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U.S. Recession Mitigating Strategies: Lessons from Thailand

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The paper compares the economic crisis of 2008 in the USA with that of the Asian Crisis of 1997 in Thailand. It finds that though the crises have similar roots, Thailand was able to tackle the crisis by taking firm steps to reform its economy and its financial sector, while in the US that resolve is not apparent. This paper answers why the US crisis feels like a prolonged one, whereas the Thai crisis was over in a little more than a year.

Field of Research: Recession, Business Cycle, Thailand

1. Introduction

One of the many functions of history is to increase our understanding of the present in the light of the past (Carr 1961). Therefore, a comparison of the Asian Economic Crisis in 1997, with that of the current economic crisis is illuminating because the underlying causes are somewhat similar. The differences between the two are in the scale and the magnitude of the crisis, and also in the response to mitigate this crisis. The current global economic crisis originated in the United States of America (USA) while the Asian Economic Crisis of 1997 originated from Thailand. The purpose of this paper is to first identify some of the factors that were common to the Thai economic crisis and the current economic crisis as it relates to USA, to analyze some of the responses to the crises and to provide the reason for the current crisis being a protracted one, unlike the Thai crisis which was a relatively short lived affair.

2. Literature Review

The Asian economic crisis of 1997 has now been analyzed very thoroughly with general consensus on most of the causes of this crisis. The two substantial sources of information are the US Congressional Research Service (CRS) Report on "The 1997-98 Asian Financial Crisis" (Nanto, 1998) and "The Asian Financial Crisis, What have we learned?" (Lane, 1999). Nanto (1998) chronologically lists the Asian crisis as it unfolds,

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and identifies a start date of May 1997, and February 1998 (Baker, 1999) as the month when the sense of crisis ebbs. Nanto also details the response of the International Monetary Fund (IMF) and the impact the crisis would have on the US economy at both the micro and the macro level. Lane (1999) stresses on “what lessons can we draw from the experience, and how can we use this knowledge to forestall future crises and minimize damage from those that occur?” Lane concentrates on the macro level economic responses that were used to mitigate the effect of the crisis and the lessons that can be learned from these responses. He recognizes the difficulty in stopping a crisis once it starts building momentum because in the short run capital is extremely mobile and suggests that prevention is the key to a recession. In particular he identifies, sound macroeconomic policies, improving financial supervision and regulation in both debtor and creditor countries and adequate stress testing of exposures to risk. Lane also recommends transparency and regional and international supervision of the financial sectors. One surprising conclusion reached by Lane is a tighter monetary policy as a tool of crisis management and an adaptive fiscal policy that responds to changing economic circumstances. Lane also identifies the recent introduction of Contingent Credit Lines by the International Monetary Fund (IMF) to provide large scale financing to countries that are affected by market contagion, as a tool for preventing a crisis from spreading. In this paper we isolate some of the common causes of the two crises and look at the differences in the governmental response to these crises. Radelet and Sachs ((1998) provide an excellent diagnosis of the Asian crisis. The IMF’s response to the Asian Crisis- A factsheet provides a detailed IMF response to the crisis. The Lessons from the Asian Crisis are summed up by Cate Rogers (2009).

3. Discussion

The Asian Development Bank identified Thailand as one of the fastest growing world economies with growth rates around 8.5% and the unemployment rate at an astounding 0.9% just prior to the situation unraveling in May 1997. The likely reasons for this high growth rate were exports of electronics and paper, expansion of the service sector and foreign investment that led to a huge inflow of foreign funds that amounted to almost half of the Gross Domestic Product (GDP). To counterbalance this huge inflow of foreign funds the Thai government reduced the expansion of domestic money supply. The rate of inflation was less than 6% and the saving/investment rate was about 35%. In the absence of capital investment opportunities, this huge inflow of foreign funds found a convenient channel in real estate markets. This was the primary cause of the bubble in real estate prices.

The US story is similar to that of Thailand. In the years before the crisis significant amounts of cash flowed into the US from the fast growing economies of Brazil, Russia, India and China (BRIC countries) and also from the petro dollar flush countries of the Middle East and all individuals who were looking for safe haven to park their long term funds. The inflow of funds found an easy credit environment in the US. Interest rates for most of the decade were at historical lows following the aftermath of September 11, 2001 and Federal fiscal and monetary policy to combat the recession. This inflow of funds fueled a housing and credit bubble in the US markets. The popularity of

Mortgage Backed Securities (MBS) and the development of more complex derivative instruments allowed the world to partake in this bubble, most often without understanding the ramifications of investing in these financial instruments.

One of the many requirements of a perfect market is rational behavior by its participants. However, another unstated requirement concerns moral behavior. The financial markets were dominated by government controlled banks. Primary and secondary stock and bond markets were inconsequential. Therefore, lending criteria to borrowing firms was not financial soundness but proximity to politicians and bureaucrats which led to corruption and very inefficient capital markets. Thailand was rated A2 for long term debt just prior to the crisis. In the US, corruption was not so endemic but the Agency problem was apparent. In California, the criteria for mortgage loans initially was said to be VIVA, Verifiable Income Verifiable Assets. These soon deteriorated to SIVA, Stated Verifiable Income Verifiable Assets, SISA, stated income and stated assets, and then to NINA, No verifiable Income Non Verifiable Assets. The loan originators packaged these junk loans into mortgage backed securities and sold them off to unsuspecting, and often uninformed investors. Most MBS just before they went under were rated investment grade by rating agencies even though they were based on risky sub-prime mortgages. In Thailand, one of the first casualties of the crisis was the failure of Finance One, a leading financial institution whereas in the US, it was the collapse of Lehman Brothers.

