

Buffeting by the Unholy Trinity and the 2006 Military Coup

Adjustments to external and internal shocks

Bhanupong
Lecture 7

Asian Economic Papers 5(2), 2006
The Thai Economy after the 2006 coup

outline

- The Avian Influenza
- The 2005 Asian tsunami
- The oil price shock in 2005
- The 2006 military coup
- Capital controls: December 18, 2006
- A shift in fiscal spending pattern

Buffeting of Thailand

Table 1. Estimates of the economic costs of the three shocks

	Crisis year	GDP growth (percent)	Financial loss (billion baht)	Loss of life
Avian influenza	2004	-0.1	20	14
Tsunami	2005	-0.3	65	5,400
Oil shock	2005	-2.0	90	

Sources: Estimates are from the Ministry of Finance, the Bank of Thailand, and the Tourism Authority of Thailand.

Bird flu

- Avian influenza (AI) broke out in Thailand in December 2003 and killed 14 people in the following 12 months.
- The Thai poultry industry had just recovered from the loss of generalized system of preferences (GSP) status in Europe in 1999 and the import ban on Thai chicken in 2002 resulting from the detection of antibiotic residues.

The damage

The spread of AI caused heavy damage to the industry because of massive culling and a temporary decline in domestic consumption.

The fear subsided by October 2004, and domestic chicken consumption returned to its rising trend.

The Ministry of Finance estimated that AI reduced GDP growth by 0.1 percentage points in 2004

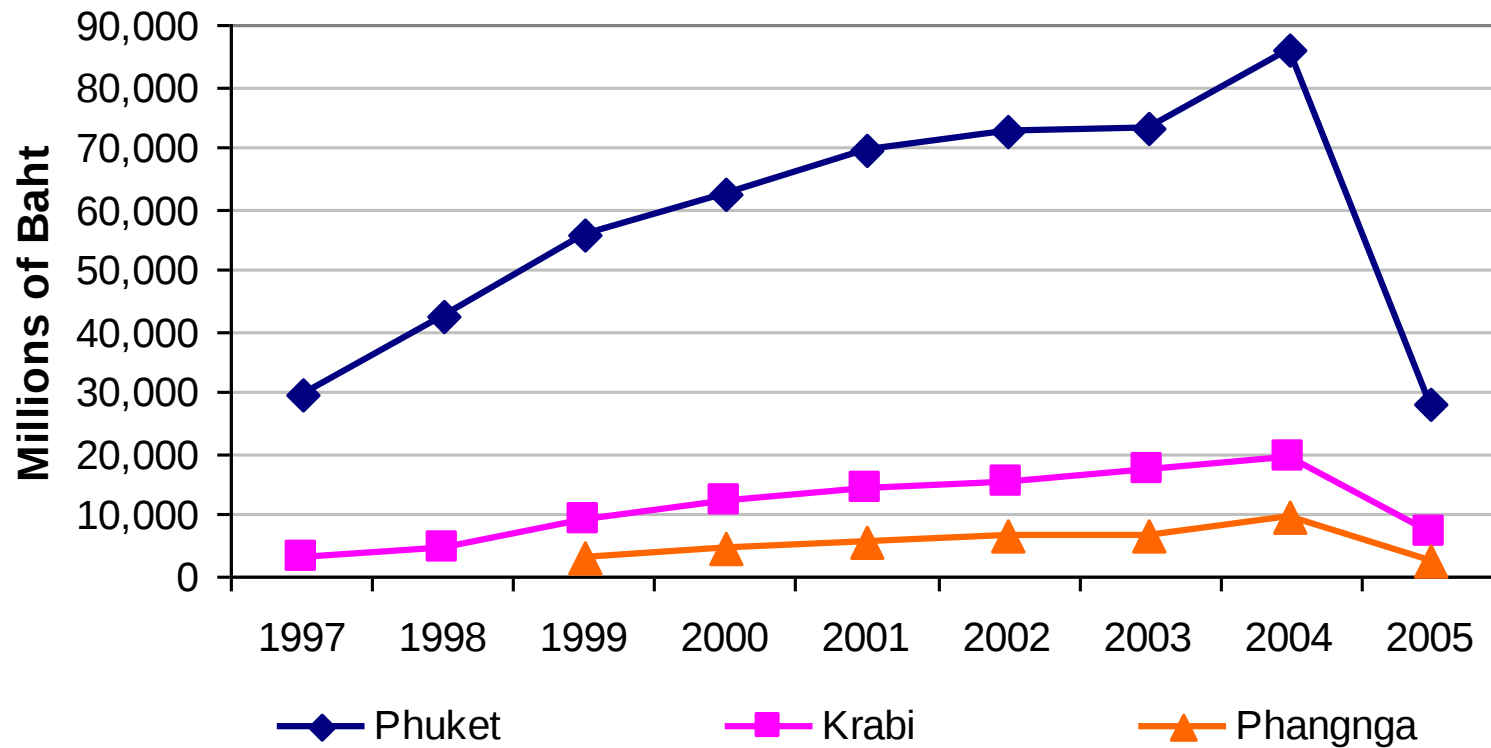
The Asian Tsunami

- AI has caused less damage in Thailand than the tsunami that hit six southern provinces of Thailand on December 26, 2004, killing 5,394 people—half of them foreign visitors.
- The tourism industry was badly affected, in particular, the hotel business on the Andaman Coast. Fisheries were also affected by the tsunami, as a result of the destruction of fishing boats and shrimp farms.
- Estimates show that the tsunami reduced GDP growth in 2005 by 0.3 percentage points

December 26, 2004



Tourism Revenue from Visitors in Three Provinces



Source: Tourism Authority of Thailand

Shocks after shocks

- World recession 1991
- Asian financial crisis 1997
- SARS and Iraq war in 2003
- Avian flu (H5N1) 2004
- Tsunami (Dec 26, 2004)
- Coup d'état (Sep 19, 2006)

More Shocks (still counting)

- Bangkok bombing (Jan 2007)
- PAD uprising and airport shutdowns (2008)
- Global (Great) recession (2009)
- Type-A(H1N1) (2009)
- Red shirts (UDD) uprising (April 2009, March 2010, April and May 2010)
- Japan quake (March 2011)
- 2013 Bangkok shutdown
- 2014: ?

