Chapter 1

Introduction

1.1 Statement of Problem

The major changes in the global political and economic environment set in train by the ending of the cold war continued to gather momentum in 1993. Two of the major impacts of these changes has been the breaking down of economic barriers, which have been a major impediment to business endeavor, and the growing emphasis on competitive business structures. Advances in technology, especially improved world-wide communications, have made a significant contribution to reducing economic barriers. These change have already set the stage for the establishment of a single world market or "globalization". The event in 1993 which will have a profound impact on the world economy was, after more than seven years of negotiation, the historical conclusion of the Uruguay Round of multilateral trade negotiations tabled by the General Agreement on Tariff and Trade (GATT). The forecast increase in world trade, as a direct result of the conclusion of the Uruguay Round, is a major contributory factor to the expected increase in growth of the world economy.

In the 1980s, financial markets in various countries were changing very rapidly, reflecting the contradictions between the old financial system with various kinds of regulations and the new technological and economic conditions. The new conditions which have brought about the recent world-wide and simultaneous trend of financial deregulation include (Suzuki, 1987); firstly the rapid progress of computer and telecommunications technology and its application to financial business, i.e., the computerization of finance; and secondly the more active international capital flows after the shift to the floating exchange rate system and the world-wide integration of financial markets.

As a result of deregulation in various countries, the globalization of financial markets has become possible: both financial institutions and corporations can now freely choose among financial systems and financial markets across the border in order to conduct their transactions. Stringent rules and regulations formerly imposed by monetary authorities were relaxed, allowing greater flexibility and increased business opportunities. One clear-cut motive behind

deregulation policies was to strengthen competition between financial institutions, thus offering the public more choice in financial intermediation.

Reasons for Economic Liberalization in Thailand[1]

Thailand's rapid growth and industrialization have created an urgent need for removal of out-date and cumbersome laws and regulations that obstruct the conduct of business. In an environment of increased globalization of trade and investment, economic liberalization is being undertaken for the following reasons:

1. Thailand's economic growth over the past five years has created the necessity to mobilize an enormous amount of savings to finance huge investments. Financial liberalization has therefore been undertaken to facilitate the mobilization of savings at home and the flow of capital from abroad.

2. Thailand's growing internationalization requires a more efficient economic framework to keep the cost of doing business low. For example when GATT free trade in services becomes the rule of the game, Thai financial institutions must be able to compete with their foreign counterparts. Great damage would occur if Thai financial institutions remain bound by absolute legislation.

3. It is hoped that, as the Indo-chinese countries become more market-oriented, Thailand will have a good chance of developing into a center for trade and finance due to its geographical position and strong economy.

The reasons outlined above confirm that economic liberalization is essential for the continued successful development of the Thai economy. However, caution must be taken in the implementation of liberalization. In short, the country needs liberalization measures that are timely, systematic and well coordinated. Follow-up efforts must also be made regularly to assess the effect of liberalization and deregulation.

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[1] Bangkok Bank's Economic Monthly review, March 1992

The Importance of Interest Rates in Economic Liberalization

In order to reach the three goals as mention above, interest rates are a key factor which can play an important role in influencing capital mobility through the linkage of domestic and foreign interest rates. If domestic and foreign interest rates are fully linked or the economy is fully open, domestic interest rates will adjusted to foreign interest rates in the long term. In the short term, the rate at which domestic interest rates adjust to foreign interest rates, depend on the speed of adjustment or the level of information lag and other source of friction in the system. On the other hand, if the economy has no information lags or other friction, the domestic interest rates will adjust instantaneous.

In an economy in which decisions by individual economic units play a major role, interest rates perform several important functions in which they influence a broad range of economic decisions and outcomes. In this respect, interest rates are similar to other economy wide prices, such as the exchange rate and the basic wage rate,[2] performing the following functions:

1) First of all, as the reward for accumulating financial assets and postponing current consumption, interest rates influence the willingness to save currently earned income.

