

Thailand's Exchange Rate Policy lessons from the past

Bhanupong

Lecture 22

Outline

- AFC revisited: Overvalued exchange rate
- Two definitions of the real exchange rate
- Implications of a flexible exchange rate regime
- QE and the impact on the Thai baht
- World trade is shrinking and is facing several headwinds
- What can the Russian Central Bank learn from the BOT?

Benefits of the fixed exchange rate

- Because volatility in exchange rates creates risks and uncertainties in trade and investment, a fixed exchange rate system provides stable environment to conduct trade with zero interest risk.
- Many countries peg their currencies with the US dollar.
- But when the dollar appreciates against other currencies, those pegged currencies also automatically rise against other currencies, eroding competitiveness.

The fixed exchange rate system prior to 1997

If the fixed exchange rate regime has been maintained far too long, it can create an illusion of zero foreign exchange risks.

- Premature relaxation of capital controls encouraged over-borrowing in foreign currencies.
- Currency and maturity mismatching of Thai commercial banks generated over-exposure to external shocks.

Nominal (ER) and real exchange rates (RER)

The first definition of the RER

$$ER = \frac{B}{\$}$$

$$RER = \frac{B / P^T}{\$ / P^U}$$

$$RER = e\left(\frac{P^U}{P^T}\right)$$

Gain in competitiveness

Depreciation

If $\Delta P_T < \Delta P_{USA}$



RER



If $\Delta P_T > \Delta P_{USA}$

Appreciation

Loss of competitiveness

Capital inflows prior to 1997 crisis

- A surge in capital inflows into Thailand began in the late 1980s and continued unabated until 1996.
- The flows generated high economic growth and surplus balance of payments and current account deficit.

Causes of rapid capital inflows

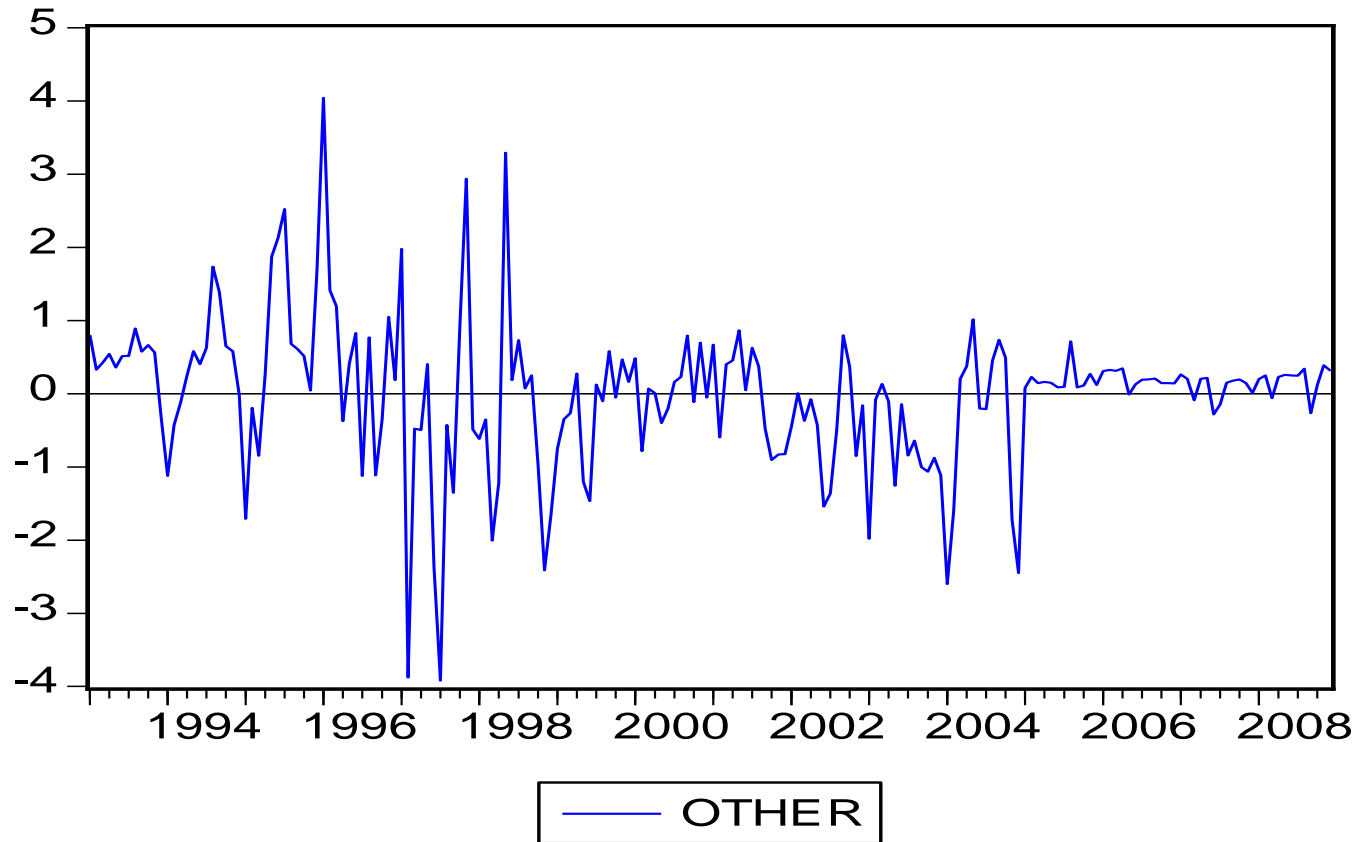
- A declining in world interest rates widened the interest rate differentials, inducing excessive foreign borrowings.
- Domestic financial liberalization increased the *sensitivity* of capital flows to interest rate differential.
- The measures undertaken to establish Thailand as a regional financial sector induced short-term capital flows through offshore borrowings by the nonbank private sector.
- The main culprit: Bangkok International Banking Facilities (BIBF)

Determinants of capital flows

$$K_f = \alpha + \beta(r - r_f) + \delta (\Delta Y / Y) \\ - \phi(Risk) - \eta(\Delta e / e)^E + \varepsilon$$

The important role of expectations

Speculative capital flows



Adverse Consequences of real exchange rate appreciation

- The second definition of the real exchange rate is the ratio of traded to non-traded good prices (P_t/P_{nt})
- The surge in capital flows led to the so-called “Dutch disease” which results in the appreciation of the real exchange rate (P_t/P_{nt}) and a consequent reduction in external competitiveness.
- In the Dutch disease, the current account deficit worsens since the price of non-traded goods (P_{nt}) rises faster than that of traded goods (P_t)

Currency and banking crises and related

- It is equally possible that currency appreciation can stimulate growth despite its negative impact on net exports.
- The crucial factor is the impact of the currency changes on bank credit.
- A country can experience currency appreciation and economic growth as long as domestic credit increases at normal phase.

