

EE460: Thai Economy

Coping with the 1998 crisis

Bhanupong

Lecture 5

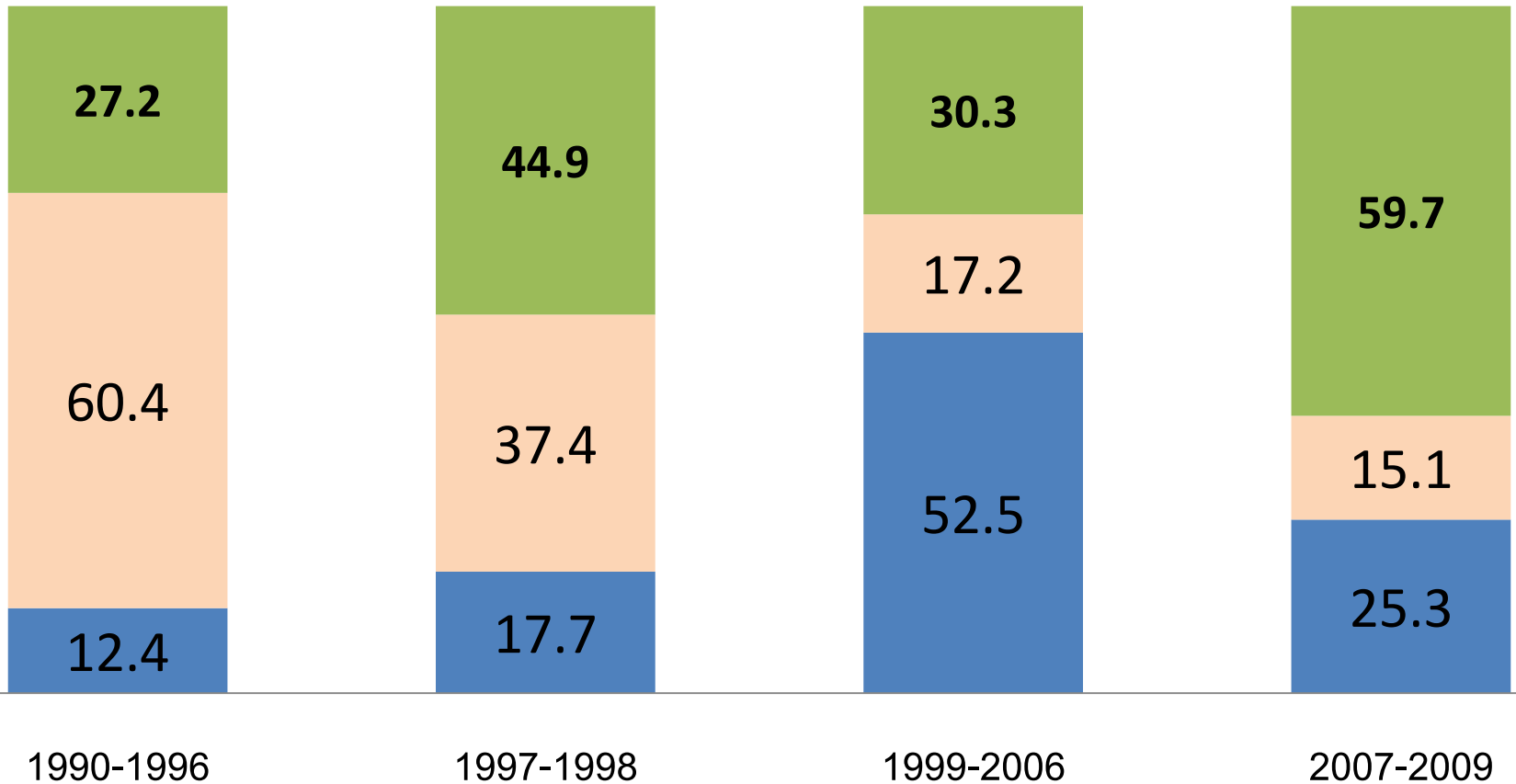
Outline

- Roots of the problem
- V-shaped recovery
- Lessons from the 1998 crisis
- growth accounting
- Sectors' responses
- Debt deflation episode