2) As an element of the cost of capital, interest rates influence the demand for and allocation of borrowed funds.

3) As the return on domestic financial assets, domestic interest rates, together with the rate of return on foreign financial assets, expected changes in the exchange rate, and the expected rate of inflation, determine the allocation of the public's wealth (accumulated savings) among domestic financial assets, foreign financial assets, and goods that are held as inflation hedges.

Through the first two of these channels, interest rates directly affect the flows of saving and investment; through the third channel, they influence the proportion of accumulated savings that are placed in financial assets denominated in domestic currency. For savings and borrowing decisions, the relevant interest rate is the real interest rate, i.e., the nominal interest rate

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[2] A detailed exposition of the influence of interest rates over economic decisions can be found in Fisher (1930) and Keynes (1936). For practical aspects of interest rate policies in developing countries, see Chandavarker (1971) and Galbis (1977, 1981).

corrected for the expected increase in the prices of goods [3] Similarly, the allocation of wealth between financial assets and goods involves a comparison of the nominal rate of return on financial assets with the rates at which prices of goods are expected to increase. Consequently, for the allocation of wealth between financial assets and goods, the relevant magnitude to consider is also a real rate of interest.

In addition to a liberal policy on foreign capital and stable macroeconomic environment, to attract foreign capital, the risk adjusted returns on the host country's assets or investment must also be attractive. This follows from the proposition that ceteris paribus capital flows from countries with low rates of returns to countries with high rates of return. In a majority of developing countries, the key prices that approximate the rates of return are domestic interest rates. Because of the dominant role of commercial banks in the financial system, bank interest rates are often the main interest rates to be considered. In this context, the rates of interest on domestic assets which are higher than the corresponding foreign interest rates, after adjusted for the relevant premiums, should work to attract the inflow of foreign capital.

The Role of Foreign Capital in Thailand's Development Process[4]

The external current account

An important contributing factor to Thailand's favorable economic performance is the substantial increase in capital inflows which about one-fourth of the inflows was in the form of equity and portfolio investment while the remaining were short and medium term borrowings. Foreign capital has been an important source of investment financing in Thailand. Notwithstanding the benefits that foreign capital has brought in terms of higher investment, output and employment, a number of important macroeconomic policy issues also emerge.

The conditions that led to the surge in capital included government policies and measures. Suffice it to say that at the global level the late 1980's were also a period of increased capital mobility which were helped in part by the

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[3] The definition of real interest rates is differences in the rates of change in prices of different goods and services that may be relevant for the calculations of borrowers and lenders. Prices of consumer goods are especially relevant for household savers, whereas wholesale prices may be more important for borrowing firms.

[4] Bandid Nijathaworn, "Managing Foreign Capital in a Rapidly-Growing Economy: Thailand's Experience and Policy Issues", Papers on Policy Analysis and Assessment, Bank of Thailand, 1993, p.19-26

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internationalization of investment portfolio and the widespread deregulation of cross border capital transactions. Countries or regions with strong growth prospect and low risk have been the main beneficiaries of this increase in capital mobility. In Asia, the surge in capital inflows was a regional phenomenon. Compared to other countries in the region, Thailand was able to benefit from the surge in capital inflows relatively early. Partly, this was because the adjustments implemented in the early 1980's had resulted in a more stable economy and a significant improvement in the economy's external competitiveness. The country was therefore in a position to reap the benefits of the improved global economic environment that began in 1986 and the surge in capital inflows beginning in 1988. The attractiveness of Thailand for foreign investment was further enhanced by the generally pro-market policy, the supportive investment promotion policy, low domestic costs, and the adequacy of skilled labour and infrastructure.

