Chapter 2

External shocks and Resilience: 1991-2005

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1 Introduction

The Asian currency crisis that followed Thailand's decision to float the baht in July 1997 has become a chapter in the history of Thailand's economic development. We have learned a great deal about what went wrong and what could have been done to prevent the crisis.[1] Pundits warn that history might repeat itself and that we might experience another crisis in the near future, because Thailand has not completely restructured the economy to prepare for the next crisis. Economists are skeptical about the benefits of the pork-barrel spending of the government and fearful of enlarging public debt. It is argued in this chapter that there exist certain mechanisms in the structure of the Thai economy that would lessen the impact of the next economic crisis, if any, whether the shock is internal or external. It is impossible to rule out various shocks in the future such as oil price hikes, realignments of major currency values, or some other kind of crisis contagion. This chapter argues that these shocks would not have a long-lasting impact and that they would simply reduce Thailand's economic growth temporarily below a stable growth path. The Thai economy is resilient enough to regain its pre-shock growth path in a few years' time, just like it worked itself out of recession in 1998.

This chapter provides an analysis of the underlying changes in the structure of the Thai economy that help Thailand to recover immediately after a year of economic crisis. Some of structural changes have been adopted after the crisis along the lines of the second-generation reforms;[2] some of them have been developed over several decades through appropriate policy implementations similar to policy prescriptions by the Washington Consensus.[3] The next section explores the relationship between growth, price stability, and the sustainability of current account by analyzing the trend of the saving-investment gap. Section 3 discusses fiscal balances and their implication on the public debt. Section 4 explains the development in the financial sectors that makes Thailand become less vulnerable to future shocks. Section 5 analyses the dynamic aspects of the real sector that make the Thai economy recover rapidly after the currency crisis. Section 6 highlights the importance of the export-led strategy that enables Thailand to take the opportunity to grow following an upturn in the world business cycle. Concluding remarks are provided in the last section.

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1 For an excellent account of the crisis, see Warr (2005) and Siamawalla (2005).

2 According to Rodrik (2003), these reforms encompass corporate governance, flexible labour markets, adherence to WTO disciplines, prudent capital opening, independent central banks and inflation targeting, social safety nets, and target poverty reduction.

3 Williamson (1990) coined the term "Washington Consensus" which includes among others, fiscal discipline, interest rate liberalization, tax reform, trade liberalization, openness to FDI, and realistic exchange rate.

2. Growth with Price Stability

The three main traditional macroeconomic policy goals are growth, price stability, and sustainable current account deficit. Since there are always trade-offs among these goals, policymakers may have to choose to strike a balance between growth and acceptable levels of internal and external stability.[4] As the Thai economy has become an integral part of the global economy, these goals have become affected by external factors such as world business cycles and oil prices.

Figure 1 Macroeconomic Performances

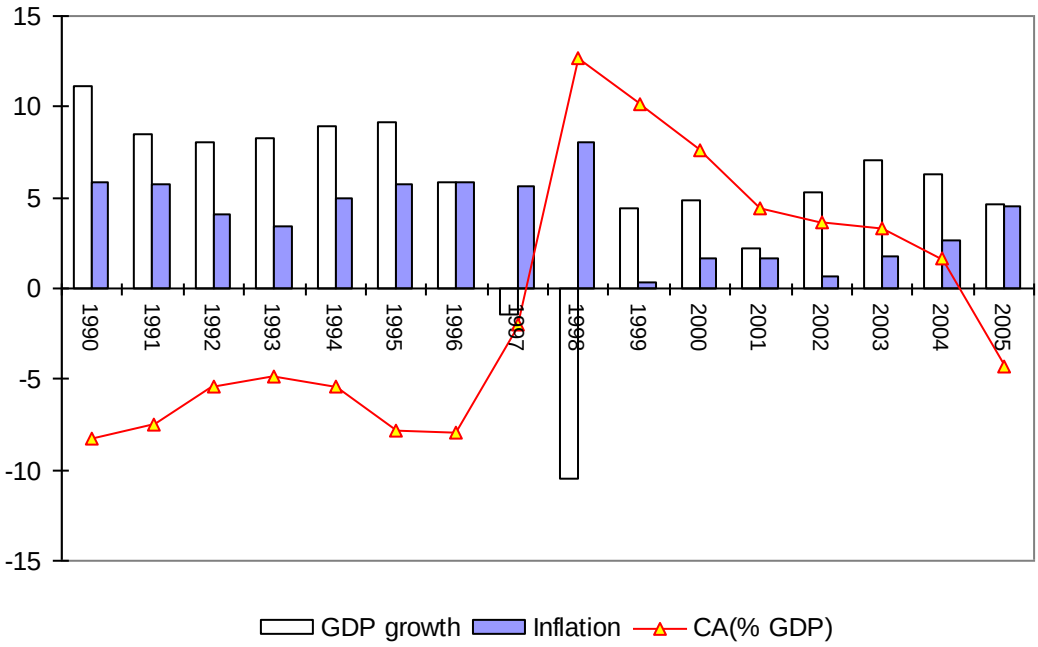


Figure 1.1 provides a stylized picture of Thailand's macroeconomic performance. There is a positive relationship between growth and current account deficit. During the boom years in the early 1990s, high growth rates led to a widening current account deficit. However, during a slowdown and moderate growth period, current accounts become surplus. High growth induces more imports of capital goods and intermediate inputs for production in manufactures. Because growth is driven by exports and investment, surges in imports and a widening current account deficit become the natural consequences of a high growth rate episode. When growth collapsed in 1998, Thailand experienced current account surplus for

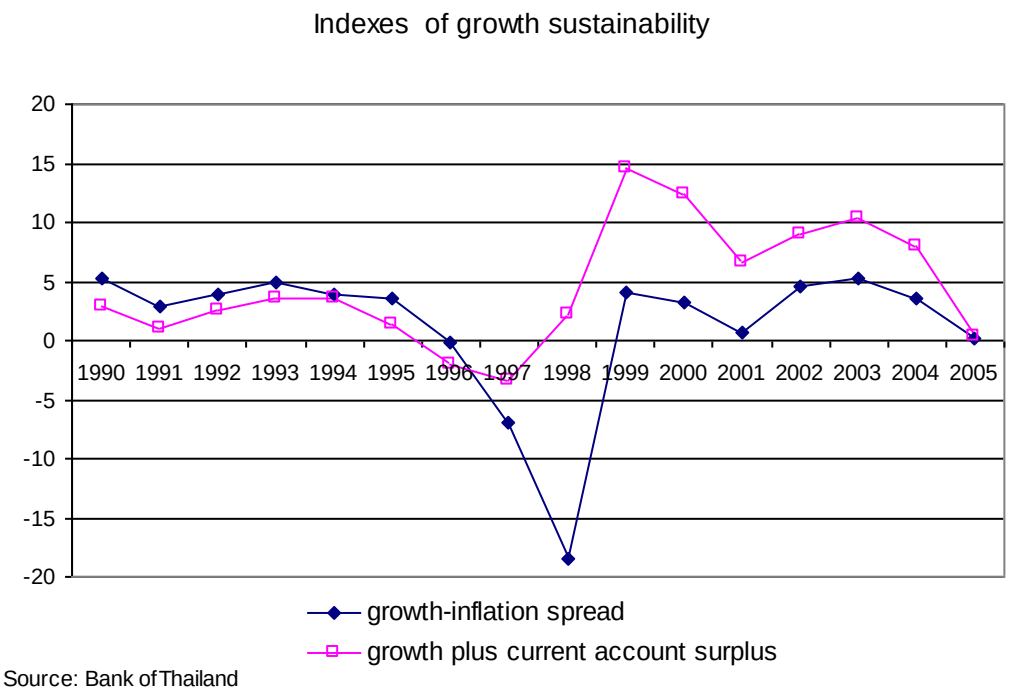
4 Inflation targeting mechanism of the Bank of Thailand is an example of such policy responses through changing the policy interest rate.

the first time in the history of Thailand's economic development. The surplus should become smaller and eventually peter out as the Thai economy regains its pre-shock growth path after 2004.

There is also a trade-off between growth and inflation. With a moderate growth rate of around five per cent, the pressure on the price level is not as great as during the period when the economy rose above the trend growth path dictated by output capacity. As can be seen from Figure 1, during the double-digit growth in the late 1980s and the early 1990s, inflationary pressure began to build up even when the growth rate slowed down. Inflation inertia has played an important role in delaying price adjustments. Once inflationary expectations are formed, their impact on wage and price adjustments will be felt in subsequent years. It should be noted that price stability is a natural feature of the Thai economy, originating from built-in-fiscal structures and institutional factors.

