THAILAND

A Dynamic Emerging Market Economy

Assignment

The CEO of your company recently made a business trip through several emerging market countries in Asia. Your company has operated in the United States and Europe for many years. Your CEO thinks it is time to look at the prospects in Asia.

He found Thailand a very attractive country. With a population of almost 60 million and located in a rapidly growing and developing region he sees potential business opportunities within Thailand and the larger region.

He spent several days in Bangkok attending briefings and talking to US and Thai business executives. The US embassy briefed him on the overall economic and political situation.

The government is based on parliamentary system of governance with multiple parties. Governments form by establishing coalitions. Because coalitions are difficult to hold together, governments often change. The King, who is the head of state, serves as a source of stability. The military, which governed Thailand until 1973, remains in the background but also influential.

According to the Economist Intelligence Unit, which is an internationally recognized research and advisory firm, foreign direct investors face certain barriers as a result of laws, customs and language. The government is considering amending the 1972 Alien Business Law which limits the operations of foreign enterprises. Thus the legal climate for foreign direct investment may become more favorable in the future.

The CEO attended an economic briefing conducted by the Thai Association of Business CEOs. This is a very prestigious and influential organization. Performance of the Thai economy over the past five years was very positive. Although a forecast was not provided, it was clear that the Association expects the next five years to be better than the last five. They believe that the government is committed to advancing open market based reforms to attract foreign investment. They also believe that the financial reforms being implemented will deepen and broaden the domestic financial markets.

Attached is an outline of the economic briefing. Drawing on the information provided in this briefing, the CEO would like your assessment of some of the pitfalls and risks facing the economy. Please be brief; a one page outline of your assessment will be sufficient.

Note: The development of this case study was supported by funds provided by The Global Business Center (Home of UW CIBER) at the University of Washington under a grant from the U.S. Department of Education. Richard D. Erb, The University of Montana

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A Presentation by the Thai Association of Business CEOs

March

Bangkok, Thailand

The following presentation was given to a group of senior business executives from the United States at a business conference held at the Oriental Hotel in Bangkok. We examine the outstanding performance of the Thai economy over the past five years. We also briefly review some of the major financial sector reforms the government has been implementing in order to build a more developed and market based financial system.

We believe that the very positive performance of the Thai economy and the financial sector reforms will provide a solid foundation for future economic growth.

Thai Association of Business CEOs, Chairman

OUTLINE

Thailand's Macro Economic Performance
Prudent Macro Economic Policies – Excellent Macro Economic Performance

The Changing Composition of Thailand's Economic Output
A dynamic and adaptable economy

Foreign Trade Drives Economic Growth
Thailand succeeds in competitive and dynamic international markets

Thailand's International Financial Performance
An extraordinary ability to attract foreign financing

Financial Sector Reform
Laying the foundation for future economic performance

Thailand's Macro Economic Performance

Prudent Macro Economic Policies – Excellent Macro Economic Performance

By any number of indicators, Thailand achieved outstanding macro economic performance during the past five years

- High real GDP Growth: 8.4% average annual growth rate
- Relatively low rate of inflation: 4.8% average annual inflation
- Low unemployment : averaged around 2% over the period
- Very high gross domestic investment: averaged 41% of GDP over five years
- Gross National Saving, although not as high as the investment rate, averaged a strong 34% of GDP over the period
- Gap between domestic savings and investment easily filled by foreign saving through capital inflows

Macro Economic performance underpinned by **strong fiscal policy**

- Central government ran **surpluses** averaging almost 3% of GDP over the five year period
- Size of government tightly controlled
    - Tax revenues kept under 19% of GDP
    - Government expenditures averaged just under 16% of GDP

Low inflation underpinned by a **prudent monetary policy**

The Changing Composition of Thailand's Economic Output

A dynamic and adaptable economy

Economic output (GDP) increased in real terms by 51% over the past five years, an annual average growth rate of 8.4 %

Several sectors experienced above average real economic growth over that period

- Manufacturing increased by 77% with its share in total output rising to 33%
- The financial sector more than doubled in size with its GDP share rising to 11%
- Electric, gas and water utilities increased by 68% to a share of 2.6%
- Transport and communications increased by 66% and accounts for 8% of GDP
- Construction increased by 57% to a 6.2% share in total output
- Retail and wholesale trade increased by 53% to a share of 18% of GDP

Other sectors also experienced real economic growth but declined in relative economic size

- Agriculture: 5% increase over the five year period with its share of GDP declining from 14% to 9%
- Mining: 43 % increase over the five years with its share of GDP declining to 1.5%

Labor force developments

- The labor force participation rate is a relatively high 73%
- Men and women are active participants in the labor market
    - Male participation rate: 80%
    - Female participation rate: 66%
- Urban population remains at a relatively low level of 18% but will need to increase at a rapid pace to supply labor for the growth sectors of the economy
- Growth in urban population will drive demand for infrastructure including transportation, communications and utilities and also demand for housing and related construction

