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EBS/01/116
Supplement 1

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July 27, 2001

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Thailand—Staff Report for the 2001 Article IV Consultation and Post–Program Monitoring Discussions**

The attached supplement to the staff report on the 2001 Article IV consultation with Thailand and post–program monitoring discussions (EBS/01/116, 7/11/01), has been prepared on the basis of additional information. This subject is tentatively scheduled for discussion on Thursday, August 2, 2001. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Thailand indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Moghadam (ext. 35626), Mr. Haksar (ext. 37157), and Mr. Jonsson (ext. 34266).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat; and to the Asian Development Bank, and the European Investment Bank, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

THAILAND

Staff Report for the 2001 Article IV Consultation and Post–Program Monitoring Discussion

Supplementary Information

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Anoop Singh and Michael Hadjimichael

July 27, 2001

In light of the recent appointment of Governor Pridiyathorn at the Bank of Thailand, a small staff team visited Bangkok to discuss monetary and exchange rate policy issues with the new central bank chief and other senior officials.[1] The team also met with Finance Minister Somkid and senior advisors to the government. This supplement to the Staff Report (EBS/01/116) summarizes the discussions.

I. Background

1. **Upon coming to office in late May, the new Governor signaled a shift in the stance and conduct of monetary policy**. The key policy rate (the 14-day repo rate) was raised by 100-basis points in early June, marking the first increase in over three years. Short-term money market rates rose by an equivalent amount. Even though lending and deposit rates remained broadly unchanged, bond yields increased across all maturities, reflecting uncertainty about the future course of monetary policy. The Governor also indicated that he would give greater weight to the exchange rate in the conduct of monetary policy. To support this goal and deter speculative pressures on the baht, he emphasized maintaining a high level of reserves as an important policy objective.

2. **Against this background, the staff sought to clarify the BOT's monetary policy objectives and framework**. Given the potential conflict between placing greater emphasis on the exchange rate and maintaining high reserves, the discussions focused on how the BOT would prioritize and achieve its objectives. The team also inquired whether the BOT planned to maintain its inflation targeting approach, and if so, how its policy objectives could be accommodated within this framework.

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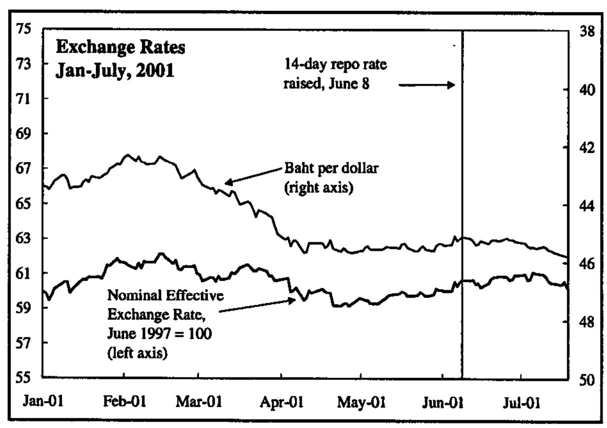
[1]The team comprised Messrs. Moghadam (head) and Schwartz (both APD), and was assisted by Mr. Giorgianni (Resident Representative). The mission overlapped with a LEG technical assistance mission (led by Mr. Hagan) on the legal framework for debt restructuring.

II. POLICY DISCUSSIONS

3. **The staff noted that recent policy statements had raised questions about the consistency of the BOT's objectives.** The authorities were aware that some of their initial policy statements had generated confusion in the market, but they responded that their policy thinking had evolved over the past several weeks. They explained that they were now in the process of clarifying their policy intentions, with a view to prioritizing policy objectives and developing a coherent monetary and exchange rate policy framework.

