Macroeconomic policy after July 1997

Bhanupong
Lecture 6
Asian Economic Papers (2003)
Premature liberalization

Main themes

- Premature liberalization
- Macroeconomic development after 1997
- Monetary policy under the “new” exchange rate regime
- Foreign exchange market intervention

Premature liberalization

- Capital control relaxation undertaken when bank supervision and financial regulations are not sufficiently stringent; it can lead to over-borrowing and inefficient lending.
- A gradual approach to capital account liberalization should be adopted instead.

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.

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 though offshore borrowings by the nonbank private sector.
- The culprit: BIBF

Determinants of capital flows

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

The important role of expectations

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.

Thailand's Macroeconomic Policy after July 1997

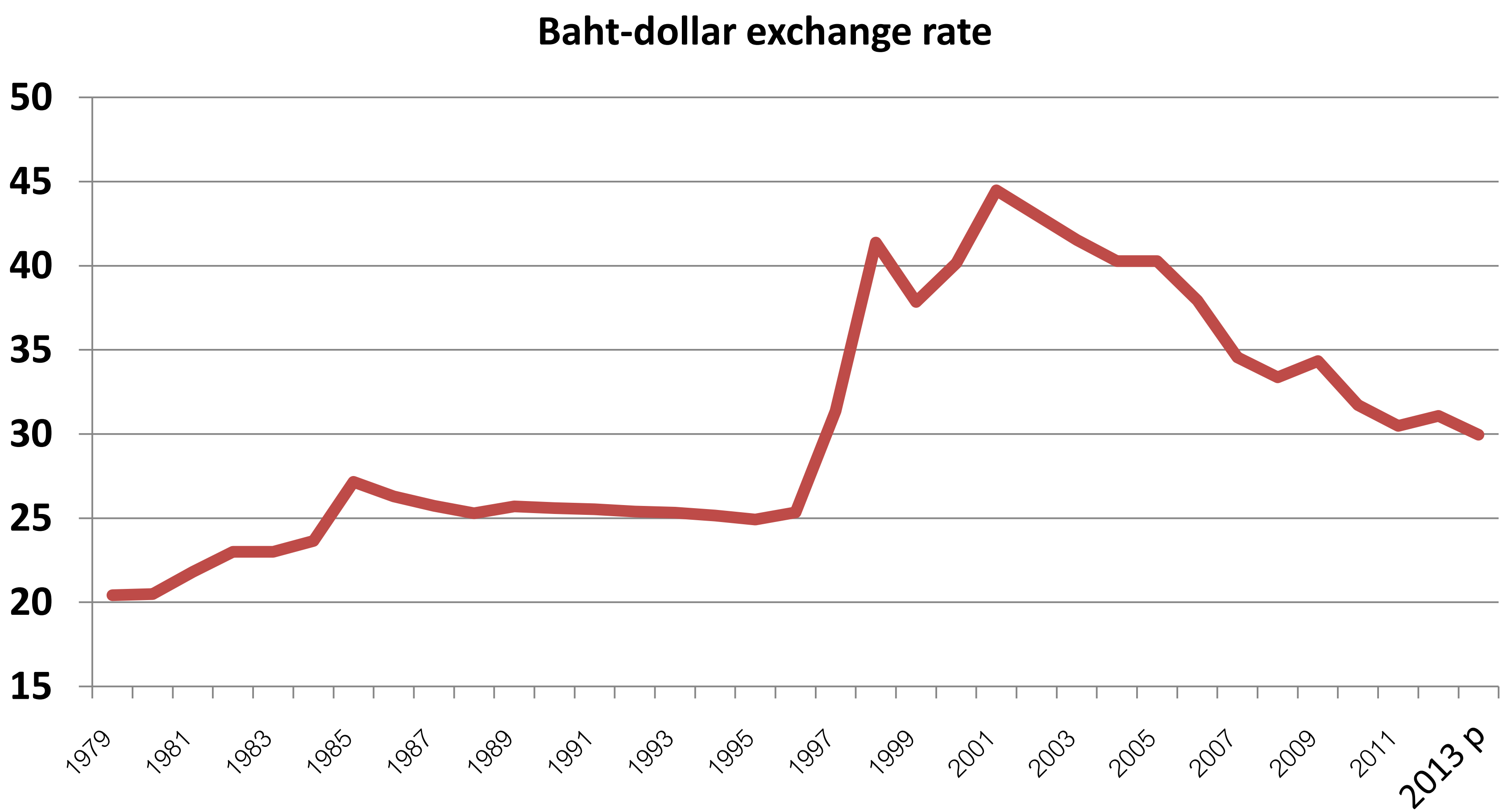
Table 1. Average growth of macroeconomic variables in Thailand (1997–2001)

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.

