Coping with the Economic Crisis: A Comparative Study Of Thailand and Vietnam*

By Praipol Koomsup and Napon Suksai
Faculty of Economics, Thammasat University

1. Introduction

This paper explains how the economic crisis in Thailand has developed and culminated in the floating of the baht in 1997. Factors causing the crisis are also analyzed. The current economic situation in Vietnam, which shows signs of distress, is then examined with comparison made between the economic malady in the two economies. It is hoped that the past lessons learnt from the Thai crisis will be useful in bringing the Vietnamese economy back on its sustainable path of prosperity.

2. Thailand's Economic Crisis in 1997: How it happened?

Since 1987 the Thai economy had experienced very high growth for several successive years. Its real GDP expansion rates during the 1987-1995 period were never below 8% per year. The growth was partly fuelled by foreign investment and lending, including exports which soared at the average annual rate of 22% for the 1986-1995 period. Per capita income in Thailand and other countries in East Asia also went up substantially during the same period. At the time, this seemingly

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* The paper is presented at a workshop on "Structural Change of the Economy and Economic Growth over Twenty Years" at the National Economics University, Hanoi, Vietnam on November 7, 2008.

economic success in the region was internationally recognized and prompted the World Bank to hail it the “Asian Miracle”.

Very high and continuous economic growth in Thailand, combined with lax credit provision by financial institutions, created the situation of “easy buy, easy sell” which eventually led to rampant speculation in many assets, particularly real estate and equities in the stock market. These asset prices rose very fast to unsustainably high levels – like a bubble being too much inflated and ready to burst. This “bubble economy” scenario was also reinforced by capital inflows. After the financial liberalization in the 1990s which facilitated international capital movement, both commercial banks and large corporations in Thailand had borrowed large sums of money from abroad. These borrowings were encouraged not only by lower foreign interest rates but also by exchange rates which were kept relatively fixed, thus virtually eliminating any exchange risk.

The event that was later regarded as a trigger for the crisis was a sudden and unexpected slowdown of exports in 1996. The total value of Thai exports in that year increased by only less than 1%, compared with over 20% annual increases during the past several years.

Stagnation in export earnings and economic growth in 1996, along with rising foreign debt burden (especially short-term debt) relative to the international reserves held by the Bank of Thailand, started to shake investors’ confidence in the Thai economy. At the end of 1996, most credit rating agencies began to lower the ratings of Thai financial institutions and the country itself. Less capital flowed into Thailand, and more even moved out, as foreign lenders refused to roll over short-term loans, causing a liquidity crunch for a number of financial institutions, more seriously for finance companies. Stock prices in the Stock Exchange of Thailand started to fall sharply since the end of 1996.

When there were signs of problems related to the financial institution and foreign debts in 1996, the Bank of Thailand decided to tackle the problems by discouraging short-term capital inflows while defending the baht. For instance, commercial banks were required to deposit at the Bank 7% of short-term capital inflow. In response to the baht attack in February 1997, the central bank tried to raise the cost of currency speculation by reducing liquidity, thus pushing up short-term local interest rates. Later in March and April 1997, though the speculative attack on the baht had subsided and interest rates declined, some finance companies started to show weakness. Another wave of baht attack in May 1997 prompted the Bank of Thailand to make swap contracts by selling spot and buying forward the US dollar to defend the baht and at the same time maintain local liquidity. The Bank also controlled the baht borrowing by foreigners by separating the local baht money market from the offshore market. In June 1997, investors eventually lost confidence in the fixed value of the baht and dumped it for the dollar from the Bank of Thailand. Short-term baht interest rates shot up again, but this time the higher cost of borrowing did not seem to deter the final speculative attack. With a very low level of international reserves in its hand, on July 2, 1997 the Bank of Thailand was virtually forced to abandon the fixed exchange regime and switched to the managed float system.