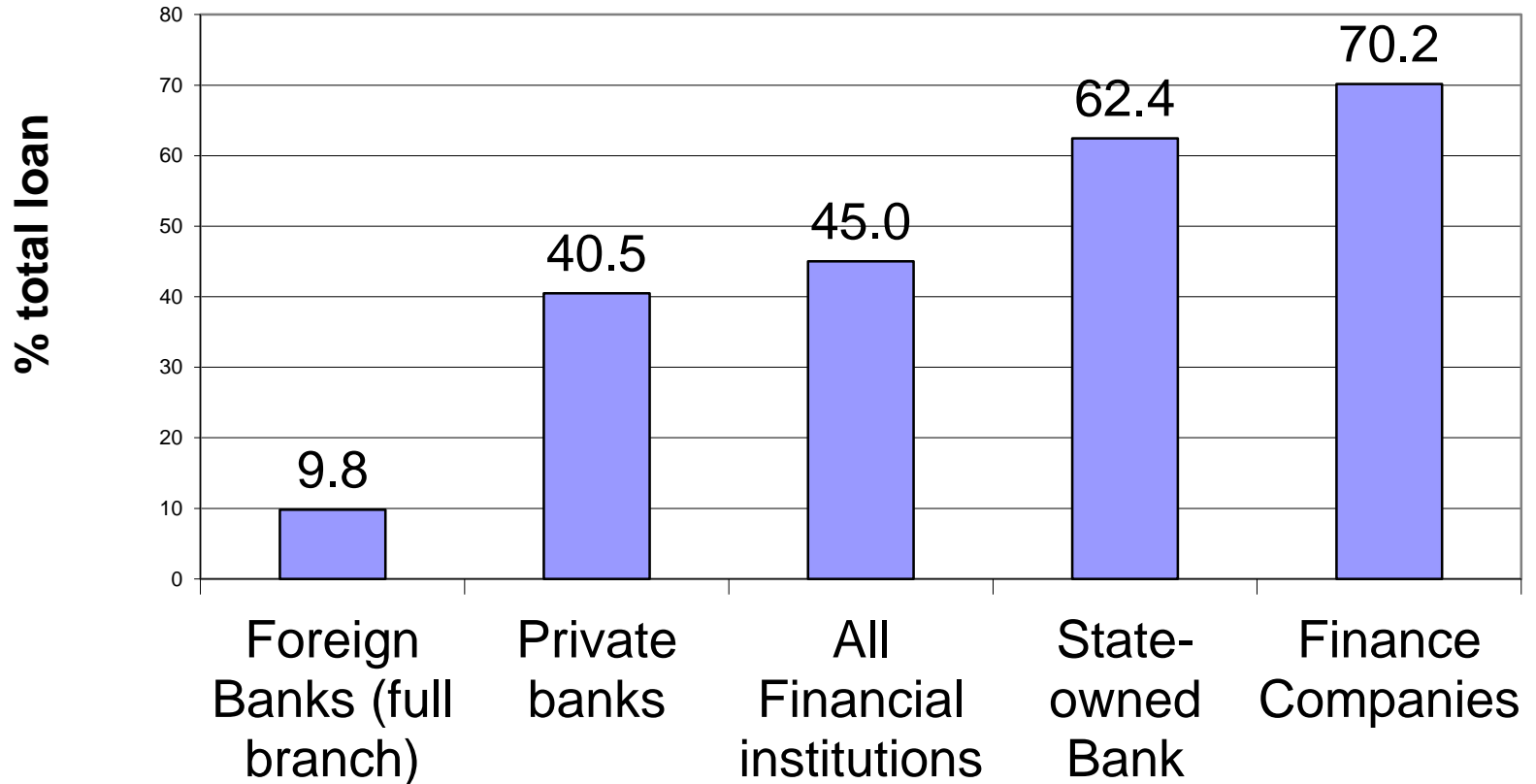
Changing structure of capital flows

% of total

■ FDI ■ Loans ■ Portfolio investment

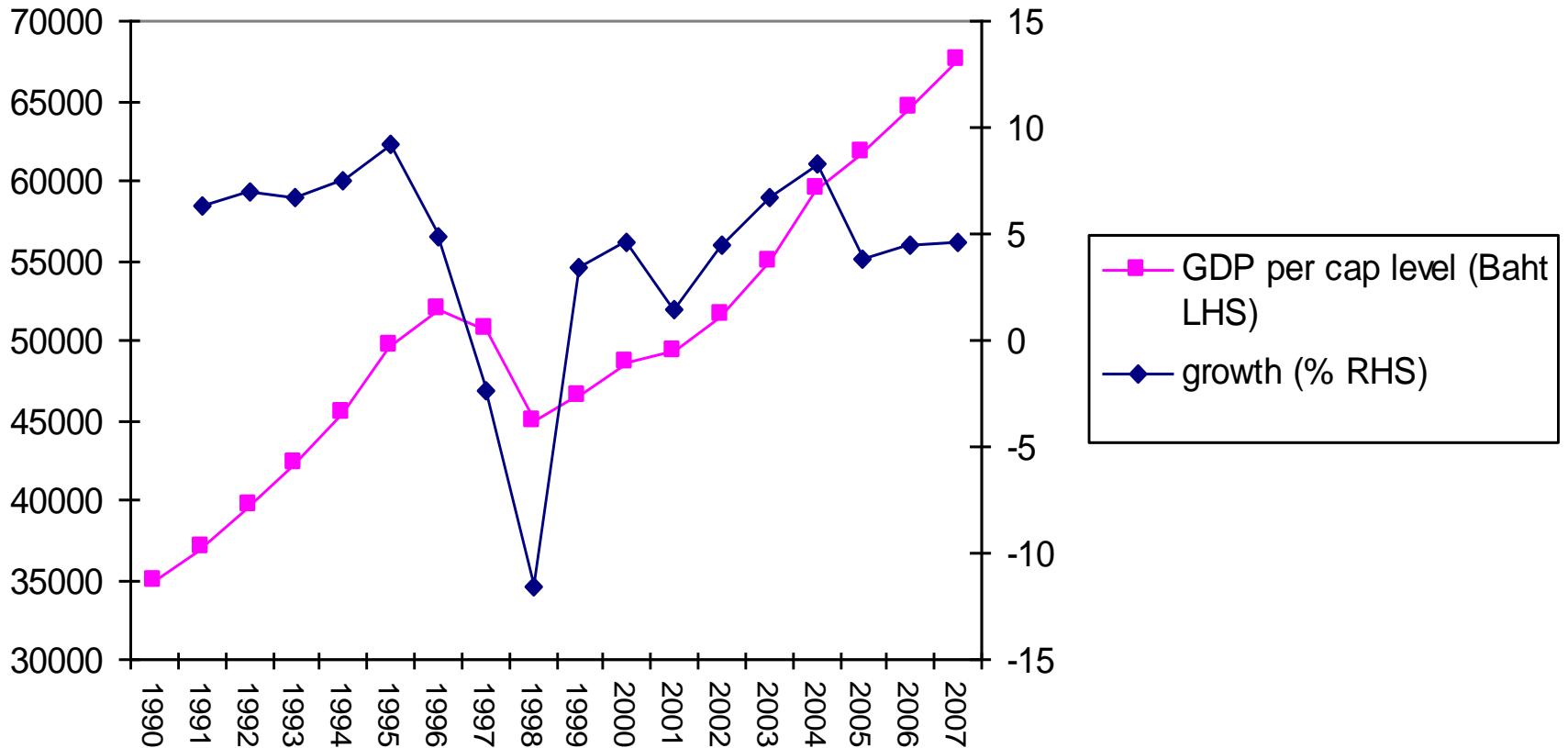


Non-performing loans in 1998



The V-shaped recovery

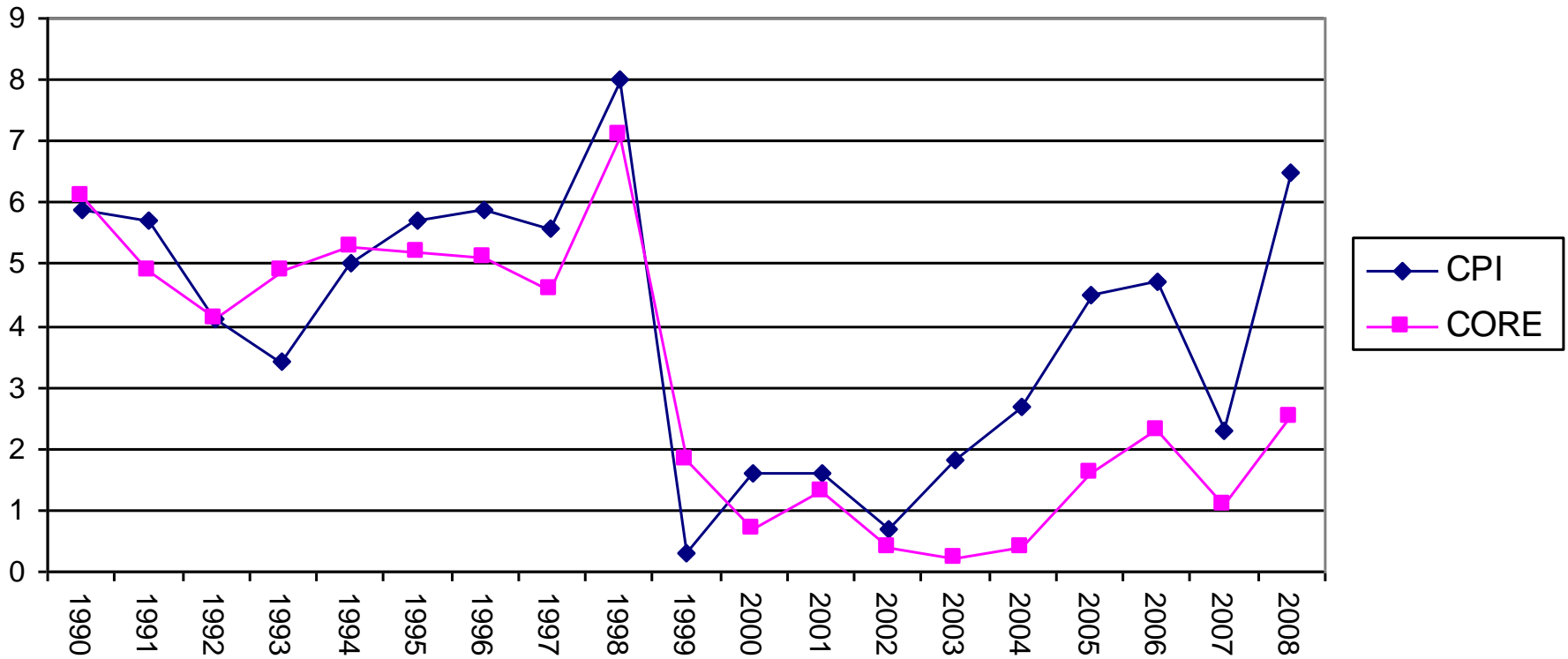
Real GDP per capita



Core vs. headline inflation

(Excluding fresh food and energy prices)

Headline and core Inflation



Source: BOT

Shocks and adjustments

- There exist certain **mechanisms** in the structure of the Thai economy that would lessen the impact of the next economic crisis, whether the shock is internal or external.
- These shocks would not have a long-lasting impact and would simply reduce growth temporarily below a stable growth path.
- The adverse impact of shocks was mitigated by the resilient agricultural sector
- Regained the pre-shock growth part in a few years.
- ***Did that mechanism operate in 2009?***