The second oil price shock in 1979–80 resulted in double-digit inflation, reaching 19 per cent in 1980. Another extraordinary year was in 1998; inflation increased to only 8 per cent despite a massive devaluation of the baht. Nevertheless, these two episodes bode well for a low-inflation prone economy like Thailand. Inflation rates went up sharply during these two events, but they also came down remarkably well within subsequent years. There is no mechanism such as wage indexation that allows spiral inflationary expectations to emerge. Because of low inflation, there is no need to create interest and bond indexation. Printing money to finance a budget deficit is not practiced by the Bank of Thailand. Although the government runs a budget deficit, most of the deficit is financed through issuing bonds; therefore it has no impact on the expansion of the monetary base.

Figure 2 Resilience and sustainable growth



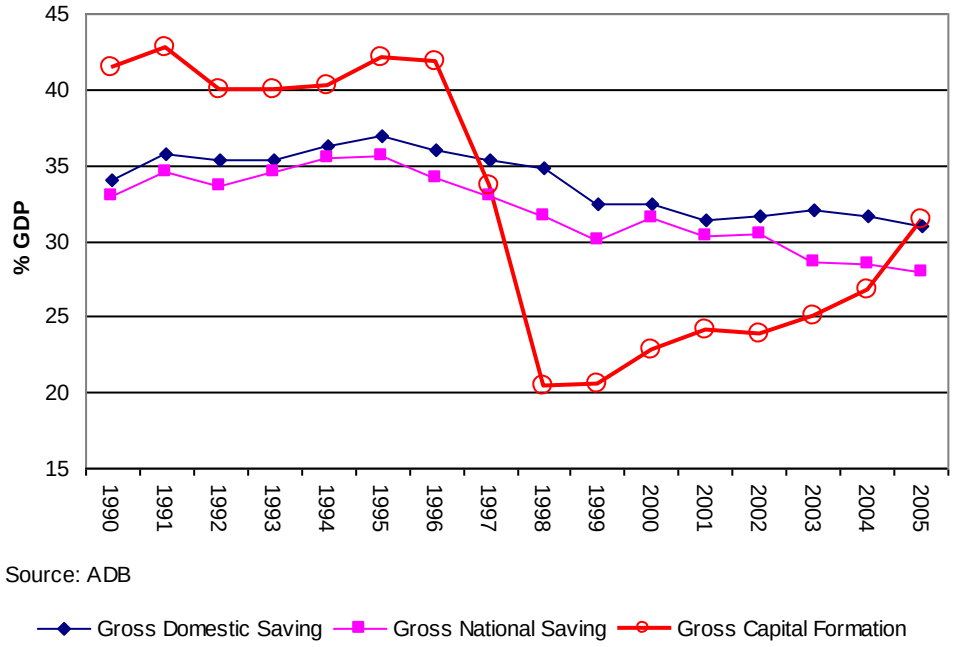
Source: Bank of Thailand

When the Thai economy was hit by the oil price shock again in 2003, oil price adjustments were delayed through public subsidies to stabilize domestic oil prices and to keep inflation at bay. The motivation behind this policy was to control key commodity prices that might ignite widespread inflationary expectations to the rest of the economy. Because of the downward rigidities in the price level, this strategy is appropriate as long as the oil prices increase is temporary. However, it would be a mistake in terms of revenue loss and an inefficient use of energy if the prices were kept artificially low when the increase in the oil prices is permanent. By September 2004, the consumer price index had already risen by 3.8 per cent on a year-on-year basis. Note that the core inflation rate, that is, the Consumer Price Index excluding food and energy prices, increased by a mere 0.6 per cent. Inflation in 2005 will be higher as the impact of higher oil prices is released through gradual withdrawals of the oil price subsidy. However, there will be no spectacular increase in the inflation rate like the one seen in the last oil shocks.

During the economic crisis in 1998, GDP contracted by 10.5 per cent as a result of negative contributions of 6.3 percentage points from consumption reduction and 17.4 percentage points from investment shortfalls. It was the positive contribution from net exports by 12.8 percentage points that prevented Thailand from plunging into a deeper recession.[5] After the currency and banking crisis, the Thai economy experienced a shift in investment financing when, from 1980 to 1997, investments exceeded savings (Figure 3). The residual resource requirement for investment came from foreign savings or current account deficit. Since 1999, savings have exceeded investment due to investment contraction caused by reduced rates of return from private investment. Consequently, as shown in Figure 1.1, the current account was surplus as a result of the slowdown in private investment. There is another implication from this shift in financing pattern. Investors rely more on tapping domestic financial resources, thereby reducing their dependency on foreign borrowing. In addition, risks from fund withdrawals, exchange rate fluctuations, and rises in foreign interest rates can be substantially reduced.

[5] See Nidhiprabha (2003) for a detailed analysis of the decomposition.

Figure 3 Investment Saving Gap



It should be noted that despite the large current account deficit in the early 1990s, saving rates in Thailand were still high. They actually rose above 35 per cent in the year prior to the crisis. These high saving rates were generated by strong income growth of households, positive real interest rates, and confidence in the banking system. The root problem of the unsustainable current account deficit lay in the excessive investment rate. Despite the high rate of saving, the investment ratio was even higher, climbing above 40 per cent for the seven years prior to the crisis. Then Thailand experienced a precipitous fall in investment from the height of 42 per cent of GDP in 1996 to only 20 per cent in 1998. A large part of the investment went to inefficient investment in the non-traded sector. The saving rate fell subsequently as a result of a public deficit caused by revenue shortfalls and the government's bailout of ailing financial institutions. However, the decline in the saving rate was marginal compared to the fall in the investment rate, resulting in a significant positive saving-investment gap in the aftermath of the currency crisis (Figure 3). To correct an unsustainable current account deficit, output contraction is necessary and the exchange rate adjustment was not enough to correct the imbalances. These imbalances originated from the private sector and not the public sector which still ran a budget surplus prior to the crisis.

3 Strengthening the Fiscal Position

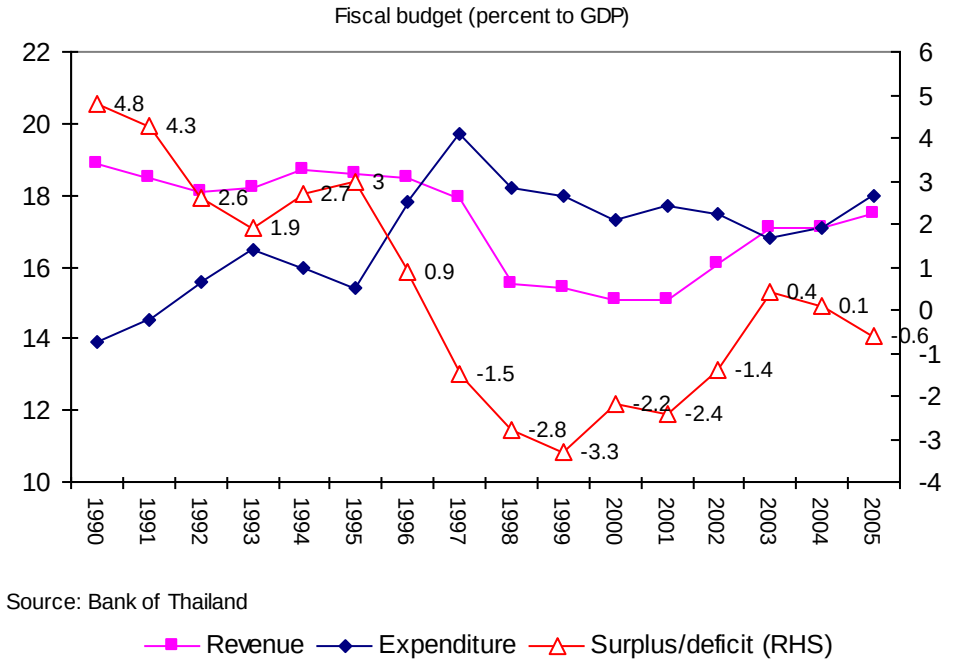
When Thaksin came into office in 2000, populist policy programs were employed to inject money into rural areas and the grassroots economy. These programs aimed to provide social safety nets and target poverty reduction. The Thai Government has attempted to reduce reliance on external demand by boosting domestic demand through promoting local enterprises and developing indigenously-owned production capacity. Housing projects for the poor, village funds and one-village-one-product projects are examples of this dual track development strategy. As pointed out by Felipe (2003), the shift to domestic demand-led growth can be compatible with export-led growth because what Asian countries need are policies to stimulate demand. The Thai Government's focus is on five sectors where Thailand can develop niches: A world centre of graphic design; the Detroit of Asia; tropical fashion; kitchen of the world; and tourism capital of Asia. Within these five competitive areas that the government wants to develop, one cannot depend solely on domestic demand because of the inability to exploit economies of scale. Critics argued that this kind of spending to promote competitive strength and social safety nets was ineffective, inefficient, and would lead to chronic fiscal balances. After four years in power, the Thaksin government's budget deficit turned around into a marginal surplus in 2004.

