

Thailand: An Economic Evaluation



International Finance

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Recent Macroeconomic Performance

Prior to the Asian crisis there were many indicators that suggested that the Thai economy was beginning to slow down and that its phenomenal growth of recent years would not last. The general trend for the statistical economic data of Thailand suggests that after 1994 and prior to the crisis, the Thai economy was slowing down and beginning to show signs of weakness due to unsustainable growth (*see Table D*). Following the crisis, many of the national income account balances in fact moved in the opposite direction leading to negative GDP growth and a contraction of the Thai economy.

In 1995, the GDP growth had reached its peak growth rate of 15.16%. Following 1995 the GDP growth trend consistently slowed down to 2.58% by 1997 signaling to many investors that Thailand's economy was beginning to falter. After the crisis the GDP had a negative growth of -1.93% in 1998 but bounced back to 1.45% in 1999. Government expenditure increased from 15.945 % of GDP in 1994 to 18.52% in 1997 causing more total debt in the economy, however government expenditure declined to 17.82 % in 1998. Output continued to decline despite increased government expenditure, which predicted negative consequences for the Thai economy.

Thailand is a developing country and thus investment is a large part of its GDP. Prior to the crisis investment had increased from 1,450.2 billions of Baht in 1994 to 1,893.7 billions of Baht in 1996. The crisis was partly due to the readily available supply of investment capital that caused over borrowing to occur in the Thai economy and poor investment decisions to be made. Again as with many of the previous data this trend experienced a complete turn in the opposite direction in 1997.

Foreign direct investment also experienced similar other data trends of the Thai economy previous to and after 1997. Investment levels fell to half of the investment of the previous year and thus caused output of the foreign investment driven Thai economy to come to a virtual halt.

The balance of payments crisis in Thailand drove up interest rates to very high levels in 1997 (7.25% to 14.59%) therefore on July 2, 1997 Thai government had to devalue the Baht and started operating a managed float for the Baht exchange rate. The exchange rate went up from 25.09 in 1994 to 47.247 in 1997.

Before the crisis Thailand had a current account deficit which suggested that Thailand borrowed against or sold its assets to foreigners to finance the difference between its spending and its income. Due to the crisis, the current account moved from a large deficit in 1996 to a huge surplus only 2 years later. Most of this reversal came not through increased exports but through a huge drop in imports as the economy contracted.

The unemployment rate had an average of 1% during 1994 to 1997 and went up to 3.4% in 1998. Due to the impact of the financial crisis many companies had to lay off workers and many financial institutions had to be closed. The inflation rate had an average of 5.8 % between 1994 and 1997 and went up to 8% in 1998. The Phillips curve suggests that in the short run, increased inflation tends to coincide with a fall in unemployment (*see figure 1*). In the case of Thailand, however, when the inflation went up from 5% in 1994 to 8% in 1998, unemployment went up from 1.3% in 1994 to 3.4 % in 1998 (*see figure 2*).

Thailand's Financial Crisis

In recent years Thailand experienced outstanding macroeconomic performance that included public fiscal surpluses and reasonably high rates of investment. Thailand's growth rate in 1995 was one of the highest in the world at the time. The trend of phenomenal growth caused investors to overlook some of the potential risks associated with their investments and also caused a false sense of security. Many investors had the false impression that the central bank of Thailand would be able to handle any default in investment and maintain the basket-pegged exchange rate. Due to the ready supply of investment capital and a false sense of security, it became much easier for people to borrow leading to over borrowing. In addition, this false sense of security caused moral hazard problems and allowed banks to lend with little restriction. Investment occurred mostly in short-term, high-risk projects, which were

unlikely to repay debts. The debts, mostly unhedged and dollar-dominated, grew to irrationally large amounts. The market became inflated. The real estate and stock market were subject to a speculative bubble. Unrealistic increases in asset prices were observed which led to an increasing of speculation.

A weak banking system and bankruptcy law also played an important part. Loans issued by banks were not strictly supervised. Also no absolute rules for dealing with insolvent financial institutions had been established thus contributing to the problem.

Thai economy began to slow down in 1996. Continual decreases in the nation's growth rates were one of the signals that triggered investors to look more carefully at the Thai market. Once weaknesses in the Thai market were identified expectations of a devaluation began to surface.

With a pegged exchange rate regime the central bank will attempt to keep the exchange rate fixed at the stated rate (or at least move within a given band). The central bank does this by selling or buying domestic and foreign currencies at the specified rate thus adjusting the money supply in circulation.

Previous to the crisis, the Baht was believed to be over-valued due to the observation by many investors that Thailand's banking sector was headed for default. This means the exchange rate (Baht/\$) was set too low. This expectation caused people in the market to "dump" Thai Baht into offshore markets due to their expectations of the Baht being devalued.

