Tarisa Watanagase: Searching for a second wind – overcoming short-term obstacles for long-term prosperity

Dinner talk by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the Foreign Correspondents Club of Thailand, Bangkok, 24 July 2008.

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Distinguished FCCT Members and Guests,
Ladies and Gentlemen,

I would like to begin by thanking members of the FCCT Board, for inviting me to deliver this dinner talk. Today, I am very pleased to have an opportunity to share with you how I see the Thai economy evolving at the moment. The Bank of Thailand relies very much on the press in our communication to the public and this includes foreign correspondents in addition to the domestic ones. Therefore, whether you are aware of it or not, you are our partners in central bank's public communication process.

At the outset, I would like to reaffirm that the Monetary Policy Committee's collective decision to raise policy rate Wednesday last week was in the best interest of the Thai economy over the medium term. And, my talk today will aim to address two important questions, which everybody may have in his or her mind, on the future prospect of the Thai economy. These questions are first whether the Bank of Thailand's monetary policy is right for the current economic situation and secondly whether Thailand has the capacity to overcome the numerous challenges and regain dynamism in the near future.

Ladies and Gentlemen,

At this moment, high oil prices have put both advanced and developing economies alike in a very tough spot. Unfortunately, for Thailand, when it comes to oil shocks, we are not as resilient as many other economies as our economy depends heavily on oil. In fact, Thailand's oil dependency ratio, although has been falling, remained among the highest in the world since our logistic system has been neglected for sometime.

Prior to the recent hike in oil prices, Thailand was on the path to recovery. Indeed, economic growth picked up since the third quarter of last year with an expansion from 4.7 percent to 5.7 percent and 6.0 percent in the subsequent quarters, respectively. Domestic demand strengthened; consumption, investment and imports, all accelerated while exports performed rather well. This was a clear recovery pattern. Up to the end of the first quarter, the sentiment was lifted to a better prospect for Thailand, with many expecting average 6 percent growth for this year.

Unfortunately, the story did not end there. Oil prices soared again, passing the 120USD mark in May. Despite some correction last week, oil prices remain much higher than where they were the beginning of this year. Compounding this negative external shock was the return of street protests. Many expect both political uncertainties and oil prices to affect consumption and investment, but the latter to also have adverse impacts on our future ability to produce or what economists often call "productivity."

To add even more bad news, higher oil prices caused headline inflation to accelerate, registering 8.9 percent in June – the highest rate for the last 10 years. Given all available indicators, it is very likely that inflation will remain elevated for a while. Periods of rebounding consumer and businesses' confidence seem to have come to an end – a picture that many of you may have currently embraced.

Ladies and Gentlemen,

Despite the adverse domestic and external shocks, the Thai economy has so far continued to perform well. Latest economic indicators for the first two months of this quarter showed

continued expansion of both domestic spending and exports. On the supply side, production and prices of major crops grew markedly, resulting in an acceleration of farm income. Manufacturing production and the tourism sector also expanded well. The continued economic expansion has facilitated greater pass-through from producer prices to prices of other goods, lifting inflation further beyond the initial cost shocks.

Given the ongoing trend in inflation rate, however, the economy in this second half of the year will likely be less robust. There are some indications that the rise in the cost of production and the acceleration of inflation have begun to affect the economy's growth momentum. The weakest area of the economy at the moment is probably private investment which has been continuously decelerating for a few months now. But the surging inflation has also put private consumption increasingly at risk. Indeed, the latest issue of Asia Pacific Consensus Forecasts shows Thailand's GDP growth falling over the next three quarters before recovering in the second quarter of 2009.

Against this backdrop, the policy priority is to head off the rising inflationary pressure while keeping a close eye on downside risks to growth. This is normally already very difficult in the presence of cost-push shocks that create a short-run trade-off between inflation and output stabilization. What further complicates the current situation is that a prolonged period of oil shocks and inflation tends to divest funds from, as well as discourage, fixed capital investment and hence deteriorates what economists refer to as the economy's potential output. This issue is especially important when the economy is energy inefficient.

