
The Hard Road Ahead for Thailand's Economic Recovery

Bhanupong Nidhiprabha

Thammasat University
Faculty of Economics
2 Prachan Road
Bangkok 10200
Thailand
bhanupong@econ.tu.ac.th

Abstract

Globalization leads to the increasing complexity of production networks through foreign direct investment, which transmits demand shocks from the rest of the world to the Thai economy. Short-term fiscal stimulus would not be able to shorten the length of recession unless consumer confidence is restored. Violation of established social obligations and contracts erodes business sentiment and eventually would lead to a negative long-term impact on economic growth. The duration of the recession and the speed of a recovery hinge on the government's ability to restore confidence during uncertain times.

I. Introduction

The baht float in July 1997 triggered the Asian financial crisis. The contagion spread to many Southeast Asian countries through the herd behavior of international investors. The Thai crisis had an orthodox cause that was preceded by weaknesses in the financial sector. The global recession in 2009, which started in the United States and transmitted to the rest of the world, was also related to problems in the financial sector of developed countries. Thailand should be able to deal with the global recession better than it did 10 years ago because the country has already undergone financial reform after experiencing both banking and currency crises. Unlike the recession in 1998, which was attributed to the precipitous fall in consumption and investment, the current crisis is triggered by the collapse of Thai exports. Trade and capital account liberalization has made the Thai economy subject to fluctuations in the world business cycle. Increasing complex production networks through foreign direct investment (FDI) transmit demand shocks from the U.S. economy to

Thailand. If domestic demand cannot be raised to mitigate the fall in exports, the adverse impact of volume of world trade shock would be substantial.

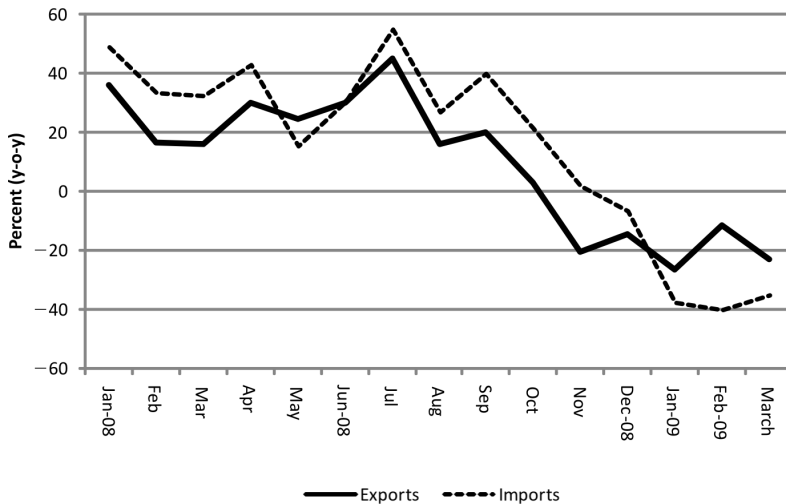
The Thai economy has already expanded below the potential output growth since 2006, because of the perennial political tension that continues to shake business confidence. Consumption and investment are no longer growth drivers even though they had performed well in the period of slow recovery in the early 2000s. Despite internal problems, GDP in 2008 continued expanding, due to the strong growth rate of exports. However, as this last engine of growth is shut down in 2009, Thailand could experience a recession once again. This paper examines the impact of global recession on the Thai economy. The dynamic relationship among consumption, investment, output, and business confidence are analyzed to reveal the vulnerability of the Thai economy. The empirical result indicates that fiscal and monetary policy cannot resuscitate the slump in consumption and investment unless the government can successfully restore confidence in households and the business sector.

2. Impact of global recession

Trade and capital account liberalization has made Thailand an integral part of the world economy. The world market share of Thai exports is less than 2 percent, implying that the economy is a price taker in both goods and money markets. The exchange rate is not flexible enough to cushion the impact of the oil price shocks. The opened capital market would not permit the central bank to utilize the interest rate policy to correct internal imbalance. The Thai economy has become vulnerable to external shocks, which transmit to domestic economy via trade flows and capital movements.¹

However, the impact of the global recession on the Thai economy was not apparent in 2008, because exports still grew at 26.4 percent because of commodity booms. Per capita income rose to US\$ 4,121, an increase by almost 3 percent. Exports contributed mostly to growth, leaving a small current account deficit around 0.1 percent of GDP. Inflation at 5.5 percent was considered high by the Thai standard, but the inflation hike was caused mainly by energy prices rather than rising domestic absorption. Investment and consumption grew roughly by 2 percent in 2008. The country could have done better if the traditional growth engine had performed its function uninterrupted by political unrest.

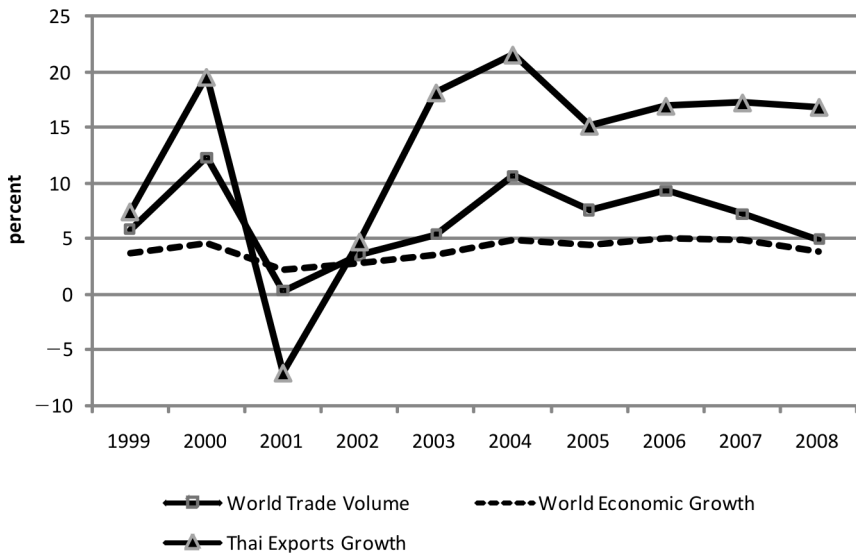
1 Martin and Rey (2006) argue that trade globalization always makes financial crashes less likely, whereas financial globalization may make them more likely, especially when trade costs are high.

Figure 1. The collapse of the last engine of growth

Source: Ministry of Commerce

By February 2009, it was apparent that the global recession had adversely affected the Thai economy. Workers in electronic and car manufacturing industries are being laid off gradually. Because manufactured products are business-cycle sensitive, these industries are the first sector to bear the burden of adjustments to falling export demands. Thailand's GDP level in the fourth quarter of 2008 suffered a decline by 4 percent. Because the world oil price has declined sharply from the previous year, it was expected that inflation would remain subdued. The Fiscal Policy Office anticipated that private consumption would be lifted by 3 percent because of the government's stimulus package, which runs an enormous budget deficit to offset the decline in private spending. As new economic data are released, the forecast output growth rate has been continuously revised downward to a negative number.

