



THE OMFIF CONVERSATIONS

Tackling global shifts Protectionism and technology change

Veerathai Santiprabhob



May 2017

This is an edited version of an OMFIF Conversation with Veerathai Santiprabhob, governor of the Bank of Thailand.

The accompanying articles are taken from OMFIF flagship publications.



Veerathai Santiprabhob has been the governor of the Bank of Thailand since October 2015. Santiprabhob has more than 20 years of experience as a policy economist in public, private and international institutions.

He was chief strategy officer of The Stock Exchange of Thailand and executive director of the Capital Market Development Fund and Capital Market Research Institute. Santiprabhob has been an economist at the International Monetary Fund and served as a co-director of Policy Research Institute, Fiscal Policy Office. He was a senior executive of Siam Commercial Bank and an independent director at Thai Airways International, Thanachart Capital and a number of leading corporations.

Santiprabhob holds a BA (Economics) (1st Class Hons) from Thammasat University and AM (Economics) and a PhD (Economics) from Harvard University.



Danae Kyriakopoulou is chief economist and head of research at OMFIF. She oversees the company's flagship publications and helps develop research relationships and programmes with public and private sector institutions across the world.

Kyriakopoulou was managing economist and deputy head of the Macroeconomics Division at the Centre for Economic and Business Research in London where she led the organisation's global research. She has served as external economic adviser to the Institute of Chartered Accountants in England and Wales for sub-Saharan Africa and Greater China and has worked at the Research Department of the Bank of Greece.

Kyriakopoulou read Philosophy, Politics, and Economics at Brasenose College, Oxford, and has an MSc in Economics for Development from the Oxford Department for International Development.

TACKLING GLOBAL SHIFTS FACING GLOBAL PROTECTIONISM



Danae Kyriakopoulou: I'd like to start by asking how worried are you about the shifting tides in global monetary policy, especially in the US? The Federal Reserve has resumed its tightening path and Donald Trump's plans for expansionary fiscal policy have increased incentives for the Fed to act more aggressively against rising inflation.

At the onset of quantitative easing, capital flowed into emerging markets that offered higher returns and now they are exposed. The taper tantrum was the first flavour of stronger responses. How worried are you about the vulnerability of the Thai economy to capital outflows or sudden stops? How well prepared is the economy?

Veerathai Santiprabhob: I believe that the Thai economy has been well prepared for that. Our external positions are relatively strong compared with other emerging markets. Our international reserves are three times the size of short-term external debt.

Foreigners' participation in the domestic bond market is on the low side. Non-residents hold 8%-9% of total public bonds outstanding, and most of these bonds are denominated in Thai baht.

On corporate borrowing, the amount of foreign currency borrowing is not substantial. In addition, most corporate borrowers have incurred foreign borrowings for their international operations. The Thai financial system also has ample liquidity. Should sudden capital outflows occur, I don't think the Thai economy will be vulnerable.

Kyriakopoulou: If anything, it sounds like you're too over-hedged. Do you think that this is a reaction to the Asian crisis? There is clearly a trade-off between supporting growth in the short term and adopting a prudent approach as you have done. If you have had a more flexible approach this time, do you think Thailand could have had higher growth?

Santiprabhob: I do not think we are too over-hedged under the current global volatility and uncertainties. Moreover, our fiscal engine is working and monetary conditions have been accommodative. Thai corporates, Thai banks and also policy-makers learned big lessons from the Asian financial crisis. In the world of uncertainties, it does not hurt to be cautious.

“Our external positions are relatively strong compared with other emerging markets. Our international reserves are three times the size of short-term external debt.”

Kyriakopoulou: Policy-makers are shaped by the crises that they experience...

Santiprabhob: ...and corporations as well, large corporations and commercial banks learned lessons from the Asian financial crisis.



“Investors in emerging markets have come a long way in understanding the differences across countries.”

Having said that I would like to emphasise how resilient economic structures we have built are. Our vigilance has helped us address weak spots in our economy with right policy, unlike when the Asian financial crisis erupted.

Kyriakopoulou: You make a convincing case for strong fundamentals in the Thai economy and the data support this. But to what extent are you worried that investors sometimes don't really look at the fundamentals of a particular economy, but they might think emerging markets, as a whole, are vulnerable? That was an important factor in the Asian financial crisis. Thailand was relatively more vulnerable and its fundamentals weaker compared to the region. But while other economies, such as Singapore, were more robust, they still got similar treatment. This was partly what gave rise to a new generation of models to explain currency crises, so we have certainly come a long way in terms of modelling such episodes. Do you think investor behaviour and approach have also come a long way?

