CHAPTER 3
THAI AND MEXICAN ECONOMIC FUNDAMENTAL COMPARISON

A better understanding of modified model's framework is obtained by examining the background of Thailand both in economic and political views. This chapter, then, attempts to describe an overview picture of Thailand and points out similarities and differences in comparison to Mexico.

Thai Economic Structure

At a glance, it seems reasonable to assert that Thai economic structure is strong and highly potential as economic fundamental of Thailand, presented by Thai economic indicator figures, was rather satisfied. Sometimes it was overdose. As regards the growth rate, Thailand has undergone high growth rate at an average annual rate of 7.75 percent, causing a five fold increment in per capita income since 1965. (reported by IMF, Annual Report 1995.) Moreover, GDP in Thailand grew at double digits rate between 1988-1990 because of the expansion of Thai non-agriculture sector and its exports.

Over the last decade (1990's), Thai economy has undergone a considerable change. At the end of the 1970's, agriculture employed more than two-thirds of the labour force and produced more than a quarter of GDP; manufacturing's share was 20 percent. By 1981, manufacturing had overtaken agriculture, and in 1990 it contributed well over a quarter of GDP.

Since 1986, Thai industrial sector has exceeded agricultural part in its contribution to GDP and the gap has increased over time. The rates of growth of exports in particular sectors such as construction, banking, transport and other services were high. Thai exports increased over twenty percent in 1988-1990 while Thai inflation rates were still low, relatively to growth rate.

Agricultural value added has declined to about 12 percent in 1995. Services, including trade, finance, tourism and government services remain the largest sector in the economy, eventhough recently it tends to go down as the stagnation of tourism sector which used to be the largest part contribute to GDP.

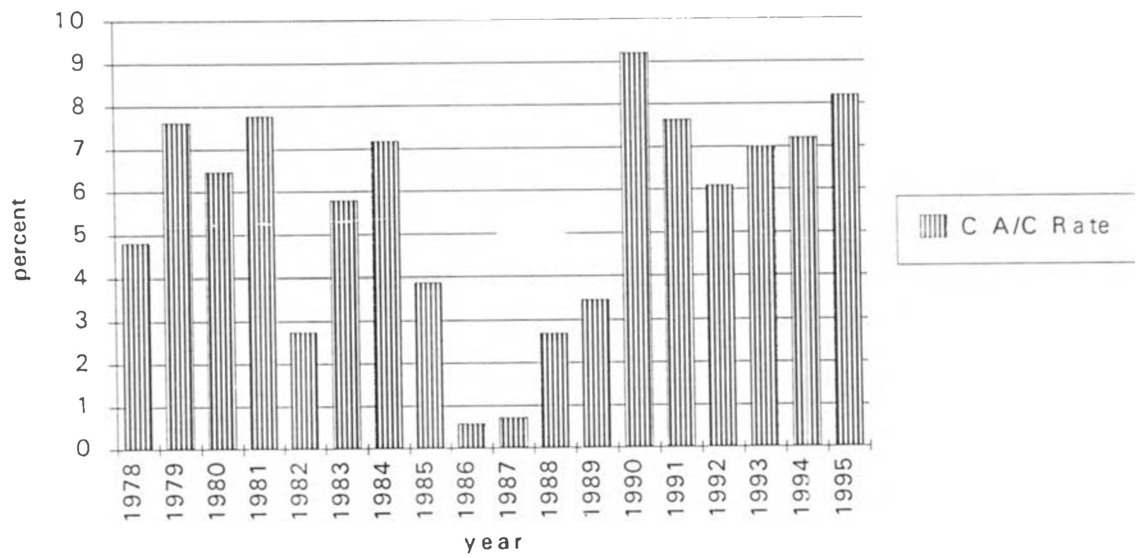
These led Thailand become one of the countries with fastest growing economy in the world which the remarkable growth rate could be explained by a sound economic base, developed in the 1970's and 1980's, accompanied in recent years by a fiscal surplus and an overall external surplus.

The transformation of the economy from dependence on natural resources and agriculture to industrial production and services has also provided Thailand abroadly diversified economic activities, which base for development as well as yields dividends to be obtained through an outward orientation, receptivity to foreign investment, and a market backed up by conservative macroeconomic management and cautious external borrowing policies.

Moreover, the Thai economy is also strongly export-oriented. In recent years, exports of manufactures have grown particularly quickly, with exports of goods and non-factor services increasing from 25 percent of GDP in 1980 to almost 40 percent in 1992 while the share of manufactures in total merchandise exports rose from 35 to 75 percent. Rice, the leading export commodity of Thailand for many years, was surpassed by textile products in 1985, and textile exports in 1995 are almost four times the value of rice exports.

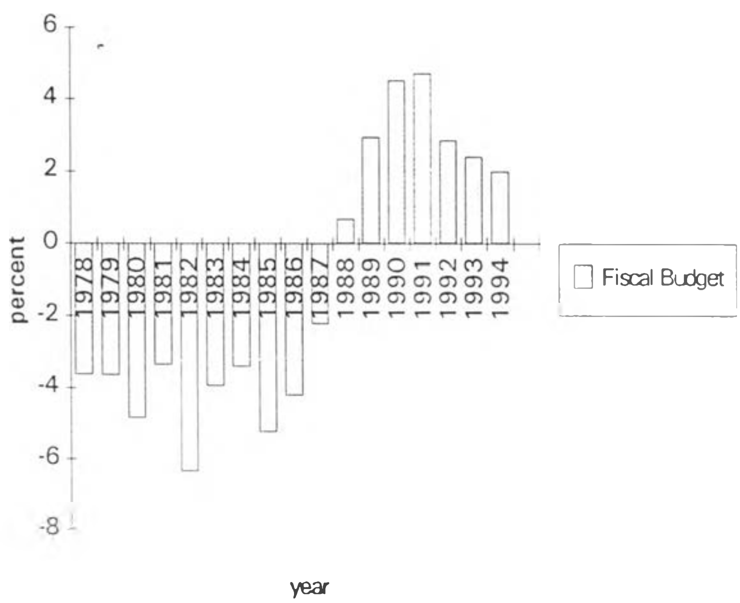
Early in the 1980's the Thai economy confronted a period of serious imbalance because oil crisis. It is due to heavy dependence on imported oil, Thailand was seriously affected by both the 1973 and 1979 oil price shocks, but it did not immediately pass on the increased prices to domestic users. This was partly because the first oil price rise coincided with the general commodity price boom, which cushioned the economy from the full impact of the price shock. When the second oil shock hit in 1979, however, a relatively expansionary fiscal policy combined with delays in taking appropriate action to correct the fundamental imbalances contributed to a sharp deterioration in the fiscal and external accounts. From 1979 to 1983 the current account deficit averaged about 6.5 percent of GDP, and the public sector deficit hovered around 5 percent of GDP for an even longer period. Long-term external debt rose sharply from 2.7 billion US$ in 1978 to 13.2 US$ billion in 1985.