Foreign Trade Drives Economic Growth

Thailand succeeds in competitive and changing international markets

Exports and imports of goods and services are large in relation to total output for a country of this size

- Exports of goods and services amount to 42% of GDP
- Imports of goods and services amount to 49% of GDP

Trade growth drives overall economic growth

- Over the past five years merchandise exports, in US dollar terms, increased by almost 150% to a level of $57 billion in the final year
- Merchandise imports increased by 113% to a level of $74 billion in the final year

Thailand adapted its production to changing international market opportunities

- rapid export growth was experienced in the following areas: computers, textiles, electrical appliances, integrated circuits and vehicle parts
- rapid import growth included the following areas: basic manufacturers, machines, transport equipment and chemicals
- exports grew rapidly to Asian emerging market countries including China, Hong Kong, Malaysia, Singapore and Indonesia; the share of all Asian developing country markets in Thailand's total exports increased from 22% to 36%
- the United States remains the largest export market ($10 b), but the US share has declined from 23% to 18%
- at $9.5 b, Japan's share of Thailand's exports remained at 17%
- the share of major European markets declined

Thailand's International Financial Performance

An extraordinary ability to attract foreign financing

Current Account Transactions and Balance

- Over the five year period, the merchandise trade deficit increased by $6.3 billion, a 60% increase. Last year, Thailand's imports exceeded its exports resulting in a trade deficit of $16.5 billion. (Merchandise trade is the largest component of Thailand's current account)
- Thailand's other current account transactions produced a surplus that increased slightly over the past five years to a level of $3.3 billion. (These other transactions include inflows and outflows involving international service transactions, foreign investment income, labor income and unrequited transfers)
- During the last year, Thailand's current account balance (net flows) amounted to $-13.2 billion, or 8.1% of GDP
- The current account balance is a measure of the extent to which a country is a net international saver or borrower. Thailand's large negative gap between domestic savings and investment is reflected in its external current account deficit.

Capital/Financial Account Transactions and Balance

- The capital/financial accounts in a country's balance of payments include inflows and outflows of trade credits, direct investment, portfolio investment, bank lending and other international financial transactions
- Last year, Thailand's <u>net</u> financial inflows amounted to $ 22 billion
- Thus, net financial inflows more than covered the country's current account deficit (including an error and omissions adjustment)
- The excess was absorbed by an increase in Thailand's Central Bank reserves

Accumulation of Debt and Reserves

- Over the past five year period, Thailand's large net financial inflows cumulated to around $65 billion
- The central bank absorbed about $23 billion and thus official reserves rose from $14 billion to $37 billion over the five year period
    - At the end of period, official reserves equaled about six months of imports
    - At the end of period, official reserves amounted to about 90% of external short term claims on Thai entities
- Thailand's total external debt increased from $29 billion to $83 billion
    - foreign debt rose from 40% to 50% of GDP over the five year period

The Composition of Thailand's International Financial Flows

- The private sector accounted for most of Thailand's international financial flows, not foreign borrowing by the government (as was the case in many Latin American countries that have run large current account imbalances and experienced periodic debt crises)
- A high percentage of Thailand's financial inflows were short term
  - Many Thai borrowers took advantage of lower interest rates in foreign markets, particularly in Japan, to fund domestic expenditures in Thailand. For example, during last year Thai bank lending rates were around 13% while Japanese bank lending rates were around 3.4%.
  - In other words, they borrowed in foreign currencies which were then converted into Thai baht
- A high percentage of Thailand's financial inflows involved Thai banks and finance companies
- Private company credit ratings have been relatively positive; for example, S&P recently announced a corporate credit rating up grade from BB to BB+ for senior unsecured debt for a company called DTAC, a provider a wireless telecommunication service

Thailand's exchange rate policy

Given the central roles that exports and external financing play in the performance of the Thai economy, Thai authorities pay a great deal of attention to exchange rate policy.

Thai Baht Peg

- As a matter of policy, the Thai authorities set the value of the baht on the basis of a weighted basket of currencies of Thailand's major trading partners and other factors
- As a matter of practice, over the past five years the value of the baht has been held at a relatively fixed rate of 25.2 baht per US dollar. (Note: Instead of buying foreign currencies and building up foreign currency reserves when financial inflows were strong, the authorities could have allowed the baht to appreciate.)
- The baht floats with the US dollar when the dollar floats vs. a vs. other currencies, for example the Japanese yen

When the US dollar depreciates (appreciates) against other currencies:

- Thailand's trade competitiveness improves (declines) vs. a vs. those currencies
- But, the cost of foreign borrowing increases (decreases) for Thai borrowers who have borrowed in the financial markets of those currencies

Financial System Reform

Creating a deeper and broader financial system

Over the past five years Thailand has implemented financial sector reforms with the following objectives guiding the reform efforts

- Open the Thai economy to international financial flows and competition from international financial institutions
- Improve monetary policy operations
- Reduce dependency of economy on commercial bank financing, which currently accounts for over 70% of company financing
- Develop a broad and liquid stock market; fewer than 500 companies belong to the Stock Exchange of Thailand (SET)
- Develop a broad and liquid bond market and promote other sources of long term baht financing