Moreover, the increase in foreign capital inflow largely reflects plant relocation from Japan and other Asian NIEs in response to the rising wage costs and the exchange rate appreciation that accompanied the large capital surpluses in those countries. These inflows were matched by Thailand's open policy on foreign capital and the high profit opportunities offered for real investment

The largest component of capital inflows, however, has been private sector borrowing, accounting for about three-fourth of the total capital inflows. This growth mirrored the rising demand for offshore funds by Thai companies, taking advantage of low overseas interest rates. From 1990 onwards, the importance of short-term inflows rose markedly to about 40 percent of private sector borrowing. The shift essentially reflects the increased attractiveness of holding short-term baht assets given the low international interest rates, and relative stability of the bath/US$ exchange rate during the period. The size and the rather unpredictable nature of short-term inflows have had a large influence on domestic liquidity, particularly making short-term monetary management somewhat more difficult.

In conclusion, mirroring a slow increase in national savings relative to investment, Thailand's reliance on foreign capital has been sizable and is increasing steadily. To manage the financing of this gap, the Government has pursued an open policy on foreign capital while maintaining a macroeconomic environment and incentives conducive to attracting foreign capital.

The Role of Government Policies

Theoretical discussion on international capital movements usually categorizes factors influencing capital inflows into demand and supply factors. Demand factors include the recipient country's demand for investment, its availability of domestic savings, and the relative costs of foreign and domestic capital. On the supply side, the main factors are those that deal with the portfolio decisions of the capital-exporting countries, involving variables such as the relative rates of returns on investment after adjusting for tax and the perceived degree of risk.

Policy on the capital account

It is instructive to begin the discussion on foreign capital by analyzing the country's degree of openness to international capital. In many respects, Thailand's capital account can be regarded as one that is formally, but not fully open. This is to say that while the capital account is fully open on the inflows side, there are some restrictions on outflows. Such restrictions, however, have not been prohibitive, as they only imply that certain transactions require a prior approval from the authorities. Before the liberalization of foreign exchange transaction in 1990, controls on foreign exchange were relatively tight and the movements of foreign exchange and domestic currency out of the country were closely regulated by the authorities. For example, residents were not permitted to buy foreign exchange except for documented purposes and foreign currency deposits by residents were not permitted. Also, the outflows other than those related to the payment of debt previously registered were subject to a limit or to approval from the authorities.

The majority of these restrictions have now been cased following the two rounds of foreign exchange control in 1990 and 1991. In practice, there are some remaining limitations that should liberalization be mentioned. First, for prudential reasons, commercial banks in Thailand are subject to limits on their net foreign positions. Second, public sector borrowings are subject to an annual ceiling set in line with the government policy on public debt management. Third, because of international reputation and credit rating only to companies in Thailand do have direct access to foreign funds. Fourth, except for exporters, residents are not allowed to hold foreign exchange denominated deposits. And fifth, certain outbound investment such as property and portfolio continues to require approval from the authorities.

Despite these limitations, the financial markets in Thailand do exhibit many characteristics common to those of a highly open economy. The most important being the fact that domestic interest rates have been increasingly influenced by foreign interest rates. Under the current exchange rate system, this development has imposed increased constraint on the conduct of monetary policy.

Maintaining stable macroeconomic environment

It is generally accepted that a stable macroeconomic environment is essential both for maintaining confidence of foreign investors/creditors and for providing a basis for rapid economic expansion. Appropriate macroeconomic policies, characterized by low inflation and a stable exchange rate are therefore necessary to sustain the inflows of capital needed for investment.

This achievement in macroeconomic stability mainly reflects the cautious stance of financial policies traditionally followed in Thailand. Suffice it to say that the period of the early 1980's was especially a difficult one. However, by adopting an early adjustment in policy, Thailand was able to weather the global economic crisis and was in a position to take the full advantage of the improved external environment beginning in 1986. Apart from macroeconomic stability, Thailand's cost factor had also been important: because of low inflation, labour costs have increased much less in real terms than in many other countries. This cost advantage combined with the baht devaluation in November 1984, significant by increased the profitability and the competitiveness of the export sector.

