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SOUTH BY SOUTHEAST
ECONOMIC INSIGHT – SOUTH AND SOUTHEAST ASIA

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THE FISCAL GIFT OF FALLING COMMODITY PRICES

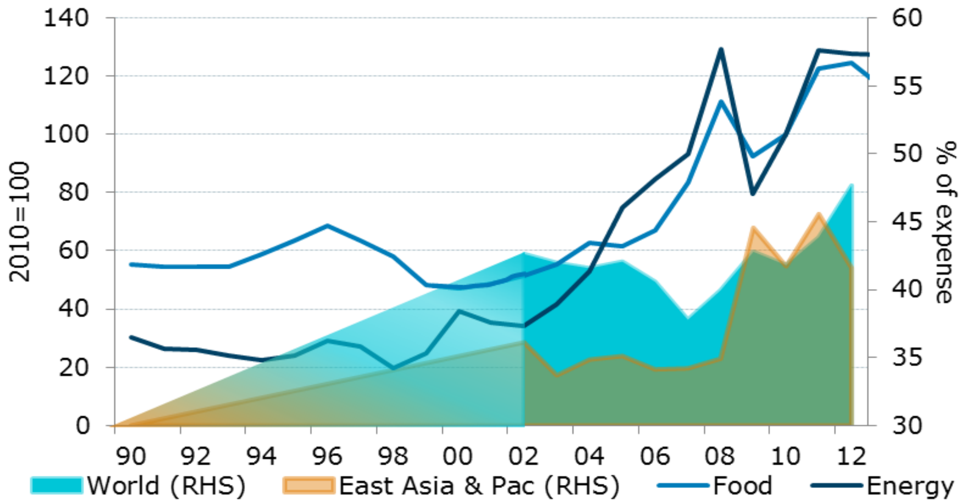
We believe commodity price disinflation is an enormous gift to Asian policy makers, one which is perhaps under-appreciated at this time. The extent and complexity of food and energy subsidies across South and Southeast Asia stand out as perhaps the clearest macroeconomic policy failing of recent years and one that creates far more distortions and opportunity costs than societal or equity benefits. Now, with food and energy prices plumbing the lowest levels since the great commodity inflation of 2005-08, Asia's policy makers are likely presented with their first opportunity to fundamentally revisit and unwind these distortionary and inefficient policies which effectively tax the allocative efficiency of their economies.

The extent of the distortion and its uniqueness to Asia is borne out in a few key figures. Fossil fuel (coal, oil, and gas) subsidies are a prominent feature of many Asian economies:

- Of the 25 top subsidizing countries in the world identified by the International Energy Agency for 2012, 10 were in Asia.
- Total known fossil fuel subsidies across ADB member countries probably amounted to just under USD600bn for 2011-2013.
- The cumulative cost of fuel and food subsidies during 2007 to 2014 would go a long way to funding South and Southeast Asia's well-documented physical infrastructure deficits.

Fortunately, 2014 appears to be the year that policy makers across ASEAN and certainly in India got serious about factor price reform. We are hopeful that the current episode of commodity price disinflation will motivate policy makers to move domestic fuel prices more in line with international prices. A more efficient fiscal policy structure that can target public investment and infrastructure will dramatically improve the allocative efficiency of the South and Southeast Asian economies whilst automatically reducing budget deficits and therefore government borrowing requirements.

ASIA'S SUBSIDY BURDEN TRACKED INTERNATIONAL COMMODITY PRICES INEXORABLY HIGHER OVER THE DECADE FROM 2002 ONWARDS



Shaded areas are equivalent to total subsidies and other transfers as % of total outlays.
Source: CEIC, Haver, ANZ Research

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BACKGROUND: THE SIZE OF THE DISTORTION

The economies of Emerging Asia account for over 20% of the global energy subsidy bill with petroleum and electricity accounting for 90% of subsidies.