Currency and banking crises and related

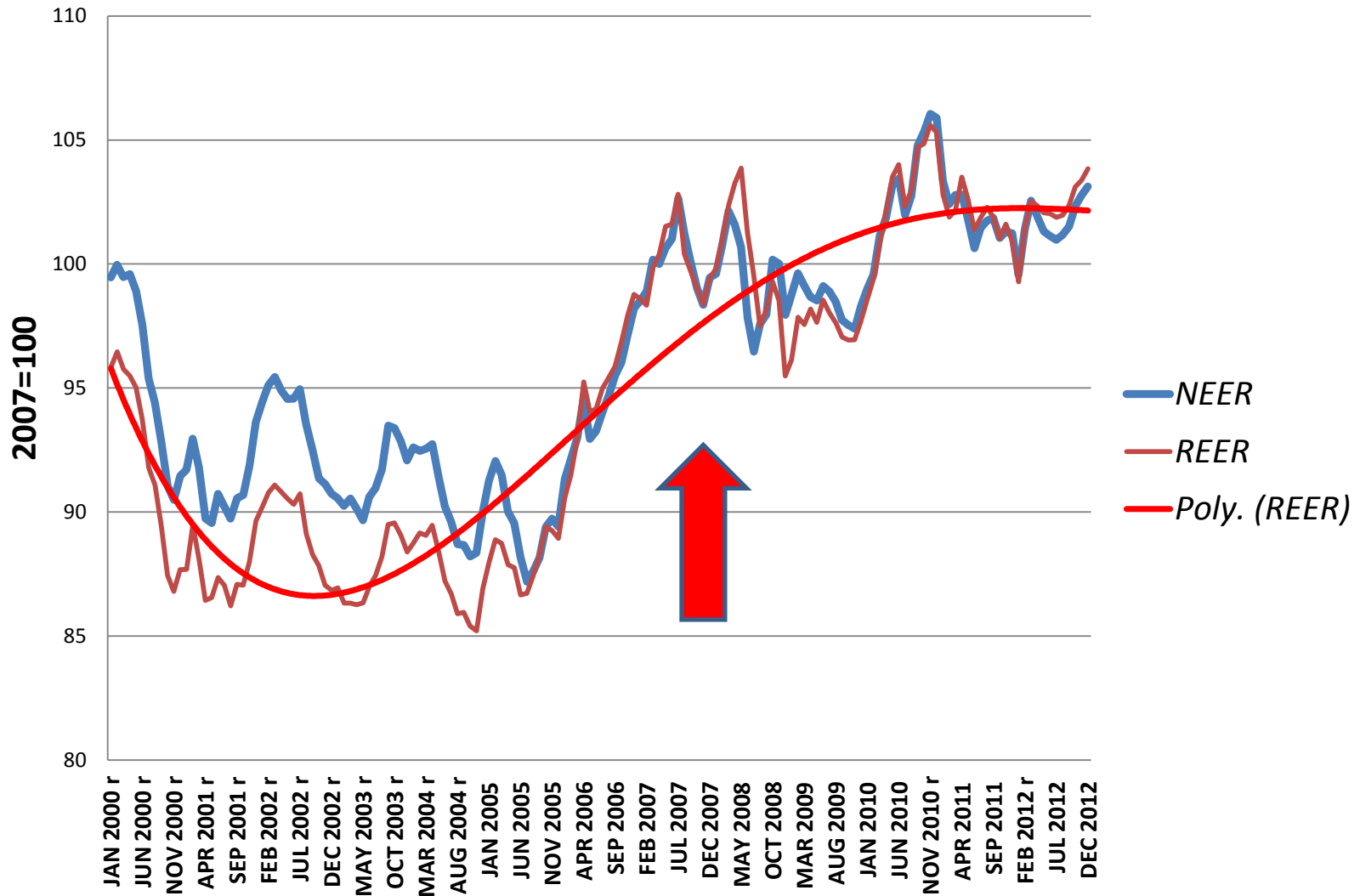
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Economic crisis in 1997/98

- With the baht succumbing to speculative attacks, the BOT floated the baht on July 2, 1997.
- Without a nominal anchor and given the lack of political credibility, the value of the baht fell by 56% through to January 1998.
- The deficit turned into surplus, thanks to income and substitution effects:
- Expenditure switching (depreciation) and expenditure reducing (lower output) policy

Effective Exchange rates: 2000-2012

Appreciation: upward direction



Policy credibility

- **Policy credibility** is essential for any country that adopts a floating exchange rate regime.
- The lack of institutional independence was evident in the high turnover of the Governors of the BOT and the Ministers of Finance during the period of turmoil.
- The Nukul Commission Report views that political intervention has weakened the ability of the BOT's crisis management.

Independence of the central bank

- ***Should the BOT has absolute independence from the control of the government?***
- Institution independence and policy instrument independence
- Correlation exists between high degree of central bank independence and low inflation.

Lesson learned

- Thailand faces the reality that the era of cheap foreign capital, zero foreign exchange risks, reckless investment, and spectacular growth is gone.
- A new era of economic rationalism would begin with investment efficiency and a sustainable growth path--albeit much less impressive.
- Do we really learn anything from the 1998 crisis?

Lessons from the currency crisis

- Capital inflows can have both positive and negative impacts.
- Thailand should have allowed the baht to appreciate during the boom years and satisfied with a lower growth rate in the early 1990s.
- Even if appreciating currency discourages exports, it is better to live with the resulted slow output growth rate and low foreign debt.
- (The so-called the new normal low GDP growth path)

Lessons from the currency crisis

- Since capital flows are many times larger than international trade flows, when a country relies too heavily on short-term foreign debt to finance a current account deficit,
- it is impossible for the central bank to defend a fixed exchange rate for very long—let alone to inflict wounds on currency speculators.
- (See the case of the Russian Ruble)

Lessons from the currency crisis

- Thailand also learned that accountability and transparency should be well established so that the central bank is not tempted to engage in behavior that is akin to gambling in order to get out of a crisis.
- But the Russian Central Bank has yet to learn from the BOT.

Flexible exchange rates

- Some instability in foreign exchange rates is a natural consequence of the adoption of a flexible exchange rate regime (slide 27).
- When Thailand floated the baht from its previous untenable fixed rate, the baht-dollar exchange rate experienced overshooting.
- Various factors contributed to this phenomenon, including speculative bubbles, price stickiness, the rapid strengthening of the dollar against the yen, political instability, and the lack of policy credibility.
- Market participants lacked experience in the flexible exchange rate system.

What is the appropriate level of the exchange rate?

- It is exceedingly difficult to determine appropriate exchange rates using purchasing power parity (burgernomics?) or the current account balance.
- The cost of intervention in foreign exchange markets could be too high to warrant the action.

What is the appropriate level of the exchange rate?

- Intervention should not be employed to ***change*** the direction of exchange rate movements.
- There is some room for the creation of an orderly and gradual movement of the exchange rate to reduce the amplitude of the swings.

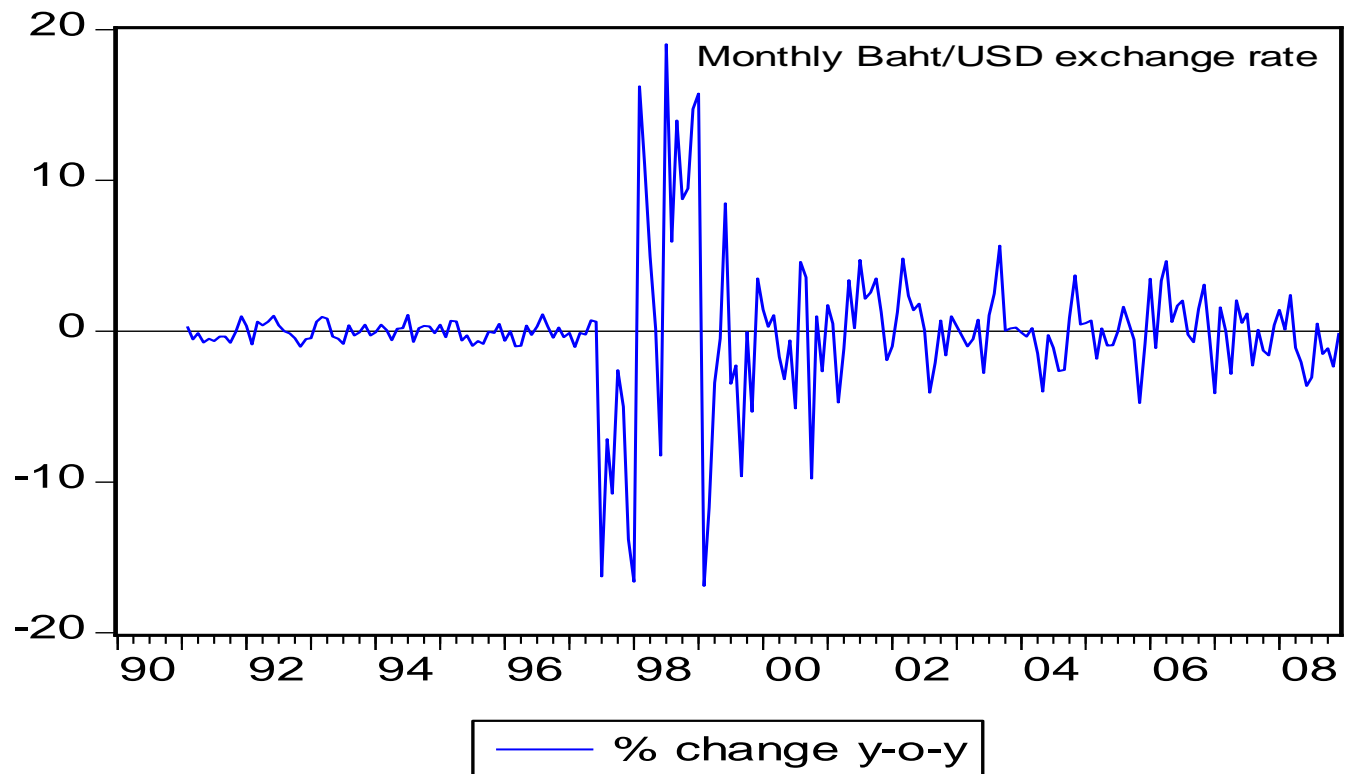
To discipline the government

- Flexible exchange rates can impose discipline on the government.
- Exchange rate movements trace the anticipated successes or failures of the government's economic management.
- Capital flight can be eliminated only with the establishment of sound macroeconomic fundamentals.

