Thailand's recent public debt issues

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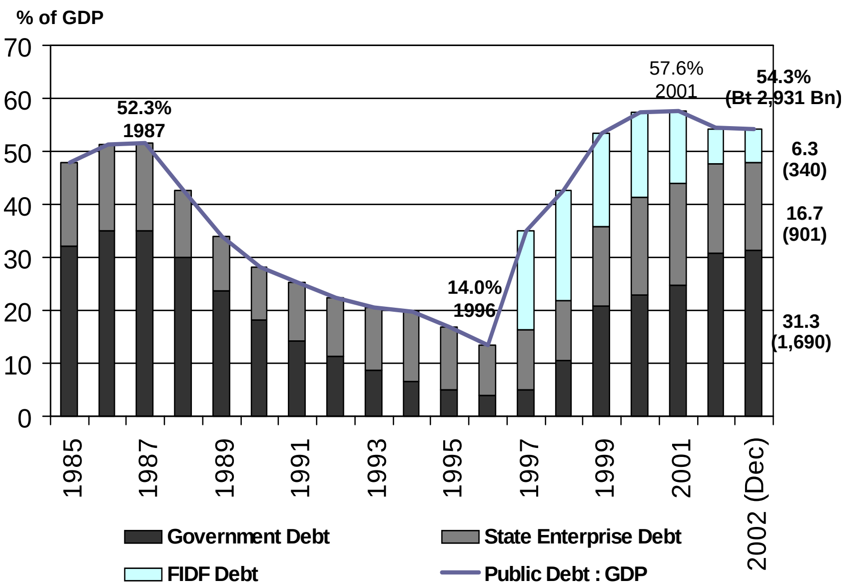
1. Introduction

Prior to the economic and financial crisis in 1997, the fiscal position of Thailand was in surplus for nine consecutive years. As a result, the public debt declined and bottomed at 14% of GDP in 1995/96. When the 1997 crisis occurred, the government absorbed substantial financial sector losses, coupled with conducting an expansionary fiscal policy. This resulted in a large increase in public debt to a peak at 58% of GDP in 2000/01. However, public debt gradually declined to 54% in December 2002 while the government cash deficit turned out better than planned in 2001/02 due to economic recovery and fiscal consolidation.

As the public debt is one of the country's medium-term risks, its increase over the past few years raises concerns over the country's economic stability. This paper assesses the current fiscal status and the sustainability of the Thai public debt over the medium term. The next section provides an overview of Thailand's public debt. Sections 3 and 4 address the public concerns over the costs of financial sector restructuring and also the government's initiatives. The analysis of public debt sustainability is presented in Section 5, and Section 6 concludes.

Graph 1

Thailand's public debt



Source: Public Debt Management Office (PDMO).

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2. Public debt

The public sector debt in Thailand consists of three components: government debt, non-financial public enterprise (NFPE) debt, and Financial Institutions Development Fund (FIDF) debt.[2]

Table 1 shows public debt as of December 2002. Debt issued by the government amounted to 31% of GDP, including domestic and external borrowings to finance government expenditure and some of the financial restructuring costs (Tier 1, Tier 2,[3] and FIDF I and III). The NFPE debt, equivalent to 17% of GDP, comprises government-guaranteed and non-government-guaranteed debts, while the FIDF debt, amounting to 6% of GDP, consists of FIDF II and non-government-guaranteed liabilities. Thus, the level of public debt as of December 2002 was THB 2,931 billion or 54% of GDP.

The current public debt data already include debt incurred by the NFPE. This inclusion somewhat overstates the resources required to service the debt, ie the fiscal burden. This is because state enterprise debt will be part of the fiscal burden if and only if a state enterprise defaults. But not all state enterprises are risky. Table 2 shows 10, out of 59, state enterprises bore operational losses for three consecutive years or had negative net worth, and their debt accounted for only THB 115 billion or 13% of total state enterprise debt.

