

# Premature Liberalization and Macroeconomic policy after the AFC

Bhanupong

Lecture 6

Two readings:

1. Asian Economic Papers (2003) “Thailand’s macroeconomic policy after July 1997”
2. Premature liberalization

# Course Syllabus

## Lecture 6

- We analyze premature liberalization of the capital account and explain the underlying *political economy of liberalization*.
- Macroeconomic development after 1997 is discussed in light of the monetary policy under the “new” exchange rate regime, where foreign *exchange market intervention* is still the order of the day.
- “Thailand’s macroeconomic policy after July 1997” *Asian Economic Papers*, Vol.2, no.1, 2003.

# Main themes

1. Political economy of the financial liberalization and its' prematurity
2. The financial crisis: 2<sup>nd</sup> July 1997
3. The role of the IMF
4. Macroeconomic policy after 1997

# 1. Political economy of financial liberalization

## **The political economy of financial liberalization**

In 1990, the Thailand Development Research Institute (TDRI), an independent think-tank, predicted that Thailand would repay all of its debt by 1992 and would graduate into a net creditor or a newly industrializing country like South Korea. It also predicted that the structure of capital inflows would be in the form of foreign direct and portfolio investment rather than foreign borrowing. Phaichitr Uathavikul, President of TDRI and former Finance Minister and executive officer of the World Bank, saw no obstacle to Thailand's becoming a net lender country, barring political interference that might create instability. According to Phaichitr, exchange control liberalization could fulfill Thailand's desire to become a commercial and financial center for the fast-growing region, and unrestricted access to the Thai market by foreign banks would bring about a competitive environment and advanced technology. Sanoh Unakul, former Governor of the Bank of Thailand, former Secretary General of the National Economic and Development Board, and chairman of TDRI in 1990, also argued that there was growing evidence of Thailand becoming the region's trade and financial center (*The Nation*, May 15, 1990).

# Relaxation of foreign exchange controls: international reserves galore

When in 1990 the Bank of Thailand was holding talks on the strategy for liberalizing exchange controls with the IMF, the latter had been calling for the Thai government to liberalize exchange controls, arguing that the robust Thai economy would entail rapid exchange control liberalization. Chavalit Thanachanan, Governor of the Bank of Thailand, basically concurred, stating that exchange control liberalization would send a signal to the rest of the world that Thailand was ready to facilitate trade and financial flows and to join the club of sixty countries that had adopted exchange control liberalization. The US\$12 billion level of international reserves was considered sufficiently large to relax foreign exchange control.<sup>2</sup>

In 1990, Prime Minister Chatichai Choonahavan argued for Thailand's compliance with the IMF rules of Article VIII by saying that Thailand was now financially mature and should thus meet the conditions under the Article. Pramual Sabhavas, Finance Minister, also argued that the level of international reserves was sufficiently high since it covered five months of imports without any earnings from exports. According to Pramual, the announcement of the acceptance was a prelude to the upcoming 1991 IMF meeting of central bank governors in Bangkok (*The Nation*, 17 May, 1990).

# Loans extended by BIBF grew from 200 billion baht in 1993 to 1.9 trillion baht in 1997

## Bangkok Internarial Banking Facilities (BIBF)

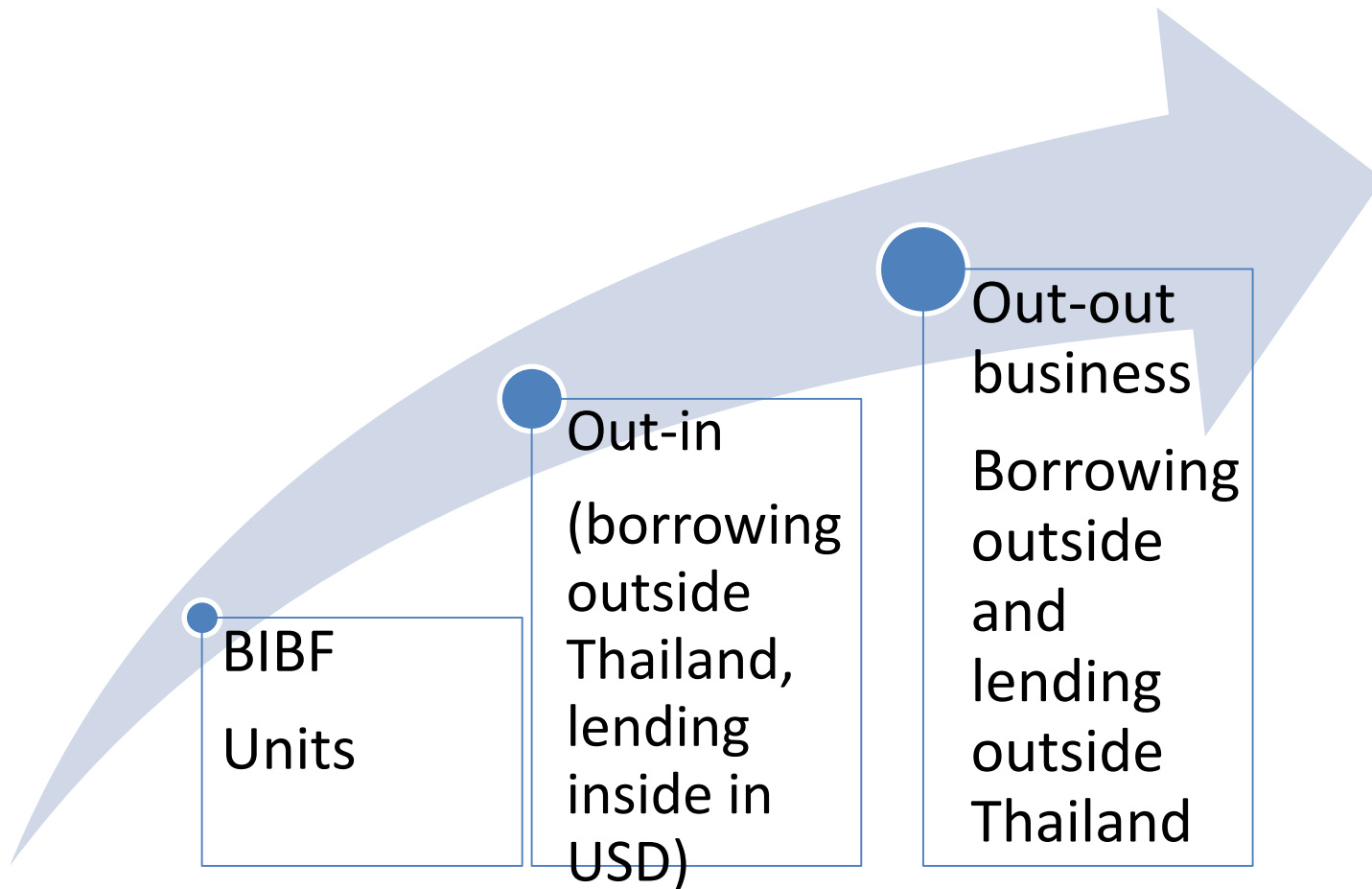
The global trend toward financial liberalization and the globalization of financial markets prompted Thailand to accelerate the development of financial institutions to serve the increasingly sophisticated needs of international trade and investment. As director of the Bank of Thailand's supervision and development department in 1995, Thirachai Phuvanatanarubala argued that Bangkok had a future as a leading international banking center in the region, replacing Hong Kong and Singapore. As he saw it, Hong Kong would be returned to China in 1997 and Singapore would be disadvantaged with rising operating costs. He thus pushed the Bank of Thailand to promote BIBFs' 'out-in' business in the form of loan syndication because it would serve, he contended, as a stepping-stone for expansion into their 'out-out' business once Thailand overcame its shortage of human resources (*The Nation*, 29 May, 1995).

Loans extended by BIBFs grew substantially from 200 billion baht in 1993 to 1.2 trillion baht in 1997, and peaked in 1997 at 1.88 trillion baht. At the end of 1999, the amount declined to just 600 billion baht, as the local interest rate declined to its lowest level in decades, resulting in the disappearance of the financial advantages of foreign borrowing through BIBFs.

