

COUNTRY SECTIONS

LARGER ECONOMIES

CHINA

China's real economy has been hit hard by the global crisis, but has been holding up. Indeed, China has fared better than many other countries because it does not rely on external financing, its banks have been largely unscathed by the international financial turmoil and it has the fiscal and macroeconomic space to implement forceful stimulus measures. Indeed, the authorities have used the space and shifted to easing monetary policy in the fall of 2008 and introduced a RMB4 trillion stimulus package (equivalent to \$587 billion) in early November. Government spending was increased starting in November, leveraged by increased bank lending, initially for infrastructure projects and of late for both companies and households.

As the global crisis has intensified, however, China's exports have declined sharply, and this is affecting market-based investment and sentiment. As the impact of the crisis deepened in the U.S., Europe and Japan and started to hit demand in many emerging markets, China's exports fell sharply in November with the decline accelerating to 21 percent year-on-year in dollar terms. Real estate investment continues to weaken in response to depressed housing sales, despite recent measures to boost the property market. Other market-based investment has also decelerated, notably in manufacturing, held back by subdued exports and profits and the emergence of spare capacity. In all, quarter on quarter GDP growth declined steadily throughout 2008, falling to 2.5 percent in seasonally adjusted annualized terms in the fourth quarter to a level 6.8 percent higher from a year earlier.

Slower growth has resulted in reduced employment. The official urban unemployment rate rose by 0.2 percentage points to 4.2 percent in the year to the fourth quarter of 2008. However, with large sections of the working population (including migrants) not eligible to register as unemployed, registered unemployment captures only a small part of the pressure. According to a survey held by the Ministry of Agriculture, 20 million workers (15 percent of the total) lost their job before the Chinese new year festival. The Ministry of Human Resources and Social Security estimates that of the 70 million rural migrant workers who returned home for the Spring Festival, about 80 percent (56 million) came back to urban areas. Of this group, about 11 million had not yet found a job in early March.¹

Looking ahead, the continued global crisis is bound to contain China's growth in 2009 and 2010, especially via weaker exports and market-based investment. The forceful stimulus policies will help dampen the downturn. Indeed, government-influenced investment is accelerating. Moreover, banks are in a position to lend, after having deleveraged in recent years. And private consumption should continue to grow, although rural consumption is likely to lag. However, China cannot escape the external weakness. In light of the very weak external outlook, we expect China's exports to shrink in 2009. Although government influenced activity will support growth, it makes up a modest share of the total and will not (and probably should not) offset fully the downward pressures on market-based activity.

Overall, thanks to the substantial policy stimulus, China's economy should continue to grow significantly in a very challenging external environment. In all, we project GDP growth of 6.5 percent in 2009. In our scenario, government-influenced direct expenditures would contribute 4.9 percentage points to GDP growth, three-fourth of the total. Two-thirds of the government contribution will come from government-influenced investment and the rest from direct government consumption. There are both

¹ China's labor market data is very weak, so it is difficult to have a good picture of overall trends. This led the government to initiate more additional, comprehensive labor market surveys this year.

downside and upside risks to this GDP growth projection. Projected real GDP growth is significantly below potential, and spare capacity is likely to lead to weaker market-based investment, lower job growth and migration, and downward pressure on prices. Indeed, inflation is likely to be very low in 2009. We also expect to see redirection of exports to the domestic market, and import substitution in the coming years.

China's economic fundamentals are strong enough to allow policymakers to consider policies that will affect the economy well beyond 2009. So far, the policy response to the downturn has emphasized stimulating investment to help achieve the economic growth targets. This was a sound response, since it provided rapid support for activity and sentiment at a very difficult moment for the global economy. Looking ahead, less focus on targeting short term GDP growth would allow for more emphasis on the rebalancing and reform agenda.

There are useful synergies between China's short- and medium-term policy objectives. The subdued prospects for the global economy—and thus for exports—increase the importance of boosting domestic demand and domestic consumption, which is also key for rebalancing. Thus, recent initiatives to stimulate consumption and improve people's livelihood by expanding the government's role and spending on health, education, and social safety are very welcome, and there is room to do more.

