Tarisa Watanagase: What determines the future of the Thai economy?

Speech by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the British Chamber of Commerce Luncheon Talk, Bangkok, 17 September 2008.

*   *   *

Chairman Bain,

Ladies and Gentlemen,

I would like to thank Chairman Bain for inviting me once again to join this gathering of distinguished members and guests of the British Chamber of Commerce. I look forward to our annual get-together in this warm and friendly atmosphere and especially welcome the opportunity to update and exchange views on the Thai economy and its outlook.

My talk today will cover three parts. First, I would like to focus on recent developments and prospects of the Thai economy in the near term. In the second part, I will share with you my perspectives on the important factors that I believe will determine the future of the Thai economy. To close, I will touch on the preparations that we should be making for the future of the Thai economy, focusing particularly on the central bank's role in achieving price stability to support long-term growth.

Ladies and Gentlemen,

Notwithstanding news headlines, most of us are aware that the overall economic atmosphere continues to be business-as-usual. Nevertheless, the current tension and ongoing uncertainty on the Thai political scene has posed worries for some investors on the prospects of the Thai economy for the rest of 2008 and 2009. Confidence has already weakened somewhat on both consumer and business ends. Evidently, the Business Sentiment Index or BSI, surveyed by the Bank of Thailand, which has lingered below the 50 benchmark, slid further in the past few months. In addition, tourism has been adversely impacted by travel warnings as the Thai political developments made global news.

This latest dent on confidence has added to the list of challenges facing the economy since the end of last year, including inflationary pressure from volatile oil and commodity prices, tightening domestic monetary policy, as well as potentially more downside risks to global economic growth in light of recent US economic developments.

The headline and core inflation in July rose at decade-high rates of 9.2 and 3.7 percent from a year ago, respectively. The rising inflation largely stemmed from soaring oil prices. At their worst, oil prices set new records almost on a daily basis, led by a combination of growing demand for fuel of emerging markets, geopolitics of the oil-exporting countries, and the depreciation of the US dollars. Even though, in August, headline and core inflation went down to 6.4 and 2.7 percent, respectively, due to moderating commodity prices as well as government measures, the risk on inflation from high and volatile commodity and oil prices remains, particularly given the constraint in supply adjustment.

In the meantime, the risk of global economic downturn seems to have accumulated as the bottom-out of US subprime problem is still uncertain. This has, in turn, affected the outlook for Thai exports as the economic prospects of Thailand's major trading partners, such as European Union and Japan, became less positive. Overall, the impact of bleaker global economic outlook depends on the degree of decoupling from developed economies and the consensus among central bankers over the world is that it is perhaps unrealistic to assume that emerging economies in general will be able to decouple. Therefore, it is more an issue of a time lag and at the present time we must wait and see when this moment of truth arrives and what the impact will be. I believe that unless the global economy dips below what we anticipated, the impact on the Thai economy will be manageable.

At this juncture, let me emphasize that Thailand's underlying economic fundamentals remain sound and growth momentum on track. During the first half of 2008, the Thai economy achieved a favourable growth rate of 5.7 percent, improving from the growth of 5.3 percent in the second half of last year. Even though three of the four main engines of economic growth, namely consumption, investment, and public expenditure, remained mostly subdued, the performance of net exports was notably better-than-expected. This reflected export sector's substantial efforts to adjust to slowing global demand by diversifying into new markets. Meanwhile, on the supply side, agricultural production was the key growth contributor, due mainly to an increase in crop production in response to higher market prices.

In fact, economic indicators for July showed the continued expansion on both production and demand sides. Farm income from major crops was up by 69.5 percent from the same period last year, due to expansion of both production and prices of paddy rice, rubber, and oil palm. Manufacturing production also registered a satisfactory growth of 11.3 percent during the first seven months.

On the demand side, private investment and consumption continued its recovery trend. Exports also expanded well in line with production expansion. Meanwhile, imports accelerated, partly in response to improvement in domestic demand. Even though this resulted in a current account deficit, strong external stability has been reflected by high level of international reserves and low external debt.

For the entire 2008, the central bank's July Inflation Report has projected a growth rate of 4.8-5.8 percent with a more moderate growth in the second half, in line with the global economy. While this forecast has already taken into account a number of key risk factors, potentially prolonged political tension and uncertainty remain a prominent one, with little known about when and how it will unwind. This is reflected in the recent plunge in consumer confidence index. In a pessimistic extreme scenario, the government budget disbursement may delay if the upcoming budget process in parliament is disrupted and mega-project investment could fall behind schedule. Prolonged disagreement could also soften domestic demand and tourism, which would be unfortunate given that the tourism high-season is approaching.

