THAILAND

Thailand's recent era of high growth ended in 1997. The financial crisis spread throughout the economy, underscoring its fragility. Accustomed to double-digit growth rates, Thailand saw negative growth in 1997, and 1998 is expected to be worse with the onset of stagflation. The short-term priority is to resolve the financial crisis that is strangling business. In the medium to long term, Thailand must rethink its growth strategy, emphasize those sectors that have a long-term growth potential, and enhance education.

RECENT TRENDS AND PROSPECTS

By the first quarter of 1997, the Thai economy was showing clear signs that it was in trouble. Speculative attacks on the baht and the closure of several finance companies constituted the prelude to financial turmoil of unprecedented magnitude. The currency depreciated from B26 to the US dollar in July 1997 to more than B50 to the dollar by January 1998. Negative growth occurred in 1997, and the political consequences included the prime minister's resignation in November 1997.

The lack of liquidity caused by the financial crisis had serious repercussions on manufacturing. While production declined only slightly during the first seven months of 1997, with growth running at 5.1 percent compared with 7.1 percent during the same period of 1996, the last three months of 1997 saw a decline in production of more than 5 percent compared with the same period of 1996. Capacity utilization fell to around 70 percent in such industries as automotive assembly and sales of motor vehicles fell 73 percent from the previous year's figures. This will undoubtedly adversely affect the future growth of the petrochemicals, glass making, rubber, and steel sectors.

Private investment expanded moderately by 4.1 percent in July 1997, but only by 2.5 percent in August 1997, from the levels during the corresponding months in 1996. This reflected the economic slowdown and the excess capacity prevailing in many industries, particularly the real estate sector. Private consumption fell by approximately 5 percent in real terms because of declining real incomes.

Thailand's fiscal position further deteriorated in 1997, with the budget deficit as a proportion of GDP reaching 0.9 percent in 1997. This was caused by a shortfall in revenues because of a decline in funds collected from the value-added tax and from customs duties. In contrast, expenditures remained as budgeted.

Liquidity conditions in money markets remained tight during the year. In August 1997 the interbank rate climbed to an average of 15.4 percent, up from 12.1 percent in December 1996, in an attempt to counteract the outflows of capital and the persistent excess demand for US dollars in the foreign exchange market.

Inflation accelerated during the second half of the year, because of the increased costs of imports following depreciation of the baht, as well as the increase in the value-added tax from 7 to 10 percent. By December 1997, the year-on-year inflation rate was 7.7 percent. This must be seen as a significantly low, even puzzling, increase in prices given the large fall in the value of the baht. Likely reasons why inflation has not shot up to date is the contraction of the domestic economy; the decrease in imports; the cutting of salaries, especially of annual bonuses; and the selling off of inventories.

After the 1996 slump, exports began showing signs of recovery around March 1997, and further minor improvements were observed throughout the year. Medium-technology exports, such as automobiles and parts, as well as electrical products and resource-based products, performed well. Exports grew by 3.2 percent during 1997, a slight improvement on the decline of almost 2 percent the previous year. Imports, by contrast, declined by about 9 percent. Imports of motor vehicles fell by 50 percent in the first ten months of 1997, while sales of brand-label clothing and leatherwear fell by 30 to 40 percent during the same period. Despite the improvement in the current account deficit, the ratio of external debt-service to exports doubled from slightly more than 12 percent in 1996 to 25 percent in 1997.

Projections indicate that the economy will register a negative growth rate of around 3 percent in 1998. Signs of a mild recovery will appear in 1999, with growth of around 1 percent. Further declines in private consumption by 9 percent in 1998 and 1.5 percent in 1999 are predicted. Inflation is projected to be 15 percent in 1998, but the exact figure will depend partly on the extent of the depreciation of the baht and the increase in import prices. Finally, exports are expected to grow at 5 percent, while imports are expected to continue decreasing. With this pattern the current account balance will show a surplus of around 3.4 percent of GDP. An increase in unemployment is also forecast for 1998.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

The interaction of two factors contributed in important ways to the Thai financial crisis. The first was Thailand's exchange rate policy, which tied the baht to a basket of currencies heavily weighted by the US dollar. The appreciation of the dollar in 1995 made Thai exports uncompetitive. The second was the lack of effective regulatory control over the private financial sector, whose lending policies were imprudent. The crisis has therefore raised questions about the conduct of Thailand's economic policy as well as the adequacy of its institutional and sectoral structures. Consequently, in the short to medium term, Thailand must address the problems of the liquidity constraint created by the closing of private banks and finance companies, and must restructure its financial sector. The latter is required to avoid future misallocation of foreign capital to speculative assets and to projects with inadequate rates of return.