More benefits from a flexible exchange rate regime

- When imports are highly responsive to changes in absorption and when capital flows do not respond significantly to changes in international rate differentials, both **fiscal and monetary policy** can play an important stabilizing role.
- The flexible exchange rate is expected to **insulate** the economy from shocks originating in the goods markets.
- But it is asking too much to expect the flexible exchange rate to cushion instability originating from money markets hit by **crisis of confidence** in the financial system.

Refer to equation on the slide no.11



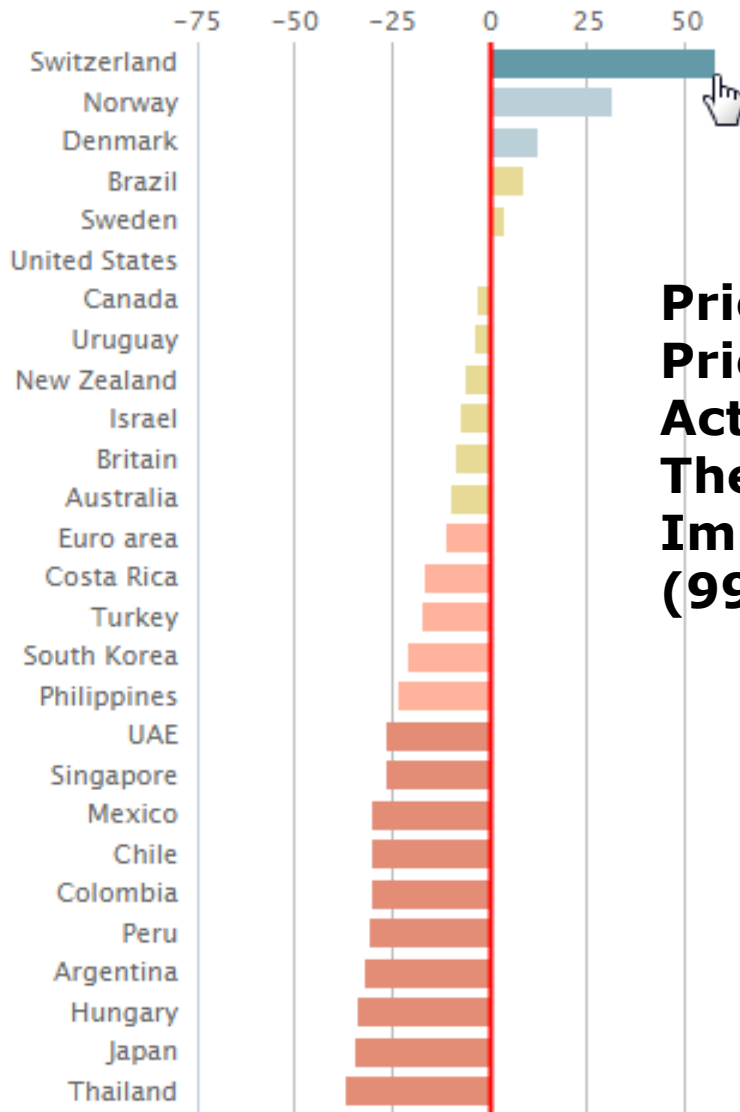
Should the baht be kept undervalued?

- It is a myth to assume a close link between currency depreciation and international competitiveness.
- Variations in Thailand's export growth can be explained very well by the fluctuation of world income.
- The strength of the US and Japanese economies is closely related with Thailand's export performance.
- The Big Mac Index (Burgeronomics)

The Big Mac Index

- The Big Mac index was invented by *The Economist* in 1986 as a **lighthearted** guide to whether currencies are at their “correct” level.
- It is based on the theory of purchasing-power parity (PPP), the notion that in the long run exchange rates should move towards the rate that would equalize the prices of an identical basket of goods and services (in this case, a burger) in any two countries.

January 2015



Price in USA: \$4.79
Price in Thailand: \$3.04 (99 baht)
Actual exchange rate: 32.6 baht/\$
The baht is undervalued by 36.6%
Implied exchange rate: 20.7
(99 / 20.7 = 4.79)

20.7 baht to \$?
This is ludicrous!

Burgernomics

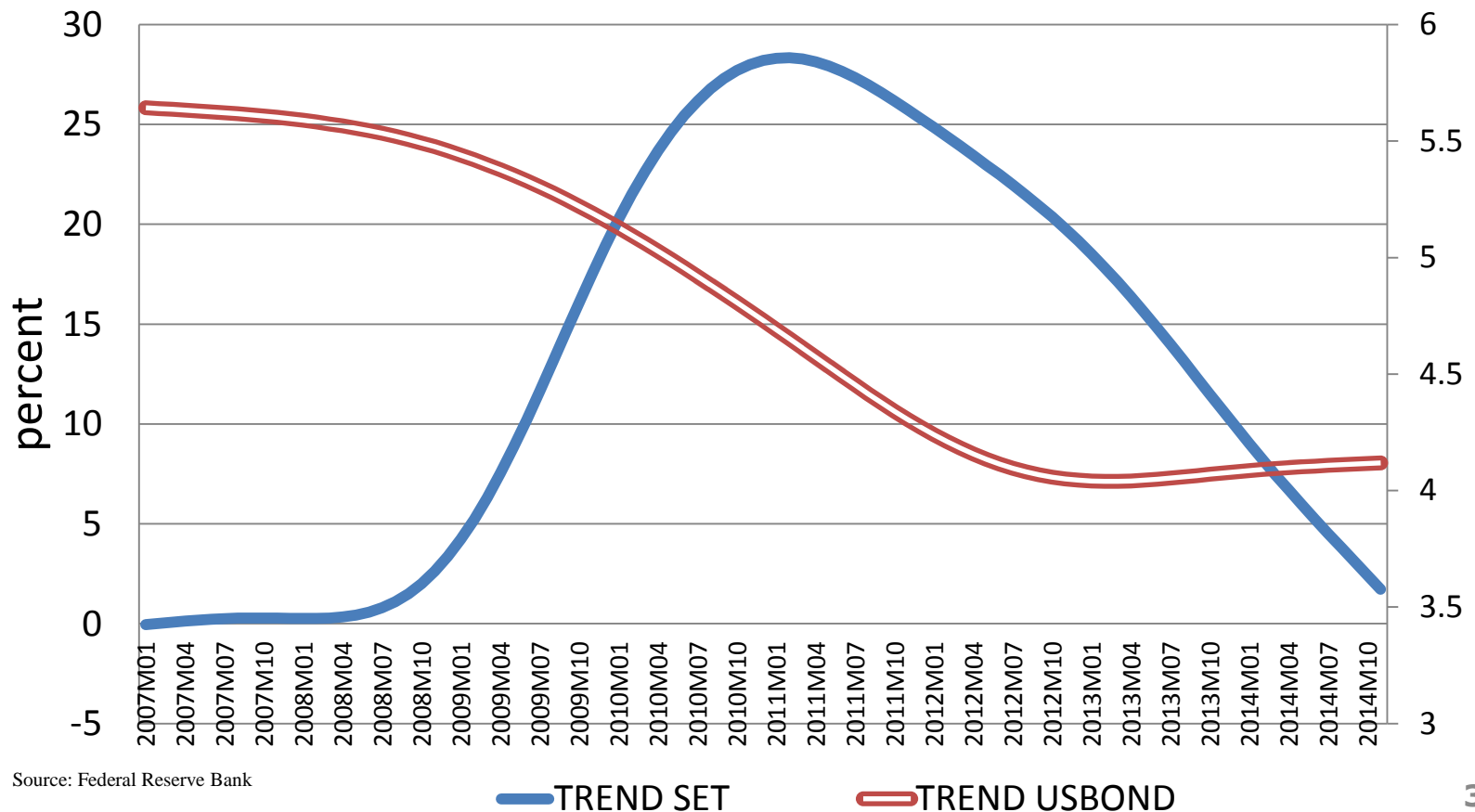
- Burgernomics was never intended as a precise gauge of currency misalignment, merely a tool to make exchange-rate theory more digestible.
- Big Mac is regarded as expensive food in some countries, while it is regarded as inferior food in high income countries.
- It is certainly not traded goods in the sense of purchasing parity and the law of one price.

