

# SECTION 1

## Overview

**Real GDP is expected to grow by 4.3 percent this year, down from 5 percent in 2006, before rising to 4.6 percent in 2008.** Like last year, growth this year has been principally supported by robust net exports, while domestic demand growth has remained weak as political and policy uncertainties, bombings on new year's day in Bangkok, and higher oil prices had led to declining consumer and investor confidence. Lower real wages and farm incomes growth had affected the local purchasing power. *Net* export growth this year is however slower than in 2006 and this is the main reason for the slower pace of GDP growth this year. Exports of goods and services are expected to grow by 6.5 percent in real terms (8.5 percent in 2006), while import growth should pick up to around 2.5 percent (1.6 percent in 2006). This year, the baht appreciation had sharply reduced the growth in export receipts in baht term. This had an additional effect of reducing the local purchasing power. Growth is forecasted to increase modestly to 4.6 next year as domestic uncertainties begin to clear up and domestic demand picks up. However there remain many downside risks related to both the global environment (oil prices and external demand) and the domestic political and policy environment. It is likely that Thailand's growth this year, like last, will be the lowest among emerging East Asian countries.

**Exports, though affected mainly by declining growth in key markets, remain the key driver of growth this year and will remain so next year.** Growth of merchandise exports this year is projected to decline to 14.5 percent in US dollar value terms (17.4 percent in 2006) mainly due to the sharp slow down in agricultural prices, the deceleration of US demand, and the appreciation of the baht. Export prices of agriculture products have increased slowly at 5.4 percent in the first 9 month of this year in contrast with a 25.5 percent increase last year. As a result, growth of agricultural exports has declined from 26 percent last year to 11 percent this year. Growth of exports to the US has declined by 3.6 percent in the first 9 months, but was offset by stronger growth in all other markets including Japan, EU, ASEAN and China. The baht appreciation had mostly affected exports of goods with high local content such as garments, canned fruits, and furniture, which account for less than 5 percent of total exports. Exports of some high-tech products, such as computers and parts, were negatively affected by the slow down in the demand from final markets for the products. Tourism arrivals and receipts have been affected by the political uncertainty and the bombings in Bangkok on new year's day. Tourist arrivals increased by only 2.8 percent in the first 9 months of this year. Nevertheless, exports remain the largest contributor to growth this year. Looking forward, next year merchandise export growth is expected to slow down to around 10 percent, in line with the continued modest growth in world demand and a strong baht. Tourism receipts should recover as elections take place and political uncertainty declines. Exports of goods and services will remain the key driver of growth next year.

**Macroeconomic fundamentals remain strong.** Headline inflation has slowed to around 2 percent this year, a 2.7 percentage-point decline from last year, and will likely be around 3 percent next year, reflecting a gradual recovery in domestic demand and oil price increases. Core inflation will be 1 percent or slightly higher this year and next. With both the headline and core inflation remaining low, average policy rate (1-day repurchase rate) for the first 9 months of this year was 0.6 percentage-points lower than that of last year, while minimum loan rate (MLR) is 0.2 percentage-points lower than its level last year. The current account has been in surplus since last year and will reach 4.9 and 2.2 percent of GDP this year and next year, respectively. The current account surplus had helped raise international reserves to US\$80 billion by October, which is 3.5 times short-term external debt, and also led to the baht's appreciation. The baht will likely remain strong at around Bt34 to the US dollar next year as the current account remains in surplus and as less political uncertainty attracts more investment inflows. The government ran a fiscal deficit in FY2007 of Bt68.7 billion, equivalent to 0.8 percent of GDP. However, the deficit next year will be slightly higher than this year's as the total budget disbursement rate should reach 95 percent, compared to 94 percent this year. Public debt has been falling continuously from 46.5 percent of GDP at end-2005 to 40.5 percent by end-2006 to 38.0 at the end of August this year.

**The slower growth over the last few years has slowed down the pace of poverty reduction.** Real GDP growth in 2002-2004 averaged 6.2 percent per year, but slowed down to 4.75 percent per year in 2005-2006. Head count poverty fell from 14.9 percent in 2002 to 11.2 percent in 2004. With slower growth in 2005-2006, poverty declined only slightly to 9.6 percent in 2006. The projected slower growth of 4.5 percent in 2007-2008 will make additional poverty reduction more difficult. Measures and transfers aimed at poverty reduction are more effective if they are targeted directly to the poor compared to broader programs. Targeted programs would ensure that the benefits reach the poor<sup>1</sup> and will make the most efficient use of public resources.