The Thai exports suffered a drastic decline by 26.5 percent year-on-year (yoy) basis in January 2009, and imports fell faster than exports at 37.6 percent. The declining trend of exports has become apparent since August 2008 (Figure 1). All imports categories—capital goods, intermediate products, petroleum products, and consumer products—declined sharply. The downward trend of imports bodes well for further decline in exports, since major parts of imports are raw materials for manufactured exports. For the first quarter of 2009, imports fell by 37.6 percent, led by a 50 percent decline in the value of fuel imports, while exports declined 20.6 percent. Agricultural and agro-industrial exports fell by 19.2 percent, and manufactured ex-

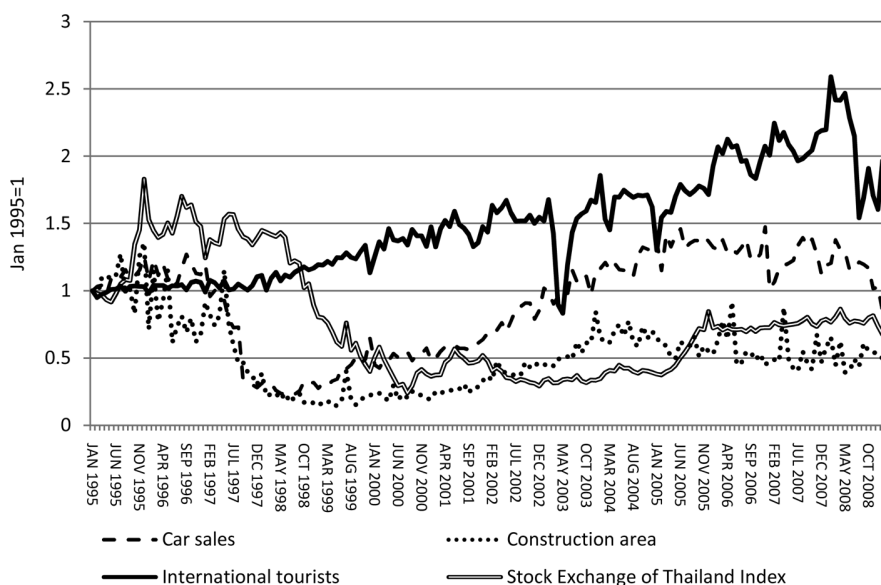
Figure 2. Impact of shrinking world trade

Source: Bank of Thailand.

ports such as electronic goods, electrical appliances, and automobiles and parts fell 17.9 percent.

The IMF predicted that the world output would decline by 1.3 percent and the world trade would contract by 11 percent in 2009. The world trade activity would barely grow at all in 2010. Thailand's exports depend largely on the world trade activity, rather than the exchange rate movement.

In 2001, the baht depreciated substantially, but it did not stimulate exports, which declined considerably due to the global recession (Figure 2). The baht began to appreciate between 2002 and 2007 because of the inflows of capital. Despite the baht appreciation, exports continued to expand at a double-digit growth rate. Fluctuations in world trade volume are greater than the world economic growth, suggesting a high degree of income elasticity of trade with respect to the world income. Similarly, Thailand's exports fluctuate more than the world trade volume. It is evident that Thai exports are sensitive to the world business cycle. Thai exports exhibit greater variations than the world trade during both upturns and downturns of the world economy. Similarly, imports are sensitive to domestic income changes. In 2008, the current account deficit registered 0.1 percent of GDP. The recession in 2009 could cause a larger fall in imports, leading to current account deficit in 2009. De-

Figure 3. Signs of imminent recession

Source: Bank of Thailand.

spite the sharp fall in exports, imports could fall faster because these imports are intermediate inputs for manufactured exports. Imports could also decline because of the reduction in investment spending that slows down imported machinery.

In 2008, the growth in world trade slowed down, but Thailand's exports growth rate did not change much in 2006 and 2007. The rising prices of primary exports such as rice and rubber mitigated the impact of decelerating activity of world trade. When agricultural commodity prices returned to the pre-commodity boom level, the impact of global recession on Thailand's exports became more pronounced in 2009.

Construction areas permitted in urban areas can be employed as a leading indicator of investment in the construction sector, which has considerable linkages to the rest of the economy. After the collapse of the property sector in 1997, the application for areas permitted for construction gradually recovered from its trough and reached its peak in 2006 (Figure 3). Since then, construction activity has been declining, which may be attributed to the rising energy prices. Additionally, political upheavals gave rise to risk and uncertainty, causing volatility in construction activity.

The number of automobile sales reflects consumer confidence. The solid recovery of car sales after 1997 up to 2006 bodes well for rising permanent income, which is the

main determinant of the demand for automobiles. Similar to the movement of construction areas permitted in urban areas, the declining trend of car sales with its large fluctuation indicates the loss of consumer confidence. This began long before Thailand was hit by the 2009 global recession; the deterioration of business sentiment and consumer confidence started well before the U.S. economy slowdown in 2008. It was a self-inflicted crisis of confidence generated by political tension.

Another important leading economic indicator is the Stock Exchange of Thailand (SET) index, which tracks business sentiment and moves closely with the Dow Jones Industrial Average Index. The rise in the SET index was propelled by portfolio investment from abroad that caused the baht appreciation. The sign of economic slowdown has become more apparent as the SET plunged sharply in 2008 and deteriorated further in 2009 in line with the stock market prices in the rest of the world. The SET has increased less than one percent from the beginning of the year to 15 April 2009—the worst performing market in Southeast Asia.

The tourism industry accounts for 6 percent of GDP, and it is a largely labor-intensive sector. An employment problem was the major concern when the number of tourists sharply declined because of the global recession. In the past, the industry endured various kinds of external shocks: SARS, avian influenza, the Asian tsunami, and oil price shocks.² As political unrest intensified, from the coup d'état in September 2006 to the airport shutdowns in December 2008, the tourism industry was adversely affected. The global recession is another severe blow to the industry that might shed more than 40 percent of its workforce. The final blow to the industry occurred after protestors forced the cancelation of the ASEAN Summit in Pattaya. Investor sentiment and tourist confidence plunged further with the riot in Bangkok streets on Thailand's traditional New Year day. These four indicators in Figure 3 point to the contraction of economic activity and prolonged recession in 2009.

3. Vulnerability to global recession

It is obvious that East Asian countries were not well prepared for the global recession. The complex industrial-production network brought about by FDI has an increased degree of interconnectedness between economies in East Asia. Business cycles are now synchronized in various parts of the world. Consequently, export demand shocks affecting Japan and China are transmitted faster and stronger than in past decade as these countries have been connected through intra-industry trade. Over the years, Asian countries' share of intermediate products in both exports and

2 For a detailed impact of these external shocks, see Nidhiprabha (2006).

imports has increased steadily, while the share of final products in total trading volume has been declining. As such, during the time of booming cycles, East Asian economies expanded together by the same gravity force of the expanding intra-industry trade. Unfortunately, during the slump, these economies suffer miserably together by the same force that made them rise during the boom.

