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# Indonesia, Malaysia, and Thailand: New Administrations, New Policies, New Performance?

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## Abstract

The administrations in Indonesia, Malaysia, and Thailand have all put in place economic policies designed to increase growth, reduce poverty, and improve governance. In Thailand, the government is taking a more activist role, a change from the previous, more hands-off approach. In both Indonesia and Malaysia, new policies reduce the activist role of the state, creating greater predictability and transparency. Better governance remains a key to growth, with many reforms within governments' reach. While many of the policies focus on the medium term, there is an acceptance of the need for prudent short-term management. The open question is whether progress on structural changes can persist when the short-term macroeconomic picture becomes more challenging.

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## I. Introduction

ASEAN has a new crop of leaders. In the last three years, both Malaysia and Indonesia have seen new administrations come to power. In Thailand, Prime Minister Thaksin had five years in power, with a resounding electoral victory in 2005 returning him to office, before protests and an annulled snap election this year prompted a coup that toppled him.<sup>1</sup> The shift in Malaysia, with the appointment of Abdullah Badawi was the first change in prime minister in over 20 years. President Susilo Bambang Yudhoyono is the first Indonesian president ever directly elected. Thaksin

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<sup>1</sup> The analysis in this paper was written before the coup. Singapore also has a new prime minister, Lee Hsien Loong, and Gloria Macapagal Arroyo has been formally elected to office in the Philippines, but this paper does not address Singaporean or Philippine economic performance.

may yet remain in office if, as expected, his Thai Rak Thai party wins a majority in the planned October election.

All these administrations represent a break with the past. All have touted new policies. This paper looks at what the distinct features of these new policies are and how they may affect their respective economies going forward. In Thailand, Thaksin's longer time in office does allow for some empirical analysis. Because of the short time involved in Malaysia and Indonesia, the judgments here rely more on the biases of the author than empirical analysis. Time will tell whether those biases reflect reality.

The analysis proceeds in two stages. First, I lay out my understanding of the key elements of the policies espoused by the Yudhoyono, Badawi, and Thaksin administrations, relying for this on their published policy statements. Second, I assess the long-term issues against the yardstick of work done across a range of emerging markets on the relevance of the themes espoused by the administrations to economic growth. I also make some preliminary assessments of the effectiveness of policies to date.

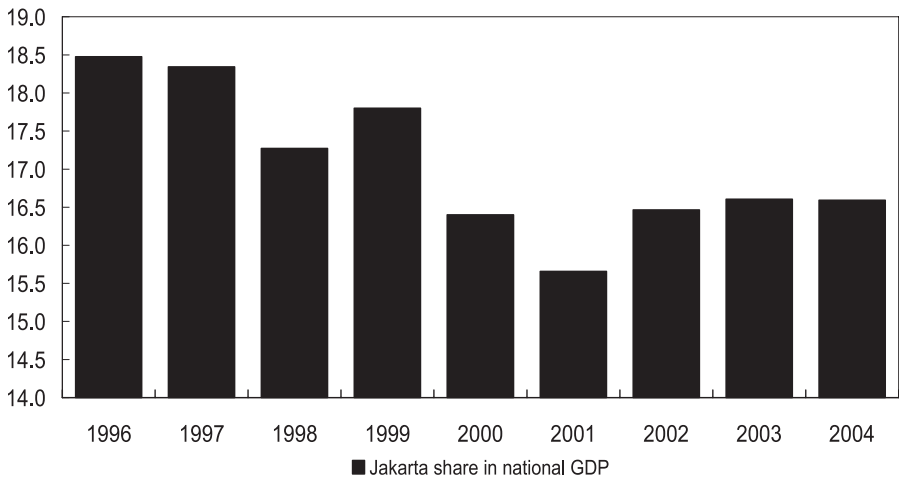
## **2. New policies, new outcomes?**

Any understanding of the effects of the policy agenda of any administration requires an understanding of just what policies it is undertaking. We look at each of the three administrations in turn, comparing them with the past agendas in each country and with each other.

### **2.1 Indonesia: Peace, justice, and prosperity**

Over the last eight years, a degree of turmoil has marked Indonesia's economic performance that is greater than any seen in the country since the 1960s. After a period of growth in per capita income that was surpassed by only a few countries in the world, the crisis that followed the 1997 Thai baht devaluation and the ensuing end of the 30 years of rule by Suharto was a rude exposure of the weaknesses of "growth with stability," the catchphrase of Suharto's economic policy.

Of course, the very phrase "growth with stability" is on one level contradictory. Something growing is, by definition, changing, at a minimum in size. One could think of the phrase, though, as the description of a stable dynamic solution in the manner of the now-classical growth theory of the 1960s. There was much in Suharto's policies that bore the hallmarks of the 1960s, especially a technocratic ap-

**Figure 1. Geographic concentration of Indonesia's GDP, 1996–2004 (percent)**

Source: CEIC Data Company Limited, Citigroup calculations.

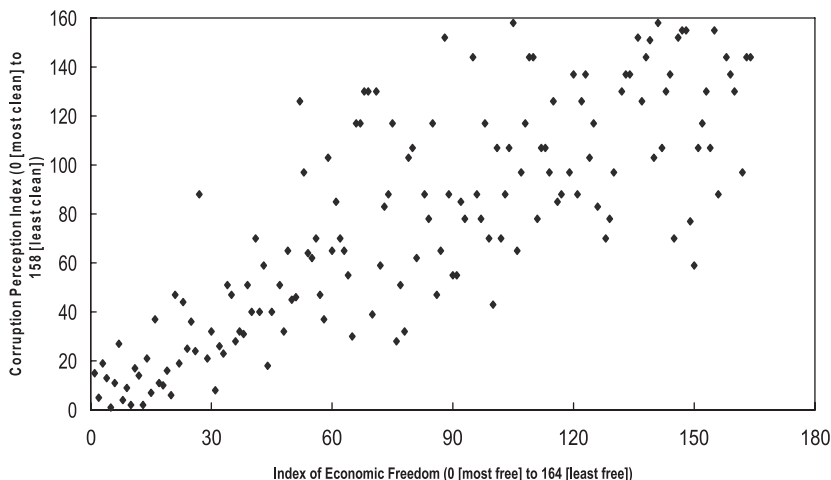
proach to economic policy that sought to isolate economics from politics.<sup>2</sup> The more usual distinction in the “growth with stability” catchphrase was the split between economics and politics. Suharto sought a growing economy and a stable polity (one led and controlled by him). However, while Suharto envisioned stable *growth* in the economy, he seemed to favor absolute stability in the *level* of politics.

One can argue that it was the conflict between pursuing stable economic growth and static politics that undermined Suharto’s regime and unwound, at least temporarily, some of the regime’s economic benefits. The effort at avoiding political change in leadership did bring change, a centralization of authority under Suharto as alternative centers of power were emasculated (the military, political parties, the parliament [Dewan Perwakilan Rakyat]).<sup>3</sup> The centralization of political authority under Suharto may have tended to concentrate economic activity in Jakarta as business sought to influence the president and his administration (certainly, the demise of Suharto’s presidency has tended to rebalance GDP away from Jakarta) (see figure 1). By the 1990s problems of pollution and congestion in the Jakarta metropolitan area were becoming severe (World Bank 1996). The bureaucracy, too, was heavily concentrated in Jakarta, reinforcing the economic concentration. With centralized

2 For a discussion of Suharto’s economic policies, see Glassburner, Nasution, and Woo (1994).

3 For a discussion of politics under Suharto, see Schwarz (1999).

**Figure 2. Country scores on Corruption Perception Index, 2005, and Heritage Foundation Index of Economic Freedom Index, 2006**



Sources: Heritage Foundation (2005) and Transparency International (2005).

political decision making, regions got short shrift, feeding simmering tensions on the fringes of the far-flung archipelago, in Aceh, in Papua (then Irian Jaya), and in northern Kalimantan.

Centralized decision making and the absence of checks on government authority not only undermined political growth, but also promoted corruption. It is perhaps not a coincidence that Transparency International's rankings of the most corrupt countries bear a direct relationship to the Heritage Foundation's Index of Economic Freedom (see figure 2). Unbridled corruption undermined justice in Indonesia, creating an environment in which justice was bought.

This backdrop is important for understanding the themes that President Yudhoyono emphasizes in his approach to governing Indonesia. In a 2005 speech he summarized his policy agenda: ". . . to change Indonesia for the better. To make Indonesia more *democratic*, more *prosperous*, more just, more *peaceful* (Yudhoyono 2005, emphasis added). These watchwords—democracy, prosperity, and peace—go beyond the typical range of economic policies toward areas that the profession has termed "governance." Only in prosperity do we have the typical set of economic policy is-

**Table 1. Key elements of Yudhoyono's 100-day plan**

Objectives	Key Actions
Ensuring security and peace	Speedily resolve conflicts in Aceh and Papua and prevent escalation of conflicts in Poso, Maluku, and North Maluku. To facilitate the above, focus on rehabilitating infrastructure and ensuring adequate autonomy laws. Ban exports from illegal logging and fishing.
Promoting justice and democracy	Combat corruption and demonstrate commitment by empowering the Anti-Corruption Court and concluding a few high-profile corruption cases expeditiously. Focus on poverty reduction, complete a strategic document on poverty reduction, and prepare a comprehensive poverty map to guide future interventions. Strengthen public services in education and health (through scholarships for books, teacher training, more staff and free services to the poor at health facilities, and adoption of a law on medical practice).
Promoting prosperity	Put in place a business-friendly tax system, with the focus on an accelerated depreciation schedule, investment allowances, extending the carry-forward period for losses, and reducing tax on dividends. Ensure budgetary needs in 2004 are met, through tighter tax collection and divestment of minority-share ownership of the government in some banks, and review 2005 budget to align priorities with resources. Improve labor regulations related to recruitment, wages, layoffs, and separation pay. Support the small and medium-sized enterprise sector through debt forgiveness from state-owned banks and other support mechanisms through state-owned enterprises.

Source: Coordinating Ministry of Economic Affairs, as quoted by Asian Development Bank, [www.adb.org/Documents/CERS/INO/2004/mo0300.asp](http://www.adb.org/Documents/CERS/INO/2004/mo0300.asp)

sues. Within each broad category is a set of initial actions that the government committed to as part of its 100-day program (see table 1).

## 2.2 Malaysia: A national performance culture

Understanding the policies of Malaysian Prime Minister Badawi is also easier if one considers those of his predecessors, Tun Abdul Razak and Mahathir Mohamed, who governed Malaysia for 35 years prior to Badawi. The dominant policy agenda of much of that period was the "New Economic Policy" (NEP) adopted in 1970 in response to serious race riots in 1969. The objectives of the policy were to eradicate all poverty and to redistribute wealth to the *bumiputera*, largely Malay, with a goal of having 30 percent of national wealth in *bumiputera* hands by 1990. In practice this meant institutionalized discrimination in favor of other Malaysians against the Chinese, the chief holders of wealth in Malaysia, in owning businesses, in education, and in job placement.

Favored by the state, *bumiputera* citizens did increase their relative incomes and their control of wealth in part by preferential access to state privatization deals as well as favorable quotas at universities and in the civil service.<sup>4</sup> But a culture of cronyism also set in, with opportunities allocated not on merit, but on race. Crony-

4 For an analysis of the NEP, see Sundaram (2004).

ism was reinforced by Prime Minister Mahathir's preference of favoring particular *bumiputera* businessmen as a means of creating a new business class rather than a strategy of distributing stakes in state assets widely through the Malay community.

