Prasarn Trairatvorakul: Global risks and the outlook for Thailand

Address by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the Fitch Ratings 100th Anniversary Conference, Bangkok, 27 September 2013.

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Distinguished speakers and panelists,
Ladies and Gentlemen,

I would like to thank Fitch Ratings (Thailand) for inviting me to give an opening address at this year's annual conference. Much has changed both at home and abroad since I gave an opening address at this event two years ago. In retrospect, however, it is interesting to look back over the past two years and notice how most global risks we talked about – for instance, fiscal drag and political gridlock in the U.S., sovereign debt crisis in the Eurozone, among others – are still with us today. Most of the risks have reduced in terms of magnitude and urgency, but they certainly have not disappeared. In fact, each of them took turn to appear in the media spotlight and became an object of market's obsession. Victor Hugo once said, "No army can withstand the strength of an idea whose time has come." And that sounds fitting for today's financial market, where obsession with one idea could have a far-reaching implication for so many countries, at once, in an invasive way that is hard to shield against.

A. The state of indecisiveness that we live in

It has been almost six years since the beginning of the global financial crisis. But despite the extraordinary policies in major economies, despite reassuring words of global authorities, despite considerable reform efforts, the healthy state of full recovery seems to be constantly pushed away from us. At this point in time, the world is still struggling in what I would like to describe as the state of "indecisiveness".

First is the indecisiveness that we have about growth prospects. Mixed signals and counteracting forces abound, and it has become less obvious how global economic forces will -equilibrate. The talk of the two-speed or three-speed world, which was heard frequently earlier this year, proves to be an oversimplication of a much more complicated reality.

Among advanced economies, the U.S. and Japan seem to have gathered some tangible traction as of late. But one should be reminded that the impact of sequestration in the U.S. is still yet to be felt fully. And one should also be reminded that for Japan, contradicting policy objectives could lead to considerable trade-offs, coupled with the fact that the public debt situation there could become more sensitive to possible rises in bond yields given that we are already in the later stage of the global easing cycle. On the other hand, emerging Asia continues to post relatively high growth compared to the rest of the world. But in the absolute term, economic momentum seems to be losing some steam, and it is also possible that the extent of the shadow banking problems in China could be underestimated.

Coinciding with uncertain growth prospects is ***the indecisiveness about the exit from policy accommodation especially in the U.S***. Global market sentiments since May have turned with the expectation about the Fed scaling back its asset purchases. While all of us know that the exit from the extraordinary stance in the U.S. is inevitable, and is actually looming on the horizon, the timing and the pace remain uncertain and data-dependent. This could actually continue to disrupt the process of global rebalancing for a while. Time and again, taking away the punch bowl has always been a tricky task for central bankers. But the impact has never been more global, given today's interconnected global financial market.

Inconclusive clues about the future world, after all, lead to increased sensitivity to new pieces of information. Beliefs about the future world are shifting fast, and with that come bouts of volatility due to successive rounds of reassessing and repricing risks. To some extent, the recent episode also served as a stress test for emerging market economies, who had to deal with sudden capital movements and volatile asset prices. It also served as a reminder for these countries to ensure that their economic stability is safeguarded as they try to benefit from the increased integration with the global financial market. And importantly, it also served as a reminder for these countries to re-examine the robustness of their growth strategy in the face of global headwinds and fickleness.

B. Thailand's outlook and BOT's monetary and financial policies

Ladies and Gentlemen,

Like the rest of emerging Asia, the Thai economy appears to soften in the near- term. On top of export recovery that could be more delayed, the vital contribution from domestic spending is also viewed to lessen. Part of this, of course, reflects a natural reversion to a more normal pace of growth following unusually strong growth last year. More specifically, the boost from the first-car scheme dissipated sooner than expected. Household debt, which has risen fast and is now in the ballpark of 80 percent of GDP, starts to weigh on durable and semi-durable purchases visibly. And businesses also seem to postpone investment awaiting better economic conditions at home and abroad. In light of these factors, the Bank of Thailand projected GDP growth to be around 4 percent this year, a downward revision from a more bullish view we had earlier.

But I would like to note that this is still a reasonable growth amid weak external environments, coupled with the fact that consumption has become somewhat overstimulated already. Looking ahead, fundamentals of the economy remain sound overall. Monetary and fiscal conditions will continue to be supportive. And despite some delay, contribution from exports is also bound to improve as the global economy gains a firmer footing. Some concerns that I have about the outlook, however, are the possibility of continued sluggishness in private demand, and the possibility that supply-side constraints – both in the labor market and the production sector – could hold back the future potential of investment and exports.