As shown in Figure 4, both spending and revenue declined after the 1998 recession, but they trended upward after rapid recovery in the early 2000s. However, revenue rose faster than spending, resulting in a narrowing budget deficit. This came about as a result of the fact that utilization of the allocated budget is not high. A new rule has been introduced which does not allow the budget to carry over into the next fiscal year. As such, planned expenditures are always greater that the actual budget spending. On the revenue side, the buoyancy of the revenue always guarantees that tax revenues rise faster than the GDP level.

Despite the fact that the value added tax rate has been maintained at 7 per cent, instead of returning to the pre-crisis rate of 10 per cent, VAT revenues increased rapidly as a result of strong growth in consumption. In the first six months of the fiscal year 2004 (October 2003–March 2004), excise tax, VAT, and income tax exceeded the target by 20 per cent.

Trade reform has been undertaken since the early 1970s by slowly dismantling tariff walls that protect domestic industries. Customs revenue as a percentage of total value of imports declined to only 3 per cent in 2003. The surge in imports enhances revenue collections, although tariff rates have been reduced regularly in line with trade liberalization and the move to establish free trade areas with ASEAN countries.

Figure 4 Strengthening Fiscal Positions

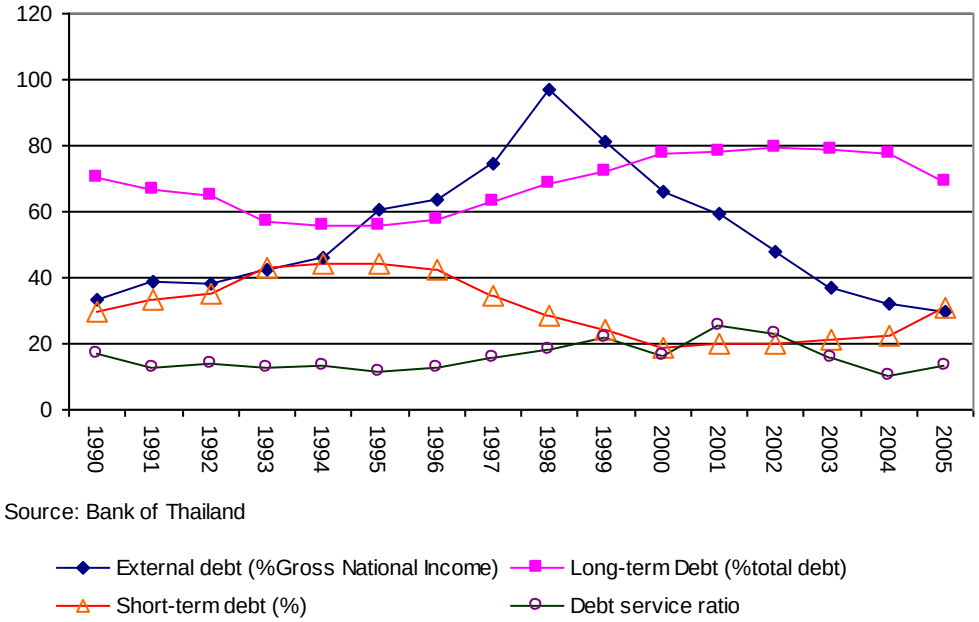


Achieving high GDP growth of around 6 per cent for three consecutive years, from 2002 to 2004, guarantees that the budget deficit is sustainable. It should be noted that inflationary pressure from money financed budget deficit is not plausible in the context of the institutional setting in Thailand, due to existing laws limiting the size of the deficit and the ceiling on public debt. In 2004, the public debt ceiling was reduced from 55 per cent to 50 percent of GDP, while the debt-service ceiling was set at 12 per cent of the annual fiscal budget. This fiscal discipline was institutionalized to prevent ballooning of the budget deficit.

Figure 5 shows that, as a result of the rapid growth achieved over the past three years, fears of explosive public debt were exaggerated. Both domestic and foreign public debts started to decline in 2003. There is also a change in the composition of debt. Reliance on foreign debt was reduced, thanks to the development of the government bonds markets, during the time when domestic interest rates are low. In addition, the composition of foreign capital flows has changed in favour of long-term flows or cold type of foreign capital. Heavy reliance on short-term foreign borrowings and other types of short-term capital flows, which are more volatile than foreign direct investment,[6] has been cited as a cause of the currency crisis.

[6] At the peak of the crisis, short-term debts amounted to 35 per cent of total debt. The amount has been declining gradually as firms have rescheduled their debt structure. The percentage of short-term debt stood at 23.4 per cent in August 2004.

Figure 5 Sustainable Public Debt



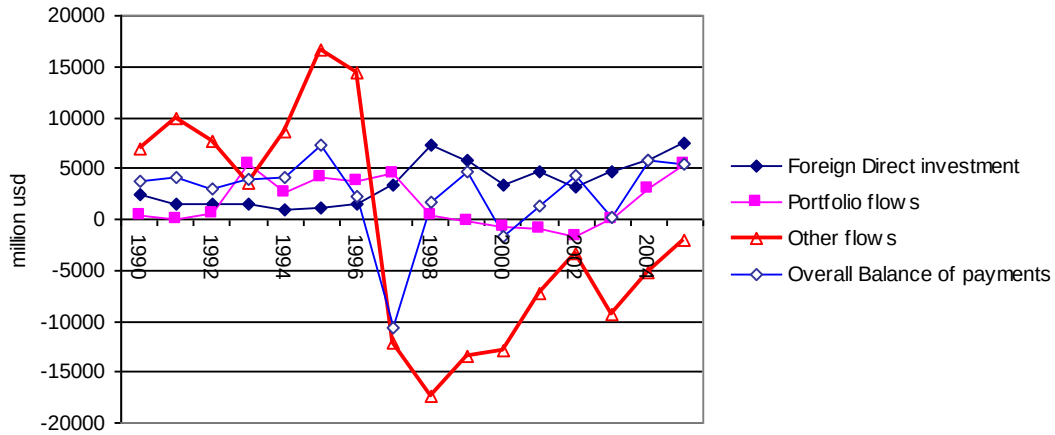
Source: Bank of Thailand

The severe contraction of output in 1998 can be attributed to a sharp decline in consumption and investment during the period of risk and uncertainty. The decline in consumption expenditures was due to the revised downward of expected incomes by households, while the sharp decline in private investment spending was due to a fall in the rate of return from investment as well as high interest rates caused by the tight monetary policy. During the boom era, the interest rates would have been raised more had it not been for the continued inflows of foreign capital that dissipated the upward pressure in the local money market.

4 Restructuring the Financial Sector

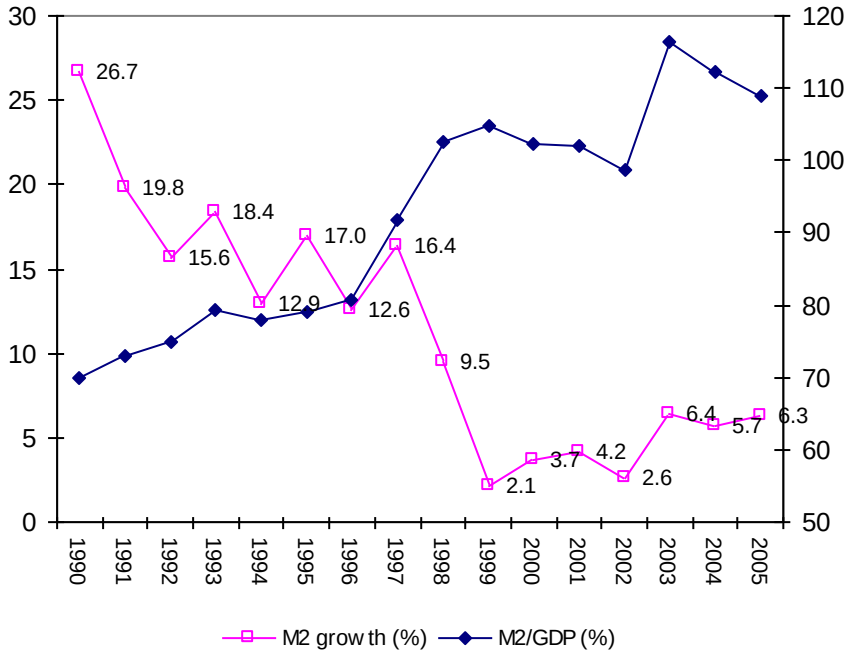
A few ailing commercial banks have been merged with strong financial institutions and some foreign banks have acquired some troubled Thai commercial banks. The solvency of the Thai banking system has been enhanced through the injection of foreign capital. Although the level of non-performing loans is high, it is declining as the economy has maintained strong economic growth since 2002. Thai banks have reported a significant amount of profit in 2004, after having to set aside a large amount of retained earnings to cover non-performing loans.

