Tarisa Watanagase: Thailand's economy in 2008 and preparations for the future

Keynote address by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the luncheon gathering of US and Thai business representatives to celebrate the 175th anniversary of Thai-US relations, at the Ministry of Foreign Affairs, Bangkok, 29 April 2008.

* * *

Excellencies,
Distinguished US and Thai business representatives,
Ladies and Gentlemen,

It is my honour and pleasure to accept the Ministry of Foreign Affairs' invitation to speak at this gathering of distinguished members of the US and Thai business corporations and to join you in celebrating the 175th anniversary of Thai-US relations. My goal today is to contribute to your understanding of the prospects of the Thai economy and investment environment in 2008 and beyond.

My talk will comprise three parts. First, I would like to draw your attention to Thailand's economic prospects and risks in the near term. Second, I will focus on some key challenges in enhancing the economy's resiliency and competitiveness while managing those risks. Finally, I would like to highlight to you the roles of the Bank of Thailand in fostering economic and financial stability going forward.

Ladies and Gentlemen,

Since my last meeting with the American Chamber of Commerce in Bangkok last September, the economic tide has already turned in Thailand's favour. In 2007, the Thai economy managed to grow by 4.8 percent for the whole year, given boost by GDP growth rate of 5.7 percent in the fourth quarter of the year. While the government pump-priming helped achieve this favorable growth outcome, net exports contributed to almost 60 percent of the overall GDP growth.

Indeed, the robust growth of exports of 18 percent in US dollar terms in 2007 illustrated the ability of Thai exporters to adjust through quality improvement and search of new markets, as well as their ability to preserve overall price competitiveness in the face of sharp dollar decline. Admittedly, this exceptional export performance was also due to strong trading partners' demand – the environment which is unlikely to reoccur in 2008. I will return to discuss this risk a bit later on.

Monetary policy has been accommodative to growth since the beginning of 2007, with an aim to firm up domestic demand while safeguarding against undue inflationary expectations. The outcome on this front was quite favorable, as headline and core inflation were well contained at 2.3 and 1.1 percent, respectively, by end-2007. The Thai financial markets remained resilient through 2007 with only moderate fluctuations. Though credit and deposit grew slowly last year as domestic demand was weak, profitability of banks and financial institutions were satisfactory and the overall non-performing loans in the banking system remained moderate.

Ladies and Gentlemen,

Against the background of sound monetary and financial stability, the growth momentum of the Thai economy is expected to gain strength through the year 2008. This trend is envisaged, notwithstanding rising financial disruptions and ebbing confidence in the US and across the world as regards the global economic prospects, linked to the sub-prime woes in the US.

Overall, reflecting the solid fundamentals and the resiliency of the Thai economy, the Monetary Policy Committee expects that the Thai economy will grow by 4.8-6 percent this year. However, due to continued high prices of energy and food, headline inflation is expected to be in a range of 4.0-5.0 percent for the whole of 2008. Having said this, the underlying inflationary pressure should be well contained as the core inflation forecast of 1.5-2.5 percent still remains within the target.

During the first two months of this year, private consumption and investment are firming up after recovering during the fourth quarter last year. Clearer political landscape post-election and continued spending by the government have helped revive confidence in private investment and consumption, which constitute almost 70 percent of total demand in Thailand. Indeed, confidence is one of the several factors underpinning private consumption expansion, in addition to fiscal stimulus measures, and agricultural prices. On this note, I should say that the strong growth of farm income has helped maintain consumption momentum especially that of non-durables during periods when confidence was weak. In 2006 and 2007, farm income grew by 32.7 and 16.6 percent, respectively. Now, we are seeing a pick-up of consumption of durable goods as confidence increases, which is aided in part by the continued strong growth of farm income by 25.8 percent during the first two months of 2008.

Private investment, an important growth engine, had been held back over the past few years. However, private investment indicators have risen steady since the second half of last year, prior to the pick-up in consumption, reflecting the continued high capacity utilization well above the 70 percent mark. Now that the Government has announced the clear implementation plan for public investment over the next 5 years, the public sector's commitment to invest heavily where it matters most should help boost business confidence for investment.

