

“The Major Challenges during my tenure as the Governor of the BOT”

Speech given to Mitakai members

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Professor Kato,

Chairman Shimada of Bangkok Mita Kai,

Distinguished guests,

Ladies and gentlemen,

I'd like to extend my deepest appreciation to Mitakai for throwing this party for me on the occasion of my retirement. My special appreciation goes to our beloved Professor Kato, who has given me the great honor of flying in from Japan to join this party, in spite of his age and less than favorable physical condition.

I'd also like to thank all of you for the opportunity to speak to this audience regularly in the past four years during my tenure as the Governor of the Bank of Thailand. It has always been a pleasure to speak and listen to fellow alumni of Keio University and to be so warmly welcomed by members of the Mitakaievery time.

This evening, I'd like to take this opportunity to talk about the major challenges during my tenure as the Governor of the Bank of

Thailand during the last four years and draw some lessons and implications going forward.

The past four years have been a turbulent time, both politically and economically. I had the honor of receiving the Royal appointment of the King to be the 21st BOT Governor on November 8, 2006. During those four years, I had worked with 5 finance ministers and 4 prime ministers. The Bank of Thailand has in deed become a pillar of stability amid the political turmoil. Economically, challenges were also abound, due to political uncertainties and external economic developments including capital flows, high commodity prices leading to inflation in the first half of 2008 and global economic crisis that hit violently after Lehman Brothers collapsed in September 2008.

The first major challenge came soon after I became the Governor. In December 2006, baht appreciated rapidly. More importantly, there was a strong wide-spread belief of a one-way bet that baht would only appreciate further. In fact, we had started to see significant capital inflows and baht appreciation since the middle of 2005. In 2006, inflows continued. In addition current accounts improved because of increased exports and lower imports, as a consequence of sluggish domestic demand. A number of soft measures had been implemented, including measures to discourage inflows and to require longer holding period of foreign bond holders. None were able to slow down the inflows. Baht appreciated more than all other currencies in the region, even though the Thai economy

was growing the least in the region. Export was the only sector propelling the economy. Government investment had been sluggish. So had been private investment as a consequence of excess capacity in some sectors since the Asian crisis and in some other sectors lack of confidence due to political instability. The BOT became increasingly concerned that the strong currency may hurt the export sector, which was the only economic engine working and may have serious implication especially on small and medium exporters who are usually highly labor intensive and do not get the benefits of strong currency due to their low import contents. If the adverse impacts prolonged to the extent that these exporters were not able to survive, there would be adverse implication on employment and consumption, increasing the fragility of the economy.

After a careful study of stronger measures, the BOT decided to impose a 30% reserve requirement on capital inflows, the so-call URR or Unremunerated Reserve Requirement. It lasted slightly over a year until February 2008. The URR was widely criticized as a draconian measure. But it was effective under the constraints and economic situation at the time in that it was able to bring about movements of the currency that were more two-way and more in line with other regional currencies. It also allowed time for the BOT to set up its monitoring system to have daily data instead of weekly data like before.

The second major challenge I faced was the difficult task of anchoring inflation expectation during the first half of 2008 and shoring up confidence and supporting the economy after the onset of the global crisis in the second half of 2008. You probably recall that our inflation started to climb since the last quarter of 2007 from 2.5% in October to 9.2% in July 2008 due to high commodity and oil prices and improved domestic demand. Some of you may also recall that the BOT was under tremendous pressure not to hike policy rate. It was reported in the media almost on a daily basis that certain advisors of the then finance minister were strongly against higher policy rate, since in their opinion, it was a cost-push inflation and raising interest rate would only add more misery to the masses.

The point was that, higher cost was only one cause. Inflation was higher because of the higher domestic demand as well. This was clearly evident from the increase of core inflation, an index that shows inflationary pressure from the demand side, which went up from 1.2% in January 2008 to 3.7% in July 2008. Hence, raising policy rate to abate inflationary pressure from the demand side and anchor inflation expectations was necessary. The MPC therefore decided in their July meeting to hike policy rate by 25 basis points, followed by another 25 basis point hike in their August meeting.

I'd like to emphasize that it is of critical importance that central banks maintain price stability so that economic growth can be sustained without booms and busts. To do so, central banks must act

credibly by taking pre-emptive actions to anchor inflation expectations. Since it takes 4-8 quarters for changes in policy rates to go through transmission mechanism, early pre-emptive actions will avoid the need to have drastic policy changes at the last minute.