Figure 6 Coping with capital flows



Source: ADB

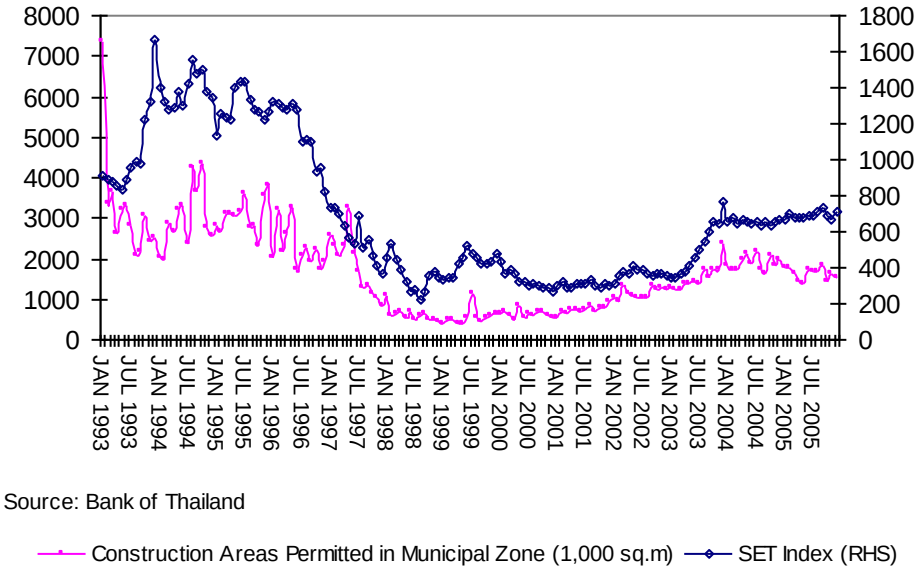
Figure 7 Slowdown in monetary expansion



Portfolio investments from abroad can stir up activities in the stock market but they are simply short-term capital flows. Capital flight can occur with rapid changes in investment sentiment caused by random arrivals of good news and bad news. Figure 8 illustrates this point. The movement of stock prices is a leading economic indicator because stock prices are

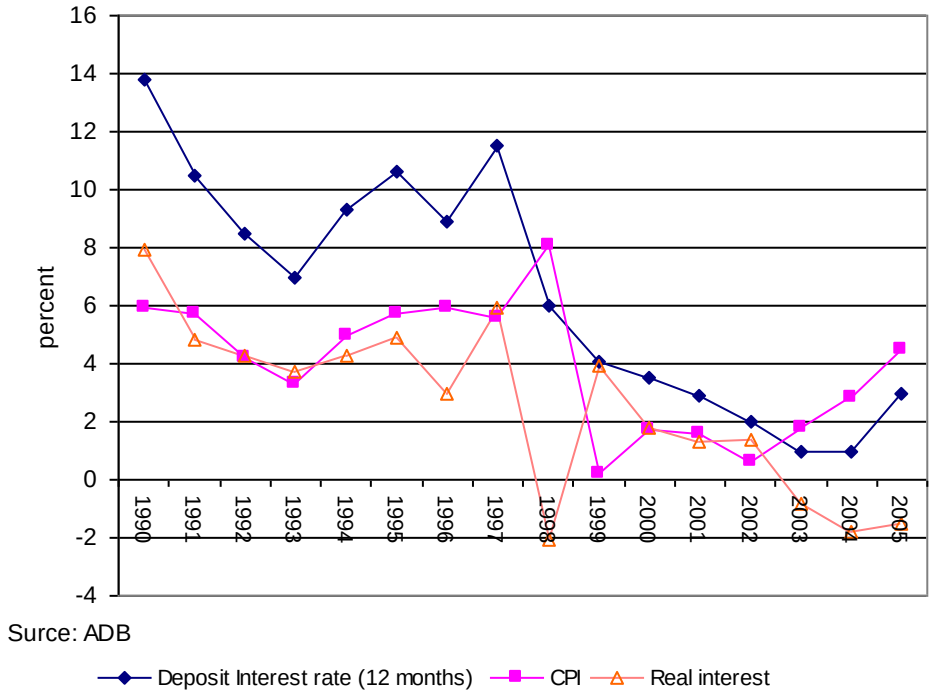
determined by expectations of dividends. The expected payments are affected by expectations of corporate performance in the future but, in the short run, stock prices are subject to volatilities caused by random shocks of good news and bad news. In 2003, The Stock Exchange of Thailand was the world's second best performer, climbing from 356 points in 2002 to a peak of 772 points in 2003. Its capital gains were more than doubled in that year, leading to high hopes and expectations in 2004. But since January 2004, the SET declined sharply by nineteen per cent in October, due to the avian flu scare and unrest in the Southern parts of Thailand. The Price-Earning Ratio that climbed to 13.6 in December 2003 dropped to just 9.2 in October 2004. Daily turnover for the first nine months of 2004 averaged 21.2 billion baht, compared with an average of 18.9 billion for 2003.

Figure 8 Volatility of Stock Market Prices



The declining trend of interest rates has had important impacts on the Thai economy. The decline encouraged the boom in the bond markets as investors looked for alternative assets to hold as sources of fixed income. The bond market has emerged as an alternative source of financial resources for firms. Although Thailand is still basically a bank-based economy, availability of resources from the capital market can provide funds when bank loans are not available during a credit crunch. Households also enjoyed high fixed incomes from holding bonds as the real interest rates from bank deposits became negative (Figure 1.6). Holding bank deposits becomes exceedingly unattractive when fixed deposit rates are below one per cent, notwithstanding a fifteen per cent withholding tax rate on interest income. Consequently, the bond market has performed remarkably well during the period of low interest rates. The fact that the government budget deficit is financed by issuing bonds has helped the bond market through establishing the benchmark for bond yields with various maturities. The reference yield curve was not available during the years when the government ran a budget surplus in the 1990s.

Figure 9 Real and Nominal Interest Rate



High interest rates are the results of high inflation and an over-heated economy. The prime lending rate was on the rise in 1995 but it was too late and too little to curb excessive investment. When it was realized that the tight monetary policy applied in the aftermath of the crisis was too severe, causing a contraction in bank credit, the Bank of Thailand relaxed its restrictive monetary policy as the world interest rates began to fall. The prime lending rate of commercial banks had been declining since 1999 until 2003 (Figure 1.6). Because low inflation translates into low interest rates, economic growth can be sustained if the interest rates can be maintained at low levels for a considerable period.

The period of low inflation and low interest rates in Thailand coincides with the general trend in the world.[7] Low interest rates in Thailand enable large corporations to refinance their external debt with cheap loans from domestic banks. Consequently, the vulnerability to currency shocks in the future has been reduced considerably. This is true for both the private and the public sector. Declining inflation and interest rates have paved the way to future sustainable recovery.

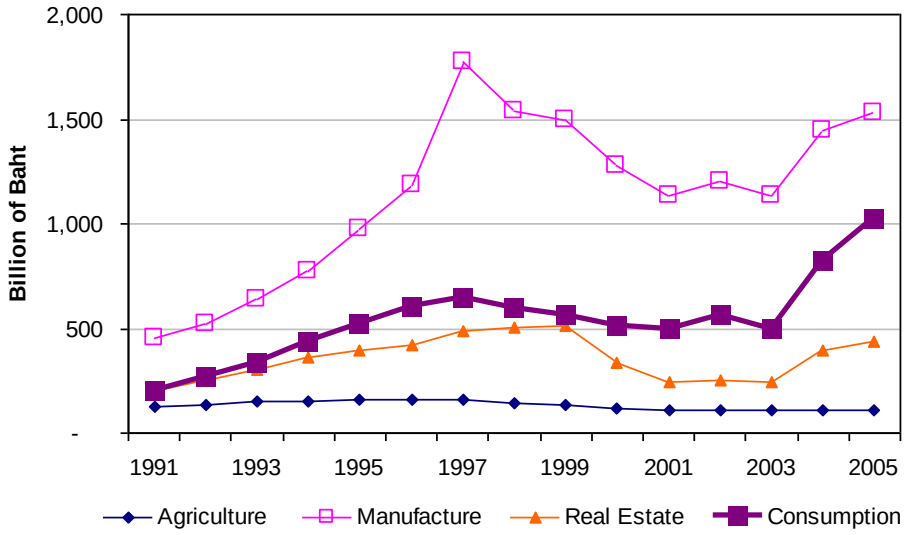
The nominal deposit rates trended downward (Figure 1.6), because of excess liquidity in the banking sector. Investors were not willing to borrow, while banks are still embedded with large non-performing loans. The resulting excess liquidity led banks to cut their lending and deposit interests. Note that the interest spread between the two rates remains rather constant.