Currency and financial crises in 1997-1998



Economic crisis in 1997/98

- 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 deficit became surplus by income and substation effects: expenditure switching and reducing

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).

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.
- 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.

Outliners: Stagflation

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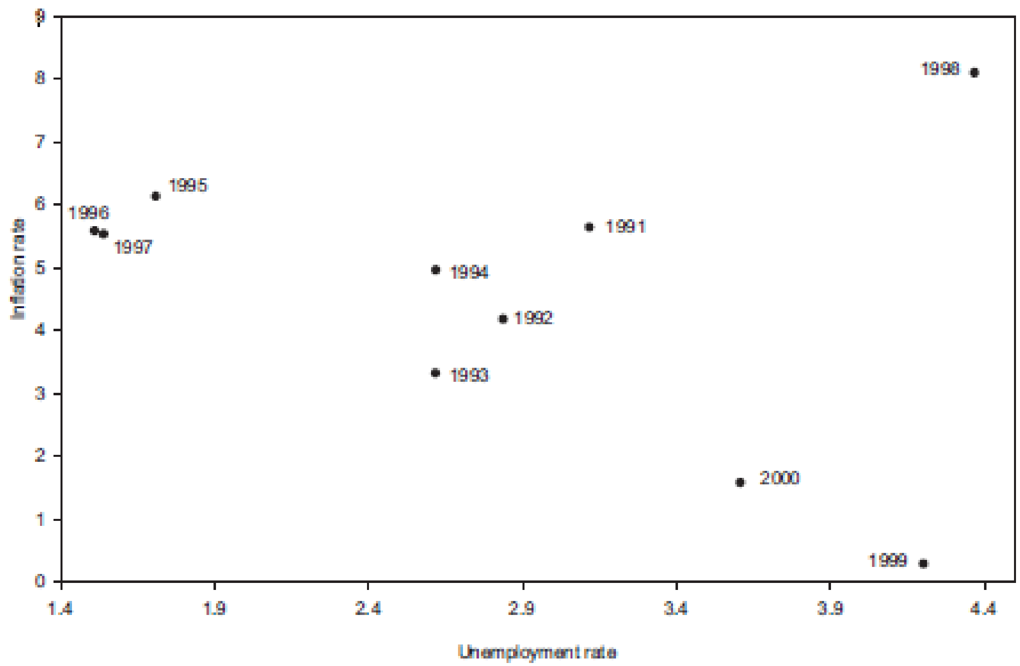
Figure 1. Trade-off between unemployment and inflation in Thailand



