

SECTION 1

OVERVIEW

A solid financial armor could not protect Thailand against the impact of the global financial crisis on its real economy. Despite a sound banking system and low external vulnerabilities, the Thai economy contracted 5.7 percent between October 2008 and March 2009, as the magnitude and speed of the contraction in foreign demand – and resulting shock to the real economy – has been greater than anticipated. There continues to be little impact of the global financial crisis on Thailand's banks: liquidity remained adequate as financial institutions did not face solvency concerns given their adequate capitalization and lack of exposure to “toxic” assets or risky derivative contracts. The combination of a sound financial sector, low external roll-over and balance-of-payment financing requirements, and, more recently, large current account surpluses, has led to capital inflows, build-up in reserves and an appreciation of the Baht relative to other currencies in the region. However, the impact of the global crisis on the real sector was far more severe than expected. Export volumes contracted by 8.9 percent in the fourth quarter of 2008, compared to the World Bank’s forecast in December of a 3.0 percent expansion. Exports contracted a further 16 percent in the first quarter of 2009. The aggravation of Thailand’s political crisis, which had been dampening investor and consumer confidence since 2006, compounded the shock to the real economy. As a result, real GDP contracted in the fourth quarter of 2008 and first quarter of 2009 after 38 quarters of growth, and is expected to contract for 2009 as a whole, the first annual contraction since the Asian financial crisis of 1997/1998.

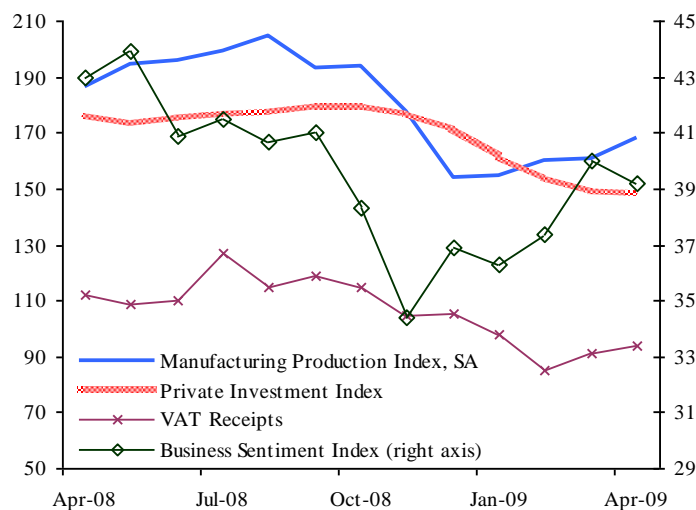
Despite some recent signs of improvement, real GDP is projected to contract by 2.7 percent in 2009 as the global outlook remains negative and the shock to external demand propagates to the domestic economy in a negative multiplier effect. Fiscal stimulus and monetary expansion may partially mitigate the impact of the slowdown, and signs of recovery in the global economy, including a possible bottoming out of trade volumes, support the view that positive growth may return in the fourth quarter of 2009. There are a number of downside risks, however. Although the political unrest that erupted in mid-April seems to have had limited impact on the economy, renewed tensions could further worsen the outlook for the year. In addition, whereas employment and purchasing managers’ index data for April and May seem to point to stabilization in the global economy, much uncertainty remains about the sustainability of the recovery, and substantial risks remain of new negative developments that could lead to a more negative outlook for the second half of 2009 and 2010.

Thailand’s immediate prospects depend primarily on an improvement in external demand. With domestic consumption subdued because of heightened uncertainties about employment prospects and political uncertainty, the pace of recovery of the Thai economy in 2009 will depend on a pick-up in external demand. Recent signs have been mostly encouraging, even if risks remain elevated. The pace of export contraction to ASEAN and China has declined in the first four months of 2009 compared to the last quarter of 2008, although exports to the “G3” (EU, the US and Japan) have, on aggregate, contracted at a faster pace (see Section 2.4.1). This reflects the recovery in China, which has been fairly robust. Stabilization in the economies of the G3, through its direct impact on Thai exports, as well as on Thailand’s East Asian trading partners, remains essential to a recovery in Thailand. On that front, there are mixed signs: purchasing managers’ and employment data have shown marked improvements in April and May, but at this point it is still unclear whether increases in industrial production are due to restocking or a more sustainable recovery.

Fiscal policy has become expansionary and will help mitigate the impact of the crisis. The government has announced two sets of stimulus measures, one of 1.5 percent of GDP targeted at FY09 (announced in January) and a plan for FY10-12 that focuses heavily on public investment and could add as much as 2.3 percent of GDP on average per year. Public investment has been sluggish since the 1998 crisis, but is expected to increase in 2009 given the political imperative to respond to the slowdown in the export sector. In the last twelve months ending in March 2009, public investment contracted by over 7 percent in real terms, largely as a result of political uncertainties, which delayed investment decisions. There is potential for government to catalyze private investment in the process of expanding public investments, but this will depend on effective and timely execution of investments, as well as an effective framework for private participation in public projects.

