

Chapter 1

Macroeconomic Perspective of Thailand's Economic Development The first three decades: 1961-1990

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1. Introduction

Economic development in Thailand can be thought of as a process that began when Thailand was forced to open trade to western countries through the Bowring treaty during King Rama V.¹ Incidentally, Japan was also forced to open its trade during the period of Meiji restoration. Trade expansion led to allocation of resources that reflects comparative advantage. With abundant land resources, Thailand chose to export rice and the emphasis was on commodities exports. In case of Japan, there was a structural change from commodity exports into manufactured exports. Japan's imports became exports and vice versa.² Japan's comparative advantage moved from producing agricultural products to manufacture products. Indeed, difference in initial conditions and development strategy has led to a stark contrast in the outcome of economic development between Thailand and Japan.

The first Development Plan (1961-1966) gave emphasis on infrastructure investment and the promotion of private investment. Important economic institutions were established in this period: Board of Investment, National Economic and Social Development Board (NESDB), Bureau of the Budget, and Fiscal Policy Office. Development strategy adopted import substitution approach. In the second Development plan (1967-1971), import substitution was replaced by export promotion policy; its impact was not obvious until after 1970, when the share of exports in GDP began to rise rapidly, reaching 35 per cent by 1990. In the third economic and social development plan (1972-1976), focus was shifted to investment in rural area and education.

The 4th Development Plan (1977-1981) gave importance to security spending. The political turmoil during that period initiated the development goal of reducing social gaps and restoring natural resources.³ By the 5th plan (1982-1986), it was realized that Thailand needed public and private cooperation in order to stimulate business investment, while rural development and investment could not be ignored. As growth decelerated below the potential path, the 6th plan (1987-1991) shifted back to maintaining economic growth and upgrading quality of life. It should be pointed out that development plans are reflections on economic development theories that constantly changed their emphasis of development strategy. Very often, development plans evolved around problems that took place during previous plans, reflecting the failure to recognize and anticipate them.

The chapter is organized as follows. Section 2 discusses how Thailand was able to return to the period of price stability after experiencing hyperinflation during and after the WWII. Section 3 describes the steady and stable growth path of output. Section 4 explains how the banking sector was developed to mobilize saving and circumvent shortages of internal

¹ See Ingram (1971) and Dixon (2004) for a thorough investigation of the early economic change in Thailand

² See Yasuba and Dhiravekin (1985).

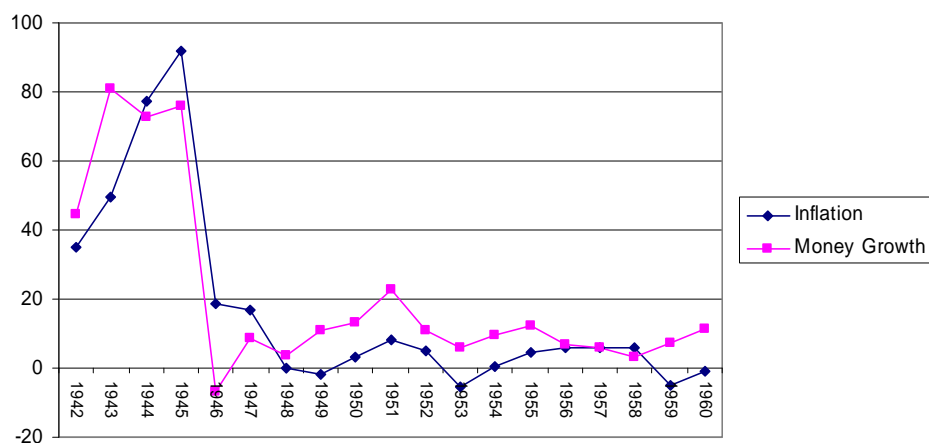
³ Lewis (1954), Hershmann (1959), Schultz (1963), and Seers (1968) are some examples of development theories that affect the formulation of Thailand's economic planning.

resources. Section 5 explains how the international trade sector became a growth driver of the economy. Section 6 observes the conservative fiscal policy and its flexibility. The last section provides concluding remarks on the remarkable achievement of the Thai economy during the first three decades of development.