The oil price shock

- The oil price shock of 2005 did not lead to loss of life, but its impact on economic growth in Thailand was the greatest among the three recent shocks.
- It caused a decline of 2 percentage points in the GDP growth of 2005.
- The oil fund deficit caused by an existing oil price subsidy carried a fiscal cost of more than 90 billion baht.
- The oil price shock had an adverse direct impact on the tourism industry by raising the cost of traveling. The slowdown in world output growth aggravated the slump in the industry

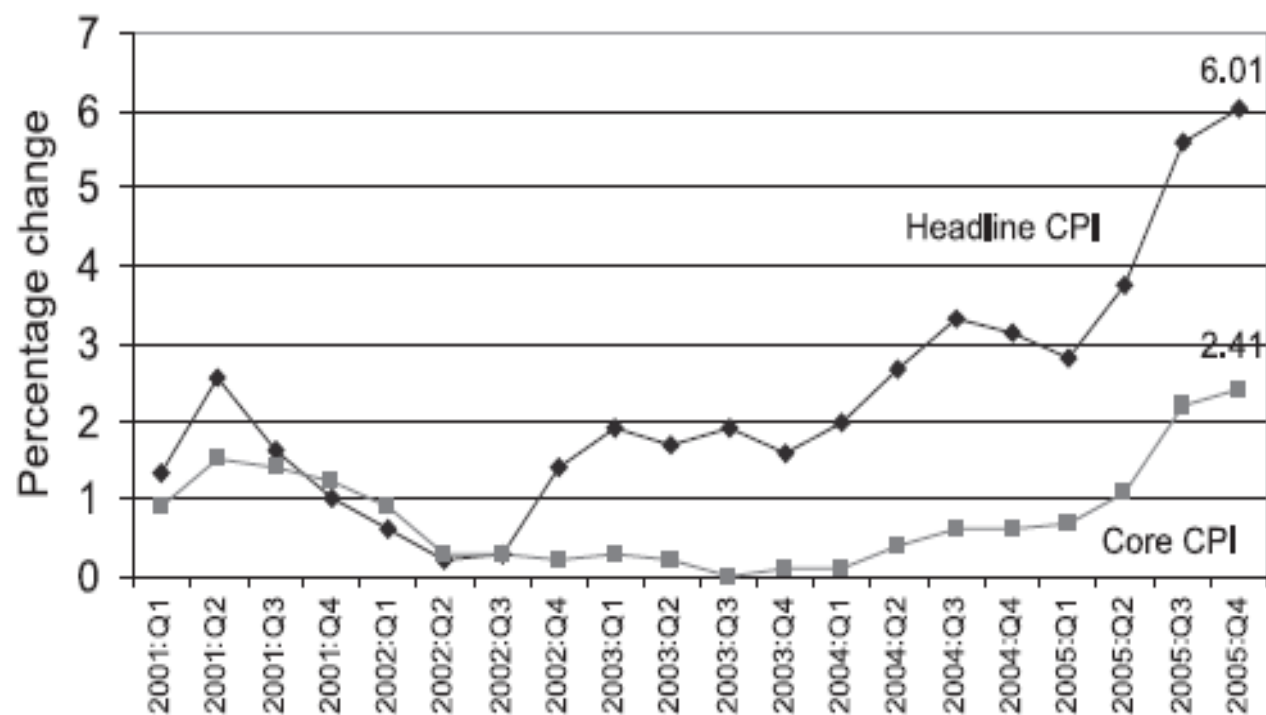
Buffeting of Thailand

Table 2. Macroeconomic impact of the three oil price shocks (percent)

	First oil shock		Second oil shock			Third oil shock	
	1973	1974	1978	1979	1980	2004	2005
GDP growth	9.9	4.4	10.4	5.3	4.8	6.1	4.5
Inflation	15.5	24.3	7.9	9.9	19.7	2.7	4.5
Current account/GDP	-0.5	-0.6	-2.8	-4.9	-6.4	4.5	-4.8
Trade balance/GDP	-1.7	-2.4	-3.1	-4.4	-6.1	2.3	-2.1
World oil price index	3.3	11.6	12.9	30.1	35.9	37.7	54.2

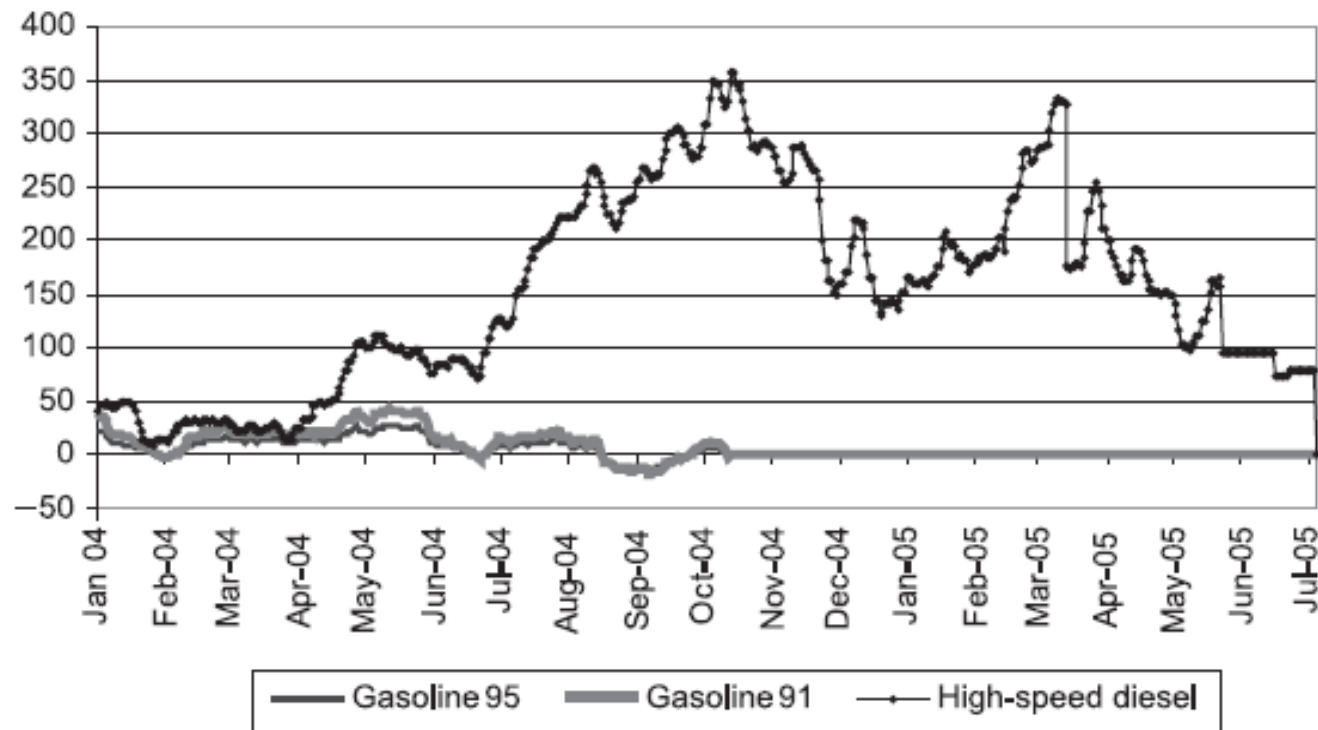
Sources: Bank of Thailand, International Monetary Fund.

