Bandid Nijathaworn: Economic volatility in the Year of the Rat

Speech by Dr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at a seminar on "Economic Volatility in the Year of the Rat, Fight or Flight", organised by the Foreign Correspondents' Club of Thailand, Bangkok, 6 March 2008.

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Thank you and good evening,

Let me begin first by thanking the FCCT for the invitation. It must have been a long while since I last visited or spoke at a FCCT event, so it is good to be back.

Tonight's topic is economic volatility in the year of the Rat. According to Chinese astrology, Rat is an auspicious animal, and the year of the rat is usually a year of plenty, bringing opportunity and good prospects. So, I think we have a good start. And judging from what has been happening, this year looks to be interesting and challenging both for the markets and policymakers.

At this time, we are seeing widespread fears of recession in the US, a deepening of the credit problem, and stubbornly high oil prices. These developments are definitely a negative setting for the global economy and financial markets. Tonight, my talk will focus on global economic volatility and possible implications for Thailand. And I want to do this by offering a perspective on how we see things developing from a financial regulator's point of view.

First, the US economy. Latest economic data from the US are not positive. There are more weak numbers than good ones, with signs of economic slowdown becoming increasingly visible. Drawing on the information up to the end of February, the key elements of the latest data include continued correction in the housing market, further fall in consumer confidence, slowdown in consumer spending and private investment, and weaker employment numbers. The good news is that exports in the US are holding up well, and the financial conditions of companies, especially the non-financial companies, are intact. But going forward, the correction in the housing market is likely to continue, which will weigh on economic activities.

On the financial market side, things also are not looking up. CDX spread continues to rise, indicating increased risk premium in the CDO market. And as confidence in the market for securitized credit is yet to return, more writedown can be expected. Next, as economic activities in the US slow down, the quality of bank's other assets such as commercial real estate and consumer loans may come under greater pressure, affecting bank profitability. With profit declining, banks may become more risk averse to protect capital, putting more pressure on credit extension and the real economy.

So, latest US data point to a weaker outlook ahead with more downside risks in the near-term. The risks include further correction in the housing market, continued tightening of the credit conditions, and further decline in economic activities.

Outside the US, the economic picture looks less negative. While the adjustments in housing market are also ongoing in Europe, and some European Banks have reported losses in CDOs, the impact on economic activities is expected to be more limited. For example, Consensus Forecasts in February, revised downward the Euro Zone's GDP growth for 2008 by only 0.3 percentage points from December compared with a 0.5 percentage point downward revision for the US. For Southeast Asia, the impact is also forecasted to be limited. Latest consensus forecasts for Southeast Asia's GDP growth is 5.7 percent for 2008, declining slightly from the forecast of 5.9 percent in December last year.

These forecasts, together with the latest data, suggest that, in the short-term, things will likely get worse before they get better, and the slowing of growth in the US will impact growth globally. The key question, at this time, is how deep can things get before we see a turnaround. This is definitely an important, but a difficult question to answer. Market participants as usual will have a range of views, and I personally do not intend to offer another prediction. Instead, I want to share with you my thoughts on the current developments and on what this will mean for Thailand.

To begin, one context that I think is useful in understanding the current turmoil is the unwinding of the global imbalance, triggered by corrections in the US housing market that began in 2006, and is now ongoing. Such unwinding is a necessary process to clear excesses and reduce financial leverages that have been built up in the form of high level of the US's current account deficits.

Economically speaking, to reduce the deficits, the value of the US dollar needs to fall and the levels of US long-term interest rates need to rise. Exchange rate adjustment is very much ongoing. The US dollar has declined by about 8.0 percent in nominal effective terms since 2006. And reflecting this, the US current account began to show improvements last year, and is expected to improve further as we go forward.

Experiences from the recent episodes of current account adjustments elsewhere, including the one here in Thailand after 1997, show that this process of adjustment can be long, with a potential for substantial dislocations to economic activities, especially if proper policies are not put in place. Important in this context is the dynamic of the interactions between the real economy and the financial sector that tend to feed on each other either positively or negatively.

Therefore, to address the current challenge, it is important that policymakers pay close attention to this dynamic especially on the issues of liquidity, the health of the banking sector, the conditions for a normalization of business activities, and the ability to service debt by households. In my view, policymakers in the US have moved relatively quickly on all these fronts, which is positive for the markets.

Let me turn now to the implications for Thailand.

Being a small open economy, Thailand will not be able to avoid the impact of the global slowdown or the increase in economic volatilities. The US now forms about 12 percent of our export markets.

As for the direct impact of the sub-prime, the exposure of the Thai banking system to CDO is very limited. Total investment by Thai banks on all CDOs is 0.26 percent of bank's total asset in June last year, of which 0.03 percent was sub-prime related. Such exposure has declined further in December, and banks that have CDO investments have increased their provisionings accordingly. At the end December last year, the BIS ratio for capital adequacy for the Thai banking system was 14.6 percent, well above the minimum requirement of 8.5 percent.

More important concern, however, is the indirect economic and financial impacts through (i) possible exports decline as the result of global economy slowdown, (ii) a tightening of global liquidity, and (iii) possible increase in the volatility of capital flows, as risk is being repriced by global investors. These indirect impacts have a potential to impart more volatility to our markets, depending on the magnitude of the global slowdown. So far, no adverse impact has emerged, but with more downside risk and uncertainty ahead, it is important that one is not complacent and is alert for all possible impacts and outcomes.

This point was fully recognized by the Bank of Thailand's Monetary Policy Committee in its meeting last month. The MPC's post-meeting statement made clear of the need to monitor the situation in the global market closely so that the stance of monetary policy can be appropriately and flexibly calibrated to ensure price stability and steady growth.

Finally, the last point I want to stress is that the ability of the Thai economy to weather external shocks and global slowdown at this time are now much greater compared to the situations say ten years ago.

First, the country's economic fundamentals have improved from the crisis years, with solid external positions marked by current account surpluses, high level of international reserves, and much lower level of external debt. This stronger financial position will enhance the ability of the economy to cushion itself against external shocks.

Second, our banking sector is in excellent shape, with good profitability, strong capital base, and improved asset quality. The corporate sector is also in good financial shape with strong earnings and low financial leverage. These qualities will make the private sector more resilient to the impact of economic volatilities from outside.

And third, policy regime in Thailand has become more flexible, especially the exchange rate, with market force now playing a dominant role in allocating resources. Such attribute provides the private sector with a mechanism to efficiently adjust to the impact of external shocks.

I am confident that these improved fundamentals will help lessen the impact of the global slowdown on the economy, enhance the ability of the private sector to manage and deal with economic volatility, and provide the economy with a strong foundation to continue with stronger growth and stability in the years ahead.

This is all I want to say this evening. I hope it has been useful. And I want to end by wishing the year of the Rat to be a year of plenty, bringing opportunities and good prospects to all of you at the FCCT.

Thank you.