Santiprabhob: Investors in emerging markets have come a long way in understanding and differentiating economic conditions across countries. What has happened in Asian emerging markets more recently could reflect how investors reacted differently across the various countries with different economic fundamentals and political situations.

Kyriakopoulou: Another important factor is the exposure to China. We saw the differential approach of the markets to different Asean economies. Malaysia was the one that was hit particularly hard during the taper tantrum and its currency depreciated the most. Its economy has very close ties to China. But Thailand is also an open economy and integrated in the supply chains of China, so how worried are you about a downturn there? The election of Donald Trump has created a very real possibility of a more protectionist attitude to China. This would have an indirect impact on the Thai economy as well and investors will no doubt be paying attention to that.



“You've kept interest rates at a near record low, but there have been pressures on you to lower them even further and you've resisted that.”

Santiprabhob: Among different external risk factors, we are most concerned with a rising trend towards trade protectionism. As it's not only an issue between the US and China, but it's also going to be a global problem.

If protectionism is a new paradigm of global trade, it will have adverse impacts for all countries. Thailand is a small open economy which is well integrated into the global supply chain of many manufacturing sectors. So, we would be affected by trade protectionism. At this point, we have to wait and see how the US administration will implement trade policy going forward and how other major countries will respond. International trade policy is very complicated, and the devil is in the detail.

Kyriakopoulou: The external factors are one of the things that you look at as a monetary policy-maker. You've kept interest rates at a near record low, but there have been pressures on you to lower them even further and you've resisted that. Looking at central banking trends around the world, how worried are you about the unintended consequences of extraordinarily loose policies?

Santiprabhob: As an emerging market economy, we are concerned with possible spillovers from the unconventional monetary policies of advanced economies, especially through capital flows and too much leverage. Even though the Bank of Thailand believes that our monetary policy has to remain sufficiently

accommodative, we need a framework that better considers adverse consequences of policy easing. In particular, we need a policy framework that also takes into account financial cycle and financial stability.



“Lowering rates is one way of encouraging lending, but another is to strengthen the transmission mechanism.”

We should also be reminded that when many countries adopt loose monetary policies, other countries might be under pressure to follow in order not to allow their domestic currency to appreciate. Further policy spillovers are generated.

Kyriakopoulou: And beyond the effect through financial markets there are also the concerns on exchange rates. Here there are further policy spillovers in the sense that many countries would also have to ease monetary policies, with a view to not allowing their domestic currency to appreciate. Which is something, of course, that doesn't work if everyone is doing it, so that is another concern.

Santiprabhob: Exactly. With very low interest rates, loose monetary policies would trigger search for yield behaviours, and could result in pockets of financial fragility, as has been observed in both global and domestic financial systems. The total size of corporate loans has accelerated sharply in some countries during the past five years.

Kyriakopoulou: ...Many of those loans in emerging markets, including dollar-denominated corporate loans, have been increasing substantially. How do you see this developing in the future?

Santiprabhob: Now, with the policy normalisation and the reversal of flows, countries that have very large foreign-currency denominated corporate loans will find it a challenge to roll them over.

If very low rates and loose monetary policies persist in the long term, the spillover effects will continue and financial fragility will increase over time. We will be able to observe these consequences globally.



“If very low rates and loose monetary policies persist in the long term, financial fragility will increase over time.”

Kyriakopoulou: These are more the side effects, if you like, of too easing policies, but what about the core issue of monetary transmission? Lowering rates is one way of encouraging lending, but another is to strengthen the transmission mechanism, to increase the possibilities for small and medium-sized enterprises that don't have access to collateral, to borrow through the use of technology. Information-based lending, I think, is something that your bank is exploring.

Santiprabhob: Yes, there are many technological changes in financial markets. Fintech would be very helpful in improving financial access and inclusion. For instance, fintech would allow SMEs to access financing for working capital, through supply chain financing or factoring. SMEs would benefit substantially from technology advances by lowering transaction costs from invoice processing and ensuring that those invoices are authentic and transferable.

Kyriakopoulou: It is as if the developments in technology are creating the potential for fintech to become a new source of financing...