2. Hyperinflation and resumption of price stability: 1948-1960

For money to perform its role as a medium of exchange and a store of value, the price level must be stable to create public confidence of the value of money they are holding. During the World War II, huge spending of Japanese military force in Thailand was financed by printing money. The rapidly growing money supply led to hyperinflation. The peak of inflation was reached in 1945; inflation registered 92 per cent. Money supply expanded at 76 per cent in the same year (Figure 1). This episode is a clear demonstration of the monetarist proposition that inflation is a monetary phenomenon. Monetary growth alone can explain the variation of inflation during this period by 75 per cent.⁴

Figure 1: Hyperinflation during the WWII



Source: International Financial Statistics

After the war, excessive growth in money supply was contained by the issuance of long-term government bonds to absorb excess money supply. Negative growth of money supply was observed in 1946 together with a plunge in inflation rate. Controlling the money supply is necessary to curb hyperinflation. Inflationary expectations can lead to a rise in velocity of money; thereby causing spiral inflation⁵.

Branches of foreign banks established in Thailand during this period mainly conducted business related to international trade. Indigenous commercial banks did not actively engage

⁴ The conclusion is obtained from a simple regression of inflation rate on corresponding monetary growth. The estimated coefficient of money supply growth is statistically significant.

⁵ Cagan (1956) states that if the elasticity of the demand for real money balance with respect to inflationary expectations is greater than one (in absolute terms), inflation could be destabilizing for the economy.

in mobilizing savings because the ability of savers was restrained by low income after the war recession. Commercial banks mainly engaged in financing foreign trade transactions. There were only 11 branches of banks in 1945. After the war, international trade expanded, requiring more banking services and more branches. For two years, the number of bank branches jumped to 72 for the whole country. Economic growth seems to be a factor leading the development of financial sector. Nevertheless, these branches were not able to attract savings because banking habit had not firmly rooted. Saving was carried out by gold hoarding, because gold was considered as liquid assets and status symbol. As a result, saving and time deposits amounted to only one percent of GDP in this period.

Commercial banks had no incentive to mobilize savings since there was no demand for loans. Limited investment opportunity did not generate demand for loan. Bank credit amounted to two percent of GDP. On the other hand, banks would not be interested in holding government bonds, which provided very low yields. The lack of lending and investment in assets reflected in a high level of idle cash balances held by banks. According to Yang (1957), the average holding of cash by banks to their deposits between 1947 and 1954 was around 34.5 per cent. However, the idle cash balances declined as the economy recovered from recession, when the demand for loan started rising.

Investment opportunity and liquidity were improved for commercial banks during the period 1955-60. New branches of commercial banks were established at the annual rate of 18.5 percent. The ratio of time and saving deposits to GDP was only 3 percent on the average between 1955 and 1960 because there were only 324 branches of commercial banks at the end of 1960. The increasing number of bank branches provided opportunities for financial savings that would otherwise had been put into physical assets or non-productive assets. Since both the ability to save, caused by rising per capita income, and the opportunity to save were available through rising expansion of bank branches, the only remaining factor for successful financial deepening process was the willingness to save, which depends on positive real interest rates.

Because hyper inflation was subdued, the internal value of the baht was stabilized after the war. However, the external value of the baht was still unstable. The shortage of foreign exchanges led the government to adopt a multiple exchange rate system, in which exporters and importers of commodities were subjected to different exchange rates. But when the multiple exchange rates were unified into a single and stable exchange rate in 1955, the stability of the baht exchange rate remained throughout the period 1955-1960. Currency speculation subsequently disappeared. The favorable financial environment provided a necessary condition for a steady increase in the demand for money in response to expanding economic activities.

The interest rate on government bonds was raised from 6 to 8 percent in 1956. Trescott (1971) pointed out that this change led to a great increase in the holding of government bonds by banks. Therefore, the government was able to rely on commercial banks to finance budget deficit. Consequently, the reliance on credit extended by the Bank of Thailand to the government was reduced. The implication is that government budget deficit was financed by non-inflationary means.

3. The period of stable and high growth: 1961-1990

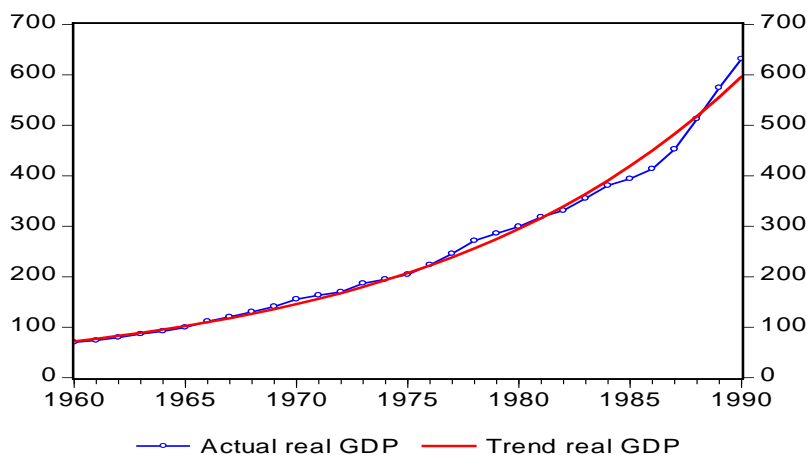
The period between 1961 and 1968 signifies the beginning of a new era of economic development. Both M2 and bank credit expanded faster than GDP, leading to steadily rising ratio of money and bank credit to GDP. The ratio of M1 to GDP reached its peak in 1961 and continued to decline, symbolizing the completion of monetization process.

