The Sub-Prime Crisis and Thailand's Growth Rebalancing*

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IMPACTS OF THE SUB-PRIME CRISIS ON THE THAI ECONOMY

In the current sub-prime crisis, it is fortunate that the Thai financial system was not directly affected in a significant way. One small bank had to be re-capitalized because of exposures to toxic assets. Most of the other banks avoided exposures to these assets or were exposed just marginally. There were certainly people going round trying to sell the various Collateralized Debt Obligations (CDOs) to financial institutions. That the Thai financial system avoided falling prey to these toxic assets must be related to the lessons that have been learned from the 1997 crisis. From the painful experiences of that crisis, the Thai financial sector is now much more risk adverse than before. Also being a less sophisticated financial system than those in the West, there was not much understanding of what these debt instruments were, and because of the risk adverseness, financial institutions generally avoided them.

The stock market was of course affected in line with stock markets around the world. As financial markets in the advanced economies experienced liquidity crunches, there was a massive liquidation of liquid investment assets in the emerging markets and a massive outflow of capital. Fortunately, Thailand had more than sufficient foreign reserves to cover for this capital outflow, and depreciation pressures on the exchange could be managed fairly easily. Other countries were not so fortunate, and some countries experienced severe depreciation of the local currency. This shows that it is no longer sufficient to think of having enough foreign reserves to cover for the current account and short-term debt, reserves also need to cover other contingent liabilities, such as foreign holdings of stocks and bonds that can be quickly liquidated and converted to foreign currencies to take out of the country.

Even though the financial system managed to avoid the direct impacts of the sub-prime crisis, the country is now seriously affected by the crisis indirectly through the trade channel. This became very apparent since the last quarter of 2008. Prior to that, Thai exports were still growing rapidly, at more than 20 percent year on year in dollar value. Starting in November 2008, export growth turned negative and has been negative ever since.

As an economy highly dependent on export of goods and services, the Thai economy is now heavily hit by the global recession and resulting decline in world trade. From export growths of more than 20 percent in the first three quarters of 2008, export declined by about 9.4 percent in dollar value in the fourth quarter of 2008 (Table 1). Real GDP declined by 4.2 percent in that quarter, making the overall growth for the year 2008 to be a mere 2.6 percent, much lower from the forecasts of around 4-5 percent before impacts were evident. The picture was even worse in the first part of 2009. Export fell by about 20 percent in the first quarter of 2009, and real GDP dropped by 7.1 percent, which is getting close to the level of declines seen after the 1997 crisis.

Table 1 Export and Real GDP Growth

	Export Growth (YoY: Nominal US$)	Real GDP Growth (YoY)
2006	18.7%	5.2%
2007	17.0%	4.9%
2008H1	23.3%	5.6%
2008Q3	28.4%	3.9%
2008Q4	-9.4%	-4.2%
2009Q1	-19.9%	-7.1%

Sources: Bank of Thailand and the National Economic and Social Development Board.

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Obviously, the growth prospect of Thai economy depends on the prospect of growth and trade at the global and regional level. While there are signs every now and then that the western economies may begin to bottom out in the not too distant future, over optimism about this would be rash. Like in the case of the 1997 crisis, even if the economy bottoms out, this does not mean that the problems are over. Thailand bottomed out after about five to six quarters from the start of the 1997 crisis, but it took five years before output got back to the pre-crisis level (see Figure 1). The decline in non performing loans ratio to below the level of 10 percent took even longer; about eight years. Thus, in the case of the sub-prime crisis, a quick return to business as usual appears to be out of the question.

POLICY RESPONSES

Like governments all around the world that are facing negative consequences from the sub-prime crisis fall out, the Thai government has responded to the crisis with various expansionary fiscal and monetary policies.

