# Pridiyathorn Devakula: Thailand - recent economic performance and the road ahead

Speech by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the British Chamber of Commerce-Thailand special luncheon, Bangkok, 1 October 2003.

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**Honorable guests, ladies and gentlemen**,

First of all, I would like to thank the British Chamber of Commerce for the invitation to speak today at this special luncheon. It is certainly a pleasure to have the opportunity to share with you my views on the economy, and on the prospects for the period ahead.

These days, Thailand's strong economic recovery, especially the growth outlook for the next year, has frequently hit the news headlines. One hears or reads about favorable economic outcome during the first half of this year even though the global environment was much troubled by uncertainties. Real GDP grew by 6.7 percent in the first quarter and was dampened only slightly by the repercussions of the Iraqi War and the outbreak of SARS to 5.8 percent in the second quarter.

Such resilience to adverse external shocks is a testimony of the economy's greater flexibility as well as its underlying strengths. With this, the National Economic and Social Development Board has revised upward the growth projection for 2003 by about half a percentage point to 5.8-6.2 percent.

From the Bank of Thailand's point of view, it is most important that the current recovery has been accompanied by a continued strengthening of economic stability both on the external and domestic fronts. While the current account has consistently been in surpluses and external debt falling steadily, public debt has also been declining substantially from roughly 57 to 50 percent of GDP over the past three quarters. Not only so, the **unemployment rate** continues to fall, and **headline inflation** is just slightly above 2 percent. As a result, international credit rating agencies have indicated positive views on the economy, citing improved growth with stability as the key reason for a number of sovereign and bank upgrades in recent months.

With these upbeat sentiments, let me now share with you my assessment of the economy. I will begin by evaluating some aspects of the economy's current performance and then move on to future prospects as well as the remaining challenges.

**Ladies and gentlemen,**

In the initial period when the economy was struggling hard to emerge from the crisis, it was exports that had provided a cyclical stimulus in shoring up aggregate demand. At that time, other engines of growth, namely, private consumption and investment, were unable to contribute much because the business sector was saddled with heavy debt burden, people were losing jobs, and machines were left idle as a legacy of over-investment in the prior years. But thanks to the fiscal stimulus, the economy eventually began to turn around within about two years after 1997.

For the past years, however, things have been looking up. Growth momentum from the private sector has picked up more firmly, making it possible for the Government to begin moving toward fiscal consolidation to ensure medium-term fiscal sustainability. According to current estimates, effective tax collection together with the economic expansion could allow the Government to achieve a balanced budget a couple of years earlier than planned. It is therefore clear that the thrust of growth has now been shifted from the fiscal sector to private hands, with export also contributing in a very significant manner. This is a much welcome development, as sustainable growth cannot rest forever on the shoulder of the government who makes up only about 15 percent of the country's GDP.

**Ladies and gentlemen,**

The key drivers of the current recovery, as you know, have been the strong performance of **export** and **private consumption**.

**Export of goods** broke its highest record in May this year at 6.5 billion US dollars and has since remained at the monthly average of 6.4 billion US dollars, with the average monthly export growth of around 12 percent year-on-year.

To many, this is a pleasant surprise given the export performance of other regional countries of late. It owes partly to the diversification of Thai export, both in terms of product type and market destination. In particular, our export is not concentrated in just one or two commodities but rather well balanced between agricultural, agro-industrial, and manufactured goods.

In terms of market destination, in the past, our export performance relied heavily on the market conditions of the G3 countries, with our export growth usually deteriorating when these economies were in recessions. However, the situation has changed in recent years with intra-regional trade quickly gaining a more significant role. With this, our export has enjoyed greater market access in China and other East Asian countries. The intensification of intra-regional trade, which is likely to continue, has made Thailand's export cycles less dependent on the G3 economies, and Thailand's strong export performance over the past year amid G3 economic slowdown is just a reflection of our more well-balanced export market base.

On this note, I would like to emphasize that **the EU** is indeed an important export market for Thailand, and export to the United Kingdom in particular comprises around 3-4 percent of Thailand's total export value. The good news is that even with keener competition in the world market, Thailand's export growth to the EU remains quite high at around 18 percent in the first half of this year, thanks in part to the contribution of chambers of commerce like yours.