Having said this, I must also highlight that, by historical records, political developments had dented confidence in the economy only in the short run. Therefore, I am optimistic that with Thailand's economic fundamentals remaining sound, the economy will be able to maintain growth momentum and overcome these short-run dips. In this regard, I wish to add that political development, which sometimes breeds strain and uncertainty within the society and economy, is not a unique phenomenon only to Thailand. Rather, it is a necessary process of growing up for most economies.

For the past thirty years, the Thai economy has taken a good lead in development progress building on lessons learnt from crises, while political advancement trailing behind. From 1977 to 2007, the economy in real term has grown at an average rate of 7.0 percent (excluding 1997 and 1998), facing phases of reforms and restructuring, from import substitution to export promotion and to liberalization after the Asian financial crisis.

In the meanwhile, Thai politics has evolved more gradually than the economy. And now, it may be time for catching up. And hopefully, out of this growing-up process, the gap between economic and political developments will narrow and a stronger economy under a more matured politics will emerge.

Ladies and Gentlemen,

I turn now to the second part of my talk. In the face of possible short-term dent on confidence, it is prudent that we do not lose sight of what importantly determines the future of the Thai economy. Sound economic fundamentals continue to provide support for favourable growth and collective efforts should be focused on raising the economy's potential output in order to achieve price stability and sustainable growth in the long run.

By old book, growth comes from utilization of the country's resource endowment with available technology. However, with the advent of global economic and financial integration, growth is no longer constrained by endowment. In today's world economy, outsourcing for inputs abundant in other countries and exchange of technology and skills allow for lower production costs and greater potential to grow. Potential output in this era is thus free from conventional hindrance.

From the Bank of Thailand's latest research, the Thai economy has a potential output growth rate of around 5.5 to 6.0 percent per year from 2008 to 2015. This is based on an assumption that investment can grow at the same rate as the economy, and therefore, the ratio of real gross investment to real GDP needs to increase from 22 percent today to 28 percent within the next 8 years.

Prior to 1997, Thai economy grew satisfactorily on the back of high level of investment as well as increasing utilization of labor. During this period, sufficient capital formation allowed for an increase in labor productivity. However, in the post crisis era, potential output gradually declined as real investment did not fully resume its pre-crisis level, which was 31 percent of real GDP. Meanwhile, labor productivity has been dwarfed by the lack of capital and lagged behind the regional standard. On the overall picture of employment, Thailand has had very low unemployment but room to increase productivity remains in the area of reducing underemployment.

Let me discuss an example of the agricultural sector. This sector has seen a steady decline of its share in GDP from 1980 to 2007. In contrast, its share in the country's employment remained high, though reducing from 65 to just about 40 percent of total labor force during the same period. Meanwhile, yield of major crops per unit area is significantly lower than yields in other agriculture exporting countries. In fact, Foreign Agricultural Service of USDA, estimated that Thailand produces rice yield about 430 kilos per rai compared with the world average rice yield of 653 kilos per rai. There is thus ample room to increase productivity in this sector through better land and water management as well as a more systematic farming.

Going forward, the problem of labor scarcity, though not unique to Thailand, will also become more of our concern as we are moving into aging society, while population growth remains low. Increasing productivity is therefore the solution to sustain potential growth as well as competitiveness. And, to do so, it is crucial that we increase investment, such that there is sufficient capital formation to facilitate productivity growth.

On this note, I am pleased to say that collective effort to increase the level of investment has already taken place. The government campaign – "Thailand Investment Year 2008/2009" is a spearhead project to make Thailand stand out as the investment destination for foreign investors. The campaign's key missions include restoring investor's confidence with more proactive marketing activities, strengthening infrastructure to accommodate for expansions, channeling investment into strategic industries for the future, as well as improving investment-related services.

Recently, a good feedback on the international level has been reported by the media. In the "Doing Business 2009" survey of 181 countries by the World Bank, Thailand just ascends 6 ranks to the 13th place where investors are provided with convenience in doing business. Thailand made key improvements in areas such as protecting investors, ease of paying taxes, and trading across borders. Apart from these efforts to induce external capital, it is also necessary to support investment through domestic saving promotion scheme in an anticipation of narrowing investment-saving gap in the future. Furthermore, the ease and coverage of financial access can also be enhanced further to facilitate efficient flow of funds.

Outside the realm of government policy, we stand to gain from a greater role of private sector. In this regard, I would like to commend the BCC's effort throughout the years. A programme like "Thailand Means Business 2008" which BCC will hold in both Thailand hotspots like Bangkok and Chiang Mai, as well as abroad like England, Hong Kong, and

Singapore, is a great help for attracting foreign investment into Thailand and enhance the country's capacity and potential.