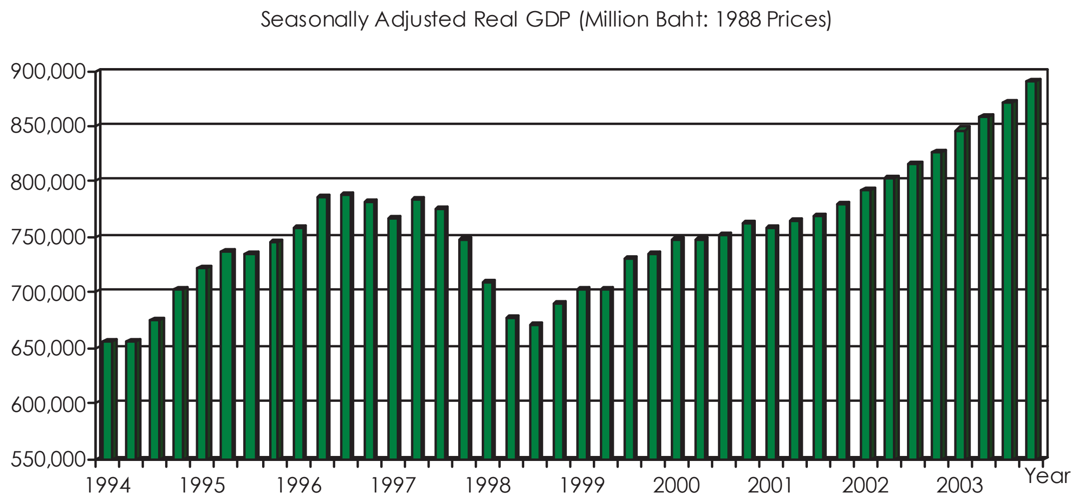
Fiscal Stimulus Programs

There have been a number of fiscal measures to stimulate the Thai economy. Increased government spending and tax cuts are the most pursued measures. A special Mid-year Budget Act amounting to 116.7 billion baht (about 1.3% of nominal GDP) was passed in early 2009, shortly after the current government took office. Included in these are two cash transfer programs amounting to around 28 billion baht (about $800 million); 18.9 billion baht for living cost subsidy to the low-income households and 9 billion baht as supplementary income for the elderly. In theory, and from experience in some low-income countries, cash transfers are among the most effective ways to both stimulate the economy as well as mitigate the negative impacts to the poor and vulnerable groups. One caveat is that the transfer must be made to the right target groups, that is, the leakage to non-eligible or to high-income must be kept at minimal. However, the two transfer programs implemented by the current government do not strictly meet this criterion.

The living-cost subsidies were given to the private employees under the Social Security System (SSS) who earn less than 15,000 baht per month. Since all SSS workers receive wage at or above the minimum wage, and the minimum wage is about twice the official poverty line, it is likely that the subsidies did not go to the very poor, who accounted for about 10 percent of the total population. Most of the poor are those working in the informal sector or in agriculture, and are not part of SSS. However, as the subsidy tended to benefit the urban low-income people, albeit not the very poor, the stimulating effect can still be high, as the marginal propensity to spend among the urban low-income group is likely to be the highest compared to other urban population subgroups. The same leakage problem occurs with the monthly allowance for the elderly. Because the allowance is universal (given to rich and poor alike), most of it will benefit non-poor elderly people.

Tax measures have also been initiated in response to the current crisis. The total tax loss from these measures is estimated at around 40 billion baht. The effectiveness in terms of stimulating economy is expected to be lower than direct government spending, as most taxpayers are not poor. Some sector-specific tax incentives, such as those in real estate, are more likely to work if and when the general economy is already on a recovery path.

Figure 1 Real GDP Trend



Source: National Economic and Social Development Board.

Monetary Easing

Again, like in most other countries, monetary policy has also been eased in response to the looming economic crisis. In fact, the monetary authorities (the Bank of Thailand) switched its position quite abruptly from a fear of inflation following the rapid hike in fuel and food prices in early 2008 to a serious concern over economic downturn in the fourth quarter, when indirect impacts from the sub-prime crisis began to hit Thailand's export. The Monetary Policy Committee (MPC) decided to lower the policy interest rate on 3 December 2008 by 100 basis points. Up until the end of May 2009, there have been three other interest rate cuts, amounting to another 150 basis points.

Most economists agree that loose monetary policy can only play a secondary role in revitalizing an economy suffering from rapidly shrinking external demand. The cause of the problem is from vanishing sale orders from overseas, and lowering the financial cost will not do much to help. Actually, the main problems for most firms under the current situation is access to credit rather than the cost of credit. With the downturn, banks become much more stringent about lending. Existing loans may be trimmed or recalled completely and getting a new loan becomes very difficult. Loans from abroad, which was part of the rapid capital inflow a couple of years ago, have also dried up as liquidity problems hit the financial system in the advanced economies. Thus, getting credit to those that can make productive use of it is probably the key problem at this time. This is not an easy problem, as it is not straight forward to separate those who can make productive use of the credit from those that will quickly become additions to the list of non-performing loans of banks. Of course, one area that will really benefit from the low interest rates is the fiscal cost of government spending, as the government will have to finance its rapidly growing debt.