Let me elaborate further. Conceptually, potential output is the level of output which can be sustained over an extended period without exerting upward or downward pressure on inflation. When the actual level of output is above potential output, inflation tends to rise. Conversely, when the actual level of output is below potential output, inflation tends to fall. In this regard, the task of monetary policy can be loosely described as getting the economy's actual output as close as possible to potential output – tightening when actual growth exceeds potential and loosening when actual growth falls short of potential.

Now, if potential output also falls in the face of persistent supply shocks, then it is possible for inflation to persist even when actual output growth is moderating. For concreteness, imagine a car going at a 100-kilometer-per-hour speed limit on a highway turning onto a local street where the speed limit is now 60 kilometers per hour. Even if the driver reduces the speed of the car to 75 kilometers per hour, a 25% reduction perhaps as a result of a narrower roadway, he will still be charged with speeding. In real-world policy making, this is what happened to the United States in the 1970s when falling potential output resulted in high and persistent inflation despite the slowing economy. At the time, the Federal Reserve overestimated the U.S. potential output during the oil shocks and unknowingly pursued policy that kept the economy going at the rate in excess of the reduced potential.

The current tightening monetary policy of most central banks around the globe amid supply shocks reflects much of these concerns. It is important to recognize that growing beyond potential for too long is a serious threat to economic stability. To use monetary policy to accommodate growth when potential output is deteriorating would aggravate inflation and the subsequent disinflation effort would entail substantial costs. The U.S. disinflation experience in the early 1980s was the prime example of this. Known memorably as the Volcker disinflation, the Federal Reserve took about four years to bring down inflation, but at a cost of the 1981-2 recession which was the most severe in the post-World War II period.

Of course, one could argue that monetary policy is ineffective against supply shocks and therefore raising the interest rate would only further hurt the economy. It is true that monetary policy is a demand management tool. It is true that the best remedy to tackle any supply shock should be one from the supply-side policy that mitigates its impact on production costs and the economy's potential output. However, most supply-side policies take time. For example, it takes many years to improve the logistic system, education and skill attainment of the labor force, and institutional quality.

On the other hand, alleviation measures such as promoting the use of alternative energy has had a limited impact on inflation. In the short run therefore, what is left as a clear option is to adjust the demand accordingly to ensure stability in the immediate future as well as the medium term. After all, it is also true that inflation is a monetary phenomenon and should be corrected by monetary policy.

To make my point clearer, let me compare the current situation with the cake eating analogy. Suppose that you gain happiness from eating cakes. I guess we all do. But one day you find out that you have diabetes. If you continue to eat the same amount of cakes, your health will be at risk in the near future. If you want to continue eating cakes, the solution is simply to get a direct medicine that lowers the sugar level in your blood. But what if the effect of the medicine takes a long time to become effective? For his survival, the patient has no option but to reduce the amount of cakes intake. This is exactly what the monetary policy is doing. It is a demand management tool to augment supply measures that take time to make an impact. If the effect of supply-side policy, the direct medicine for supply shock, is limited and rising inflation is a threat to the health of the economy, one must forego the happiness today for a better future tomorrow.

Ladies and Gentlemen,

You may then ask where the evidence of the demand pressure is. Looking around, everywhere people seem to be tightening their belts and saving for the rainy days. Here, I would like to highlight the readily accessible indicators on capacity utilization and unemployment. Partly due to strong demand for Thai products abroad, the average capacity utilization rate for the first five months of this year was the highest since the 1997 crisis. Meanwhile, despite the unofficial figure of 2-2.5 million labour immigrants, the unemployment rate has been hovering around 1.5% during the past four months. In fact, internationally, it is very difficult to find countries with similar or lower unemployment rates than Thailand. The tightness of the labor market has manifested itself in the form of rising unit labor costs which in the first quarter of this year rose higher than productivity growth. This could be a sign of possible wage-price inflation.

Intuitive as it may seem, the cake eating analogy as well as several simple analogies you may have heard from our critics is not the whole story. What is missing in them is the reference to inflation expectations. Our critics seem to have completely disregarded the important and long-lasting role of inflation expectations. Strangely, concerns on inflation expectations, which feature prominently in the public discussion in other countries, seem to be relatively absent in this country. With your help, we can raise the level of public discussion about the forces underlying inflation here.

