Premature Liberalization and Macroeconomic policy after the AFC

Bhanupong
Lecture 6
Asian Economic Papers (2003)
Premature liberalization

Main themes

- Premature liberalization
- Political economy of liberalization
- Macroeconomic development after 1997
- Monetary policy under the “new” exchange rate regime
- Foreign exchange market intervention

The political economy of financial liberalization

In 1990, the Thailand Development Research Institute (TDRI), an independent think-tank, predicted that Thailand would repay all of its debt by 1992 and would graduate into a net creditor or a newly industrializing country like South Korea. It also predicted that the structure of capital inflows would be in the form of foreign direct and portfolio investment rather than foreign borrowing. Phaichitr Uathavikul, President of TDRI and former Finance Minister and executive officer of the World Bank, saw no obstacle to Thailand's becoming a net lender country, barring political interference that might create instability. According to Phaichitr, exchange control liberalization could fulfill Thailand's desire to become a commercial and financial center for the fast-growing region, and unrestricted access to the Thai market by foreign banks would bring about a competitive environment and advanced technology. Sanoh Unakul, former Governor of the Bank of Thailand, former Secretary General of the National Economic and Development Board, and chairman of TDRI in 1990, also argued that there was growing evidence of Thailand becoming the region's trade and financial center (*The Nation*, May 15, 1990).

When in 1990 the Bank of Thailand was holding talks on the strategy for liberalizing exchange controls with the IMF, the latter had been calling for the Thai government to liberalize exchange controls, arguing that the robust Thai economy would entail rapid exchange control liberalization. Chavalit Thanachanan, Governor of the Bank of Thailand, basically concurred, stating that exchange control liberalization would send a signal to the rest of the world that Thailand was ready to facilitate trade and financial flows and to join the club of sixty countries that had adopted exchange control liberalization. The US$12 billion level of international reserves was considered sufficiently large to relax foreign exchange control.[2]

In 1990, Prime Minister Chatichai Choonahavan argued for Thailand's compliance with the IMF rules of Article VIII by saying that Thailand was now financially mature and should thus meet the conditions under the Article. Pramual Sabhavasu, Finance Minister, also argued that the level of international reserves was sufficiently high since it covered five months of imports without any earnings from exports. According to Pramual, the announcement of the acceptance was a prelude to the upcoming 1991 IMF meeting of central bank governors in Bangkok (*The Nation*, 17 May, 1990).

The global trend toward financial liberalization and the globalization of financial markets prompted Thailand to accelerate the development of financial institutions to serve the increasingly sophisticated needs of international trade and investment. As director of the Bank of Thailand's supervision and development department in 1995, Thirachai Phuvanatnaranubala argued that Bangkok had a future as a leading international banking center in the region, replacing Hong Kong and Singapore. As he saw it, Hong Kong would be returned to China in 1997 and Singapore would be disadvantaged with rising operating costs. He thus pushed the Bank of Thailand to promote BIBFs' 'out-in' business in the form of loan syndication because it would serve, he contended, as a stepping-stone for expansion into their 'out-out' business once Thailand overcame its shortage of human resources (*The Nation*, 29 May, 1995).

Loans extended by BIBFs grew substantially from 200 billion baht in 1993 to 1.2 trillion baht in 1997, and peaked in 1997 at 1.88 trillion baht. At the end of 1999, the amount declined to just 600 billion baht, as the local interest rate declined to its lowest level in decades, resulting in the disappearance of the financial advantages of foreign borrowing through BIBFs.

Wade (1998) blamed the IMF for its pressure on developing countries to open the capital account without an adequate framework of regulation. In the case of Thailand, the IMF was in fact a major influence behind the push for financial liberalization and there was a trace of the Washington Treasury complex (Bhagwati 1998). But also important for Thailand's drive for financial liberalization was the consensus among domestic players such as central bankers, commercial bankers, and independent think-tank economists, who walked in and out between the public domain of regulatory agencies and private financial institutions. For example, Tarrin Nimmanahaeminda, Finance Minister under the Chuan Administration in 1993 and an advocate of the idea of establishing Bangkok as a financial center for the region, was once the president of Siam Commercial bank.

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This network of influential players shared the IMF's ethos of free market ideology. Furthermore, the IMF gave them indirect support by providing the standby loan agreement in case of capital outflows after exchange control liberalization and thus encouraged the perception that nothing could go wrong with an open capital account. It should be noted, however, that the IMF influence alone was not sufficient to push for complete financial liberalization. Had central bankers and bankers-turned-finance ministers not subscribed to financial liberalization, the pace and shape of liberalization in Thailand would have produced a different outcome. There was also an environment of 'irrational exuberance' that was inflated by large accumulated international reserves and an unrealistic dream of becoming a financial center in the region.

Since the Finance Ministry controlled the number of foreign banks in Thailand, foreign banks that wished to enter the Thai market had to seek a BIBF license for full services. Given that there were large economic rents from having the license (tax privileges and the possibility of illegally siphoning money to offshore branches in locations like the Cayman Islands), there was keen competition for the license among foreign banks. This competition took the form of demonstrating their willingness to enter the Thai market by showing an impressive lending volume and thus resulted

in their excessive lending despite the low interest spread and high default risks. Thus it is not surprising that foreign banks' lending volume increased more rapidly than Thai banks.