Economic activity and quality of bank loans

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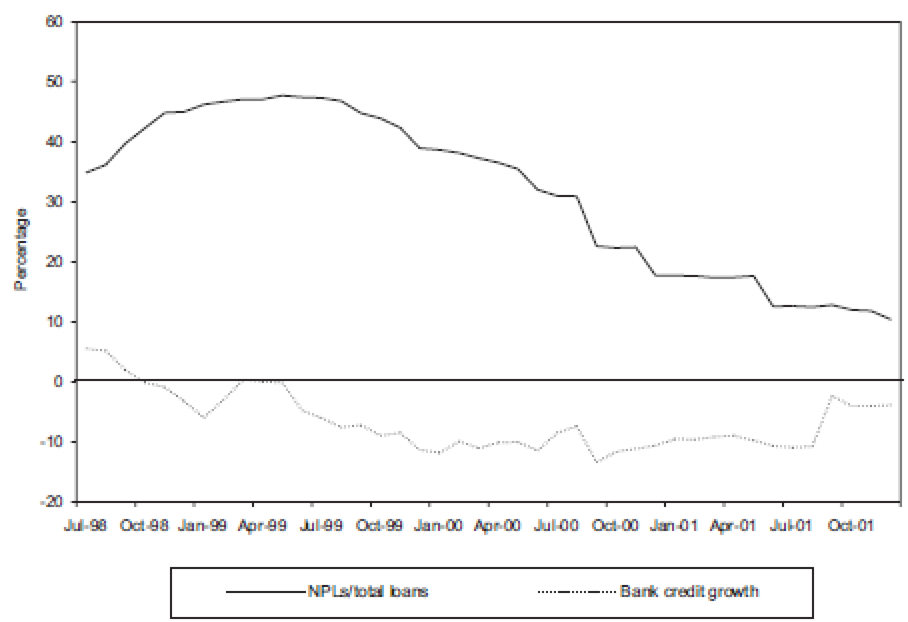
Figure 2. Nonperforming loan ratio and bank credit growth in Thailand



Consequences of rising debts

- The large currency depreciation aggravated the foreign debt burden, causing credit crunch, high interest rates, bankruptcy, and financial disintermediation.
- The loss of consumer and business confidence stemming from expected recession exacerbated the contraction in investment and consumption.

Southeast Asian Experience in 1998 (%)

	Exchange Rate	GDP	**INVESMENT**	credit	Inflation
Indonesia	244.2	-13.1	-39.4	28.7	58.5
Malaysia	39.5	-7.36	-43.0	0.41	5.3
Philippines	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

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 became stable, consumer confidence had been restored.