The year 1961 was also the year in which the first economic development plan was implemented. The focus of Thailand's first economic development plan was on building basic infrastructure. The share of investment to GDP rose from 15 per cent in 1961 to 25 per cent in 1968. The average GDP growth rate of 8.1 percent and the average inflation rate of 2.2 percent led to a substantial increase in the demand for deposits in commercial banks. The low inflation rate during this period means that the real rate of return from bank deposits was positive. Until 1977, the tax exemptions on interests earned from saving and time deposits made holding bank deposits very attractive long-term financial savings.

From 1961 to 1990 real output moved in line with the annual trend growth path of 7 per cent expansion (Figure 2). There were some episodes that actual GDP was above the trend, as new engine of growth has emerged. On the other hand, actual GDP was below the trend because of the oil price shocks during the periods 1973-1974 and 1979-1980.

The slowdown in exports in the early 1980s as the result of the real exchange rate appreciation caused the output to grow below its potential level. The 1984 devaluation restored the international competitiveness. The Thai economy regained the pre-shock growth path rapidly after exchange rate adjustment.

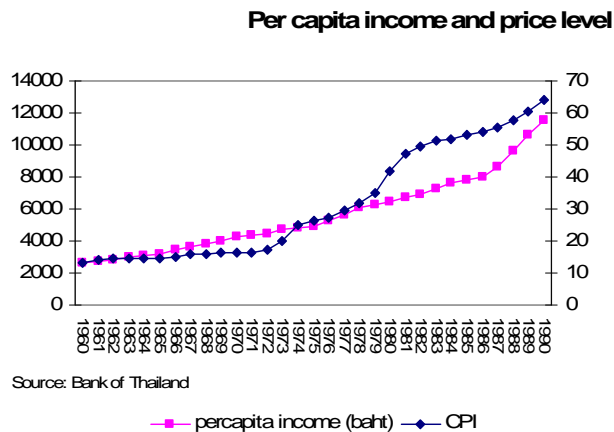
Figure 2: Stable growth path



Source: International Financial Statistics

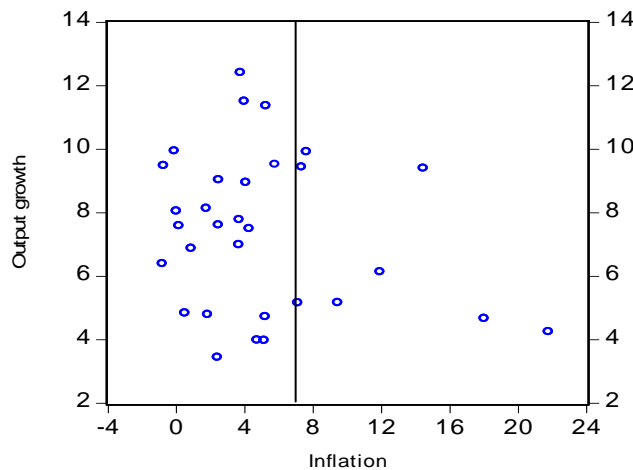
From 1960 to 2000, the exponential growth rate of population was 2.4 per cent, while the real GDP growth rate was 7 per cent. As a result, real GDP per capita increased rapidly during this episode of high growth and price stability (Figure 3).

Figure 3: Rising per capita income



The double-digit inflation was attributed to the two oil price shocks in 1974-75 and 1979-80. Inflation rate came down within a year after the cost-pushed inflation put upward pressure on consumer price levels. External shocks did not cause a runaway inflation as monetary growth rate were moderate. In Figure 4, if we ignore four years of double digit inflation, faster growth rates were achieved without accelerating inflation. There was no trade-off between growth and price stability during this period.

Figure 4: Growth with price stability



Source: Bank of Thailand

The terms of trade was also favorable in 1973 when the first oil shock struck. During this period there was no single year that the economy suffered from negative growth. In other words, the economy maintained positive growth, albeit experiencing a slowdown during the shocks.