Reforms aimed at opening Thailand's financial system

- Controls on foreign exchange transactions have been relaxed or eliminated; thus it is much easier for Thai nationals to get access to foreign currency and for foreign nationals to buy and hold baht
- In an effort to develop Thailand as a regional funding center and to facilitate international financial flows and the financing of the current account deficit, the government established the legal and regulatory basis for Bangkok International Banking Facilities (BIBF).
    - A domestic or foreign financial institution granted a license to open a BIBF can perform a range of international currency and financial transactions.
    - Government provided tax and other incentives to promote the development of this market

Reforming Monetary Policy operations

- In recent years the central bank has moved from direct (e.g. establishing bank lending limits for different activities; providing interest rate guidance) to indirect monetary policy instruments (use of open market operations and market determined interest rates)

Promoting the development of securities markets

- Securities and Exchange Act passed in 1992 established a clearer legal basis for security transactions and thus establish the basis for more developed baht capital markets
- A Securities and Exchange Commission was established to oversee and supervise the development and operations of local capital markets

Broadening Allowed Banking Services

- Banks and other financial institution allowed to offer a wider range of financial services, including provision of underwriting and distribution of securities and selling of mutual funds

Strengthening Commercial Bank Supervision

- Central bank is strengthening its supervision and examination of commercial banks; bank capital requirements brought in line with international standards established by the Basle Banking Committee

THAILAND
A Dynamic Emerging Market Economy

A Case Study in Country Risk Assessment

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The development of this case study was supported by funds provided by The Global Business Center (Home of UW CIBER) at the University of Washington under a grant from the U.S. Department of Education.

Instructor Notes

Although the actual time period is not revealed, this case study covers the period from 1991 to 1995 with 1990 as the base year. Most of the data would have been available by late winter 1996. Reflecting the time period and general perceptions of Thailand at that time, the report is upbeat and very positive on Thailand's economic performance.

Although there were some warning signs, for example a decline in exports, Thailand's economic performance during 1996 was not too different from the first half of the 1990s. But Thailand was an accident waiting to happen. In 1997 Thailand was involved in a multi car collision that came to be known as the "Asian Financial Crisis".

Thailand's real economic growth declined, international capital flows reversed, the government implemented a large devaluation in the Thai baht, exports receipts remained constant(although export volume increased), imports declined sharply, the government ran a budget deficit, and companies and banks went bankrupt. Although the outcome was much worse because the declines across the region fed on each other, Thailand's risks were such that it probably would have experienced economic problems even if the rest of the region had not joined the crisis.

The objective of this exercise is to give students practice in identifying large economic imbalances and the risks they pose from an individual country perspective. Although instructors may wish to draw on the extensive Asian crisis body of literature when discussing this case, this case is not placed within the context of the regional crisis. The regional crisis raises a host of other complicated issues that would need to be addressed, including for example the response of multilateral financial institutions.

This case study is designed to be used in different business and economic courses, including in particular international finance and business strategy courses and international macro economic courses.

Thailand's Economic Imbalances - - Major risks

- dependent on high export levels <u>and</u> high export growth rate
- dependent on high import levels <u>and</u> high import growth rate
- large gap between domestic investment and savings that is reflected in the large current account (trade) deficit
- trade deficit is financed by large and growing foreign capital flows
- foreign capital flows increasingly dominated by short term capital
- foreign capital flows attracted by a positive interest rate differential but subject to a hidden exchange rate risk
- accumulation of foreign borrowing over time resulting in an increase in foreign debt relative to the size of the economy (GDP)

Interrelated risks: the overall risk is greater than the sum of individual risks

Alone, any one of these imbalances could create problems. But the imbalances are interrelated. Deterioration in one imbalance, for example the trade balance, could lead to a reduction in foreign confidence and thus foreign financial flows. The central bank would then sell reserves to fill the gap. Loss of reserves eventually would force the government to depreciate the exchange rate. But a sharp reduction in the exchange rate would raise the baht cost of foreign currency debt and result in bankruptcies for those companies that had borrowed in foreign currencies. Eventually this is what happened to Thailand in 1997.

Thailand maintained sound fiscal and monetary policies

- unfortunately, Thailand's macro policy performance may have contributed to a false sense of confidence in the Thai economy

Thailand's structural policies were more open to question, including in particular:

- **Exchange rate policy**: the authorities maintained a fixed rate against the dollar in spite of decline in the importance of the dollar in Thailand's trade and financial transactions and in spite of a growing trade imbalance
- **Financial sector reform policies:** although reforms were needed to modernize the Thai financial sector,
    - the government implemented financial sector reforms skewed towards attracting short term international capital flows; latter tend to be volatile
    - efforts to improve the environment for longer term foreign direct investment did not come until late

- steps to strengthen the supervision of financial institutions did not keep pace with overall financial sector reforms