

# EE460: Thai Economy

## Coping with the 1998 crisis

Bhanupong

Lecture 5

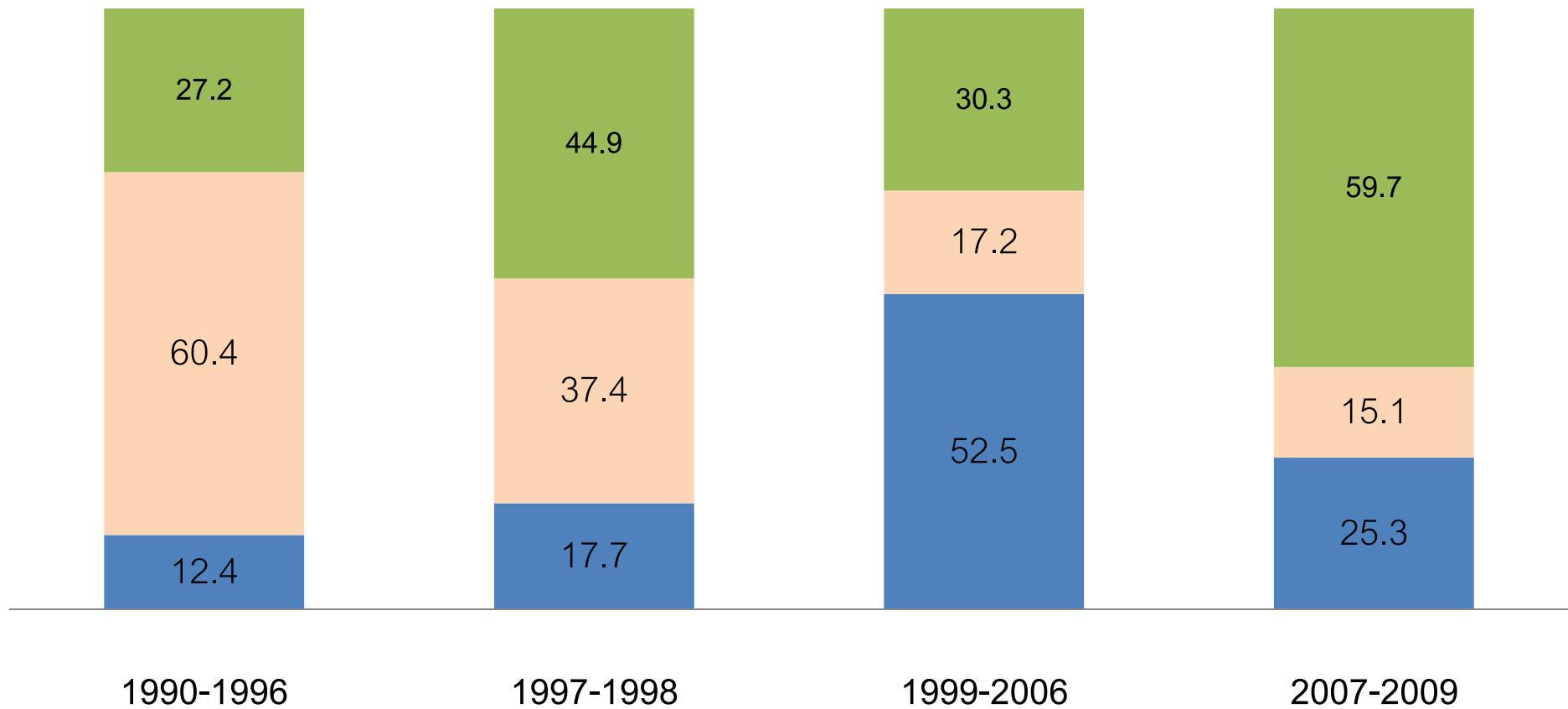
# Outline

- Roots of the problem
- V-shaped recovery
- Lessons from the 1998 crisis
- growth accounting
- Responses by sector

