Financial Instability, Banking Crisis, and Growth Volatility in Thailand: An Investigation of Bi-Directional Relationship

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I. Introduction

In the second half of the 1990s, financial markets around the world captured strong attention because financial stability started to tremble in several countries as a result of formidable macroeconomic imbalance amid the atmosphere, which had been liberalized a few years earlier. Thailand experienced a severe economic crisis in 1997, which had the combined effects of a currency crisis and it was indeed the most severe one since the Second World War. Key elements of Thailand's financial crisis reflected its cumulative balance of payment problems, particularly persistently large current account benefits. The Bank of Thailand (BOT) was depleted most of its international reserves in defending the baht currency, then had to float the currency on July 2, 1997, ending the long decades of fixed exchange rate regime. Banking crises in Thailand were particularly painful and costly, as their governments were often caught unprepared and had to rescue ailing units without many options. Public debts therefore surged to a large extent. Meanwhile, corporate debt restructuring did not proceed at a satisfactory pace, making many parties question whether a clear-cut economic recovery was forthcoming, and if so, how long it would take and whether it would be sustainable. These strong and negative consequences of banking crises demonstrate that it is worth examining their fundamental conceptual framework and some actual experiences in the past.

On the external front, three variables deserve immediate attention of current account shock in Thailand: terms of trade or the extent of foreign demand, world interest rates, prevailing degree of confidence and its primary determinants. Terms of trade or foreign demand ordinarily affect performance on the current account, while interest rate differentials, exchange rate volatility, and confidence motivate capital flows. These current account shocks and capital flows represent one crucial source of liquidity changes, which have strong impact upon financial institutions' positions or potential. For instance,

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deterioration of terms of trade can impair debt-servicing capacity of banks' customers. Furthermore, such unlucky incident may weaken foreign investors' confidence, leading to capital outflows, exchange rate depreciation, and substantial losses to financial institutions' cash flow positions. In this context, another important item is the degree of globalization or how much the local economy is allowed to interact with the rest of the world with respect to trade and capital flows.

On the internal account, confidence affects behavior of both lenders and borrowers, therefore the extent and pace of credit expansion. Meanwhile, it has influence upon capital flows, which can stimulate or slow down credit expansion via market competition and changes in exchange rates. The pace of credit expansion is an important determinant of not only economic growth and inflation but also the extent of non-performing loans (NPL), depending upon the quality of credit management. In any case, though NPL will impair both financial stability and confidence, the central authority can help preserve stability of the whole financial system via prudent examination and supervision. Finally, politics is also another significant domestic factor that has strong psychological impact upon investor confidence.

However, regardless to the 1997 economic crisis, we can observe how well the Thai economy performed in the past if one concentrates on lists of macroeconomics indicators, for example the real growth of national income, inflation or changes of price level, and rates of employment. The Thailand's average growth rate between 1970 and 1990 was fairly high at 6.7 percentage points per annum if compared to those of other emerging countries. Actually, it is widely agreed that Thai economy also enjoyed considerable expansion as early as since 1950s. Nonetheless, among high and steady growth, instabilities did occur, like other countries, Thailand, in the past, has undergone several economic shocks, most of them were transmitted from outside the country but some emerged form the internal factors. However, since macroeconomic variables show how well the country could adjust themselves to those shocks, questions that might be addressed are, firstly, how could the Thai economy perform quite well during the periods of 1970-1990 even though there were a number of external shocks that affected to the country's current account? Secondly, what were the majored factors of shocks that caused Thai economy more struggle since 1990 and, at the end, led country to the most turbulent in financial market and severe economic crisis in the end of 1990s?