Figure 4. Inflationary impact of the third oil price shock



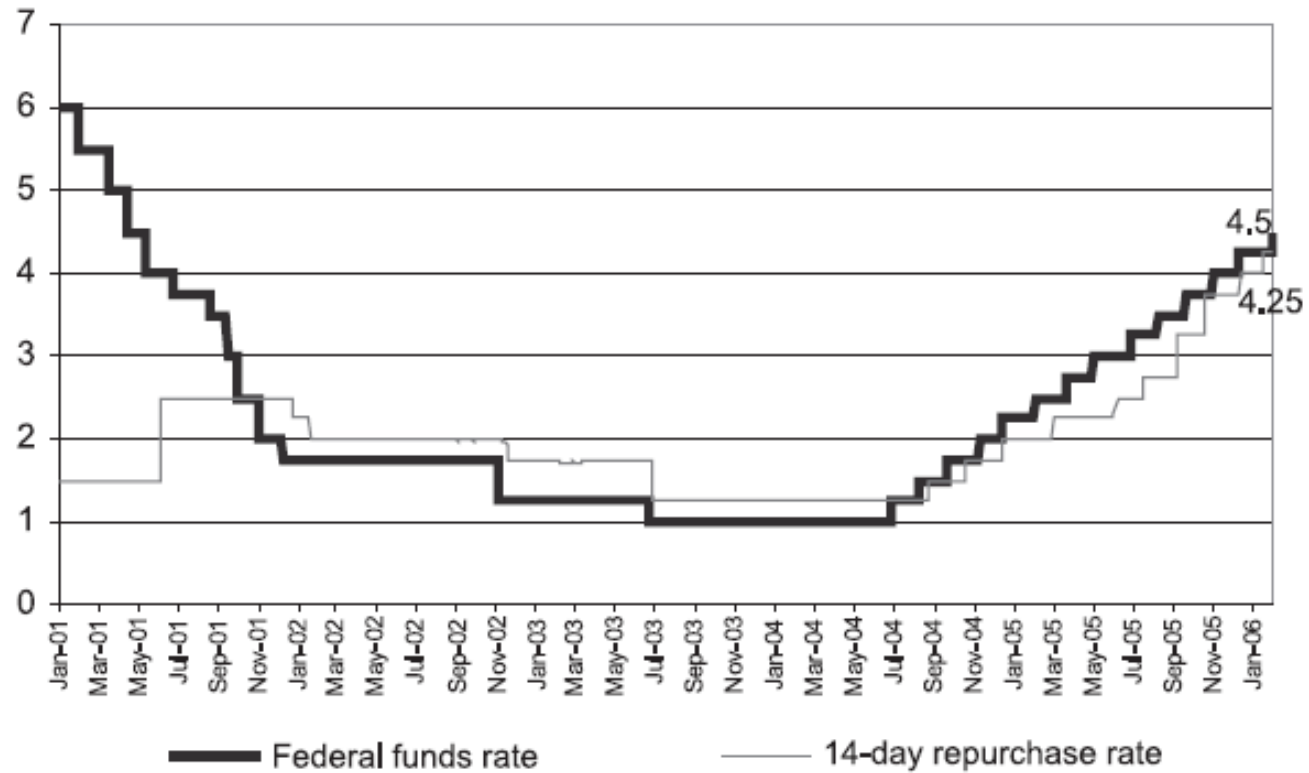
Source: Bank of Thailand.

Figure 5. Oil subsidies per day (million baht)



Source: Energy Policy and Planning Office.

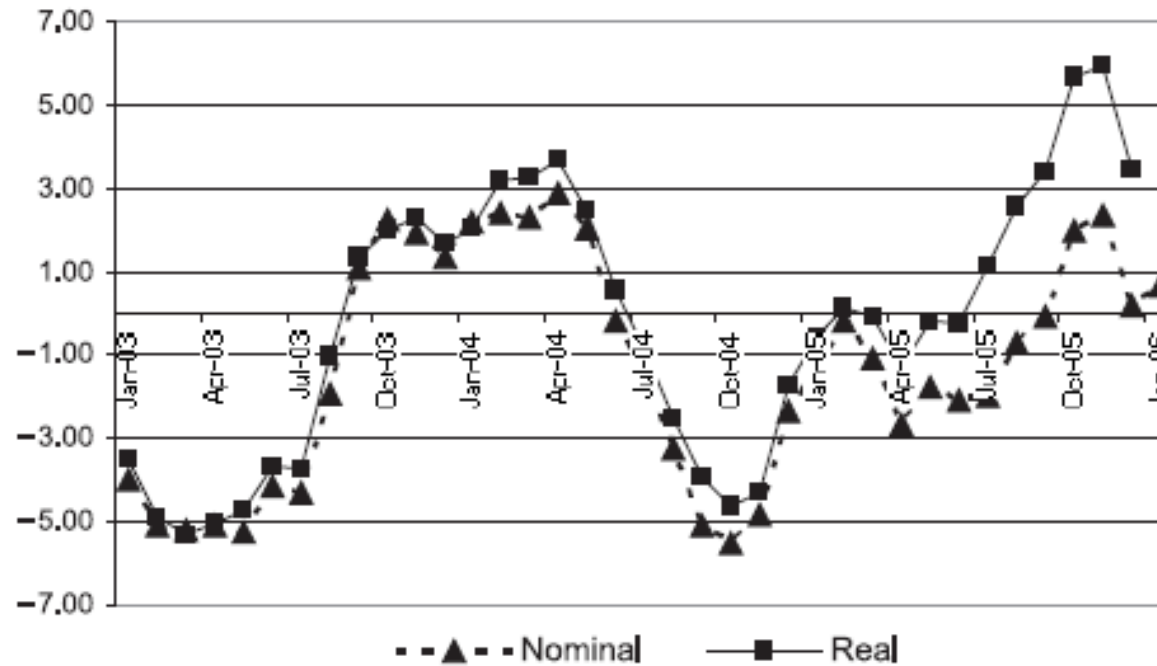
Figure 6. Federal funds and repurchase rates



Sources: Bank of Thailand, Federal Reserve.

Buffeting of Thailand

Figure 7. Real and nominal effective exchange rate (% change year-on-year)



Source: Bank of Thailand.

Appropriate policy responses

The establishment of realistic exchange rates and positive real interest rates by reducing the degree of price intervention will induce economic agents to adjust properly to cushion the impact of external shocks.

Nominal exchange rates must be allowed to depreciate to maintain competitiveness.

