CHAPTER 3: OVERVIEW OF THE THAI ECONOMY

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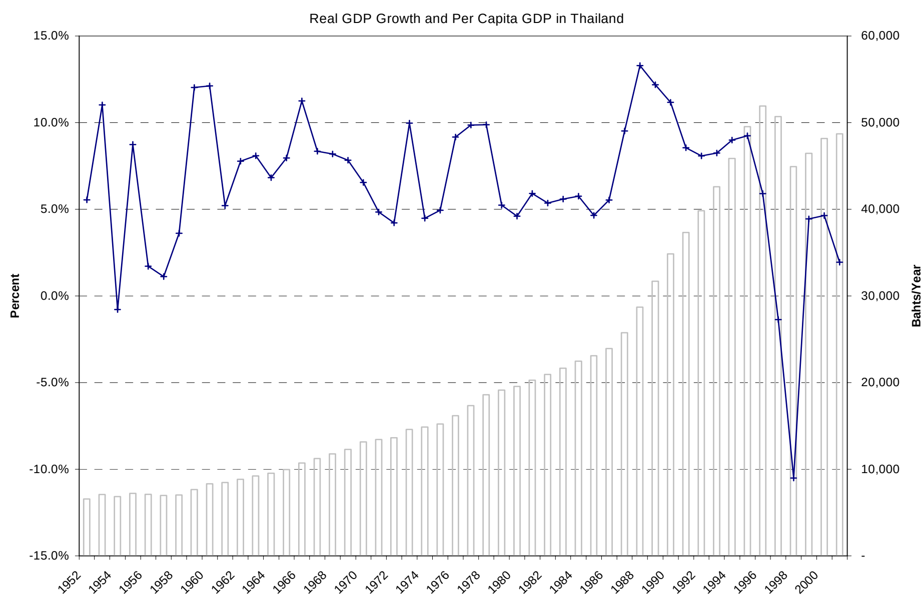
3.1 OVERVIEW OF THE THAI ECONOMY

Thailand is unique. Its conservative, yet open-minded, Buddhist customs have given the Thai economy a distinctive shape. The objective of this chapter is to describe the structure of the Thai economy, narrate its evolution, and tell the story of its notorious financial crisis. We will start with the success story of the continuous and extensive growth of the Thai economy during past 50 years. It will be shown that the structure of the Thai economy has evolved immensely throughout this period in various aspects. From a primitive agricultural economy, Thailand is now quickly becoming a newly industrialized country. Several economic factors that have framed the development of the economy will be discussed. Attention will be given to employment and productivity, capital accumulation and technological progress, international trade and foreign direct investment. These factors have helped the Thai economy grow over time. Thailand's story of booms and bust will be told, and the chapter will be completed by a discussion of the financial crisis during 1997-1998.

3.2 OUTPUT GROWTH AND STRUCTURE OF THE THAI ECONOMY

Thailand has been one of the fastest growing countries in the world. From 1951-2001, the average annual growth rate of real GDP was 6.5% per year. Per capita GDP has been increasing substantially during the past 50 years. Yet, a wealthy country is hardly built within a half century. Thailand is still searching for its way to become a strong and prosperous economy.

Figure 3.1: Real GDP growth and per capita GDP in Thailand during 1952-2001



Although Thailand does not abound with oil and ores, its abundance in other natural resources, such as timber and agricultural products, helped start its growth. Fifty years ago, Thailand was still a primitive economy whose main output was agricultural products, particularly rice. In 1960, agriculture accounted for 32% of the total GDP of the country. At the same time, the share of manufacturing was only 14%. Thailand (or, Siam at that time) was known as the ‘rice-economy’. This picture is somewhat reversed nowadays. During the past 40 years, the proportion of agricultural products in the total GDP has been decreasing continuously. In 2000, they provided only 12% of the total product, while manufactures took up 35% share.

Not only has the structure of production changed during the past four decades, but the structure of demand has also evolved. On the expenditure side, the structure of demands for domestic products has changed remarkably. Forty years ago, the main driving force of the economy came from private consumption expenditures. As much as 73% of the total GDP was absorbed by private consumer demand. In the recent decades, however, its role has been reduced. Although the private consumption expenditure is still the largest part of the GDP, private fixed investment has become an important factor. During 1990s, private fixed investment absorbed as much as 40% of the total output of the country. Table 3.1 below summarizes the structure of GDP in Thailand.

