EE 360: Thai Economy
Coping with the AFC crisis

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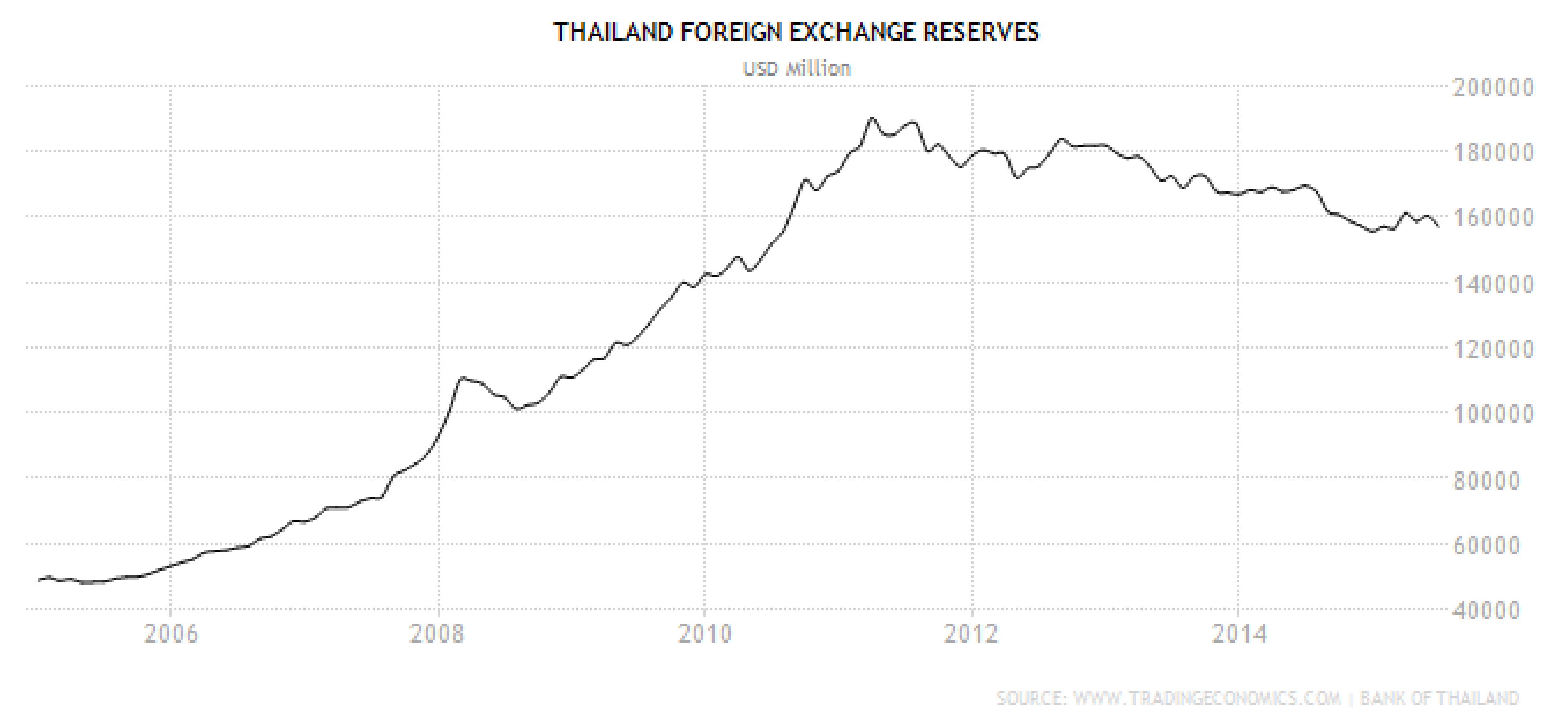
Lecture 5

18 years later
July 2, 1997

	December 1997	July 1, 2014	August 31, 2015
Baht/dollar	55.5	32.6	
International Reserves	$27 million	$167.5 billion	