Turning to the **external sector**, this year, the moderating net external demand would result from the anticipated slowdown of the global economy, linked to the US economic and financial downturns through the international trade channel. At the same time, agricultural exports are expected to increase in line with higher prices and global demands. During the first two months of 2008, while the value of exports grew strongly by 24.5 percent, the value of imports increased more rapidly by 36.2 percent, resulting in a small trade deficit. However, we expect the overall trade balance in 2008 to remain in surplus due to the expansion of exports to new markets. As for the current account, we expect the surplus to amount to about 4-7 billion US dollar for the whole year, up from the surplus of 2.1 billion US dollar for the first two months of 2008.

Distinguished Guests,

I now move to the second part of my talk, on the issue of risks to the Thai economy in 2008. I believe that there are two important risks stemming from external sources, namely 1) the US recession and high oil and commodity prices, and 2) the potentially more volatile international financial markets.

On the prospects of **global growth and global inflation**, there is no doubt that the risks for both have increased in the near term. Despite the US Fed's sharp and substantial interest rate cuts and liquidity support measures to forestall the rise in mortgage interest rates and ease the liquidity and credit crunch, the world now expects the US economy to weaken substantially.

In the meantime, global price pressure has not yet peaked as the prices of crude oil and commodities continue to rise as world demand for them strengthens in the face of tight demand-supply situation. Moreover, price pressure could come from potentially adverse geopolitical events, unfavorable weather condition, and further dollar slide in the future. At this point, we cannot be certain that when the oil price finally adjusts downward, such a correction will be substantial enough to bring the global inflation risk down.

What do these risks mean for the macroeconomic management in Thailand?

So far, we have observed the cost-push pressure in the recent acceleration of domestic headline inflation, which rose from 2.3 percent at end-2007 to 5.3 percent at end-March, averaging 5.0 percent during the first quarter of this year. During this same period, core inflation averaged 1.5 percent.

The central bank is keeping close monitoring of the inflation trend. The aim is to prevent higher inflation from dampening the anticipated recovery of consumption as purchasing power declines. And, rising costs would also reduce business profit margins and delay private investment. Nevertheless, though this downside risk is substantial, higher commodity prices will accelerate farm income, which tends to augment consumer purchasing power and income of agricultural exporters.

As for the volatility emanating from international financial markets, my view is that the global financial environment may become more volatile for the rest of this year. However, now that the US dollar has lost sufficient ground, no one knows for sure which way a currency will move. But, with increasing likelihood, we should expect to see more 2-way movements in regional currencies.

On the impact of the sub-prime woes on the Thai financial system stability, I can assure you that the direct impact of the sub-prime crisis on the Thai economy is minimal. As you may already know, only four Thai banks have CDO investment exposures, accounting for merely 0.3 percent of the banking system's total assets. Of the four banks, the one that was more affected than the rest has already recapitalized.

Against the backdrop of these two external risks, Thailand, benefiting from ongoing adherence to policy discipline, is fortunate to have ample room for maneuvering a flexible policy mix going forward. Fiscal policy now aims at firming up growth and reviving confidence without worry on public debt sustainability. Concurrently, the monetary and exchange rate policies have room to safeguard economic stability and smooth out short-term fluctuations.

On monetary policy, the Monetary Policy Committee has been holding the policy rate, in light of the fact that growth recovery has remained on track, while closely following inflation developments. As for the exchange rate management, the Bank of Thailand will maintain our principle under the managed float exchange rate system to let the exchange rate reflect the fundamentals of the economy.

Indeed, to gain most from exchange rate flexibility, recognizing that US dollar is an invoice currency, we have consistently sought to limit the volatility of the Thai baht vsUS dollar exchange rate. In fact, the baht has been the least volatile currency in the region last year. Going forward, we will continue to take care of the short-term volatility when we deem it too disruptive to export or import price-quotation.