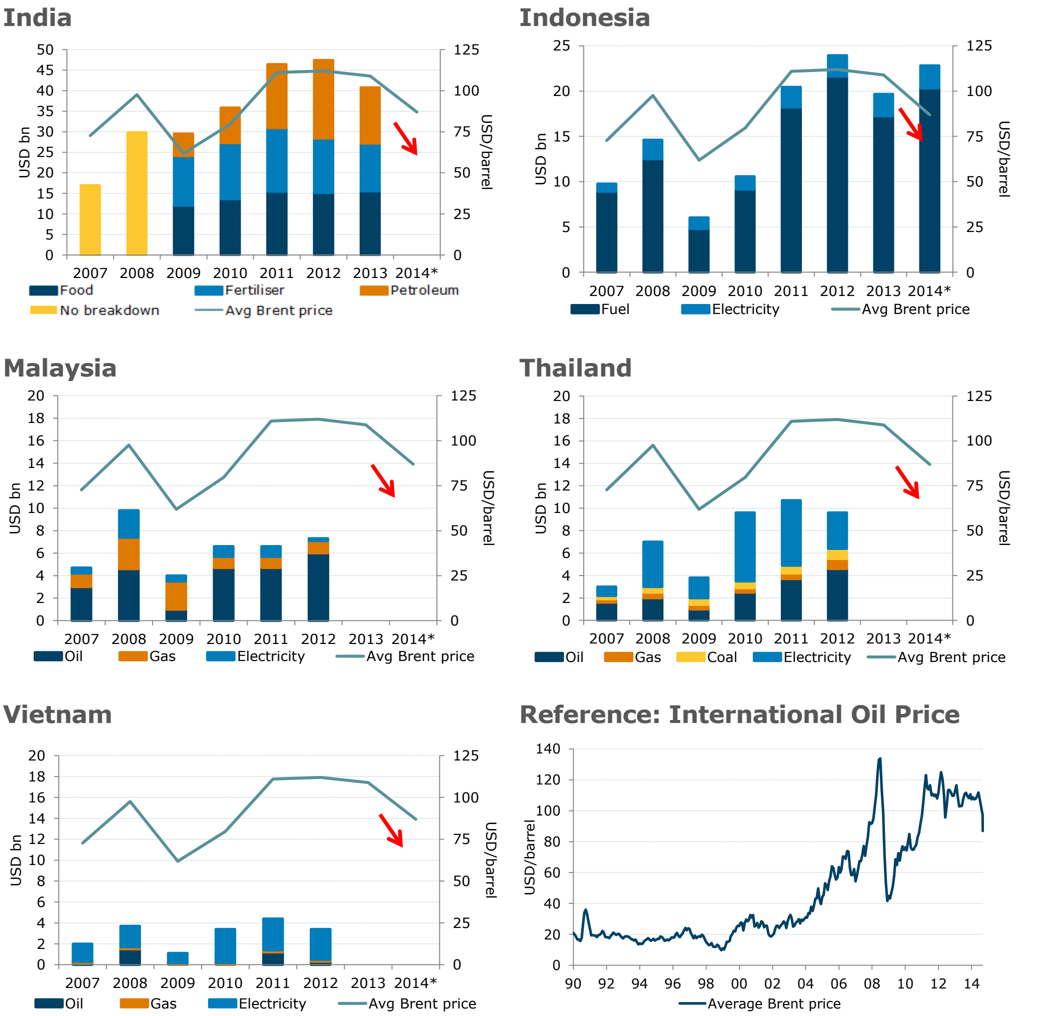
According to the IMF, the countries of Emerging Asia account for over 20 percent of global energy subsidies. These amounted to nearly 1 percent of regional GDP or 4 percent of total government revenues in 2011. Based on our analysis, this subsidy burden would have only risen since 2011 with strong rises in both the international price of energy and more importantly rapid household and industrial demand for energy and petroleum within Asia. That demand increase has outstripped remedial efforts to stabilise or manage an increasingly intolerable subsidy burden.

One of the key challenges facing Asia's policy makers is managing the political cycle as well as the economic cycle given the popularity of these subsidies with voters and the (in our view erroneous) perception that they are actually equitable policies. The political sensitivity on subsidy reform is extremely high.

The increase in the subsidy burden has been largely responsible for the deterioration in Asia's fiscal position in recent years.

India and Indonesia stand out as the two economies with the most problematic subsidy structures, whilst Thailand and Malaysia have also engineered significant subsidy burdens for themselves (Figure 1). Figure 2 shows that the cost of these subsidies is borne by the public purse and not surprisingly, fiscal positions have deteriorated as the subsidy burden has grown with rising international energy prices and increased domestic demand.

FIGURE 1. THE SIZE OF SUBSIDIES ACROSS SOUTH AND SOUTHEAST ASIA



Source: IMF, ADB and CEIC, ANZ Research
*2014 is current price instead of year average

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The new Indonesian President Jokowi has inherited an annual subsidy bill of more than USD20bn that accounts for more than 20% of total government spending.

In Indonesia, the new President has inherited a fuel subsidy bill that is running at more than USD20bn a year, accounting for more than 20% of all government spending. This is a truly remarkable figure given that Indonesia was actually a net petroleum exporter up to 2011 and formerly a member of OPEC.

Jokowi's transition team has clearly outlined a strategy of gradually cutting existing subsidies over the next four years but the fall in international prices may allow Indonesia to move at a faster pace on completely unwinding subsidies. The inherent savings will clearly be a motivation given Jokowi has key expenditure-heavy projects he would like to deliver including a significant infrastructure build-out, maritime corridors and the rollout of Jokowi-care (universal health care) nationally.

Fuel price hikes attracted protests, and often violent riots in the past, despite their overwhelming skew to benefit the rich and middle-class, not the poor.

The task won't be easy. Outgoing President Susilo Bambang Yodhoyono raised energy prices by 44% in June last year and was met with protests on the street. Most spectacularly, fuel price rises triggered a violent uprising that resulted in the downfall of former President Suharto in 1998.

Much has changed since then; however, the inefficiency of fuel subsidies in terms of reaching the poor, as opposed to middle-class drivers, has only grown.

India stands outs as the economy with disproportionately higher food subsidies. Indeed, food subsidies rose fivefold under Prime Minister Singh.