One area of monetary policy which is likely to become an issue of heated debate is exchange rate management. It is natural for an economy like Thailand, where export is such an important part, that when problems arise for the export sector, such as rapid capital inflows leading to significant appreciation of the currency back in 2006/07 or contraction of export demand as in the current situation, there will be calls from the export sector (which is very vocal) for a weaker exchange rate. This call is reinforced by the fact that there are countries in the region, countries that can be regarded as competitive with Thailand for certain products, whose currencies have weaken considerably as a result of the large withdraw of capital resulting from the sub-prime crisis, such as South Korea, Indonesia and India. Some of these countries have fundamental problems of lack of enough reserves to back up the short-term debt as well as the contingent liability on reserves as discussed earlier. However, whatever the reason for the large depreciation of other countries' exchange rate, the business sector can make a persuasive case that they should also be helped by weakening the local currency.

There is, therefore, a danger of the whole region, which is generally dependent on the export engine, descending into a competitive depreciation episode. This would benefit no one. It will also make the needed adjustment of the region's growth path, to be less dependent on export and increase the role of domestic demand for economic growth much more difficult. For example, public investment, which will be a very important component of growth rebalancing for many economies will become much more costly.

Limitations

Most of the policy responses to the crisis are directed to the short-term need to shore up the economy in the face of the economic contraction. Fiscal injections are expected to generate greater domestic consumption that will ease the pain of domestic producers and consumers. Not much attention has been paid to how to make the fiscal injections sustainable. Even less thought has been given to what might a new "rebalanced growth path" for the country look like and how it can be achieved.

Policy makers seem to hope that the current crisis will be short and that fiscal injections can provide a temporary relief before everything goes back to normal. As indicated earlier, this is likely to be wishful thinking. Even if the US and other western economies hit bottom this year, it may take a while before full recovery is achieved. And it is unlikely that full recovery will mean that East Asian export can play as big a role in East Asian economies as it did before the crisis. Thus, some fundamental restructuring of Thailand's economy, as well as those of other East Asian countries, to a new growth path which is less dependent on exports will be necessary. This will certainly not be easy and cannot be achieved in the short term.

If recovery from the crisis is long drawn out, then sustainability of the fiscal injections will become a major issue. If growth depends mainly on fiscal injections, then to be effective, larger and larger injections will be needed each year. If 10 billion dollar is used for injection this year and the same amount is used next year, then this is basically zero growth. So to rely on fiscal injections to generate growth over an extended period, the country can get into a situation of massive public debt, even though it may have started the crisis with a fairly healthy fiscal position. Once the financial situation begins to become normalized, interest rates can shoot up, as countries around the world all need to borrow to finance their fiscal injections. This could become a major impediment to growth for many years, as many countries that went through the debt crisis in the aftermath of the second oil shock know only too well.

STRATEGIES TO REBALANCE GROWTH

For an export dependent economy like Thailand, the current crisis may be harder to deal with than the 1997 crisis. After 1997, Thailand exported her way out of the crisis, assisted by the depreciation of the baht. This was a natural recovery path for the country, as Thailand, in a similar way to most of the other East Asian economies, is used to the export-led growth path. East Asia has followed the export-led development path for decades, following the successful example set by Japan. This was regarded as a "flying geese" pattern of development (Akamatsu 1962).

During the 1997 crisis, the advanced economies were not affected much (with the exception of Japan which has extensive economic links with other parts of East Asia). Thus, the main export markets for East Asian products could provide the demand for increased export from East Asia; from the crisis affected countries as well as from newly emerging production powerhouses, such as China.

The current situation is very different. The crisis has led to a collapse of world demand for export and this hits at the very heart of the East Asian model of export-led growth. Exporting their way out of the current crisis is out of the question for East Asian economies. Indeed, many economists view the global imbalance, with East Asia exporting its way into growth, huge balance of payment surpluses, and vast accumulation of reserves, while the US runs bigger and bigger deficits as being a partial cause of the sub-prime crisis and subsequent credit crunch. Of course, while the global imbalance may have provided excessive liquidity to the financial markets in the West, but a much more fundamental cause of the sub-prime crisis is the regulatory failure in the West, particularly the US, that allowed a huge explosion of toxic assets, built up from sub-prime mortgages, through out the financial system.