Figure 3 presents the Balance of Payments Crisis model that represents what is believed to have happened to the Thai economy as the financial crisis occurred. Before expectations of devaluation arose, the Thai economy was at equilibrium where the fixed exchange rate was at 25 Baht/\$ (S_1), our interest rate was at i_1 , and our real Money supply was at M_{s1}/P . The expectation of a devaluation shifted the foreign returns curve to the right by increasing the S_e term. This resulted in a foreign returns increase relative to domestic returns. Thus this created an excess demand for foreign assets due to their yield of higher returns and pressure for the spot exchange rate S to increase.

To keep the spot exchange rate fixed, the central bank was forced to contract the money supply by selling its foreign reserves to buy back Thai Baht and take the Baht out of circulation. The contraction of the money supply is displayed in figure 3 as the movement from M_{s1}/P to M_{s2}/P . The contraction of the money supply resulted in an increase in domestic returns (domestic interest rate), thus bringing the domestic relative to foreign interest rate back to its previous level. Money supply decreased from M_{s1}/P to M_{s2}/P and domestic interest rate increased from i_1 to i_2 , thus keeping the exchange rate fixed at S_1 .

The sharp fall in foreign reserves and the unreasonable rise in domestic interest rates were observed by investors, peers, and speculators in the market. Added pressure in the market caused people to believe that the government would have to devalue the Thai Baht in the near future.

Following these expectations investors tried to get out of the Thai market by selling Thai Baht and buying foreign currency (especially US dollars). Speculators dumped a huge amount of the Thai Baht into the market in exchange for US dollars. To keep the exchange rate fixed the central bank was again forced to sell its foreign currency reserves and buy all the Baht being dumped into the market. With increasing expectations of a devaluation, increasing capital outflow, and foreign currency reserves running low, Thailand was forced to let the Baht float. Allowing the Baht to float led to an immediate devaluation, a movement from S_1 to S_2 (devalue). With the devaluation the interest rate moved down from i_2 to i_1 . In 1996 the exchange rate was 25.61 Baht/\$ but in 1997 it suddenly moved to 47.247 Baht/\$.

Before the government devalued the Thai Baht, the government was faced with an awkward dilemma, stemming partly from the dependence of its economy on trade and partly from the fact that domestic banks and companies had large debts denominated in dollars. If Thailand simply allowed its currency to drop, rising import prices would threaten to produce dangerous inflation, and then there would be a sudden increase in domestic bankruptcy. On the other hand, to defend the currencies would require at least temporary high interest rates to persuade investors to keep their money in Thailand, and these high interest rates would themselves produce an economic slump and cause banks to fail.

The huge devaluation of Thai Baht caused many problems in the Thai economy. Many businesses were forced to file for bankruptcy and many workers were laid off causing high rates of unemployment. The economy was virtually suspended. There was very little investment in Thailand and

Investors were increasingly hesitant to give out loans to Thai businesses. This resulted in lower levels of output. The crisis also decreased the Thai government's credibility worldwide.

The AA-DD model suggests that in the short run if a country decides to devalue its currency then the AA curve will shift outward and output will increase (*see figure 4*). After a devaluation domestic goods and services are now cheaper (given prices fixed in the short run), thus output increases. The central bank must buy foreign assets and thus expand the money supply to neutralize the initial effect of the increase in money demand due to the increase in output or domestic interest rates will exceed that of world interest rates. Therefore this model would predict that a devaluation will lead to an increase in output, an increase in official reserves, and an expansion of the money supply. This was not the case for the devaluation in Thailand. Thailand's goal was to stop the devaluation of the Baht and thus using this model one would predict that output would fall, official reserves would decrease, and money supply would contract. These circumstances were in fact the case as Thailand tried desperately to maintain the value of the Baht during the crisis. This model may not apply to Thailand's current situation however, because it does not take into account consumer sentiment or expectations.

The AA-DD model also suggests that perhaps the IMF recommendations of contracting fiscal policy may have in fact worsened the economic situation in Thailand following the crisis. By contracting fiscal policy, in a now floating exchange rate regime, the currency would be expected to depreciate even further and output in the economy would fall even further (*see figure 5*). Contraction of fiscal policy would decrease output and thus decrease the demand for money causing pressure to decrease interest rates. With no forced central bank intervention the decrease in money demand would eventually lead to a depreciation of the currency.

Recommendation for Thailand's Future Policies

Thailand is a small country relative to the rest of the world. The Thai economy is very dependent on trade and thus capital mobility is an important aspect of its financial markets. However, being a small country, Thailand desires exchange rate stability and thus allowing for a volatile and flexible exchange rate cannot be sustainable. The Thai economy does not have the size or capacity to handle large fluctuations or exchange rate volatility. Developing economies have less ability to influence their terms of trade than developed countries, making exchange rate stability a more important priority for keeping inflation expectations under control.

Currently, Thailand is in the process of recovering from the financial crisis and at the same time the economy is adjusting to increased volatility of the exchange rate due to a new managed floating exchange rate policy. Among the most pressing issues caused by the crisis are the dramatic decreases in output and an increase in unemployment. These two problems are primarily internal balance problems but in the case of Thailand these issues are integrated with external balance due to Thailand's heavy dependence on international markets.