Table 1

Structure of public debt

In billions of baht; end-September

		1996	1997	2000	2002	2002 (Dec)
1	Government debt	176	238	1,114	1,671	1,690
	% of GDP	*4.3*	*5.0*	*22.8*	*30.9*	*31.3*
2	NFPE debt	432	538	909	907	901
	% of GDP	*10.5*	*11.3*	*18.6*	*16.8*	*16.7*
3	FIDF debt[1]	0	893	781	357	340
	% of GDP	*0.0*	*18.7*	*15.9*	*6.6*	*6.3*
4	**Public debt (1+2+3)**	**608**	**1,669**	**2,804**	**2,935**	**2,931**
	% of GDP	***14.8***	***35.0***	***57.3***	***54.4***	***54.3***
	(Domestic : external)	**(36 : 64)**	**(67 : 33)**	**(69 : 31)**	**(72 : 28)**	**(72 : 28)**

[1] Since December 2002, the FIDF debt has consisted of the THB 112 billion of government-guaranteed bonds (FIDF II) and the non-guaranteed debt, which was THB 228 billion.

Sources: Public Debt Management Office (PDMO); Bank of Thailand.

Taking into consideration only debt incurred by loss-making state enterprises, the figure stood at THB 2.1 trillion (40% of GDP) compared with the public debt figure of THB 2.9 trillion (54% of GDP), which included the debts of all non-financial state enterprises.

[2] A more detailed explanation of the cost of financial sector restructuring is given in Section 3.

[3] The government recapitalised the distressed financial institutions by issuing Tier 1 and Tier 2 bonds, for which, in return, it received preferred stocks and subordinated debentures, respectively.

Table 2

Non-financial public enterprises with net losses over three consecutive years

In millions of baht

NFPE		Net loss			Financial statement 2001			Debt
		1999	2000	2001	Assets	Liabilities	Equity	Dec 2002
1	State Railways of Thailand	4,153	4,685	3,824	66,020	43,306	22,714	47,585
2	Bangkok Mass Transit Authority	2,689	2,889	3,721	4,418	21,590	–17,171	16,093
3	Bangchak Petroleum	1,783	1,565	2,987	26,393	23,962	2,431	18,318
4	National Housing Authority	116	452	877	50,103	47,188	2,915	21,037
5	New Bangkok International Airport	94	147	57	17,980	3,571	14,409	11,222
6	Dairy Farming Promotion Organisation of Thailand	175	220	117	998	900	98	409
7	Zoological Park Organisation	12	30	42	1,459	8	1,450	
8	Botanical Garden Organisation	31	37	34	539	6	534	
9	Thai Tanning Organisation	18	11	90	361	416	56	50
10	Express Transportation Organisation of Thailand	87	43	118	315	1,505	–1,189	53
Total								**114,767**

Sources: NESDB (2002); PDMO.

3. The cost of financial sector restructuring

During the crisis, the FIDF[4] carried out quasi-fiscal activities such as providing full guarantees to the depositors and creditors of closed financial institutions, recapitalising a number of financial institutions, and bearing the additional cost of the non-performing assets of financial institutions transferred to the Thai Assets Management Corporation.[5] BOT (2002) estimated the FIDF's losses at THB 1.4 trillion.

A part of FIDF's losses has already been covered by the issuance of THB 500 billion worth of government bonds in 1998. In 2000, the FIDF issued FIDF bonds worth THB 112 billion with a government guarantee to compensate the losses. In 2002 the government passed an emergency decree to empower the Ministry of Finance to issue up to THB 780 billion of bonds (FIDF III) to cover the estimated non-guaranteed FIDF losses. Consequently, THB 305 billion of saving bonds were issued in September 2002 to repay part of the FIDF's liabilities in the money market.

By end-2002, THB 805 billion of the FIDF's losses were already fiscalised (as FIDF I and III) and are considered as government debt. The THB 112 billion of government-guaranteed bonds issued in 2000 were considered as the FIDF's debt, which was already included in the public debt. Out of the remaining THB 472 billion of losses (Table 3), only THB 228 billion (see footnote to Table 1) are realised as FIDF liabilities in the balance sheet as non-guaranteed debt, while the rest is expected future losses of the FIDF.

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4 Established in 1985, the FIDF is a separate legal entity from the BOT. Its roles and responsibilities are, inter alia, to provide liquidity support as a last resort to illiquid financial institutions, and to guarantee payment to depositors and creditors.

