Pongpen Ruengvirayudh: The state of the Thai economy and macroeconomic policy

Speech by Ms Pongpen Ruengvirayudh, Deputy Governor for Monetary Stability of the Bank of Thailand, on behalf of Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the Joint Foreign Chambers of Commerce (JFCCT), Bangkok, 28 May 2013.

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Opening remarks

Your Excellencies,

Ladies and Gentlemen,

First of all, on behalf of the Governor, I would like to thank the Joint Foreign Chambers of Commerce for the invitation. Thailand and the members of JFCCT have a long-established relationship, in some cases spanning over several decades. The Chambers' work and efforts over the years have contributed significantly toward the economic development and prosperity here in Thailand. I hope that our economic partnership and cultural ties will continue to thrive as we further our cooperation in the future.

Let me share with you today my views on Thailand's economic assessment and how monetary policy can help address some of the immediate challenges facing the economy. Later in my talk, I will also touch on longer-term structural challenges which monetary policy may have little bearing on, but are nonetheless crucial for sustaining economic prosperity. But first, let me begin by reviewing current economic conditions and medium-term economic outlook.

Economic outlook and monetary policy

The economic expansion in 2012 at 6.4 percent proved to be stronger than most had anticipated, driven mainly by robust domestic demand amid post-flood reconstruction spending. The broad strength of private spending also testified to inherently sound economic fundamentals, including rising income, low unemployment, and robust private sector confidence. At the same time, additional support from accommodative macroeconomic policy, both fiscal and monetary, helped maintain economic momentum throughout last year.

Notwithstanding a somewhat lackluster economic performance in the first quarter of this year, many of the supportive factors are expected to remain in place. Forward-looking indicators suggest both businesses and consumers continue to hold positive outlook on the economy. Fiscal stimulus related to the large-scale public investment in infrastructure should begin to phase in from the latter part of this year, potentially generating positive crowding-in effects on private spending. Financial conditions also continue to be supportive of growth, with policy interest rate staying low and private sector credit growth expanding at a double-digit rate. Longer-term interest rates and borrowing costs have been low and stable, affording both businesses and households relatively easy access to finance. In fact, if anything, a high pace of credit growth may have raised risks of overheating in some sectors, with potential implications for financial stability. The Monetary Policy Committee (MPC) has flagged this risk several times since last year, and will continue to monitor the situation closely.

On the other hand, there remains an important drag to growth, largely stemming from a protracted global recovery. In some parts of Asia, the first quarter growth has turned out to be lower than expected, as a result of slowing global trade. In Thailand, Q1 growth has similarly been subdued, expanding 5.3 percent as both private consumption and investment moderated. Part of this pullback may have been a natural reversion to a lower pace of growth after an unusually strong expansion last year. Lingering uncertainty about global demand may have also caused some export firms to delay planned investment. Consumption may have been held back by farm income in the midst of low global commodity prices, and an accumulation of household debt, which is now at 78 percent of GDP. Set against this weaker-than-expected domestic demand, is relatively resilient exports which expanded more than 8 percent.

Given the still weak global demand on the one hand, and already easy financial conditions on the other, monetary policy must carefully weigh the merits of providing growth support against financial stability concerns. Policy interest rate is not the only available tool to address these multiple objectives. Macroprudential measures, in particular, are also part of the policy tool kit. The MPC will continue to exercise its best collective judgement as to what course of action and policy mix are deemed most appropriate to ensure maximum sustainable growth for the Thai economy.

Challenges from capital flows and exchange rate volatility

Let me now turn my discussion to a topic that has attracted a lot of attention recently, namely the issue of capital flows and exchange rate. The appreciation of the Thai baht this year up to late April has raised some concerns. During this period, the baht strengthened nearly 7 percent against the US dollar, and 10 percent against our trading partners' currencies. What has caused such movement in Thai baht?

There is little disagreement that, over a long period of time, exchange rates tend to appreciate in economies with better growth prospects, strong external balances and overall sound fundamentals. Over the past decade, currencies in Thailand and other parts of Asia have followed gradual appreciation trends, broadly consistent with their respective fundamentals. What sets this recent episode apart is the pace with which the baht has appreciated. Part of the appreciation could be interpreted as a 'catch-up' move, following a tepid period of last year when the baht underperformed many in the region. Meanwhile, several currencies in the region were also subject to their domestic issues. In South Korea, geopolitical factors resurfaced. In Malaysia, a looming election curbed risk appetite until mid-May. In Indonesia, current account balance remains in deficit, for example.

But even if one takes these factors into account, sharp movements in Thai baht in March and April are still difficult to justify by fundamentals alone. Our internal analysis has shown that the baht has, at times, deviated from its range of equilibrium or fair values. Elements of self-fulfilling prophecies were likely at work, encouraged by market speculation that the policy makers were adopting a hands-off approach regarding exchange rate. We welcome signs that the market has abandoned this misguided belief. The baht has been depreciating since late April, reducing the year-to-date appreciation against the dollar to about 3 percent. The correction is also evidence that under flexible exchange rate regime, unwarranted overshooting inevitably will be corrected by market forces.

