

**Prospects for Foreign Multinationals in Thailand in
the Late 1990s: Another Test for Thailand's Economic
Policy Makers**

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Abstract

This paper examines the prospects for foreign multinational corporations (MNCs) in Thailand in the late 1990s. After a brief introduction, the paper discusses a few basic conceptual issues, emphasizing the importance of the distinction between MNCs and non-MNCs for economic analysis. The paper then looks at the roles of foreign MNCs in Thailand, showing that foreign direct investment (FDI) of foreign MNCs is a relatively unimportant source of fixed investment financing and only a moderately important source foreign capital in Thailand. In manufacturing, foreign MNCs are shown to be a relatively large source of Thai exports as compared to production or employment, and to account for very large shares of all economic activities in a few important industries, most prominently electric machinery and transport machinery. The paper then takes up the prospects for foreign MNCs in Thailand, emphasizing the strong and positive relationship between FDI and Thailand's GDP. Accordingly, the economic slowdown that Thailand is likely to experience in late 1990s will adversely affect FDI. It is noted, however, that the effects on FDI are likely to be much larger than the effects on employment, production, and exports by foreign MNCs because FDI flows are often highly volatile, production and other related activities are much more stable. However, the extent of Thailand's economic slowdown will have important effects on the level of new investments as well as on the level of withdrawals by foreign MNCs in the medium run.

The paper then discusses the substantial problems in Thailand's policy making institutions because these problems are thought to be the major cause of the recent slowdown. The most important principle here is that Thailand must do much more to promote competition in Thailand's markets and increase the competitiveness of Thailand as a location for economic activity. The need for greater competition is most apparent in the financial sector, even though increased emphasis on competition in this sector will likely lead to the bankruptcy of a number of financial institutions. In addition, the competitiveness of firms operating in Thailand, again both foreign and local, is further undermined by the failure to provide sufficient infrastructure (e.g., education, transport, and communication) and addressing these deficiencies will remain an important task for policy makers. The paper concludes that Thailand's policy makers will determine the future of foreign MNCs in Thailand but that there is still considerable uncertainty about the ability of Thai policy makers to come to grips with the substantial problems they face. Will Thailand's present policy makers be unable to make necessary reforms and thereby continue to create a bleak economic outlook for Thailand and foreign MNCs operating in the country? Or will present difficulties be a catalyst to major policy reforms and a brighter economic future, as in Indonesia in the mid-1980s or in Thailand itself in the early 1980s? The jury is still out.

Prospects for Foreign Multinationals in Thailand in the Late 1990s:

Another Test for Thailand's Economic Policy Makers

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1. The Setting

Recently the adverse effects of several large economic problems have become apparent in Thailand. The most obvious signs of these problems are the rapid accumulation of external debt in recent years, rapid decline of the value of the Thai baht since July 1997, the bursting of an asset price bubble beginning in 1994-1995 and accelerating in 1996-1997, the apparent insolvency of a large number of finance companies by early 1997, and the apparently rapid decline in the rate of economic growth in 1997. Other effects of note include the expected reduction in foreign investment in Thailand in the next few years. Those who predict reductions in foreign investment often point to a loss of confidence in Thailand among foreign investors. Among foreign investors, the roles of foreign multinational corporations (MNCs) and foreign direct investment (FDI) by those MNCs in Thailand has also been emphasized. The primary purpose of this paper is to describe precisely what these roles are and then use that information to speculate on what the future might hold for foreign MNCs in Thailand in the next few years. Obviously there are many possible scenarios one could use in such a forecasting exercise. However, instead of describing the technical aspects of various scenarios, this paper focuses on a couple of key economic relationships and describes the implications of those relationships for the future.

The paper first summarizes why economists are interested in MNCs and clarifies a few basic

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definitions (section 2). Then, the major roles of foreign MNCs and FDI in Thailand (section 3) and the prospects for the evolution of those roles (section 4) are discussed. Related policy issues are then discussed in more detail (section 5) and some concluding remarks are offered (section 6).

2. Why are Economists Interested in Foreign Multinationals?²

Much of the interest in the activities of foreign multinationals derives from political considerations. Issues range from valid national security concerns to unwarranted attempts to make foreigners scapegoats for the problems created by local citizens. Despite the high profile sometimes accorded such politically-based concerns, the focus here is on a set of less conspicuous economic problems. These economic problems are sometimes related to politically-based concerns, but it is important for the reader to understand that this paper focuses rather narrowly on the economist's perspective and largely ignores political concerns.

The first step here is to clearly define what is meant by a multinational corporation or MNC. For the purposes of this paper an MNC is defined as a firm with operations in two or more countries. Statistically, a foreign MNC is a company with a foreign ownership share that exceeds a given threshold. This definition can be ambiguous in important respects. For example, ownership cutoffs differ among reporting economies and even among different data sources for one reporting economy. A cutoff of 10 percent has become the international standard in recent years and I understand that this is also the cutoff used by the Bank of Thailand in its balance of payments statistics. When joint ventures (firms with more than one owner) are involved, especially when no one owner has majority control, any ownership criterion can become ambiguous, especially when trying to distinguish among groups of foreign owners. In addition, some firms classified as foreign MNCs may actually be better classified as local firms as their only operations may be in the local economy (e.g., a Malaysian national may own a company in Thailand but have no business interests outside Thailand). Moreover, this definition of an MNC does not distinguish between types of MNCs, nor does it encompass the vast array of non-ownership based international relationships (e.g., international subcontracting of various types) that exist among firms.

²This section is based on Ramstetter (forthcoming a, section 2).

Correspondingly, the economic theory of the multinational corporation focuses first and foremost on the question of why a firm chooses to become a multinational and incur costs of cross-border operations not incurred by non-MNCs. Very simply put, the answer to this question is commonly thought to lie in identifying the advantages possessed by MNCs that allow them to overcome the additional costs of operating across international borders. The interested reader is encouraged to see more comprehensive surveys of this literature (e.g., Caves 1996 and Dunning 1993) but here I will try to summarize the three sets of advantages are often hypothesized in this regard.

The first set consists of advantages accruing from exploitation of assets that belong to a given firm. These assets are often called firm-specific assets and advantages accruing from the possession of such assets are called ownership advantages. Important examples of such firm-specific assets are patents, in-house research capability, and exclusive marketing networks. The intangible nature of such assets is often emphasized (e.g., Markusen 1991) in comparison to the tangible nature of fixed assets (e.g., buildings, machinery).

