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Sustainability of the World/Thai Economy and Fiscal Integrity¹

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The world financial crisis that broke out in summer 2007 was the most severe since the second World War and has caused a lot of problems and changes in the ways we look at the world economy. The role of the government that was previously perceived to accept a low profile and gave ground to the liberal view of free market was suddenly reversed and government interventions have played key roles in combating the crisis. Keynesianism that was thought to have faded out since Reagan/Thatcher era has been revived. In spring 2009, the G20 together with many other emerging market economies jointly announced to introduce huge stimuli packages in a scale that the world has never experienced. Even though the crisis has been declared to pass since mid 2009, the world is still faced with several aspects of the aftermaths of crisis that will require more time to resolve. One of the problems is the consequence of the expansionary fiscal policy that together with the structural deficits resulted in huge government debts. The question of sustainability of recovery is thus depending on strong efforts of policy makers and political determination to restore fiscal integrity.

In the US, private spending that used to be the driving force of the economy prior to the crisis has moved downward sharply. This was aggravated by commercial banks'

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behavior that has lost their appetite for lending, particularly to housing sector. Banks are more mindful about real estate sector risks. Once seemed to be secured lending such as mortgage because housing prices steadily increased for a long time suddenly became unsound assets as housing prices dropped sharply. This has caused a severe financial strain among many households who saw their housing asset values sink to levels lower than their financial debt. As the financial turmoil intensified, households' wealth dwindled significantly. American consumers once well known for using credit cards and enjoyed a comfortable life style unmatched elsewhere abruptly changed consumption behaviors. It is the first time in US financial history that the total usages of credit cards have been shrinking, a phenomenon that has not happened in the previous financial crises.

At macroeconomic level, US economy exhibited a higher saving rate, this fell in line with what Keynes has pinpointed as thrift paradox. In the time of recession, we require high aggregate demand so as to pull the economy out of sliding downward and not more saving. Many households and SMEs were naturally forced by credit controls of commercial banks as their credit standing has been impaired. Household debt has risen from over 65% of GDP in 2000 to nearly 95% of GDP by 2007. Micro finance has been reported to grow with higher interests.

As a consequence, the US slid into the more difficult problem of unemployment, the rate of which has risen to reach double digit at end 2009, one of the worst level since World War II. Although there has been sign of easing since late last year, the rate is still twice the unemployment rate in normal time with many who may have given up joining the labor pools.

With a large number of people unemployed and faced with bleak job prospects, it is natural for consumers to be more careful about their spending. Despite the repeated efforts by the central bank to inject liquidity and force the decline of long term interest rates, the financial system has not been responsive by extending credits. The Federal Reserve Systems that used to be very hawkish in its fight for inflation, has flooded the world with dollar under the Quantitative Easing programs(QE), not just one during the crisis time but even in 2011. By embarking on the second round of quantitative easing (QE2), Mr. Bernanke has expressed his intention repeatedly to inject \$600 billion into the financial system so as to avert recession, if not deflation. The Fed balance sheet has exploded from below \$1 trillion to near \$2.4 trillion within a short period of 2 years after the breakout of crisis. As the statistics on headline inflation remains low, it could be comfortably expected

that it will take more than one year before the Fed is looking to raise the interest rates. However, as commodity price including oil price edged up, the Fed is going to face with a dilemma as inflationary pressure mounts. It will need to timely mop up excess liquidity so as to prevent fueling inflation spiral. The restrictive monetary policy with higher interest rates will restrain further spending and limit economic activity.

Apart from the consumers, corporate in the US is not adding demand to the economy either, as capacities are still underutilized. Any new orders are met with existing workforce and production capacity, new hires have not been forthcoming as corporate prefers to employ existing staff to work overtime or to outsource as well as to automate and relocate outward. The good news about the US corporate at present is that it has retrenched and accumulated more cash. Problems are that corporate is not willing to use the strong balance sheet to embark on big scale investment and would rather prefer to payout dividends or take over other companies without adding more net labor demand. That is why the stock markets have been doing well and executives are expecting big bonuses. Several troubled corporate that undertook government financial supports decided to repay their liabilities from past borrowing to the government so as to avoid being constraint to follow government policy on job creation or on bonus payments.

The US trade deficit has not shown any significant reduction, even though domestic demand has been weak. Imports from China have occupied the most basic part for consumption among Americans and thus are difficult to be cut down. If exchange rate between the world's number 1 and number 2 economies is to shift in line with the text book, it will put further strains on consumption as imports from China should be more expensive. The US President is travelling everywhere in the world to cheer up demand for jobs in the US, and exports from US, both at home with the US corporate and abroad with the foreign governments. It will take a long time for the imbalance in the external sector to be stored. Consequently, the financial market will continue to face with uncertainty in the US economy and the volatile US currency and cross border capital movements.