Subdued inflation prospects imply space for continued expansionary monetary policy. Deflation is a risk, but in China the government has some tools to fight it. Given the prospects of continued large current account surpluses, policymakers do not need to worry about a somewhat reduced pace of capital inflows or even some net outflows.

INDONESIA

Indonesia's slowdown has come relatively later and has so far been more moderate than for many countries. Real GDP growth in the fourth quarter slowed to 5.2 percent year-on-year from 6.4 percent in the third quarter. For 2008 as a whole the Indonesian economy expanded by 6.1 percent, only slightly below the 6.3 percent pace registered in 2007. Nevertheless, the slowdown late in the year was broad-based as weakness spread to private consumption, exports and investment, with only declining imports and expanding government spending providing some offset. A notable outlier was the increase in agricultural production to 4.8 percent, the highest growth since 1992. Agriculture now accounts for 14.4 percent of total output and provide most or all of the support for 42 percent of households.

Indonesian financial markets have followed the ups and downs of recent global trends. After being severely affected in October and early November, they strengthened with renewed global confidence from late November, before weakening again in mid-January as market participants' perceptions of the global situation deteriorated. More recently, Indonesian markets have strengthened again in response to policy shifts in the major economies, and Indonesian moves to shore up financing that included contingent financing for the budget from development partners and swap agreements with Japan and China. After settling at around Rp11,000 per dollar in December, the rupiah depreciated gradually to well over Rp12,000, before recovering again recently. By the end of the year Indonesian government bond yields had recovered much of their October and November losses (when, for example, yields on five-year government bonds denominated in rupiah rose to more than 20 percent), but then retreated again in line with renewed global risk aversion. They have been recovering again recently and five-year yields now stand at 11.3 percent. Front loading its financing needs, Indonesia issued \$2 billion in ten-year bonds and \$ billion in 5 year bonds in February.

Although Indonesia's direct exposure to troubled American- and European-domiciled banks is limited, Indonesian bankers are becoming more conservative in line with tightening in global financial conditions. Far fewer new loans are being approved, and anecdotal reports suggest that new customers are having difficulty accessing credit. While interbank lending has been improving since November and there is sufficient overall rupiah liquidity in the system, it is not well distributed with larger banks typically liquid and smaller banks facing problems. Nevertheless banking sector indicators continue to be relatively good.

After several years of strong and sustained growth lifted by rising commodity prices, the global downturn hit Indonesia's trade flows in late 2008. Indonesia's exports rose 20 percent in 2008 to \$136 billion. But the fall in commodity prices and to a lesser extent the decline in global demand had the anticipated impact on exports in the last quarter of 2008. By January, export values had dropped by 36.1 percent (year-on-year), the largest monthly fall in a decade. The dramatic decline in oil prices and associated falls in other commodity prices drove much of this drop in value. According to the national accounts statistics, real exports were up only 1.8 percent from a year earlier in the fourth quarter. Imports are closely linked to exports and have been falling rapidly as well. Real imports were down 11.7 percent from a year before.

In response to weaker foreign demand and lower commodity prices, firms have begun reducing investment and laying off workers, although the pace of labor shedding has been slow so far. Employers in the formal sector have reported around 30,000 permanent redundancies out of a formal sector workforce of about 36 million by early 2009 (total labor force is 105 million), although newspaper reports suggest the number may be above 200,000, including contract workers.

Inflation has slowed sharply with the fall in commodity prices. Reductions in international prices are passing into domestic and regulated prices (as fuel prices have been adjusted downward). Consumer prices have stabilized, with an average monthly increase of just 0.1 percent from November to February, reducing 12-month inflation to 8.6 percent from its peak of more than 12 percent in September. Inflation has dropped more for poorer households whose consumption basket has a greater weight in food. Consumer inflation expectations are now at their lowest level since early 2005, when actual inflation was running close to 5 percent. Lower inflation and the deteriorating global economy have prompted the central bank to lower its policy rate by 125 basis points in the last three months.

Indonesia's external position remains sound, though weaker than 2007. Developments in global commodity and financial markets buffeted Indonesia's balance of payments throughout 2008. While the current account ended in a small surplus of \$600 million portfolio outflows at the end of the year moved the overall into deficit at \$1.9 billion, the first since 2001. After declining by close to \$10 billion in September and October foreign reserves have subsequently been relatively stable rising slowly from \$50 billion to \$54 billion in mid-March, equivalent to about 4 months of imports and official debt repayments.