Through this turbulent time, the Bank of Thailand has been steering its monetary and financial policies with prudence. The flexible inflation-targeting framework succeeds in anchoring inflation expectation, thus fostering continued growth and stability. The managed-float regime accommodates baht movements that are in alignment with fundamentals, with policy instruments ready to curb excessive speculation and overshooting if needed. The strong international reserves position, at the same time, helps cushion against sharp flow reversals. Efforts have also been expended on financial liberalization and regulatory reforms under the Financial Sector Master Plan. And for the banking sector, banks' capital bases have been strengthened well above international standard, while granting new subsidiary licenses for foreign banks will ensure that the future banking system stays competitive and vibrant.

C. Lifting barriers to sustainable growth

Distinguished audience,

Sound macroeconomic and financial practices have been instrumental in safeguarding economic stability and helping the country weather through numerous shocks that have come its way. Sufficient policy spaces in monetary and fiscal policies provided buffers amid intense headwinds and supports in the times of need – notably in the aftermath of the global financial crisis and the flood devastation in late 2011. But now that the height of the global crisis is behind us, and the need for short-term macroeconomic management less pressing, ***a serious attention should also be given to the agenda of long-term competitiveness and sustainable growth.*** This calls strongly for structural reforms of the supply side of the economy, where the constraints are particularly binding and a large-scale upgrading long overdue.

Pursuing demand management policies alone can only take us so far – somewhat akin to stepping on the gas pedal without upgrading or modifying the car we drive. Pursuing demand–side policies can also come with a steep price tag, especially when the policy borders on the realm of populism. Such policy would add to micro-level risks by making households undisciplined and addicted to "easy" money, while also add to macro-level risks by stretching fiscal resources without enhancing competitiveness in any meaningful way.

The Bank of Thailand views the need to address structural issues to be very timely and pressing. "Lifting barriers to sustainable growth" was indeed the central theme of investigation of the Bank of Thailand Symposium this year, which was held at the Bangkok Convention Center last week, and I hope some of you had a chance to participate in the event. My comment today, however, is my personal view and is not intended to be related to the Symposium.

Successful reforms, in my opinion, will need concentrated efforts on the following three areas: relieving labor market constraints, engineering a "transformative" upgrading of the supply side, and leveraging opportunities surrounding us. Let me elaborate on each of them.

(1) Relieving constraints in the labor market

Ladies and Gentlemen,

Moving the country forward requires taking a step backward to examine closely what is holding us back at the moment. ***The first area that has been particularly binding is the labor market*** – an issue that has been nagging us all along, but often fails to get attention amid the clamor of short-term economic issues. Over the past decade, both the total workforce and labor productivity have been growing very sluggishly. Another related problem is that of skill mismatch, where workers with needed vocational training are in much shorter supply relative to university graduates. These pose serious limits to capacity expansion and innovation efforts of the private sector.

To alleviate the problems in the near term requires that ***distorted incentives be corrected.*** Policy distortion such as the rice mortgage scheme and subsidy of other agricultural prices should be kept to a minimum, for these incentives drive workers away from high value-added sectors to the agricultural sector. To solve the problems in the longer term requires ***educational reforms that tackle two major challenges: namely, raising the supply of workers with vocational training in demand and ensuring labor productivity upgrades.*** I cannot stress enough the importance of having a future generation of workforce that is capable and flexible enough to accommodate changes in production technology. In addition, fostering close collaboration with the private sector could also be an essential part of the solution, and it is very encouraging to see more involvement from large Thai corporates in the process of recruitment and training as of late.

(2) Engineering a "transformative" upgrading of the supply side

In addition to relieving constraints in the labor market, ***the second reform focus I would like to discuss is the urgent need for a "transformative" upgrading of the supply side***. Pursuing growth from labor-intensive activities is no longer a viable option, due to the fact that Thailand would not be able to compete with lower-wage competitors, and also the fact that such strategy is simply unsustainable from a long-term perspective. More importantly, failing to upgrade now will cost us an inestimable amount in the form of missed opportunities.

Indeed, it was precisely the inability to engineer a large-scale upgrading, when the time was ripe, that separated our path from peer countries like Taiwan and Korea that started out at a relatively similar income position several decades ago.

