CHAPTER 1

INTRODUCTION

1.1 Background

Unlike the past, nowadays Thailand is a more open economy; the degree of openness has increased gradually until international transactions values has accounted for more than 60-70 percent of GNP in recent years. Trade is an important part in economic development. Thailand as developing countries[1], in international trade, the economic relationship between developed and developing countries exporting primarily food and raw materials in exchange for manufactured goods from developed countries.

Since 1960 the economic plan for our development has aimed to push the country to become an industrial country by trying to use the outward-oriented strategy, which was an unbalanced growth. In the past 35 years we emphasized mainly on the total growth, such as in producing some products to replace what we have imported and in producing the pure exports.

The main policy was the promotion for the private investment and a special motivation as well as the forcing down of the waging payment and the intervention in the currency markets. Therefore Thai Government played an important role in changing our economic system to become industrialization. We enhanced the growth of GDP by means of the growth of exports.

There is a positive relationship between international trade and long-run economic growth and development. Seeing at Table 1.1:

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[1] Developing countries are characterized in general by low (and sometimes extremely low) average a real per capita income, a high proportion of the labor force in agriculture and other primary activities such as mineral traction, low life expectancies, high rate of illiteracy, high rate of population growth, and low rate of growth in average real per capita income.

Table 1.1 Growth of GDP and Export of Thailand and some other Asian Countries, 1980-1996[2]

	Growth of Real GDP		Growth of Exports	
	1980-1990	1990-1996	1980-1990	1990-1996
Thailand	**7.6**	**8.2**	**14.3**	**21.6**
Malaysia	**5.2**	**8.4**	**11.5**	**17.8**
China	**10.2**	**12.9**	**11.4**	**14.3**
Singapore	**6.4**	**8.3**	**12.1**	**16.1**

Source: *World Bank, World Bank Development Report, 1996.*

In this case when we looked closely at the structure of import of Thailand we found that the linkage between imports on capital goods, intermediate products and exports was more important because Thailand was mainly importing intermediate goods and raw material for exports. Imports of raw material and capital goods was equal to 72 percent of the whole imports in the year 2000 (Table 1.2)

Table 1.2 The Structure of Thailand's Imports

Year	Capital goods	Raw material	Fuel	Consume goods	Others
1978-1982	26.9	28.1	27.0	8.3	9.8
1983-1987	30.7	26.0	19.5	8.0	9.2
1988-1992	38.6	36.4	8.8	7.1	9.1
1993	42.2	32.5	7.5	7.8	10.0
1994	44.1	31.8	6.8	8.4	8.9
1995	44.7	31.8	6.8	8.1	8.7
1996	45.4	28.9	8.8	8.2	8.7
1997	48.1	28.7	9.3	8.4	2.4
1998	50.0	30.2	8.0	8.7	3.1
2000	46.0	26.0	17.0	10.0	1.0

Sources*: Bank of Thailand*

On July 2, 1997 the government changed exchange rate system from basket currencies to managed float and determined to maintain the present managed float exchange rate system, with limited intervention to smooth out fluctuations. From this many parts of economy have to be effected from change in exchange rate especially on import-export part.

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[2] Dominick Salvatore, International Economics (Prentice hall international, 1998), p.335.

This thesis aimed at studying the effect of change in exchange rate to the demand for import on intermediate products and capital goods for Thailand because there were not many studies concentrated on the imports of intermediate products and capital goods of Thailand which seemed to be the important parts of trade and this was the opportunity to see the long time relationship of exchange rate to intermediate imports of Thailand from 1964-2000. That is to say, how important it was and how much it effected the demand for imports. And further more this thesis wanted to compare the influence of the exchange rate and the income variable (in this thesis means GDP), as we know that higher level of income for the liberalizing economies, come from increase in volumes of exports, and consequently resulted in growth and the economic development.

What variable are more important determinant of import on intermediate products and capital goods of Thailand? And what the results of this study tell us about?

