Prasarn Trairatvorakul: Achieving Thailand's true growth potentials – the role of the central bank

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the Thailand Focus 2014: Reforming for Sustainable, Bangkok, 27 August 2014.

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Ladies and gentlemen,

I am very honored and pleased to be addressing you at Thailand Focus once again. I would like to thank the Stock Exchange of Thailand, Phatra Securities and Bank of America Merrill Lynch for arranging what has become the must-attend forum on investment, policies, and the Thai economy.

This year's topic, potential growth, has gained new dimensions on the world stage since the Global Financial Crisis. Through harsh experience, advanced economies have learned that their long-term growth potentials may have been diminished by a protracted period of sub-par short-term growth. This idea of "secular stagnation" which went back to Alvin Hansen during the Great Depression and brought back to the spotlight last year by Larry Summers has now been widely discussed in the media as well as policy circles.

While our situation is different from the West, Thailand has also been experiencing sub-par growth during most of the past seven years. As the economy now wakes up from the third contraction since 2008, it is natural to ponder about the economy's growth going forward. Ladies and gentlemen, I am most pleased to have this talk with you today because the Bank of Thailand stands between short-term hiccups and Thailand's long-term growth, bringing decades of experience in economic stabilization. The Bank also has a role in developing the financial system to promote growth. I would like you to follow me now through the details of our role on growth and hope to leave you with more confidence that Thailand is in good policy-makers' hands.

My talk today will cover three areas. Firstly, I would like to share Bank of Thailand's views on Thailand's current growth potential. Secondly, I would like to walk you through the current economic conditions and illuminate the role of central bank in returning balance in these situations. And thirdly, I will address the classical yet very current challenge of lifting growth through boosting productivity. I will share with you the opportunities we see for Thailand, involving the structural changes that are now underway, and the cooperation by the central bank, public and private sectors that will transform these opportunities into sustainable long-term growth.

Ladies and Gentlemen,

Having outlined our plan for today, I would like to begin with the concept of growth potential and its application to the state of Thailand's economy. What do we expect to see from a Thai economy achieving true growth potential? ***Two components. First is growth at full sustainable capacity.*** We would expect to see factories producing their optimum output while hotels have the maximum number of guests that can be served comfortably, and infrastructure from roads to banking system able to lend full support. ***Second is lifting the long-run growth trend***. We would expect to see the same factory owners boosting technology investment to be able to manufacture more valuable products in the future, or the banking system being improved to bring funds to investors more effectively. The first component requires full utilization of current resources and can be achieved through demand-management policies, while the second component requires *improvement* of these resources and production processes so that production can yield a higher rate of return. This can be achieved by supply-side policies: increasing productivity of the labor force, adding value to products by innovation, and improvement in infrastructure.

Looking at the Thai economy right now, we can see room for both demand-side and supply-side policies. Our economists have analyzed two decades of trend in capital accumulation and estimated that Thai economic growth potential has declined since the 1997 crisis and is currently at 4 to 4.5% per year. Thai growth potential is also low compared to ASEAN peers, who average around 5%, according to an IMF study this year. This reflects lower productivity, and suggests that there is room for supply-side policies to lift growth trend.

Looking at need for demand-side policies, Thailand's actual growth has averaged 2.5% between 2008 and 2013. In this period the Global Financial Crisis and the Thai mega flood occurred, and the economy's rebound was not enough to compensate for lost growth during these large shocks. Demand-management policies are needed to restore confidence and growth to full capacity. The Bank of Thailand has deployed accommodative monetary policies throughout these shocks, as has the government sector by deploying stimulating fiscal policy.

Over the downturns during this period, Thailand's economy has been maintaining strong fundamentals and stability, and thus allows policy makers to accommodate and boost the recoveries without much risk to future growth. The central bank actively takes part in building these strong fundamentals and stability.

Ladies and Gentlemen,

Now that we are on the same page about Thailand's growth potential, I would like to turn your attention towards the present roles of the Central Bank in restoring growth through stabilization policies.

The Thai economy is currently well below its growth potential. Particularly over the last 3 quarters, average growth is close to zero due to political uncertainty and payback period from earlier government policies, most notably the first-car buyer tax rebate scheme, which has dragged down private spending. A prolonged period of diminished economic activity eventually hurts growth potential. When businesses lose confidence, they draw down production and investment, which blocks progress in knowhow and technology. A steady growth path is desirable because growth stability helps the private sector make long-term decisions. This is why the monetary policy committee also takes a role in stimulating the economy towards regular activity.

