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Impact and Policy Responses
Indonesia, Philippines and Thailand

Asian Development Bank

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CHAPTER 1: INDONESIA

Indonesia has rebounded strongly from some initial wobbles when the global financial crisis turned critical in late 2008. Following disruptive capital outflows and a precipitous Rupiah depreciation in late 2008, the country steadied itself and recovered quickly. Over the course of 2009, its GDP growth has remained positive, unlike most of its export-dependent neighbours. In short, this report argues that:

- A critical question for Indonesia is the true degree of resilience to global shocks given our view that 2010 is likely to see a global recovery that will tend to be accompanied by new financial and other stresses. Our detailed examination of the transmission of global shocks to the Indonesian economy and the components of its resilience suggests that Indonesia is indeed likely to remain resilient in terms of GDP growth.

- However, it is also fair to say that Indonesia was profoundly impacted by risk aversion in late 2008 and remains vulnerable to financial shocks. The financial dimension of the economy still requires policy attention.

1.1 Where does the economy stand?

As Table 1.1 shows, Indonesia's economic growth held up well despite the worst global crisis in decades. Indonesia proved to be among the most resilient economies in terms of GDP growth during the crisis in comparison with its Asian neighbours. Between 3Q08 and 1Q09, Indonesia saw only a modest two percentage point fall in its GDP growth rate, in line with other resilient economies such as India and substantially better than the highly vulnerable smaller economies such as Singapore (Chart 1.1).

Table 1.1: Breakdown of Indonesian GDP

(%y/y)	Weight in GDP	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009
Gross Domestic Product (GDP)		6.4	5.2	4.4	4.0	4.2
Supply aggregates						
Agriculture	14.5	3.4	4.7	4.8	2.4	2.7
Mining and Quarrying	8.3	2.1	2.1	2.2	2.4	6.5
Manufacturing	25.8	4.3	1.8	1.6	1.5	1.3
Electricity, Gas and Water Supply	0.8	10.4	9.3	11.4	15.4	14.6
Construction	6.4	7.6	5.7	6.3	6.4	8.8
Trade, Hotels, restaurant	16.7	8.4	5.6	0.6	-0.1	-0.6
Transport/Communication	8.9	-1.1	15.8	16.7	17.5	18.2
Financial Services	9.4	33.3	7.4	6.3	5.3	4.9
Other Services	9.2	8.6	6.0	6.8	7.4	5.8
Demand aggregates						
Private Consumption Expenditure		5.3	4.8	6.0	4.8	4.7
Gross Fixed Capital Formation		12.2	9.1	3.4	2.7	
Government Consumption Expenditure		14.1	16.3	19.2	17.0	
Exports of Goods and Services		10.6	1.8	-18.7	-15.7	
Minus Imports of Gods and Services		11.0	-3.5	-26.0	-23.9	

Source: Collated by Centennial Group using CEIC Database.

A number of features stand out from Indonesia's experience during the global crisis:

First, the export-oriented part of its economy was hit hard as shown in Charts 1.2 and 1.3: the fall in exports leading to a sharp deceleration in industrial production

Exports contracted from November 2008 onwards but the pace of contraction eased a little in the second half of 2009. Other externally-dependent activities also took a hit. The growth in tourist arrivals decelerated to just 2.6% in January–October 2009 (Chart 1.4). Considering the shocks to Indonesian tourism—apart from the global crisis, there was also the H1N1 flu scare, the Jakarta hotel bombings in July 2009, and major earthquakes—this was a good performance. Average hotel room occupancy up to October 2009 was higher in 2009 at 52.5% compared to 51.7% in 2008. Bali, which is the premier tourist destination, has also seen its tourism industry remain relatively intact through the year.

Chart 1.1

Indonesia – among least hurt by crisis

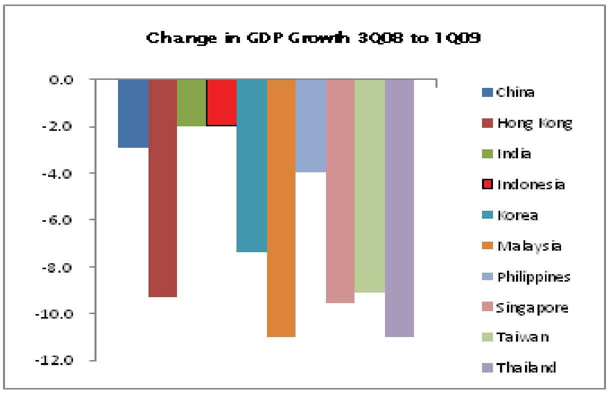


Chart 1.2

…despite sharp fall in exports

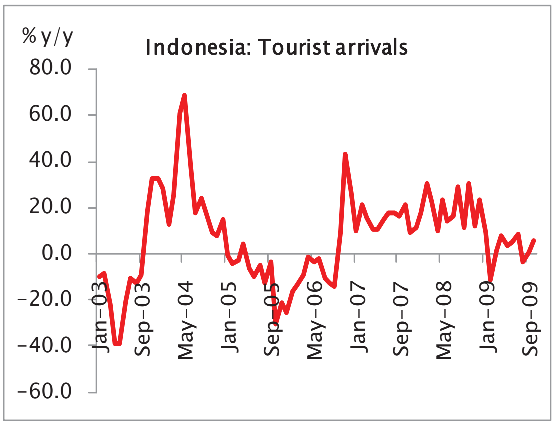
Source: Collated by Centennial Group using CEIC Database.

Chart 1.3

…which hit industrial production

Chart 1.4

Tourist arrivals also took a hit but rebounded



Source: Collated by Centennial Group using CEIC Database.

Second, other components of domestic demand retained some vigour

Investment spending did not contract as it did in other export-oriented economies (Chart 1.5), suggesting that domestic businesses remained confident about long-term prospects. Boosted by election-related spending during the legislative and Presidential elections in early

2009, consumption has been growing in 2009. Retail sales took a sharp hit in the early part of the crisis when the Rupiah depreciated suddenly and there were concerns over smaller banks but it also rebounded quickly once these fears receded (Chart 1.6).

Chart 1.5	Chart 1.6
…but investments held up well	**…with consumption and rebounding**

Source: Collated by Centennial Group using CEIC Database.

Third, the financial sector and related asset markets were hit hard in the initial months of the crisis

The Jakarta Stock Exchange stumbled in late 2008 but has soared since then (Chart 1.7). Portfolio inflows reversed into large outflows at the height of the crisis (Chart 1.8). During the phase of capital outflows, international reserves fell to $51.6 billion[1] in 4Q08 from $59.4 billion in 1Q08. The currency came under severe pressure in late 2008 (Chart 1.9) but this fall was reversed as confidence returned to global markets and global investors regained their appetite for riskier emerging market assets such as bonds and equities in Indonesia. Without timely measures at the global level to restore confidence, however, there was a danger that the portfolio outflows could have produced a downward spiral as falling asset prices, diminishing confidence, and the depreciating Rupiah fed on each other.

Fourth, as a result of the stabilisation of the crisis, the impact on economic stability was contained

While wholesale prices are still in deflation, consumer price inflation remains positive. As in other economies, inflation fell sharply with falling demand and declining oil prices through 2008/09 (Chart 1.10). The overall balance of payments recorded a deficit of US$1,945 million in 2008. In the first three quarters of 2009, the balance of payments was in a positive balance of US$2,851 million. The current account has also improved in 2009 as export growth outpaced import growth (Chart 1.11).

Fifth, with confidence not taking a prolonged hit, lending activity by banks remained robust

Commercial bank loans rose 9.6% y/y in September 2009 (Chart 1.12). Non-performing loans (NPL) increased in the first half of 2009, but the rate has eased in the second half of 2009. The NPL ratio in June 2009 was 3.94%. Notably, the credit rating agency, Moody's, downgraded Indonesia's banking sector to negative but reversed the change in September 2009. Consequently, only a few small banks had to be shut down, preventing the kind of loss of depositor confidence that shook Indonesia in 1997. In short, Indonesia had a relatively

[1] In this report, "$" refers to US dollars.

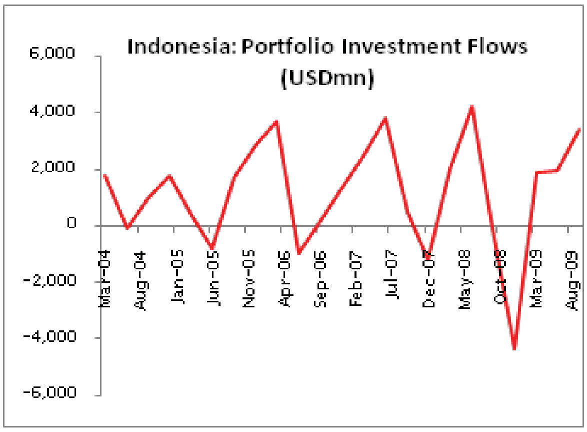
good crisis, recovering smartly from the initially worrying damage to the currency and asset markets.

Chart 1.7

Equity prices fell sharply, then bounced up

Chart 1.8

… in line with portfolio flows



Source: Collated by Centennial Group using CEIC Database.

Chart 1.9

Prompting a sharp fall in the Rupiah

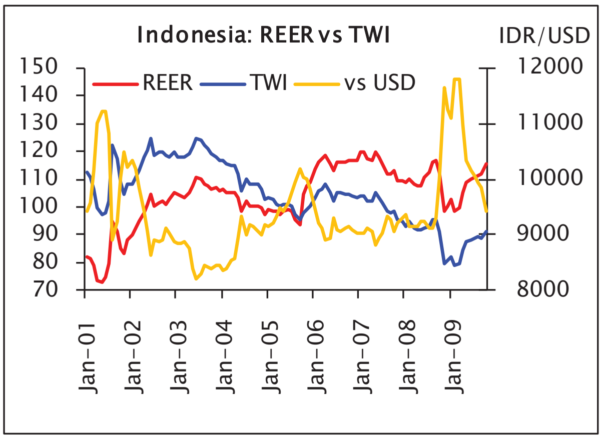


Chart 1.10

… which raised inflation, but only by a bit

Source: Collated by Centennial Group using CEIC Database.

Chart 1.11

External accounts held up as well

Chart 1.12

…as did bank lending deceleration

Source: Collated by Centennial Group using CEIC Database.

1.2 What explains Indonesia's resilience?

The important question is how Indonesia was able to stabilise its financial markets despite appearing under severe stress for a while in late 2008.

First, the impact of a spike in risk aversion was muted by steady policy responses in Indonesia and the stabilising impact of co-ordinated global counter-measures on global financial markets

Thus, Indonesia was able to put in place swap lines and other financial support arrangements from Japan, the People's Republic of China (PRC) and others to restore confidence. Another factor was that while Bank Indonesia's foreign reserves were small compared to most other Asian countries, it had sufficient reserves to enable it to slow the depreciation of the Rupiah and prevent a complete rout of the sort we saw in 1997-98. Also, the government intervened swiftly to mitigate financial risks. For example, it injected Rp1 trillion to increase liquidity after the Deposit Insurance Corporation seized Bank Century on 21 November 2008 following the fall in that bank's capital adequacy to 2.3%, far below the minimum 8% required by Bank Indonesia.[2] Swift policy responses by credible policy authorities were critical to mitigating the risks Indonesia faced in late 2008.

Second, the income impact of the fall in commodity prices was mitigated by the fact that the preceding years had seen record high prices for these same commodities, allowing rural households to build up a savings buffer to help them smoothen out consumption spending

The fortuitous timing of previously planned government fiscal initiatives also helped social expenditures increased as a result of the increase in the national poverty programme (PNPM) spending while the previously announced tax cuts kicked in at the right time as well. In fact, falling commodity prices had the beneficial impact of stabilising urban consumers' inflationary expectations and so helped to support urban consumer spending.