The second set of advantages are advantages accruing from the internalization of economic transactions within a single firm unit. These advantages are called internalization advantages. For example, a firm can often reduce costs associated with a given transaction when uncertainty makes inter-firm transactions risky and thus costly. A good example of this is to suppose that a firm develops a very advanced semiconductor that can greatly improve the performance of a personal computer. However, in such cases there is often a problem of asymmetric information, namely that the firm developing the semiconductor will know far more about its capabilities than any perspective buyer. This will lead to a tendency for the perspective buyer to undervalue the semiconductor from the perspective of the developer and create a motive for the developer to also produce personal computers using the semiconductor in an attempt to extract (what the developer perceives as) the full value from its development efforts. Another example is the problem of lemons in subcontracting, when quality is very important to a final goods producer (e.g., a personal computer company). The final goods producer will be very reluctant to purchase from an intermediate goods supplier (e.g., a subcontractor), unless it is assured that its concerns about quality control will be addressed by the supplier. Moreover, the firm producing the intermediate good may have a smaller incentive to emphasize quality than the final good producer. If this is the case, the final good producer may have

to produce the intermediate good itself rather than buying that it from a supplier. Both of these are examples where it may be advantageous to internalize transactions that would take place in arms-length markets within a single firm. The existence such internalization advantages is often thought to be a major reason for the existence of MNCs.

The third set consists of advantages accrue from operating in a specific location or locational advantages. Traditional examples of locational advantages are reductions in the costs of serving markets when firms are faced with high levels of trade protection in the target market and reductions in production costs afforded by increased access to lower cost factors of production (e.g., labor and natural resources).

Together these elements comprise Dunning's OLI (ownership-location-internalization) paradigm (e.g., Dunning 1993). There is an extensive theoretical debate over whether all of these advantages are a necessary condition for a firm to become an MNC (and thus for FDI to occur). Some argue that internalization advantages alone are sufficient to explain the existence of the MNC (e.g., Buckley and Casson 1991, Rugman 1985). However, from an empirical point of view, I think that the general agreement that MNCs tend to possess a distinctive set of firm-specific, intangible assets is important, whether or not such assets are necessary for a firm to become a multinational. The possession of distinctive firm-specific, intangible assets is important because it implies that behavior of MNCs may differ systematically from the behavior of non-MNCs. More specifically, there are at least three interrelated sets of firm-specific, intangible assets that foreign firms are thought to possess in relatively large amounts, production technology, marketing networks, and management know-how.

The possession of superior production technology (and superior management know-how) implies that MNCs tend to be more efficient than non-MNCs. One simple example lending support to this proposition is the casual observation that foreign MNC shares of host country of production often tend to be larger than corresponding shares of employment in Thailand and other Asian developing economies (e.g., Ramstetter 1993, 1994, 1995a, 1996b, Tambunlertchai and Ramstetter 1991), where there are relatively few home-based MNCs. In other words, the average product of labor (=production per worker) often tends to be relatively high in foreign MNCs in these economies. Note, however, that these differences are often accompanied by relatively large variation across time, industries, and/or firms, and are thus statistically insignificant (Brimble 1993, Khanthachai 1987, Ramstetter 1994,

1995a, 1996b, Tambunlertchai and Ramstetter 1991).

In addition, the relatively sophisticated marketing networks of MNCs, particularly those related to international trade, also lead to the expectation that MNCs will be more dependent on exports than non-MNCs. This proposition is again supported by the casual observation that foreign MNC shares of host country exports often tend to be much larger than shares of production and employment in developing economies, or in other words, that export propensities (i.e., export-sales ratios) are higher in foreign MNCs than in local firms in these economies. Moreover, in the export propensity case, variation is relatively small, and thus differences are often statistically significant. For Indonesia, Singapore, and Thailand, there is also strong evidence that export propensities are highest in firms with large foreign ownership shares, with differences between firms with large foreign ownership shares and other firms usually being significant statistically (Ramstetter 1994, forthcoming b).

These are of course many other comparisons of potential interest between MNCs and non-MNCs (e.g., Ramstetter 1994, Sibunruang and Brimble et al 1991, Tambunlertchai and Ramstetter 1991). However, it is also important understand that comparisons of foreign MNCs and local firms in Thailand and other Asian economies is becoming more complicated due to the fact that a number of local firms are becoming multinationals themselves. In this respect, it is important to reemphasize that more important economic distinction is between MNCs and non-MNCs, not between foreign firms and local firms. In other words, nationality is in and of itself of less economic concern than whether a firm operates in more than one economy because both theory and the existing empirical evidence strongly suggest that a local MNC is much more likely to resemble a foreign MNC than a local non-MNC. Similarly differences among different nationalities of foreign MNCs are less pervasive than differences between MNCs and non-MNCs.

3. The Role of Foreign Multinationals in Thailand

This section is not meant as comprehensive review of the role of foreign multinationals in the Thai economy.³ Rather the aim is to highlight four key points as a general introduction to various

³There are a large number of sources the reader can refer to in this area including, for example, Brimble (1993), Khanthachai et al (1987), Ramstetter (1994, 1997a, 1997b), Sibunruang and Brimble, et al (1991), Tambunlertchai and Ramstetter (1991).

dimensions of the topic.

The first point is that net inflows of FDI from abroad constitute a relative small source of financial capital in Thailand. This is first evidenced by relatively low ratios of cumulative FDI to cumulative private fixed investment, cumulative FDI amounting to a little less than 5 percent of cumulative private fixed investment for 1965-1996 (Figure 1). Annual ratios fluctuated in a wider band, peaking at a little above 8 percent in 1989-1990 and registering a low of under 1 percent in 1979. The second piece of evidence of importance here is the relatively low share of inward FDI in total flows of foreign capital (Figures 2, 3). For the entire 1965-1996 period cumulative inward FDI amounted to less than 24 percent of total foreign capital flows, where total foreign capital flows are defined as minus the current account surplus, though there is relatively large variation in the annual shares, from more than 200 percent to less than -100 percent. One other characteristic of some interest is that the shares of FDI in total foreign capital flows were relatively low in the early 1980s, the last time Thailand experienced a major macroeconomic slowdown.