In this situation the monetary policy committee has taken a more accommodative stance since early this year to support the economy to reach its full level of activity faster without sacrificing the monetary policy objective of maintaining price stability. ***The accommodative stance has been maintained until now and is starting to bear fruit*** as political clarity resuscitates confidence from both domestic and international stakeholders. Given that balance sheets are healthy enough to resume normal activity, ***regained confidence of economic agents is the key to recovery and return to the existing growth potential.***

The most recent economic data shows that consumption and investment have started to recover in line with progression of political clarity and accelerated government disbursement. At the same time, world economic growth which continues to recover steadily, especially in the U.S., will help export recovery. With all these positive developments, ***prospect of growth recovery is promising***.

In fact, we project the economy to grow at around 5% over the next 4 quarters. Once again, in this situation, the monetary policy committee needs to weigh the gain of short-term boost to growth with the risk of financial instability that can deter future growth. Besides price stability, financial stability is also a necessary component of healthy growth potential. Financial instability can spread to and disrupt the real economy as seen in the recent economic development of industrial countries over the past decade.

What methods does Bank of Thailand have to maintain financial stability? Monetary policy's priority is maintaining inflation expectations within the target range. As a tool against financial imbalance, monetary policy is blunt and can create costs to sectors that are not at risk. Macroprudential tools can complement monetary policy by acting on specific high-risk sectors. Bank of Thailand has experience in employing several macroprudential tools since 2002 to prevent financial instability that may stem from, for example, excessive credit card loans to sub-par debtors, excessive foreign exchange speculation, and a formation of real estate bubble.

I would like to refer to another of our policies to maintain financial stability. To ensure capital flows and exchange rate stabilities, the Bank of Thailand uses a managed float on exchange rates. The policy allows the Thai Baht to adjust via market mechanism, helping to stabilize against volatile capital flows. It also allows flexibility for the Bank of Thailand to influence the exchange rate in extreme events in order to avoid excessive volatility.

All the mentioned policies have helped to keep the current economy in good balance. Today, capital flows, private sector balance sheets, as well as real estate values remain healthy, which should allow private spending to return with confidence and enable fast recovery.

However, ***there are risks we must closely monitor over next year***. As the U.S. economy continues to recover strongly, earlier timing of the U.S. interest rate normalization is anticipated, which could result in capital flow volatility. At the same time, household debt, at 83% of income, is also a factor to be monitored with caution.

We have now covered growth, price, and financial stability. The Central Bank aims to maintain all three facets of stability for continuity in order to support growth potential. With a promising recovery prospect, minding the future risks to financial stability and being equipped with stability tools tested and refined over time, ***the monetary policy committee will carefully weigh the tradeoff between short-term gains and longer-term risks and ensure that the economy will be provided with enough financial ease to recover sustainably to its potential.***

Ladies and Gentlemen,

Apart from the deviation from potential I mentioned earlier, the current economy shows symptoms that potential growth, which depends on labor, productivity and infrastructure development, may have reached its limit.

At this stage of our discussion, let me refer to some prominent symptoms. Thai labor supply has started to gradually decrease due to the trend of aging society. Research has shown that increasing labor supply by increasing retirement age and reliance on foreign labor will not be sufficient. Since we must accept the aging workforce trend, ***we must rely on increasing productivity and efficiency through structural changes to lift growth potential, a task which requires supply-side policies.***

Thailand's productivity growth has declined since the Asian Financial Crisis due to the misallocation of labor, government policy, and low capital investment, leading to supply constraints. Productivity can be increased by matching labor to valuable production. Labor in Thailand still has potential to move from the current concentration in agriculture, which was distorted by government policy, to more productive sectors like electrical appliance and capital machinery. As advanced economies drive global demand going forward, these sectors stand to benefit, as seen in the recent pickup in exports of automotive parts and printers to the U.S. There is much potential for movement to competitive sectors, as Thai labor is recognized for quality in complex manufacturing as well as delicateness in services. Leading global auto manufacturers for instance are committed to long-term investment in Thailand.

At this stage, government can play an essential role in development of skills in the labor force. The alignment of hiring needs, education in relevant skills, and the right incentive structure is the most important requirement to unlock Thailand's productivity limit.

