

Prasarn Trairatvorakul: The outlook for Thailand's economy in the face of concerns about the slowing US recovery and Europe's debt crisis

Address by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the Foreign Correspondents' Club of Thailand, Bangkok, 3 November 2011.

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Distinguished FCCT Members and Guests,

Ladies and Gentlemen,

First of all, I would like to thank the FCCT Board for inviting me to share my view on Thailand's economic outlook in the face of the U.S. economic slowdown and the Eurozone's sovereign debt crisis. Actually, the organizer's original intention reflects very well what was in the back of everyone's mind over the past few months when we talked about key challenges to the Thai economy. But as all of us here today might agree, things have changed so dramatically over the past month alone, with the country now being swept over by the flood.

While our feet need to stand firm weathering through and recovering from the flood together as a nation, our eyes cannot lose focus on what happens in the U.S. and the Eurozone. I think it is fair to say that what happens in the U.S. and the Eurozone will likely reshape the global financial and economic landscape over the years to come. And for Thailand, these factors and their implications on the global economy will also determine whether the recovery from the flood will be a rosy or a painful one. So, my talk today will be divided into two parts. First, I would like to touch briefly on the Bank of Thailand's latest view on domestic growth in short and medium term. Then I will delve more deeply into concerns in the U.S. and the Eurozone, along with the likely implications on Thailand's recovery.

Ladies and Gentlemen,

I would like to first share with you the Bank of Thailand's latest economic projection and our outlook for the Thai economy. Despite the fact that we have less than two months to go for 2011, the Bank has just revised down its growth projection for the Thai economy this year, from 4.1 percent in July's assessment to only 2.6 percent in October's. This significant downward revision reflects the severity and the broad-based impacts of the flood, which has brought about a halt in agricultural and manufacturing production in affected areas, and has also disrupted production chains in other areas as well. The automobile industry, which has just recovered from supply chain disruptions following natural disasters in Japan earlier this year, is once again terribly affected. And in the big picture, we have sharply lower consumption and investment spending that will require some time to resume their normal trend.

But even in the face of this hardship, and amidst the external environment that is quite unpredictable given heightened risks and uncertainty from the U.S. and the Eurozone, we still expect Thailand's growth outlook to be favorable next year. Provided that the flood situation starts to improve by early December, we should see Thailand staging a respectable comeback on the back of domestic demand revival. We expect private consumption to rebound as early as the first quarter next year, and investment to regain its firm footing by the second. This will be made possible by pushes from reconstruction spending and fiscal stimulus, both through the government's direct spending and additional measures. And in particular, higher investment on developments of flood warning and prevention systems is also urgently needed, both to prepare Thailand for future flood incidents and to restore foreign investors' confidence.

I would like to stress again that Thailand's fate will depend upon her success in reviving domestic demand, given that the problems in the U.S. and the Eurozone are still far from resolved and are expected to last well into the next year and beyond. Early resolution of the

U.S. and the Eurozone crises will rejuvenate the now-sluggish global growth momentum, and this will benefit Thailand by allowing her exports to work with domestic demand in driving growth. But if the opposite happens, then it is likely that another global economic slowdown, even a global recession, is coming underway.

Ladies and Gentlemen,

This leads us to our second focus today on developments in the U.S. and the Eurozone, along with their implications on Thailand's outlook going forward. Serious structural concerns continue to threaten the health of the U.S. economy. And given the lack of momentum from private and public sectors, U.S. growth will likely remain low for an extended period of time. While economic data releases have pointed time and again to delayed consumption spending and persistently high unemployment, available fiscal and monetary policy space seems to be quite limited. On the fiscal side, further stimulus will be constrained by the promised cuts in federal spending that accompany the recent raise of the U.S. debt ceiling. On the other hand, the Fed's commitment to maintain the federal funds rate "exceptionally low" at least through mid-2013 should remind us that, in order to be even more accommodative, the Fed might need to rethink and come up with some creative policy actions – probably something that is much more creative than the recent "Operation Twist" that seems to disappoint many market participants. The fact that the U.S. government and the Fed are running out of traditional policy "bullets" leaves one only to wonder what the government and the Fed will do in the face of future shocks. And if they eventually resort to "creative" policy actions, the implications of their policies on the global economy can be quite unpredictable.

Across the Atlantic, the Eurozone is also struggling with their sovereign debt crisis, which only deepens and intensifies as time passes. Over the past few months, we have seen some Eurozone member countries that are unwilling to collaborate fully, let alone going the extra mile, to get the problems solved. We have also seen Germany under tremendous pressure both at home and abroad with regard to its role in solving the crisis. Moreover, the future of Greece, where it all started, also remains unclear. We have seen various attempts in engineering debt restructuring for Greece, even an "orderly default"; and in late October we have seen agreement between Eurozone leaders and banks on Greek debt's haircut. Personally, I am concerned that many of these steps are merely "technical" solutions that do not address the situation at its root causes, and only time will tell how these "technical" steps would play out as well as what the eventual fate of Greece in the European Union would be.

Looking beyond Greece, some contagion of the sovereign debt crisis to the financial sector and the real economy of other European countries and beyond seem to be inevitable at this point, with countries that are "too big to bail" such as Italy also on the list. Private holders of PIIGS bonds face substantially higher risks, which have already led to recent downgrades of several financial institutions. Without decisive actions and unreserved collaboration in solving the debt crisis, the outlook for Eurozone economy is likely to be affected – given the possibility of further fiscal consolidation in countries like Italy, Spain, and even France.