It is likely that a sustainable solution to the current crisis will involve not only a strengthening of financial regulations everywhere, but also better mechanisms to prevent a build-up of vast global imbalances as occurred in the past decade. However, correcting such deep-rooted global imbalances needs time, as many major economies or economic groups will have to undergo substantial economic restructuring. For example, economists know that the US economy must consume and import less and export more, while East Asia and other major trading partners to the US must do the opposite. However, switching from importing to exporting, and vice versa, do not involve just changing numbers on paper, but real adjustments at the level of firms and other microeconomic settings, such as retraining of labors to be able to shift to new economic sectors as the skills required may be very different.

Another important change that is likely to be needed in realigning the global imbalance is a substantial realignment of major currencies. The US dollar certainly needs to be much weaker against its major partners' currencies. Again, this is not an easy adjustment. East Asian is certainly facing a huge dilemma on this. On the one hand, not implementing changes to prevent a reemergence of huge global imbalances in the future runs the risk of future financial crises that will hit East Asian economies severely as in the current crisis. On the other hand, working to bring about a realignment of currencies, particularly a significant weakening of the US$, will mean that East Asia will need to accept a book loss on the value of the huge amount of US$ denominated assets that are held by the region.

Whatever might be the solution to preventing a crisis like the sub-prime crisis in the medium to long term, it is clear that East Asia has been forced to make a significant adjustment to its development strategy in the short to medium term. In the short-term, countries have been making sizeable fiscal injections to try to shore up the economy under the collapse of the export engine. The Thai short-term response was discussed earlier. In the medium term, some form of growth rebalancing will be necessary. This does not mean that exports will no longer be important to East Asia, as it is very unlikely that a lot of the production base that feeds the world consumer demand for manufactured products can shift back to the advances economies, or that another region can replace East Asia in this production role. What rebalancing means is that East Asia needs to rely less on the export engine and supplement it with other engines based on domestic demand. This, again, is not that easy to achieve. It will require a significant restructuring of various economies, and also appropriate policies to make sure that domestic demand driven growth, such as through investment, does not generate large economic bubbles and current account deficits similar to what occurred prior to the 1997 crisis.

In the case of Thailand, one can say that the economy has not grown in a well-balanced manner since the 1990s. During the economic bubble of the 1990s, growth was driven by excessive and speculative investment. When 1997 crisis occurred, Thailand then had to rely too much on the export engine to restore growth and overall economic health. The over reliance on export now makes the country highly vulnerable to the current global recession as was already seen from recent export and growth figures. There have been discussions in academic and policy circles about rebalancing growth to be more dependent on domestic demand and less on export. How to achieve these goals is however not clear and not much serious analyses have been carried out on this issue.

Actually, the issue of Thailand being highly dependent on external trade was discussed seven to eight years ago, when the share of export rose rapidly in the process of recovery from the crisis. Many were already voicing concerns that the increased dependence on exports makes Thailand more vulnerable to volatilities in our trading partners' economic conditions and world trade. However, it is difficult to be precise about whether a country depends too much on export. Certainly, there are countries that have much higher ratio of exports in GDP than Thailand (Malaysia, Singapore, Hong Kong, Japan, to name a few), and the growth experiences have been very successful. It is true that when external conditions deteriorate, the more open economies experience greater transmission to the domestic economies (see e.g., Rodrik 1996). However, volatilities from short-term external factors does not mean that these economies do not perform well on average over time. Actually, the more open, export-led economies tended to perform better than those who were more inward looking (see e.g., Chalongphob 1997). Certainly, having to compete in the export markets can bring about efficiency spillovers. There are also evidences for Thailand that the degree of openness positively affects the total factor productivity (TFP), see Pranee and Chalongphob (1998) and Chalongphob, Somchai and Yos (2003).

Irrespective of the impacts of openness on volatilities and growth, it is clear that the fall-out from the sub-prime crisis will mean that Thailand (and other East Asian export-led economies) will have to live with a lower dependence on the export engine over the next several years, and probably over the course of the medium term. It is therefore of interest to see what might be some of the important strategies to generate sustainable growth given lower export dependence.