Capital inflows and vunerability to economic crisis

Favorable events such as rapidly rising growth rates of exports and GDP generated the expectation of continued prosperity. Asset prices were bid up by the linear expectation of continued prosperity, and credit from financial institutions only added fuel to the bidding-up process to the extent that asset prices far exceeded their fundamental values. For instance, whereas in 1986 the share of bank credit allocated to real estate was only 3.8 per cent of total bank loans, it went up to 10.5 per cent in 1994 to decline slightly to 8.8 per cent in 1996 (Table 1.3).

Once psychological factors such as the herd instinct took over the sensibility of market participants, asset prices became highly overvalued. Greed and euphoria kept the level of 'paper profits' high. Capital control relaxation coincided with the boom in the real sector of the economy. Thus with the cheap funds they were able to obtain abroad financial institutions pumped credit and margin loans, fueling the bubble. What further weakened the financial fragility was that credit extension was concentrated in the nontrade sector. The open capital account also allowed large portfolio capital inflows from international investors who wished to diversify their portfolios, thus pushing up share prices further.[3]

Premature liberalization

- Capital control relaxation undertaken when bank supervision and financial regulations are not sufficiently stringent; it leads to over-borrowing and inefficient lending.
- A gradual approach to capital account liberalization could have been adopted.

Capital inflows prior to 1997 crisis

- A surge in capital inflows into Thailand began in the late 1980s and continued unabated until 1996.
- The flows brought high economic growth and a surplus in the balance of payments and current account deficit.

Causes of rapid capital inflows

- A declining in world interest rates widened the interest rate differentials, inducing excessive foreign borrowings.
- Domestic financial liberalization increased the *sensitivity* of capital flows to interest rate differential.
- The measures undertaken to establish Thailand as a regional financial sector induced short-term capital flows though offshore borrowings by the nonbank private sector.
- The culprit: BIBF

Determinants of capital flows

$$K_f = \alpha + \beta(r - r_f) + \delta\ (\Delta Y / Y) - \phi(Risk) - \eta(\Delta e / e)^E + \varepsilon$$

The important role of expectations

Lessons from the currency crisis

- Since capital flows are many times larger than international trade flows, when a country relies too heavily on short-term foreign debt to finance a current account deficit, it is impossible for the central bank to defend a fixed exchange rate for very long—let alone to inflict wounds on currency speculators.
- Thailand also learned that accountability and transparency should be well established so that the central bank is not tempted to engage in behavior that is akin to gambling in order to get out of a crisis.

Thailand's Macroeconomic Policy after July 1997

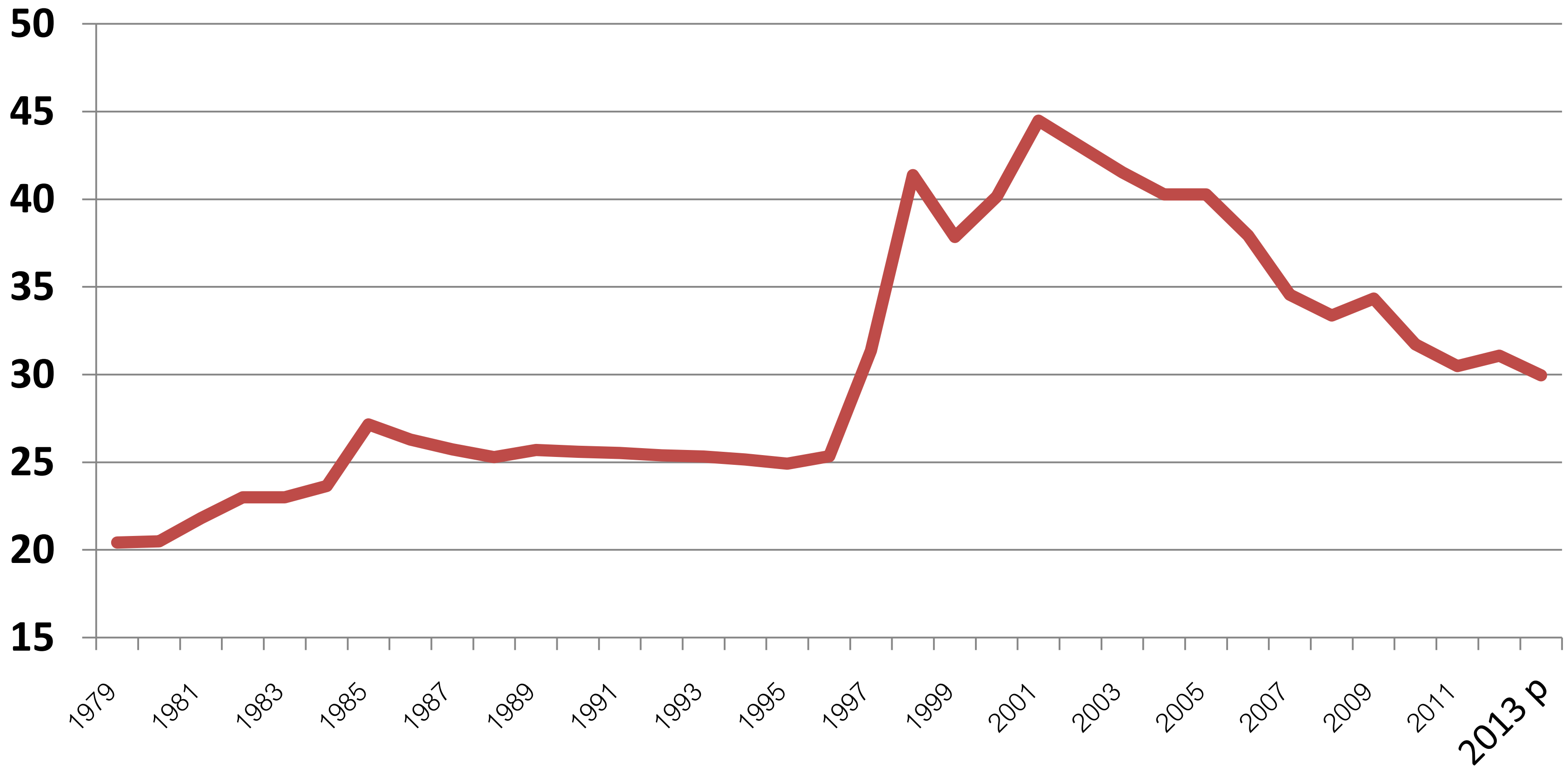
Table 1. Average growth of macroeconomic variables in Thailand (1997–2001)