Expansionary fiscal policy

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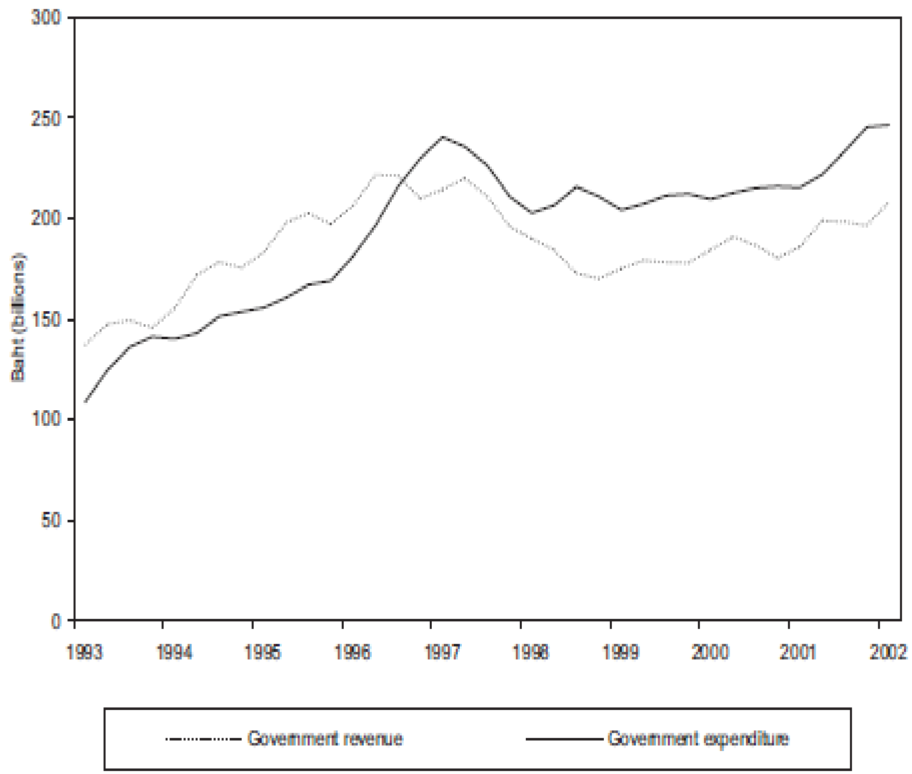
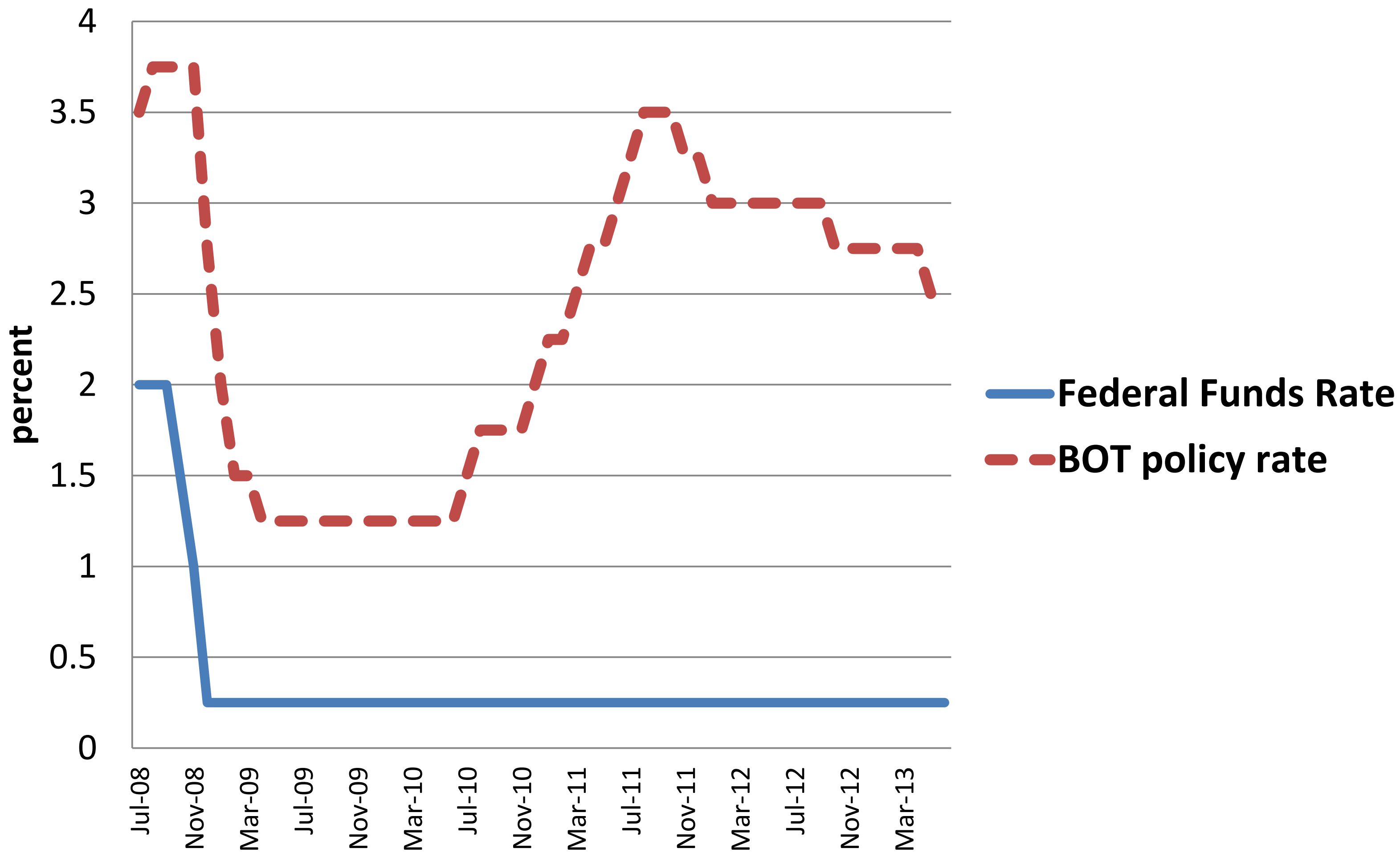
Figure 3. Fiscal policy stance in Thailand