The subsidy burden and fiscal deficit inherited by Prime Minister Modi in India achieves the remarkable in making Indonesia's look relatively benign. **The total cost of fuel subsidies alone is likely to be $10bn in India this year with food and fertilizer subsidies costing an additional $30bn.** Despite the significant size of the subsidy bill, this is likely to be down 25% from the previous 12 months, thanks to the progress that has already been made on oil and diesel price reform.

The new Prime Minister, Modi, failed to tackle India's complex food subsidies in his first Budget.

India stands out as the economy that has disproportionately higher food subsidies than energy subsidies given the large number of Indians existing on subsistence incomes. Indeed, India's food subsidy bill rose fivefold under the administration of former Prime Minister Singh. Given the complexities of food subsidies, it is not surprising that Prime Minister Modi did not attempt a piece-meal reduction in his first budget this past July. He has left them unchanged, establishing instead a commission to better target food and energy subsidies. With international prices for food and energy falling, the task of that commission is made easier as equalising domestic and international prices becomes less problematic with a narrower gap between the two.

Though many claim the equity benefits of fuel and food subsidies far outweigh the opportunity cost of misallocated spending, we need to correct this misperception from the outset. The history of these subsidies, particularly the Asian experience, shows them to be extremely poorly targeted and demonstrably failing those they were introduced to benefit – the poor to very-poor.

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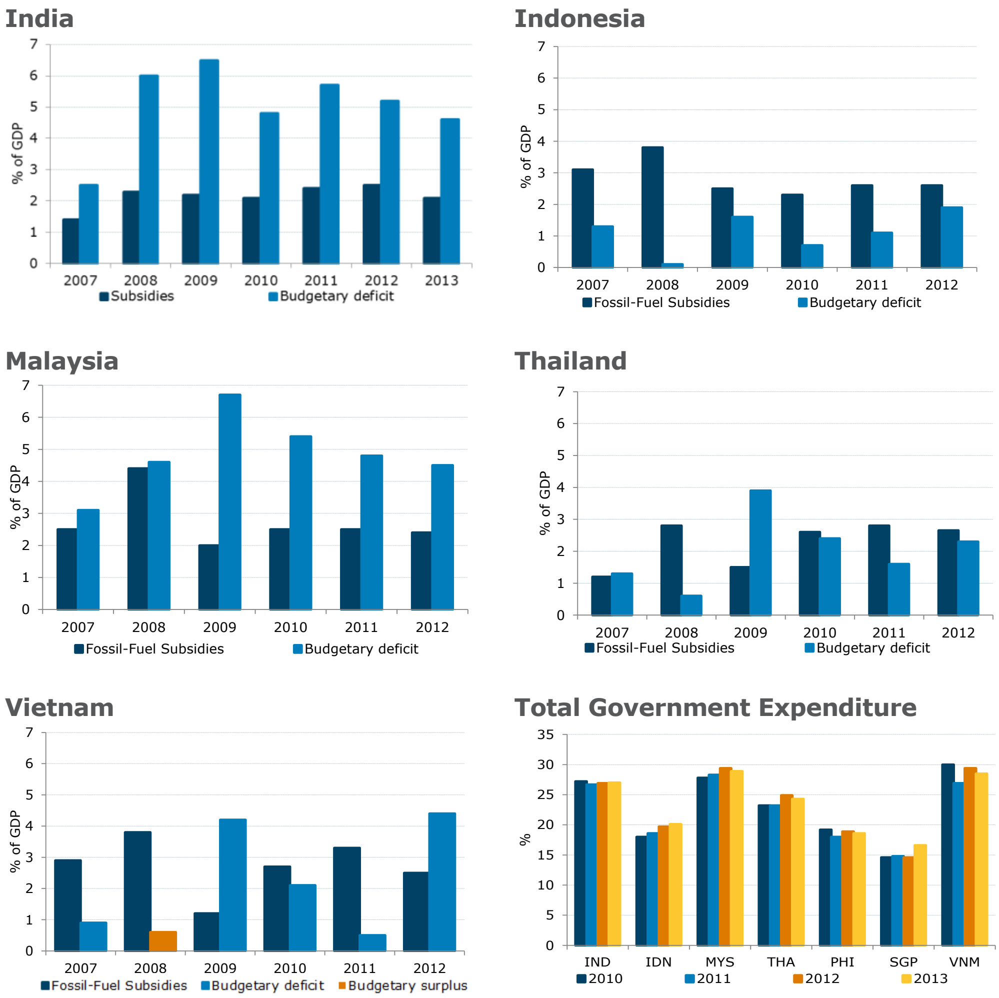
FIGURE 2. SUBSIDY BURDEN AND THE BUDGET POSITION