Macroeconomic variable	July 1997 to December 1998	January 1999 to December 2000	January 2001 to December 2001
Manufacturing output index (percentage change)	−8.27	7.99	1.25
Government expenditure (percentage change)	−11.22	1.12	2.13
CPI (percentage change)	7.67	0.94	1.86
Nominal exchange rate (baht/ US$)	40.33	−0.51	14.09
Repurchase rate of interest (14 days)	15.38	1.80	1.75
Monetary base (percentage change)	2.15	3.60	7.00

Source: Bank of Thailand (http://www.bot.or.th).

Note: Figures are averages of monthly data.

Currency and financial crises in 1997-1998



Economic crisis in 1997/98

- With the baht succumbing to speculative attacks, the BOT decided to float it on July 2, 1997.
- Without a nominal anchor and given the lack of political credibility, the value of the baht fell by 56% through to January 1998.
- The deficit became surplus by income and substation effects: expenditure switching and reducing

Table 3. Thailand's wage and price adjustments and capacity utilization during 1997–2000

Year	Price (CPI)	Real average wage rate of all sectors	Capacity utilization (%)
1997:1	4.53	6.82	68.72
1997:2	4.86	7.35	57.44
1998:1	7.83	−0.09	51.90
1998:2	9.65	−3.86	48.78
1999:1	4.68	−4.09	55.06
1999:2	−0.32	−1.53	57.39
2000:1	0.16	−0.56	59.87
2000:2	1.68	−1.49	59.14

Source: Bank of Thailand, labor force survey (http://www.bot.or.th).

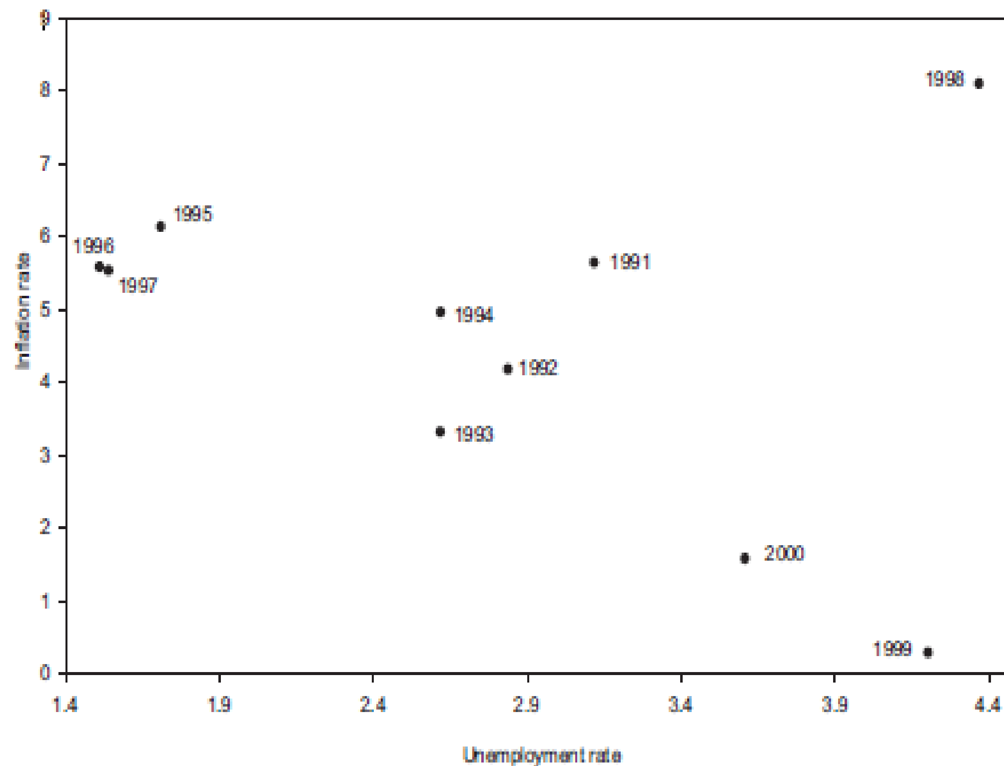
Inflation vs. unemployment

- Thailand’s labor market is flexible enough that wage cuts occur during recession, a feature that reduces unemployment.
- The price level does not adjust as quickly as wage rates.
- Because of inflation inertia, there is a trade-off in the short run between inflation and unemployment.
- Expansion monetary policy can reduce unemployment with minimal inflation.