Table 3.1: Output growth and the structure of GDP

	1960s	1970s	1980s	1990s	2000s
Real GDP Growth* (Percent)	6.0	7.8	6.7	7.8	4.4
Real Per Capita GDP* (Bahts)	8,329	13,143	19,558	34,839	48,159
Ratio of the Domestic Product by Industrial Origin (selected sectors) to GDP (Percent):					
Agriculture	32	27	20	14	12
Manufacturing	14	17	23	28	35
Transportation and Communication	8	7	7	8	10
Wholesale and Retail Trade	16	18	18	17	15
Services	11	12	13	12	12
Ratio of Expenditure to GDP (Percent):					
Private Consumption	73	70	65	57	56
Government Expenditure	10	11	12	9	11
Fixed Investment	14	24	28	40	22
Net Export	-1	-4	-6	-8	9

Source: National Economic and Social

**10-year average of annual real GDP.*

The abandonment of the fixed exchange regime in 1997 also changed the demand structure from abroad. Prior to 1997, the exchange rate for the baht, the Thai currency, was fixed at an over-valued level. After the baht was floated, net exports of the country have experienced continuously surpluses for the first time. International trade has become increasingly important in the recent years.

3.3 EMPLOYMENT AND LABOR PRODUCTIVITY

Currently, Thailand has a total population of roughly 62 million people. About 34 million people are in labor force, and 94 percent of this labor force is employed. The national unemployment rate was around 3.6% in year 2000. The majority of the workers is still in agriculture; however, it has been continuously losing labor participants to other sectors, especially over the last ten years. The employment share in agricultural sectors fell from 59.5% in 1990 to 45.3% in 1999. In return, shares of the employment in manufacturing, trade, and service sectors have increased gradually. These 14.2 percentage points of share went to manufacturing 3.4 points, trade 4.1 points, services 3.9 points, and other 2.8.

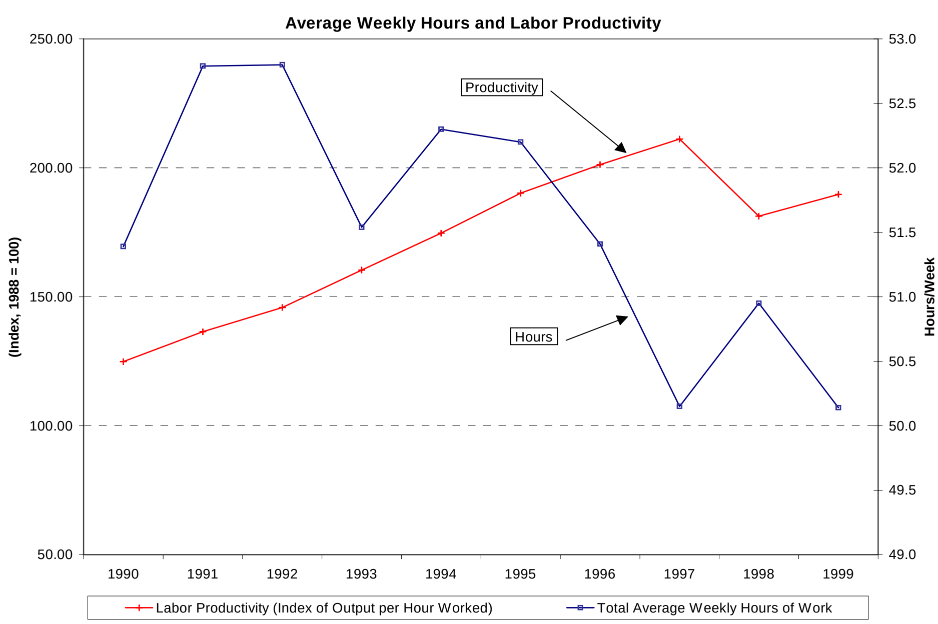
Table 3.2: Employment share by sector

(*Percent of Total Employment*)	**1990**	**1996**	**1997**	**1998**	**1999**
Agriculture	59.5	45.4	45.1	45.7	45.3
Manufacturing	11.5	14.9	14.6	14.8	14.9
Wholesale and Retail Trade	10.2	13.1	13.3	13.8	14.3
Services	8.4	10.1	10.8	11.6	12.3
Others	10.4	16.4	16.1	14.1	13.2