Increased domestic investment is obvious one important strategy, and this will have to be mainly public investment as the private sector has been considerably weaken by the crisis and there are large excess capacities in the manufacturing and services sectors. However, it is not entirely clear that an investment led growth strategy can be sustainable. If the investment is not excessive, then it should be sustainable. But then the generated growth may not be that high. If investment becomes excessive, then there is a danger of large adverse impacts on the current account and external stability. There is also a danger of a bubble, like prior to the 1997 crisis. So management of an appropriate level of public investment will be important. The quality of these investment will be equally important. Thailand has gone through phases of wasteful and inefficient mega project investments in the past, whether purely public sector projects or those given out as concessions to the private sector. This is again a very important issue needing carefully planning and monitoring.

There are other strategies that will be important parts of a growth rebalancing strategy. In the rest of this paper, we highlight three important strategies from analyses in Chalongphob, Somchai and Yos (2003). That paper used a computable general equilibrium (CGE) model of Thailand to carry out policy analyses on how to achieve a moderate average growth path given an assumed decline in the role of exports in the Thai economy. It was assumed that the ratio of export in GDP will decline by about 10 percent over a five year time horizon. This will imply that growth will slow down significantly. The paper then analyses various strategies that can increase growth while ensuring sustainability in the sense of maintaining external stability. In the analyses, the current account was kept fixed for each scenario, with the level of investment being endogenous.

The analyses highlighted three strategies that will be important for growth rebalancing. These are 1) increasing TFP, 2) deepening the production structure of the economy, and 3) lower energy dependence.

Improving Total Factor Productivity (TFP)

Improving TFP is the best way to make growth more well-balanced. With higher productivities, the country can compete better on a long-term basis. At the same time, higher productivity will translate into higher wage rates and higher real incomes of the working population, enhancing the purchasing power of domestic market.

In the past, productivity gain in Thailand came primarily from resource mobilization between economic sectors, and from accumulation of physical capitals, usually in the form of imported technology (see Pranee and Chalongphob 1998). Resource mobilization had limitations as the country depleted its natural resources at an alarming rate. Moving people from low-paid agricultural activities to higher-paid industries and services is also approaching its limit, as agriculture accounted for less than 12 percent of GDP now, and most farmers already have substantial non-farm income. Relying on accumulating imported capital is not a sustainable ways of gaining productivity either, as the value-added tend to be small and vulnerable.

The real productivity gain should come from improving human capital. In this regard, there are plenty of room for Thailand to make more progress. The education and training system need to improve a lot. Thailand's international rankings in education and training lag behind its performance in other areas, such as physical infrastructure. There are many sub-areas in education and training that must be improved. For example, although Thailand has made much progress in secondary enrollment since 1990s, its ranking is still low.

Improvement in scientific and technological capabilities is another important area. Investment and expenditures on scientific research and development is low compared to more advanced countries, and much of those that have been made have not yielded commercial benefits. There has been great difficulty in linking R&D to commercial products.

Deepening the Production Structure of the Economy

Deepening of the production structure means reducing the import contents of various sectors in the economy to increase domestic demand. The focus here is more on intermediate demand and the stress is not on protectionism but rather on encouraging a deeper and more diversified production base.

The structural weakness of Thailand's reliance on exports is that most of the leading exports have high import-content. Almost half of Thailand's imports are raw materials and intermediate goods. When combined with imports of capital, these two import groups account for two third to three quarters of total import. Thailand is clearly a member of regional production networks that spread the production of parts to many countries. In theory, this international division of labor benefits all member countries. In practice, however, a country will benefit more if more parts are produced within that country, lowering the import volume while raising export volume. To accomplish that, a highly developed domestic network of industry clusters must be put in place, and logistic arrangement must be efficient.