The importance of foreign exchange reserves

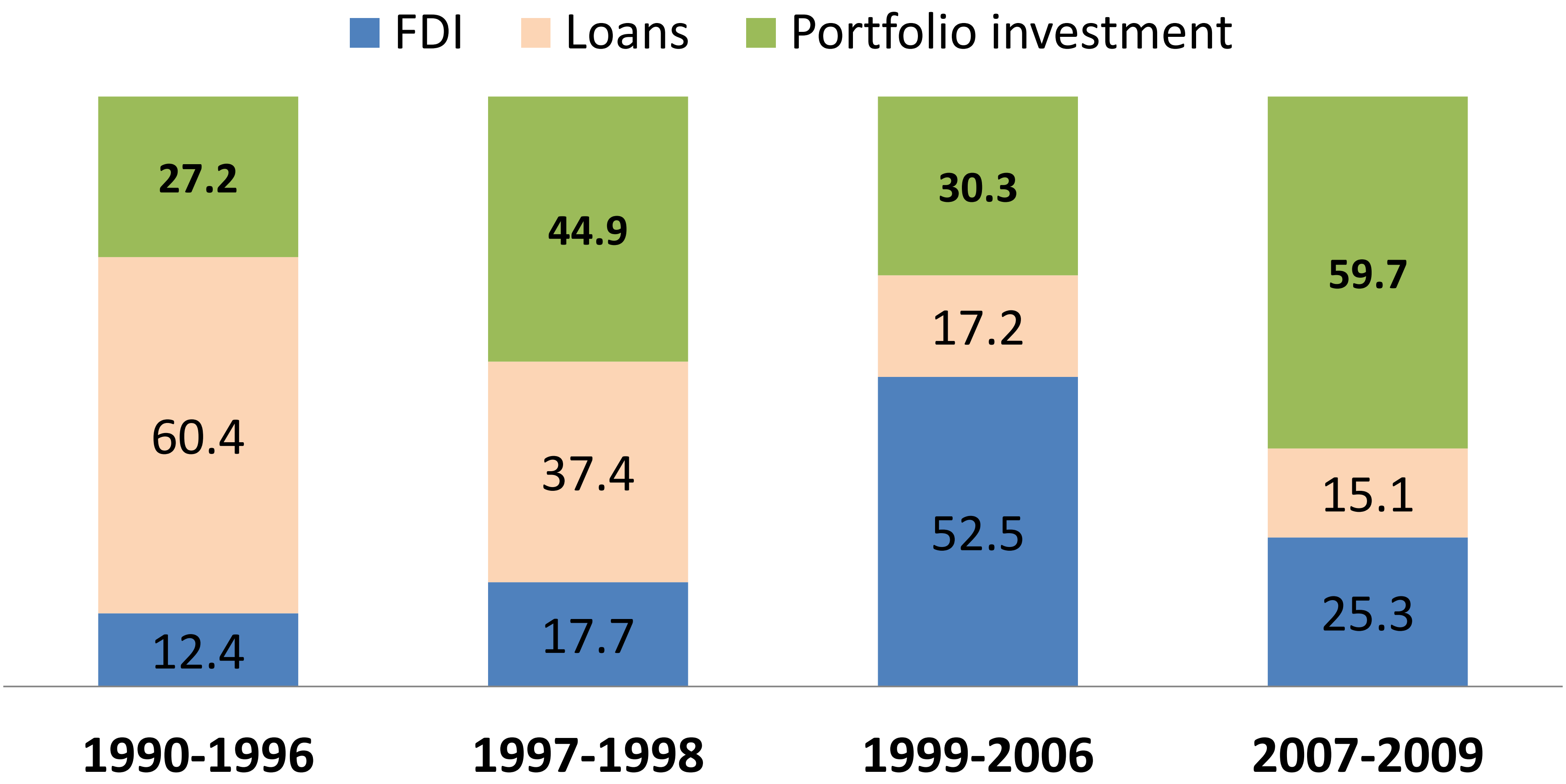


How do we measure reserve adequacy?