Figure 3.1: Current Account Deficit to GDP (percent)



Source : International Financial Statistics Yearbook 1995, IMF.

Figure 3.2: Fiscal Budget to GDP (percent)



Source : International Financial Statistics Yearbook 1995, IMF.

A number of actions were taken by Thai government in the first half of the 1980's, toward stabilization and structural reform. These involved fiscal retrenchment, stronger tax collection, competitive exchange rate management, active export promotion and reduced external borrowing. Initially, the economy responded slowly to these policy changes because of the unfavourable global economic situation and in part because the adjustment was relatively gradual.

From 1985, however, the cumulative effect of policy measures, including a 14 percent devaluation of the Baht in late 1984, combined with more suspecious external economic conditions, stimulated a rapid turnaround and recovery. This turnaround was sustained by effective exchange rate management and an increasingly attractive market for Thai exports. Accompanied by improvements in the terms of trade, the economy grew faster and the fiscal and external deficits both fell rapidly.

While the economic rebound in the latter half of the 1980's was also directly referred to a more favourable international environment including the depreciation of the Dollar against the Yen, rising cost pressures in East Asia and Japan, and lower oil prices; it was reinforced by prudent macroeconomic and structural policies. Conservative fiscal management, competitive exchange rate policy, and a general shift in the incentive system from import substitution toward export promotion had strengthened investor confidence in the Thai economy and significantly boosted exports.

Since 1991, despite the deepening recession in the world economy, GDP growth was still at high level, 8 percent. Although this was lower than the double-digit growth rates during the latter part of the 1980s, this performance was more sustainable. Lower domestic demand, caused by monetary and fiscal tightening, had been the main factor in slowing GDP growth. Private fixed investment in particular, was almost stagnanted in 1992 after having risen by over 15 percent a year over 1988-91. Even with rapid economic growth, consumer price index inflation had remained below 6 percent. While the public sector maintained a current budget surplus for eight consecutive years.

For the current account deficit it rose to 9.2 percent in 1990, due to rapidly increased imports, particularly mechinary. After the occurrence of Gulf War Crisis, oil price rises and a significant decline in visitor arrivals, the deficit for 1991 was expected to be even higher, but fell to 7.7 percent. The deficit fell slightly to 5.7 percent in 1992. However, in 1995, it went up to 8.2 percent which led to more serious concern.

Trade liberalization has continued, particularly for raw materials and intermediates. Agreement was reached on establishing an Association of Southeast Asian Nations Free Trade Area on January 1, 1993, to promote regional economic integration. New tax reforms raised indirect taxes through a value added tax and cut income and company taxes. There was also a slight easing of monetary policy to accompany these fiscal changes, which resulted in a fall in interest rates.

Monetary arrangements have also been liberalized, and the regulatory and supervisory framework of financial transactions are strengthened. Deposit interest rates, except savings deposit rates, have been completely freed. Lending rates have been substantially liberalized, essentially by raising the ceiling rates. The foreign exchange regime and controls, already quite liberal, have also been further relaxed and the authorities have signed the Article VIII Agreement of the IMF[1]. The net result has made the system more open and to integrate Thailand more fully integrated into the international financial market.

Hence, the need to mobilize domestic savings to supplement external financing is likely to increase. In terms of mobilizing foreign savings, Thailand remains highly creditworthy and still enjoys a favourable market perception. Growth official reserves at the end of 1994 represented more than half a year's imports of goods and services.

The political instability has been much improved. Democracy has boosted. The Thai business community and international investors appear optimistic about Thailand's medium-term economic outlook. Two factors that justify this confidence are Thailand's strong economic performance over the first half of 1990's in a period of varying international fortunes, and the general sense that the right economic environment for private sector export-led industrial growth has been created.

If the government can restore more political stability, the Thai economy remains well placed for continued industrial growth, with policies being adopted to further strengthen competitiveness and to increase the measure of privatization.

However, the current account deficit rose to 8.2 percent in the end of 1995, which increased from around 5 percent in the last year because of unpredicted import, caused fear of Thai economic situation

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Article VIII purposes to eliminate exchange restriction on payments and transfers. For current international transaction, member accepting the obligation of Article VIII, section 2(a), 3 and 4 of IMF article agreement, undertake to refrain from imposing restriction on the making of payment and transfer for current international transaction and from engaging in discreminatory currency arrangement or multiple currency practises without approval of the IMF

After the occurrence of the Peso crisis, many researchers identified that Thailand has economic structure similar to of Mexico which may conduce the same currency problem to Thailand. The researchers paid particular attention on some economic indicators that tend to worsen such as inflation rate, trade deficit, the nature of short-term capital flows and currency overvaluation.

As there have been opinions pro and against whether Thai economy is like of Mexico, to apply Garber-Blanco model, giving the satisfied results for examining Mexican devaluations experience, to Thailand, it is, therefore, essential to observe the similarities and the differences between both countries in order to guide the Baht devaluation model establishment in the next chapter. Also to investigate the foreign researcher's analysis which stated that the economic structure of Thailand is similar to that of Mexico, they also concluded that the crisis which happended in Mexico may reoccur in Thailand.

The next section, thus, will illustrate the remarkable points, compare between the economic fundamentals of both countries. After that, there will be the deeper analysis concerning about the possible process of the occurrence of BoP crisis in both countries.