5 The Thai Assets Management Corporation, established in 2001, is a legal person with the status of a state agency, rather than a state enterprise, under special laws designed to expedite the resolution of the NPL problem of both state-owned and private financial institutions and to enable transferred debtors to be in a position to continue their business operations.

Table 3

Estimated total FIDF losses

In billions of baht

1. Depositor assistance programme	
56 closed finance companies	519
Other financial institutions	35
2. Loss from shares owned by FIDF	169
3. NPLs	651
Total losses from all programmes	**1,374**
Add interest expense	163
other expenses	3
Less FIDF premium and others	(139)
Total losses to be fiscalised	**1,401**
Fiscalisation by end-Dec 2002:	
Compensated from FIDF I (THB 500bn of government bonds) in 1998	*(513)*
Compensated from FIDF II (THB 112bn of government-guaranteed FIDF bonds) in 2000	*(112)*
Compensated from FIDF III/1 (THB 305bn of government saving bonds) in 2002	*(305)*
Remaining bonds to be issued	**472**

Source: Bank of Thailand.

In summary, in total THB 0.9 trillion of the estimated financial institutions restructuring cost of THB 1.4 trillion has already been compensated. For the remainder, more bonds will be issued in response to the FIDF's financing needs and market conditions. Payments of principal on the bonds issued for financing the FIDF losses will mostly come from the BOT's proceeds from operations, while the government will meet the interest payments.

4. Future fiscal position

To assess the future fiscal position of the Thai government, its recent initiatives concerning government expenditures and revenue are explored.

Expenditure side

There are certain government policies that either are perpetual or need future financing, but some are not yet recognised as government debt. In Thailand, a number of government initiatives could potentially generate additional demands on future budget, or could be possible contingent liabilities. These initiatives can be classified into three categories by the source of financing. These include:

1. *Initiatives to be financed directly from the budget*.

   - The **village fund**[6] is a revolving fund facility, whereby each village or urban community receives a one-time transfer of THB 1 million to finance local investment and supplementary occupations.

[6] This project was financed by the government guaranteed loan (already included in the public debt figure) from the Government Saving Bank, which the government would amortise the amount from the budget within eight years.

- The **universal health insurance** scheme aims to extend the provision of low-cost health care service to 45 million people (compared with the current 25 million).
- The **education reform** aims to provide free basic education for 12 years (previously six), expand compulsory education to nine years (previously six), and improve the quality of teaching and the salaries of teaching staff.
- **Decentralisation** involves the transfer of authority and responsibilities from central government to local government. This coincides with the Decentralisation Act 1999 regarding the transfer of revenue to ensure a ratio of local government revenue to central government revenue of not less than 20% in 2000/01 and 35% in 2005/06. The revenue transferred to local government would be deducted from the gross revenue and not be counted as part of the budget.

2. The *Specialised Financial Institutions (SFI)*: there are also government initiatives that are implemented through SFIs; some items could become contingent liabilities for the government, depending on the operations of the SFIs.
    - **People's Bank** was established to improve access to banking facilities and resources for the poor. The Government Saving Bank (GSB) implemented this policy by granting small loans of THB 15,000 per first-time customer at a flat interest rate of 12%, with the repayment period not exceeding one year. The government will not guarantee these loans in order to ensure prudent lending practice.
    - **Other lending facilities,** such as housing lending by the GSB and loans to SMEs, were not guaranteed for the same reason.
3. *Shared financing*: some projects are implemented through SFIs or other government agencies, with partial financial support from the government budget, for example:
    - The **debt burden relief programme** comprises two separate projects: debt suspension and debt burden reduction. Farmers who joined the debt suspension programme are granted a grace period of three years for both principal and interest payments. Farmers who joined the debt burden reduction programme still have to repay the loans, although with a 3 percentage point reduction in the interest rate for three years. The revenue foregone by the GSB through carrying out this programme will be compensated from the government budget.
    - The **housing project for the low-income group** was approved by the cabinet with a small appropriation from the budget. The government will support low-income households by offering up to THB 80,000 per unit per household and seek a low-cost financing source for the National Housing Authority (NHA). In building the housing units, the NHA will finance the project largely by borrowing from the SFIs with partial financial support from the government budget. In addition, the GSB will grant credits to people to build or buy a house outside the NHA housing project. Both projects aim to construct 1 million residential units within five years.
    - The **oil fund** was established as a cushion against the costs of rising domestic fuel prices stemming from volatility in the global oil market. The government implemented a temporary measure that capped retail petroleum prices for four months from February to May 2003. The cost of this scheme was covered by borrowing from the GSB, with the interest expense to be paid from the budget and the principal to be financed from the fund's gain from world oil prices being lower than the fixed prices.

