Sustaining Institutional Reform and Economic Growth in Thailand

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BACKGROUND

Beginning in May of 1997, currency speculators began selling Baht in massive quantities, threatening the country’s considerable foreign reserve holdings. The lack of confidence in the baht was precipitated largely by a lack of confidence in the Thai banking sector:

- Banks lent with little restriction.
- Many high-risk ventures were financed because of confidence that the central bank would guarantee the loans.
- Dollar-denominated debts grew unsustainably large.

Because many expected the banking sector to default, investors perceived the Baht to be overvalued. Therefore, the exchange rate at the time was considered to be too low, and those who held Baht wanted to exchange it for other currencies before a devaluation would be announced. Much domestic capital left Thailand for offshore accounts.

BALANCE OF PAYMENTS CRISIS MODEL

So represents the fixed exchange rate, 25 Baht/$ which was maintained throughout the early and mid-nineties. The shifting out of the expectations curve demonstrates a preference for holding foreign currency over domestic currency, and as the i* curve shifts out, more appreciating pressure is placed on the exchange rate.

The monetary authority wanted to maintain a fixed exchange rate, however, so it contracted the money supply. As the monetary supply contracted, interest rates increased from \(i_0\) to \(i_3\).

However, foreign reserves were finite in supply and their diminution caused panic among investors. Coupled with the unusually high domestic interest rates, investors continued to expect a devaluation.

The expanding foreign returns expectations curve (\(i^*0\) to \(i^*_3\)) demonstrates the transfer of Baht into other foreign currencies, primarily USD. The Thai government could no longer maintain the fixed exchange rate by buying Baht and taking it out of circulation, and was compelled to let the Baht float. This decision caused the exchange rate to depreciate from its stable level, 25.61 to a steadily increasing rate, and sharp increase in the Summer and Fall of 1997 to 46.5. The exchange rate peaked at 56.1 in January of 1998.
**RECENT MACRO-PERFORMANCE**

“In 2002, the Thai economy was once again engaged in the cycle of recovery, which continued to strengthen amidst sluggish global demand and rising geopolitical tensions in the international arena.”

- Bank Of Thailand- Economic Performance In 2002 And Outlook For 2003

**GROWTH**

After the 1997 financial crisis, Thailand’s real GDP contracted by 10% (104.4 to 93.5), but after implementing deep reforms in the banking sector to rebuild investor confidence, Thailand has maintained an average real GDP growth rate of approximately 3.5% per year during 1999 to 2001. Even with the downturn in the global economy in 2001, which was worsened by the September 11th attacks on the U.S., and deterioration in the external terms of trade, Thailand has managed to sustain a positive real growth rate of 1.8% in 2001. The Thai economy has since rebounded, and grew by 4.5% in the first half of 2002.

This initial strong recovery and the slowdown can be explained using the Solow Growth Model. As the capital fled the country k declined rapidly. However since the savings curve was above the depreciation line, and k began to grow immediately. While the GDP held steady during 1998 and 1999 it began to rise rapidly in 2000 and 2001.

Growth in Thailand has been broad based. Many attribute the economic upturn to consumer credit driven growth and fiscal pump priming. However, private consumption increased by only 4.1% in 2002, much slower than overall GDP, while government consumption grew only 0.5% in 2002. This shows that these were not the only causes of the economic upturn.

Economic expansion has been balanced in recent times with increased private consumption, domestic investment, expansionary fiscal policy and exports’ increases and external

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current account surpluses all contributing to broad based growth.

**EXTERNAL BALANCE**

Despite the slump in the global markets, exports performed relatively well, and expanded favorably compared to other countries in the region.

While Thailand’s current account surplus has begun to decline, this seems to be the result of global economic conditions. The declining current account may also have to do with a domestic fiscal expansion.

**MONETARY POLICY AND MONEY SUPPLY**

Under the inflation targeting framework, the Bank of Thailand sets the 14-day repurchase rate as key policy rate, and signals a shift in monetary policy stance through a change in the announced rate. The main objective of monetary policy is price stability by keeping core inflation within target.

The shift to a managed floating exchange rate regime in 1997, increased the ability to pursue an independent domestic monetary policy where the need to defend a specific exchange rate level is no longer at the forefront of decision making. As a consequence, monetary intervention has been limited.

Thailand did engage in a considerable monetary expansion in 1998, which can be seen on graph below. This policy was apparently endorsed by the IMF and coincided with expansionary policies in several other Asian economies.

**3 PERIODS OF THAILAND’S MONETARY POLICY:**

- **Pegged exchange rate regime (WWII- June 1997):** The value of the baht was initially either pegged to a major currency/gold or to a basket of currencies.

- **Monetary targeting regime (July 1997 - May 2000):** After the adoption of the floating exchange rate system on 2 July 1997, Thailand received financial assistance from the IMF. During the IMF program, monetary targeting regime was adopted. Under this regime, the Bank targeted domestic money supply using the financial programming approach in order to ensure macroeconomic consistency as well as to reach the ultimate objectives of sustainable growth and price stability.

- **Inflation targeting regime (May 2000- present):** After the IMF program, the Bank made an extensive reappraisal of both the domestic and the external environment and concluded that the targeting of money supply would be less effective than the targeting of inflation. The main cause for change was that the relationship between money supply and output growth was becoming less stable, especially in the period after the major crisis and the uncertainty in credit extensions as well as the rapidly changing financial sector in Thailand. The Bank announced the adoption of inflation targeting in May 2000.