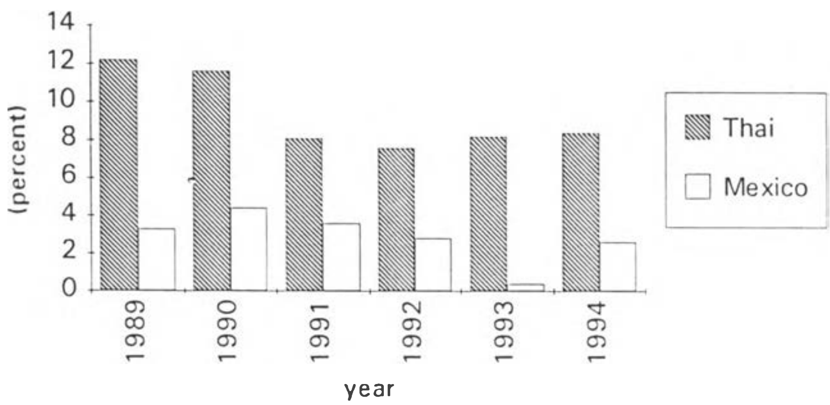
Thai and Mexican Economic Fundamental Comparison

This section attempts to provide some economic backgrounds of Thailand and Mexico during 1978 to 1995.

Growth Rate

Growth rate is one of the most essential economic indicators which represents the economic health. High and sustainable growth rate is the one factor that can guarantee for the strength of domestic currency

Figure 3.3 : Growth Rate between Thailand and Mexico



Thailand : IMF, Annual Report 1995 indicates that since 1965, GDP in Thailand has increased annually by around seven percent, confirmed by table 3.1 which is presented by Bank of Thailand. In the late 1980's, Thailand was one of the countries with the fastest growing economy in the world. During 1988-1990, growth rate were as high as its double digits, peaking at 13.28 in 1988. From 1991 until now, the growth rate could not reach two digits, however, it was still around 8 percent despite of the world economic recession. It is due to sound economic based on development in the 1970's and 1980's. Morever, in the future, Thai government has an important objective, set in Thailand's Sevênth National Development Plan aims to sustain growth rate to be sufficient to absorb expected growth in labour force. Thus, it is obviously found that the growth rate has attained at stable high level for a long period of time.

Mexico : The growth rate of Mexico has been concerned at the low level, although before debt crisis Mexico enjoyed a prolonged period of high economic growth which was 6.2 percent a year over 1940-1980. Between 1982 and 1988 GDP growth rate was roughly unchange, implying an 11 percent decline in per capita GDP. During 1988-1992, economic revolution and open economic policy led to economy expansion rapidly from 1.5 in 1987-1988 to 3.3, 4.4, 3.6, and 2.8 in 1989-1992, respectively. After that economic growth slowed down from roughly 4 percent to around 3.6 percent in 1991, 2.8 percent in

1992 and less than 1 percent in 1993. In 1995 the growth rate was expected at less than 1 percent as a result of Zedillo's rescue program.[2] , however, it was 1.5[3] .

Table 3.1 : Thailand; Growth, Investment and Saving

	1980-1994*	1994
GDP growth	7.8	8.4
Investment/GDP	33.3	40.1
Savings/GDP	28.5	34.2
I-S/GDP	4.8	5.9

Source : Economic Research Department, Bank of Thailand
* Average of period

Capital

This section provides the-analysis about the capital in Thailand, particular types of capital since the capital both inflows and outflows are highly correlated with the level of international reserves in the sense that as price of goods and services are dominated in term of local currency, the capital inflows have to be changed to domestic currency. The BOT will collect foreign money and supply domestic currency which leads an increase in the reserves. While the capital outflows induces a decrease in the reserves. The international reserves are corresponding to the stability of the exchange rate regime.

Thailand: Since Thailand's economic recovery which began in 1987 the gross investment has remained a high share of GDP. Although the

Zedillo's resue program is shown in Appendix1

The informal data is from the Mexican Embassy.

need to mobilize domestic savings to compensate external financing seems to rise up, I-S gap to GDP is still high, then it induces net private capital inflows has grown significantly. Net inflows were 600 million US$ in 1987. The inflows increased to more than 6 billion US$ in 1989 when the government began financial liberalization.

With the acceptance of article VIII of the IMF, lifting of all interest rate restrictions and the operation of 47 BIBF (off-shore banking units in 1994), net private capital inflows jumped to an estimated 13.5 billion US$ in 1994. Meanwhile the gap between foreign and domestic interest rate has been cut in half over the past 4 years of liberalization. Rather, financial liberalization has greatly reduced the cost of financing for Thailand's corporations. Moreover the higher domestic interest rate, compare to foreign interest rate, as well as the satisfied stability of Baht attract the hugh capital inflows to do arbitrage as the financial sector has continually liberalized.

Since the end of the 1980's until 1993 as the financial liberalization, most of capital inflows has been concerned as short term. The researchers identified that more than one-third of capital inflows each year are non quality capital inflows which is highly sensitive to the movement of interest rate and stock market yields.

However, the medium term and the long term grew rapidly. Recently there is a report from Bank of Thailand that the medium term and the long term are the maturity of capital inflows. Anyway, the short term capital still exists in commercial bank's transaction. In 1995, capitals inflows was greater than the current account deficit, at 8.2% of GDP). The deficit, however, is larger than quality capital inflows. Observing that there may be such abnormal capital outflow evidence, monthly net private capital inflows has risen and fallen in line with stock market movements and interest rate trends. However, there was neither excessive volatility nor a net outflow during any month of 1994. The net inflows averaged 20.4 billion Baht per month during the first quarter, 36.5 billion Baht during the second quarter, 30.4 billion Baht during the third quarter and 21.4 billion Baht during the fourth quarter in 1994. Since the domestic interest rate is much higher than foreign rate, then the capital inflow is mostly concerned as non quality capital control, purposing only to speculate. The government have to monitor.

Mexico : After capital account being negative in 1987 and 1988, Mexico's capital account showed a surplus of 8.2 billion US$. in 1990, 20.2 billion US$, in 1991 and 26 billion US$, in 1992. The interest rate controlling policy, to reduce inflation rate, was able to motivate huge foreign capital inflow, nevertheless, the inflow capitals have been the purpose of speculative in high interest rate and in stock returns which have high returns as in other emerging markets. This source of fund did not help to contribute growth of economy. However, Mexico heavily depends on these foreign capital since the large current account deficit has been financed by this source of foreign capital inflow.