# Preliminary requirements for establishing a financial center

1. Free flows of capital: No capital controls
2. Stability of the baht/dollar exchange rate
3. Ample international reserves

# Playbook of an Asian Financial Center



# Consensus among bankers and think-tank economists: We need to establish Bangkok as a financial center

## **IMF pushed Thailand to relax capital control**

Wade (1998) blamed the IMF for its pressure on developing countries to open the capital account without an adequate framework of regulation. In the case of Thailand, the IMF was in fact a major influence behind the push for financial liberalization and there was a trace of the Washington Treasury complex (Bhagwati 1998). But also important for Thailand's drive for financial liberalization was the consensus among domestic players such as central bankers, commercial bankers, and independent think-tank economists, who walked in and out between the public domain of regulatory agencies and private financial institutions. For example, Tarrin Nimmanahaeminda, Finance Minister under the Chuan Administration in 1993 and an advocate of the idea of establishing Bangkok as a financial center for the region, was once the president of Siam Commercial bank.

# Don't just blame the IMF

The Thai elites had an unrealistic dream of establishing Bangkok as a financial center in the region

This network of influential players shared the IMF's ethos of free market ideology. Furthermore, the IMF gave them indirect support by providing the standby loan agreement in case of capital outflows after exchange control liberalization and thus encouraged the perception that nothing could go wrong with an open capital account. It should be noted, however, that the IMF influence alone was not sufficient to push for complete financial liberalization. Had central bankers and bankers-turned-finance ministers not subscribed to financial liberalization, the pace and shape of liberalization in Thailand would have produced a different outcome. There was also an environment of 'irrational exuberance' that was inflated by large accumulated international reserves and an unrealistic dream of becoming a financial center in the region.

Irrational Exuberance

We have a dream: Bangkok will be the Asian Financial Center

Intense competition by foreign banks to upgrade BIBF units to a full bank status and to earn economic rent in the Thai banking industry, to which entry was limited.

Since the Finance Ministry controlled the number of foreign banks in Thailand, foreign banks that wished to enter the Thai market had to seek a BIBF license for full services. Given that there were large economic rents from having the license (tax privileges and the possibility of illegally siphoning money to offshore branches in locations like the Cayman Islands), there was keen competition for the license among foreign banks. This competition took the form of demonstrating their willingness to enter the Thai market by showing an impressive lending volume and thus resulted

A rent seeking minister

# Capital inflows, asset price bubbles, and over-lending into the nontraded sector

## A typical Dutch disease

*Premature liberalization and economic crisis in Thailand* 41

in their excessive lending despite the low interest spread and high default risks. Thus it is not surprising that foreign banks' lending volume increased more rapidly than Thai banks.

### **Capital inflows and vulnerability to economic crisis**

Favorable events such as rapidly rising growth rates of exports and GDP generated the expectation of continued prosperity. Asset prices were bid up by the linear expectation of continued prosperity, and credit from financial institutions only added fuel to the bidding-up process to the extent that asset prices far exceeded their fundamental values. For instance, whereas in 1986 the share of bank credit allocated to real estate was only 3.8 per cent of total bank loans, it went up to 10.5 per cent in 1994 to decline slightly to 8.8 per cent in 1996 (Table 1.3).

Once psychological factors such as the herd instinct took over the sensibility of market participants, asset prices became highly overvalued. Greed and euphoria kept the level of 'paper profits' high. Capital control relaxation coincided with the boom in the real sector of the economy. Thus with the cheap funds they were able to obtain abroad financial institutions pumped credit and margin loans, fueling the bubble. What further weakened the financial fragility was that credit extension was concentrated in the nontrade sector. The open capital account also allowed large portfolio capital inflows from international investors who wished to diversify their portfolios, thus pushing up share prices further.<sup>3</sup>

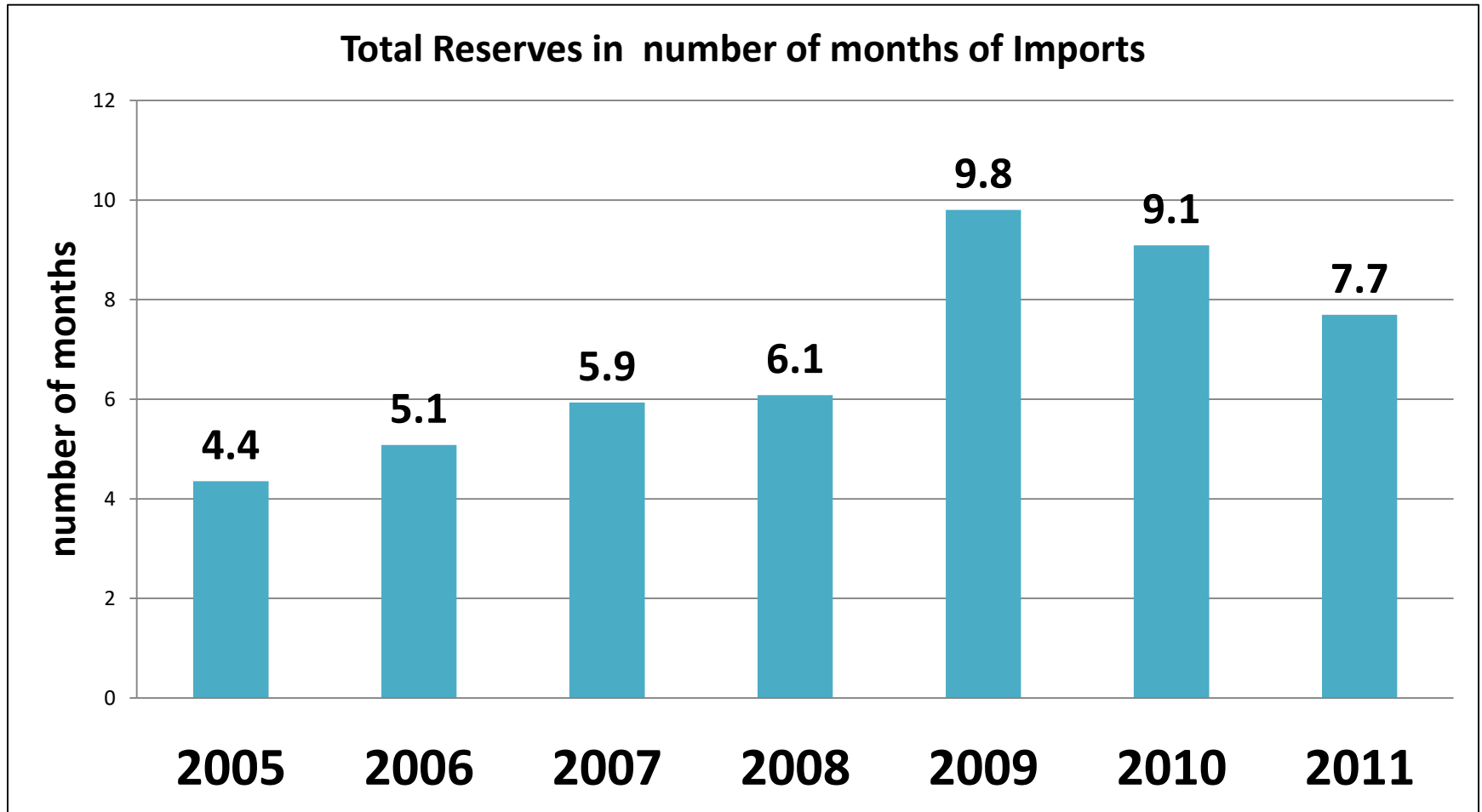
# Premature liberalization: We were not yet ready for that

- Capital control relaxation undertaken when **bank supervision and financial regulations** were not sufficiently stringent led to over-borrowing and inefficient lending.
- A gradual approach to capital account liberalization could have been adopted.

