Fiscal position and its implications for macroeconomic stability

The current global economic crisis necessitates several countries to use fiscal policy to shore up and stimulate their economies. This practice has created both explicit and implicit risks to fiscal position and can adversely affect investor confidence and country creditworthiness, which have implications for costs of borrowing and ultimately macroeconomic stability.[1/]

In Thailand, public sector expenditure has played an important role in boosting the economy by partly compensating for the contraction in exports, private consumption, and private investment. In fiscal year 2009 the government ran a cash deficit of 4.8 per cent of GDP (which was above the budget deficit of 3.9 per cent of GDP), bringing the public debt to GDP ratio up from 37.2 per cent at the end of fiscal year 2008 to 45.9 per cent at the end of fiscal year 2009. Although the economy is improving in fiscal year 2010, the recovery is only gradual and still fragile. The government thus continues to run a budget deficit of 3.7 per cent of GDP as fiscal stimulus is deemed to be necessary.

However, both shrinking public sector expenditure following a shortfall in revenues and increasing contingent expenditure and social welfare expenditure reduce the budget for investment sharply. As a result, the government has decided to borrow further by enacting special bills[2/] to make possible public investment in accordance with the "Strong Thailand 2012 Project," the stimulus package over 2010-2012. It is also expected that the government will continue to run budget deficits for some time in the future to keep output expansion at a rate close to the potential growth rate. Consequently, if the government fails to restructure its public spending – by cutting back current expenditure and transfers – public debt is expected to rise above 60 per cent of GDP, the threshold level suggested by the Ministry of Finance's medium-term fiscal sustainability framework. Moreover, if implicit contingent liabilities of quasi-fiscal activities become actual losses, the actual debt burden of the government will turn out to be higher.

Prolonged fiscal deficits and rising public debt have become issues of concern among academics and investors. The main question is whether they adversely affect a nation's creditworthiness and costs of borrowing. Greece, for

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[1/] Fiscal position is one of the seven aspects of the economy the Bank of Thailand closely monitors and conducts analyses on. The other institutions and market conditions that have important implications for macro stability are firms, households, financial institutions, international trade and capital flows, real estate markets, and financial markets.

[2/] The Emergency Decree Empowering the Ministry of Finance to Borrow for Economic Restructuring and Strengthening, B.E. 2009, and the Act Empowering the Ministry of Finance to Borrow for Economic Restructuring B.E. ...

Chart 1 Ratio of government debt to GDP

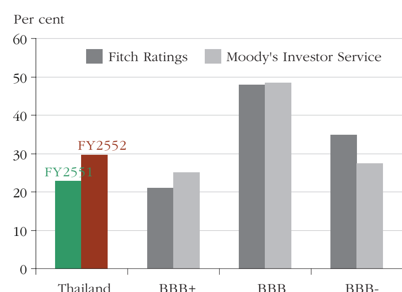
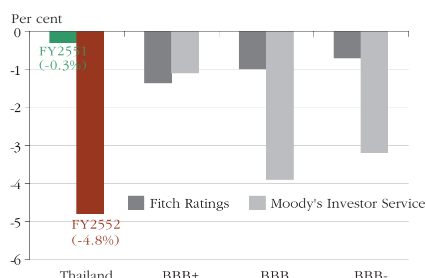


Chart 2 Ratio of government balance to GDP



Note: Thailand is at present rated Baa1 (equivalent to BBB+) according to Moody's Invester service and BBB according to Fitch Ratings.
Source: Fitch Ratings and Moody's Investors

example, was downgraded in 2009 in light of its fiscal deficits as much as 12.7 per cent of GDP and public debt that reached 112.6 per cent of GDP. Such an elevated debt level and massive budget deficits pose risks to debt service ability, risk premiums, and long-term bond yields of any country facing a similar problem.

Credit rating agencies do not usually have debt thresholds when determining creditworthiness of a country. Instead, one important criterion that they use is debt affordability – a ratio of interest payments to government revenues. Currently, the debt affordability indicator for Thailand stands at 8 per cent. It is possible that this ratio will approach the 14 per cent benchmark used by Moody's Investors Service. One reason is the uptrend in interest payments. Another is a low level of government revenues, as the collection rate in Thailand is quite low at 16 per cent of GDP, about half of that in advanced economies.

Maintaining fiscal discipline by keeping fiscal position at an appropriate level is a challenge to policymakers. Going forward, the conduct of fiscal policy will be under tighter constraints. First, both current and long-term contingent expenditures have been rising. This will depress public investment earmarked for infrastructure development, which has an implication for the nation's competitiveness. Second, to raise capital expenditure the government can either decrease current expenditure or increase government revenues by reforming the tax system and enhancing the effectiveness of revenue collection. For this reason, when the economy heads towards full recovery it is important that the government reduces its impetus and instead works to support private sector investment.