develop a spectrum of monetary policy instruments, which can be proactively used to minimize potential distortions. Otherwise, the objective of maintaining long-term price stability could be compromised when BOT's monetary policy instruments have to serve more than one objective.

---

[23] At end 1999, the BOT's Banking Department had cumulative losses of around 110,000 million baht from the failure in defending the baht.

[24] The previous government agreed to fiscalize around 166 billion baht of FIDF losses during fiscal year 2000/2001 through guaranteeing principle and interest payments of FIDF bonds. The bonds have been issued with 2-5 year maturity, and proceeds from the bonds are used to repay FIDF short-term liabilities in the money market.

Strengthening remaining financial institutions. Financial system's health is not only crucial for effective monetary policy transmission, but could also threaten the government's financial position. At present, the largest source of government's contingent liabilities is the blanket deposit guarantee introduced at the peak of the economic crisis. In addition, unsound financial institutions may require liquidity support from the BOT, distort the financial market, and easily undermine the inflation targeting framework.

The restructuring process of the Thai financial system is yet to be completed, and both the government and the BOT need to play an active role in addressing remaining problems. Among others, the key problems are: (1) limited capital cushion at some financial institutions; (2) lack of competitiveness of small financial institutions and mechanisms to facilitate their consolidation; (3) uncertain future of intervened banks and mechanisms to minimize their ongoing losses; and (4) establishment of good credit culture, especially by tightening related legal frameworks and government policies. These issues need to be addressed in a timely and effective manner before the blanket deposit guarantee can be replaced with a partial guarantee scheme.

III. Concluding remarks

Based on *ex post* observations of the BOT's monetary policy stance and performance during its first year of inflation targeting, this paper argues that the BOT had established a credible inflation targeting framework. Core inflation was kept below the midpoint of the BOT's target range, and bond yields had not reflected any evidence of inflation expectation. The BOT had also been very passive in responding to adverse shocks and, perhaps, had focused too heavily on keeping inflation low.

Looking forward, the paper wonders whether the BOT could be more accommodative to growth, while keeping inflation within its target range. In particular, the paper asks whether the BOT should lower its policy benchmark interest rate with a view to lower the whole interest rate structure. Among others, low interest rates will help reduce the government's financing costs, which have recently been kept under control by BOT's discreet interventions at bond auctions.

The paper also argues that, to avoid policy constraints in the long term, the BOT and the government need to: (1) establish necessary legal and institutional foundation for inflation targeting; (2) ensure that fiscal discipline is maintained and FIDF's contingent liabilities are managed in a transparent and accountable manner; and (3) press on with financial sector restructuring.

References

Bank of Thailand. *Inflation Reports*, various editions (Bangkok: Bank of Thailand).

Bank of Thailand and Ministry of Finance (2000). *Consolidation of Bank of Thailand's Accounts*, background paper for the seminar on the Consolidation of Bank of Thailand's Accounts, May 24, 2000.

Blejer, M. (et al.) (2000). *Inflation Targeting in Practice*. (Washington, D.C.; International Monetary Fund).

Cecchetti, S.G. and Ehrmann, M. (1999) "Does Inflation Targeting Increase Output Volatility? An International Comparison of Policymakers' Preferences and Outcomes," NBER Working Paper 7426.

Mishkin, F. S. (1999). "International Experiences with Different Monetary Policy Regimes," NBER Working Paper 7044.

———— (2000). "Inflation Targeting in Emerging Market Economies," NBER Working Paper 7618.

Schaechter, A.; Stone, M.; and Zelmer, M. (2000). *Adopting Inflation Targeting: Practical Issues for Emerging Market Countries*, International Monetary Fund Occasional Paper 202 (Washington, D.C.; International Monetary Fund).