

SECTION 1

SUMMARY

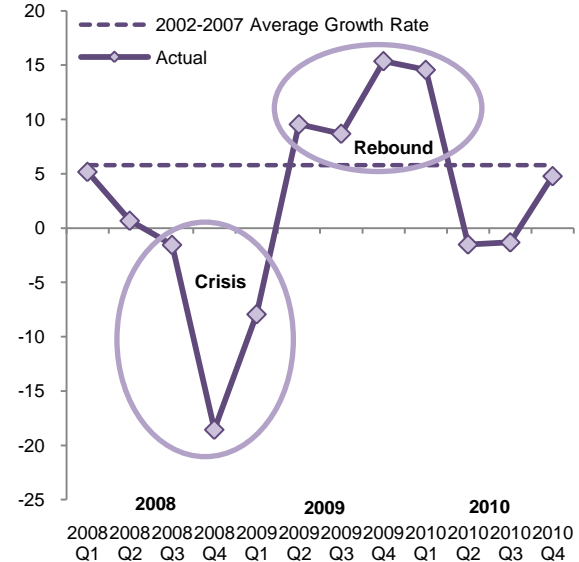
The pace of economic activity is gradually returning to pre-crisis levels. After a roller-coaster of sharp drops, vigorous rebounds and mild contractions, GDP was up 4.8 percent in the last quarter of 2010 on a seasonally-adjusted annualized (SAAR) basis—closer to pre-crisis “normal” levels (Figure 1). For 2010 as a whole, GDP expanded by 7.8 percent from 2009. Growth was broad-based, with significant contributions from external and domestic demands.

Domestic demand accelerated mainly due to higher farm incomes and low interest rates. Consumption and investment of domestically-produced goods and services expanded in 2010 well above the rates registered between 2006 and 2009. This was mainly due to growth in household consumption. Notwithstanding severe weather events and rising consumer prices, agricultural incomes made significant gains (Figure 2). This helped push up real wages in agriculture, which in turn tends to lift wages of unskilled workers more generally. Along with low deposit rates and a renewed appetite for lending on the part of banks, higher household incomes stimulated consumption of durable goods such as vehicles and housing.

External demand picked up in the fourth quarter. Following the post-crisis rebound in the first quarter (when growth was above 30 percent SAAR), external demand contracted in the second and third quarters, first because of the collapse in tourism during the political turmoil, then due to the end of the restocking cycle. By the fourth quarter, a bounce-back in tourism and higher demand for autos and agricultural products supported renewed growth in external demand. As a result, both the number of tourists and the value of merchandise exports reached new all-time highs in December.

Figure 1. Growth rates are returning to “normal” (pre-crisis) levels.

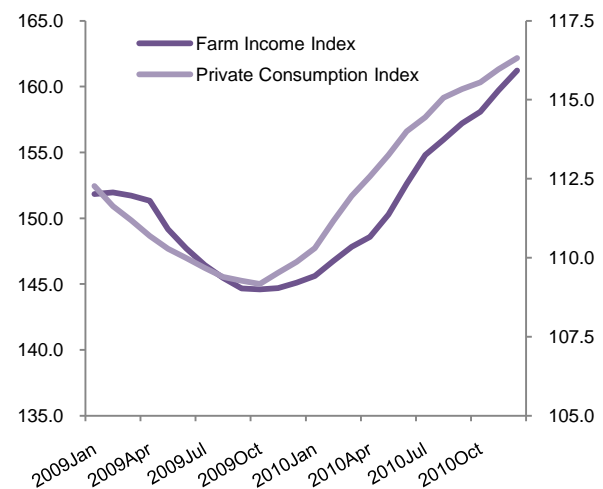
Annual rate of change of GDP, based on quarterly figures adjusted for inflation and seasonal fluctuations (percent per year)



Source: NESDB and World Bank staff calculations.

Figure 2. Rising farm incomes supported domestic demand in 2010.

Indices, 12-month moving averages



Source: BoT and World Bank staff calculations.

