

Tarisa Watanagase: Thailand – its resiliency and medium-term challenges

Address by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the Thailand Investment Forum, Euromoney Conferences, Bangkok, 13 May 2008.

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Distinguished Speakers and Guests,

Ladies and Gentlemen,

I am delighted to join you at this gathering of prominent members of Thailand's public and business sectors. This year's Thailand Investment Forum by the Euromoney Conferences comes at an opportune time when we see clearer signs of the Thai economy gaining growth momentum, supported by government policy measures and revival of private sector confidence. Nevertheless, there are also imminent downside risks predominantly from external fronts, which could hinder the continuation of this positive trend.

I will focus the first part of my talk on Thailand's resiliency to achieve healthy growth in 2008 and beyond. The second part will highlight key issues on competitiveness and strength of Thailand's economic future in the face of trade and financial globalization. Judging from the list of experts from whom you will be hearing over the next two days, I would like to share with you my perspective from the policy making side.

Ladies and Gentlemen,

Thailand's record of economic resiliency to adverse shocks and uncertainties in the past should clearly demonstrate the strong underlying fundamentals. In 2007, notwithstanding political uncertainties which dented confidence since September 2006, the Thai economy grew by 4.8 percent. Overall, the main growth driver continued to be net exports, which contributed to almost 60 percent of the overall GDP growth. While demand was weak in tandem with confidence, government pump-priming also helped achieve the favorable growth outcome. Going forward, sustainable economic growth can be achieved through several different means. But, among them, the prerequisite is maintaining the healthy growth momentum with the right policy mix. I will elaborate on this point later.

For 2008, the growth prospect hinges largely on the recovery of private consumption and investment, supported by increased government spending. This year, the strengths of these three growth engines will be particularly important, since exports – the fourth engine – is expected to moderate in line with the global economic slowdown. Overall, the Monetary Policy Committee expects the Thai economy to grow by 4.8-6 percent. 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. Nevertheless, the MPC expects the core inflation forecast of 1.5-2.5 percent. But, there are important risks to these forecasts.

On the growth momentum, data for the first three months of 2008 point to GDP growth close to 6 percent, up from the previous quarter of 5.7 percent. During the first three months of this year, private consumption and investment, which constitute almost 70 percent of total demand, are firming up. Meanwhile, the disbursement rate of central government budget during the first half of fiscal year 2008 was also up from the same period last year. Moreover, we see a pick-up in consumption of durable goods as confidence increases, aided in part by the continued strong growth of farm income by 21.1 percent during the first quarter of 2008.

As for the strength of the investment engine, private investment indicators have continued the uptrend while investor confidence has been boosted by the public investment plan over the next 5 years. During the first three months of this year, the Private Investment Index was up by 7.2 percent from the same quarter of 2007. Though we know that actual disbursement

of government investment expenditure may not occur till the final quarter of this year, the strong government commitment has already led to stronger investor confidence. Additional expenditure for land acquisition for mega projects would also boost domestic demand to some degree. This should prompt the pent-up demand for private investment, which has been held back over the past several years, to begin to materialize.

Turning to the external sector, the strong trading partners' demand, seen in 2007, will unlikely reoccur in 2008. The world now expects the US economy to weaken substantially. Clearly, we will have to wait quite sometime for the clear upturn of the US economy after the US Fed's sharp and substantial interest rate cuts to shore up the economy and confidence. Since the US crisis will most dominantly affect the Thai economy through the trade channel, we also have to watch for growth trends in Europe and Asia to see how extensive the adverse impacts of the US recession are.

Nevertheless, during the first three months of 2008, the value of exports continued to grow strongly by 21.1 percent. But, this was outpaced by the growth of imports of 34.5 percent, resulting in a small trade deficit. However, we expect the overall trade balance in 2008 to be in surplus due to the expansion of exports to new markets. As for the current account, we expect that the surplus will amount to about 4-7 billion US dollar for the whole year, up from the surplus of 3.1 billion US dollar for the first quarter of 2008.

At present, the focus of monetary policy is tilting more toward price stability. Data for April showed headline inflation at 6.2 percent and core inflation at 2.1 percent, respectively. These compared to the average first quarter data of 5.0 percent for headline inflation and 1.5 percent for core inflation. At this juncture, it is clear that global price pressure is yet to peak as world demand for oil and commodities continue to face tight demand-supply situation. We also cannot discount the possibility of potentially adverse geopolitical events, unfavorable weather condition, and further dollar slide which could drive up oil prices in the future.

Up to now, monetary policy has remained accommodative to foster the growth momentum but the Monetary Policy Committee will be monitoring inflation developments closely, especially the second round effect of energy prices feeding through to core inflation. The aim is to prevent higher inflation from dampening the anticipated recovery of consumption and derailing the pick-up in investment. Indeed, the MPC has been holding the policy rate, in light of the fact that the growth recovery has remained on track and supported by fiscal policy, while closely following inflation developments.

As the MPC meets next Wednesday 21 May, we will assess the latest data available and indicators on both growth and stability to decide on the appropriate stance of forward-looking monetary policy.

Ladies and Gentlemen,

Undoubtedly, the risks to global growth and inflation will not make macroeconomic management an easy task in the immediate term. But, I can reassure you that Thailand's economy will maintain its resilience against potentially adverse developments, judging from the following four dimensions.

First, policymakers today have sufficient room for maneuvering a flexible policy mix as a result of continued adherence to policy discipline. Our fiscal policy is not constrained by concern on public debt sustainability while monetary and exchange rate policies have room to safeguard economic stability and smooth out short-term fluctuations. Indeed, under the new Bank of Thailand Act, the Monetary Policy Committee will be charged with legal responsibility in the realm of both monetary policy target and exchange rate policy and management.

