

The hard road ahead for Thailand's economic recovery

Effectiveness of macro policy in response to GFC

Bhanupong

Lecture 9

# Course Syllabus

## Lecture 9

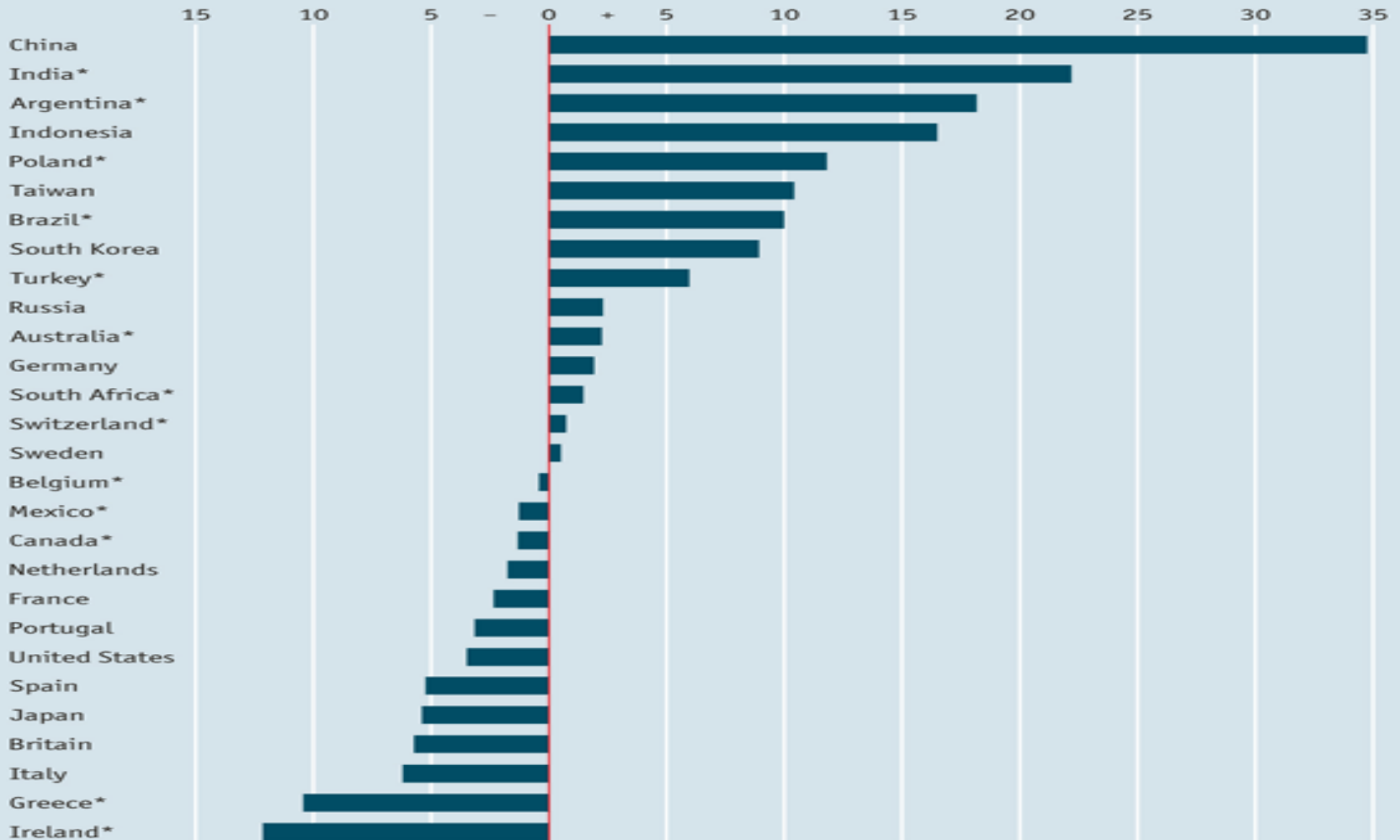
- The effectiveness of policy responses to external shocks depends on the government's ability to maintain the rule of law, accountability, human rights, and effective legal infrastructure.
- Maintaining the rule of law implies predictable outcomes from court ruling of legal disputes.
- Investors can proceed with less concern about risk and uncertainty that may arise from policy inconsistency.
- Fiscal and monetary policies would be more powerful with accompanying measures to boost consumer confidence and business sentiment to nourish the animal spirits of investors.

# Key words

- Coincident, leading, and lagging indicators
- Austrian Business Cycle Theory
- Business sentiment and consumer confidence
- Volatilities of macro variables
- Effectiveness of fiscal and monetary policy

# Global Recession and Recovery

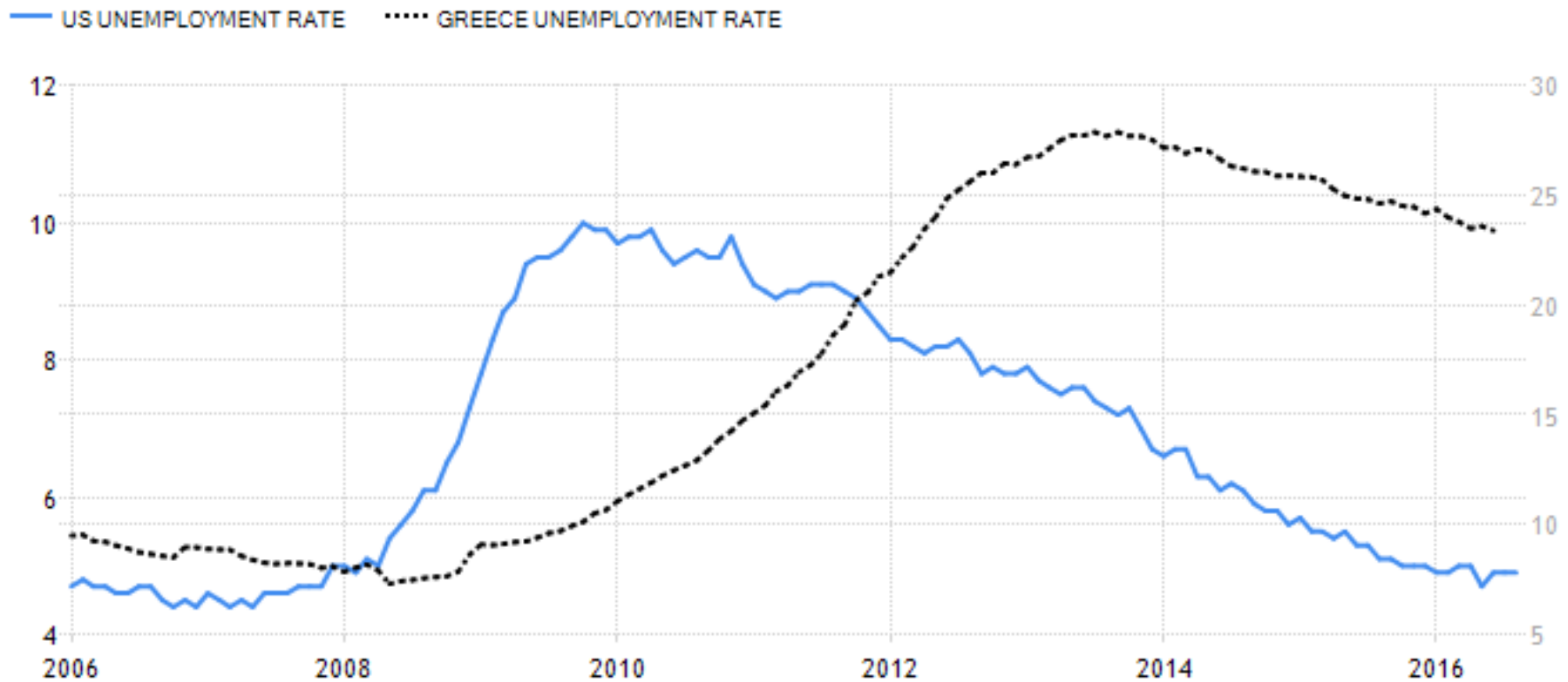
**Real GDP per person**  
Q4 2007 to Q2 2011, % change



Sources: Economist Intelligence Unit; Haver Analytics; IMF; JPMorgan; *The Economist*