The floating allowed the baht to depreciate substantially from 26 baht per dollar before July 2, 1997 to the weakest level of 56 baht in January 1998. The degree of depreciation was so much that it worsened the balance sheets and financial positions of all firms carrying large sums of foreign debts. The problem of debt burden, the lack of liquidity in the money market, and depositors' lack of confidence in banks and finance companies were all related with one another, and created adverse chain effects. To remedy these problems, the government intervened by providing 100% deposit guarantee and allowed the Financial Institution Development Fund (FIDF) to bail out problem-ridden financial institutions. Thailand also received from IMF and a group of friendly governments an emergency loan totaling $16.6 billion. Despite all these measures, capital continued to flow out of the country, weakening the baht and discouraging domestic investment, consumption, production and employment. It was the first time since the end of the second World War that Thailand experienced serious economic recession -- the economy actually shrank in 1997-98 and managed to grow slowly in the next two years.

The economic slowdown helped to lower imports, as both private investment and consumer spending contracted. At the same time, exports recovered strongly due to the much weaker baht. As a result, both trade and current accounts has gained surpluses since 1998. On the other hand, repayments of foreign debts led to deficits in the capital account for an extended period. (See Table 1.)

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Thailand’s economic and financial crisis in 1997 has produced two new issues which never existed in any previous economic crisis in the world. The first is related to controversy over the role of the International Monetary Fund (IMF) in assisting member countries. Some economists criticized the loan conditions set by the IMF, requiring more restrictive monetary and fiscal policies adopted by the Thai government. These critics felt that these austere measures, which are normally prescribed by the IMF, hurt rather than helped the Thai situation. They argued that the policies stifled economic growth, accelerated business bankruptcy, and made it more difficult to solve the problems related to non-performing loans (NPLs). On the other hand, other experts believed that the IMF traditional “medicine” had over time cured the patient by bringing back more confidence to the Thai economy and stabilizing the baht.[†] However, the IMF finally agreed with the critics by later allowing the Thai government to relax these macroeconomic measures, e.g. allowing some budget deficit and more government spending.

Another new issue is a phenomenon in which the crisis originating in Thailand had spread out into other countries in East Asia. The countries most affected are Indonesia and South Korea. Moderately affected are Malaysia, Singapore, Philippines, and Hong Kong. Up to 1996 these countries did not exhibit any sign of serious problems in their economic fundamentals. The crisis seemed to spread out like contagious diseases,

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[†] Critics of the IMF include Stiglitz and Sachs. See Joseph Stiglitz, “The Insider” in The New Republic, April 2000; and Jeffrey Sachs, “The Wrong Medicine in Asia” in www.stern.nyu.edu/globalmacro, November 1997. Those who support the IMF include Dornbusch and Rogoff. See Rudiger Dornbusch, “The IMF Didn’t Fail” in Far Eastern Economic Review, 2 December 1999, page 28; and Kenneth Rogoff, “The IMF Strikes Back” in Foreign Policy, January/February 2003.

and therefore the spreading effect has been dubbed “contagion effect”. This was probably due to the behavior of international investors and speculators whose regional situation analysis could not tell the difference among countries in the same region. The financial channel was turned into a carrier for economic and financial diseases allowing their adverse effects to rapidly move from one country to another.

3. Causes of the Crisis

A number of books and articles have analyzed and explained factors causing the 1997 crisis in Thailand and some East Asian economies. Based on some of these studies, we can categorize the causes of the crisis into six items: three of them are of international characteristics and the other three are of domestic nature.

Firstly, the flow of international funds into the emerging markets in Asia and Latin America was a significant phenomenon in the 1990s, reflecting new and attractive investment opportunities in these markets. Foreign funds flowing into the Thai economy was not only part of that phenomenon, but also the result of the Thai government policy of fixed and stable exchange rate, financial liberalization, and capital account deregulation. These measures had promoted foreign investment in the country since 1990, when initially most of these inflows were in the form of foreign direct investment (FDI) which is of long-term nature. Later when the authority allowed foreigners to open non-resident baht accounts, and promoted offshore banking activity (officially called “Bangkok International Banking Facilities” or BIBF), the maturity of capital inflows became shorter. Most of these were in the form of short-term loans, portfolio investment (in the stock market), and deposits in the non-resident baht accounts. Most loans were not hedged, because there was no exchange risk under the fixed exchange rate regime. Though these debts were short-term, they were rolled over to extend the maturity. Some of these loans were used to finance long-term investment projects which earned income in baht – a potential problem of maturity and currency mismatching. Not only financial institutions, but non-banks private firms also borrowed directly from abroad. The share of short-term foreign debts in total foreign debts increased from 26% in 1989 to 50% at the end of 1995. The total value of short-term foreign debt outstanding exceeded the international reserves during the period between 1995 and July 1997. Because these short-term debts can be turned into capital outflows within a short time period, their rising share made Thailand vulnerable to the risk of capital flight and currency speculation.