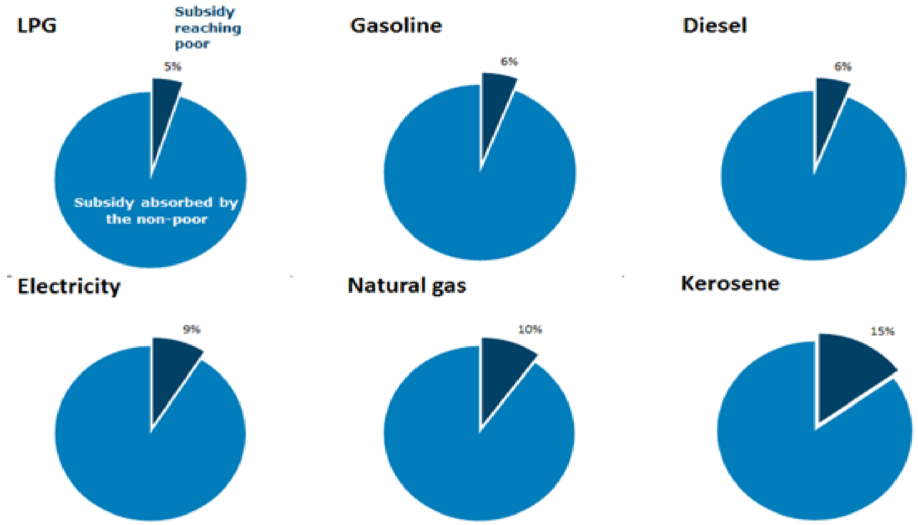
Source: IMF, ADB and CEIC, ANZ Research

Gasoline subsidies across most of Asia largely benefit the middle-class for whom first time car-ownership has become more of a novelty than a necessity.

Gasoline subsidies across most of Asia largely benefit the middle-class for whom first-time car ownership has become more of a novelty than a necessity. The ADB has found that in India less than 0.1 per cent of rural subsidies for Liquefied Petroleum Gas go to the poorest quintile, while 52.6 per cent go to the wealthiest. Worldwide, far less than 20 per cent of fossil-fuel subsidies benefit the poorest 20 per cent of the population.

In the chart set below, based on International Energy Agency estimates, it can be readily seen that subsidies are not in fact benefitting the poor. For LPG, gasoline and diesel, less than 6% of the subsidy actually benefits the poor with over 90% of the welfare gain accruing to the middle and upper classes.

FIGURE 3. THE DEMONSTRABLE FAILURE OF SUBSIDIES TO BENEFIT THE POOR



Source: International Energy Agency

The great folly of the Asian subsidy decision of recent years is choosing policies that subsidise middle-class vehicle ownership and not fund public transport that would boost labour market mobility for the poor and very poor.

The folly of fossil fuel subsidies in most Asian economies, in particular in India and Indonesia, is striking. Fuel subsidies in general benefit the new middle-class who are purchasing vehicles for the first time. The poor either walk, bicycle, or take under-developed public transport infrastructure with poor connectivity. The great folly of the Asian subsidy decision of recent years is choosing policies that subsidise middle-class vehicle ownership and not fund public transport that would boost labour market mobility for the poor and very-poor is.

India's agricultural subsidies are particularly complex and will be difficult to unwind. India has created a policy that rations grain to consumers at low prices while simultaneously creating excess supply via high prices paid to farmers. Not only are farmers paid a high price, key inputs into agricultural production such as fertilizer, water and electricity are also heavily subsidized. The government has thus accumulated huge stockpiles of rice and wheat which largely perish while rationing supply at low prices, a policy outcome that is both inequitable and wasteful.

The existing subsidy structures across Asia are poorly targeted and the true welfare loss from unwinding them either by design or natural attrition (as international prices fall) should be minimal.

Our starting point then is that the existing subsidy structures across Asia are poorly targeted and the true welfare loss from unwinding them either by design or natural attrition (as international prices fall) should be minimal.

THE GREAT COMMODITY PRICE INFLATION OF 2007-08

Most of Asia's subsidy burden can be traced to the introduction or enhancement of subsidies during the dual food and energy inflation of 2007-08.

Most of the subsidy burden now facing Asian policy makers results from policies either introduced or increased during the Great Commodity Inflation of 2007-08. This period was remarkable for the simultaneous doubling in both food and energy prices at a time when exports and production (and therefore aggregate income formation across Asia) were collapsing.

It is perhaps not surprising then that subsidy structures were either increased or expanded over this period. However, with the benefit of hindsight it is now apparent that these policies have proved to be poorly targeted and resulted in sub-optimal economic outcomes. Rather than assisting the poor, they drained the public purse and the opportunity cost has been lost public investment in both physical and social infrastructure that would have made a more tangible impact on poverty alleviation and reduction.

FIGURE 4. THE GREAT COMMODITY PRICE INFLATION OF 2007-08

Source: CEIC and ANZ Research

SOUTH AND SOUTHEAST ASIA ARE NOW EXPERIENCING A POSITIVE TERMS OF TRADE SHOCK

South and Southeast Asia largely experienced a significantly negative terms of trade shock for over a decade from 2001 to mid-2014

For more than a decade from 2001 onwards, most Asian economies experienced a profound negative terms of trade shock. The prices of goods produced by Asian economies have consistently fallen whilst the prices of imports used for both production and consumption picked up dramatically over this period. Indeed, it was the simultaneous doubling of both food and energy prices over 2007-2008 that led to a significant transfer of income from the South and Southeast Asian economies to commodity exporting economies such as Australia.