Santiprabhob: Financial inclusion is not only about access to credit. With rapid developments in e-commerce platforms, access to electronic payment infrastructure is equally important. E-commerce platforms would broaden SMEs' markets from their local community or province to the global level. We, thus, need to have good and efficient payment systems.

Kyriakopoulou: Also, it would constrain the underground economy in some occasions, when transactions happen in e-commerce platform or through the use of technology.



Santiprabhob: The informal economy can also benefit from these technologies. Their operations will become more transparent and it will be easier to comply with tax and accounting regulations. Electronic payments will also reduce leakages in government's welfare payments, many of which are currently done in cash.



“There are multiple dimensions to deal with cybersecurity on top of technology investment. What matters equally is how people use technology.

Kyriakopoulou: Certainly, fintech has a lot of benefits for development, but there are also risks. At OMFIF we are calling 2017 the year of cybersecurity. This is becoming increasingly important for central banks.

The private sector has been much more on the cutting edge of this. How important do you feel that is? What level of resources do you devote to that? What practices do you employ?

Santiprabhob: Cybersecurity is crucial not only for the central bank's operations, but also for the whole banking community. We need to develop capabilities to deal with cybersecurity in a big way. It is not simply investing in newest technology, but also dealing with how banks, regulators, and enforcement agencies work together to combat cybersecurity threats, how commercial banks build trust among themselves to be able to share information on cybersecurity incidents.



“You need close co-operation with banking associations to strengthen the skills of personnel and banking professionals working on cybersecurity.

Kyriakopoulou: Certainly a very sensitive issue. No doubt you need a very trusted platform for that as well as close co-operation with the banking associations to strengthen the skills of personnel and banking professionals that are working on this.

Santiprabhob: Yes, and you also need a proper regulatory framework to ensure that banks comply with international cybersecurity standards. This is particularly important for emerging markets with a shortage of cybersecurity professionals. There are multiple dimensions to deal with cybersecurity on top of technology investment. What matters equally is how people work and use technology. They need to be financial technology literate, as their workplace could be an open door for threats to their institutions. ■