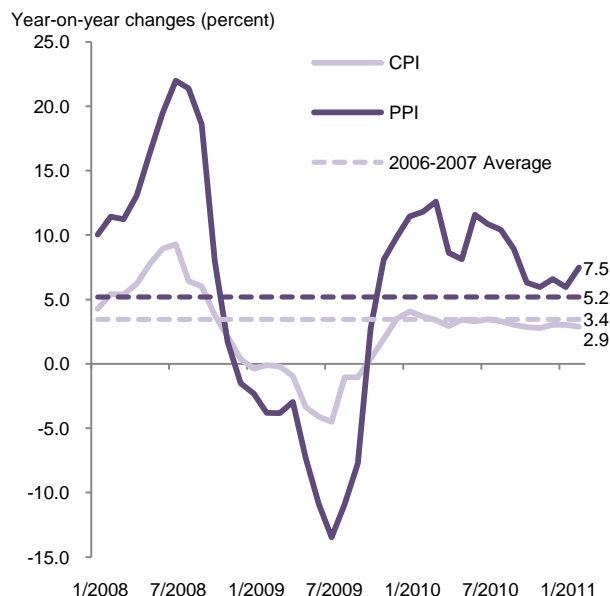
The outlook for 2011 is likely to be dominated by high energy and agricultural commodity prices. The political turmoil in the Middle East and North Africa (MENA) drove oil prices higher in February. While prices stabilized in March, they remain at high levels as the turmoil continued to spread, most recently to Libya and Bahrain. Agricultural prices, especially of food items, moderated recently, but also at relatively high levels: agricultural commodities were up in February for the ninth consecutive month.

Commodity prices have been steadily increasing in the past decade. The turmoil in MENA and supply shocks in agriculture such as last year's floods may be temporary, but commodity prices have trended higher in the past decade. This is due to a combination of rising demand from among fast-growing developing economies, especially China, and frequent supply disruptions amid increasingly unpredictable weather patterns. The implication of this trend is that high (though perhaps not higher) commodity prices are likely to persist into 2011.

Despite high food and energy prices, inflation has remained low. This has been due to subsidies for diesel, energy and transport, and formal and informal price controls. In addition, capacity utilization in domestically-oriented sectors remains below pre-crisis levels, suggesting that demand-pull pressures are currently subdued. As a result, higher producer prices have so far not passed on to consumer prices, which have continued to increase around their 2006-2007 pre-crisis average pace even as producer price inflation climbed (and stayed) above its pre-crisis average (Figure 3).

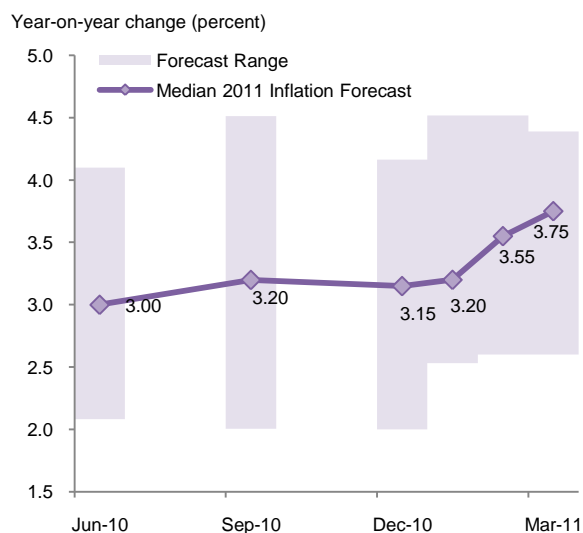
Price pressures are building up, however. Inflation expectations have been on the rise as the lifting of price controls and subsidies has been widely anticipated (Figure 4). The Bank of Thailand has become increasingly concerned that inflationary dynamics could emerge. As a result, the BoT increased the policy rate twice in 2011 and indicated that further hikes are forthcoming.

Figure 3. Higher input costs have yet to show in current inflation readings...



Source: MoC and World Bank staff calculations.

Figure 4. ... but inflation expectations have been increasing.