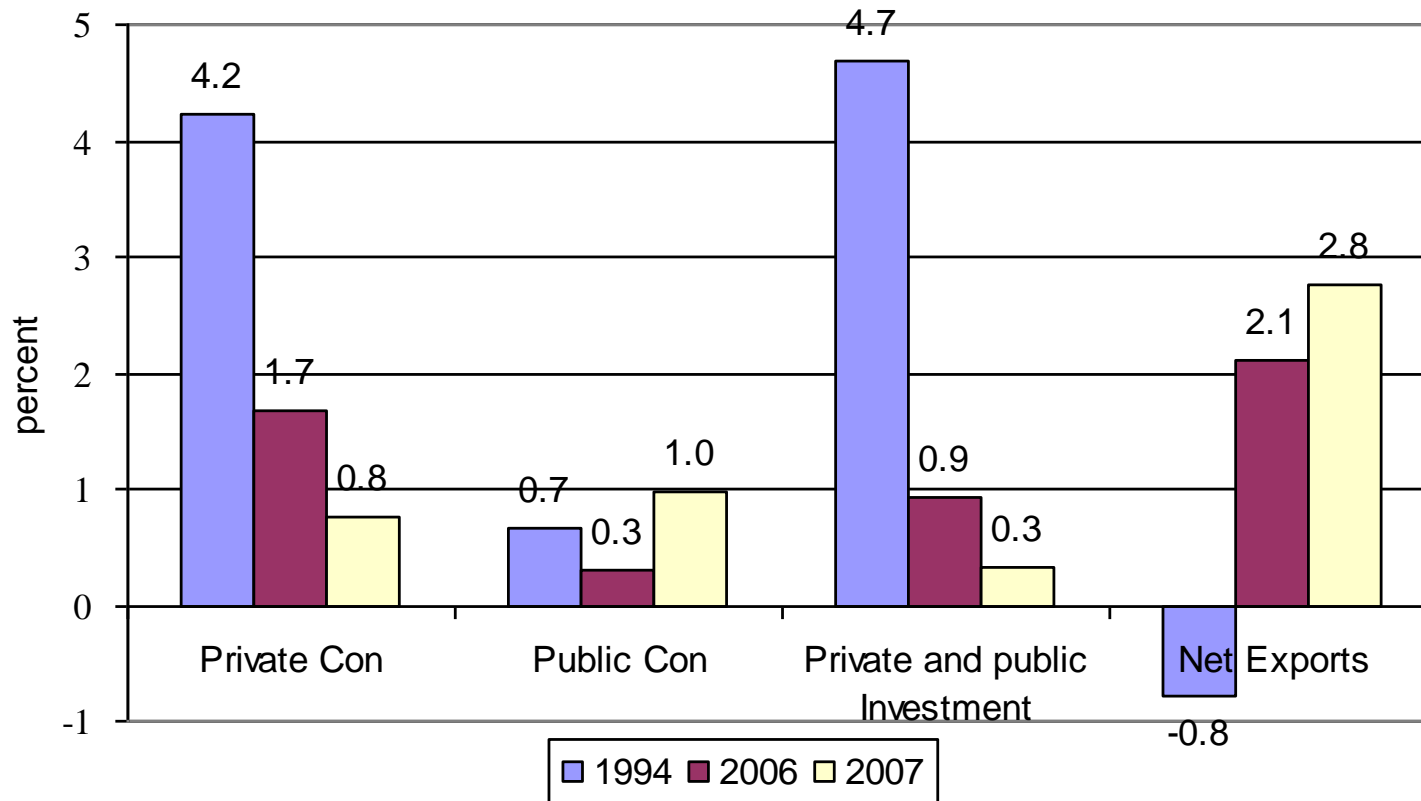
O learned Thailand

- The Asian currency crisis followed Thailand's decision to float the baht in July 1997.
- What went wrong?
- What could have been done to prevent the crisis?
- The original sin
- The impossible trilemma for an open economy