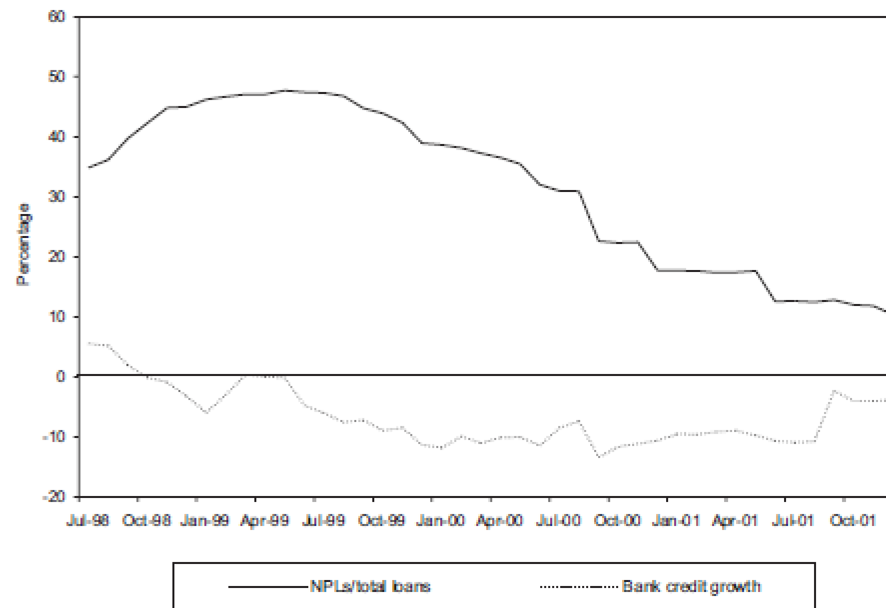
Outliners: Stagflation

Thailand's Macroeconomic Policy after July 1997

Figure 1. Trade-off between unemployment and inflation in Thailand



Economic activity and quality of bank loans



Consequences of rising debts

- The large currency depreciation aggravated the foreign debt burden, causing credit crunch, high interest rates, bankruptcy, and financial disintermediation.
- The loss of consumer and business confidence stemming from expected recession exacerbated the contraction in investment and consumption.

Southeast Asian Experience in 1998 (%)

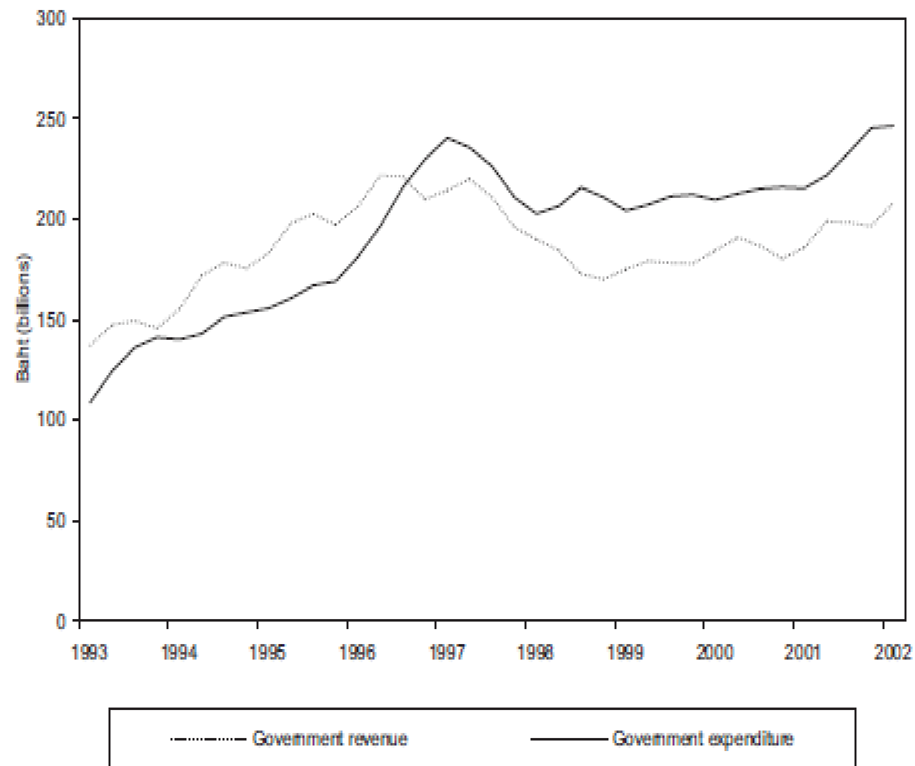
	Exchange Rate	GDP	INVESMENT	credit	Inflation
Indonesia	244.2	-13.1	-39.4	28.7	58.5
Malaysia	39.5	-7.36	-43.0	0.41	5.3
Philippines	38.7	-0.58	-16.3	-2.73	9.7
Singapore	12.7	-0.09	-13.3	18.2	-0.3
Thailand	31.9	-10.5	-50.9	-1.2	8.1