Third, because the global recession was of relatively short duration, the lagged effects of the financial crisis were avoided

Remittances held up reasonably well. Job losses were also mitigated as a result, despite the crisis, the unemployment rate continued its secular decline. Latest figures for August 2009 indicate that the rate stands at 7.9%, lower than the 8.4% in August 2008.

Fourth, the government's good housekeeping of previous years provided it with the space to take swifter and more effective policy responses than in previous episodes of external shocks

The fiscal position was stronger, allowing a large enough fiscal stimulus package to support growth. Bank Indonesia's previously tight monetary policy had also provided the monetary backdrop for a sustained reduction of interest rates to support spending in the economy.

Fifth, the balance sheets of the banking, corporate, and household sectors were much stronger

This acted as a shock absorber, unlike in 1997 when poorly capitalised banks failed and over-geared companies collapsed.

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[2] Bloomberg. 2008. *Indonesia Seizes Century as Capital Deteriorates*.

In short, Indonesia had more shock absorbers than in 1997 and fewer shock amplifiers. The question then is whether these components of resilience can be relied on to ensuring Indonesia's continued resilience. Table 1.2 examines this in more detail.

Table 1.2: Analysis of Indonesia's economic resilience

Component/Indicator	2000	2008	Comments
Export Diversity			
Avg. coefficient of variation for top 10 exports and destinations	0.7	0.6	*The more diversified your export base, the more resilient the economy is.* Somewhat less diversified than in 2000 but its score is much better than most other Asian peers.
Demand Diversity			
C + I + G (% of GDP)	88.0	97.0	*The greater the dependence on exports and less exposure to domestic demand, the less resilient the economy is likely to be.* Less dependent on external demand over time and much better than many Asian peers.
Automatic Stabilisers			
10 yr. avg. of change in tax revenue/change in GDP	3.0	3.4	*Tax revenues automatically adjust as economy accelerates or decelerates, providing a natural automatic stabiliser or shock absorber in the economy.* Improved in Indonesia and now among the better indicators in Asia.
Capacity for swift and effective policy response			
Fiscal - Public Debt (% of GDP)	40.9	31.2	*Higher public debt imposes a constraint on use of fiscal tools.* Indonesia's position has improved but it remains behind many of its Asian peers.
Monetary - G7-Country Inflation over 8 yrs (%y/y)	-15.1	-6.7	*The greater the credibility the central bank has built up by controlling inflation not too different from major countries' inflation, the more latitude central bank has to ease monetary conditions in a slowdown.* Indonesia has improved significantly over this decade but is a severe laggard compared to other Asian countries.
External Financial Vulnerability			
Financially mobile capital (% of foreign exchange reserves)	129.8	186.8	*High financially mobile capital in relation to FX reserves and high current account deficit/GDP signify reduced resilience.* This is Indonesia's most serious gap in resilience—substantially worse in relation to its Asian peers.
Domestic Financial Vulnerability			
NPL Ratio	20.1	4.6	*A stronger banking sector with low non-performing loans is less likely to amplify an external shock by cutting lending drastically.* Indonesia has improved substantially.

Component/Indicator	2000	2008	Comments
Vulnerability to oil prices			
Avg. excess production of energy (% of GDP)	4.5	-0.3	*Country is more resilient if it is a net producer of energy.* Indonesia has deteriorated hugely on this indicator as its net oil exports have turned negative.
Political Stability			
Index of Stability	4.2	5.1	*Country with political stability is more resilient.* Big improvement in Indonesia.

One other factor that is not well captured by the data is the importance of growth momentum to economic resilience. After many years of recuperating from its systemic crisis of 1997-98, Indonesia was enjoying an improvement in the supply side drivers of growth. There has been a surge of foreign direct investment (FDI) again in Indonesia and this is set to revive manufacturing sector growth. Table 1.3 shows the surge in FDI. According to the Indonesian Investment Co-ordinating Board, realised investment—as opposed to approved investments—has surged to $14.9 billion in 2008 compared with $10.3 billion for 2007 and only $5.9 billion for 2006. The total realised investment in January–February 2009 was $2.0 billion, compared to $1.0 billion in the same period in 2008.

Table 1.3: Rising Foreign Direct Investment Approvals

Year	Total FDI Approvals $ million	Of Which - Manufacturing
2002	9,991.3	3,307.4
2003	14,300.8	6,678.7
2004	10,470.1	6,438.7
2005	13,635.8	6,093.7
2006	15,659.1	8,312.0
2007	40,145.8	27,225.5

Source: Indonesian Investment Co-ordinating Board.

In essence, Indonesia has made considerable headway in improving its resilience but it remains vulnerable in the financial dimension of its economy. If anything is to go badly wrong in Indonesia's economy in the near future, it is likely to be in the financial realm. Consider the following:

- Indonesia has had a long record of high inflation and sudden currency depreciations. This means that inflationary and exchange rate expectations can shift abruptly and dangerously. Domestic economic agents are quick to pull money out of banks, especially smaller banks when inflation or currency weakness threatens and moves their funds abroad.

- Indonesia's bond and equity markets remain relatively thin and illiquid compared to more developed markets. Given the relatively less developed nature of its own savings industry, its asset markets remain substantially influenced by external portfolio capital flows. During periods of high global excess liquidity as we have now, capital flows into Indonesia and inflates valuations. But, capital can also flow out very disruptively once risk appetites change. This can cause the currency to depreciate sharply, spurring fears of further depreciation and higher inflation, hence producing a downward spiral.

1.3 Prospects for the various transmission mechanisms

The outlook for the Indonesia economy amidst the receding recession looks optimistic given the positive lead indicators.

- **OECD lead indicator has reversed.** The OECD's economic lead indicator for Indonesia (Chart 1.13) has been picking up of late, pointing to an economic rebound.

- **Consumer confidence also on a high.** Confidence indicators continue to signal a fair degree of optimism. In the face of the worst global crisis in recent times, consumer confidence only edged down in the early stages of the global financial turbulence (Chart 1.14). Since then it has risen to near its highest level in many years.

Chart 1.13

OECD lead indicator shows turning point

Chart 1.14

…consumers also remain optimistic

Source: Collated by Centennial Group using CEIC Database.

- **Property prices are rising.** At the same time, another measure of popular confidence - prices of residential property (Chart 1.15) - continued to rise, albeit at a modest pace, again suggesting that domestic economic agents remained confident about the overall economy and prospects.

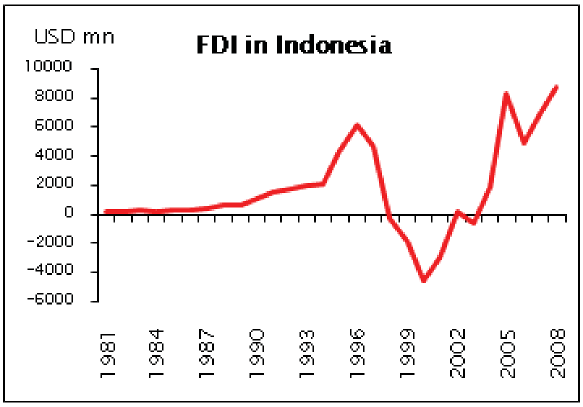
- **Inflows of FDI are rising.** Realised inflows of foreign direct investment are also rising substantially (Chart 1.16). However, this will likely slow in face of slow economic growth in the advanced economies.

Chart 1.15

Property prices continued to rise

Chart 1.16

… while FDI surge will boost growth



Source: Collated by Centennial Group using CEIC Database.

Table 1.4 summarizes the prospects for the Indonesian economy in 2010 and possible risks to the outlook.

Table 1.4: Transmission mechanisms

	Scenario for 2009/10	Risks/Upsides
Capital flows	▪ A revival in capital flows is most likely as investor confidence in Indonesia and abroad improves.	**Risks** ▪ Any major adverse development in emerging markets (e.g., a crisis in Emerging Europe) or another outbreak of global financial stresses will reduce risk appetites of investors. ▪ Since yields on sovereign bonds in Indonesia are higher than its peers, foreign investors into Indonesia will be watchful about any sudden instability. ▪ If smaller banks lose deposits rapidly because savers fearful of currency losses move their money abroad, bank failures could rise and spark off a wider financial crisis.
Trade	▪ Exports will recover as economic growth in Indonesia's trading partners improves.	**Risks** ▪ If the global recessions remain protracted then external demand for Indonesian goods will wane.
Remittances	▪ Income transfers will remain stable and not a cause for immediate concern.	
Tourism	▪ The surprising resilience of tourism in spite of the deterring conditions indicates that we should expect a secular growth in tourism in the coming years. ▪ With increased economic activity, we also expect a rise in business tourism.	**Risks** ▪ While past cases of deterrents like the Jakarta hotel bombings and earthquakes have not deterred tourists much, we cannot be assured of the same in the future.
FDI	▪ Small rebound in 2010 from depressed 2009 levels. ▪ Shifts in MILLIONC production outsourcing strategies and increased competition from Viet Nam and other populous but dynamic emerging economies pose a competitive threat to Indonesia.	**Risks** ▪ Failure by government to improve investment climate, construct infrastructure, or maintain pace of reforms would compromise FDI flows which are key to growth in the manufacturing sector.
Commodity Prices	▪ Upward pressures on oil prices as PRC and other emerging market demand recovers. In 2010, prices could range \$70–\$80 per barrel. ▪ Prices of economically-sensitive commodities (metals, rubber, etc.) see moderate rise. ▪ Food prices could rise due to bad weather in India, etc.	**Risks** ▪ Higher oil prices would put a strain on the fiscal position given the still-large fuel subsidies. ▪ If global food prices surge, domestic inflation would rise.

We see Indonesia's GDP growing 4.6% in 2009 and then accelerating to 7.1% in 2010 and 7.5% in 2011.

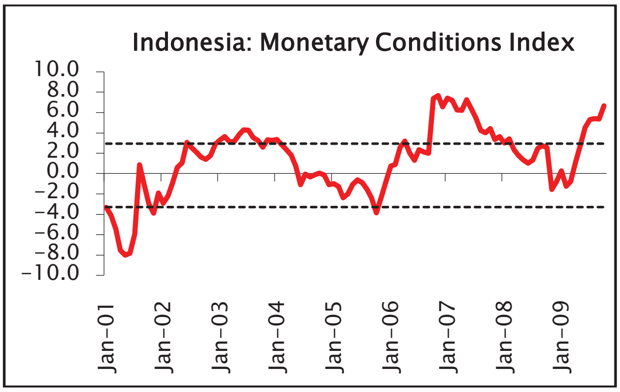
1.4 Policy recommendations

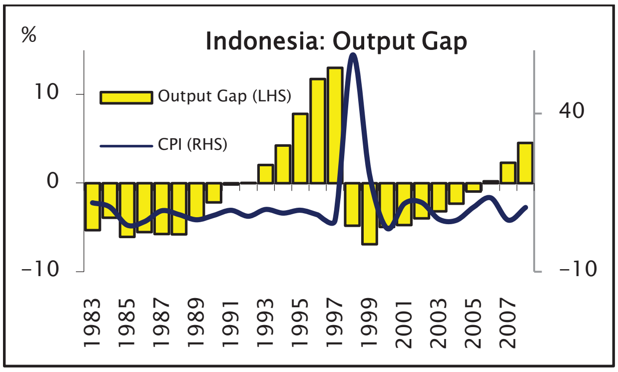
The final question is how policy makers see these risks and what they might do about it.