Source: *National Economic and Social Development Board (NESDB)*

Labor productivity in Thailand has been increasing steadily. The average output per hour in 1997 almost doubled that of 1990. The financial crisis in mid-1997 also led to a significant slowdown in labor productivity during the subsequent years. Both growing outputs and the decrease in hours worked contributed to the labor productivity growth in Thailand. Figure 3.2 shows that the average of weekly hours worked by all workers has been decreasing over time.

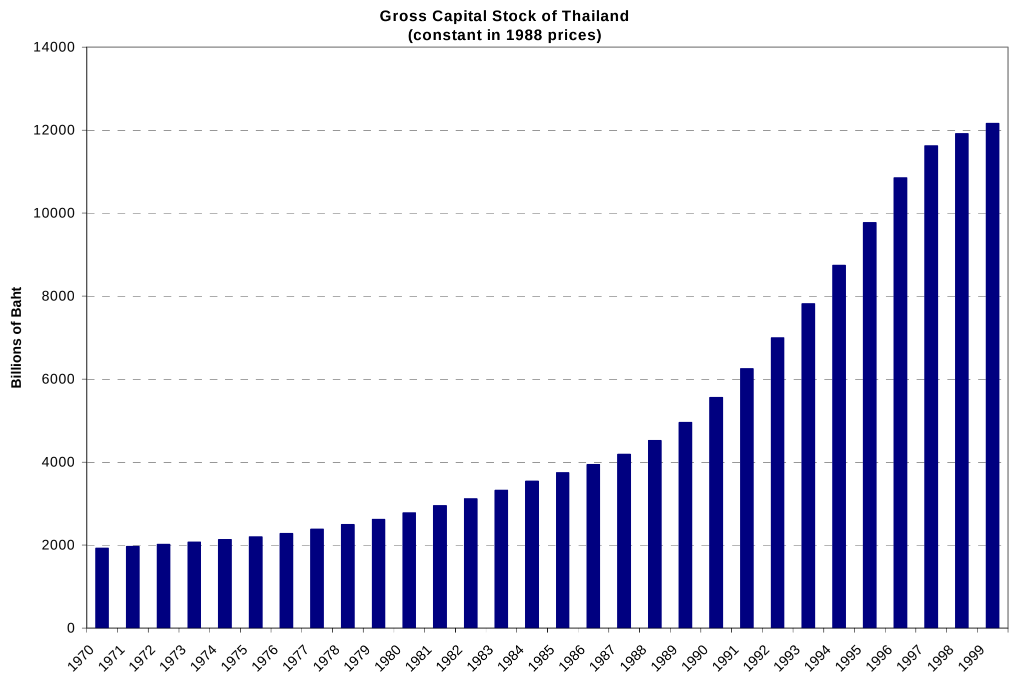
Figure 3.2: Average weekly hours and labor productivity in Thailand



3.4 CAPITAL ACCUMULATION AND TECHNOLOGICAL PROGRESS

Fixed investment has become increasingly important in domestic expenditure. Capital endowment is a crucial factor in economic growth, and part of the massive output growth in Thailand during the past decades has been contributed by capital accumulation. Gross capital stock in Thailand has been increasing continuously over the past three decades. A massive capital accumulation started to take off in the early 1990s. From 1985-1999, the values of gross capital stocks in Thailand have increased by about three times. Tinakorn and Sussangkarn (1994) suggest that capital endowment contributed to 37% of the average real GDP growth during 1978-1990.