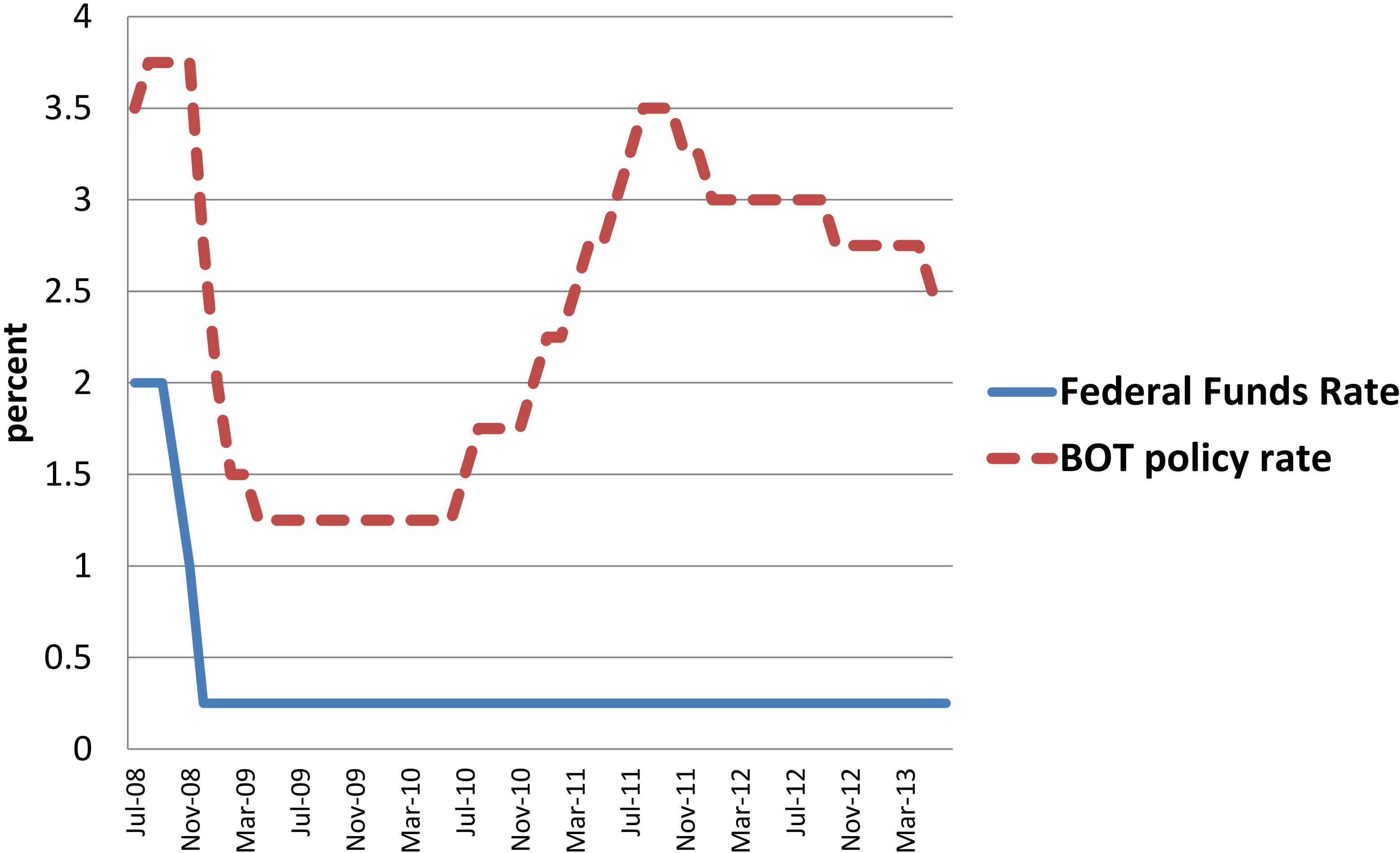
After the storm in 1997,

- After the tight fiscal and monetary policy was relaxed, the short-term interest rate declined from 25% in 1997 to 8% by September 1998.
- Real interest rates declined, enough to ease debt burden.
- When the exchange rate regained stability, consumer confidence had been restored.

