

Tarisa Watanagase: The Thai economy – risks, challenges, and opportunities

Speech by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the Foreign Bank Association Dinner Talk, Bangkok, 28 February 2007.

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Mr. Chairman,
Distinguished members of the Foreign Banks' Association,
Fellow bankers, members of the press,
Ladies and gentlemen,

I am very pleased to be here today, and to have this opportunity to share with you some thoughts on the challenges and outlook for the economy and our banking sector this year.

This forum has always been one where we can have frank discussions. And I very much look forward to hearing your views. Indeed, open communication is the cornerstone of a healthy working relationship.

Today, I would like to focus on three key topics.

First, the outlook for the economy,

Second, the immediate challenges for the economy and the banking sector,

And third, prospects for the Thai economy and the banking system in the medium and longer terms.

Let me begin with **the economy**.

Last year was a challenging year for all of us. The economy was buffeted by several negative factors. These included political uncertainties, high oil prices and severe flooding in many provinces. The combination of these factors led to increased upside risks to inflation, especially during the first half of 2006; and downside risks to growth. Domestic demand softened, and robust exports on the back of strong global growth helped sustain the momentum of the economy.

Our policy response, namely monetary tightening, proved timely. And as a result, inflation and its second round effects have been well contained. Headline inflation came down from a peak of 6 percent in the second quarter, to 3.3 percent in the last quarter, and to 3 percent in January this year.

Meanwhile, external stability continues to improve, with current account turning into surplus, and a strengthening of international reserves to almost 67 billion US dollars.

The economy proved to be quite resilient to external shocks. And growth momentum continued satisfactorily at 5.1 percent for the whole of last year.

But most of you are probably more concerned about prospects for this year and the next. This is understandable. **This year, the economy will continue to face a number of important challenges.**

Economic uncertainty has increased, as evidenced by declining investor sentiment and consumer confidence. Outside Thailand, the threat of a disorderly unwinding of global imbalances still persists. At home, the implementation of the reserve requirement and the introduction of the amended Foreign Business Act turned out to be unpleasant surprises to investors and the global community. And on top of all these, political uncertainty remains a material factor in the private sector's decision to invest.

The concern that some of you may have is: Can Thailand weather all these challenges well? Are we turning our back on globalization? A confluence of events in the past few months does appear to present a cause for concern. But I believe that Thailand will persevere, and that we should continue to take all advantages that globalization has to offer for years to come.

Our outlook for the Thai economy in the medium term remains positive. Our forecasts, once incorporating the risks I mentioned, show the Thai economy growing by 4-5 percent in 2007 and by 4-5 percent in 2008. The growth is expected to come mainly from exports, given healthy global conditions, additional government spending, and lower oil prices. These represent a respectable growth outlook for Thailand in light of the challenges and our focus on stability.

But a positive outlook by no means allows for complacency. We must constantly work to identify and manage the challenges. This leads me to my second point.

What are the key challenges to the Thai economy in the near term?

The first major challenge is that of financial globalization. On the **financial system front**, globalization brings complex financial instruments that require significant improvement in risk management, and the challenge of meeting international standards of Basel II and IAS 39. These are the manifestation of the forces of globalization that the Thai banking system is already facing, and will continue to face.

The overall effect is that the financial system and the economy may be subject to heightened uncertainties. And unless we strengthen our ability to manage these risks and challenges, the vulnerability can exacerbate, with possible implications for our economic and financial stability.

This, in my view, is a major challenge for all of us in the financial community.

The second major challenge to the Thai economy is how to cope successfully with volatile global financial markets and an appreciating baht. This challenge is the more pressing of the two. Let me explain why.

Thailand, like many emerging market economies with a small and shallow financial market, is particularly vulnerable to fast-moving international capital. Such rapid movements of capital flows, if vastly out of line with our ability to absorb it, can have negative impacts on the export or import sectors, depending on the direction of the exchange rate movement. In our case, the recent surge in speculative capital inflows caused a rapid one-way appreciation of the baht relative to regional currencies. The appreciation momentum hardly reflected our economic fundamentals. Left unchecked, it could have presented a clear threat to growth and stability – beginning with export, a current engine of growth, trickling down to the real sector, and eventually harming financial stability.