The fact is that although the exchange rate is not the BOT's main policy tool, or an intermediate policy target, it is an integral part of our macroeconomic analysis and policy deliberation. Beyond aggregate statistics, it is also recognized that sharp exchange rate volatility can have significant impact on small businesses with less capacity to adjust. Thus, while exchange rate is allowed to play an active automatic stabilizing role under current framework, the MPC constantly monitors the impact of baht movements on the overall economy. To supplement this baseline analysis, the BOT staff also conducts projections under different degrees of baht appreciation. In a recent joint forecast exercise with the Ministry of Finance and the Office of the National Economic and Social Development Board (NESDB), the BOT's estimate of growth impact of baht appreciation in fact proved to be the largest among the three, testifying to our conservatism. In broad terms, however, the three agencies' analyses agree that baht appreciation alone should not derail the underlying momentum of the economy.

The MPC continues to be prudent, and vigilant about the potential adverse impact of extreme exchange rate volatility. The committee recognizes that, in the current environment where growth prospects differ wildly across regions and monetary policy in advanced economies remains ultra-loose, pressure from capital inflows may persist in the medium term. All available policy options are therefore open to considerations. Substantial preparation work has been ongoing to ensure that the right measures can be readily implemented should the situation warrant. Investors seeking long-term presence in Thailand should be reassured that productive capital inflows are still highly valued, and any introduction of measures will be carefully designed to minimize unintended consequences. After all, the goals of these measures are to preserve the financial and economic integrity, the very reason that attracts investors to Thailand in the first place.

Structural Impediments

Ladies and gentlemen,

Macroeconomic stabilization and demand management policy can only get us so far. The ultimate determinants of long-term growth are tied to the supply side of the economy, namely the deployment of effective capital and labour inputs. It is a pity that the supply-side issues are often overlooked in policy discussion, and action is often limited to structural 'reform' that comes too late. By addressing the structural issues early and preemptively, the long-run growth benefits are likely to be more substantial. So let me venture out of my familiar territory, and devote the rest of my talk to discuss one key structural issue facing the Thai economy – the labour shortage.

Unemployment is persistently low in Thailand, and is not very sensitive to the business cycles. One underlying cause is the low labour force, which limits the supply of workers. The total size of workforce may further decline with the secular demographic trend, an important issue I will come back to in a moment. But the low degree of cyclicality of unemployment suggests that there may be factors keeping the labour market tight other than demand pressure. Through our business contact and recent surveys, the labour shortage has repeatedly come up as one of the top concerns, alongside competitiveness and production costs among others, yet pressure on wages is largely absent. What labour market imperfections are responsible for the structural shortage of labour supply, or equivalently, persistent excess demand for labour?

A long standing issue is that of education and skills mismatch. The manufacturing industry, for example, often reports difficulties in hiring workers with vocational training, which is in shorter supply relative to university graduates.

There are also reports of under-supply of graduates in science, relative to social science. One reason may be the firms' reluctance to adjust wage upwards, resulting in shortage of supply at the going wage. This reluctance, in turn, may be caused by low marginal productivity of labour, which is a consequence of subdued capital formation over the years, resulting in low capital-to-labour ratio. Escaping this vicious cycle of low wage and labour shortage, involves an improvement in labour productivity via higher investment in physical capital. Several strategies have been proposed. Some argue that raising the minimum wage, despite its costs, can potentially promote investment and improves labour productivity. Some prefer to provide direct fiscal incentives for firms to invest. Others see public investment as holding the key.

The jury is still out as to how successful these approaches will prove to be in catalyzing an investment up-cycle, and ultimately alleviating the labour market issue. Fortunately, the currently conducive macroeconomic environment is already providing ample incentives for businesses to invest. Financing costs are currently low. Strong baht facilitates imports of capital goods. Firms stand to gain more from AEC integration if they carry out their planned investment in a timely manner. Collective efforts by all will also generate positive externalities, and can go a long way in easing the labour shortage problem for all parties.

One fundamental force that may exacerbate the labour shortage problem is the demographic change. Slowly but inexorably, the Thai society is aging, as the total fertility rate is consistently lower than the replacement rate. The number of people aged 65 and above will double in less than 10 years. As projected by NESDB, by 2030 the working-age population will fall from the current rate of 68 percent to just over 60 percent, making Thailand's old age dependency ratio slightly higher than the Asian average. The government can help manage this demographic transition by speeding up the reform of immigration policy, and simplify registration procedure. The initiatives can also fit in with the broader agenda of ASEAN integration, to leverage on regional resources and promote regional economic integration simultaneously.

Closing remarks

Let me close my remark by thanking all of you once again for your invaluable contributions to the Thai economy. The Bank of Thailand will continue our work of ensuring a stable financial and economic environment, so that businesses can continue to thrive and individuals can enjoy better standards of living on a sustainable basis. I hope that Thailand will continue to be a destination of choice for your investment, and a country of shared opportunity and prosperity for us all.

Thank you