Like that of Indonesia, Malaysia's economic performance through the NEP years was among the best in the world. Per capita income soared from US\$370 in 1970 to US\$2,400 in 1990. The incidence of poverty slipped, life expectancy lengthened, and infant mortality plummeted. By the 1990s Prime Minister Mahathir was focused on "Vision 2020," a plan to push Malaysia to developed-country status by that date. Achieving this goal was complicated, though, by the Asian crisis and the weakness in Malaysia's corporations and banks that it exposed. Favored, state-connected, and previously high-flying institutions like Renong defaulted as many of the *bumiputera* managers, who had not seen a recession since the mid-1980s, found themselves unable to cope with the country's economic downturn. Banks' balance sheets were riddled by bad loans, threatening their solvency.

Five years later, as Prime Minister Mahathir gave way to Prime Minister Badawi, the criticisms of the discrimination inherent in government policies had risen, not just among those who had been discriminated against, but also among Malays who had begun to resent the stigma of favoritism, rather than personal achievement, that clung to accomplishments.<sup>5</sup> Against this backdrop, Prime Minister Badawi, shortly after assuming office in October 2003, proclaimed his new economic policy agenda:

Let us now enter into a "performance contract." The public sector hereby commits to maintaining strong fiscal discipline and growth-supporting policies, and at the same time strives to overhaul the levels of bureaucracy and red tape to achieve higher levels of efficiency and transparency. In return, the corporate sector commits to leading the growth effort, by improving productivity and international competitiveness, while capitalizing on focused investments in key sectors to build our future economic growth engines. Additionally, we will collectively commit to upgrading the quality of our human capital. (Badawi 2004)

Notable in this enumeration was the total lack of any racial or religious references. Performance, rather than race, has become the watchword.

### 2.3 Thailand: 21st-century global populism

Thai Prime Minister Thaksin's economic policies, as announced in his March 2001 policy speech, also reflect a response to the aftermath of Thailand's 1997 economic

<sup>5</sup> For an insightful personal view of the NEP period, see Rashid (1993).

crisis (Shinawatra 2001), to a sluggish economy and rising poverty, and to perceived decaying moral values, epitomized by rising corruption and drug use. As the crisis has receded and economic performance has improved, the emphasis has shifted to eliminating poverty and building a “sustainable” Thailand.

Tellingly, the Thaksin administration attributes the weak performance of Thailand’s economy immediately after the 1997 crisis to “heavy dependence on foreign markets” (see Shinawatra 2005, 1). Hence the policy prescription at heart attempts to build Thai resilience in the face of greater global competition, rather than simply shielding the economy from that competition. To this end, the government’s “Dual Track” policy pronouncements have tended to focus on building rural, “grassroots” Thailand (the revolving Village Fund, the farmer debt moratorium, the “One Village, One Product” campaigns). They have also tended to emphasize advantages to Thai business integral to Thailand due to its geography or culture (tourism and agriculture again are prominent). Finally, there has been a willingness to use the state more actively in promoting economic growth (the consolidated asset management company, clusters of state-owned enterprises).

At the same time, Thailand has pursued a policy of promoting trade, negotiating for a free trade agreement with the United States, and pushing to expand the ASEAN Free Trade Agreement. These efforts are constrained, though, by a desire to promote local business interests. This again, comes across very clearly in the 2001 policy statement of the trade agreement: “Support free trade in the international arena, taking into full consideration the level of preparedness and national interests of the country as well as the interest of domestic entrepreneurs” (Shinawatra 2001, section 4.3(1)). The tension between national and foreign interests in trade and production is also evident in a more recent policy speech: “. . . industrial manufacturing continues to be run by placing orders or according to the pattern developed by the foreign intellectual property owners, which, in turn, makes the country deeply dependent on the imports of raw materials, capital and technological expertise from abroad” (Shinawatra 2005).

Some observers have attributed this bias to Thaksin’s own background as a Thai entrepreneur whose telecom businesses benefited from Thailand’s initially protected regulatory environment and from government contracts. The popularity of the policy may also be a backlash by domestic business against the sale of assets, largely to foreigners, instituted by the Democratic administration that preceded Thaksin.<sup>6</sup>

<sup>6</sup> See Phongpaichit and Baker (2002) for an espousal of this view.

There has also been a tension between the Thaksin administration's desire to promote grassroots development and the somewhat newer emphasis on providing social protections from "cradle to grave." The interesting issues are how to strike the balance between absorbing the technology and prowess of the rest of the world and being absorbed by it, and how the state can promote risk taking while sheltering those who fall behind.

Finally, there is little said in Prime Minister Thaksin's policy statements about the conduct of macroeconomic policy. There was a commitment in Thaksin's first administration to reducing the fiscal deficit as Thailand's economy rebounded, a commitment that was met. Because of concerns about the faltering economy, the administration has now pledged to keep public debt below 50 percent of GDP and debt service to under 15 percent of public spending, even as it announced a July 2005 fiscal package of Bt\$50 billion, or 0.7 percent of GDP, and infrastructure spending of US\$63 billion over the next five years.

On monetary policy, though, little has been said, even as inflation picked up in 2005. Thaksin's original 2001 policy statement commits the administration to "implement monetary policies that facilitate the extension of credits to the real sector" (Shinawatra 2001, section 2.2, paragraph 1). There is no mention of price stability. Of course, this could simply represent the independence of the Bank of Thailand, though the ouster of the previous governor seems to imply limits on the effective independence of the bank.

#### **2.4 Parallels across the region**

There are echoes in Thaksin's economic policies of those of former Malaysian Prime Minister Mahathir.<sup>7</sup> The willingness to remain open to trade, while harboring suspicions about the motives and consequences of foreign trade, is very reminiscent of Mahathir. So, too, is a willingness to use the state as an agent of change. But with Thaksin having just begun the process of political and economic consolidation, there is less of the performance contract/transparency theme inherent in the Badawi administration policies.

Like his fellow leaders in neighboring countries, Thaksin is also emphasizing the need to root out corruption. This goal was one of the key planks of his first administration and repeated in the second. Against this goal, it is ironic that the sale of his

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<sup>7</sup> Phongpaichit (2004) argues that there are also political echoes of Mahathir in Thaksin, particularly his willingness to use the state as an engine of reform and his penchant for concentrating authority in his party, the Thai Rak Thai.



family's flagship company in early 2006, in a manner that avoided any tax payments, sparked the current political turmoil in the country.

There is an interesting evolution, though, in the government's position on democracy and transparency and civil society: "That the Government received the people's trust so overwhelmingly in the last election has given rise to a new dimension in the Thai political system: a strong government. However, the Government fully recognized that in a democratic society, there must be checks on the administration of public affairs, through a strong civil society" (Shinawatra 2005, section 7). These comments seem at odds with other observers' concerns about the human rights of southern Muslims and of drug traffickers and about press freedom. They are consistent, though, with Thaksin's decision to temporarily step down from the position of prime minister, holding the position now only in a caretaker capacity until new elections can be arranged.

There are echoes in Thaksin's Thailand of the pro-domestic-business stance evinced by Indonesian Vice President Jusuf Kalla and his chosen Economic Coordination Minister, Aburizal Bakrie. Both countries focus on calls for reduced poverty and greater decentralization. Prime Minister Thaksin, though, with a stronger fiscal and political base, seems more willing to use state authority for his aims than President Yudhoyono has been to date. Both countries have plans for a large expansion of infrastructure: in Thailand's case, some US\$63 billion over the next five years, in Indonesia's case, US\$25 billion.<sup>8</sup> In Thailand's case, though, there is a greater emphasis on state-driven projects, while Indonesia has tried to focus on a better enabling environment and less direct state funding.

Other elements of Thaksin's agenda appear in the 100-day plan of the Yudhoyono administration: ensuring peace (Aceh and the Maluku versus southern Thailand), lessening corruption, reducing poverty, support for small and medium-sized enterprises, and more effective decentralization and public infrastructure. The similarity in ends, though, seems to mask some differences in means, in particular, the willingness to use the state as a catalyst rather than focusing on removing governmental obstacles. This in turn may simply reflect the differences in the effectiveness of administrations in the two countries, evident in the World Bank data on governance (see appendix 1).

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<sup>8</sup> According to a presentation made by Raden Pardede, the head of the Indonesian government's task force for infrastructure financing, the total amount needed for infrastructure adjustment is as much as US\$149 billion in the next five years. This includes Aceh/Nias reconstruction. However, only US\$25 billion of that will come out of the national state budget.

### 3. Policy evaluation: Current and likely effects

#### 3.1 Indonesia

One way of assessing President Yudhoyono's economic program in the first year is simply to enumerate how much of the 100-day program has actually been carried out. The answer to that is straightforward: there has been a good start on some structural measures, but the record on short-term policy management and on the infrastructure initiative is very mixed.

**Enhancing peace and security** The tsunami that devastated western Aceh provided an opportunity for progress on peace negotiations with the Free Aceh Movement. Both sides agreed to a cease-fire as they focused on the need to prioritize disaster relief. Several rounds of talks in Helsinki ended with a peace agreement in July that is now being put in place. Along with peace negotiations, infrastructure rebuilding in Aceh has begun, with billions of dollars in aid flows beginning to be felt in the province, and a one-year debt moratorium from the Paris Club to provide some US\$4.5 billion in temporary cash flow relief. Progress on autonomy laws or on conflicts elsewhere around Indonesia, though, has suffered as the government's attention and capacity is occupied by tsunami relief.

**Combating corruption** In regard to fighting corruption, too, there has been some progress, largely with the Corruption Elimination Commission bringing cases against 10 prominent government officials and opening investigations into 16 others as of May. Five cases have been decided, but four are still under appeal.<sup>9</sup> President Yudhoyono has also publicly acknowledged police and army connivance in illegal logging in Papua and Kalimantan, a major source of corrupt income for both entities. Under new scrutiny from the president, customs has reduced bribe taking to such an extent that exporters are now complaining that imports of components are being held up as officials demand proper bills of lading and tariff payments. Structural changes in public sector compensation, though, remain unaddressed. A much-awaited reshuffling of senior civil servants designed to root out corruption and also increase the effectiveness and competence of the civil service is still pending.