Indonesia's government is well-positioned to respond to the downturn. In 2008 the fiscal deficit was just 0.1 percent of GDP, compared with 2.1 percent projected under the 2008 budget earlier in the year when international oil prices and Indonesia's energy subsidies peaked. Revenues were 9.6 percent above budgeted levels, due to high commodity prices and improvements in tax office administration while underspending continued as in recent years. Despite the depreciation of the rupiah, government debt continued to decline relative to GDP, reaching 33 percent by year-end.

In anticipation of declining revenues and the need for fiscal stimulus, parliament approved a revised 2009 budget with a 2.5 percent deficit target including a stimulus equivalent to 1.5 percent of GDP. The revised budget seeks to stimulate demand, expanding government spending on infrastructure, and lowering taxes for specific sectors, in addition to the already-programmed reductions in taxes. This stimulus will add to the government's financing needs in 2009, which the government plans to meet by drawing

government deposits and by raising \$12.5 billion in external and domestic markets. By mid-March the government raised nearly half this amount.

The global downturn, lower global commodity prices, and tighter global financing will continue to slow Indonesian growth. The sharp downturn in the global economy combined with the fall in commodity prices imply lower external demand and reduced incomes in exposed sectors and regions. Tightening domestic credit conditions and greater uncertainty about the global outlook are reducing investment and purchases of consumer durables. Together these factors are expected to slow growth to 3.4 percent in 2009, before a gradually recovering global economy in 2010 pushes growth back into the 5 percent range. The crisis is expected to put pressure on poverty but some protection is provided by lower food prices, strong growth in agriculture and government programs including cash transfers and a program of community block grants that reaches national scale in 2009. Continued employment and income losses risk reversing these gains in 2010, although the Government is to be commended for its efforts to put in place a crisis monitoring and response system.

MALAYSIA

The economy started to lose steam late 2008. For the year as whole, growth slowed from 6.3 percent in 2007 to 4.6 percent in 2008. This slowdown is primarily attributed to growth grinding to a halt in the last quarter of 2008 (0.1 percent year-on-year) due primarily to a drop in external demand and private capital formation. Business sentiment has deteriorated sharply, and consumer confidence has started to weaken due to rising job insecurity, falling equity prices, and less supportive oil and rubber prices.

With the export-oriented manufacturing sector set for a rough ride, an economy-wide contraction seems inevitable. The manufacturing sector contracted 8.8 percent in the last quarter of 2008, and worse is likely to come as exports fell 7.5 percent during the last quarter of 2008 and a larger still 28 percent in January, the largest drop in decades. Malaysian exports are relatively undiversified in terms of products and markets. The key electronic and electrical goods industry is leading the contraction. The impact on external demand is mitigated by the fact that exports have high import content. Even so, with exports expected to fall more sharply than imports, the poor outlook for the world economy will drag the open Malaysian economy into contraction.

Real GDP is projected to decline 1 percent in 2009, with risks tilted to the downside. Growth in domestic demand is likely to suffer a pronounced slowdown, even if it may not enter negative territory (from an increase of 6.9 percent in 2008 to 0.5 percent in 2009). This is thanks to the relative resilience of private consumption and the government's stimulus packages. Private capital formation, however, is expected to take a hard hit. With global conditions unlikely to improve, external demand is expected to face an intensified contraction (from -3.8 percent in 2008 to -21.8 percent in 2009). The outlook beyond 2009 remains highly uncertain. A gradual recovery is expected for 2010, but this remains subject to a large degree of uncertainty.

Against this backdrop, labor market conditions may weaken considerably. So far, though, the impact has been relatively muted. Retrenchments have been on the increase, but not yet on a very large scale. Companies are also cutting labor costs in other ways, including by reducing working hours. Still, several factories, particularly in the electronics sector, have had to close or reduce operations substantially. Sizeable job losses are also observed in trade, hotels and restaurants, and in the financial services sectors. The unemployment rate was at 3.7 percent in 2008 but could well rise to over 5 percent in 2009. This increase in unemployment would be larger than the one observed during the Asian financial crisis.