\*Q2 2011 estimate

# Unemployment in Greece and the US



SOURCE: TRADINGECONOMICS.COM

# The Hard Road Ahead for Thailand's Economic Recovery

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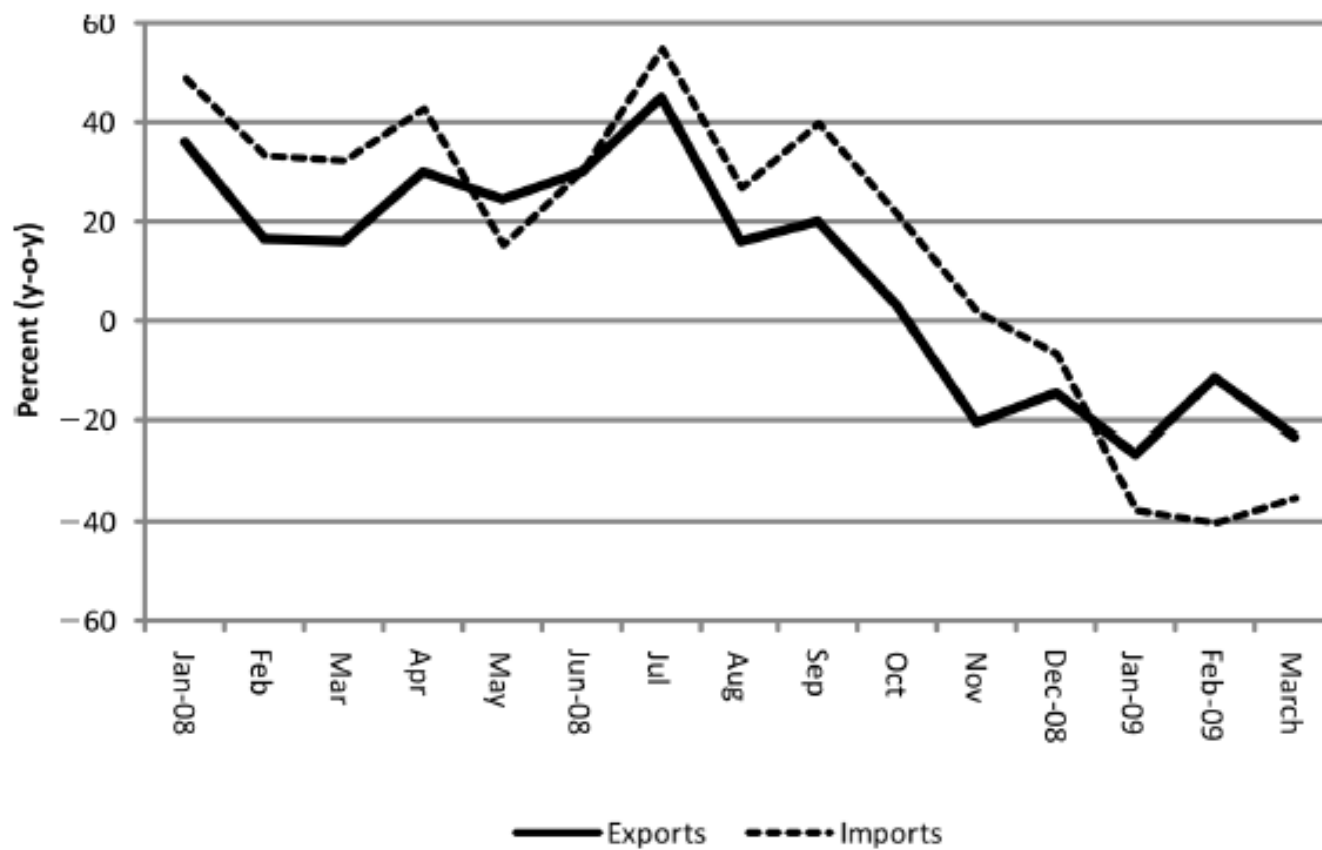
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## **Abstract**

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.

## The Hard Road Ahead for Thailand's Economic Recovery

Figure 1. The collapse of the last engine of growth



Source: Ministry of Commerce

## The Hard Road Ahead for Thailand's Economic Recovery

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.*

# Contribution to GDP growth: 1990-96

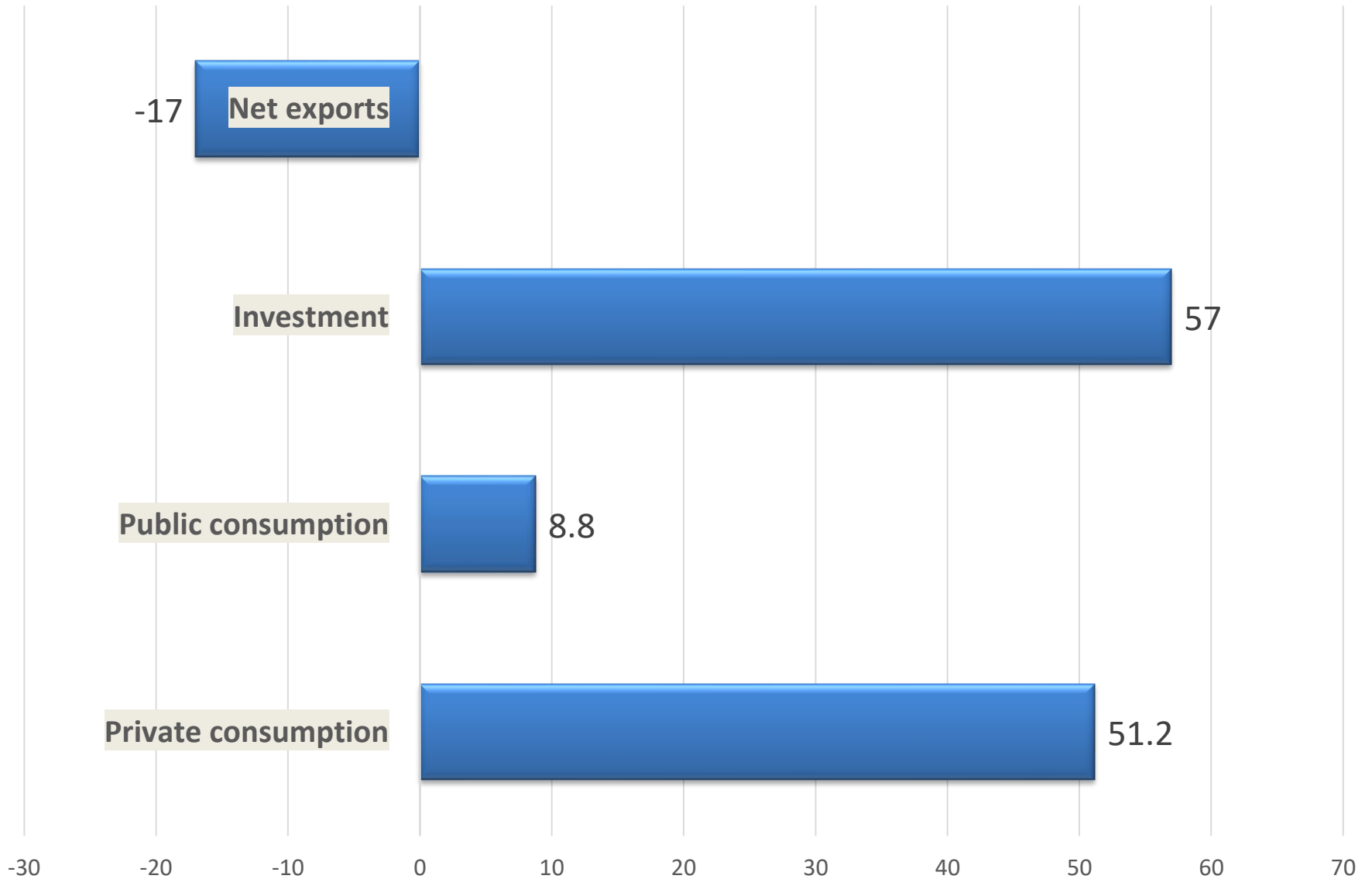
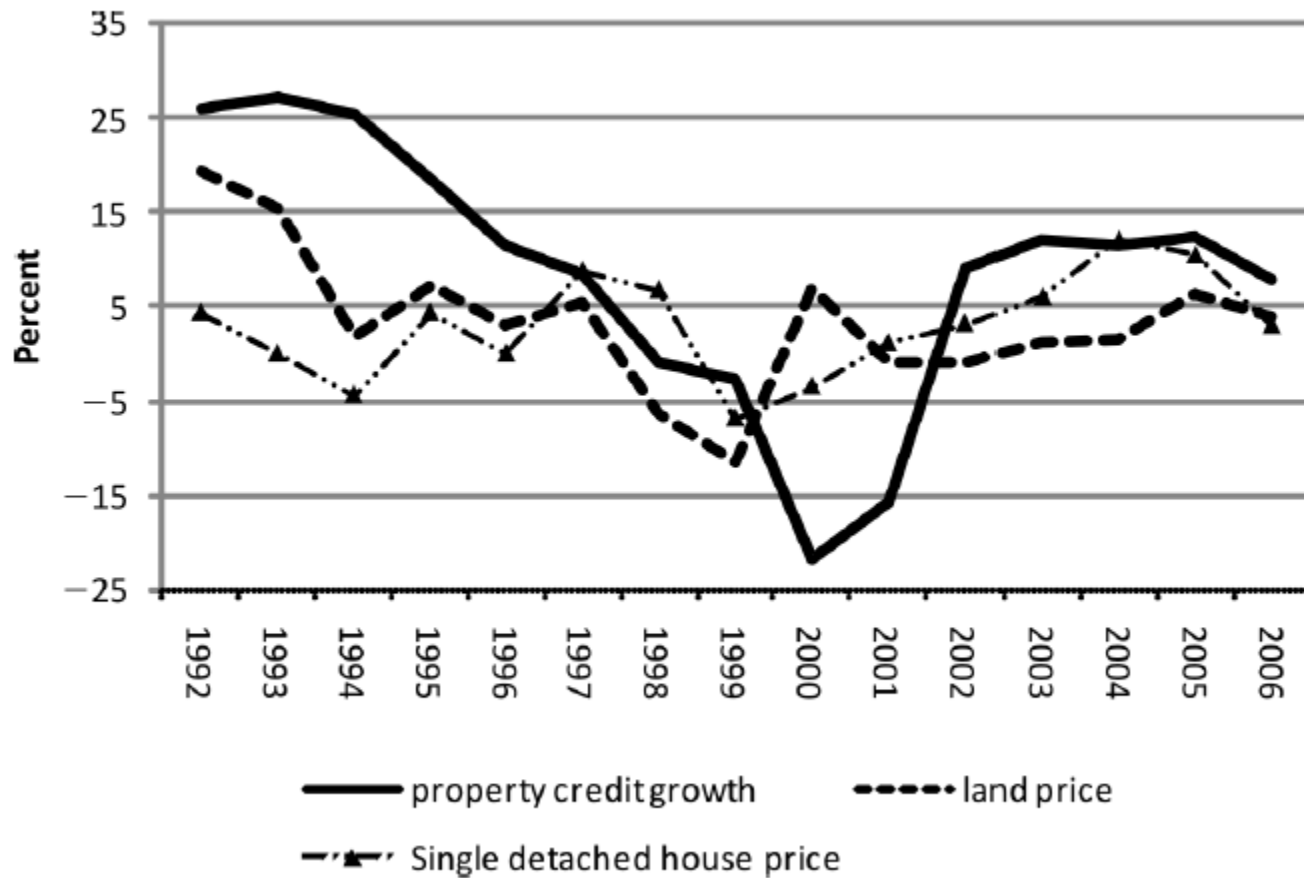