Determinants of the baht-dollar exchange rate

- When the dollar appreciates (**depreciates**) against major currencies, baht depreciation (**appreciation**) is a natural consequence.
- Inflation differentials, interest rates, and output growth matter.
- Should the Bank of Thailand raise (**reduce**) the interest rate to prevent baht depreciation (**appreciation**)?

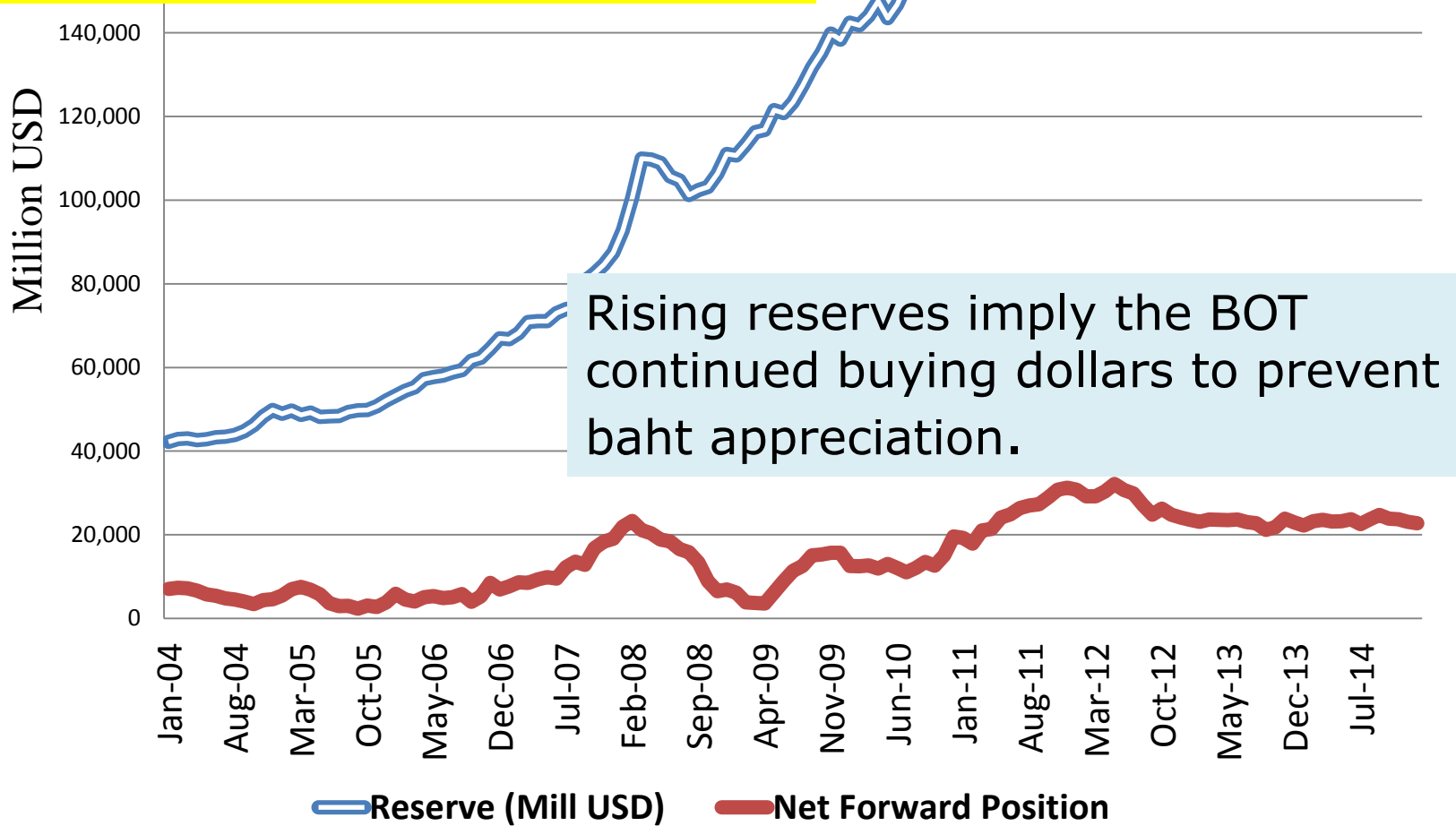
Huge capital inflows to Thailand between 2008 and 2011

Trends of SET Returns and US Bond Yields



Source: Federal Reserve Bank

Thailand's level of international reserve reached the all-time high at 181 billion USD in May 2011, thanks to the capital inflows as repercussions from the QE.



Property bubbles

- Rising asset prices in the property sector leads to expansion in bank credit and vice versa.
- The steady rising level of property credit for real estate development and personal housing perpetuate asset price bubbles, which are aggravated by speculation.

Property in Sweden

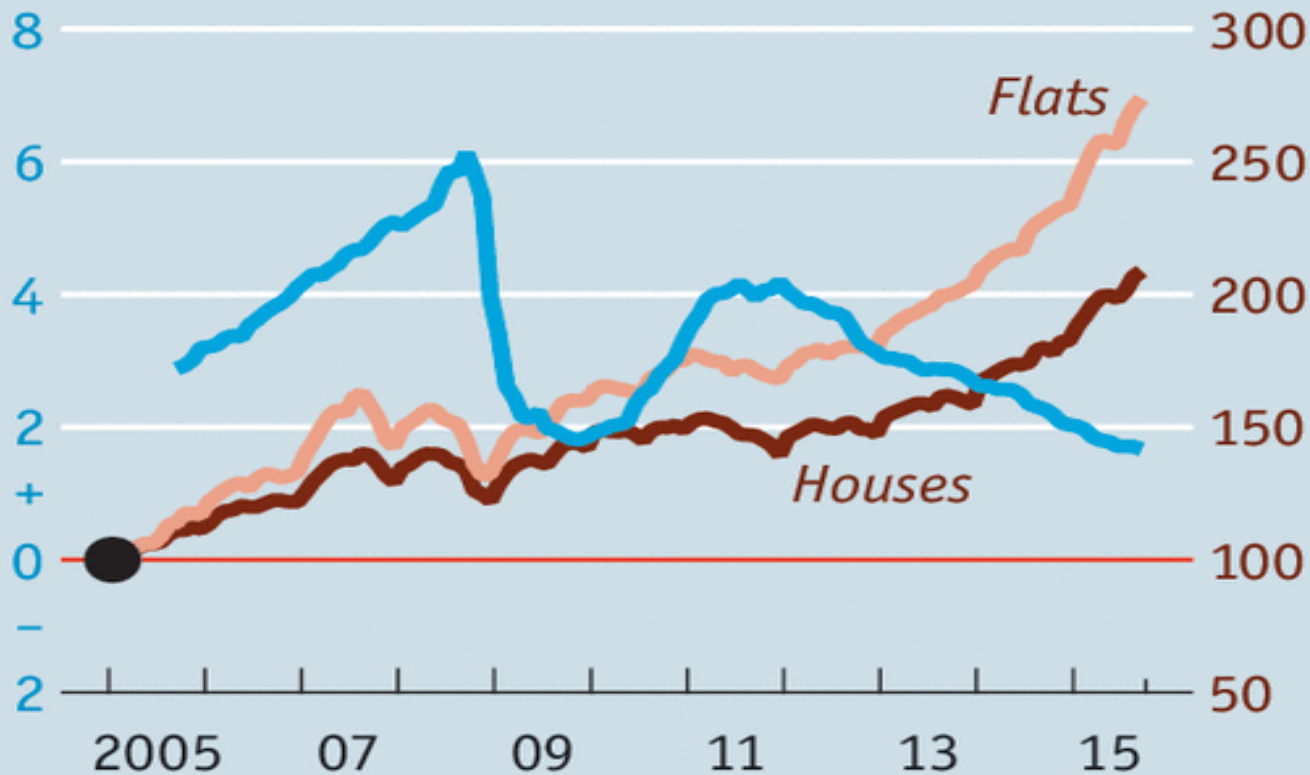
- Sluggish and restrictive planning procedures limit supply: the current shortage of around 150,000 homes is expected to triple by 2025.
- A counterproductive rent-control regime has crimped the supply of flats in particular, and led to long waiting lists.
- Earlier this year an apartment in central Stockholm went to someone who had been in the queue since 1989.