Inflation

As known that high inflation rate will deteriorate the competitiveness of export products. If the inflation rate increases, to sustain competitiveness, the government has to devalue domestic currency to offset the increase in the price of exported products.

Thailand : While the inflation was slightly up from the 3.3 percent recorded in 1983, it is well within the country's average inflation rate of 4.0 percent recorded during the past 10 years. Inflation rate is expected to remain not beyond 6 percent. Although it tends to increase, comparing to high growth rate, it is still not too high.

Mexico : Conservative fiscal policy kept inflation in single digits until 1972, but large increase in public expenditures in the early 1970's pushed inflation to double digits. In 1981 the inflation was almost 30 percent and in September 1982 the inflation jumped up to 60 percent and continued to rise to 90 percent in the late 1986.

Economic stagnation which caused triple digits inflation continued to 1987. After that many policies has been applied to solve inflation problem and had been highly successful since inflation rate was below 22 percent in 1991 and 15.4 percent in 1992; single digit level was 7 percent in 1994.

Investment

Among significant factors, the high rate of investment must be emphasized, particular its contribute to national income. Since in both countries, investment exceeds saving, the gap has been filled by the foreign capital, means debts, so the value of such this type of capital inflows should be taken into account as the external debts can contribute something to compensate its principle and interest rate in the future.

Thailand : Throughout the 1980's the ratio of private investment to GDP stood at around 25-30 percent and there was a high inflows of foreign direct investment while the world economic environment has been generally favourable to Thailand, with growing markets for Thai products and the existence of appropriate technology for labour-intentive industries that could be transferred, often with foreign capital investment, from countries such as Japan, Taiwan and South Korea.

The open economic policy led to foreign investment acceptence. Since the early of 1980's, most of investment has done by private sector and increased by about 20 percent a year. Although, from 1992 to recent 1995, the investment rate is slower, but it was still high. During 1988-1991, private fixed investment has risen by over 15 percent. Furthermore, the investment tends to transfer from private expenditure on construction and equipment to public and private provision of infrastructure services.

In addition, the transformation from import substitution to export promotion strengthened investor's confidence in Thai economy and boosted exports.

Mexico : In the history of Mexico, most of investment has been engaged by the government, which leads to huge accumulated fiscal budget deficit continuously. Furthermore, the government investment has been inefficient and not contributed income for the whole economy. Also corruption is a principal problem for management of the Mexican government.

The improved regulation framework and increased confidence have stimulated foreign investment. In May 1989, the regulations on foreign investment were modified to encourage investment by introducing transparency and harmonizing the tax system. In most sectors 100 percent foreign ownership is allowed; in some sectors, where foreign participation was previously banned, a 49 percent minority is permitted, with the exception of brokerage houses and banks, where the limit is 30 percent.

These limits would be further liberalized under the Free Trade Agreement. Foreigners are allowed to purchase securities, including government paper in the stock market. Direct and portfolio foreign investment in 1992 was 18.9 billion US$, compared with 3.5 billion US$. in 1989 and 2.5 billion US$. in 1988.

Mexico has been increasing private sector participation in financing, building, and operating infrastructure services. The objective include increased efficiency and reversing the declining infrastructure investment from fiscal retrenchment. In the 1980's Privatization has been comprehensive, in 1982 there were 1,155 public enterprises, by June 1992 there were only 220. This has had important implication for the government budget while the government revenue has also declined.

In 1993, the restricted monetary policy, however, reduced domestic investment from 16 percent in 1992 to 1 percent.

Oil production becomes government monopoly and the government allow foreign participation in petrochemical industry. So that public sector has been very significantly narrowed and these also introduces uncertainty to the economy.

Government Budget

In the sense that the trade account is consisted of the gap between investment and saving, both in public and private sector, to visualize clearly the external debts, fiscal budget should be taken into account.

Thailand : In 1979-1983, there was 5 percent of fiscal budget deficit to GDP by average. Recently, as a result of conservative fiscal management, government budget has been surplus for eight consecutive years since 1988 and during the seventh plan, they also succeeded to make it under control. The government has a cash balance surplus on nearly 10 billion US$ in 1994.

Mexico : The overall fiscal balance had been negative continuously and it went from a deficit of 15.6 percent of GDP in 1982 to a surplus of 1.6 percent of GDP in the first half of 1992. (excluding privatization proceed) In 1995, it went to deficit again at 0.5 percent to GDP.

Exports

To consider trade account, export and import should be seperately analysed.

Thailand : The phase of export-led growth, began towards the end of the 1960's and persued increasingly in the 1970's, continued throughout the 1980's.

After the period of import substitution, the export is a significant basis of Thailand's strategy to be industrialization. The manufactural goods exports have been continually growing and dominated over the export of rice. Overall, Thai exports grew from only 14.3 billion Baht in 1970 when Thai only emphasized in the export of agriculture products to 616 billion Baht, over twenty years and also doubled its share of world export trade.

During booming period, 1989-1991, export manufacture has been increasing quickly, export of goods and non factor service increased 28.4 percent of GDP, in 1980 and 77.8 percent in 1992. While the share of manufactures in total merchandise exports rose up 35 to 75 percent. Also rice leading export commodity changed to textile and right now textile value is equal to 4 times of rice value.

Table 3.2 : Share of Manufactures in Total Exports, 1960-1992

(percent of GDP)

1960	1965	1970	1975	1980	1988	1992
1.2	4.8	15.1	18.6	28.4	63.0	77.8

Source : Bank of Thailand

Although Thai Baht has appreciated since 1990, share of manufactures in total exports still increases.

Mexico : Since 1991 Mexico has enjoyed a more diversified export based on non oil exports which represented 66.8 percent of total exports as compared to only 22 percent in 1982. The major exports of Mexico concentrates mainly on agriculture products, especially tea, coffee and spices. Her major trade partner is US.

