

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

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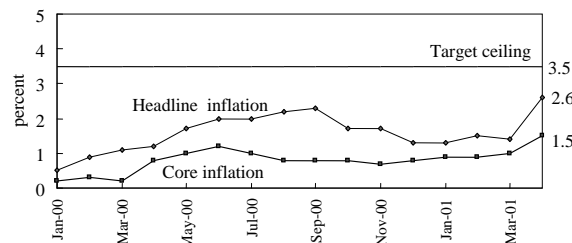
Scope of the paper

- ⌘ Review BOT's stance and performance since the official adoption of inflation targeting on May 23, 2000
- ⌘ Present *ex post* views of an outsider
- ⌘ Raise policy-related questions that need to be clarified

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Recent performance: ability to control inflation

- ⌘ Core inflation had turned out within the target range of 0 - 3.5 percent since the target was announced.



Source: Internal Trade Department

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Recent performance: ability to control inflation

- ⌘ The fact that core inflation turned out within the target range may not be sufficient to conclude that the BOT has succeeded with inflation targeting.
 - ☑ Is the rationale for setting the BOT's target range appropriate?
 - ☑ Has inflation been biased toward the target range's ceiling or floor?

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Recent performance: ability to control inflation

- Is the rationale for setting the BOT's target range appropriate?
- ⌘ The range's ceiling of 3.5 percent was based on:
 - ☑ Headline inflation of Thailand's main trading partners and competitors during 1990-99, and
 - ☑ Their expected inflation of around 2-3 percent in 2000-01.
- ⌘ "Ensuring that Thailand's inflation rate is in line with those of trading partners enhances export competitiveness, which in turn leads to the stability of the Thai baht" (BOT's Inflation Report, July 2000).

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Recent performance: ability to control inflation

Is the rationale for setting the BOT's target range appropriate?

- ⌘ 1. Should monetary policy under inflation targeting emphasize on export competitiveness?
 - Inflation targeting, as opposed to exchange rate targeting, allows monetary policy to focus on domestic considerations.
 - Inflation targeting allows central bank to utilize all available information.
 - The value of the baht has been driven by capital flows and expectations on key domestic and external imbalances.

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Recent performance: ability to control inflation

Is the rationale for setting the BOT's target range appropriate?

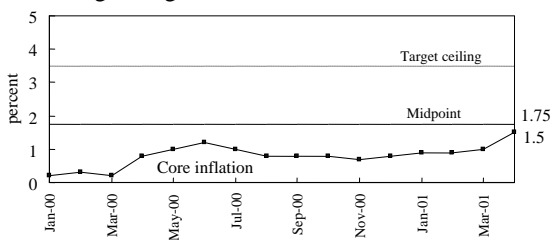
- ⌘ 2. Export competitiveness is a forward looking issue.
 - Most central banks are becoming more conservative about inflation.
 - Relative change in productivity
 - Potential change in trading patterns

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Recent performance: ability to control inflation

Has inflation been biased toward the target's ceiling or floor?

- ⌘ Core inflation had persistently been below the midpoint of the target range.



Source: Internal Trade Department

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Recent performance: ability to control inflation

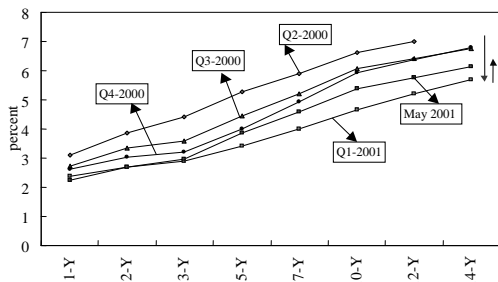
Has inflation been biased toward the target's ceiling or floor?

- ⌘ Undershooting the inflation target is as costly as overshooting the target.
- ⌘ Could the target be narrowed down to lower inflation expectation?
- ⌘ Could the BOT be more expansionary?