Interest rate policies

In addition to a liberal policy on foreign capital and stable macroeconomic environment, the risk adjusted returns on a host country's assets or investment must also be attractive in order to induce inflows of foreign capital. This follows from the proposition that everything else being equal capital flows from countries with low rates of returns to countries with high rates of return. In a majority of developing countries, the key prices that approximate the rates of return are domestic interest rates.

Fiscal incentives

Tax incentives are widely used as instruments to attract foreign capital, especially the long-term inflows. These fiscal incentives are administered in the context of investment incentives. In Thailand, incentives offered to foreign investors are relatively liberal and are operated via the promotion privileges granted by the Board of Investment (BOI). Activities promoted by the BOI are not confined to manufacturing as in some countries, but are extended to other sectors including agriculture and agricultural services, mining, hotels, international trading firms, and other services. The aim is to promote export-oriented and other investment projects which will supporting industries and increase rural linkages, as well as promote research and development activities.

Bangkok International Banking Facilities (BIBFs)

Thailand's stable economic conditions, liberal exchange controls, and high level of international borrowing transactions have induced the Central Bank to begin to take action to make Thailand a regional funding center. The Bank proposed the establishment of Bangkok International Banking Facilities (BIBFs) in 1993 to facilitate international borrowings, to reduce their costs, and to encourage fund inflows to finance the current account deficit. The BIBFs is also meant to gradually introduce a greater degree of competition into the local financial system, as new market participants.

Moreover, the Thai monetary authorities embarked on a strategy to promote more flexible portfolio management and to widen the scope of operation of Thai commercial banks. It is aimed at improving mobilization of domestic savings and foreign capital inflows and also enhancing the efficiency of Thai commercial banks.

Managing foreign capital: macroeconomic impacts and some key policy issues[5]

Macroeconomic impacts

In actively pursuing policies which attract foreign capital, a key question which needs to be addressed is whether the economy will have the capacity to utilize the increase in resources efficiently without threatening the stability of the financial system in the longer term. Another equally important question concerns the impact on macroeconomic stability: that is, the ability to properly handle the monetary impacts of the inflows.

The macroeconomic impacts of capital inflows depend largely on the size of the inflows relative the country's resource utilization prior to the inflows, as well as the exchange rate regime of the country. Under fixed exchange rate regimes, as is the case of Thailand, the effects of capital inflows are transmitted to the economy more through the income channel than the exchange rate channel. Under such a setting, a new equilibrium is established when the increase in the inflows is matched by a deterioration in the current account brought about by a higher level of domestic demand, and by rise in international reserves. The extent of the worsening in the current account will depend on the degree of import intensity of domestic demand and the resulting decline in the relative price of tradable to non-tradable goods. The latter depends on the increase in domestic price which, in turn, depends on the degree to which resources become a constraint. As far as the monetary impacts are concerned, the post-inflows equilibrium will be characterized by higher monetary growth and possible lower interest rates.

Macroeconomic policy

To rein in domestic demand, the macroeconomic policy options include the control on the growth of money supply and the maintaining of fiscal balance. To control money supply growth, the policy discussion focuses more on the scope for sterilization and the degree to which the exchange rate system imposed a constrain on monetary policy. This is because the rise in domestic interest rates associated with sterilization operations in itself can further induce the inflows.

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[5] Bandid Nijathaworn, "Managing Foreign Capital in a Rapidly-Growing Economy: Thailand's Experience and Policy Issues", Papers on Policy Analysis and Assessment, Bank of Thailand, 1993, p.27-32

The degree to which this conflict is a constraint to monetary policy depends largely on the openness of the economy. As noted earlier, Thailand's capital account is quite open, but because of the existing restrictions on the capital account as well as transaction costs and information lags, there is considerable scope for monetary policy in the short term.

Within this setting, Thailand's monetary policy was aimed at neutralizing the monetary impact of the inflows while other policies were aimed at counteracting the tendency for the inflows in the overall balance of payments. To reduce domestic liquidity, mopping up operations were conducted through the issuance of the Bank of Thailand's own securities while the Bank of Thailand exercised moral suasion, asking commercial banks to limit their lending to speculative activities. More importantly, monetary restraint was supported by a fiscal policy that emphasized a sizable fiscal surplus. Central Government's budgetary surplus averaging about 3 percent of GDP was maintained from 1987-92. This policy stance helped boost national saving and made room for higher investment and exports.