Certain behavior of international investors and fund managers contributes to the risk of capital flight. Some economists explain that these investors have a "herding behavior" – they tend to move together in the same direction like a herd of animals. They make the same investment decision, probably because they tend to rely on the same set of information (e.g. information from some credit rating agencies). Their investment portfolio in each developing country may be a small portion of their total worldwide volume, but they act in unison by moving their funds in and out of such a small market like Thailand, it can create sudden and significant impacts on the economy. In 1997, even though the initial economic fundamental for Thailand did not quite justify "panic exit" of foreign funds, but in the eyes of international investors the economy had become too fragile and risky for their money. Their decision to pull out by refusing to roll over short-term debts almost at the same time contributed to the precipitous fall of the economy, developing further into a crisis. Therefore, the serious consequences of their action finally gave justification to their herding behavior.

Secondly, Thailand had run current account deficits throughout the decade before the 1997 crisis. In the latter part of the 1990s the deficits exceeded 5% of GDP, which is normally regarded as the upper limit of comfort zone. The imbalance was due to very high economic growth, as well as the type of industrialization which relies heavily on imported capital goods and raw materials, including imported oil. Though manufacture export items had become more high technology products (e.g. computer parts and electronics), their production still depended largely on imported parts and components.

Current account deficits in the 1990s were financed mainly by private borrowing, as the government during the period ran budget surpluses for 8 years consecutively, reflecting strict fiscal discipline. In a normal situation, it is generally believed that private borrowing is more prudent than government borrowing, because the private sector should be more careful in financial assessment. However, when lenders' confidence is eroding, as in the case of Thailand in 1996-97, private debts become more risky for creditors because private debtors can go bankrupt (and lenders may not get all their money back) while the government cannot.

Thirdly, Thailand experienced export slowdown in 1996 for a number of reasons. One explanation is that high economic growth and rampant speculation put inflationary pressure on prices of non-traded goods and wages. The asset price inflation led to the real appreciation of the baht, which eventually reduced the degree of export competitiveness. There are at least three studies which prove that the baht appreciated in real terms before the crisis. [‡] Pegging the baht mainly with the US dollar also contributed to the baht appreciation, because the dollar had strengthened against the yen and other regional currencies during 1995 and 1997. Another reason for Thailand's export stagnation is related to world trade. In 1996 total world exports grew by only 3.8%, compared with 18% in the previous year. Detailed examination shows that the product group with the biggest drop in world trade was electronic goods, which were one of the top export items of Thailand.

Fourthly, there were weaknesses in business financing and the institutions in the financial sector. Thai businesses tended to rely heavily on bank borrowing, relative to their own equity. During the "boom" period in the 1990s, many private firms obtained loans to finance their speculative activities in real estate and the stock market. On the lending side, both commercial banks and finance companies lack prudence in their credit provision: lending without proper risk and viability analysis, requiring inadequate collateral, mismatching between domestic loans and foreign borrowing, and insufficient loan loss provision. Thai banks

[‡] See Warr, Peter G., "What Caused the Thai Crisis?" Paper presented to the Conference on "Challenges of Globalization", organized by the Faculty of Economics, Thammasat University, October 21-22, 1999; and Goldstein, Morris, The Asian Financial Crisis : Causes, Cures, and Systemic Implications. Policy Analyses in International Economics, No. 55. Washington, D.C.: Institute for International Economics. June, 1998.

usually demanded collateral in the form of real estate (especially land) which created problems both for borrowers and lenders when land prices fell sharply after the bubble burst. In many cases, credit approvals were based on personal connection and personal gain rather than the merit of investment projects, thus the system was later called “crony capitalism”.