Furthermore, policy consistency and transparency are necessary for businesses to be certain about their long-term investments. Misalignment of policies, both between agencies and across regimes, must be reduced while concrete long-term plans should be communicated to businesses on the regular basis.

The current government is aware of the need for supply-side development policies, and is implementing policies to improve infrastructure, support SMEs, and increase research and development, and will recommend continuation of these policies to the next government for consistency.

Ladies and Gentlemen,

I mention these structural challenges as I have in my previous talks, as complex issues benefit from the sharing of ideas. However, let me now move to issues within ***the direct mandate of the Bank of Thailand***.

Although less often mentioned, the Bank of Thailand's roles in lifting growth potential still exist. ***Two roles*** are worth mentioning. Firstly, the role of ***maintaining economic stability*** that I described earlier in this talk, as stability is a prerequisite to structural changes that lift productivity. Secondly, ***the developmental role***, a form of supply-side policies, ***to enhance financial sector efficiency*** and create a favorable financial environment for investment that would lead to higher productivity growth.

The importance of financial markets has long been realized by the Bank of Thailand as being the crucial part of growth potential. Indeed, our annual economic symposium this year, "Rethinking Finance for Sustainable Growth", will discuss the links in detail. A healthy financial market can distribute funds to the parties that can bring most value out of them. For example, investors in the stock market closely monitor businesses, and will withdraw funds from those that have low prospects of future growth, moving them to those with better prospects. The growth prospects will be realized, and in aggregate will improve the whole economy's growth potential.

A well-developed financial market also lowers the cost of raising funds, as the increased competition broadens the variety of financial products offered. An SME for example, whose credit-worthiness is difficult to assess compared to a corporation, might be limited to self-funding in a less-developed market. But in a well-developed financial market, corporations can turn to other channels, leaving commercial banks more incentive to serve SMEs.

In 2004, ***Financial Sector Master Plan*** Phase 1 was adopted and, to continue improving the financial sector, Financial Sector Master Plan Phase 2, the current phase, was launched in 2010. This current plan helps promote competition in the financial market. Continuity of these plans and implementation over several years has improved Thailand's financial infrastructure, as indicated by ***lower cost-to-income of commercial banks***. Progress is especially visible in the SME segment. Promoting competition among players in the banking sector has steered ***banks to seek more opportunity in this segment.*** At the same time, the Bank of Thailand has helped lay down infrastructure that reduces the asymmetric information problem in this segment by means such as setting up the SME Database. With the convincing results of the current plan which will end this year, the Bank of Thailand has recently set up a steering committee to look after the next phase, Financial Sector Master Plan Phase 3.

In addition to Financial Sector Master Plan, the Bank of Thailand also encourages Thai companies and depositors to diversify their investments and promote financial market development through the implementation of ***Capital Account Liberalization Master Plan***. As a result, there is ***increase in the number of Thai companies doing outward Foreign Direct Investment which allows capital as well as resources to be allocated more efficiently***.

At this point, it is important to note that resources and infrastructure built by the government and central bank are not sufficient in themselves to lift the economy's growth potential. More importantly, financial institutions and businesses must utilize them and act as the main player that will drive the economy to its highest potential. Therefore, ***cooperation of financial and business sectors*** is vital for lifting growth potential. The private sector needs to add more value to products and services by having long run commitment and investing in both physical and human capital, for example, high technology machinery, employee training as well as research and development. In order to support this, the public sector and Bank of Thailand can improve accessibility to sources of funds, especially for SMEs, and lower the costs of long-term investment.

Ladies and Gentlemen,

The Bank of Thailand pursues economic growth as part of its commitment to sustainable well-being. Economic growth, as discussed today, is maximized by keeping growth close to potential as well as lifting growth potential itself. The central bank can contribute to growth potential by stabilizing the overall economy. The Bank of Thailand has looked after growth, price, and financial stability during the downturn, leaving the economy on a more confident track to recovery. As for raising growth potential, cooperation of all sectors is needed, while the central bank provides a favorable financial environment which is prerequisite.

In the football game of the economy, the Central Bank acts as ***Center Back***. In order to ***safeguard*** stability during the recent circumstances, we have played a ***proactive*** role due to high economic uncertainty. Now that political and economic clarity is higher, the central bank will play a supportive role. At the back we can clearly see the whole field and choose a path ***to support the team's offense***, especially now that the government has gotten back to its position as the ***play maker*** to ***assist the private sector*** to reach the goal of achieving growth potential.

Thank you.