The US is locked into problems of the twin deficits. Apart from the large current account deficit, the fiscal deficit is alarmingly large. The federal deficit will grow from US\$ 1.3 trillion in 2010 to US\$1.65 trillion in 2011. The deficit is nearly equal to the government revenue! The outlook for the deficit for the next 10 years was to continue with a deficit of about \$1 trillion per year. Net Federal debt after Social Security, held by the public has risen from 25% of GDP in 1980 to reach 75% of GDP at present. The market also

started to worry about the State Government debt. Together with the local government debt, US government debt is approaching 100% of GDP. Fortunately, the Congress seems to be more ready now to tackle the government budget by targeting to cut 2% of the expenditure which was still a small part. However, it is a step in the right direction. The US will require a lot more years with strong political determination to resolve the fiscal problem. As the election is coming next year, politics could emerge to pose a major constraint as the President and politicians still need to carry on with campaign agenda by using further budget funds. This could compromise the need to tackle the fiscal issues and thus derailing the sustainability of the US recovery.

Although Europe was not the cause of crisis, the financial meltdown in the US has struck the European economies rather hard, particularly the UK with housing bubble and ballooning fiscal deficit. Through investment into US financial paper and the globalization of the financial market, the financial system in Europe has been severely impacted. In fact, the European Union as a whole with the size of the economy close to the US, should pose a counter balance to the US's set back and thus reduce the impacts of US crisis to the world. Unfortunately, Europe has been faced with one of the worst and the deepest recessions since the second World War. Having struggled with severe structural deficits before the current financial crisis, the Euro zone members that have agreed on the Stability and Growth Pact, have slid into further fiscal cyclical deficits. The most serious are the smaller members of the EU that have been faced with ballooning government deficits and thus the financial market shows no mercy to these economies since 2010. The debt to GDP has gone over 125% in Greece and approaching 100% of GDP in Ireland and above 80% in Spain and Portugal, not to mention non members like Hungary and Iceland, that had already faced with financial disturbances. All of these have spilled over into the confidence crisis for the Euro as a currency.

The Euro has weakened from the peak level of 1.6 US dollar/Euro in the first quarter of 2009, to below 1.18 US dollar/Euro in early June 2010. The weakening of the Euro has boosted exports for Germany where fiscal standing is in good order with significant surpluses in current account and thus helped keep the German economy buoyant. With numerous automatic stabilizers being in place, Europeans policy makers have argued against introducing massive discretionary fiscal stimuli during the formation of concerted effort of G20 to coordinate their policies.

The financial market has been quite responsive to the malaise from fiscal problems. The yield spreads between government bonds of Greece, Portugal, Ireland and others vis-à-vis German government bonds have been widening, which reflects the discomfort of market. For example, the spread between the German bund and the Greece government 10 year bond has grown near 9%, despite the common denomination in Euro currency. Huge financial packages were introduced by the European Central Bank (ECB) and International Monetary Fund (IMF) so as to help shore up confidence and yet the yield differentials keep on rising. Rating agencies has been busy downgrading these government bonds. Market needs to see tangible results from fiscal adjustments before returning to stability.

Within a year of agreeing on global stimulus, most EU countries in 2010 reversed to austerity measures and thus pursuing more restrictive fiscal policies in order to limit the deficits and government debt levels. The UK new government came up with serious expenditure cut that will responsible for 75% of the deficit reduction, this was met with wide protests by the affected Britons. Similarly French and other have introduced cuts on welfare that led to street protests. If untamed, the UK net public debt is expected to reach 100% in the next 2-3 years. The strong measures are naturally faced with resistance from the affected population groups. Fortunately, most governments in Europe have had the political wills to pursuing strong doses of adjustments. Nevertheless, Portugal was a case of failing political support as the government had to resign for lack of support to its austerity measures in the parliament in late March 2011. Again just like in the US, political will plays a big role in the success of reigning in fiscal problem. The EU is hard pressed to react partly to help avoid the breakup of Euro zone.

Confidence in Japan has turned to the worst among all the developed economies. It has faced with 3 recessions in the past 20 years. The world financial crisis has led Japan to the worst economic condition since the first oil shock in 1974. Declining population, deflation and the sluggish consumer demand have dampened economic sentiment in the decade. Public sector debt rose steadily from below 20% of GDP during the first Oil price crisis in 1974 to approaching 200% of GDP at present. The authorities have repeatedly resorted to fiscal and monetary policies without tangible success and exhausted the policy options as interest rates have been cut to touch near 0% and the government spending boost that causes the widening of deficits and thus raising government debt, which is the highest among the developed countries.

