Thailand's Economic Prospects and Financial Stability

by

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The Four Seasons Hotel, Bangkok
7 December 2005, 12.00 PM – 2.00 PM

Khun Sivavong, Chairman of PTIT,
Distinguished Members of the Institute,
Ladies and Gentlemen,

It is my great pleasure to be here among distinguished personalities in the oil and oil-related industries. I have been invited by PTIT to share with you today, my thoughts on the current economic conditions of Thailand, its financial stability, as well as its prospects over the next few years. I believe that the main interest of the Institute and all of you is the effect of high world oil prices on the growth and stability of our economy. So, my presentation today would center around the relation of high oil prices and the Thai economy.

Let me start by giving you some facts. First, on economic growth, the Thai economy had already fully recovered from the 1997 crisis with its annual GDP growth in 2003 and 2004 at 7.0 and 6.2 per cent, respectively, which, by any international standard, is quite satisfactory. However, in the first quarter of 2005, our GDP growth fell sharply to 3.2 per cent. On this point, many may think at first that it was caused mainly by the rise in world oil prices. But, in fact, it was not the whole story.

The slowdown was attributable to other negative factors such as the Tsunami that occurred in last December, the severe drought since the second half of last year, and the downward trend of the global electronic cycles that began since the middle of 2004, in addition to the high oil prices. With careful and detailed analyses to estimate the impact of each negative factor mentioned above, we found that each of the factor had quite small impact with the total reduction of the GDP growth due to the high oil prices being only around one per cent. However, their impact together had been quite substantial.

This particular point was confirmed by the recent release of economic data in the third quarter of 2005. By that time, the impact of the Tsunami on the tourism industry had already subsided; the drought had already ended, with the water level in our main reservoir now back to normal and already exceeding last year's level; exports also accelerated markedly, especially the exports of our high-tech sector. Despite the prices of world and domestic oil remaining high compared to the year before, economic growth in the third quarter already returned to 5.3 per cent. So, high oil prices were not the drag on the economy as much as many people believe it to be.

Looking ahead, we have made quite a conservative assumption concerning world oil prices for our growth forecast in 2006, using Dubai oil prices of 56-57 dollar per barrel during 2006-2007. Under this assumption, our economy would still grow at a rate higher than 5 per cent in 2006 with exports and private investment as the main growth engines. In fact, with the recent decline in world oil prices, there are greater possibilities that growth will be on the upside of our baseline forecast.

This does not mean that oil prices are not important, but rather that high oil prices had so far caused only a slight drag on our GDP growth. On the other hand, there were substantial effects on the economic and financial stability fronts, especially with regards to the domestic price level and the current account balances.

Let me first discuss the impact on inflation. We expect inflation to rise in the fourth quarter of 2005 to around 6 per cent which is quite high compared to the past few years. In fact, inflation in October and November 2005 were 6.2 and 5.9 per cent, respectively, almost double its rates of 3.5 and 3.0 per cent for the same months a year earlier.

This sharp rise in inflation was partly the result of pent-up pressure on the price level. The oil price stabilization scheme that began to put the cap on the domestic oil price increase since early-2004, has delayed the normal process of general prices adjusting to the rise in world oil prices. But, this scheme became too costly at the end when domestic oil prices were allowed to float freely again. As a result, the sudden jump of domestic diesel prices of more than 50 per cent, from around 14.7 baht per liter to 22.4 baht per liter between end-February and mid July, raised both transportation and production costs and subsequently prompted some of our producers to adjust their prices at the same time.

If we had allowed domestic oil prices to increase since last year, the impact on inflation would have been more moderate and the price adjustments that followed would have been more gradual and spread out over 2004 and 2005. Inflation would certainly not be this high. Nevertheless, we are confident that long-term inflationary pressure still remains under control and we should be able to handle it. According to our latest forecast, high inflation will not persist and will decelerate to roughly 3 per cent by the end of 2006 once the price adjustment process run its course and given the high base in 2005.

The observed rise in the inflation is our concern for three reasons. **First**, we do not want inflation to rise unchecked with the supply shocks having a prolonged effect on inflationary pressure. In particular, we are concerned that there might be several rounds of price and wage increases that will lead people to expect that inflation will remain high for some time to come. This is why we began tightening our monetary policy and raised our policy interest rate eight times since August 2004, for a total of 2.50 percentage points from 1.25 per cent to 3.75 per cent. Should oil prices had remained around 40 dollars per barrel and did not have the second round of increase as it happened over 2005, inflation would not have been so high and our policy interest rate would have already caught up with inflation.

Second, as inflation rose sharply, real interest rates turned negative. Many depositors are now earning negative real deposit rates.

Third, we have to ensure that real interest rates are positive to help induce more saving. In fact, the interest rate increase is a necessity given that in 2005 our domestic saving was less than our domestic investment and resulted in a current account deficit for the first time in the past 8 years. This is an early warning signal that Thailand needs to increase its savings, especially its household savings, to help close the saving-investment gap and prevent our current account from becoming excessively in deficit.