Expansionary fiscal policy

Figure 3. Fiscal policy stance in Thailand



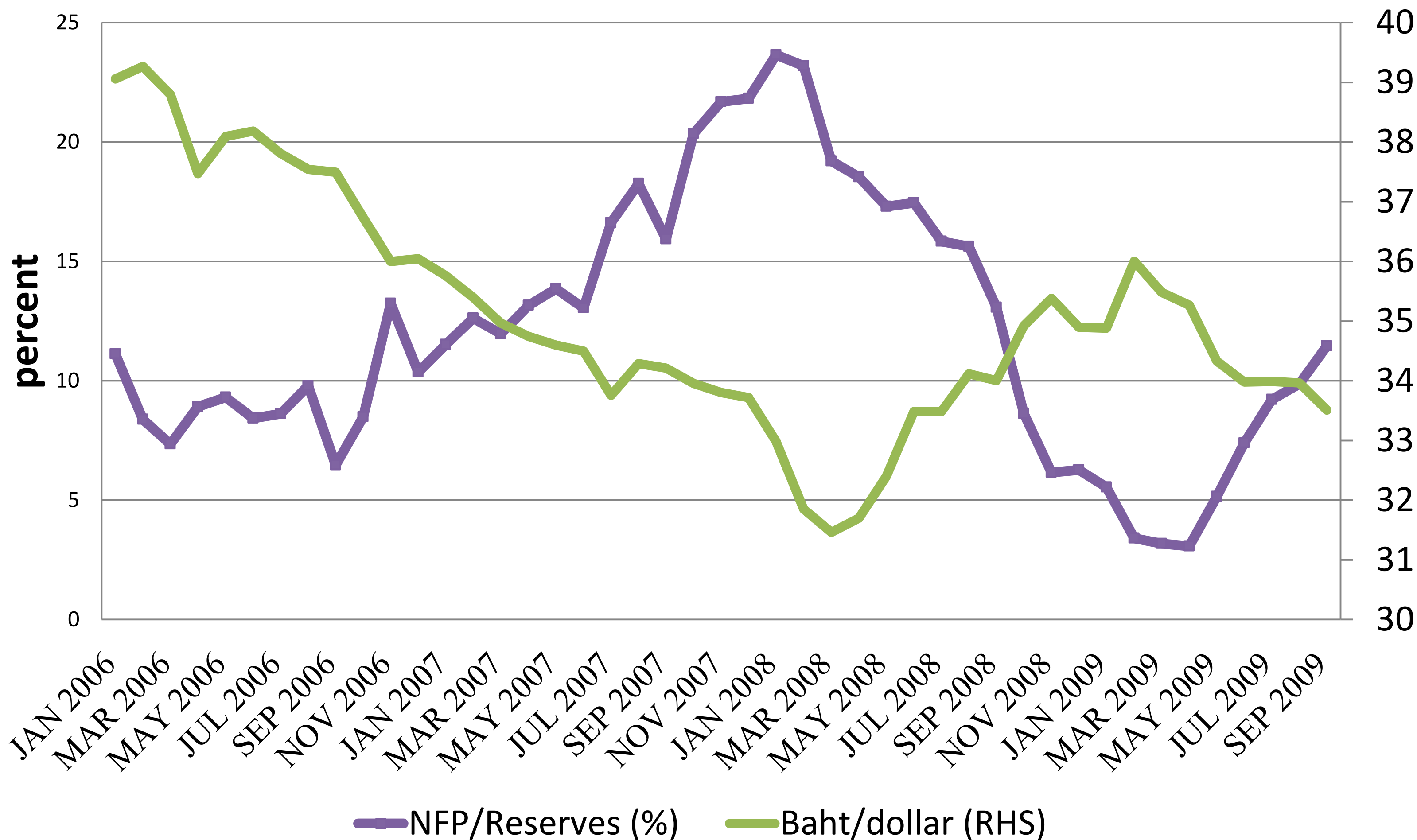

Key Policy Rates: Interest rate gap
percent
4
3.5
3
2.5
2
1.5
1
0.5
0
Jul-08
Nov-08
Mar-09
Jul-09
Nov-09
Mar-10
Jul-10
Nov-10
Mar-11
Jul-11
Nov-11
Mar-12
Jul-12
Nov-12
Mar-13
Federal Funds Rate
BOT policy rate

Interest rates and exchange rates

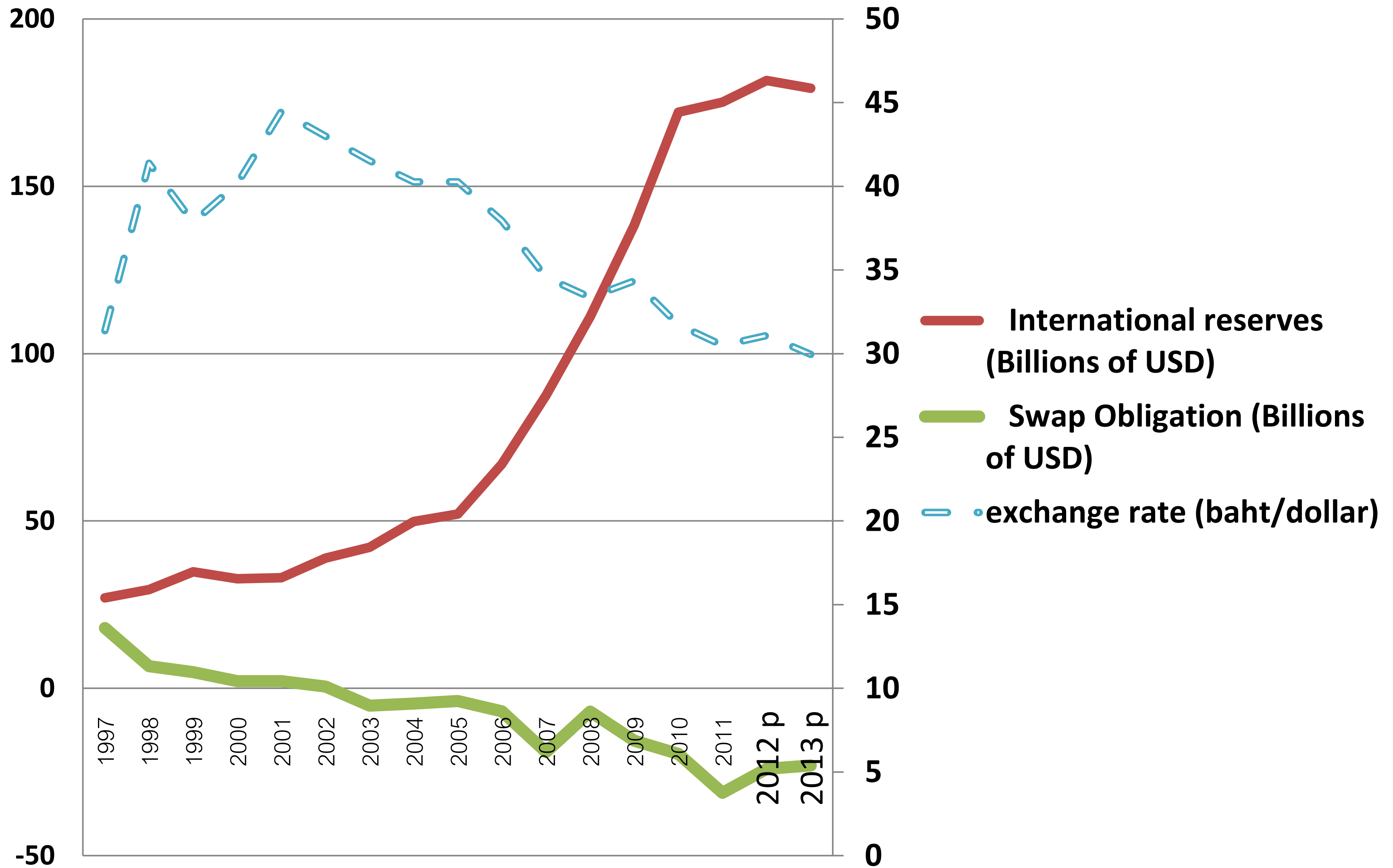
- The BOT once again tried to use the high interest rate policy to protect the baht, which has gained strength while the yen has depreciated against the dollar.
- The high cost of defending the currency by using high interest rates should be obvious from the painful experience of Thailand during the currency crisis.