GENERAL PROFILE: THAILAND

General information

Population
67.96m

GDP (Current \$)
\$390.6bn

GDP growth
3%

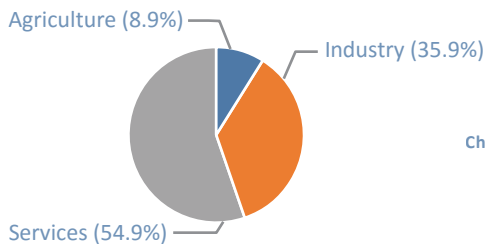
Policy rate
1.50%

Land area
510,890km²

Exchange rate (\$/Bht)
34.6

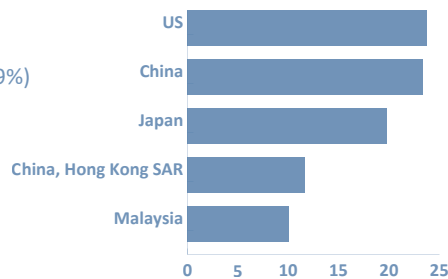
Economy composition

GDP by sector of origin



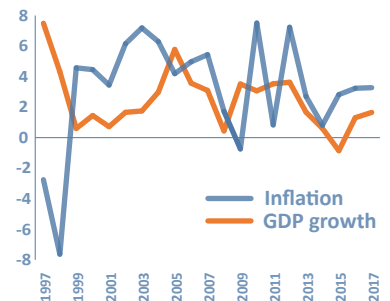
Top 5 trading partners

Exports from Thailand, \$bn



Performance

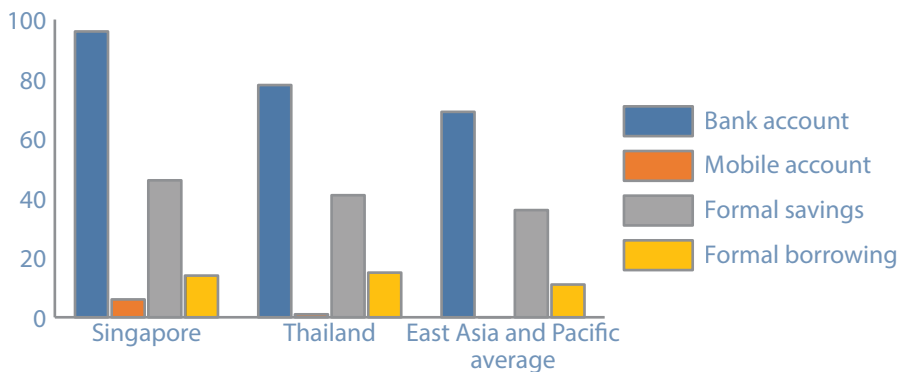
GDP growth and inflation, %



Financial inclusion

Thailand has a higher rate of financial inclusion than the regional average

% of population over age 15



Asean 5 country	Bank account	Mobile account	Formal savings	Formal borrowing
Singapore	96%	6%	46%	14%
Malaysia	81%	3%	34%	20%
Thailand	78%	1%	41%	15%
Indonesia	36%	<1%	27%	13%
Philippines	31%	4%	15%	12%

- Thailand has been an upper-income economy since 2011.
- The economy has enjoyed sustained strong economic growth and significant poverty reduction.
- Although partially hindered by the Asian financial crisis, Thailand still had average growth of 3.5% between 2005 and 2015.
- The long-term goal of the country has been economic reforms including human capital investment, economic stability and environmental sustainability.

CASE STUDY: ASIAN FINANCIAL CRISIS

Background

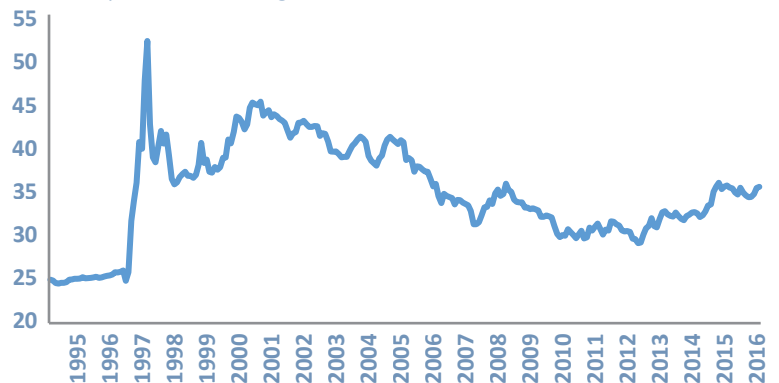
Countries most affected by the 1997 crisis



- A period of financial crisis from July 1997 that gripped much of East Asia.
- The currency markets failed first in Thailand as a result of the central bank unable to peg the local currency against the dollar.
- Currency declines spread rapidly through South Asia causing stock market declines, slumping asset prices and a rise in private debt.

Thai government forced to abandon the dollar peg

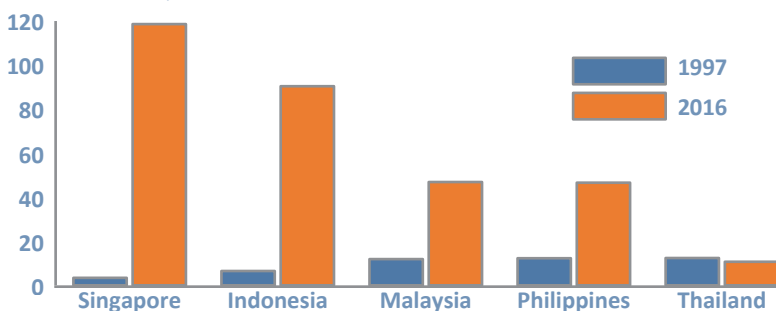
Thai baht per dollar exchange rate, \$/Bht



Resilience of the Thai economy

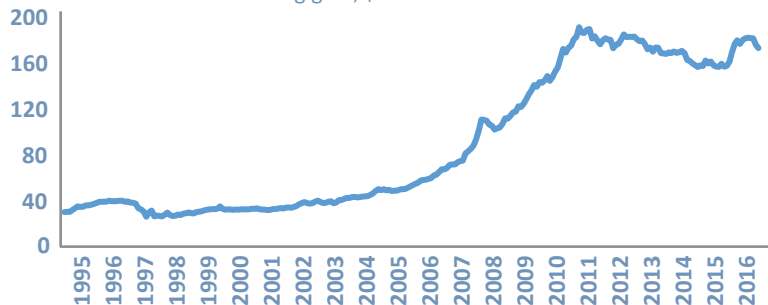
Thailand has the lowest external debt in Asean-5