Key Policy Rates: Interest rate gap



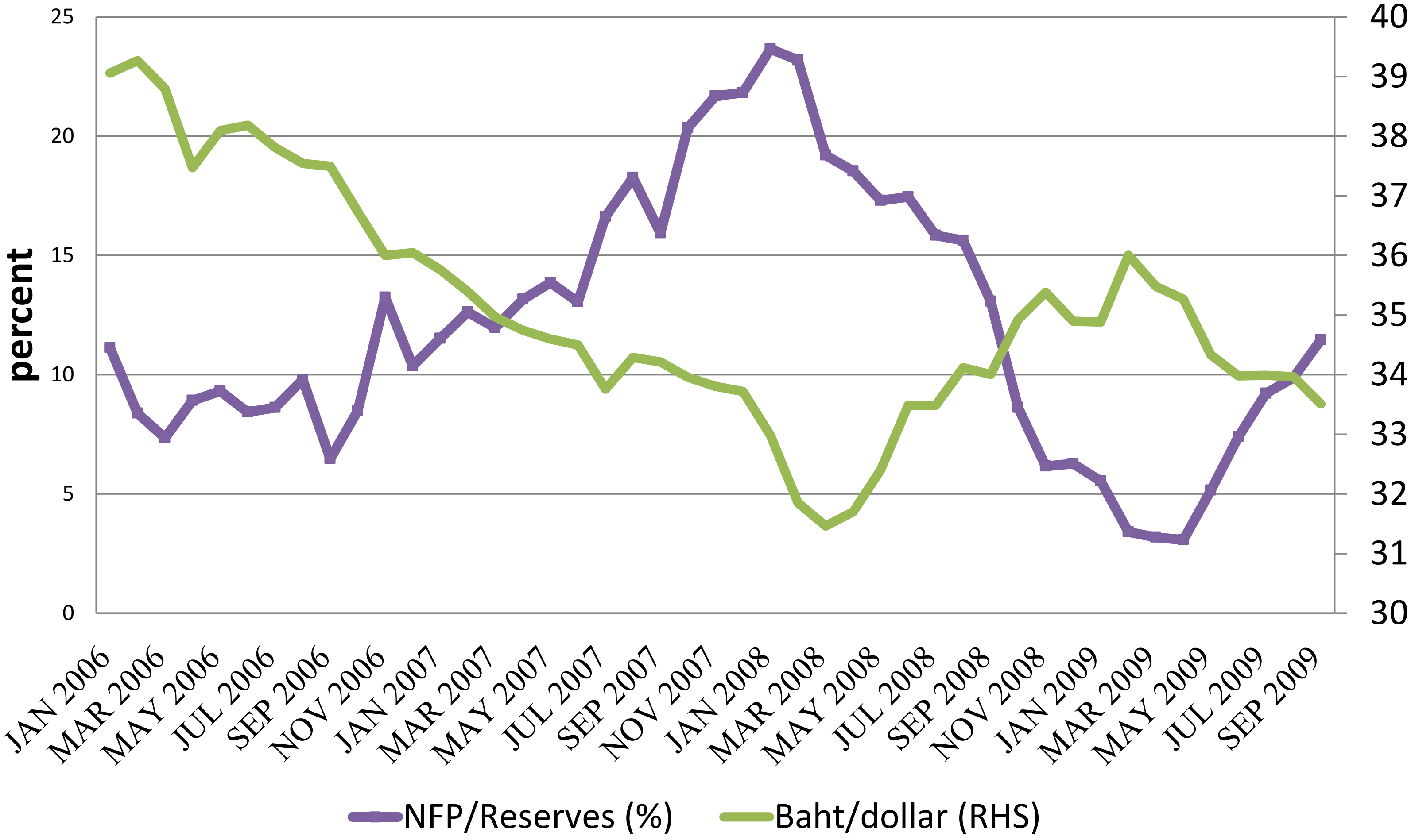
Interest rates and exchange rates

- The BOT once again tried to use the high interest rate policy to protect the baht, 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.