Figure 5: Investment as engine of growth

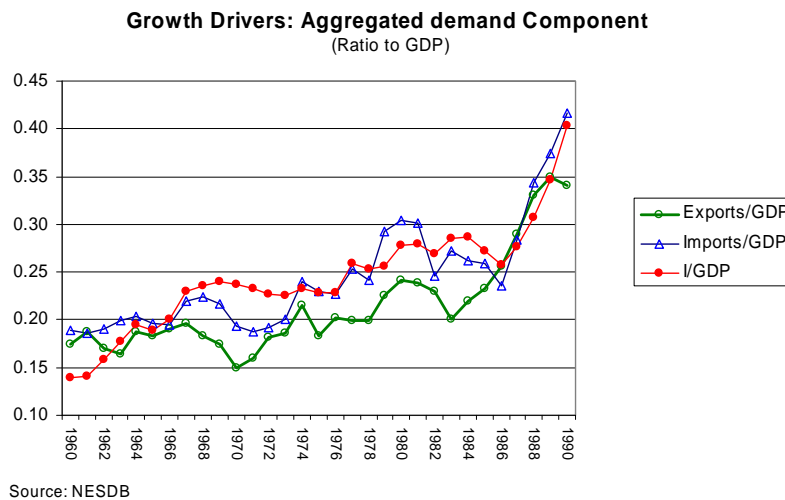
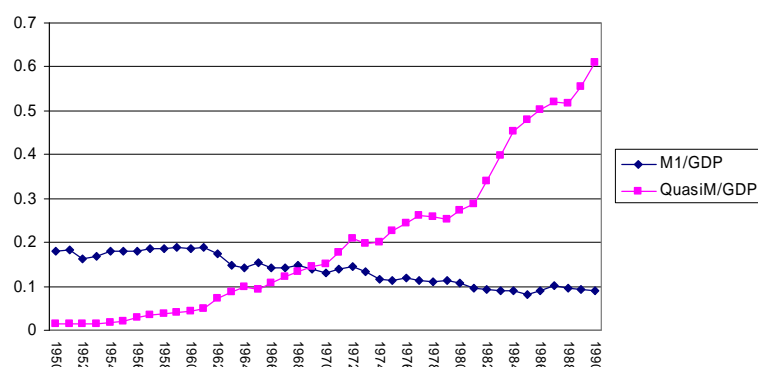


Figure 5 illustrates that growth was driven by investment. The share of investment in GDP increased rapidly from below 15 per cent to 25 per cent in 1980. Although imports rose sharply during the oil shocks, both investment and imports were highly correlated. A large part of imports was capital goods. Imported capital goods contributed to productivity improvement in the manufacturing sector, which in turn gave rise to competitiveness and enhanced export capacity.

4. Development of commercial banks

The conditions for successful financial development are the ability to save, opportunity to save, and willingness to save. The ability to save is determined by income level. At the early stage of development after the world war, when per capita income was low, financial savings were limited. The opportunity to save was opened the public only when banks established public branches to establish banking habit all over the country. When interest rates offered attractive rates of return, the public would be willing to part with their money in saving deposits. If deposits began to rise faster than output growth, the process of financial deepening would earnestly begin to take place. We will trace out various stage of financial development and stress the argument that growth in output took place because of stability in the financial sector that provides financial resources for efficient investment.

Figure 6: Financial wealth accumulation



Source: International Financial Statistics

The quantity of M1 was on the average 18 per cent of GDP during the period 1950-1954. When bank credit, time and savings deposits were small as a proportion of GDP, financial institutions did not play the role of financial intermediaries. Private investment was self-financed. Consequently, domestic investment of the private sector was constrained by the amount of financial resources at the beginning stage of economic development. When the real interest rate was negative, there was no incentive to save. Output determines savings, while the real interest rate dictates how much people would allocate their savings to financial savings. There is a strong correlation between the real net interest rate and the share of financial saving in total saving.

The year 1969 was important since it was the first time that the amount of time and saving deposits (quasi money) exceeded currency and demand deposits (Figure 6). The cross-over point between the ratio to GDP of the narrow money and the quasi money occurred in 1969. It indicates the rapid degree of financial deepening. Thailand has reached the stage where financial development process made the traditional role of money as a medium of exchange become less important than means of wealth accumulation and saving. There is also an implication on the velocity of money. As the country was transformed from predominant rural agricultural society to urban manufacturing modern sector, the demand for money increases as the degree of monetization became widespread. The banking habit was not firmly rooted, resulting in the rapid rising demand for broad money. As the velocity declined, the upward pressure on the price level was reduced. Infrastructure investment or money-financed public investment projects did not lead to inflationary pressure. Price stability was secured despite strong economic growth.