Regarding **export of services**, we are all aware that the Thai tourism industry was hit hard by the outbreak of SARS in the second quarter. The number of foreign tourists in May dropped by as much as 50 percent year-on-year, a magnitude that dwarfed the impact of 911 by comparison. However, the severe impact was quickly over by the end of the quarter, and external income from services started to return to normalcy by July. For August, the number of foreign tourists indicated positive year-on-year growth, and the service account was in strong surplus for the second consecutive month.

Favorable conditions for the export of goods and improving environment for the export of services have allowed for a continued **current account surplus** and a **reduction in external obligations**. Steady external debt repayments, both by the public and private sectors, have resulted in a remarkable decline in the external debt stock, from the peak of 112 billion US dollars in June 1997 to only 52 billion US dollars at the end of July 2003. Even with the last portion of loan prepayment to the IMF two months ago, it is good news that our international reserves position continues to remain at a comfortable level of 39 billion US dollars.

Looking ahead, barring any unusual market developments, export should do well for the rest of this year. We have already seen in recent months sizeable raw material import in preparation for export at end year. Beyond that, the momentum is likely to benefit from encouraging signs of economic improvement in the US and Japan.

**Ladies and gentlemen,**

The other important engine of growth in this recovery has been **private consumption**.

On the one hand, strong household spending has been induced by a strengthening of consumer confidence, especially confidence on future income as farm income and non-farm employment continue to expand favorably.

On the other hand, consumers have benefited much from lower interest rates and greater access to loans from financial institutions, leasing firms, and other non-bank institutions. This pick-up in consumption is most clearly seen in the double-digit growth rate of durable consumption such as passenger cars and motorcycles, which in part reflects a large portion of the stock adjustment or the replacement of old cars bought prior to the 1997 crisis. And more recently, rising stock index, higher corporate profitability and higher dividend yields as well as recovering property prices have boosted household wealth, which would be positive for consumption.

Therefore, even though we have seen some moderation in consumption growth from the beginning of this year, favorable underlying factors regarding income, wealth, and financing are likely to stay supportive of consumption growth in the near term. It is thus likely that consumption will continue to be an important contributor to GDP growth, though not as strongly as in late 2002 and early 2003.

With consumption growth moderating, the big question is, "How then can people be talking about stronger GDP growth in Thailand next year?"

**Ladies and gentlemen,**

No economy can or should rely on private consumption as **the** main growth driver for an extended period of time. For the recovery to be sustained, the economy must eventually be supported by a pick-up in private capital spending. Thailand is no exception.

It is understandable why private investment so far has not contributed much to the economic recovery following the 1997 crisis. With about half of industrial capacity lying idle at the trough of the situation as a result of prior over-investment and demand contraction, there was very little incentive for firms to spend further on capital accumulation. Thus, the share of real private investment to real GDP fell from the average of 33 percent between 1990 and 1996 to just 11 percent in 1999.

The collapse in private investment is also reflected in the large and persistent saving-investment surplus, which has thus far narrowed only slowly despite the strong recovery in GDP. These symptoms show that a recovery in private investment has lagged substantially behind the overall economic recovery and that there is still much room for private investment to catch up and close the existing saving-investment gap.

The good news is that we have already begun to see a gradual pick-up in capital spending. Private investment growth that was at a modest 4.7 percent in 2001 has accelerated to 13.3 percent in 2002 and 17.5 percent in the first half of this year, and the share of real private investment to real GDP has also risen to 16 percent last quarter. But will this trend continue long enough to provide the needed fuel to sustain the current expansion?

Economic forecasting, as I have now learned, is a tricky business, not the least with a highly volatile component like private investment. In assessing future investment trend, we at the Bank of Thailand look at **key investment determinants**, including the return, cost of capital, and confidence factors.

Judging from the recent trend as well as outlook for each of the determinants, we have come to conclude that the prospect of a continued and robust growth of capital spending is good. In terms of return, corporate profitability is up, and marginal return to new investment is likely to be on the rise in line with a steady increase in the capacity utilization rate.