Thailand's main concerns according to the recent trends of the statistical data are focused on unemployment, output, and price stability. Recently, as a means of stabilizing the economy, Thailand has adopted an inflation targeting policy. At first, this may seem dangerous because it does not hold a definitive position on exchange rate policy and thus fosters uncertainty. One could argue that if an exchange rate policy is not decisive then the market will force the hand of the central bank towards a definitive position through speculation. However, taking an intermediate position also offers flexibility of much needed monetary policy that can be tailored to a country's individual situation at any given time. Focusing on the current situation in Thailand this may be the best policy given that there has been a recent transition from an almost fixed exchange rate policy to a more floating exchange rate policy.

In the Thai inflation targeting policy essentially the Bank of Thailand states an expected level of inflation that is targeted through monetary policy. The expectation of inflation spills over into interest rates and the spot exchange rate through the Fisher equation and thus the central bank can still indirectly influence the exchange rate. The Bank of Thailand is not officially stating a fixed exchange rate thus retaining flexibility with monetary policy, but in practice will attempt to stabilize the Baht exchange rate.

Inflation targeting policy may also provide an escape clause for Thailand, making Thailand less vulnerable to speculative attacks by not officially committing to a fixed exchange rate and thus not creating a one-way bet for speculators. If the Bank of Thailand states an inflation target, it is signaling to the market that the central bank will intervene to meet its inflation target. As a result, the market will expect the targeted inflation to hold (given 100% credibility of the central bank) thus creating additional stability in the Thai economy and increasing investors confidence while building credibility. By keeping expectations in check, inflation targeting policy will add stability to the economy and avoid future balance of payments crises. It is the hope that additional investor confidence spurred by an inflation targeting policy will create capital inflow/investment from abroad, thus in addition to more stability, will allow for real growth in Thailand and for a smooth transition from a more fixed to more floating exchange rate policy.

The inflation targeting policy will only work if the central bank has credibility, on the other hand it can also be used to gain credibility. It is the hope of the Bank of Thailand that by committing to an inflation targeting policy the bank will send a signal to the market that the economy has settled down and is now growing. The goal is to spark more investment and increase the degree of consumer sentiment in the Thai market.

The acceleration of Thailand's growth in recent years before the crisis was primarily investment-led. Currently, one of the problems in the Thai market is that investment is too low and consumption is in a slump. It is believed that if government spending is increased with an equal increase in the money supply then there would be little effect on price levels and thus little effect on the exchange rate because there would be an equal increase in employment and in output to offset the growth of money supply. However, the government must be sure that the increase in its spending is directed towards real investment and not redistribution programs so as to increase output and not to crowd out private investment. This may possibly be one way to stimulate the economy. Recently, the government debt to GDP ratio was at its highest level at about 20% of GDP, but 20% of GDP is not yet considered to be at dangerous levels (*see figure 6*). The Thai government does possess debt but not so much that it cannot afford an increase in government spending, making the recommendation of a fiscal expansion a feasible option.

The effects of increasing government expenditure in the real sector and offsetting expansionary monetary policy are shown in the AA-DD diagram by a shift out of both the AA and DD curves. The result is an increase in output (holding technology constant) and an increase in employment in the economy while maintaining a stable exchange rate (*see figure 7*). Initially, a fiscal expansion would increase output and thus increase the demand for money putting pressure on domestic interest rates to rise and appreciate the currency. However, to alleviate this pressure the central bank buys foreign assets with domestic currency, thus increasing the money supply and allowing the exchange rate to remain unchanged.

Inflation targeting is a very sensitive policy that can either make or break the credibility of a central bank. It is very important that the inflation target is met and this will be more likely if there are some types of capital controls. Perhaps a capital control policy should be implemented in which foreign investors may invest in Thailand, but if they pull out of the Thai market having had their investment in Thailand for less than a year they would be forced to pay an early withdraw fee of some percentage of their investment.

Implementing such a policy may at first deter foreign investors from investing in Thailand due to their fear of losing control of their money. However, there is the possibility that implementing capital controls may increase the risk premium of Thai investments and may in fact make Thai investments more attractive to foreign investors. Capital controls may also signal to the market that the Bank of Thailand will be more likely to meet their targeted inflation level due to the implementation of capital controls and thus instill investor confidence.

Capital controls could very well be a solution to many of the dilemmas facing Thailand's economy, but can they realistically be enforced? Are they too disruptive to normal business? It is true that with increased technology and communication it is very difficult to maintain effective capital

controls. As the holes in which money can seep out of an economy grow larger money eventually finds a way to fly out of the country at the slightest hint of a devaluation. The positive aspect of capital controls would be to eliminate temporary (speculative) capital from entering the country in the first place, the goal is to have capital stay for longer periods and actually invest as opposed to simply lend (equity vs. debt).

Conclusion

The future outlook for the Thai economy remains uncertain. Macroeconomic policies are breaking new ground as Thailand shows slight signs of economic recovery. However, as Thailand's major trading partners (Japan and the United States) head into economic slow downs the need for reform within the financial sectors of Thailand will inevitably prove the correctness of Thai macroeconomic policy and force the Thai economy to either sink or swim.