# Tarisa Watanagase: Securing Thailand's future with capital market development and the role of the Bank of Thailand

Keynote address by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the Thailand Focus 2008, Bangkok, 17 September 2008.

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Excellencies,

Distinguished Participants,

Ladies and Gentlemen,

Good morning, I would like to begin by thanking the Stock Exchange of Thailand for inviting me to deliver a keynote address at this year's Thailand Focus. This annual forum, traditionally opened by the Prime Minister of Thailand, has firmly established itself as the event of the year where domestic and foreign investors meet and interact with Thailand's top policymakers and leading listed companies. It is thus not only my great pleasure but also my great honor to be here.

Ladies and Gentlemen,

Given the turbulent time we are in at the moment, I am very pleased at the number and the composition of this year's turnout. Glancing through the list of prospective attendees, I saw participants from Asia, Australia, Europe and North America, representing a large spectrum of investors. This is despite the fact that a number of invited fund managers were forced to cancel their trips due to the declared state of emergency that was lifted on Sunday. Moreover, I see that many of you have been long-time investors in the Thai stock market. All of these are quite reassuring, for they reflect your continued faith in the Thai economy. And for those of you who are newcomers, I hope my talk today will give you reasons why you should invest in Thailand.

My talk today will be divided into three parts. In the first, I will touch on how the Bank of Thailand sees the Thai economy evolving at the moment as well as in the longer term. In the second, I will talk about the role of capital market in the economy's long-term growth. The final part will then highlight the Bank of Thailand's roles to promote capital market development.

Let me start with the current picture of the Thai economy. As you all know, our real GDP growth moderated from 6.1% in the first quarter to 5.3% in the second quarter of this year. Thailand however was not alone in this development, as most countries in the region, with the notable exception of Indonesia, all experienced growth slowdown at varying degrees. In fact, when compared to Hong Kong, Singapore, and Taiwan which saw their growth rates cut down sharply from 7.3% to 4.2%, 6.9% to 2.1%, and 6.3% to 4.3%, respectively, Thailand fared much better with respect to the magnitude of the slowdown. The fact that we managed to hold on a satisfactory growth performance given the surrounding circumstances is a testament to the resiliency and the underlying strength of the Thai economy.

Two major negative developments were behind the slowdown in the second quarter. On the external front, crude oil prices surpassed the 120USD mark for the first time in history. Successive rises in oil prices weighed down heavily on firms' production costs and cut in consumers' real spending power. Had our exports not held up well, Thailand's real GDP growth would have been much lower. In addition, the direct and second-round effects from oil price increases also led to the acceleration in inflation this quarter, with the headline inflation rate reaching 8.9% for the month of June.

The second negative development was on the domestic front and that was the return of street demonstration that has escalated to today's political standoff. This development has had significant effects on consumers' and businesses' sentiment, not to mention investors' confidence that has contributed to continued net selling by foreign investors.

Fortunately for Thailand, agricultural prices also accelerated in the second quarter. The rise in the prices of agricultural exports contributed to the robust export performance and at the same time partially offset the negative impact of increases in the prices of oil and other commodities imports. Moreover, increases in farm income due to the price effect coupled with strong production allowed farmers to cope with higher costs of living associated with rising inflation, providing support for private consumption which continued into this current quarter.

For the remainder of this year, the recent trend in oil prices appears to be on our side, especially on inflationary pressure. Oil prices have fallen much lower than what we had anticipated during our last round of economic forecast in July which had headline inflation projection in the range of 7.5-8.8% for the year. The fall in oil prices adds on top of the temporary favorable price impact from the government's six-months-six-measures program which was not included in time for the forecast and will together be a major factor in our October forecast round.

The fall in oil prices is also expected to have a significant impact on economic growth which was forecasted to be in the range of 4.8%-5.8% for this year. Unfortunately, the impact of the escalated political tension was also something we had not anticipated. In particular, the damage it has inflicted on the tourism sector will significantly shave off one significant source of external revenue the economy has relied on.