Recent data suggests a possible bottoming out of economic activity, but it is unclear whether the pick-up can be sustained. As shown in Figure 1, the Manufacturing Production Index (MPI) and the Business Sentiment Index (BSI), which also tracks manufacturing production, bottomed between November and January, and posted at least three months of month-on-month improvement until April. The decline in the BSI in April may not be informative given the political unrest that took place, and manufacturing production continued to improve on a seasonally-adjusted (SA) basis. The private investment index stabilized in April, although it still posted a decline for the sixth consecutive month. On the positive side, VAT receipts, a key indicator of private consumption, has been on an upward trend since bottoming in February. While consumer confidence continued to decline in April, the increased VAT receipts reflect that the fiscal stimulus disbursements of late March and early April have been put to work, which would have a positive multiplier effect on the economy. The key question remains whether the pick-up in production reflects an adjustment to over-shooting in the first quarter, but to a lower level of production, or a sustained recovery towards long-term year-on-year growth.

Figure 1. Key Real Sector Indices: April 2008 – April 2009



Source: BoT, World Bank calculations

Market indicators confirm Thailand's relatively strong financial position, which would be supportive of a recovery. Less than two weeks after the state of emergency was imposed, credit default swap (CDS) spreads were still about 35 bps lower, on average, than those of other East Asian countries since the onset of the global financial crisis in mid-September. The SET gaining 36 percent in 2009, close to the regional average and recovering some of the 48 percent decline posted in 2008 (a decline that was nonetheless in line with other regional markets). The Thai Baht had depreciated against the US dollar in the first quarter of the year, but in line with other emerging market currencies has appreciated since mid-

March. The Nominal Effective Exchange Rate (NEER) has been quite stable, appreciating by 0.6 percent since September 2008; in contrast, the average movement in other developing Asian countries' NEERs since September has been around 6 percent.

The labor market response has been primarily through a reduction in the quantity of labor, leading to increases in unemployment and reduced number of hours worked. Employment has contracted in 2009 as agricultural employment failed to absorb lay-offs from the manufacturing sector (as it had been doing since May 2008) and employers reduced work hours in an attempt to avoid outright layoffs, especially for employees with scarce skills. The unemployment rate has risen by nearly one percentage point or 329,000 more unemployed in the first quarter of 2009 compared to the third quarter of 2008, and the number of hours has also been reduced, with an additional 539 thousand individuals working less than 20 hours per week. Real wages were up 3.6 percent in the fourth quarter of 2008 and although they declined in the first quarter of 2009 by 6.6 percent, they come from a very high base (real wages were up 13.1 percent in Q1 2008). There are reports of declines in wages in low-productivity informal sector jobs, however, as individuals seek to make up income lost to reduced hours in primary jobs.

The social impact of the global financial crisis is expected to be felt primarily by the urban informal sector. The structure of Thailand's economy and trade patterns suggest that the most immediate impact of the crisis is likely to come will come from falling employment in manufacturing, tourism and construction. These sectors are concentrated in urban areas, and most marginal jobs are informal (from day labor, for example). The impact on the rural poor will be mainly from the decline in commodity prices. Falling urban employment and incomes would also lower the ability of urban workers to send remittances to their families in the rural areas, and indeed some may return to their rural households, putting pressure on already limited incomes. As a result of the crisis, poverty is expected to increase in 2009 for the first time since 2002. Factors may mitigate these developments are a decline in food and fuel prices, and public spending, including transfers to the low-income and poor households and public investment, which may be supportive of continued growth.

Returning to a high growth rate is essential for poverty reduction as well as the sustainability of fiscal policy. Thailand implemented important reforms following the 1998 crisis that are largely responsible for the low levels of external vulnerabilities and the health of the financial sector. This crisis should be used as an opportunity to promote reforms and investments that will restore Thailand to a high steady-state level of growth that will contribute to continued improvement in standards of living and poverty reduction. The planned expansion in public investments can help reduce infrastructure bottlenecks and could be supportive of long-term growth. Nevertheless, care must be taken that the planned public investments complement rather than replace timely expenditures to support a reduction in unemployment and protect the poor during the crisis.

Positioning Thailand for the post-crisis environment will be vital to a resumption of robust long-term growth. The post-crisis global economic environment is likely to be characterized by lower steady-state consumption in the G3 economies, higher demand from the "BRICs" (Brazil, Russia, India and China) and ASEAN, and increased capital flows to developing countries as savings in the US increase and returns in mature economies remain depressed. It is essential for Thailand to position itself for this new economic environment by removing constraints to domestic consumption growth, as well as binding constraints for productivity improvements that would allow exports of higher value-added products to new markets that are abundant in low-skill labor. This will require, among others, improving the quality of education, which both addresses skills shortages for firms as well as income inequality. Reducing income inequality increases the purchasing power of the middle class, which along with stronger social safety nets that reduce precautionary savings from individuals may help boost domestic demand. Finally, it is necessary to deepen reforms of the regulatory framework, such as restrictions on the services sector – where productivity has lagged over the years – to enhance competitiveness.