Table 2.10 Major Economic Indicators: Thailand, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth	8.8	5.5	-0.4	-3.0	1.0
Gross domestic investment/GDP	41.6	41.7	35.0	26.0	29.0
Gross domestic saving/GDP	33.6	33.7	31.0	31.4	32.0
Inflation rate (consumer price index)	5.8	5.9	5.6	15.0	9.0
Money supply (M2) growth	17.0	12.6	16.4	6.8	7.5
Fiscal balance/GDP	3.0	0.9	-0.9	-2.0	-1.0
Merchandise exports growth	24.8	-1.9	3.2	5.0	8.0
Merchandise imports growth	31.9	0.6	-9.3	-15.0	3.0
Current account balance/GDP	-7.9	-7.9	-4.0	3.4	2.0
Debt-service/exports	11.4	12.2	25.0	15.0	15.0

Sources: Asian Development Bank (1997f), Bank of Thailand (1997), International Monetary Fund (1998), and staff estimates.

The substantial volume of nonperforming loans, the depreciation of the baht, and a run on deposits have weakened the capital base of Thailand's financial institutions. Together with sluggish economic activity, this could increase the incidence of corporate bankruptcy. A fall in inflated property prices could further depress the commercial banks' balance sheets. With monetary policy no longer constrained by a fixed exchange rate, the baht has depreciated substantially since July 1997 in response to the perception that the authorities might have decided to rescue the economy and the banking system by printing money. In the absence of a comprehensive reform package for the financial sector, the international capital markets' fears of a banking crisis are likely to keep the baht under pressure.

The establishment in October 1997 of the Financial Restructuring Agency and the Asset Management Company was an important step forward. The Financial Restructuring Agency will supervise the overall rehabilitation of the financial sector and will help viable companies merge and/or raise capital, while the Asset Management Company will oversee the liquidation of unviable companies. In December 1997 the government announced that it would liquidate all but 2 of the 58 suspended finance companies in a move to restore investor confidence and to reduce selling pressure on the baht. The government has also decided to allow foreigners to hold controlling interests in the banking sector. In addition, the Central Bank has lifted most remaining foreign exchange controls, for example, local financial institutions can now resume their baht trading with nonresidents, and foreigners are no longer restricted from transferring baht offshore after selling Thai stocks and bonds. Finally, the government now prohibits banks and the remaining finance companies from lending for nonproductive purposes, for instance, consumer spending and real estate development. The restructuring costs will be large: around 15 percent of GDP.

In A ugust 1997 Thailand negotiated a $17 billion line of credit with the International Monetary Fund (IMF) in exchange for implementing an austerity plan. The initial plan called for increasing the value-added tax from 7 to 10 percent, which has already been implemented; reducing the current account deficit to 3 percent by 1998; low but positive growth; capping inflation at 9.5 for 1997 and 5 percent for 1998; maintaining foreign exchange reserves equivalent to more than four months' worth of imports; implementing fiscal policies to generate a budget surplus of 1 percent of GDP in 1998; and restructuring the financial sector. However, six months after the implementation of the IMF program the economy showed few signs of improvement. This called into question the feasibility of targets negotiated with the IMF, in particular, the requirement for a budget surplus, and has created uncertainty about the final policy mix the authorities are scheduled to adopt.

Sectors of Thai society have questioned the appropriateness of the IMF program. The combination of anti-inflationary policies with reductions in the money supply and in government spending could deepen a crisis generated by private sector debt. These concerns led the IMF and the Thai government to revise previous agreements, and toward the end of February 1998, they issued a third Letter of Intent that set more realistic objectives, such as a negative GDP growth rate for 1998, higher inflation, and a budget deficit. Likewise, the government backtracked on some previous privatization commitments. On the financial side, the government aims to reduce its stake in four recently nationalized banks.

POLICY AND DEVELOPMENT ISSUES

Thailand's industrialization process began accelerating in the mid-1980s. Given its relative abundance of labor, the country specialized in producing and exporting labor-intensive products. However, after only a little more than one decade, this comparative advantage has ended. Thailand is currently caught between the newly industrialized economies, against which it cannot yet compete in medium- to high-technology products, and countries such as People's Republic of China, Indonesia, and Viet Nam, which can produce a wide variety of labor-intensive products at lower labor costs.