Price controls must be employed temporarily to avoid market disruptions and to calm inflationary expectations.

The Thai economy after the coup: 2006-2008

- Coups d'état and the vicious circle
- The importance of capital formation
- Animal spirits of investors

Coups galore

- There have been 20 military coups since June 24, 1932, when absolute monarchy was replaced by constitutional monarchy.
- Only nine coups succeeded.
- June 20, 1933: Phraya Phahol toppled the government led by Phraya Manopakorn.
- Nov 8, 1947: Gen Pin Choonhawan overthrew the government of Thawan Thamsrongdhnawasavad

Timeline of coups d'état

1958 Coup

General Plaek regime (1948-58) was overthrown by

- General Sarit (1959-63)
- General Thanom (1964-1974)

1971 Coup (Nov 17) by Field Marshal Thamom against his own government.

Oct 14, 1973

- PM Sanya (1974)
- PM Kukrit (1975)

Another coup, another constitution,
and another election

Oct 6, 1976

PM Thanin

Coup 1977

(October 20) by Adm Sa-ngad Chaloyu overthrew the government of Thanin
Kraivichien

General Kriangsak

General Prem 1981

Coup 1981

Coup 1985

PM Chatchai

Coup 1991

A vicious circle

And we thought that we saw the last coup in 1991