Revenue side

Although there are many government initiatives that have raised concerns about future spending, the improved budgeting methods facilitate implementing fiscal policies without generating fiscal instability. While there are risks that government expenditures not fully recognised in the medium-term framework could increase, the following fiscal measures and initiatives would improve the fiscal position:

- **Tax reforms and modernisation.** The government is implementing measures to expand the tax base and enhance the efficiency of tax collection. In 2001/02, government revenue increased considerably as a result of the economic recovery and improved tax administration, while expenditure decelerated in the second half of the fiscal year. This resulted in an actual cash deficit of 2.2% of GDP, lower than the planned 3.2%.

- **Focus on the strategic plan and strategy.** The implementation of a zero-based budgeting method accompanied by performance-based budgeting will lead to more efficient allocation and effective spending.
- **The corporatisation of Thailand's state enterprises.** This will increase the efficiency of the state enterprises and generate higher profits to shareholders.
- **Civil service reforms.** The policy will help the government to manage personnel expenses. Moreover, evaluation based on performance and outcome will help improve the efficiency of budget allocation.

5. Public debt sustainability

At the present level of public debt, the fiscal position remains stronger than planned. The government has improved fiscal flexibility by improving the efficiency of both revenues and expenditures. The government has increased revenue by raising tax collections and expanding the tax base. In 2001/02, the tax elasticity to GDP stood at 2.2 compared with 1.5 in 2000/01, reflecting substantially more efficient tax collection. The corporatisation of state-owned enterprises will further enhance efficiency and bring higher returns to the government. On the expenditure side, the government has improved the efficient allocation and effective spending by implementing the zero-based budgeting method accompanied with performance-based budgeting.

The BOT assessed the public debt sustainability from 2002/03 (which extends from October 2002 to September 2003) onwards, incorporating the FIDF debt resolution. The general conclusions drawn from this exercise indicate that Thai public debt remains sustainable even under relatively dire circumstances, some of which are assumed to maintain the VAT rate at the present level of 7%.

Table 4

Baseline scenario assumptions in the medium term (2002/03-08/09)

Nominal GDP growth	6.4%
Implied revenue elasticity	1.10
Interest rate per annum	6.4%
Disbursement rate	91%
Current expenditure growth	
– Wage and salary expenditure[1]	5.0%
– Non-interest and non-wage[2]	4.8%
Capital expenditure growth[2]	6.4%

[1] Fixed rate. [2] Depending on GDP growth.

In the projection under the baseline assumptions, shown in Table 5, the public debt already peaked at 55% of GDP in 2001/02 and is on a declining trend. The large decline in the public debt in 2006/07 from 2005/06 is attributable to the repayment of the government debt that will become due in 2006/07 and the improvement in the FIDF debt level due to the FIDF's expected income in the next four years. The cash balance will turn positive in 2006/07.

Table 5

Projections of important ratios

In percentages

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Debt service/budget	10.0	12.0	13.2	12.6	12.8	12.7	12.6	13.9
Public debt/GDP	55.1	53.0	51.2	51.7	50.3	44.2	39.5	35.4
Budget balance/GDP	–3.7	–3.0	–1.7	–1.1	–0.6	–0.3	0.0	0.0
Cash balance/GDP	–2.2	–0.5	–0.3	–0.3	–0.1	0.2	0.8	1.2
Primary Balance/GDP	–0.9	1.0	1.4	1.4	1.6	1.9	2.2	2.4
Revenue/GDP	15.9	16.5	16.6	16.4	16.5	16.6	16.7	16.8
Budget expenditure/GDP	19.2	17.6	17.0	17.5	17.1	16.9	16.7	16.8