Sources of growth

net exports = exports-imports

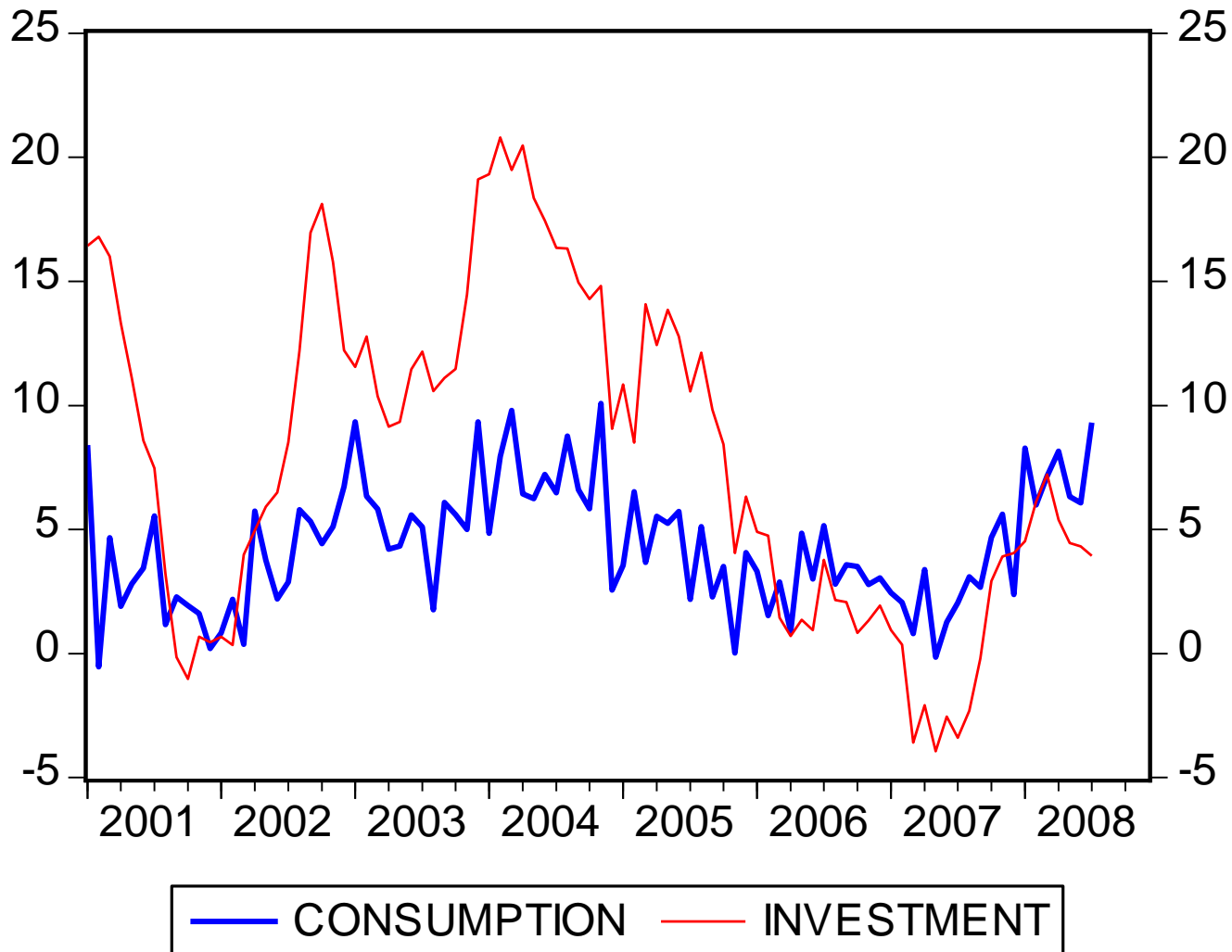
Growth Decomposition



Source: Calculation based on NESDB data

Long run relationship

Investment expenditures in the past can be used to predict current and future consumption



Determinants of consumption and investment

- Investment expenditures in the past can be used to predict current and future consumption.
- Flexible accelerator model
- Neoclassical theory of investment
- Life cycle hypothesis of savings
- Liquidity constraints

Trend (exponential) growth rate

percentage

January 2000-December 2008

	Consumption	Investment
Mean	4.4	7.9
SD	2.4	6.6
CV	0.54	0.83

The labor market

- The flexibility of wage rates in Thailand helped mitigate the damaging effect of a sharp fall in output in the aftermath of currency crisis.
- What if downward rigidity exists?
- Unemployment has declined as the economy gradually recovered.
- Inflation remained subdued compared with global inflation
- The resulting fall in domestic interest rates enabled Thai firms to restructure their foreign debts, thereby reducing the degree of vulnerability to **the global financial crisis** (2007-2009).

