Bandid Nijathaworn: Thailand’s economic conditions and prospects - a mid-year update

Speech by Mr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at a luncheon organised by the Australian-Thai Chamber of Commerce, Bangkok, 27 August 2004.

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Let me begin first by thanking the Australian-Thai Chamber of Commerce for the invitation to speak to you today. For the Australian-Thai Chamber, this is the first for me and I am very pleased to be here.

Today, I plan to cover the evolving economic pictures both at home and abroad. For the global economy, a number of interesting new themes are now emerging and I will try to put these developments into the perspective as we understand it at the Bank of Thailand.

As for the domestic economy, despite a number of risks and challenges, this year the economy has managed well under the circumstances. Growth momentum remains firm and economic stability remains intact. Today, I will not open up any new kind of inquiry on the Thai economy, but will simply update you on the recent economic outturn and explain the rationale behind this week's decision by the Monetary Policy Committee to increase the policy interest rate. This decision, which is the first increase in three years, has been expected by the market following signs of increased pressure on domestic prices and following our own assessment and communication to the market that low interest rates have become less necessary given the changed outlook on inflation.

Let me begin with the global economy.

At present, it is still very much the case of a firm recovery in the global economy continuing into the first half of this year. Growth of the G3 economies for first half of the year is estimated at 4.9 percent for the US, 5.2 percent for Japan, and 1.9 percent for the EU, all accelerating from the rates of growth observed in the second half of last year. For the whole of this year, even allowing for the recent higher oil prices, market still anticipates a continued recovery in the global economy driven by the economic expansion in the US, Japan, and Asia. The latest consensus forecast now puts global economic growth this year at about 4 percent, significantly higher than the average of the past three years.

To put these numbers into perspective, it is worthwhile to note that sentiment on the global economy at this time is less robust than the perception we had six months ago. This change has been driven in part by the recognition that the reversal of several important factors that had been supporting global growth since the second half of last year is now beginning to impact the global economy. The key factors I am referring to here include the higher oil prices, the rising global interest rates, and the slowing of the Chinese economy. While the outlook for the global economy remains firm, the persistently higher oil prices and some softness in the recent US data have shifted the balance of risks more to the downside. The key issue at this time is thus the oil prices, and the key question is how the higher oil prices will affect the global economy going forward.

Ladies and Gentlemen,

This year prices of oil have gone up by more than 40 percent. The Dubai price, which is the key reference price for Thailand, went up from last year’s average of US$ 27 per barrel to now about US$ 39 per barrel. Domestic retail oil prices, however, have gone up by less because of the price support scheme that the Government has been running. This has helped limit the immediate effects of the high global oil prices on the economy. But notwithstanding the subsidies, domestic inflation has been rising. Headline CPI inflation, for example, rose to 3.1 percent in July. At this time, we believe there is substantial price pressure building up in the economy that could eventually translate into higher consumer prices once the proft margin is adequately squeezed. This pent - up price pressure is linked not only to the higher global oil prices that have yet to be passed through to the consumer prices, but also to the continued high level of capacity utilization and to the reported tightening in some segments of the labour market.

The risk to global growth from higher oil prices is now an issue that captures the attention of financial markets. Compared to the previous episodes of high oil prices, this time the high oil prices could very well persist longer because the increase has been driven by the rise in global energy demand as well as by supply disruptions. But because the oil prices in real terms are still lower than the peak levels during the oil crisis of the 1980’s, while the global economy has also become less dependent on oil, common wisdom at this time is that the higher oil prices will put pressure on global growth and inflation but will not in itself derail the ongoing momentum of global recovery.

As for the rise in interest rates, the risk to global growth coming from higher global interest rates so far looks less threatening. This is because interest rates especially in the US are being increased from very low levels and are being done gradually. In the case of the US, the increase is more of an indication that the Fed is regarding the current recovery as being solid. Moreover, because the increase in rates is good for maintaining economic stability as well as for addressing global imbalances, the increase in interest rates should be seen as a good thing and should be welcomed.

Against this background, we at the Bank of Thailand see the global recovery continuing firmly in the short term despite the higher oil prices. This year, Thailand's export market - as measured by GDP growth of our major trading partners - is expected to grow by about 5 percent. This growth will be the key factor supporting our exports this year. At the same time, Thailand's exports to China continues to expand, though at a lower rate compared to last year's. Hence, the effect of the slowing Chinese economy on our exports is a factor that should be monitored closely.

For the first half of this year, I am happy to report that Thailand's exports to Australia grew by 16.6 percent while imports from Australia grew by 38 percent. Australia is now Thailand's 11th and 12th largest trading partner on exports and imports, respectively, claiming a share of 2.3 percent of Thailand's total trade. And with the recent conclusion of the bilateral free trade agreement between our two countries, trade between our two economies is likely to grow and grow.

As for the global financial markets, let me just say briefly that this year global financial markets have been dominated by the changing expectations about the pace and the timing of monetary policy tightening in the US. And this has led to a global repricing of financial assets and some reversal of international capital fows, especially away from emerging markets. So far, the repricing of assets and the unwinding of positions have been quite orderly and the financing of the US current account deficit continues to be smooth. In broad terms, bond yields have increased, equity prices have declined, and the US dollar has appreciated in nominal effective terms.

In terms of policy, the key issue in the global economy now is how to manage the transition to a higher interest rates environment so as to safeguard economic stability in view of the continued firm growth. Another is the management of the risk that higher oil prices might affect the global recovery. And the third is the issue of addressing the major global imbalances without creating serious volatilities to the financial markets.