Before we can analyze the effect of exchange rate of Thailand we have to mention about the exchange rate regimes in Thailand; In general, we can divide into five periods as follow:

The Exchange Rate Regimes in Thailand since 1970-present

From 1970 to the present, there have been five exchange rate regimes adopted in Thailand as follows.

Par value system, 1970-1978

Thailand adopted a fixed parity or par value system after the Second World War till the beginning of 1978.During that period the external value of the bath was effectively tied to the value of gold or the U.S. dollar. Under the system, the Exchange Equalization Fund (EEF) determined the U.S. dollar rates at which it would buy from and sell to commercial banks. On the other hand, the Thai Bankers' Association determined the rates applicable to any exchange transactions between commercial banks and their customers' foreign currencies.

In the same period, the value of the bath was adjusted three times. The first adjustment occurred after the realignment of currencies by the ten major industrial nations on 18 December 1971, which entailed and effective devaluation of the U.S. dollar from $35 to $38 per troy ounce of fine gold. The Thai government decided to maintain the official exchange rate with the U.S. dollar at B 20.80 per U.S. dollar. However, the gold parity for the bath was officially changed from B 1 to 0.0427245 grams of fine gold to 0.0393561 grams when the U.S. devaluation was finally made official on 9 May 1972. Throughout 1972, the spot buying and selling rates for the U.S. dollar in the free market were therefore maintained at B20.825 and B 21.00 respectively, the same rates as in 1971.

In the fact of the first oil shock in 1973, the devaluation of the U.S. dollar by 10 per cent, and the floating of the major currencies of the EEC, the Swiss franc and the Japanese yen. The parity of the bath against the U.S. dollar was again maintained at B20.80 per U.S. dollar, but the bath was devalued by 10 per cent in the terms of gold on 10 April 1973.

The objectives of the two devaluation were, first, to prevent the deficits in the balance of trade and payments from further deterioration and, second, to help exporters and farmers to maintain their earnings in terms of the bath. In addition, the devaluation would enable Thailand to be more competitive abroad. In the period following the devaluation of the bath, major currencies in Europe floated upward against the U.S. dollar resulting in further depreciation in the real value of the bath. Thus, on 15 July 1973 the Thai government announced the revaluation of the bath by 4 per cent, making the bath equivalent to 0.0368331 grams of the fine gold or B 20 per $1. The objective was to restore the value of the bath vis-à-vis other currencies to its previous level and to help revert rising import costs as a result of the floating of certain currencies.

Pegged to a basket of currencies. March 1978- November 1978

The Bretton Woods system, which was adopted for almost 30 years, began to show its weakness in the second half of 1971. The exchange rates of major currencies exhibited wide fluctuations and instability, with the U.S. dollar depreciating sharply. Many other currencies such as the Pound sterling, the Netherlands guilder and the

Deutsche mark, were allowed to float freely instead of trying to maintain their value against the U.S, dollar. There were also considerable capital movements and speculations in the world foreign exchange markets. In 1978, the International Monetary Fund (IMF) finally endorsed the new generalized floating exchange rate system. Which stressed on greater flexibility in the exchange rates and a system was introduced on 1 November 1978. Under this system, the U.S. dollar rate was determined in the daily fixing session by representatives from the EEF and commercial banks. Demand for and supply of U.S. dollars at various exchange rates were observed. The EEF would intervene by buying or selling at a certain rate, i.e., a fixing rate. Basically, the daily fixing rate was determined partly by the EEF in an endeavor to maintain an orderly market condition. The U.S. dollar fixing rate was used as the base rate at which transactions in other six currencies were determined on the basis of the cross rates between the fixing rates for the U.S. dollar an d the exchange rates of the currency concerned in international markets.

Since 1981, the value of the bath continued to decline against the U.S. dollar. This was due to the strong appreciation of the U.S. dollar compared to other major currencies following a restrictive monetary stance intended to arrest the inflationary trend. In order to keep the value of the bath stable against other currencies, the bath was devalued by 1.07 per cent and 8.7 per cent in terms of U.S. dollar on 12 May and 15 July 1981 respectively. The exchange rate adjustment was conceived as a means of boosting exports while deterring imports.