Again, central banks may be accused of being concerned on issues like inflation expectations that seem more academic than real. On this, I wish to emphasize that a valuable lesson from the previous two oil shocks thirty years ago is the role of inflation expectations in inflation developments.

It is now well established that, independent of demand and supply shocks, an increase in the public's long-term inflation expectations leads to higher inflation and lower output. Failure to keep inflation expectations in check will lead to persistent increases in the price level well after supply shocks vanishes. This is why modern central banks pay so much attention to ensure that inflation expectations do not run away. In general, how well a central bank can anchor the public's inflation expectations will depend on the extent in which the public perceived the central bank's seriousness in fighting inflation. Such credibility hinges critically on the central banks' actions and what the public expect it to do. Words like "behind the curve" are often used to describe central banks that move too slowly to curb public's inflation expectations.

Central bank, unlike the government which has a fixed term, has a greater incentive to care for economic stability. While the government tends to be more myopic in their policies, central bank is mandated to optimize the benefits across horizon. History has taught us that

a popular central bank is not always the most credible central bank. A pro-growth central bank is prone to inflationary bias which undermines its credibility in fighting inflation. Disinflation would then become more costly.

Inflation targeting is one framework to discipline the central bank by paying attention to price stability. It has been working very well for us and for many other countries in the world that have adopted the regime. But the challenge today is to find the right sacrifice ratio between economic growth and inflation. In addition, the central bank must ensure that inflation expectation is under control and the adherence of inflation targeting framework can go a long way to ensure this.

One thing people often misunderstand about inflation targeting is that we only care about inflation. This misunderstanding is propagated in the media through a narrow interpretation of the regime by some of its critics. For example, in a widely quoted article, *The Failure of Inflation Targeting*, the 2001 Nobel Prize winner, Joseph Stiglitz writes that inflation targeting implies "whenever price growth exceeds a target level, interest rates should be raised" and hence is destined to failure. This is certainly not true since all inflation targeting central banks look as well at indicators of real economic stability in a balancing act. The framework of inflation targeting as is currently practiced is flexible to accommodate secondary policy objectives. One needs not to look further than our MPC statements that the Bank of Thailand is also concerned about economic growth in addition to price stability. Other things that we do look at include external stability, financial conditions of households, financial institutions , and corporate sectors, and fiscal sustainability.

Another point that I would like to stress here is that, in the context of a small open economy like ours, taking care of inflation also has a positive impact on growth through a competitiveness channel. This works through the real effective exchange rate which takes into account our inflation differentials with our trading partners and trading competitors. Despite the recent weakening of the baht, Thailand's real effective exchange rate actually appreciated due to the surge in inflation. High inflation therefore erodes price competitiveness of our export sector which is perhaps the economy's only reliable growth engine at the moment. In the current environment where trying to squeeze more growth from domestic demand could lead to the situation of wage-price spiral where wage and price increases feed in each other, the MPC's latest decision could thus also be viewed as an attempt to maintain growth along with price stability.

While there are certain limits to what inflation targeting can achieve, after all it is not a cure all medicine, the focus on price stability makes the regime suitable to the rapidly changing global environment. Just a few years ago, supply expansion in countries like China and India contributed to a downward pressure on global prices. Today, the tide has turned and it is now strong demand in these countries that fuel rising energy and commodity prices. Going forward, it is expected that global price swings may become more unpredictable, in terms of duration and turning points. In this context, anchoring of inflation expectations offers the economy some protection from global price volatility.

Ladies and Gentlemen,

Let me turn to address the second question on the future dynamism of Thai economy. In this regard, I would like to emphasize that the situation in Thailand is not as bad as you might think. In fact, the fundamentals and room for maneuvering the right policy mix remain strong. Allow me to elaborate.

First, Thailand continues to preserve a strong external position. Our external debt to GDP ratio has hit an all-time low since 1980, recording 29.4 per cent last year. Our foreign reserves have doubled within three years, increasing from 50 billion US Dollars by the end of 2005 to more than 100 billion US Dollars at present day. The amount of foreign reserves is more than four times higher than short-term external debt. This gives us an ample room to safeguard against instability from volatile capital flow and exchange rate movements which are deemed out of line with the economic fundamentals if necessary.

