Tarisa Watanagase: Thailand’s economic outlook and challenges under the volatile financial environment

Keynote address by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the International Herald Tribune and Citigold Wealth Management Economic Forum 2007, Bangkok, 19 September 2007.

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Distinguished Guests,
Ladies and Gentlemen,

It is a pleasure to be here today to give a keynote address at the economic forum hosted by the International Herald Tribune and the CitiGold Wealth Management. I also like to thank the hosts for this important opportunity to share with you my perspectives on the Thai economy moving forward, especially in the global environment of greater financial volatility and uncertainties. I believe that the media, local and international, provides a very important two-way avenue for the central bank to communicate our views and the rationale underlying our policies to the public at large, and to receive feedbacks, positive as well as negative.

The topic of my talk today is ***“Thailand’s Economic Outlook and Challenges under the Volatile Financial Environment.”*** I will divide my address into three parts. First, I would like to highlight the key risks stemming from the recent global developments and outlook. In this connection, I would briefly touch on the implications of the US sub-prime market on the Thai economy. Second, I like to focus on recent key economic developments in Thailand and the outlook for 2008. I will then discuss the risks and challenges facing the Thai economy, especially those relating to volatile international capital movements and their impact on the Thai baht in the short term and in building resiliency and enhancing productivity for the long-term.

Ladies and Gentlemen,

Let me start with the global picture. For a number of years now, we have witnessed strong global growth driven mainly by growth in the US economy and in emerging markets, particularly non-Japan Asia. During this same period, we have also seen growing global imbalances with the rest of the world financing the US’s growing current account deficits. There is yet no consensus on how this global financial imbalance will unwind, but everyone expects that a large dollar correction will be part of the unwinding process, which will impact on financial markets and exchange rates worldwide.

My view is that we are likely to see more market jitters along the unwinding process of this global imbalance. Indeed, for the last couple years, we have already experienced large magnitude of capital fluctuations and exchange rate volatilities. This year alone, we have observed two episodes, in February and again in August, of the shift toward greater risk aversions, with sharp falls in the stock markets across the world, from New York to Shanghai, and Bangkok included.

At this juncture, there seems to be an increasing disconnect between global growth and financial stability. On the one hand, the global economy has continued and is expected to expand robustly, driven mainly by strong growth in the euro area and the emerging market economies, particularly China and India. Financial stability has, on the other hand, become more vulnerable than a few years ago.

Recent developments in the US economy and sub-prime credit markets may indeed be an early wake-up call for policymakers and market players worldwide. The US sub-prime related problem has prompted a retrenchment from risky assets and de-leveraging, causing wider credit spreads for riskier assets classes and higher volatilities in bond and equity markets around the world. The unwinding of carry-trade and flight to quality of international capital have also been observed.

Importantly, the resulting disruption has already required extraordinary liquidity injections by a number of central banks to smooth market fluctuations. Beside the financial sector, turmoil in the sub-prime markets also posed negative impact on the real sector, denting US growth prospects going forward.

I would like to digress briefly to tell you that the direct exposures of Thai financial institutions in collateralized debt obligations (CDOs) are relatively minimal, in terms of shares of their total assets. I also like to reassure you that we are keeping vigilance on potential indirect repercussion that may arise further from the impacts of US sub-prime markets to the global economy and financial markets, as the adjustment process is likely to be protracted. Moreover, we will have to wait and see how the US economy responds to the latest rate cut by the Fed.

In sum, the external risks facing the Thai economy have been tilted more towards financial volatility rather than growth at this point.

Ladies and gentlemen,

I have highlighted to you the risks that may likely emanate from the external front. But as recent developments in the Thai economy stemmed also from internal factors, this brings me to the second part of my talk, which is the recent key developments in Thailand and the outlook for 2008.

This year, even though Thailand's growth rate has underperformed those of our peers in the region, I still consider GDP growth of around 4-5 percent, which is expected for the whole of 2007, quite satisfactory. Notwithstanding the baht appreciation, Thai exports have expanded well and remained the main engine of growth this year. Our exporters have also successfully penetrated new markets to compensate the falling demand from the traditional market, namely the US.