Cheap money, expensive property

Sweden

*Average interest rate,
New housing loans %*

*Prices
January 2005=100*



Sources: Statistics Sweden; Nasdaq OMX; Valueguard

Home is where the heartache is

- The most obvious way to calm things down is to raise rates. But the Riksbank, Sweden's central bank, tried that in 2010-11, with disastrous results.
- Unemployment stopped falling and inflation soon withered, stirring fears of deflation.
- That prompted the Riksbank to reverse course in late 2011 and **start cutting rates again**.
- The benchmark has ended up lower than it was to begin with, at -0.35%, increasing the sums flooding into housing.

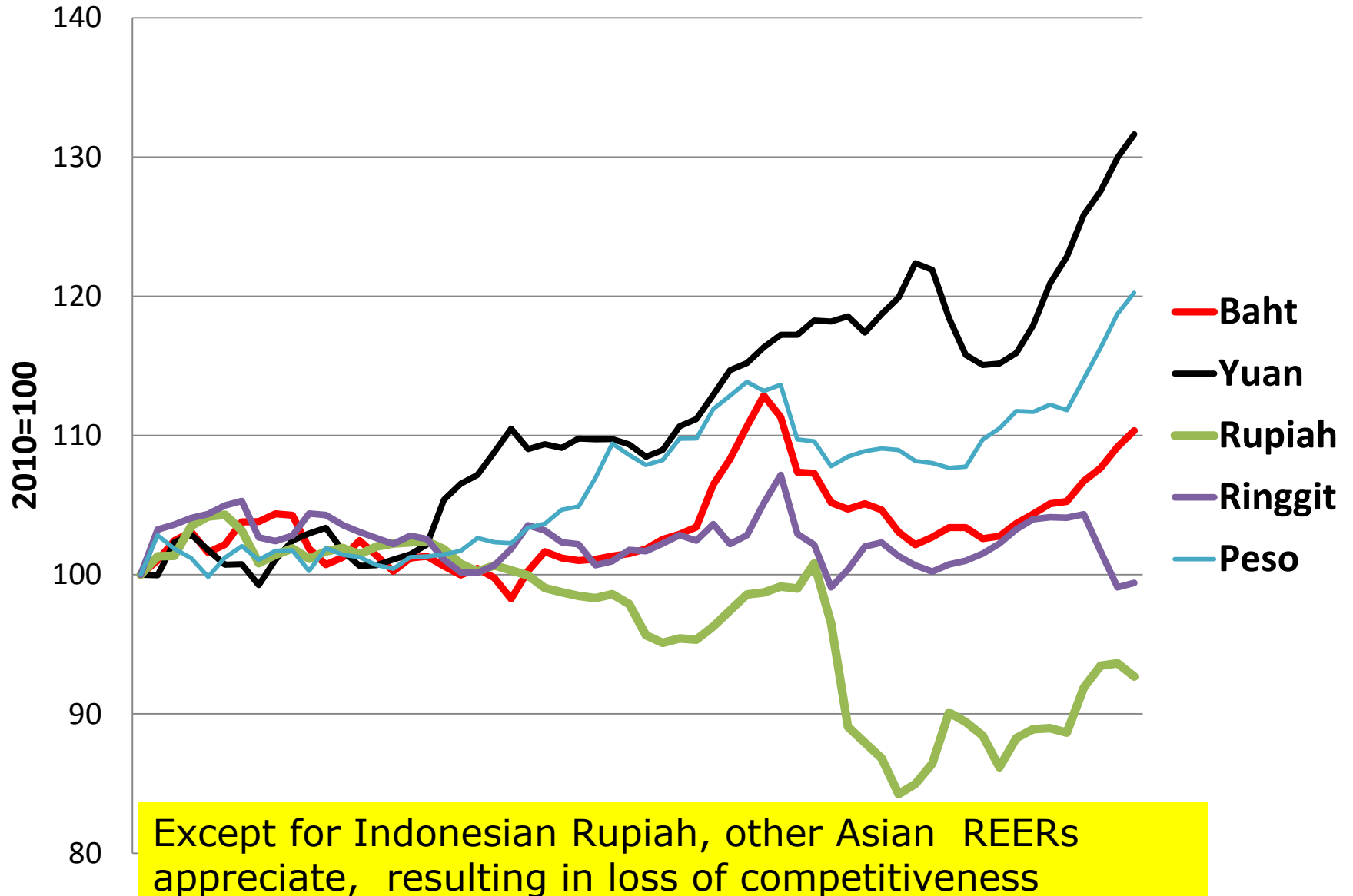
House prices in Sweden continue to soar, to regulators' despair

- Low interest rates have given Swedes the capacity to borrow more, pushing prices ever higher.
- The debt of the average household has reached 172% of income after tax.
- For people with mortgages in the big cities, the figure is nearly double that.