The distortion of Peso value to appreciate induced the disadvantage of the exports because export price increased following Peso value which impacted investment, expenditure and also exports. Thus, during the Salinas' period, Peso has to be devalued by around 3.7 percent[4] annually in order to increase compettitiveness.

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[4] "จากวิกฤตการณ์ค่าเงินเปโซ......ถึงข่าวลือลดค่าเงินบาทผลพวงจาก Globalization", เศรษฐกิจทันเหตุ, ปีที่ 4 1 มกราคม 2538, หน้า 1-26.

Imports

Thailand : In order to transfer from labour-intensive industries such as textiles and footwear to more skill and capital-intensive industries such as machinery, automobiles and electronics, the greater need for imported, particularly capital goods, is occurred. Recently, 1995, imports, then, outstandingly emphasize on raw materials and mechanisms as the expansion of investment sector.

There is one remarkable point that the imported capital goods is expected to pay off in future in term of a more productive economy which will also be less dependent on imported capital equipment. For example, the factors that contribute to the growth in real imports during January,1995 to September, 1995 are demonstrated in Table 3.3.

Mexico : In 1983, all merchandise imports were subject to quantitative restriction. After that, New Mexico is one of the more open economies in the world. Less than 20 percent of tradable product is subjected to quantitative control. Economic revolution and open economic policy speeded up the imports to be used for investment expansion. The Peso distortion lowerd the import price. Then it motivated imports particularly consumption goods and led to more increase in current account deficit of Mexico.

Table 3.3 : Thailand; Contributions to the Growth in Real Imports (percent of total imports)

(Jan.-Sept. 1995)

Total imports	Oil imports	Consumption goods imports	Raw material imports	Capital goods imports	Other imports
16.1	1.2	1.8	5.7	6.1	1.3

Source : Economic Research Department, Bank of Thailand

External Debts

To pay off the external debts, the international reserves will be used, so the external debts directly impacts the level of reserves.

Thailand : Due to the oil crisis in early 1980's, there was an imbalance since Thailand depended heavily on oil. The external debt increased from 2.7 billion US$ in 1978 to 13.2 billion US$ in 1984. As a result of the exchange rate management in 1984, it recovered external debt. Now, the overall external debt is surplus and BOT confirms that it is under control during this 7th plan. Thailand can easily sustain any unforeseen external deficit both in the short and long run since Thailand has enjoyed balance of payments surplus every years since the last time when the Baht was devalued, 11 years ago This led to high level of international reserves, about seven months of import value. However, there has been a concern about a dramatic decrease in services balance where as trade deficit tends to rise up.

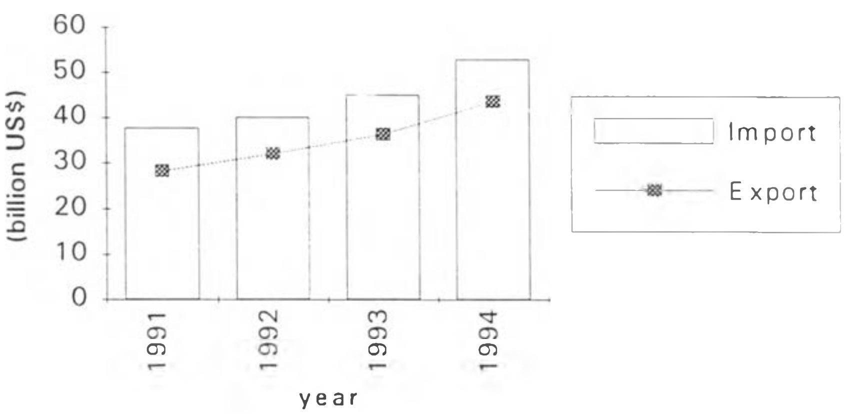
Mexico : . On August 13, 1982, the government of Mexico announced that Mexico could not continue to pay interest and principal on its 80 billion US$ external debt, at the same time, she requested 3 billion US$ loans that would enable hers to continue her debt payments. This event sparked the beginning of the deep debt crisis that spreaded like a forest fire across a large number of Latin American countries, most African countries, various East European and Asian economics.

The foreign capital dependence caused more debt problems to Mexico, particular in 1993, total external debt rose up from 1992 by 15.5 percent from 133,100 million US$ to 153,100 million US$ and tended to increase more with higher rate. Due to this matter, the external debt burder related to GDP was high to 43.7 in 1994. External debt burden export ratio was about 270 percent and debt service ratio was 21.4 percent.

Trade Account

Trading in goods and services causes the movement of reserves level. Both Thailand and Mexico, recently, have trade account deficit, however there are differences in its causes.

Figure 3.4: Thai Import and Export Values



Thailand : Due to the continuous surplus in the services account, the rise in current account deficit is essentially a trade deficit. Therefore, there has been a consideration about the factors that contribute to the trade deficit.

Trade deficit is generally because of huge imports exceeding exports. The dramatical growth in imports and deficit have been caused by the increase in private investment as well as private consumption and other temporary factors such as government imports which were also important. While exports increases sharply 25.3 percent, it is still less than imports. Thus a rise in the trade deficit does not reflect change in Thailand's international competitiveness. But it is because greater domestic demand and the effect of other temporary factors.

In addition, the deficit is perhaps caused by the increased import price which can be observed by the fluctuation of currencies --- appreciation of foreign currency. In case of Thailand, terms of trade shock caused by a fluctuation in the price of raw materials as well as the appreciation of the Yen and the DM contributed to the deficit by higher import prices.

Table 3.4 : Contributions to the Trade Deficit

Billions of Baht	Jan. - Sept. 1994	Jan. - Sept. 1995
Trade Balance	-162.8	-264.2
1. Temporary Factors	-8.8	-67.0
1.1 Terms of Trade Shock	-4.0	-48.7
1.2 Special Government Imports	-4.8	-18.3
2. Cyclical Factors (Underlying Trade Deficit)	-154.0	-197.2

Source : Economic Research Department, Bank of Thailand

Mexico : Unlike Thailand, the trade deficit in Mexico continuously rises because of increasing fiscal budget deficit. The sharp increasing trade deficit in the first half of 1990's continuously occurred because the reason of the economic revolution and open economic policy during 1988-1992. It led to more imports in raw material and mechinary in order to expand investment sector. The import value grew more rapid than the exports, while the total expenditure of this country was greater. Domestic saving was much lower than investment.