Ladies and Gentleman,

For Thailand to achieve the goal of long-term sustainable growth, commitments have to be made today. And, this leads to the final part of my talk.

As Governor of the central bank, I am committed to pursuing price stability and financial stability to foster medium and long-term economic growth. On the financial stability side, I see that the Thai banking sector has decoupled from the direct impact of the global credit crisis. In fact, the banking sector's exposure to CDOs was only 0.3 percent of its total assets in 2007, which was completely sold off.

On non-performing loans, the net NPL level will be one of the issues that we will be addressing through second-phased financial sector master plan. As of end June 2008, net NPL of the banking sector in relation to its total credit is 3.4 percent, not a terribly high level. In addition, since the potential losses of these NPLs have already been provided for according to IAS39, the international accounting standard, the financial implication of NPLs on the banking sector's financial standing is very small. However, reducing NPLs further should improve the banking sector's credit rating.

The master plan will also focus on improving competition and efficiency of banks, while also broadening financial access to a bigger base of clientele. After the industry-hearing, we will announce the FSMP so that market players have a clear picture of the banking sector going forward.

On the pursuit of price stability, I wish to emphasize two points:

First, most central banks, both inflation targeter and non-inflation targeter, have their main objective on price stability, which is well-accepted as a necessary condition for sustainable growth. Studies show that "too loose" monetary policy for "too long" could potentially fuel severe inflation and fail us in the pursuit of long-term growth. More importantly, it will take a bitter-than-necessary pill to bring down inflation once its expectation persists. As an inflation targeter, therefore, it is important that central bank can anchor inflation expectations such that everyone believes that central bank will not tolerate high inflation which, in the long run, can undermine economic growth.

In Thailand's case, our studies have confirmed that during the first half of 2008, actual growth is close to potential growth, which could add on to inflationary pressure, with the real policy rate becoming mostly negative in July 2008. Moreover, another piece of central bank research also points out that Thailand's inflation dynamics has exhibited greater persistence. In part, this has been because food and fuel prices, though are cost-push factors, change as a result of structural shifts in supply and or demand. These are the rationale for the Monetary Policy Committee to raise the policy rates by a total of 50 basis points during the past two meetings in order to gradually withdraw the demand stimulus.

Second, monetary policy aims to create a conducive environment for consumption and investment decisions. Through price stability and efficient allocation of resources and finance, the economy will be able to achieve its potential growth. In this regard, 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, coordinating with the fiscal authorities in setting a target aims to ensure that monetary policy is aligned with the country's overall economic policy direction. By the end of this 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 2009. More importantly, this understanding must also be shared with the public at large – that the only long-term role for monetary policy is in creating an environment of price stability which would help support sustainable economic growth.

Ladies and Gentlemen,

In raising the economy's potential output, it requires that we pay attention to our capacity. I would like to raise two important areas of commitments that all economic participants together can help the economy build strong capacity. These are greater energy efficiency and advancement in education.

On the commitment to improve energy efficiency, we must reduce our dependence on imported oil from the present net oil imports ratio to GDP of about 8 percent, which is the highest in Asia. This can be done through investment to modernize new energy-efficient machinery and technology used for production. Importantly, price and tax mechanisms should foster energy saving.

As for the commitment to help upgrade education to increase labour productivity, reform in the education system should focus on raising the standard and quality of education for future generation of labor force. Skill specialization must be shaped to complement for Thailand's competitiveness in the world market. Indeed, better education would also improve financial literacy and access, which will, in turn, allow more efficient allocation of consumption and investment.

In sum, no matter how fast the economy manages to grow, at the end it is merely numbers. The development makes a real difference only when we are committed to building strong fundamentals to support long-term growth to ensure that the people are really better off on a sustained basis. Moreover, as we move toward an ageing society, fiscal policy is able to ensure a sound social safety net system to accommodate for an increase of elder population in the future. Meanwhile, the monetary policy takes care of price and financial stability.

Ladies and Gentlemen,

After a rather heavy presentation, I would like to end my talk on a lighter note. I trust that during your years in Thailand, you may have come across some fortuneteller stalls packed with worried-looking customers. In finding out what lies ahead, these customers hope that the right thing can be done today to secure a brighter future. I believe that all of us at this gathering are not dissimilar in trying to do the right things today for a better tomorrow. Indeed, the pursuit to become a higher income economy is not a lone man or lone organization journey. This ambitious goal calls for coordination and synergy of all participants in the economy. And, with everyone's support, including all of us here in this room, Thailand's fortune should be as bright and promising as ever.

Thank you very much for your attention.