Still, we see the economy's growth momentum to remain in tact. Here I am not alone in believing so. The latest SET's CEO Survey released last week showed that the majority of listed companies' CEOs remained confident in the growth prospect of the Thai economy. Obviously, this is a difficult time for the economy. But you have to remember that we are no strangers to difficult challenges, some much worse than what we are facing. Most importantly, as I repeatedly said on different occasions, Thailand possesses strong economic fundamentals and room for maneuvering the right policy mix that makes us resilient against economic shocks. Allow me to elaborate on some of these.

First, Thailand's external position remains strong. Our external debt to GDP has hit an all-time low since 1980, recording 29.4 percent last year. Our foreign reserves doubled within three years reaching over 100 billion US dollar at present day. The amount of foreign reserve has by far exceeded the short-term external debt by more than four times. This provides us an ample room to safeguard against instability from volatile capital flows and exchange rate movements.

Second, the government's fiscal position continues to improve as reflected by a falling trend of public debt to GDP. This gives the government the financial flexibility to tackle economic problems and stimulate the economy if necessary. It is no coincidence that credit rating companies often stated the strength of our fiscal and external position in their underlying reasons for affirming Thailand's sovereign ratings. In fact, to cite James McCormack, the Head of Asia Sovereign of Fitch Ratings, at the firm's last week annual Thailand conference, unless political uncertainty significantly undermines Thailand's future growth prospect, it is unlikely that Thailand will be downgraded, for the country's sovereign credit fundamentals remain sound.

Third, the banking sector remains healthy and strong enough to weather the current global financial turmoil. The BIS ratio remains high and the ratios of NPLs to total loans continued to decline. Together with the implementation of IAS39 accounting standard in 2006-2007 and the adoption of Basel II by the end of this year, the banking sector would be less prone to adverse shocks. Finally, the soon-to-be-implemented second phase of the financial sector master plan will further improve efficiency of the banking sector through reduction of regulatory costs, enhanced legal and information infrastructure, and new competition introduced in orderly manner through phased deregulation and liberalization.

Fourth, the private sector has shown much resiliency and adaptability. For example, in response to the appreciation of the baht, exporters have made increasing uses of foreign exchange hedging instruments. At the same time, the increasingly diversified export market structure has provided Thai exporters with cushions against the current slowdown in major advanced economies. As another example but perhaps more relevant to today's audience, our listed companies no longer over-leverage their balance sheets, turning instead to equity and retained earnings as major sources of funds.

Fifth, Thailand is among the world's top places when it comes to the ease of starting and operating businesses. The recent report, "Doing Business 2009," by the World Bank upgraded Thailand by six places. Despite all the storms we have faced, we are now ranked at 13th place out of 181 countries (4th in Asia after Singapore, Hong Kong, and Japan). According to the report, Thailand led other reformers in the region with improvements in four areas – Registering Property, Protecting Investors, Paying Taxes, and Trading across Borders. As investors, you may be interested to hear that one of the cited reform measures is amendments to the Thai Securities and Exchange Act to strengthen minority shareholder rights.

Ladies and Gentlemen,

Provided that the current political deadlock is soon resolved and the new political equilibrium is reached, these fundamentals should provide a solid platform for Thailand's economic growth going forward. A recent study by the Bank of Thailand's staff finds Thailand's potential GDP growth to be in the range of 5.5-6.1% between 2008 and 2015. This may appear a far cry from the 1987-1996 period when the growth of the Thai economy averaged 9.5%. However, everyone now realizes that the Thai economy then was operating beyond its potential and therefore not sustainable. In contrast, our staff's projection was based on a balanced growth path scenario used to characterize an economy in a steady state.

There is however an important catch in the cited projection and that is the implicit assumption that the ratio of real gross investment to real GDP recovers from the current level of 22% to 28-30% by the end of the period. Thus, things like mega-project investments are conceivably already included in the projection. The current political doldrums only make the scenario far reaching. Without the resuscitation of investment, Thailand's potential growth rate will likely fall to a lower path.

The same study also points out the impact of demographic change on Thailand's future growth. By 2026-2035, the economy's potential GDP growth rate under the balanced growth path assumption is projected to fall to 4.8-5.4% due to ageing population. Moreover, the study finds that measures such as attracting foreign workers and raising the retirement age from 60 to 65 have only small impact at boosting the economy's long-term growth and that the key to maintaining high growth rate lies in enhancing productivity growth rather than trying to squeeze out more hours from the aging population.