External balances have remained comfortable thus far. The current account balance rose from 15.6 percent of GDP in 2007 to 17.4 percent in 2008. The trade balance remained in surplus as imports dropped more heavily, particularly for intermediate goods which accounted for 70 percent of all imports. For 2009, a lower trade surplus is likely to materialize, causing the current account balance to decrease to 15.1 percent. Large net outflows of portfolio and direct investments occurred in 2008. Where FDI inflows were reasonably high in 2008, this is unlikely to be the case for 2009. Further portfolio outflows are also possible. International reserves are currently at about \$91 billion (or about four times short-term external debt), which is nearly 30 percent lower than the peak in June 2008. The ringgit has depreciated continuously over the past 12 months. The current level (RM 3.64 per U.S. dollar) is 15 percent weaker than that in April 2008.

The aggregate picture for the financial sector remains one of strength. Banks are sound and have the capacity and liquidity to support private sector borrowing. The system's capitalization is adequate, with the risk-weighted capital ratio at 12.6 percent. Asset quality improved over 2008, with the non-performing loan ratio at 2.2 percent in January. NPLs did however rise over the last quarter of 2008, especially in the manufacturing and household sectors. This trend, if continued, could lead to isolated pockets of vulnerability. Key in this regard will be the evolution of export orders, farm incomes, and labor market conditions. Asset quality problems related to troubled financial institutions in mature markets are unlikely, as exposures have been limited.

The pace of poverty reduction is likely to slow. During the last crisis episode, poverty incidence rose from 6.1 percent in 1997 to 8.5 percent in 1999. National poverty has since declined to 3.6 percent in 2007 but is more severe in rural areas (7.1 percent). During the current episode, a combination of job losses, shorter working hours, and lower wages in the production and services sectors could raise urban poverty. For many rural, net-producer households who benefited from agricultural prices hike in 2008, such windfall will disappear if palm oil and rubber prices fall as expected. Rural households that rely on remittances from family members working in the urban areas will also be adversely affected. Meanwhile, month-on-month changes in the CPI food items indicate that food prices have continued to rise over the past several months, as opposed to the overall CPI. This disproportionately hurts low-income groups as food items account for a higher share of their expenditures. Inflation has also been higher in Sabah and Sarawak, where poverty incidence is greater.

Facilitated by a decline in inflation and against a background of weakening activity, monetary policy has been eased. The central bank cut its key policy rate from 3.5 percent in November in three steps to 2 percent and reduced required reserves from 4 percent of deposits to 1 percent. Twelve-month inflation fell to 3.7 percent in February 2009 from a peak of 8.5 percent in mid-2008. Easier policy is not fully reflected into easier financial conditions, however, with commercial banks limiting cuts in lending rates. Banks have also taken a more cautious approach towards extending credit. The scope for further cuts in the policy rate is limited as the central bank has indicated that a near-zero policy rate policy is undesirable.

Two fiscal stimulus packages have been announced. Since Malaysia cannot export its way out of the recession and the scope for monetary policy easing is limited, the main burden has been on fiscal policy. The authorities announced a first stimulus package in November 2008 (RM7 billion or 1 percent of GDP) and a second one in March 2009 (RM60 billion or 9 percent of GDP). The second package is spread over two years and includes spending measures (RM15 billion), guarantee funds (RM25 billion), equity investments (RM10 billion), private finance and off-budget initiatives (RM7 billion) and tax incentives (RM3 billion). The direct fiscal injection implied by the package is estimated at about 3.5 percent of GDP over two years, and consists of about 80 percent of spending measures (mostly investment expenditure) and 20 percent tax cuts.

The effectiveness of the fiscal stimulus depends on a number of factors. One factor is the extent to which the direct impact of the fiscal incentives is translated and multiplied into aggregate economic activity. Key here is the propensity of recipients to consume

or invest in the case of households and nonfinancial corporations and to lend in the case of financial corporations. A second factor is the rate and speed of disbursement. The government estimates that 75 percent of the total amount of the first package will be disbursed by June 2009 or 7 months since its launch. Given that the second package is much larger and entails a wider range of initiatives, there is a risk that the rate and speed of disbursement could be lower.

