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Quan B. Lai '00
Illinois Wesleyan University

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Currency Crisis in Thailand: The Leading Indicators

Abstract

Among the developing countries across the globe, those in Southeast Asia have experienced the most economic success within the last several decades. The ASEAN-5's (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) outstanding economic performance earned them, among other Asian countries, the title Asian Tigers. In the last decade, the annual growth rate of the ASEAN-5 has risen close to 8 %. The economic growth that the Asian Tigers were experiencing seemed indestructible, until the summer of 1997.

Keywords

Thailand economy

Currency Crisis in Thailand: The Leading Indicators

By Quan B. Lai

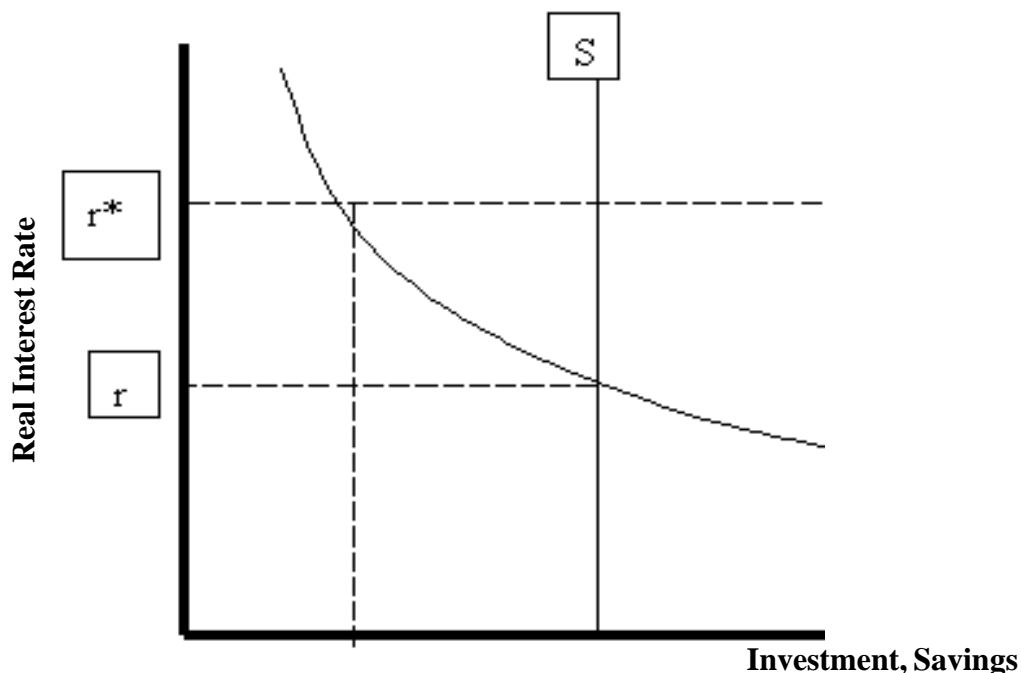
Among the developing countries across the globe, those in Southeast Asia have experienced the most economic success within the last several decades. The ASEAN-5's (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) outstanding economic performance earned them, among other Asian countries, the title Asian Tigers. In the last decade, the annual growth rate of the ASEAN-5 has risen close to 8%. Per capita income has increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia during the last 30 years. Moreover, per capita income levels in Hong Kong and Singapore now exceed those in some industrial countries. Asia attracted almost half of the total capital inflows to developing countries (Fischer, 1998). The economic growth that the Asian Tigers were experiencing seemed indestructible; that is,

until the summer of 1997.

In July 1997, the currencies of many Asian countries began to depreciate sharply. The devaluation of their currencies sparked a financial crisis that spread throughout the Asian countries. To understand why the once triumphant Asian Tigers took such a steep downfall, the root of the crisis must be determined. One can trace the origins of the Asian financial market disturbance back to economic developments that occurred since 1994. "Conditions in Thailand, the first country to be affected, best illustrates the causes of the recent currency crisis" (Alexander and Guthrie). Thailand's high exchange rate and excessive spending are two of the country's leading currency crisis indicators.