Dutch disease

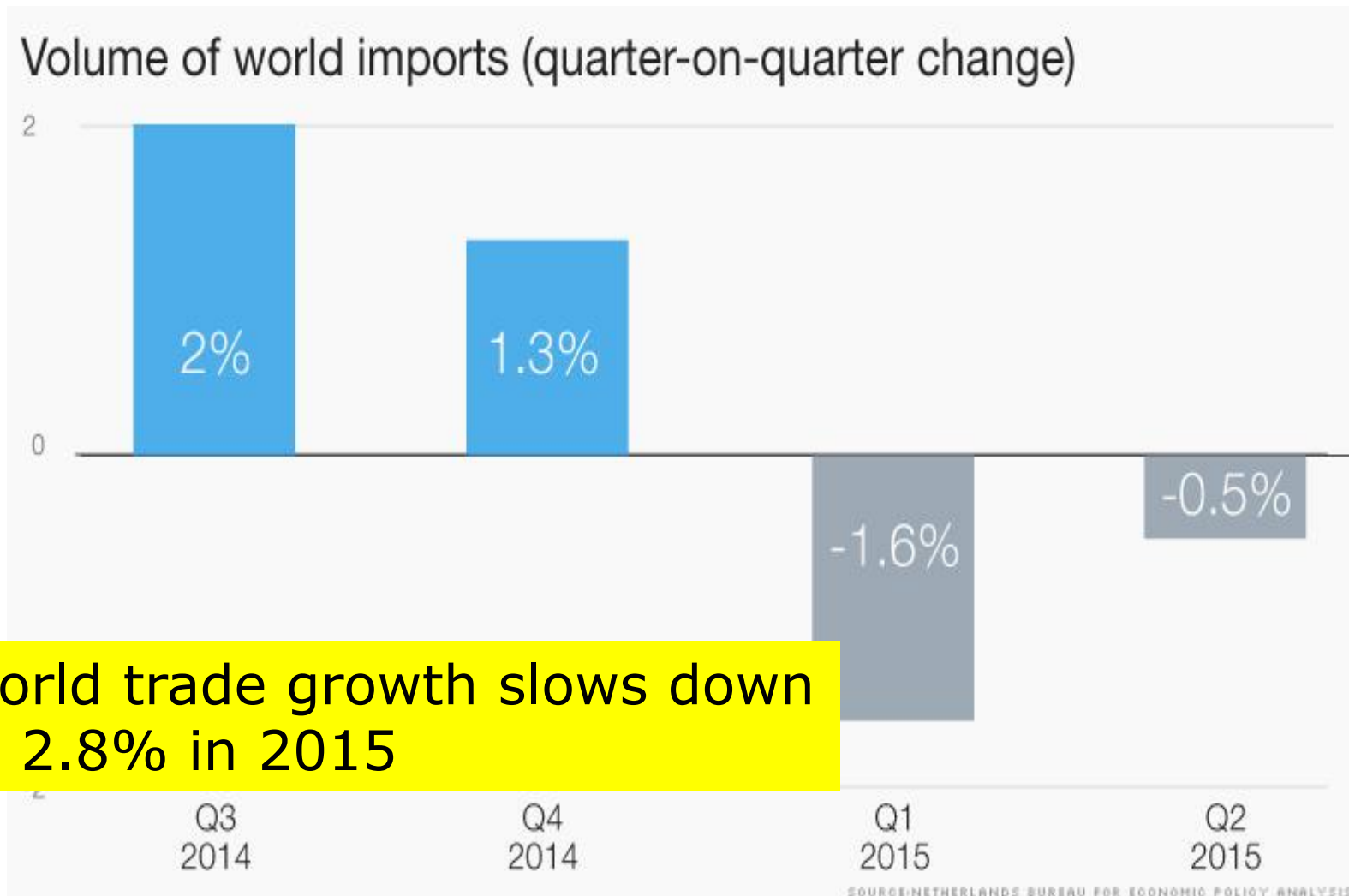
- Excessive credit growth in the non-trade sector causes relocation of resources to non-traded sector, while the export sector is shrinking.
- The situation is akin to the Dutch disease, when the real exchange rate appreciates, shifting resources from the traded sector to the non-traded sector.

Index of Real Board Effective Exchange Rates



Except for Indonesian Rupiah, other Asian REERs appreciate, resulting in loss of competitiveness

Slowing world trade is bad news for the economy



World trade growth slows down to 2.8% in 2015

The volume of world trade grew by 13% in 2010 but has faltered since then.

- **Unless the world's biggest economies speed up efforts to make it easier to trade, the slowdown could get worse.**
- The WTO has just lowered its forecast for growth in trade volumes this year to 2.8% from 3.5%, well below the average of 7% seen in the two decades leading up to 2007.

World trade grew 7% on the average from 1997 to 2007

- The eurozone countries account for one third of global trade, and sluggish growth there is a big reason for weak trade figures.
- Then there is the slowdown in China, which once sucked in huge numbers of imports, and the decrease in trade between Russia and the West because of the chill in relations over Ukraine.

Concluding remarks

- If the export engine of growth is damaged by the appreciation of the baht against the dollar, fiscal policy must be employed to counteract economic downturn.
- Given political instability and the loss of investor confidence, expansionary fiscal policy is less effective when undertaken during the absence of consumer confidence.
- The military coup in May 2014 rules out the use of fiscal policy to offset the fall of exports, because of the interruption in the fiscal budget process.

Concluding remarks

- As a result, Thailand's exports barely grew in 2014 and GDP growth rate declined from 2.3 percent in 2013 to 0.7 percent in 2014.
- Notwithstanding the economic slowdown, the stock market and property prices are booming, thanks to capital inflow from other parts of the world.

Russian ruble hits all-time low as support reduced

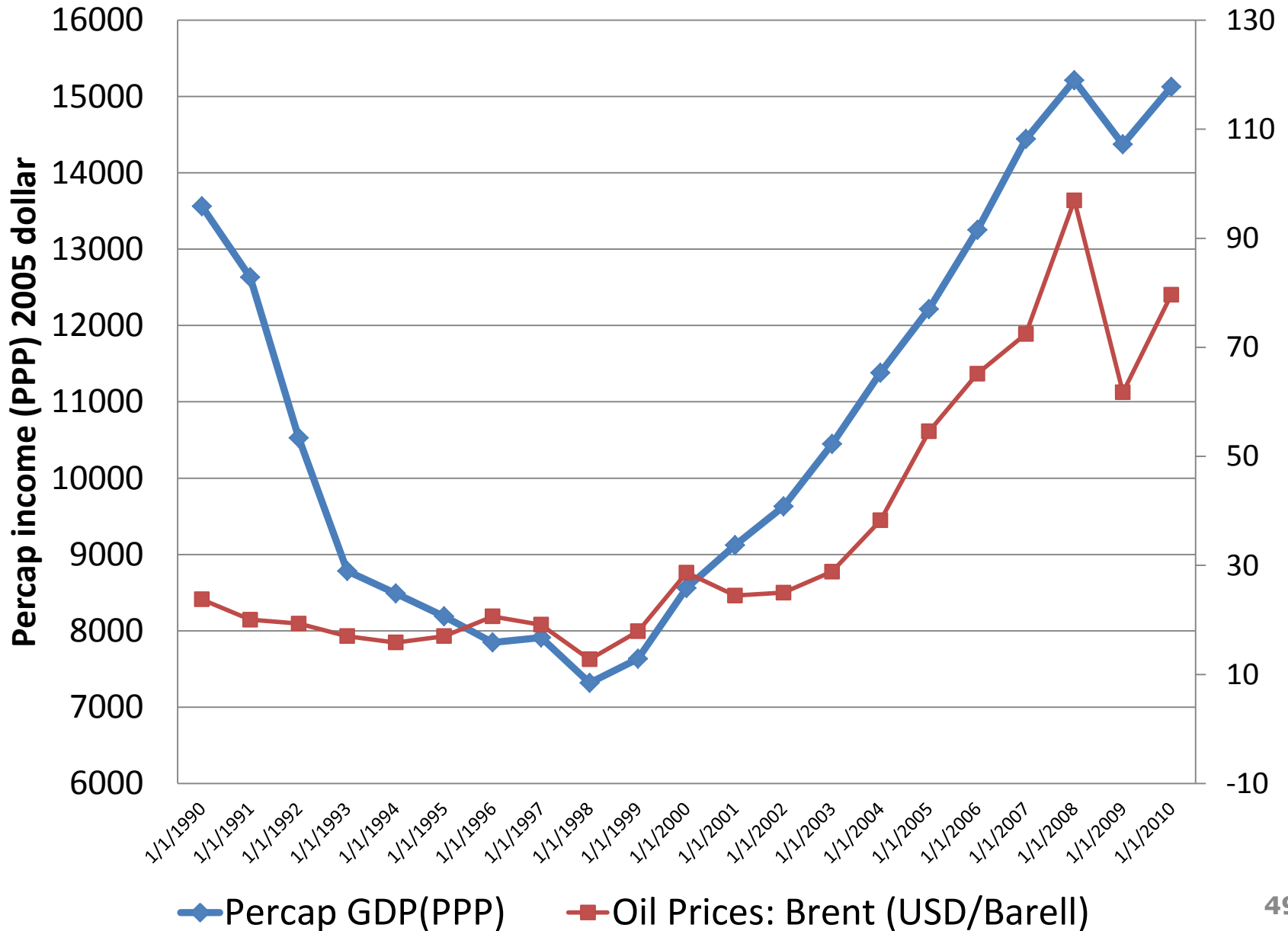
November 6, 2014

- As confidence in the Russian economy wanes, supporting the ruble is proving increasingly difficult — and expensive.
- The ruble has lost more than 25 percent this year amid concern over economic sanctions from the United States and the European Union as well as a fall in the price of oil and gas exports.
- The Russian Central Bank said it would limit its intervention in markets to **\$350 million** a day.