**Promoting prosperity** Promotion of prosperity is perhaps the area most closely tied to immediate economic performance. It is also one where the items identified in the 100-day plan remain largely works in progress. The most contentious issue has

<sup>9</sup> See article by the Deputy of Prevention of the Corruption Elimination Commission, published by the Independent Commission Against Corruption of Hong Kong in the *International Anti-Corruption Newsletter*, 2005, no. 2, cited at <http://www.icac.org.hk/news/issue22eng/frame.htm>

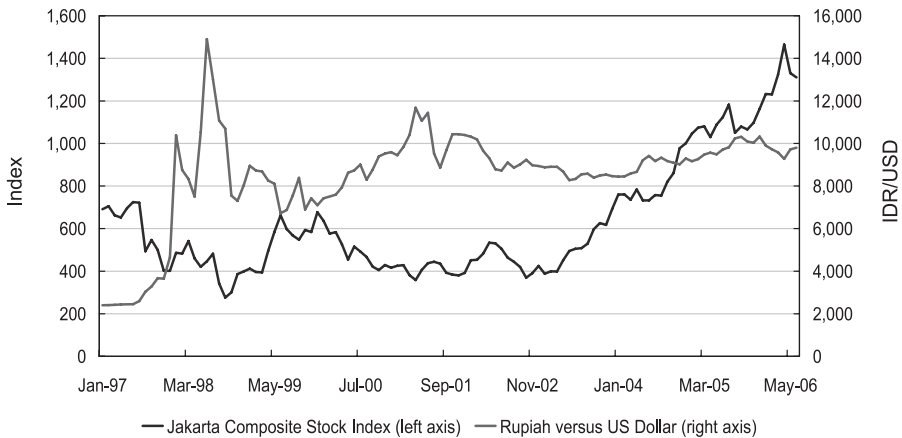
been implications of the steady rise in oil prices and its fiscal and inflationary consequences. Poverty reduction efforts and fiscal coherence got a boost from the 1 March 2005 announcement of a 29 percent average hike in the price of fuels in Indonesia. Roughly half the expected subsidy cut of Rp20 trillion was earmarked for the 16 percent of Indonesia's population living under the poverty line. To avoid the misuse of these funds, as occurred after a similar effort in 2001, the government has also funded a commission to monitor and report any corruption or abuse in the use of the funds. The money will largely be used for rural infrastructure and health programs and for subsidizing rice purchases, thus addressing some of the public service issues on the government's agenda.

Initial gains from this measure, however, were quickly stripped away by rising international oil prices that threatened to drive the domestic fuel subsidy to 5 percent of GDP. Even netting out higher revenues from oil production, domestic demand at Indonesia's low prices was enough to generate a fiscal deficit of about 0.5 percent annually. In part this reflected the fall in domestic production to under 1 million barrels a day from 1.5 million pre-crisis, which, in turn, was a result of Indonesia's uncertain investment climate and a paucity of exploration and development. The most visible example of this is the case of the Cepu oil field in central Java, currently operated by Exxon. In order to invest the money needed to add some 15–20 percent to Indonesia's annual oil production, Exxon had asked for a lease extension. A long and contentious negotiation was necessary, with only the intervention of President Yudhoyono moving the issue forward in the summer of 2005.

With Pertamina's oil demands rising, and Bank Indonesia lagging behind on interest rate adjustments (see below), the nominal exchange rate on the rupiah moved through 10,000 to the U.S. dollar in late August 2005 and quickly moved through 11,000 (see figure 3). Faced with a crumbling currency and slumping equity and bond prices, President Yudhoyono finally moved, promising a fuel price hike in October. Bank Indonesia joined in the stabilization effort, pushing up policy rates by 125 basis points in two weeks. While this initially stabilized asset markets, greater market confidence was engendered by the passage of a new 2005 budget in September that implied an 80 percent increase in domestic fuel prices. On 1 October, however, the government actually surpassed market expectations by boosting fuel prices 110 percent. Since then world oil prices have continued to rise, without further domestic adjustments. However, the effects on Indonesia's oil product imports from the 2005 price moves have been so dramatic that currently higher oil prices positively affect both the balance of payments and the fiscal accounts.

The whole episode surrounding the fuel subsidy and monetary policy highlights some key points about macroeconomic management in Indonesia. Under Suharto,

**Figure 3. Indonesia rupiah/U.S. dollar nominal exchange rate and the Jakarta Stock Exchange**



Source: Haver Analytics.

short-term macro stability was generally protected, while progress on long-term, structural reforms, especially in the 1990s, was painfully slow. Megawati's economic team has restored short-term macro stability, as evidenced by the declining fiscal deficit, a strong trade balance, and stronger currency and falling inflation (see table 2). However, it has not been very successful at boosting investment. In the first year of Yudhoyono's term, just the opposite was the case, at least as far as inflation, the rupiah, and investment were concerned.

The minicrisis surrounding the rupiah has served to focus attention again on short-term management and has led to changes in Yudhoyono's economic team, with the well-respected former finance minister, Boediono, brought back in to coordinate economic policy, helped by a more decisive new finance minister, Sri Mulyani. Part of the problem in Indonesia, though, has not been so much poor fiscal policy as it has been easy monetary policy that does not respond to a changing environment (see figure 4). Bank Indonesia seemed mired in a debate over which interest rates to follow, deposit or lending rates. Some argued that because lending rates were very high, monetary conditions were tight, and the weaker rupiah was just due to oil prices. Others looked at near-zero short-term interest rates, accelerating GDP growth, and a shrinking trade surplus and concluded that monetary policy needed to tighten. Certainly 30 percent credit growth, more than double nominal GDP growth, didn't seem to jibe with lending rates' being "too high."

Table 2. Comparative summary of Indonesia's macro performance

GDP	CPI excluding fresh foods and fuel		Three-month SBI* rate		Real interest rate		Rupiah per U.S. dollar		Fiscal balance (% of GDP) <sup>a</sup>		Trade balance (% of GDP) <sup>a</sup>			
	Average seasonally adjusted sequential growth rate	Volatility (standard deviation)	Volatility (standard deviation)	Avg. growth rate	Avg. deviation	Volatility (standard deviation)	Avg. deviation	Volatility (standard deviation)	Avg. deviation	Volatility (standard deviation)	Avg. deviation	Volatility (standard deviation)		
Prior to installation of previous administration	1.5	2.7	0.2	0.1	19.5	10.9	4.6	9.2	7,863	723	-2.4	0.3	6.3	4.4
Previous administration (Jul-01 to Sep-04)	1.1	0.6	0.4	0.2	12.7	3.6	3.4	1.6	9,261	808	n.a.	n.a.	14.0	2.4
Current administration (from Oct-04)	1.3	0.6	0.2	0.0	9.6	2.5	-1.2	2.1	9,662	397	-0.5	0.7	9.0	0.8

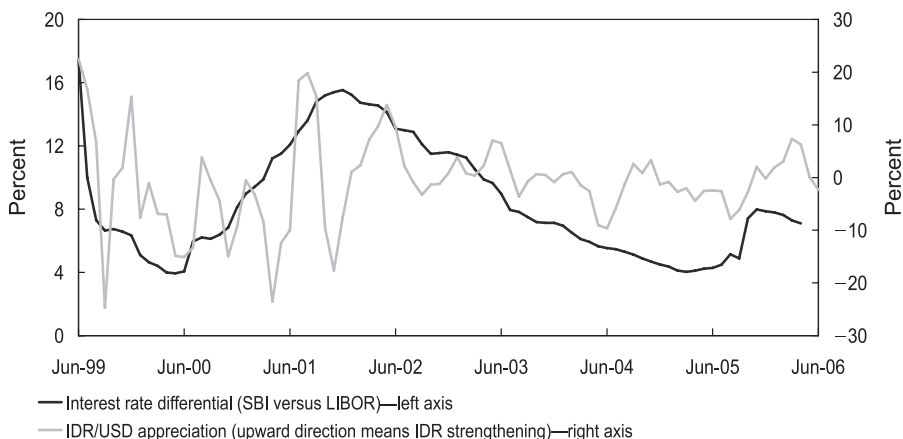
Source: *Haver Analytics and Citigroup estimates.*

a. *Rolling 12-month sums.*

\* *Sertifikat Bank Indonesia.*

*n.a. = not available.*

**Figure 4. Indonesia's short-term interest differential and rupiah/dollar exchange rate changes (percent)**



Source: Haver Analytics and Citigroup calculations.

Note: Upward direction in the "IDR/USD appreciation" line denotes a devalued IDR vis-à-vis the U.S. dollar.

With Bank Indonesia independent, however, there is more limited means for the administration to influence monetary policy. It took the minidebacle surrounding the rupiah to shift the argument sharply in favor to those pushing for tighter monetary policy. This mistake was not lost on Bank Indonesia, however, which has kept nominal and real interest rates high as the inflationary effects of the fuel price adjustment subsidy. Still, the episode underscores how important accountability, as well as autonomy, is to the success of an independent central bank.

**From 100 days to 1,825 days: Possible growth effects over time** The general market reaction to President Yudhoyono's administration had been positive prior to the August 2005 debacle and has largely recovered to the levels prior to the debacle. The combination of shifting policies and personalities has seen a dramatic strengthening of the rupiah on the back of higher capital flows and falling month-to-month inflation (see Figure 3). International reserves have reached all-time highs, as Indonesia now is grappling with the problem not of capital flight, but of capital excess driving up the real exchange rate. Rating agencies, having upgraded the country's sovereign rating in 2005, saw no reason to change their ratings, and bond markets have tightened the spread to U.S. Treasuries on Indonesia's dollar-denominated bonds, with Indonesia issuing the largest trade in 30-year dollar paper of any Asian sovereign, US\$600 million, during the first week of October 2005. This despite another in a string of fall bombings, the second episode to strike Bali.

Whether these market judgments prove correct will depend on two things: the potential impact of the policies on stated objectives and the actual effects. Given the general scope of the policy agenda, and our limited expertise as economist, we choose to focus on the gains to economic growth that could potentially accrue to the policy agenda if implemented.

One strategy is to simply look at the gains to GDP that would accrue from either larger or more effective use of resources in Indonesia commensurate with the policy objectives. A growth-accounting framework is one way of carrying out such an exercise.<sup>10</sup>

The Indonesian government has a medium-term projection for reducing unemployment and poverty—by 2009—cutting open unemployment to 5.1 percent from 9.7 percent in 2004. What would that mean for GDP growth? We use an expected labor force growth rate of 2.3 percent, derived by taking the moving-average growth in the working-age population over the six years to 2004 and a modest increase in the labor participation rate from the 2003 value of 65.7 percent to the recent peak value of 68.6 achieved in 2001. Assuming that the reduction in unemployment occurs smoothly over the next five years means an effective gain in the labor force of 1 percent year each year. This in turn should boost GDP growth by the same amount, assuming constant labor productivity.

But Indonesia plans other changes that should affect growth through both the capital stock and educational attainment. A dramatic surge in infrastructure is one of the key elements of the new policy program within the promoting-prosperity agenda. At the infrastructure summit held in Jakarta in January 2005, the country argued that it would need to roughly double infrastructure investment from 2.3 percent of GDP to 5 percent of GDP. Assuming an incremental capital output ratio of four, the average of the last two years, would imply a boost in GDP growth as a result of higher infrastructure investment of 0.7 percent each year.

There are no quantitative increases in educational attainment yet specified. Given the lags between improving educational attainment and quality and moving people into the workforce, it is unlikely that changes instituted now would have an appreciable effect over the next five years, even if successfully implemented. There is,

<sup>10</sup> Bosworth and Collins (2003) looked at growth accounting across the world from 1960 through 2000 using information on labor quantity, labor quality and capital. Their underlying production function in intensive form assumed constant factor share ratios of 0.65 for human capital (educational attainment over the labor force) and 0.35 for physical capital (capital stock over the labor force). Total factor productivity was taken as a residual.

however, growth regression work that relates improvements in educational attainment and quality to GDP across a wide cross-section of countries. Bosworth and Collins (2003), for example, work with a human capital share of 0.65, meaning that for every 1 percent gain in educational attainment, output per worker would rise by 0.65 percent. Their empirical work, however, casts some doubts on the magnitude of the effects of educational attainment on growth (see table 3).