The regulator of financial institutions was also at fault. The ministry of Finance and the Bank of Thailand followed the policy of “no new entry and no exit” by not allowing new banks to open for decades. They also relied on the FIDF to prevent ailing banks from closing down. This policy amounted to guaranteeing the safety and survival of existing banks. It created the so-called “moral hazard” problem by encouraging banks to assume too much risk. The rules adopted by the Bank of Thailand with regard to loan classification, loan loss provision, and information dissemination were not up to adequate standard. These weaknesses and widespread business bankruptcy during the crisis contributed to the serious problem of NPLs in financial institutions.

Fifthly, there was inconsistency in macroeconomic policies concerning exchange rate, monetary policy, and measures on international capital movement. It is generally accepted that by most economists that the following three policy measures cannot be simultaneously implemented:

- Fixed exchange rate
- Free capital movement
- Independent monetary policy

In the context of the Thai crisis, the Bank of Thailand tried to violate this rule of "impossible trinity". It kept the value of the baht fixed, while allowing capital to move freely across the border. As more foreign funds were attracted by higher interest rates in Thailand, the Bank of Thailand had to prevent the baht from appreciating by buying up the incoming dollars and selling the baht. Without sterilization, this would increase the domestic money supply, inducing higher aggregate demand and putting more upward pressure on inflation. And, as explained before, this resulted in the real appreciation of the baht.

However, in most cases, the Bank of Thailand tended to sterilize the impact of capital inflow on the money supply in order to control inflation. If sterilization was successful, the unchanged money supply implied that local interest rates would remain high, thus attracting further rounds of capital inflow. Over a long period, the country accumulated foreign funds in the form of short-term debts and made it more vulnerable to speculative attack on the baht and destructive capital flight.

Lastly, during the period leading up to the 1997 crisis, Thailand's political system was rather unstable as it was adjusting to a more democratic era. Policy implementation lacked continuity and consistency in a situation where within six years, the country had four governments, ten finance ministers and four central bank governors. The Thai society became too complacent, as many of its members indulged in seeking speculative short-term gain at the expense of long-term sustainable development.

4. Vietnam Economy: Crisis in the Making?

In the past few years, Vietnam has shown signs of economic difficulties. Though the problems have not quite reached crisis level, the following symptoms point towards dangerous future.

Firstly, the Vietnamese economy grew from 2004 to 2007 at an average growth of 7-8% per year, of which agriculture, forestry and fishery rose by 3.4%, industry and construction by 10% and services (including financial service) by 8%. (General Statistics Office: GSO) The growth in construction and financial service was particularly high, indicating some degree of speculation in real estate. The Vietnamese stock price index has risen from below 300 in the first quarter of 2007 to 1,170 in the last quarter of 2007—a very steep increase by four fold within a year. (Vietnam economy report, Office of Commercial affairs, Ho Chi Minh, June 2008) These figures indicate that the economy was overheating.

Secondly, Vietnam’s economic expansion in the past four years has caused higher demand for import of capital and intermediate goods. General Statistics Office reports that import value rose from US$ 34.9 billion in 2005 to US$ 42.6 billion in 2006 (an increase of 22.1%). In 2007 import value was estimated at US$ 58.9 billion (increasing by 38.3%). And import value for the first 9 months of 2008 was estimated at US$ 64.4 billion – a jump of 48.3% from last year. Meanwhile, export value rose from US$ 32.5 billion in 2005 to US$ 39.8 billion in 2006 (an annual increase of 22.7%). In 2007 it climbed to US$ 48.6 billion (22.0% increase). And for the first 9 months of 2008 the export estimate was US$ 48.6 billion, a gain of 39% against last year.