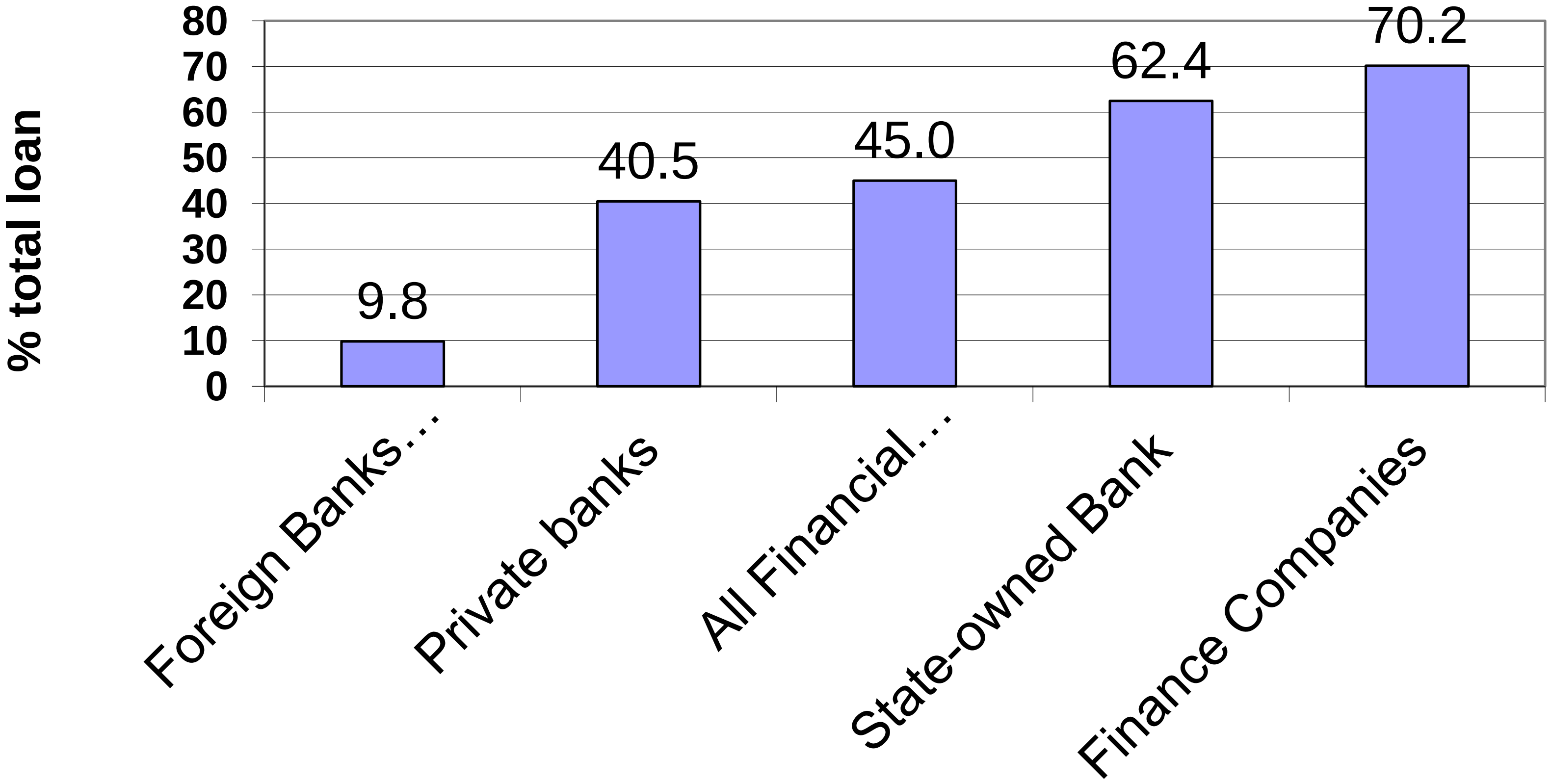
Outline

- Consequences of capital inflows
- Macroeconomic management and sustainable growth
- The roots of the financial crisis
- V-shaped recovery
- Lessons from the 1998 crisis
- Debt deflation

