Tarisa Watanagase: The Thai economy – monetary policy and the challenges of globalization

Speech by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the British Chamber of Commerce Luncheon Talk, Bangkok, 11 June 2007.

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Chairman Bain, Mr. Ambassador,
Ladies and Gentlemen,

I would like to begin by thanking Chairman Bain for his kind invitation for me to speak at this luncheon before all of you: the distinguished members and guests of the British Chamber of Commerce. As Thailand's oldest chamber of commerce, you have shown your commitment to the Thai economy. As Thailand's largest non-Asian chamber of commerce, you represent a significant economic force. And most importantly, the gathering here today demonstrates your active participation in the future of Thailand.

It therefore gives me great pleasure to share my views on the prospects of the Thai economy with you today. I particularly look forward to your questions, your comments, and a lively exchange of views.

Distinguished Guests,

Following mass street protests against the previous administration, a military coup and the annulment of the 1997 constitution in September last year, we continue to see heightened political uncertainty. Much has happened over the past six months. On the political front, the recent historic ruling by the Constitutional Tribunal removed some political uncertainty. But until a new constitution and a democratically elected government are firmly in place, political uncertainty is bound to remain a factor that affects Thailand's near-term economic prospects.

Economic uncertainty has also increased. Around the end of 2006, we saw rapid appreciation of the baht, declining consumer confidence, and weakened consumption and investment. In addition, the implementation of the reserve requirement, the amended Foreign Business Act, and the compulsory licensing of certain medicines proved to be unpleasant surprises to the investor community, local and international.

Notwithstanding the less than favorable political and economic environment and despite both external and internal shocks, the Thai economy has shown remarkable resilience. Recent figures show GDP expanding by 4.3 percent in the first quarter of the year. Net exports and government expenditures expanded well. However, household consumption slowed while investment contracted. Much of the slowdown has been due to the rise in political uncertainty. Softened business sentiments led firms to delay their investment plans. Decreased consumer confidence led households to delay purchases of durables, such as automobiles and motorcycles.

In light of the diminished pressure on prices, the Bank of Thailand responded by shifting to an accommodative monetary policy stance. Since the beginning of the year, the policy interest rate was lowered from 5 per cent to the present rate of 3.5 per cent. At this juncture, the Monetary Policy Committee deems the current level of policy interest rate to be supportive of economic expansion while maintaining stable inflation.

At this point, allow me to elaborate on Thailand's economic prospects going forward. Our outlook for the Thai economy remains positive. Present data and our forecasts point to a satisfactory growth outlook for this year and next year. Our forecasts, taking into account the potential risk of high and volatile oil prices, show that the Thai economy could grow by 3.8-4.8 percent in 2007 and accelerating to 4.3-5.8 percent in 2008. The growth is expected to come mainly from exports, given healthy global demand, additional government spending and investment in public infrastructure, as well as lower oil prices. Core inflation, or inflation excluding raw foods and energy, is forecast to remain within a comfortable range of 1-2 percent in both 2007 and 2008. Fundamentals remain strong with low inflation, a current account surplus, and manageable levels of public and external debt.

But a positive outlook by no means allows for complacency. Political risk remains substantial. The threat of a disorderly unwinding of global financial imbalances remains imminent; and by this I mean a surge in capital inflows still looms. And oil prices continue to be difficult to predict. We must constantly work to manage current challenges and prepare for those in the future.

Undoubtedly, many of you here are concerned about Thailand's recent economic and policy developments and the considerable challenges ahead. Some among the international community have voiced concerns that Thailand is withdrawing from the global economy. **I have therefore chosen to focus the rest of my talk today on coping with the challenges of economic and financial globalization.**

In particular, I hope to address any lingering fears and concerns by concentrating on **three key issues**. First, I would like to draw your attention to the benefits and challenges of globalization from the perspective and actual experience of Thailand. Second, I want to identify the main challenges of globalization and how to meet them. And last, I would like to conclude with a discussion of how Thailand should position itself in order to reap the benefits of globalization while avoiding its pitfalls in the long run

First, I wish to emphasize that globalization brings both opportunities and challenges to small open economies. Thailand is no stranger to this reality and successive administrations have shown strong commitment to supporting the progress of global economic integration. Nevertheless, we should also put the issue of benefits and challenges of financial and economic globalization into a proper perspective.

I would like to do this by examining the experience of Thailand during the past two decades. Over the past twenty years, it is an undeniable fact that globalization has brought substantial gains to Thailand. The evidence is all around us. International trade and investment have boomed. Thai exports expanded by over 11 percent per year during the same period. Our large and vibrant export sector sends goods all over the world. And, in turn, Thai consumers enjoy goods from all corners of the globe. On the investment side, healthy joint ventures and foreign investment abound. Interaction at the person-to-person level has also grown, underlying the fundamental importance of the sharing of knowledge and skills between nations.