Figure 3.3: Gross capital stock in Thailand



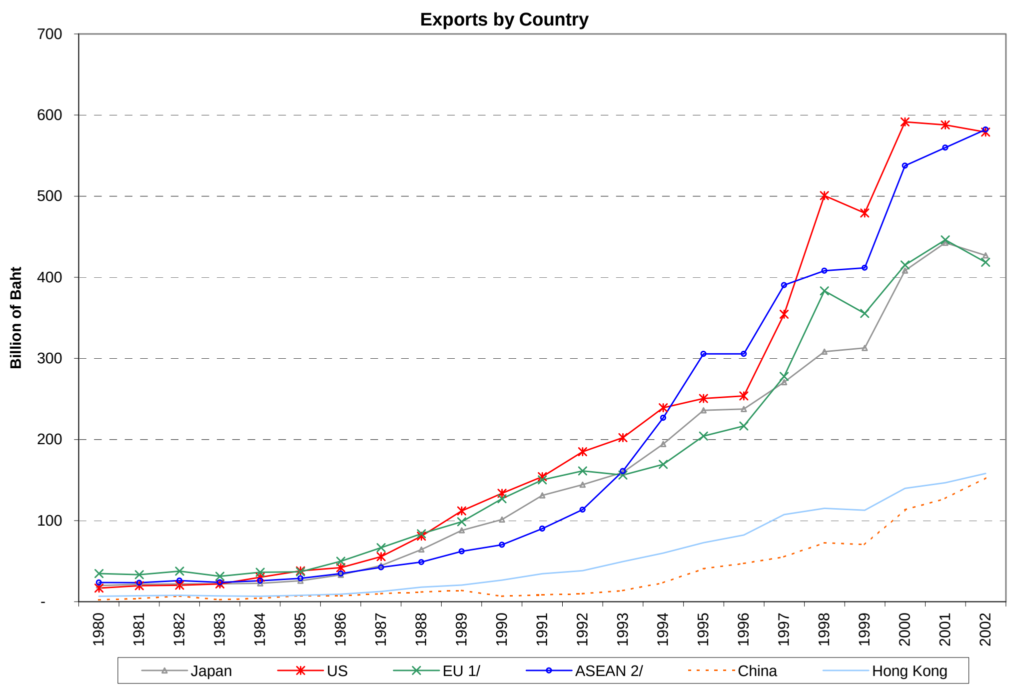
Capital endowment alone cannot keep a country growing over the long run. Economic growth theory suggests that sustainable long-term growth is energized by technological progress. There is very little literature that examines the role of technological progress on the output growth in Thailand. Among the few studies, Tinakorn and Sussangkarn (1994) employed the growth-accounting method to study the sources of economic growth in Thailand during 1978-1990. They found that technological progress has **not** been the major factor in the growth in Thai economy during the past decades. As they put it, "Thailand's rapid growth in the past decade or so has been achieved by adding more labor, capital and land to production. Some productivity improvements have been achieved, but these may have been through importing more efficient and modern machinery and through the employment of better or more productive workers". They reported that the total factor productivity (TFP) explained only 16% of the real GDP growth during 1978-1990, while labor and capital contributed to the GDP growth for 46% and 37%, respectively.

Technological progress in Thailand has been lagging behind. This point is crucial because increased use of basic production resources, such as unskilled labor, land, and low-tech capital is nearing its limit. Technological progress is necessary for the future growth. Failure to improve technology in production may lead to a sluggish development in Thai economy.

3.5 INTERNATIONAL TRADE AND FOREIGN DIRECT INVESTMENT

Thailand's international trade has started to expand since the late 1980s. Important trading partners with Thailand include the U.S., the ASEAN (Association of SouthEast Asian Nations), EU, and Japan. The U.S. is the biggest market for Thai exports. However, there was also a change in the structure of exports worth mentioning. In 1992, the ASEAN countries signed the Free Trade Agreement (AFTA), aiming to reduce the regional trade tariffs to 0-5%. Consequently, the intra-trade within the Southeast Asia countries has expanded extensively. Since 1993, values of the exports to the ASEAN countries have surpassed those to EU and Japan. In spite of the slow down during the crisis periods, the ASEAN intra-trade picked up quickly in 2000. In 2002, the value of export to the ASEAN was about 580 billions bahts (13.5 billion dollars), accounting for 20 percent of the total exports. This figure is approximately equal to the export share to the U.S.