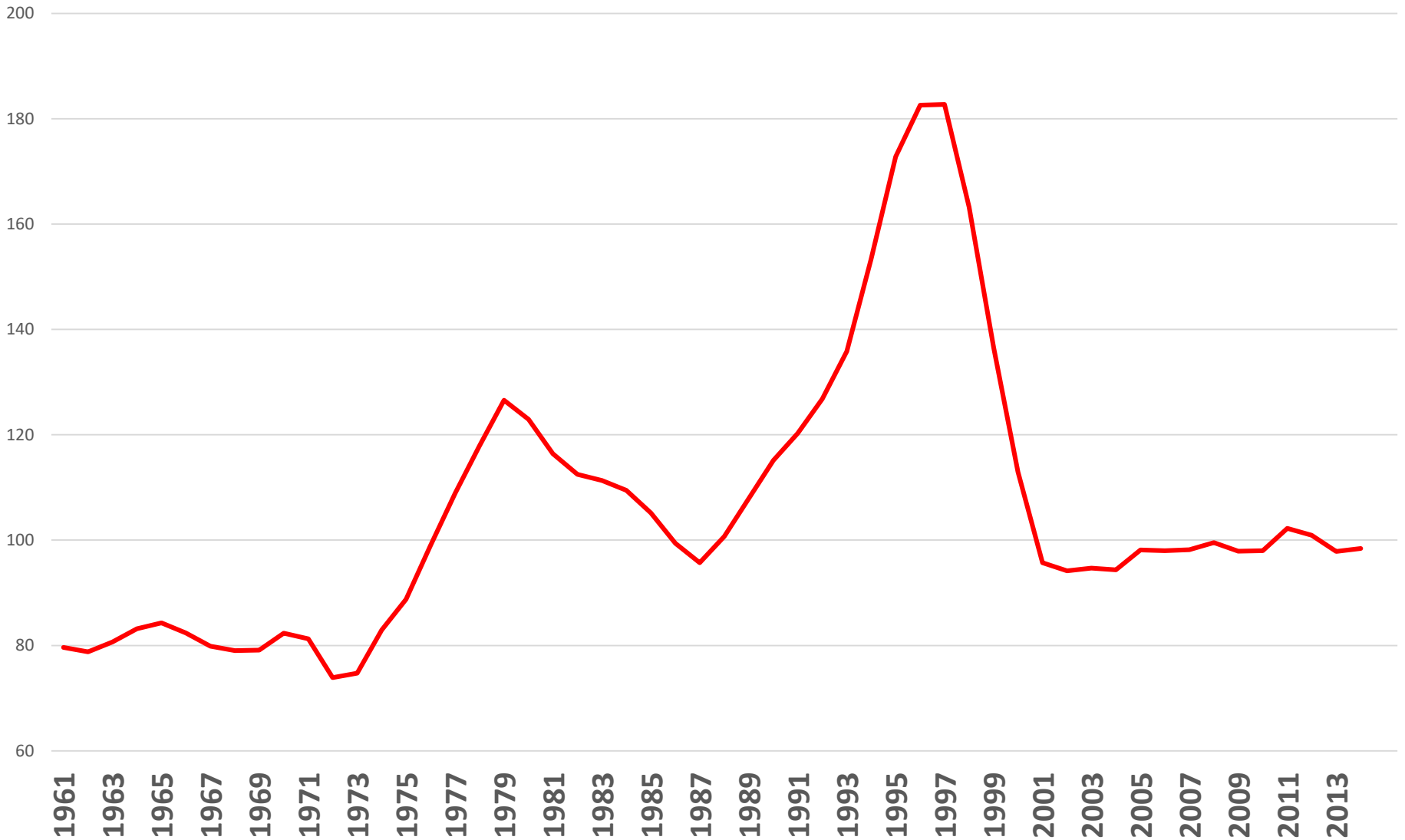
Figure 4. Real estate bubbles and property credit



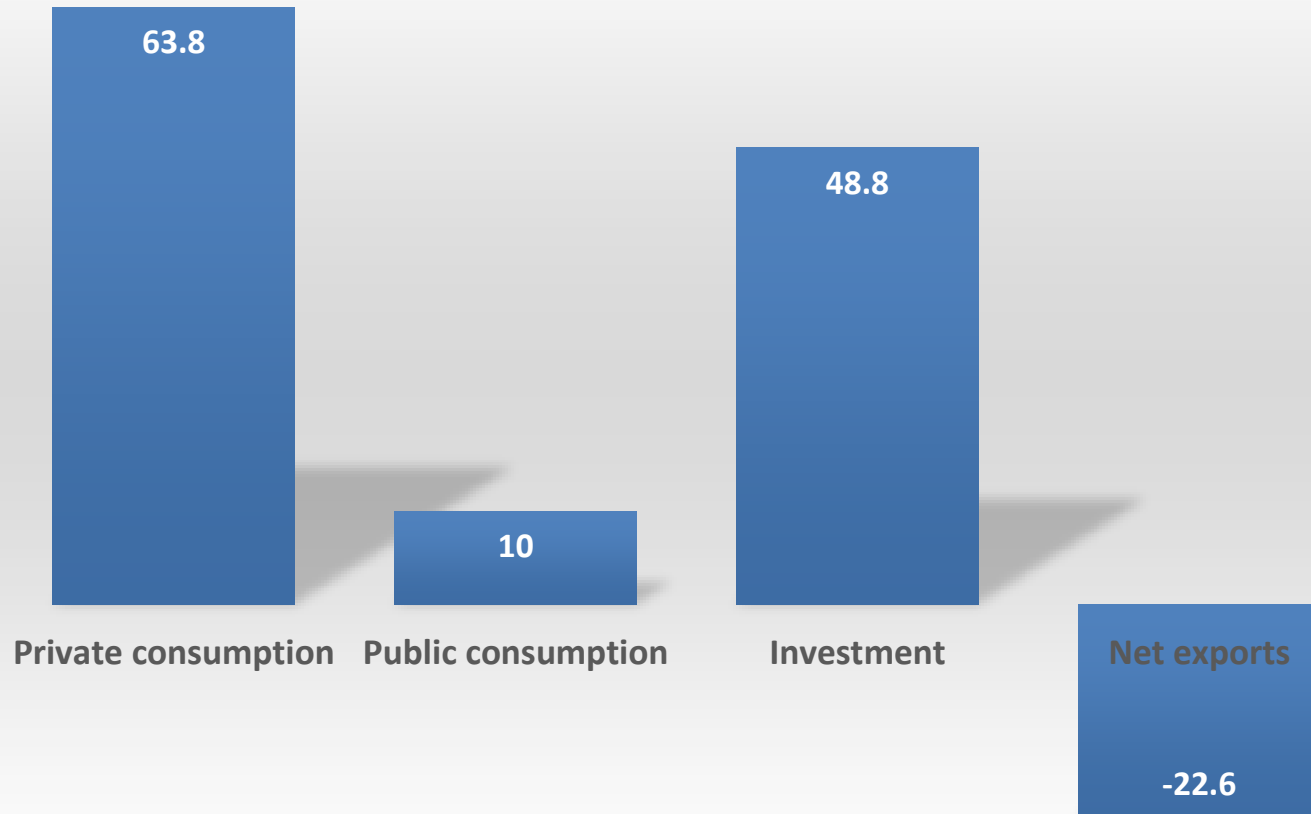
# Austrian Business Cycle Theory

- The theory views business cycles as the consequence of excessive growth in bank credit, due to artificially low interest rates set by a central bank
- The Austrian business cycle theory originated in the work of Austrian School economists Ludwig von Mises and **Friedrich Hayek**, who won the Noble Prize in economics in 1974.