Asia is now experiencing a positive terms of trade shock.

That dynamic now appears to be at least partially reversing. For heavy commodity importers, a fall in commodity prices is the equivalent of a positive terms of trade shock and should at a broad level lead to an improvement in aggregate income formation across the economy.

A significant decrease in import prices relative to export prices means that a larger volume of imports can be purchased with an unchanged volume of exports. This increase in the real purchasing power of domestic production is equivalent to a transfer of income from the rest of the world and can be expected to have large impact on consumption, savings and investment if it were to be sustained.

As the ratio of trade to GDP is around 75% to 80% of GDP for ASEAN and over 400% of GDP for Singapore, the impact of the positive terms of trade shock will probably be outsized.

Arguably the impact of the positive terms-of-trade shock could be outsized for Asia given how high trade is as a proportion of GDP. Whereas countries such as Australia that experienced a positive terms of trade shock as commodity prices rose have a total trade to GDP ratio of around 40%, for the ASEAN-5 economies, total trade represents 75-80% of GDP. For Asia's most open economy, Singapore, total trade is over 400% of GDP. Given these much higher trade to GDP ratios, it should not be surprising that the terms of trade shock is more pronounced for those Asian economies with a high trade to GDP ratio.

The typical automatic stabiliser to a terms of trade shock is exchange rate appreciation.

The typical automatic stabilizer to a positive terms of trade shock is exchange rate appreciation. This makes the current episode in Asia particularly unusual. If our forecast of a continued strengthening in the USD were to hold, then we are likely to see Asian economies experiencing a positive terms of trade shock with the currency weakening, that is not alleviating any of the positive shock.

Asian currency depreciation is thus likely to ameliorate, not alleviate, the positive terms of trade shock.

Though there is a good deal of negativity surrounding the current episode of commodity price disinflation, attributing it to faltering global demand, it should be recognized that a positive income dynamic is being created and that Asian currency depreciation will ameliorate, not alleviate this. It is this double degree of stimulus arising from the positive terms of trade shock which makes us confident that fiscal policy can be tightened across Asia via the unwinding or removal of subsidies. Indeed, a degree of fiscal tightening may be warranted in this environment as the Australian experience has shown how powerful sustained positive terms of trade shocks can be.

Now that commodity prices are in decline, we find that Asian policy makers are presented with a remarkable opportunity to unwind these incredibly expensive and inefficient structures and moving towards market-determined prices for these goods.

Some degree of fiscal rectitude, via subsidy rationalisation, may prove to be the prudent policy choice.

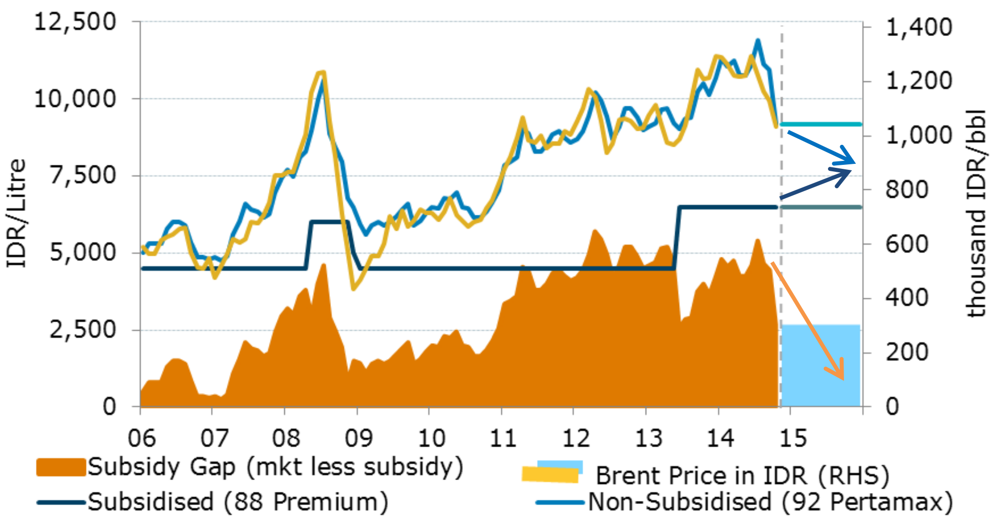
Unwinding of subsidies could potentially free up as much as 3% of GDP in some economies that could be more efficiently allocated to public investment in physical and social infrastructure. This will likely prove to be a better targeted approach to poverty reduction goals. More importantly, given currency appreciation is unlikely to be mitigating the impact of a positive terms-of-trade shock, some degree of fiscal rectitude, via subsidy rationalisation, may prove to be the prudent policy choice.

SUBSIDY REFORM: BY DESIGN OR COINCIDENCE

Subsidy reform can either occur via an active policy of raising fixed domestic prices or a passive policy of waiting for international prices to fall.

Subsidy reform can either be achieved by an active policy of dismantling subsidies – where they are set as a permanent discount to the international price – or by the "automatic stabiliser" of international or market prices for commodities falling below the domestic subsidised price.