Some industries that relied mainly on domestic markets were adversely affected by the Asian financial crisis in 1997–98. However, they were able to rebound quickly as they shifted their focus from domestic to foreign markets. That V-shaped recovery was possible because of the considerable depreciation of the exchange rate. More importantly, because the rest of the world was not affected much by the Asian crisis, the expansion of the world trade volume in 1999 and 2000 generated higher demand for Asian manufacturing products. The reorientation from domestic markets to foreign markets has contributed to more vulnerability to external shocks.

Manufactured products under the ultra-export-oriented category include the so-called high-tech products: integrated circuits, computers, monitors, hard disk drives, and printers. Some resource-based products are also produced mainly for foreign markets: canned pineapple and seafood, leather products and leather footwear, rubber blocks and rubber gloves, wood furniture, and glass sheets. Electrical appliances such as televisions, air conditioners, and washing machines are also produced mainly for foreign markets, where the demand for these products increases faster than the rate of growth in world trade volume. The export-oriented industry was able to take full advantage of expanding world trade. Manufacturing products geared toward domestic markets did not benefit from the world trade expansion as much as the export-oriented industries because domestic-oriented industries have less ability to exploit economies of scale and are subject to lesser degrees of competition in foreign markets (Table 1). There is always constant pressure for the outward-oriented firms to improve their productivity and differentiate their products to maintain their market shares in the world market.

Between 1995 and 1998, the sharp decline in capacity utilization of industries that depended on foreign markets can be attributed to the appreciation of the real exchange rate. The unrealistic overvaluation of the baht exchange rate reduced the international competitiveness of export-oriented industries more than domestic market-oriented ones. As GDP declined by 10 percent in 1998, all industries faced shortfalls of their sales in both domestic and foreign markets. The industries that rely less on foreign markets did not suffer as much as export-oriented industries. Nevertheless, when the economy began to recover, the expansionary impact of currency depreciation began to take effect. The export-oriented industries rebounded faster than the domestic market-oriented industries.

Table 1. Rate of industrial capacity utilization by market orientation

	1995–98	1999–2005	2006–08	1995–2008
Domestic oriented	74.3	69.6	79.3	74.4
Export oriented	60.6	63.7	68.5	64.3
Ultra-export oriented	71.5	68.8	66.4	68.9

Source: Bank of Thailand.

Note: Domestic market-oriented industry is defined as the industry that exports less than 30 percent of total production, as export-oriented if exports are between 30 and 60 percent, and as ultra-export-oriented if exports are more than 60 percent, respectively.

As the economy recovered, capital spending of these exported-oriented firms was increased because of FDI. When the world economy slowed down in 2008, these firms operated under a high level of excess capacity. Conversely, domestic-oriented firms still operated in a normal production capacity. These industries are petrochemicals, beer, and construction materials. Their revenues are more related to domestic business cycles than world trade movements. However, when the domestic economy moves in line with the developed economies' cycle, they could face the same difficulty.

Another important factor that determines the utilization capacity is the income elasticity of the demand for products. Firms that have more exposure to foreign markets but the demand for their products is not sensitive to business cycle can still maintain a high level of capacity utilization. Firms whose products are sensitive to world trade volume and have ultra foreign trade exposure are likely to be hit harder during the global recession. Industries with domestic-oriented markets utilized their production capacity around 74.4 percent between 1995 and 2008. Conversely, export-oriented firms experienced a greater variation in their output, utilizing 64.3 percent of their total capacity. Output fluctuations occur more in the export-oriented industry, whose vulnerability to shocks stems from high exposure to the world business cycle.

4. The export-led growth strategy

Successful economic development requires steady growth. A high-income country must continue growing and avoid shock interruptions. To maintain a stable growth path, consumption and investment must not be the source of instability. As a small country, external shocks cannot be avoided. However, a small country can at least minimize shocks that originate within the country.

Investment and consumption were growth drivers in the pre-crisis period of high growth. In terms of percentage contribution, more than 50 percent of GDP growth stemmed from investment and consumption (Table 2). The two growth engines

Table 2. Contribution to GDP growth of demand components (percent)

	1990–96	1997–98	1999–2005	2006–07
Private consumption	51.2	–57	63.8	25.3
Government consumption	8.8	–8	10.0	16.8
Investment	57.0	–313	48.8	–8.1
Net exports	–17.0	278	–22.6	65.9

Source: Author's calculation.

were related because the higher investment rate raised expected income, which encouraged more consumption that is private. Higher expenditures from households generated favorable business sentiment, which gave rise to a higher level of capital formation. Because imported intermediate products and capital goods are necessary for output expansion, imports rose dramatically as the economy moved along the high-growth trajectory path. Furthermore, exports of manufacturing products also require imported raw materials. Consequently, the current account deficit was a natural consequence of a rapid growing economy. As Table 2 shows, net exports did not contribute to growth as much as investment and private consumption.

The negative contribution to the growth of net exports during the boom implies that the importance of the export-led growth model has been overstressed. Growth rate of exports rises *pari passu* with imports growth. For high-tech products, net value-added of the industry is small when compared to labor-intensive and resource-based manufactured exports. During the episode of the unsustainable current account deficit, except a small positive contribution in 1992, net exports did not significantly contribute to growth. However, it should be noted that this growth contribution exercise reported in Table 2 does not capture the indirect positive dynamic impacts of exports on output growth that stem from productivity improvements made possible by the exploitation of economies of scale and technical spillover effects from export growth. Nevertheless, Table 2 indicates that major growth drivers in the pre-crisis period were private consumption and investment—not the net exports.

Rapid rates of growth in investment and consumption were not possible without external financing. The huge current account deficit was financed through capital inflows, which roughly related to the size of the investment-saving gap. Government spending did not play a significant role in the growth process, for the fiscal position remained healthy with a large budget surplus. As such, the current account deficit was caused entirely by the excess of investment over savings. When the flows of foreign savings dried up after the reversal of capital flows, investment and private consumption collapsed in 1997 and 1998 to restore the external equilibrium.

During both episodes of the pre- and post 1997–98 crisis, the role of fiscal spending was limited. Fiscal balance is countercyclical by the nature of automatic fiscal stabilizers. High growth brought about higher tax revenues, whereas government spending did not rise as fast as revenue. During the recession, the fiscal position reversed to deficit because revenue declined while public spending was raised to offset the contraction of private consumption and investment. In 2007, the contribution to GDP growth by public consumption, for the first time, surpassed those contributions from private consumption and investment.

The recovery period of 1999–2003 was led by private consumption because consumers had regained confidence in the aftermath of the worst recession in Thailand. Net exports did not perform the role of an active growth driver until the shutdown of both traditional twin growth engines. High growth indirectly affects current account disequilibrium. Net exports were the main growth drivers when both investment and consumption did not perform their traditional roles. When the economy slowed down, the current account surplus implied a positive growth contribution of net exports. Only when growth is accompanied with a current account surplus would we see the positive growth contribution of net exports. In sum, the growth drivers of the Thai economy in the past were private consumption and investment. Nevertheless, the role of net exports as an engine of growth was more prominent during the 1997–98 financial crises and during the 2006–07 slowdown of domestic demand.