What a difference a year makes

- The central bank spent as much as \$3 billion a day in October trying to support the ruble.
- The announcement saw the ruble drop 3 percent in the day to 44.9 to the dollar in late trading on the MICEX exchange in Moscow.
- **A year later (November 6, 2015) the ruble hit 63.4 to the dollar, representing a 41 % (y-o-y) depreciation.**

An Oil-Driven Economy: Russian Federation



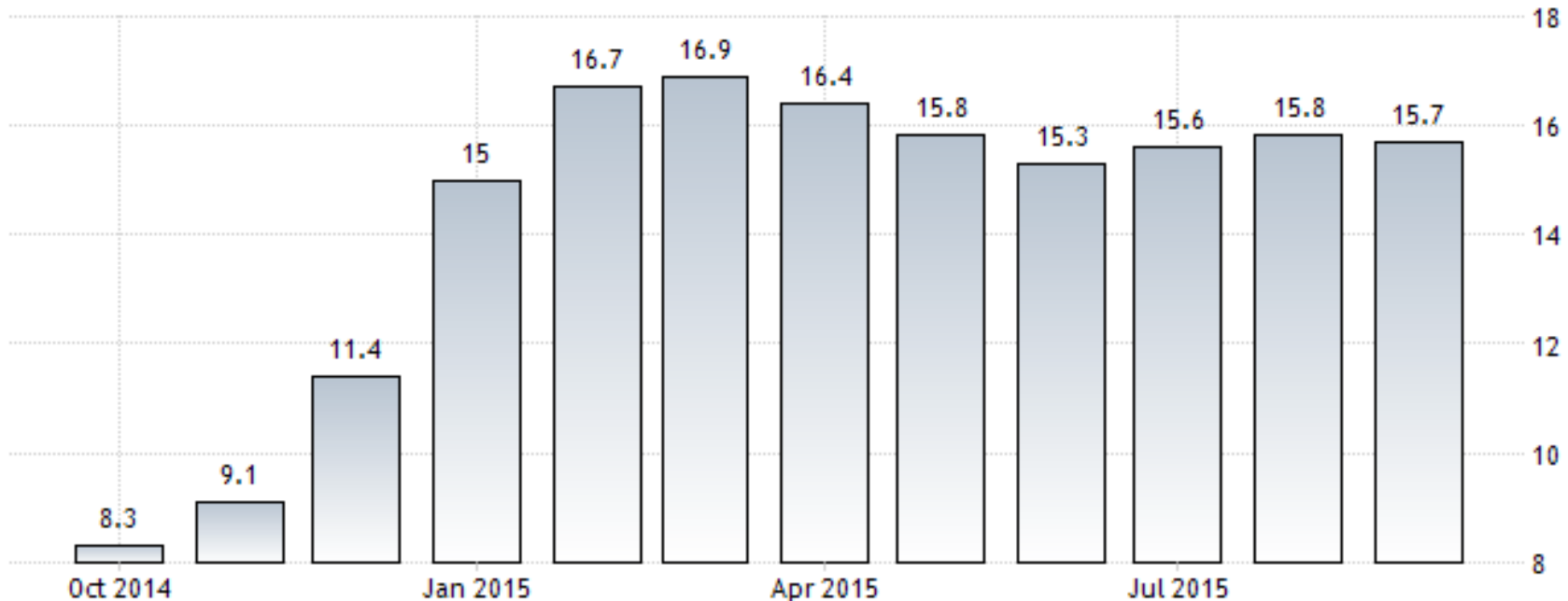
Russian Ruble (per USD)