Because imports expanded faster than exports, trade deficit increased from US$ 2.4 billion in 2005 to US$ 2.8 and US$ 10.3 in 2006 and 2007 respectively. The trade deficit in the first 9 months of 2008 has gone up further to US$ 15.8 billion, rising by 86% against the same period of last year. The increases in trade deficit caused wider gaps in the current account. Current account deficit rose from US$ 0.5 billion (0.3% of GDP) in 2005 to US$ 7.0 billion in 2007 (9.0% of GDP). The higher current account deficit the first 9 months of 2008 was expected to be about 12% of GDP – a ratio much larger than the IMF minimum standard of 3-4% of GDP. (Bangkok biz, 19 June 2008)

Compared with the crisis in Thailand where its current account deficit peaked at about 8% of GDP during the decade before 1997, the deficit of 12% of GDP in Vietnam seems to be more serious. However, the current account gaps in Vietnam has been financed mainly by foreign direct investment (FDI) and portfolio investment as seen in Table 2 – a better position than Thailand where financing came mostly from short-term loans. Therefore, the probability of massive outflow affecting the Vietnamese currency and financial sector is not as high.

Table 2: Vietnam's Current and Capital Accounts

	2005	2006	2007
Current account	-0.5	-0.1	-7.0
Capital account	3.0	3.1	18.8
FDI	1.9	2.3	6.6
Portfolio	0.9	1.3	7.4
Loans	0.9	1	2.2
Medium and Long-term loans	0.9	1	2.1
Short-term loans	0	0	0.1
Currency and deposits	-0.6	-1.5	2.6

Vietnam's export structure indicates that crude oil is the most important export item, increasing from US$ 7.3 billion in 2005 to US$ 8.3 billion in 2006 (13.7% increase), and again to US$ 8.5 billion in 2007 (2.0% increase). On the other hand, import demand for capital and intermediate goods expanded at higher rates: machines, equipment, tools, and spare parts rose from US$ 5.2 billion in 2005 to US$ 6.5 billion (25.0% increase) and 10.4 billion in the next two years (60.0% increase); petroleum products jumped from US$ 4.9 in 2005 to US$ 5.8 billion

(18.4% increase) and 7.5 billion (29.3% increase) in the next two years. If these trends continue, trade and current account balances for Vietnam are likely to get worse. The current and expected declines of oil prices in the world market will not be helpful because Vietnam is a net oil exporter.

Thirdly, high and rising inflation is probably the most worrying economic problem so far. The inflation rate was 7-8% between 2004 and 2007. It accelerated to an annual rate of 25.3% in May 2008 as a result of such cost-push factors as the more expensive crude oil and commodities, particularly food items. The demand-pulling influence of rapid economic growth also contributed to high inflation. Individual consumer products with higher prices include food products (43% price increase compared with 11.16% in 2007), and housing and real estate (23% price increase compared with 11.01% in 2007). Moreover, the 15% increase of transportation cost was also one of the major factors. (Macroeconomic Analysis Briefing, Fiscal policy Office, 13 June 2008 and General Statistics office)

One important factor explaining price increases in housing, real estate and stocks is speculation. As a result of expanding domestic money supply and bank credit, the Vietnamese stock exchange price index has increased by 47% in the first quarter of 2007, skyrocketing from 300 to 1,170 in the whole year of 2007. To calm down the market, the State Bank of Vietnam (SBV) intervened to control bank credits related to the stock exchange in the last quarter of 2007. As a result, the daily volume has come down to less than 5 million dollars. (Bangkok Biz, 18 June

2008) In addition, the stock price index dropped down to 370.6 on June 12, 2008. (Bangkok Biz, 19 June 2008)

Nonetheless, speculators turned to invest in other assets instead, pushing up the prices of houses and land to extremely high levels. The government responded by imposing a higher transfer tax rate and restricting real estate trading. (Vietnam economy report, Office of Commercial affairs, Ho Chi Minh, June 2008)

The current inflation in Vietnam is much higher than the level of inflation experienced in Thailand during the 1997 crisis – averaging less than 10% per year. However, the Vietnamese central bank seems to act more quickly than the Thai counterpart in efforts to control inflation and speculation. For instance, The SBV required banks to hold more reserves, to buy Treasury bond limiting liquidity in the economy, to limit real estate loans, and to curb credit expansion from 53% to 30%. It raised the reference interest rate from 12% to 14% to tighten borrowing. It also widened the exchange rate band between the dong and the US$, allowing the currency value to be more flexible. (Vietnam economy report, Office of Commercial affairs, Ho Chi Minh, June 2008) With less degree of financial openness in Vietnam, it is expected that the SBV will do a better job in controlling inflation.