Fiscal discipline and consolidation are crucial to medium-term growth. The government's stimulus packages, if implemented in full, will result in the fiscal deficit rising from 4.8 percent of GDP in 2008 to 7.6 percent in 2009, substantially higher than the deficits recorded in the last several years. The deficit could be higher still if revenues decline by more than projected.

PHILIPPINES

Economic growth slowed markedly in 2008 following years of sustained expansion. The boom years, however, were disturbed by a series of major external shocks, including the food and fuel price shocks, the global financial crisis and the global recession. The food and fuel price shocks caused inflation to rise to a decade-high, squeezing household income and bringing significant hardship to the poor. Then the global financial crisis led to a collapse in domestic asset prices and a disruption of credit markets, bringing corporate and financial sector earnings down and public investments on hold. Finally, the global recession is taking its toll on the real sector as exports and remittances fall relative to GDP, and unemployment and underemployment rise. As a result, growth in 2008 slowed to 4.6 percent from a record high of 7.2 percent in 2007. Despite these shocks, confidence in the country has remained strong with Moody's and Standard and Poor's both maintaining their positive outlook for the Philippines citing its strong macroeconomic position.

Inflation reached a decade high of 9.3 percent in 2008 largely due to the rapid increase in food prices and to a lesser extent fuel prices. Rice inflation accelerated and peaked at 50 percent in July 2008. Core inflation has fallen since November as inflationary pressures started to recede more sharply after the financial crisis entered a more tumultuous phase in September. However, month-on-month headline inflation once more increased in February. Notwithstanding the latest price developments, monetary policy has remained accommodative, allowing a total of 125 basis points cut in policy rates since December.

The country's external position sharply weakened in 2008 due to a sharp drop in exports, elevated import bill, slowing remittances, and retreating capital. In the first half of 2008, strong remittances, moderate growth in exports and imports, and net capital inflow enabled the country to accumulate a balance of payment surplus of US\$1.9 billion. However, this was quickly eroded in the second half of 2008 by the rising import bill, moderating inflow of remittances, rising capital outflow, and in recent months, plummeting exports. By year end, the balance of payment position fell to US\$89 million—the lowest in four years.

The domestic financial market has remained volatile since September 2008 with lingering risk aversion and weak investment appetite. Equity prices fell by another 2 percent this year following the 49 percent decline in 2008 with the massive sell-off of foreign equity holdings equivalent to about \$1 billion. Borrowing spreads, which had fallen below 200 basis points in 2007, jumped to over 800 basis points in October before improving to 500 basis points by the end of 2008. After appreciating strongly in 2007, the peso weakened about 14 percent against the dollar in 2008 and a further 2 percent in 2009. The negative wealth effect of the collapse in asset prices should however be contained as less than 2 percent of the population is estimated to have investments in equities, fixed-income and other instruments.

Overall, quoted companies have also weathered the global economic and financial shocks well to date. In the first three quarters of 2008, total net earnings of companies listed on the Philippine Stock Exchange fell by 20 percent to P163 billion. Holding firms, financial institutions and services firms suffered the biggest drop in profits (42, 37, and 27 percent respectively). The drop in total earnings stems partly from foreign exchange transactions and hedging losses. Pre-payment of debt in the last three years, however, has served to limit the impact of currency volatility in some firms. Corporations have also deleveraged considerably—with average debt/equity ratios of around 0.5. For the banking sector, significant impairment provisions and mark-to-market losses have weighed earnings down by about 36 percent through September. The impact would have been bigger had the central bank not allowed a change in accounting rules to enable banks to avoid further mark-to-market losses on their significant amount of bond holdings. Moody's recently changed their Philippine banking sector outlook to negative, citing expectations of lower banking earnings and worsening balance sheets in the future. Nonetheless, the financial sector remains financially sound with a capital adequacy ratio higher than required.

A few sectors of the economy are however facing a particularly challenging environment. Export-oriented firms, especially semiconductor manufacturers, have reported large losses in revenues due to the collapse in global demand. Semiconductors and other electronics manufacturers such as automotive parts which account for 60 percent of total exports have seen demand fall by as much as 60 percent in recent months. Other export industries reporting a sharp downturn in activity include the labor-intensive garments, furniture, footwear, and handicraft industries. The agribusiness and mining sectors have also been affected with the fall in commodity prices, while the property sector is exhibiting early signs of impending localized stress.