First, we believe that an early exit from accommodative monetary policy is the less risky option

As Chart 1.17 shows, monetary conditions in Indonesia are extremely loose. This was appropriate when the crisis was threatening but given the resilience and prospects for the Indonesian economy we have assessed above, our view is that to persist with such loose monetary conditions when we expect economic growth to be strong and lift the output gap as high as shown in Chart 1.18, is to risk a rise in inflationary expectations that could prove harmful.

Chart 1.17	Chart 1.18
Loose monetary conditions…	**…but output gap is expanding**





Source: Calculated by Centennial Group using CAA Model.

Second, the fear that monetary tightening might invite speculative and destabilising capital inflows is a fair one

However, we believe that micro-prudential and other administrative measures should be used to address such concerns. For example, measures that will take effect in January 2010 that are principally aimed at the misuse of double taxation agreements will also have the secondary effect of deterring some forms of capital inflows. There is wide scope for administrative measures which can throw sand in the wheels of excessive capital movements.

Third, Indonesia should continue structural reforms that build economic resilience by increasing growth momentum and expanding the capacity for credible and effective policy responses to a shock

We list some of these possible structural reforms below:

(1) Infrastructure will remain the key

The government needs to address the bottlenecks which have slowed the launch of infrastructure programmes such as the difficulties involved in land acquisition. More can be done to encourage public-private partnerships.

(2) Subsidy reform will improve fiscal space

Subsidies continue to constrain fiscal policy. The government needs to expand its efforts to replace poorly targeted subsidies with more targeted cash transfers.

(3) Consistency in institutional and regulatory reform is paramount

Unlike the PRC, and more like India, Indonesia needs to rely on its private sector to boost growth. Streamlining the institutional capacity of the public sector will ensure the smooth functioning of the private sector. The government has been among the most active in Asia in introducing reforms and it needs to continue the same agenda in its second term. Maintaining consistency in the reform process is essential as it signals some permanency to investors.

In addition, the collapse and sometimes messy rescues of major banks in the US and Europe during the recent crisis is testament to the need for definitive resolution regimes for banks. It is important that Indonesia has in place a clear legal framework to allow such critical interventions, one that brings greater transparency but also permits swift and effective responses in such emergency actions.

CHAPTER 2: PHILIPPINES

Introduction and Summary

The Philippines has demonstrated remarkable resilience in the face of the global financial crisis. Output continued to grow unlike many of its more export-dependent Asian peers.

This resilience stemmed from a number of factors. First, remittances continued to grow, bolstering consumer spending. Second, the short duration of the global crisis meant that lagged negative effects such as a sharp rise in worker retrenchments did not occur. Third, new sources of growth, such as business process outsourcing, helped to sustain the momentum of growth. However, the export sector with its heavy reliance on the globally-sensitive technology cycle suffered a sizeable downturn.

The economy's prospects in 2010–2011 will be supported by the revival of external demand but domestic factors may play a more important role and largely positive role—including reconstruction work after the devastating typhoons in late 2009, as well as election-related spending.

Given the large amount of slack in resource utilization, there is no urgency in reversing monetary accommodation. The emphasis of policy should be on further improving the fiscal position and promoting supply side improvements to its growth potential.

2.1 Where does the economy stand?

First, the economy has out-performed many of its peers by avoiding a technical recession

The Philippines economy has slowed in 2009. After recording real GDP growth of 7.1% in 2006, the highest in over three decades, growth decelerated to 3.0% in 2008 (Chart 2.1 and Table 2.1). As the global crisis deepened, the Philippines economy continued to grow, avoiding the recessions experienced by its peers and despite the very real adverse impact on its export sector. In fact, annual real GDP growth rebounded in 2Q09, after decelerating to 0.6% in 1Q09. Government spending has been a major driver of growth, accelerating to 9.1% y/y in 2Q09 from 4.5% in 1Q09.

Table 2.1: Philippines GDP Breakdown

% y/y	Sep 2008	Dec 2008	Mar 2009	Jun 2009
Gross Domestic Product (GDP)	**4.6**	**2.9**	**0.6**	**1.5**
By expenditure				
Private Consumption Expenditure	4.4	5.0	1.3	2.3
Government Consumption Expenditure	11.8	2.6	4.5	9.1
Gross Fixed Capital Formation	7.1	0.1	-7.2	-1.9
Imports	3.3	-11.5	-14.7	-16.0
By industry	6.7	5.0	-20.6	-2.7
Agricultural, Fishery, Forestry				
Mining and Quarrying	2.5	2.9	2.1	0.3
Manufacturing	0.7	18.2	19.5	21.4
Construction	5.4	3.4	-7.6	-7.2

% y/y	Sep 2008	Dec 2008	Mar 2009	Jun 2009
Electricity, Gas and Water	20.5	14.5	14.0	16.9
Transport, Storage and Communications	9.2	3.8	0.6	2.9
Trade	2.9	4.5	5.6	1.7
Finance	1.3	0.0	0.4	3.0
Government Services	1.8	-4.6	1.2	1.8

Source: Collated by Centennial Group using CEIC Database

Second, the main impact of the global crisis was on the export and manufacturing sectors

As Chart 2.2 shows, Philippine exports contracted sharply as global demand fell. This fall was transmitted to the industrial sector where production fell (Chart 2.3), mainly the result of weaker demand for electronic components, apparel, and footwear. The capacity utilization rate fell in 1Q09 but has recovered since then (Chart 2.4).

Chart 2.1

Relatively benign impact from global crisis

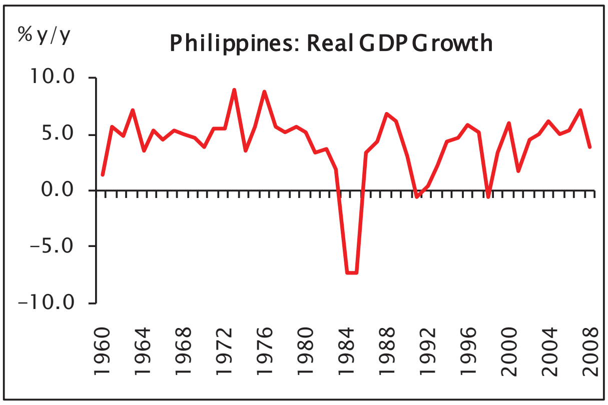
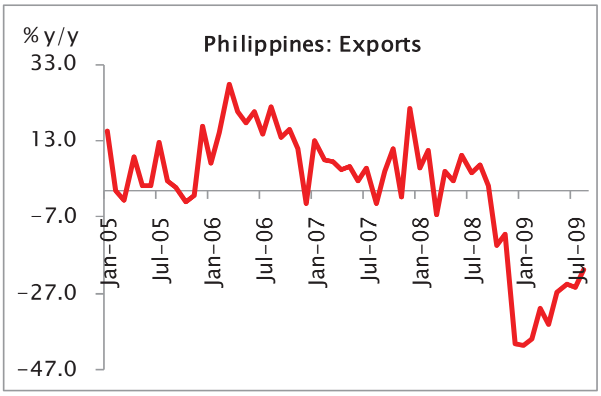


Chart 2.2

… despite sharp fall in exports



Source: Collated by Centennial Group using CEIC Database.

Chart 2.3

…reducing industrial production

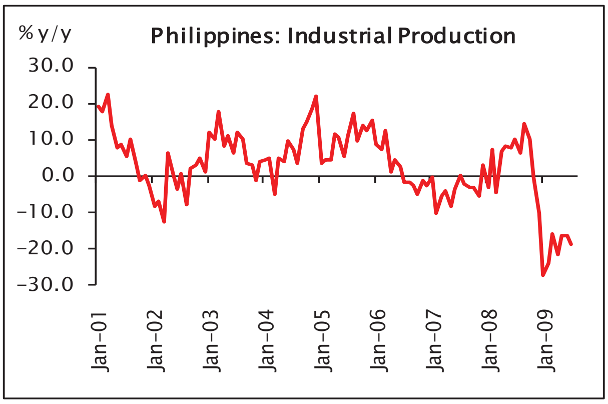
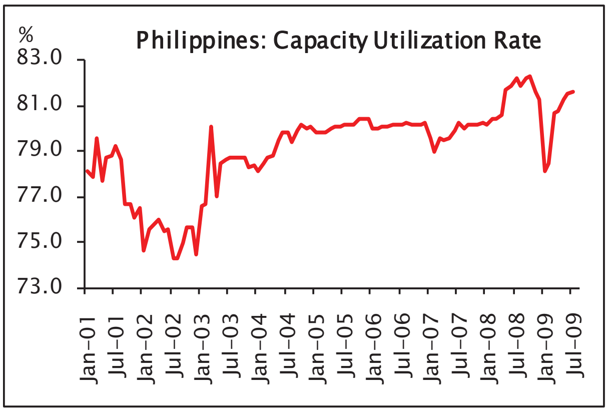


Chart 2.4

…but capacity utilisation fell marginally



Source: Collated by Centennial Group using CEIC Database.

The service sector, which contributes to over 50% of the GDP, was also hit by the global downturn. The financial sector and the business process outsourcing (BPO) sector are deeply integrated with the markets of advanced economies. However, the services sector was supported by the growing interest in the Philippines among BPO companies. For example, Convergys, among the leading call centre companies in the Philippines, opened its largest call call-centre in the world in Manila recently. They also expect to overachieve their forecasted hiring of 20,000 employees by December 2009.[3]

Third, remittances from overseas Filipino workers provided a critical source of support to the economy during the crisis

Inflows from overseas Filipino Workers (OFWs) remained robust, exceeding values of the previous year (Chart 2.5). Remittances from Filipinos employed in the US and Europe have been the fastest to contract but remittance inflows from the Middle East, while decelerating in growth, do not seem to be at risk so far (Chart 2.6). There are an estimated 8 million Filipinos employed abroad. Remittances from OFWs rose 6.7% y/y in October 2009 to $1.49 billion. We expect remittance inflows in 2009 to record an eighth positive year of growth – except for a small fall in 2001. Remittance inflows have been a reliable source of growth for the Philippines economy.

