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Financial liberalization and economy crisis: macromodelling the Thai economy

Wilai Auepiyachut
University of Wollongong
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FINANCIAL LIBERALIZATION AND ECONOMIC CRISIS: MACROMODELLING THE THAI ECONOMY

This thesis is submitted in fulfilment of the requirements for the award of the degree

DOCTOR OF PHILOSOPHY

from

UNIVERSITY OF WOLLONGONG

by

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BA (Economics) (Thammasat University, Bangkok, Thailand), MA (Economics) (National Institute of Development Administration, Bangkok, Thailand), M. Comm. (Economics) (University of Wollongong)

DEPARTMENT OF ECONOMICS
UNIVERSITY OF WOLLONGONG, AUSTRALIA
2000
AUTHOR’S CERTIFICATION

I certify that the substance of this thesis has not already been submitted for any degree and is not being currently submitted for any other degrees.

I certify that any help received in preparing this thesis and all sources used have been acknowledged in this thesis.

(Miss Wilai Auepiyachut)

25/October/2000
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Any appearing omissions and errors in this thesis are my own responsibility, and any sincere suggestions from the readers for further improvement of this study are highly appreciated.
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<tr>
<td>AD</td>
<td>Aggregate Demand Schedule</td>
</tr>
<tr>
<td>ADF</td>
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<td>AIC</td>
<td>Akaike Information Criterion</td>
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<td>AS</td>
<td>Aggregate Supply Schedule</td>
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<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
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<td>BBC</td>
<td>Bangkok Bank of Commerce</td>
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<td>BIBF</td>
<td>Bangkok International Banking Facilities</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>ECM</td>
<td>Error Correction Model</td>
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<tr>
<td>ECU</td>
<td>European Currency Unit</td>
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<td>EEC</td>
<td>European Economic Community</td>
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<td>EMDB</td>
<td>Emerging Market Data Base</td>
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<td>EMTNs</td>
<td>Euro Medium-term Notes</td>
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<td>EU</td>
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<td>FCRP</td>
<td>Foreign Credit Restraint Program</td>
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<td>FDI</td>
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<td>FIDF</td>
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<td>GDP</td>
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<td>LDCs</td>
<td>Less Developed Countries</td>
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<td>LIBOR</td>
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<td>ML</td>
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<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<tr>
<td>ROA</td>
<td>Return on Assets</td>
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<td>UIP</td>
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The introductory part of this thesis identifies developments in world financial markets, and then focuses upon the financial crisis that afflicted East Asia and Thailand in particular. The crisis in Thailand that began in mid 1997 occurred due to a loss of international and domestic confidence in the Thai economy arising from the weakness of its financial sector. This in turn is attributed to inadequate prudential regulation that resulted in an excessive stock market boom and a real estate bubble, in which foreign loans were used to finance non-productive investment in land and properties.

A dynamic macroeconomic model for the Thai economy was constructed by emphasizing the impact aspect of the Thai crisis: namely the impact of a jump in the perceived financial risk in investing in the Thai economy; the impact of an increase of short-term flows in financing non-productive investments; and the impact of a collapse in aggregate supply resulting from financial and corporate sector insolvencies. In addition, government policy advocated by the IMF in response to the Thai financial crisis in the initial stage is explicitly analyzed and compared with the Radelet and Sachs (RS) policy approach.

The major conclusion from the simulation results presented is that an exogenous shock arising from a temporary increase in the perceived risk of Thai financial assets during the onset of the crisis period, in conjunction with the collapse in aggregate supply as a result of financial and corporate sector insolvencies, can lead to a severe temporary economic contraction both in domestic demand and supply.

Implementing the IMF approach, by tightening monetary and fiscal policies in the initial stage of the crisis, could strengthen the real exchange rate in the short run but at a potentially high cost. Such a policy contraction contributes to a more protracted decline in aggregate supply and private capital stock, the latter being detrimental for long-term economic growth and aggregate demand.
The IMF approach produces more favorable effects in terms of external developments (more stabilized exchange rate), while the RS approach brings about favourable effects upon domestic demand and supply. The simulation results suggest that adopting the RS approach is an appropriate policy option in the short-term, particularly in dealing with such a crisis in the early stage. The RS policy approach eases the crisis in its initial stages arising from the abrupt and severe contraction in domestic demand and supply, but it comes at the cost of the larger depreciation of the real exchange rate than that for the IMF approach.

Restructuring of the financial sector is important but needs a more comprehensive and well-thought-out financial restructuring plan, otherwise it may lead to a more protracted contraction in economic activities. Encouraging long-term flows is also essential because they can generate a larger accumulation of private capital stock and a higher level of aggregate supply relative to short-term flows.