Ladies and Gentlemen,

I would like to restate that what happens on both sides of the Atlantic will likely shape the global economy over the years to come. And at this point, I would like to stress more on why we cannot afford to be complacent with the situation.

Most importantly, there always seems to be an unbridgeable gap between what market anticipates and what governments and central banks can really offer at the end of the day. And if history is any guide, it is precisely this gap that creates ripples of disappointment and risk aversion that propagate throughout the global financial market almost instantly.

When we look back, not so far in the past, all of us have just witnessed a panic sell-off in global stock markets starting from late July to September. In addition to stocks, almost every type of risky assets was also under tremendous selling pressure across the board, and some

market commentators even went so far as comparing this event with the onset of the 2008 global financial crisis.

And when we look forward, the future is not very promising either due to two major reasons. First is the fact that so-called “milestone” developments toward the resolution of the crises in the U.S. and the Eurozone so far do not seem to address problems at their root causes; rather, issues have been dealt with merely temporarily, one after another. A recent example of this would be the eleventh-hour negotiation in the U.S. in raising debt ceiling limits only to meet the August-second deadline, which did nothing but leave the big elephant standing in the room. This event also serves very well to highlight the second reason, namely the political factor, which explains the temporary nature of the milestone steps mentioned earlier. Unless the so-called political “gridlock” is dealt with effectively in the U.S., passing and approving laws will remain a daunting task that needs to wait until the last minute. And unless the Eurozone leaders collaborate unreservedly, full resolution of the Eurozone crisis seems to be too lofty a goal to materialize.

Ladies and Gentlemen,

High risks and uncertainty surrounding the crises in the U.S. and the Eurozone contribute to higher risks in the global economy and financial markets, and Thailand will be affected in three primary ways – through international trade, financial market volatility, and inflation. I would like to touch briefly on each of these three channels respectively.

The impacts through the first channel, namely international trade, are natural given Thailand’s strong tie with the global economy, with G3 economies accounting for almost one-third of Thailand’s exports. Slowdown in the U.S. and the Eurozone, and their spillovers to the global economy, will dampen global demand for Thai exports. But fortunately, the impacts through trade can be cushioned to some degree, given that Thailand has moved toward more intra-regional trade within Asia and also has succeeded in diversifying to alternative export markets. Although I have mentioned before that Thailand’s economic fate next year will be in the hands of domestic demand recovery, further contribution from exports will be very helpful.

In addition to the international trade channel, what we should be even more concerned about is higher financial market volatility. While market sentiment on the U.S. and the Eurozone will determine the direction of capital movements, we anticipate volatile capital flows into Asia given the region’s continued strong growth prospects compared to advanced economies. Over the period ahead, capital inflows into Thailand also owe to the fact that monetary policy in advanced economies will likely remain exceptionally easy, which means excess global liquidity and capital inflows into emerging markets.

The third channel that the U.S. and the Eurozone crises may affect the Thai economy is through inflation. Generally speaking, global demand slowdown will likely lead to lower oil and commodity prices, hence the lower imported price pressures. So in contrast to the first two channels, this is a positive one. Nevertheless, domestically, as the flood situation improves, public and private spending will pick up thanks to reconstruction spending and fiscal stimulus. This, coupled with inflation expectations that will remain high over the months to come, points to significant upside risks to inflation that will need to be monitored.

Ladies and Gentlemen,

Given enormous challenges both at home and from abroad, moving Thailand forward will require policymakers to utilize a wide range of policy instruments at their disposal. At the very least, it is crucial to ensure a proper, integrated conduct of fiscal and monetary policies. On the fiscal front, investment in effective water management systems is urgently needed on top of reconstruction and assistance for flood victims and affected firms. This will not only restore foreign investors’ confidence, but will also enhance the economy’s productivity and its potential growth by avoiding future disruptions and making more efficient use of the country’s abundant water resources.

Nevertheless, the expected massive spending for such purposes will unavoidably stretch the government's fiscal resources. At the same time, the government will have to spare some fiscal policy "bullets" in the event that the situations in the U.S. and the Eurozone worsen more than expected and lead to another global recession. Against this backdrop, medium-term fiscal discipline is needed to ensure long-term sustainability of the country's public finance. This means the government will have to rethink or reprioritize certain policies that may not contribute to productivity enhancement.

Meanwhile, the Monetary Policy Committee (MPC) had been raising the policy interest rate over the past year, until the last meeting in October where the MPC held the policy rate unchanged. Personally, I view the current level of our policy rate to be accommodative enough to support domestic recovery, with some room available for further easing if needed. While upside risks to inflation are not very serious at the moment, we still need to keep our eyes on inflation pressures that are likely to build up with the pick-up in public and private spending after the flood is over.

Ladies and Gentlemen,

To end my talk today, I would like to restate my firm belief in the Thai economy. Even in the face of challenges at home and heightened risks from abroad, particularly from the U.S. and the Eurozone, the Thai economy should manage to recover soon after the flood situation resolves given the overall solid economic fundamentals. The Bank of Thailand will closely monitor upcoming developments both on domestic and external front, and will stand ready to take appropriate actions to ensure a smooth recovery process in the short term and sustained growth over the longer term for the Thai economy.

Thank you for your attention.