While improvement in educational and skill attainment of the labor force and de-bottlenecking of inefficient sectors such as improvement in the logistic system and water management for irrigation are most obvious policies, financial deepening must not be neglected. It is the efficiency of resource allocation which includes funds and capital that enhances economic productivity, hence, raising the economy's long-term growth potential. This is the focus of the rest of my talk to which I now turn.

Ladies and Gentlemen,

As you know, the fundamental function of financial markets and intermediaries is to channel funds from those who have a surplus of savings to those who have a deficit. If financial markets are functioning efficiently, they contribute to an optimal allocation of resources, reduce the cost of capital, and allow for risk-sharing and risk-diversification. Well-developed and efficient financial markets contribute to higher productivity growth because they are better at channeling capital from sectors in decline to those with growth opportunities, in a process of Schumpeterian “creative destruction” that ultimately drives economic growth. Having efficient resource allocation is particularly important now for the Thai economy, given the ongoing structural shift in relative prices of commodities and asset prices which render some businesses obsolete while opening up many other new opportunities.

Indeed, the vast body of research over the past decade strongly suggests that improvements in financial developments precede and contribute to economic performance. In other words, the widespread desire to see an effectively functioning financial system is warranted by its clear causal link to growth, macroeconomic stability, and poverty reduction.

As for the specific form of financial market development, it is also well accepted by policymakers that economies that have well-developed banking sectors and capital markets are advantageous to others that rely mostly on only one type of the financial markets. Indeed, banks and capital markets are complements, and not substitutes. For some industries at certain times of their development, capital market-based financing is advantageous. For example, financing through stock markets is optimal for industries where there are continuous technological advances and where there is little consensus on how firms should be valued or managed. The stock market checks whether the manager's view of the firm's production is a sensible one. For other industries, bank-based financing is preferable. This holds in particular for industries which face strong information asymmetries. Financing through financial intermediaries is an effective solution to adverse selection and moral hazard problems that exist between lenders and borrowers.

Furthermore, efficient and well-balanced financial system will allow the system to better manage and absorb shocks as the market would be less prone to one-way market conditions and possesses greater liquidity. The experience of the Asian crisis, for example, points to the critical importance of the development of long-term local currency debt market, to increase the depth and the breadth of financial market. In addition, the lack of diversified structure and market may lead to increased risk from concentration of credit and maturity risks in the banking system. Lack of markets may lead to the mispricing of risk and excessive delay in correcting large exposures, as well as increased vulnerabilities from capital inflows.

Ladies and Gentlemen,

The interaction between financial markets, economic growth and monetary policy is by no means a new issue for central bankers. Indeed, the continued deepening of capital markets is a significant issue for policymakers, and particularly for central bankers, since smooth functioning and efficient financial markets are crucial in ensuring an effective transmission of monetary mechanism.

The best contribution that monetary policy can make to Thailand’s capital market development and its economic growth is to maintain steady medium-term price stability. Such a policy is beneficial, as it will minimize the adverse effects of inflation and high inflation uncertainty. As we all know, price stability brings numerous benefits. It not only creates a climate for higher economic and investment activities, but also reduces the economic and social inequalities caused by the asymmetric distribution of the costs of inflation among the various economic agents. In addition, in an environment of low inflationary expectations, inflation risk premia become relatively less important as a determinant of financial prices. As a result, other factors such as credit risk can play a larger role in the price formation mechanism. Ultimately, this results in clearer market price signals and a more efficient allocation of financial resources.

On the BOT’s role in the pursuit of price stability, allow me to elaborate further on two points:

First, the BOT’s inflation targeting framework aims ultimately at anchoring medium term inflation expectations. As we are all aware, central banks have direct control only on the very short end of the market interest rates. In the case of the BOT, it is the one-day repurchase rate. Meanwhile, the interest rates that matter to investment decisions by most businesses are those in the medium to long end of the yield curves. Thus, it is imperative that the central bank gain trust with the public by conducting monetary policy in such a way that is consistent with anchoring low inflation expectation in the medium and long term. To put in plain words, markets and the public must be confident that the central bank would not tolerate inflation developments deem to undermine long-term economic growth. Given the possibility of persistent expectations of high inflation following the run-up of oil and other commodity prices early this year, the issue of central bank's credibility in achieving price stability has become even more critical.