Ladies and Gentleman,

Let me now turn to the impact of the high oil prices on the current account. As you may already know, the current account turned sharply from a surplus of 6.6 billion US dollars in 2004 to a deficit of 6.1 billion US dollars in the first half of 2005. As shown in the slide, more than half of this reversal was attributable to the rise in world oil prices. And we continue to expect that the high oil prices will cause our current account to remain in deficit over the next few years despite the recent improvement in the third quarter from our stronger-than-expected export performance.

This is because the rise in the oil price already resulted in Thailand paying roughly 7.2 billion US dollar more for our oil imports in the first 10 months of 2005 compared with the same period last year and the oil import bills now accounts for a substantial share of the total import bill. Moreover, we expect oil prices will likely remain high for some time. Even in the present condition in which oil prices are sufficiently high to make new investment for additional supply of oil and for alternative sources of energy economically feasible, it would still take at least 3-4 years before the new supply will enter the market. These prolonged high oil prices would therefore definitely have negative effects on the balance of trade and the current account of Thailand.

Furthermore, increased investment in both the private and public sectors may cause the current account deficit to deteriorate further. Given the steady increase in the capacity utilization level which in many industries has already exceeded 80 per cent, we expect private investment to continue to increase especially in vehicles, petroleum, chemicals, electronics, paper, concrete, tin metal, and synthetic fibers. In addition, in the next few years, government spending on mega-projects will already go into full steam. So, the capacity utilization is likely to rise further from present levels and more private investment will subsequently be needed. In particular, we estimate that with and without the mega-projects, our current account in the next 5 years will be in deficit and average around 2.5 and 3.5 per cent of GDP, respectively.

Thailand, in my view, should be able to handle current account deficits of these sizes without difficulty given our high level of international reserves and the present level of capital inflows from aboard. But we must remember not to repeat the same mistakes of 1997: we must avoid capital inflows that are short-term and give more emphasis to attracting foreign direct investment and long-term borrowings. The Bank of Thailand will keep a close watch so as to ensure that the capital flows will help and not destabilize the economy. At the same time, we must also ensure that the current account deficit does not become too excessive and subsequently lead to an increase in the overall vulnerability of the economy. I would like to add here that concerted effort to introduce more energy conservation measures is needed to lower the size of the current account deficit in the medium term.

Ladies and Gentlemen,

Besides the effect on the current account, high oil prices will have a more considerable and longer-lasting effect on the cost competitiveness of Thailand. From the data, we found that not only does the energy import bill account for a considerable 18 per cent of our imports, but Thailand's energy intensity level is also among the highest in the region. Consequently, with a high oil dependency ratio, Thailand cannot compete effectively. And our exports will be disadvantaged compared to our competitors in the region. Since Thailand will have to depend on exports as one of the main engine of growth for a long time to come, we should be very much concerned about this.

A recent study conducted by the NESDB indicated that, first, Thailand has inefficient structure of transportation and uses too much of oil-intensive transportation. There are other alternative modes of transportation that are less oil-intensive which Thailand must consider. Second, taking a close look at our manufacturing industries, the NESDB also found that industries in Thailand continue to employ technologies that depend on oil or need energy input more than our competitors. This made Thailand more vulnerable to swings in the world oil prices and to negative shocks in the oil supply and thus reducing our overall economic resiliency.

From what we have heard thus far, the NESDB is preparing policy measures that will allow a modal shift from our current mode of transportation that rely on cars and trucks to that which rely more on railroads and to the lesser extent, on waterways. I think this is a good first move that will eventually benefit the Thai economy in the long run, but there are many other things to consider. Simply building more railroads will not suffice to achieve the modal shift as there are also other considerations. Some may find that, over short distances and certain routes, it continues to be more cost effective and more convenient to use cars and trucks as the major mode of transportation.

To bring about a modal shift, additional measures to encourage people to use the railroad more and road transportation less are required. Such measures include restrictions on freight loads, tax breaks on oil for railroad transportation and the improvement in the rail systems management, for instance. Above all, we have to look at it both from political and practical point of views in assessing the viability of this project before we make the final decision to put in a large amount of investment in the rail system.

Concerning alternative sources of energy such as bio-diesel, gasohol, or solar energy, the NESDB already has a plan to encourage the greater use of energy sources other than oil, or the so-called fuel-shift strategy. The search for a new and clean energy source that can be produced domestically and whose prices are not too volatile is an important step in the right direction, provided that the NESDB plan is based on a careful and in-depth cost-benefit comparison of each alternative energy source. Certain alternative energy sources may at first look promising but this may simply be the result of preferential treatment in our tax system. Once the preferential treatment is accounted for, these seemingly promising energy sources may no longer be economically feasible. Therefore, the true economic cost and benefit should be elaborated upon very carefully so as to make the right policy decision.