FIGURE 5. THE EXAMPLE OF INDONESIA ON SUBSIDY DISMANTLING



Source: CEIC, ANZ Research

Indonesia is an example of an economy where we expect an active policy of raising domestic prices in coming months.

Indonesia is an example of an economy where an active policy of unwinding subsidy is expected rather than a reliance on the automatic stabiliser of falling international prices. The domestic price of gasoline is set at a fixed level irrespective of market movements. The convergence of the domestic price to the international price is largely expected to come via a process of both further declines in the international price of oil plus a series of fuel hikes in coming years.

The new leaders of Indonesia and India, Jokowi and Modi, have both given clear indications they will be tackling subsidy reform. What about elsewhere in Asia?

MALAYSIA

Malaysia is the economy that could perhaps surprise on the subsidy front given it has already shown its fiscal reform credentials.

Malaysia is the economy that could perhaps surprise with fiscal reform already demonstrably successful. Against the backdrop of falling commodity prices (particularly oil), Malaysia will see revenue falling. Nonetheless, should oil stay below $80, this is an amazing opportunity for Malaysia to dismantle subsidy structures which we expect a fiscally reformist government to seize upon. On the expenditure front, if crude stays well below US$80, we do not rule out the possibility of fuel subsidies being entirely dismantled which would imply savings of around MYR 25 bn.

On the revenue front, the declining share in oil-related revenue trend is expected to continue well into 2014 and 2015. In view of the relative smaller contribution from oil-related revenue, a decline in oil prices will translate to a smaller loss in oil-related revenue. Furthermore, any decline in oil revenue will be mitigated by gains in GST revenue–which will be implemented in 2015.

Already, recent fuel subsidy reforms in Malaysia signal that policymakers are very keen on the structural reform agenda. In a bid to narrow its structural deficit to 3.5% in 2014 and 3.0% in 2015, Malaysia undertook a series of energy subsidy rationalisation as follows. Subsidy reforms are essential to reduce the fiscal deficit as subsidies account for around 21% of central government expenditure; of which fuel subsidies accounted for more than half of total expenditure on subsidies.

In addition to current measures, we expect another round of fuel subsidy reforms (in the form of a multi-tiered price scheme) next year in a bid to curb fuel smuggling which is rampant under the current system. Specifically, the fuel price scheme is likely to be multi-tiered that will be based on income, shifting towards a targeted and needs based paradigm- rather than the current blanket system.

For food, Malaysia has most recently removed sugar subsidy of MYR0.34/kg in Oct 2013. However, this only makes up a small portion of the subsidy bill, of which food subsidies account for less than 10%. Thus, the focus remains firmly on reforming the fuel subsidy.

THAILAND

Subsidy reforms are definitely a low-hanging fruit for Thailand that we expect to be plucked.

Subsidy reforms are definitely a low-hanging fruit for Thailand. By reducing fuel subsidy, there will be greater savings for infrastructure investment which will help Thailand increase her growth potential and play catch up to her regional peers whom she has lagged since the GFC. Thailand fuel subsidies are expensive to the public purse. The cost of subsidies from 2009 to 2011 amount to USD10.3bn which is equivalent to approximately 3.0% of GDP and 15.2% of total government expenditure, according to data from IEA and ADB.

Lower oil prices will be a boon to Thailand who is a significant net importer -with net oil imports of around 8% of GDP. Furthermore, Thailand is undertaking energy reforms by ending decade-long subsidies for cooking gas and natural gas prices in a bid to move retail prices closer to actual costs. This will also help reduce the current account deficit pressures.

However, Thailand is also a key exporter of rubber and rice and in Thailand's case falling export prices will mitigate positive terms of trade effects from import price falls.

Offsetting this, however, the slump in commodity prices (particularly rubber and rice) is a bane for Thailand that ranks amongst the world's top exporter. Rubber prices have slumped to near 5 year lows amid a supply glut. The junta has approved a total of THB 8.5bn of cash hand-outs in late October to rubber farmers across the nation which will be paid out in November. This is in addition to the state-run Bank for Agriculture and Agricultural Cooperative (BACC)'s loan of around THB 1.1bn baht. Furthermore, the other short term measures include direct purchase of rubber from farmers. The junta has also provided assistance to rice farmers. Specifically, the BACC has started to make one-off cost-subsidy payments - totalling THB176m- to rice farmers in October. This follows the THB150bn refinancing requirement in fiscal year 2015 by the Public Debt Management Office for the rice subsidy scheme of the Yingluck administration.

INDONESIA

In Indonesia, falling oil prices will have effect on both the expenditure and revenue sides of the Budget.

Total subsidy expenditure in Indonesia is expected to come in at just over IDR400trn (USD33bn) in 2014, more than doubling over the past four years. In the current state, subsidies are expected to account for over 20% of government expenditure and reach almost 4% of GDP. This is not sustainable. Roughly 84% of these subsidies are allocated towards energy, with a 67% share for fuel (retail gasoline, diesel, and kerosene) and 17% towards electricity consumption. The major allocations for the remaining 16% of subsidies are for food, fertiliser, project loans, and tax relief.