Ratios of FDI to fixed investment and foreign capital flows are rather moderate in Thailand compared to other Southeast Asian economies. For example, these ratios are much larger in neighboring Singapore and Malaysia, and of similar magnitude in Indonesia and the Philippines (Ramstetter 1993, 1996a). Singapore and Malaysia are two rather unique countries in that foreign MNCs literally dominate large sectors of these economies, accounting for a little over two-thirds of all manufacturing production in recent years in Singapore and about one-half of all manufacturing production in Malaysia, for example. By contrast, the most comprehensive estimates to date suggest that foreign MNCs accounted for about one-third of manufacturing production in Thailand and this share is about one-fifth to one-fourth for Indonesia (e.g., Ramstetter 1996a).

The second point is that, in Thailand as elsewhere, foreign MNCs tend to dominate a few important sectors, the most prominent being electric machinery and transport machinery manufacturing (e.g., Ramstetter 1994a, 1997b). As pointed out by Ramstetter (1997a, 1997b), these industries, including the foreign MNCs in these industries, have been a major source of growth in Thailand in recent years, especially in terms of exports. Furthermore, as indicated by Markusen (1991), the fact that foreign MNCs dominate these industries is in many ways a technological accident. This is because investments in intangible, technology-related assets that are easily moved

among production locations account for a relatively large portion of costs in these industries. As a result, firms in these industries face what Markusen calls multi-plant scale economies, creating a motive for geographical dispersion, which is one of the most important characteristics of the MNCs.

The third point is that FDI flows and/or stocks are generally rather poor indicators of real activities in MNCs such as employment, production, and trade. For example, Ramstetter (1996a, forthcoming a), examines trends in ratios of FDI flows and/or stocks to GDP on the one hand, and ratios of foreign MNC production to GDP on the other, for the Asian region. The analysis shows that FDI-based indicators often move in different directions with much different time trends than do foreign MNC shares of production. It also shows that the time-wise variance of FDI-based indicators is generally much larger than for foreign MNC shares of production. Thus, if one looks at FDI-based indicators one gets the impression that foreign MNCs have become much more important in a wide range of Asian economies in recent years, and that economic activities in foreign MNCs are subject to wide fluctuations. This gives credence to the view that MNCs are rather footloose and the view that foreign MNCs are becoming much more important in Asia. On the other hand, if one examines foreign MNC shares of production, one gets the impression that shares of foreign MNCs have not increased as much as is often believed and that production by foreign MNCs is much more stable than is often perceived.

The fourth point is to emphasize once again that the relative size of foreign MNCs depends on the indicator used to measure that size (c.f., section 2). In this respect, it should also be reemphasized that commonly used ratios of FDI to fixed investment, or other similar ratios (e.g., Figure 1 above) are very poor indicators of the size of foreign MNCs relative to the host economy because the numerator and denominator refer to very different things.⁴ When data are available, it is possible to construct much better measures by if one calculates the ratio of employment in MNCs to total employment, the ratio of production in MNCs to total production, or the ratio of international trade flows in MNCs to total trade flows, for example. As indicated above, if one constructs such

⁴Perhaps the most commonly used ratios of this type are ratios of FDI to total fixed investment or total investment, total investment being defined as gross capital formation as measured in the national accounts. The ratios of FDI to GDP is another common measure that is similar. The fundamental problem with these ratios is that the numerator and denominator measure very different things. Specifically, the numerator refers to the change in a portion of corporate liabilities (e.g., flows of equity and loans among MNC parents and affiliates), while the denominators refer to changes in a portion of corporate assets (e.g., changes in fixed assets) or to a measure of production (e.g., GDP).

measures for Thailand's manufacturing industries, shares of foreign MNCs are largest if measured in terms of exports, of moderate size if measured in terms of production, and relatively small if measured in terms of employment (e.g., Ramstetter 1994).⁵ In this respect, it is important to emphasize that there is no single best way to measure the relative size of foreign MNCs in Thailand. Rather it is most appropriate to say that foreign MNCs are relatively important sources of exports, moderately important sources of production, and relatively small sources of employment opportunities. Note again that this a pattern common to many other Asian economies.

4. Prospects for Foreign Multinationals in Thailand

As indicated in the introduction, when discussing the prospects for foreign MNCs in Thailand in the next few years, the key factor to consider is that beginning in 1997, Thailand is entering what is likely to be a pronounced and perhaps lengthy macroeconomic slowdown. For example, the Thai government recently revised its official projections for GDP growth rates in 1997 and 1998 to 0.6 percent and 1.0 percent, respectively (*Business Day*, www.bday.net, 26 November 1997). The fact that these growth rates are by far the lowest that Thailand has experienced at any time in at least the last two and a half decades (Figure 4) is a clear indicator of severity of the problems the Thai economy now faces. Moreover, it is important to emphasize that the primary causes of this slowdown are failures on the part of the Bank of Thailand and the Ministry of Finance to appropriately regulate asset markets and manage exchange rates. These policy failures have caused, not only a marked economic slowdown, but also a loss of confidence in these key policy making institutions that have previously been viewed as relatively competent in Thailand. Three points are of particular importance when considering how foreign MNCs will react to these changes.

First and foremost, one must understand the cyclical nature of FDI (and all investment) and its relationship to macroeconomic variables. Namely, there is clear evidence that inward FDI flows

⁵In other words, as discussed in the previous section, there is a tendency for foreign MNCs to have relatively high labor-productivity and export-sales ratios. Note that no reliable measures are available for all non-manufacturing firms in Thailand as yet, though I am in the process of assembling a large firm level data base that should be able to identify most major foreign investors in non-manufacturing as well as manufacturing.

are closely related to economic cycles in Thailand as well as in most other countries. For example, when estimating the determinants of FDI's variation over time for major industry categories, Ramstetter (1995b) found that real GDP was the only consistently significant determinant of FDI flows in Thailand. Moreover, the same study reviewed more detailed studies of bilateral FDI flows as well as substantial cross sectional evidence, suggesting that the size of the Thai market and/or its growth as a key factor in determining the scale of foreign MNC activity in Thailand. Although there remains much room to improve on the technical aspects of such studies (especially with respect to the time series techniques used in studies such as Ramstetter 1995b), all available results suggest a very strong and positive relationship between foreign MNC activities, including FDI, and economic size or economic growth. One simple perspective on this procyclical relationship can be obtained from Figure 4 which shows real growth rates of GDP, private fixed investment, and FDI. This relationship in turn implies that the substantial downturn in economic growth now being predicted for Thailand in 1997 and 1998 will lead to lower levels of FDI than would have occurred had growth remained at higher levels. Predicting precisely how far FDI will actually fall, or whether it will fall at all, is difficult to ascertain because other factors must be considered.