But finding the right transportation structure and energy source is only the first step. What is more important is the strategy to upgrade technologies of our manufacturing sectors and reduce their dependence on oil. At present, this strategy is not in the NESDB plan. Nevertheless, I have learned that some manufacturing firms have already put in place certain reward incentive programs to improve energy efficiency. But we still feel that Thailand lacks in-depth research on how to restructure our industries and production process in order to reduce the usage of oil. In my view, this is definitely a critical matter that will determine the competitiveness of Thailand in the long run which will require a substantial and serious effort in conducting detailed and in-depth research.

We, at the Bank of Thailand, would like to conduct comprehensive research on this particular issue but we do need a partner with expert knowledge of oil-saving technology. As we have heard many goods things about PTIT, may we assume that we can rely on our PTIT connection in identifying any experts you may have in the areas I just mentioned? If so, we would like to invite PTIT to collaborate closely with the Bank of Thailand on this important research. Our main objective is to come up with the strategies and measures to induce industries to upgrade to more energy efficient manufacturing technologies or production processes. Perhaps PTIT may not like it at first thought, since this will result in the reduction of oil consumption level in Thailand. But this I believe is a necessary and critical step that will help ensure Thailand's survival and eventual prosperity in the long run.

This policy of reducing our dependency on oil to improve Thailand's competitiveness in the world market is all the more pressing in light of another possible threat to us and the world at large, namely, the unwinding of the global imbalances that originated from the large and prolonged current account deficit in the US. So far, the widening US current account deficit has been sustained by the continued inflow of money from the rest of the world, largely in the form of portfolio investment in equities and debt instruments. The most worrisome aspect of this development is that the US current account deficit has continued to widen while the US external debt has grown and the financing of the deficit has become more volatile. This is why financial markets and policy-makers have become more nervous about how this financial imbalance will be resolved.

This situation is certainly not sustainable in the long run and economists are talking about the unwinding of the US current account deficit which could happen in three possible scenarios.

The first scenario is that the US will take care of its problems by putting in place policies that will help reduce its domestic spending and resolve its twin deficits. This will be the most orderly resolution to the problem. In the second scenario, other countries in the world could slowdown their investment into the U.S. when their domestic investment picks up with economic recovery. This will subsequently force interest rates in the US to rise and help raise the level of savings in the US, reduce its spending and thereby reduce its current account deficit. And in the final scenario, in which no corrective action is taken as mentioned in the first two scenarios and the US continues its spending spree unchecked. Several renowned economists have pointed out the risk that there could be a sharp depreciation of the US dollars if there is a crisis of confidence or market panic. In fact, one day, investors may wake up and decide that the US current account deficit is no longer sustainable and start rapidly diversifying their funds away from the US market. The resulting sharp fall in the dollar will in turn force the reduction of US imports and correct its current account problem rather abruptly.

What is troubling in all of these three scenarios is that they lead to the same conclusion. That is, at the end, the US will have to purchase less from the rest of the world in order to restore its current account balance. This means that Asian exports as well as Thai exports will be reduced substantially. So, we need to prepare ourselves by diversifying our export markets. Luckily, intra-regional trade among the non-Japan Asian 9, namely China, South Korea, Hong Kong, Taiwan, Singapore, Indonesia, Malaysia, Philippines and Thailand, is growing fast. In the first 10 months of 2005, Thai exports to China grew almost 30 per cent. And for the East Asian region as a whole, the share of intraregional trade grew sharply in the past 14 years from 29.1 per cent of total trade in 1990 to 40.8 per cent in 2004. Besides East Asia, we also have to look for the possibility of expanding into other markets as well, such as the Middle East and Africa.

In order to gain more market share in these markets, Thailand's exports will have to be more competitive. This should convince you that we together have to take steps to help our manufacturing industries become more efficient in many areas. And one of the key areas that needs urgent improvement is in energy efficiency.

Ladies and Gentlemen,

In conclusion, the Thai economy has weathered the rise in oil prices well thus far. And I would like to emphasize again that rising oil prices were not the main drag on GDP growth. On the other hand, high oil prices did significantly affect inflation and the current account. Nevertheless, these adverse effects proved manageable and will be under control with enough concerted effort to promote energy conservation. What is more important is the impact on Thailand's cost competitiveness.

While we expect that the overall economy will continue to grow satisfactorily in 2006 with the continued expansion of the world economy and a more stable world oil price, our key policy challenges, however, are in the longer term. Whether Thailand will substantially prosper in the future or not depends critically on whether we will be able to restructure our real sector, financial sector, as well as our energy sector to allow the Thai firms to compete competitively in the world market. A committed and in-depth research effort to improve the energy efficiency of industries is needed. With your help and our fruitful cooperation, I am very confident that we will succeed and contribute to Thailand's prosperity in the long run.

Thank you.