



THAILAND ECONOMIC MONITOR

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Overview

The Thai economy remained resilient through the first three quarters of this year, amidst the sharp rise in food and fuel prices. In the first three quarters of the year, real GDP expanded by 5.1 percent year-on-year, compared to 4.6 percent in the same period of 2007. This was led by the robust export growth of 25 percent year-on-year in US dollar terms and 9 percent in real terms, not withstanding the continuous appreciation of the baht. Private consumption and investment also grew by more than they did in 2007, despite the sharp increase in food and fuel prices. On the other hand, public consumption and investments in real terms have contracted in the first three quarters as a result of slow disbursement rates amidst political instability and slow project completion as raw material prices rose sharply.

Real GDP growth in 2008 is expected to be 3.9 percent as the global economic slowdown and domestic political unrest weigh upon growth in the last quarter. Growth in the last quarter is expected to slow down to less than 1 percent year-on-year as exports of goods are negatively affected by the deceleration in demand of Thailand's major export markets. Exports of services, of which more than half are tourism receipts, have also been severely affected by the political unrest since October. As a result, manufacturing and services growth in the last quarter of this year will slow down considerably. Layoffs and work hour reduction, particularly in the manufacturing sector, have also started to rise, while private investment slows. As job security and income growth uncertainties increase, consumer confidence is falling and household consumption growth has shown clear signs of a deceleration. These trends will extend into next year as the global economy continues to slow.

Thailand's real GDP is projected to grow by 2 percent next year. This will be the lowest growth Thailand has seen since 1998, when real GDP contracted. The major factor weighing down growth next year is the sharp slow down in the global economy, particularly the contraction of the economies that are Thailand's major export markets – US, EU, and Japan. This will have a large negative impact on Thailand's exports of both goods and services which has been the major source of income and the driver of the output growth in the past few years. The US dollar value of exports of goods is expected to expand by only 8 percent in 2009, compared to around 20 percent this year. The political unrest in the last quarter of 2008 will continue to dampen tourist confidence into at least the first half of 2009. In addition, the slow down in growth of the economies from which a large number of tourists come to Thailand, such as EU and Japan, will reduce tourist receipts next year. With the slow down in exports capacity utilization is expected to fall; which will negatively affect private investment. Household consumption growth will also continue to be dampened as income growth will be slower next year with employment increasing minimally, and consumer confidence falling, even though inflation will be significant lower at only around 2 percent compared to 6 percent this year. Significant downside risks remain to the growth projection should political instability heighten, the global economy decelerate faster than projected, and implementation of the fiscal stimulus is delayed.

The impact of the global financial crisis on the Thai financial sector, on the other hand, has so far been limited. Although risk-sensitive indicators have risen since Lehman Brothers announced its bankruptcy on September 15th, they have been lower in Thailand compared to those in its East Asian peers – prior to the airport closure. Credit default swaps (CDS) spiked in line with global conditions and the stock market is down over 50 percent year-to-date. These were however, less than those in other East Asia economies. From September 15th to November 25th before the takeover of the airports, the baht has depreciated by 2 percent against the US dollar. It has, however,

appreciated against regional currencies by 6 percent. Similarly, the nominal effective exchange rate (NEER) had appreciated by 2 percent. During the closure of the airports in Bangkok from November 26th to December 2nd, the CDS rose and was on par with regional peers, while the stock market fell further below that of regional peers. As discussed earlier, the impact of the global financial crisis has been started to be felt in the real sector, particularly that of exports.

Strong external accounts have enabled Thailand to withstand the contraction in global liquidity.

International reserves remain relatively large and external debt – especially short-term debt – is low. International reserves stood at US\$106 billion in early December 2008 compared to US\$87.5 billion at end-2007. This is due to the large capital inflows in the first quarter of the year and again in the last quarter of the year. External debt is low at around US\$66 billion or 30 percent of GDP, of which two-fifths are short-term debt. Three quarters of the short term debt are trade credits and inter-company loans. Public external debt (government and state-owned enterprises) make up one-fifth of total external debt and less than 1 percent of it is short-term. Overall, external debt service ratios are manageable at 6.1 percent of exports.

The banking sector remains sound, but individual banks needs to be closely monitored.

Banks' foreign investments are less than 2 percent of their total asset with investment in foreign debt instruments being around 13 percent of total debt-instrument holdings. Foreign banks account for about 12 percent of the Thai market (although this figure goes up to 30-40 percent through equity holdings in Thai banks). Non-performing loans (NPLs) have been declining and stood at 3.3 percent of total loans in the third quarter of 2008, compared to 4.4 percent in same quarter of 2007. The adjusted loan-to-deposit ratio is around 90 percent. Average capital adequacy ratios are over 15 percent compared to Bank for International Settlement (BIS) requirement of 8.5. While these ratios suggest that the banking system as a whole is relatively sound, it is important to monitor individual banks, however.

Loan growth, however, will slow down next year.

As the economy slows down, liquidity in the global markets tightened, and corporate balance sheets weaken, commercial banks have signaled that they will focus more on risk management than on loan growth. Commercial banks' loan growth next year will likely be in a single digit after registering 11.2 percent growth as of October this year. A large share of loans in 2008 was for working capital as the cost of raw materials and fuel increased significantly in the first half of the year. Next year, loans will be more scrutinized for credit quality. Large corporations will increasingly turn to domestic borrowing as the cost of off-shore borrowing increases rapidly. Bank loans to large corporations will therefore to continue to expand, as their credit quality is generally high, but those to small and medium enterprises (SMEs) may not.