Among other factors explaining the variation of FDI over time, labor costs, capital costs, accelerator effects, and exchange rates are often thought to be important. For example, evidence for Thailand (e.g., Ramstetter 1995b) suggests that FDI is often negatively correlated with increases in the wage share of GDP (a measure of productivity-adjusted labor costs), and that this relationship was often statistically significant. Accelerator effects, indicated by the combination of positive effect of GDP and a negative effect the stock of FDI at the end of the previous year, were also observed in some of the industries studied in Ramstetter (1995b) but not all. Real interest rates were also negatively correlated with FDI in most cases reflecting the negative impact increases in capital costs are thought to impart on FDI, though the coefficients on these variables were often statistically insignificant.

The effects of changes in exchange rates are of particular interest given the large devaluation of the baht beginning in July 1997, but it should first be emphasized that the effects of changes on exchange rates on FDI flows are complex and theoretically ambiguous. For example, the recent depreciation of the baht will lower the costs of production in Thailand as well as the costs

of Thai assets. This may encourage FDI by firms seeking to export from Thailand or firms seeking to benefit from the low costs of Thai assets. On the other hand, the depreciation will reduce the purchasing power of Thai consumers, increase the costs of imported inputs, and may cause capital losses for some foreign MNCs that acquired Thai assets at high prices in the early 1990s. This may discourage FDI by firms who rely on the Thai market and/or on imported inputs and may also lead some firms that experience large capital losses to pull out of Thailand altogether. Perhaps more significantly, the capital losses on past investments may be another factor leading to the loss of investor confidence among foreign MNCs. In sum, it is impossible to establish a priori what the net effects of exchange rate changes will be on aggregate MNC activities such as aggregate FDI. In the respect, it is important to note that most past studies of FDI's determinants into Thailand (e.g., Ramstetter 1995b) indicate that the effects of exchange rates are statistically insignificant. This finding in turn suggests that the effects of exchange rate changes have been a wash in the past, with some firms increasing FDI and others decreasing FDI as a result of exchange rate changes.

Whatever the net effects of exchange rate changes, the effects of the slowdown in GDP growth are likely to have by far the largest effect on aggregate FDI inflows in the next few years. Another important factor is that FDI inflows reached their second highest annual total in 1996 (57 billion baht) and preliminary estimates indicate they were even higher in the first half of 1997 than in the first half of 1996 (35 billion baht versus 31 billion baht, Bank of Thailand various years b, c).⁶ This trend has two possible implications. On one hand, it may be that FDI is not that sensitive to short-term changes in the investment environment. This would be consistent with the suggestion that present FDI flows reflect decisions taken a year or two ago and that foreign MNCs saw no reason to reverse these decisions in the first half of 1997, despite the deteriorating economic situation. On the other hand, more ominously this trend may indicate that several MNCs are likely have substantial excess capacity coming on line in the next few years, another factor that could reduce FDI in this period. For example, in the automobile industry, (1) recent decisions by several foreign MNCs to temporarily suspend production (*Bangkok Post*, www.bangkokpost.net, 6 November

⁶Note that FDI flows were below 10 billion baht through 1987, increased to 28 billion baht in 1988, 46 billion baht in 1989, 65 billion baht in 1990, then fell off to 44-54 billion baht in 1991-1993 and 33 billion baht in 1994, before recovering to 50 billion baht in 1995 and 57 billion baht in 1996 (Bank of Thailand, various years c).

1997) and (2) increased FDI in recent years indicate that excess capacity is likely to be a problem in this industry, especially given the large share of local market sales in total sales.⁷ Another fact consistent with the view that FDI is likely to fall significantly in the near future is the 29 percent decline foreign equity capital in projects approved by the Board of Investment (BOI) from 26.5 billion baht in the first half of 1996 to 18.9 billion baht in the first half of 1997 (*Weekly Thai Keizai*, 1997 Sep 15, p. 14).

The second point is that, as discussed above, there are often large differences between trends in FDI and trends in other activities of foreign MNCs such as employment, production, and trade. Here it is important to reiterate that it is perfectly possible for declines in FDI to occur even when foreign MNCs are expanding employment, production, and other economic activities. Moreover, such a phenomenon is a distinct possibility in Thailand in the next few years, because new FDI may be very slow in forthcoming but many existing MNCs are on expansion paths that are largely determined by previous investments. Hence one may see MNCs expand operations a fair amount without much increase in FDI financing.⁸ In other words, it is important to understand that MNCs are not as footloose as is implied by trends in FDI, which is a rather volatile indicator. MNCs (and non-MNCs) usually devote substantial resources to setting up operations in Thailand (and other host economies) and thus usually think long and hard before shutting a plant. This fact in turn implies that foreign MNCs are not likely to leave Thailand in large numbers in response to present difficulties, at least not in the short run. However, this fact should not be taken as license for complacency on the part of policy makers because substantial withdrawals can be expected in the

⁷For evidence on the low level of export propensities in the Thai auto industry, see Ramstetter (1997b). Note, however, that Thai auto exports, though still a small portion of total sales, have been increasing rapidly in recent years (*Business Day*, www.bday.net, 3 November 1997). Net flows of FDI in the machinery and transport equipment sector, were an average of 3.1 billion baht annually in 1995-1996 and amounted to 1.0 billion baht in the first half of 1997, after averaging only 1.0 billion baht per year in 1992-1994 (Bank of Thailand, various years b, c). Increasing FDI in the automobile sector is thought to account for a large portion of these flows.