4. **The Governor indicated that he did not see the need for further interest rate increases in the near term.** He explained that the rate increase in early June was intended to narrow the (negative) gap between domestic and international interest rates, in order to reduce the incentive for early repayment of external debt, and stabilize the baht. The rate hike was also intended to correct "distortions" in the interest rate structure.[2] He de-emphasized earlier calls for an increase in bank deposit rates to boost the income of savers and stimulate consumption. The staff welcomed the intention to refrain from further interest rate increases given the absence of inflationary pressures and the need to support the weakening recovery.[3]

5. **The authorities explained that on the exchange rate, their aim was to limit short-term *volatility*, and there was no intention to target a particular level or range.** In this context, they would be prepared to intervene in the market more frequently than had been the case over the last couple of years, during which time the BOT had essentially pursued a free float. They preferred not to use policy interest rates to minimize volatility as the transmission mechanism would be slower, and any higher rates could undermine the recovery. The authorities emphasized that they would not resist exchange rate fluctuations due to fundamentals or regional market developments (i.e., they would keep the nominal effective exchange rate under close review). Indeed, they pointed out that over the past few weeks they had not resisted depreciation in line with regional currency developments (Text Chart and Table 1). The staff underlined the importance of



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[2]Despite having excess liquidity, domestic banks have kept deposit rates above interbank rates since end-1998. Foreign banks, on the other hand, have lowered their deposit rates further, and have been funding themselves in the interbank market. In this context, the interest rate increase was meant to push up interbank rates and increase the cost of funds for foreign banks, forcing them to raise their deposit rates to the level of domestic banks.

[3]The staff has previously argued that the source of interest rate "distortions" is political pressure on domestic banks to keep their deposit rates artificially high, rather than the low level of money market rates.

maintaining a flexible exchange rate regime. However, the team noted that translating the idea of minimizing baht volatility into day-to-day operations would be a challenge, and that the authorities would inevitably have to rely on policy discretion rather than rigid rules. If not handled carefully, there was a risk that the policy could lead to an erosion of reserves.

6. **The Governor stressed that the BOT would not jeopardize reserves in supporting the baht.** He explained that the authorities were determined to prevent a decline in reserves beyond repayments of the financing package.[4] Indeed, he saw some scope for replenishing reserves by making net purchases over time, and contrary to rumors of intervention in support of the baht, the BOT had been a net buyer of foreign exchange since end-May. In response to the staff's concern about consistency of objectives, the Governor indicated that in the final analysis preserving the level of reserves would take priority, if necessary, over minimizing exchange rate volatility. He also ruled out any tightening of capital controls.

7. **The authorities believed the above objectives could be maintained within the existing inflation targeting framework.** Thus, in a July 12 meeting of the monetary policy committee, the BOT reaffirmed its target range of 0-3½ percent for core inflation. The BOT will also continue publishing a quarterly inflation report (the latest report was to be issued on July 26). In response to staff questions about how the framework would accommodate the new Governor's emphasis on limiting exchange rate volatility, BOT staff explained that foreign exchange intervention aimed at smoothing exchange rate volatility would be sterilized, so as not to affect the stance of monetary policy.

8. **The mission urged the authorities to enact pending central bank legislation, and to resist pressures to ease bank prudential rules.** A legislative priority is the draft BOT Act. In this regard, the Governor has initiated a review of the draft, in order to strengthen provisions for central bank accountability. A revised draft is expected to be submitted to the government for consideration by end-year. The authorities stressed that, contrary to media speculation, there was no plan to relax bank supervisory standards.

9. **On fiscal policy, the authorities presented their medium-term framework to the team, which they have now published.** In line with staff's earlier recommendation, the authorities have developed a multi-year budget and debt framework. The plan aims to contain the public debt-to-GDP ratio to no more than 60 percent of GDP (including the debt of NFPEs). At the same time, the authorities have announced a detailed plan to make the costs of financial sector restructuring fully transparent by bringing them on budget.[5] The plan also

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[4]Details on the scheduled repayments of the financing package and projected gross reserves are provided in the main staff report (e.g., paragraph 24, and Table 3). The BOT's latest balance of payments projections, including for gross reserves, were in line with those presented in the staff report.

[5]The staff's fiscal projections in the main staff report already incorporate these costs.

envisages converting the FIDF's reliance for financing from the short-term money market to long-term bonds.