Indeed, over the past few months, there was intense debate on the appropriate monetary stances to deal with the current inflation problem. The Bank of Thailand has decided to gradually withdraw the demand stimulus, by increasing the policy rate by a total of 50 basis points during the past two Monetary Policy Committee Meetings. The rationale is that uncontained demand, boosted in no small part by the presence of large real negative interest rates, as well as relatively small output gap during the first half of 2008, could potentially fuel even more severe and persistent inflation and force us to take a bigger dose of bitter medicine with significant loss of economic growth in the future.

Second, to further enhance the effectiveness of central bank's objective in achieving price stability, it is crucial to establish an understanding between the central bank and the government of the lagged-nature of monetary policy transmission, and the need for targeting stability to effectively anchor long-term inflation expectations.

To this end, the recently passed BOT Act specifies that, at the end of each year, the Bank of Thailand's Monetary Policy Committee, jointly with the Minister of Finance, will be required to set an annual target for monetary policy for the following year. This formal process of close coordination would help ensure that monetary policy is aligned with the country's overall economic policy direction. More importantly, it will also contribute to a greater understanding of the public at large of the fact that the only long-term role for monetary policy is in creating an environment of price stability which would help support sustainable economic growth.

In addition to the mandated responsibility of maintaining price stability, the BOT has also taken a direct role to further develop Thailand's capital market and its infrastructure via our involvement in the National Capital Market Development Committee and the Domestic Bond Market Development Sub-committee which were set up to coordinate capital market development efforts among government agencies as well as the private sector.

With regard to equity market development, beginning in 2002, we have taken a step-by-step approach in opening up outward portfolio investment, by first allowing institutional investors, such as mutual funds and insurance companies, to invest abroad. This year, as Thai investors have become more familiar with diversifying risks abroad and with financial instruments in more developed markets, we have now allowed Thai individuals to invest abroad through local securities company. Through this initiative, not only local investors and professionals in the capital market industry would have a better understanding of the link between the local market and the global market, as well as risk management strategy, it would help contribute to higher standards and practice in the local capital market in the long run.

With respect to bond market development, we have taken a more active role both in the primary and the secondary market. This is because the bond market is where we operate monetary policy through liquidity injection and absorption in order to align short-term interest rate with the policy interest rate. Therefore, the more developed and efficient the bond market is, the more effective the monetary management would be. Besides, a vibrant domestic bond market is essential for a robust and efficient financial system, which is a solid foundation for long-term economic stability.

In the primary bond market, while meeting with the sterilization needs, the issuance of BOT bonds and bills are also designed to promote the bond market. In particular, we coordinate closely with the MOF on issuance schedule to provide regular and predictable supply, reduce auction frequency and consolidate issuance to reduce the number of issues in order to facilitate secondary market trading. The BOT bonds have helped widen investor base and contributed to the growth of mutual fund industry, as retail investors are seeing this as an alternative to banks' deposit. Other than the issuance of BOT bonds and bills, we also introduced floating rate notes to add diversity to the products in the market as well.

With respect to secondary bond market development, developing the private repo market has been one avenue that the Bank has adopted to enhance a more liquid bond market.

What I have mentioned here is only some examples of the earlier and ongoing efforts that the Bank of Thailand was involved in developing the capital market. Going forward, there is still much work to do. The Bank of Thailand will continue to coordinate with other authorities and the private sector in order to move us closer to having a deeper and well structured capital market.

Ladies and Gentlemen,

In closing, I would like to stress that the underlying fundamentals of the Thai economy remain sound, as evidenced by its continued ability to weather various adverse shocks. While it is uncertain how the current political confrontation will unwind, I am confident that the economy will prevail, as it has done a number of times in the past. Over the longer term however, Thailand will need, among other things, a deeper and stronger capital market in order to grow sustainably. It is therefore in our best interest to promote the development of the Thai capital market and make Thailand an attractive destination for quality investors. For this, we will need your active participation and continued faith in the Thai economy.

Thank you very much for your attention.