⁸For example, according to data from its 1996 survey of Japanese firms in Thailand, the Japanese Bangkok Chamber of Commerce (1997, pp. 16-19) estimates that investment by surveyed problems was 37 billion baht in 1995, 41 billion baht in 1996, and reports that planned investment by these firms for 1997-2000 is only 21 billion baht per year in 1997-2000. In contrast, planned sales for 2000 are 1,124 billion baht up from 748 billion baht in 1995, planned exports for 2000 are 276 billion baht up from 177 billion baht in 1995, and planned employment in 2000 is 202,568 up from 169,699 in 1995. Thus, despite the fact that planned investment figures indicate a decline in Japanese MNC activity, data on planned sales, exports, and employment indicate substantial increases are likely.

medium-term if major policy problems are not addressed effectively in the short-run.

Third, it is important to understand that there is mutual causation between FDI and other activities of MNCs on the one hand and GDP on the other. In this paper I emphasize the effects of GDP on foreign MNCs because I think that is by far the most important policy point in this context. However, one must also be aware of the fact that foreign MNCs directly affect GDP, by creating and training factors of production (e.g., labor, capital) and by introducing more efficient production, sales, and management techniques, among other things. Moreover, by exposing local firms to the more efficient business practices used in foreign MNCs, and forcing local firms to compete with those practices, foreign MNCs can and often do stimulate increased efficiency in local firms as well. This means that to some degree foreign MNCs can influence their own fate by influencing GDP in the local economy. This is another reason that there is a strong correlation between growth rates of GDP and FDI (e.g., Figure 4). On the other hand, during the boom of the late 1980s, it is significant that increases in FDI followed (in 1988), not lead, the increases in GDP and total private fixed investment (in 1987), suggesting that Granger causality tends to run from GDP to FDI in Thailand, not the reverse (see Ramstetter 1995b, Appendix). Perhaps more important than this minor statistical point, however, is the point that decision making in foreign MNCs is much more likely to be influenced by economic events and policies in Thailand rather than to influence those events and policies. Of course, this assertion may be incorrect in some individual cases where MNCs have substantial monopoly power, but I strongly believe that the vast majority of foreign MNCs and foreign MNCs as a group have only limited abilities to control policy and/or market outcomes in Thailand. If this view is correct, most MNCs have no realistic choice but to cope with the effects of the slowdown, not try to influence the nature and scope of the slowdown itself.

5. Thailand's Macroeconomic Slowdown: An Important Turning Point in the Policy Environment?

Given the large role that Thai macroeconomic events will play in determining the prospects for foreign MNCs in Thailand in the next few years, it is important to understand the causes of the recent slowdown in some more detail. The theme I would like to stress here is that a relatively new problem, specifically the inability of the Bank of Thailand and the Ministry of Finance to properly

manage the exchange rate and regulate financial institutions in recent years, is the primary cause of the current macroeconomic problems in Thailand today. However, I would also like to stress that these policy failures bear a strong resemblance to Thailand's failures to manage what I call classic market failures (e.g., failures of private markets to assure adequate supplies of physical infrastructure, education, environmental goods). In other words, Thailand has long experienced systematic failures of several of its key policy making institutions and that these systematic failures have now spread to macroeconomic policy making. Four points are important in this respect.

First, Thailand has always had problems with getting policy making bureaucracies to operate efficiently. All one has to do is to look out of a Bangkok window at the traffic to realize that policy makers have grossly mismanaged Bangkok's transport infrastructure, though transport infrastructure is markedly better outside of Bangkok. There are also problems with the communication infrastructure throughout the country that could have been avoided at relatively low cost had action been taken earlier. Education policy has also been rather poor and Thailand still had among the lowest secondary school enrollment rates in Southeast Asia through the early 1990s.⁹ Correspondingly, finding qualified skilled workers is a large problem faced by all firms operating in Thailand (e.g., Ramstetter 1995b, 1997b). The outcomes of environmental management policy, including flood management policy, have also been poorer than might have been hoped a decade ago. Although the specific causes of these policy failures differ depending on the problem, there is an important common element. Namely, they all involve the use of public money to provide so-called public goods, when there is little if any social consensus on how to spend the money. As in many other democracies, budgets for such public goods in Thailand are often allocated on the basis of lobbying for the benefits those expenditures provide for certain groups rather than the so-called public good. There is also a popular perception that such lobbying activity is much more corrupt in Thailand than in other economies.

Second, Thai policy makers have done a number of important things very well over the last few decades. For example, as mentioned above, the bottlenecks in transportation infrastructure are

⁹For example, the most recent secondary school enrollment rates reported by the World Bank (1997) were 84 percent in Singapore (1994), 79 percent in the Philippines (1993), 59 percent in Malaysia (1993), 43 percent in Indonesia (1992), but only 37 percent in Thailand (1992).

far less pronounced outside of Bangkok, partially due to the fact that rural-based politicians, which constitute a majority in Thailand, insure that such infrastructure is provided in rural areas. Perhaps most significant in this context, however, is that fact Thailand has earned well-deserved praise for its previously good record of macroeconomic management (e.g., Warr and Nidhiprabha 1996). There is ample evidence of numerous and important successes in past macroeconomic policies, for example high savings and investment rates (measured as ratios of savings or fixed investment to GDP), and rapid growth of exports (and thus imports), production, and investment (e.g., Ramstetter 1997a, Figure 4). With a few exceptions, Thailand was also able to keep inflation in check and keep its fiscal and external balances within tolerable limits. The major exception to this was an increase in the fiscal deficit and external debt in the late 1970s and early 1980s, and Thailand's relatively skillful management of this problem in the mid-1980s (e.g., Warr and Nidhiprabha 1996) contrasts markedly with the mistakes committed in the mid-1990s.

Third, the same macroeconomic policy making institutions that were largely responsible for past macroeconomic successes, namely the Bank of Thailand and the Ministry of Finance, are primarily responsible for Thailand's present problems. At least three important mistakes were made in recent years. The first mistake was to establish Bangkok International Banking Facility (BIBF), while at the same time refusing to liberalize local financial and markets and relax the more or less fixed exchange rate regime. Although the creation of the BIBF was not in itself problematic, the refusal to liberalize local financial and markets made it possible to borrow foreign currencies (mainly U.S. dollars) through the BIBF at much lower interest rates than could be obtained for baht-denominated financing and attempts to maintain a more or less fixed exchange rate vis-a-vis the U.S. dollar led to unrealistic expectations that borrowing foreign currencies through the BIBF entailed only minimal currency risk. The result of this incentive structure was an unsustainable accumulation of debt, mainly in the private sector. For example, BIBF-related debts accounted for \$31 billion or 39 percent of the \$80 billion foreign debt at year end 1996 and 72 percent of the \$43 billion increase in foreign debt experienced between 1992 and 1996 (Figure 5). In other words, since the establishment of the BIBF, Thailand doubled its external debt, with most of the increase concentrated in BIBF-related activities. However, if there is a positive trend that can be seen from these data is that the growth of both total debt (1.6 percent) and BIBF-related debt (4.4 percent) was

much slower in the first half of 1997 according to preliminary figures.