Let me turn now to the domestic economy.

This year a theme that has kept recurring in my presentation of the Thai economy is that of risks and adjustment. This is to say that, for Thailand, this year has been a year of greater risks and the key theme has been adjusting to risks as the global economic and financial environment has become less helpful.

The key external pressure an the Thai economy throughout this year has been the higher oil prices, the higher global interest rates, and the potential impact an our exports of a slowing Chinese economy.

This year, we also have our own domestic challenges. These include the two episodes of bird flu that have affected production and exports of poultry, and the uncertainty linked to the situations in the south which has importantly affected consumer confidence and business sentiment.

So, for the most part, the performance of the Thai economy this year is essentially a story of how the domestic economy has been adjusting to the risks that emerged. This includes adjustments in the domestic financial markets and the real economy, as well as the implications for economic and financial stability. Let me go through each of these points in turn.

As for the domestic financial markets, the adjustment has been led by the repricing of financial assets that has been underway since the second quarter. Yields on long bonds have been rising. Equity prices have declined. There have been some outflows of short - term capital, and the Baht has weakened from last year. In all, the adjustment has been smooth and orderly, and has benefited from the flexible market mechanism that underpins the movements of the economy's key prices.

And for the real economy, the adjustment has been accompanied by a moderation in growth in the first quarter to 6.5 percent, led by the slowdown in agriculture because of drought and the bird flu. Output of manufacturing and services, however, has continued to expand robustly. On the demand side, the dampened consumer confidence has moderated the momentum of private consumption in the first half of the year, but private investment and exports have expanded well and have been the key drivers of growth so far this year. On this point, it is comforting to note that domestic demand expansion has benefited increasingly more from the pick-up in credit extension, driven by ample liquidity in the system. Private credit growth was a high 9 percent at end-June.

Turning to economic stability, with continued growth, pressure on resources has become more visible this year with output gap continuing to close, inflation rising, the trade surplus narrowing and some tightening in the labour market reported. Overall external stability, on the other hand, remains strong with continued current account surpluses, falling external debt, and higher international reserves. But the higher oil prices and the rebound in investment have evidently put greater pressure on imports and the trade balance.

One thing that we have been monitoring more closely this year is financial stability. Some indicators of financial fragilities are rising. These include rising household indebtedness and a very active real estate sector. Although there are no signs of overheating as yet in these two sectors, their developments need to be monitored closely especially with the credit cycle now turning. This is because they have the potential to become a source of financial fragility if their growths are left unchecked.

In all, the domestic economy seems to have adjusted well to the greater risks and challenges that have emerged. The pace of growth has moderated from last year’s but the overall growth momentum still looks firm and economic stability remains sound. The key issue going forward is the risk posed by the higher oil prices to the outlook on domestic growth and inflation. And under a more pessimistic scenario, an important question is how resilient is the domestic economy to absorb a much larger shock, this is to say persistently higher oil prices.

In the meeting of the Monetary Policy Committee last Wednesday, members of the Monetary Policy Committee spent considerable time discussing this type of questions based an preliminary analyses prepared by our staffs at the Bank of Thailand. While the numbers are still preliminary, the results seem to suggest a greater trade-off between growth and inflation going forward. In particular, higher oil prices will adversely affect both growth and inflation, but the effects on inflation is projected to be more pronounced because of the pent-up pressure on prices as mentioned earlier.

Reflecting this, the Committee felt that the risks to economic stability have increased with higher oil prices and it is only proper that monetary policy should be vigilant on inflation.

So, with the recovery momentum remaining firm but the risks to economic stability rising, the Monetary Policy Committee saw less need for maintaining low interest rates and felt that the monetary policy stance should be adjusted to give priority to economic stability, with the adjustment being gradually paced.

This is essentially the rationale behind the decision on Wednesday by the Monetary Policy Committee to raise the policy interest rate by 25 basis points.

At this juncture, many of you may wonder whether higher oil prices together with higher domestic interest rates might be too punitive to the health of the domestic economy.

Let me say that we have looked carefully at this issue and are of the opinion that the growth momentum at this time is quite firm. Although the adverse effects an growth from higher domestic interest rates will be there, the effects will not be large to the extent that they will derail the ongoing momentum of recovery. This is because the fundamentals of the economy at present are quite good, and with a strong fiscal position, these two factors should allow the economy to flexibly adjust to the negative shocks without interrupting the momentum of growth. On the contrary, the early rise in domestic interest rates will help maintain macroeconomic stability which is cruial for sustaining economic growth in the medium term.

Ladies and Gentlemen,

A few weeks ago, I had the good fortune of visiting both Melbourne and Sydney and came across this concept of a cleanskin wine. For those of you who have not been home for a while, cleanskin wine is quality wine that is sold more cheaply because it is unlabeled. So, you are getting something good but you don’t know why because you don’t know what it is.

Half an hour ago, the Thai economy this year to many of you was like cleanskin wine. You know the economy is doing better but you don’t know why.

In this brief space of time, I hope I have given you an adequate account of how we at the Bank of Thailand see the Thai economy evolving this year, and hopefully have helped improve your understandings of the economy.

As with the cleanskin wine, I will definitely go back for more. I only hope you will do the same by continuing to have confidence in the Thai economy and remain a trusted friend and a dependable partner of Thailand for many many years to come.

Thank you.