The low interest rate environment helps reduce the cost of capital as well as improve firms' liquidity and leverage position. Progress on corporate debt restructuring and the budding growth of bank credits to the industrial sector are also likely to help relax firms' financial constraints further. This means easier acquisition of the funding for new projects. Moreover, business sentiment as measured by the Business Sentiment Index is on a general rebound.

Therefore, barring no major disruptions to the recovery process coming from abroad, I expect private investment to come into the limelight, replacing private consumption as the main driver of growth in the period to come. That is to say, in terms of growth drivers, we should soon graduate from the combination of export and consumption to the combination of export and investment.

**Ladies and gentlemen,**

It is against this background of economic recovery that the stance of monetary policy in the past two years has been accommodative, given the absence of inflationary pressure. Reflecting this, the policy interest rate has been cut gradually since late 2001 to help stimulate domestic demand, ease financial constraints of the corporate sector, and ensure an uninterrupted process of recovery. So far, the low interest rate environment has been instrumental in reinvigorating domestic demand and maintaining the momentum of recovery. Such an environment, I believe, would need to be maintained until the expansion in consumption and exports was sustained enough to have led to a firmer pick-up in private investment. This, for the most part, has been a rationale behind our decision to lower interest rates given our strong external position and the absence of inflation.

**Ladies and gentlemen,**

To recapture, the Thai economy has managed well both in terms of growth and stability amidst external uncertainties and shocks like SARS. The recent performance reflects to a large extent favorable ingredients for further prosperity, including resilient confidence, robust domestic demand, and export competitiveness. It is fair to say that we have done well, but the true test of success is still down the road. At this juncture, it is important that we do not turn the corner to complacency but rather face the challenge of how to sustain or even raise growth slightly without creating problems in the long run.

I have three challenges for us to think about.

**First**, the government has emphasized the importance of balancing between external reliance and domestic strength in order to mitigate the problem of over-dependence on the possibly volatile external demand. The government's **dual track policy** aims to maintain global links between Thailand and her external markets while also creating a strong and broad-based domestic demand especially at the grass-roots level. The merit of programs that reach out to the grass roots like the Village Fund and the People's Bank is to help relax some of the financial constraints on low-income families which have had limited access to formal financial services.

On the upside, more opportunities are being granted to the underprivileged, with long-term benefits hopefully realized in the form of greater ability to earn and consume. However, overdoing some of these programs may induce households to assume too much risk and accumulate debt beyond their ability to service. That will eventually give rise to loan defaults and a burden on the government's budget.

At present, Thailand's household debt is still considered low compared to other emerging countries. At the end of 2002, the ratio of Thailand's household debt to GDP is only 27 percent, significantly lower than the ratios observed in other Asian economies. Moreover, this debt accumulation has taken place along with a steady increase in household income and asset, thus mitigating the risk of excessive debt burden.

While the debt issue does not look to be serious for now, a build-up of household debt stock could imply that private consumption would likely to become more sensitive to interest rate changes. This would have a direct implication on monetary policy because even a small change in the policy rate could now have a large impact on GDP when households are highly leveraged. It is therefore prudent for us to monitor household debt closely and ensure that the rise in household leverage is manageable.

The **second** challenge is posed by the slow recovery of commercial bank credits. Despite some positive development, it is clear that credit expansion has not kept up with economic growth, and the intermediary process between depositors and investors is still clogged up. While it is true that many companies can now resort to other means of financing such as issuing debentures or drawing from their retained earnings, the banking sector is still by far the largest source of funds for the corporate sector and is likely to remain so for many more years. Thus, a dysfunctional banking sector can surely threaten to undermine the strength of the economic recovery.

In the near term, non-performing loans (NPL) as well as non-performing assets (NPA) must be reduced more speedily, and indeed this has been one major focus of my work at the Bank of Thailand.