The economic slowdown is already taking its toll on the labor market, albeit the impact will be felt with a lag. The unemployment rate increased to 7.7 percent in January from 7.4 percent a year ago, with employment of less skilled workers being disproportionately affected. Along with the slump in exports, the manufacturing sector continued to shed jobs, posting about 120,000 job losses through January. Labor absorption in the transportation, communications and financial sector has also declined but to a lesser extent. The government reported that as of March 2009 there were about 45,000 job losses from Filipino overseas workers and electronic industry workers while more than 30,000 workers were affected by forced leave, reduced work-hours and other cost-cutting measures implemented by companies.

To stimulate the economy, the government has postponed its medium-term balanced budget goal to 2011 and announced an Economic Resiliency Plan (ERP). Despite the ambitious size of the ERP (4.1 percent of GDP), the actual impact of the plan in 2009 is estimated to be limited. A rapidly deteriorating tax effort is a key concern to undertaking a credible and controlled fiscal easing in 2009. While the draft 2009 budget envisages an overall deficit of 3 percent of GDP on a GFS basis, revenue shortfall could undermine the government's spending plans aimed at protecting its poor and vulnerable citizens and boosting medium-term growth prospects.

Growth in 2009 would likely slow to 1.9 percent. A key downside risk lies on how vulnerable remittance inflows are to the global recession. Domestic demand, boosted to a large extent by strong remittances since 2001, has been the most important growth driver for the economy.

THAILAND

Real GDP growth slowed to 2.6 percent in 2008 from 4.9 percent in 2007. In the first three quarters of 2008, output grew 5.1 percent year-on-year thanks to robust exports and investment. Starting in October, however, the sharp decline in global

demand, amplified by the domestic political crisis took a toll on growth and real GDP contracted 4.3 percent year-on-year in the fourth quarter. While Thailand's financial sector was mostly insulated from the financial crisis, the real sector was impacted quickly, and export volumes contracted in October for the first time in six and a half years. Political unrest and the shutdown of the two airports in Bangkok in late November severely affected tourism and consumer confidence.

Real GDP is projected to contract by 2.7 percent in 2009, as the global outlook remains negative and external demand continues to contract. The fiscal stimulus and monetary expansion implemented by the authorities are likely to partially mitigate the impact of the slowdown, allowing growth to resume in the fourth quarter of 2009 assuming a better outlook for the global economy in 2010. However, significant downside risks remain should political instability resurface and the global decline proved more protracted or steeper than now expected

Inflation has been easing with the slowdown in economic activity and the decline in oil and food prices. After peaking at 9.3 percent in July 2008, 12-month inflation fell to only 0.4 percent in December, although the average for 2009 at 5.5 percent was roughly double the level in 2007. Core inflation averaged 2.3 percent in 2008, within the central bank's target of 0-3.5 percent. In January and February, prices declined 0.3 percent from the first two months of 2008, but this has been driven primarily by fuel prices, with other prices still increasing year-on-year. Given the increased excess capacity in the economy and the continuing decline in global oil and food prices this year, inflation in 2009 is expected to be negligible.

Export volumes are projected to contract 16 percent in 2009 after a 6 percent expansion in 2008. Exports of services, more than half of which were accounted for by tourism receipts (around 8 percent of GDP) will also be heavily impacted by the slowdown in arrivals from advanced countries (40 percent of total tourists). Accordingly, exports of services are projected to contract by 6.6 percent this year. Import volumes should contract more than exports due to businesses running down inventories and a contraction in overall investment and consumption of imports. Net foreign demand will nevertheless contribute negatively to growth since in real terms exports represent a much larger share of GDP than imports.

Private investment has been subdued in the past three years due to uncertainty about the political situation. In 2006-2008, investment grew by an average of 2.7 percent a year (compared with real GDP growth of 4.3 percent on average), down from 14.8 percent during 2003-2005. This earlier retrenchment of investment has dampened the impact of the financial crisis, most notably on foreign direct investment (FDI). While little new FDI is expected, there has been no rush to exit from foreign investors. Growth of private investment in 2008 came mainly from Thai investors, as gross FDI inflows declined from 2007 levels. Private investment is expected to contract 5 percent in 2009 as capacity utilization remains low (around 50 percent). However, growth could resume in the fourth quarter on the back of increased public investment.