Source: Bank of Thailand website- Monetary Instruments

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EXCHANGE RATES

Thailand adopted a managed-float exchange rate regime in July 1997. Market intervention by the Bank of Thailand is limited and permitted only when necessary to prevent excessive volatilities. The floating regime allows for greater flexibility in monetary policy implementation, as money supply does not necessarily have to target a specific exchange rate.

To “safeguard against potential instability and speculation in the currency market,” the Bank of Thailand imposed a new measure in 1998 that prevents foreign currency traders with no underlying investment or trade interest in the Thai economy from borrowing or buying large quantities of baht. This capital control regime seems aimed at the notion that foreign currency traders helped bring about the crisis. It appears, however, that currency traders can engage in currency swaps with on-shore companies. We have not found any evidence that the control has notably positive or negative effect on investor sentiment towards Thailand or on the exchange rate.

INFLATION

The inflation rate of Thailand's trading partners averaged about 3.5 percent during the past 10 years. Keeping that in mind, the Thai authorities have an inflation targeting policy, setting the target core inflation at between 0 - 3.5 percent. This ensures that Thailand's inflation rate is in line with those of trading partners enhances export competitiveness. The aim of this inflation targeting policy is to help cushion temporary economic shocks and minimize the need for the Monetary Policy Committee (MPC) to adjust monetary policy frequently, thereby reducing short-term interest rate volatility and promoting financial stability. The current headline and core inflation rates are 1.64% and 0.2% respectively.

3 Bank of Thailand – Policy Target :
http://www.bot.or.th/BOTHomepage/BankAtWork/Monetary&FXPolicies/Monet_Policy/

4 Bank of Thailand – Policy Target :
Over the past 10 years, core and Headline inflation averaged 4.7 and 4.8%, respectively, with core inflation being less volatile in the short run. In the long run, the movements of both core and headline inflation rates seem correlated and these two measures seem to move together in the long run.

This trend is perhaps the cause of overall price stability.

Price indices have been stable (Producer Price Index increased marginally from 118.8 in 2000 to 121.8 to 123.8 in 2002 while the change in Consumer Price Index was even smaller from 123 in 2000 to 125.1 to 125.8 in 2002)

**Recommendations for Future Policies**

**Do Nothing**

An important part of the popular characterization of Former Secretary of the Treasury Rubin’s was a minimalist approach to economic policy. The idea was that the government has limited and sluggish tools to affect the market. It is sometimes important to let economic problems play themselves out and to be patient with previously implemented solutions. We base our recommendations for the Thai government on a similar feeling. Thailand is doing virtually everything that can be done to cope with the aftermath of the crisis and with the current global downturn. Thailand’s managed floating exchange rate has allowed exports to increase since the crisis and the government has pursued aggressive and verifiable institutional reforms to the banking sector. Thailand is also pursuing an expansionary fiscal policy based on social spending.

**Institutional Reform**

In spite of the fact that Thailand is often characterized as a victim of international financial markets, there is considerable evidence that the Thai government has taken responsibility for the financial crises by addressing the perceived source Thailand’s weakness, the banking sector. Bankruptcy law has been reformed and nearly half of Thailand’s banks are now under the control of foreign banks with strict lending practices. Most of Thailand’s investment houses are now also under foreign control (Asia Money).
Fiscal Policy

Thai President Thaksin Shinawatra has recently instituted an expansionary fiscal policy aimed at rural economic development and healthcare reform. The precise magnitude of the expansion is not clear from currently available data. We believe that some fiscal stimulus is appropriate given that the state of the world economy in general and Asia in particular. Aside from the fiscal expansion itself, instituting reforms to Thai social policy is also a positive institutional response to the crisis and its effect on ordinary Thais.

![Graph showing supply and demand with an outward shift and appreciation]

An increase in government spending increases demand in the goods market, which causes an outward shift in the DD curve. This causes an appreciation in the currency and an expansion in output.

Trade

We have also argued that much of Thailand’s recovery has been driven by exports and the weakened Baht. As a result, we believe that foreign aggregate demand is important to the Thai economy and that weakened demand from world markets is grounds for particular concern. We believe that this is probably the central issue currently facing the Thai government. Unfortunately, Thailand is a small country with no control over its key export markets, the US, Japan, and China.

The expansionary fiscal policy mentioned above is one appropriate response to falling demand but not necessarily an adequate one. Another option that the Thai government should continue to aggressively pursue is trade barrier reductions. Any improvement in Thailand’s terms of trade could help to offset the effects of the current global downturn.

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5 Asia: Bubbling along; Thailand’s economy, The Economist, London; September 21, 2002
LIMITATIONS

Some critics suggest that the Thai economy is at risk of overheating as a result of government encouraging cheap credit and pursuing expansionary fiscal policy. *The Economist* described the Thai policy as “asset revaluation,” suggesting that the government actually wanted to create a bubble in the hopes that fundamentals would later catch up with these inflated asset values.\(^6\) Others have been more vague in their criticism of the Thai policy, referring to it as “populist.” In short, the most common criticism of current Thai fiscal policy seems to be that it is irresponsibly expansionary. However, given that Thailand’s domestic production can still serve Thai demand along with sizable exports, we believe that over-employment of productive resources should not be a central concern. Given the war with Iraq, the SARS epidemic, and economic problems in Japan and the United States, it would be more appropriate to worry about recession than inflation.

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\(^6\) Asia: Bubbling along; Thailand’s economy, The Economist, London; September 21, 2002