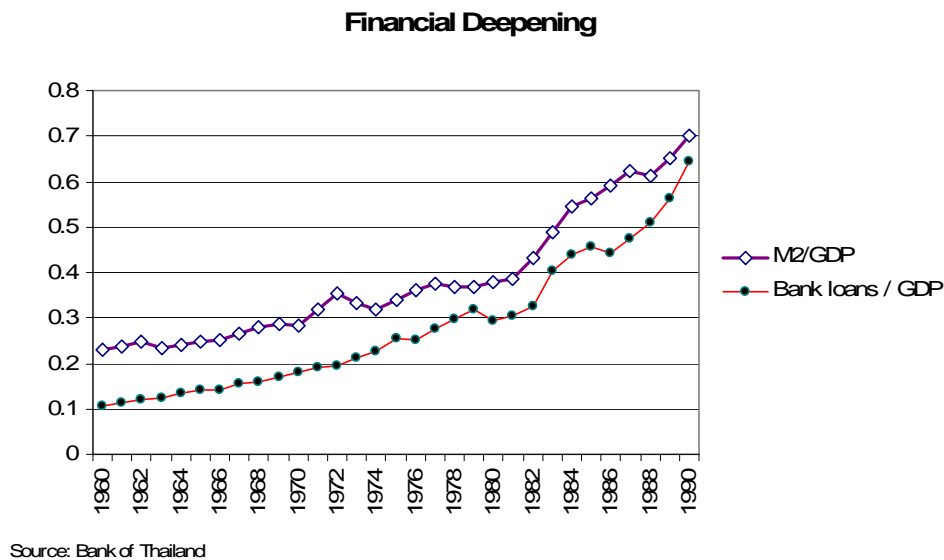
The stock market of Thailand was established in 1975 to promote long term funds for investment. The market capitalization was less than 5.0 per cent from 1975 to 1985. However, during the two-digit growth period after 1987, there was significant contribution from the capital market. Nevertheless, Thailand is still a bank-based economy.

Utilizing data from 1960 to 1990, from a simple double log regression, the estimated income elasticity of demand for loan and quasi money (saving and time deposits) were 1.4 and 1.6 respectively, while the income elasticity of the demand for M1 was 0.82.

For this reason, bank loans and M2 increase faster than GDP (Figure 7). As a result, we observe a steady increase in the degree of financial deepening. Rapid capital accumulation was permitted by availability of bank credit. The broad money supply has a long run

relationship with bank loans as banks' main source of loanable funds were time and saving deposits. The rise in the ratio of M2 to GDP can be thought of an indicator of economic development (McKinnon, 1973).

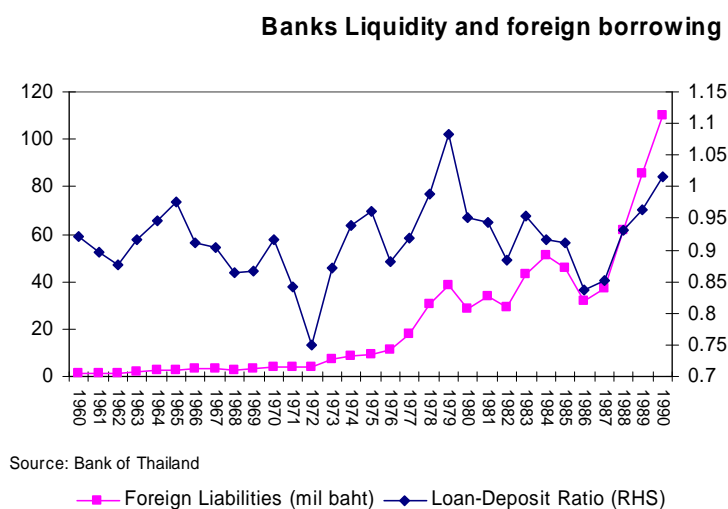
Figure 7: Index of economic development



During the transformation of agriculture to manufacture, the demand for money would increase. As a result, we would observe an increase in the demand for money and a fall in velocity of money.⁶ The implication of the declining in velocity is that government spending through monetary expansion would not create inflationary pressure on the economy. This is another reason why Thailand was able to maintain price stability during the early stage of development that ignited by infrastructure development though foreign borrowing.

⁶ Driscoll and Lahiri (1983) founded evidence that as developing economies transformed from predominant agriculture to manufacture, velocity of money would decline as the demand for money increased.

