

Tarisa Watanagase: Japan-Thailand – partnership in prosperity

Dinner talk by Dr Tarisa Watanagase, Governor of the Bank of Thailand, to the Japanese Chamber of Commerce, Bangkok, 25 March 2008.

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Ladies and gentlemen,

I would like to thank the Japanese Chamber of Commerce for the invitation to speak before you tonight. It has been a year since I gave a talk at a similar function held by the Chamber. I remember we had a lively exchange of ideas then, and I am glad you keep in touch.

With long presence in Thailand, the Japanese Chamber has played an active role in promoting common understanding between Thai government agencies and the Japanese business community here. Japan-Thailand economic relationship is both special in breadth and depth. Even a casual observer cannot fail to notice this prosperous partnership. Trade between our nations has doubled in value over the past 5 years; that's roughly 14 per cent increase per year. On the investment front, Japan's annual direct investment in Thailand has been steady at close to 3 billion US dollars over the past few years, considerable uncertainties notwithstanding. Japanese financial service providers are lively participants in the Thai financial system.

Ladies and gentlemen,

Much has happened since we last met. The story of financial disruption is playing out in the US and reverberating across the world. Oil prices have increased by more than 50 per cent. Businesses and governments are looking for best response strategies to ensure smooth expansion of their enterprises and the economy in general.

Tonight, I would like to focus on 3 related and timely subjects. I will begin with my view on the outlook of the Thai economy and the risks surrounding its prospects. Then, I would like to outline what I think is necessary for monetary and exchange rate policy going forward. And lastly, I would like to talk about how we can foster private investment and what Japanese businesses can do, in your role as investors and employers, to help make Thailand an even better place to invest.

Ladies and gentlemen,

As you well know, the Thai economy had to weather through a host of challenges over the past 2 years. To my mind, and from the view of the Monetary Policy Committee, domestic political uncertainty, high and rising energy prices and sharp US dollar decline were at the top of our concern. Indeed, political uncertainty, coupled with rising retail oil prices, took a toll on private sector confidence and consumers' purchasing power. These negative developments dented domestic demand during the first 9 months of 2007.

The fall of the US dollar, while widely anticipated, had been a major risk that could disrupt Thailand's robust export activities. In fact, the risk was even greater after the extent of the US financial crisis became clearer during the second half of 2007. The US sub-prime mortgage market, while small compared to the entire global financial system, could deliver a large impact on the back of US housing concerns, credit crunch and global liquidity squeeze. It made for a bad prognosis especially as last year's growth momentum relied heavily on net exports.

When all is said and done, however, the Thai economy managed to grow at the rate of 5.7 per cent for the fourth quarter and 4.8 per cent for the whole year. Government pump-priming contributed to this favorable growth outcome. But most importantly, it turned out that net exports contributed to almost 60 per cent of the overall GDP growth. Indeed, exports grew at a remarkable rate of 18 per cent in US dollar terms in 2007. The robust expansion was due

to the ability of exporters to adjust through quality improvement and search of new markets. But exceptional export performance was due no less to healthy global growth, which translated into strong trading partners' demand. Another factor that contributed to the success of exports was our ability to preserve overall price competitiveness in the face of sharp dollar decline. I will come back to this point in a few minutes.

I would like to turn briefly now to economic stability. Monetary policy has been accommodative to growth since the beginning of 2007 with an aim to shore up domestic demand while keeping inflation in check. The outcome on this front is quite favorable, as headline and core inflation were well contained at 2.3 and 1.1 percent, respectively, by end-2007. Despite the unusual global situation, the Thai financial markets also remained resilient through 2007 with only moderate fluctuations. And while credit and deposit grew slowly, profitability of banks and financial institutions remained at a satisfactory level. Overall NPLs in the banking system remained moderate, as low income households' ability to service debt started to decline mostly on account of slow income expansion.

Ladies and gentlemen,

These growth and stability outcomes under significant downside risks paint a picture of a resilient economy.

As far as the outlook for the Thai economy in 2008 is concerned, I would like to address first the growth momentum and then talk about the risks and uncertainties confronting the economy this year.

Preliminary data indicate that private consumption and investment are firming up after recovering during the fourth quarter last year. This is good news, as private consumption and investment constitute almost 70 per cent of total demand. Clearer political landscape post-election and continued spending by the government has helped revive private demand. Reflecting that, we have started to see strong pickup in imports in January. February data also confirmed the strength of imports. Moreover, plans for further fiscal stimulus as well as accelerated budget disbursement should ensure that domestic demand revival is firmly in place.

On the external side, even though export growth in January is especially robust at 33 per cent, the likelihood of seeing a repeat of spectacular export performance is slimmer this year, as global growth is projected to slow down considerably. In fact, export growth in February has already decelerated to 16 percent.

Going forward, the risk factors that can weigh on the ability of the Thai economy to expand will likely come from the US recession and high oil and commodity prices.