# Capital inflows prior to 1997 crisis

- A surge in capital inflows into Thailand began in the late 1980s and continued unabated until 1996.
- The flows brought high economic growth and a surplus in the balance of payments and current account deficit.
- We can measure the adequacy of international reserves by using the import-covered reserves in number of months

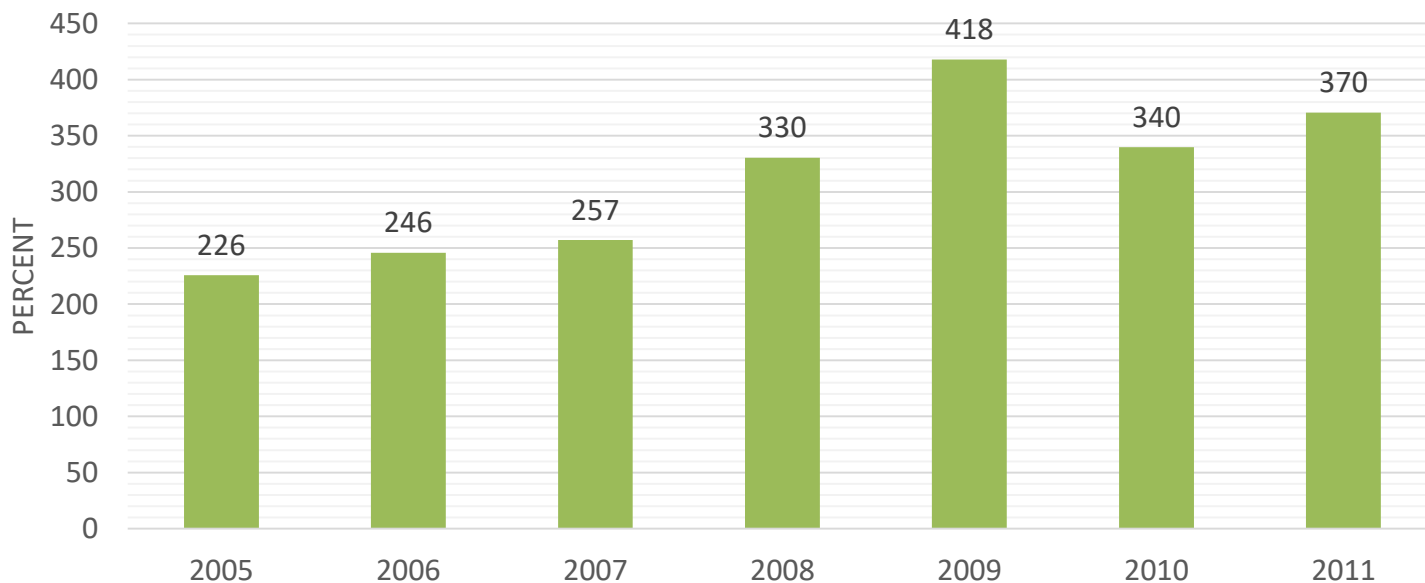
# Import-covered international reserves



# A better index of reserve adequacy

When the financial account dominates current account by huge and volatile capital inflows, reserves to short-term debt ratio should be used.

Total Reserves to short-term debt ratio



# Causes of rapid capital inflows

- A declining in world interest rates widened the interest rate differentials, inducing **excessive** foreign borrowings.
- Domestic financial liberalization increased the **sensitivity** of capital flows to interest rate differential.
- The measures undertaken to establish Thailand as a regional financial sector induced short-term capital flows through **offshore borrowings** by the nonbank private sector.
- The culprit: Bangkok Inter Banking Facilities (**BIBF**)

# Determinants of capital flows

$$K_f = \alpha + \beta(r - r_f) + \delta (\Delta Y / Y) - \phi(Risk) - \eta(\Delta e / e)^E + \varepsilon$$

Expected baht depreciation causes capital flight in 1998

In 2019, expected appreciation heightens capital inflows and baht speculation

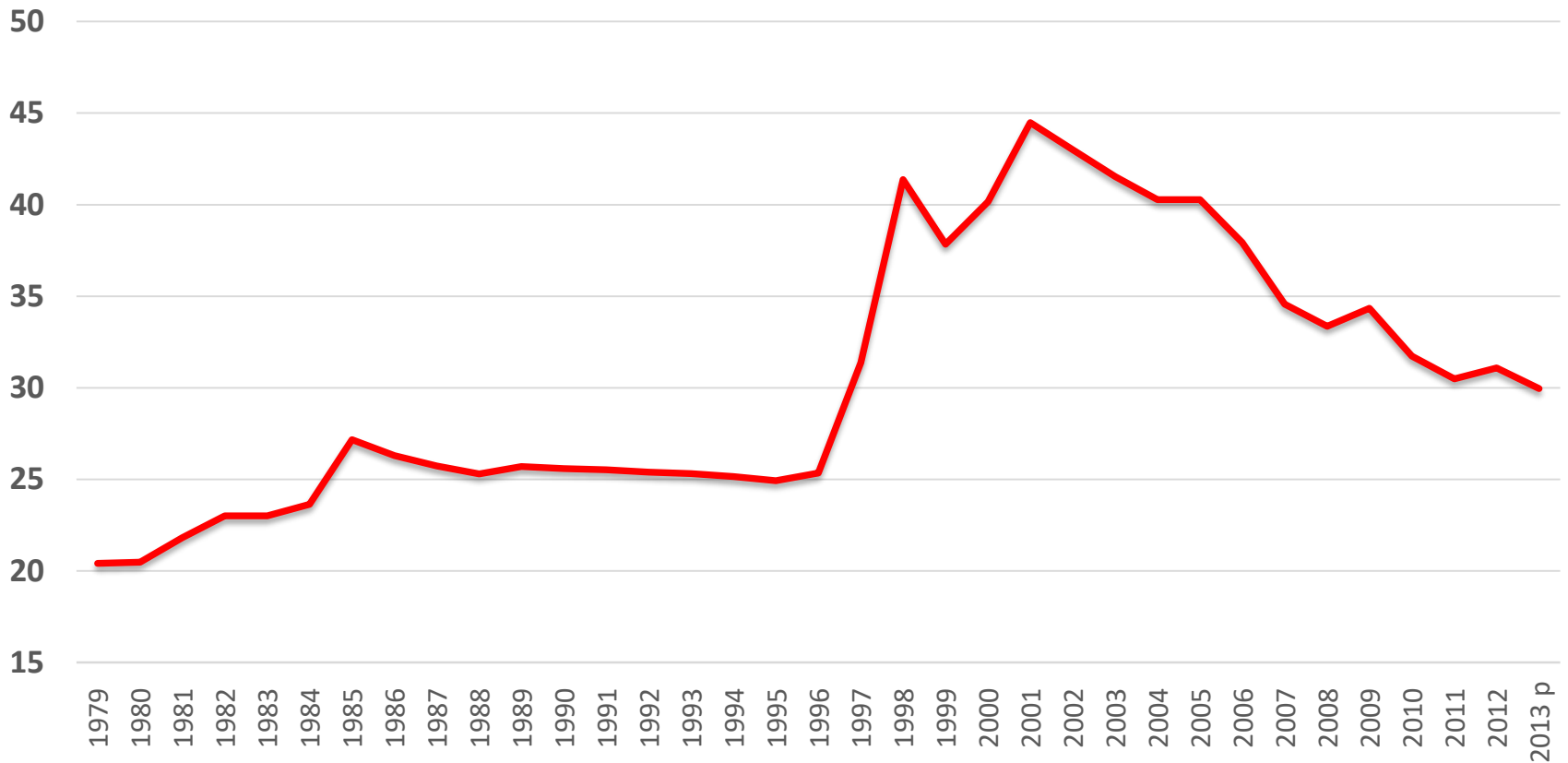
## 2. The Asian Financial Crisis

On that fateful day of July 2, 1997

- With the baht succumbing to speculative attacks, the BOT decided to float it on July 2, 1997.
- Without a nominal anchor and given the lack of political credibility, the value of the baht fell by 56% through to January 1998.
- The fixed exchange rate was a nominal anchor of the price in Thailand.
- $P^T = e \cdot P^U$

# Currency and *financial* crises in 1997-1998

Baht-dollar exchange rate



# July 1997



# The Asian Financial Crisis

- The Asian crisis first emerged in Thailand in 1997 as the baht came under a series of increasingly serious *speculative attacks* and markets lost confidence in the economy.
- Hedge funds: Quantum funds of George Soros, Tiger funds, and long-term capital funds
- The rapid spread of the Asian crisis in late 1997 brought a larger-than-expected depreciation of the baht, a sharp economic downturn, and adverse regional economic developments

“Hedge Funds and the Financial Markets dynamics”  
Barry Eichengreen and Donald Methieson  
May 1998

- Hedge funds were small entities of a very large system and it is *misguided* to blame them.
- But hedge funds and proprietary trading desks have the potential to destabilize financial markets.

# Hedge Funds and the Asian Currency Crisis of 1997

Stephen J. Brown, William N. Goetzmann, James Park

NBER Working Paper No. 6427

February 1998

- Hypothesis: Hedge funds were responsible for the crash in the Asian currencies in late 1997
- Findings: The hedge funds' net long or short positions in the ringgit or its correlates (baht) fluctuated dramatically between 1994 and 1998.
- But these fluctuations were not associated with moves in the exchange rates.
- The fluctuated net positions of the major funds were ***not unusual*** during the crash period, nor were the profits of the funds during the crisis.
- Conclusions: No empirical evidence to support the hypothesis that George Soros, or any other hedge fund manager was responsible for the crisis.

Huge flows of foreign investment to Southeast Asia increased from \$20 billion from 1990 to 1995 and had dramatically increased to \$45 billion per annum.