Policies to counteract the tendency towards capital inflows focused on the liberalization of the current and capital account transactions. On the trade side, liberalization policy included making goods previously subject to import restrictions more readily available as well as bringing forward the planned tariff restructuring program. Tax incentives that had encouraged private capital inflows were withdrawn while the public sector's annual limit on foreign borrowing was maintained. To encourage capital outflows, the Government prepaid external debt and adopted a liberal policy in authorizing the outflows of capital, especially those for direct investment.

Impact on domestic savings

Another important policy issue is whether the availability of foreign finance has weakened the domestic savings efforts, particularly private savings. There being a number of a priori arguments suggesting that such a relationship may hold.

Firstly it is argued that, the availability of foreign finance permits the Government to reduce or not increase taxes in order to finance investment; to increase current expenditure; or to divert resources to projects which have low or even negative social returns. All these activities having the effect of lowering public savings.

Secondly, the availability of foreign finance, or greater access to it, may deter efforts of domestic financial institutions to mobilize private savings. By taking advantage of low international interest rates, financial institutions may find it cheaper to raise funds by borrowing abroad than to compete for deposits. This may have the effect of encouraging consumption and diverting resources to activities that would not otherwise have been carried out. Because the counterpart of a larger net capital inflow is a larger growth in domestic demand and a higher current account deficit, one can also view the availability of foreign finance as allowing the economy to postpone taking the necessary policy adjustments i.e., expenditure reduction measures that would otherwise have been necessary.

On the contrary, if domestic interest rates move below the foreign rates, especially on a substantial basis, this can result in a capital outflow.

Reflecting a shortage of domestic savings relative to investment, as well as the imperfect degree of capital mobility, Thailand's nominal interest rates have generally been above the foreign rates. The differentials have contributed to attracting capital inflows. There were also occasions when withholding tax on interest income was temporarily exempted to increase incentives for attracting foreign capital. It should be noted that domestic interest rates were relatively high during 1990 and 1991, owing partly to the high interest rate policy pursued by the Government to cool the overheated economy. Deviations from the interest rate parity also increased noticeably during this period, suggesting that it is possible for the domestic interest rate to persistently deviate from the international rate. This evidence suggest that the authorities may be able to exert a significant influence over domestic monetary factors in the short-term.

Efficiency of capital and costs

Another important concern is how to ensure that the foreign capital is used efficiently, and that it does fit in with the economy's overall resource requirement. In the case of foreign direct investment which is generally sector specific, some influence on its allocation can be achieved through the specification of tax and other incentives. Control of the secteral allocation of foreign capital is, however, more difficult in the case of private borrowing. According to data compiled by the Bank of Thailand, the three major beneficiaries of foreign borrowing including short-term funds during the recent period have been the industrial sector, the finance sector, and the housing and real estate sector. This pattern appears to be consistent with the observation that there had been many new investment opportunities in

these sectors, which outperformed other sectors in terms of the rates of return. The key question then is whether the high returns so observed reflect the real economic benefit and cost of capital.

As a general policy, the best way to ensure an efficient utilization of foreign capital would be to remove any distortionary incentives that might attract capital inflows on the basis of the perceived high returns. One basis for excessive profit is a noncompetitive market environment which allows for some monopoly gains. The features of non-competitive market include excessive tax incentive, licensing, lax regulation, fiscal subsidy, and control on entry and exit. An allocation of resources in this type of environment is certain to be sub-optimal. Reflecting this line of reasoning, there is an argument strongly in favour of implementing international capital liberalization last in the sequencing of liberalization measures.