Preceding the currency crisis, Thailand's

Figure 1: The Effects of the World Interest Rate



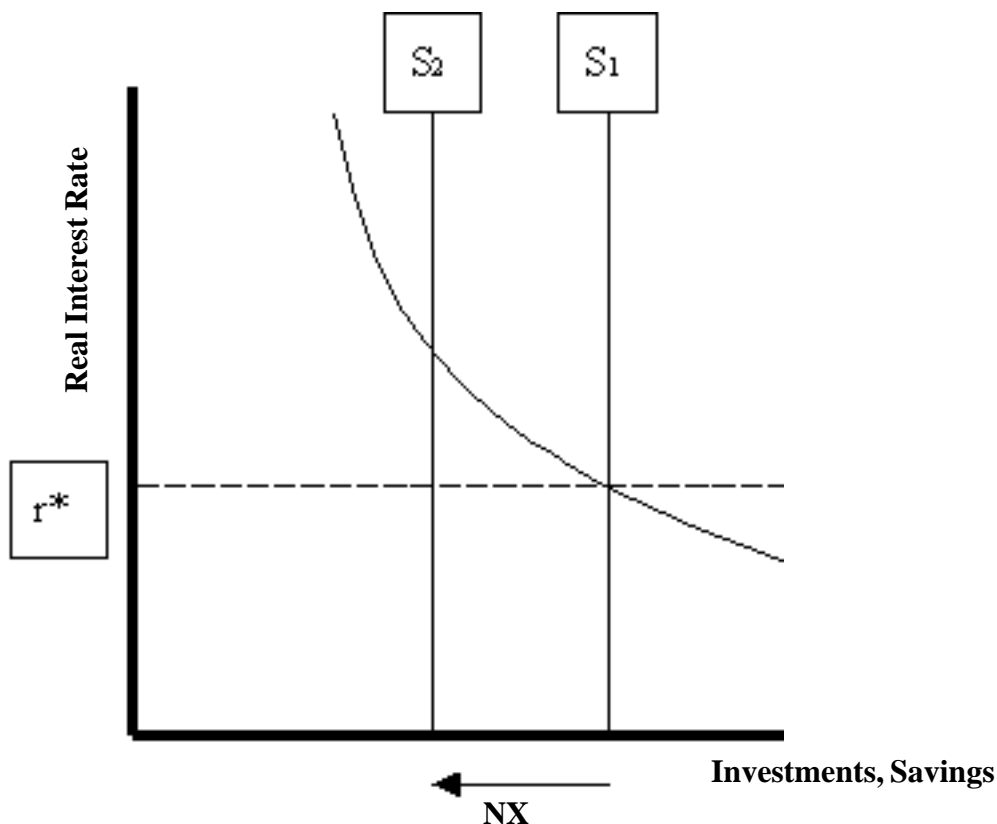
economic growth rate soared. During its period of development, Thailand experienced strong economic growth that averaged almost 10% per year from 1987-1995 (Fischer, 1998). Similar to other Southeast Asian countries, Thailand has a low-wage/low-skilled labor force; thus, it successfully attracted significant foreign direct investment (FDI) to build production plants for export to developed economies (Ciminero, 1997). Thailand ran a trade surplus, which attracted large capital inflows (see figure 1). Additionally, the Thai currency (the baht) was pegged to the US dollar, meaning that if the US dollar appreciated in value so did the baht, and if the dollar depreciated, the baht also depreciated. This brought in more capital inflows “so as long as the baht was pegged to the US [dollar], Thailand was viewed as even more attractive for FDI and foreign portfolio investment in its securities market” (Ciminero, 1997).

Thailand enjoyed its rapid annual real GDP growth. It became overconfident of its economic

state because of its quick growth and the US dollar-baht peg. The Thai government embarked on excessive official spending and encouraged the country’s banks to lend generous amounts of money for private real estate and other spending (Ciminero, 1997). Inclusively, liberalization of the financial sector encouraged domestic companies to borrow extensively from foreign countries. Companies in Thailand borrowed large sums of money as the economy boomed (see figure 2).

Most of the loans were made in US dollars because interest rates were much lower than the Thai currency. By borrowing money from a country where the interest rate is lower, Thailand assumed it would profit from the lower interest rate. Since the exchange rates were pegged against the US dollar, companies were not concerned with having to earn domestic currency to repay the loans in dollars. Unfortunately, the weakness of the US dollar at the time masked the weaknesses in the Thai economy. As the US dollar appreciated, Thailand

Figure 2: The Effects of Decreased National Saving



became less competitive in the world's market and its net exports declined (see figure 3).