Chart 2.5

Growth rate of remittances eased then rose

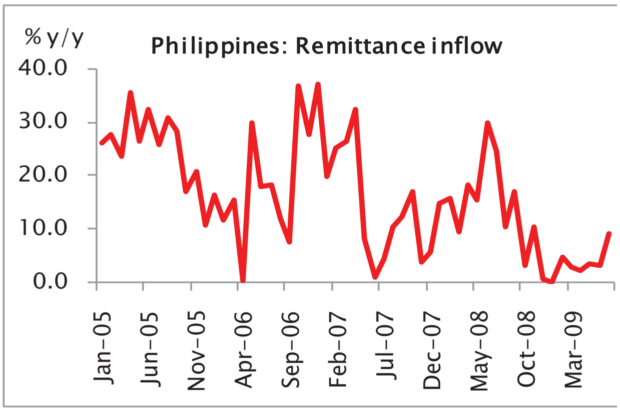
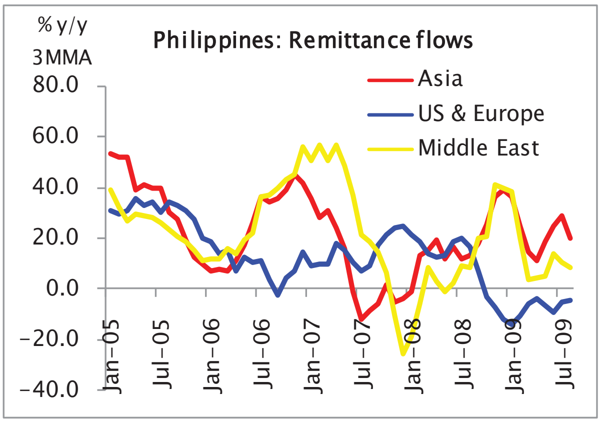


Chart 2.6

… with only US/EU sources weakening



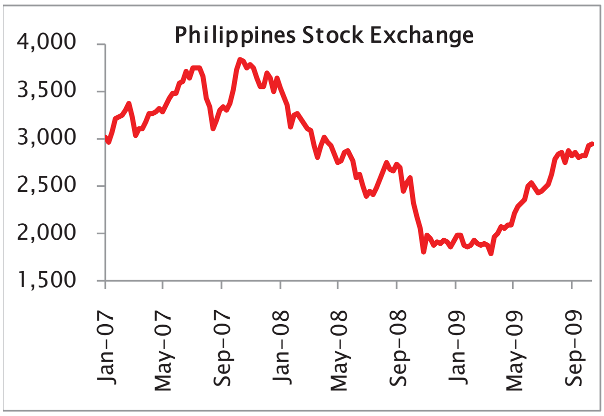
Source: Collated by Centennial Group using CEIC Database

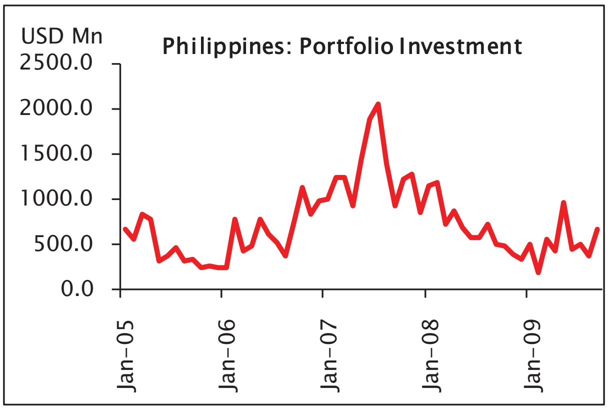
Fourth, the financial shock from the global financial turmoil was material but manageable in its impact

Chart 2.7 shows how equity prices in the country fell in line with the sharp falls in equity markets across the world. It is notable, however, that portfolio inflows remained positive even while falling significantly – and recovered quickly as well (Chart 2.8).

[3] Inquirer. 2009. *Largest call centre in the world opens in RP*.

Chart 2.7	Chart 2.8
Equity prices fell and rose with global equities	**Portfolio inflows fell and then rebounded**



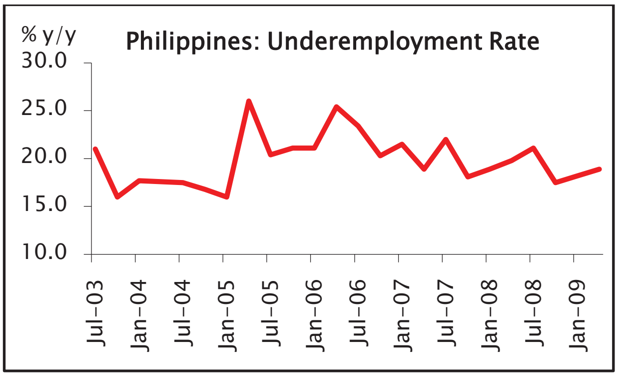


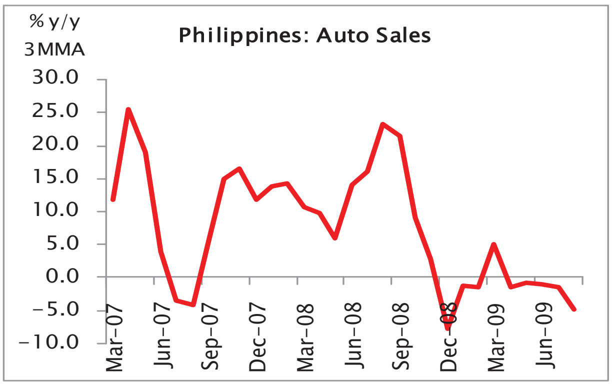
Source: Collated by Centennial Group using CEIC Database.

Fifth, consumer demand continued to support the economy

Private consumption expenditure eased in 1Q09 but rebounded in 2Q09 (Table 2.1) – probably boosted by the continued growth in remittances but resilient labour markets also helped. Chart 2.9 shows how the under-employment rate remained largely unchanged through the global crisis, with labour market conditions as measured by under-employment improving in the second half of 2009. However, spending on durables such as autos declined (Chart 2.10).

Chart 2.9	Chart 2.10
Labour market did not take a big hit	**… though spending on durables fell**



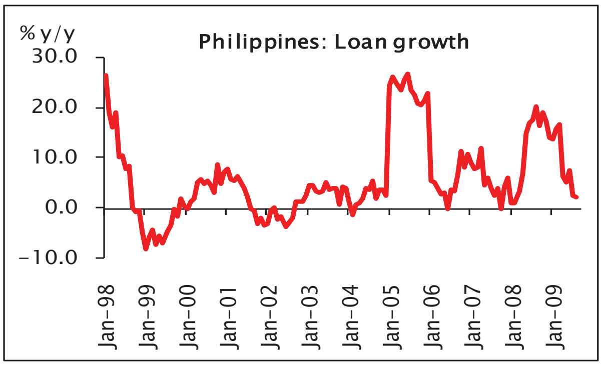


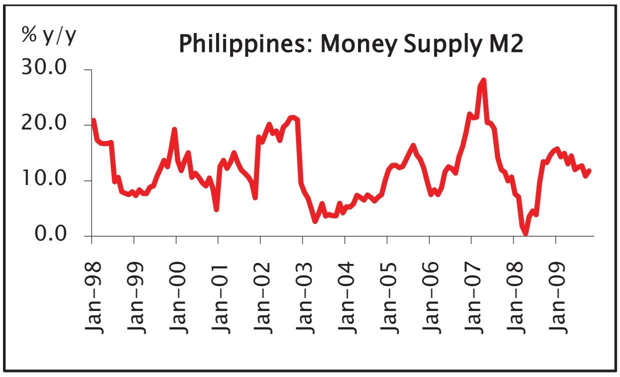
Source: Collated by Centennial Group using CEIC Database.

Sixth, the banking and external sectors did not amplify the external shock unlike previous crises

Liquidity conditions continued to be reasonably resilient. While loan growth decelerated significantly (Chart 2.11), it did not contract. Commercial bank loan growth fell steeply from 20.3% y/y growth in September 2008 to 2.0% y/y growth in September 2009. The slowdown has come from both production loans and consumer loans as cautious businesses and consumers curtailed borrowing. Broad money continued to grow at a fairly robust pace (Chart 2.12). The broadest indicator of money supply (M4) grew 12.0% in September 2009, only slightly lower than the growth of 18.8% at the beginning of the year. It is also noteworthy that unlike during the Asian Financial Crisis, the non-performing loan ratio did not rise sharply—at 3.5% in August 2009, it marked only a slight increase from June 2009 when it was 3.36%.

Chart 2.11	Chart 2.12
Credit extension weakened but did not fall	**… and broad money growth continued**



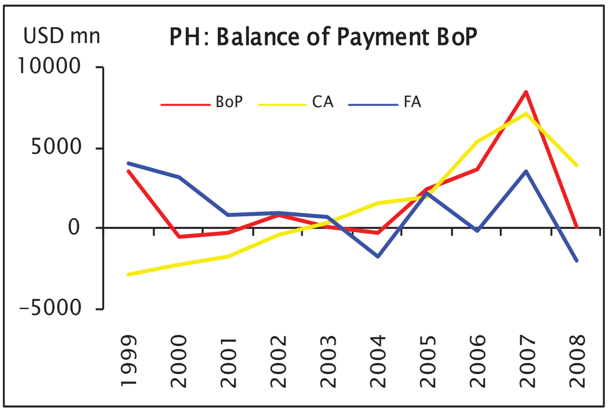


Source: Collated by Centennial Group using CEIC Database.

Seventh, the external accounts remained firm as well

While the balance of payments weakened in 2008 as the global crisis spread, (Chart 2.13), it avoided a material deficit and foreign reserves continued to rise (Chart 2.14).

Chart 2.13	Chart 2.14
Weaker balance of payments	**… but foreign reserves roles markedly**



Source: Collated by Centennial Group using CEIC Database.

2.2 Prospects for the economy are brightening

The country's economic prospects are set to improve in 2010–2011. In the following section, we examine (a) some factors specific to the Philippines which will affect the economy; (b) the likely transmission of global turbulence to the domestic economy; and (c) the likely degree of resilience to such shocks.

First, special one-off factors may be more important than global factors in 2010

Here it is important to mention three key domestic factors which will play an important role, along with global factors, in shaping the Filipino economy.

- **First, natural disasters in October have had drastic effects and have diverted policy attention**

  The Philippines was hit by a series of destructive typhoons in October 2009 which caused the heaviest rains experienced by the country in 40 years, resulting in the destruction of major infrastructure and the disruption of agricultural as well as commercial activities. GDP growth in 4Q09 will reflect this damage but reconstruction activities thereafter will boost economic activity.

- **Second, election-year spending will be positive for economic activity**

  The Philippines is holding presidential and congressional elections in May 2010. Typically, an election year sees a bounce in consumer spending as populist policies and spending by political parties infuses money into the household sector.

- **Third, ratings upgrade in July 2009**

  The sovereign rating for the Philippine economy was raised by Moody in July 2009 from B1 to Ba3 which has a stable outlook. The reasons backing the upgrade included the country's resilient financial system. This has helped boost confidence in the economy.

As a whole, these factors will be supportive of GDP growth in 2010.

Although the lead indicator published by the National Statistical Coordination Board suggests a more sombre outlook, (Chart 2.15), other indicators are more optimistic.

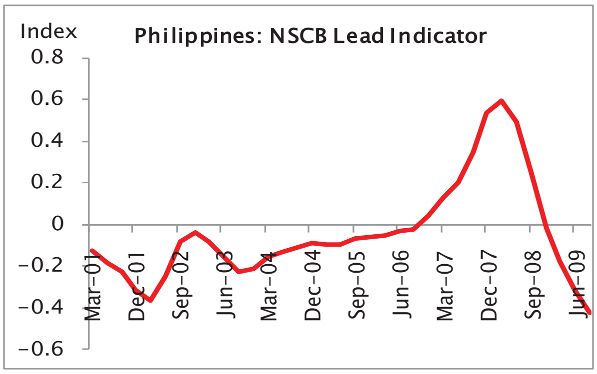
- The BSP business outlook index returned to positive territory after four consequent quarters of a negative index (Chart 2.16).

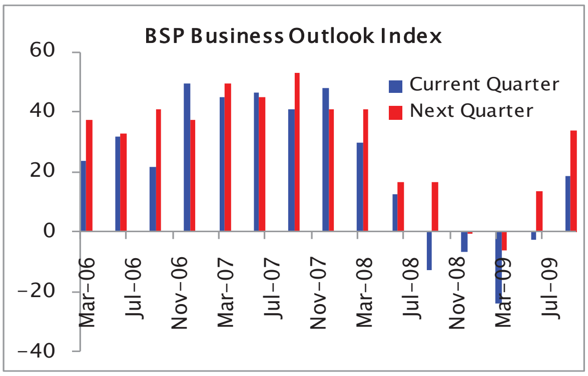
- Investor sentiments have improved compared to 4Q08 and 1Q09. The yield spreads between US and Philippine treasuries have narrowed over the last few months (Chart 2.17).