7 The average global inflation stands at 2 per cent, the lowest for half a century.

Profit in the banking sector depends crucially on the interest spread and, in turn, profitability in the banking sector indicates the solvency of the entire banking system. Banks have begun seeking non-interest income from services to compensate for the shortfall in their interest income due to sluggish lending activity.

The continued decline in interest rates has also stimulated households' consumption as financing durable goods has become cheaper. Credit availability induces households to consume more by using future resources, while liquidity constrained borrowers enjoy additional financial resources which were not previously available to them. This means that the recovery of the Thai economy becomes possible once consumers have regained their confidence and started spending on durable items such as automobiles and housing.

Figure 10 Extensions of Commercial Bank Loans



Source: Bank of Thailand

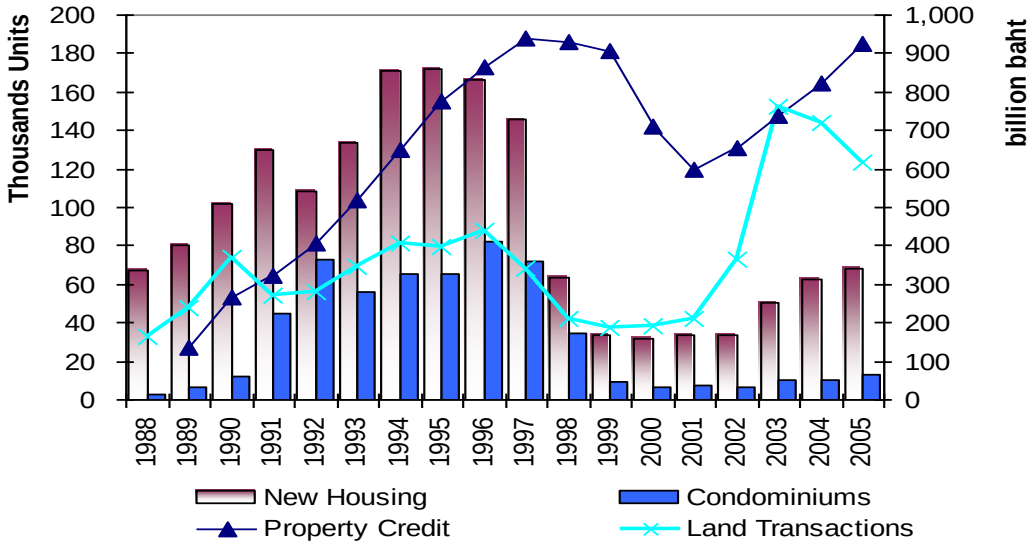
The amount of commercial loans extended to consumption increased gradually as the economic recovery became permanent (Figure 1.7). On the other hand, credit extended to the real estate sector has been shrinking since the property bubble burst after 1998. The decline in manufacturing loans became stabilized and showed signs of recovery in 2004. Credit allocated into this sector will increase gradually as long as many industries have not increased their capacity utilization above 75 per cent.[8] With expansion in export demand, the utilization rate was raised to 70 per cent in September 2004. It is not surprising that agriculture receives smaller amounts of credit compared to other sectors because of its smaller size in GDP and its lower
capital-labour ratio.

Speculative bubbles are largely created by over-confidence and reckless investment during a period of continued rises in property and share prices. However, sustainable increases in asset prices are made possible by credit expansion. Thus an early warning signal of bubbles is property credit. With available funds, property developers engage in land transactions and

8 At the end of 2003, the overall capacity utilization of the Thai manufacturing sector stood at 66.3 per cent.

start building new housing projects and condominiums. Figure 11 clearly demonstrates that the number of new housing units and condominiums in Bangkok and surrounding areas increased rapidly prior to the bubble burst in 1998. The values of land transactions as well as the credit extended to the property sectors by commercial banks declined sharply until 2002, when the first signs of recovery appeared in the property market. All these four indicators in Figure 1.8 started to turn around after five years of a long slump.

Figure 11 Property Bubbles



Source: Bank of Thailand

The recent boom in the property sector gave rise to a demand for intermediate inputs. The linkages to other sectors are high both backwards and forwards. The sector itself depends crucially on bank lending and low interest rates have given rise to greater demand for housing. Nevertheless, the Bank of Thailand is trying not to repeat the mistake made during the previous boom when bank credit expanded at an alarming rate. In November 2004, the Bank of Thailand raised the fourteen-day repurchase interest rate by 25 basis points to 1.75 per cent in line with the rise in the federal funds rate. The repurchase rate is a policy instrument of the inflation targeting process of the central bank. Because commercial banks still have excess liquidity, the increase rate should not have any impact on the prime lending rate of commercial banks in the near future. Nevertheless, tight monetary policy is required as the repurchase rate is below the inflation rate. The negative policy rate implies accommodative monetary policy. With the pressure on the price level, interest rates in Thailand will be on a rising trend although the adjustment will be gradual as loan growth is slowly catching up with deposits.[9]

9 In August 2004, bank loan expanded at 9.6 per cent, compared to the deposit growth of 3.8 per cent. Loan growth has started to outpace deposit since January 2004.

5 Dynamism of the Real Sector

In 1997 Thailand witnessed its lowest level of unemployment rate (1.5 percent) although the official figures seem to be biased downwards and may not take proper account of open and seasonal unemployment in the economy. Notwithstanding the natural rate of unemployment, the series of official unemployment rates can be used to trace the movement of unemployment over time. The output contraction in the non-agricultural sector of 11.4 percent in 1998 corresponds with high unemployment in the same year (Table 1.1). However, the resilience of the Thai economy has become apparent and the unemployment rate has been declining steadily and gradually since 1999. Flexibility in wage rates is a major contributing factor which prevented Thailand from suffering massive unemployment after the economic crisis.[10] There has been no downward rigidity in both real and nominal wage rates in Thailand; both real and nominal wage rates were cut during the high unemployment.[11] Although there are minimum wages, they are largely nonbinding in the sense that some workers are paid above the minimum levels. In addition, lags in adjustment of the minimum wage levels result in a delay in wage adjustment during tight labour market conditions and rising inflationary expectations.

The overall index of the manufacturing sector's capacity utilization points in the same direction of economic growth as in the non-agricultural sector (Table 1.1). The mild recession of the world economy in 2001 led to a lower rate of capacity utilization at 53.5 per cent.[12] Since 1998, the degree of capacity utilization has been higher than the lowest level of 58.7 per cent in 1998. As non-agricultural growth expanded above 5 per cent in 2002 and 2003, capacity utilization was raised to 64 per cent and 70 per cent respectively.
By 2004, the utilization rate went up to 72 per cent, as GDP growth in 2004 will register 6.6 per cent — despite oil price shocks and the adverse impact of the avian flu epidemic. When the capital utilization rate is high, firms start expanding their plant sizes if they anticipate a permanent increase in the demand for their products.

10 See Manning (2002) for a detailed discussion on the comparison of labour adjustment to the crisis in South Korea, Thailand, and Indonesia.

11 The average real wage rate was cut by around 4 per cent both in the second half of 1998 and in the first half of 1999.

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Table 1.1 Salient Features of Thailand's Real Sector

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Unemployment Rate	1.5	4.4	4.2	3.6	3.3	2.4	2.2	2.1	1.8
Capacity Utilization	69.9	58.7	65.7	68.4	64.4	64.4	69.7	71.7	72.3
Per Capita GDP (Index)	100.0	88.4	91.5	94.9	96.1	100.2	106.2	111.6	115.4
Agriculture Output Growth	-0.7	-1.5	2.3	7.2	3.2	0.7	11.4	-4.8	-2.4
Non-Agriculture Growth	-1.4	-11.4	4.7	4.5	2.0	5.9	6.5	7.4	5.2

Source: Bank of Thailand, IMF

Compared with the level of per capita income in 1997, the crisis led to a fall in per capita income, but by 2000, the Thai economy was able to regain its previous peak income level. By 2003, income increased by 20 per cent from the peak in 1997. Because of the dynamism of the agricultural sector, agricultural income increased at a higher rate than non-agricultural sector from 2000 to 2003. The agricultural sector has been able to respond effectively to rises in commodity prices in recent years because of the improvement in the sector's productivity. In 2003, farm output rose by 7.8 per cent in response to a 16.5 per cent increase in the price of agricultural products.