**The need to revive private investment growth is urgent.** Private investment growth has been declining since 2004 and will be at its 8-year low this year at around zero growth. Foreign direct investment also contracted this year for the first time since 2003. Weak domestic and foreign demand, policy uncertainties, and less crowding-in from public investment have delayed capacity expansion by firms. High oil prices and greater global uncertainty related to the US sub-prime crisis are not helping either. With its low growth, private investment's share of GDP in 2007 has dropped to its 2004 level of 16.6 percent. This is low compared to even its 1980s average of 22 percent. As a result of the sluggish growth in private investment in the recent years, capacity utilization, which has been rising since 2004, is now approaching pre-1997 crisis levels with many industries running above 80 percent capacity utilization. Should demand pick up next year or the year after, Thailand may face supply constraints if private investment growth does not pick up quickly next year.

**Clear policy direction from the new government after the December 2007 elections should help improve investor sentiment and raise private investment growth next year.** Even though actual investment has been weak, the Board of Investment (BOI) investment promotion applications and approvals for both local and foreign firms have reached record highs this year. This indicates the improved investor sentiment and a potential investment recovery next year. The signing of the Japan-Thailand Economic Partnership Agreement (JTEPA) earlier this year, which was effective on November 1<sup>st</sup>, has also helped boost confidence. However, the extent of actual investments will also likely depend on reduced perceptions of policy uncertainty. Relaxation of capital controls and revisions to proposed amendments to the Foreign Business Act (viewed as making foreign investment more restrictive than before) and the liberalization of a few services industries, for example, will greatly help revive investor confidence. With the reduced uncertainty, investments which have been delayed in the last couple of years could be started up next year. The BOI investment approvals since 2004, for example, are largely waiting to be translated into actual investments.

**Faster public investment disbursements will also help boost private investor confidence.** Public investment this year expanded by 6.8 percent compared to 10 percent last year in nominal terms. The slower growth this year was partly due to the fact that the government's budget increased only marginally (4.5 percent in 2007 compared to 8.7 percent in 2006). In addition, several new measures to make public procurement more transparent and accountable have tended to slow disbursements in the beginning of the year. Disbursement of public investment funds by the government and state-owned enterprises in 2007 will be around 70 percent of its approved budget (compared to 73 percent last year). The carry-overs from this year will be spent next year. In addition, the government's investment budget for FY2008 has been raised by 8 percent. Hence, public investment could rise by around 10 percent in nominal terms. This would provide not only a direct stimulus to growth but also a boost to private investor confidence as well as help slow down the pace of Baht appreciation. However, there is concern that there could be continued delays in disbursements next year, especially for large investment projects, as the new government will assume office only around February next year and may delay decisions.

**Many reform measures issued this year have laid a strong foundation for future growth.** The current Cabinet has endorsed many acts and regulations that would lead to greater liberalization,

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<sup>1</sup> Poverty data from the latest Socio-economic Survey shows that the majority of the poor reside in the agricultural sector in the rural areas of the Northeast. Poverty maps by district, which are being developed by the National Statistics Office, could help identify poor households at the district level.

competition and improved governance. An example is the draft Public Procurement Decree, recently approved by the Cabinet, which would enhance the transparency of the procurement process as well as cancel the privileges of state-owned enterprises which used to have the sole right to sell certain services to the public sector. Another example is the Life Insurance Act and Non-Life Insurance Act, which will allow insurance institutions to increase their foreign equity from the current 25 percent to 49 percent. Moreover, the State Enterprise Corporatization Act and the Deposit Insurance Institution Act have been approved by the Cabinet and will likely be passed by the National Legislative Assembly this year. The National Productivity Master Plan, aimed at raising productivity at both the sectoral and aggregate levels, was approved by the Cabinet. Similarly, the Intellectual Master Plan which aims to promote knowledge creation and dissemination and innovation has been approved by the Cabinet. The Commission of Higher Education has recently approved the 15-year Higher Education Development Plan (2007-2021) which aims to raise the access to and quality of higher education in Thailand. These would help raise the skills levels of future Thai workers, increase innovation and move Thailand towards a knowledge economy.

**The challenge ahead for the next government is to implement and build on these reform measures.** Implementing and building on the ground work that has been laid by the current government would bring about sustainable growth in the coming years. Further actions to promote greater growth, competitiveness, and equity in Thailand are also needed. Ensuring future growth includes promoting both the quantity and “quality” of public and private investments. Investments of high quality are those that bring about higher productivity, which lead to products and services which are of greater value-added and greater competitiveness in the market. One significant way which helps raise the quality of investments is to promote a more conducive investment climate and greater competition. A better investment climate generally lowers both direct and indirect costs of doing businesses for firms, thus, leaving them with more resources to focus on productivity improvements through, for example, skills development or research and development. Better transportation infrastructure provided through public investments, for example, would help improve the investment climate as they reduce the logistics cost for firms. Cross-country experience has shown that greater competition increases firms’ productivity as they compete with one another. A significant way competition can be promoted is through liberalization.