Figure 8: Overcoming limited domestic savings



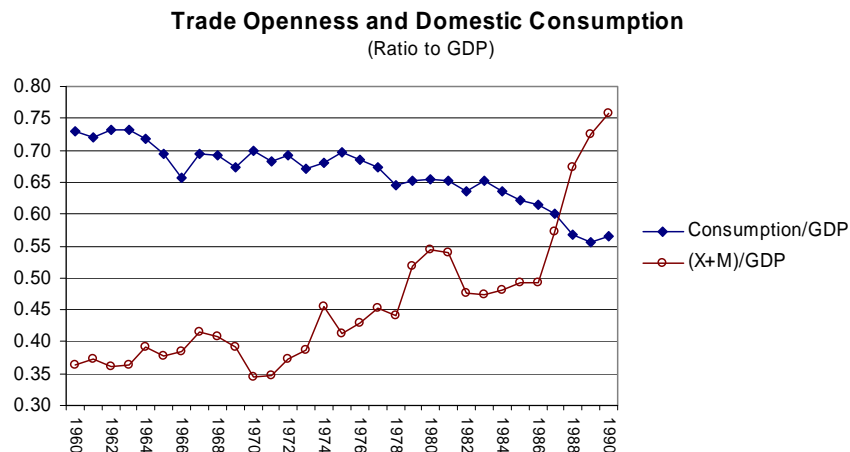
As banks expanded their lending to the private sector, they demanded deposits from household. The increase in the loan-deposit ratio indicates the shortage in liquidity in the money markets. Since 1973, commercial banks began borrowing from abroad as a new source of funds. The amount of foreign borrowings moved in line with the loan-deposit ratio (Figure 8). Financing domestic investment was no longer constrained by domestic savings. Commercial banks borrowed from abroad to circumvent low savings. The growth of the economy was not constrained by internal resources. Capital mobility through bank borrowing had enhanced output growth. It is not just foreign trade openness but also the financial openness that permit high economic growth during the first thirty years of economic development.

5. Development of the trade sector

As consumption share in the GDP declined between 1960 and 1990 (figure 9), the impact of an increase domestic demand on output growth was weakened. Fiscal policy would not be as powerful as in the early stage of development. Rising income level also gave rise to the higher rate of saving. The share of foreign trade (the sum of values of imports and exports) to GDP increased from 35 per cent in 1960 to 75 per cent in 1990. Openness in the trade sector was related to output growth. Exporters were able to exploit economies of scale and they were forced to improve their efficiency in order to compete in the world markets⁷.

⁷ See Johnson (1955) for early argument for using international trade to stimulate growth. Balassa (1979) provided early evidence of the impact of exports on economic growth in developing countries.

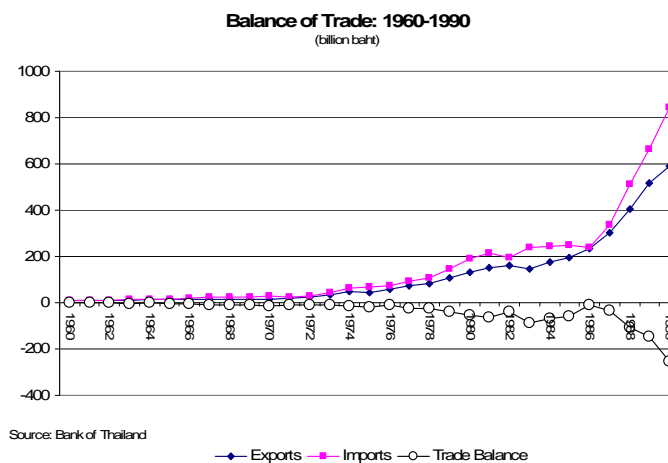
Figure 9: Trade-biased growth



Source: NESDB

In the first ten years of the implementation of economic development plan, trade deficit was insignificant (Figure 10). International trade expanded as the fixed exchange rate provided conducive environment with zero foreign exchange risk. As the trade deficit enlarged after 1978, the need for exchange rate adjustment became apparent.