Current Account

The hugh current account deficit that is insufficiently financed by capital account surplus will induce the deficit in BoP. The BoP deficit which happened continuously leads to the decline in international reserves and ultimately reaches the lower level. Then the government can not supply foreign exchange rate to maintain the fixed rate, the devaluation will occur. However, in some countries, the current account deficit is financed by large amount of capital inflows which is concerned as short term capital inflows, fluctuating as the movement of domestic interest rate and the yields from stock market. Then this type of capital will be very sensitive and can flow out easily which implied that the movement of international reserves, are being concerned uncertainty.

Thailand : Between 1979-1983, current account deficit in Thailand was mainly due to the effects of oil crisis. After that export-import values has been affected by a steady appreciation of Baht's real exchange rate over the last ten years. In 1990, Gulf crisis occurred, led to a rise in oil price and dramatically drop in tourism revenue. The current account was worse to 9.2. However, in 1991 it dropped to 5.7 and it was 7.7 percent of GDP in 1992, and be around that 5.0 until 1994. In 1995, it was 8.2.

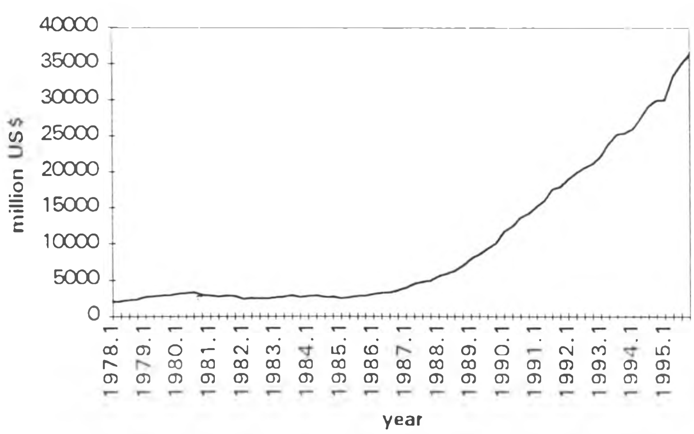
As regard to the causes of rapid increased deficit, Bank of Thailand confirms that these were impacted primarily by the private investment and term of trade shock rather than the decline in competitiveness. Moreover the huge current account deficit is also expressed by the greater need for imported capital goods which can be expected to pay off in future years in terms of a more productive economy which will also be less dependent on imported capital equipment.

A fast-growing developing country, like Thailand actually needs to finance its development by using foreign saving through current account deficit. In Thailand, although saving to GDP rate averaged about 35, its investment has been over running at about 40 percent.(see table 3.1) Thus, Thailand has on average been running a current account deficit equivalent to 5 percent of GDP. In fact, the 1995's current account deficit was predicted to be at 5.8 percent, which would be general situation, particularly when the economic growth was over 8 percent in 1995. Nevertheless, it jumped up to 8.2 percent due to the temporary import factor.

Mexico : Since import value and total expenditure grew quickly, saving-investment gap was still negative by large volume. This was induced by the gap between the government saving and investment. They led to more trade deficit as well as current account deficit. In July, 1994, current account deficit was 24,500 million US$., calculated as 6.6 percent of GDP with the expectation (written in IMF annual report) that it will rise by 2 percent annually.

International Reserve

Figure3.5: International Reserves at BOT



In case that international reserves are not enough to supply through the foreign exchange market while the domestic currency price continuously declines, the government will be stop the rise in foreign currency demand by increasing the foreign currency price, means by announcing devaluation of domestic currency.

Thailand : Thailand was accumulated from 2.4 billion US$ in 1981, 7.1 billion US$ in 1988, 25.4 billion US$ in 1993, 30.4 billion US$ in 1994 and 34.4 US$ in 1995. International reserves in Thailand increase on an average of 400 million US$ per month. Recently foreign reserves of the Bank of Thailand has increased nearly ten-fold from 3.8 billion US$. in 1986 to 30 billion US$. at present 30 billion US$. would finance 7 months worth of imports. It is also 3.5 times the current account deficit and more than twice the size of net private capital inflows in 1994.

Mexico : Mexico had high international reserve in February 1994, about 29 billion US$. After turmoil from the guerrilla band "Patista" and the assassination of two important persons in the pevious cabinet, foreign investors brought money back to their own countries. Thus, at the end of 1994, Mexico had only 6 billion US$ in international reserves leading to the Peso devaluation on December 19, 1994, by President Zedillo. Some sources believed that after the beginning of crisis, foreign reserves was less than 1 month.

Exchange Rate

Thailand : Thailand has two experiences of large devaluation, in 1981 and 1984. In 1984, 14 percent devaluation of Baht to solve deficit. This plan proved term of trade, economy grew faster and fiscal external deficit decrease rapidly. Thailand have used basket of currencies which is to use quasi fixed exchange rate since November 5, 1984.

In 1981, according to the foreign exchange settlement; daily fixing, Thai Baht value tended to decline against US dollar. Because US dollar was stronger than other major currencies, Thai Baht had to be devalued against US dollar in order to be stabilized against other currencies in basket; intervention currency, unless Baht would be strengthen than other major currencies.

Moreover, foreign interest rate which was higher than domestic's led to a huge capital outflow and recession of export value. Though, there was Baht devaluation in May 12, 1981 from 20.775 baht to 21.00 Baht per 1 US dollar which was equal to devaluation by 1.07 percent, BoP did not improve anyway. In July 15, 1981, the Exchange Equalization Fund announced Baht devaluation by 8.7 percent and also the Daily Fixing allowed the Exchange Equalization Fund to set the exchange rate alone.

In the late 1983, Thai Baht tended to appreciate especially in mid 1984, Thai Baht value appreciated against Deutsche Mark and Pound Sterling. The government pointed out that the exchange rate system was not conformed with economic situation at that time. Since Thai Baht was pegged with US dollar, Baht appreciated and led to a damage to Thai economy particularly in the trade account and agricultural price.