What is an appropriate level of the exchange rate?

- It is exceedingly difficult to determine appropriate exchange rates using PPP or the current account balance.
- The cost of intervention in foreign exchange markets could be too high to warren the action.
- Intervention should not be employed to change the direction of exchange rate movements.
- There is some room for the creation of an orderly and gradual movement of the exchange rate to reduce the amplitude of the swings.
- But the Bank of Thailand cannot lean against the wind of volatile changes in the yen-dollar rate.

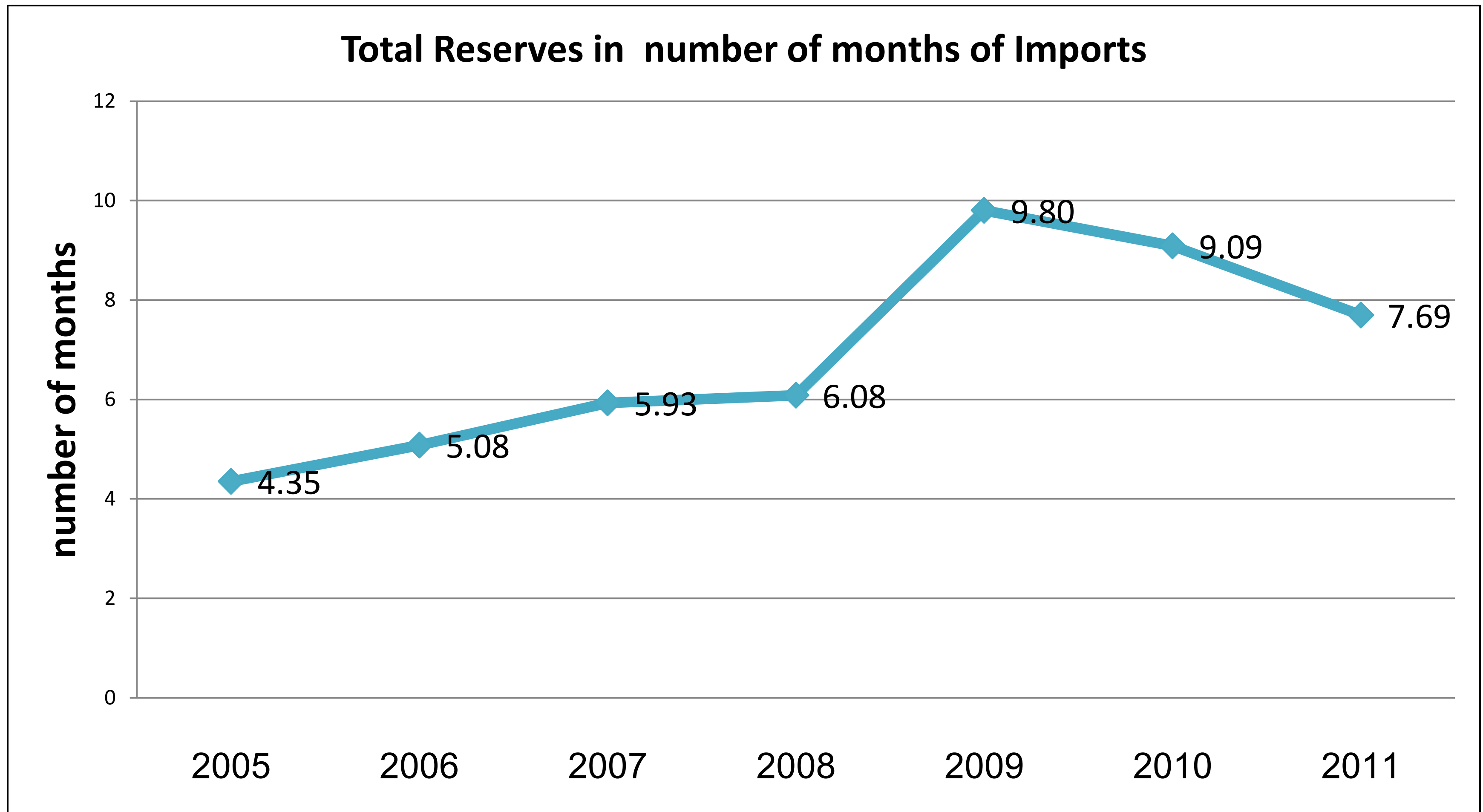


Net Forward Position (NFP)
percent
25
20
15
10
5
0
40
39
38
37
36
35
34
33
32
31
30
JAN 2006
MAR 2006
MAY 2006
JUL 2006
SEP 2006
NOV 2006
JAN 2007
MAR 2007
MAY 2007
JUL 2007
SEP 2007
NOV 2007
JAN 2008
MAR 2008
MAY 2008
JUL 2008
SEP 2008
NOV 2008
JAN 2009
MAR 2009
MAY 2009
JUL 2009
SEP 2009
NFP/Reserves (%)
Baht/dollar (RHS)