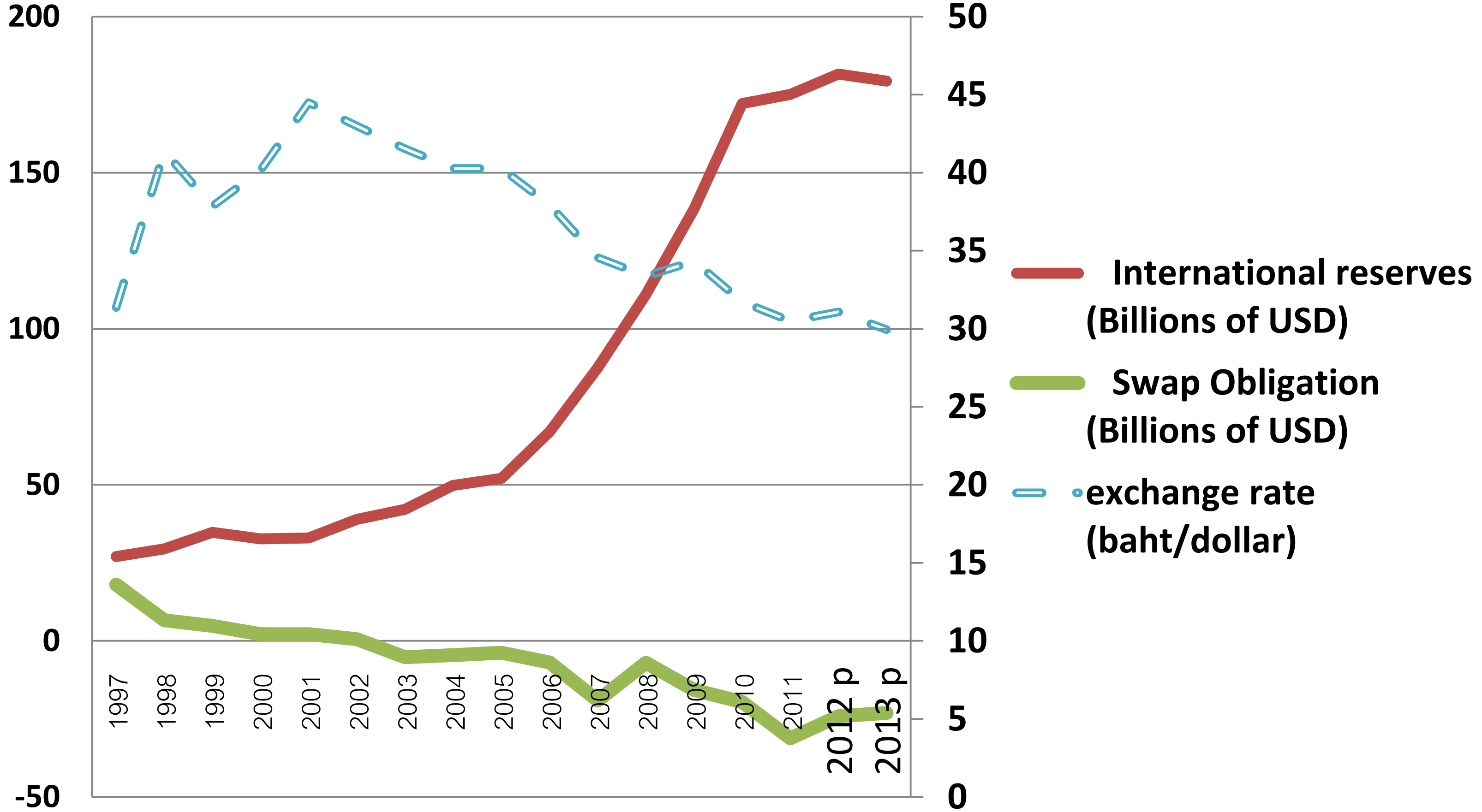
What is an appropriate level of the exchange rate?

- It is exceedingly difficult to determine appropriate exchange rates using PPP or the current account balance.
- The cost of intervention in foreign exchange markets could be too high to warren the action.
- Intervention should not be employed to change the direction of exchange rate movements.
- There is some room for the creation of an orderly and gradual movement of the exchange rate to reduce the amplitude of the swings.
- But the Bank of Thailand cannot lean against the wind of volatile changes in the yen-dollar rate.