Table 1.2 summarizes the industrial sector's performance as Thailand regained the pre-shock growth path.

Except for the iron and steel industry, all sectors have achieved solid recovery. Using 1995 as the benchmark, the total manufacturing output declined by 3.5 per cent in 1998. Vehicles and components suffered a dramatic output fall of 65 per cent in 1998, while petroleum, textile, and jewellery registered strong growth due to the exchange rate depreciation. By 2000, all sectors, except the steel industries that still suffered from the collapse in the property sector, had recovered and expanded their output.

Propelled by the increased exports, manufactured outputs in jewellery, electronic and electrical appliances, such as air conditioners, have been rising continuously at a very high growth rate. Textile products did not experience output expansion significantly due to the problem with export quotas and high production cost.

Table 1.2 Manufacturing Productions (Percentage Change from 1995)

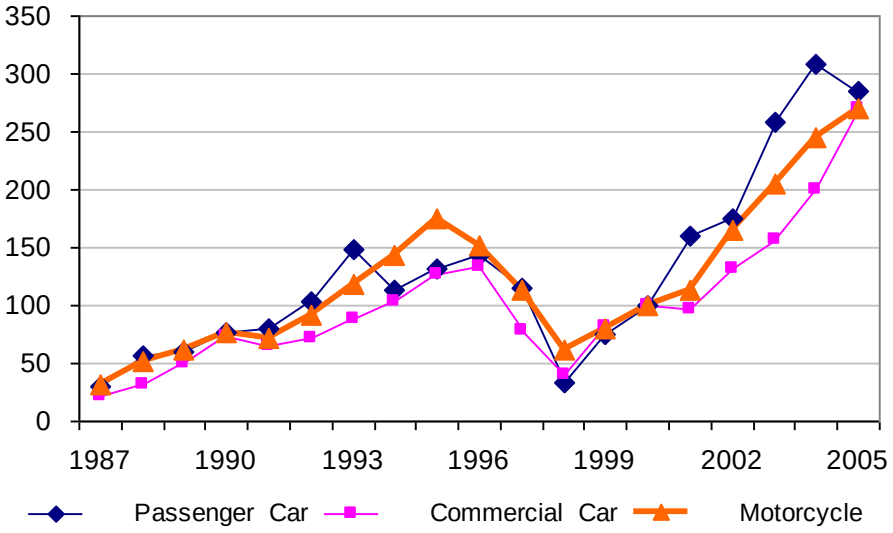
	1998	2000	2002	2004	2005
Overall Index	-0.3	19.5	33.9	70.2	85.8
Food	1.8	17.7	20.7	37.9	39.0
Textiles	14.5	26.2	46.2	63.1	66.8
Petroleun	43.6	45.3	51.1	71.1	70.4
Steel	-21.4	32.0	73.2	105.0	98.1
Vehicles	-63.5	-20.0	18.8	89.6	101.5
Electronic products	25.0	124.9	123.7	313.5	477.4
Jewellery	20.7	77.4	84.3	93.2	97.6

Source: Bank of Thailand

It becomes clear that sectors that depend more on exports can rebound successfully and faster than domestic oriented industries. The automobile industry suffered during the slump because the industry relied heavily on domestic markets. Now that the industry has become more export-oriented, it is in a better position to take advantage of the expansion phase of the world business cycle.

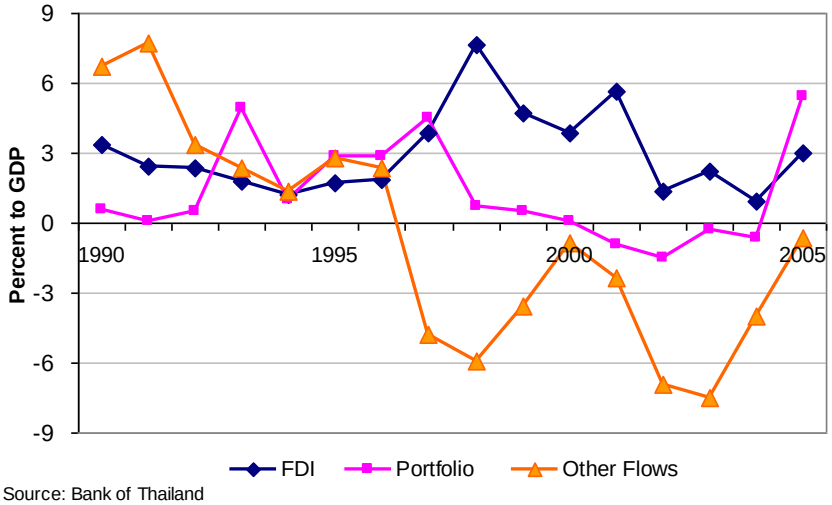
Figure 1.9 illustrates that output of passenger cars, commercial vehicles, and motorcycles moved in the same direction since they are sensitive to the growth of domestic demand. The industry experienced a gradual reduction in output in 1997 and a sharp fall in 1998, because of its reliance on domestic sales but after the industry had become more export-oriented, production growth rates were even higher than their past decade's average growth.

Figure 12: Production of Vehicles and Equipment, 2000 = 100



Source: Bank of Thailand

Figure 13 FDI and Net Capital Flows



Source: Bank of Thailand

The growth of the manufacturing sector has been driven by exports. Regional integration can enhance market excess of Thai exports to countries in Asia. Export growth also depends crucially on output capacity. The inflows of foreign direct investment over the past three decades have enabled the Thai industry to build up export capability. Industrialization in Thailand followed the development path earlier taken by other newly industrialized economies, along the lines of the flying geese model described by Akamatsu (1962). However, the inflows of FDI have started to decline (Figure 1.10) in particular the flows of foreign direct investment into industrial sector. FDI has been diverted to China, while other countries in Asia are also experiencing drying-up of foreign direct investment.

6 Export-oriented Industries

Exports contribute to growth because firms can exploit economies of scale by expansion of production runs to fill demand from external markets. In addition, firms are subject to a competitive environment so they must constantly improve their efficiency in order to compete abroad. The demand constraints in industrial countries can be ameliorated by a progressive shift of industries and in successful developing countries into more capital-intensive exports, while they would in turn import skill-intensive manufactures from other developing countries at a lower level of development (Balassa 1989). The export-led growth strategy is a desirable development strategy since it is pursued in the context of laissez-faire (Krueger 1997). Empirical evidence from ninety-five developing countries between 1976 and 1985 seems to point to the conclusion that outward-oriented development strategy makes developing countries grow faster (Dollar 1992).

Table 1.3 Output Performance of Export-Oriented Industry

	1990	1998	2002	2003	2004	2005
Overall	52.6	83.4	112.0	127.6	142.3	155.4
LOW	54.7	93.7	121.4	140.4	154.1	154.6
MODERATE	58.7	78.4	114.4	124.1	133.5	140.0
HIGH	39.2	74.2	100.9	118.3	138.4	169.7

Note: Manufacturing Production Index (2000 = 100)

Low: Export less than 30% of total production

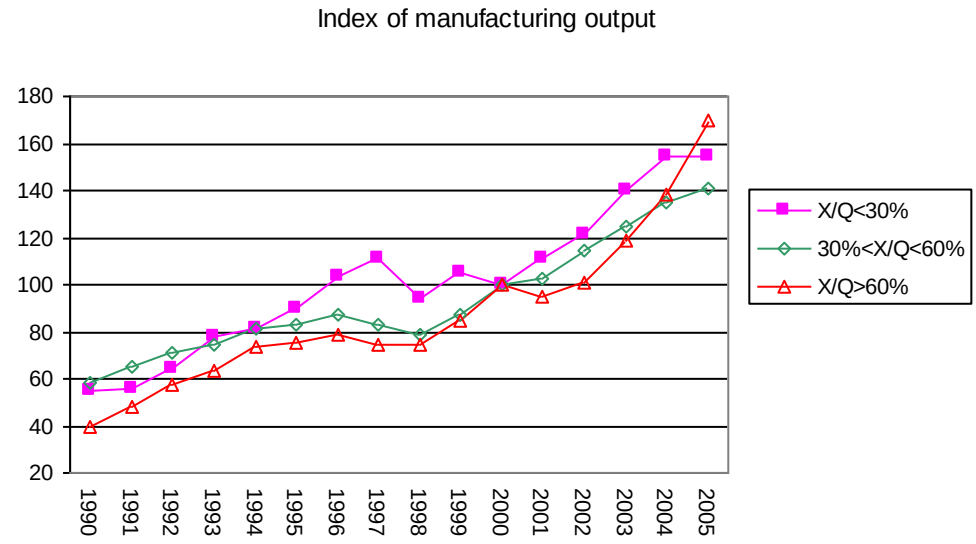
Moderate: Export between 30% to 60% of total production