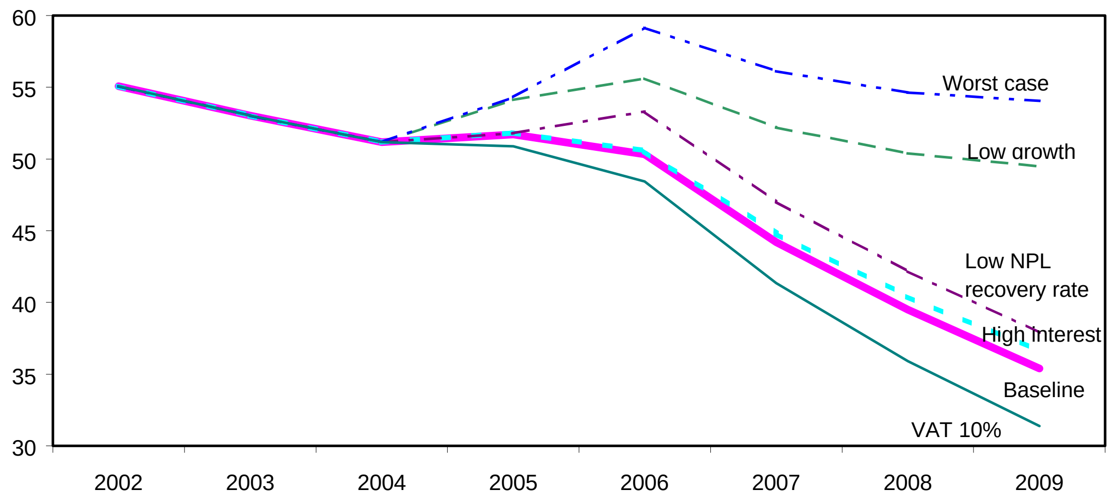
Besides the baseline scenario, the stress test analysis (see Annex for details), as shown in Graph 2, illustrates the sensitivity of debt dynamics under changes in the macroeconomic scenarios as follows:

1. Case A: baseline with the VAT rate adjustment from 7% to 10%.
2. Case B: low growth, ie long-run average growth rate (1970-2001) is reduced by one standard deviation.
3. Case C: higher interest rate from baseline by 3 percentage points.
4. Case D: lower NPL recovery rate from baseline by 20 percentage points.
5. Case E: worst case scenario, ie cases B to D are combined.

Graph 2

Stress test analysis: public debt/GDP

In percentages



Source: Calculation from stress test analysis in the Annex.

The scenarios above analyse public debt in the medium term under various macroeconomic assumptions and fiscal policy adjustment. Even in the worst case scenario - low growth and high interest rate coupled with low NPL recovery rate - the public debt is still moderately sustainable. Nevertheless, there remain other factors that could alter the debt path towards a more or less sustainable level.

Factors that contribute to debt sustainability include:

- high private saving rate
- high domestic liquidity and low interest rate environment
- moderate public external indebtedness
- exchange rate flexibility

Factors that detract from debt sustainability include:

- adverse economic scenarios other than those considered above
- contingent liabilities
- near-term gross financing requirement
- ongoing fiscal decentralisation process

Under the fiscal sustainability framework announced by the government, budget balance should be achieved within 2006/07. However, in order to ensure sufficient investment spending, the ratio of debt service to total budget will be curbed at 16%. The increasing ratio of debt service to the budget is attributed to debt repayment. This is supported by evidence that the rise in the budget expenditure in 2003/04 is partially due to the increase in debt service expenditure, 25% of which will be allocated to repayment of principal.[7]

Policy efforts that help contain debt/GDP even when it exceeds the ceiling of 60%:

- Introducing structural increases in revenues by expanding the tax base and increasing tax collection efficiency.
- Raising the NPL recovery rate through effective asset management and imposing a risk management framework in public and state-owned enterprises, speeding up the NPL resolution process, and strengthening the position of SFIs.
- Privatisation to increase profits and realise proceeds from the sale of assets. Note that, amongst state enterprises, large debtors tend to have more assets than liabilities, while those that are poor performers are small in size and have little debt.
- Spending cuts, including fiscal consolidation, three-year budgeting plans, and zero- and performance-based budgeting, all of which induce efficient management of government spending and eliminate inefficient programmes, together with a VAT increase to 10% when necessary.
- Ensuring transparency in budgetary operations.
- Building institutional capacity for public debt management, including bond market development.