Figure 3.4: Values of the exports by country

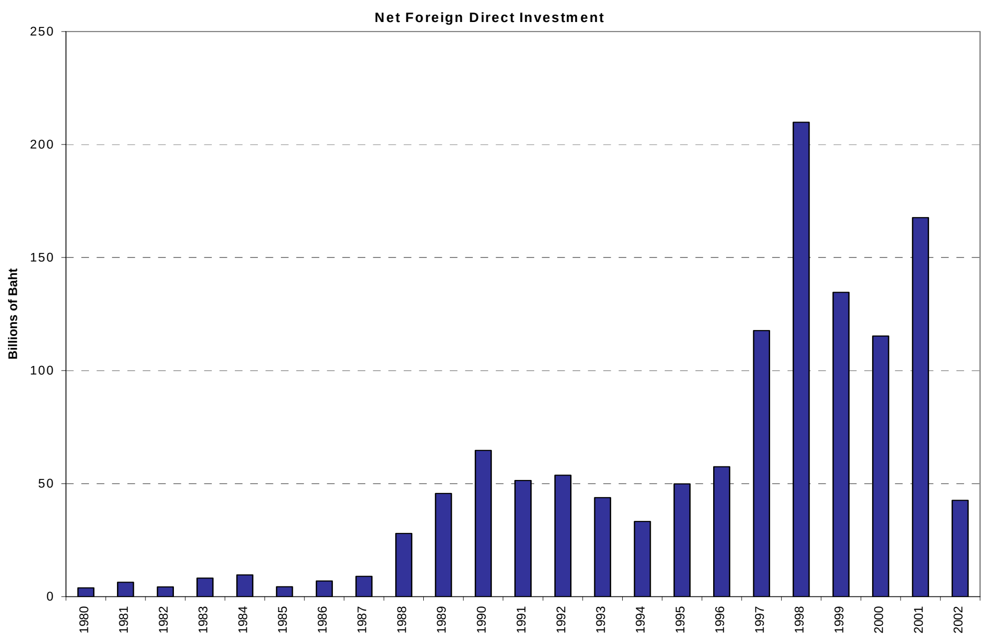


Source: Bank of Thailand and the Customs Department, Ministry of Finance.

In terms of the exported goods, the structure has also changed considerably. In early 1980s, 45% of the total exported goods were food products. However, the share of food products in exports is now replaced by machinery products. Currently, the exports of machinery products accounted for 43%, while food products account only for 14% of the total exports.

Net foreign direct investment (FDI) in Thailand has been significant since the early 1990s. Partly this rise in FDI is due to the abolition of the capital controls over financial capital markets, allowing foreign capital to move in and out of the country freely. The average annual FDI jumped from 13 billion bahts per year during the 1980s to 83 billion bahts per year in the 1990s. The most important sources of net capital inflows, in order of size, were Japan, ASEAN, the U.S., and the EU. Net capital inflows have been most important in manufacturing, trade, and services.

Figure 3.5: Net foreign direct investment



3.6 THE ECONOMIC CRISIS: WHAT WENT WRONG?

At the end of the last millennium, East Asian countries experienced the most notorious economic crisis ever. The crisis originated in Thailand in mid-1997 and later spread out to other countries. The Asian miracle turned to shame. Because of its unexpectedness and its contagion, research on the Asian crisis has been extensive in the international economic literature. For example, Krugman (1998), Miller and Luangaram (1998), Radelet and Sachs (1998a), and Radelet and Sachs (1999) provide good discussion of the onset of the Asian crisis. Siamwala (1997) also provides the excellent overview of the situation particularly for the crisis in Thailand.