- Then with the collapse of Thai Baht and Malaysian Ringgit, there was ***a sudden outflow of \$58 billion*** which created a chain reaction and currencies of other nations also started falling.
- But the question is that South East Asian faced economic crisis only ***because*** of outflow of money;
- Or this outflow acted as ***catalyst*** in the already existing weak and fragile domestic structural factors.



IMF = I'm Fired or International Monetary Failure

# Lessons from the currency crisis

- Since capital flows are many times larger than international trade flows, when a country relies too heavily on *short-term foreign debt* to finance a current account deficit, it is impossible for the central bank to defend a fixed exchange rate for very long—let alone to inflict wounds on currency speculators.
- Thailand also learned that **accountability and transparency** should be well established so that the central bank is not tempted to engage in behavior that is akin to **gambling** in order to get out of a crisis.

# TIME Magazine 1997 Loser of the year



# Macroeconomic conditions after 1997

- Output contraction, recovery, and the return to price stability
- Declining inflation, interest rates, and slowdown in monetary growth

Thailand's Macroeconomic Policy after July 1997

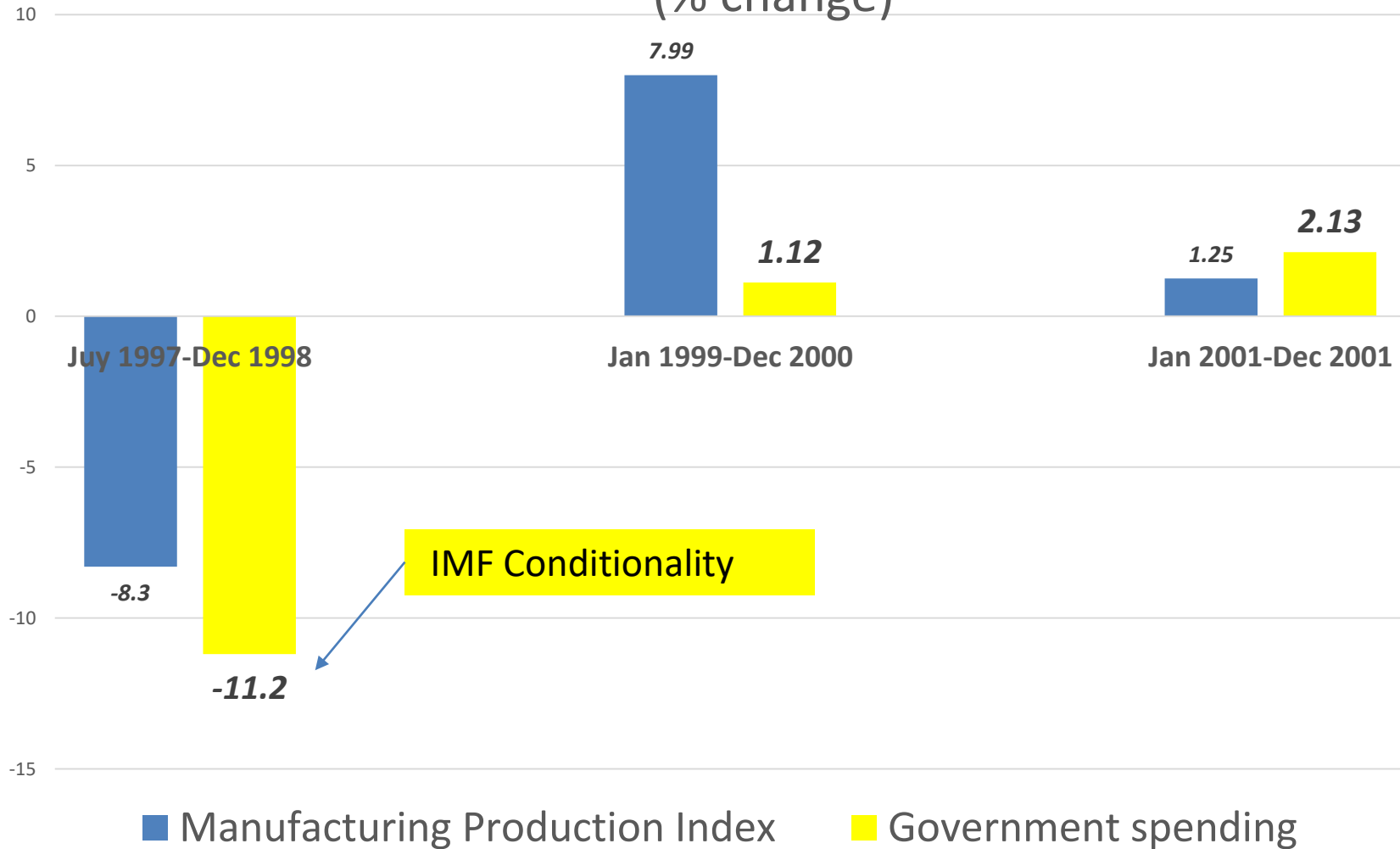
**Table 1. Average growth of macroeconomic variables in Thailand (1997–2001)**

Macroeconomic variable	July 1997 to December 1998	January 1999 to December 2000	January 2001 to December 2001
Manufacturing output index (percentage change)	-8.27	7.99	1.25
Government expenditure (percentage change)	-11.22	1.12	2.13
CPI (percentage change)	7.67	0.94	1.86
Nominal exchange rate (baht/US\$)	40.33	-0.51	14.09
Repurchase rate of interest (14 days)	15.38	1.80	1.75
Monetary base (percentage change)	2.15	3.60	7.00

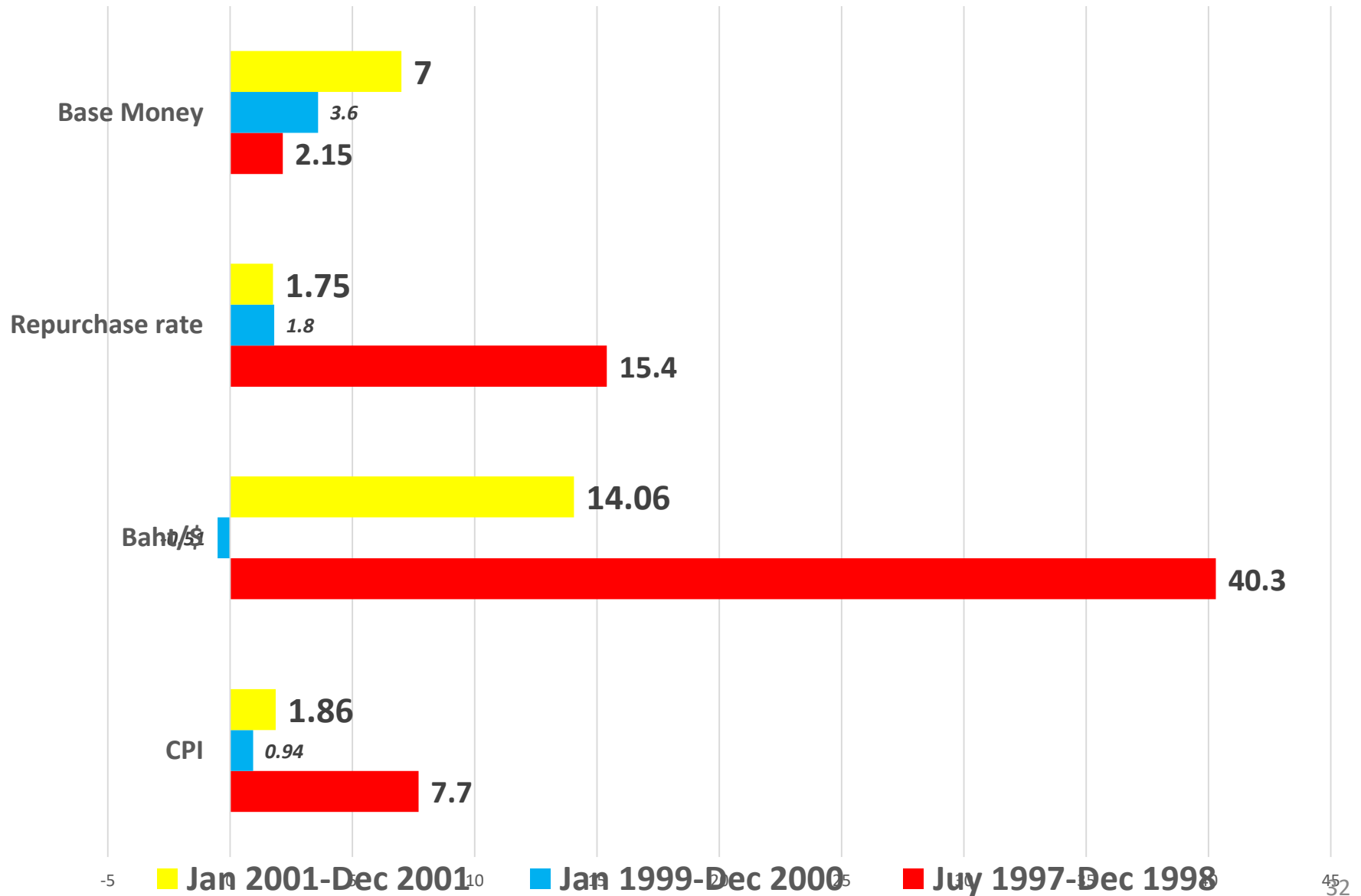
Source: Bank of Thailand (<http://www.bot.or.th>).