Therefore, there was an announcement to change the exchange rate system on November 2, 1984. The Exchange Equalization Fund declared neutral exchange rate starting with 27.0 Baht : US dollar on November 5, 1984 which caused Thai Baht depreciated by 14.8 percent against US dollar.

Mexico : The currency of Mexico is the New Mexican Peso, the external value of which is determined in the interbank market on the basis of supply and demand conditions and a part comes from government management. Annually, since the Salinas' time, the Peso has been set to depreciate by 3.7, adjusting according to the inflation gap between US and Mexico, to revive the competitiveness against US., the major trade partner. No limitations apply on access of ownership or transfer of foreign exchange. Forward cover is available from commercial banks.

The exchange rate devaluation policies were used as tool to solve debt problems and to stimulate exports, in August, 1976, February, August 1982, as well as minidevaluation during 1981. The high interest rate, which is a result of the restricted monetary policy, also distorted the Peso value to appreciate.

Politics

Making decision about devaluations is mostly done by the central bank, however it does not only refer to the economic reasons, but also the politics. Moreover the distrust on local currency perhaps reflects from the confidence on the behavior of government.

Thailand : The instability of political side has still occurred continuously because there are too many parties and the cabinet is often changed. The new cabinet mostly comes up with their own new policies which causes inconsistent in policies implimentation. Moreover the corruption of government authorities still exists. If the cabinet is able to convince people, it will cause stability as well as smooth economic growth in this country.

Mexico : Mexican government used to be well known as using cautionary policy in economic management and was also famous in corruption issue. The previous cabinet, leading by president Carlos Salinas, stayed in house for more than 10 years which led to certainty in policies application. However, the assasination of two important persons in the government by farmer lowered the confidence in the new government, under the leading by President Ernesto Zedillo. This is one of reasons of the January Crisis, in 1995.

Next, there is an analysis about the process of the occurrence of BoP crisis. Visualizing the approach that causes BoP crisis in both countries will help to understand the reasons behind the model establishment.

The Possibility of BoP Crisis

There were fears of a Mexico-style devaluation in Thailand. This was caused by the analyse of foreign critic. The analytic approach is based only on the comparison of some economic indicators and concludes that Thai Baht will have to be devalued as Mexico did. However, Thai economic fundamentals are not absolutely like Mexico's. Then this section will identify the economic indicators and compare between both countries before the analyse of the possible approach of BoP crisis is done.

In 1991-1994, economic growth of Mexico was 2.4 percent per year by average, compared to Thai's which was 8.1 percent while inflation rate in Thailand was much lower than Mexico. Thai inflation rate has been controlled to remain around 5 percent range in 1995. In the past it slightly increased from 3.3 percent, recorded in 1983. It was sound that the country's average inflation rate had been 4.0 percent annually, recorded during the past 10 years. Presently, CPI inflation remains below 6 percent and tends to increase but it is still acceptable in comparison to high growth rate.

On the other hand, the Mexican inflation rate was not stable as they were 30,-90, 22 and 7 percent in 1981, 1986, 1991 and 1994 respectively. The Financial Time Currency Forecaster[5] predicts the CPI of Mexico in 1995 and 1996 by 51 and 23 percent. According to PPP theory, the inflation is corresponding to the value of domestic currency. In case of Mexico, Peso has been adjusted to depreciate annually 3.7
percent in order to compensate the inflation gap between Mexico and US.

Although Thai current account deficit relative to GDP is closely to Mexico's, the objectives of deficit compensation are different. In Thailand, the saving-investment gap as the cause of current account deficit, are mostly compensated by foreign capital that generated income in the future whereas Mexico used it mainly for consumption purpose.

Note that investment to GDP ratio in Thailand was about 40.0 percent whereas Mexico's was less than 20 percent. In 1994, the 19 percent export growth was the fastest rate in the world and it tends to increase further. Since Thai development strategies focus on Industrial sector in order to maintain strong export leading growth.

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[5] "Currency Comments", The Financial Time Currency Forecaster, (December 1995), 8, 20, 26.

The export promotion policy concentrated on high-tech products to enhance more advance competitiveness. The policy also increases efficiency of small and medium firms which leads to income distribution and creates employment.

To consider foreign capital dependence in portfolio investment, foreign investors invested in Mexico more than 27 billion US$ compare to 11 billion US$ in Thailand. In addition, most foreign capital inflows to Thailand done by commercial banks in 1994 were middle and long term which more than 3 years. Currently, short term foreign capital inflows is one-third of total foreign capital inflows.

Furthermore, the external debt of Mexico was more than 130 billion US$ while there were 40 billion US$ in Thailand. Thai debt service ratio decreases from 18 percent in 1986 to 10.9 percent in 1994.

Besides,-fiscal budget is continually surplus for more than eight years. Thailand, therefore, has a lot of official reserves and be able to pay back the external debt before due.

In contradiction, Mexico confronted with large amount of fiscal budget deficit which led to issuing short-term treasury bill aboard; Tesobonus, to compensate the deficit.

The most important indicator that reflects Thai situation is international reserves. In the last 10 years, reserves was accumulated continuously. Since 1994, reserves have continually increased by 400 million US$ per month by average, even though, there were a large amount of sale volume in SET by foreign investors during 1994.

International reserves at the end of 1994 was 30.4 billion US$. which equal to 7 months of import value, 3.5 times current account deficit and more than twice of net capital inflows. In contrast to Mexico's which was 20 billion US$ on February, 1994 and dropped down to less than 10 billion US$ after the rebel "Patista" on January and two assasination during that year.

Ultimately, the exchange rate regime of Thailand and Mexico is one of the important factors, are used to express the stronger economic fundamental of Thailand. Thai Baht is managed according to a quasi-fixed exchange rate by basket of currencies system while Mexico applied fixed exchange rate by crawling pegged with US dollar. This can be seen clearly that the Thai Baht has more stability than Mexican Peso which has to be adjusted according to the inflation differential between Mexico and US. Peso also fluctuated with the movement of Mexican inflation and led to depreciate in Peso. Then adjusted exchange rate would establish speculators in financial exchange market.

Once US dollar was sharply weakened, Mexican Peso had to be adjusted to prevent loss from relative higher price of exports in terms of US$. It led to more depreciation.