Figure 10: Widening trade gap

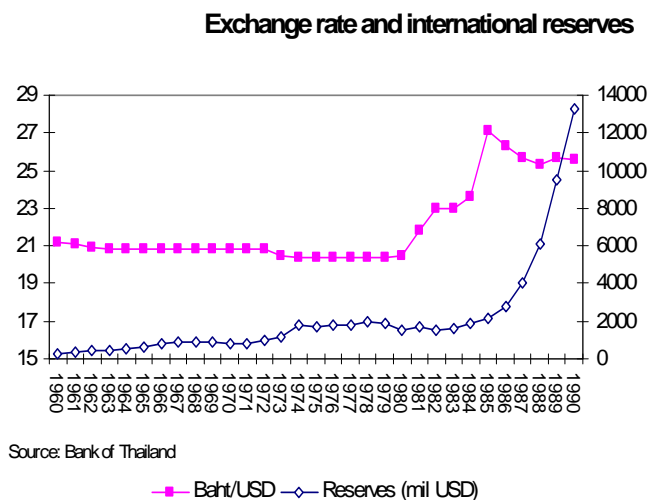


Source: Bank of Thailand

—◆— Exports —■— Imports —○— Trade Balance

Exchange rate adjustments became more frequent as the trade balance was widening. By 1990, the amount of trade deficit deteriorated further as the baht appreciated, despite the fact that the fiscal budget was in surplus. Thus the widening trade deficit was mainly due to enlarging investment-saving gap. High growth rate did not generate savings high enough to close the investment gap, which was financed through foreign borrowings. Despite the trade deficit and real appreciation of the currency, international reserves rose rapidly as the result of capital inflows. Dealing with excessive capital inflows has been a perennial problem to the Bank of Thailand.

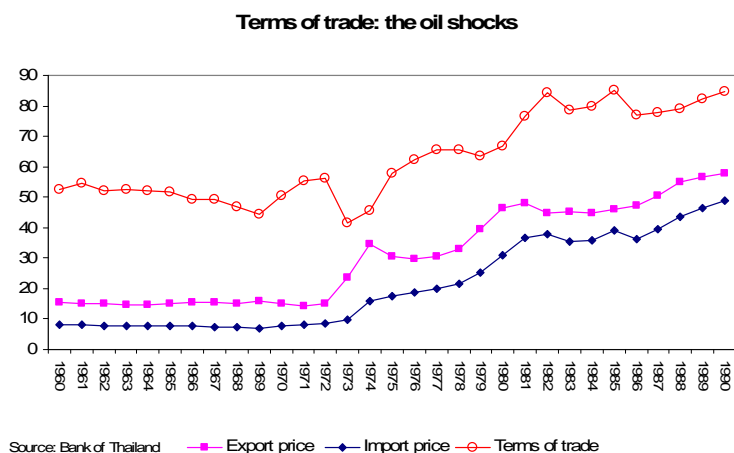
Figure 11: The virtue of the fixed exchange rate



In May 1981, the baht was devalued against the US dollar by 1.1 per cent, which was followed by another devaluation of 8.7 per cent in July 1981. Another major devaluation was undertaken in November 1984 by 14.9 per cent, which followed by another 1.9 per cent in December 1985. These devaluations were the policy responses to current account deficit stemmed from the loss of competitiveness caused by the baht appreciation against non-dollar currencies. The months of import covered international reserves declined steadily before the mid-1981 and the late 1984 devaluations. Since the baht was pegged with the US dollar, the appreciation of the US dollar against other currencies implied that the baht was strengthened, resulting in the loss of competitiveness in non-US markets. These devaluations were undertaken as all other measures failed to correct the current account deficit. The ceiling on the issuance of the letter of credit in 1983 and the 18 per cent ceiling on bank lending were imposed to avoid adverse political consequences of large devaluations. By using these indirect measures, the Bank of Thailand did not correct the root of the problem, which was the unrealistic exchange rate. Devaluations were quite successful as the level of international reserves increased sharply from the level of 2 billion in 1985 to more than 12 billion USD in 1990 (Figure 11). Both large devaluations did not lead to inflationary pressure. Nevertheless, the baskets of currency exchange rate system of Thailand continued to provide the stability of the bath-dollar exchange rate, as the weight of the US dollar in the basket was more than two-thirds and had been rising over time (Warr and Nidhiprabha, 1996). This practice led to the unsustainable current account deficit in the 1990s.