Public investment has been sluggish since the 1998 crisis, but is expected to increase in 2009 given increased political stability and the political imperative to respond to the slowdown in the export sector. The share of public investment in real GDP averaged only 5.7 percent during 2004-2008 compared more than 10 percent before the 1998 crisis. In 2008, public investment contracted by nearly 5 percent as a result of political uncertainties, which delayed investment decisions. Public investment is projected to grow at 7 percent in 2009 as the implementation of large infrastructure projects step up.

Fiscal policy has become expansionary to mitigate the impacts of the crisis. The government is implementing two sets of stimulus measures, one of 1.5 percent of GDP targeted at FY09 (announced in January) and a recently-announced plan for FY10-12 (fiscal years run October-September) that anticipates deficits as high as 5 percent of GDP. As a consequence, government consumption is expected to increase by nearly 10 percent in 2009.

The current account registered a small deficit in 2008, and is expected to turn to a surplus starting in 2009 supported by a steep decline both the price and volume of imports – especially fuel. The small deficit registered in 2008 was mostly due to the increase in imports and reduced exports and service receipts in the second half of the year. The financial account is expected to register modest net outflows in 2009 as portfolio investments continue to show outflows, while FDI net inflows will continue to be positive, but at a lower level compared to the past few years. After falling from \$117 billion in March, foreign exchange reserves have increased since September, reaching \$111 billion at the end of 2008, equivalent to 8 months of imports and 4.7 times short-term external debt.

External debt is low at around US\$65 billion or 25 percent of GDP. About 38 percent of the external debt is short-term, but trade credits – which increased with commodity prices – represent more than half of private short-term debt, while another 20 percent are intercompany loans. Public external debt (primarily owed by state-owned enterprises) comprises 20 percent of total external debt and less than one percent is short-term. External debt service ratios are manageable at 5.4 percent of exports overall. Total external debt was under 60 percent of international reserves at the end of 2008.

The Thai financial sector is basically sound and has been largely insulated from the immediate impact of the global financial crisis, but increasing pressure from the slowdown on companies will be passed to banks. The average capital adequacy ratio amounted to about 14 percent at end-2008. Net NPLs declined during 2008 to 2.9 percent of total assets. While this trend is set to reverse during 2009, banks appear to have enough room, at least in the short-term, to cope with higher NPLs. There is adequate liquidity in the domestic banking system, but banks have become more cautious given that credit quality is expected to deteriorate. Credit expanded by 9 percent in 2008, initially due to higher demand for working capital, then as a consequence of large domestic firms switching from foreign to domestic borrowing. Credit growth slowed in January, and the ratio of loan to deposit decreased to 86 from 90 percent, suggesting some room for future loan growth.

Expansionary monetary policy has been employed to help mitigate the impact of the global financial crisis and is starting to be reflected in the financial sector's lending rates. As inflation rose rapidly in the first half of the year, the central bank hiked its policy rate by 50 basis points to 3.75 percent. The decline in inflation facilitated cuts to 2.75 percent in December and 1.5 percent in late February.

Market indicators confirm Thailand's relatively strong financial position. Large foreign exchange reserves, smaller gross financing requirements on both the fiscal and external side, and ample domestic liquidity are among the key strengths in the current crisis. Despite the political turmoil late last year, CDS spreads have risen by about 100 bps less than some other East Asian countries since the onset of the global financial crisis in mid-September.

VIETNAM

Against the odds, Vietnam had a decent year in 2008. It suffered from two major shocks. The first was the overheating domestic economy starting in late 2007 due to massive capital inflows which led to inflation acceleration, asset price bubbles and a larger trade deficit. The second was the global slowdown starting in late 2008, including the tightening of credit markets, the plunge in commodity prices, and decline in world trade. The authorities were determined in their policy responses: by March 2008, government priorities shifted from growth to stabilization. In November 2008, they shifted again to supporting economic activity. For 2009 as a whole, growth is projected to slow to 5.5 percent.

