Tarisa Watanagase: The prospects of the Thai economy and monetary policy

Speech by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the Japanese Chamber of Commerce (Bangkok) Dinner Talk, Bangkok, 16 March 2007.

* * *

President Banno, fellow bankers, distinguished business leaders, ladies and gentlemen, good evening.

"First of all, I would like to thank the Japanese Chamber of Commerce (JCC) for inviting me to speak at this dinner."

Japan's relationship with Thailand has a long history and encompasses many aspects – as a trading partner, investor and major contributor to Thailand's economic development. Japan is ranked as Thailand's number one trading partner and investor. In 2006, Japan contributed 16.3 percent to Thailand's total trade, while net foreign direct investment (FDI) from Japan constituted 32.6 percent of Thailand's total net FDI inflows. It is therefore my pleasure to be here and share my views on the Thai economy – the outlook and challenges, as well as our monetary policy, with all of you.

I would like to structure my talk to cover three key areas. First, I will touch briefly on the overall condition of the economy. Secondly, and in relation to the first one, I will elaborate on recent monetary policy decisions. Finally, before concluding, I will share my views on the prospects and challenges facing the Thai economy.

Let me begin with the economy.

The past year was one of the more challenging times for Thailand, in terms of both political and economic aspects. On the economic side, uncertainties heightened because of both external and internal factors. The impending threat of global imbalance became even more pronounced. The dwindling confidence in the US dollar continued, which brought about massive capital inflows into the region, resulting in an across-the-board currency appreciation. At the same time, rising oil prices continued to put pressure on inflation during the first half of 2006. Consumer and investor confidence, meanwhile, was clouded by lingering political uncertainties that brought about delays in consumption and investment decisions, as well as in government spending. As domestic demand weakened, export became the main driver of the Thai economic growth.

Despite the negative environment, the overall economic performance was quite satisfactory. The economy proved to be resilient, as the growth momentum continued while overall economic stability improved.

Regarding internal stability, headline inflation came down from a peak of 6 percent in the second quarter of 2006 to 3.3 percent in the last quarter and to 2.3 percent in February this year. Core inflation fell from its peak of 2.9 percent in April 2006 to 1.4 percent in February – well within our target range.

Overall external stability remained sound. The current account turned into surplus since August and registered a surplus of 1.2 billion US dollars in December 2006, or an overall surplus of 1.5 percent of GDP for the year 2006. Meanwhile, reserves to short-term debt also rose further.

The economy registered a growth rate of 5 percent in 2006, a respectable number, against the backdrop of external and internal disturbances. The recent slowdown in consumption and investment could be traced to the confidence factor. Political uncertainties and the unwarranted strengthening of the currency that prompted the introduction of reserve requirements on short-term capital inflows, together with the amendment of the Foreign Business Act that, unfortunately, happened successively within such a short period of time, all had a negative effect on consumer and business confidence. However, we believe that the momentum has not been lost, and uncertainties only postponed consumption and investment decisions. Evidently, retained earnings to total assets averaging over Q1-Q3 of 2006 was at 17.6 percent, higher than the average of 13.3 percent in 2005, while capacity utilization rose to 74.2 percent in 2006, indicating that further investment in production capacity should be in the pipeline.

To sum up, while challenges abound, we have weathered them relatively well so far. This can be attributed to a fine combination of the economy's resiliency and appropriate policy stance. By appropriate policy stance, we refer to the “right” policy for the “right” reason at the “right” time.

Let's now turn to our monetary policy.

Monetary policy's main objective is to maintain monetary stability. By this we mean price stability and confidence in the value of the currency. Thailand has adopted inflation targeting since May 2000. Under inflation targeting, the emphasis is given to maintaining core inflation within the target range and, at the same time, achieving a balanced growth path. We use the 1-day repurchase rate as a policy instrument to keep the quarterly average of core inflation within the target range of 0-3.5 percent. If inflationary pressure heightens and thereby increases the possibility of core inflation breaching the target, interest rate has to be raised. Bearing in mind that a time lag of 4-8 quarters before a change in the policy rate can be fully transmitted to the rest of the economy, policy consideration needs to be forward-looking.

Upward inflationary pressure over the past few years, due to higher oil prices, has been tamed by monetary tightening. We raised the policy rate 13 times between August 2004 and June 2006, bringing the policy rate to 5.00 percent from 1.25 percent per annum. Hikes in the policy rate have brought the money market and commercial bank interest rates higher over the past 2 years. Our policy response proved timely, with inflation and its second round effects well contained.

Recently, domestic demand, particularly in private consumption and investment, showed signs of a slowdown, while economic momentum from exports was expected to moderate, given the prospects of the global economy in 2007. Since inflationary pressures have subsided in line with easing energy prices, monetary policy could be eased in support of a further expansion of the economy. The MPC, thus, lowered the 1-day repurchase rate, the policy rate, to 4.75 on 17 January meeting and a further 25 basis points reduction on 28 February and expect to pursue a downward path of interest rate in a cautious manner. This accommodative monetary policy stance will help stimulate domestic demand by supporting economic sentiments, cutting down financial costs and preparing the stage for private investment recovery once confidence has returned, most likely in the 2nd half of this year.

Having considered the recent economic conditions and monetary policy, **we will now turn to the prospects and challenges of the Thai economy as we move forward, and how we are going to deal with them.**

Ladies and gentlemen, for this year, we expect the economy to continue facing a number of important challenges both internally and externally.