Second, the government's fiscal position continues to improve as reflected by the falling trend of the public debt to GDP. Indeed, these improvements were the backbone of medium-term economic stability and provide much cushion against various economic shocks in the short term. They give the government the financial flexibility to execute policies that temporarily alleviate the public's inflation burden. It is no coincidence that over the past few years, credit rating companies have affirmed their ratings on Thailand, pointing at the strength of our fiscal and external position despite the economic downturn. Notwithstanding the difficult political climate in 2006, credit rating companies did not downgrade Thailand's sovereign rating. Although a few agencies put Thailand on a negative watch list but those were removed a few months afterward.

Third, the labor market shows no sign of rising unemployment rate, something that would be expected in a worsening business environment. But the tightness in the labor market may add inflationary pressure, a point in which I have already mentioned.

Fourth, the private sector has shown much resiliency and adaptability. For example, in response to the appreciation of the baht, exporters have made increasing uses of foreign exchange hedging instruments. At the same time, the increasingly diversified export market structure has provided Thai exporters with cushions against the current slowdown in major advanced economies. As another example, many private firms, burned by the crisis experience, no longer over-leverage their balance sheets and turn to equity and retained earnings as major sources of funds.

Fifth, the banking sector is now much healthier than even a few years ago. The BIS ratio of the entire banking system remained high at 15.3 per cent in May. Despite the economic slowdown, both ratios of gross NPL and net NPL to total loan declined slightly since the third quarter of last year. In fact, the outstanding amount of NPL declined in the last quarter. In addition, the implementation of IAS39 accounting standard in 2006-2007 and the preparation for the adoption of Basel II at the end of this year have together strengthened the stability of our banking system. With insignificant exposures to collateralized debt obligation (CDO) investments, the Thai banking sector as a whole is also immune to the U.S. sub-prime spillover.

Last but not least, Thailand is among the world's top places when it comes to the ease of starting and operating businesses. The recent report, "Doing Business 2008," by the World Bank upgraded Thailand by two places. Despite all the storms we faced, we are now ranked at 15th place out of 178 countries for the most attractive destination to invest. This reflects a better infrastructure for doing businesses in Thailand. The improvement was cited on the back of E-Custom system introduced since October 2006. Cost reduction, lesser time consuming and fewer procedures for imports and exports, all induce efficiency for international trades. Overall, we have strengthened the infrastructure or the micro aspects of doing businesses in Thailand.

Ladies and Gentlemen,

In all, I believe that quality investors look at both economic performance and policy credibility. It is obvious that short-term performance is not difficult to achieve but a consistent performance across horizon is a challenge. Getting the political will as well as policy mix and actions in the right direction is essential. The BOT has a clear stance and stands ready to secure the overall health of the Thai economy. The MPC has done its action last meeting and I believe we are on the right track. I need not remind you that Thailand is no stranger to difficult challenges. While being patient, we certainly have strong fundamentals for the second wind. It is just a matter of time to come.

At this critical juncture, the most the Bank of Thailand can do is to keep the macroeconomic environment conducive to sustainable growth and productivity improvements. The key to high-performance economy inevitably lies in supply-side policies that raise the economy's potential growth.

The fact that supply-side policies take time should urge the government to hasten such policies. However much conflict of interest between a fixed-term government and long-term policies may be, it is important to realize that raising productivity, and hence the economy's potential output, is ultimately the key to raise economic performance without provoking subsequent instability. As mentioned earlier, Thailand needs to be more resilient to oil shocks. For example, it is now a good opportunity to shape up our logistic system. Much integration needs to be done to coordinate the use of rail, road, river, and air transportation.

Ladies and Gentlemen,

My main message for you this evening is that the key for a successful economy is to preserve competitiveness and to grow at the potential rate as well as raising the potential output. This is to ensure both the performance and the sustainability of an economy. Many central banks are doing this through inflation targeting. At present, the risk of political uncertainty not only lies in terms of consumers and businesses' confidence, but also in the efficiency of the government to pursue policies that raise productivity. As negative supply shocks persist, the better the job done by the government to enhance productivity, that is, to secure our potential output, the lesser the cost of economic stabilization.

Thank you very much for your attention.