Expansionary monetary has been employed to help to mitigate the impact of the global financial crisis.

As inflation rose rapidly in the first half of the year, the Bank of Thailand (BOT) raised its policy rate by 0.5 percentage points to 3.75 percent. With inflation less of a concern in the coming year, the Bank of Thailand has lowered its policy rate from 3.75 percent to 2.75 percent in early December. Moreover, the Bank of Thailand also has the capacity to inject additional liquidity when needed. Commercial banks' interest rates are expected to decline next year, but probably by not as much as the policy rate, as banks will be cautious about maintaining their liquidity.

Measures will be needed to mitigate the short-term impact of the global crisis on low-income groups and small and medium enterprises (SMEs).

As economic growth slows down, there have been reduction in work hours and the rise in layoffs of workers from the manufacturing sector since September. It is expected that almost 1 million employees (or 2.6 percent of the workforce) will be laid off next year¹. These will lead to unemployment for some, while most will move to the informal sector. There will need to be targeted measures to assist these groups of people as well as programs to improve their skills, so that they are able to return to the formal sector employment when manufacturing growth rebounds in the next couple of years. Similarly, the impact of an economic

¹ Source: Federation of Thai Industries and Thai Chamber of Commerce

downturn on SMEs will be greater than on larger firms, as SMEs generally have less excess cash and ability to borrow from banks. Loan extension to SMEs as well as measures to increase their productivity and risk management are necessary for them to maintain their operations in the next few years, as well as remain competitive in the longer term.

The government has implemented several measures in 2008 to mitigate the short run impact of rising inflation and falling incomes. In 2008, the government issued four sets of measures – three of them are aimed at mitigating the impact of the rise in food and oil prices on households and businesses and one in October aimed at mitigating the impact of the global financial crisis. They include personal income and corporate tax reduction, tax deductions for investment, reduction in property sales transaction fees, subsidies on gasoline, water, electricity, and public buses and train services, direct transfers from the government to administrations at the grassroot level, as well as loans by specialized state-owned financial institutions to SMEs and households. However, additional measures to assist affected workers and SMEs in improving their productivity and capacity would enable them to better cope and withstand future shocks.

However, measures for the medium term that will enable Thailand to poise itself for higher and sustainable growth as the global economy recovers in the next few years are no less important. While coping and mitigating with the impact of the financial crisis in the short-run, it is equally important for all stake holders in Thailand to prepare for a recovery in global demand and ensure sustainable growth thereafter. The global economy is projected to recover over the next few years and, thereafter competition will intensify. Thailand should take the opportunity during the next few years to strengthen its productivity and competitiveness so that when demand resumes, Thailand will be in a position to jump the band wagon of global recovery. To do so requires serious efforts of all stakeholders in Thailand including the government, private sector, and academia. As these improvements take time, for Thailand to achieve them in time for the projected global recovery, the efforts must start right away.

In order to ensure Thailand's competitiveness in the near future, Thailand needs to improve its productivity and investment climate. Experience from countries that have managed to increase productivity and rise up the value chain such as South Korea and Taiwan have shown that productivity improvements at the national level are achievable with a concerted efforts by the private sector, government, and academia. Firms need to raise their productivity and adaptability to the rapidly changing macroeconomic environment and intensifying competition through greater product and service development, higher efficiency, and better risk management. Government should take measures to improve the country's investment climate such as streamlining the regulatory environment and improving public infrastructure which will help stimulate private investments as they help to reduce operating costs for firms. At the heart of productivity improvement is the quality of the country's human resource². Examples from Korea, Taiwan, and Singapore above have shown that improving the skills and knowledge of their human resource has enabled them to move towards a knowledge economy, which has in turn raised and sustain their productivity and competitiveness. However, these were possible through the collaborative efforts of the government, private sector, and academic institutions³.

Clarity and continuity in policy directions and greater public infrastructure investments are needed not only to help stimulate growth in the short-run, but also improve productivity for the longer-term growth. Political stability would help to regain investors as well as assure them the clarity and continuity of policy directions. These could help promote investments by the private sector amidst the unfavorable external environment. Greater public investments in infrastructure will also

² A survey of firms in 2007 showed that in addition to the macroeconomic environment, other aspects of the investment climate that needs to be improved in order to promote greater investment and productivity improvements by firms are skills of the workforce, regulatory environment and public infrastructure. See *Thailand Investment Climate Assessment Update* report (forthcoming).

³ See World Bank, *Moving Thailand Towards a Knowledge Economy* report (2008)

boost investor confidence and investments. Public investments would not only inject funds directly into the economy, but better infrastructure services will stimulate further investments and productivity of firms. Firms in the 2007 survey⁴ indicated that inadequate infrastructure services have led to increased costs, such as logistics costs, which have discouraged them from investing. This is consistent with the fact that public investment levels in Thailand have been relatively low with its share in real GDP at only 5-6 percent in recent years. This is because public investment was contracting since the 1998 crisis and only expanded in 2004-2007, before contracting again this year with delays in disbursement and project completion as a result of the sharp rise in construction material prices and political uncertainties. Starting next year, the government needs to speed up disbursements on public investments. The government could also raise the amount of public investment. It has the fiscal capacity to do so as public debt levels and debt repayments remain well below the fiscal sustainability guidelines.

⁴ See *Thailand Investment Climate Assessment Update* report (forthcoming)