Bias in the Pattern of Industrialization

Compared with countries at a similar level of development, Thailand's industrial structure is biased toward light industries that produce consumer goods, in particular, toward food and beverages, textiles, and apparel. This bias is partly explained by the economy's natural resource base. The industrial sector processes natural resources and manufactures labor-intensive products. Intermediate and investment goods are imported. Thailand depends heavily on demand in the industrial countries to which it exports. This pattern of trade and industrialization lies at the core of Thailand's balance-of-payments problems.

As concerns Thailand's policy options, one short-run strategy would be to reduce the prices of exports to stay competitive. This would probably be reflected in real wage cuts and the adoption of capital-intensive technologies. A second, longer term option would be to develop the domestic market rather than relying on exports. Either strategy or a mix of the two should be combined with investment and research in more technologically advanced sectors. To achieve product diversification and improve product quality, Thailand will have to raise its current level of human capital and its capacity to adopt and adapt advanced technologies.

Given Thailand's economic structure and natural endowments, the sectors that offer the most promising possibilities for the future are food processing and tourism. Thailand has plenty of scope for continuing to develop a competitive and world-class food processing industry. Thai producers must constantly adapt to changing tastes: wealthier societies may consume less regular rice, but spend more on first-class (and well-marketed) mangoes, aromatic rice, and oven-ready frozen foods. These are goods for which, as income grows, the demand for them grows more than proportionately. The businesses that make and export such items can use increasingly sophisticated production technologies and management methods to increase agricultural productivity and raise incomes.

Thailand also has considerable potential for developing its tourism industry further. In 1997, 6 million tourists visited Thailand. This figure could be increased by targeting tourists with high purchasing power. The Tourism Authority of Thailand has prepared the "Amazing Thailand" campaign for 1998/99 to try to make the best of the currency depreciation by increasing tourist arrivals to 7.7 million in 1998 and 8.3 million in 1999.

The appropriate development strategy is for Thailand to focus on the factors that are likely to give the country a longer term comparative advantage. Thus from a policy perspective, the important question is to be able to move to higher stages of development, avoiding the types of shocks the economy is currently experiencing. To accomplish this Thailand must work on three fronts. The first is intra-industry restructuring, implementing changes within existing industries, such as textiles and food processing, to improve production methods and attain best practice standards. The second front is relocating labor-intensive activities in the country's poorer regions for reasons of both efficiency and equity. The third front is intrasectoral restructuring. This involves making the transition from low-productivity, low-skill, labor-intensive industries to higher productivity industries, such as information technology. The first two are medium-term strategies and the third is a long-term strategy.

Lack of Competitiveness and the Role of Education

Thailand has a weak human capital base. Until recently, it lagged far behind other Asian countries in terms of the enrollment ratio at the secondary school level. While enrollment at the primary level was satisfactory, more than half of those who finished primary school did not go on to secondary education. This is partly because a large share of the population was still engaged in agriculture. A low value placed on education plus difficult access to schools made secondary education unattractive.

In the past five years, however, the situation has improved, and currently the transition rate from primary to secondary education is close to 90 percent. While Thailand currently has only 6 years of compulsory education, plans exist to raise this to 9 years in the near future and to 12 years by 2007. The government plans to achieve almost universal lower secondary education by 2000 or so and virtually universal upper secondary education around 2020.

Today, 80 percent of Thailand's labor force of around 33 million has no formal education or only a primary education. These workers have little access to better jobs and frustrate Thailand's hopes of moving up the development ladder. Four reasons account for the prevailing situation. The first is access: institutions of higher education tend to be concentrated in the capital, Bangkok, thereby putting rural populations at a disadvantage in terms of their access to higher education. Second, curricula do not match employers' needs. This is due, in part, to the predominance of course offerings in the humanities and arts at the expense of scientific and applied education and training. While education of the latter kind is more costly to deliver, it is likely to have greater linkages with the economy's needs and thereby have greater benefits, particularly in the longer term. Moreover, the quality of the system is low, it does not encourage creativity, and it does not emphasize research at the university level. Efforts must be made to increase agricultural research in particular. This could not only raise the sector's productivity by providing new and improved inputs, methods of cultivation, and machinery, but could have a far-reaching effect on the job situation in rural villages as higher incomes increase demand for goods and services. Third, teachers are underpaid and undertrained, as reflected in the quality of teaching. Finally, the physical infrastructure of many schools is extremely poor.

Thailand needs a radical, sustained, and far-reaching reform of its national education system to face the economic challenges of the 21st century and the technology age. However, even if such a reform program is implemented immediately, there may not be any significant effect on the economy in the short run. The reform, which should be directed toward improving the quality of education across various levels and increasing enrollment ratios, particularly at the secondary level, will take at least a decade to bear fruit and contribute toward enhanced growth and structural transformation of the economy.