The second half of 2008 was drastically different from the first half. The Lehman brothers' collapse in September brought the world's worst crisis since the great depression. The direct impact of the 2008 global crisis through the Thai financial sector was negligible because of the strong fundamentals and the high risk awareness and strong risk management as a consequence of the financial sector and supervisory reforms after the Asian crisis. However, the indirect impact through the trade channel was sudden and substantial. Export growth in October slowed to 3% from 20% a month earlier, before contracting by 30-40% in the following months. The MPC in December decided to slash policy rate by one full percentage point, followed by three more successive rate cuts from 3.75% to 1.25% in April. The speed and the magnitude of policy rate cuts were unprecedented. They sent a strong signal to the private sector of the BOT's strong commitment to shore up the economy, which helped boost the private sector's confidence and reduce its financial burden. The timely monetary policy together with fiscal stimulus contributed to the fairly rapid recovery. The economy grew from a negative growth rate in the last quarter of 2008 to a growth rate of 5.8 % in the last quarter of 2009. The recovery continued and in its

July and August 2010 meetings, the MPC decided to start its policy normalization by raising interest rate.

The third major challenge was to push for the amendment and passage of four important laws, namely the Bank of Thailand Act, the Financial Institutions Businesses Act, the Deposit Protection Act, and the Currency Act. Learning from the 1997 crisis, the Bank of Thailand realized that there was a need to revamp these financial laws and started the drafting a year after the crisis. Several attempts had been made over the decade to try to push for the passage of these laws without success. The window of opportunity came in 2007, a year after the coup, when several academics and people from the business and financial sectors who were well-versed in financial matters and understood the importance of these financial laws were represented in the Parliament. However, it was still an uphill task for me and the staffs to try to present the case for the legal amendment to different stakeholders, both private and public sectors, interest groups, the media, committees and sub-committees of the Parliament. The proposed draft laws represented significant changes which may have been difficult to understand for the masses. After endless rounds of meeting and lobbying, we were able to successfully convince the law makers and get the Parliament to pass three laws, the fourth one, i.e., the Currency Act was withdrawn by the Finance Minister due to its sensitivity and lack of support.

The new laws have brought significant changes to the country's financial infrastructure. Specifically, the Bank of Thailand Act endorses the independence of the central bank. The Governor has a term of five years and can be dismissed only when there is an explicit reason that he or she has wrongful misconduct, dishonest performance, gross incompetence or incapability in performing duties. Even though the five year term does not apply to me and I would be retiring at the retirement age, in order not to have personal gains from pushing for law changes, I did have the protection of the law about my independence. Thanks to the new Bank of Thailand Act, I was able to perform my duties until my retirement, without being dismissed, unlike many of my predecessors. In fact, out of the 21 governors of the Bank of Thailand, I was only the third to have served until retirement in the Bank's 68 years' history. Fortunately, from now on, all Governors should be able to stay full-term in his or her office.

In exchange for the Governor's independence, the new Bank of Thailand Act adds new check and balance mechanism. Specifically, the chairperson of the Bank of Thailand's Court of Directors will no longer be the Governor but will be an outsider selected through an independent process. However, the Governor still chairs all three policy committees, i.e., the Monetary Policy Committee, the Financial Institution Policy Committee and the Payment System Committee.

A central bank's job is to maintain long-term price and financial stability, a job that can be unpopular, especially when it has to tighten

the monetary policy to prevent an over-heating, and may clash with the Government, which by nature tends to focus on short-term issues. Therefore, It is of critical importance that central bank independence is guaranteed by law. I'm happy to say that the new Bank of Thailand Act is doing exactly that. It has set the stage for the Bank of Thailand to carry out its mandates independently for long-term sustainability of the economy.

As for the new Financial Institutions Businesses Act, it allows the Bank of Thailand to adopt international supervisory standards. For example, it will be able to take prompt corrective actions when an institution's required capital starts to show signs of weaknesses, enabling the institution to embark on an early corrective plan. Earlier under the old law, we would have to wait until there is a clear case of distress when the institution's required capital falls short of the legal requirement, by which time the problem will be much bigger and the corrective measure far more costly. The new Financial Institutions Businesses Act, no doubt, further enhances the supervisory and financial sector reforms that we have implemented since the 1997 crisis.