And last, but by no means least, this luncheon and our presence here today reflect the progress of globalization. I am glad to say it is a progress that we have made together.

Ladies and Gentlemen,

It is also undeniable that Thailand has shown a strong commitment to global economic integration. Thailand's economy and openness have grown together hand-in-hand. But openness brings forth not only benefits; it also invites challenges. As such, **we must embrace globalization with our eyes open** for potential risks and pitfalls.

Although globalization has brought considerable gains over the last decades, the path traveled has not always been smooth. In fact, it has been strewn with risks, some predictable and some not. Nearly ten years ago, Thailand was in the midst of a financial crisis that had been caused by a number of factors. The most telling one was the premature liberalization of the financial sector. That round of financial liberalization encouraged significant capital inflows and massive over-investment, creating financial vulnerabilities which eventually led to abrupt reversal of flows in the period that followed. I am sure many of you can recall the event vividly.

And further back in time, nearly twenty years ago, Thailand was embroiled in a global oil crisis that thrust the world economy into a period of recession and high inflation. During both episodes, the prognosis for globalization seemed grim. Nevertheless, Thailand emerged from these crises with a renewed commitment to global economic integration and internal reform.

The situation today is nowhere near as grim. But the economic lessons of the past remain relevant. Openness comes with challenges. And as the world grows increasingly interconnected, these challenges will not only be more numerous, but they will also be more varied.

Today, the Thai economy again faces challenges from the external front. The main challenge comes in the form of global financial imbalances; another challenge is the threat of high and variable oil prices.

By global financial imbalances, I refer to the pattern of savings and investment allocation across the world. At the present, the US economy saves very little relative to its investment needs. Asian and oil-producing economies save more than their domestic investment opportunities. The European Union saves just enough. As a result, the US economy has been borrowing a large sum from Asia and oil producers. The magnitude of capital flows from the rest of the world to the US economy is not sustainable; it is a matter of time before the flows eventually reverse. And, in the process, the US dollar will depreciate against various currencies, including the Thai baht. The issue here is not only when the correction will take place, but how fast and how disruptive.

Thailand, like many emerging market economies with small and shallow financial markets, is particularly vulnerable to fast-moving international capital. Such rapid movements of capital flows, if vastly out of line with the underlying economic fundamentals, can have negative impacts on the export or import sectors depending on the direction of exchange rate movement. In our case, the surge in speculative capital inflows at the end of last year caused a rapid appreciation of the baht relative to regional currencies. I must stress that the recent capital surge heralds the onset, and not the end, of the unwinding of global financial imbalances. There remains considerable room for US dollar correction. As such, the threat of global imbalances to the economic and financial stability of Thailand is still very much present.

You may recall that we have experienced sizeable capital inflows, and accompanied with that, a rapid appreciation of the baht effective exchange rate toward the end of last year. In dealing with the rapid appreciation, conventional wisdom suggests an adherence to market mechanisms. This proved to be inadequate. The baht continued to appreciate with the likelihood of it becoming more and more out of line with its fundamentals. After a number of unsuccessful conventional measures, we resorted to the measure of imposing a reserve requirement on capital inflows in December 2006. The measure was designed to break the one-way currency momentum, to preserve our overall economic stability, and to buy some time to allow a smooth transition. Let me be clear that we intended for the reserve requirement to be a temporary measure, designed to preserve financial stability and to afford the real sector time to adjust to a more volatile market condition. To this end, I believe that it has succeeded.

To be sure, no measure is without its costs. The reserve requirement resulted in a wide-ranging effect on the market and the economy. In light of this, once the appreciation momentum was broken, we have been carefully modifying the coverage of the measure to allow greater flexibility for business operations. We have done this without compromising the needs to contain excessive volatility. That is, we have provided the option to fully hedge for loans and debt instruments. At the same time, we expect ongoing relaxations on capital outflow to bring about a better balance between inflows and outflows.

The unwinding of global imbalances will remain with us for the foreseeable future. During the transition, monetary policy can and must play a vital role in supporting the economy in its adjustment. And should the balance of risk shifts from inflation to growth, monetary policy will continue to focus on stability while supporting long-term economic expansion.

Ladies and Gentlemen,

The second challenge comes in the form of high and variable oil prices. As the global economy grows, so does its thirst for energy. An importer of oil, Thailand continues to be vulnerable to a sharp oil price shock that could abruptly exacerbate our current account. More importantly, as one of the most oil-intensive economies in Asia, the high price of oil can create a substantial price pressure and the risk of persistent inflation. The continued expansion of China and India suggests that oil prices may rise yet again in tandem with the global economic cycle. Nevertheless, increased productive capacity of oil suppliers and technological progress, which will enable us to decrease our reliance on oil over time, should dampen the impact in the medium run.