External debt, \$bn



Thailand's reserves near historic high

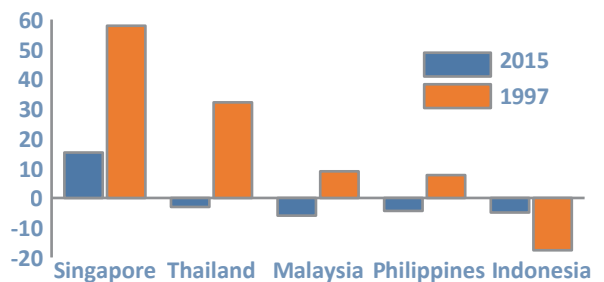
Total reserves including gold, \$bn



- In August 1997, Thailand agreed to take on tough economic measures for a \$17bn bailout from the IMF.
- The Thai government has since passed laws to establish strong frameworks for financial regulation and bankruptcy.
- Thailand's economy had recovered by 2001. Since then it has taken significant precaution against future economic shocks.

Second-largest regional surplus after Singapore

Current account balance, \$bn





Thailand's ambitious reforms

Making the most of its potential

Veerathai Santiprabhob

Central banks in Asia have become more mindful of financial stability in the aftermath of the 1997 crisis. The Thai experience is illustrative. After lowering interest rates to 1.5% in the second quarter of 2015, the central bank has kept rates unchanged despite relatively soft growth, even though headline inflation was below target. This reflects the central bank's recognition of the wider context and set of factors which are muting the monetary transmission mechanism.

Structurally, Thailand is affected by many of the same fundamental forces that are suppressing inflation and growth in advanced economies. They include an ageing population, rising income inequality, and the transition to a services-orientated economy. This evolution is dampening investment, since modern services are less labour- and capital-intensive than manufacturing.

The resistance to lowering rates even further also reflects financial stability concerns in the light of high household debt and evidence of search-for-yield behaviour among investors. The latter is leading to risky shadow banking activities. The central bank's desire to maintain room for manoeuvre reflects a

long-term framework that recognises the limits of monetary policy.

The central bank has forecast 2017 growth will be broadly similar to 2016, while inflation should rise as the base effect from lower oil prices dissipates. With available fiscal headroom, government spending and investment, particularly on infrastructure, ought to stimulate growth. Externally, if the surprises that transpired last year in the global political and economic landscape are any indication, 2017 will prove to be a challenge. Here, Thailand's high foreign exchange reserves, around 3.2 times short-term foreign debt, and its strong current account position, should provide adequate buffers.

Thailand's main challenges remain microeconomic in nature. A key growth engine in past decades has been the productivity gains from structural transformation, whereby labour moves from low-productivity agriculture to high-productivity manufacturing and services. This has stalled, and even reversed, of late. To reinvigorate growth, Thailand needs to upgrade education and skills, streamline regulations that shackle business, catalyse public and private investment in key infrastructure, and establish means of spurring innovation. There is great potential for Thailand to use its geographical advantage in the middle of the Greater Mekong subregion close to rapidly developing economies like Cambodia, Laos, Myanmar, and Vietnam.

The government recognises these priorities and is embarking on an ambitious reform agenda. It has already implemented several legal and governance reforms affecting business. Small and medium-sized enterprises stand to benefit, both in terms of lower operating costs and greater financial access.

Thailand is considering a comprehensive reform of the governance of state-owned enterprises. Given their size and critical role as provider of basic infrastructure, state-owned enterprises exert a significant influence on overall economic efficiency. However, the existing regulatory framework is complicated by a large degree of overlap among the relevant government agencies and a lack of overriding authority. The proposed establishment of the National State-owned Enterprise Corporation, with a clear separation of government responsibilities as policy-maker, regulator and owner, could bring tremendous improvements in resource allocation.

The Bank of Thailand's overriding focus is on strengthening the Thai financial system to serve the economy through fundamental technological improvements. As the backbone of all economic activities, the payment system and infrastructure are critical to efficiency and stability. Policy-makers can enhance financial connections with neighbouring countries through various means, including promoting currency use for regional trade. Moreover, in recognition of the potential for innovative financial platforms to increase efficiency and expand financial inclusion, Thailand has launched a limited-regulation 'sandbox' approach to facilitate fintech development – similar to the policy already undertaken in Singapore.

The policy strategy is clear. Thailand must make use of its strong macroeconomic fundamentals to push through critical microeconomic and structural reforms and unleash productivity improvements. The challenge is one of execution.