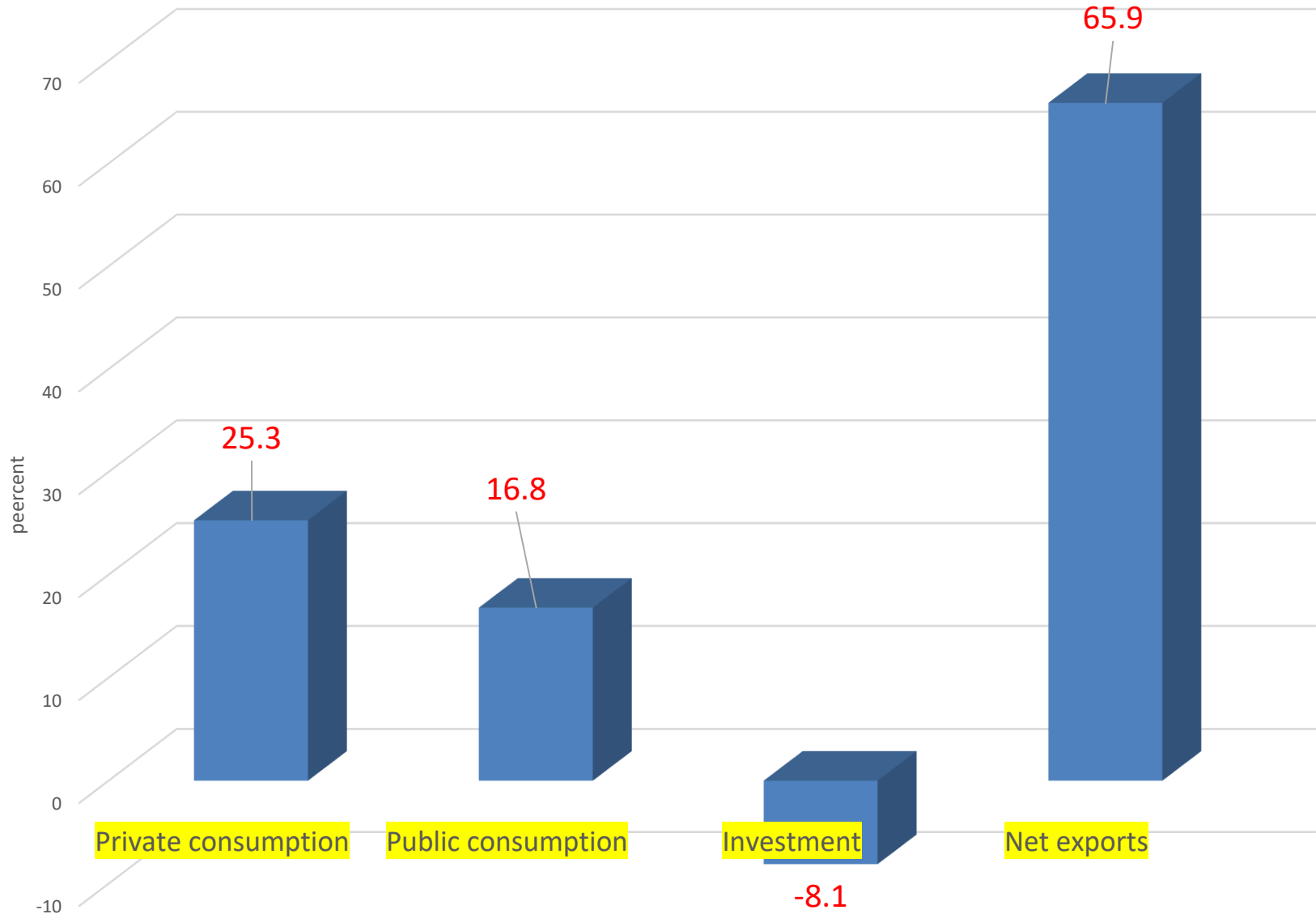
# Commercial Banks: loan/deposit ratio



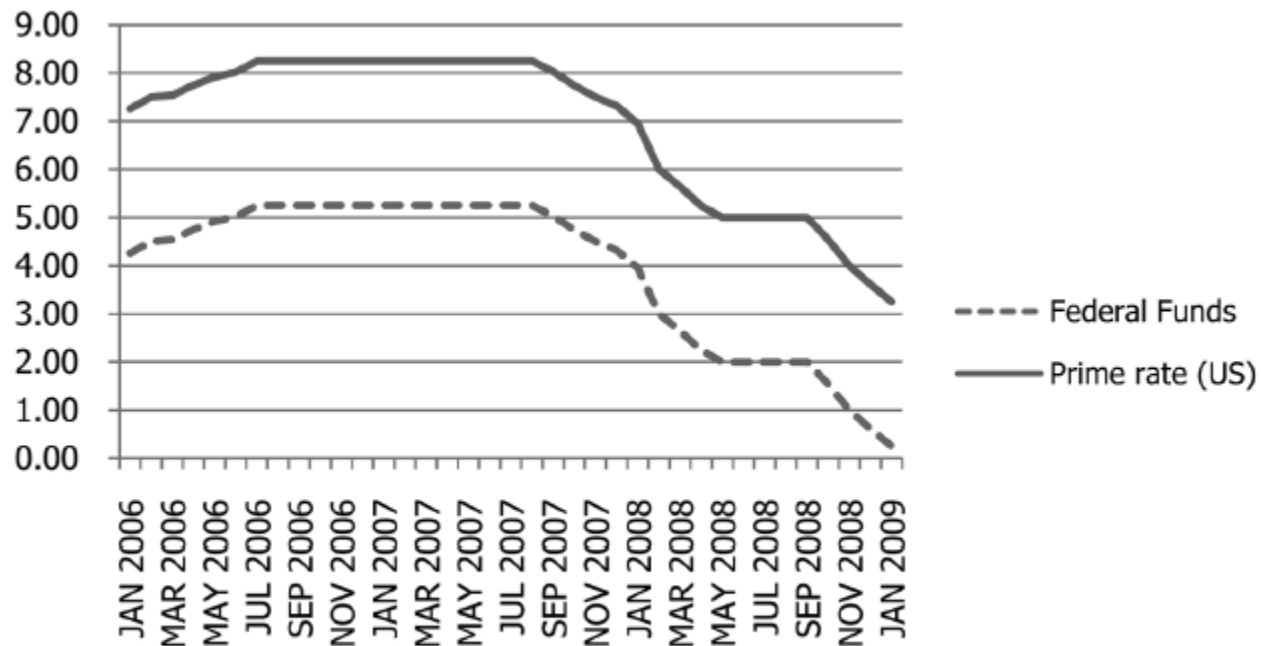
# Contribution to GDP growth: 1999-2005



# Contribution of GDP growth: 2006-2007

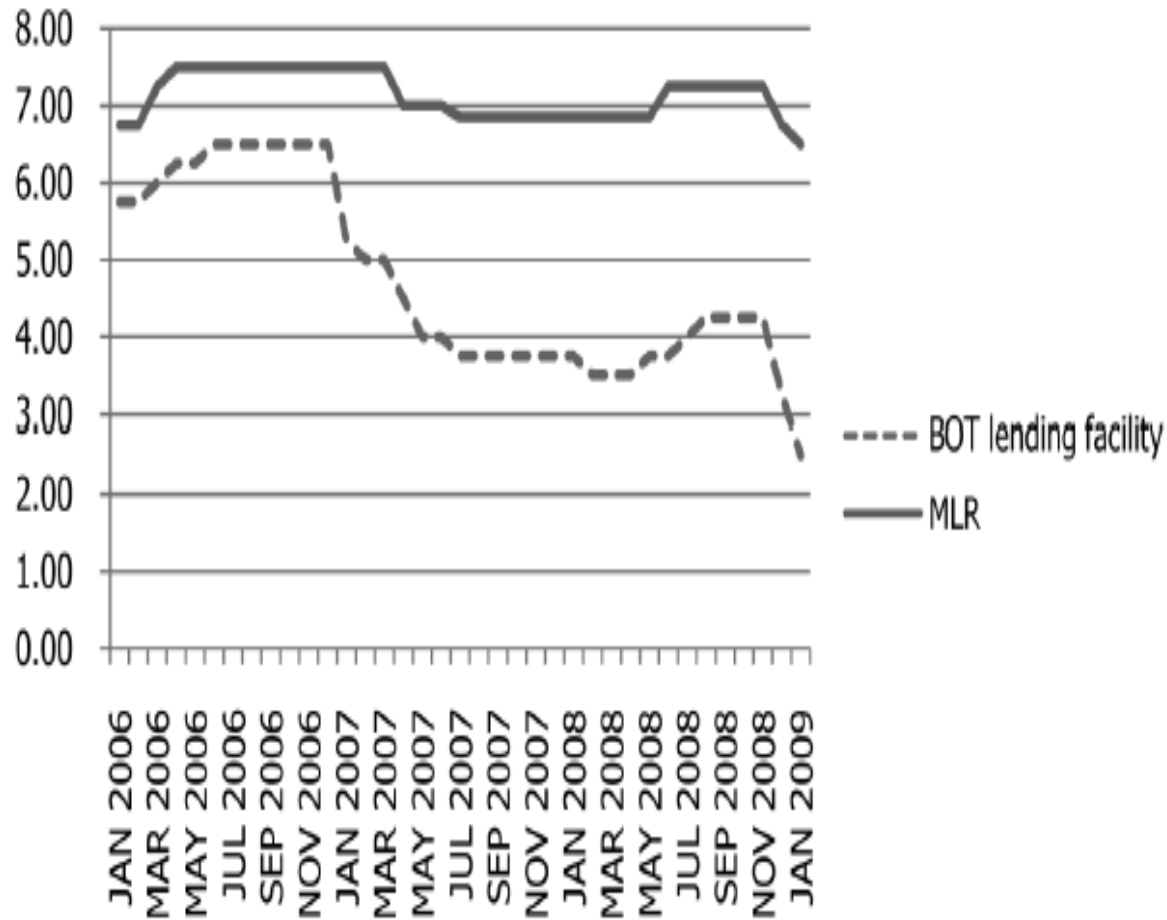


# The Federal funds rate and impact on US prime lending rate



Source: Bank of Thailand.

# The BoT key policy rate and impact on commercial bank Minimum lending rate (MLR)

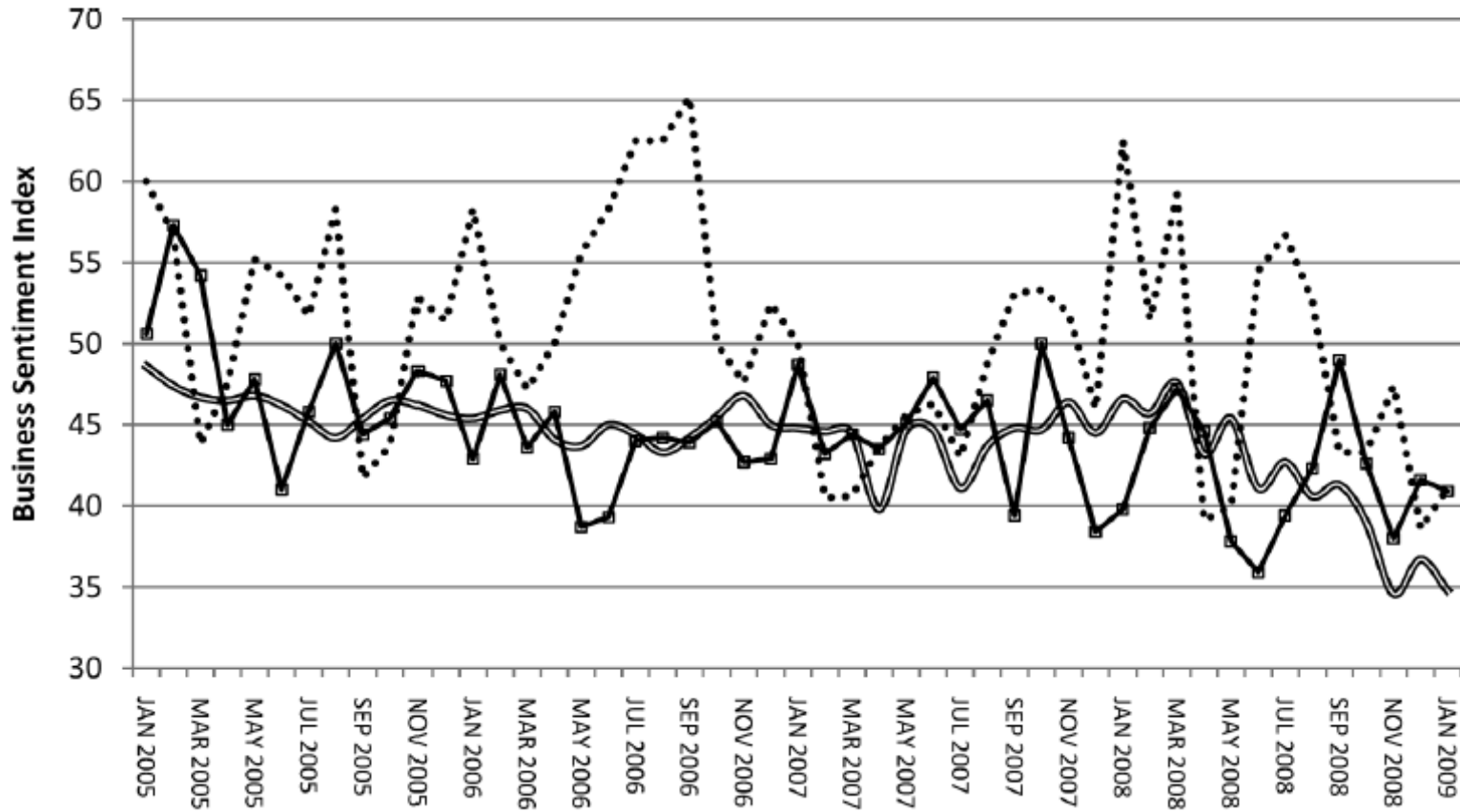


# Pessimism and effectiveness of monetary policy

- 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 (J.M.K)
- 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.