Thailand's total exports declined by 0.2% (compared to increases exceeding 20% per year in prior years) when it lost competitiveness in labor intensive products (Sussangkarn, 1998). The slowdown in export growth caused Thailand to abandon the dollar peg and devalue its currency in order to promote exports. Losses in revenue gave rise to a crisis as debts became heavier and heavier ("Lessons ..."). The large amount of capital inflows Thailand received led to rapid growth in outstanding external debt. "The total outstanding external debt rose from 28.8 billion US [dollars] (33.8% of GDP)

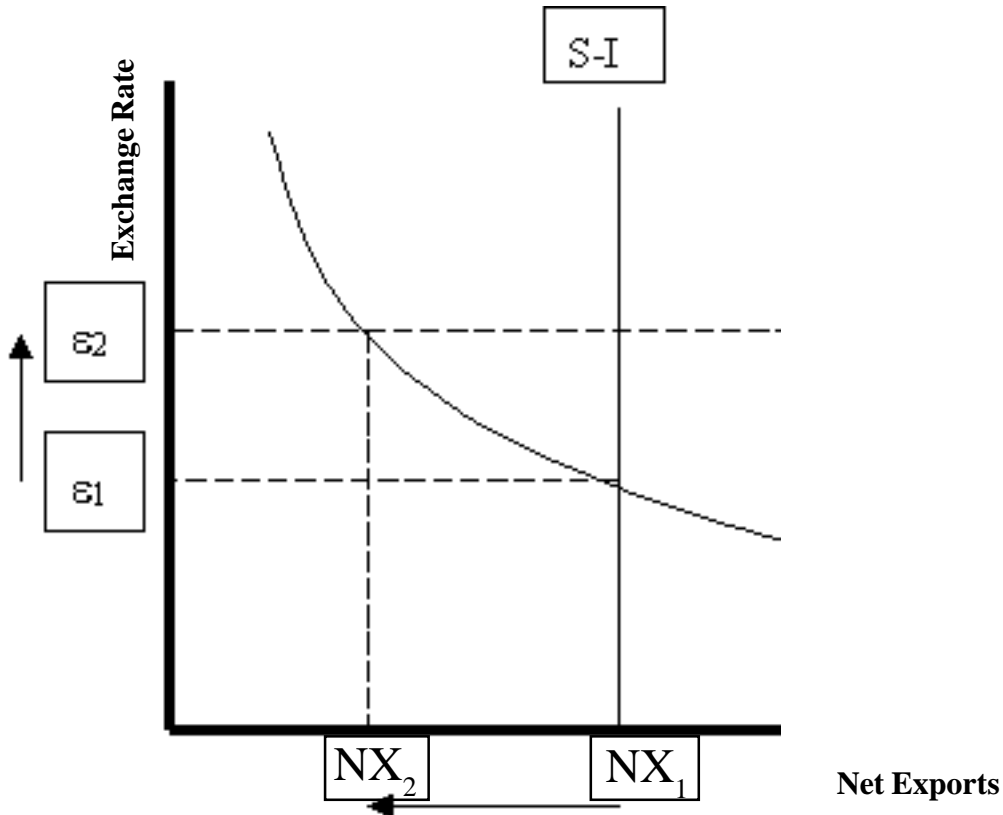
in 1990 to 94.3 billion US [dollars] (50.9% of GDP) at the end of 1996" (Sussangkarn, 1998) (See figure 4).

The international financial market's confidence in the Thai economy subsided. With the realization that the currency was overvalued, investors began selling the Thai baht in the summer of 1997. The Thai baht depreciated from 25 baht/US dollar to over 55 baht/US dollar by early January 1998 (Hill, 1998). Thailand faced many repercussions as the baht severely depreciated.

Many of Thailand's newly established finance companies had accumulated large quantities of bad loans; because of this fact, most went bankrupt by

The slowdown in export growth caused Thailand to abandon the dollar peg and devalue its currency in order to promote exports.