“The central bank's desire for room for manoeuvre reflects a long-term framework that recognises the limits of monetary policy.”

“The Bank of Thailand's overriding focus is on strengthening the Thai financial system to serve the economy through technological improvements. The payment system and infrastructure are critical to efficiency and stability.”

This is an abridged version of Santiprabhob's speech given at an [OMFIF City Lecture](#) in London on 10 January.



Scales tilted against relenting stimulus

Pervasive side-effects of monetary easing

Veerathai Santiprabhob

Policy-makers are too often preoccupied with the technical management of our instruments. Most of our energy is devoted to analysing the latest economic developments and deciding on the size and timing of our actions. But a more urgent and important task is getting the paradigm right.

If one gets the paradigm right but the details wrong, the damage will generally be limited. If you move policy instruments slightly too much or a few months too soon, it won't matter very much in the long term. But if policy-makers get the paradigm wrong, the resulting harm will be severe, as the same mistakes are repeated again and again. It is therefore healthy to question prevailing paradigms.

Nine years on from the 2008-09 financial crisis, it is remarkable that policy rates in advanced economies are essentially zero or negative. Central banks are continuing to seek innovative ways to stimulate their economies. Developments are still cast in terms of 'the recovery' and the crisis mentality has yet to abate. During this period, which could aptly be called the 'great transition', we have seen remarkable things.

Weak link between demand and inflation

If someone had asked in 2007 what to expect if major central banks cut policy rates to zero for almost a decade, tripled their balance sheets, and bought up one-third of outstanding government bonds in their jurisdiction, few would have expected subdued price pressure and tepid growth to be the outcome.

The prevailing view is that inflation is low and recovery weak because the zero lower bound prevents central banks from lowering real interest rates enough to re-equilibrate the economy. That is, the actual real interest rate is too high relative to the equilibrium or natural real interest rate. This view rests on two key propositions: first, that the problem besetting economies is one of aggregate demand deficiency; and second, that low interest rates can offset this by encouraging individuals to bring future expenditure forward. But this prism, based on macroeconomic models, is too narrow given recent developments.

Globally, changes in the structure of trade, rising competitive pressures and forces such as falling oil prices have increased the influence of external factors on inflation. In individual jurisdictions, changes in labour market fundamentals mirroring changing demographics and reduced wage bargaining power have exerted a downward force on price dynamics. Meanwhile, the digital revolution has driven the prices of many services, such as

telephone calls, to almost zero. These forces have contributed to a weakening of the link between inflation and measures of economic slack. Low inflation can no longer be primarily attributed to insufficient aggregate demand.

Effects of monetary accommodation

These forces also account for weaker growth. For open economies, slowing world trade has undermined exports as a growth engine. Equally, the transition to services has contributed to growth headwinds by dampening investment, given that modern services are less labour and capital intensive than manufacturing. Investment is interest-sensitive, so the transition to services may have also made the economy less responsive to monetary policy.

“We need monetary policy that reacts to the financial cycle, in good times as in bad.”

The consequence is that many of the forces propelling inflation and output are structural and not easily amenable to monetary policy. These factors may limit the returns stemming from monetary ease. This would not be so much of a problem if monetary accommodation had no costs, but there are pervasive side-effects.

Persistent ultra-low interest rates and the increased presence of central banks raise concerns that policy-makers are distorting prices. Very low interest rates have driven a search for yield that has boosted asset prices globally, compressed risk premiums and supported high leverage. It is striking that global leverage, at 225% of world GDP in terms of gross debt of the non-financial sector, is higher than it was before the onset of the financial crisis.

There is a dichotomy between diminished monetary influence on inflation and output, and hypersensitivity of financial markets and asset prices to monetary policy actions. This raises a dilemma. Against structural headwinds, inflation and output fail to respond to monetary ease, and the temptation is to implement further easing. In the meantime, financial markets respond to low interest rates and the search for yield results in greater financial fragility over time. This has important long-term implications that current frameworks neglect.

The prevailing paradigm views monetary policy as a stabilisation tool for managing cyclical economic movements with no impact on the trend. But it is becoming increasingly clear that there is a direct link between the financial cycle and long-run output trajectories. Given that financial instability has long-term impacts on the economy, if monetary policy plays a role in influencing the likelihood and magnitude of a crisis, monetary policy has long-term implications.