In an increasingly integrated world, the slowdown in US demand can impact on Thailand's export prospects. Despite the Fed's aggressive interest rate cuts and innovative measures to forestall the rise in mortgage interest rates, substantial downside risk remains. Most US watchers agree that the US economy may not be able to avoid a recession; indeed, employment, house price and business confidence data all point to a possibility that it is already in a recession. It's only a matter of how deep and how long this process will last.

But while the US economy weakens substantially with worsening prospects, global price pressure is not letting off. Crude oil prices continue to rise as world oil demand strengthens in the face of limited global production capacity. In this tight demand-supply situation, adverse geopolitical events, unfavorable weather condition or further dollar slide can spike up oil prices. This phenomenon is not new. In fact, continued demand pressure coupled with supply constraint and other uncertainties have led countries to find substitutes to fossil fuel. So far they have found them in bio-fuels, which in turn put pressure on agriculture commodity prices.

Signs of mounting cost-push pressure from oil and commodity prices can be observed in the recent acceleration of domestic headline inflation, which rose above 5 per cent in February.

Such increase, if continued, can pose risk to the incipient recovery in private consumption as it lowers households' purchasing power. Rising production and construction costs can also dampen business profit, especially in the face of tight control on final goods prices. Dampened prospects for profits in turn may lead to delays of planned investment. While this downside risk is substantial, there is also an upside. Higher commodity prices strengthen farm income, which tends to benefit a large section of the Thai workforce.

Ladies and Gentlemen,

The risks to global growth and global inflation have both increased in the near-term. At this point, we cannot be sure how the slowdown of global growth will affect global inflation this year. And even though, from an asset price perspective, there is a positive probability for a correction in oil and commodity prices going forward, we cannot be certain that such correction will be substantial enough to bring the inflation risk down.

One thing is more or less certain, however: Global financial interconnectedness almost all but ensures that we should expect higher financial volatility in the near term, as market players alternate between yield-seeking and risk-aversion investment strategies. The Bank of Thailand is closely monitoring the situation and assessing the impact on Thailand's financial and economic stability.

Given the pickup in domestic growth momentum and various risks the Thai economy is likely to confront, the Monetary Policy Committee expected Thailand's GDP to expand by 4.5-6 per cent this year while inflation excluding raw food and energy should remain within target of 0-3.5 per cent for the next 8 quarters. In the face of rising food and energy prices, headline inflation is expected to hover between 2.8-4 per cent in 2008, but is expected to come down next year. I want to note however that the Monetary Policy Committee's new forecast will be given in April along with the latest *Inflation Report*.

Ladies and Gentlemen,

I have talked at length about the economic outlook and risks going forward. What then is the appropriate course for monetary and exchange rate policy that I think can help cushion the economy along the bumpy road ahead?

Monetary policy is aimed to ensure price stability so that the economy can continue to expand at its full potential. The definition of price stability that the Monetary Policy Committee uses is in alignment with that of the public; that is, we want to see low and stable inflation over time. At the moment, when our policy interest rate is the lowest in the region, monetary policy continues to be supportive of domestic demand growth. In the periods ahead, the challenge to monetary policy is likely to come from increased price pressure.

With regard to our exchange rate policy, the Bank of Thailand has used the managed floating approach for some time now. Our principle is to let the exchange rate reflect the fundamentals of the economy relative to our trading partners and competitors.

In the short run, international price competitiveness depends on 2 things: 1. the appreciation of the Thai baht vis-à-vis a basket of currencies of our trading partners and competitors; and 2. the increase in production cost of a Thai company relative to that of our trading partners and competitors. For example, given the same appreciation path of two competing currencies vis-à-vis the US dollar, if production cost of a Thai company rises beyond that of its foreign competitors, then it loses price competitiveness. Generally, production cost rises with inflation. And so, keeping inflation low helps to lower relative cost increase for Thai exporters and boosts their price competitiveness. The exchange rate that the Bank of Thailand manages is that which represents price competitiveness; it is called the real effective exchange rate.

Let me give you a specific example: It is well known that even though the baht has gained against the US dollar, it has been appreciating in line with regional currencies. From the beginning of 2007 to early March 2008, the real effective exchange rate of China has

appreciated by roughly 8 per cent while India has gained by 5.4 per cent. During the same period, the Thai baht real effective exchange rate has appreciated by only 1.8 per cent. So taking into account higher inflation in China and India, an average Thailand-based exporter has not lost price competitiveness against those based in these two countries.

Viewed in this light, the export boom should not come as a big surprise.

Ladies and Gentlemen,

To gain the most from exchange rate flexibility, the Bank of Thailand has always sought to limit the volatility of the Thai baht-US dollar exchange rate. We do this because businesses use US dollar as invoice currency. To this end, the baht has been the least volatile currency in the region over the past year. Going forward, we will continue to take care of the short-term volatility when we deem it to be too disruptive to export or import price-setting.