Ladies and Gentlemen,

In my talk with AMCHAM in Bangkok in September 2007, my key message was that Thailand's future prosperity depends critically on capitalizing on and strengthening further the resiliency of our domestic economy. This is so that the economy can withstand volatility and safeguard against monetary and financial instability that may eventually disrupt real sector activities. Today, I wish to reiterate that same key message even more strongly in light of the risks I highlighted.

Looking forward, income can be increased in the short term through higher wages and fiscal stimulus to augment purchasing powers, especially when price pressure is high. But, over the medium term, the mix of macroeconomic policies needs to maintain focus on helping economic players to adopt better risk management, deal with market excesses, and reduce distortions in the economy. Over the longer term, increases in wages and employment can be sustained only by the growth of productivity that in turn improves the economy's competitiveness.

For the Thai economy to compete successfully and grow robustly over the medium term, I like to echo the Finance Minister's key message in the recent New York Roadshow. That is policies need to focus on the investment in infrastructure and embark on further structural reforms. The government investment plans for 2008-2012, as they are, will address the entire spectrum of infrastructure deficiency our economy faces. 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.

In parallel with building modern infrastructure has to be the development of skilled human resources. Similar to elsewhere in the world, the labor quality shortage is also a key problem in Thailand. Here, skills produced through formal schooling are found to be different from those which firms find useful. Therefore, while formal schooling is an important source of skill and quality development, experience in the workplace is equally essential for human resource development.

As members of the business communities, your role as investors and employers will help make Thailand's real sector more competitive by investing in the best technology and capacity to use that technology efficiently. This will in turn increase the attractiveness of Thailand for international trade and investment, especially as Thai exporters have benefited from new market penetration and the growth of intra-regional trade. We recognize that the US is the largest single trade partner for Thai exports, though its market share has been declining. As for US direct investment in Thailand, the US ranks fourth in terms of the size of FDI, accounting for about 12 percent of total FDI inflows annually since 2000.

Ladies and Gentlemen,

I turn now to the last part of my talk which focuses on the roles and directions of the Bank of Thailand in fostering economic growth, investment, and financial stability. Let me touch on two topics here, namely 1) the three new financial legislations that will enhance the transparency and efficiency of central bank responsibilities in safeguarding monetary and financial system stability, and 2) the second-phased financial sector master plan.

The three new financial legislations, which were passed at the end of 2007, are the new Bank of Thailand Act, the Financial Institution Business Act (FIBA), and the Deposit Protection Agency Act. The interconnectedness between these three laws recognizes the importance for central bank in optimizing the synergy in responsibilities for safeguarding concurrently monetary and financial stability. The new BOT Act empowers the central bank to ensure monetary and financial system stability and enhances its operational efficiency and effectiveness of monetary operations. This is achieved by strengthening the transparency and accountability of the BOT's monetary policy process. Under the new Act, the Monetary Policy Committee will be charged with legal responsibility in the realm of both monetary policy target and exchange rate management policy. The Act will also increase the Bank's operational independence by making it more difficult to dismiss the Bank's governor, requiring a cabinet decision with a clear underlying reason.

Meanwhile, the Financial Institutions Business Act (FIBA) governs the framework and conduct of financial institution supervision, designed to capture the international best practices of financial institution supervision according to Basel Core Principles (BCP). Specifically, this law allows the central bank to implement consolidated supervision of financial conglomerates, as their business models evolve, together with prompt corrective actions, macro-prudential measures, and measures to improve consumer protection from unfair practices by some financial institutions and non-banks.

Finally, the Deposit Protection Agency Act will replace the current blanket deposit guarantee in place since 1997. The new system of limited-coverage deposit insurance will be phased in over four years to allow banks and depositors to adjust to the new framework. The establishment of the Deposit Protection Agency should reduce banks' moral hazard and introduce more market discipline to the banking sector by putting pressure on banks to improve financial strengths if they want to attract and retain depositors.