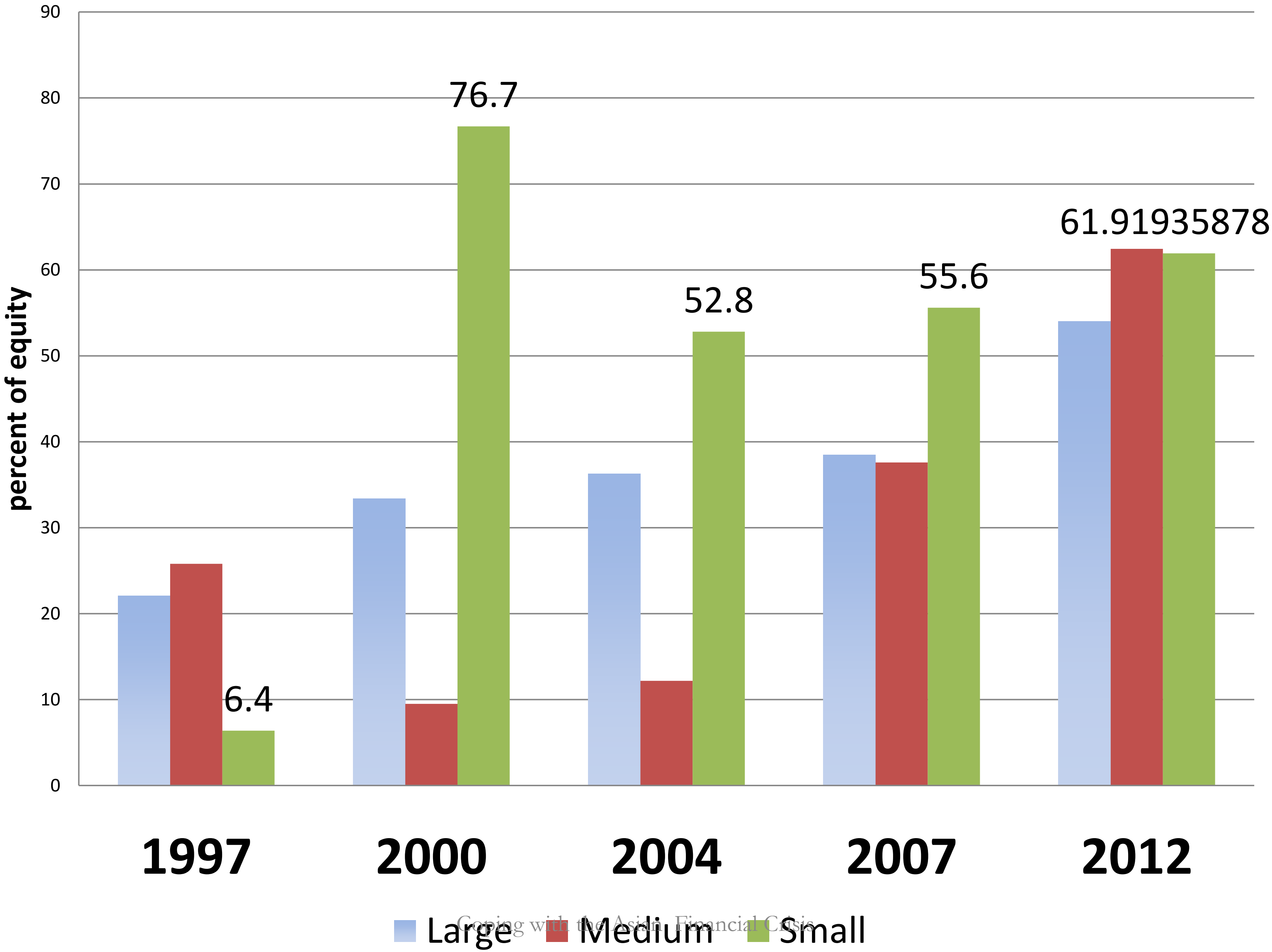
Changing structure of capital flows
% of total