Much of the extent of growth underperformance in comparison to our regional peers has been accounted for by slower domestic demand. Over a year-long political uncertainty led to weak consumer confidence and an unfavourable investment climate. I am hopeful that once the general election date is scheduled and the cloud of political uncertainty has lifted, consumer confidence would rebound.

In line with the consumption recovery, I also expect investment to pick up and play a stronger role as growth driver, to promote a more balanced economy. In this regard, greater clarity about the large public investment projects will be crucial in putting both public and private investment back on track. The continued high capacity utilization and investment promotion applications to the Board of Investment have pointed to stronger appetite for investment once the investment climate becomes more favourable.

During this period of uncertainties, monetary policy has become more accommodative in line with declining inflation and low risks of picking up going forward. Latest data for August showed headline inflation at 1.1 percent and core inflation at 0.7 percent. Set in this light, the Monetary Policy Committee cut its policy interest rate in total by 175 basis points since the beginning of this year. The aim is to stimulate the domestic demand to offset the expected slower export growth in light of the slower US economy and baht appreciation, though exports still remains an important driver of growth for next year. Latest economic forecast projects the economic growth to lie between 4.5-6.0 per cent in 2008, while core inflation is expected to stay comfortably around 1.0-2.0 percent.

Given the appreciation trend of the Thai baht thus far, we cannot deny that certain industries, especially those who rely more on the high local content materials, have been affected far more than those who rely more on the import-content materials. Though such deterioration in price competitiveness has been expected for some times, we have not seen real sector adjustments keeping up with the pace of changes in financial environment.

For those waiting to hear about the exchange rate trend, I will have to disappoint you as always. I would just like to say that, given the current inflation targeting framework, monetary policy can take care of exchange rate as long as there is no conflict with inflation. And, we have no target level for the Thai baht in mind. Foreign exchange market is intervened when there is too much volatility in the market. The objective is to smooth the country's adjustment during the transitional period.

Looking forward, the baht movement would depend largely on external developments which I have already discussed. Moreover, there are also internal drivers: large surplus in current and capital accounts. The Thai stock market remains one of the most popular destinations in emerging markets for foreign investors, given its relatively low P/E ratio. During the first 7 months of this year, foreign investors became net buy about 4 billion US dollar. Such inflows together with foreign direct investments have also added pressure on the currency.

Ladies and Gentlemen,

I would like to turn to the third and final part of my talk today, which is Thailand's approach in coping with the risks and challenges posed by globalization. Indeed, the challenges of globalization are constantly changing. To meet these challenges from without, it is critical that the Thai economy build strength from within: by continuously improving the flexibility and efficiency of its firms, the resiliency of its households, and the competitiveness of its business environment.

But beyond getting the fundamentals right and strengthening them, the Thai economy needs a strategic policy package that builds a system that allows for constant self-correction – one that also let the economy regain its strength quickly after a severe negative shock. That system should be underpinned by a strong link to the world economy, which will encourage innovation and efficiency.

Specifically, I should underscore that this approach requires policy markers to focus on achieving three key objectives, namely managing volatilities especially those emanating from volatile global capital movements; building resiliency in both real and financial sectors; and fostering long-term productivity improvement.

Looking ahead, the pressing and practical challenges we face in the near term are three-fold and indeed they are also inter-related. They are "hot money" inflows and large inflows in general, pressure for rapid domestic currency appreciation, and finally, the potential loss of monetary autonomy in the sense of independent interest rate policy.

Being part of the fast growing Asia, Thailand and its neighbors have become attractive destinations for international investors – although the more powerful underlying reason may ironically be a medium-term flight from US dollar assets since 2002. With large capital inflow comes pressure for these currencies to appreciate.

In this experience, some currencies appreciate faster than others. In fact, those that surrender most of their monetary autonomy or maintain restrictions on cross-border capital flows need not feel immediate pressure to appreciate. But those that have come further along the liberalization road have to face a different kind of challenge.