Too difficult and too expensive to support

Russia Inflation Rate: consequences of currency depreciation

RUSSIA INFLATION RATE

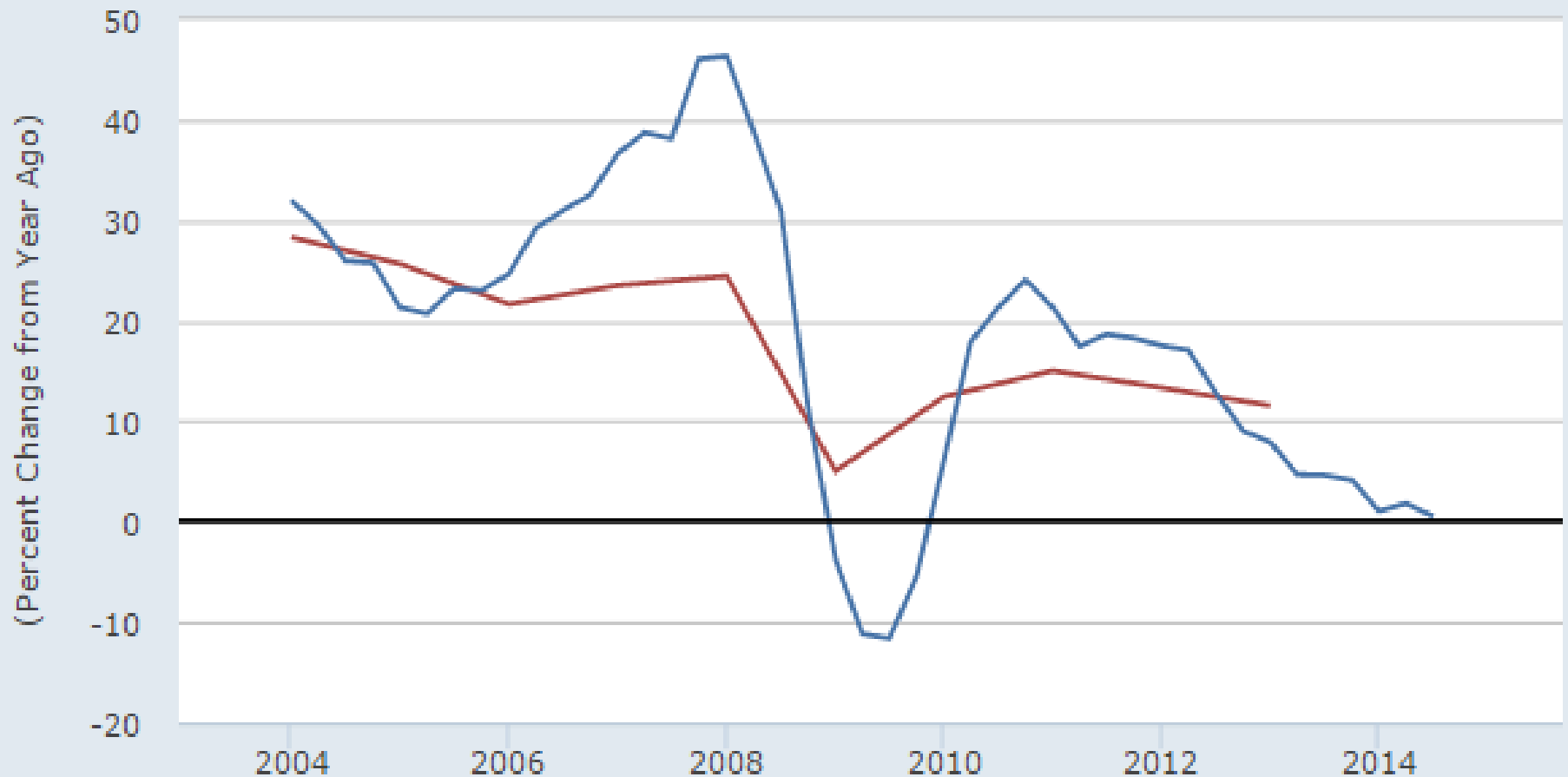


SOURCE: WWW.TRADINGECONOMICS.COM | FEDERAL STATE STATISTICS SERVICE

Russia's Growth volatility: Collapses investment and consumption expenditures

FRED 

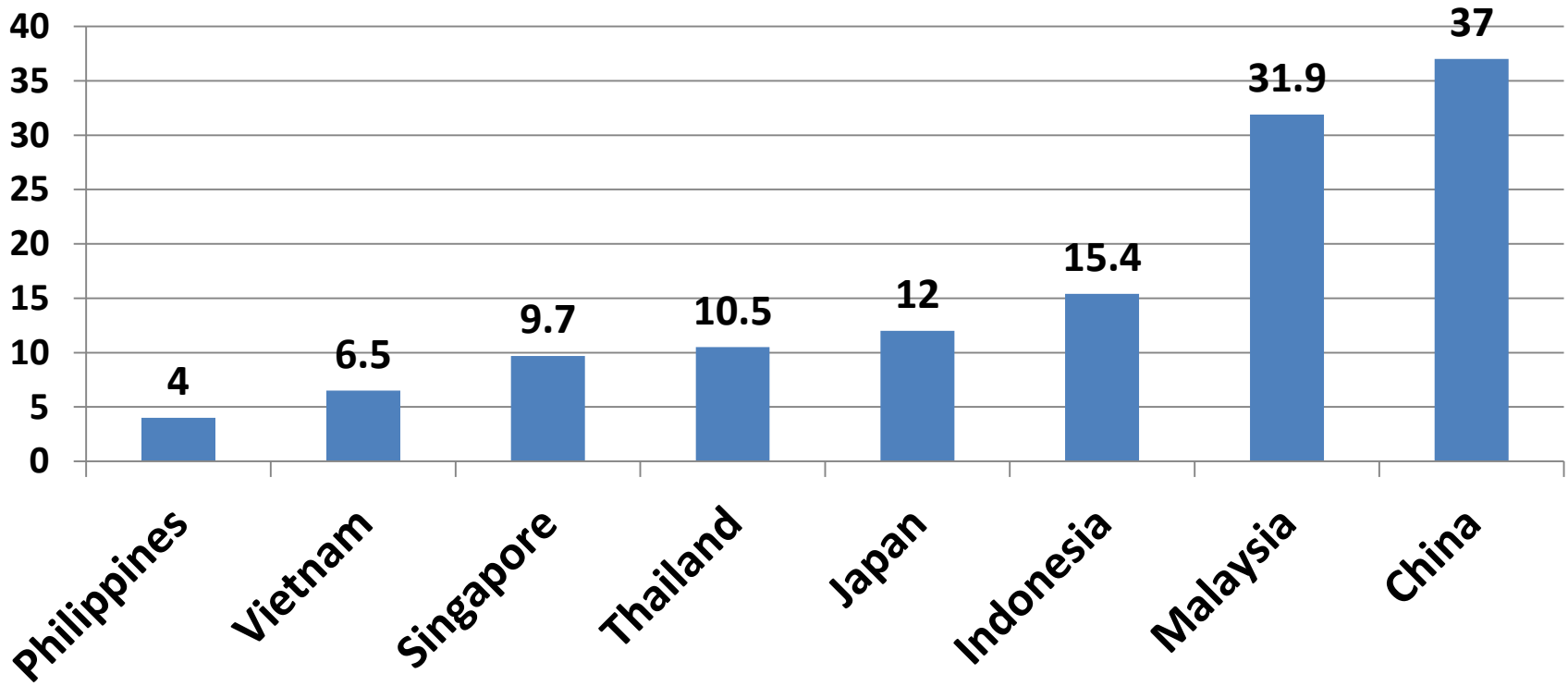
— Private Final Consumption Expenditure in Russian Federation©
— Gross Fixed Capital Formation in Russian Federation©



Dollar rising

US unemployment declined to 5%
Anticipation of the Fed interest hike

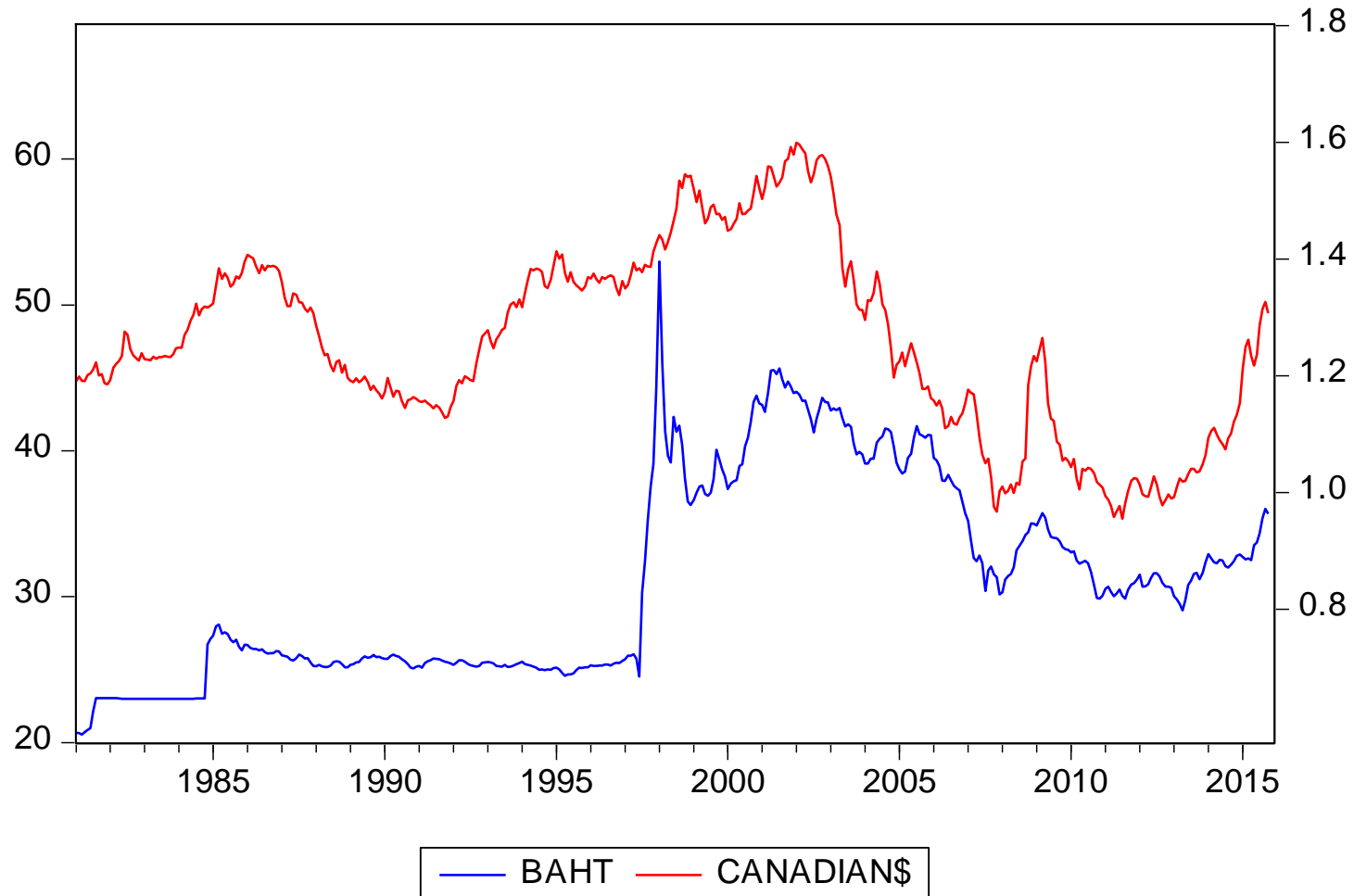
Asian Currency Depreciation November 2015 (y-o-y)



What do Thailand and Canada have in common?

From 2000 to 2015, the correlation coefficient was 0.89

From 1981 to 2015, it was only 0.3



Conclusions

- Appropriate policy responses to external shocks must include:
- Realistic exchange rates and positive real interest rates.
- Avoid price distortions caused by price controls.
- Intervention can be done in case of market failures: utilizing public spending to restore confidence
- Transparency to establish confidence and cooperation between private and public sector.

Concluding remarks

- Until recently, Thailand's exchange rate policy exhibited consistency of market intervention.
- Output recovery depends on consumption rebound which requires consumer confidence.
- Export growth, an important growth driver in Thailand, is mainly determined by conditions in the world market rather than the baht's weakness.
- What does the lesson from the 1997 currency crisis tell us about Thailand's exchange rate policy in 2015?