Thai public debt is therefore sustainable in the medium term, even under unfavourable conditions. In the context of its target of fiscal sustainability, the government has committed to maintain a debt ratio of less than 60% of GDP, achieve budget balance within five years, and steer the debt service ratio to lower than 16%. This is achievable if the recent fiscal reform and consolidation continue.

6. Conclusion and implications for monetary policy

The economic and financial crisis in 1997 created a large public debt and has deteriorated the fiscal position ever since. The public debt rose rapidly from 14% of GDP in 1996 to 54% in November 2002, due to two major policies: financial sector restructuring and expansionary fiscal stances.

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[7] In Thailand, the principal repayment is included in the budget expenditure.

In addition to the increase caused by the cost of financial institution restructuring, the public debt also rose as a result of the expansionary fiscal measures aimed at stimulating the economy. Although there are certain government policies that impose a greater financing burden on the government, the outturn of the fiscal position in 2001/02, which was better than the planned deficit, reflected the government's goal of fiscal consolidation. Moreover, the positive outcome resulting from the current public sector reform may reduce the fiscal burden in the future.

The medium-term analysis suggests that the public debt is sustainable. However, the government could balance the budget within five years and keep the debt/GDP ratio below 60% of GDP if it prudently consolidates the budget. This could be achieved by eg (1) spending cuts through fiscal consolidation, multi-year budgeting plans, zero- and performance-based budgeting, together with a VAT increase to 10% when necessary; (2) the recent structural tax reform continuing to increase the tax base; (3) raising the asset recovery rate by speeding up the NPL resolution process and strengthening the position of SFIs; (4) privatisation in order to increase profits and realise proceeds from the sale of assets; and (5) building institutional capacity for public debt management.

An analysis of the potential downside risks suggests that even in an adverse scenario the debt dynamics would remain manageable and in the government's debt sustainability framework. These risks include: (1) the high sensitivity of debt dynamics to adverse economic conditions; (2) the costs of financial sector restructuring; (3) contingent liabilities; (4) the near-term gross financing requirement; and (5) the ongoing fiscal decentralisation process. Nevertheless, favourable conditions in the Thai economy that should reduce fiscal risks include: (1) the high private saving rate; (2) the high domestic liquidity and low interest rate environment; (3) moderate public external indebtedness; and (4) exchange rate flexibility. The worst case scenario (low nominal growth of 2.5%, a high interest rate of 9.4% and a low asset recovery rate of 15%) drives the debt ratio close to 60%. The government's commitment to fiscal consolidation, accompanied by thorough fiscal reform to increase efficiency in budget and debt management, and the acceleration of other tax reforms will lead to fiscal sustainability in the near future.

Monetary and fiscal policy coordination

The BOT closely coordinates with the government in the management of macroeconomic policy. In order to sustain long-term economic growth, the BOT adopted an inflation targeting framework in 2000, while fiscal policy became more expansionary. While the latter inevitably increased the public debt, the fiscal consolidation started in 2002/03 reflected the government's commitment to bring down the level of public debt in the medium term.

The Ministry of Finance and the Bank of Thailand have agreed to find a solution that is acceptable to all parties for dealing with the cost of financial sector restructuring. Any resolution must have a minimal impact on the government's fiscal position, and place a minimal burden on taxpayers in both the short and long term. The principal will be funded using the annual net profits from income earned from the Bank of Thailand's currency reserves and operations, rather than through an expansion of the monetary base. This guarantees independence of the central bank in its conduct of monetary policy. This independence will be further strengthened once the new BOT Act, which stipulates that price stability is an overriding objective, comes into effect.