Actually, there are many ways to sustain the fixed exchange rate. From the experiences of both Thailand and Mexico, the government will intervene through foreign exchange market by either to buy or to sell foreign currencies. Besides, the indirect intervention can be done through the repurchase market.

As mentioned in the previous chapter, the devaluation, therefore, occurs when the government needs to intervene through foreign exchange market but there is not sufficient international reserves. Then it can be concluded that the exhausted reserves will cause the collapse of the exchange rate. There are, however, many factors to explain why the international reserves run out. This leads to the difference in collapse process of Mexico and Thailand.

In Mexico, since Bank of Mexico became a major source financing the public sector, it led to huge deficit in fiscal budget. Government expenditure is larger than revenues. This deficit required the huge domestic credit creation. Furthermore, this large government's saving-investment gap caused the trade account deficit and current account deficit respectively, without contribution to national income.

In the past, this gap could not be offsetted by the capital account which led the BoP deficit. However, after the economic revolution and open economy, there was the huge capital inflows. Those capital flew into Mexico in order to gain from the interest rate differential or the stock yields as the same as in other emerging markets. This type of capital is sensitive to any disturbances in economy.

While the domestic credit was rapidly increasing, it created a rise in money supply in economy, which caused high inflation. Because of this high inflation rate, the Peso has depreciated consecutively. To maintain the official rate, the government intervened through foreign exchange market.

There would be a point that there was no more international reserves because of the severe current account deficit and the distrust in domestic currency, people tried to alter from Peso to US$. The international reserves dramatically declined, at some point before the reserves finished, speculative occurred to eliminate the last portion of international reserves.

The Peso strongly tended to depreciate since an increase in demand for US dollar when the reserves depleted. The government could not maintain the fixed exchange rate any longer then they abolished the fixed exchange rate.

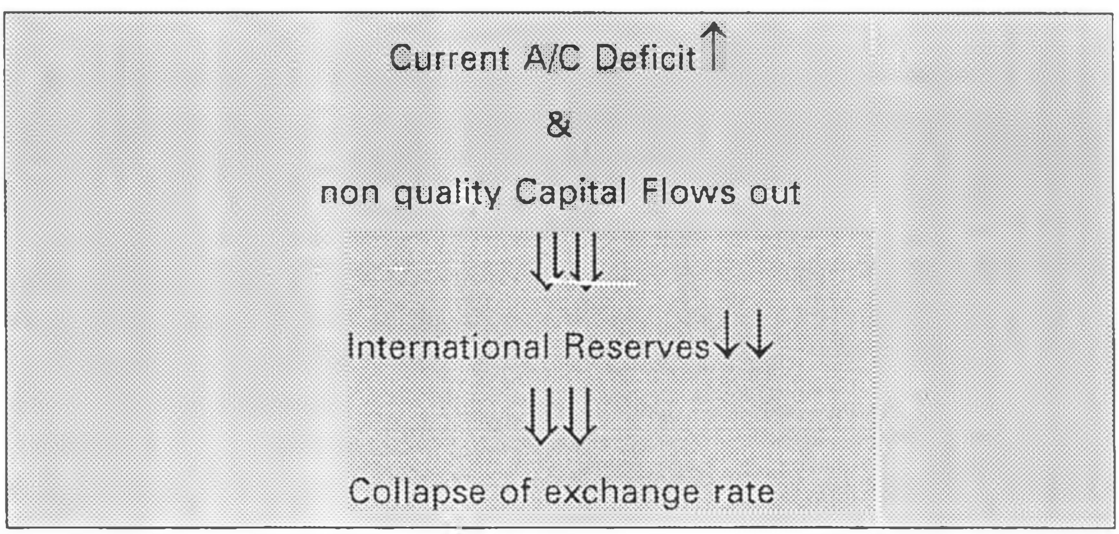
There is a remarkable point of this process. The exchange rate can be controlled as long as the inflation can be controlled. The easiest way to control inflation rate is to control money supply in economy. In Mexico, the domestic credit is a component of money base, therefore, if the government is able to control domestic credit, they will be able to sustain exchange rate. For Thai economy, the domestic credit creation is not a major problem, leading to the collapse of the exchange rate. However, there was a little bit of worry. Although the exchange rate is allowed to float during the day, the intervention is still required to keep it within the suitable, undisclosure bands.

Thus the devaluation occurs when the market exchange rate of Baht is highly tending to depreciate but the government is incapable to supply foreign currency since the reserves decline. To stop the increase of foreign currency demand, the government has to increase the price of foreign currency leading to domestic currency devaluation.

Although Thailand has enjoyed BoP surplus over ten years, the severe current account deficit and its increasing trend ought to be concerned because trade account deficit tends to increase whereas the services account surplus tends to decrease. In 1995, the current account deficit about 8.2 percent to GDP was financed by the capital inflows and also led to BoP surplus.

Alike Mexico, those capital inflows are concerned as non quality capital inflows which are sensitive and easily to flow out. If there is something that shocks economy, it will cause unexpected capital outflows, leading to high demand for foreign currency and immediately depletion of international reserves. Then speculators will attract to acquire the reserves and will further to collapse of exchange rate.

Chart 3.1: The Possible Approach of BoP Crisis in Thailand



While the current account deficit has been financed by surplus in the capital account, a rise in BoP surplus will increase supply of foreign currency. This caused domestic currency appreciation. To prevent this event, the government has to collect the foreign currency and supply Baht into economy.

In order to sterilize the effects of BoP surplus to internal economy, the government has to maintain money supply by decreasing domestic credit when international reserves rises. But in Thailand, by the experience, there was always excessive money supply since domestic credit was steadily going up when international reserves rose. These cause an increased inflation rate. A higher inflation rate implies more depreciated of domestic currency. To avoid domestic currency devaluation, the government has to intervene through foreign exchange market to maintain exchange rate at the same level.

Once the government does not have enough reserves-e.g. something shocks economy and leads to capital outflows- they are not able to sustain exchange rate any longer, then they have to announce a devaluation to stop a decline of value of domestic currency. Hence in the next chapter, the BoP crisis will be analysed by the log-linear model.