I have so far outlined the main challenges on the external front. But the key question remains: how will the Bank of Thailand meet these challenges and attain the goal of ensuring low and stable inflation as well as a resilient, well-functioning financial sector that is able to intermediate efficiently between savers and investors? **This leads to my <u>second point</u>.**

Before we grapple with global imbalances and high oil prices, we must first realize that the key factors underlying these challenges are largely beyond our control. They arise from the complex economic interactions on the global scale. However, the central bank can attempt to contain the adverse impacts of these external shocks on the domestic economy by preserving domestic monetary and financial stability. This is, of course, easier said than done. Rapid changes, whether from within or without, typically bring forth tension and necessitate tough decisions in trading off short-term pain for long-term gain.

The recent surge in oil prices is a case in point. High oil prices have had two adverse effects: pressure on prices and a drag on economic growth. Tightening interest rates is the Bank of Thailand's primary method of fighting inflation. However, high interest rates would burden firms and households already trying to cope with high oil prices. Domestic demand would be adversely affected. The decision entails a tough trade-off between lower interest rates that boost the economy today but invite inflation tomorrow. Tightening interest rates burden households today but pre-empt inflation tomorrow. In the most recent episode of high oil prices in 2004-2006, the Monetary Policy Committee's decision to tighten interest rates to maintain price stability was crucial for sustaining economic stability and growth in the current period.

Inflation has been well contained and its persistence pre-empted. Last year, consumer price inflation came down from a peak of 6 percent in the second quarter, to 3.3 percent in the last quarter. In the first quarter of this year, headline inflation registered 2.4 percent.

Ladies and Gentlemen,

My third and final point is that Thailand must enhance its ability to compete through productivity improvement to continue reaping the benefits of globalization.

The challenges of globalization are constantly changing. To meet these challenges from without, it is critical that the Thai economy build strength from within: by continuously improving the flexibility and efficiency of its firms, the resiliency of its households, and the competitiveness of its business environment. In this respect, public policy must engage in financial and real sector reforms and policies that promote a stable macroeconomic environment and a competitive private sector.

Looking ahead, our financial and legal infrastructures will continue to be strengthened particularly through the introduction of a number of legislations and amendments. The new Financial Institutions Act and the Deposit Insurance Act are in the pipeline. The Financial Sector Master Plan (FSMP) will move into its second phase, with an emphasis on increased competition and consideration on potential entry of new players to further enhance financial efficiency and resiliency. Our accession to the Basel II accord, an international framework for the risk management of banks, will further raise financial sector stability.

Monetary policy, a key responsibility of the Bank of Thailand, will continue to ensure low inflation environment crucial to well-functioning market economy. But there are limits to monetary policy in raising the standard of living over time. As such, a stable macroeconomic environment, no matter how crucial, is not enough to ensure long-run prosperity in the face of globalization. For that, we must turn to the private sector.

The private sector must also work continuously to improve its competitiveness by strengthening productivity. A sustained rise in wages and living standards cannot take place without productivity growth. And adaptability to the shifting winds of global competition cannot happen without the ability to adopt the best technology and the ability to use that technology efficiently.

To this end, the best competition policy for Thailand is policy to encourage competition. Encouraging competition means open markets. Open markets give firms the wherewithal and the incentive to invest, innovate and learn to be the best. The pacing and sequencing of market reform will also be crucial to its success.

While the goal is to have sustained productivity increase, we may not see the effects of these reforms right away. But we must continue pressing on with the reform effort and not let reform fatigue get in our way.

I need not remind you that Britain herself undertook deep and painful reforms during the 1980s. To a great extent, I believe the golden age the British economy is enjoying today reflects the hard work of not so long ago.

Ladies and gentlemen,

Globalization is a long and difficult road. We all know the rewards are considerable and the journey worthwhile. But sometimes the obstacles may seem discouraging, even insurmountable. The risks may seem too great. Nearly twenty years ago, the Thai economy was staggering from a global oil crisis. Ten years ago, Thailand was at the epicenter of the Asian financial crisis. Today, we face the challenges of global imbalances and high oil prices. I am optimistic that Thailand will once again overcome these challenges as it overcame those in the past with experience, lessons learned and foresight.

The future will bring with it a new set of challenges. I cannot tell you the shape or form that these future challenges will take. But I can tell you this: ten years from today, when my successor addresses the distinguished members of the British Chamber of Commerce, I expect that this room will not be large enough for such a gathering. Your membership will have grown by leaps and bounds together with your enterprises.

Ladies and Gentlemen,

The road ahead still beckons. We have come a long way together. Let us not stop now.

Thank you for your attention.