Between 1991 and 2005: A period of no coup

PM Anan

PM Chuan

PM Banhan

PM Chawalit

PM Chuan

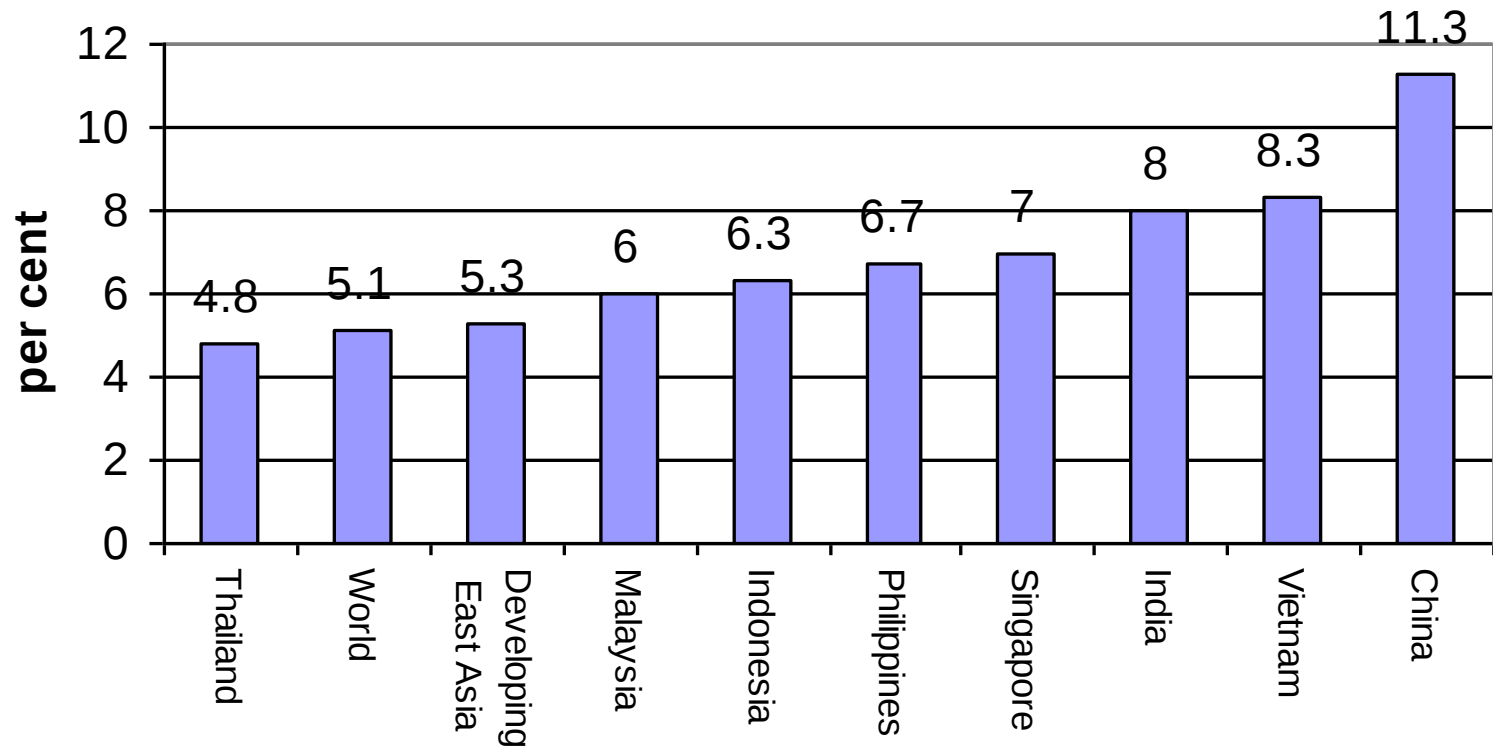
PM Thaksin

Thailand's perennial problems

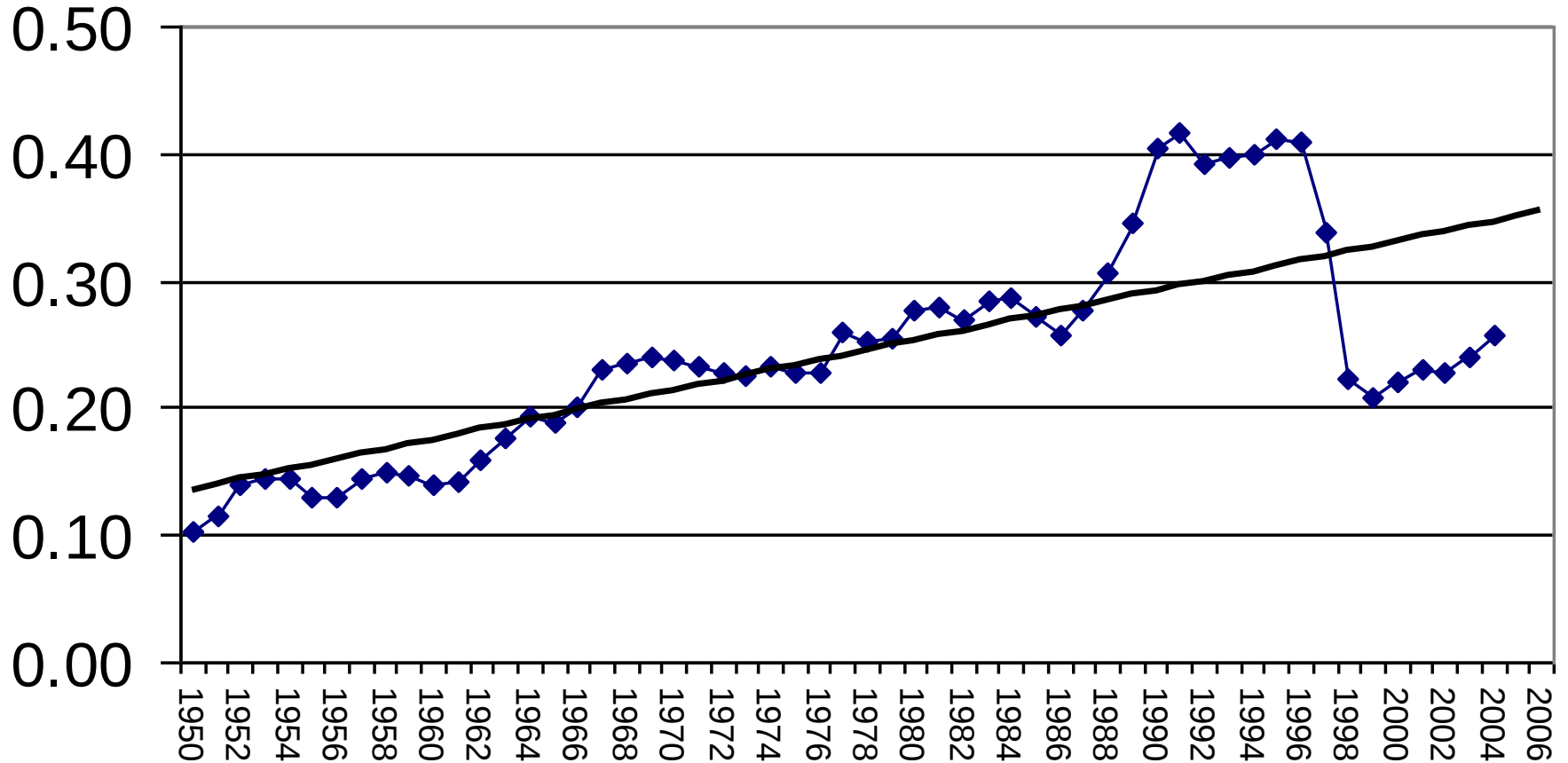
- Exchange rate risks
- Fluctuations of the world economy
- Weak governing institutions: the rule of law
- Military and judicial coups threat and political disturbances
- Southern violence

The price of the September 2006 coup

Comparison of Growth in 2007



Share of investment in GDP



Capital formation

- Investment causes short-term fluctuations in GDP by affecting aggregate demand.
- Investment also enhances long-term growth by increasing potential, or full-employment national income.
- Investment improves living standards.
- Opportunity cost of growth is precious heritage of natural resources and pollution.

Why growth is good for the poor

- Growth increases the ability to redistribute income among people and reduce unemployment.

- Okun's Law

$$g_t = \alpha - \beta \Delta u_t$$

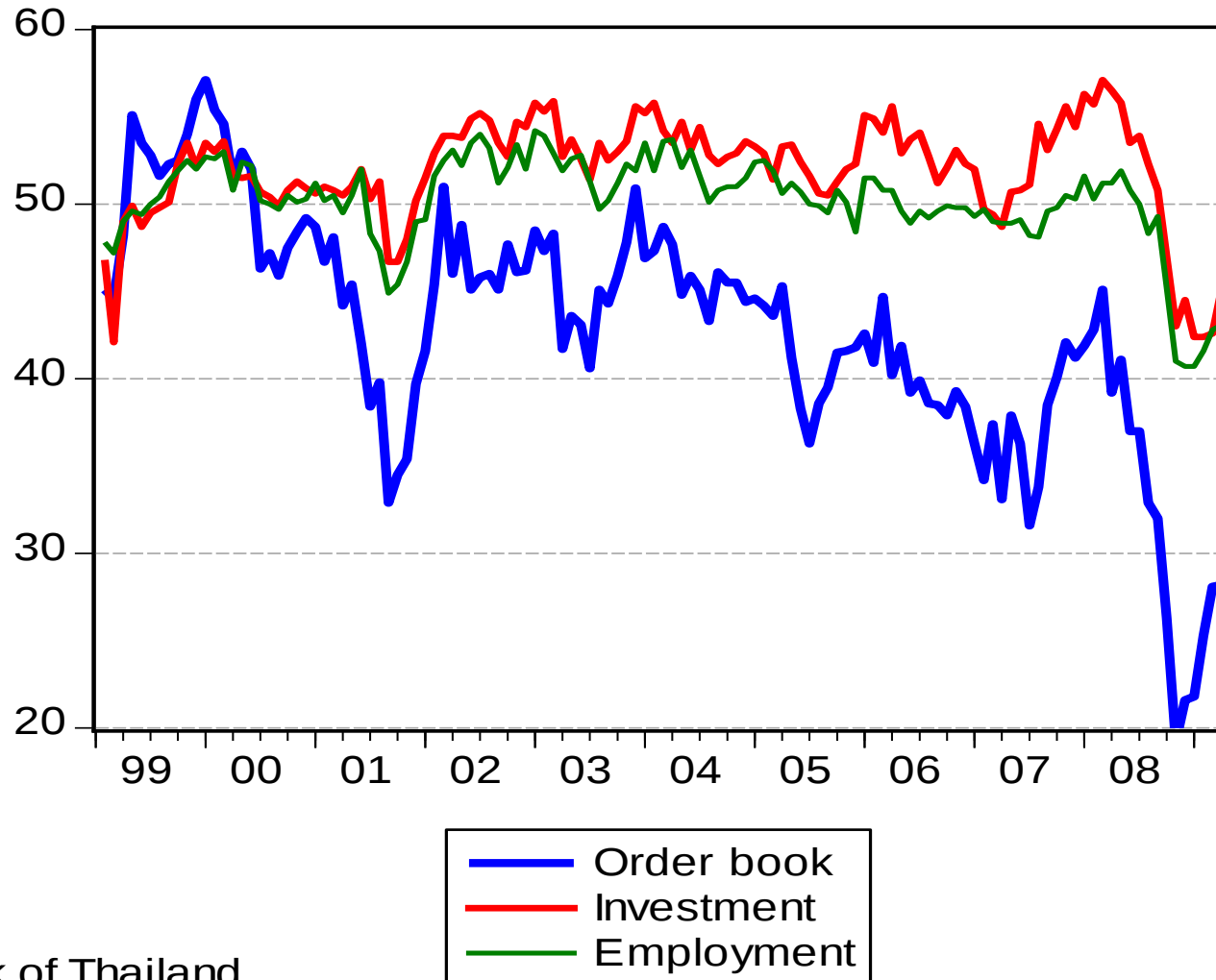
- For every 1% of increase in unemployment rate, GDP will be lower by roughly 2% (In USA).