High: Export more than 60% of total production

Source: Bank of Thailand

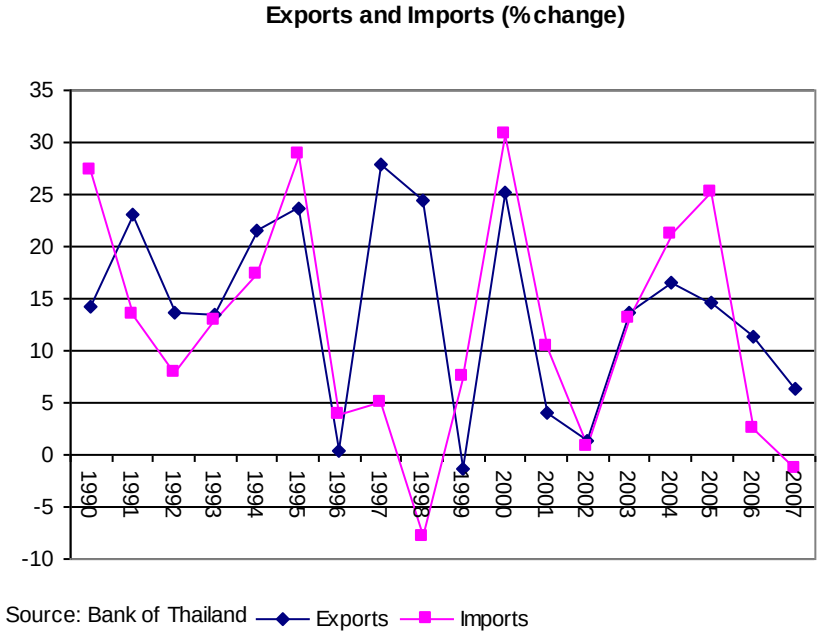
When analyzing the performances of firms classified by their degree of export orientation, we find that firms which exported more than 60 per cent of their output suffered less in the recession of 1998 and were able to recover faster than firms with a lower level of export dependency. Firms classified as moderate export-oriented in 2003 were able to produce 21 per cent higher output than the pre-crisis level of 1995, while those classified as high export-orientation were able to raise output by 55.5 per cent above the level of 1995 (Table 1.3). Nevertheless, the low export orientation group was able to raise its output by 42.8 per cent during the same period. This level was even higher than the level achieved by the moderate orientation group because the automobile sector was classified in the low export-oriented group by taking their situation in 1995 when domestic markets were still the main focus of that sector

Figure 14 Foreign market exposures



Source: Bank of Thailand

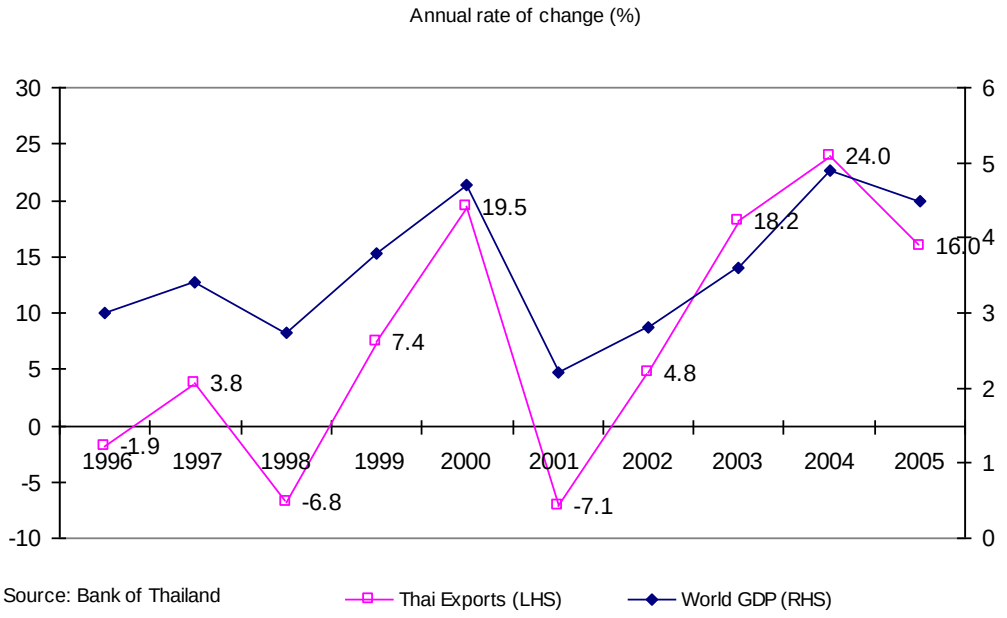
Figure 15 Long-run Relationship between Export and Import Growth



Source: Bank of Thailand

As previously discussed, exports depend on imported capital goods and intermediate inputs. It is not surprising that imports move together with exports over time as they exhibit a non-stationary nature of time series. To see the long-term relationship, we have to subtract the time trend elements from the level of exports and imports by focusing on their rates of changes. Figure 1.11 illustrates that the rates of change of both imports and exports are highly correlated. In other words, there exists a long-term relationship between the two series. In addition, the demand for imports of Thailand is highly income elastic in the sense that percentage changes in imports are always greater than the percentage changes in GDP. Rates of change in imports are usually larger than exports. During the recession in 1998, imports fell sharply, resulting in a larger current account surplus than Thailand had ever experienced before; this is not surprising since Thailand has never experienced such a severe contraction in output. During the expansion path of the business cycle, imports tend to grow faster than exports. In consequence, current account deficit will always accompany periods of high economic activity. Current account surplus is a sign of weakening economic activity and so a current account deficit indicates the strong growth of the Thai economy. Furthermore, tax revenues are generated from excise taxes and customs can make the tax revenue move anti-cyclically, thus providing a stabilizing effect during the boom.

Figure 16 Global Influence



We have discussed the supply factors that make Thailand's exports respond to an increase in demand from the world market. Given the elastic supply response of Thai exports, growth in export demand very much depends on market access and on demand factors. Redding and Venables (2003) found that more than half of the quadruple increase in Thailand's exports between 1982 and 1997 stemmed from an improvement in internal supply-side conditions. In addition, own region foreign market access and other region foreign market access contributed to 43.6 per cent and 17.3 per cent of total export growth, respectively. Because

key exchange rates did not change significantly, the major determinant of Thailand's robust exports in recent years has been basically the increasing income levels of industrial countries. Figure 1.12 depicts rates of changes in world GDP and Thailand's exports between 1996 and 2004. The world GDP growth rate is represented by the GDP growth of the United States, Japan, and the European Union. The striking coincidence between turning points of the two variables suggests that global markets have a strong impact on Thailand's export performance.

Table 1.4 Changing Export Destination

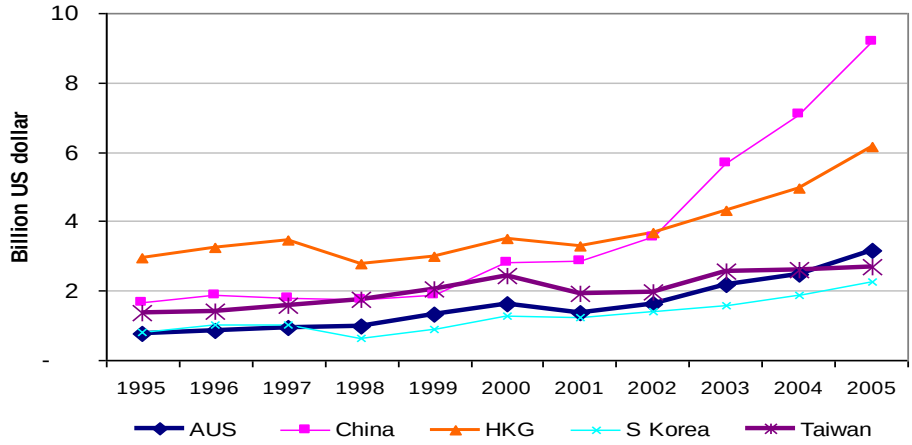
	1980	1990	1995	2000	2003	2004	2005
Japan	14.2	17.2	16.8	14.7	14.2	14.0	13.6
USA	12.6	22.7	17.8	42.1	40.2	44.3	48.6
EU	26.0	21.5	16.4	32.1	36.0	41.1	42.7
ASEAN	16.4	11.4	21.7	38.2	48.7	60.6	68.7

Source: Bank of Thailand, Direction of Trade Statistic

During the past five years there has been an emerging new pattern of international trade. Thailand exports are increasingly expanding into Asian markets, while the share of exports going to the United States and Europe has been declining (Table 1.4). Thailand has been integrating more into Asia, in particular with ASEAN countries. The same can be said about Japan, China, and South Korea. The new regionalism trend points to economic cooperation between ASEAN and the three countries in East Asia. Globally, volumes of trade within regional blocs are much larger than inter-bloc trade. According to Rugman (2000), intra-blocs export trade in NAFTA, the EU, and Asia intra-bloc exports was 49, 60, and 53 per cent respectively in 1997. There has been a proposal to form an Asian Economic Community by the year 2020 and free trade agreements between ASEAN and Japan, China, and South Korea would be a pre-condition for such a grand undertaking. The reason behind the increasing volume of trade among countries in Asia is the fact that these countries experience growth together, while they have different levels of economic development. Their economic activities are more complementary in general rather than competing with each other.