In our case, the Bank of Thailand has sought a balanced approach to managing capital flows under flexible exchange rate. We also undertake concomitant reforms in the area of financial system and market development. These initiatives are closely related and progress in one requires progress in the others. In building a resilient economy, prudent fiscal and monetary policy does help. As an automatic stabilizer, flexible exchange rate also helps.

Ladies and Gentlemen,

Hot money, or indeed large inflows in general, can fuel asset prices and encourage excessive risk-taking behavior. Central banks may wish to counter that excess in the interest of financial stability. If the central bank chooses to maintain a high interest rate stance, the pressure on the currency to appreciate will likely mount.

Since these challenges require significant ability for the domestic economy to adjust flexibly, the solution package we seek must help reduce the distortions in our economies. Allowing the competitive pressure and incentive to operate is undoubtedly the best way to foster investment in physical and human capital, as well as innovation and risk-taking, all of which are crucial to long-term productivity growth. They are also crucial for a flexible and resilient economy. But policy and regulations still have a role to play. The imperative here is to improve on policy and regulation design that can help deal with market excesses.

Building on the spirit of entrepreneurship, the **real sector** must work continuously to improve its competitiveness by strengthening productivity. A sustained rise in wages and living standards cannot take place without productivity growth. And adaptability to the shifting winds of global competition cannot happen without the ability to adopt the best technology and the ability to use that technology efficiently.

To this end, the best competition policy for Thailand is policy to encourage competition. Encouraging competition means open markets. Open markets give firms the means and the incentive to invest, innovate and learn to be the best.

As regards the **financial sector**, Thailand not only requires stronger financial intermediaries but also market players of different views and risk appetites to ensure that the markets and financial system will undergo constant self-correction. Access to deeper and more liquid capital markets is another crucial element of financial development going forward.

At this juncture, our own financial markets may not be deep enough soon enough, but some domestic players who are ready for it should not be encumbered from having access to the world financial markets. Indeed, those who can manage the risks have benefited from liberalized inflows in the past, but the Thai economy may benefit more if its citizens can unload domestic systematic risk abroad.

To this end, the Bank of Thailand has progressively pursued capital account liberalization on the outflow side. Outflow for portfolio investment was first permitted in 2003. Since the beginning of this year, we have expanded the limits of Thai direct investment and portfolio investment abroad. To promote more balanced-capital movements, further liberalization measures, including the relaxation of FX holdings by juristic persons and individuals, were implemented during the last two months, and we are currently monitoring their impact on capital outflows.

Indeed, the appropriate degree of financial openness through time is a controversial issue. Key is the right pacing and sequencing of capital account liberalization. It is also important to underline the fact that big market events that pose systemic risks tend to reflect collective mistakes in which most market participants are offside in the same direction. In this regard, capital control measures can be useful tools for reducing the chance of prolonged financial misalignment with economic fundamentals.

Ladies and Gentlemen,

The **Thai financial landscape** is changing. Therefore, it is our goal to ensure that our regulatory and supervisory responses keep pace with the financial intermediaries and the products they offer. In this endeavor, the Bank of Thailand has put emphasis on robust stress testing, enhanced counterparty risk management, and safe and efficient market infrastructures. Our financial and legal infrastructures will continue to be strengthened particularly through the introduction of a number of legislations and amendments. The new Deposit Insurance Act and the Financial Institutions Act are in the pipeline. Specifically, the latter Act will stipulate prompt corrective action and grant the Bank of Thailand power to conduct supervision on a consolidated basis.

The current Financial Sector Master Plan (FSMP) will move into its second phase, with an emphasis on increased competition and consideration on potential entry of new players to further enhance financial efficiency and resiliency. Our accession to the Basel II accord will upgrade the risk management of banks to the best standard and will further enhance financial sector stability.

Ladies and Gentlemen,

To end my talk today, I would like to emphasize that policymakers must avoid misplacing the focus of policies just on short-term issues. They must instead always weigh very carefully between short-term and long-term objectives toward achieving strengthened resiliency of the overall economy. Only with such resiliency, will a small open economy like Thailand be able to sail through the waves of global financial turbulence in the years ahead.