10. **The staff emphasized again to the authorities the pressing need to accelerate corporate debt restructuring**. The authorities noted that their plans for the TAMC were on track, despite a recent challenge to the constitutionality of the establishing law.[6] The staff welcomed the rapid progress on the TAMC, and urged the authorities to press ahead with reforms to the legal framework to assist debt restructuring outside the TAMC.

III. Staff Appraisal

11. **Indications of the authorities' commitment to maintain the flexible exchange rate regime are welcome**. This flexibility has facilitated a reduction in external vulnerability and helped maintain competitiveness. The authorities' prioritization of monetary policy objectives—in particular, the intention to subordinate exchange rate stability to the objective of preventing a decline in reserves—is appropriate. Moreover, the staff supports the affirmation of the broader inflation targeting framework, which has gained credibility with financial markets, and should help guide interest rate policy and promote exchange rate stability. The staff also welcomes the authorities' intention to refrain from further interest rate increases in the near term.

12. **However, the commitment to lowering exchange rate volatility may in practice be difficult to deliver**. The operational details of minimizing exchange rate volatility have yet to be specified. This will be a challenge, and there remains the risk that an over-zealous pursuit of this objective could threaten reserves and increase external vulnerability. In view of market confusion on the stance of monetary and exchange rate policy, the authorities need to communicate a clear and consistent view to the markets. Pressing ahead with legislation to enhance central bank independence, would also increase policy credibility.

13. **The staff is encouraged by the authorities' intention not to relax banking supervision standards, and to refrain from introducing new capital controls**. The development of a medium-term fiscal framework is also welcome, and should help allay market concerns about the recent rise in public debt.

14. **The emphasis in the main staff report on the need to accelerate corporate debt restructuring and press ahead with legal reforms remains appropriate**. This is important given that weak corporate balance sheets remain a key source of vulnerability. While the TAMC should help in this regard, weaknesses in the overall bankruptcy and foreclosure framework also need to be addressed to accelerate debt restructuring outside the TAMC.

[6]The provisions of the law that have been challenged relate to the TAMC's power to foreclose on debtor's collateral with no right of appeal to the court system.