Note: Figures are averages of monthly data.

# Output and Government Spending (% change)



# Changes in Key Macro Variables (percent)



## 3. The role of the IMF

### The 14.1 billion-dollar-bailout

- On August 20, 1997, the IMF's Executive Board approved financial support for Thailand of up to SDR 2.9 billion, or about US\$4 billion, over a 34-month period.
- The total package of bilateral and multilateral assistance to Thailand came to \$17.2 billion.
- Thailand drew \$14.1 billion of that amount before announcing in September 1999 that it did not plan to draw on the remaining balances, in light of the improved economic situation.
- Two years after the crisis, the economy stopped bleeding.

# Southeast Asian Experience in 1998 (%)

	Exchange Rate	GDP	INVESTMENT	credit	Inflation
Indonesia	244.2	-13.1	-39.4	28.7	58.5
Malaysia	39.5	-7.36	-43.0	0.41	5.3
<b>Philippines</b>	38.7	-0.58	-16.3	-2.73	9.7
Singapore	12.7	-0.09	-13.3	18.2	-0.3
Thailand	31.9	-10.5	-50.9	-1.2	8.1

# IMF's conditionality

- The first letter of intent called for a government *budget surplus equal to 1 percent of GDP in 1997/98*
- *What are countries that depends on IMF bailouts until today? What are their conditionality?*

# A policy mistake

- Former World Bank Chief Economist Joseph Stiglitz explains in a New Republic article,
- “Unlike the Latin American nations, the East Asian countries were already running budget surpluses”.
- The Thai government was running such large surpluses that it was actually starving the economy of much-needed investments in education and infrastructure, both essential to economic growth.
- Joseph Stiglitz: the IMF’s policy prescription on surplus budget was a mistake

Joseph Stiglitz: Blame the crisis on the Imprudent private sector—not government.

- And the East Asian nations already had tight monetary policies, as well: inflation was low and falling.
- In South Korea, inflation stood at a very respectable four percent.
- The problem was not imprudent government, as in Latin America; the problem was an imprudent Asian private sector--all those bankers and borrowers, for instance, who'd gambled on the real estates bubble.”
- See the epilog on the last two slides

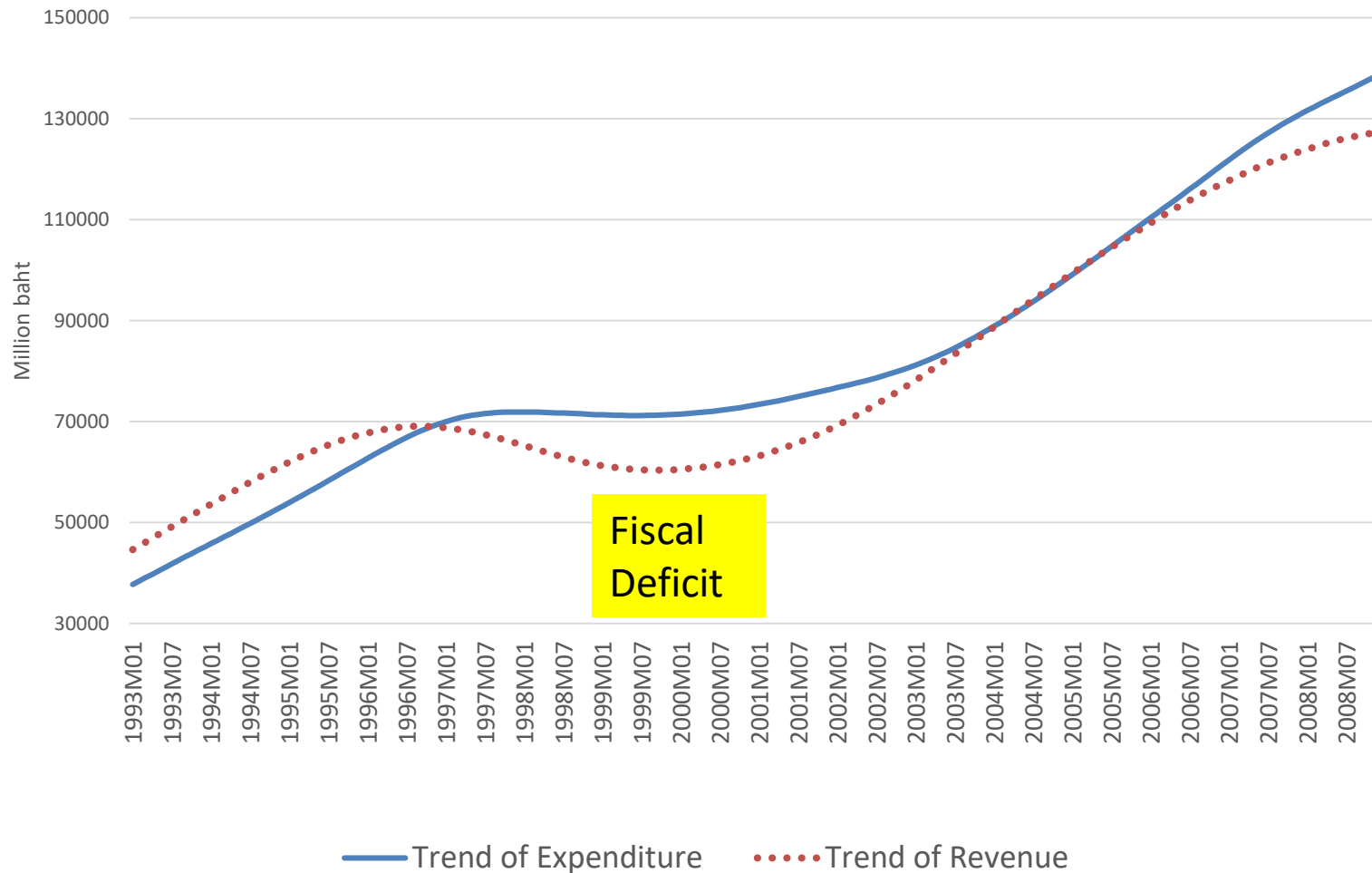
# A change of heart in February 1998

- Fiscal policy shifted in the face of the economic slowdown.
- While the first letter of intent called for a government *budget surplus equal to 1 percent of GDP in 1997/98*, beginning in February 1998 the program began targeting a fiscal deficit.
- *The targeted deficit (excluding interest costs of financial sector reform) grew from 2 percent to 6 percent* by April 1999, although the actual deficit for 1998/99 is estimated to have been under 5 percent (inclusive of interest costs of financial sector reform, amounting to almost 2 percent of GDP, the deficit was about 6.5 percent).

# 4. Macroeconomic Policy After 1997

Expansionary fiscal policy: Deficit budget was required to stimulate output growth

## Trends of Fiscal Variables



# Fiscal stimulus

- Much of the increased spending focused on boosting social safety net programs to ensure the protection of Thais affected by crisis.
- While *fiscal stimulus* remains important for the time being, over the medium term, *fiscal consolidation* was needed to reverse the rise in public debt.
- **Fiscal Austerity (contraction) vs Fiscal Stimulus**

## After the storm in 1997,

- After the tight fiscal and monetary policy was relaxed, the short-term interest rate declined from 25% in 1997 to 8% by September 1998.
- Real interest rates declined, enough to ease debt burden.
- When the exchange rate regained stability, consumer confidence had been restored.

The massive depreciation restored the current account disequilibrium, stimulating exports and curtailing imports.

Recall that the rest of Asia was not in recession. Thailand was able to export its way out of recession.