The Thai crisis began with a run on its currency and the Thai government was initially lax in dealing with this problem and was hesitant in approaching world financial institutions for help. This was because of the onerous restraints placed on the local governments by the International Monetary Fund (IMF) and the World Bank. It was also felt that these organizations rescue the lenders in the developed economies rather than the borrower countries. In the US too, financial institutions were hesitant on seeking federal help, while the attitude of the Federal Reserve Bank (FED) was that in a free economy market forces would take care of the problem. When the FED did take action the feeling persisted that the FED was bailing out Wall Street rather than the economy in general. The IMF took the lead role in responding to the crisis in Thailand, and other Asian countries. The IMF devised a Structural Adjustment Package (SAP) of $17 billion for Thailand that was to be paid in tranches dependant on the reform process. The main steps to be taken in the case of Thailand were to float its currency, raise interest rates accompanied by financial sector reform in which weak institutions were allowed to go under, and the reduction of fiscal deficits. In the US the initial response was to lower the Federal Funds rate from 5.25% in September 2007 to 0.25% in December 2008. The FED ensured that member banks remained liquid by lending against collateral of dubious quality and by March 2009 had purchased 1.35 trillion dollars worth of MBS. The underlying philosophy was that many financial institutions were too big to fail and all must be done to prevent them from going under.

Thailand recapitalized and closely supervised its financial institutions and markets. It designed better bankruptcy laws, streamlined and promoted good governance. The response of the US government was to pass the $700 billion Troubled Asset Relief

Program (TARP) in October 2008, and in February 2009 it passed the $787 billion American Relief and Recovery Act (ARRA). The ARRA was a comprehensive legislation that included unemployment benefits, tax cuts, infrastructure, and health care provisions. It was recognized that the Thai crisis had adverse effects on output and employment. To alleviate the pressures on the general public the Thai government launched steps to stabilize the economy, boost domestic demand, encourage the growth of Small and Medium Enterprises (SME's) and improve rural incomes and development. The Thai government launched social sector programs (SSP's) to help increase the availability of food, fuel and medicines to the needy. Lunch and milk projects were established for poor families. The government established Centers for assistance to laid-off workers (CALOWS) to provide counseling, referral and placement services and provided student aid to stem the decline in school enrollment. The Thai growth rate increased to 4.4% in 1999 just one year after the crisis (it was negative 8% in 1998) and the unemployment rate fell to 4.19% in 1999, 3.59%, 3.23 in 2001, and 2.24% in 2002 (it was 4.36% in 1998). A summary of the mitigating strategies is provided by Rogers (2009). In the United States half hearted measures left banks reluctant to modify loans and only 5% of foreclosures have been prevented. Unemployment has steadily climbed to over 10% in early 2010. Thailand was successful in mitigating the immediate adverse social impact of the crisis while in the US the absence of dedicated social adversity alleviation programs, and programs to develop and retool skills in unemployed workers has exacerbated the effects of the economic crisis.

Table 1: Selected data for three consecutive crisis years
Year 1: 2008 (USA) and 1997 (Thailand)

THAILAND			
USA			
	YEAR 1	**YEAR 2**	**YEAR 3**
Growth rate (%)	1.1	-2.8	0
	-1.68	-10.17	4.18
Unemployment	5.4	8.5	10.6
	3.2	7.3	6.3
Inflation (%)	3.8	-0.9	-0.1
	5.61	8.1	0.3
Interest rate (%)	3.7	2.6	2.5
	4.63	4.63	4.63
Xport % change	6.2	-13.1	3.1
	4.3	-6.7	7.3
Mport %change	-3.5	-13.7	4.1
	-12.3	-33.0	18.1
USD/EURO	1.47	1.41	1.45
Baht/USD	31	41	38

Data from World Economic Outlook, World Bank 2010 and 2000; Year 1; 2008(US) and 1997(Thailand); consecutive years 2 and 3.

4. Conclusion

The global economic crisis of 2008 originated in the USA while the Asian crisis of 1997 originated in Thailand. The causes for these crises are similar as they both originated in the real estate and the equity sectors, and then bubbled over to the economy and were transmitted by capital markets and by trade to the rest of the world. Thailand resolved their crisis by taking effective steps to reform the financial and governmental sector, built in social programs to ameliorate the effects of unemployment and poverty, and retooled its workforce for employable jobs. Further, the Thai government floated its currency, wound up unsound financial institutions and resolved its financial sector problems by making it transparent and putting it under close supervision. In the US, the government has been reluctant to carry out drastic reforms and directly alleviate unemployment. The mantra is to rescue institutions rather than letting them fail and let the free market forces take care of the unemployment problem.

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