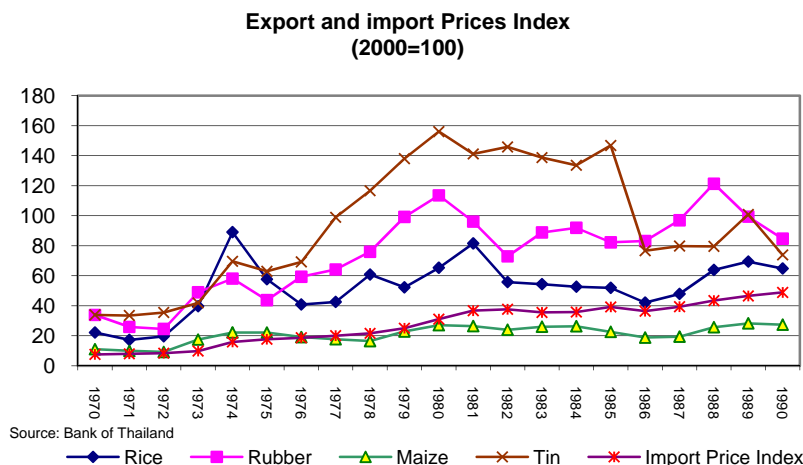
Export-biased growth tends to worsen a growing country's terms of trade. While export-biased growth pattern occurs in developing countries, developed countries experience import-biased growth. There is a possibility that the terms of trade decline so much that the country is worse off than if they had not grown at all--immiserizing growth (Bhagwati, 1958). This notion is not consistent with the case of Thailand (Figure 12). One of the reasons is that Thailand's structure of exports has gradually changed from exporting primary commodities such as rice, rubber, tin, and teak to manufactured products. Even if the terms of trade was unfavorable to agriculture, Thailand did not suffer much from deteriorating terms of trade between agriculture and manufactured products.

Figure 12: Terms of trade and the oil shocks



The terms of trade deteriorated marginally in the 1960s, because when oil price rose, export commodities such as rubber also fetched higher prices. The first oil shock in 1973-74 was compensated by higher commodities prices. As a result, Thailand was not affected very much by the oil shocks. In fact, the country experienced increases in export prices of primary commodities between 1974 and 1990 (Figure 13). During this period, the importance of agricultural exports had declined, while manufacturing exports became more dominant. The shift in the export structure prevented Thailand from the adverse effects of declining terms of trade of agricultural commodities.

Figure 13: Commodity booms



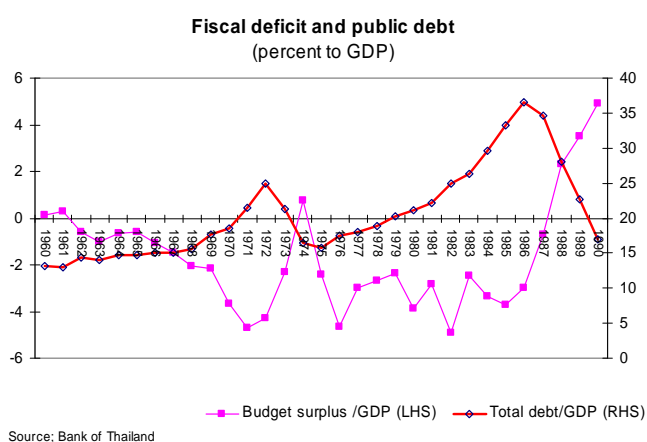
6. Fiscal position

Conservative fiscal policy of the Thai government in the early stage of development is evident in Figure 14. The government adhered to balanced budget principle during the regime of General Thamon administration (1964-1974). The size of budget deficit was larger in the early 1970s but the deficit turned around into surplus in 1974, because of the trade tax revenues. During the premiership of MR Kukrit in 1975, the budget deficit started growing due to his populist policy that injected money into villages in rural area. The budget deficit

was expanding during General Prem regime which began in 1981. By 1989, the strong growth of the Thai economy generated tax revenues and the country experienced substantial surplus budget, enabling the government to undertake trade liberalization program through tariff reduction.

Public debt is a mirror image of fiscal position. Figure 14 shows that as the public debt increased gradually in the early 1960s, the increasing trend was able to reverse as the budget deficit was curtailed. That reversal was observed again when the budget deficit was enlarged and the share of public debt started climbing from 15 per cent in 1975 to above 35 per cent of GDP in 1986. The ability to cut down budget deficit led to a sharp decline in the debt to GDP ratio, as a result of the turnaround in the fiscal position.

Figure 14: Fiscal sustainability



Fiscal discipline of the Thai government contributed to price stability. The budget deficit was not financed by printing money or borrowing from the Bank of Thailand. As debt burden declined, the government did not have large burden to service public debt; thereby having sufficient capital spending for infrastructure development.

7. Conclusions

The stable long term growth of the Thai economy was characterized by the average annual growth rate of 7 per cent between 1961 and 1990. The process of financial deepening led to price stability and strong economic growth. There are long run relationships among real output, money supply and bank credit. Trade openness led to rapid growth and transformed output structure of the Thai economy. During this period, the Thai economy experienced two oil price shocks, when inflation rose to two digits. Nevertheless, the economy adjusted back to price stability within a year. The problem with current account deficit was dealt with by two major devaluations in 1981 and 1984. After adopting a basket of currencies system, the baht exchange gradually returned to a fixed exchange rate system, where the weight of the USD in the basket of currencies had gained more weight over the years. This practice paved way to complication in the following decade.

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