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Recent performance: ability to influence inflation expectation

- ⌘ Yield curves had shifted downward between Q2 2000 and Q1 2001.

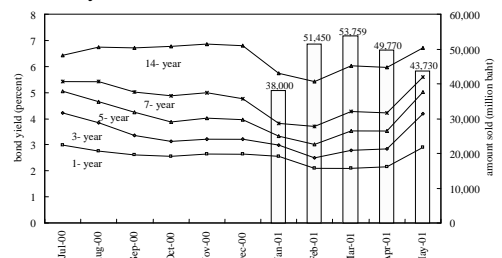


Source: Thai Bond Dealing Center

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Recent performance: ability to influence inflation expectation

- ⌘ Rising yields during February - April 2001 were mainly driven by supply of new bonds issued. Yields were also influenced by BOT's interventions.



Source: Bank of Thailand and Thai Bond Dealing Center

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Recent performance: responses to external shocks

⌘ Since May 2000, Thailand has experienced two main types of shocks:

☒ Unexpected rise in oil prices during the second half of 2000

☒ Stronger than expected slowdown of the US economy

⌘ BOT's assumptions on shocks had persistently underestimated their outcomes during 2000.

⌘ The BOT had adjusted its assumptions on the fed fund rate to reflect worsening conditions.

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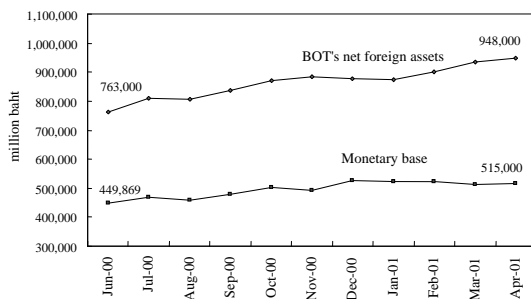
Recent performance: responses to external shocks

Inflation Report Issuing Date	Predicted Average Core Inflation (%)	Predicted GDP Growth Rate (%)	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

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Recent performance: responses to external shocks

⌘ Slight expansion of monetary base

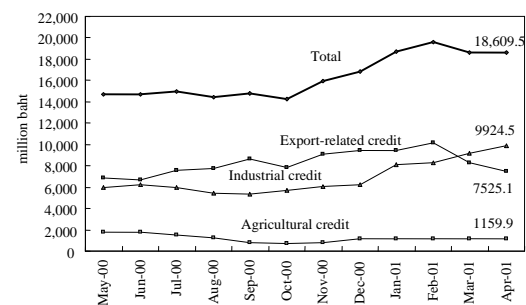


Source: Bank of Thailand

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Recent performance: responses to external shocks

⌘ Increase in usage of BOT's direct credit facilities

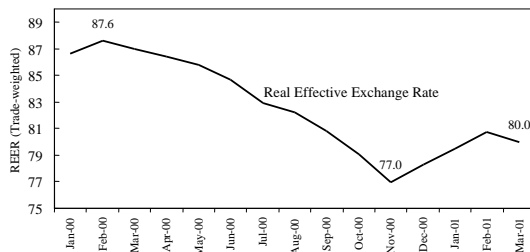


Source: Bank of Thailand

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Recent performance: responses to external shocks

⌘ Depreciation of the REER



NOTE: Trade weighted index
Source: Bank of Thailand

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Recent performance: responses to external shocks

⌘ The BOT appears to be very passive in responding to adverse shocks.

☒ No change in its policy benchmark rate (14-day R/P rate)

☒ Slight changes in monetary aggregates and REER

⌘ The BOT chose to revise downward its projections of growth and core inflation when learning that adverse shocks turned out larger than expected.

⌘ Was the BOT concerned too much about keeping core inflation low?

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BOT's recent performance

- ⌘ The BOT had established a credible inflation targeting framework.
 - ☑ Core inflation had persistently been below the midpoint of the target range.
 - ☑ Bond yields had not reflected any evidence of rising inflation expectation.
 - ☑ The BOT responded to shocks passively, thereby indicating its commitment to keeping core inflation low.