5. Impact of the global recession on the financial sector

Unlike the 1997–98 Asian financial crisis, which was preceded by excessive growth in property loans and asset price bubbles, the recession in 2009 is taking place when there are no asset price bubbles, nor un-hedged foreign borrowings of commercial banks. Thai financial institutions have undergone consolidation and strengthened rules and regulations after experiencing the 1997–98 financial disaster.³ At the height of the banking crisis, non-performing loans (NPLs) rose to 50 percent in mid 1999. Since then it has gradually declined. The gross NPLs at the end of December 2008 stood at 5.3 percent, whereas the net NPLs, which is the gross level subtracted by loan loss provision, declined to just 2.9 percent. Bank credit expanded by 4.7 percent in 2007 and accelerated to 11.4 percent in 2008. The high inflation rate led to higher demand for credit from the private sector. In times of economic slowdown, the volume of lending is determined from the demand side. After the banking crisis, the

3 Hanna and Huang (2002) recognize the problem in the improvement of the legal infrastructure in Thailand. Foreclosure and reorganization were painfully slow as the tremendous power of the well-connected borrowers can be used against creditors.

landscape of financial institutions changed dramatically. Foreign ownership is allowed to save the Thai banks from bankruptcies. Foreign capital injection saved the government budget to keep bad banks afloat. Stringent rules and regulations have been imposed. By the end of 2008, Basel II was in place and the capital adequacy ratio of the banking system stood at 14.2 percent, which is much higher than the 8.5 percent required by the new regulations.

The Bank of Thailand has also strengthened its monitoring system. A new definition of NPLs and international accounting standards were imposed to detect problems of banks and their borrowers before they develop into a full-blown crisis. Just like the unemployment rate, the level of NPLs is a lagging indicator of business activities. We would observe a rising level of NPLs in 2009 and unemployment even if the recession ends in 2009.

What is needed is an early warning indicator that can accurately predict problems in financial institutions and a formation of asset price bubbles.⁴ Special-mentioned loans, between 30–90 days overdue, are an early signal of the rising NPLs. These special-mentioned loans increased from 3 percent in the first half of 2008 to 4 percent in the second half of 2008. The increase reflects growing problems from small and medium-sized enterprises (SMEs) and consumer loans. Although non-performing consumer loans would rise as the number of unemployed workers increases, conservative banks would not be much affected because their exposure to this sector is limited. Nevertheless, we cannot totally rule out panic and herd behavior in a time of political unrest.

Capital inflows lead to currency appreciation and speculation in asset markets. The stock market prices can serve as a good predictor of the boom in the housing market. The boom itself cannot be sustainable if there are excessive speculations. Most of the time, an excessive growth of bank lending is caused by loans extended to property buyers. Property lending is associated with new construction units in urban areas. In Thailand, the number of the new housing construction exceeded 1 million units between 1994 and 1996. This excessive supply of housing units could not come about without credit extended by financial institutions. Just like the case of sub-prime loan problems in the United States, the financial crisis in Thailand was preceded by lending booms in the asset markets. Additionally, when the bubble

4 According to Leijonhufvud (2007), the presently structured incentive system encourages risk-takers to adopt a short-term view. The mark-to-market accounting does not reflect the future risks of present decisions. The complexity of financial products has increased the degree of uncertainty in the accuracy of risk managements; thereby encouraging excessive risk-taking in bullish markets and excessive retrenchment in bearish markets.

bursts after the collapse of expectations, we have seen a sharp reduction in investment construction, followed by a contraction in bank lending.

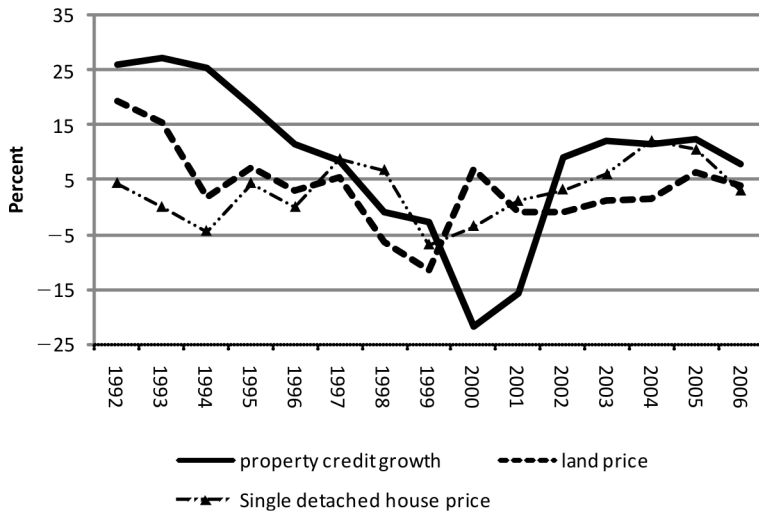
The rebound of the real estate business was led by another sharp increase in property lending that began in 2002. Although the amount of credit far exceeded peak lending in 1998, this is not a cause for concern; the rising cost of construction requires a larger amount of loans and the number of new housing units is still small compared to the past housing bubble period. Furthermore, the rises in land and real estate prices were below 5 percent in 2006 and 2007.

By 2007, the slowdown in the number of new housing units was apparent in Thailand. The oil price hikes and loss of business confidence caused by political turmoil made households revise their expected income downward. Investment in residential construction barely contributed to economic growth during this period of uncertainty. We observed a similar pattern of property lending that occurred in the past: a considerable slowdown in lending after a decline in new construction.

Land and housing transactions move in line with economic growth. A booming economy generates higher demand for property, which is slow to respond to the rapid rise in the demand generated by optimistic households. The housing prices increased by a double-digit growth rate in the early 1990s. An economic slump reverses favorable expectations and abruptly reduces property demand. However, the supply is too slow to adjust to the fast-changing demand. The resulting housing glut causes a sharp decline in the asset prices to correct the disequilibrium. This correction took place in 1998 and 1999 when the bubble burst. The slow recovery of the property sector after 2001 was demonstrated by a steady rise in the property values. The increase was gradual and largely predictable, rising above 5 percent in 2005, tapering off as economic growth stalled in 2006.

To resuscitate the moribund property market, interest rate cuts and improved credit availability are not the answer. Demand for bank credit follows the demand for property, which is mainly determined by expected income. As long as households are facing risk and uncertainty about their job prospects, there would be no real increase in the demand for housing. Because the real estate sector has strong linkages to other sectors, the Thai economy would not be back to the solid path of recovery unless there is a rebound in the property market. Uninterrupted economic growth matters most in shaping consumer confidence and enhancing business sentiment in the property sector.