The **second** source of resilience comes from the strength of our prudential and supervision of financial institutions. In this regard, the Bank of Thailand's capacity and performance in supervising financial institutions has been assessed against international best practices in the context of the joint IMF/World Bank Financial Sector Assessment Program or FSAP.

Indeed, the outcome of the FSAP assessment was very satisfactory, validating our observance of international best practices. Moreover, the assessment results also strongly endorse the policy-making frameworks and transparency.

As you may be aware, the new Financial Institutions Business Act (FIBA), which governs the framework and conduct of financial institution supervision, is designed to capture the international best practices of financial institution supervision according to Basel Core Principles (BCP). With this law, the BOT can undertake consolidated supervision of financial conglomerates, together with prompt preventive and corrective actions, macro-prudential measures, and measures to improve consumer protection. Overall, our goal is 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.

This leads me to the **third** source of resiliency. This is the continuous improvement in our financial infrastructure, legal as well as information, and the intermediary functions of financial institutions within the economy. We now have more effective foreclosure law, a credit bureau, and accounting standards such as IAS 39 that conform to international best practices. Moreover, under the Deposit Protection Agency Act which will replace the current blanket deposit guarantee in place since 1997, the establishment of the Deposit Protection Agency should reduce banks' moral hazard and enhance market discipline. That is by putting pressure on banks to improve financial strengths if they want to attract and retain depositors.

As part of Thailand's efforts to advance reforms, the Bank of Thailand will, under the second-phased financial master plan, focus on improving efficiency and intermediary functions of the financial sector by reducing regulatory costs, enhancing legal and information infrastructure, and increasing the level of competition through further deregulation and liberalisation.

Deregulation would potentially involve expanding business scope and enhancing the role of existing players, including banks, non-banks and other niche banks. One of the key factors for deciding the optimal number and type of new players would be the value added that new financial institutions, be they universal banks or niche banks, could bring to the financial system, such as technical expertise and product innovations. Having said this, I wish to emphasize that we will also closely look at the risks from potential concentration of market power and financial instability stemming from disorderly competition and exits.

Last but not least is better governance to bring about better risk management. For the central bank, there will be more checks and balance with a separate chairman from the governor under the new BOT Act. In the private sector, the roles of Boards of Directors in providing oversights and setting guidelines for business decisions, and having in place the proper risk management systems are essential to deal with market excesses. The ultimate aim is to enable the economy to adjust flexibly in keeping with changes in the financial environment. To facilitate this, key policies and regulations should focus on promoting market efficiency, as well as reducing distortions and unproductive risk-taking behaviours in the economy.

Ladies and Gentlemen,

The risks on growth and inflation make 2008 a very challenging year but we will be able to weather it because there is room for the right policy mix and we can capitalize on the economy's resiliency. But we cannot be complacent about the medium-term challenges of improving and maintaining our competitiveness. Fortunately, the government has already committed to a number of important investment projects to address infrastructure deficiencies. Its investment plans for 2008-2012 focus on the entire spectrum of infrastructure, including the modernization of public transportation, housing and water resource management, as well as health and education spending.

Let me share my thought, in particular, on Thailand's education system which has immense implications on labor productivity and labour market efficiency, hence competitiveness. Today, more than half of the Thai labour force is in the non-agricultural sector (including services), which is more averse to changes in global competition for trade and investment. Moreover, to maintain competitiveness, our economy needs the labour force that possesses higher and more flexible skill sets to move up the valued added chain of production and trade.

In reality, Thailand, just like other countries, has weakness in the mismatch of skills produced through formal schooling from those which firms find useful. Government policies need to address this weakness quickly, by finding ways to align formal education with training through vocational schools and apprenticeship programs organized by private businesses. Key questions will be on designing appropriate incentive structures for players in the education and business sectors, while being mindful of social safety net considerations when businesses close. This is especially important because the agricultural sector now accounts for about 10 percent of the overall economy and cannot provide social-safety support for the non-agricultural sector should a downturn hit.

In addition to government policies, investors and firms can play their parts in helping to improve labour skill and quality development. This can be achieved through building more experience in the workplace by investing in the best technology and capacity to use that technology efficiently. Importantly, we also need to focus on the quality of investment that will help build skills and enhance production techniques that adds higher values and saves costs.

Ladies and Gentlemen,

To close, let me highlight another important underlying strength of the Thai economy. In view of our unique location as the gateway to Indochina, with a population of about 160 million, we have the strength of a potentially much bigger market. Within ASEAN, there is greater progress on the ASEAN blueprint, which lays out the strategic plan to achieve further trade and financial integration within 2015. In fact, with the AEC blueprint, we and the entire region stand to gain more from further trade and financial integration. Soon, Thailand will also be an integral part of the ASEAN Community under the new ASEAN Charter. Indeed, while we continue to wait for the resolution of WTO negotiations, Thailand and ASEAN have made progress on a number of free trade arrangements with Japan, China, Korea, Australia, and New Zealand.

Ladies and Gentlemen,

I hope that I have left you with some food for thought for the two days that you will hear directly from eminent experts of various fields. As a veteran central banker, I believe that over-optimism is just as dangerous as complacency in policy-making. Therefore, in today's world of uncertainties and volatilities, vigilance and caution are crucial elements because the road ahead is likely to be a rocky one. But this should not prevent us from having a pleasant journey toward the more prosperous future for the Thai economy. The central bank is the only institution that has the legal responsibilities to preserve monetary and financial institution stability. While the expectation is high, I can assure you that we will strive to fulfill our responsibilities the best we can to ensure that the economy overcomes any difficult challenges that may lie ahead.

Thank you.