Figure 1.13 shows that when Asian economies suffered a recession in 1998, Thailand's exports to Hong Kong, China, Taiwan declined accordingly. But this is not the case for Australia, where imports from Thailand increased in that year. Nevertheless, when the world experienced a mild recession in 2001, exports of Thailand into these new markets suffered a shortfall accordingly. The export rebound afterward in these markets followed the same pattern. As conventional wisdom suggests, diversifying export markets geographically is a way to minimize risks when there is no synchronization of business cycles.

Figure 17 Thailand's Export to New Markets



Source: Bank of Thailand

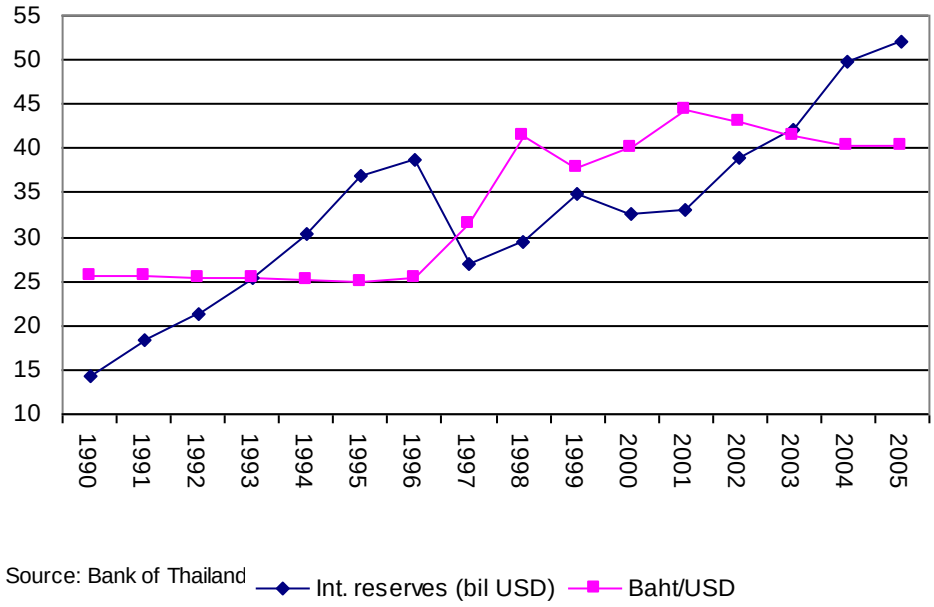
The real effective exchange rate, which reflects the incentives for export production, has improved significantly following the onset of the financial crisis. The econometric evidence provided by Athukorala and Suphachalasai (2004) confirms that real exchange rate depreciation is an important factor contributing to the post-crisis export recovery. Exchange rate depreciation thus has a role to play in stimulating exports to these new markets, where the baht has depreciated.

Japan and the United States are traditional major trading partners whose combined shares of Thailand's exports were more than 30 per cent. As shown in Figure 1.14, the value of the baht has been maintained close to the yen and the dollar. Intervention takes place regularly to prevent the baht appreciating against the dollar, resulting in a large accumulation of international reserves.[13] By August 2004, international reserves rose to US$44.8 billion. Thailand is not the only country that is trying to prevent currency appreciation through intervening in the foreign exchange market. The fear of floating has become an epidemic. Many countries attempt to maintain fixed exchange rates despite the claim of adopting a flexible exchange rate system. In fact it might be less risky to allow exchange rates to reflect changing market conditions rather than holding onto a fixed rate against a major currency.[14]

[13] In terms of the sufficiency of reserve coverage, the US$44.8 billion is equivalent to 3.8 times the size of short-term foreign debt.

[14] According to Calvo and Reinhart (2002), the probability that changes in reserves fall within a relatively narrow band is a declining function of the degree of exchange rate rigidity.

Figure 18: Fluctuations of the Baht



Because of the continued strength of the euro and Australian dollar against the U.S. dollar in 2004, the baht depreciated against the euro and the Australian dollar by almost 30 per cent since the beginning of 2001. The weakening of the dollar vis-à-vis other currencies implies the weakening of the baht against the yen, the euro and other currencies, while the baht still appreciates marginally against the dollar. With the problem of twin deficits in the United States, the baht might be actually undervalued. In the future when the dollar declines, the U.S. economy will have to undertake output contraction to resolve the unsustainable current account deficit; the inevitable sharp appreciation of the baht against the U.S. dollar cannot be postponed. The fear of baht appreciation against the dollar is a cause for concern, but we should remember that maintaining unrealistic fixed exchange rates was one of the causes of the crisis in the past.

7. Concluding Remarks

The flexibility of wage rates in Thailand helped mitigate the damaging effect on a sharp fall in output in the aftermath of the currency crisis. Unemployment since 1998 has been declining as the economy is slowing recovering. Inflation remains subdued compared with global inflation and the resulting fall in domestic interest rates enables Thai firms to restructure their foreign debts, thereby reducing the degree of vulnerability to a future currency crisis. Furthermore, the development of bond markets should reduce the heavy dependency on bank loans which was a factor that lead to sharp output contraction when Thailand suffered from a banking crisis.

The agricultural sector has been supporting the Thai economy by generating a high income throughout the early 2000s. Agricultural output responded positively to high prices for world commodities. In turn, the agricultural sector generates demand for manufactured products and provides a steady pool of labor for the manufacturing and service sectors. The dynamism of

export-oriented industries, which have focused more on foreign markets, has raised the output level far above the pre-crisis period. These industries are able to respond to the growing demand generated by the upturn in the world business cycle. The role of foreign direct investment is crucial to the industrial development of Thailand. The consistent open policy towards FDI has contributed to continued flows of technology transfer and spillover effect into local industries.

Fiscal budget deficit is under control, thanks to the built-in-automatic fiscal stabilizer of taxation and the nature of budget utilization. The reorientation of public expenditures provides social safety nets and targets poverty reduction. It remains to be seen whether these programs can provide positive social net benefits. International reserves also increased significantly from 1998, indicating sufficient coverage for short-term debts.

Commercial bank credits are expanding into non-speculative investment, unlike the lending pattern in the early 1990s. The financial crisis has given valuable lessons to good corporate and banking governance. The banking sector has become efficient as a result of industry restructuring and getting rid of the problem of non-performing loans. Adherence to international financial standards has improved the quality of bank loans. The Bank of Thailand has been aware of the possibility of asset bubbles and has taken precautionary measures.

Although the Thai economy seems to be resilient, riding on the expansion of world trade, there are still some structural problems. Public enterprises which enjoy monopoly power and high economic rents must be reformed to make them more efficient and competitive. Other monopolistic industries can be subject to competition if they are forced to compete with imports as a means to force them to restructure. Thus free trade agreements with other countries can help speed up the structural reform of inefficient sectors. The government has negotiated multiple free trade agreements with countries with various sizes and different levels of economic development. Thailand's current trade strategy implies a new regionalism that will commit Thailand to structural reform by creating efficiency through adaptation to the forces of globalization.

Its dependence on imported oil makes Thailand vulnerable to oil price shocks. The adverse impact of the oil shocks has been postponed through public subsidy but the surge in the inflation rate and the loss in competitiveness will become apparent as wage and prices adjustments begin to take place. For this reason, the exchange rates must be made more realistic with little intervention so as to cushion the economy from external disturbances.

If Thailand happens to experience another economic crisis, whether it is generated by internal or external sources, it should not be as painful as the brief episode in 1998. Thailand has an underlying economic structure and institutional factors that will make the impact of the crisis remain temporary. The Thai economy is resilient enough and will soon return to the pre-shock growth path once again as it had done after 1998, except that the economy will become more efficient and stronger than before.