**Improving the investment climate by reducing the regulatory burden can be done quickly and would yield large efficiency gains.** A survey of firms in the study of Thailand’s investment climate<sup>2</sup> revealed that the top constraint to firm’s expansion is regulatory burden. This includes the length and uncertainty in the time taken to obtain approvals and licenses from relevant government agencies, multiple inspections by tax authorities, the delays in tax refunds, as well as price controls. These were largely reported by firms in the garments, food processing, and auto-parts industries. In recent years, the relevant government agencies have made progress in stream-lining some of these processes, resulting in Thailand’s improvement in the World Bank’s Doing Business rankings since 2004<sup>3</sup>. However, some of the key concerns above as voiced by firms can be further addressed both at the cross cutting level and at the industrial level. These would reduce firms’ costs in dealing with government bureaucracy, thus, allowing firms to focus more on improving their productivity.

**Policies to improve the productivity of the services sector would not only help unleash its large potential growth, but also promote growth of the manufacturing sector.** A recent sectoral analysis of total factor productivity growth in Thailand over the last 25 years shows that the services sector has lagged behind industry and agriculture<sup>4</sup>. Based on the Thai national accounts data, productivity growth in the wholesale and retail industry and the hotel and restaurant industry were particularly low. This urgently calls for policies to promote productivity improvements in the services sector. Increasing competition in the services sector through liberalization could unleash its productivity growth, which

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<sup>2</sup> *Thailand Investment Climate, Firm Competitiveness and Growth* (2005), a joint study of the NESDB and the World Bank

<sup>3</sup> Thailand ranks 15 out of 178 countries in the ease of doing business indicator in 2007, compared to its rank 20 in 2004. See [www.doingbusiness.org](http://www.doingbusiness.org)

<sup>4</sup> Finding from *Measuring Output and Productivity in Thailand’s Services-Producing Industries*, a joint study of the NESDB and the World Bank (forthcoming)

would also benefit the manufacturing sector which is the users of many of these services such as logistics and engineering. Liberalizing a few of the service industries currently restricted to foreign operators under the List 3 of the Foreign Business Act<sup>5</sup>, for example, would not only promote higher productivity in those industries and the related manufacturing industries, but also help boost investor confidence.

**Measures to improve productivity can help to ease the impact of the baht appreciation on sectors and sub-sectors that are most affected.** The rapid baht appreciation in the past 12 months has mainly affected the exports of labor intensive and agriculture products such as garments, furniture, and canned fruits<sup>6</sup>. The baht may fluctuate in the coming years but will unlikely return to the 2005 level of Bt40 to the US dollar. It is therefore imperative to target assistance to improve the productivity and competitiveness of the labor intensive and agriculture-based industries, which employ around 40 percent of the workforce. This could be done in a targeted manner through programs aimed at promoting productivity-improvements, technological upgrades, better designs, and training to improve skills of workers in these industries. These would be less costly than a blanket baht support and at the same time help improve the real competitiveness of these industries.

**Skill development remains key to Thailand's move towards a knowledge economy and to promote equity.** The latest World Bank's Knowledge Economy index (KEI)<sup>7</sup>, which is an aggregate index representing the overall preparedness of a country towards a knowledge economy, showed that Thailand's KEI ranking has fallen from 48 in 1995 to 56 (out of 137 countries) in 2007. The level of education and training is one of the key pillars of a knowledge economy. Moving towards a knowledge economy is the key to maintaining Thailand's competitiveness in the medium term as Thailand tries to move up the value-chain. Thailand's competitiveness in the past relied on cheap resources, particularly, labor. In the near future, its competitiveness will rely on knowledge. Development of knowledge and skills takes time, so Thailand needs to act immediately if it does not want to be left behind in the next few years. The network of higher education institutions, public research institutions, and the private sector must play an increasing role in the creation of new knowledge and its dissemination. Moreover, research shows that there is a strong correlation between education attainment and income equality. Countries which have a higher proportion of population with education attainment tend to have lower income inequality. Income inequality in Thailand has been persistently high for the past 20 years. Developing skills through higher education and training could lead to better pay and job opportunities which would help lower income inequality in Thailand.

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<sup>5</sup> Foreign firms must receive prior approval from the Ministry of Commerce in order to operate in the industries under List 3. These include logistics, engineering, architectural, and retail services.

<sup>6</sup> The exports of these 3 industries contracted by 9 percent year-on-year in the first 9 months of this year.

<sup>7</sup> KEI is a simple average of 4 sub-indexes which represents the 4 pillars of the knowledge economy: (1) economic incentive and institutional regime, (2) education and training, (3) innovation and technological adoption, and (4) information and communications technologies (ICT) infrastructure. See [www.worldbank.org/kam](http://www.worldbank.org/kam)