Internally, political uncertainties, which have adversely affected private sector's decision to invest, are likely to stay until the next general election. Externally, the threat of an impending global imbalance remains high, while the global economy is expected to slow down. Moreover, the risk from volatile global financial markets lingers, while the baht could continue to appreciate against the US dollar. It may be a great concern to you whether the Thai economy will be resilient enough to withstand such an adverse environment. However, we believe that sound fundamentals and the appropriate policy stance would prepare the economy well in the long term.

Facing internal challenges, the monetary policy stance has become more accommodative as mentioned earlier. The reduction in the policy rate has been effectively transmitted into lower money market rates as well as lower commercial banks' retail rates. To date, 4 major Thai commercial banks have reduced their deposit rates and 3 of them have cut down their lending rates. The downward interest rate path should help improve sentiments and lower the cost of funds, which would support the recovery in domestic demand, particularly, investment.

The outlook for the Thai economy within the next few years remains positive. The BoT's forecasts, having incorporated the aforementioned risks, show that the Thai economy should be growing by 4-5 percent in 2007 and by 4-5.5 percent in 2008. Such growth rates are respectable in light of these challenges.

Regarding the challenge arising from the volatile global financial market and an appreciation of the baht, Thailand, with a relatively small and still shallow financial market like many emerging market economies, is vulnerable to the fast-moving international capital. Rapid movements of capital flows can have negative impacts on the export or import sectors, which could pass on the adverse effects to the real sector and financial sector and eventually jeopardizing economic stability. The rapid appreciation of the baht particularly in the last quarter of last year, which proved to be inconsistent with economic fundamentals and much out-of-line with the rest of the region, inevitably forced the Bank of Thailand to implement a reserve requirement on capital inflows to break the rapid one-way momentum and preserve overall stability after several capital account measures proved unsuccessful.

Ladies and gentlemen.

I would like to reassure you that we have always welcomed genuine foreign capital flows and investors and will continue to do so. The measure implemented in December was not meant to affect genuine investors and this was clear from the beginning. The measure announced on 18th of December clearly stated that capital inflow in the form of foreign direct investment (FDI) was exempted from the reserve requirement. And later on, as it turned out that genuine flows were still affected by the measure, we attempted to find an alternative option to alleviate pressure on the baht and adverse effects on productive sectors.

To date, the exchange control measure has effectively slowed down the appreciation of the baht. On average, the nominal effective exchange rate in February strengthened by only 0.5% relative to January, compared to an appreciation of 1.7% between November 2006 and the first half of December – before the measure was implemented. After we have successfully slowed down the one-way appreciation momentum, we have allowed greater flexibility to the measure without compromising the needs to contain excessive volatility – by providing the fully-hedging option for all categories of inflows that are covered under the reserve requirement measure. We will closely monitor the hedging requirement. If its implementation is effective, we can lift the reserve requirement and keep only the hedging requirement.

In safeguarding economic stability and fostering long term growth, the BoT also looks beyond the immediate horizon. However, to overcome the challenge of global dynamism over the long run, monetary and financial stability alone are not sufficient. The challenge here is for the Thai economy to make sustainable gains in productivity through increased flexibility, efficiency, and competitiveness amidst the dynamic global economic conditions and structure. In this respect, we need to promote a sound and stable macroeconomic environment by carrying out necessary reforms in the real sector and financial sector.

The real sector must work continuously in improving productivity to enhance its competitiveness. So far, reform efforts from both the private and public sectors have been made to promote transparency, strengthen governance and improve the quality of human resources. In the long term, the government plans to embark on key infrastructure investment projects, which include the expansion of the mass transit network in Bangkok, water resource management, and an integrated logistics system. These public investments will ease bottle-necks without exerting too much pressure on external stability and allow firms to focus on improving their efficiency and productivity.

On the financial sector, the Bank of Thailand has played an important role in strengthening the financial infrastructure. The Financial Sector Master Plan (FSMP), in place since 2002, will move into its second phase. FSMP aims to broaden access to financial services to all potential users, promote competition in financial services in order to enhance financial efficiency and resiliency and ensure that our financial sector can perform well in the global competitive environment. We have already seen significant consolidation and increased efficiency of the banking sector as the first phase of FSMP ended. In addition to FSMP, the amendments and introduction of a number of legislations, such as the new Financial Institutions Act and the Deposit Insurance Act, will foster a more efficient financial sector. On the supervisory side, we have also continued our efforts to enhance financial sector's resiliency to unfavorable disturbances through an early adoption of IAS 39, currently underway, and the new Basel Capital Accord at the end of next year. FSMP and improved supervision will complement structural reforms in the real sector to bring about strong foundations for further economic growth and stability. Structural reforms in the real sector continue to need concerted efforts from both the private and public sectors as well **as** support from foreign investors like all of you here. The BoT **is** committed to doing all the necessary work for **a** strong **financial** sector **that will** provide a supportive environment **and** infrastructure for the private sector to prosper.

Ladies and gentlemen, the essence of my talk today is to reassure you that the performance of the Thai economy has been satisfactory and that, despite the adverse environment and challenges facing the Thai economy, I strongly believe that the Thai economy will be able to continue to perform favorably while moving forward. We are strongly committed to implementing the most appropriate policies to help foster growth, stability and resiliency of the economy and to further strengthen its solid foundation.

In closing, I would like to express my appreciation to Japanese businesses for their contribution to the progress of the Thai economy over the years. Here's hoping that we continue to build and strengthen the foundation of this great relationship. Again, I am deeply grateful for this opportunity, and thank you for your kind attention.