Fourthly, the SBV has maintained fixed exchange rate while FDI continued to rise from US$ 1.9 billion in 2005 to US$ 2.3 billion and US$ 6.6 billion in 2006 and 2007 respectively. This has caused an increase in foreign reserves, money supply and credit. The growth in money supply was 33.6% in 2006 and 43.0% in 2007. Accordingly, bank credit rose from 25.4% in 2006 to 53.0% in 2007, especially credit for trade in the stock market.

As explained earlier, in the 1997 crisis the Bank of Thailand tried to maintain the fixed exchange rate regime, but kept defending the baht until it ran out of reserves and had to switch to the managed float exchange rate policy in July 1997. We are not aware of any speculative attack on the dong, but it should be noted that the SBV slightly devalued the currency twice this year. In March the dong was devalued by 1.8% from 15,815 VND/US$ to 16,100 VND/US$, and again in June by 1.96% from 16,290 VND/US$ to 16,620 VND/US$. There is no tendency for the SBV to have to use its reserves of US$ 21 billion to defend its currency.

Fifthly, trade and current account deficits, combined with government budget deficit could cause an economic crisis. Total government expenditure for Vietnam in 2007 was estimated to increase by 17.9% against 2006, of which spending for investment and development rose by 19.2%. The increase in government expenditure resulted in higher government budget deficit (4.9% of GDP) in 2007. The “twin deficit” problem with low national saving may eventually shake the confidence among international investors, leading to capital outflow. It should be noted that, as far as government spending is cconcerned, the situation in Thailand before the crisis was quite different from that of Vietnam. As mentioned before, the Thai government was rather conservative in its fiscal policy – running budget surpluses for eight years before 1997.

However, we feel that the Vietnamese government has recognized the danger of too much spending. In the middle of 2008 the Vietnamese government tried to slow down the economy by reducing economic growth target from 8.5-9% to 7%, delaying its investment projects, and cutting current expenditure. (Vietnam economy report, Office of Commercial affairs, Ho Chi Minh, June 2008)

Finally, Vietnam has attracted not only FDI, but also portfolio investment. Before 2008, portfolio investment increased from US$ 0.9 billion in 2005 to US$ 7.4 billion in 2007, exceeding FDI in the same year (FDI in 2007 is US$ 6.6 billion). In 2008, it is expected that portfolio investment will drop to about US$ 2 billion. (Macroeconomic Analysis Briefing, FPO, 13 June 2008) The slowdown of capital inflow is similar to what happened in Thailand in 1996-97. However, the debt situation is different. While total external debts peaked at 70% of GDP in 1997 for Thailand, this ratio for Vietnam is currently about 30%. We do not have the figures for short-term foreign debts of Vietnam, but we think that the ratio between short-term foreign debts and total international reserves for Vietnam is also smaller than that for Thailand in 1996-97, which peaked at 140%. [§] Therefore this confirms our belief that the danger of capital flight in Vietnam now is much less than that in Thailand 10 years ago.

[§] We find that the ratio of total external debt to foreign reserves of Vietnam is currently 104.8% , external debt being US$ 22 billion and foreign reserves at US$ 21 billion.

However, with the advent of the world financial crisis which is caused by the subprime crisis in the USA, Vietnam will not be able to rely on the world market in helping to solve its current problem. Most developed countries are expected to experience some degree of economic recession, and will slow down their demand for import. Vietnam (and Thailand also) which depends a great deal on these countries for its exports will definitely be adversely affected. Investment from developed countries will also be reduced, as many MNCs are grappling with their own financial distress, thus less FDI will be coming to Vietnam. The prices of oil and other commodities have declined and are expected to remain at low levels for some time. These lower prices will help to reduce the cost-push inflationary pressure in Vietnam, but will also reduce its export earnings from crude oil. It is very likely that economic growth in Vietnam will be lower, which is what the government would probably like to see in order to contain inflation. In some way it will be easier to tame inflation, but the government will have to deal with low growth which may affect the livelihood of the population. It is interesting to watch how the government will adopt its policy stance in the new and challenging scenario of “low growth, low inflation”.