Responses in the agricultural sector

- The agricultural sector has been supporting the Thai economy by generating a high income through out the early 2000s.
- Agricultural output responded positively to high prices for world commodities.
- The agricultural sector generates demand for manufactured products and provides a steady pool of labor for the manufacturing and service sectors.
- It can act as a shock absorber during the time of recession: no body dies of starvation.

Dynamism of the industry sector

- Export-oriented industries had raised output level far above the pre-crisis period.
- These industries were able to respond to the growing demand generated by the upturn in the business cycle.
- The role of foreign direct investment is crucial to the industrial development in Thailand.
- The consistently open policy towards FDI has contributed to continued flows of **technology transfer** and **spillover effect** into local industries.

Growth rate by sector

1990-2007

	Agriculture	Industry	Services
Growth	1.8	6.8	4.6
μ			
σ	5.7	6.5	4.9
σ / μ	3.2	0.95	1.1
Correlation coefficient between the service sector)	-0.12	0.91	

Changing vs. switching expenditure policy

- To restore both external and internal balances, domestic demand (sum of consumption, investment and public spending) and the exchange rate must be allowed to play an equilibrating role .
- To reduce the current account deficit:
 - (1) imports must be reduced through output contraction (cut down domestic absorption);
 - (2) exchange rate must depreciate to switch spending from imports to domestic goods.

Export Demand Function substitution and income effects

$$X = \alpha + \beta [\ln(P_T/e)/P_w] + \gamma \ln(Y_w) + v$$

e = baht/usd

P_T = Thailand's export price index

Y_w = world income

P_w = world price index

Import Demand Function

Income and substitution effects

τ = tariff rate

P_m = import price in USD

$$M = \mu + \theta \ln[(1 + \tau)(eP_m/P_T)] + \eta \ln(Y_w)$$

Economic Crisis

- A fixed exchange rate regime created an illusion of a zero foreign exchange rate risk.
- Premature relaxation of capital controls over borrowing in foreign currencies.
- The export shortfall in 1996 and widening current account deficit raised doubt about the sustainability of the baht currency peg.

Currency and financial crises

- With the baht succumbing to speculative attacks, the Bank of Thailand decided to float the baht on 2 July 1997.
- Without a nominal anchor and given the lack of policy credibility, the value of the baht fell 56% through January 1998.
- This large currency depreciation aggravated the foreign debt burden, causing a credit crunch, bankruptcy, and financial disintermediation.

- The loss of consumer and business confidence stemming from the expected recession exacerbated the contraction in consumption and investment.
- Until the exchange rate rebounded to the level determined by economic fundamentals, the economy will continue this debt-deflation episode.

Pigou Effect

- $C = f(\text{Net Wealth}/P)$
- In theory, as prices fall during recession, consumption can increase as real wealth increases.
- In practice, prices do not fall large enough to stimulate consumption to move the economy out of recession.
- Irving Fisher (1933) Debt-deflation theory of great depressions, *Econometrica* (1) no.4

Negative wealth effect

- If net wealth is negative due to rising foreign debt caused by massive devaluation, real debt burden increases when price level falls.
- Hence price deflation increases real value of debt, leading to further contraction of consumption and contraction of output.

After a recovery: Structural problems remain

- Although the Thai economy seems to be resilient, riding on the expansion of world trade, there are still some structural problems.
- Public enterprises which enjoy monopoly power and high economic rents must be reformed to make them more efficient and competitive.
- Free trade agreements with other countries can help speed up the structural reform.

Remaining structural problems

- Dependence on imported oil makes Thailand vulnerable to oil price shocks.
- Adverse impact of the oil shocks had been postponed through public subsidy, but the surge in inflation and the loss of competitiveness became apparent as wage and price adjustments began to take place.

Remaining structural problems

- The exchange rate must be made more realistic with little intervention so as to cushion the economy from external disturbances.
- Resilience requires sensible policies such as realistic exchange rates and macro prudential policy.
- **A Big Mac Index** may provide a clue to exchange rate undervaluation or overvaluation.

Review questions

- How well did Thailand cope with the global financial crisis?
- Did Thailand learn any lessons from the past mistakes?
- How resilient is the Thai industry when facing external shocks?
- What are social implication of Thailand's economic fluctuations?