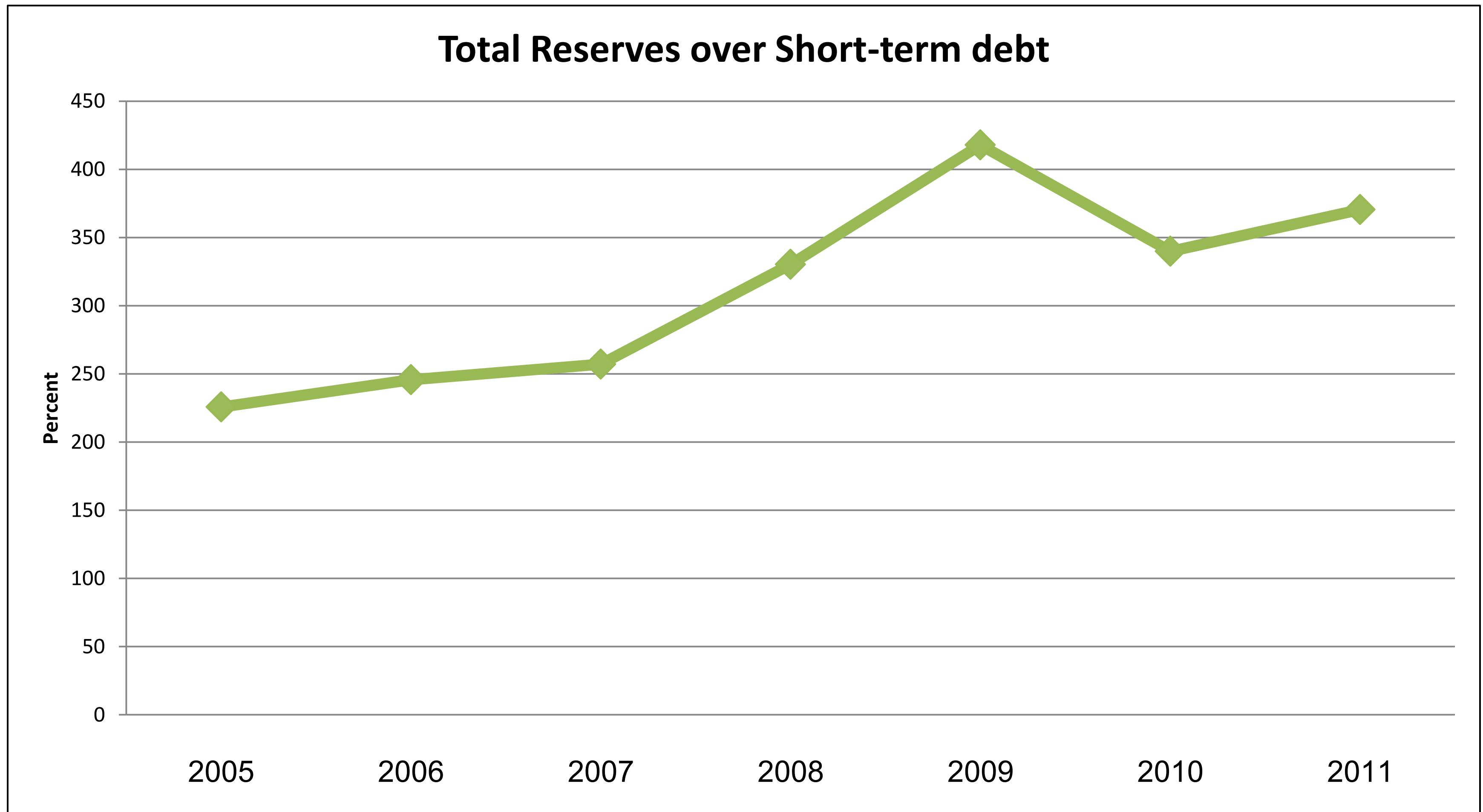


Exchange rate intervention
200
150
100
50
0
-50
50
45
40
35
30
25
20
15
10
5
0
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012 p
2013 p
International reserves (Billions of USD)
Swap Obligation (Billions of USD)
exchange rate (baht/dollar)

Import-covered international reserves



Reserves adequacy



BAHT BOOMING

Regional cross-rates against US dollar, Jan 2012-2013

	23 Jan 2012	23 Jan 2013	% Change
• Philippine peso	43.15	40.59	5.93%
• **Thai baht**	**31.36**	**29.77**	**5.07%**
• Singapore dollar	1.266	1.226	3.15%
• Malaysian ringgit	3.105	3.040	2.09%
• Indonesian rupiah	8,940	9,615	-7.55%

Source: Reuters

POSTgraphics

Concluding remarks

- With a realistic exchange rate and steady growth in the monetary base, even in the face of virulent external circumstances, the Thai economy can still make the best use of globalization by maintaining a moderate expansion along a sustainable growth path through employing a sensible economic policy.

- The Bank of Thailand could have eased its monetary policy to prevent a slowdown in 2001. An expansionary monetary policy or budget deficit financed by money creation can spur growth during recession, provided the Bank of Thailand does not intervene in the foreign-exchange market.
- The bah-dollar exchange rate cannot disengaged from the yet-dollar rate by central bank intervention in the long term.
- Monetary policy seems to be more effective than other policy alternatives during the debt deflation episode in Thailand