The trade deficit became surplus, thanks to income and substitution effects: expenditure reducing and expenditure switching policy

During recession ( low utilization of output capacity)  
 real wage rate was reduced; thereby mitigating the rise in  
 unemployment

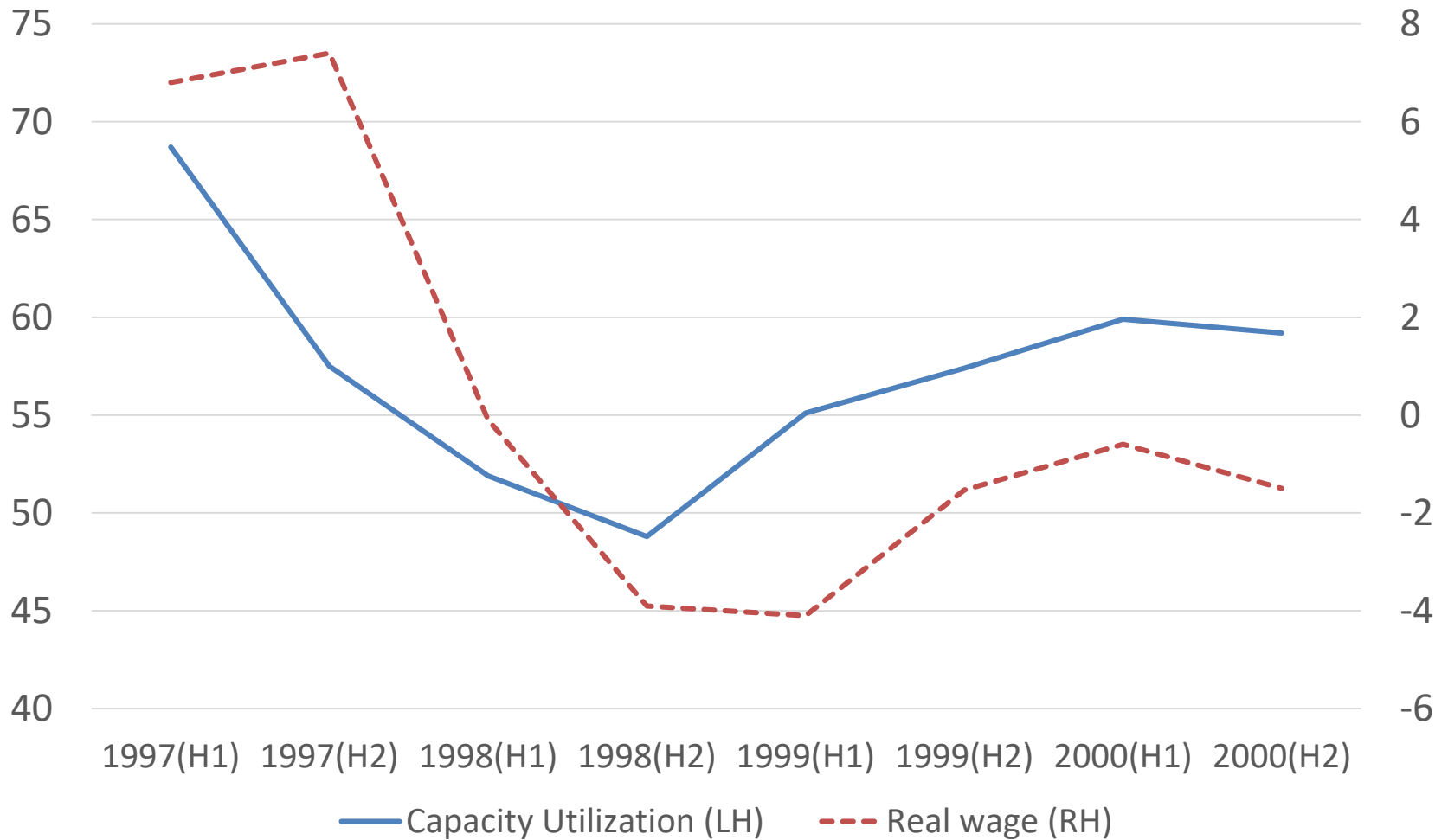
Table 3. Thailand's wage and price adjustments and capacity utilization during 1997–2000

Year	Price (CPI)	Real average wage rate of all sectors	Capacity utilization (%)
1997:1	4.53	6.82	68.72
1997:2	4.86	7.35	57.44
1998:1	7.83	-0.09	51.90
1998:2	9.65	-3.86	48.78
1999:1	4.68	-4.09	55.06
1999:2	-0.32	-1.53	57.39
2000:1	0.16	-0.56	59.87
2000:2	1.68	-1.49	59.14

Source: Bank of Thailand, labor force survey (<http://www.bot.or.th>).

**Does the relationship still hold after 2000?**

## Capacity utilization and real wage changes (percent)

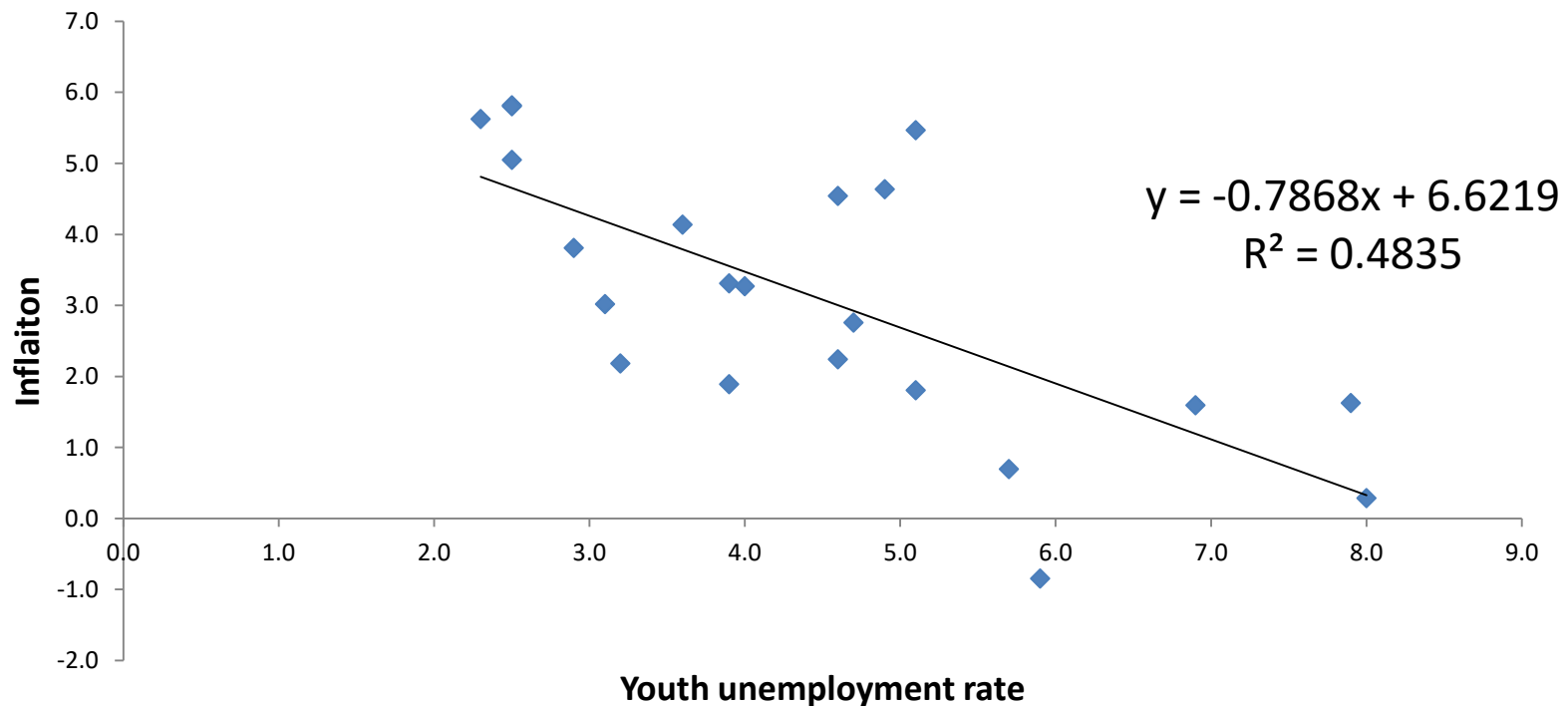


# Inflation vs. unemployment

- Thailand's labor market is flexible enough that wage cuts occur during recession, a feature that reduces unemployment.
- The price level does not adjust as quickly as wage rates.
- ***Real wage rates fall as nominal wage rate declines, prices are sticky in the short run. If prices fall while wage rate falls, there will be no cut in real wage rate.***
- Because of ***inflation inertia***, there is a trade-off in the short run between inflation and unemployment.
- Expansion monetary policy can reduce unemployment with minimal inflation.