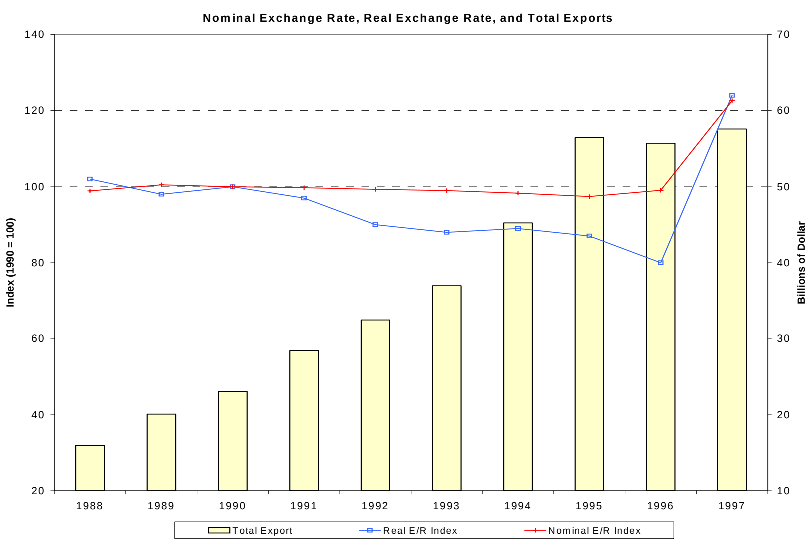
Searching for the cause of the crisis is, of course, beyond the scope this research paper. However, it will be helpful to present some important facts that contributed to the economic crisis in Thailand. Broadly speaking, the crisis in Thailand during 1997-1998 was brought about by three main factors: [1] Fundamental problems and mismanagement in macroeconomic policies, [2] Institutional problems in the financial sector, and [3] A sudden reversal of foreign capital flows.

Fundamental Problems and Mismanagement in Macroeconomic Policies

In the attemp to open up the domestic capital market, the Bangkok International Banking Facility (BIBF) was established in early 1993. The main objective of the BIBF was to fill the investment-saving gap in the country at the time and to make Bangkok a center of the capital market in the Southeast Asia. From Thai authorities' point of view, the benefit from the BIBF was prosperous. To promote the success of the BIBF, a fixed exchange rate regime was maintained to ensure off-shore lenders that the Thai baht wouldl be kept fixed against U.S. dollars in nominal terms. The BIBF was successful. Massive inflow of cheap offshore capital flowed to Thailand. However, it seems that Thai authorities did not think through the entire consequences of these actions. In fact, the consequence of the BIBF was enormous. The combination of the BIBF and a fixed exchange rate system was disastrous.

Opening up the capital account and adopting a fixed exchange rate regime at the same time produced a macroeconomic imbalance. The influx of the foreign capital, resulting from the BIBF, and the economic booms in early 1990s caused domestic prices to rise. Fixing the currency to the appreciating U.S. dollars during 1995-1996, while the country lost its exporting competitiveness, was not a wise thing to do. Several articles suggest that the Thai currency was overvalued, particularly during 1994-1996[1]. Redelet and Sachs (1998a) suggested that Thai currency was overvalued by as much as 20% in real terms. The figure below shows that total exports slowed down in 1996. For the first time, total exports of Thailand declined (-1.3%) in dollar terms.

Figure 3.6: Nominal exchange rate, real exchange rate, and total exports



Sources: Redelet and Sachs (1998a) and Bank of Thailand.

[1] Chinn (1998), Furman and Stiglitz (1998), and Redelet and Sachs (1998a).

At this point, these fundamental problems were enough to trigger the crisis. With the apparent unsustainability, foreign exchange rate speculators had started to attack Thai baht since 1996. That is, they would sell bahts they did not own for future delivery, hoping to acquire them cheaply before the delivery date. The situation became even worse when the foreign exchange reserves were used to defend the currency. The depletion in international reserves made the country's financial credibility deteriorate.

When the reserves ran out, the Bank of Thailand had no choice but to abandon the fixed exchange rate regime. The baht was floated in July 1997. From 25.78 bahts per dollar in June, the exchage rate had depreciated continuously. By the end of 1997, the exchage rate had sunk to 45.23 bahts per dollar. But that was not the end of the story.

Institutional Problems in the Financial Sector

A massive capital flight from abroad also led to another problem: overinvestment in inefficient and unproductive projects. These external debts were primarily short-term (less than 1 year of maturity) and were uncovered by hedging instruments. Liquidity in the domestic financial market increased immensely as a consequence of the capital account liberalization. Financial institutions could access cheap offshore funds. Without close monitoring from the central bank, moral hazard problems emerged in the financial sector.