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Looking forward: short-term challenges

- ⌘ “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” (Mishkin 2000)
- ⌘ Could the BOT be more accommodative to economic recovery while delivering core inflation within its target range?

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Looking forward: short-term challenges

- ⌘ Available policy measures to accommodate recovery
 - ☑ Likely ineffective
 - ☑ Open market operations: no binding environment due to excess liquidity
 - ☑ Foreign exchange intervention: increasingly limited supply of foreign exchanges in the private sector and fragility of the currency market
 - ☑ Direct credit facilities: small size of the facilities and export focus
 - ☑ Against the principle of independent central bank
 - ☑ Direct purchase of government bonds in the primary market
 - ☑ Potentially accommodative
 - ☑ Reducing the R/P rate

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Looking forward: short-term challenges

- ⌘ Potential effects from a reduction in the R/P rate
 - ☑ Signal a decline of the whole interest rate structure
 - ☑ Support interest-sensitive private consumption and investment
 - ☑ Lower NPL carrying cost
 - ☑ Lower financing cost of the government's fiscal programs
 - ☑ Minimize BOT's intervention in bond auctions
 - ☑ Lower carrying cost of FIDF contingent liabilities
 - ☑ Clarify the objective and framework of monetary policy
 - ☑ Aimed at macroeconomic objectives

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Looking forward: long-term constraints

- ⌘ The BOT, together with the government, needs to establish strong foundations for effective monetary policy implementation in the long term.
 - ☑ Strengthen institutional and legal foundation for inflation targeting
 - ☑ Assist the government in maintaining fiscal discipline and minimize potential distortions from realizing contingent liabilities
 - ☑ Strengthen financial institutions' soundness

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Looking forward: long-term constraints

- Institutional and legal foundations for inflation targeting
- ⌘ Need to have the new BOT Act in place
 - ☑ Institutional commitment to maintaining price stability and safeguarding stability of the financial system
 - ☑ Increased policy transparency and accountability
 - ☑ Independence in conducting monetary policy
 - ⌘ The passage of the new act will demonstrate Thailand's commitment to a credible monetary policy framework.

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Looking forward: long-term constraints

Fiscal discipline and threats from contingent liabilities

⌘ Inflation targeting may breakdown because of fiscal dominance.

⌘ The BOT needs to ensure that fiscal discipline is maintained.

- ☑ Step up analysis of government's fiscal programs, their financing needs, and contingent liabilities
- ☑ Regularly inform the public of such analysis
- ☑ Strengthen coordination between monetary and fiscal policy

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Looking forward: long-term constraints

Fiscal discipline and threats from contingent liabilities

⌘ FIDF liabilities must be managed in a transparent and accountable manner.

- ☑ Need not be mixed with other contingent liabilities of the government
- ☑ Need to have government's commitment to fiscalizing all FIDF losses to preserve BOT's policy independence and credibility
- ☑ Maturity of FIDF liabilities needs to be well structured to reduce money market fragility

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Looking forward: long-term constraints

Strengthening remaining financial institutions

⌘ Blanket deposit insurance is the largest source of government's contingent liabilities.

⌘ Key issues

- ☑ Limited capital cushion at some financial institutions
- ☑ Competitiveness of small institutions and mechanisms to facilitate their consolidation
- ☑ Uncertain future of intervened banks and mechanisms to minimize ongoing losses
- ☑ Establishment of good credit culture

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Final remarks

⌘ The credibility of BOT's inflation targeting framework has been established.

- ☑ Delivering low core inflation
- ☑ No rising inflation expectation
- ☑ Preference to keep inflation low

⌘ Looking forward

- ☑ Could the BOT be more accommodative to growth, while keeping core inflation within the target range, by lowering the R/P rate?
- ☑ How can the BOT and the government work together to minimize monetary policy constraints in the long term?

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