# When pessimism reigned in

Figure 6. Loss of business confidence



# Business Sentiment Index (BSI)

**Source:** Bank of Thailand

A survey of 1,500 business enterprises

Index = 50 indicates that business sentiment remains stable.

Index > 50 indicates that business sentiment has improved.

Index < 50 indicates that business sentiment has worsened.

# Strong rule of law is required to regain investor positive sentiment and consumer confidence

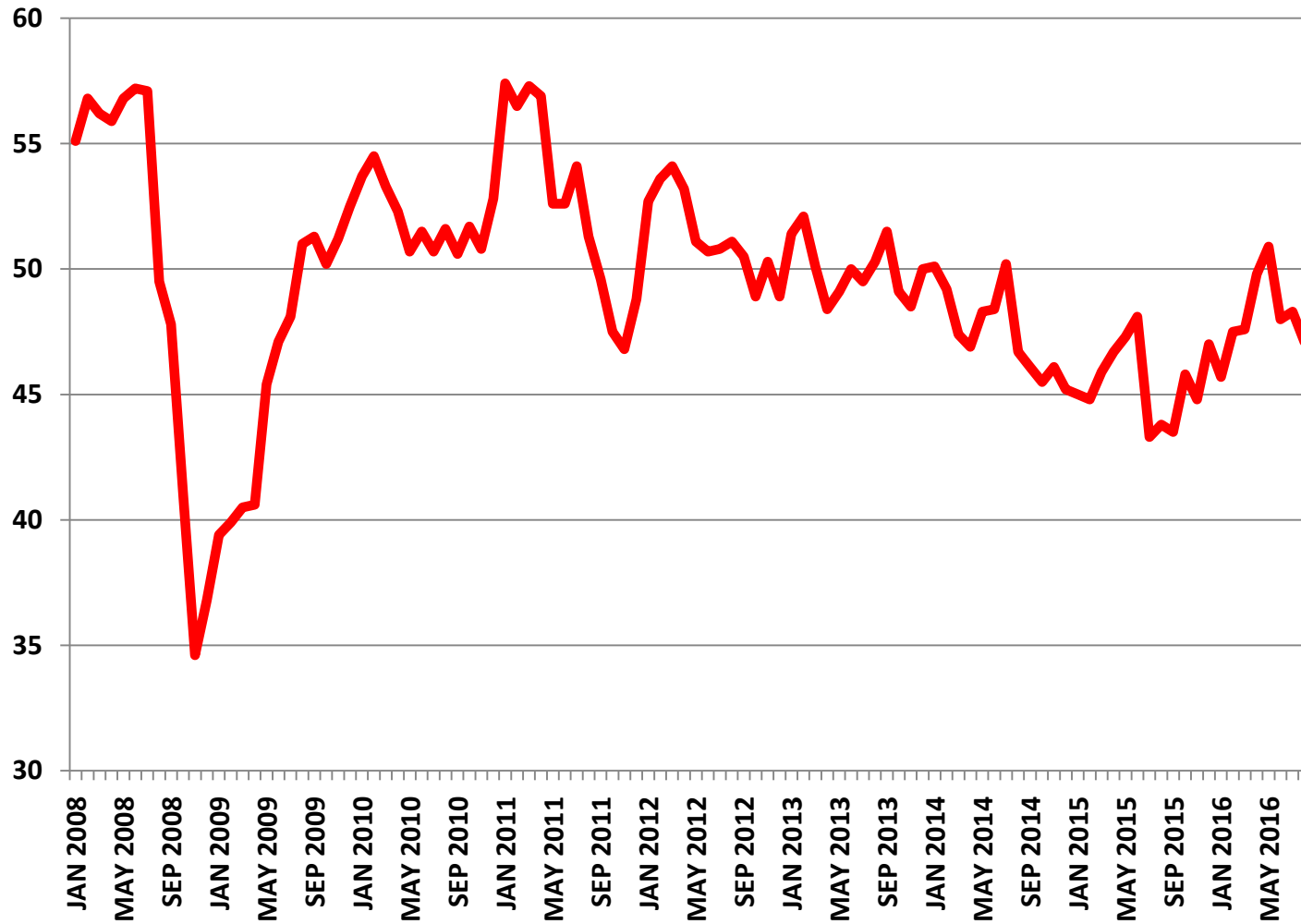
- Business sentiment can be restored and maintained by policy consistency.
- If the government and the public adhere to the rule of law, political shocks can be minimized as a concern for fairness would be eased.