The second mistake relates to the classic bubble experienced in Thailand's asset markets in the early 1990s and the regulatory authorities' failure to shore up a weak financial system to deal with the consequences of the bubble's inevitable collapse. Here it is important to emphasize that the bubble's inevitable collapse was indicated as early as 1995 by a slowdown in the real estate sector and then in 1996 when the Thai stock market lost almost half of its value, a decline which has continued into 1997. Despite these obvious signs that financial institutions would be next in line to pay the price for the bursting of the bubble, Thailand still has no deposit insurance scheme, much less a regulatory framework to implement its use should financial institutions. Consequently, a major problem the Thai authorities now face is how to cope with the failure of several financial institutions in the context of this systematic weakness.

The third mistake was the when the Bank of Thailand risked at least \$23.7 billion of its reserves in a failed defense of the baht in the first half of 1997 (e.g., Siamwalla 1997). With the 40-60 percent devaluation of the baht that has been experienced since, this means that Thailand stands to lose another US\$9-15 billion in reserves in the last half of 1997 and the first half of 1998 at a time when it can little afford to do so. How the Bank of Thailand and/or the political authorities that may have been behind the Bank's actions could have thought that they could defend the baht at roughly 25 to the dollar is simply incredulous. For example, it is now known that the IMF was advising the Thai authorities that the baht would need to be devalued as early as June 1996. However, my experience is that many Thai authorities and academics were in a state of denial in this respect. For example, at a special session of the fifth convention of the East Asian Economic Association on the Thai economy held in Bangkok in October 1996, I also asked the panel "when", not "if", the baht would be devalued. Yet no one attempted to answer the question and my friends kept telling me there was "no way" the baht would be devalued due primarily to political pressure. The fact that the country's Central Bankers were willing to gamble such a large sum to maintain the value of the baht despite being aware of the very small chances of success suggests that (1) the political pressures on the policy makers may have been very strong or (2) the officials were totally incompetent or both. Whatever the cause, however, it still remains that the Thai authorities cost themselves and the Thai economy dearly by not devaluing and/or floating the baht much earlier than they did.

These costs will come in the form of two major adjustments that have to take place. The first adjustment began in July 1997 when the baht was floated. This adjustment is not a cost to everyone however, and it is encouraging to see stories in the newspapers about how some industries, primarily more traditional exporters such as food products and textiles are projected to respond with large export increases in 1998 (*Bangkok Post*, 25 November 1997, www.bangkokpost.net). However, as discussed above, the drop in the baht's value will also hurt firms that rely on imported inputs as well as domestic market oriented firms because there has been a significant reduction in purchasing power as a result of the depreciation. The second adjustment, the reform of the financial sector and related regulations is much more difficult and poses the largest potential problem for Thailand in the next six months. Here financial assets and debts must be restructured, and for this to be possible clear rules about deposit insurance and the failures of banks and finance companies need to be formulated, articulated, and implemented. A reasonable start has been made in this direction as of this writing, and the mood appears somewhat more optimistic than in the past few months.

However, there remains much work to be done and present problems may actually get much worse in the short run. A key factor here is whether the Thai government will opt for a firm-oriented approach to financial sector reform similar to that employed by Japan in the mid-1990s. This approach is distinguished by its emphasis on protecting both individual depositors and the banks or finance companies involved. The major problem with this approach is that bailouts of the financial institutions incur very high, though not always obvious, costs (e.g., Japan's growth slowdown since 1992). On the other hand, it is fairly clear that a depositor-oriented approach to financial sector reform, such as that adopted by the United States in the 1980s, is much less costly and thus more likely to stimulate relatively rapid and more robust recovery, even though the bankruptcies entailed in this approach may lead to a more pronounced slowdown in the short-run. The distinguishing element of this approach is an emphasis on protecting depositors eligible for deposit insurance while facilitating the bankruptcy of failed financial institutions. In this respect, large foreign debts, liquidity shortages, and IMF oversight may be blessings in disguise, because they may make it impossible for Thailand to adopt a firm-oriented approach.

Fourth, the economic principle underlying the difference between the firm-oriented and

depositor-oriented is very simple and important for Thai policy makers to remember at this time, namely it is the principle that greater competition usually improves economic welfare, precisely by facilitating bankruptcies that lead to more efficient uses of the resources (e.g., capital, labor) originally controlled by bankrupt firms. Thailand has many restrictions on competition that almost certainly have large negative impacts on the economy (e.g., relatively high tariffs, foreign ownership restrictions) and removal of these barriers presents an important challenge to Thai policy makers.¹⁰ In other areas, Thailand has failed to regulate competition when necessary to prevent negative externalities (e.g., pollution, congestion), for example. However, in the short run, Thailand faces no greater challenge than the restructuring of its financial sector where policy makers will have to walk a fine line between closing too many companies and creating panic among depositors on the one hand, and closing too few companies and thereby failing to instill greater competition on the other.

In this respect, Thailand may be approaching, if not already at an important fork in the policy-making road. After a long period of enjoying a good reputation, Thailand's macroeconomic policy makers have made colossal errors in the last few years, and much infrastructure development remains hostage to acute failures in microeconomic policy making. Thailand's macroeconomic policy making institutions must now rebuild themselves and reestablish their reputations as bastions of economic stability in Thailand. If macroeconomic policy making institutions can be rebuilt, there may also be an opportunity to greatly improve microeconomic policy making institutions at the same time. The passing of the new constitution will change the political landscape somewhat, perhaps giving some political reinforcement to these changes in the medium term. In short, the present malaise presents several opportunities to correct important institutional problems and Thailand's economy has grown to the point where such institutional failures cannot be continued without paying an increasingly large economic cost.