Japan is another economy where policy options, both the fiscal and monetary instruments have been stretched to the limits. This was further aggravated by the strengthening of the currency as it would adversely affect exports, the remaining part of aggregate demand that Japan counts on to boost its economy. The Yen has strengthened vis-à-vis the US dollar as market ironically reacted that there would be huge capital repatriation to cope with the Tsunami of 11 March 2011. However, the recent triple disasters have put a severe strain on the Japan, not the least the economy. It will require a few more years to recover the economic losses as it is two times more damaging than Kobe earthquake 16 years ago. With the threat of nuclear plant meltdown, the outlook in Japan is a lot graver than earlier perceived.

Japan has been plaque with deflation threat since the second part of 1990s and recently, the continued price decline for the last 2 years posed fear of another round of deflation. Consumers have been holding back demand while government debt has sky rocketed to 200% of GDP. This could trigger panic in the capital market if investor confidence wavers. Unlike other debt stricken countries, Japan' government debt is mostly matched by domestic saving. Consumers are concerned about the employment and income prospects. Traditionally Japan has a lifelong employment culture and the natural unemployment rate was around 2%. The economic downturn that started since the burst of bubble at begin 1990 has changed the practice. Unemployment peaked in July 2009 at 5.7% at the height of the world financial crisis. After all, Japan is a matured economy and may not require strong growth to boost income and consumption levels to lift population out of poverty. It has a strong entrepreneurial and innovative culture that will drive the economy. What it requires is probably strong political commitments to pursue structural policies so as to win confidence back to its society.

The world is counting on Asia to be the locomotive to prime pump the world economy out of the doldrums. Fortunately both China and India are growing fast and likewise Asean together with the newly industrialized East Asian countries are in good shape. They have recovered from the 1997 crisis and thus have not been severely impacted by the subprime crisis in the US. On the contrary, after a few doses of fiscal and monetary stimuli in 2009, most of these economies are faced with inflationary pressure. Central banks have to resort to restrictive monetary policy by raising interest rates and limiting money supply as well as bank lending to real estate sector. The robust economic condition induces further investment and capital inflows that put upward pressure on their exchange rates. However, monetary authorities are not ready to let the exchange rate to move freely for

fearing the adverse impact to exports which is the vital policies of almost all countries in the region. Certain capital and administrative exchange controls have been employed which could be proved inefficient in the long run.

In particular, China has emerged to surpass Japan as the second largest economy in the world and is expected to become the largest within the next two decades. China has become the major trading partners of many countries and exerts great demand on raw materials and key commodities. Recently, Chinese investors have become more visible worldwide, particularly in energy and resource based investments. As the Asian economies grow stronger, risk is mounting as real estate poses a bubble risk. Labor is becoming scarce as wages and exchange rate of the Yuan have risen. Some other late comers are faced with strong pressure on inflation and foreign exchange constraints. Inflation rose to 13.9% in Viet Nam in March 2011 and 8.3% in India in February 2011. This time, Asia seems to be reviving across the board. The threat is if the economy gets out of hand and the country is unable to keep inflation under control or unable to achieve a soft landing so as to avoid the bubble burst like Japan.

As for Thailand, the economy has been faced with political upheavals. Since the final years of Prime Minister Thaksin's regime in 2005, there have been numerous street protests as well as the coup d'état in September 2006. Ever since the fall of Thaksin, there have been frequent changes of government with 4 Prime Ministers and even more changes of Ministers. The unrests have soured the investment and tourism climate. After having ruled since late December 2008, the current government has announced an early election to take place in July/August 2011. Fortunately, the business activity in agriculture and manufacturing has been continuing to do business as usual. But investment activity has been halted as concerns to the industrialization impact on the environment gave rise to the investment embargo at Map Ta Put industrial zone, where the major petrochemical complex of Thailand is located. However, the employment situation in Thailand is different from developed countries as Thailand has enjoyed inward direct investment and relocation of manufacturing into Thailand, particularly in the automobile sector. Exports continue to do well, despite some setbacks during the world crisis. Imports have been slow as investment demand is not strong. The current account is still enjoying a big surplus and thus resulting in a large accumulation of reserves. Labor market is further tightened as workers prefer to go back to agriculture as agriculture prices shot up. School leavers that used to go straight to work, get more access to university education. However, higher food price has put pressure on cost of living and thus cost- push inflation is looming. The

baht appreciation vis-à-vis the US dollar by around 10% last year is certainly inflicted an adverse impact on export competitiveness. Labor intensive exports will have to give further ground to neighboring countries such as Viet Nam, where the exchange rate of the Dong has depreciated further by 9% in February 2011. The outlook of Thai economy depends largely on the ability of private sector to adjust itself to the new competitive environment by upgrading productivity and product quality. It cannot rely on abundant supply of labor or resource bases as was the case in the past.