While the BOT has full independence in setting monetary policy, the fiscal stance is taken into consideration in order to bring about an appropriate policy mix that facilitates sustained growth. Monetary policy plays an increasing role when fiscal policy is consolidated in order to address the problem of public debt in the medium term. The success of economic stabilisation is subject to a well defined monetary policy framework, even under the constraint of the high public debt.

Annex:
Stress test analysis of the medium-term public debt projection

Table A1

Assumptions: Fiscal years 2003/04-08/09

	Baseline	**Case A** VAT 10%	**Case B** Low growth rate	**Case C** High interest rate	**Case D** Low NPL recovery rate	**Case E** Cases B to D combined
Real growth	4.8	4.8	2.0	4.8	4.8	2.0
Inflation	1.6	1.6	0.5	1.6	1.6	0.5
Interest rate	6.4	6.4	6.4	9.4	6.4	9.4
(real interest rate)	*4.8*	*4.8*	*5.9*	*7.8*	*4.8*	*8.9*
(growth – real interest rate)	*0.0*	*0.0*	*–3.9*	*–3.0*	*0.0*	*–6.9*
VAT (after Oct 2004)	7.0	10.0	7.0	7.0	7.0	7.0
NPL recovery rate	35.0	35.0	35.0	35.0	15.0	15.0

- **Baseline:** The public debt already peaked at 55% of GDP in 2001/02. The large decline in the public debt in 2006/07 reflects repayment of government debt due then and the improvement of the FIDF debt level due to the FIDF increase expected in the next four years. The cash balance will turn positive in 2006/07.
- **Case A:** With an increase in the VAT rate to 10%, and keeping all other variables at their baseline values, debt/GDP follows a lower path than baseline and is about 4 percentage points lower than baseline at the end of the projection period. The increase in tax revenue puts the cash balance and the budget balance in surplus earlier than baseline.
- **Case B:** A one standard deviation reduction in Thailand's long-run growth rate is consistent with a higher real interest rate, due to a lower inflation rate. The rise in the real interest rate coupled with the low growth rate causes debt/GDP to decrease to 50% at the end of the projection period from 56% at its peak in 2005/06. Primary balance to GDP is at a low of 0.9%, compared to the baseline of 2.5%. The cash balance and the budget balance remain in deficit throughout the projection period.
- **Case C:** The results of an increase in the interest rate by 3 percentage points are not significantly different from baseline as an increase in the interest rate will affect only the new debt. Debt/GDP is slightly higher at the end of the projection period, with a similar declining path. Thus the increase in borrowing costs from higher interest rates does not place too great a burden on public debt.
- **Case D:** A lower NPL recovery rate by 20 percentage points increases debt/GDP by 2 percentage points above baseline at the end of the projection period, although debt/GDP still follows a downward trend. Despite the lower NPL recovery rate, the cash balance and the budget balance are in surplus in the same period as in the baseline scenario.
- **Case E:** Combining cases B to D as the worst case scenario, debt/GDP reaches a peak of 59% and declines to 54% at the end of the projection period. Although the debt/GDP path is not explosive, it is higher than all the cases considered so far and declines with the rate of acceleration less than others. Even under a dire circumstance, the government debt ratio at its peak is lower than the government ceiling of 60% as a result of the fast fiscal consolidation that will provide the cushion for unfavourable economic condition.

Table A2

Public debt stress test analysis

In percentages

	BOT Baseline	**Case A** VAT 10%	**Case B** Low growth rate	**Case C** High interest rate	**Case D** Low NPL recovery rate	**Case E** Cases B to D combined
Debt/GDP, September 2009	35.4	31.4	49.5	36.6	37.9	54.0
Peak debt/GDP	55.1	55.1	55.6	55.9	55.1	59.2
Change in debt/GDP, (2001/02 to 2008/09)	–19.7	–23.7	–5.6	–18.5	–17.2	–1.1
Primary balance/GDP (average 2002/03-08/09)	1.7	2.5	0.9	1.7	1.7	0.9
Budget balance/GDP (year of surplus)	2008	2005	>2009	2008	2008	>2009
Cash balance/GDP (year of surplus)	2007	2005	>2009	2008	2007	>2009

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