I now turn to the Bank of Thailand's financial sector master plan (FSMP). You may recall that the implementation of the first master plan started in 2004 and was completed in March 2007, when the last commercial bank licensed under the plan started its operation. Key initiatives under the first plan involved 1) improving financial access, 2) increasing efficiency of the banking sector through removal of regulatory obstacles to market development and through consolidation of smaller financial institutions, and 3) strengthening market discipline through more stringent information disclosure and enhanced consumer protection mechanism. Through licensing reform and the so-called one-presence policy, there has been a significant consolidation and reduction in the number of financial institutions under the supervision of the Bank of Thailand. While evaluation of FSMP Phase I is currently being undertaken, there is evidence to suggest that the banking sector has shown improvement in both operating efficiency and resiliency.

Turning to the second-phased financial sector master plan, the overarching objective is to improve efficiency, competitiveness, and resiliency of the financial sector. The goal is that financial institutions can more effectively perform their intermediary functions and meet the challenges of a rapidly changing environment. Moreover, we expect the financial sector advancement to also contribute to the overall economic and social development of the country. Thus, the plan will also aim to promote a more complete financial access, ensuring that all needed financial services are available at appropriate prices to bankable users in all market segments.

I envisage that these objectives would be achieved through policy measures under three main pillars. The first pillar will aim to improve financial institutions' operational efficiency by reducing unnecessary costs that stem from outdated or overly restrictive regulations and approval process. In this regard, private sector's input will be a key ingredient in improving the regulatory environment to one that is more conducive to business efficiency and innovation, while ensuring that prudential considerations both at individual and systemic levels are not compromised.

The second pillar will look at improving efficient intermediary functions of the financial sector by increasing the level of competition through further deregulation and liberalisation. Deregulation would involve expanding business scope and enhancing the role of existing players, including banks, non-banks and other niche banks. One of the deciding factors for the optimal number and type of new players would be the value added that these new institutions, be they universal banks or niche banks, could bring to the financial system, such as technical expertise and product innovations. Set against these benefits, however, are potential risks to financial stability stemming from disorderly competition and exits.

Thus, liberalisation considerations will be grounded on a robust supervisory framework and be appropriately sequenced and phased. This is so that risks from potential concentration of market power and financial instability are minimised.

The final pillar aims to fill the gaps in institutional, including legal and information, infrastructure that are necessary for an efficient and modern financial system. We will be looking at the legal framework and other measures that would support a more effective functioning and supervision of financial institutions. These include sound credit culture (e.g., bankruptcy and foreclosure laws) and implementation of international best practices, such as new international accounting standards. On the information side, efforts will focus on the information infrastructure that would assist financial institutions in pricing and managing risks better. Areas for improvements are, for example, the operation of the Credit Bureau, rating agency, and more complete data on key economic sectors such as the real estate and housing market, etc.

On the whole, while the policy recommendations will largely cover BOT-supervised financial institutions, those related to other types of financial institutions and broader financial markets can also be addressed if they are deemed to be systemically important.

Ladies and Gentlemen,

In closing, allow me to emphasize once again that Thailand's record of economic resiliency to adverse shocks and uncertainties in the past should clearly attest to the strength of our underlying fundamentals. The US and Thailand are long-time partners, and I need not mention how crucial it is to both our economies that we strengthen our trade and investment partnership in the years ahead.

Going forward, the policy mix will centre on the fiscal prudence and public investment in basic infrastructure and the Bank of Thailand's commitment to maintaining economic and financial stability. These together should translate into moderate long-term cost of investment financing and sustained economic expansion for Thailand.

We live in the global economic and financial environment that is highly uncertain. Policymakers need always to be aware of what is in store for us so that we use the policy room available to craft the right and flexible macroeconomic policy mix that is best suited to changing circumstances. At the same time, with the collaboration of our trade and investment partners, we must remain firmly committed on the national goal of enhancing the economy's productivity and competitiveness.

Thank you for your attention.