Animal spirits

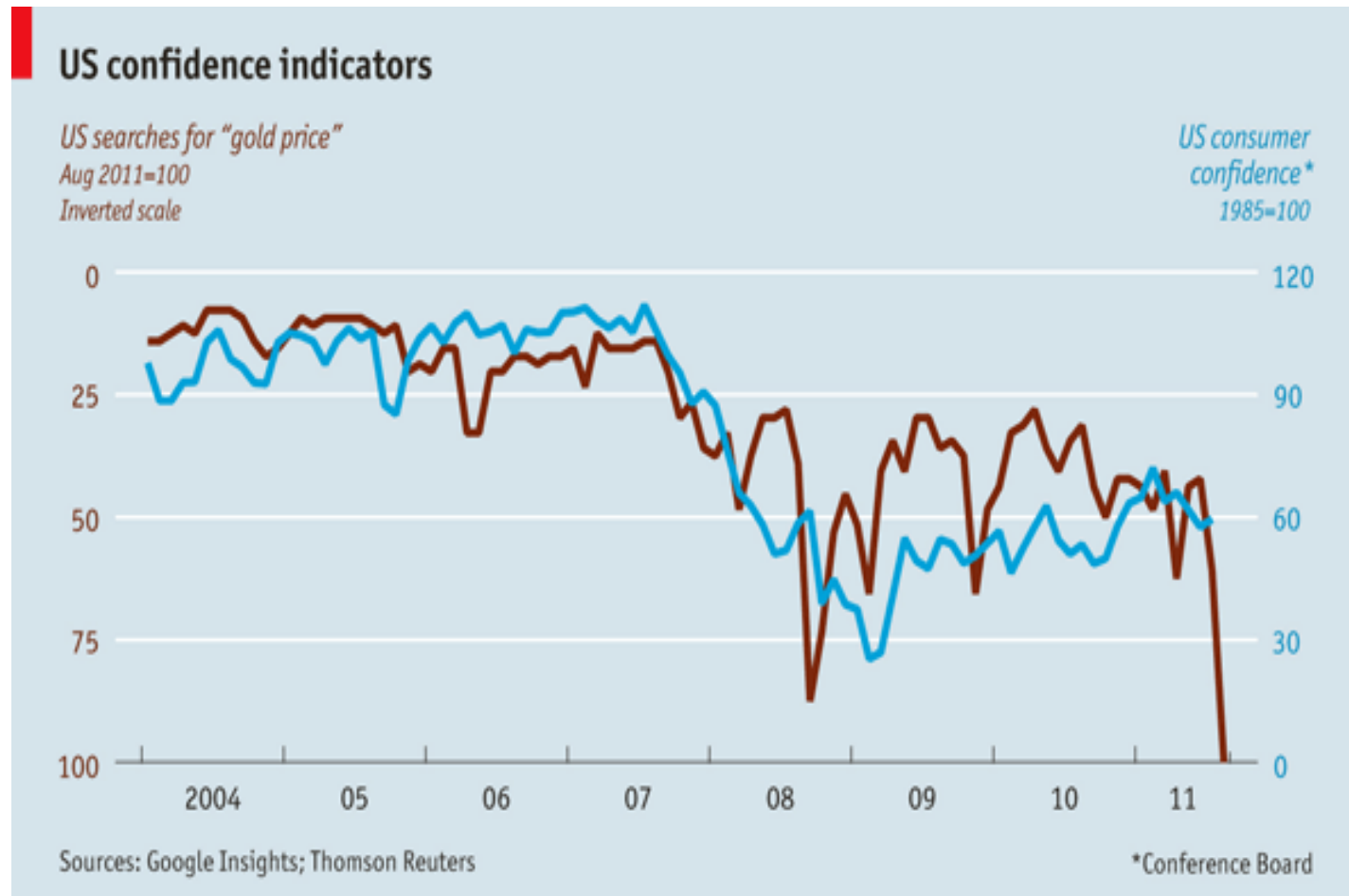
- Akerlof and Shiller (2009) extend Keynes' animal spirits from investor confidence to fear, blind faith, corruption, and a concern to fairness, and the stories we tell ourselves about our economic fortunes.
- *We must uphold fairness and social justice: no more double standards*

Business sentiment Index

How can we rekindle favorable investment climate?

