

## Prasarn Trairatvorakul: Asian and Thai economies in a volatile world

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at The Nation's 43rd Anniversary International Conference, Bangkok, 19 July 2013.

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Distinguished CEO and Chairman,

Members of Asia News Network,

Distinguished Guests; Ladies and Gentlemen,

It is a delight to address you on this auspicious occasion of The Nation's 43rd anniversary. Let me congratulate you warmly, and wish you many flourishing years ahead.

We gather here at an important juncture of what seems to be yet another shift in global economic and financial landscape. The three-speed world economy appears to be on a convergence course recently as China and some other emerging markets start to show signs of slowdown, while the US and Japan are gathering momentum. These changing global dynamics coinciding with market's enthusiastic reactions to Federal Reserve's signal of so-called "QE tapering" led to a sell-off of emerging market debt and equities, and reversal of foreign capital flows that had rushed into the region earlier this year.

### Living in a more volatile world

The financial world has indeed become more volatile. Many factors intertwine to render such great financial market volatility we observe today. These include (1) closer integration of global economy through stronger trade and financial linkages, (2) increasingly large and mobile capital flows due to lower costs on cross-border investments, (3) rapid spread of information made possible by advancement in technology, and (4) more pronounced reactions on the part of market participants in times of heightened uncertainties ever since the onset of the global financial crisis. ***The interplay between market players' expectations, their self-fulfilling nature and spillover effects paves the way for market exuberance in response to a trigger event.*** As a clear case in point, the recent ups and downs of financial markets upon new information the market perceives from each round of the Fed's announcements highlight the role of "shifts in beliefs" on market volatility.

What made the post-2008 period particularly vulnerable to such self-fulfilling global turmoil is the current stage of the world economy characterized by lingering structural weaknesses of the crisis countries and limited policy space that reduce the potential of macroeconomic stabilization policy. All of these factors reinforce the role of global shocks and contagion through real linkages as well as expectation channel in transmitting volatility around the world.

***Notwithstanding the turbulence of the global economy, Asian economies had proven to be resilient in the face of negative external developments,*** with favourable macroeconomic performance and well-maintained stability during the past period, thanks to the region's flexible policy framework, robust financial system, and improved risk management as lessons had been learned from the crisis of 1997.

### Making headway towards sustainable growth

Ladies and gentlemen,

The success of Asian economies in weathering the global financial crisis is certainly commendable. But it would be a mistake to be lulled into complacency by this success of short-term volatility management. In particular, there remain important long-term challenges to the sustainability of growth in Asia. Indeed, latest economic indicators already pointed to a

less upbeat growth trajectory of the Asian region including China. ***The apparent slowdown in Asia, despite gradual improvement of the advanced economies, lends support to the idea that Asia also has its own structural bottleneck issues to deal with.*** The time is ripe for all parties involved to look beyond short-term fluctuations and give serious consideration to longer-term structural issues that are holding back Asian potential growth. This is the second topic of my talk today: what can Asia do to sustain its high pace of growth in the post-crisis world?

Since the onset of the global financial crisis, most policy responses in emerging markets have been focused on demand-side management, through monetary or fiscal policy stimulus. But boosting demand alone could only get us thus far. The real lift of potential growth of the economy must essentially come from supply-side progress. This refers to either the more abundance or the better use of capital and labor inputs in the economy. Although Asia's potential growth remains higher than in other regions, recent studies pointed to a possible reduction in trend growth since the 2008 financial crisis.<sup>1</sup> In my reading of anecdotal evidence and through policy discussions, two common drags to long-term growth among emerging Asia are ***the labor shortage*** and ***the decline in productivity growth***.

Let me explain the labor market issue using the case of Thailand as an example. The problem of labor shortage has been deep rooted in Thailand for many years but has not received much attention until recently. This could be partly due to favorable economic expansion during the past years that has masked this problem and also because of the ability on the part of firms to employ immigrant workers. But now with protracted external demand slowdown coinciding with recent weakening in domestic demand, long-standing weakness of the labor market has emerged as an important bottleneck hampering potential growth. Leaving aside the demographic aging problem that has yet to reach its peak, pervasive skills mismatch has been identified as a main cause of labor shortage. In particular, workers with vocational training needed by manufacturing industry, is in much shorter supply relative to university graduates. This has been one of the major holdbacks on manufacturing capacity. I would like to urge that, in searching for labor market solution, attention must also be paid to the problems of the wage structure, since at the going wage, price mechanism and its signaling function do not work efficiently enough to clear the labor market to eliminate this skill mismatch.

Related issue is that of a long stall in labor productivity as well as overall productivity growth. Policy distortions and a lack of clear policy directions can discourage firms from accumulating physical capital and investing in innovation, and prevent workers from moving to higher value-added sector. For example, agricultural price subsidy measures, while serving their redistributive purposes, may inadvertently channel workers away from highly productive manufacturing to agricultural sector, thus contributing to lower overall productivity of the economy. At the same time, low public spending on R&D and insufficient protection of intellectual property rights may deter innovative entrepreneurship and hinder a transformation towards a knowledge-based economy.