The slowdown of the Thai economy in 2009 will not lead to a financial crisis of the 1997–98 type, since there is no risk of bubble asset prices. Although the U.S. finan-

Figure 4. Real estate bubbles and property credit

Source: Real Estate Information Center and the Bank of Thailand.

cial crisis has led to a global recession and affected financial markets, Thailand's financial sector remains stable. Thai banks have minimal exposure to the U.S. toxic assets. Some banks like Bangkok Bank, Bank Thai, Krung Thai Bank, and Bank of Ayudhya have purchased collateralized debt obligations (CDOs) in the amounts of US\$ 101 million, US\$ 260 million, US\$ 160 million, and US\$ 85 million, respectively. In addition, U.S. banks have limited presence in Thailand—only Citibank and JP Morgan Chase have full branch operations. These foreign banks have a less than 1-percent share of total bank loans in Thailand in 2008. However, the U.S. financial crisis and recession have caused negative impacts on the real and financial sectors. In the first quarter of 2009, profits of the four largest banks declined by 20 percent on average.

In December 2008, five international rating agencies downgraded Thailand's rating outlook from stable to negative though maintaining sovereign ratings to reflect economic and political risks in Thailand. In April 2009, S&P downgraded the local currency default rating by one step to BBB. Fitch Ratings also downgraded two state-owned banks to reflect the government's inability to provide support in case of crisis and local units of two foreign banks to reflect limited support from foreign companies to these banks. Nevertheless, the five major private banks were not affected by the sovereign downgrade. In the second half of 2009, the impact on banking performance will become more apparent as the Thai economy enters into a deeper recession. Moody's Investors Services predicted in April 2009 that the Thai

economy in 2009 would contract by 4 percent due to political shocks and the collapse of world trade.

6. Monetary policy responses

The production and export structure of the Thai economy has gradually changed from heavy reliance on agricultural to manufactured products. Additionally, the proportion of high-tech products has become more dominant, far outweighing the labor-intensive and resource-based manufactured products. The Bank of Thailand envisaged the need for intervention, as exports' share in GDP were around 65 percent. The Bank of Thailand has a certain exchange rate level to foster the growth of exports.

Before the crisis in 1997–98, the Bank of Thailand did not allow the baht to appreciate, despite the substantial amount of capital inflows. It was believed that strong currency could thwart export growth and slow down the growth engine. The Bank of Thailand accumulated international reserves via buying dollars. When exports started falling, the Bank of Thailand did not let the baht depreciate freely, fearing that it might hurt banks and firms that borrowed heavily in the dollar-denominated debts. After the fierce battle of the baht in 1997, the Bank of Thailand failed to defend the currency against speculative attacks, international reserves declined sharply, thanks to the policy blunder of the central bank.

The role of the Bank of Thailand has not changed after the crisis. As the dollar depreciated sharply in 2006, the Bank of Thailand, once again, attempted to lean against the wind of currency appreciation. Capital controls were imposed in November 2006 to stop capital inflows that gave rise to baht appreciation. However, the weakness of the dollar also gave rise to the strong baht. The fear that currency appreciation would hurt exporters was unwarranted. It turns out that export growth in 2006 and 2007 remained vigorously high despite the strengthening baht value. The Bank of Thailand finally abandoned the capital controls in early 2008, reasoning that the economic situation had returned to normal and hence there was no need to curb capital inflows.⁵

The international reserves kept on rising after 2002, as the Bank of Thailand heavily intervened in the foreign exchange market. The level increased above US\$ 100 bil-

5 Williamson (2004) reckons that capital controls are likely to play an important role in avoiding financial crisis and the best chance to avoid a regional crisis involves a preemptive IMF move to help countries avoid floating their exchange rates at the wrong time.

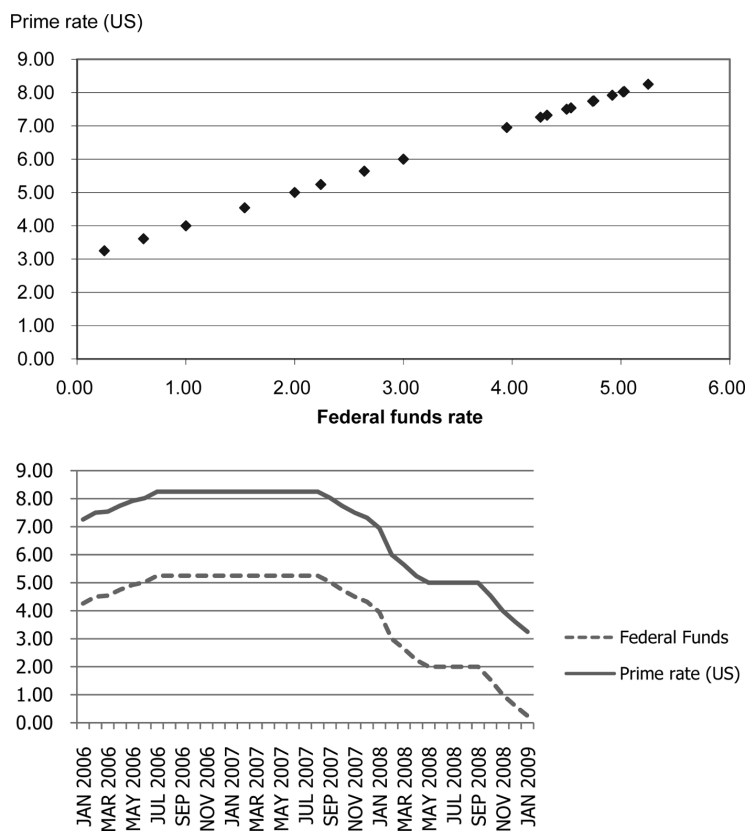
lion at the end of 2008. The forward position of the swap obligation declined gradually after 1997, as the Bank of Thailand did not sell dollars forward to resist the baht depreciation. When the baht gained strength, the Bank of Thailand started buying the dollar forward. Thus, we observe the negative swap obligation of the Bank of Thailand. Capital controls were used in addition to buying the dollar forward, amounting to US\$ 20 billion in 2007. Because the dollar kept on appreciating, the Bank of Thailand suffered severe losses from the swap intervention. It is obvious that there has been no fundamental change in the exchange rate policy since the 1997 crisis: intervention is always high on the agenda.

From time to time, the inflation targeting strategy takes into account the exchange rate movement when the central bank wants to adjust the key policy interest rate. However, it is not possible to strike balances among the three impossibilities: the fixed exchange rate, free capital flows, and independent monetary policy. The policy implication of expanding international reserves is that the Bank of Thailand needs to sterilize the impact of capital flows. The Bank of Thailand cannot let the history of bubble assets repeat itself when capital inflows ignited speculation in asset markets. The Bank of Thailand has learned that lesson well from past mistakes.

In a flexible inflation targeting strategy, the key interest rate can deviate from the policy rate that only maintains growth and price stability. Other variables such as the exchange rate and financial sector stability condition can affect the central bank's decision to change the key policy interest rates, not just inflation and unemployment rates that enter the central bank's reaction function. This was precisely what the U.S. Federal Reserve (Fed) has done to save ailing U.S. financial institutions.