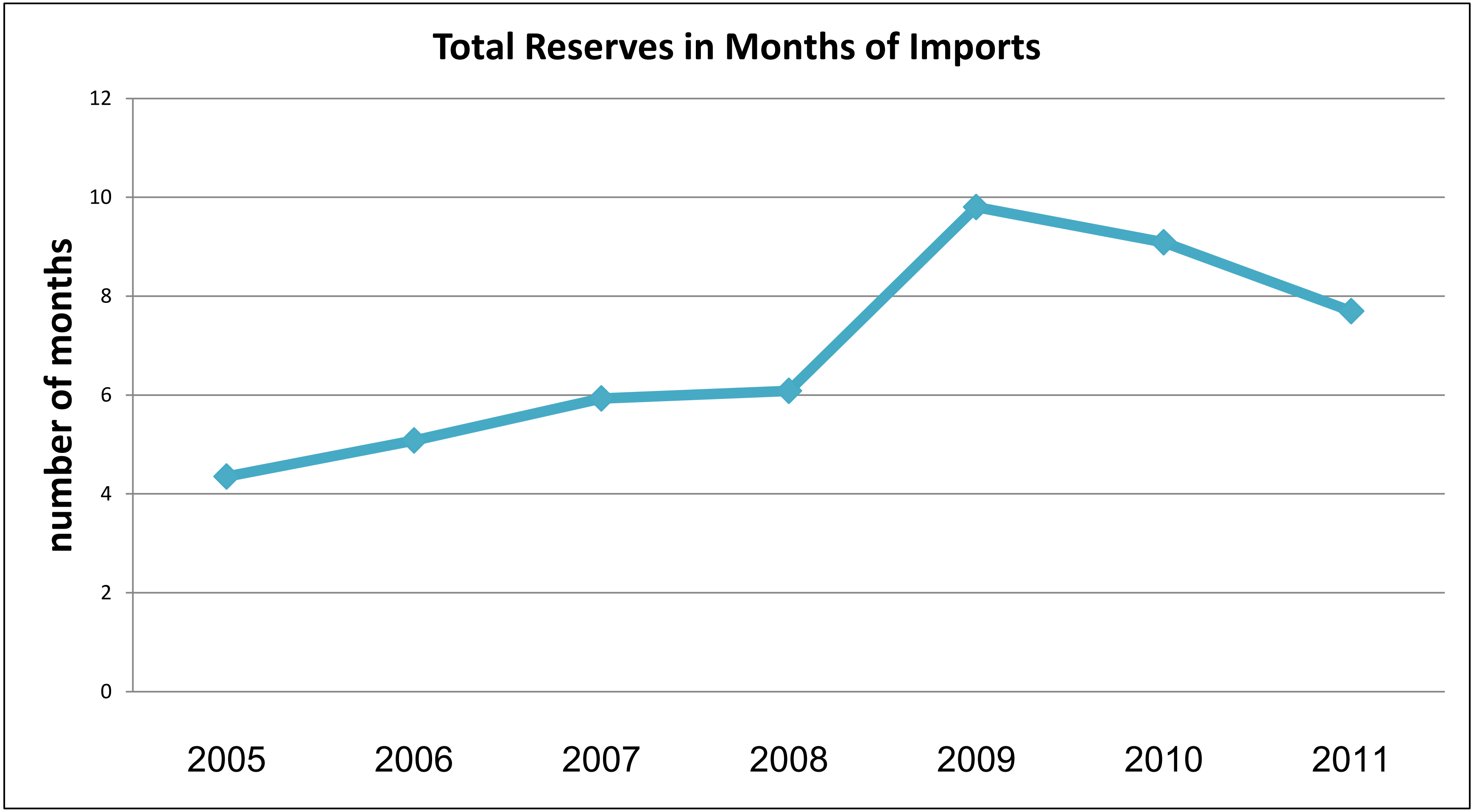
Net Forward Position (NFP)