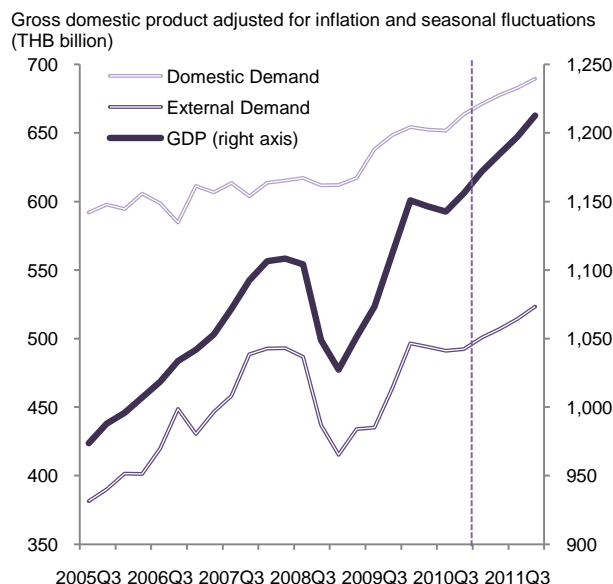
Source: Consensus Forecasts World Bank staff calculations.

Growth in 2011 is expected to be resilient to high food and fuel prices and to move closer to pre-crisis levels. Notwithstanding the jump in oil prices and the earthquake in Japan, the Thai economy maintained the momentum from the fourth quarter of 2010 into early 2011 and is expected to post healthy growth during the year (Figure 5). Domestic demand will continue to perform well, while the growth of external demand is still dragged down by the unfinished recovery in advanced economies and the impact of the earthquake. Due to the high base in 2010, yearly growth comes out at 3.7 percent.

High agricultural prices are a net positive for domestic consumption. Firm agricultural prices, more muted supply shocks from natural disasters and spillovers from agricultural prices to unskilled wages will boost household incomes and consumption. Interest rates, while heading higher, will be accommodative for the year as a whole and the favorable economic prospects suggest bank lending should remain robust. Finally, election-related spending and subsidies to put a (temporary) lid on the cost of living of low-income earners provide further support to consumption.

Thailand's changing export mix offers some resilience against higher oil prices and sluggish growth in advanced economies. Thailand's export basket has changed since 2007 towards products that experienced healthy price gains over the past year, partially offsetting higher prices of imported fuel (Figure 6). In part, exporters of these products have been able to raise prices because they are mainly destined to fast-growing emerging economies (for example, most of Thailand's petrochemical exports go to China). The switch in the mix of products and destinations bodes well for the outlook of external demand. On the other hand, E&E items remain Thailand's top exports, and these products are consumed mainly in advanced economies, which are on the mend but not fully recovered. In addition, supply chain constraints arising from the earthquake in Japan may further dampen Thailand's exports.

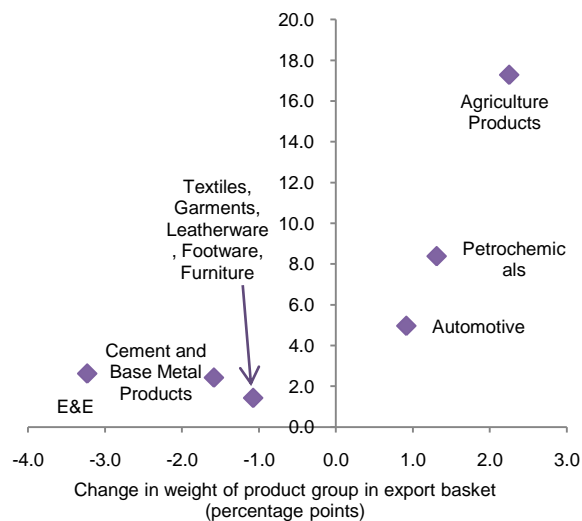
Figure 5. Domestic demand will continue to underpin growth.



Source: NESDB and World Bank staff calculations and projections.

Figure 6. The composition of Thailand's export mix shows a switch towards products with most favorable price changes.