In developed countries, there are strong linkages between short-term policy rates and the long-term interest rates and stock market prices. The effectiveness of monetary policy tends to be larger in mature economies. Using monthly data between 2006 and 2008, Figure 5a illustrates that there is a predictable and consistent relationship between the Fed's funds rate and the prime lending rate of commercial banks. If this relationship holds in the end, the job of central bankers would be more pleasant as they can engineer a certain level of interest rate hike or cut to suit the direction of monetary policy.

In Thailand's case, such a precise policy outcome is not predictable. Using the same corresponding period, Figure 5b shows that in many occasions, there was no adjustment of the minimum lending rate of commercial banks despite the continued changes in the policy rate. The free flows of capital movement, the competition within the banking system, and efficiency of the banking system, as well as the loose

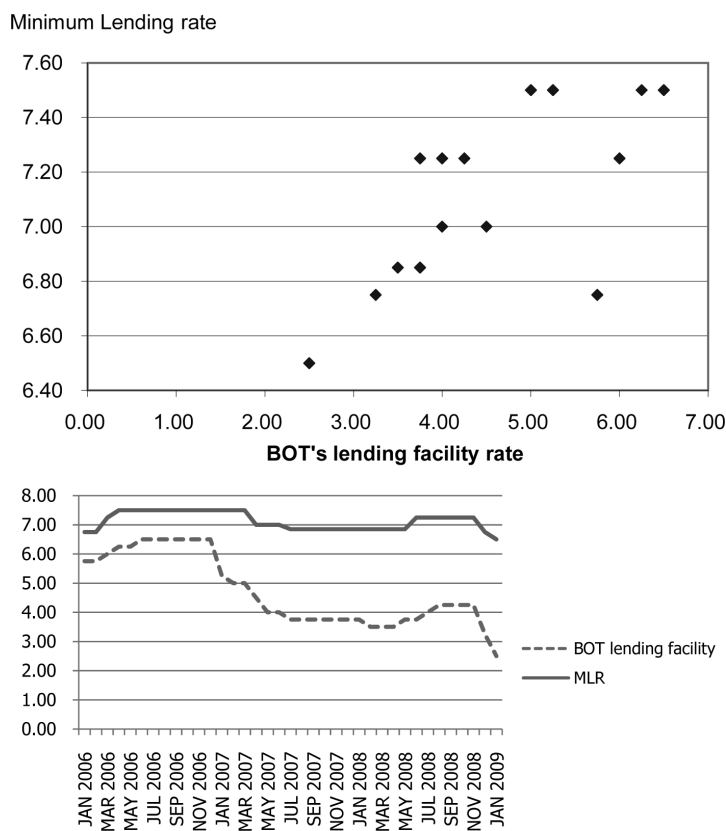
Figure 5a. Impact of the key policy rate in the United States

Source: Bank of Thailand.

connection between the short-term money market and long-term capital markets, make it difficult for the Bank of Thailand to affect the desirable level of lending rate that influences private investment and consumption.⁶

Even if Thai monetary authorities had the ability to change commercial banks' lending rate, monetary policy would not ultimately change the course of the economy during the period of recession. During a deflation episode, low interest rates would

⁶ Commercial banks argue that they have to pay contributions at 0.4 percent of their deposits to the Deposit Protection Agency under the Bank of Thailand, causing inflexibility to reduce the lending rate or increase the deposit rate. Despite the excess liquidity of more than 1 trillion baht in the banking system, the minimum lending rate in April 2009 remained at 6.5 percent, whereas the Bank of Thailand's key interest rate was reduced to 1.25 percent.

Figure 5b. Impact of the key policy rate in Thailand

Source: Bank of Thailand.

not encourage borrowing from investors because the rate of return to investors is low when all risks and uncertainties are taken into account. Monetary policy therefore tends to be more effective during the upturn as the central bank can decelerate credit growth through available instruments to limit credit availability to investors during the economic boom.

In sum, there is little scope for monetary policy to prevent the Thai economy from the adverse impact of the global recession. A low interest rate policy cannot revive private spending when excessive industrial capacity remains high. Unlike the export-led growth after the 1997–98 crisis, the weak baht would not help either as the volume of world trade is shrinking. It would be a great mistake to maintain an unrealistic exchange rate by causing an undervaluation of the baht, with the hope that

export growth can spur domestic output because the income effect of world trade is much stronger than the substitution effect caused by changes in the exchange rate.

7. Fiscal stimulus package

The global recession of 2009 compels the Thai government to offset the shortfalls in domestic demand and exports by employing fiscal stimulus. This strategy is a return to the conventional Keynesian fiscal policy as a reaction to a global slump when all engines of growth are shut down. It is a matter of reprioritizing the growth engine when trade does not perform its handmaiden of growth role. It does not mean that Thailand would return to inward-orientated development strategy. When the world economy rebounds, and investment and private consumption return to their normal levels, there would be no need to run a budget deficit to stimulate growth.

Fiscal prudence and discipline are factors in maintaining internal and external stability. During the boom in the early 1990s, running a fiscal surplus was the norm until the financial crisis broke out in 1997. Both the financial crisis and the unsustainable current account deficit were not the result of excessive public spending. A higher public deficit, with other factors remaining constant, would lead to deterioration in the current account. The size of the budget and current account deficits should be related. However, other factors such as income level change simultaneously. We observe that fiscal deficit moved in line with the current account surplus. Fiscal surplus and the growing current account deficit turned out to be a sign of economic strength. Booms are associated with a current account deficit and budget surplus, while a fiscal deficit and surplus current account are characteristic during economic slumps. As long as the government maintains the principle of fiscal prudence, a long-term growth path would not be jeopardized. Because of the conservative fiscal policy maintained in the past, the public debt remained at 40 percent of GDP, while the size of fiscal deficit did not exceed 2 percent of GDP in 2008; the government still has more room to run a larger deficit to counteract the global recession.⁷

Fiscal discipline was observed between 2003 and 2005. Public expenditures increased in line with revenue. The slow growth rate of public spending in 2006 and 2008 reflected difficulties and the delay in budget appropriations during transitional

7 In a dynamic stochastic general equilibrium model featuring a fraction of non-Ricardian agents in the euro area, Forni, Monteforte, and Sessa (2009) provide evidence that public spending on goods and compensation for public employees have small and short-lived expansionary effects on private consumption.

administrations. The slowdown in economic activity led to a shortfall of revenue. The value-added tax, the largest component of all taxation, declined by 25 percent in February 2009 yoy. The plunge in tax collection is expected as it should be the case during the economic downturn, which requires the counter-cyclical movement from automatic fiscal stabilizer. The rise in expenditure should offset the decline in private spending. Nevertheless, prudential fiscal rules should always be applied to all kinds of spending. The sharp increase in the 2007 budget suggests a new round of pump-priming the Thai government.