Here I'd also like to note that during my tenure, in the capacity of the chairperson of the FIDF, which is the policy arm of the Bank of Thailand in dealing with failed banks, we were able to privatize two remaining banks that the FIDF had acquired after the 1997 crisis. It's notable that both cases of privatization were successfully executed

amid the political turbulence and were able to fetch quite good prices. More importantly, the privatization marked the final chapter of the 1997 banking crisis, and the success provided another testimony about the Thai banking sector's strength.

As for the Deposit Protection Act, it aims to reduce the extent of deposit protection with no limit currently to a maximum of 1 million baht per account per bank, starting from August 2012. This will help reduce the issue of moral hazard especially of the large depositors who usually have the sophistication to ensure the safety of their deposits. At the same time, the Deposit Protection Act will be an impetus to banks to continuously improve their quality to gain the trust of depositors. Therefore this is another important piece of law that shapes the right financial infrastructure for our economy.

The fourth challenge that I had to face unexpectedly was to try to maintain the continuity of banking services during the political turmoil in April and May this year. In the middle of May when the Government declared a week of national holidays for schools and Government agencies, the Bank of Thailand, after close consultation with banks, decided that banks would remain open to provide banking services which would give a sense of comfort to the masses amid all the uncertainty. Bank branches that were close to the protest sites or had security concerns for their staffs and customers would be able to close based on their judgment. At the Bank of Thailand we also exercised our judgment about the safety of the staffs in commuting

and in case there might be a need for evacuation, so only staffs that were absolutely necessary according to our business continuity plan were required to report to work. With the banking system remained open and the reduced numbers of staffs both at the Bank of Thailand and commercial banks, some of whom had to shift their back-room operations to the back-up sites, the biggest challenge was to ensure that there would be no payment and settlement failure, both domestically and internationally. All ATMs needed to have sufficient cash for withdrawal to prevent panics, cheques and electronic means of payments needed to be cleared and settled to take effect at the normal time-table.

One of the most difficult decision to make came on May 18, when it appeared that the Government would clear the protest sites. Having declared an early closure of the banking system for that day, the option for the following day ranged from declaring a normal banking hours, in case the dispersal of protesters was successful and things would go back to business as usual, to early closure or to a bank holiday, in case the dispersal brought about more turmoil. In fact, I had to change my decision three times that day, because of the very liquid and volatile situations. In the end, as the footage of the burning of tires and buildings were being shown on TV, it became clear that declaring a closure of the banking business was the only option. The decision was followed by actions to make sure that there would be enough cash in all ATM machines and bank branches in shopping malls in safe areas remained opened.

Both the Bank of Thailand and all commercial banks worked hard and closely together throughout this entire period, and I'm proud to say that apart from a few minor glitches, our payment systems have proven to be quite robust. Throughout the entire period of political turmoil, we did not have a single episode of payment failure. Except for a period of three days at the very end of the turmoil, when we declared them bank holidays, the banking system was able to provide continued services. So we can proudly say that the Thai banking system is robust and resilient both financially and operationally.

Lessons and implications from the challenges

So, what are the lessons and implications from these challenges going forward?

First, on capital flows. Currently, capital inflow is becoming a huge challenge for emerging market economies because of their strong economic fundamentals vis-à-vis advanced economies. These days, even the IMF accepts that capital controls can be a short-term policy tool in dealing with capital flows if a country has enough foreign exchange, its currency is not under-valued and the inflow is deemed temporary.

Capital controls can take different forms. Apart from direct restrictions on inflows, my view is that under the current global condition, capital control is unlikely to be an effective solution to stop capital inflows and currency appreciation. This is because advanced economies will remain weak and exit from ultra-accommodative

policy regime is not likely to happen soon. As a consequence, emerging market economies will remain favorable investment destinations for an equally extended period. A few emerging market economies have started to impose taxes on short-term flows. This can perhaps extend the maturity of inflows to make them less volatile but may not be very effective in slowing down the total flow, unless the tax rate is punitively high.