Over the next 12 months, as the global financial environment becomes even more volatile, it is likely that a few regional currencies will become more flexible. Those of you who follow the foreign exchange market regularly should know that markets are beginning to take different views about regional currencies after the US dollar has lost sufficient ground. No one knows for sure which way a currency will move, but with increasing likelihood we will see more 2-way movements in regional currencies. So the key message here to all parties concerned is that they should not assume a one-way movement in any currency over the next 12 months. Instead, they should make it a normal practice to hedge against undesirable outcomes.

Ladies and Gentlemen,

Monetary and exchange rate policy can at best help safeguard economic stability and smooth out short-term fluctuations and bumps here and there. Price competitiveness may be important, but it is only one side of the story. The other side of competitiveness is product improvement and efficient production techniques. Japanese companies are no stranger to this dimension of competitiveness. After the Plaza Accord in the mid-1980s, when the yen gained roughly 50 per cent in one year against the US dollar, Japanese businesses found ways to improve. Those that succeeded became more resourceful as a result.

For the Thai economy to compete and grow robustly into the 21st century, we need to foster investment in infrastructure, physical and institutional, as well as in human resource. This is the only way to improve our productivity while enabling the majority of the Thai people to share the gains from economic growth and global integration.

What's especially important to continued prosperity is the clarity and the implementation of planned public investment over the next 5 years. These plans, as they are, will address the entire spectrum of infrastructure deficiency our economy faces. The public sector's commitment to invest heavily where it matters most should help boost business sentiment and with it private investment, an important growth engine that had been held back over the past few years. Moreover, the modernization of public transportation, housing and water resource management, as well as health and education spending should translate into better private sector return from cost reduction and productivity increase. Better outlook for returns should enhance the charm of Thailand as an investment destination.

We also need to focus on service as well as manufacturing sectors. In fact, the service sector is larger than manufacturing in employment terms. The Bank of Thailand can help in this endeavor by continuing to strengthen our financial infrastructure. Aside from broadening people's access to financial services, we also aim to promote competition in the financial sector. Competition, while being mindful of the risks involved, will enhance efficiency as well as knowledge building and transfer. With good prudential supervision in the background, the pressure of competition will help ensure that our financial institutions can perform well in the globally competitiveness environment. To this end, better accounting standard, for example, the adoption of IAS 39, is expected to strengthen financial sector's resiliency to adverse shocks and will bring forward better investment climate.

Going hand in hand with modern infrastructure has to be skilled human resource. Studies on labor market condition and my dialogues with entrepreneurs, Thai and foreign, have confirmed that labor quality shortage is the key problem here as well as everywhere else in the world. To be sure, formal schooling is an important source of skill and quality development, but experience in the workplace contributes no less. In Thailand, there is an acute problem of skill mismatch; that is, skills produced through formal schooling are found to be different from those which firms find useful.

Ladies and Gentlemen,

Japan's direct investment here has contributed to skill improvement for Thai businesses and workforce, mostly through learning by doing, training and other knowledge transfers. But beyond that, to reduce mismatch in demand and production of skills, Japanese firms can play a direct and beneficial role. The solution is to break down the barrier between work and school early on. Firms can get involved in training vocational students while potential workers can get a glimpse of what's really needed out there in the real world. If done well, I think it gives incentive for firms to invest in training these students because it gives them the opportunity to identify and select the best workers before they enter the workforce. To the students, there are potential gains as an incentive as well. With the opportunity to be trained by the best and getting to know its corporate culture first-hand, student trainees are more likely to compete for limited hires by improving their performance. This sort of apprenticeship program has long been practiced in Germany, and has been shown to reduce skill mismatch in the workplace as well as improve firms' profitability. Practiced here, it could also reinforce mutual understanding between Thai workers and the ways Japanese firms do business.

That said, human capital development takes vast and continuous effort over a long period of time. In the near term, I think your experience from adjusting to the yen's sharp appreciation should be particularly helpful to your local partners. Japanese companies are capable of lending a helping hand to your local suppliers as they try to upgrade their productive efficiency. That would help smooth their adjustment process during these rough and tumble times.

Ladies and gentlemen,

I hope I have contributed to your understanding of the economic conditions and outlook for Thailand. The Thai economy has shown that it is resilient to adverse shocks. I am confident that our fundamentals are strong. Public investment in basic infrastructure and the Bank of Thailand's commitment to maintain economic and financial stability should translate into moderate long-term cost of investment financing.

With the awareness of what's in store for us and the right macroeconomic policy mix going forward, we should see the economy expand favorably and in a sustainable fashion. I need not mention how crucial it is to both Thailand and Japan in ensuring that our trade and investment partnership prosper in the years to come.

Thank you for your attention.