16 THAILAND

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2004: DOMESTIC-LED STRONG GROWTH

The year was marked by continued expansion in economic activity, maintained economic stability, and an appreciable gain in employment despite temporary adverse impacts on the economy throughout the year. In Q1, Thailand was hit by an avian influenza epidemic; unrest in the three southernmost provinces turned more violent in Q2; and the impact of drought was seen in Q4 along with the tsunami on December 26. However, underpinned by accommodative monetary policy, favourable financial conditions, rising farm prices and higher corporate profits, household spending remained buoyant and businesses increased investment in capital equipment and machinery and inventories, despite the restraint imposed by surges in oil prices. In 2004 the tourism sector also rebounded from the SARS scare of 2003. Meanwhile public investment picked up significantly after many years of retrenchment.

The economy grew by 6.1%, based predominantly on domestic demand. Real private consumption expanded by 5.6%, contributing 3.1 percentage points to real GDP growth. Private investment measured at 1988 price rose by 15.3%. In the public sector, government expenditure increased by 4.1% in real terms while public investment enjoyed a rapid growth of 11.7% from 2003, the first year of expansion since 1998. Private and public investment combined contributed approximately 3.0 percentage points to growth. In all, domestic demand contributed 6.4 percentage points to economic growth in 2004.

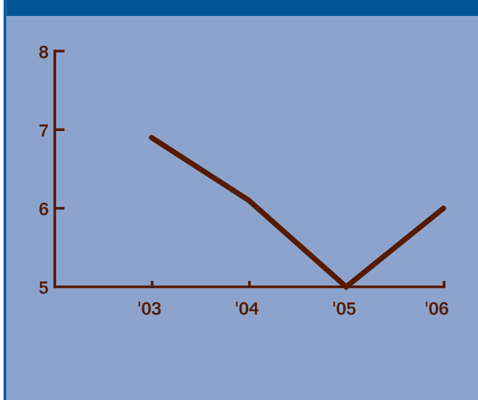
The faster increase in imports than exports led to a negative contribution of net exports of goods and services to GDP growth. Net exports of goods and services trimmed about 1.1 percentage points from real GDP growth compared to the 0.7 percentage points added in 2003. As the world economy peaked, 2004 was indeed one of the best years for Thai exports. In nominal terms, exports of goods reached US$96B, 23% higher than that in 2003. Due to the recovery from 2003's SARS epidemic, tourism revenue improved significantly, resulting in a 20.3% increase in service receipts. In real terms, exports of goods and services rose by 7.8%, with 7% growth in exports of goods and 11.2% growth in services receipts. On the other hand, imports of goods surged by 26.9% in US dollar nominal terms, led primarily by imports of oil and capital goods, in large part attributable to price rises. Over the year, import prices jumped by 13.4% on average, much faster than the 7.2% increase in 2003. Service payment also increased by 16.8% from an abnormal low base in 2003. In real terms, imports of goods and services rose by 12.1%, with 12.1% growth in exports of goods and 12.3% growth in service payments. Despite the rapid increase in import price, 2004 was the third year since 2002 that Thailand gained in its terms of trade.

Various indicators suggested that economic stability was successfully maintained. Consumer price inflation was driven higher in 2004 by the sharp rise in energy prices, but core consumer price inflation, which excludes food and energy prices, remained well contained.

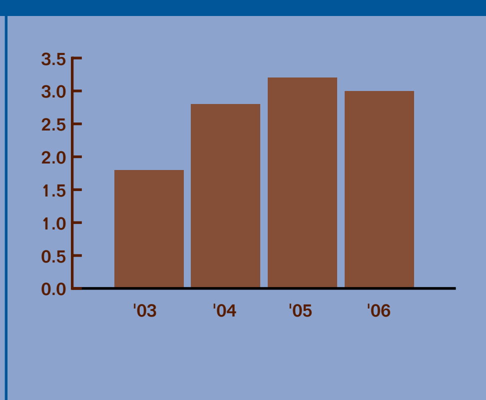
The headline inflation was 2.8%, compared to 1.8% in 2003. Core consumer price inflation moved up somewhat from unusually low levels recorded in 2003, but it remained well contained at 0.4%. General price increases were restrained by severe competition from China, improving productivity, the oil price subsidy, and the stronger baht, all of which helped offset the effects of higher energy and commodity prices. Public debt ratio to GDP declined continuously to 47.8% as of December 2004. The current account remained in surplus of US$7.29B, or 4.5% to GDP, thanks to the surplus in the services account of US$5.6B, which greatly eased the pressure caused by the rapid deterioration of trade surplus. International reserves stood at US$49.8B as of December 2004, which was equivalent to 4.4 times short-term foreign debt. Supported by healthy economic fundamentals and the weaker US dollar, the exchange rate appreciated slightly and averaged at Baht 40.3:US$1.

Although economic activity increased substantially in 2004, the expansion appeared to soften as 2004 ended, in large part because households as well as corporations stabilized their spending amid rising interest rates and oil prices. Over the latter half of the year, it became clear that the expansion of economic activity was softening, judging by the quarterly growth of 6.7%, 6.4%, 6.1% and 5.1% in the four consecutive quarters. In response to continued rising household debt and expected higher core inflation, the Monetary Policy Board at its August meeting began to reduce

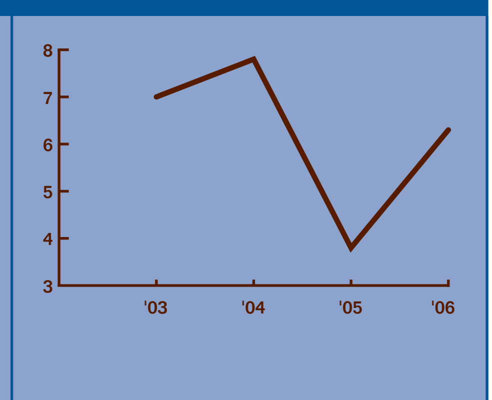
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



the substantial degree of monetary accommodation that was in place. The gradual removal of monetary stimulus continued in its October and December meetings as the economy expanded at satisfactory rates, and inflation picked up rapidly.