But from the point of financial stability, as a macro-prudential measure, perhaps there is a need to strike a better balance between regulations and market-based behavior in global capital flows. This is very much in line with the current thinking about the need to strike a better balance between regulations and market-based behavior in the domestic financial sector. We all have learned from the 2008 global crisis that the financial sector should not be allowed to operate freely based on market mechanism but should be properly regulated. By the same logic, global financial flows should be adequately regulated. For example, hedge funds must be made more transparent and short-term investments, whose movements are volatile and disruptive, especially when there is a reversal of flows, can be made less attractive with a lower net after-tax return. In fact, under this context, imposing taxes can be viewed as a measure to adjust market return to reflect the adverse externalities of capital flows. I would view this measure as a macro-prudential measure to prevent financial instability rather than a capital control.

In the case of Thailand, where we also have a current account surplus, an effective way to slow down currency appreciation is to expedite our imports for infrastructure building, which we badly need. The private sector should also take this opportunity of strong currency to expand their operations in foreign markets or upgrade their local production technology and machinery.

The more fundamental way to deal with the problem of capital flows is for the U.S. to stop printing more money into the system and for international efforts and cooperation to build up a multi-currency international monetary system which will mitigate the over-reliance and excessive volatility associated with a single international currency regime.

We have learned from our experience after the 1997 crisis that accommodative monetary policy is useful in lessening the financial burden of debtors and financial institutions. But with an impaired financial sector, the transmission mechanism of accommodative monetary policy is also significantly impaired, and monetary policy becomes less effective to revive growth or create employment. This was what we had witnessed with the first quantitative easing of the U.S. as well. It helped reduce the burden of debtors, especially mortgage loan borrowers, stabilize the housing and the financial sectors and shore up market confidence. In my view, with the still weak financial sector, the second round of the Fed's quantitative easing will not be able to do what the first QE could not accomplish,

namely revive growth or employment. It would only add more liquidity to the global system and worsen the problem of capital flows and global inflation prospects.

For the sake of a robust global economy going forward, we need to have a strong U.S. economy, because of its sheer size. For that, the U.S. needs to do serious fiscal reforms, which will create some fiscal room for fiscal stimulus in productivity building, a strategy that will benefit the economy both in the short and long runs.

As for the building of a multi-currency international monetary system, some strong and large economies, such as China have a significant global leadership role to play. Currently, the Chinese foreign exchange market is gradually opening up and renminbi is expected to become more convertible. In fact, anticipating these developments, towards the end of my tenure, the Bank of Thailand decided to apply for and was granted a license to open a representative office in Beijing to monitor and better understand China's new initiatives. A faster financial integration of China to the global economy and a more flexible exchange regime will no doubt add more stability to the global capital flows.

Secondly, on the issue of price and financial stability. After my departure, in its latest meeting on Oct 20, the MPC decided to maintain the policy rate for the time being, citing the risk that decelerated global growth, due to an increase in uncertainty in the world economy and financial markets compared to the last MPC, may

adversely impact Thai exports. It appeared that the MPC decided to pause in order to further observe and assess risks to growth and inflation. If upcoming indicators show continued robust recovery, the MPC would need to resume policy normalization since keeping interest rate at an unusually low level for too long in spite of the continued robust recovery and buildup of inflationary pressure runs the risks of inflation as well as the buildup of asset price bubble. Capital inflows also add to the risk of asset price bubble. It's important to maintain financial stability and if necessary, macro-prudential measures to reign in excessive asset price increase can be adopted.

Thirdly, even with the support of the new financial acts that have been passed, it's important that both the supervisors and supervisees do not become complacent. Continued vigilance on risk identification and management are critically important to ensure a strong and resilient financial sector, especially in anticipation of higher competition when the market has to open up in a few years, according to the time table of our Financial Sector Master Plan and the Asean Economic Community Plan.

During the last days in my office, I was able to finalize with Thai commercial banks on an arrangement to substantially reduce the fees they charge on payment services. I was glad that I was able to do it after about three years of discussion. A financial sector must serve the economy by providing quality services at low cost, and that will in

turn support further growth of the financial sector. In essence, the economy and the financial sector must grow hand in hand. It would not be in anybody's interest if the financial sector were to have a life of its own, like what we witnessed in the U.S. before the global crisis, where the financial sector had very many financial innovations that added little value to other sectors of the economy, apart from to the financial sector itself . Going forward, the Bank of Thailand and the financial community will need to continue to work closely together for further improvement and new developments for a better serving, more efficient and more inclusive financial sector.

Before I end, let me once again thank the Board and members of the Mitakai both for the past supports and for this occasion.