Fixed to U.S. dollar, July 1981 – November 1984

After the two devaluation of the baht, the value of the U.S. dollar in the international foreign exchange market continued to be high, thus forcing the EEF to release an unusual amount of dollars on to the market. In order to promote the country's financial stability and exports as well as relieve the trade and payments problem, the daily fixing system was discontinued on 1 July 1981. Under the new system, the EEF was solely responsible for the determination of the daily U.S. dollar rate. All other features remained the same under the daily fixing system except that commercial banks no longer played any role in the exchange rate determination process and that the EEF offered to buy or sell an unlimited amount of U.S. dollars at the intervention rate, which was fixed at B23.0 per U.S. dollar

Pegged to a basket of currencies, November 1984 to July 1997

After a fixed exchange rate against the U.S. dollar was maintained for about three years, the continuous appreciation of the U.S. dollar abroad caused the /Thai authorities to devalue the bath to 27.0 baht per U.S. dollar on 8 November 1984. The system of pegging the bath to a basket of currencies, once adopted during 1978, had been restored in order to give more flexibility to the baht. Other wise, the upswing of the U.S. dollar abroad would lead to too strong an appreciation of the baht when compared to other currencies. This would in turn deteriorate the balance of trade position. However, towards the end of 1985, the U.S. dollar began to depreciate rapidly after the intervention of G-5. The baht, which was determined by the trade weighted basket of currencies, appreciated strongly when compared to the U.S. dollar

In view to these developments, the authorities thus changed the basket's composition from a trade-weighted basis to a currency-weighted basis. Under the new basis, the baht became closely related to the U.S. dollar. This was necessary for Thailand where around 80 percent of trade payments was settled in terms of the U.S. dollar.

Thailand Exchange Rate System at present

Presently, Thailand foreign exchange market has become more liberalized since the deregulation of foreign exchange transactions beginning from the accepted IMF 8 on May 24, 1990.to the adaptation of the managed float exchange rate system on July 2, 1997. Under the managed float exchange rate system, the exchange rate is mostly determined by the demand and supply of currencies by private parties. The exchange rate moves in response to market force3s. Each commercial bank will quote the exchange rate themselves (Counter Rate) and this rate may different among them. The bank's expectation, the profit margin and their negotiate power with customers are the factors that influence their exchange rate.

The government may sometimes intervene in foreign exchange markets (in order to influence the exchange rate) to prevent the over fluctuate in short run and lead to the stability in long run. In general, the exchange rate movement under the managed float system will fluctuate more than the basket of currencies system due to

the world's foreign exchange market. Exchange rate will reflect the market's demand and supply in every second.