By using the word "transformative", I mean that the upgrading process needs to go beyond mere efficient use of workers and capitals. It has to support firms to move up the value chain to higher value-added activities. It has to equip firms with ***capability*** to move toward higher product sophistication and ***flexibility*** to cater to changing global consumer demand. It has to nurture innovation, given that meaningful growth spurt tends to come from either new products or new ways of producing and delivering them. ***The strategic focus is thus to create the right environment and give the right incentive for firms to invest and innovate.***

Physical infrastructure is where we lack behind and suits to be the starting point. High-tech, capital-intensive industries tend to benefit greatly from knowledge spillovers and concentration of economic activities. Therefore, more specialized hubs and clusters – in the spirit of, for instance, Singapore's Biopolis and Japan's Tsukaba Science City – are needed. For industries with lower capital intensity, establishing industrial hubs and zonings of related industries would be beneficial, so that these industries can reap localized benefits such as the availability of specific inputs and better labor market pooling. Supporting these less capital- intensive industries will also serve toward the agenda of inclusive growth, for these industries contribute significantly to employment in rural areas. Last but not least, well-integrated and cost-efficient logistics systems are called for, in order to ensure connectivity and efficiency of domestic production chains. ***Along with physical infrastructure upgrading, "soft" infrastructure has to be upgraded***. In addition to educational reforms that I talked about earlier, improvements on the legal front are also needed. Protecting intellectual property rights and minimizing regulatory burdens for businesses are the two key areas that continue to require reform efforts.

I would like to note that several moves in the right direction are already in place. Government's massive investment plan in water management and long-term infrastructure is one of them. At the very least, the attempt has managed to elevate the urgency of infrastructure upgrading to the status of a national reform agenda. On a related note, the government also has the plan to push Thailand toward an innovation-driven economy. While these are laudable initiatives, challenges still remain in the implementation phase, and more work remains to ensure that we get the biggest bang for the baht and that fiscal discipline is respected.

(3) Leveraging existing opportunities around us

Ladies and Gentlemen,

The third ingredient I would like to discuss today is the importance of identifying opportunities surrounding us and leveraging them. Upgrading efforts that I spoke about at length should put the country in a better position to reap benefits from these opportunities, which can make the route to prosperity less arduous.

The timing is still on our side. First is ***China's changing role in the international trade*** – from a large manufacturer of export goods to a large import country of the world. Even with signs of losing some steam, one should not forget that even a 6-to-7 percent growth of today's Chinese economy still adds far more to global demand than the double-digit growth of the past decade. Taking advantage of this opportunity wisely can benefit exporters immensely.

The second source of opportunities is ***the upcoming regional economic integration***. With the advent of the ASEAN Economic Community (AEC), intra-regional trade volume will grow given that more trade barriers are removed. With its geographical advantage, especially its proximity to the vibrant CLMV countries, Thailand gets a head start in positioning itself as an investment and production hub for the AEC, although this requires continued efforts on minimizing regulatory burdens for businesses and increasing regional connectivity by strategic investment in logistics and transportation systems. After all, combining the capital and the technology of more advanced members with the cost advantage of newer members will result in a synergy that benefits the region as a whole. It should be noted, also, that the rising significance of intra-regional trade will serve the region well as an additional buffer against weak global environments.

To support Thai businesses to seek investment opportunities abroad, the Bank of Thailand continues to gradually relax capital flow regulations, initially on outward direct investment and more recently on portfolio investment for Accredited Investors. On a related note, to facilitate banking integration, ASEAN central banks are also in the process of negotiating the common standard of Qualified ASEAN Banks (QABs), which will allow qualified banks to expand into other ASEAN countries with greater ease. Freer flows of funds and closer financial ties within the region, after all, will provide much-needed support for investment activities and business dealings over the years to come.

D. Concluding remark

Ladies and Gentlemen,

I would like to conclude my talk today by restating my firm belief in the promising future of the Thai economy, and stressing again the pressing need for the country to move forward to the long-term agenda of competitiveness and sustainable growth. In these days, once we get so used to reacting to new information in the marketplace, it does not take long before we get so involved in the battle scene that we might lose the long-term perspective. It also does not take long before we forget that meaningful upgrading takes a careful, deliberate planning to truly succeed and a considerable amount of time to unfold.

Given many challenges at home and abroad, moving Thailand forward is sure to be an arduous task. As a non-crisis country this time, it is wise to stay vigilant since “good” time is still the time when bad loans are made and imbalances accumulate. It is much wiser, however, to also use this time to make a head start toward the brighter future. The world is moving toward greater speed and greater interconnectedness every second, and to thrive in such environment, a balanced mix of demand management and structural reforms is a prerequisite. They are entrance tickets to a safe, undisrupted trip on the road to prosperity over the years to come.

Without further delay, I now would like to officially open the Fitch Ratings Annual Conference and wish everyone a fruitful discussion and exchange today. Thank you Fitch Ratings (Thailand) again for organizing the conference, and thank you for your attention.