In a regression in which the contribution from physical capital is constrained to the assumed 0.35 share, educational attainment is significant, but when initial conditions or educational quality is included, the magnitude and the significance of the relation breaks down (see columns 3–5 of table 3). None of this should be taken to mean that human capital is not a crucial input to growth, only that quantifying its effect is tough.

President Yudhoyono's policy agenda goes beyond better labor markets that lower unemployment and higher infrastructure spending that boosts investment and growth. There is also a focus on improving the investment climate through improving security and revamping the regulatory and legal environment, especially as it relates to establishing a business, enforcing contracts, or closing businesses. On measures of these areas, Indonesia rates poorly (see table 4).

The peace and democracy aspects of policy may also have important effects on Indonesia's growth. Issues of governance and growth have been examined in Kaufmann, Kraay, and Mastruzzi (2005). Indonesia, at least in 2002, ranked very poorly (see appendix 1). Kaufmann identifies six facets of governance: voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and control of corruption. Each of these indicators is positively correlated with per capita income growth. While correlation is not causality, the positive correlation between governance and growth holds out hope for President Yudhoyono's policies.

So far the goals and focus of President Yudhoyono's new policies appear, according to our examination, aligned with economic evidence supporting higher growth—one measure of the prosperity that Indonesia seeks. If that judgment is right, then the real change isn't the objectives of the policy, but rather their implementation. Then-Planning Minister Sri Mulyani echoed as much in a 2005 public speech in which she cited implementation of policy, not its formulation, as the biggest challenge facing the administration. There are clearly huge benefits to lifting investment, improving governance, and maintaining monetary and fiscal prudence. Capturing those benefits will depend on the execution. Success for President Yudhoyono



Table 3. Regression results on educational attainment, quality, and economic growth, 1960–2000

Independent variable	Average seasonally adjusted sequential growth rate		Volatility (standard deviation)		Average seasonally adjusted sequential growth rate		Volatility (standard deviation)	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	
Growth in physical capital per worker	0.51	0.35	0.27	0.48	0.27	0.48	0.27	
Growth in human capital per worker	11.5	—	6.2	10.5	6.0	10.5	6.0	
Initial level of average years of schooling	0.74	1.55	0.55	0.82	0.53	0.82	0.53	
Educational quality	1.4	3.0	1.3	1.6	1.3	1.6	1.3	
Initial conditions included	0.11	0.13	0.08	0.07	0.07	0.07	0.07	
Constant	3.5	3.7	1.4	1.8	1.0	1.8	1.0	
Adjusted R <sup>2</sup>	—	—	—	0.02	0.01	0.02	0.01	
Number of observations	—	—	—	2.2	0.7	2.2	0.7	
Summary statistics	No	No	Yes	No	Yes	No	Yes	
Adjusted R <sup>2</sup>	-0.41	-0.51	-4.25	-0.9	-4.53	-0.9	-4.53	
Number of observations	-1.4	-1.6	-3.9	-2.5	-3.9	-2.5	-3.9	
Summary statistics	0.71	0.7	0.84	0.72	0.84	0.72	0.84	
Number of observations	84	84	84	84	84	84	84	

Source: Bosworth and Collins (2003).

Note: *t*-statistics are in italics. Initial conditions include GDP per capita in 1960, life expectancy in 1960, log population in 1960, trade instrument, geography, and institutional quality. —: not available.

Table 4. Indonesia rates poorly on business climate measures

Economy	Ease of doing business	Starting a business	Dealing with licenses	Hiring and firing	Registering property	Getting credit	Protecting investors	Paying taxes	Trading across borders	Enforcing contracts	Closing a business
Singapore	2	5	7	7	14	8	2	9	6	11	2
United States	3	3	17	6	12	15	7	30	17	10	17
Hong Kong, China	7	6	77	3	70	2	4	2	26	16	14
Japan	10	81	5	20	36	18	14	50	12	3	1
Thailand	20	29	8	23	22	59	33	34	89	49	37
Malaysia	21	57	101	34	53	6	5	19	36	61	43
Korea	27	97	25	105	64	25	87	44	16	18	13
Taiwan, China	35	79	126	108	26	58	65	32	54	27	5
China	91	126	136	87	24	113	100	119	48	47	59
Vietnam	99	82	18	122	39	106	143	107	83	102	95
Philippines	113	89	91	82	92	121	132	80	33	89	132
<b>Indonesia</b>	<b>115</b>	<b>144</b>	<b>107</b>	<b>120</b>	<b>107</b>	<b>63</b>	<b>58</b>	<b>118</b>	<b>49</b>	<b>145</b>	<b>116</b>
India	116	90	124	116	101	84	29	103	130	138	118

Source: World Bank (<http://www.doingbusiness.org/Economy/Rankings/>).

Note: The Ease of Doing Business Index ranks economies from 1 to 155, with 1 being the highest. The index is calculated as the ranking on the simple average of country percentile rankings on each of the 10 topics covered in Doing Business in 2006. The ranking on each topic is the simple average of the percentile rankings on its component indicators.

would be a bigger milestone than the peaceful election process that brought him to power. Stories of the corruption of Indonesian officials and their antipathy to business go back at least to the 16th century.<sup>11</sup>

### 3.2 Assessing Malaysia's new performance contract

As with Indonesia, there has been little time since the announcement of Badawi's policies, making an empirical assessment of their impact difficult, though some partial indicators are available. Fiscal discipline looks improved, with the 2004 deficit running at 4.5 percent of GDP, budgeted to fall to 3.8 percent of GDP in 2006, though this remains much worse than the average under Mahathir (see table 5 and figure 5). The ratio of public debt to GDP is also falling, with ratings agency upgrades in 2004 lauding the country's economic management.<sup>12</sup>

These policies reverse the expansionary fiscal policy pursued to stabilize the economy after the 1997–98 debacle. Still, the Malaysian government has not returned to the surpluses it was running in the 1990s.

The history of fiscal adjustment in Malaysia is encouraging. Past surplus gave the government considerable room to operate countercyclical fiscal policy during the Asian crisis downturn. Although the country's budget balance is improving, there is probably greater room to steer a more aggressive fiscal consolidation path in meeting the commitment to "strong fiscal discipline." Malaysia's tax effort compares well regionally (see figure 6).

But an increasing need for a lighter direct tax burden to cope with growing international competition for foreign direct investment and to stimulate domestic private investment implies that policymakers need to broaden the country's revenue base to pave the way for a cut in direct taxes. Recent fiscal consolidation has relied mainly on the scaling back of development spending. However, there is also greater scope for tighter discipline in regard to operating expenditures, such as a partial hiring freeze in the public sector to reduce the public sector wage bill.

With the government dedicated to fostering entrepreneurship, in addition to a low tax burden, an important driver is the ease of opening a business. If establishing a business is too expensive or cumbersome, potential entrepreneurs may decide

<sup>11</sup> See Milton (2000) for a description of an early encounter between English spice traders and Indonesian locals.

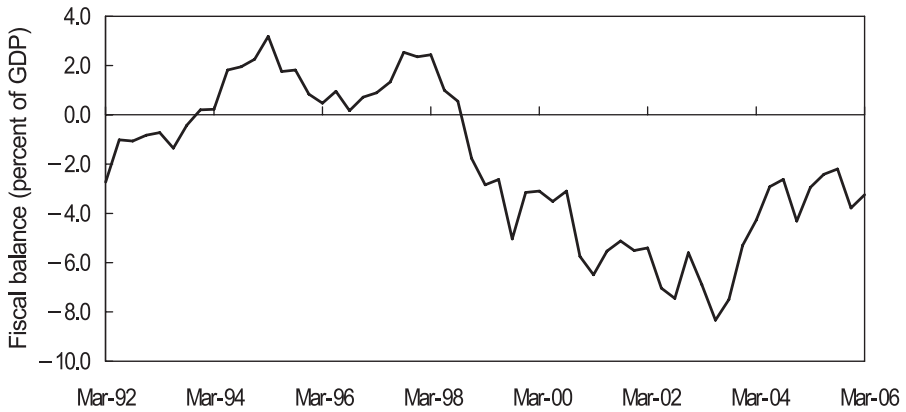
<sup>12</sup> Moody's upgraded its rating of Malaysia one notch to A+ in December 2004; Fitch also moved its rating up one notch to A3 in November 2004.

Table 5. Comparative summary of Malaysia macro performance

GDP	CPI excluding fresh foods and fuel		Three-month kilbor rate		Real interest rate		Ringgit per U.S. dollar		Fiscal balance (% of GDP) <sup>a</sup>		Trade balance (% of GDP) <sup>a</sup>			
	Average seasonally adjusted sequential growth rate	Volatility (standard deviation)	Average seasonally adjusted sequential growth rate	Volatility (standard deviation)	Real interest rate	Volatility (standard deviation)	Avg. deviation	Volatility (standard deviation)	Avg. deviation	Volatility (standard deviation)	Avg. deviation	Volatility (standard deviation)		
Previous administration (Sep-92 to Sep-03)	1.5	2.0	0.3	0.3	4.8	2.7	2.4	1.6	2.81	0.50	-0.2	2.1	5.3	10.2
Current administration (from Oct-03)	1.5	0.7	0.2	0.1	2.9	0.1	0.7	0.9	3.79	0.02	-5.1	1.8	17.8	1.9

Source: *Haver Analytics and Citigroup estimates.*

a. *Rolling 12-month sums.*

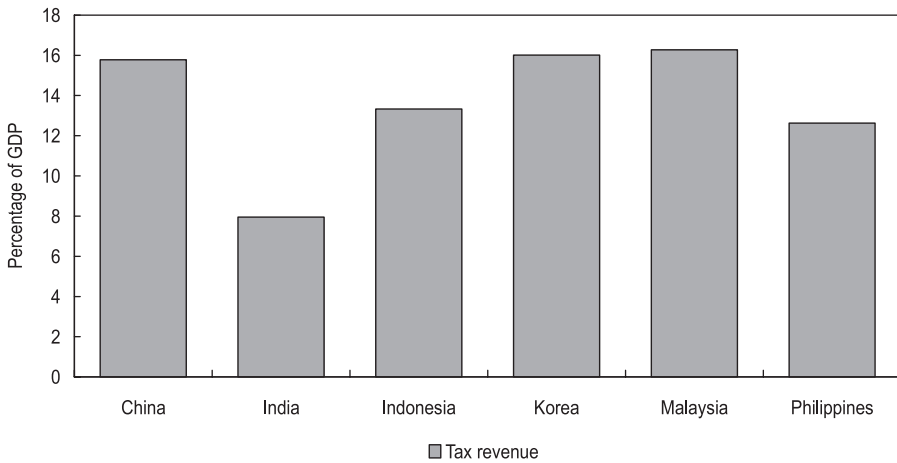
**Figure 5. Public deficit in Malaysia**

Source: Haver Analytics and Citigroup calculations.

to abandon their ventures. The commitment of the Badawi government to cut red tape and improve public service delivery, therefore, is a step in the right direction toward fostering a more positive official attitude toward entrepreneurship. Although the process that a Malaysian entrepreneur must complete to establish a business ranks favorably among the Asian countries in a cross-country comparison, such a comparison also shows that there is still plenty of leeway to improve the business climate (see table 4).