Table 1. Thailand: Daily Monitoring, July 31, 1997 - July 27, 2001 1/

	1997		1998				1999				2000				2001		Mon	Tue	Wed	Thu
	Jul.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Jul-23	Jul-24	Jul-25	Jul-26
(Baht per U.S. dollar)																				
Spot exchange rate	31.7	48.0	38.9	42.2	39.5	36.7	37.6	36.9	41.1	37.5	37.9	39.2	42.1	43.4	45.0	45.3	45.8	45.7	45.7	45.7
NEER (7/1/97=100, rise denotes appreciation)	83.4	59.0	73.6	69.7	71.9	73.6	74.5	76.4	65.7	72.1	73.1	70.9	68.2	66.7	67.3	67.6	66.5	66.6	66.4	...
REER (June 97=100, rise denotes appreciation)	86.7	64.9	73.1	74.6	76.2	80.3	80.2	81.7	73.0	76.5	78.7	76.8	73.9	72.2	72.6	72.9	...	...	...	...
Forward exchange rate, one-month 2/	31.9	48.3	39.2	42.6	39.5	36.7	37.6	36.8	41.1	37.5	37.8	39.1	42.0	43.3	44.9	45.3	45.7	45.7	45.7	45.6
Onshore swap premium, 1-month (in percent) 2/	6.0	8.6	9.5	11.4	0.6	-0.3	-2.1	-2.2	-2.7	-1.6	-2.2	-3.7	-3.9	-3.4	-2.5	-0.8	-0.6	-0.6	-0.7	-0.7
Offshore swap premium, 1-month (in percent) 2/	9.6	10.7	10.5	26.2	1.8	1.8	-0.2	-1.8	1.2	0.5	-0.3	-0.9	-2.6	-0.7	11.8	3.1	8.4	7.0	5.9	4.3
(Billions of U.S. dollars)																				
Current account balance	-0.4	1.1	1.5	0.9	1.1	1.5	0.9	0.5	0.7	1.2	1.1	0.2	0.6	0.8	0.3	...	...	...	...	...
Exports (twelve-month percent change)	7.9	7.8	-3.5	-3.1	-10.3	-8.5	-1.6	5.8	10.8	15.5	21.4	15.1	20.0	9.6	3.5	...	...	...	...	...
Imports (twelve-month percent change)	-8.7	-27.9	-37.6	-35.9	-32.3	-15.9	2.7	20.2	33.1	38.6	27.7	26.6	24.4	16.3	21.1	...	...	...	...	...
Gross reserves	30.5	27.0	27.6	26.6	27.3	29.5	29.9	31.4	32.4	34.8	32.3	31.9	32.0	32.0	31.8	31.3	31.5	31.6	31.5	...
- IMF borrowing	0.0	2.4	2.7	2.8	3.0	3.1	3.1	3.4	3.4	3.4	3.4	3.4	3.4	3.1	2.7	2.5	2.3	2.3	2.3	...
+ Swaps and forward obligations of BoT	-29.2	-18.0	-15.7	-12.0	-9.7	-6.6	-4.6	-3.3	-3.0	-4.8	-2.8	-2.1	-2.1	-2.1	-2.2	-2.2	-2.0	-2.0	-2.0	...
= Net international reserves, *of which*:	1.3	6.6	9.2	11.8	14.6	19.8	22.2	24.7	26.0	26.6	26.2	26.4	26.5	26.8	27.0	26.7	27.2	27.2	27.3	...
Financing package (excluding IMF)	0.0	5.5	7.6	7.9	8.9	9.1	10.0	10.5	10.7	10.9	10.9	10.9	10.9	11.1	10.5	10.4	10.0	10.0	10.0	...
Other official financing 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.9	0.9	1.1	1.1	1.1	1.3	1.3	1.3	1.3	1.3	1.3	1.3	...
Non-borrowed reserves 4/	1.3	1.1	1.6	3.8	5.7	10.8	11.4	13.3	14.4	14.7	14.2	14.4	14.4	14.4	15.3	15.0	15.9	16.0	16.0	...
Swaps and forwards, net stock	-29.2	-18.0	-15.7	-12.0	-9.7	-6.6	-4.6	-3.3	-3.0	-4.8	-2.8	-2.1	-2.1	-2.1	-2.2	-2.2	-2.0	-2.0	-2.0	...
Onshore	-10.1	-9.2	-9.7	-10.0	-9.3	-6.6	-4.6	-3.3	-3.1	-4.8	-2.8	-2.1	-2.1	-2.1	-2.2	-2.2	-2.0	-2.0	-2.0	...
Offshore	-19.1	-8.8	-6.0	-1.9	-0.4	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	...
(Percent)																				
																	7/05-7/12			
External debt rollover rate 5/	...	71	76	73	90	72	61	61	64	70	69	74	69	92	89	109	92	...	...	...
Foreign banks	...	86	83	71	106	73	70	88	71	91	121	92	74	105	105	130	94	...	...	...
Thai banks	...	58	60	67	59	59	55	11	73	67	31	39	42	38	112	89	91	...	...	...
Non-bank	...	33	81	86	94	83	51	47	25	49	53	73	73	95	76	95	90	...	...	...
Interest rates																				
One-day repurchase rate	16.5	24.0	19.8	16.6	6.0	3.1	1.0	0.8	0.9	0.6	2.0	1.9	1.3	1.0	1.3	2.2	2.0	2.1	2.1	2.0