¹⁰Note that tariff reductions and liberalization of ownership restrictions are scheduled to come into effect with the implementation of the Uruguay Round trade agreement.

6. The Road Ahead

This paper started out analyzing the roles foreign MNCs and has ended up discussing Thai policy making and the changes that are going to be necessary if Thailand is going to return to previous levels of economic growth. This is because it is first and foremost necessary to evaluate various scenarios for Thai economic performance over the next few years before it is possible to project what will happen to FDI and other activities of foreign MNCs in Thailand. For example, if the Thai growth rate really does decline for the next few years, then it is very likely that Thailand will also experience reductions in FDI and in new activities by foreign MNCs over the next few years. If on the other hand, the slowdown is not as bad as projected, or if it is worse than projected, projections for FDI and other activities of foreign MNCs would change accordingly.

Although Thailand faces numerous problems, the length of the economic slowdown then depends crucially on how Thailand handles its financial sector problems. If Thailand can implement a depositor-based approach that uses a deposit-insurance scheme to instill confidence among small or moderate savers but does not try to protect large savers or the financial firms themselves, then recovery is likely to be quick and robust. On the other hand, if Thailand tries to implement a firm-based approach that tries to save the finance companies themselves and most or all depositors, then the recovery is likely to be slow and not very vigorous. Obviously a quick and robust recovery will be much more likely to stimulate economic activity in foreign MNCs (and local firms) than a slow and not very vigorous one would.

Finally, Thailand may have reached an important transition point as its policy making institutions are under immense pressure that may make change inevitable. However, the constructive reform of these policy making institutions will take considerable bureaucratic and political resources that will be very difficult to muster. In short, it is clear that Thailand's policy makers will determine the future of foreign MNCs in Thailand, but the nature of that future is less clear. Will Thailand's present policy makers be unable to make necessary reforms and thereby continue to create a bleak economic outlook for Thailand and the foreign MNCs operating in the country? Or will present difficulties be a catalyst to major policy reforms and a brighter economic future, as in Indonesia in the mid-1980s or in Thailand itself in the early 1980s? The jury is still out.

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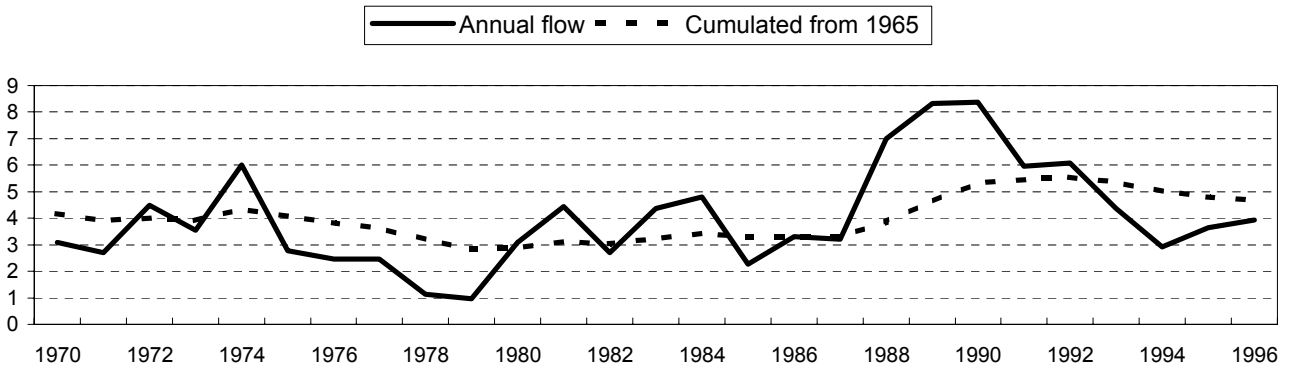
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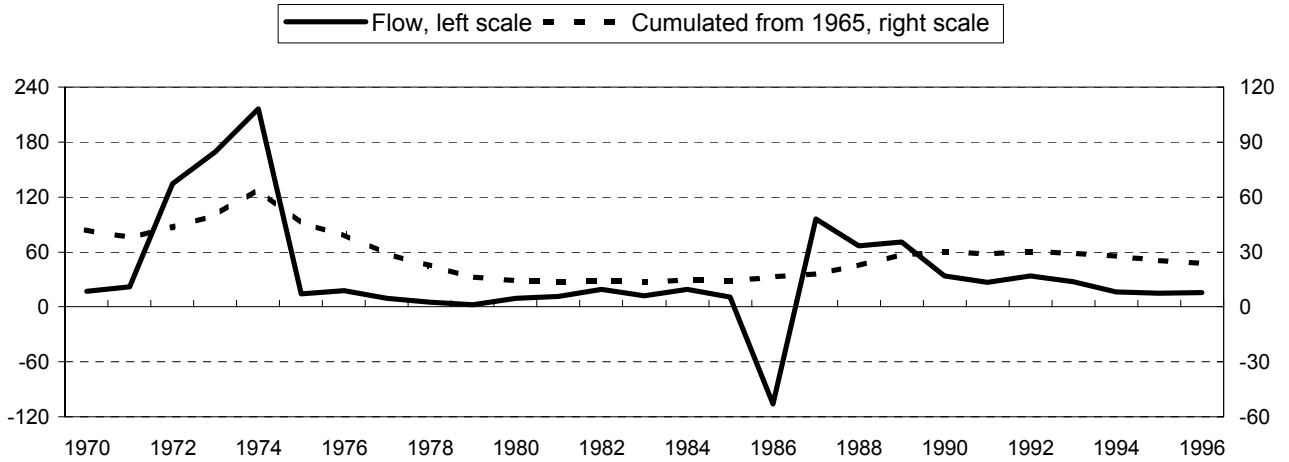
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Figure 1: Ratios of FDI to Private Fixed Investment (percent)