From a cyclical perspective, managing fiscal policy has been complicated by the oil price shock. While Malaysia is an oil exporter with significant positive benefits from higher oil prices for the balance of payments, the GDP effects are negative, given the feed-through from weaker non-oil export markets and the consolidation of oil profits from the state oil company in the treasury (see table 6). Depending on which model one uses, Malaysia shows a loss in GDP of between 0.3 and 0.6 percent from a US\$25 increase in oil prices. In grappling with this effect, the government has again moved to accelerate infrastructure projects as an additional fiscal stimulus.

**Monetary policy: New flexibility, but to what end?** Part of the new commitment to performance and transparency can be seen in the new interest rate framework introduced in April 2004, which shifted Bank Negara Malaysia's (BNM) policy rate to an overnight rate, coupled with BNM's use of repos to manage money market liquidity and maintain the policy rate. At the time, Malaysia was following a fixed-exchange-rate policy that limited the room for interest rate divergence with the

**Figure 6. Tax effort across Asia**

Source: CEIC Data Company Ltd. and Citigroup calculations.

Note: Data as of 2005.

United States.<sup>13</sup> In introducing the change BNM argued that it would help to signal policy intentions. In practice, the overnight rate has been at 2.7 percent for 5 years, implying that that BNM's effectiveness in communicating its intentions with the new regime has yet to be tested.

The objective of monetary policy has become a more important element of the picture with Malaysia's decision in July to follow the Chinese and abandon its peg to the U.S. dollar. The daily volatility remains low at less than 1 percent, compared to the daily standard deviation in the yen-dollar exchange rate of 8 percent in the last 3 years. Still, greater flexibility raises the question of what will anchor Malaysian monetary policy. A vehicle exists for communicating policy intentions: the quarterly Monetary Policy Statement introduced in August 2003 and issued with the GDP figures. In this the setup would mimic that of the Reserve Bank of Australia or the Federal Reserve, neither of which explicitly targets inflation. At issue, however, is how transparent BNM would be in disclosing the relative importance it places on inflation versus GDP growth and how its preference in that regard moves over time. With core inflation rising (see figure 7), despite continued controls on domestic fuel prices, greater clarity in monetary policy may be needed to avoid building a risk premium into the domestic yield curve.

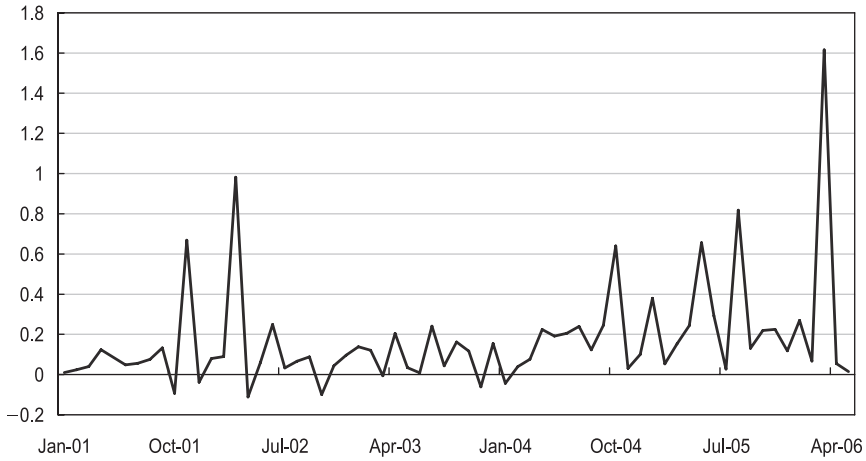
<sup>13</sup> Restrictions on capital outflows and short-term inflows created some scope for domestic interest rate policy even with the peg.

Table 6. Oil price effects in Asia in the event of a rise in oil price to US\$70 per barrel, 2006 (percentage points of GDP)

	GDP growth, OEF	Budget balance, OEF	GDP growth, IMF MULTIMOD (2000)
G3 (US, Japan, Euro Zone)	-0.5	-0.3	-0.5
China, People's Republic of	-1.0	-0.1	-0.6
Hong Kong, China	-0.9	-0.1	—
India	-1.1	-0.9	-0.8
Indonesia	(-0.09) -1.1	(0.0) 0.2	0.1
Korea, Republic of	-0.5	-0.9	-1.4
Malaysia	(-0.6) -1.1	(0.0) 1.0	-0.3
Philippines	-1.4	-0.8	-1.3
Singapore	-1.3	-0.4	—
Taiwan, China	-0.2	-1.1	—
Thailand	-1.8	-0.7	-1.4

Sources: Staff calculations using OEF model (available to subscribers: [www.oef.com](http://www.oef.com)), OEF data release, August 2005; and IMF Research Department (2000).

Note: The baseline is calculated under an assumption of oil prices at \$53 per barrel from 2005:Q3 to 2005:Q4. The simulation is based on a rise in prices to \$70, sustained over the same period. The International Monetary Fund (IMF) numbers in the "GDP growth, IMF MULTIMOD" column result from scaling the impact of a \$5 per barrel rise over a \$25 per barrel baseline by 1.5, which is roughly equal to a 32% rise in the oil price. This assumes that impacts are linear, which they may not be, and are independent of the base starting price. The IMF MULTIMOD estimate is for industrial countries, not an average for the G3. For Indonesia and Malaysia, the numbers in parentheses show the estimated impact when additional oil revenues accruing to government are recycled. — = not available. OEF = Oxford Economic Forecasting.

**Figure 7. Malaysian CPI inflation (seasonally adjusted month-on-month rate, percent)**

Source: CEIC Data Company Ltd. and Citigroup calculations.

**Fostering entrepreneurship** We have used the growth-accounting framework in thinking about productivity and its impact on medium-term growth. Malaysia is no exception to the familiar criticism that Asia's growth has relied too much on perspiration and not enough on inspiration. Growth decomposition reveals that Malaysia's growth since 1960 has been driven largely by capital accumulation. Close to half of the economic growth between 1960 and 2000 can be accounted for by capital accumulation, while total factor productivity (TFP) accounted for less than one-fifth of growth (Bosworth and Collins 2003). This contrasts with the growth experience of the United States and other industrialized economies, where TFP typically plays a more significant and enduring role in driving growth. The case for boosting TFP growth is not an argument against capital accumulation. On the contrary, it is crucial that policymakers stay focused on lightening the direct tax burden and cutting red tape to foster private investment—both domestic and foreign.

Instead, faster TFP growth can be achieved by easing domestic constraints on productivity, such as allowing greater competition, notably within the services sector, which will force firms to innovate and reduce cost. There is also a corresponding need for greater labor market flexibility to facilitate the change. One of the Badawi government's priorities is to lift the performance of government-linked companies (GLCs) Although some progress has been made, most of these efforts have focused on improving the GLCs' organizational makeup and sharpening the linkage of car-



**Table 7. Educational attainment of total population aged 25 and over, 2000**

	Population over age 25 (thousands)	Highest level attained (percentage of the population aged 25 and over, 2000)						Average years of school	
		No schooling	First level		Second level		Postsecondary		
			Total	Complete	Total	Complete	Total		Complete
China	761,566	20.9	40.7	15.3	35.7	14.1	2.7	2.3	5.74
Hong Kong	4,137	10.7	26.6	13.9	47.4	28.7	15.3	8.7	9.47
India	487,730	44.5	33.2	12.4	17.4	6.5	4.8	3.3	4.77
Indonesia	105,121	36.2	37.0	18.0	21.8	11.5	5.0	2.2	4.71
Korea	28,989	8.0	16.7	15.9	49.5	34.5	25.8	19.1	10.46
Malaysia	10,240	13.9	35.6	21.8	43.0	23.6	7.5	6.3	7.88
Philippines	32,596	6.3	40.1	19.9	31.4	17.5	22.2	14.4	7.62
Singapore	1,923	12.7	28.3	16.8	48.5	13.2	10.6	7.2	8.12
Taiwan	13,919	12.4	27.5	15.4	41.1	22.9	19.1	9.7	8.53
Thailand	34,017	17.3	62.2	27.3	9.3	4.1	11.3	11.2	6.10
Japan	91,033	0.0	28.1	12.9	47.9	17.4	24.0	15.0	9.72
United States	178,443	1.0	9.3	4.5	39.6	21.6	50.1	30.3	12.25

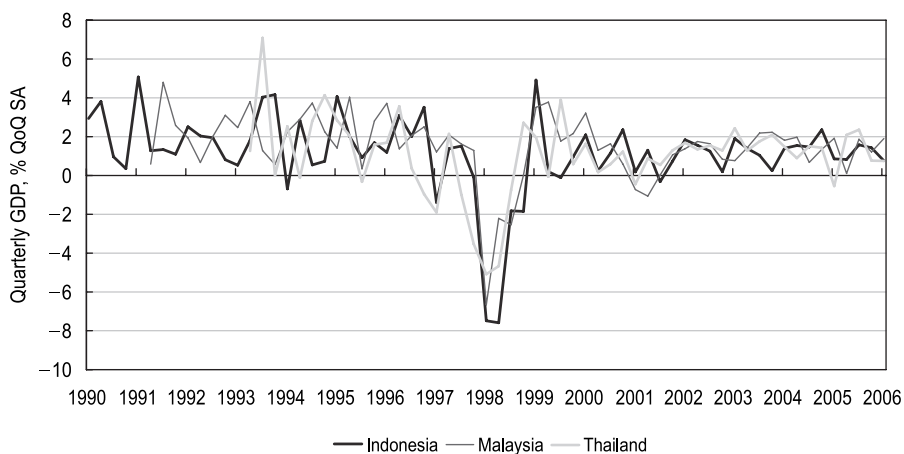
Source: Barro and Lee (2003).

rot and stick to individual managers' performance. But unless greater competition is introduced, it remains to be seen how much productivity growth will improve in the sectors in which the GLCs operate.

Further investment in human capital may yield substantial growth dividends. If average years of schooling are taken as a gauge of human capital (see table 7), Malaysia's ranking is below that of industrialized countries. Much has been said about revamping education, but more needs to be done. Although the controversy surrounding the teaching of mathematics and science in English has subsided and the government has stepped up education spending in recent years, the familiar issue of skill mismatches needs to be addressed more comprehensively in the areas of the curriculum, teaching practices, admission systems, and assessment mechanisms. Facilitating the importing of talented people and professionals, not just in the corporate, but also in the academic world, should go some way toward addressing the shortage of high-skilled labor. Increasing the supply of high-skilled labor will likely have a positive spillover onto the demand for low-skilled labor, but not the other way around. Toward this end Malaysia has been easing visa requirements for well-educated expatriates while cracking down on low-skilled, mostly illegal immigrants.

### 3.3 Thailand: 21st-century populism in practice

Unlike in either Malaysia or Indonesia, where a short time in office for the current administration makes empirical analysis difficult, the Thaksin administration has served for over five years in Thailand, long enough to enable us determine how the thrusts of its policy have affected the economy. The initial key agenda items of Thaksin's administration were

**Figure 8. Economic recovery in the ASEAN+3**

Source: Citigroup calculations on data from CEIC Data Company Ltd.