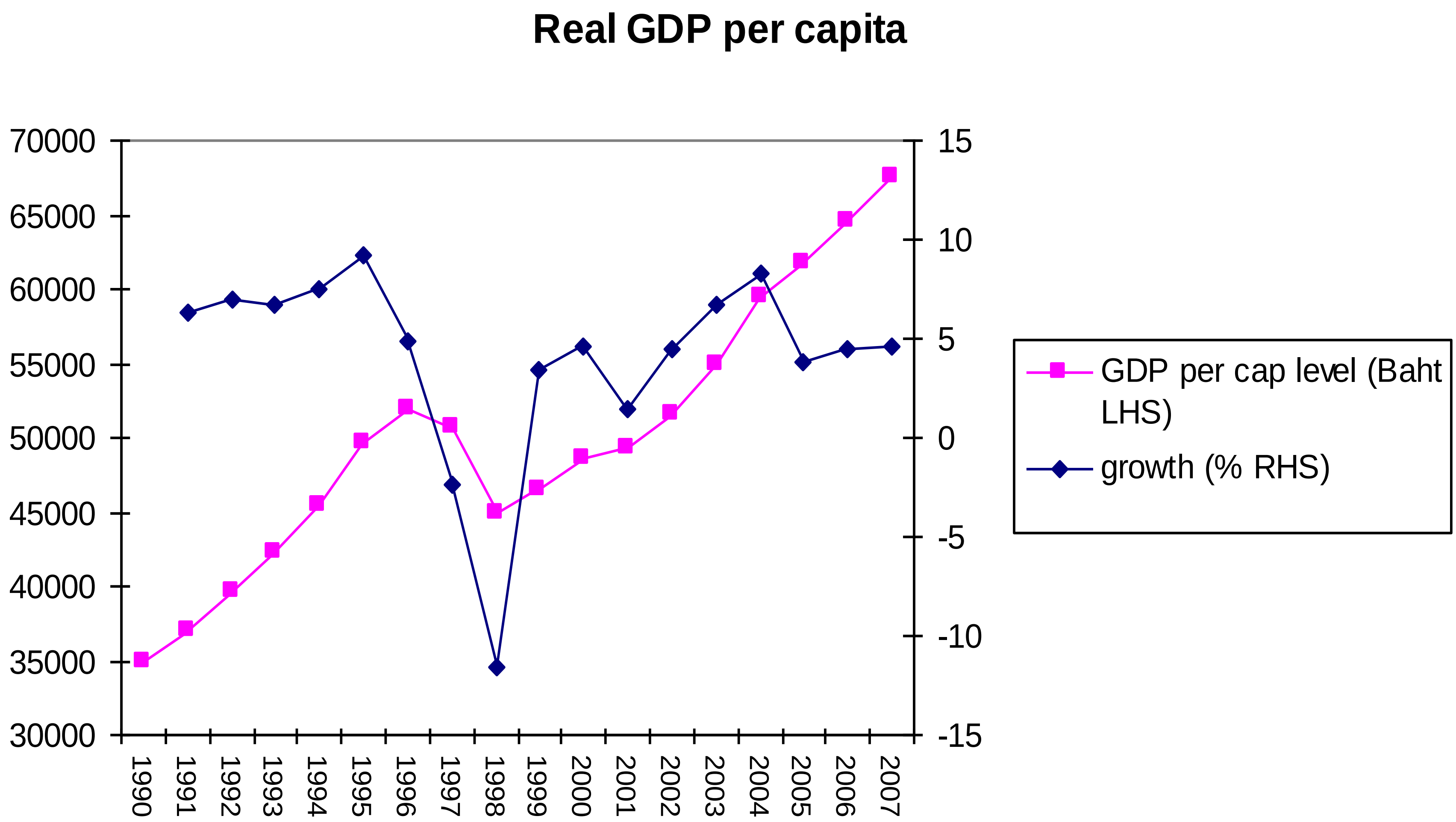
Non-performing loans in 1998



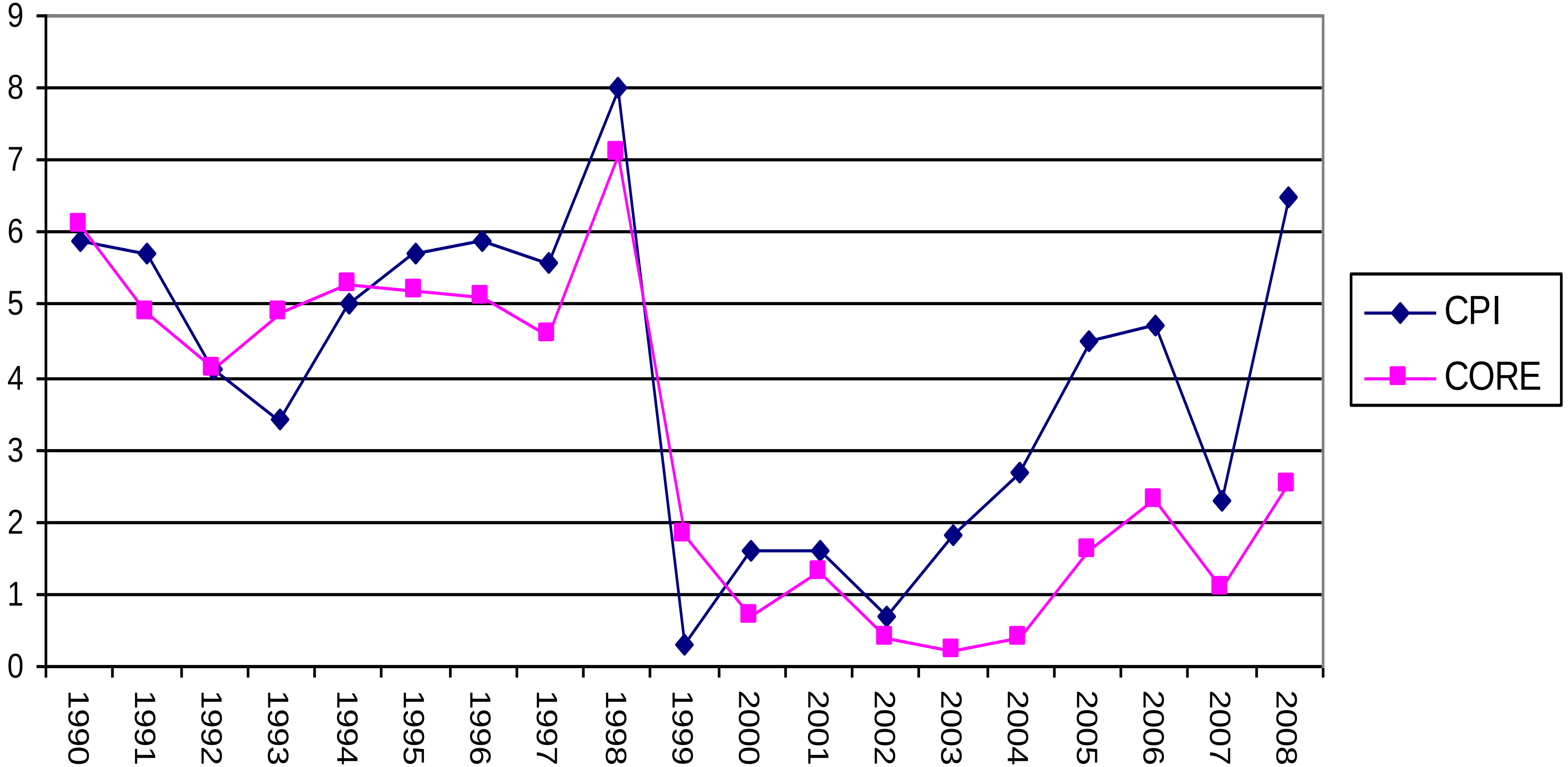
Foreign Ownership in Thai Banks



The V-shaped recovery



Headline and core Inflation



Source: BOT

Shocks and adjustments