OUTLOOK FOR 2005 AND 2006

The moderate pace of growth in 2004 will continue in 2005 amid high oil prices and a slowing world economy at a time when Thailand continues to face the impacts of drought and the tsunami. However, the fundamental factors underlying the continued strength of the economy in 2002-2004 should carry forward into 2005 and 2006. Despite the rising trend of interest rates, monetary policy is still relatively accommodative, and financial conditions generally continue to be advantageous for households and firms. Profits have been rising steadily in the past 3-4 years and corporate borrowing costs are low. The capacity utilization rate has been in the range of 70-75% on average and this will prompt demand for further capacity expansion. Corporate balance sheets have been healthier as continued economic recovery has gradually improved the asset quality. Listed companies' return on equity has turned from a negative number in 2000 to over 20% in 2004. Similarly, the interest coverage ratio increased from a negative ratio to over three times in 2004. The improved profitability and interest rate coverage will provide a better assurance to banks as they extend private credit in 2005 and 2006. For the banking sector itself, after years of intensive balance-sheet repair, government assistance and economic recovery, several of the big banks are becoming healthier and enjoying a higher effective interest rate spread. Despite the Bank of Thailand's tightened loan classification rules, average non-performing loans (NPL) of financial institutions have continuously declined to around 10.92% in Q1/2005. The Bank of Thailand has set an ambitious target of NPLs ratio to reach 2% by the end of 2006.

Under the government's scheme of economic restructuring and logistics improvement to enhance competitiveness and sustain long-term growth, an ambitious infrastructure spending plan worth approximately Baht1.7 trillion over the next decade should start to play a bigger role from 2005 onwards. Higher investment from both private and public sectors should be the main drivers for growth in 2005 and 2006. Although there have been some delays in the contracting process for some projects in 2005, it is expected that infrastructure development will accelerate in 2006 led by projects to improve mass transit in Bangkok and vicinities. Also, there is a clear commitment toward renewing momentum in the privatization process, which in turn signals a commitment to economic restructuring as well as to greater corporate discipline. In sum, key investment themes for 2005 and 2006 are revival of infrastructure spending, stable recovery in the investment cycle, and progress in corporatization of state-owned enterprises.

Consumer spending is likely to moderate, continuing on from the latter half of 2004. Faster investment expansion and the further increases in public sector salaries should trigger higher growth in private consumption in 2006 than in 2005. Moreover, the high savings rate and relatively low household indebtedness mean there is room to tactically support private consumption over the next 1-2 years. Although household debts have been rising, households have accumulated more real estate assets as well as gains in their value. However, there has been growing concern over increasing credit card spending. According to the Bank of Thailand, 8.65 million credit card accounts were outstanding at the end of 2004, an increase of 28% from the year before. Credit card spending in 2004 was Baht 118.456B, up 25.5%, with 3% debt overhang. To prevent higher bad debt, credit card issuers are encouraged to make use of information under the National Credit Bureau more efficiently in managing risks. Credit scoring has also been recommended to improve credit worthiness appraisal.

On the external front, exports of goods are projected to moderate as the world economy slows. However, recovery from the tsunami disaster is expected to be fully fledged by mid 2006, with a boost to tourism income. With a new high equilibrium price of oil, Thailand, which is heavily import dependent, will face a higher import bill, jeopardizing the trade balance. A trade deficit is expected to persist throughout 2005 and service receipts will have to increase more strongly if a current account surplus is to be maintained in 2005 and 2006.

The economy is projected to grow by 5% in 2005 with the bias toward downside risks, particularly oil prices, world growth and the tsunami impact on tourism. Growth is projected to accelerate to 6% in 2006 as investment gains momentum and tourism enjoys a full-fledged recovery. Various indicators point to continuing stability, namely manageable inflation, ample reserves, and decreasing short-term foreign debt and public debt. Inflation rates are projected at 3.2% and 3.0% in 2005 and 2006, rising from 2.8% in 2004 in response to continuing pick up in demand and cost-push factors like rising commodity and oil prices. The average crude oil price — Dubai quoted — is assumed at US$45/barrel for 2005 and US$40/barrel in 2006, up from US$34.23/barrel in 2004. However, the flow-through effect on consumer prices of higher raw material and commodity costs has a lagged impact due to price controls and intense competition.

RISKS AND UNCERTAINTIES

The key risks associated with the economic outlook in 2005 and 2006 are mainly rising oil prices and slowdown in the world economy. With rising private credit, the monetary authority will need to keep a close watch on credit allocation. The key areas to be closely monitored will be credit card spending, the real estate sector and stock market performance. However, with the removal of government measures to stimulate the real estate sector, progress in the operation of National Credit Bureau, close monitoring of credit card spending, more stringent criteria imposed on loan classification, economic stability will be constantly in check. As for the fiscal stance, the government is determined to balance the government budget from FY2005 onward.