In dealing with currency appreciation, the prevailing wisdom of "letting the market work" has been given a chance. Yet the baht kept rising against almost all major and regional currencies at an alarming speed. Letting such rapid appreciation work itself out could have entailed significant risks to our agriculture sector, which employs nearly 40% of the labor force, and small and medium-sized firms in the labor-intensive manufacturing sector. We recognize that the real sector needs to adjust. But the overall economy needed some breathing room to afford a smooth transition.

After a number of unsuccessful capital account measures, we resorted to imposing a reserve requirement on capital inflows in December to break the rapid one-way momentum and preserve overall stability. To this end, the measure has succeeded in its task.

To be sure, no measure is cost-free. The reserve requirement has imparted a wide-ranging effect on the market and the economy. In response to this, once the appreciation momentum was broken, we have been carefully modifying the coverage of the measure to allow greater flexibility for business operations without compromising the needs to contain excessive volatility. We did this by providing the option to hedge fully for loans and inter-company loans. At the same time, significant relaxations on capital outflow were undertaken earlier this year to bring about a better balance between inflows and outflows.

Let me be clear that the reserve requirement was designed to preserve market stability and to afford the real sector, which includes many SME operations, time to adjust to a more volatile market condition. To be clear, the reserve requirement was not designed to maintain a certain exchange-rate level.

While the measure was necessary, we recognize its negative long-term effects and the adverse consequences on investor confidence and financial market development. As such, let me emphasize again that the reserve requirement is not a permanent measure; it is temporary. Its need is subject to constant review by the Bank of Thailand as the situation develops. A database of capital flows is also being upgraded. When we are satisfied that the situation has normalized – that is, the one-way speculation has more or less disappeared, and that the exchange rate movement is in line with other regional currencies – then we should be able to remove this measure. I will specifically address this issue again toward the end of my talk today.

My third and final point has to do with how we should deal with the challenge of global dynamism in the medium and longer terms.

Global dynamism in the form of international competition and 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 to the impact of global imbalances. As the balance of risk shifts from inflation to growth, the Bank of Thailand will ensure that monetary policy will continue to focus on stability while supporting growth. On the external stability front, should there be a disorderly unwinding of global imbalances, we may see rapid US dollar depreciation, which will put greater pressure on the baht.

Adjusting to these rapid exchange rate movements is inevitable. Last year, the Bank of Thailand intervened when necessary in the FX market to smooth the adjustment. This led to the increase in international reserves from 52 billion US dollars at the end of 2005 to almost 67 billion US dollars by the end of last year. In addition, the forward obligation rose from 3.8 billion US dollars in 2005 to 6.9 billion US dollars in 2006. These FX interventions and exchange rate movements do have implications for our own balance sheet.

First, the appreciation resulted in the unrealized loss from FX valuation of the international asset we hold when marked-to-market in baht. Simply put, the value of our international reserves in baht terms has fallen purely due to the falling US dollar and other major currencies vis-à-vis the baht.

Second, FX interventions lead to increased domestic liquidity. As a result, monetary sterilization is required to remove the resultant liquidity and safeguard price stability. This is a necessary and justified cost to central banks for preserving price stability, and safeguarding the economy against excessive exchange rate movements.

Such losses are an unavoidable consequence of central banking operations under a managed floating exchange rate regime. As regional currencies have sharply strengthened over the past year, most central banks in the region will also be facing a similar challenge. The key point here is that, our foreign assets, measured in foreign currency terms, have not fallen. More importantly, the goal of a central bank is to maintain monetary and financial stability. And I want to assure you that the loss will not affect the capacity of the Bank of Thailand in delivering its mandate in any way.

In the final analysis, monetary and financial stability alone can only provide a favorable environment for sustainable growth, but it is not sufficient to ensure that Thailand will overcome the challenge of global dynamism over the long run. The critical challenge here is for the Thai economy to make sustained gains in productivity through increased flexibility, efficiency, and competitiveness amid ever-changing global economic conditions and structure. In this respect, we need to continue with financial and real sector reforms, and pursue policies that promote macroeconomic flexibility and sustained growth.

Ladies and gentlemen,

I want to turn now to **the banking sector** and its challenges in the medium and longer terms.

Despite a challenging year, the banking system turned in a sound and robust performance, recording profit for the 5th consecutive year. Strong earnings over the past few years, together with improved asset quality and recapitalization efforts have strengthened banks' capital base. The BIS capital ratio is at a comfortable level and the NPL ratio has declined.

