



“The Thai Economy: Challenges and Prospects”

by

**Tarisa Watanagase
Governor of the Bank of Thailand**

**European Heads of Mission Luncheon
Residence of the Ambassador of the Federal Republic of Germany
Bangkok, Thailand
21 February 2007**

Ambassador Brümmer,
Your Excellencies
Ladies and gentlemen,

At the outset, I would like to thank Ambassador Brümmer for inviting me to speak at this luncheon. It gives me great pleasure to share my views on Thailand's economic prospects with all of you.

This talk is most timely for these are difficult times for Thailand. In the past year, Thailand under major political developments. We saw mass street protests against the previous administration, a military coup and the annulment of the 1997 constitution. The present government has promised an election and a new constitution but, as year-end bombings painfully show, political uncertainties remain.

Economic uncertainty has also increased. In the past few months we saw rapid baht appreciation and declining consumer confidence. The threat of a disorderly unwinding of global imbalances still persists. In addition, the implementation of the reserve requirement and the introduction of the amended Foreign Business Act proved to be unpleasant surprises to investors and the global community.

These are indeed difficult times. And difficult times require difficult choices to be made. Some of you may be concerned that Thailand may not be able to weather all these challenges. Some of you may fear that Thailand is turning her back on globalization. I believe that these fears and concerns are unfounded and that Thailand will persevere.

Our outlook for the Thai economy in the medium term is positive. Our forecasts show the Thai economy growing by 4-5 percent in 2007 and by 4-5.5 percent in 2008. These are respectable growth estimates for Thailand in light of the challenges and our focus on growth with stability. In the rest of my talk, I will address in detail the challenges and prospects for the Thai economy going forward. This brings me to the first of my three key points.

The first key point is that the Thai economy is no stranger to difficult challenges. And we have always persevered in each instance. In 1997, we had the Asian crisis and undertook painful reforms; in 2001, the global economic downturn adversely impacted the Thai economy; and in

the past two years, we had the Tsunami, SARS, the avian flu, southern unrest, political uncertainty, and the recent oil shock.

The recent oil shock in particular proved to be a difficult test for the Bank of Thailand. High oil prices have two adverse effects: pressure on prices and a drag on economic growth. Tightening interest rates is the Bank of Thailand's primary defense against inflation. However, high interest rates would burden firms and households already trying to cope with high oil prices. Domestic demand would be adversely affected. There was no clear or easy choice to make. In the final analysis, the Bank of Thailand decided to tighten interest rates with the view that maintaining inflation stability, notwithstanding the short-term adverse impacts, was necessary for sustained economic stability and growth in the long run.

I could go on with more of such examples from further back in time, but I am sure that you are well aware of them. However, the past is not always a good predictor of the future. And indeed, the Thai economy is currently faced with a new kind of challenge. This leads me to my second point.

The preeminent challenge to the Thai economy in the medium term is how to cope with the unwinding of global imbalances, a slowdown in the world economy, volatile global financial markets, and an appreciating baht. Thailand, like many emerging market economies with a small and shallow financial market, is particularly vulnerable to fast-moving international capital. Such rapid movements of capital flows, if vastly out of line with the underlying economic fundamentals, can have negative impacts on the export or import sectors depending on the direction of exchange rate movement. In our case, the recent surge in speculative capital inflows has caused a rapid one-way appreciation of the baht relative to regional currencies. The appreciation, which was vastly out of line with our economic fundamentals, if left unchecked, could be detrimental to not only the export sector but also economic stability.

In dealing with the rapid appreciation, conventional wisdom suggests an adherence to market mechanisms. This proved to be inadequate, and the baht continued with its appreciation. After a number of unsuccessful conventional measures, we resorted to the less conventional measure of imposing a reserve requirement on capital inflows in December 2006. The measure was designed to break the one-way momentum, to preserve overall economic stability, and to give the export sector time to adjust. To this end, it has succeeded. Other regional currencies continued to appreciate while the Thai baht had stabilized.

The decision to impose the reserve requirement was a difficult one as it entailed a painful tradeoff between investor sentiment and export sector competitiveness as well as economic stability. In the end, cost-benefit analysis led us to choose the latter given the importance of export sector stability to the overall economy. Indeed, during the first three quarters of 2006, net exports accounted for 5.1 per cent out of 5.3 per cent GDP growth in total. Losing export sector stability will result in economic instability. As a small open economy, Thailand relies a great deal on international trade.

Let me be clear that the reserve requirement was designed to preserve economic stability and to give time for the export sector, which includes many SME operations, to adjust. The reserve requirement was not designed to maintain a certain exchange-rate level. As such, the reserve requirement is not a permanent measure; it is temporary. In addition, the intended benefits of measures such as these will tend to decrease as people find ways to circumvent the regulation over time.

Therefore, after the appreciation momentum was broken, we gradually adjusted the measure to add flexibility without compromising the original objective of maintaining baht stability. Now, firms borrowing from abroad can either set aside the required reserves or fully hedge their loans. Similar flexibility will be extended to other types of inflows in due course. Capital outflows will be further liberalized while a better database of capital flows is being built.

This leads me to my third and final point: how to deal with the challenge of global dynamism in the medium term.

The critical challenge for the Thai economy is how to continuously improve its flexibility, efficiency, and competitiveness amid ever-changing global economic conditions and structure. In this respect, we need to engage in financial and real sector reforms and policies that promote a sound and stable macroeconomic environment.

To mention a few examples, our financial and legal infrastructures will continue to be strengthened particularly through amendments and the introduction of a number of legislations such as the new Financial Institutions Act and the Deposit Insurance Act. The Financial Sector Master Plan (FSMP) will move into its second phase, with the review of the plan and an emphasis on increased competition and consideration on potential entry of new players to further enhance financial efficiency and resiliency.

The real sector must also work continuously to improve productivity. Sustained economic growth cannot happen without productivity growth. To this end, significant real sector reforms have been made to raise real sector productivity, promote transparency, and strengthen governance. We may not see the effects of these reforms right away but we must continue pressing on with the reform effort and not let reform fatigue get in our way.

Productivity also depends on the availability and quality of public goods. With a strong fiscal position, the Thai government this fiscal year has opted to pursue much needed infrastructure projects. Key infrastructure investment projects include the expansion of the mass transit network in Bangkok, water resource management, and an integrated logistics system. These public investments will ease bottle-necks and allow firms to focus on improving their efficiency and productivity.

The importance of productivity cannot be overstated. But with integrated world financial markets, exporting firms must also learn to cope with exchange rate risk. We encourage exporters to hedge against foreign exchange rate risk, to bill their exports in foreign currencies other than the US dollar, and to use imports as a natural hedge.

**Your Excellencies,
Ladies and gentlemen,**

The risk of global imbalances has been with us and will remain with us for some time to come. Each country has to do its own part in managing the risk. For us, we will forge ahead with our economic and political reforms. But major economies must also do their best to mitigate global imbalances since this is a global problem. We must solve it together. International policy dialogues such as the Fund-initiated Multilateral Consultation would need to be strengthened. It is the duty of major economies, such as the United States, China, Japan, and, of course, the European Union to ensure that there are sufficient international policy dialogues and that they are successful.

Without the economic cooperation and political will of the major economies, each and every country will be at risk. We all agree that difficult times require difficult choices. But there is one choice that should not be difficult: that is, the decision to stand together.

Thank you for your attention.