Falling oil prices will have effect on both the revenue and expenditure side, with the benefits outweighing the costs. On the revenue side, income derived from oil and gas is expected to be about 7.6% of total revenue, while fuel subsidies account for 14.4% of expenditure with electricity subsidies eating up 3.6%. The move in the international oil price is expected to shave off roughly 0.3ppt of GDP (IDR34trn) from the outlays side of the fiscal balance. However, the net fiscal impact is likely to be lower as President Jokowi has clearly outlined a plan to reallocate subsidy savings to other public outlays.

The fall in international energy prices may make Jokowi's job easier and limit the size of the hike necessary in domestic fuel prices.

However, this ignores further fuel price adjustments, which the market expects as early as 1 November. Jokowi's administrative advisors have been tipping the fuel price increase as much as 3000rp per litre, or about 46%, but given the move in oil prices, even a 1500rp hike should result in more fiscal savings than a 3000rp hike when brent was at USD105.

INDIA

The total cost of fuel subsidies alone is likely to be USD10bn in India this year with food and fertilizer subsidies costing an additional USD30bn. Despite the significant size of the subsidy bill, this is likely to be down 25% from the previous 12 months thanks to the progress made on oil and diesel price reform. Falling oil prices from hereon in can only make a further positive impact on the fiscal balance. Food prices on the other hand are less sensitive to international prices and will be more problematic. Indeed, India's food subsidy bill is likely to be rising in the coming year despite a fall in international soft prices.

India stands outs as the economy with disproportionately higher food subsidies. Indeed, food subsidies rose fivefold under Prime Minister Singh.

India stands out as the economy that has disproportionately higher food subsidies than energy subsidies given the large number of Indians existing on subsistence incomes. Indeed, India's food subsidy bill rose fivefold under Prime Minister Singh. Rather than protecting consumers from rising international food prices, Singh's food subsidy policy was largely designed with guaranteed prices for farmers in mind. This boosted rural incomes and created a significant wedge between the prices paid to farmers and the prices of food sold to consumers.

The new Prime Minister, Modi, failed to tackle India's complex food subsidies in his first Budget.

Progress on food subsidy reforms in India may prove to be slow. The key to understanding this is the recognition that the subsidy is not so much targeted at consumers as it is at providing income support to producers. Over the next few years however, the government is likely to slowly start relying on cash transfers to better target subsidies and reduce wastages. Modi's latest thrust to have all households open a bank account is a step in that direction.

It needs to be recognised, that India has already made significant and important progress on fuel price reform compared to Indonesia. Both diesel and gasoline price deregulation is now complete. Next, fuels such as cooking gas and kerosene are likely to be targeted for reform and an announcement for that might happen as early as at the next budget in Feb 2015. We expect tangible progress to be made on subsidy reform for these two products in coming years along with some tackling of fertiliser (urea) subsidy as well.

SCENARIO ANALYSIS

SCENARIO 1: IMPACT ON FISCAL BALANCE OF OIL PRICE FALL TO DATE, IF SUSTAINED THROUGH END OF 2015

The drop in oil prices over recent months, if sustained through the end of 2015 will have a marked impact on the fiscal balances of those economies most dependent on oil imports or those that heavily subsidise domestic prices.

A sustained drop in both oil and food prices will have more divergent effects with some key soft and commodity exporters in ASEAN such as Thailand, Malaysia and Indonesia seeing revenues suffer.

- As the Philippines progressed with subsidy reform as early as 1996, there will be no discernible impact on the fiscal accounts from falling international oil prices.
- The most significant impact will be skewed towards Indonesia where the fall in oil prices to date is likely to improve this year's fiscal balance by 0.1% of GDP and more significantly in 2015 by 0.3% of GDP for Indonesia
- In India we look for only a 0.1% improvement in the fiscal deficit in both 2014 and 2015. The key reason for this is that the bulk of the subsidy bill is tied up with food subsidies that will not be meaningfully impacted by oil price falls alone. Further, diesel price reform has been completed.
- For India, under both Scenario's 1 and 2, the insensitivity of Urea prices to movements in international commodity prices is also a causal factor in the significantly smaller-than-expected total fiscal impacts of commodity price disinflation.
- The clear loser in this scenario is Malaysia where the fiscal balance is actually expected to deteriorate due to the loss in revenue from petrol taxes, royalties and export duties. The savings from the fuel subsidies will not be sufficient to mitigate these losses. Malaysia has not yet reached the tipping point where subsidies can be dismantled. We believe this tipping point is at oil prices below USD80 a barrel for a sustained period, a dynamic which comes into play in Scenario 2.

Sensitivity of Budget Balance if oil prices remain unchanged at current levels through end of 2015	**Fiscal Balance (% of GDP) 2014**	**Fiscal Balance (% of GDP) 2015**
The Philippines	0	0
Thailand	0.16	0.14
Malaysia	-0.06	-0.2
Singapore	0.02	0.04
Indonesia	0.1	0.3
India	0.1	0.1

Source: ANZ Research

SCENARIO 2: IMPACT ON FISCAL BALANCE OF COMMODITY PRICE FALL AND PROGRESS MADE ON SUBSIDY REFORM

For most of the ASEAN economies plus India the cumulative improvement in the fiscal position will not be as large in 2015 if oil prices drop by another 10% compared to the near 20% decline recorded thus far

Indonesia is likely to be the economy that makes the most progress given domestic prices of gasoline are likely to be rising.