- Consumers also seem less negative about the economy. The BSP consumer expectations index was at -31.9% for the quarter ending in September 2009 rather than −34.2% for the previous quarter (Chart 2.18). High and middle income groups were more optimistic about the future than the low income group which stayed unchanged. 18% of the people surveyed also consider 3Q09 as a favourable quarter to purchase big ticket items.

Consequently, we believe that economic activity in the Philippines will spring back starting in 4Q09.

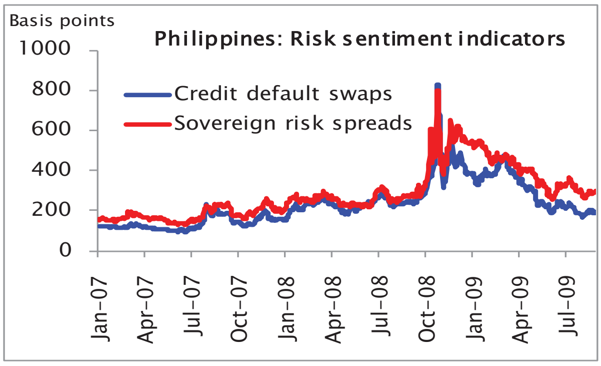
Chart 2.15	Chart 2.16
Lead indicator negative but…	**… businesses point to growth**

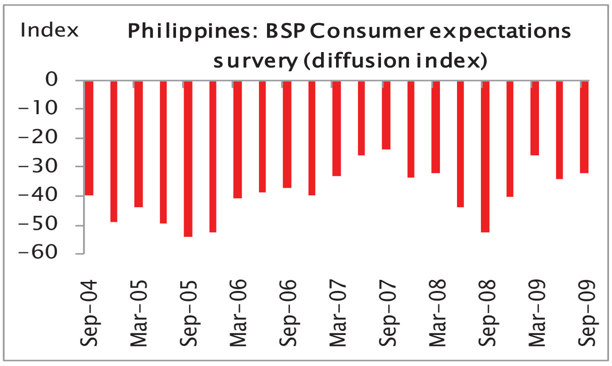




Source: Collated by Centennial Group using various sources.

Chart 2.17	Chart 2.18
Investors risk aversion to Philippines down	**…And consumers are less negative**





Source: Collated by Centennial Group using various sources. For risk sentiments indicators - Bloomberg; For BSP Consumer index - CEIC Database.

Second, transmission of stresses from the global environment to the Philippines will be a concern.

A detailed breakdown of how the various transmission mechanisms will pan out is shown in Table 2.2.

Table 2.2: Transmission mechanisms

	Scenario for 2009/10	Risks/Upsides
Capital flows	▪ Signs of upturn will boost investment sentiments which will spur higher capital inflows. The government already announced that there will be no capital control rules which will encourage international investors to look to the Philippines[4].	**Risks** ▪ The fear of over inflow of capital could put pressure on the currency to appreciate, making exports less competitive. ▪ Sustainability of capital inflows through 2010 depends on the May 2009 elections and how the new government pursues its economic agenda.

[4] Business Mirror. 2009. *Crimping money flows not an option.*

	Scenario for 2009/10	Risks/Upsides
Trade	▪ Inventory restocking is boosting demand for Filipino exports. ▪ But exports will be limited in the next few years by sluggish external demand.	**Risks** ▪ The narrow base of the Filipino exports could fall to competition from other emerging market economies like PRC and Viet Nam.
Remittances	▪ Remittances will continue to grow though the growth rate of remittance inflows could soften.	**Risks** ▪ Dubai's problems may lead to some OFWs returning home.
FDI	▪ Prior to the elections, investors are likely to adopt a wait and watch attitude.	▪ FDI inflow is also linked to the political climate and the signals which emanate from the new government.
Commodity Prices	▪ Increase in the prices of food items like rice would adversely affect the economy as it imports most of its rice.	▪ With more optimistic agricultural prospects for both Thailand, and to an extent India, a sudden dramatic spike in food prices is unlikely.

2.3 How resilient can the Philippines be?

We examine in Table 2.3 below the main components of the country's economic resilience.

Table 2.3: Analysis of the Philippines' economic resilience

Component/Indicator	2000	2008	Comments
Export Diversity			
Avg. coefficient of variation for top 10 exports and destinations	1.5	1.4	*The more diversified your export base, the more resilient the economy is.* There is little diversity in export oriented market. About 50% of exports are electronic goods and the improvement from 2000 has been only slight.
Demand Diversity			
C + I + G (% of GDP)	103.9	94.8	*The greater the dependence on exports and less exposure to domestic demand, the less resilient the economy is likely to be.* Large land mass and population offer a sizable domestic demand, can serve as an effective shock absorber.
Automatic Stabilisers			
10 yr. avg. of change in tax revenue/change in GDP	2.6	2.5	*Tax revenues automatically adjust as economy accelerates or decelerates, providing a natural automatic stabiliser or shock absorber in the economy.*
Capacity for swift and effective policy response			
Fiscal - Public Debt (% of GDP)	66.5	63.6	*Higher public debt imposes a constraint on use of fiscal tools.* Little room for fiscal action thought the government has done well to rope in the deficit from 3.8% of GDP in 2005 to 0.9% of the GDP in 2008; the actual public debt is still quite high at 63.6%.
Monetary - G7-Country Inflation over 8 yrs (%y/y)	-6.0	-3.3	*The greater the credibility the central bank has built up by controlling inflation not too different from major countries' inflation, the*

Component/Indicator	2000	2008	Comments
			more latitude central bank has to ease monetary conditions in a slowdown.
External Financial Vulnerability			
Financially mobile capital (% of foreign exchange reserves)	164.1	112.1	*High financially mobile capital in relation to FX reserves and high current account deficit/GDP signify reduced resilience.* Although Philippines has a current account surplus, the ratio of financially mobile capital to the foreign exchange reserves is about 112.1%. While this is not a threat individually it can be a shock amplifier in case of a BoP crisis.
Domestic Financial Vulnerability			
NPL Ratio	15.1	3.7	*A stronger banking sector with low non-performing loans is less likely to amplify an external shock by cutting lending drastically.* Though less than in year 2000, the NPL ratio in the Philippines is still high at 3.7% of total commercial bank loans in 2008.
Vulnerability to oil prices			
Avg. excess production of energy (% of GDP)	-5.1	-2.1	*Country is more resilient if it is a net producer of energy.* Higher energy consumption and lower energy production has caused increased reliance on foreign energy.
Political Stability			
Index of Stability	5.6	5.1	*Country with political stability is more resilient.*

Two issues relating to resilience need further examination:

First, is the role played by remittances. While the strength of remittances has buffered the economy during this crisis, the extent of dependence on such remittances might, in a broader view, be a concern. A survey by the Philippine Institute of Development Studies found that about 39% of households which have members working abroad have had at least one member return due to retrenchment (Table 2.4). We believe that the sustainability of the remittances is open to question.

Table 2.4: Survey results about OFW Households, 2009

Indicator	Magnitude	Proportion
Households (HH) with OFW	415	14.8
Of which		
HH with returning OFW	162	39.0
HH with returning OFW who was retrenched or laid off from work	26	6.3
HH with OFW who has experienced wage reduction	38	9.2
HH who received remittances during the past 6 months	411	99.0
HH who experienced a decline in the amount of remittances received	36	8.7
HH experienced a decline in the frequency of receipt of remittances	31	7.5

Source: Community Based Monitoring System Survey, Philippine Institute for Development Studies, 2009.

A second issue for resilience is the labour market which has been remarkably firm despite the slowdown in the external sector. There are some interesting lessons for economic resilience in this:

- ***The short duration of the global recession.***: This meant that companies could afford to hold out and not be eventually forced to retrench workers. In October 2009, the recovery in the export sector was credited with adding 43,800 jobs directly and probably more jobs if the spill-over effects on other sectors are considered;

- ***Supply side growth.*** Momentum for job creation came from new sources of growth which remained resilient in the face of the global recession. The hotels and restaurants sectors added 96,442 jobs as new establishments opened while the Philippines' continued attractiveness as a location for global services sustained the increase in BPO hiring. The latter had considerable positive spinoffs for other sectors such as real estate and business services which added 98,330 workers.

2.4 Implications for policy

First, while inflation will probably rise in 2010, there is no sign that it will become a serious concern. There is thus no urgency for monetary tightening

As Chart 2.19 shows, headline inflation has fallen from 11.8% y/y in September 2008 to 0.7% y/y in September 2009, a fall of over 11 percentage points. The fall in inflation was not due only to external factors such as lower commodity prices: inflation in non-tradable goods also eased sharply. Good conditions in agriculture have also helped keep food prices in check.

As Chart 2.20 shows, there is considerable slack in resource utilisation in the country. This limits the risk that domestic inflation might surge. An early tightening of monetary policy might also aggravate the risks of undesired inflows of short term capital. As it is, the ratio of financially mobile capital to reserves is uncomfortably high, further inflows would aggravate this and reduce economic resilience as argued in Table 2.3.

Chart 2.19

Inflation has eased…

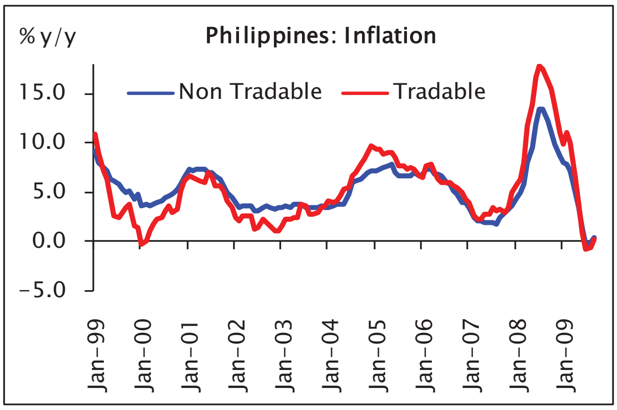
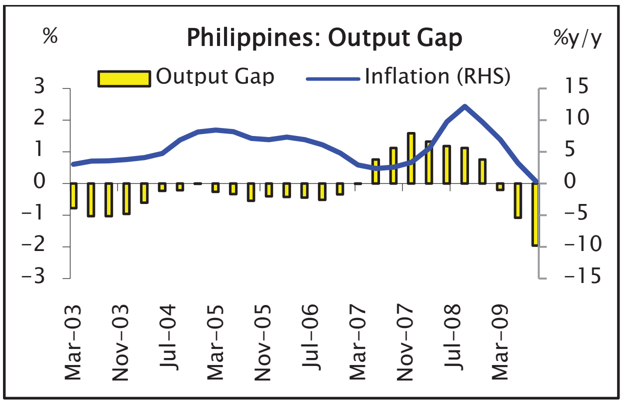


Chart 2.20

…but considerable slack in resource utilization



Source: Collated by Centennial Group using CEIC Database and CAA model.

Second, the authorities need to build on the foundations for fiscal improvement that they have already constructed

In the short term, the need to deal with the repairs to typhoon damage and related works probably means that fiscal policy should remain supportive of growth.

In the longer term, a legally bidding framework to govern fiscal policy might need to be developed rather than piecemeal measures to consolidate the large budget deficit.

Third, while the Philippines has made important improvements to boost its economic resilience, it still needs to do more

There are a number of areas where reforms could boost resilience:

- ***Diversification.*** The Philippines remains far too reliant on remittances. Within the manufacturing sector, it is heavily dependent on segments that other rapidly growing emerging economies are improving their capabilities in, such as electronics components. A revamped and unified investment promotion agency could be tasked to develop a strategy for diversification.