Table 3.3: External debt and international reserves of Thailand

(Billions of US$)	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total External Debt	43.6	52.1	64.9	100.8	108.7	109.3	105.1	95.1	79.7
Public Sector	13.1	14.2	15.7	16.4	16.8	24.1	31.6	36.2	33.9
Private Sector	30.6	37.9	49.2	84.4	91.9	85.2	73.5	58.8	45.8
Long-term	12.2	15.3	20.2	32.1	44.3	46.9	45.2	39.4	31.1
Short-term	18.4	22.6	29.0	52.3	47.7	38.3	28.3	19.4	14.7
Commercial Bank	5.5	4.0	6.4	10.0	8.4	5.2	2.5	1.6	1.3
BIBF	0.0	6.4	15.1	23.7	20.5	19.2	14.9	7.8	4.1
Non-Bank	12.8	12.3	7.4	18.6	18.8	13.9	10.8	9.9	9.2
Debt/GDP(%)	39.1	41.6	44.9	60.0	59.7	70.1	93.2	77.5	64.9
Intl Resrv/Short-term Debt(%)	112.0	112.4	103.8	70.7	81.1	70.4	103.9	178.0	222.3
Exchange Rate (Bahts/Dollar)	25.40	25.32	25.15	24.92	25.34	31.37	41.37	37.84	40.16
International Reserves	21.2	25.4	30.3	37.0	38.7	27.0	29.5	34.8	32.7

Note: Short-term external debt is defined as debt that has an original maturity of one year or less.
Source: Bank of Thailand

A desire to maximize profits encouraged domestic financial institutions to give out loans carelessly. The loans were granted primarily to unproductive sectors, especially to real estate projects. Land was used as a primary collateral. Prior to the BIBF, there were already signs for the excess supply in real estate sector (Siamwala, 1997). A growing number of non-performing loans (NPLs) made the financial sector in Thailand ever more vulnerable. Liberalization of the capital market is not itself a problem. The main problem was that it lacked institutions and regulations that could closely monitor financial instutions in the market-based system. By the end of 1996, not only was the Thai economy facing external pressure from the real exchange rate appreciation and the declining exports, it was also facing the serious internal problem – the moral hazard in the financial sector.

Sudden Reversal of Foreign Capital

When the Thai baht was let float after a huge decline in the international reserves, everyone was sure of the coming disaster. Foreign short-term lenders paniced by fear of not getting their money back, made a sudden reversal. The Thai domestic financial market was then faced a huge liquidity problem. A large number of financial institutions were suspended and bankrupt. After the foreign capital had left, Thailand was left with a liquidity problem in the financial sectors, a collapse in the real estate sector, a crash in the stock market, and a huge amount of non-performing loans (NPLs). It may now become clear that why the crisis was so severe and its consequences were so deep.

Table 3.4: Net flows of private financial account

(Billions of US$)	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total Net Flows	9.5	10.3	12.0	20.8	18.2	-7.6	-15.5	-13.5	-9.8
Bank	1.9	3.6	13.9	11.2	5.0	-5.7	-12.7	-10.6	-6.6
Commercial bank	1.9	-4.1	3.8	3.1	0.4	-5.2	-3.3	-1.3	-2.6
BIBFs	0.0	7.7	10.1	8.1	4.6	-0.5	-9.5	-9.4	-4.0
Non-bank	7.6	6.7	-1.9	9.6	13.2	-1.9	-2.8	-2.9	-3.2

Source: Bank of Thailand

What do we learn from the crisis? The main lesson that we have painfully learned from the crisis is that we did not carefully think through how the economy actually works and is integrated. In this particular situation, the opening of capital account was done with lax implementation. A free capital account was combined with a fixed exchage rate regime. The financial sector was not well functioning and still not ready for the opening of the capital market. Institutions and regulations were not well established in order to closely monitor financial institutions in the ‘market-based’ financial system.

All in all, this chapter has summarized the big picture of the Thai economy in aggregate terms. The economy has experience both booms and a bust during the past decade. Beneath these macroeconomic changes the structure of the economy has been evolving over time both in the structure of production and in the demands of the economy. We turn in subsequent chapters to the analysis of the changes in the sectoral detail of the Thai economy.