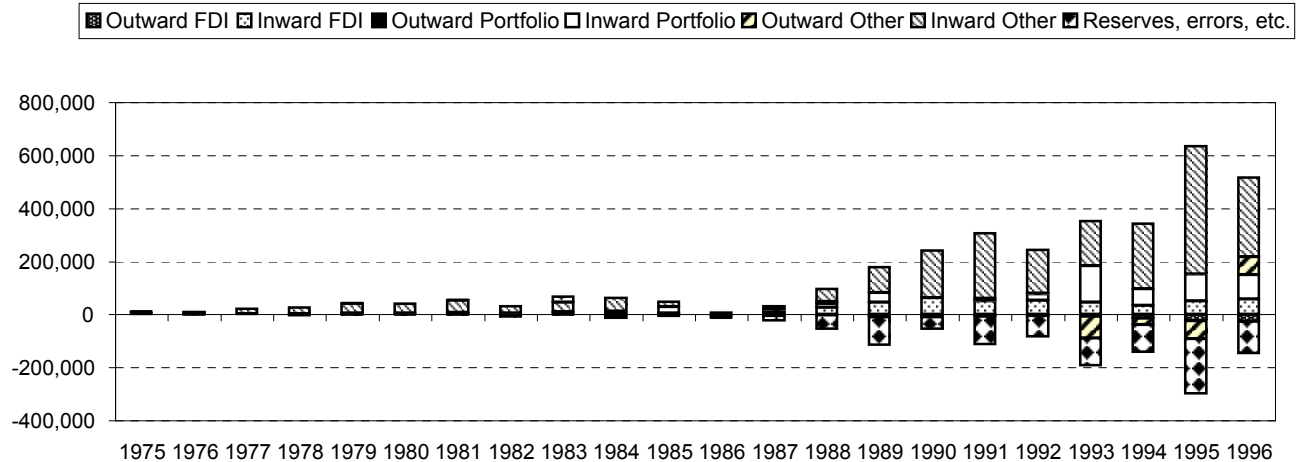
Sources: Bank of Thailand (various years c), National Economic and Social Development Board (1988, 1991, various years).

Figure 2: Ratios of FDI to Total Foreign Capital (percent)



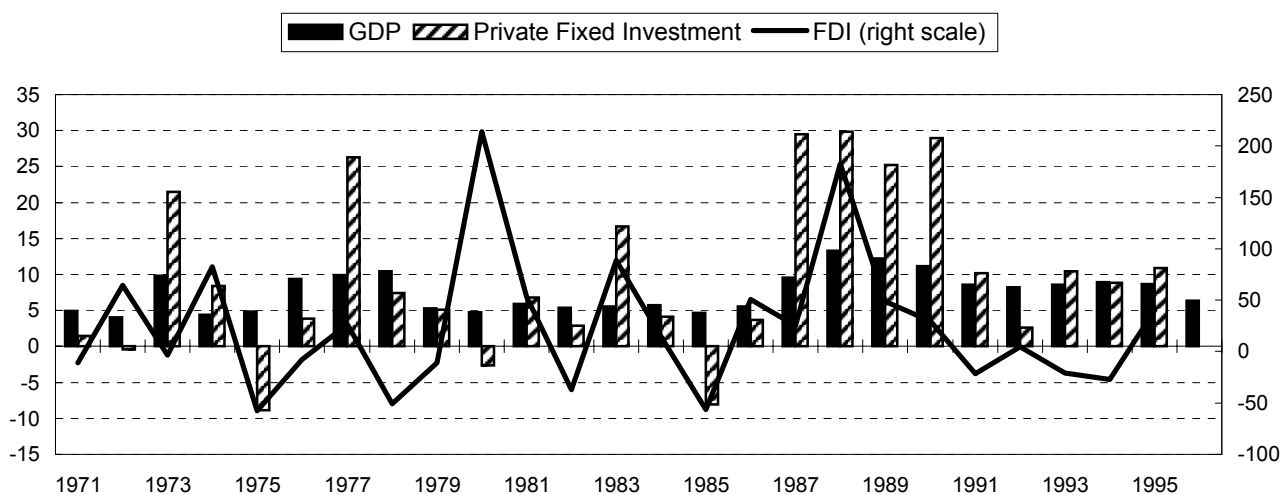
Source: Bank of Thailand (various years a, b, c).

Figure 3: Foreign Capital Flows by Type (baht millions)



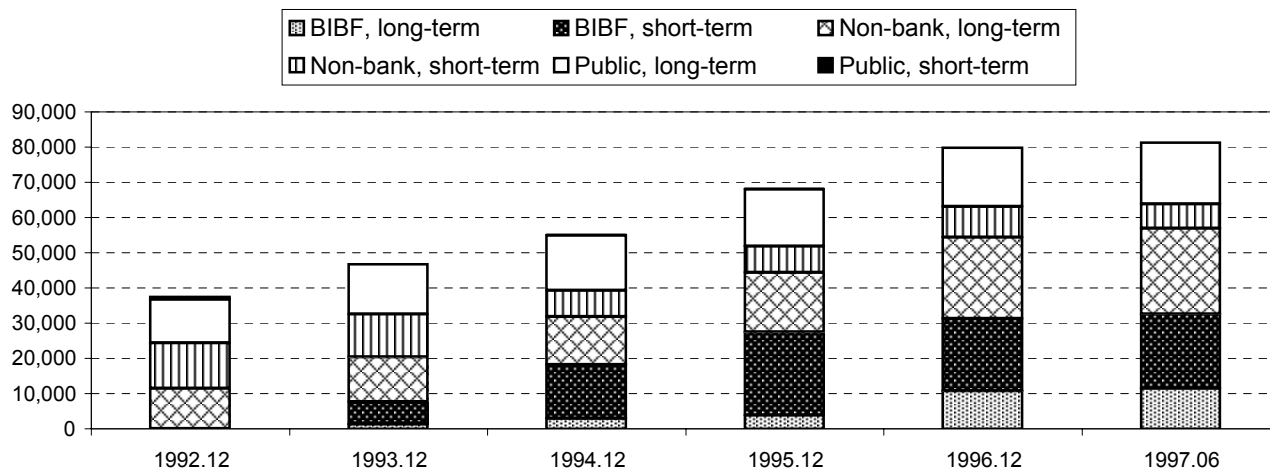
Source: International Monetary Fund (1997).

Figure 4: Real Growth Rates of GDP, Private Fixed Investment, and FDI (percent)



Sources: Bank of Thailand (various years c), National Economic and Social Development Board (1988, 1991, various years).

Figure 5: External Debt (US\$ millions)



Source: Bank of Thailand (various years c).