In fiscal year 2010, the budget deficit will be around 430 billion baht or 4 percent of GDP. The parliament has approved a fiscal stimulus package of 117 billion baht. The first tranche of 19 billion baht reached low-income people on 26 March 2009 in the form a 2,000 baht (US\$ 55) check to social security holders whose monthly income is less than 15,000 baht (US\$ 417). Approximately 9.2 million people benefit from this once-and-for-all cash-handout. Those unemployed would get a 5,000 baht (US\$ 139) salary for six months attending training programs. The elderly will get a 500 baht (US\$ 14) monthly income. To spur growth in real estate, home buyers would get tax deductions up to 400,000 baht (US\$ 1,110). Other public spending includes free schooling for children up to 15 years, public works in rural areas, free tap water and electricity, free rides on public buses and trains, and financial assistance to community enterprises. With the implementation of this fiscal stimulus package and an expected zero growth or a negative 3 percent GDP growth, the public debt may exceed 44 percent of GDP.

If consumers view the increase in public spending as a positive transitory income, the impact of fiscal stimulus would be weak. Only when consumers view that their permanent income increases do they respond by increasing their permanent consumption. The expansionary impact of fiscal deficit is questionable since the benefits from the stimulus package are temporary.⁸

The marginal benefit and cost of each stimulus program must be examined. The urgency of spending is not as important as the long-run impact on growth. If the increase in the budget concentrates in current rather than capital spending, the impact on long-term growth is questionable. Spending on infrastructure and communication lead to a higher growth of output than other types of government spending. Furthermore, the rising proportion of current expenditures in the total budget

8 Ravallion and Chen (2005) provide evidence rejecting the commonly held view that poor people tend to rapidly consume the income from a development project. Aid recipients felt that a large share of the income gains was likely to be transient.

makes cuts to the budget difficult in the future.⁹ Experiences show that capital spending can be cut more easily than current spending. The pump-priming could lead to larger a deficit in the future.

There is also an issue on deficit financing methods. The government has a plan to borrow US\$ 2 billion from international financial organizations. During this economic downturn, domestic interest rates are declining, reflecting the rise in excess liquidity. The Bank of Thailand holds more than US\$ 100 billion, and financial institutions have excess liquidity and households are discouraged to save because of low interest rates. Financing a budget deficit to finance long-term investment in infrastructure by tapping domestic markets is more sensible than foreign borrowing because it unnecessarily increases foreign exchange risk exposure.

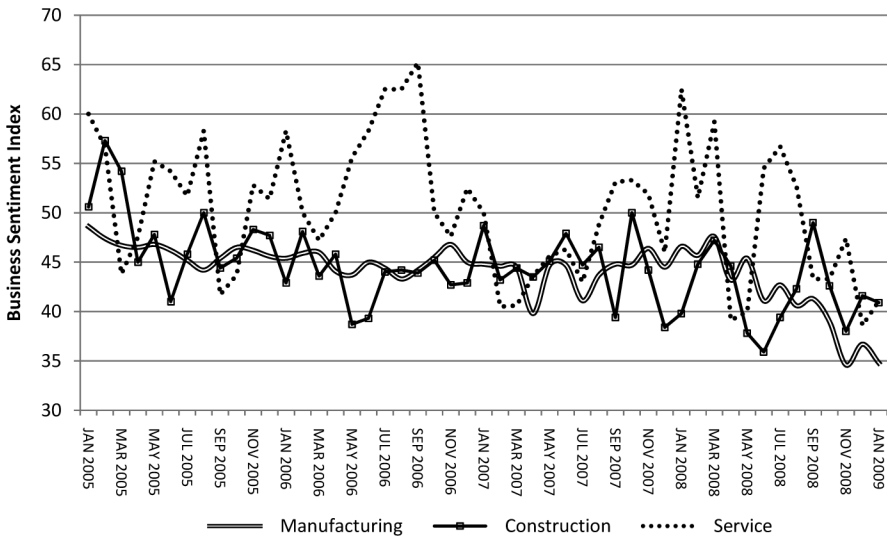
8. The importance of confidence: animal spirits

The sharp fall in exports in August 2008 gave rise to the fear of imminent recession. The survey of business confidence reveals that the index of business sentiment dropped below 50 as early as January 2005. The index above 50 indicates improving sentiment, whereas the index value below 50 indicates a gloomy prospect for the business sector. Figure 6 shows that the movement of the sentiment index in manufacturing and construction sectors moved down, but more gloomy feelings were apparent in the manufacturing sector, which was hit severely by the export collapse.

In a mild business cycle, fear of recession and pessimistic expectations can increase the perception of the fall in future income and it can turn a mild recession into a depression. Investment and consumer expenditures are linked to business confidence. During the boom, investment would expand in response to strong sales growth. In turn, capital spending on new plants would generate employment and income that further induce more capital formation.

If exports are determined by world income, an important question is whether consumption and investment can be raised to offset the fall in external demand. In an attempt to examine the impact of changing business confidence on capital investment and private consumption spending, a vector autoregressive (VAR) model is employed to shed light on dynamic aspects of the interactions of between the two growth engines (consumption and investment), manufacturing output, and business

9 Taylor (2000) envisages that fiscal policy should have its main countercyclical impact through the automatic stabilizers. For long-term growth, a country needs fiscal policy rules that clearly state systematic responses to unusual situations. Activist discretionary policy might make the job of monetary authorities more difficult.

Figure 6. Loss of business confidence

Source: Bank of Thailand.

confidence. The monthly data employed a span from January 1999, when the Bank of Thailand started collecting data on business sentiment in various manufacturing sectors, to December 2008. Because monthly data on private consumption are not available, the value-added taxes can be used as its proxy because they are related directly to consumer spending. The value-added tax rate has remained constant at 7 percent during the period of the analysis. Monthly output is approximated by the manufacturing production index. New registered capital is used to represent monthly investment expenditure.

The VAR approach sidesteps the need to specify the structure of the relationship among the key variables that interest us, by specifying all endogenous variables as a function of all lagged endogenous variables in the system. It is assumed that a vector of the error terms or innovations may be contemporaneously related to each other but they are uncorrelated with their own lagged values and uncorrelated with all of the right-hand side variables in the model of four equations. The problem of simultaneity can be ruled out with the OLS estimation because only lagged endogenous variables appear on the right-hand side of the estimating equations, while the problem of serial correlation of innovations can be avoided by including longer lagged endogenous variables in the system of estimation.