- ***Improving supply side efficiencies.*** As argued in the discussion on resilience above, creating new sources of growth can lend momentum to the economy and thereby boost resilience. Improving the supply side of the economy can help achieve this. Expanding the infrastructure construction programme would help. In addition, the Philippines is among the worst performing countries when assessed on corruption. Its rank in the Corruption Perceptions Index has fallen shockingly from 65 in 2001 to 141 in 2008. There is an urgent need to give better supervisory powers to the Philippine Anti-Graft Commission.

CHAPTER 3: THAILAND

Introduction and Summary

Thailand has had a rough period in recent years. Its economy entered the global crisis weakened by a political crisis which had depressed consumer and business sentiment. The political crisis worsened significantly in the first few months of 2009, complicating Thailand's responses to the global crisis. In addition, the Thai economy has also been adjusting to increased competition in the export markets and in the area of foreign investment as a result of the rise of new emerging economic powers, including in particular the PRC, India, and Viet Nam.

- After contracting throughout much of 2009, the economy is beginning to rebound but the recovery remains patchy and volatile.

- Considering the challenges it has faced, Thailand's economy has been reasonably resilient. Strong and credible policy agencies such as the central bank, flexible labour markets and robust balance sheets in corporations and banks have helped Thai resilience.

- The prospects for 2010–2011 are brightening, with the recovery in global demand being reinforced by the lagged effects of easy monetary and fiscal policies. However, there is no sign that the domestic political risks have abated.

- With low inflation, considerable slack in resource utilisation and no sign of asset bubbles, there is no urgency for the withdrawal of monetary policy support. Thailand retains the space for continued fiscal stimulus as well.

3.1 Where does the economy stand?

Table 3.1 and Chart 3.1 show the recent performance of the economy. This performance has been characterised by the following features:

Table 3.1: Thailand GDP breakdown

% y/y	Sep 2008	Dec 2008	Mar 2009	Jun 2009	Sep 2009
GDP	2.9	-4.2	-7.1	-4.9	-2.8
By expenditure					
PCE	2.7	2.1	-2.5	-2.2	-1.3
GCE	3.3	13.5	5.9	7.8	4.7
GFCF	1.9	-5.0	-15.9	-10.2	-6.3
Exports	9.8	-9.3	-16.7	-21.7	-15.0
Imports	14.7	1.7	-30.5	-25.6	-23.8
By industry					
Agriculture	3.3	0.0	2.7	-1.3	-2.5
Mining and Quarrying	2.3	-3.1	-0.2	-4.9	-3.7
Manufacturing	5.4	-6.8	-14.5	-8.7	-5.9
Electricity, Gas and Water Supply	2.5	2.4	-2.8	-0.9	2.5
Construction	-6.5	-12.7	-7.8	1.5	1.8
Sales, Repair of Motor Vehicles	1.3	-1.3	-3.0	-3.8	-3.3
Hotels and Restaurants	0.3	-8.1	-7.0	-5.7	-2.9

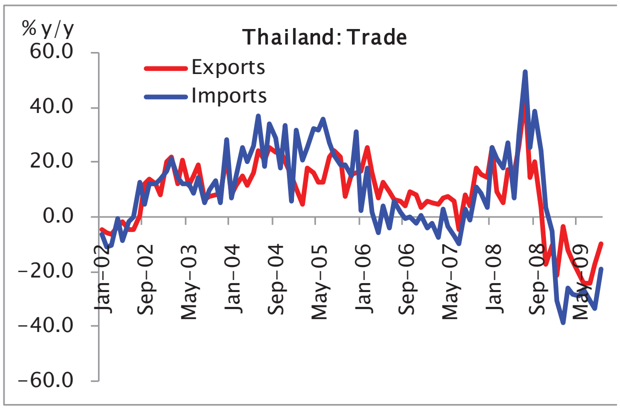
% y/y	Sep 2008	Dec 2008	Mar 2009	Jun 2009	Sep 2009
Transport, Storage and Communications	1.4	-10.8	-6.8	-6.7	-2.1
Financial Intermediation	6.5	4.0	2.6	5.3	4.5
Real Estate, Renting and Business Activities	3.1	-0.8	-3.4	0.1	0.0
Public Admin and Defence, Social Security	0.3	5.7	6.1	3.7	5.9
Education	-4.4	3.1	2.2	0.1	3.0
Health and Social Work	-1.6	4.7	3.8	1.0	3.5
Other Community, Social and Personal Service	0.1	0.0	-2.5	-1.2	0.7

Source: Collated by Centennial Group using CEIC database

First, as with other export-dependent Asian economies, weakness in external demand hurt Thailand quite severely

In year before comparisons, GDP has been contracting since Q4 2008 (Chart 3.1), with the worst contraction being in Q1 2009. Since then, the pace of the contraction has eased. The fall in GDP coincided with the collapse in export demand as seen in Chart 3.2, which was then transmitted to a decline in manufacturing production (Chart 3.3). Thailand's exposure to the global technology cycle partly explains the sharpness of the export deceleration. The technology cycle is highly sensitive to global business spending and therefore to global GDP growth, making for the high correlation of Thai technology exports with world GDP of 65.6%.[5]

Chart 3.1	Chart 3.2
GDP growth sank as global crisis deepened	**…and as exports contracted**



Source: Collated by Centennial Group using CEIC Database.

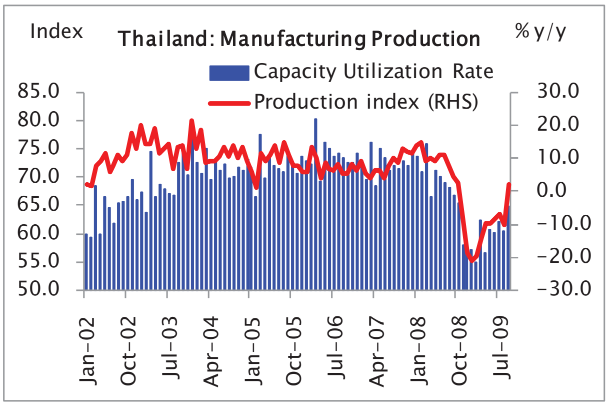
Second, domestic political conditions reinforced the weakness in economic activity

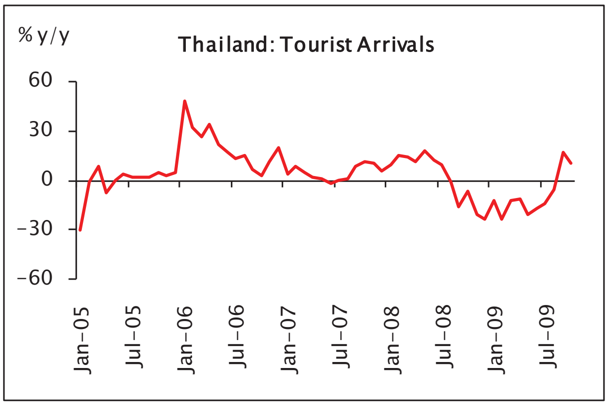
This brings out a key feature of the Thai economy during this crisis. Thailand has endured an extended period of political uncertainty which began with street demonstrations against the government of ex-Premier Thaksin in late 2005 and culminating in the military coup of September 2006 and the troubled return to elected government thereafter. The political impact was seen in how tourist arrivals fell sharply in early 2009 following the occupation of the international airport by protestors in December 2008 and the violence in Pattaya and Bangkok in April 2009 (Chart 3.4). As political conditions stabilized, tourism rebounded

[5] KGI. 2009. *Daily Navigator*.

smartly, even as global economic activity remained weak. There has been a sharp increase in tourists from East Asia as well as from Europe. Hotel room occupancy has also increased, though at a slower pace.

Chart 3.3	Chart 3.4
Which caused manufacturing to decline	**Falling tourism deepened impact on GDP**



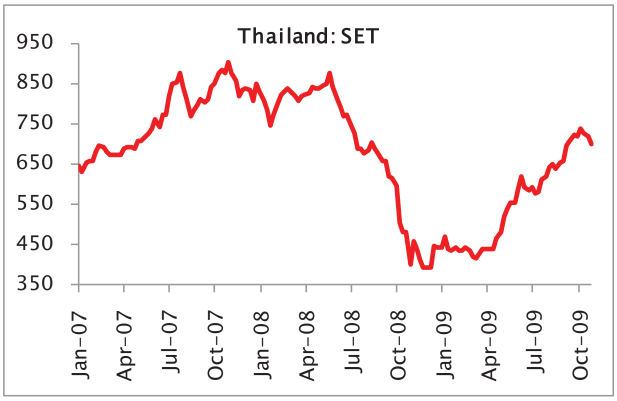


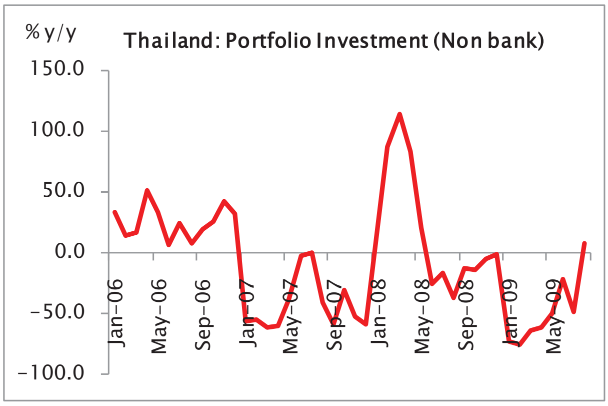
Source: Collated by Centennial Group using CEIC Database.

Third, the financial sector was not as severely hurt as in other economies

As Chart 3.5 shows, Thai equities fell sharply, in line with emerging market equities around the world. However, portfolio capital inflows had been relatively weak in Thailand for an extended period (Chart 3.6) and had not boosted Thai equities as sharply as elsewhere in the emerging world. Thus, the damage from the withdrawal of portfolio capital, while material, was not as excruciating as elsewhere. Portfolio inflows had been weak for some time before the crisis following the sudden imposition of the unremunerated reserve requirements in December 2006 and uncertainty over the enforcement of the Alien Business Act by the military government in January 2007.

Chart 3.5	Chart 3.6
Equity correction would have been worse	**… if portfolio inflows had been substantial**



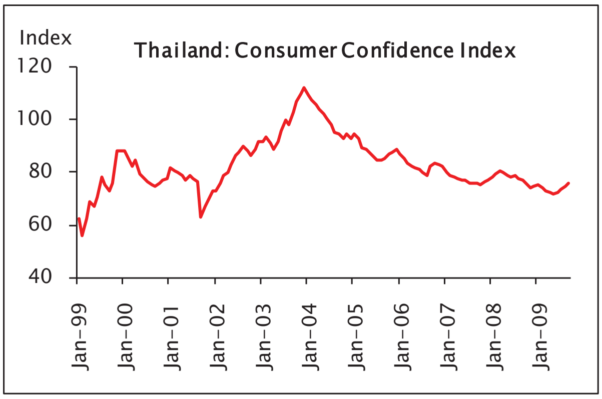


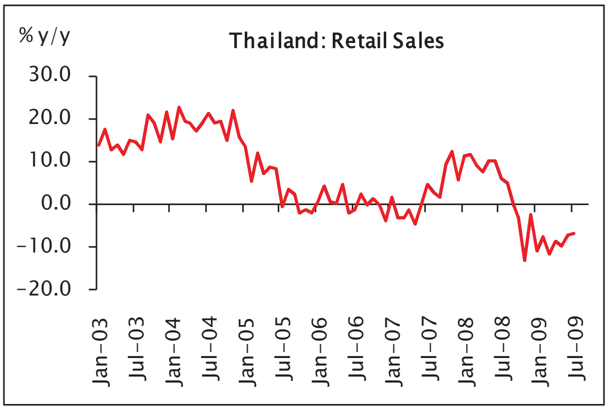
Source: Collated by Centennial Group using CEIC Database.