## Weak rule of law and rampaging corruption destroy investor and consumer confidence

- 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.***
- Business Sentiment Indexes are constructed into four different areas: Output prices, domestic and foreign orders, and liquidity.

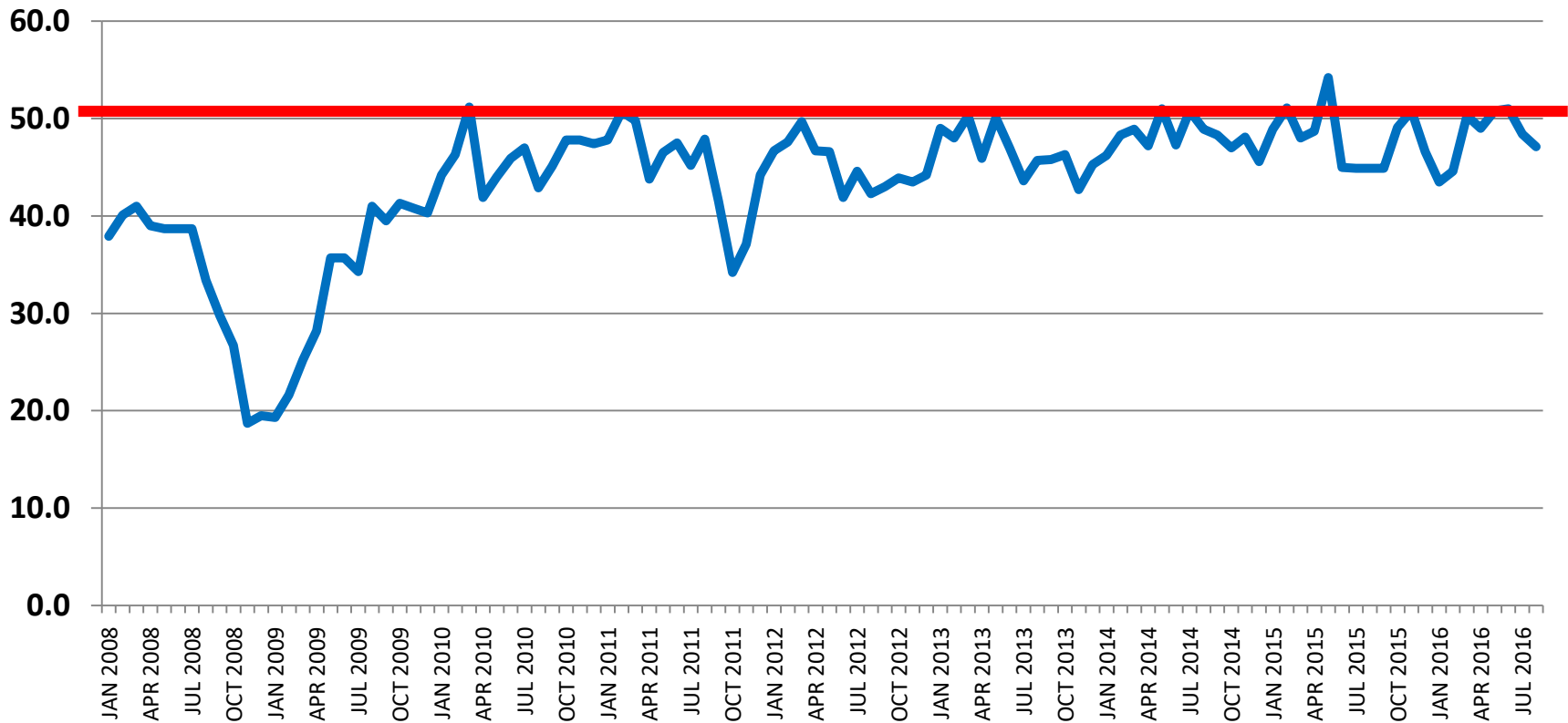
# Business Sentiment Index I

## *output prices*



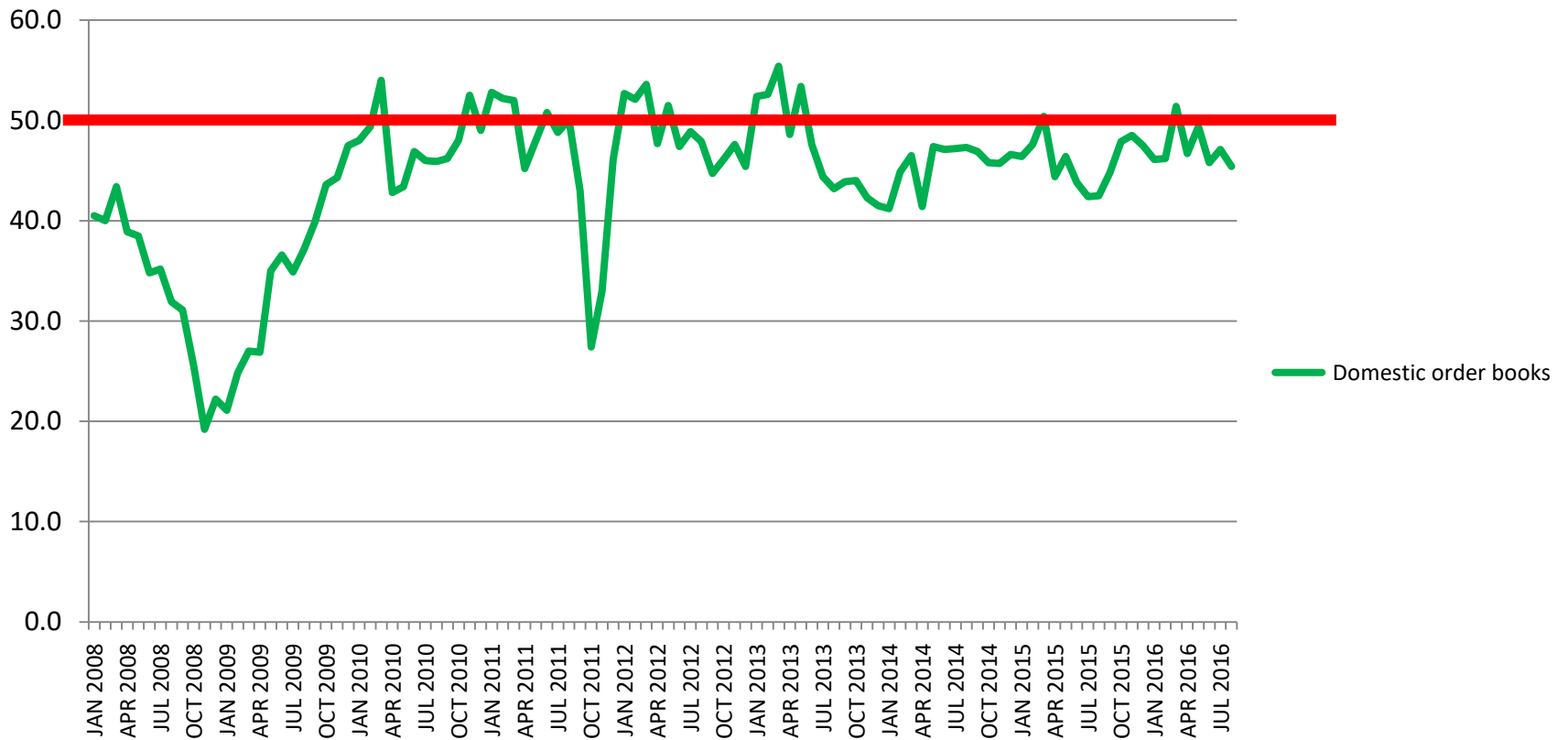
# Business Sentiment Index II

## *Foreign order books*



# Business Sentiment Index III

## *Domestic order books*



# Short-term gain, long-term loss?

- Fiscal policy is the only remaining policy 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