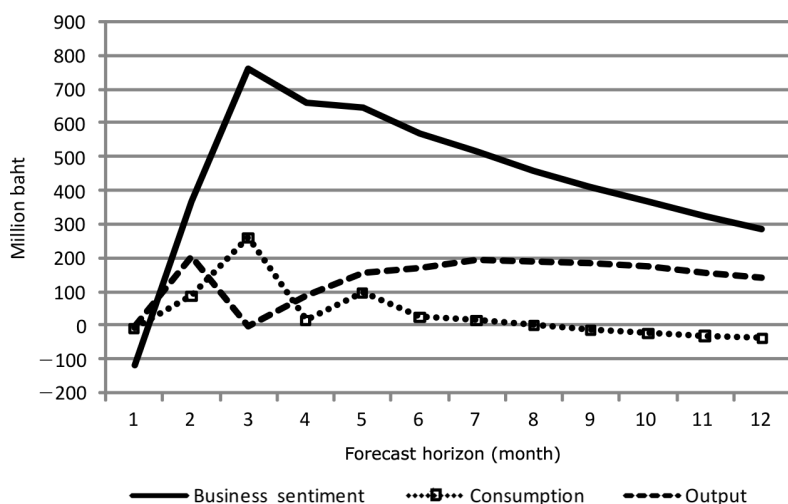
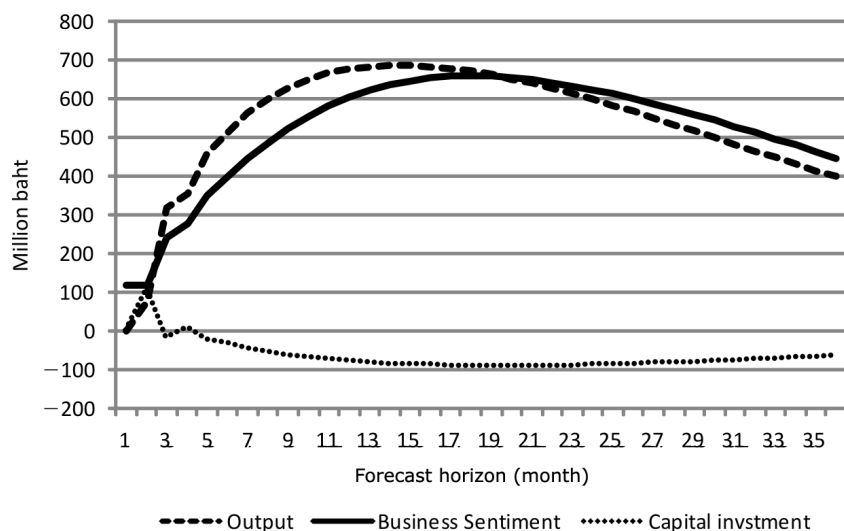
Figure 7. Impacts of shocks on investment

Figure 7 shows the response of investment to shocks from consumption, output, and business sentiment. A negative shock would produce similar responsive magnitudes but with opposite directions that occur when the system is perturbed by a positive shock. An improvement in business sentiment can cause overshoot investment spending. The impact is longer than one year and it dies off slowly. A positive consumption shock can raise investment for three months and the positive impact dies off quickly, reversing to a negative impact for six months after the consumption shock took place. In other words, investors would not overreact to a temporary rise in demand by expanding their output capacity, which turns out to be so excessive that they have to reduce its capital stock after experiencing excess capacity.

Note that the impact of output shock has a more permanent impact on investment than a consumption shock. The impact tapers off slowly after 10 months. Figure 7 shows the importance of business confidence in determining investment spending, indicating that animal spirits of investors are sensitive to changing sentiment. The impulse response analysis suggests that investment is best supported by providing and maintaining stable and favorable business conditions. Other methods employed to stimulate capital formation, such as lump-sum transfers or tax rebates given to consumers, would not have a permanent impact on stimulating private investment.

In the second exercise of the impulse response of private consumption, a one standard deviation of shocks in capital investment, output, and business sentiment is

Figure 8. Impact of shocks on private consumption

conducted. The result is demonstrated in Figure 8. We observe a similar pattern of consumption response to business sentiment shock. A change in business sentiment can result in an explosive response of private consumption, reaching the peak level in 18 months after the shock. The impact decreased after three years. When the economy is subject to shocks from world trade volume or terms of trade shocks, output will be affected as exports are directly related to output. Thus, we can envisage that shocks originating from the global slowdown or shocks from changing terms of trade would have similar impacts on investment and consumption in the same way that an output shock affected them.

Output shocks affect both consumption and investment spending, but eventually they return to their original equilibrium paths. The model seems to suggest the resilience of the Thai economy, which can gravitate back to its pre-shock growth path after experiencing output shocks. Both broken growth engines can work themselves out of the disequilibrium in the end.

The analysis of the impulse response functions underlines an important factor contributing to fluctuations in consumption and investment. In a time of global recession, when confidence remains low, a mild recession can become a full-blown depression unless the government is able to restore business confidence. Fear of unknowns, uncertainties, and deteriorating sentiment has a similar impact on the

economy just like the self-fulfilling prophecy of doom and gloom. Coping with animal spirits is a difficult task for the government.¹⁰

9. Concluding remarks

Financial restructuring undertaken since the 1997–98 Asian financial crisis has improved the resilience of the Thai economy. Before the current financial crisis in the United States, stringent rules and prudential regulations had been imposed on Thai financial institutions. There has been no indication of property bubbles similar to the type that preceded the Asian financial crisis, despite the huge inflows of capital that caused real exchange rate appreciation in 2007.

Vulnerability stems from high-risk exposure to foreign market shocks. Global integration has made the Thai economy subject to fluctuations in the world business cycle. However, vulnerability also arises from internal sources. If inappropriate macroeconomic policy is applied in response to external shocks, the economy can be thrown out of the long-term growth path. Overreaction can lead to adverse consequences especially when shocks are temporary. Although external shocks cannot be avoided, internal shocks can be minimized. Sometimes internal shocks are policy-induced. The kind of policy blunder that destroys business confidence must be avoided. Maintaining output growth is subject to the ability to restore confidence in time of crisis because investment and private consumption are sensitive to dismal sentiment.

A decade has passed since July 1997 when the Bank of Thailand abandoned the fixed exchange rate regime. The recovery from that crisis was relatively fast; indicating the ability to rebound after the growth path was interrupted by shocks. The crisis has not changed the trend of trade and financial liberalization in Thailand. Ironically, the liberalization has made Thailand more vulnerable to external shocks, through heavy reliance on international trade and capital flows. The policy focus has shifted to the short-run stabilization policy that relies on stimulating domestic absorption when the world trade volume cannot generate growth through strong demand for exports. There is no sign of turning back to protectionism during a time of export slowdown.

Business sentiment can be restored and maintained by policy consistency. If the government and the public adhere to the rule of law, political shocks can be minimized,

10 Akerlof and Shiller (2009) extend Keynes's animal spirits from investor confidence to fear, blind faith, corruption, and a concern to fairness, and the stories we tell ourselves about our economic fortunes.

as a concern for fairness would be eased. Once we allow elements of unknowns to violate established social obligations and contracts, business confidence erodes quickly; eventually it could lead to a negative long-term impact on economic growth.

Fiscal policy is the only option left. Unless the government maintains law and order to restore business sentiment and enhance consumer confidence, both the monetary and fiscal policy package would fail miserably. Ultra-populist policy would lead to an unsustainable fiscal position. Fiscal discipline has been neglected in the pursuit of short-run political gain at the expense of the long-term economic growth and stability.

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