Fourth, domestic spending by consumers and businesses, already brittle as a result of the political crisis, weakened significantly

- The Consumer Confidence Index had been declining since 2004 (Chart 3.7) and continued to slacken as the global crisis spread. The recovery in retail sales after the return to elected government consequently lost momentum (Chart 3.8). However, government stimulus programmes which targeted utilities subsidies for low-income groups, job training programmes and tax cuts helped bolster consumer confidence. Moreover, unemployment was hardly impacted. Domestic businesses reversed their initial retrenchments very quickly allowing the unemployment rate to fall from 3.4% in January 2009 to 1.2% by August 2009.

Chart 3.7	Chart 3.8
Consumer confidence already down	**…retail sales recovery reversed abruptly**



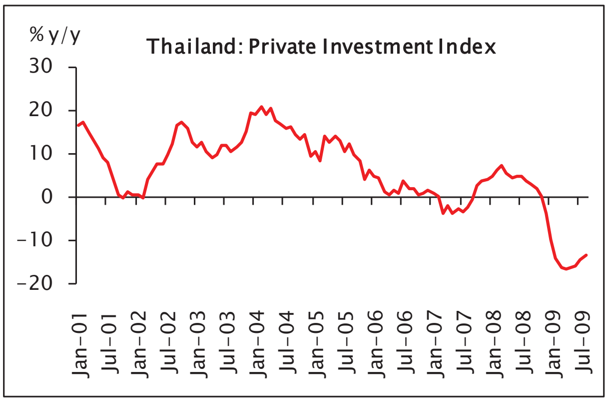


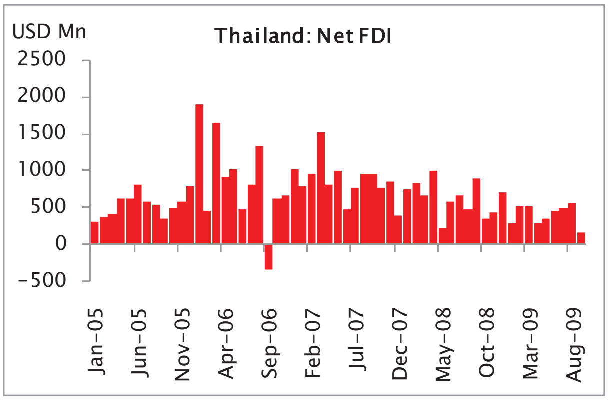
Source: Collated by Centennial Group using CEIC Database.

- The Private Investment Index (Chart 3.9) fell sharply in 4Q08 and contracted until 2Q09, when contractions began to decelerate, showing how domestic businesses froze capital spending in response to the uncertainty in external demand. Interestingly, actual commitments of foreign investors remained steady and only began to weaken materially in August 2009 (Chart 3.10). Net FDI inflow into Thailand totalled $3.6 billion in the first nine months of 2009, almost half of the $6.1 billion inflow in the same period in 2008.

The weakness in domestic demand is also seen in how, as the economy recovered after mid-2009, production in export-dependent industries (exporting more than 60% of output) increased 7.8% y/y in September 2009 while domestically-oriented industries (exporting less than 30% of output) increased only 0.2%.

Chart 3.9	Chart 3.10
Businesses slashed capital spending	**…but FDI remained steady until August 09**



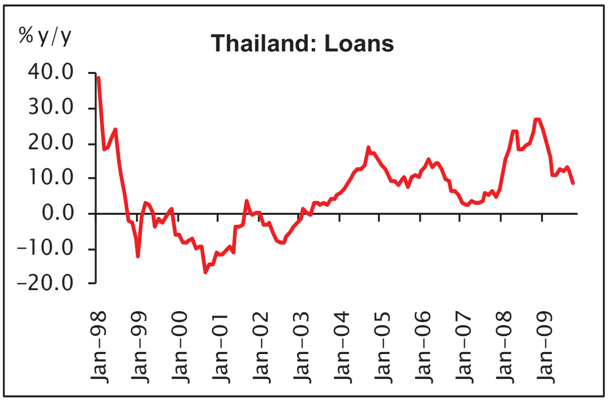


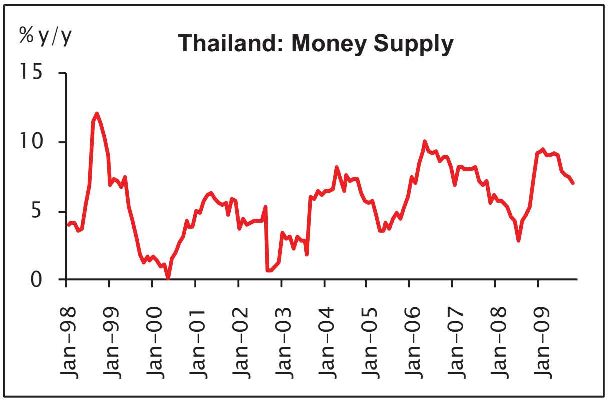
Source: Collated by Centennial Group using CEIC Database.

Fifth, credit extension and liquidity conditions while weakening did not seriously aggravate the economic downturn induced by external weakness

Credit extension decelerated sharply from the end of 2008 onwards (Chart 3.11) but did not contract. Broad money continued to grow, with the initial deceleration in 2008 reversing quite quickly (Chart 3.12).

Chart 3.11	Chart 3.12
Banks continued to grow lending	**And broad money accelerated after easing**



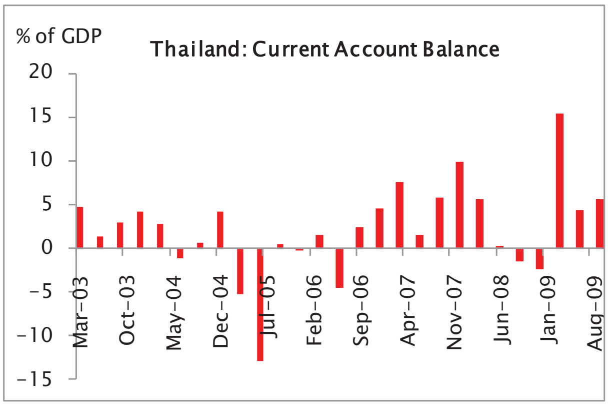


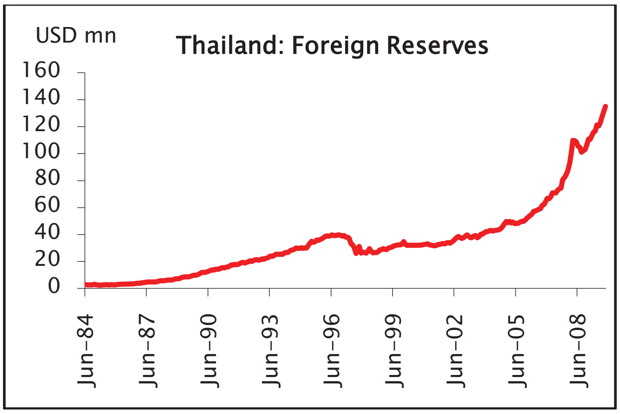
Source: Collated by Centennial Group using CEIC Database.

Sixth, external stability remained robust despite the outflow of portfolio capital

Imports fell much more sharply than exports, allowing the trade surplus to remain high. The current account balance returned to surplus by early 2009 (Chart 3.13) while foreign exchange reserves continued to rise significantly (Chart 3.14).

Chart 3.13	Chart 3.14
Current account held up strongly	**…allowing foreign reserves to rise**





Source: Collated by Centennial Group using CEIC Database.

3.2 The outlook: recovery will be slow as economy rebalances toward domestic demand

Thailand's economic prospects are brightening as the key determinants of Thai growth are mostly positive while it is likely to be resilient to the kind of turbulence that we identified as risks in our overview report.

First, lead indicators point to a recovery, driven by improvements in external conditions

- The Business Sentiment Index rebounded remarkably quickly in 1Q09 and 2Q09 after turning down in 2008 (Chart 3.15). Business sentiment reached its pre-crisis level in July 2009.

- The BOT Leading Index confirms that a strong recovery is likely (Chart 3.16).

Chart 3.15

Business sentiments up strongly

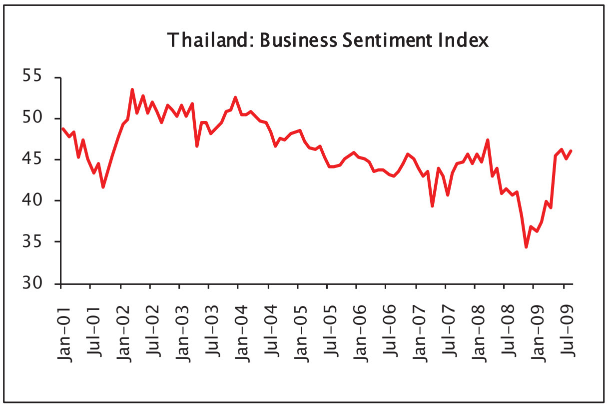
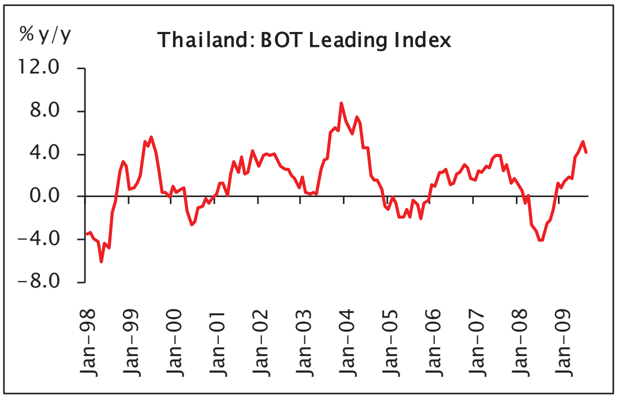


Chart 3.16

Lead indicator points to smart recovery



Source: Collated by Centennial Group using CEIC Database.

Second, the global environment is likely to be mostly supportive of Thai economic recovery

We look at some of the key transmission mechanisms between the global economy and Thailand's economy in Table 3.2. In essence, despite the turbulence we see in the global economy, we believe that the overall impact on Thailand is likely to be positive.

Table 3.2: Transmission mechanisms

Mechanism	Baseline Scenario for 2009–2010	Risks/Upsides to Baseline Scenario
Trade	▪ Exports dependant on G3 demand. ▪ Economically sensitive items such as electronic components and autos are important export products.	**Risks** ▪ If G3 demand will remain subdued after the current restocking period lapses, demand for Thai exports will also stagnate.
Tourism	▪ Tourism will recover slowly. ▪ Visitors from the G3 will also not spend as much leading to some moderation in tourist revenue growth.	**Upside** ▪ There could be increase in traffic from newly wealth households in the PRC and India.

Mechanism	Baseline Scenario for 2009–2010	Risks/Upsides to Baseline Scenario
FDI	▪ FDI inflows are likely to recover but may not recover as fast as regional peers due to continued political uncertainty.	
Portfolio capital flows	▪ Capital outflows are returning but political concerns limit the extent of inflows.	**Risks** ▪ Restrictions on capital flows are a genuine possibility as Thailand has introduced such controls in the past. ▪ Another concern is a repeat of the political turmoil which occurred in 2009. This could lead to a sudden withdrawal of flows.
Commodity Prices	▪ Thailand is a major exporter of food products as well as economically sensitive commodities such as rubber. Prospects continue to be bright.	