Of the remaining 773 billion baht of NPL in the banking system at end-June 2003, over 400 billion are either in the court process or have completed the court process and in the legal execution process with assets awaiting to be liquidated. To speed up the process of asset sales and liquidation, we have proposed to the Ministry of Finance to carve out this portion of the NPLs from the banks by an independent body that would be assigned the task of asset sales and liquidation. This proposal could become effective by early next year and the approach would greatly assist a speedy resolution of NPL problems. The remaining NPL of approximately 350 billion baht would not be a difficult problem for banks to handle, given the current low interest rate environment, the ongoing economic recovery, and improving bank profitability.

As for the longer term, it is important that the banking system diversifies its services and reaches out to meet the needs of the rural population currently considered under-serviced by the industry. This will ensure that financial constraints will not remain as an obstruction to a broad-based economic prosperity of Thailand. The Financial Sector Master Plan, which has been drafted by the Bank of Thailand and is currently under the Ministry of Finance's review, has looked closely at this important issue.

**And last but certainly not least**, even when the Thai economy can manage to sustain growth, we are not immune from new challenges and risks brought about by globalization. Outstanding export performance, strong domestic fundamentals, and continued GDP growth will unavoidably attract foreign capital into the country and, as in the recent months, exert upward pressure on the currency. While the economy now enjoys a more flexible adjustment mechanism compared with the past, a huge influx of foreign capital relative to the size of domestic financial and capital markets can nevertheless cause substantial market volatility and, if persists, can even lead to the emergence of asset price bubbles.

Regarding the upward pressure on the baht, the Bank of Thailand has been monitoring the currency movements closely and has introduced a number of measures to ensure that the adjustment is orderly, in particularly that the exchange rate volatility is kept at a manageable level for the corporate sector. Let me emphasize here that the Bank of Thailand regards the current appreciation of the baht as a natural occurrence for an economy on the recovery and is not concerned with a trend movement that is in line with improved economic fundamentals. However, with realization that Thailand has always been more open on the inward than the outward direction, we have taken this opportunity to liberalize the outflow side of the capital account to make things a bit more balanced. With this intention, institutional investors have been permitted to invest in overseas securities, and the establishment of mutual funds to invest on behalf of local individuals in Asian Bonds issued by sovereign and quasi-sovereign entities has also been encouraged. Moreover, the allowed holding period of foreign currency deposits was extended from 3 to 6 months.

The important lesson here is that we cannot push away globalization. Instead, we must learn to cope with and understand it well enough to reap maximum benefit from such an open environment. At the same time, we must reinforce our own immunity system, for example, by strengthening and broadening the domestic sector and by having good early warning indicators so that large capital fluctuations, should they occur, will not put a strain on the economy and impede our growth process. Appropriate policy mix regarding interest rate, exchange rate, and capital account liberalization thus remains an important challenge for the central bank.

**Ladies and gentlemen,**

I hope I have done my part today in sharing with you my assessment of the economy. My key point is that the economy is now doing better in terms of both the growth prospects and macroeconomic stability, and has the potential to continue to do well in the next year as the global economic environment improves. This important turnaround has come about through a combination of hard work, luck, and appropriate supportive policies, not to mention the progress that has been made on economic restructuring and reforms since the crisis.

But most important perhaps has been the commitment, the spirit, and the confidence of our private sector that have helped steer the Thai economy through one of her most difficult periods. On this, the contribution from the organization and people like yourself has played no small part, and I would like very much to use this opportunity to acknowledge this.

Going forward, the challenge is to translate the current momentum into a sustainable growth well into the medium term. This, as I noted earlier, would require a continued fostering of the export and consumption expansion so that capacity utilization could increase to the point that private sector capital investment would gain an even firmer footing.

During this period, monetary policy must remain supportive of the growth process. At the same time, we will continue to keep watchful eyes on certain areas of the economy that may expand too fast and impose risks to economic and financial stability. Should some of these excesses occur, however, the Bank of Thailand will make sure that appropriate measures will be employed to prevent and mitigate such risks.

**Ladies and gentlemen,**

Thank you for your attention.

I think I would just stop now to give time for questions. I’ll do my best to answer any questions you may have.

Thank you.