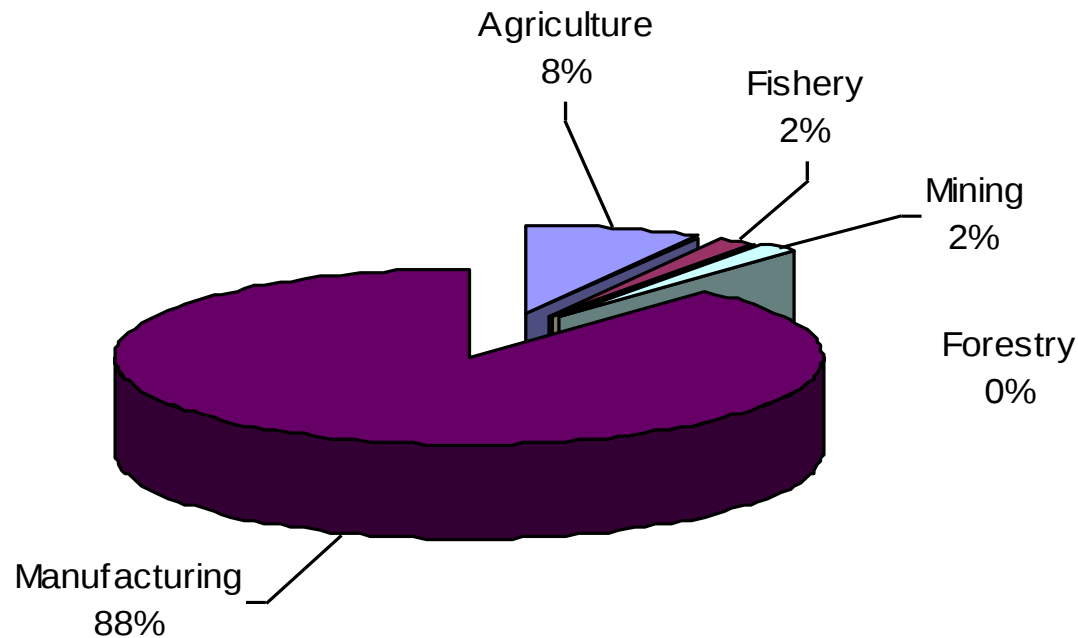


GFC: Gold price as an indicator of the lack of consumer confidence



The export-led growth

Export structure: 2006

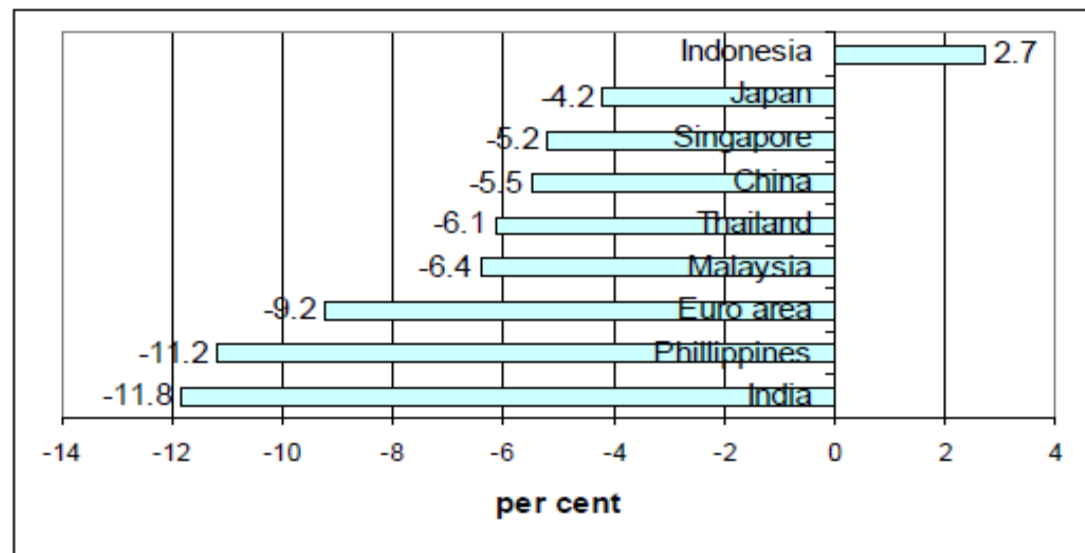


■ Agriculture ■ Fishery ■ Forestry ■ Mining ■ Manufacturing

3. Capital Controls: A Policy Faux Pas

Except for Indonesia, Asian currencies appreciated against the dollar in 2007. As a result, exports from Asia decelerated throughout Asia. However, lower exports demand from the US and the appreciation of the Asian currencies did not preclude their economies from expanding. Note that the Philippine peso, the Malaysian ringgit, and the India rupee appreciated at a larger percentage than the Thai baht. These economies grew in spite of strengthening currencies because of their domestic demand expansion, enhanced by business and consumer confidence.

Figure 5: Currency Appreciation against the USD
December 2007 (y-o-y)

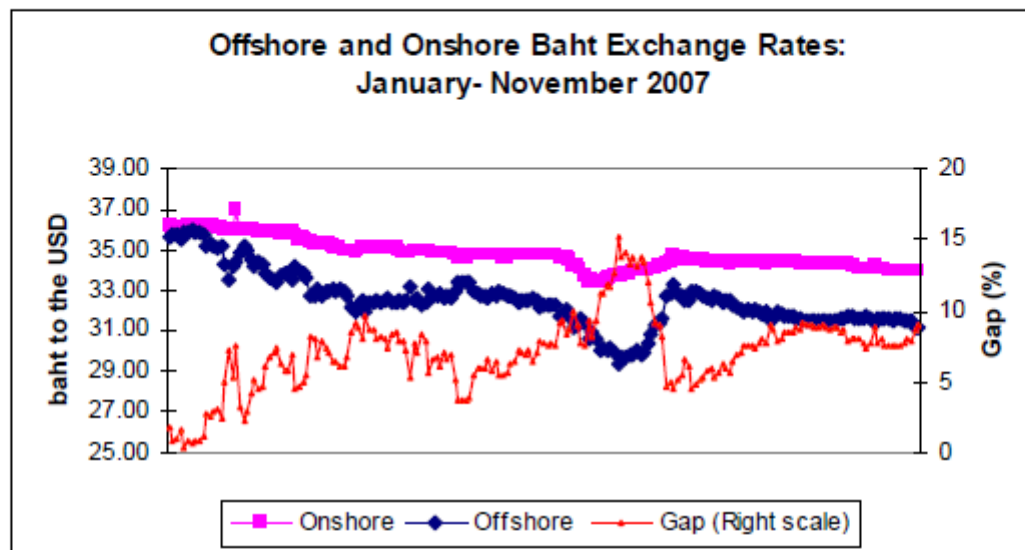


URR on December 18, 2006

Conventional wisdom is that strong economic growth must be led by good exports, which in turn require weak currencies. The Bank of Thailand opted to maintain a weak baht to stimulate exports. Moral hazard usually follows any attempts to bailout weak commercial banks and inefficient exporters. Because of the failure to see the big picture of the economy, the Bank of Thailand imposed a 30 percent Unremunerated Reserve Requirement (URR) on short-term capital inflows on December 18, 2006, three months after the coup took place. A 10 percent withholding tax is imposed on the capital inflows that leave the country before one year. The measure led to panic and stock market crash⁶. The Bank of Thailand had to reverse its policy the following day to cool down the panic and since then had gradually relaxed measures on capital controls, allowing the exception for foreign portfolio investment. The abandonment of stringent capital controls was a policy blunder that ignored wide-economy impacts of the capital controls. The Bank of Thailand argued that monetary authorities did not want to reverse the course of the baht appreciation, but aimed to slowdown its fast

⁶ The Securities Exchange of Thailand Index dropped by 108 points within one day.

Figure 6: Market Separation



Source: Bank of Thailand

Capital controls lead to separation of foreign exchange markets: onshore and offshore markets. The former is protected by high tariff, while the latter is freely traded in foreign markets. The controls gave rise to differentials in the price of the baht (Figure 6). The gap between the two rates widened with rising speculation of - baht appreciation. Like many markets that offer same products at different prices, there is opportunity to profit from price differentials. The Bank of Thailand essentially intervenes in the foreign market by targeting a certain foreign exchange level. From 2003 to 2007, the baht appreciated against the dollar by 16.6 percent, from 41.5 to 34.6 baht to the dollar. During the same corresponding period, -

At the end of the day

After a year of the capital control implementation, the BoT further relaxed the measure by waiving the withholding of 30 per cent reserve and full hedge requirement for Thai companies with less than USD1 million of external debt with over one year maturity. In sum, the Bank of Thailand repeated its mistake committed a decade ago—albeit an opposite direction of the value of the baht. The result remained the same: huge financial losses and ineffective outcome. The Bank of Thailand suffered financial losses of 170 billion baht in 2006.