The Abhisit government has actively pursued expansionary fiscal policy since assuming office over two years ago. Apart from the normal annual budget expenditure, additional expenditure programs i.e. Strong Thailand Projects (SP1 and SP2) with large borrowing plans amounting to 400,000 million baht for two times were announced so as to support government initiatives and to boost the economy during the midst of the world crisis. The size of SP2 amounted to Baht 1.4 trillion, as compared to the Baht 1.7 trillion for 2011 Budget. Many of these programs were initially slow to implement due to limited absorptive capacity of the bureaucracy and the vigilance on corruption controls. There is also another extra budget bill presented to the parliament since early 2011. Some programs were not financed directly by the budget but became a contingency liability as the government promises to repay state owned banks later for financing government's policy programs, such as rice income support scheme through BAAC. Many expenditure items are short term populist programs and not long term infra structure investment. It is a direct way to handing out public money for political gains. It looks as if all political parties are using the same tactics and methods to win grassroots supports. This trend, if continues unchecked could compromise fiscal integrity by locking future public resources and adding burden for debt repayments. The government debt to GDP was expected to rise from 40% in 2008 to 60% in 2012. This number may not be achieved as a big part of SP2 has been delayed for lack of financing and have to be relocated back to the normal budgets in the future. The current government could make a difference from the past governments in pursuing its own populist policy by making sure that loopholes or channels for corruptions are being closed. More importantly, the budget funds should be properly targeting the needed groups of population who need help the most. There should be more openness and transparency to facilitate audit and control. Mechanism should be put in place for investigation by third parties. The provision of government financial supports should not be meant for paternalistic purposes.

The formulation and allocation of the SP1 and SP2 have not gone through the normal budget bureau process, as the Budget Bureau was bypassed. This could give ground to loopholes and weakness in budget control process. The Ministry of Finance in Thailand has traditionally not been responsible for the scrutiny of budget allocation. It deals mainly with the terms and conditions of borrowing and the release of funds. This danger has later been corrected and yet the Budget Bureau would not claim responsible for the allocation of SP2.

The SP2 was meant to prime pump the economy in the middle of the world financial crisis in 2009. It was announced with an Emergency Decree and has bypassed the parliamentary scrutiny on the details of expenditure. Yet, the major part of the funds have been delayed and being disbursed in 2010 when the economy was already growing in full stream and the central bank has already started to raise interest rates.

There is a question about fiscal and monetary policy coordination. The central bank has raised interest rates since the middle of 2010 and is expected to raise the rates further so as to check inflation. However, the step up of government expenditure and the extra budget bill in 2011 are inconsistent with the monetary policy and have sent confusing signals and add further pressure on monetary policy to bear the burden of adjustment. If continued, there would be crowding out effect and derail the recovery in the private sector as funds are scarce and at a higher cost.

As late as the past week after Songkran, while the central bank raised another notch of interest rate, the government announced to subsidize diesel price as well as gas price which will add burden to the public finance. Such policy contradiction is being pursued before the general election that is expected to take place within the next 2 months.

CONCLUSION

All in all, economics is not a discipline that can stand alone. When it is being applied to countries, it encounters the biggest challenge, i.e. the political will and constraints to execute the economic plan. Many well thought out policies and reforms got bogged down by political decisions that gave more weight to short term populist gains. In other words, voters are shortsighted! Therefore, the sustainability of global and Thailand's economy hinges very much on the political commitments to implement the appropriate

policy for the long term benefits. Most countries in developed economies are currently faced with fiscal sustainability and drastic actions for budget reforms are required. For Thailand, we are in a political atmosphere where the government budget is being used to support political agenda. Keynesianism was often cited in political debates to legitimize expenditure programs during sluggish time. But when the economy turns around to overheat, Keynesianism was ignored and spending is left to continue as usual instead of being adjusted, i.e. cut down, so as to help bring better balance to the economy. This time, both the developed and developing countries need to take serious political decisions to address fiscal problems so as to support sustainable economic recovery in the years ahead.