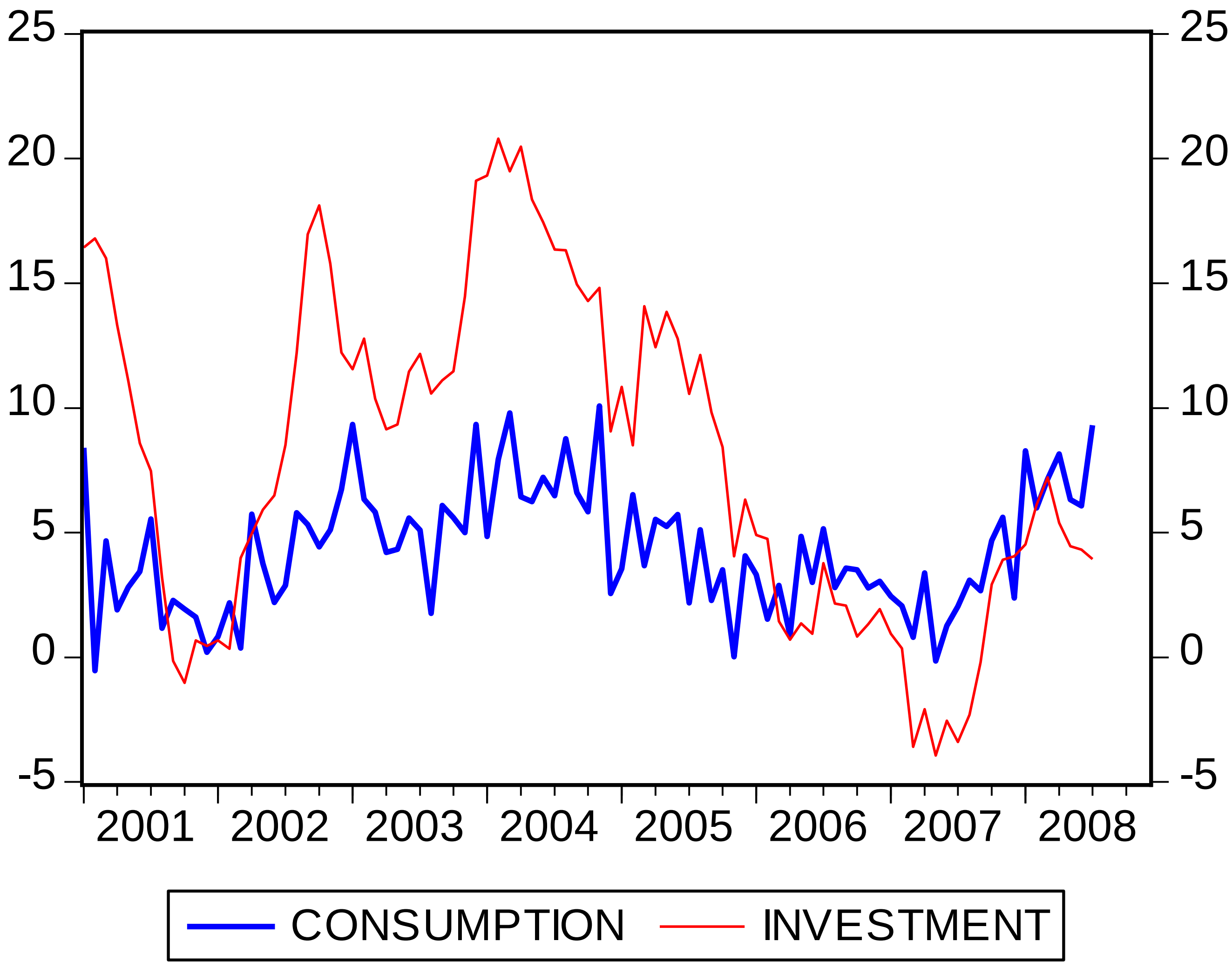
- There exist certain **mechanisms** in the structure of the Thai economy that would lessen the impact of the next economic crisis, whether the shock is internal or external.
- These shocks would not have a long-lasting impact and would simply reduce growth temporarily below a stable growth path.
- The 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

Long run relationship

Data on i*nvestment expenditures in the past can be used to predict current and future consumption*