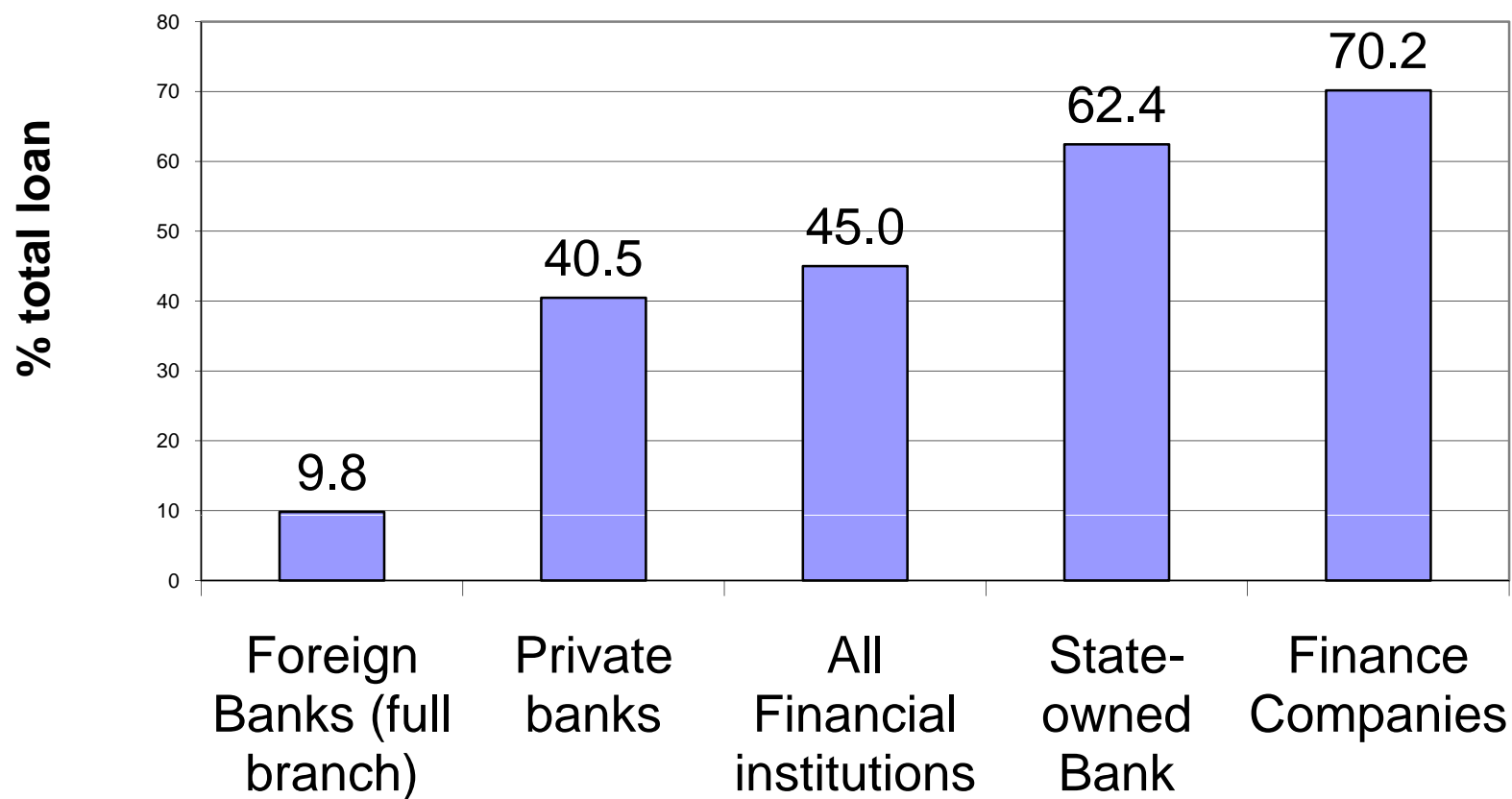
# Changing structure of capital flows

% of total

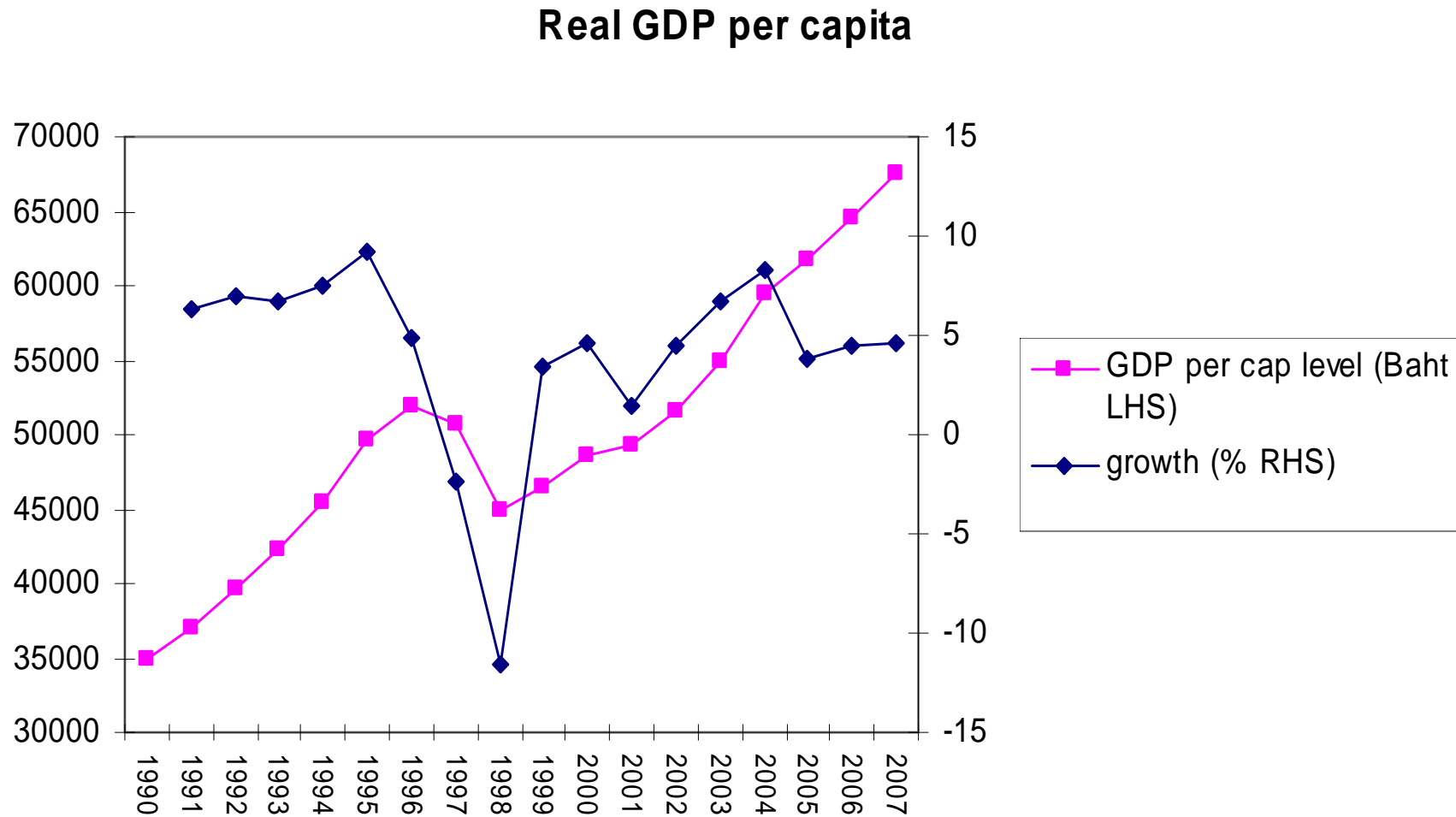
■ FDI ■ Loans ■ Portfolio investment



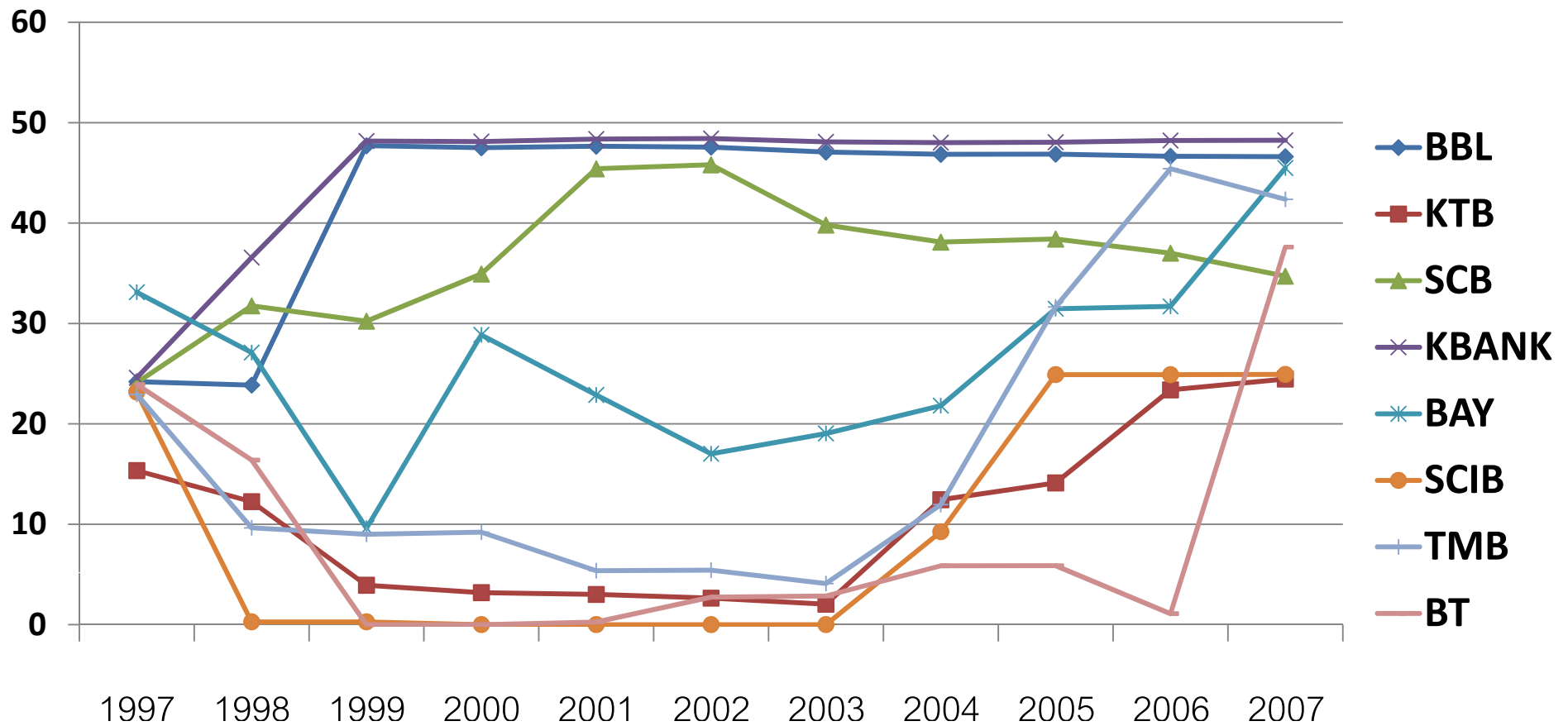
# Non-performing loans in 1998



# The V-shaped recovery

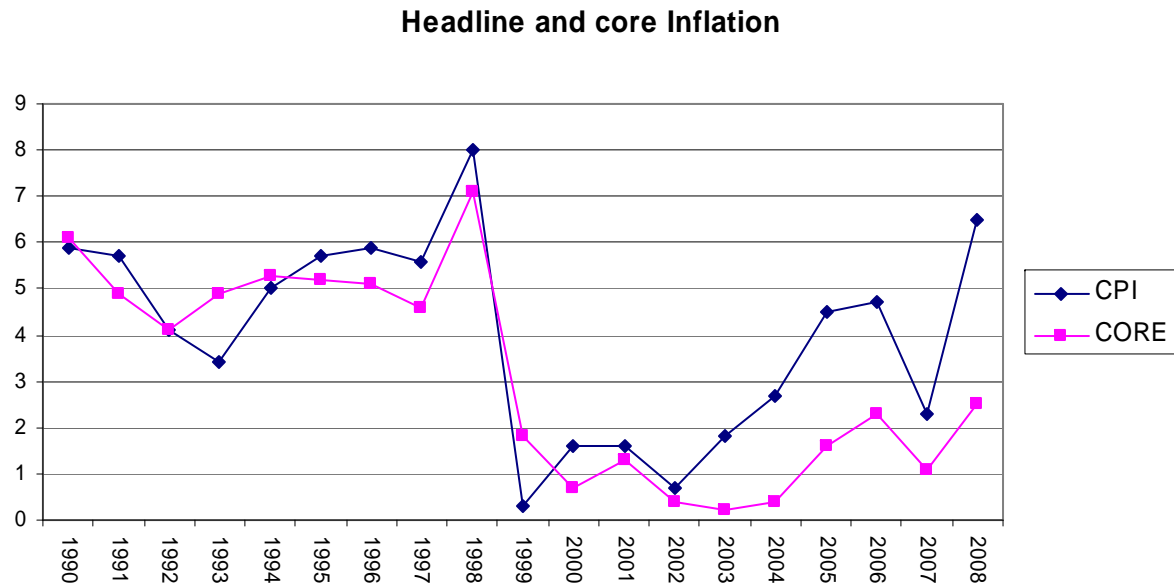


# Foreign ownership in Thai banks before and after the crisis



# Core vs. headline inflation

*(Excluding fresh food and energy prices)*



Source: BOT