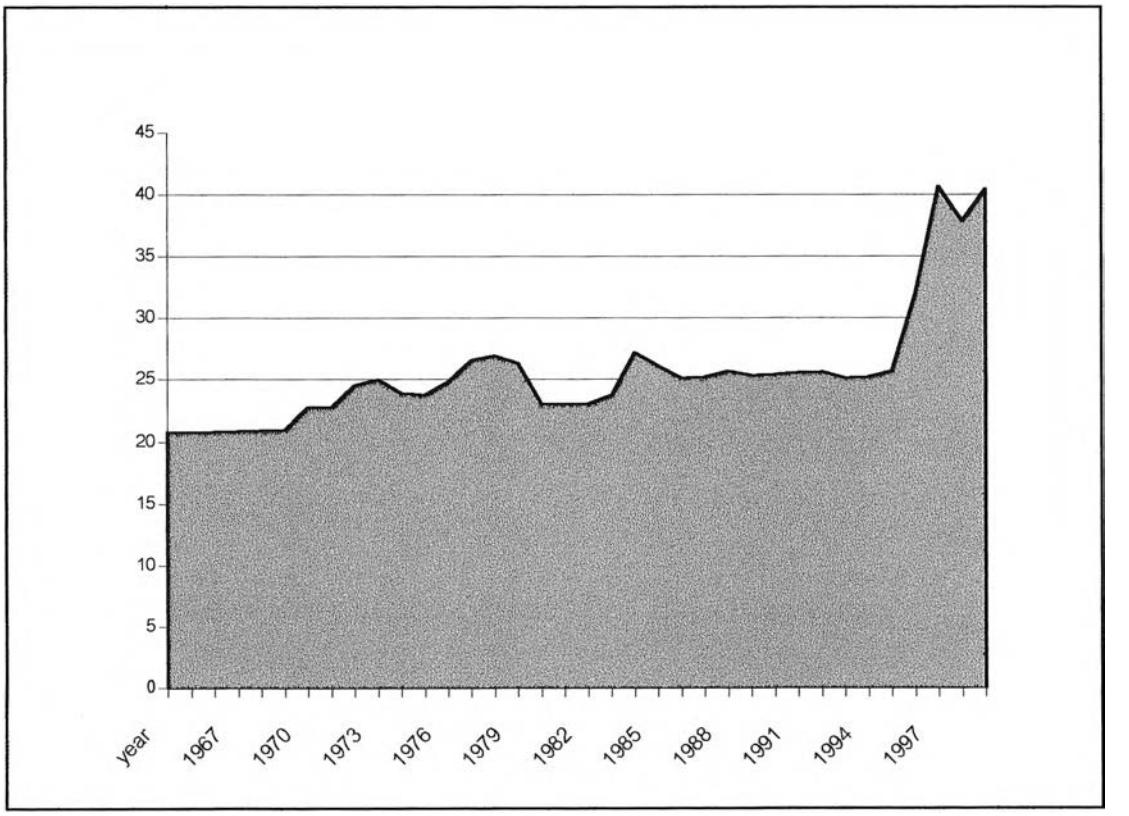

Figure 1.1 ***Movement of Thai Exchange Rate since 1970-present***

1.2 Objectives of the Study

This study has two objectives. First, To investigate the linkage between exchange rate and import on intermediate products and capital goods and how it affected each category of intermediate products and capital goods? Second, To compare the effect of change in exchange rate and the effect of change in income (GDP) to the capital goods and intermediate goods imports, i.e., what was the important determinant of capital goods and intermediate goods imports?

1.3 Scope of the Study

To study the first and second objectives, this study considered how the imports on intermediate products and capital goods linkage to the exchange rate by analyzing the effect of exchange rate change on each category of capital goods and intermediate product imports.

The study covers the period from 1964-2000. This study used long period because this could show clearly fluctuation and relationship of each variable. The year 1964 was the earliest year we could collect systematic data from annual report Bank of Thailand. Before that the data of capital goods and intermediate goods imports was not completely. The data are collected on the yearly basis.

The data was divided into 4 categories of imports data, which are 1.Intermediate products chiefly for consumer goods 2.Intermediate products chiefly for capital goods 3.Capital goods and 4.Other imports. The exchange rate (Baht/dollars US.), GDP of Thailand.

Sources of data

In this study, all data were secondary data collected from many sources as follows:

- Intermediate products and capital goods import, Gross domestic product of Thailand were collected from the Annual report of Bank of Thailand
- Exchange rates (Baht/dollars US.) were from Bank of Thailand database.

- All other data that used in this thesis were collected from Thailand Information Center (TIC), Central Library, Center of Academic Resources, Faculty of Economics Library, Faculty of Commerce and Accountancy Library.

1.4 Organization of the Study

This thesis consists of five chapters as follows:

Chapter 1 introduces the statement of problem, the objectives of the study, the scope of the study and sources of data, and finally the organization of the study. ***Chapter 2*** exhibits the theoretical framework on an approach to deal with impact of exchange rate on import demand function. ***Chapter 3*** discusses the research methodology to assess the effect on import of intermediate product and capital goods. ***Chapter 4*** submits the empirical import demand functions. ***Chapter 5*** proposes Summary conclusions and recommendations