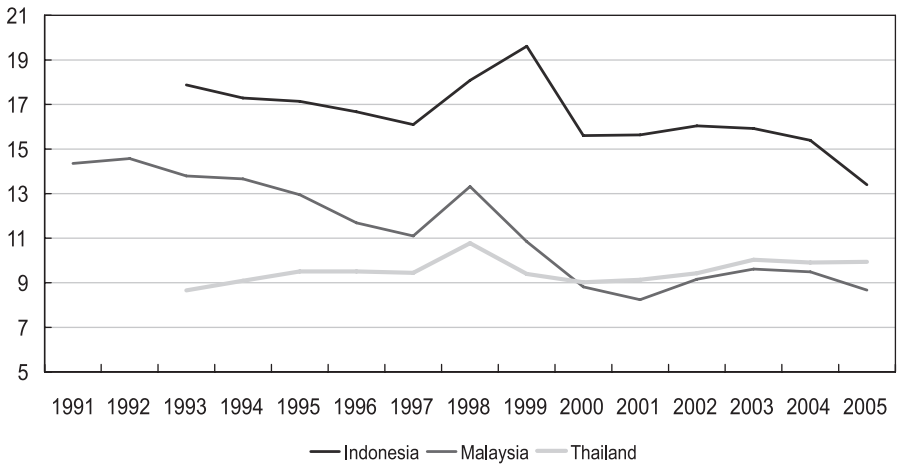
- reinvigorating the economy, particularly that of rural Thailand;
- reducing poverty and strengthening small and medium-sized enterprises;
- eliminating the debt overhang in the financial system;
- expanding health care coverage;
- reducing drug dependency.

The data on economic recovery in the country are quite straightforward. Thailand's economy did recover from the 2001 recession, but then so did the rest of the ASEAN+3 (see Figure 8). Indeed, Malaysia's rebound was more abrupt, most likely reflecting its greater dependence on the tech sector, which was at the heart of the 2001 recession. Hence attributing the recovery to the Thaksin administration policies is not clear-cut.

There is a follow-up question as to whether the agricultural sector fared better than industry, given the emphasis on the grassroots, which are largely rural. Here, too, there was some improvement in agriculture's share in GDP, but at a trend that was not appreciably different than that of Malaysia (see Figure 9).

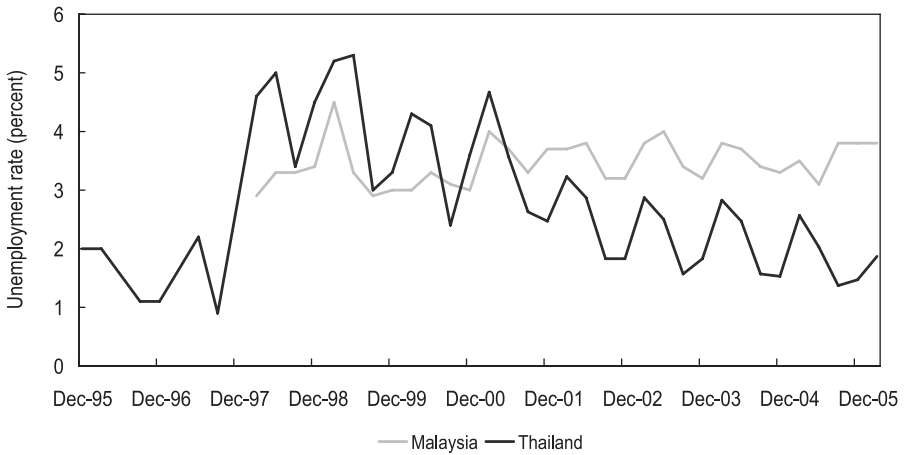
Thailand's growth does seem to have lowered unemployment more than in Malaysia, a point in favor of the poverty alleviation goal of the government (see Figure 10). The Thai government's own figures show a reduction in the impoverished of 2 million over the first Thaksin administration. Other social indicators, educational attainment, and access to health care also improved, while the number of

**Figure 9. Agriculture's share in nominal GDP (percent)**

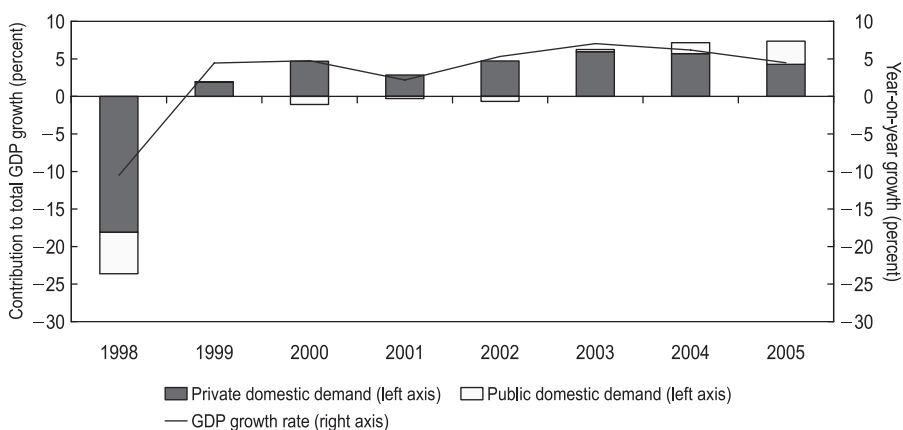


Source: CEIC Data Company Ltd. and Citigroup calculations.

**Figure 10. Unemployment trends in Thailand and Malaysia**



Source: CEIC Data Company Ltd.

**Figure 11. Contributions of public and private growth to domestic demand in Thailand**

Source: Citigroup calculations on data from CEIC Data Company Ltd.

drug arrests fell by almost 75 percent between 2000 and 2004 after the harsh 2001 crackdown (see Shinawatra 2005, introduction).

The sources of Thailand's economic growth show a bias toward initial use of fiscal policy that was then rolled back to foster fiscal consolidation (see table 8). This continued through 2002 and 2003. As Thailand's fiscal position and Thaksin's political authority improved and the triple whammy of bird flu, the tsunami, and oil prices took hold, government demand became a bigger part of economic growth (see figure 11).

One of the key tensions highlighted in the discussion of Thaksin's policies is the ambivalent attitude toward foreigners. There are several ways of trying see how this ambivalence has played out over the last five years. One is to look at the trade balance, with the supposition that Thailand would try to run a larger trade surplus to "reduce" reliance on foreigners. This it has done (see table 8), though so, too, have other ASEAN countries (see tables 2 and 5).

The administration's policies espousing domestic competitiveness, if successful, might have stimulated exports from domestically owned firms. Alternatively, foreign investors might have shied away from direct investment. Unfortunately, I am not aware of ownership data to assess any differential in Thai export performance. Aggregate export data are available and show that Thailand's export growth

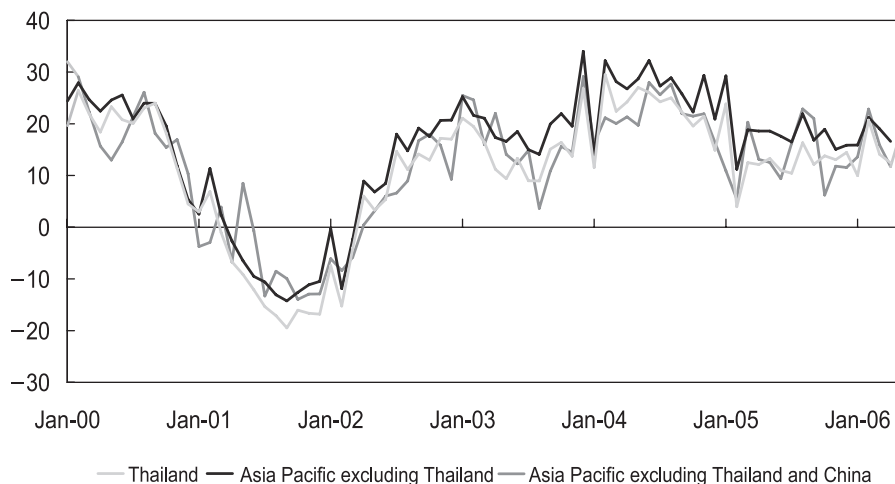
Table 8. Comparative summary of Thailand's macro performance

GDP	CPI excluding fresh foods and fuel		14-Day repo rate		Real interest rate		Baht per U.S. dollar		Fiscal balance (% of GDP) <sup>a</sup>		Trade balance (% of GDP) <sup>a</sup>			
	Average seasonally adjusted sequential growth rate	Volatility (standard deviation)	Average seasonally adjusted sequential growth rate	Volatility (standard deviation)	Real interest rate	Volatility (standard deviation)	Avg. deviation	Volatility (standard deviation)	Avg. deviation	Fiscal balance (% of GDP) <sup>a</sup>	Volatility (standard deviation)	Avg. deviation	Volatility (standard deviation)	Avg. deviation
Prior to installation of previous administration	1.7	2.2	0.4	0.3	9.1	3.1	3.8	2.6	25.4	2.0	1.7	2.4	-9.6	2.9
Previous administration (Sep-97 to Dec-00)	-0.2	2.7	0.2	0.3	6.5	7.5	2.7	4.1	40.0	3.4	-3.4	1.2	10.5	3.0
Current administration (Thaksin) (from Jan-01)	1.2	0.8	0.1	0.1	2.2	1.0	-0.4	1.3	41.7	2.0	-0.1	3.7	-1.9	5.4

Source: *Haver Analytics and Citigroup estimates.*

a. Rolling 12-month sums.

**Figure 12. Export growth in Thailand, Asia Pacific excluding Thailand, and Asia Pacific excluding Thailand and China (year-on-year percentage)**



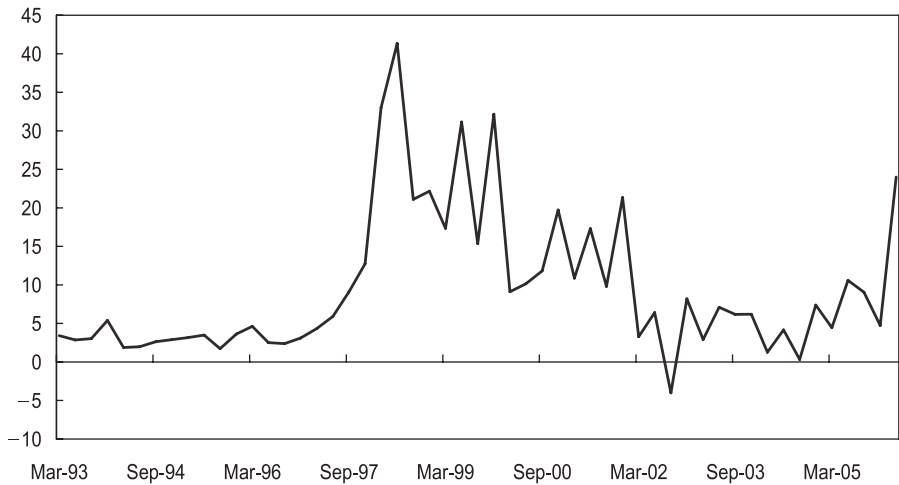
*Source: Haver Analytics and Citigroup calculations.*

underperformed the regional average (see figure 12). This average, though, was dominated by China. If China is excluded, Thailand's performance matches that of the rest of Asia very closely. This supports that idea that Thaksin's concerns about the "order economy" quoted above haven't dampened exports unusually.

The foreign direct investment (FDI) data show a more nuanced picture than do those for exports (see figure 13). As a share of gross fixed investment, FDI rose sharply during the immediate aftermath of the 1997 crisis. With Thaksin taking office, though, the share dropped initially before rising as the concerns about the administration's attitudes toward foreigners softened. The fall-off evident of late may reflect fighting in southern Thailand and bird flu rather than a shifting view on Thai policy toward FDI.