Third, despite political problems, Thailand remains a fairly resilient economy

3.3 Thailand's economic resilience

Table 3.3 outlines the key components of our resilience index (featured in the Overview section), showing a breakdown of Thailand's resilience framework.

Table 3.3: Analysis of Thailand's economic resilience

Component/Indicator	2000	2008	Comments
Export Diversity			
Avg. coefficient of variation for top 10 exports and destinations	0.8	0.5	*The more diversified your export base, the more resilient the economy is.* Extremely high dependence on exports Large share of imports are inputs used in export production.
Demand Diversity			
C + I + G (% of GDP)	89.4	94.1	*The greater the dependence on exports and less exposure to domestic demand, the less resilient the economy is likely to be.* Weak domestic demand cannot compensate for loss in external demand.
Automatic Stabilisers			
10 yr. avg. of change in tax revenue/change in GDP	1.3	2.2	*Tax revenues automatically adjust as economy accelerates or decelerates, providing a natural automatic stabiliser or shock absorber in the economy.*
Capacity for swift and effective policy response			
Fiscal - Public Debt (% of GDP)	23.6	44.4	*Higher public debt imposes a constraint on use of fiscal tools.* Inefficient fiscal stimulus disbursement.
Monetary - G7-Country Inflation over 8 yrs (%y/y)	-2.9	-0.7	*The greater the credibility the central bank has built up by controlling inflation not too different from major countries' inflation, the more latitude central bank has to ease*

Component/Indicator	2000	2008	Comments
			monetary conditions in a slowdown. Successful inflation targeting by the Bank of Thailand has seen gradual ease in monetary conditions.
External Financial Vulnerability			
Financially mobile capital (% of foreign exchange reserves)	97.8	74.6	*High financially mobile capital in relation to FX reserves and high current account deficit/GDP signify reduced resilience.*
Domestic Financial Vulnerability			
NPL Ratio	17.7	5.5	*A stronger banking sector with low non-performing loans is less likely to amplify an external shock by cutting lending drastically.* Financial sector needs to upgrade its regulatory and legal framework.
Vulnerability to oil prices			
Avg. excess production of energy (% of GDP)	-4.9	-2.6	*Country is more resilient if it is a net producer of energy.* Thailand's energy production has grown faster than its consumption since 2006, but this makes it only slightly less dependent on foreign oil: Thailand remains exposed to sharp surges in oil prices.
Political Stability			
Index of Stability	6.1	6.4	*Country with political stability is more resilient.* Political turbulence lowers chances of capital inflow, FDI inflow, plays down on consumer and investor confidence.

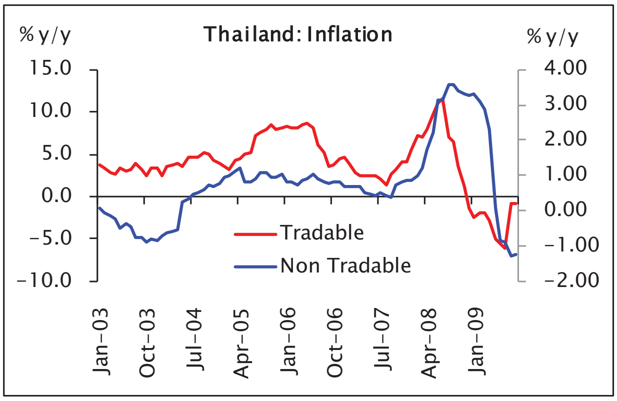
One important feature of the Thai economy that supports economic resilience is not captured by the above and that is its flexibility. The labour market is an example – businesses preferred to reduce working hours rather than retrench workers, mitigating the damage to consumer confidence. The currency also depreciated in real terms, helping to provide support to goods exports as well as tourism.

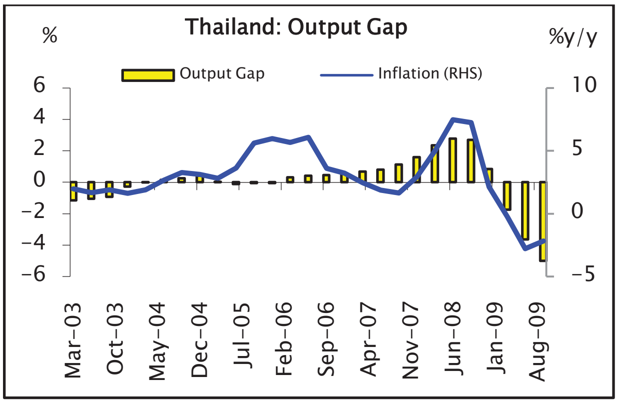
3.4 Implications for policy

First, with inflation risks remaining low, there is no urgency to tighten monetary policy in the near term

As Chart 3.17 shows, inflation remains subdued. Core inflation—as measured by inflation in non-tradable items—remains negative. Chart 3.18 explains why below potential growth since 2005 has left Thailand with substantial slack in its economy, reducing the risk of a surge in inflation. The risk to inflation comes from necessary adjustments to administered prices, which may be in place in 1Q10. However, we believe that the impact on core inflation will be muted. We also believe that Thailand has a lower exposure to the risk of a spike in global food prices because it is a net food exporter and has built up large reserves of rice and other food items.

Chart 3.17	Chart 3.18
Inflation remains subdued…	**…with substantial slack in resource utilisation**





Source: Collated by Centennial Group using CEIC Database.

Second, the fiscal stance is appropriate; the policy focus should be on addressing structural weaknesses in the implementation of fiscal initiatives

The current level of public debt is sustainable but the disbursements under the “Thai Khem Kaeng” programme will raise the ratio of public debt to GDP over time, but to a still manageable level. The Public Debt Management Office estimates this ratio to rise from a forecast 53% in 2010 to 56% in 2011 and 58.5% in 2012 before falling from 2013 onwards.

Consequently, and in the light of our economic assessment above, we believe that the shift in the fiscal balance from a surplus of 0.1% in 2006 to an estimated -4.0% in 2009 and projected -4.2% in 2010 is appropriate. The two main measures of Stimulus Package 1 of January 2009 and May 2009 were cash transfers and subsidies directed at increasing private consumption and infrastructure development and are outlined in Table 3.4A. Table 3.4B provides details on the second and much larger stimulus programme “Thai Khem Kaeng”.

Table 3.4A: Stimulus Package 1

Type of scheme	Amount	Details	Coverage
Cash Handouts: Save the Nation Cheques	B116.7 billion	▪ Aimed at low income earners. ▪ The government will give out B2000 cheques.	▪ About 9,000 persons included in the scheme. ▪ Mainly civil servants, members of social security fund, teachers) earning less than B15,000 a month.
Vocational Training programmes	B6.9 billion	▪ Free vocational training for up to a month. This includes living and transport costs. ▪ Those who return to their home province receive an additional grant of B4800 for up to three months.	▪ Expected to cover 240,000 unemployed workers in 2009 and 260,000 in 2010.

Source: Collated by Centennial Group using media reports.

Table 3.4B: Spending Allocation Plan for Thai Khem Kaeng

Baht billion	2010	2011	2012	Total
Phase1	**378**	**341**	**345**	**1,064**
Irrigation and water management	65.7	78.4	78.4	222.5
Irrigation expansion and maintenance	45.0	61.0	65.0	171.0
Mass transit/Railways	35.5	70.7	75.2	181.4
6 lines	31.5	62.7	67.8	162.0
Railways	2.9	7.3	7.4	17.6
Air	1.0	0.6	0.0	1.6
Roads	55.6	46.7	52.2	154.5
Highway expansion & maintenance	36.3	29.4	32.0	97.7
Provincial dust-free road	14.8	9.8	9.8	34.4
Energy/Power	76.7	37.5	42.4	156.6
PTT	72.7	25.5	15.6	113.8
Electricity	4.0	12.0	26.8	42.8
Telecom (3G)	19.5	5.3	0.0	24.8
Misc	124.6	102.8	96.6	323.9
Tourism	5.7	4.9	3.0	13.6
- Promotion etc.	*4.1*	*2.2*	*1.7*	*8.0*
- Infrastructure	*1.6*	*2.7*	*1.3*	*5.6*
Healthcare (construction, facilities, supplies)	31.8	35.5	31.0	98.3
Education (construction, facilities, training)	43.9	42.0	42.7	128.6
R&D	2.6	3.4	5.2	11.2
South	12.7	13.3	12.1	38.1
State banks recap	14.5	0.0	0.0	14.5
Others	14.8	4.9	4.0	23.8
Phase2	**74.8**	**64.4**	**89.8**	**229.0**
Phase3	**0.0**	**46.2**	**92.5**	**138.7**
Total investment under TKK	**452**	**452**	**527**	**1,431**

Source: Collated by Centennial Group from Thai government sources.

However, the impact of the fiscal programme on boosting the economy will be constrained by structural characteristics of fiscal system in Thailand:

- **Low disbursement/implementation rate.** The past record of fiscal disbursements has been slow but the current stimulus programme appears to be on track for an improved pace of disbursement.

- **Low multiplier.** The multiplier for government investment spending is only about 0.9 or 1.0, according to both the Bank of Thailand and the National Economic and Social Development Board (NESDB).

- **Leakages from the fiscal package.** The import content of infrastructure projects is high. With 70% of the second stimulus package comprising infrastructure spending, the NESDB estimates that about 30% of the package will leak abroad in the form of imports.

We believe that so long as there are no political disruptions in 2010, the disbursement of the remaining stimulus package will be efficient.

Third, Thailand needs to diversify its demand base towards domestic demand, but this will involve structural reforms that will take time to yield results

Longer term rebalancing of the economic structure should be pursued to relieve the economy's heavy reliance on exports to propel growth.

- ***Expanding the spread of social security nets.*** The current social insurance welfare and insurance schemes need to be broadened to include the poorest sections of society.

- ***Raising total factor productivity.*** Higher productivity will allow Thailand to remain competitive through the medium term, and will result in higher wages, real income, and purchasing power of the working population. The government should concentrate on ensuring availability of vocational and technical education facilities, a particular weakness in Thai competitiveness.

- ***Reducing dependence on energy imports.*** Thailand's economy remains among the more vulnerable to oil price shocks in Asia. In addition to not having enough domestic energy sources, inefficient usage of energy is another problem in Thailand. The government needs to advocate the importance of energy conservation, as well as to promote the usage of more energy-efficient appliances by both households and firms.

Fourth, legal uncertainties that hurt the business climate need to be addressed

For instance, the legal issues which have prevented the disbursement of $42 billion investment programme in the Map Ta Phut industrial estate. The Federation of Thai Industries estimates that the standoff would have caused damage of up to B100 billion through its impact on investor confidence and delays. [6]

Fifth, Thailand needs to strengthen its exports by diversification and climbing up the ladder of value chain

Although Thai exports are fairly diversified, the US, Europe, and Japan remain the main export markets for Thai goods. Thailand needs to diversify away from the G3 economies and toward Asia. Simultaneously, as competition in low-value manufactured goods from countries such as Viet Nam intensifies, Thailand needs to move up the value chain to produce higher value added exports.

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[6] Thailand Business News. 2009. Federation of Thai Industries (FTI): Map Ta Phut Impasse cost up to B100 billion.

Report 6

Impact and Policy Responses
Indonesia, Philippines and Thailand

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