# Shocks and adjustments

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

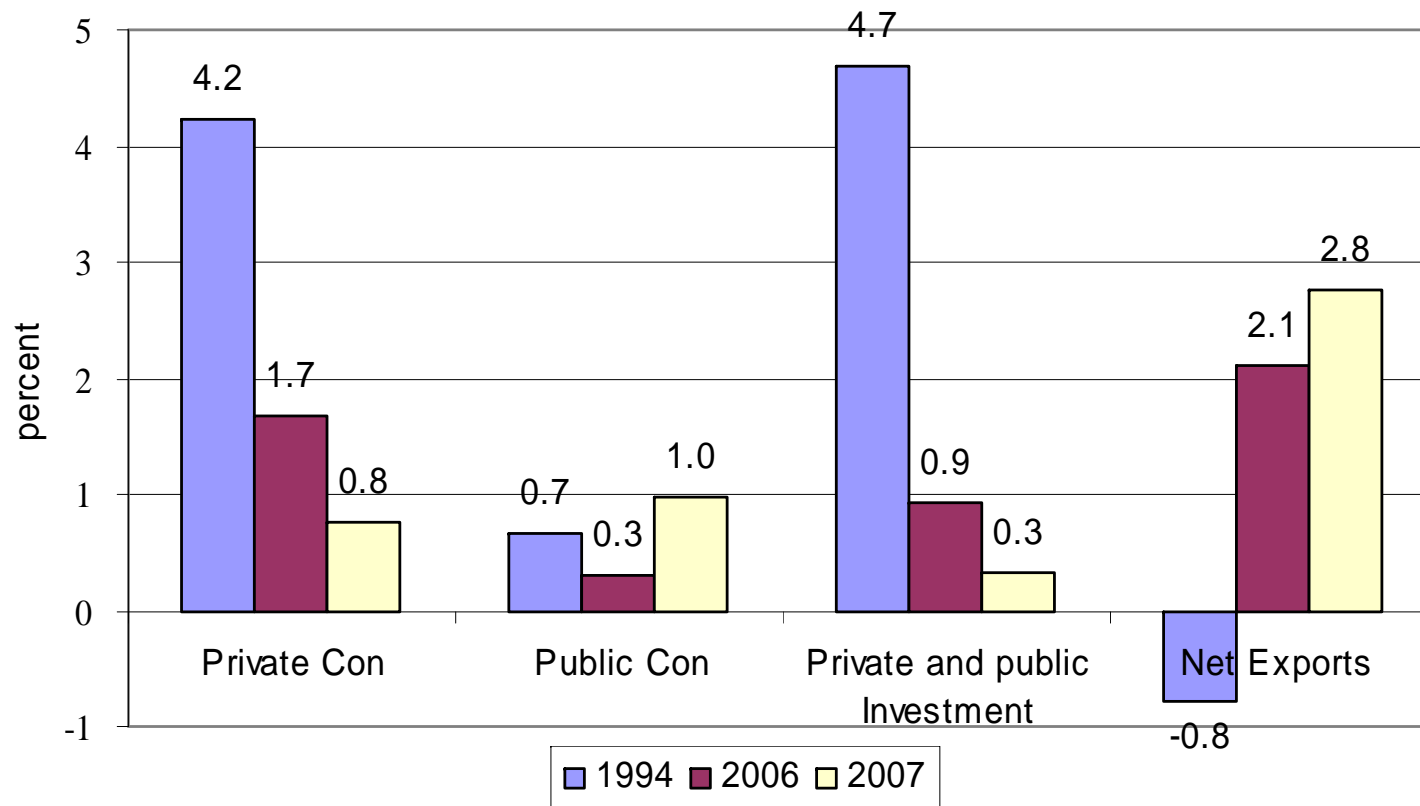
# O learned Thailand

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

# Sources of growth

net exports = exports-imports

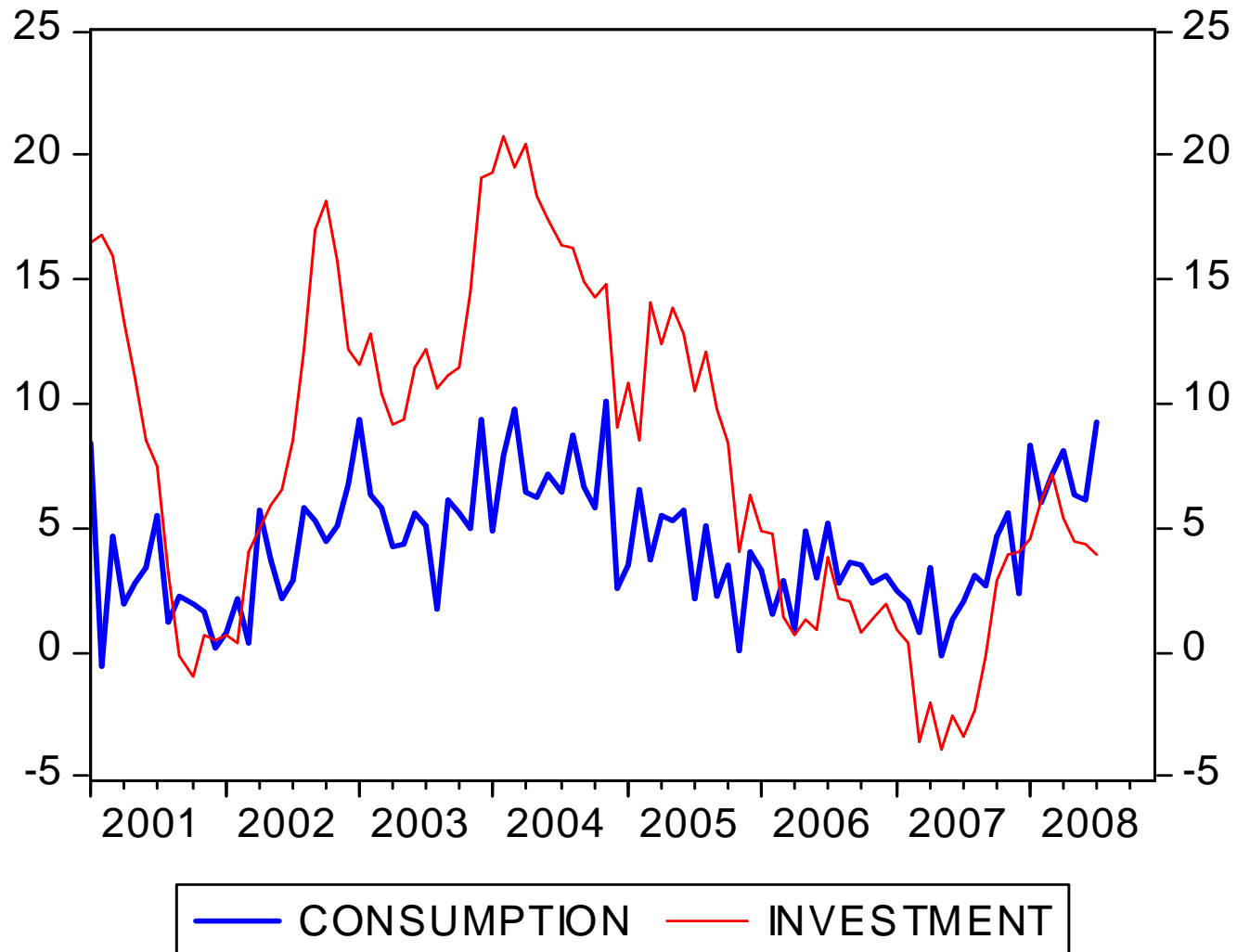
## Growth Decomposition



Source: Calculation based on NESDB data

# Long run relationship

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



# Determinants of consumption and investment

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

# Trend (exponential) growth rate

percentage

January 2000-December 2008

	<b>Consumption</b>	<b>Investment</b>
<b>Mean</b>	4.4	7.9
<b>SD</b>	2.4	6.6
<b>CV</b>	0.54	0.83

# The labor market

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

## Responses in the agricultural sector

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

# Dynamism of the industry sector

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

# Growth rate by sector

## 1990-2007

	Agriculture	Industry	Services
<b>Growth</b>	1.8	6.8	4.6
$\mu$			
$\sigma$	5.7	6.5	4.9
$\sigma / \mu$	3.2	0.95	1.1
Correlation coefficient between the service sector)	-0.12	0.91	

# Changing vs. switching expenditure policy

- To restore both external and internal balance, domestic demand (sum of consumption, investment and public spending) and the exchange rate must be appropriately adjusted .
- To reduce the current account deficit:
  - (1) imports must be reduced through output contraction;
  - (2) exchange rate must depreciate to switch spending from imports goods to domestic goods.

# Structural problems

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

# Remaining structural problems

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

# Remaining structural problems

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

# Review questions

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