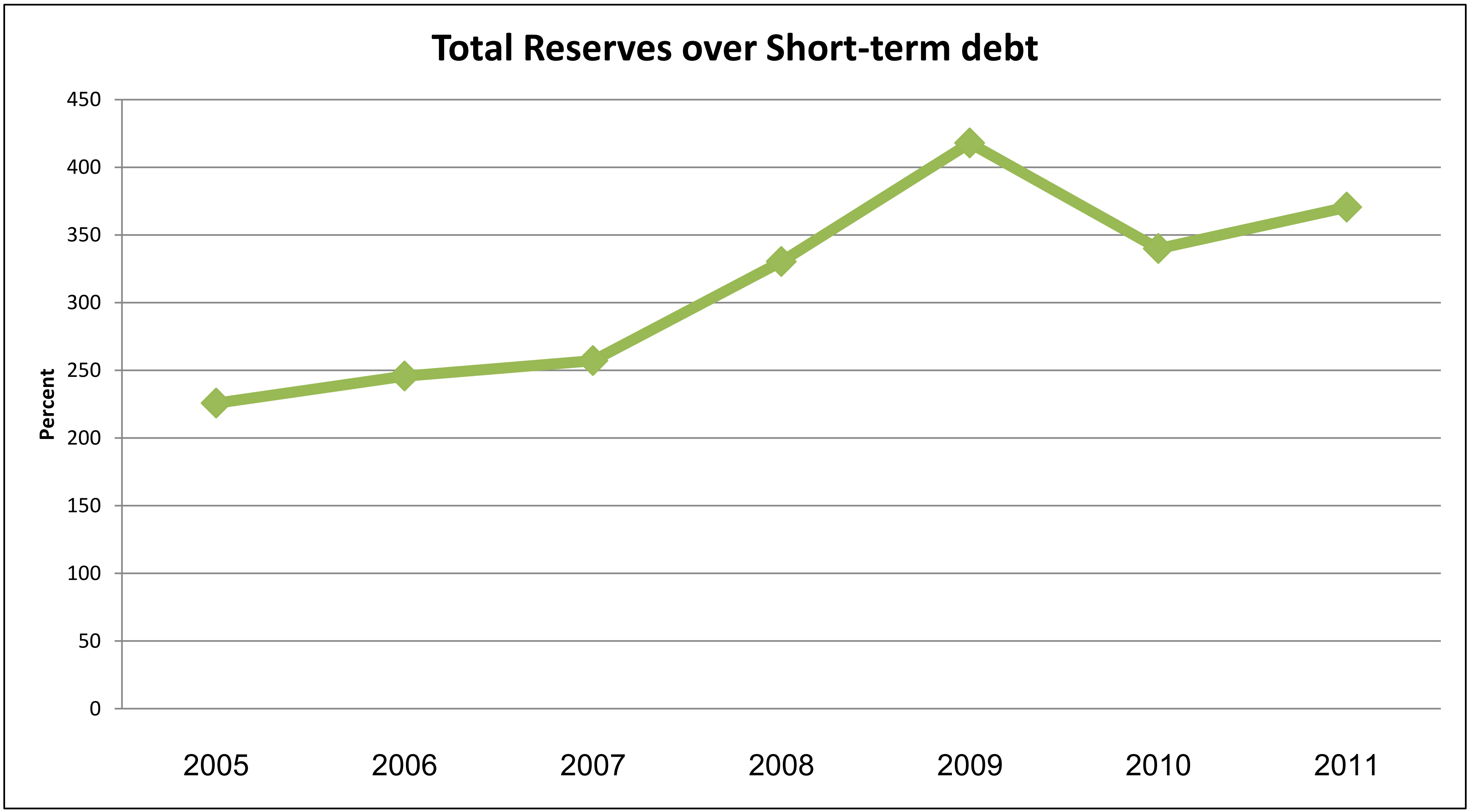
Exchange rate intervention



Import-covered international reserves



Reserves adequacy



BAHT BOOMING

Regional cross-rates against US dollar, Jan 2012-2013

	23 Jan 2012	23 Jan 2013	% Change
• Philippine peso	43.15	40.59	5.93%
• **Thai baht**	**31.36**	**29.77**	**5.07%**
• Singapore dollar	1.266	1.226	3.15%
• Malaysian ringgit	3.105	3.040	2.09%
• Indonesian rupiah	8,940	9,615	-7.55%

Source: Reuters

POSTgraphics

Concluding remarks

- With a realistic exchange rate and steady growth in the monetary base, even in the face of virulent external circumstances, the Thai economy can still make the best use of globalization by maintaining a moderate expansion along a sustainable growth path through employing a sensible economic policy.