The year 2008 witnessed some positive policy developments. The authorities were not experienced in managing the volatility stemming from the increased openness of the economy to the rest of the world. However, they climbed quickly the steep learning curve and did well in managing the economy. There was growing awareness of the importance of having a technically strong central bank. They showed their ability to prioritize, postpone or cancel public investment projects. There was also a clear recognition of the risks posed by large state-owned enterprises creating or controlling financial intermediaries, and new willingness to reconsider the governance, oversight and investments of economic groups and state corporations.

There is low risk of a financial sector crisis in Vietnam. The direct impact of the global financial crisis on Vietnam is minimal, as banks in Vietnam were not exposed to “toxic” products, nor owned to a large extent by exposed foreign banks. Concerns regarding domestic problems stemming from reckless lending for real estate in late 2007-early 2008 are receding. Most of the loans issued during the asset price bubble have come to maturity, without boosting unduly the NPL ratio. The larger joint-stock banks increased shareholder capital, retained earnings and improved provisioning. State-owned banks were restrained in their lending and made large profits by buying bonds sold by foreigners. Even the smaller and weaker joint stock banks managed to increase their capital to the new legal minimum.

The risk of a balance-of-payment crisis is also low. The trade deficit during the last six months was around \$2.2 billion, while inflows of FDI, ODA and remittances in 2008 amounted to \$16 billion. Remittances and FDI disbursements held well during 2008. There is speculation about a dramatic slowdown in FDI disbursements going into 2009, but there is no evidence yet to support them. Remittances are not so much associated with migrant workers sending money to support the consumption of their families as they are with aging overseas Vietnamese investing in Vietnam for their retirement. This gives them some structural stability. The Vietnamese overseas community may suffer from the slowdown in industrial countries.

The trade deficit declined and recently shifted to a small surplus. It is true that the exports are declining, with a sharp decline in the price of exported commodities since mid-2008 and a drop in orders for garments, footwear and other products in late 2008 suggests that the downward trend will continue. But Vietnam may suffer less than other countries because it remains competitive, as demonstrated in its growing market shares. In 2009, it may be granted the Generalized System of Preferences by the U.S. In addition, imports are declining even more rapidly than exports, partly because the import content of non-commodity related exports are high. Foreign-invested enterprises are large net importers, so the slowdown in FDI inflows will translate into smaller trade deficit.

The smaller trade deficit projected for 2009 and short-term capital flows could reduce volatility in the exchange rate. There was very substantial real appreciation of the dong in 2008 which at 25 percent exceeded real GDP growth fourfold. It does not necessarily follow that substantial real depreciation will take place in 2009, but the authorities are gradually moving towards a more flexible regime.

Inflation slowed dramatically during the second half of 2008. The trend was partly driven by lower food and fuel prices in international markets, but it started earlier as a result of the determined stabilization program. However, the last two months have seen inflation inching up again. This is in part due to seasonal factors but may also reflect the rapid loosening of monetary policy.

Monetary policy has been well-timed to offset the shocks stemming from fluctuations in world prices and exports demand, although it may be due more to luck, than by design. Increased exchange rate flexibility and slower capital inflows during 2008

have made monetary policy more effective. The authorities are willing to use this tool; they have cut policy rates since June 2008 by 700 basis points to 7 percent in March 2009.

In 2009, fiscal policy will take a more prominent role. On the surface, the fiscal stance did not change in 2008. However, real GDP growth was lower in 2008 than in 2007, and the underlying trend appears toward some fiscal tightening. The Vietnamese economy faces insufficient demand in global markets, which is bound to translate into insufficient demand in domestic markets through plant closures and job losses. Cheap bank credit and loan guarantees can offset the fall in demand due to drying up of trade finance. But cheap bank credit will not encourage firms to produce if they do not have demand for their products. It would be more effective to support demand directly through transfers to households and public investment projects. Construction is the sector with the highest potential to offset the decline in manufacturing. The state budget for 2009 foresees a large fiscal deficit, consistent with an overall deficit of 7 percent of GDP. (In the past, however, outcomes have been lower than budgeted, and this may be the case this year as well.) The authorities have also announced a fiscal stimulus package consisting of a one-time cash handout to poor households, increased infrastructure spending, tax cuts, interest subsidies for working capital credits, and a credit guarantee for loans to small- and medium-size enterprises.