This perspective calls for a reassessment of prevailing macroeconomic models that focus on flows and shocks but neglect stocks and states. The financial cycle is the thread that binds the challenges of today to the decisions of the past. This path dependency sharpens the trade-off between short-term inflation and output stabilisation, and financial fragility and long-term trajectories.

Based on this alternative perspective, the scales are tilted against unrelenting monetary stimulus. We need instead monetary policy that systematically reacts to the financial cycle, in good times as in bad. This differs from an approach in which policy leans against the wind only when risks to stability become evident. The alternative entails more flexibility on the delivery of inflation targets and longer horizons over which the effects of policy are judged.

Macroprudential tools not a panacea

Such a framework should be complemented by macroprudential tools. These are seen often as a useful way to offset the excesses that come of low interest rates. But macroprudential measures were originally envisaged as complements to monetary policy, rather than instruments to substitute or offset the effects of monetary or other government policies.

It is easy to believe that safeguarding stability is left to macroprudential tools while monetary policy focuses on inflation and output. But this would be like driving a car with one foot on the accelerator, trying to reach the destination as soon as possible, and the other foot on the brake making sure we don't crash. This is an especially precarious task if each foot belongs to different drivers.

The monetary policy paradigms that have got us where we are need to be openly reassessed. We have reached this juncture partly because of an unanchored financial cycle. More of the same will not do. ■

This is an abridged version of Veerathai Santiprabhob speech given at an [OMFIF City Lecture](#) in London.

The OMFIF Conversations

Previous OMFIF Conversations include:

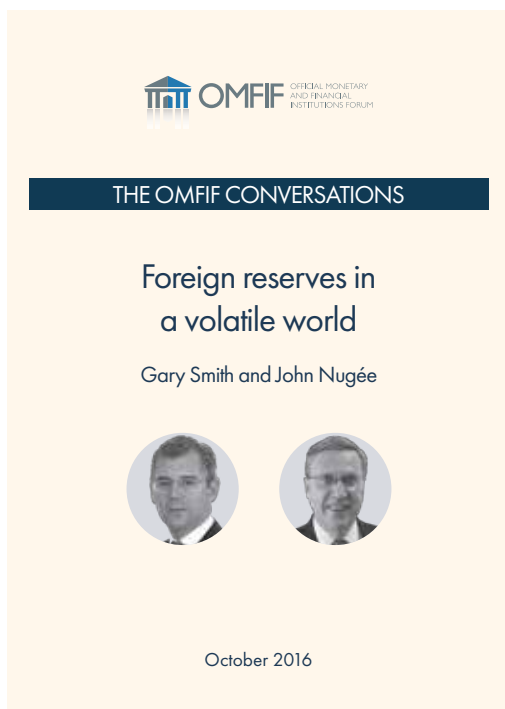


Development of the euro: Lessons for Europe

Jean-Claude Trichet, president of the ECB in 2003-11, elaborated on key episodes in development of the Europe's single currency in a wide-ranging OMFIF interview. He acknowledged the risks taken with his 'tough as possible' 2011 private letters to crisis-hit euro governments, blamed financial markets for failure to 'discipline' errant euro members before 2010, and outlined the evolution of his thinking on ECB independence.

He said European countries such as France should have supported political union at the time of the 1991 Maastricht conference, and spoke of an earlier 'extraordinarily difficult' rift over pan-European banking supervision, repaired only in the last four years with agreement on banking union.

On Greek debt relief, Trichet expected that loans would be restructured, provided Greece complied with conditions. 'Friendly taxpayers,' from creditor countries would 'make the additional big efforts in terms of net present value [adjusting the size and terms of loans] through different forms.'



Foreign reserves in a volatile world

Central bank foreign exchange reserves around the world are likely to start growing again as emerging market economies rebuild currency ammunition to counter economic shocks and capital outflows, according to Gary Smith, Strategic Relationship Management Team: Sovereigns at Barings, and John Nugée, formerly chief manager of reserves at the Bank of England. This was the key conclusion of a discussion accompanying the publication of the second report by Smith and Nugée for OMFIF on foreign exchange reserves management, 'Foreign exchange reserves in a volatile world'.

Despite the decline in global foreign exchange reserves in the 18 months to end-2015, the trend of reserves accumulation by central banks over the preceding 15 years is unlikely to go into full reverse, they say. The experience of reserves shrinkage will raise the perception of what counts as adequate, both for those managing reserves and those commenting on their actions, leading to higher overall holdings in the future.

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Dialogue on World Finance and Economic Policy

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