In considering foreign direct investment, there is an issue concerning whether the cost of attracting capital has exceeded the benefits. A tentative estimate of the net fiscal cost given to investment projects by the BOI in 1980 is that it represents about 3 percent of the total tax revenue. This figure is likely to have been higher in recent years. On the negative side, foreign investment has been criticized for the lack of spill over benefits to local industries as they have created relatively few linkages with domestic producers. Other areas of concern are the lack of technological transfer with centralization of research and development with the parent company and their use of relatively old technology which is not energy-efficient and is harmful to the environment. More importantly, the expected benefit that foreign investment could raise factor productivity of the host country's resources has also been questioned. This is because foreign investment has placed additional pressure on infrastructure resources and the labour market, thereby affecting the factor productivity of the existing industries.

Size and Composition of Capital Inflows[6]

Greater short-term capital inflows have made liquidity in the money market more volatile while inducing short-term interest rate to converge toward international rates. This, of course, may not be desirable for domestic policy objectives. The constraint on monetary policy depends also on the stickiness of the bank lending rates with respect to the money market rates. This constraint is more binding when the degree of stickiness is lower, i.e., when

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[6] Bandid Nijathaworn and Thanisorn Dejthamrong, "Capital Flows, Exchange Rate and Monetary Policy: Thailand's Recent Experience", Quarterly Bulletin, Bank of Thailand, Vol. 34 No. 3, September 1994, p.35-49

bank lending rates adjust more quickly to changes in the money market rates. Such stickiness tends to be influenced by the cost to banks in adjusting interest rates, the degree of competition in the financial system, and the level of development of the money market.

Net capital inflows appear as surpluses in the capital account of the balance of payments about US$ 1.0 billion in 1987, US$ 3.7 billion in 1988, peaking at US$ 11.3 billion in 1991, falling to US$ 10.1 billion in 1992, and increasing to US$ 11.7 billion in 1993. A substantial proportion of the inflows was channeled to reserves which increased from US$ 5.2 billion in 1987 to US$ 25.4 billion in 1993.

The inflow of foreign capital into Thailand has been substantial since 1988, as illustrated in Figure 1, which following the second round of exchange control liberalization of exchange controls in 1991, has shown a substantial increase in gross capital outflows accompanying the increase in capital inflows, as foreign investors had become more confident of the separation of funds.

However, the total net inflows of capital to Thailand rose significantly to an average of more than 9 percent of GDP during the 1988-93 period. In particular, the net private capital inflows rose sharply from 1.7 percent of GDP in 1987 to a peak of 12.8 percent of GDP in 1990 and, thereafter, averaged 9.4 percent from 1991 to 1993.

The surge in capital inflows during this period has been influenced by a variety of external and internal factors of which the main factors include:

- The rapid growth of Thai economy;
- Exchange control liberalization;
- Interest rate differentials;
- World economic recovery;
- Increased integration of Thai and world financial markets; and
- Exchange rate and price stability.

Reflecting the changing relative importance of the factors listed above, the pattern of capital movements varied considerably over the period.

1.2 Objectives of the study

Thailand has been going through a period of rapid change, including financial deregulation.

Casual observation suggests that domestic interest rates have become more responding to international interest rates.

The main objectives of this study are:

1) to measure the degree of openness of Thailand financial liberalization, and

2) to measure the speed of adjustment for fully of openness of Thailand financial liberalization.

1.3 Organization of the study

There are five chapters in this study as follows:

This chapter has provided an introduction to the study and consisted of the statement and significance of the problems, the process of major financial liberalization which emphasize on the interest rates ceilings deregulation, the relaxation of foreign exchange control, and the liberalization on commercial banks and other financial institutions, objectives and organization of the study. The second chapter set the theoretical framework which follows Mckinnon and Shaw and for the review of literature is classified in each topic concerns which are interest rates and savings, financial liberalization and deepending, measuring efficiency, banking system, others countries experience, and empirical studies. The third chapter discusses methodology, and chapter four describes the empirical results. Chapter five contain the summary of findings, policy implication, and limitation of the study. It also suggests areas for further studies.