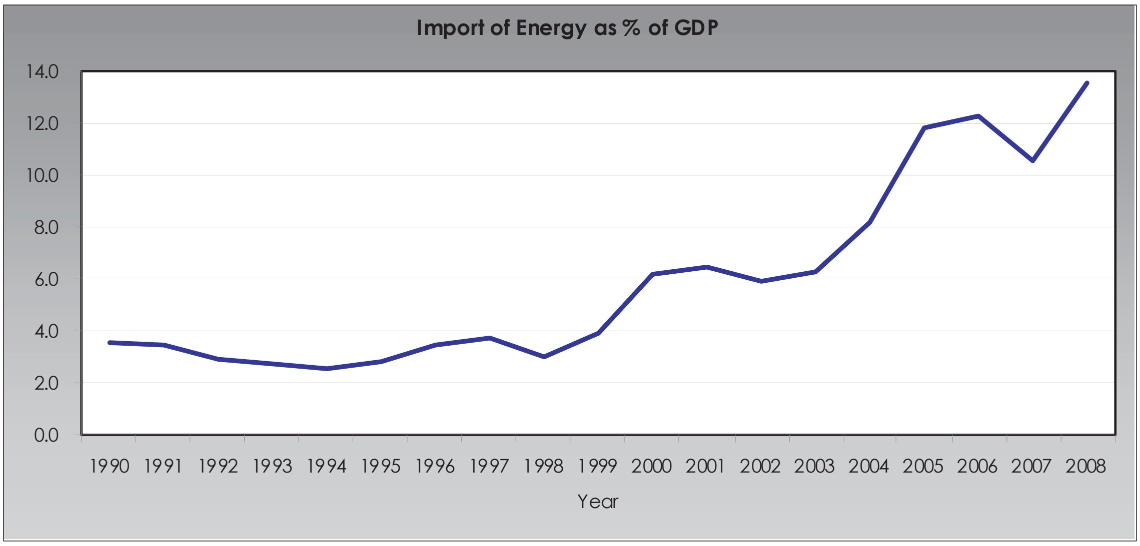
To reduce intermediate imports, the key issue is to increase the productive capacity of local producers so that they can link more and more to the supply chain of various industries. Thailand has seen some successes on this in the past for some industries, particularly the auto industry. In the early days, most of the auto industry were simply the assembly of completely knocked down parts imported from abroad. Over time, more and more of the parts were produced locally. This occurred as local producers improved the quality of their products up to international standards. More foreign direct investment in the parts industry, some as joint ventures with local companies also helped this process. The auto sector in Thailand is now very competitive with high local contents, and some of the parts industry are now also exporting their parts to other countries.

The production deepening will reduce the import share in GDP. This reduction of import share brings the potential for higher growth. In the CGE analysis, it was found that a reduction of total import share by 5 percent across all import categories allowed about an average 1.6 percent per annum gain in economic growth. The experience of the auto industry is one that Thailand can attempt to emulate in many other industries. This should be an important part of the medium term growth strategy in the rebalanced growth path.

Lowering Energy Vulnerability

Import dependence is probably most concerning when it comes to energy import. As shown in Figure 2, the proportion of imported energy in GDP went up from less than 4 percent in 1998 to 12-14 percent in 2006-2008, an increase by three times in less than a decade. As a result, the economy became very vulnerable when energy prices went up, and the vulnerability becomes more and more serious. Not having sufficient domestic energy sources is only a small part of the problem, using energy inefficiently is a much bigger problem.

Figure 2 Dependence on Imported Energy



Sources: Bank of Thailand and the National Economic and Social Development Board.

Lowering energy dependence can also be used as a policy to promote new industries and contribute directly to growth. For example, the Thai government initiated the so-called "Eco-car" project in 2007. These eco-cars are small cars (less than 1,300 cc engine for gasoline and less than 1,400 cc for diesel) that can achieve more than 20 kilometers per liter, compile with the Euro-4 emissions standard and also some stringent safety standards. Excise tax reduction from 30 percent to 17 percent was the main attraction. After the project was announced, seven manufacturers applied to the Board of Investment for promotional privileges to carry out eco car projects. Output was initially due to come to the market in late 2009 or 2010. Unfortunately, with the current crisis, this is likely to be postponed until market conditions get better. Nevertheless, these fuel efficient and environmentally friendly cars should be able to drive a new growth path for the auto industry in Thailand.

Other Rebalancing Factors

There are obviously many other important aspects of growth rebalancing strategies. For Thailand, income distribution is another important issue. Thailand is among the most unequal country in the world when it comes to income distribution. The Gini coefficient remains stubbornly above 0.5 in the past two to three decades. One of the important consequences of high inequality is the small size of domestic market, as wealth concentrates among only a handful of rich people. A successful redistribution would therefore increase the domestic market size to make growth better balanced. This is especially true for a country with moderate average income like Thailand. Measures to improve income inequality ranges from fiscal measures, micro credit policies, equitable enforcement of rules of law, etc. Another important by-product of more equal income distribution is to lessen the political polarization that is damaging Thai politics and economy at the moment.

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