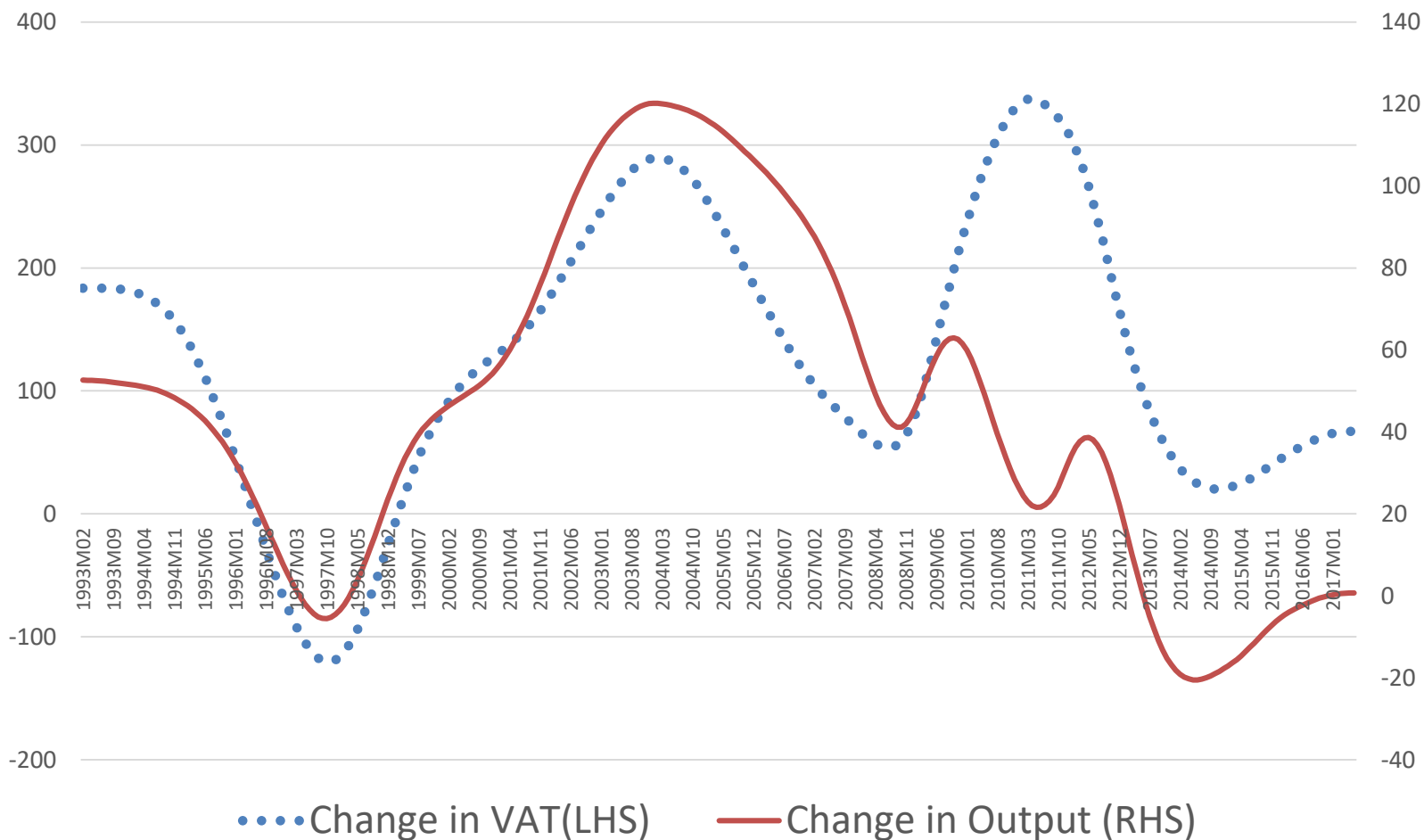
There is a tradeoff (negative relationship) between inflation and unemployment, except in 1998 when high inflation and high employment occurred simultaneously

**inflation and uneployment trade-off  
1992-2014 (excluding 1998)**



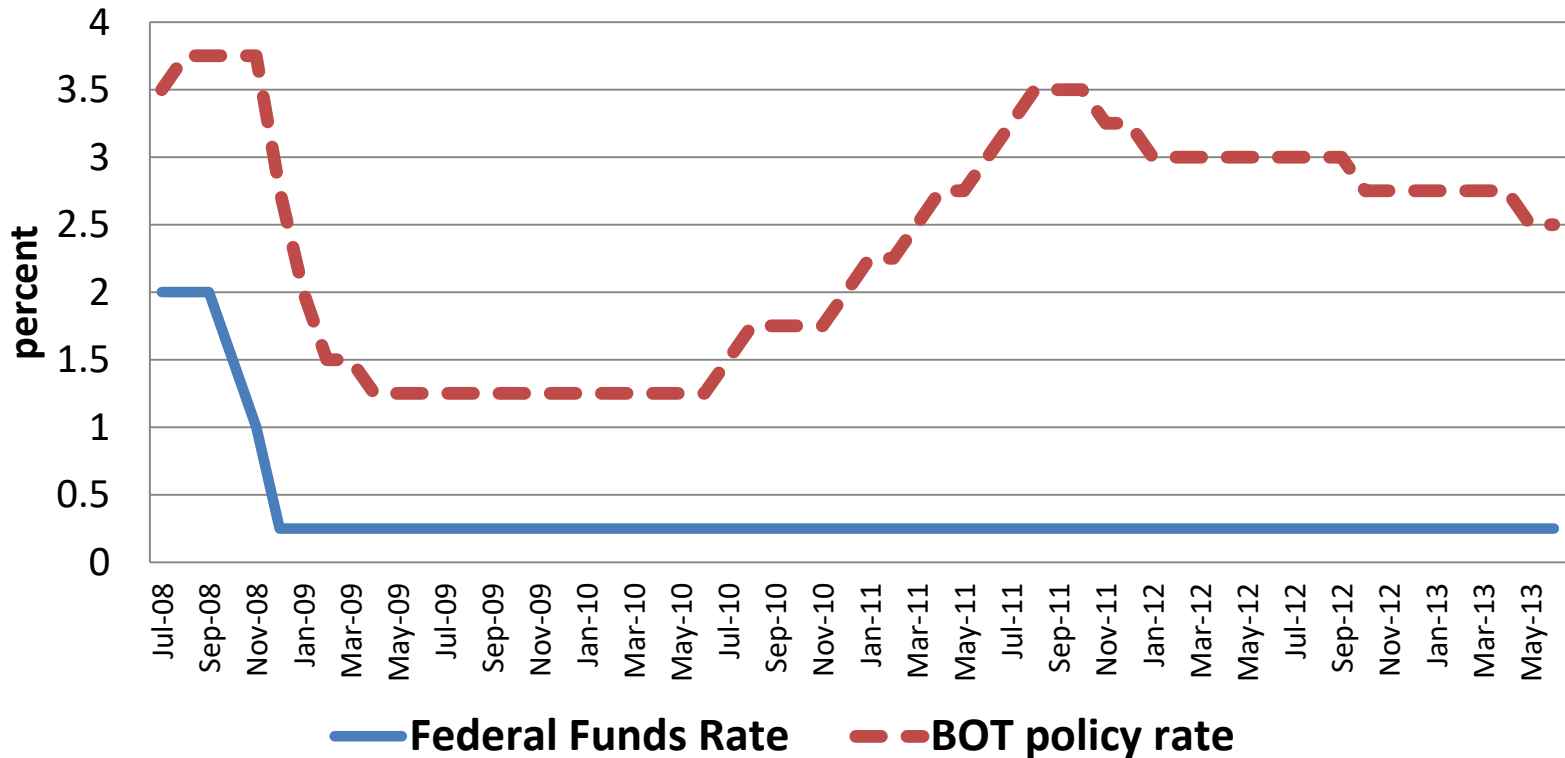
# 4.1 Fiscal Policy after July 1997

Business Cycles and Value Added Tax Revenue  
(2000 price level)



# 4.2 Monetary Policy after July 1997

**Two Key Policy Rates**  
**Widening interest rate gap triggered capital inflows**



## 4.3 Exchange rate policy after July 1997

- The BOT once again tried *to use a high interest rate policy to protect the baht from falling, low interest rate policy to protect the baht from rising*, which has gained strength while the yen has depreciated against the dollar.
- The high cost of defending the currency by using high interest rates should be obvious from the painful experience of Thailand during the currency crisis.