Good news is, the risk of a sustained growth slowdown could be reduced or even avoided, as success of some mature economies in Asia have shown in the past. ***This will depend crucially on the quality and the timeliness of public policies across a wide spectrum in tackling these long-term issues.*** To be sure the task is not going to be easy. Reorienting the country's growth strategy to focus more on skills development, innovation, and productivity involves deliberate planning over relatively long stretch of time. ***Three principles are of the essence: visionary leadership, consistency, and continuity.***

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<sup>1</sup> For example, the IMF's Regional Economic Outlook for Asia and Pacific region (April 2013) highlighted that a number of emerging Asian economies could run the risk of a sustained growth slowdown of the so-called the "middle-income trap" phenomenon.

Due to the long-term nature of structural readjustments, **continuity** of policy implementation is required for the policy measures to take meaningful effect on the economy. **Consistency** both over time and across the broad spectrum of macroeconomic policies, guided by the overriding economic reform agenda, is needed to reach an optimal outcome at minimum cost. And precisely because of all the challenge and difficulty in searching for the right direction for the economy and making it happen, a **visionary leadership** is vital for successful structural transformation. Clear and far-sighted vision for the economy, the ability to maintain coherency between strategic ideas and short-term actions, and the ability to bridge differences and cultivate shared beliefs are but some of the important characteristics needed for policymakers to deliver changes.

These three principles – visionary leadership, consistency, and continuity – should be at the root of the national economic policy formulation and implementation to ensure quality public policy that can enhance the country's competitiveness and sustain long-term growth.

### Realizing potentials of regional integration

Ladies and gentlemen,

Implementing reform through domestic policy alone is likely to be a daunting task, but fortunately Asian economies can leverage on the vast opportunities offered by the regional economic network. ***This brings me to the final topic of my talk, that of regional economic and financial integration in Asia.*** Under ASEAN economic community (AEC), the region's prospects will be much enhanced by further integration efforts to foster freer international trade and more mobile movements of factors of production. Four broad facets of regional connectivity are expected to contribute to ASEAN economic growth and stability. **First**, with barriers to trade in goods and services brought down, there will likely be a substantial expansion in intra-regional demand. This increasing role of intra-regional trade in final consumption goods should provide the region with a potential source of resiliency against global demand shocks. **Second**, higher mobility of factors of production and cross-border infrastructure development can help unlock the tremendous potential of the region by removing supply-side constraints and bottlenecks to growth faced by individual countries, while also making best use of resources and comparative advantages through regional and global supply-chain networks.

**Third**, through closer ties of financial and capital markets, ASEAN countries stand to benefit from tapping the vast pool of Asian savings, to finance intra-regional investment activities. This will prove particularly valuable given that many ASEAN countries are currently in much need of investment to lift their potential rates of growth after a prolonged period without large-scale upgrading. And **lastly**, the strengthening of regional financial safety net through institutional mechanism and arrangement such as the development of the Chiang Mai Initiative Multilateralization (CMIM) will increase the region's ability to respond to a crisis, build confidence and hence lessen possible market turbulence during times of financial stress.

As I have outlined here, numerous advantages for member countries and for the region as a whole can be expected from the launch of the AEC in just a few years from now. However, capitalizing on these opportunities will not be automatic. ***ASEAN leaders will need to step up their efforts in their preparatory works to achieve a credible and meaningful start.*** For one thing, boosting each member country's competitiveness and addressing key structural problems should be priorities that lie primarily with respective nations. Furthermore, to ensure sustainable success of regional economic integration, growth must be inclusive both within and between member countries. To this end, the **equitable economic development** pillar of the AEC blueprint calls on member states to narrow the development gap within ASEAN through mutual assistance and cooperation. Under this pillar, subregional programs such as the Greater Mekong Subregion (GMS) Economic Cooperation have been underway to accelerate economic integration of the newer members through various capacity

building and infrastructure projects. This would help spread the benefits of growth more widely and evenly while enabling the AEC to take advantage of the potential source of synergies by bringing the capital and know-how of the more mature economies together with the competitive costs and abundant resources of the new frontier member countries.

Another key element for sustainability of this ambitious effort towards a pan-Asian economic integration is to bring on board **private sector involvement** to draw in private expertise as well as private capital in funding and operation of intra-regional investment projects. In this regard, greater efforts should be made to raise awareness of AEC among the business community in sustaining high levels of collaborative economic dynamism within the region.

Last but not least, since regional integration relies much on harmonization and coordination of cross-national policies with strong commitment by national leaders in implementing the agreed arrangements, political stability and peaceful relationship among member states will prove imperative to the success. This calls for the promotion of **peace and stability** within the region with fair mechanism to arbitrate disputes to ensure that progress on economic integration will not be delayed or discontinued due to conflicts among member nations.

### Concluding remark

Ladies and gentlemen,

I have spoken at length, from a subject of a volatile world, onto more structural issues facing Asian economies, and the regional cooperative forces that provide promising ways forward for Asia. Let me now wrap up by leaving you with a final remark on these issues.

In these uncertain times and with all the increased interconnectedness of the world economy, volatility and short-term fickleness of marketplace are unavoidable. The wise thing to do is to understand the nature of this global interconnectedness, enhance risk management at both the macro and micro levels to mitigate negative impact that it may bring upon, all the while maximizing opportunities that it can immensely provide. It is conceivable that, in this highly integrated world, information and confidence are very important in influencing actions. Just as how “shifts in beliefs” can go a long way to create extreme market reactions and volatility, on a positive side I trust that a successful “anchoring of confidence” in our “shared beliefs” of ASEAN’s strength and future will encourage actions and commitments that will bring sustained prosperity for all.

Thank you. And happy birthday to The Nation.