Determinants of investment

- Accelerator model: change in sales or output
- Neoclassical theory of investment: interest rate and cost of capital goods
- Credit availability

Determinants of consumption expenditure

- Life cycle hypothesis of savings: smoothening consumption expenditures
- Liquidity constraints: consumption surges as credit availability increases

Trend (exponential) growth rate

percentage

January 2000-December 2008

	Consumption	Investment
Mean	4.4	7.9
SD	2.4	6.6
CV	0.54	0.83

CV= Mean/SD

The Thai labor market

- The flexibility of wage rates in Thailand helped mitigate the damaging effect of a sharp fall in output in the aftermath of currency crisis.
- What if downward rigidity exists?
- Unemployment declined as the economy gradually recovered from recession.
- Inflation remained subdued compared with global inflation.
- 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.
- Agricultural sector acts like 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.

Output growth by sector

1990-2007

	Agriculture	Industry	Services
Growth μ	1.8	6.8	4.6
σ σ/ μ	5.7 3.2	6.5 0.95	4.9 1.1
Correlation coefficient between the service sector)	-0.12	0.91	

Changing vs. switching expenditure policy

- To restore both external and internal balances, domestic demand (sum of consumption, investment and public spending) and the exchange rate must be allowed to play an equilibrating role .
- To reduce the current account deficit:

(1) imports must be reduced through output contraction (cut down domestic absorption);

(2) exchange rate must depreciate to switch spending from imports to domestic goods.

Economic Crisis

- A fixed exchange rate regime created an illusion of a zero foreign exchange rate risk.
- Premature relaxation of capital controls over borrowing in foreign currencies.
- The export shortfall in 1996 and widening current account deficit raised doubt about the sustainability of the baht currency peg.

Currency and financial crises

- With the baht succumbing to speculative attacks, the Bank of Thailand decided to float the baht on 2 July 1997.
- Without a nominal anchor and given the lack of policy credibility, the value of the baht fell 56% through January 1998.
- This large currency depreciation aggravated the foreign debt burden, causing a credit crunch, bankruptcy, and financial disintermediation.

Consumer confidence

- The loss of consumer and business confidence stemming from the expected recession exacerbated the contraction in consumption and investment.
- Domestic prices tend to fall.
- Until the exchange rate rebounded (appreciated) to the level determined by economic fundamentals, the economy would stay in the debt-deflation episode.

Pigou Effect

- C = f(Net Wealth/P)
- In theory, as pieces fall during recession, consumption can increase as real wealth increases.
- In practice, prices do not fall large enough to stimulate consumption to move the economy out of recession.
- Irving Fisher (1933) Debt-deflation theory of great depressions, Econometrica (1) no.4

Negative wealth effect

- If net wealth is negative due to rising foreign debt caused by massive devaluation, real debt burden increases when price level falls.
- Hence price deflation increases real value of debt, leading to further contraction of consumption and contraction of output.

Debt-deflation episode in Thailand

A fixed exchange rate regime can create an illusion of a zero-exchange rate risk, while premature relaxation of capital controls can encourage overborrowing in foreign currencies. Currency and maturity mismatching of Thai commercial banks generated their overexposure to external shocks. The export shortfall in 1996 and widening current account deficit raised doubts concerning the sustainability of the baht currency peg. With the baht succumbing to speculative attacks, the Bank of Thailand decided to float it on 2 July 1997. Without a nominal anchor and given the lack of policy credibility, the value of the baht fell by 56% through to January 1998. This large currency depreciation aggravated the foreign debt burden, causing a credit crunch, high interest rates, bankruptcy, and financial disintermediation. The loss of consumer and business confidence stemming from the expected recession exacerbated the contraction in investment and consumption. Until the exchange rate rebounds to a level determined by economic fundamentals, the economy will continue this debt-deflation episode.

Review questions

- How did Thailand cope with the 2009 Global Financial Crisis (GFC)?
- Did Thailand learn any lessons from the past mistakes?
- How resilient is the Thai industry when facing external shocks?

Review questions

- What are social implications of Thailand's economic fluctuations?
- How important is the role of macroeconomic policy management for long term growth?