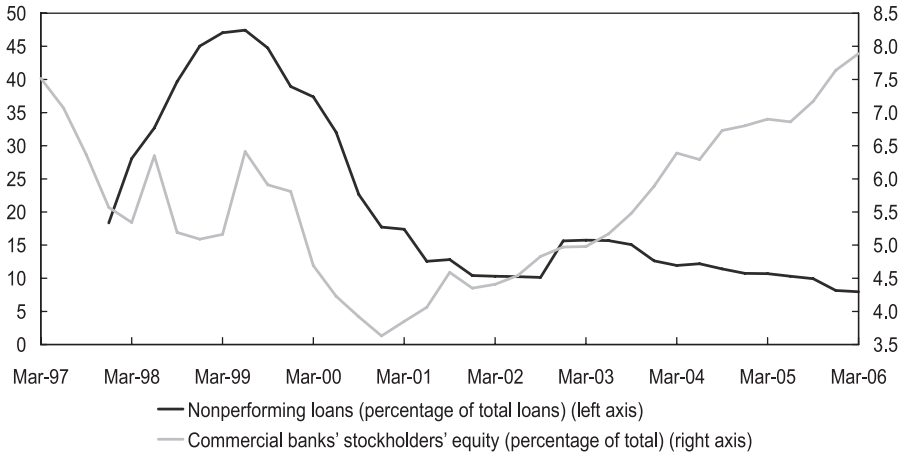
Another key item on the Thaksin agenda was the restoration of financial sector health, spearheaded by the consolidation and sale of bad debts in the Thai Asset Management Company. When measured by either nonperforming loan ratios or capital adequacy, conditions since 2001 have clearly improved (figure 14). But this misses the risk associated with the much smaller changes in the underlying legal protections for creditors. Should another period of financial distress arise, the public debt-to-GDP ratio of 48 percent will preclude simply larding the government's balance sheet again.

**Figure 13. Thailand: Foreign direct investment as a share of fixed investment (percent)**



Source: Haver Analytics and Citigroup calculations.

**Figure 14. Banks' nonperforming loan ratio and shareholder equity-to-asset ratio of Thailand (percent)**



Source: CEIC and Citigroup calculations.

#### 4. Conclusions

The administrations in Indonesia, Malaysia, and Thailand have all put in place economic policies designed to increase growth and competitiveness, reduce poverty, and improve governance. In each case, these efforts are a response to their own histories. In Thailand, there is now a tendency for the government to take a more activist role, a change from the more hands-off approach that was either chosen or forced on Thai politicians by frequent government changes. In both Indonesia and Malaysia, the efforts are to reduce the activist role of the state, creating greater predictability and transparency.

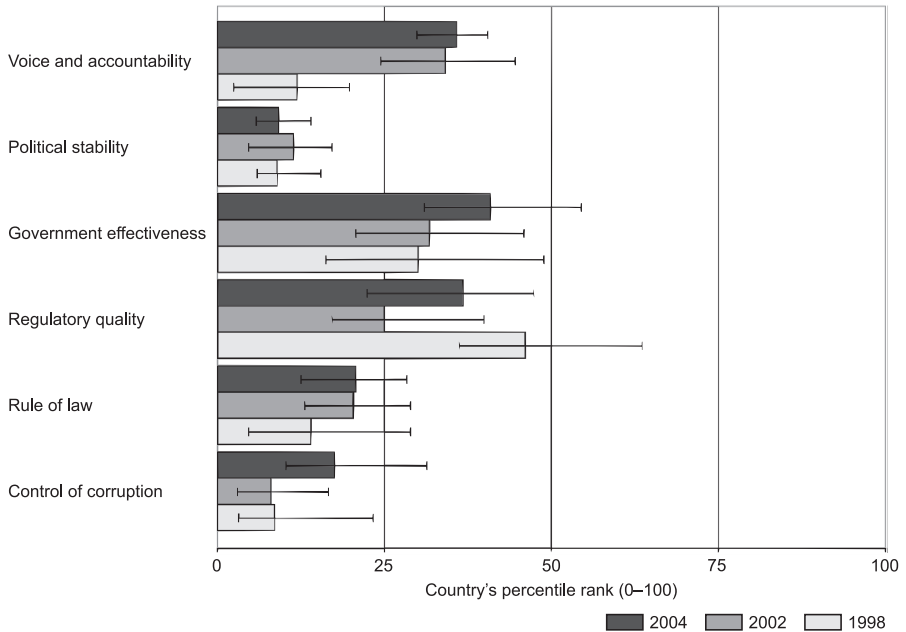
Governance and GDP growth are positively correlated. If that relationship is causal, there is considerable scope for higher GDP if governance can be improved. This seems a particularly important avenue for Indonesia, given its low governance ratings. Many of the necessary steps to heighten governance are directly under government control, which should ease the problem that implementation is often hampered by government's own ineffectual actions.

While many of the policy prescriptions focus on the medium term, there is an implicit or explicit acceptance of the need for prudent short-term management. This is inherent, for example, in the performance of Thai fiscal policy or the recent fuel subsidy decisions in Indonesia and Malaysia. The short-term macro environment, however, is likely to turn more complicated in the next year as the effects of higher oil prices, global inflation, and interest rates creep in. This more challenging environment will test the mettle of Asian central banks and their coordination with other parts of government. This has already proved a challenge in Indonesia, where the late August 2005 rupiah slump was in large part a monetary policy mistake. Malaysia has created more options through floating its currency, but the standard for setting domestic monetary policy remains unclear. The Bank of Thailand continues to be very cautious about rate changes, despite surging inflation. Luckily for Thailand, a near budget surplus provides some flexibility in dealing with higher oil prices. In Malaysia, pressures on the trade balance and the fiscal balance from higher oil prices are positive, giving some scope for being slower in adjusting interest rates and in cutting the fiscal deficit. The open question is whether progress on structural changes can persist when the short-term macroeconomic picture becomes more challenging. If the governments' goals of better growth, greater justice, and lower poverty are to be met, they will have to meet the challenge.



## Appendix I. World Bank Governance Indicators

Figure A.1 Indonesia (2004)



Source: Kaufmann, Kraay, and Mastruzzi (2005).

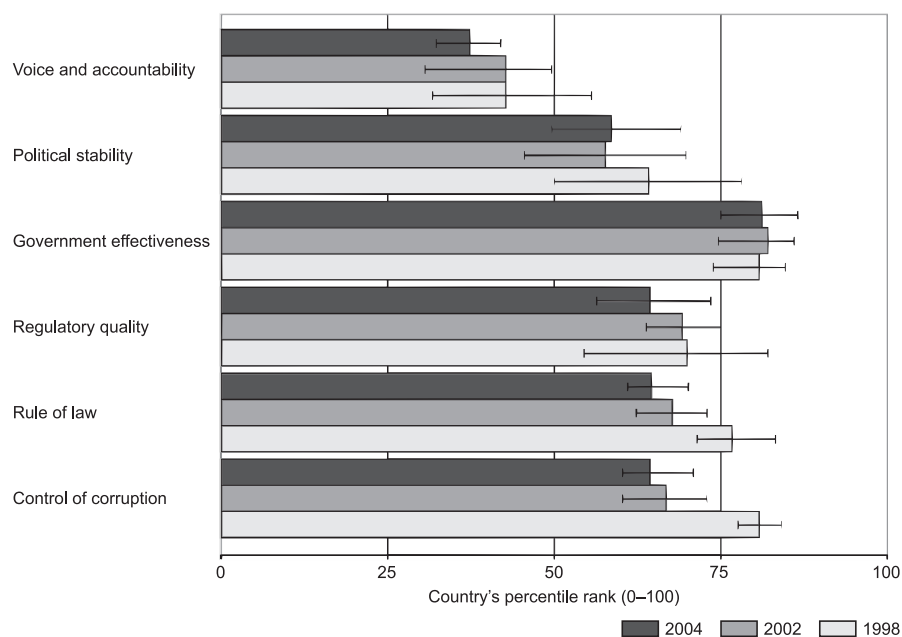
Note: The above chart depicts the percentile rank on each governance indicator. Percentile rank indicates the percentage of countries worldwide that rate below the selected country (subject to margin of error). In the bar chart, the statistically likely range of the governance indicator is shown as a thin black line. For instance, a bar of length 75 percent with the thin black line extending from 60 percent to 85 percent has the following interpretation: an estimated 75 percent of the countries rate worse and an estimated 25 percent of the countries rate better than the country of choice. However, at the 90 percent confidence level, only 60 percent of the countries rate worse, while only 15 percent of the countries rate better. Higher values imply better governance ratings.

**Table A.1 Indonesia governance indicators**

Population	210.4M			
Capital	Jakarta			
Income per capita	US\$570			
Life expectancy	66 years			
HDI rank	102			
Adult literacy	86.90%			
Infant mortality	42			
Maternity mortality	450			
Women in the labor force	41%			
Freedom of press	53			
	<b>2002</b>	<b>2000</b>	<b>1998</b>	<b>1996</b>
<b>Voice and Accountability</b>				
Estimate (-2.5 to +2.5)	-0.49	-0.52	-1.33	-1.08
Percentile rank (0-100)	34.8	32.5	12.0	16.2
Standard deviation	0.17	0.22	0.23	0.21
Number of surveys/polls	10	7	5	5
<b>Political stability</b>				
Estimate (-2.5 to +2.5)	-1.37	-1.85	-1.52	-0.34
Percentile rank (0-100)	12.4	3.0	9.1	30.5
Standard deviation	0.20	0.23	0.25	0.27
Number of surveys/polls	9	9	6	6
<b>Government effectiveness</b>				
Estimate (-2.5 to +2.5)	-0.56	-0.49	-0.58	0.08
Percentile rank (0-100)	34.0	33.2	26.8	66.5
Standard deviation	0.15	0.17	0.21	0.20
Number of surveys/polls	9	10	7	7
<b>Regulatory quality</b>				
Estimate (-2.5 to +2.5)	-0.68	-0.43	0.10	0.19
Percentile rank (0-100)	26.3	28.1	47.3	65.7
Standard deviation	0.17	0.24	0.21	0.21
Number of surveys/polls	8	8	6	7
<b>Rule of law</b>				
Estimate (-2.5 to +2.5)	-0.80	-0.90	-0.97	-0.34
Percentile rank (0-100)	23.2	15.1	14.1	39.8
Standard deviation	0.13	0.14	0.18	0.15
Number of surveys/polls	13	12	10	9
<b>Control of corruption</b>				
Estimate (-2.5 to +2.5)	-1.16	-1.09	-0.99	-0.44
Percentile rank (0-100)	6.7	8.7	6.6	35.3
Standard deviation	0.15	0.16	0.17	0.17
Number of surveys/polls	10	11	8	7

Source: World Bank (<http://www.worldbank.org/wbi/governance/index.html>).

Figure A.2 Malaysia (2004)



Source: Kaufmann, Kraay, and Mastruzzi (2005).