A sustained drop in commodity prices (energy plus food) coupled with further progress being made on subsidy reform will have a more mixed impact.

Sensitivity of Budget Balance to a further 10% Food and Energy Commodity Price Decline + progress made on subsidy reforms	**Fiscal Balance (% of GDP) 2014**	**Fiscal Balance (% of GDP) 2015**
The Philippines	0	0
Thailand	0.15	0.01
Malaysia	0.021	0.035
Singapore	0.02	0.04
Indonesia	0.1	0.5
India	0.1	0.1

Source: ANZ Research

- In the first instance we note that Thailand will suffer a revenue loss from a decline in international commodity prices for its key exports that will be sufficient to almost offset the reduction in fiscal outlays.
- If Indonesia continues with its process of domestic fuel price hikes over

2015 this would mechanically increase the improvement we expect in Indonesia's fiscal deficit in 2015.

- Again India is the more complex economy where strong directional reductions in the fiscal balance are not readily apparent. As we outlined above, the subsidy structure of food is based more on high payments to farmers, which may be politically difficult to achieve meaningful reductions in the short term.
- Modi will attempt to progress on reducing food subsidies in the 2015/16 budget and we would look for an improvement in the fiscal balance next year of 0.1% of GDP.
- It is important to note that given the large number of subsistence households in India, programs such as cash transfers are being piloted as possible replacements to food subsidies.
- Again, falling commodity prices will have no discernible impact on the Philippines fiscal balance.

END GAME: TOTAL FISCAL BENEFIT OF COMPLETELY REMOVING SUBSIDY STRUCTURES

Though the potential size of the prize from subsidy reform is huge, the gains are only going to be realised slowly.

The total economic efficiencies that can be gained from subsidy reform are likely to be more slowly realised. Indeed, unwinding of subsidy structures is likely to be a much more complicated process than the introduction of subsidies given the political sensitivity and perceived equitable aspects of food and fuel subsidies. Taking the average subsidy bill over the 2007-12 period as the base-line scenario, if subsidy structures were to be completely unwound via either automatic convergence of international and domestic prices or an active policy of lifting domestic prices than the cumulative fiscal impact will be substantial. For most of the ASEAN economies plus India the cumulative improvement in the fiscal position could approach 2-3% of GDP from the complete reform of subsidies.

We believe they should, however, be a priority for policy makers to target.

A fiscal improvement of this magnitude would have profound impacts on the allocative efficiency of economies if re-allocated to physical and social infrastructure and would place economies on a much more sustainable fiscal path. There would be a mechanical reduction in government borrowing requirements, all other things being equal, and better targeted and sustainable fiscal policy would be favourably viewed by foreign investors and ratings agencies.

Maximum fiscal improvement likely if subsidy structures completely unwound over 3-4 years *	Change in fiscal balance over 3-4 years
Thailand	+2.3ppt
Malaysia	+2.7ppt
Indonesia	+2.8ppt
India	+2.1ppt

*Total improvement is expected to be an unwind of the average subsidy level over the 2007-12 period

Source: ANZ Research

CONCLUSION: SUBSIDY REFORMS ARE LOW HANGING FRUIT THAT WILL LIKELY BE SLOWLY PLUCKED

Asian policy makers have enormous scope to reduce the subsidy burden on the public purse now that commodity prices are falling.

The exercise above shows that there is enormous scope for Asian policy makers to significantly reduce the subsidy burden on the public purse and to use these saved outlays for more efficient spending that will improve the allocative efficiency of economies and thus boost potential growth. The welfare loss associated with subsidy reform is likely to be low given that these polices have proved to be inefficient and poorly targeted.

However there are many moving parts at play. For economies such as Indonesia, Malaysia and Thailand where a proportion of revenues depend on the international price of some commodity exports, falling export commodity prices will be mitigating some of the gains coming from falling commodity import prices.

India and Indonesia perhaps have the greatest potential for fiscal improvement.

South and Southeast Asia's two largest economies – India and Indonesia – clearly have the greatest potential to improve the efficiency of fiscal policy and reduce their deficit stance. However, these two economies are also likely to face the most difficulty via political sensitivity in progressing subsidy reform.

As South and Southeast Asia are experiencing a strong positive terms of trade shock, policy makers should take comfort from this dynamic and steel their fortitude to progress much-needed subsidy reforms.

As we believe Southeast Asia and India are likely to be experiencing a significantly positive terms of trade shock that will boost aggregate income formation at the national level, policy makers should take comfort in this dynamic and steel their fortitude to progress much-needed subsidy reform. Subsidies, though the goal was admirable, have proved to be inefficient and poorly targeted and there are much greater social and physical infrastructure needs that will be better served by their removal.

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