Figure 3: The Formation of the Trade Deficit



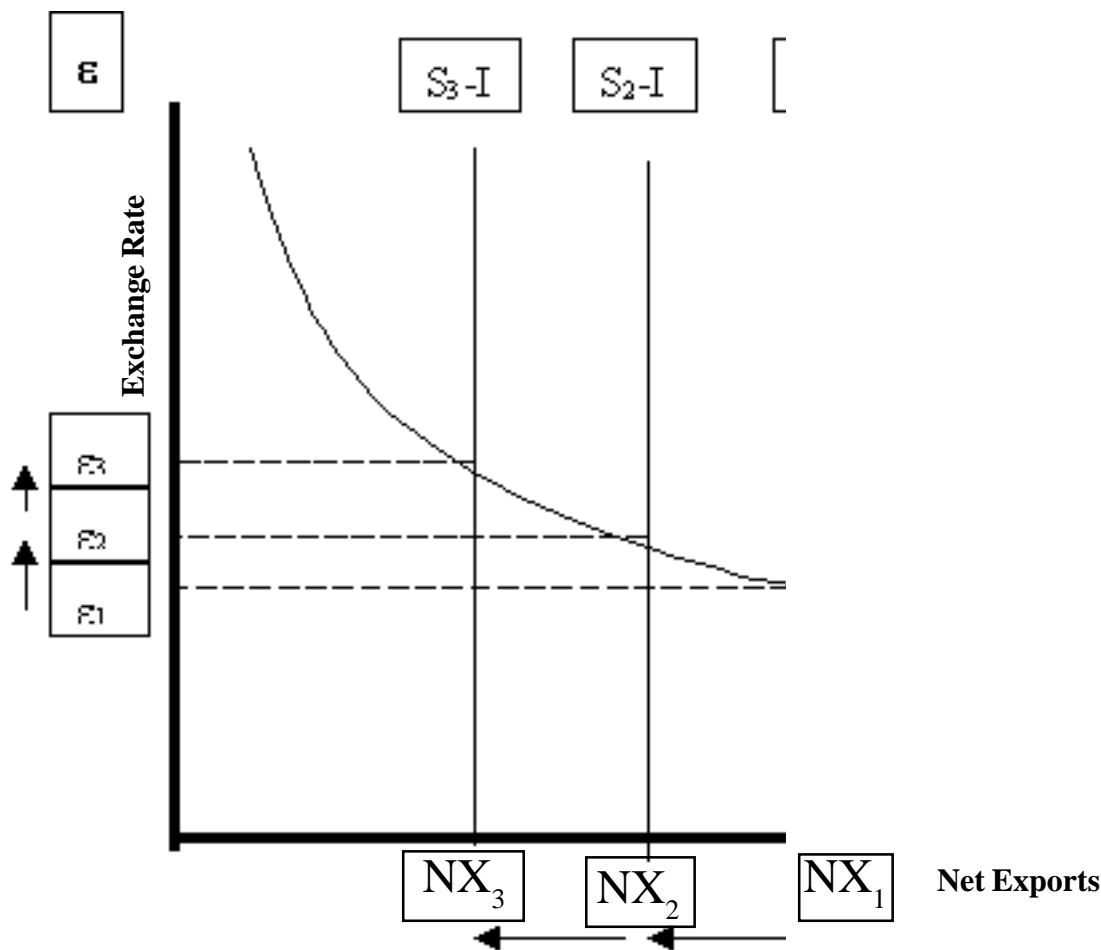
1996. The Thai government could have lowered interest rates and/or lowered the domestic currency exchange rate in 1996 to stimulate the economy, but the high foreign debt many of the domestic companies held steered the government away from such actions. They thought it would be much more costly to repay the foreign currency loans with a lower baht (Alexander and Guthrie). Most of Thailand's debt was in the private sector, and the newly established companies had no effective debt management mechanism (Sussangkarn, 1998). The companies' borrowings had greatly exceeded the firm's capital; companies with high debt had to close down, causing high unemployment.

Thailand's standoff proved unsuccessful. Although speculation of the Thai baht had increased Thailand's foreign reserves from about 16.5 billion US dollars in 1990 to 46.5 billion US dollars in 1996, the crisis drained its foreign reserves when

the Bank of Thailand used a vast amount of the reserves to defend the baht against speculative attacks (Sussangkarn, 1998). On July 2, 1997, after draining its foreign exchange reserves, the world market forced the Bank of Thailand to give up its defense of the baht. The government sought aid from the IMF (International Monetary Fund) and central banks in Japan and Asia (Alexander and Guthrie).