# Summary: Key words

1. Premature liberalization
2. Political economy of financial liberalization
3. The BIBF
4. Fiscal austerity
5. Unemployment and inflation trade-off
6. Fear of floating and incessant intervention

# Concluding remarks

- The bah-dollar exchange rate has limited flexibility, because of the intervention by the central bank.
- The Bank of Thailand could have eased its monetary policy to prevent a slowdown in 2001 and in 2014.
- An expansionary monetary policy or budget deficit financed by money creation can spur growth during recession, provided the Bank of Thailand does not intervene in the foreign-exchange market.
- Monetary policy seems to be more effective than other policy alternatives during the brief debt deflation episode in Thailand.

# Recent monetary Policy

## February 6, 2019

The Monetary Policy Committee voted 4-2 to hold its one-day repurchase rate at 1.75%, as expected by all 20 economists in a Reuters poll.

The two dissenters favoured a 25 basis-point hike to curb financial stability risks and to build policy space. One member was unable to attend the meeting.

In December, the rate was raised by 25 basis points to the current level from near record lows for the first time in more than seven years, mainly aimed at tempering financial stability risks. The vote was 5-2, with the two dissenters favouring no change to policy.

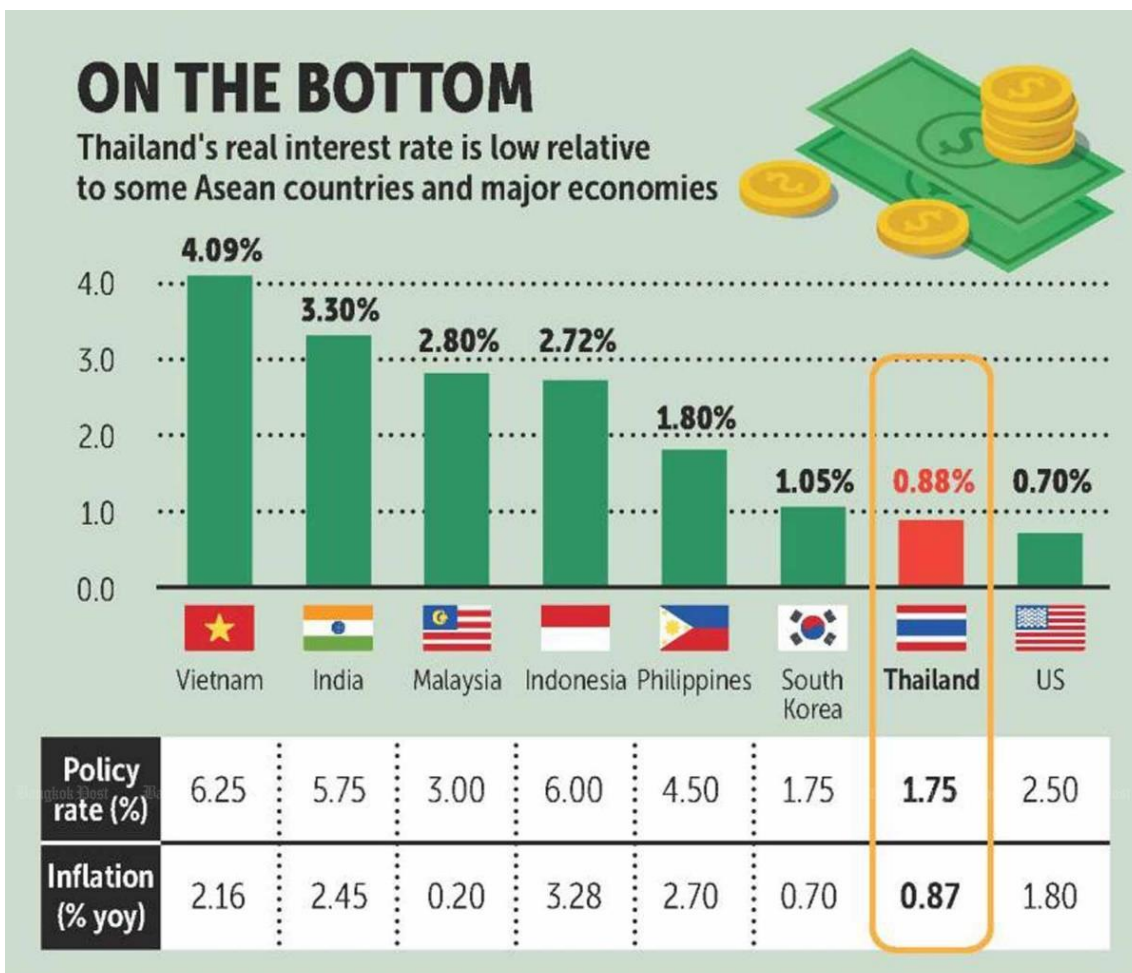
At 1.75%, the rate is still stimulatory as it is only 50 basis points above the record low seen during the global financial crisis. The economy was expected to continue expanding around its potential despite increased downside risks, the MPC said in a statement.

"The committee viewed that accommodative monetary policy would remain appropriate in the period ahead, and thus would continue to monitor developments of economic growth, inflation, and financial stability, together with associated risks," it said.

The key policy rate is set in response to changes in the exchange rate

The baht has gained 7.6% against the US dollar in the past 12 months, making it among the best performers in emerging markets tracked by Bloomberg.

July 11, 2019



Source: Bank of Thailand

Note: Data as of July 11, 2019

BANGKOK POST GRAPHICS



As of Feb 6, 2019		Unit: %
	Baht	+4.16
	Indonesian rupiah	+3.08
	Chinese yuan	+2.06
	Malaysian ringgit	+0.98
	Singapore dollar	+0.76
	Philippine peso	+0.27
	Taiwan dollar	-0.04
	South Korean won	-0.28
	Japanese yen	-0.39
	Indian rupee	-2.50

Source: Reuters

BANGKOK POST GRAPHICS

The baht's movement typically has a positive or negative effect on the economy, and a firmer baht could indirectly affect the central bank's inflation target, Mr Titanun said.

"If the baht gains rapidly, which is not in line with fundamentals and could affect the business sector, the central bank could take action," he said.

Finance Minister Apisak Tantivara-wong said the central bank's duty is to closely monitor the baht's movement.

"The financial crisis of 1997 stemmed from monetary policy," he said. "The central bank must prevent this from repeating."

Mr Apisak last week urged the Bank of Thailand to rein in the strengthening baht after the currency hit a nine-month high against the greenback.

Supant Mongkolsuthree, chairman of the Federation of Thai Industries, said the

Joint Standing Committee on Commerce, Industry and Banking (JSCCIB) has agreed to call for the central bank to closely watch the baht's movements.

"The firmer baht is dealing a blow to Thai exporters and hindering the economy because exports are a key engine for the country's growth," he said after Wednesday's committee meeting.

# Review Questions

- Why was the financial liberalization in the early 1990s considered as premature?
- How does political economy explain the Asian Financial Crisis?
- Was the interest cut made by the BOT in August 2019 to 1.5% too-late, and too little?

# Epilog: Mr. Sondhi

- Sondhi, 68, also was the founder of the People's Alliance for Democracy (PAD), which sought to force then-Prime Minister Thaksin Shinnawatra to step down in 2006 for alleged corruption and disrespect toward the king.
- Sondhi was one of a generation of Thai business entrepreneurs who built their empires during the boom years of the late 1980s and early 1990s, *taking advantage of a loose regulatory climate.*

# Joseph Stiglitz blamed the crisis on the imprudent private sector

- Sondhi expanded a mostly print-based media empire (Manager newspaper) focusing on business coverage and *diversified into other fields*, including satellite communications and tourism. His circle of businessmen friends included Thaksin, who was a pioneer in the mobile phone sector as well as cable television.
- Sondhi, whose holdings were overextended and highly leveraged, was struck hard by Asia's 1997 financial crisis, which devastated even established Thai banks and businesses.

# Epilogue: Some of those who failed after the crisis

- Thailand's Supreme Court on Sep 6, 2016 upheld a 20-year prison sentence for fraud for a media tycoon, Sondhi Limthongkul, whose successful crusade to oust prime minister Thaksin Shinawatra triggered a decade of political violence and instability.
- Sondhi violated Securities and Exchange Commission regulations in 1996-97 by presenting **fraudulent financial data** to obtain a large bank loan for one of his businesses.
- He was also accused of not informing the Stock Exchange of Thailand and the board and shareholders of the company guaranteeing the loan, which fell into default.