Percent Change in Export Prices: Oct-Dec 2010 vs. Oct-Dec 2009



Source: BoT and World Bank staff calculations

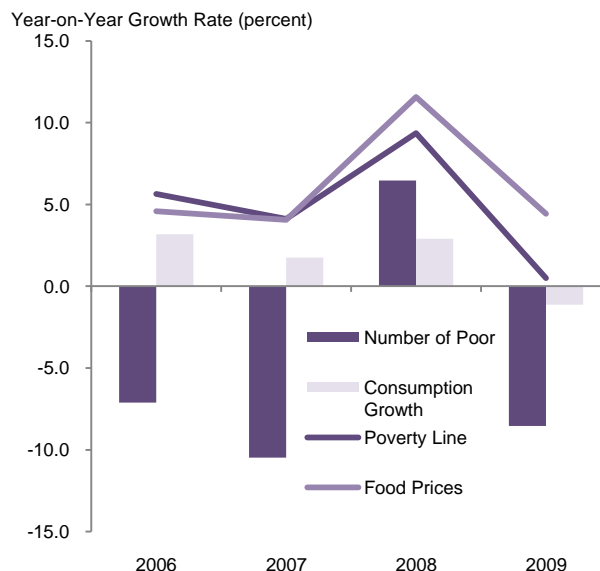
But higher prices also mean higher risks to the outlook. The main risk is a continued increase in oil prices. This could derail the still-fragile recovery of advanced economies, which would severely dampen external demand. Domestic demand would also suffer, as consumers divert their income towards (imported) fuel and farmers' income gains are reversed as they would face a higher cost of living and higher input costs.

Considering the elevated risks, a deliberate pace of fiscal and monetary 'normalization' is warranted. With the economy on its way back to pre-crisis growth, it is natural that fiscal and monetary stimulus be withdrawn, and authorities have signaled that this is the direction they are heading. The pace may be gradual, however, as the direction of policy is likely more important than reaching "normal" levels within a given timeframe.

In the near term, policy needs to shift from broad subsidies to targeted interventions. In 2008, the spike in food prices was correlated with an increase in poverty rates in Thailand for the first time since 1997 (Figure 7). This suggests that higher food prices hurt many of the poorest in society, so the concern with the impact of higher prices on low-income households is warranted. Currently, fiscal efforts to lower the cost of living of these households have focused on subsidies to diesel oil. However, such subsidies are not targeted and may distort incentives for energy conservation. More targeted interventions would pose a lower fiscal burden while better assisting the neediest.

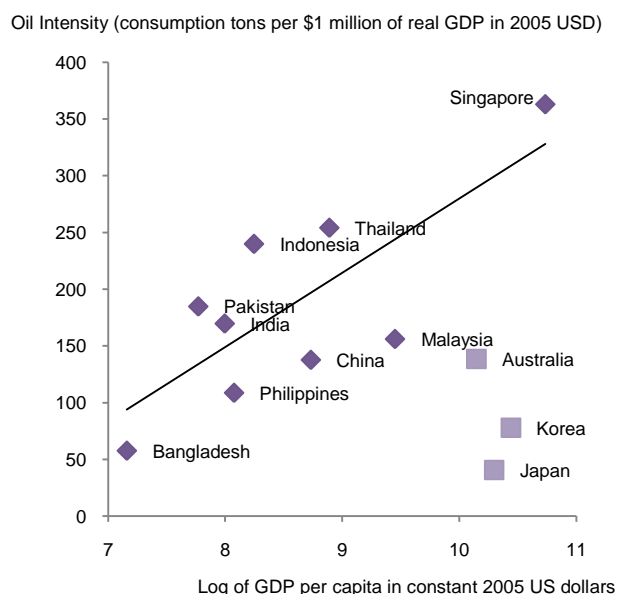
In the long-term, Thailand needs to increase energy efficiency to reduce risks from oil price volatility. Thailand's economy is one of the most energy intensive in the region (Figure 8) because of the large (and growing) share of energy-intensive manufacturing in the economy and high proportion of cargo transported by trucks. Thailand can reduce its vulnerability to oil price shocks by raising fuel standards, improving tax incentives for conservation and relying more on rail for cargo transport.

Figure 7. Higher food prices were associated with the increase in poverty in 2008.



Source: NSO, NESDB, MoC and World Bank staff calculations.

Figure 8. Thailand's oil consumption is above average in the Asia Pacific region, making it more vulnerable to price shocks.



Source: BP Oil, World Development Indicators and World Bank staff calculations.