# Effectiveness of Thailand's Macroeconomic Policy Response to the Global Financial Crisis

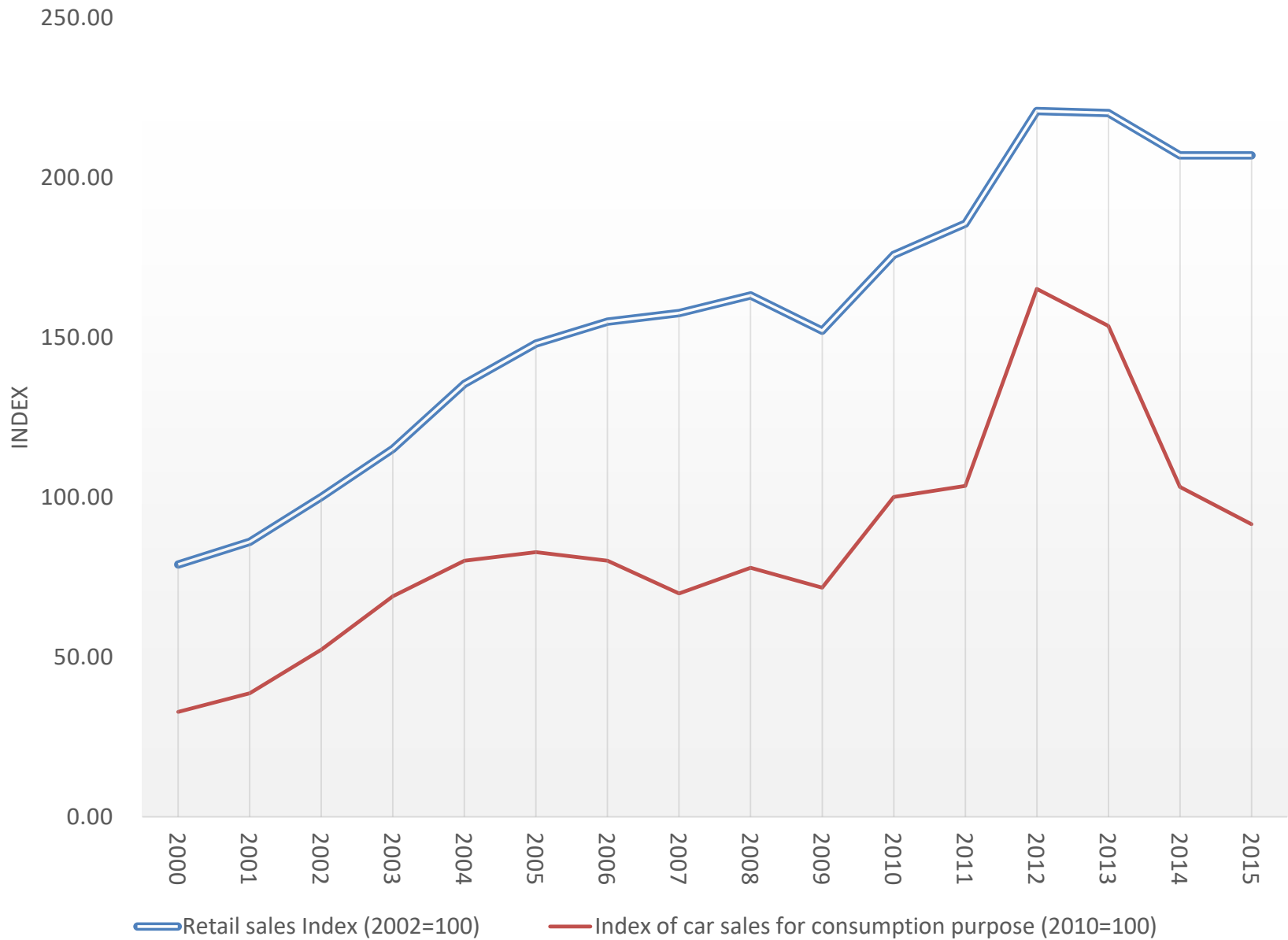
**Bhanupong Nidhiprabha**

*This paper investigates Thailand's macroeconomic policy responses to the global financial crisis in 2009. Empirical evidence found in this paper indicates that fiscal policy is relatively less effective than monetary policy. Tax reduction is more powerful in stimulating output than government spending. Maintaining undervalued exchange rates does not create the output expansion effect. Sustained economic recovery requires growth in the world trade volume and enhanced business confidence.*

**Keywords:** Thailand, output volatility, effectiveness of monetary and fiscal policy.

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# Private Consumption Indicators



# What determines consumption expenditures

- Traditional theories of consumption behavior: LCH, PIH, RIH, Random Walk Hypothesis
- Instant vs delayed gratification: The role of psychology
- Expectations about the future also play an important role
- The role of credit availability should not be underestimated

The year 2006 witnessed a fundamental change in Thailand's politics, which has a profound impact on the previously stable economy.

The economic outcome of policy responses to external shocks is influenced by the declining quality of institutions.

Political transformation through military coups, revolution, and civil war cycles involve high risk exposure to **output and consumption volatility** that would lead to serious economic crises.

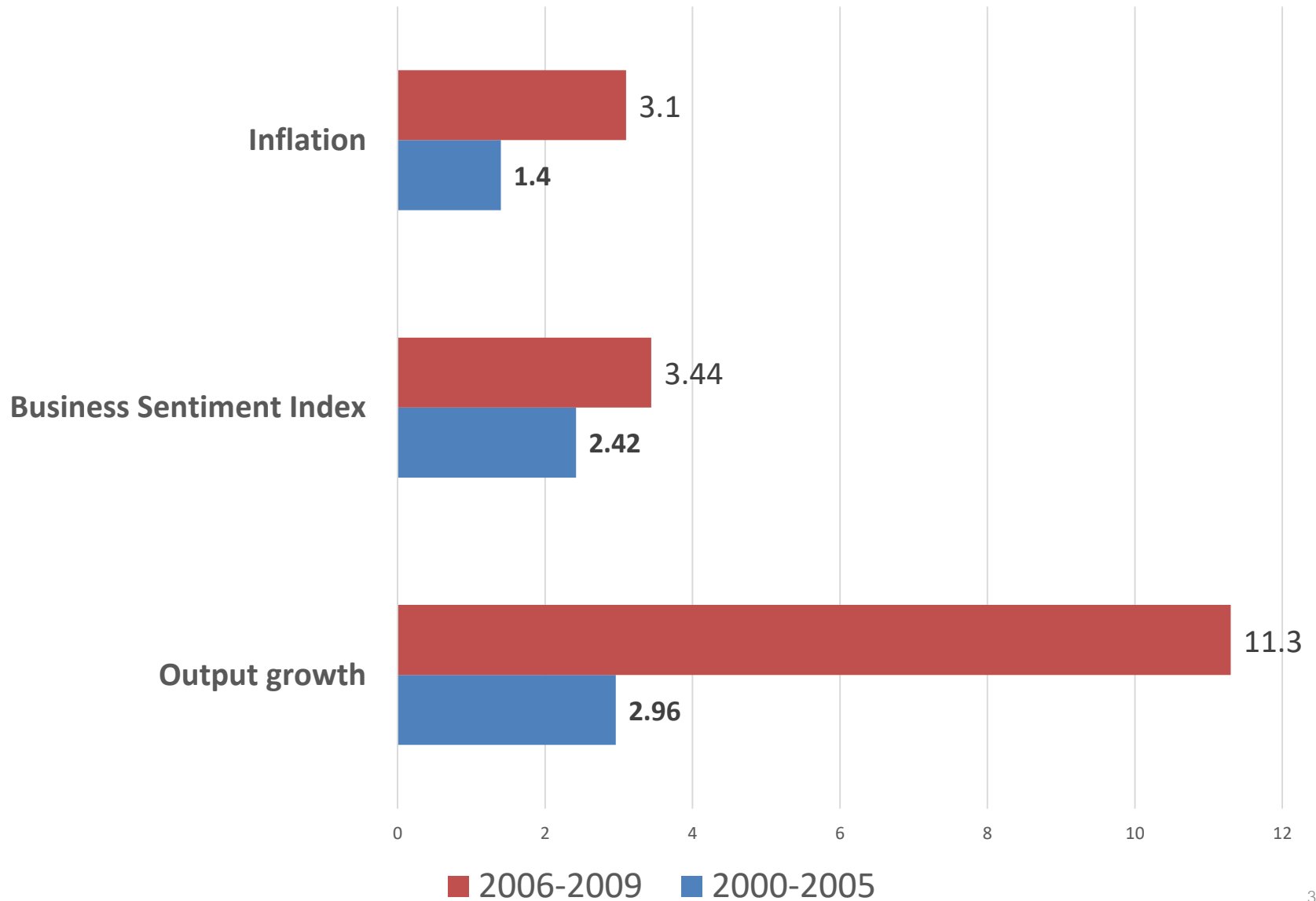
# Increasing volatilities after the 2006 coup: growth, sentiment, and inflation

TABLE 2  
Volatility in Output, Price, and  
Business Confidence  
(Measured by standard deviation)

|         | <i>Output</i> | <i>Business<br/>sentiment<br/>index</i> | <i>Inflation</i> |
|---------|---------------|---|------------------|
| 2000–05 | 2.96          | 2.42                                    | 1.43             |
| 2006–09 | 11.3          | 3.44                                    | 3.06             |

SOURCE: Bank of Thailand.