Overnight interbank (median)	13.8	24.8	20.4	16.9	4.8	2.3	1.5	1.3	1.4	1.1	4.4	4.9	2.0	2.4	1.8	2.4	2.7	2.5	2.4	...
Lowest (most creditworthy)	9.5	16.0	15.0	16.8	4.0	2.0	1.3	1.0	1.1	0.9	3.3	3.1	1.1	2.0	1.5	1.8	2.0	2.0	1.9	...
Highest (least creditworthy)	20.0	29.8	23.3	18.0	8.0	2.5	2.0	1.5	2.0	3.0	5.3	12.0	2.4	2.6	2.0	5.0	3.0	2.8	2.6	...
One-month repurchase rate	13.9	24.5	21.6	17.5	7.8	5.0	3.4	2.8	2.4	2.4	2.5	2.0	2.1	2.0	1.9	2.6	2.6	2.6	3.6	4.6
One-month swap rate	11.6	14.2	15.1	17.0	5.9	4.7	2.8	3.0	2.6	4.1	3.9	2.9	2.6	3.1	2.5	3.1	3.1	3.1	3.0	3.0
Ten-year Yankee bond spread (b.p.s)	103	446	249	386	715	348	243	219	229	156	156	173	161	169	151	119	141	141	134	...
CPI inflation (twelve-month percent change)	4.9	7.6	9.5	10.7	7.0	4.3	1.6	-1.2	-0.8	0.7	1.1	2.0	2.4	1.3	1.4	2.3	...	...	...	...
One-month percent change, s.a.	0.9	0.5	1.0	0.6	-0.2	0.1	-0.3	0.0	0.1	0.8	-0.3	0.1	0.3	0.1	0.0	0.3	...	...	...	...
Manufacturing Production (97q1=100, s.a.)	98.1	91.9	82.6	87.5	85.5	89.1	92.3	97.9	101.4	101.0	101.7	99.4	102.9	102.8	99.8	...	...	...	...	...
M2A (twelve-month percent change)	3.9	2.0	3.6	4.3	8.1	6.1	4.9	3.1	0.8	1.3	0.3	1.2	2.0	2.2	4.6	...	...	...	...	...
One-month percent change, s.a.	-0.3	0.7	0.5	1.6	1.2	-0.2	0.1	-0.4	0.7	-0.4	-0.1	0.8	0.2	-0.3	0.7	...	...	...	...	...
Total credit, seas.& val. adj. (12-mo. perc. change)	7.4	4.5	1.1	0.7	-1.1	-4.4	-2.9	-2.6	-3.0	-0.7	-0.8	-0.9	1.0	0.3	1.3	...	...	...	...	...
One-month percent change	0.7	0.9	-0.6	-0.1	-0.7	-0.7	0.2	0.1	-0.3	-0.2	0.0	-0.3	0.6	-0.7	0.7	...	...	...	...	...
(Billions of baht)																				
FIDF support, including debt-equity swaps	423	676	706	741	828	894	873	812	821	807	805	804	803	799	793	786	775	775	775	...
Banks	47	292	309	314	378	397	493	433	433	429	428	427	426	424	424	423	423	423	423	...
Thirty-three finance companies	8	29	44	74	99	147	29	30	40	30	30	29	29	29	29	29	29	29	29	...
Fifty-eight finance companies	368	355	353	353	351	350	350	349	348	348	348	348	348	345	341	334	324	324	324	...
Balance sheet of the BOT																				
Reserve money	469	473	448	428	440	475	489	431	426	621	497	450	479	527	513	485	481	...	...	...
Ten-day moving average	...	445	435	410	432	458	468	418	418	550	476	443	449	467	506	501	496	...	...	...
Net foreign assets	973	630	586	536	536	588	608	637	629	701	632	621	635	639	667	676	681	...	...	...
Net domestic assets	-505	-157	-138	-108	-96	-112	-119	-206	-203	-80	-135	-172	-156	-112	-154	-191	-200	...	...	...
(SET Index)																				
Stock market	666	373	459	267	254	356	352	522	389	482	400	326	277	269	292	323	310	309	308	305

Sources: Bank of Thailand; and staff calculations.

1/ All data are end of period, except for the external debt rollover rate, which is a period average.
2/ The forward rate is computed from the swap premium and the spot (closing) quote. The swap premium is equivalent to a baht-dollar interest rate differential.
3/ Consists of foreign exchange receipts from official financing that is not part of the original $17.2 billion financing package (such as from the Miyazawa Initiative).
4/ Non-borrowed reserves are increased by foreign exchange purchases, interest income and valuation changes.
5/ The rollover rate is calculated as (1-(loan repayments - new credits)/amortization due)*100.