The IMF turned out monetary programs to support Thailand, as well as the other Asian countries in financial crisis. The IMF package focused on reversing the devaluation process by restoring confidence in the currency. Thailand made its currency more attractive by temporarily raising interest rates (Fischer 1998). This rise in interest rates halted Thailand's currency depreciation. The increased interest rates also reduced expenditures in all sectors of Thailand's economic system which

Figure 4: The Effect of Reduced National Savings on the Trade Deficit



therefore reduced the account deficit

By temporarily raising Thailand's interest rate (r) above the world interest rate (r^*), investments were reduced (*see figure 5*). This led the Thai economy toward a trade surplus because the country's national savings level was greater than its investments.

The decrease in investment demand decreased the quantity of domestic investment from I_1 to I_2 . This resulted in the supply of the baht to be exchanged into foreign currencies, a shift from $S-I_1$ to $S-I_2$. The shift lowered the exchange rate and raised net exports. Once confidence was restored, interest rates returned to a more normal level (*see figure 6*).

The models used to describe the impact on Thailand's trade balance are long-run models, but the models can also be employed to explain short-term shocks to the nation's economy. By following the trade balance models, Thailand could have foreseen the dangers to its economy that resulted from the nation's excessive spending. Instead, Thailand became overconfident in its currency, which led to high outstanding debts. The country's foreign loans were not hedged, so their greatly depreciated currency made it impossible to pay off

the loans.

The IMF and Thailand worked together to create a program which should be successful because of Thailand's dedication. However, in the short run, Thailand's economy has contracted due to declines in manufacturing and private investment. One of the main reasons for the contraction is the high interest rates imposed as part of the IMF's rescue package. Although Thailand's exchange rate is still low, the raised interest rates have steadily appreciated the currency, as well as kept inflation down (Hill, 1998).

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Figure 5: The Effects of a Shift Away from the World Interest Rate

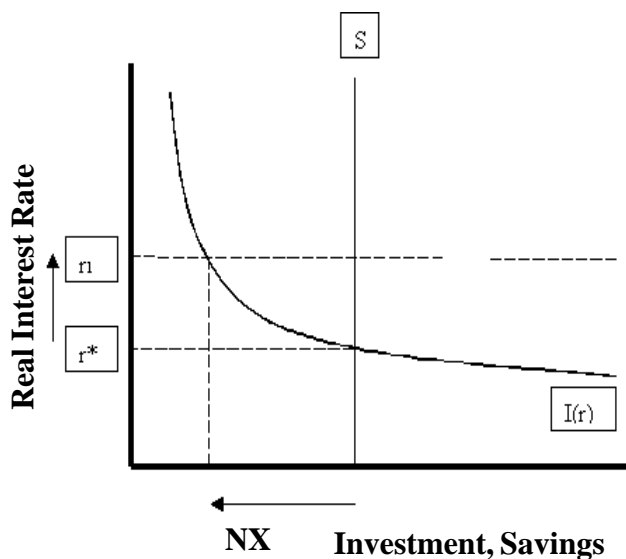
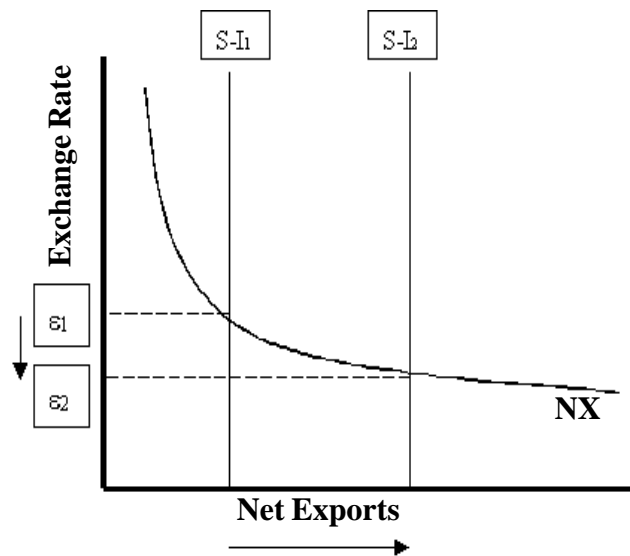


Figure 6: The Effects of a Decrease in Investment Demand



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