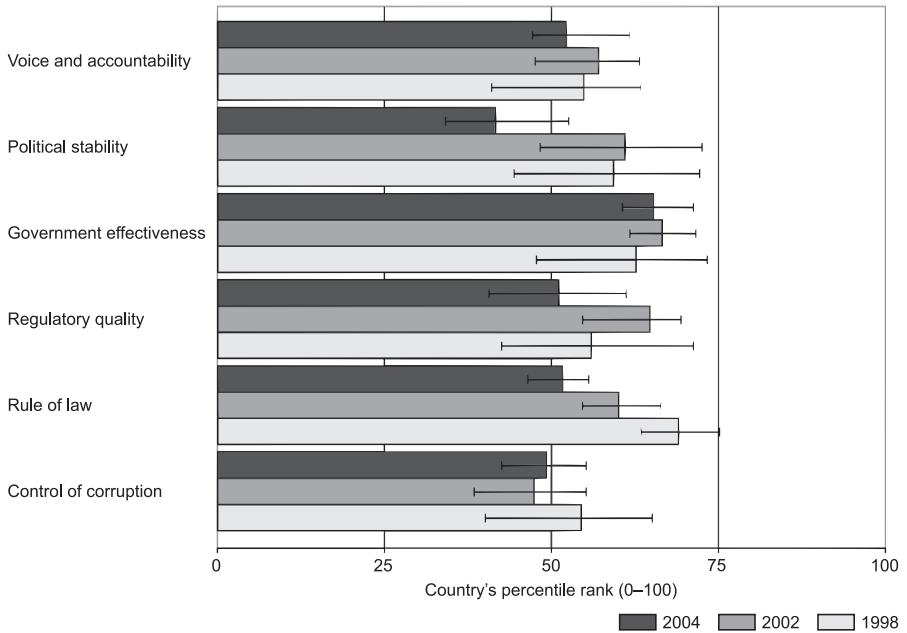
Note: The above chart depicts the percentile rank on each governance indicator. Percentile rank indicates the percentage of countries worldwide that rate below the selected country (subject to margin of error). In the bar chart, the statistically likely range of the governance indicator is shown as a thin black line. For instance, a bar of length 75 percent with the thin black line extending from 60 percent to 85 percent has the following interpretation: an estimated 75 percent of the countries rate worse and an estimated 25 percent of the countries rate better than the country of choice. However, at the 90 percent confidence level, only 60 percent of the countries rate worse, while only 15 percent of the countries rate better. Higher values imply better governance ratings.

**Table A.2 Malaysia governance indicators**

Population	23.3M		
Capital	Kuala Lumpur		
Income per capita	US\$3,380		
Life expectancy	72 years		
HDI rank	56		
Adult literacy	87.50%		
Infant mortality	8		
Maternity mortality	Not available		
Women in the labor forces	38%		
Freedom of press	30		
	<b>2002</b>	<b>2000</b>	<b>1998</b>
Voice and accountability			
Estimate (-2.5 to +2.5)	-0.27	-0.27	-0.25
Percentile rank (0-100)	42.4	42.4	42.9
Standard deviation	0.17	0.21	0.23
Number of surveys/polls	10	8	6
Political stability			
Estimate (-2.5 to +2.5)	0.51	0.33	0.55
Percentile rank (0-100)	61.6	58.8	69.1
Standard deviation	0.20	0.23	0.24
Number of surveys/polls	9	10	7
Government effectiveness			
Estimate (-2.5 to +2.5)	0.92	0.68	0.77
Percentile rank (0-100)	80.9	73.9	80.9
Standard deviation	0.15	0.18	0.20
Number of surveys/polls	9	10	8
Regulatory quality			
Estimate (-2.5 to +2.5)	0.58	0.35	0.57
Percentile rank (0-100)	68.6	62.7	70.1
Standard deviation	0.17	0.25	0.21
Number of surveys/polls	8	7	7
Rule of law			
Estimate (-2.5 to +2.5)	0.58	0.55	0.82
Percentile rank (0-100)	69.6	71.4	76.8
Standard deviation	0.13	0.14	0.17
Number of surveys/polls	13	13	11
Control of corruption			
Estimate (-2.5 to +2.5)	0.38	0.18	0.75
Percentile rank (0-100)	68	67.9	80.9
Standard deviation	0.15	0.17	0.16
Number of surveys/polls	10	10	9

Source: World Bank (<http://www.worldbank.org/wbi/governance/index.html>).

Figure A.3 Thailand (2004)



Source: Kaufmann, Kraay, and Mastruzzi (2005).

Note: The above chart depicts the percentile rank on each governance indicator. Percentile rank indicates the percentage of countries worldwide that rate below the selected country (subject to margin of error). In the bar chart, the statistically likely range of the governance indicator is shown as a thin black line. For instance, a bar of length 75 percent with the thin black line extending from 60 percent to 85 percent has the following interpretation: an estimated 75 percent of the countries rate worse and an estimated 25 percent of the countries rate better than the country of choice. However, at the 90 percent confidence level, only 60 percent of the countries rate worse, while only 15 percent of the countries rate better. Higher values imply better governance ratings.

**Table A.3 Thailand governance indicators**

Population	62.01M				
Capital	Bangkok				
Income per capita	US\$2,000				
Life expectancy	69 years				
HDI rank	66				
Adult literacy	95.50%				
Infant mortality	28				
Maternity mortality	44				
Women labor force	46%				
Freedom of press	71				
	<b>2004</b>	<b>2002</b>	<b>2000</b>	<b>1998</b>	<b>1996</b>
<b>Voice and accountability</b>					
Estimate (-2.5 to +2.5)	0.24	0.20	0.25	0.11	0.01
Percentile rank (0-100)	52.4	57.1	57.6	55.0	52.9
Standard deviation	0.15	0.17	0.22	0.23	0.21
Number of surveys/polls	10	9	7	6	5
<b>Political stability</b>					
Estimate (-2.5 to +2.5)	-0.15	0.45	0.24	0.28	0.20
Percentile rank (0-100)	41.7	61.1	57.6	59.4	53.0
Standard deviation	0.19	0.19	0.23	0.24	0.27
Number of surveys/polls	11	10	9	7	6
<b>Government effectiveness</b>					
Estimate (-2.5 to +2.5)	0.38	0.29	0.20	0.12	0.47
Percentile rank (0-100)	65.4	66.7	62.9	62.8	74.3
Standard deviation	0.15	0.15	0.18	0.20	0.20
Number of surveys/polls	12	11	10	8	7
<b>Regulatory quality</b>					
Estimate (-2.5 to +2.5)	-0.01	0.31	0.70	0.27	0.49
Percentile rank (0-100)	51.2	64.8	77.5	56.0	69.6
Standard deviation	0.18	0.17	0.24	0.21	0.21
Number of surveys/polls	10	9	8	7	7
<b>Rule of law</b>					
Estimate (-2.5 to +2.5)	-0.05	0.23	0.41	0.40	0.49
Percentile rank (0-100)	51.7	60.2	69.0	69.2	71.1
Standard deviation	0.12	0.13	0.15	0.17	0.15
Number of surveys/polls	14	13	12	11	9
<b>Control of corruption</b>					
Estimate (-2.5 to +2.5)	-0.25	-0.28	-0.30	-0.26	-0.32
Percentile rank (0-100)	49.3	47.4	47.8	54.6	42.0
Standard deviation	0.12	0.13	0.15	0.14	0.17
Number of surveys/polls	12	12	12	10	7

Source: World Bank (<http://www.worldbank.org/wbi/governance/index.html>).

## Appendix 2. Asia and the Pacific Index of Economic Freedom Scores (30 Economies), 1996–2006

Table B.1 Yearly scores (1996–2006)

2006 rank	Country	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996
1	Hong Kong	1.28	1.35	1.34	1.44	1.39	1.29	1.40	1.51	1.40	1.54	1.50
2	Singapore	1.56	1.60	1.61	1.61	1.69	1.66	1.59	1.54	1.54	1.68	1.63
9	Australia	1.84	1.84	1.93	1.95	1.96	1.96	1.95	1.99	2.00	2.24	2.13
10	New Zealand	1.84	1.75	1.70	1.68	1.73	1.76	1.80	1.76	1.88	1.80	1.79
29	Japan	2.26	2.46	2.53	2.36	2.34	2.04	2.06	2.16	2.21	2.16	2.18
37	Taiwan	2.38	2.34	2.48	2.34	2.38	2.23	2.03	2.14	2.29	2.16	2.18
45	Korea, Republic of (South Korea)	2.63	2.64	2.64	2.75	2.54	2.40	2.55	2.43	2.35	2.36	2.54
61	Mongolia	2.83	2.75	2.85	2.96	2.98	3.03	3.06	3.18	3.14	3.28	3.55
68	Cambodia	2.98	2.89	2.90	2.73	2.83	3.00	3.19	3.18	3.29	3.68	n.a.
70	Malaysia	2.98	2.91	3.16	3.14	3.18	3.00	2.81	2.64	2.59	2.80	2.68
71	Kyrgyz Republic	2.99	3.34	3.41	3.46	3.60	3.75	3.73	3.68	3.95	n.a.	n.a.
72	Thailand	2.99	3.03	2.81	2.71	2.51	2.34	2.76	2.58	2.56	2.53	2.53
90	Fiji	3.15	3.28	3.06	3.48	3.49	3.50	3.29	3.29	3.23	3.23	3.24
93	Sri Lanka	3.19	3.03	3.06	3.05	2.89	2.84	2.91	2.86	2.76	2.61	2.94
98	Philippines	3.23	3.30	3.10	3.00	3.05	3.21	3.00	3.03	2.89	3.06	3.14
110	Pakistan	3.33	3.73	3.35	3.44	3.49	3.50	3.50	3.50	3.31	3.29	3.26
111	China, People's Republic of	3.34	3.51	3.59	3.49	3.56	3.55	3.49	3.56	3.69	3.73	3.78
113	Kazakhstan	3.35	3.61	3.65	3.50	3.65	3.80	3.95	4.14	4.23	n.a.	n.a.
121	India	3.49	3.53	3.53	3.58	3.61	3.91	3.93	3.93	3.83	3.88	3.93
123	Azerbaijan	3.51	3.43	3.44	3.50	3.58	3.88	4.28	4.24	4.30	4.58	4.78
125	Nepal	3.53	3.55	3.53	3.63	3.51	3.65	3.79	3.49	3.71	3.89	3.86
134	Indonesia	3.71	3.59	3.76	3.43	3.49	3.65	3.55	3.14	3.00	3.05	3.00
138	Tajikistan	3.76	4.05	4.20	4.15	4.14	4.16	4.16	4.15	4.30	n.a.	n.a.
141	Bangladesh	3.88	3.95	3.70	3.69	3.95	4.05	4.04	3.98	3.80	3.76	3.79
142	Vietnam	3.89	3.83	3.93	3.90	3.98	4.24	4.49	4.48	4.33	4.46	4.50
144	Uzbekistan	3.91	4.05	4.29	4.29	4.34	4.56	4.51	4.59	4.63	n.a.	n.a.
148	Turkmenistan	4.04	4.36	4.31	4.21	4.39	4.39	4.40	4.39	4.50	n.a.	n.a.
149	Laos	4.08	4.33	4.40	4.68	4.76	4.70	4.80	4.75	4.63	4.65	4.51
155	Burma (Myanmar)	4.46	4.60	4.40	4.35	4.33	4.45	4.28	4.15	4.31	4.33	4.40
157	Korea, Democratic Republic of (North Korea)	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00

Source: Heritage Foundation (2005).

Note: n.a. = not available.

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