# Increasing Volatilities (standard deviation)

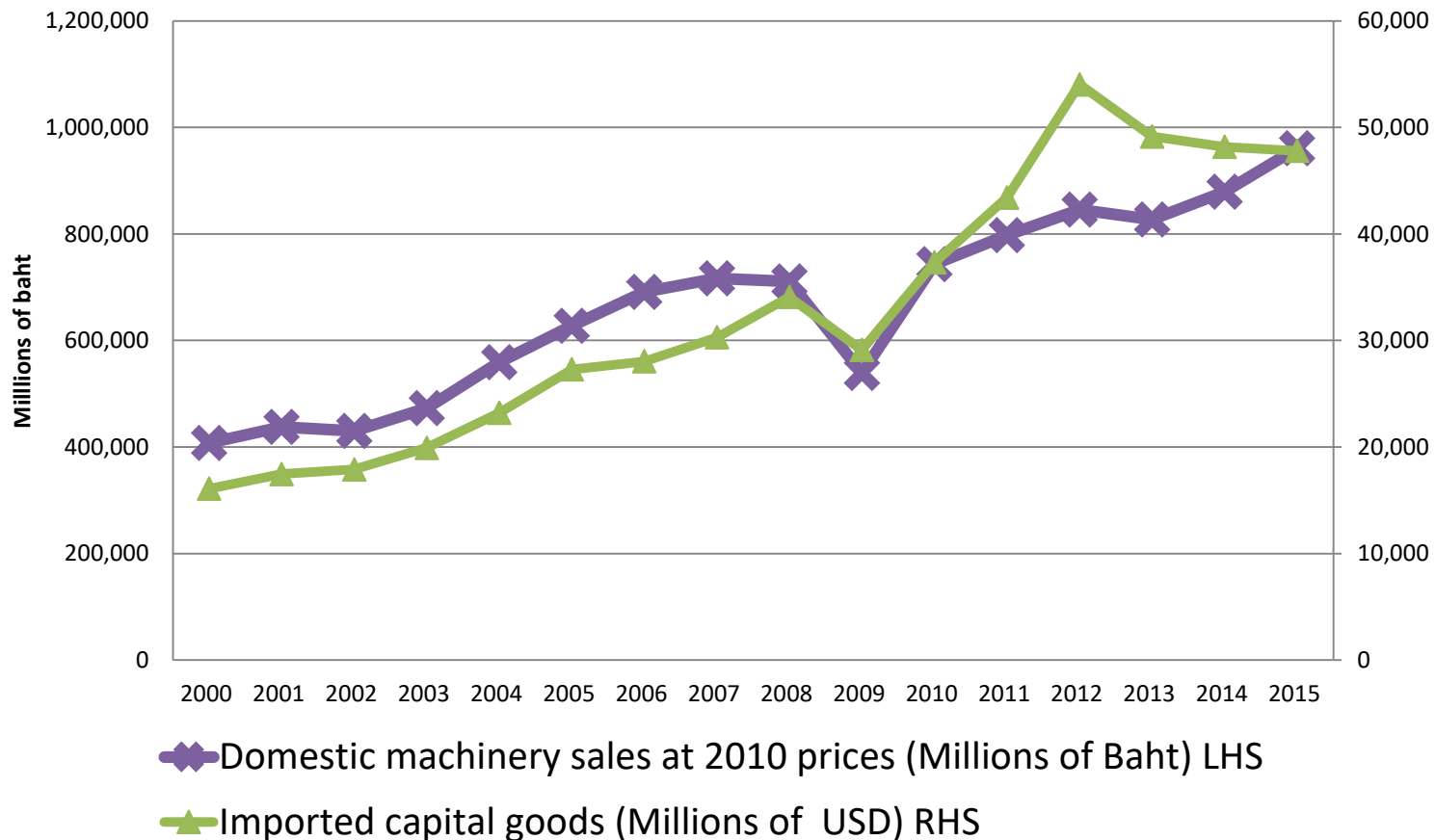


The effectiveness of policy responses depends on the government's ability to maintain the rule of law, accountability, human rights, and effective legal infrastructure.

Maintaining the rule of law implies predictable outcomes from court ruling of legal disputes. Investors can proceed with less concern about risk and uncertainty that may arise from policy inconsistency

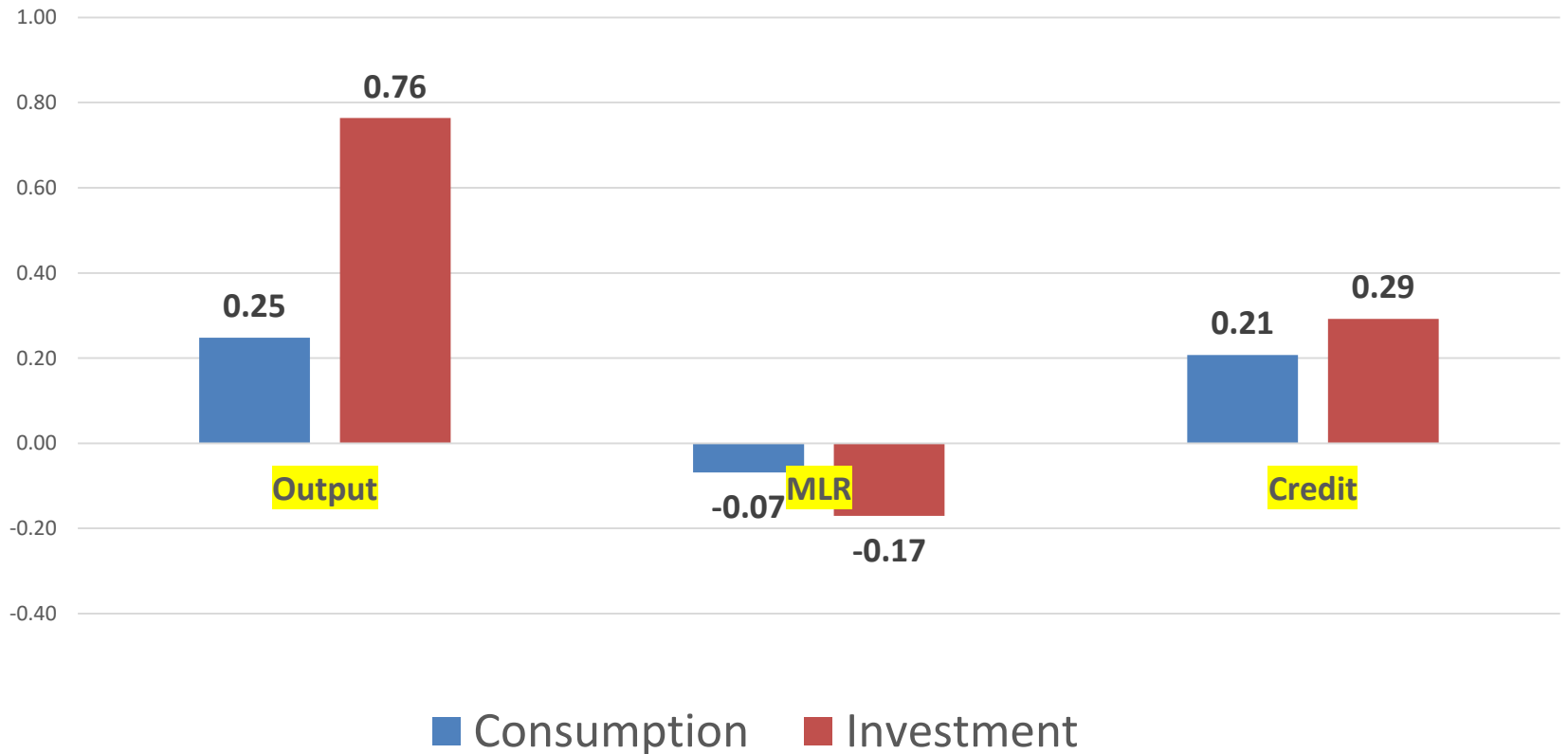
# What determines investment spending?

## Private investment Indicators



# Elasticities of Consumption and Investment expenditures (trend)

Source: FMOLS estimates (Jan 2000-June 2017)



If those policy stimuli can be used under a favorable investment environment, Thailand can recover quickly from the global financial crisis and would have been subject to lesser adverse consequences of the global recession.

Thailand has sufficient policy instruments to respond to fluctuations in the global export demand, but those policy instruments must be selectively chosen to ensure maximum impacts on stabilization.

# Fiscal policy is less effective than monetary policy

- Recall the Mundell Fleming model
- When exchange rate is fixed, fiscal policy work like a charm
- But when exchange rate is allowed to change, fiscal policy become less effective as the exchange rate hinders rather than help the fiscal stimulus.

Monetary policy remains effective despite the high degree of capital mobility because its impact on the exchange rate intensifies the initial impact of monetary policy on the aggregate demand.

These macroeconomic policies would be more powerful with accompanying measures to boost consumer confidence and business sentiment to nourish the animal spirits of investors.

Currency appreciation does not necessarily lead to output contraction.

When consumption and investment spending are constrained by poor business sentiment and weak consumer confidence, the recovery must come from the rebound of export demand.

What determines Thailand's exports?

A sustainable recovery depends on the resumption of world trade expansion and regained consumer confidence.