The Bank of Thailand also sterilizes the inflow of capital by issuing - BoT bonds to mop up liquidity in the financial markets. The measure is not effective in the long run in preventing money supply from growing, because higher interest rates offered by the BoT bonds gave rise to more capital inflows in response to interest rate differentials. At the beginning of 2007, the BoT asked permission from Ministry of Finance to issue 900 billion baht BoT bonds and additional 500 billion baht bonds at the end of 2007. The sterilization is ineffective and costly, because the BoT must use the proceeds from selling the bonds to invest abroad to be able to pay BoT bond holders. If the baht keeps on appreciating, the BoT ends up losing more money. The question is therefore whether the loss of billion of baht worth the outcome of sterilization. Wouldn't it be better to spend the same amount of money on - projects with higher social rate of return?

Fiscal budget under the military-backed government (Gen. Surayud)

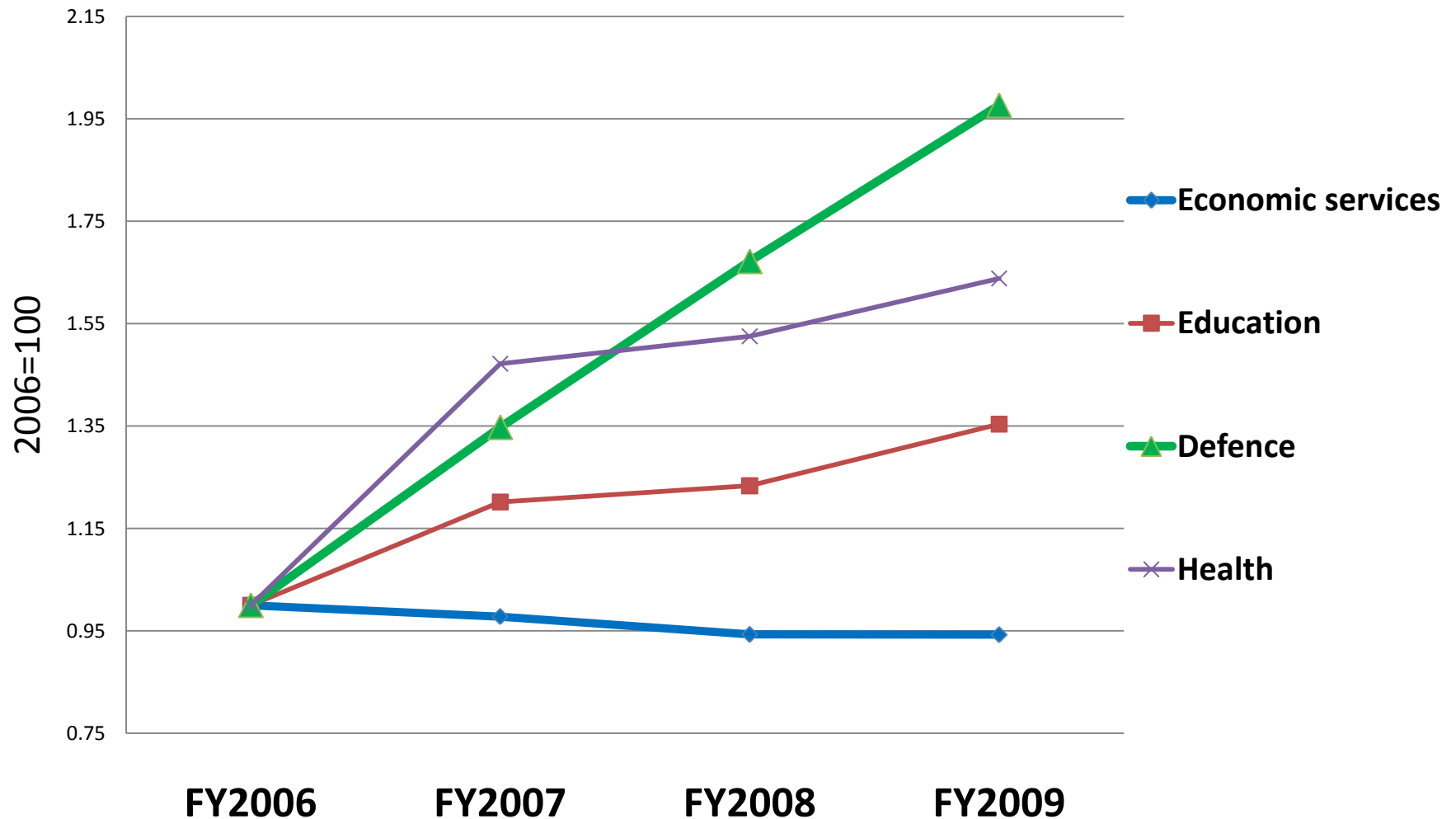
	FY 2007	FY 2008	% Change in value
Defense	7.3	8.6	24.3
Education	18.0	18.1	6.7
Public health	4.0	3.9	4.7
Central fund	12.6	14.8	24.3
Agriculture	4.1	3.9	0.6
Total amount (bill baht)	1566.0	1660.0	6.0

Defense spending and health capital

- Determinants of military spending: external and civil wars, military spending by potential enemies, population, and democracy.
- Democracy is negatively related to military burden.
- Cross-country evidence shows a negative impact of military spending on economic performance.
- Grossman, M (1972) *“On the concept of health capital and the demand for health”*
Journal of Political Economy, 223-255.

Government Budget appropriation after the 2006 military coup

Source: BOB



The Thai Economy after the coup

5. Concluding remarks

According to Rodrik (2003), institutions are quality of formal and informal sociopolitical arrangement—from legal system to political institutions. Good institutions provide property rights, appropriate regulatory structures, the quality and independence of the judiciary and bureaucratic capacity. Institutions that provide dependable property rights, manage conflict, maintain law and order, and align economic incentives with social costs and benefits are the foundation of long-term growth.

The overthrow of the legitimate government by the military coup cost considerable damages in terms of economic losses. The rule of law, good governance and good institutions, both legal and democratic infrastructure are required to nurture economic environment suitable for long-term development to raise living standards. In Thailand, the military coups in the past did not destroy the confidence of the business sector; thereby leaving intact the country's economic strength. The latest coup, however, has destroyed the democratic underpinning of the stability of political and economic structure; thereby sapping the economic strength of the Thai economy. The long-term growth of the economy and social welfare is threatened as the government budget is allocated to non-productive spending. Infrastructure public investment and human capital-related spending was curtailed for the sake of defense. The Thai economy has stepped backward, losing opportunity to grow when the world economy expanded in 2007. Alas, the September 2006 coup may not be the last one.

Concluding remarks

- The long term economic cost of the coup was underestimated.
- Political instability damages economic performance and derail the return to the pre-shock growth path.
- Domestic demand could have been stimulated to offset the shortfall in exports in 2009 caused by the GFC.