Loan growth has moderated in line with the economy, while borrowers as well as banks, have exercised caution in light of prevailing uncertainties. Improved financial strength and equally important, significant improvement in risk management at banks, have contributed to the resiliency of the system. This allows it to withstand the forces of change from globalization and intensified competition in the banking industry.

Banks will need to further build on this significant progress in order to meet the challenges going forward. These include macroeconomic challenges, growing pressure from increasing competition, and the changing regulatory environment. Obviously, the ability to meet these challenges varies among banks. But we, as regulators, are well prepared to steer a steady course for the banking system as a whole.

As you know, the first phase of the **Financial Sector Master Plan** has been completed. We have already seen significant consolidation and increased efficiency of the banking sector. We are moving onto the second phase of the Master Plan, which will further step up the pace of reform. This will increase the efficiency of the system and ensure that it can meet intensified competition that will come with globalization.

Let me emphasize that globalization is a pervasive process. Given financial innovations, it can transcend national borders even without an explicit market opening. Our liberalization strategy is to ensure strengthening of the domestic system, and allow gradual opening of the banking sector. This will mean new entries into the system, as well as more intensified competition between existing players. The phasing of this process will be consistent with continued economic and financial stability. The banking system must be prepared for greater competition.

Improved risk management framework will be the critical success factor for banks' ability to meet future challenges. These include the adoption of **IAS 39**, currently underway, and the **new Basel Capital Accord** at the end of next year. We realize that these reforms pose a major challenge to the banking system in Thailand as in the global market. However, the process of policy consultation and dialogue with the banking sector has assured us that banks are able to cope, although some more so than others. Nevertheless, IAS 39 will improve the transparency and provision buffer against impaired assets, while Basel II has already raised the standard of risk management that will be absolutely crucial going forward.

In summary,

We are **moving in the right direction** and are in a good position to build on this reform and to consolidate our progress.

How well-founded is our confidence?

As you know, we are currently undergoing **the Financial Sector Assessment Programme or FSAP** with the IMF and the World Bank, which assesses the supervisory process and financial sector soundness.

Preliminary findings on our compliance to the BIS core principles of banking supervision are favorable, with the results mostly fully compliant and largely compliant. All in all, Thailand's supervisory system compares well to international best practices. The only exception, as we all know, has to do with the inadequacy of the current legal infrastructure that provides for the Central Bank's autonomy and explicit supervisory power in key areas.

I must thank the tremendous effort and cooperation made by the banking sector throughout the whole FSAP process thus far. The next phase of the process will involve the stress test analysis of the banking system, which again, will require your cooperation.

The value of this exercise is not only to confirm our strength, but also to help guide us to areas of improvement that can safeguard us against future challenges. You can expect more improvements in our supervisory system in the months and years ahead, especially after the new Financial Institutions Businesses Act is enacted.

Ladies and gentlemen,

The economy and the banking system have come a long way to reach this point, where we are able to remain resilient against many difficult challenges. Such ability, to a large extent, rests crucially on setting the right policies to safeguard economic and financial stability.

For this, I have an excellent team of people with the knowledge and experience to help me deal effectively with the risks and the challenges. On the financial stability side, the team is headed by Dr. Bandid Nijathaworn, and on the monetary stability side, by Dr. Atchana Waiquamdee, both of whom are here with me today. And with the excellent cooperation from our colleagues in the financial sector, I am confident that the banking sector and the economy will continue to make solid and sustainable progress.

In closing, I would like to express my sincere appreciation to all of you who have contributed to our progress through your frank and candid dealings with us; and the competition you have infused into the banking system that has benefited consumers and served the business community at large. Indeed, orderly market competition is the most potent economic force that fosters progress. I hope that we will continue to build on this great relationship.

Ladies and gentlemen,

Tomorrow, March the first, the Bank of Thailand will implement a final review of the reserve requirement measure to give more flexibility to investors. Fully hedged capital inflows for the purchases of bonds, mutual fund shares, and property fund shares will be exempted from the reserve requirement. In essence, all investment flows that are until today subject to the reserve

requirement will be given a full-hedging option. With this announcement, let me conclude my talk this evening.

Thank you for your kind attention.