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Opening Speech:
The 2000 Year-end Conference

"Transparency and Uncorrupt Society"*

Anand Panyarachun**

Ladies and Gentlemen,

First of all, let me congratulate the National Counter Corruption Commission (NCCC) on the occasion of its first anniversary that falls exactly today. As a newly independent organization conceived for the first time under the present Constitution, the NCCC represents a new dimension of the Thai society. Within the past year, the NCCC has, in the form of concrete output, demonstrated to us the depth of its potential. As a Thai citizen, I would like to take this opportunity to offer my appreciation and support.

Within the past year, we have seen a series of continuing efforts from different sectors in society to stem out the deep-rooted problem of corruption. Let me start with the Conference co-organizers. The NCCC has quickly moved ahead to demonstrate its commitment to fulfilling its mandate. In the public sector, the Office of the Civil Service Commission (OCSC) has been playing a key role in public sector reform and has supported surveys on corruption perceptions of households, businesses and the public sector. The TDRI has supported and worked for the promotion of good governance all along.

Private businesses, particularly professional groups in the construction sector, have been talking more openly about bribes and other mischievous tactics one has to put up with in order to obtain public sector contracts. In addition, movements by the civil society sector have been continual too. This kind of concerted effort must be maintained and fostered, for the fight against a problem as complex as corruption cannot be successfully tackled in a fragmented fashion or by any one particular group.

Corruption is the most severe threat to the Thai society today. The problem has spread to all parts of society and its roots are spreading deeper. Corruption incubates and aggravates political, social and economic problems. The OCSC study[1] reveals that as high as 96.4 percent of companies have experienced giving tea money to state officials. Bribes paid by low-income households[2] are as high as 30 percent of their annual income. On the contrary, bribes paid by middle-income households[3] are lower than 5 percent of income, and households in the highest income group in the survey[4] only pay bribes equivalent to less than 1 percent of their income.

It is clear that corruption leads to unprincipled private and public administration. The country loses tax revenue, while taxpayers have to bear higher costs. More importantly, corruption instigates uncertainties: it stirs social distrust, loss of faith in the rule of law, and disunity among social members. Once the social binding starts falling apart, society is doomed to failure. It will lead to social discontent and low quality of life for the people.

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In my view, we must all recognize that corruption leaves devastating imprints on the lives of all, regardless of whether the individuals are corrupt or honest. In a society where armed guards are needed for the submission of procurement bidding documents, where corruption finds its niche even in the sale of milk or textbooks to primary schools or in the purchase of medicines by the Ministry of Public Health, in a society where the police needs to monitor movements of hired assassins every time there is a general election—in such a society, it is simply impossible for any man, even one who is corrupt, powerful and wealthy, to continue to enjoy the good life forever.

Despite having suffered the chronic disease of corruption for decades, why haven't we succeeded in containing it to a manageable level?

In my opinion, *first*, our anti-corruption efforts have not yet systematically built up effective institutional mechanisms. Generally, we rely on piecemeal solutions, without tackling the root cause of the problem, stressing repression rather than prevention. Moreover, the repressive methods that we stress are not sufficiently effective.

Secondly, social values have changed dramatically. Economic competition and consumerism lead to money worshipping. People believe that money is the cure-all for any problem; whether concerning work, business, or personal life. In this society, a great number of people associate wealth with power; possessing wealth will lead to power, and conversely, power can be used to generate wealth. It does not matter which comes first; just aim to possess wealth and power, and fame and honor are expected to follow automatically.

Thirdly, the distorted social values affect people's sense of judgment. They affect the perception of what is right or wrong, what is good or bad, and ultimately distort the sense of integrity in personal conduct. Corrupt behavior is immoral and unethical behavior, because in the process of corruption, some group will suffer as a consequence of being cheated or taken advantage of.

Corruption is a complex problem. It is linked to the vested interests of diverse groups and has infused into virtually every part of our social life. Therefore, it must be tackled through a holistic approach.

Allow me to share with you a few remarks with regard to a holistic approach against corruption.

First:

We must not view corruption in isolation from other social problems. While corruption is a complex phenomenon that can lead to many other social problems, it is also a reflection of other problems existing in society. As a result, we should view problems of corruption, poverty, education, poor administration in the public sector, non-transparency in the public and private sectors, and even weaknesses in civil society, as problems that are all interrelated. To fight corruption, one needs to take into account these other problems. And vice versa, to solve other social problems, one needs to examine the conditions, influences, and roles that corruption imposes on those problems. Not until we see things holistically will we be able to tackle these problems in an integrated fashion.

Second:

We must understand that corruption is multi-leveled.

At *the personal level*, the fortress against corruption is individual ethics and moral standards. This concerns personal characteristics, upbringing and the socialization process. It has to do with parents, teachers, friends as well as good examples from leaders in society. It is an outcome of a long-term grooming process.

At *the social level*, factors that encourage or discourage corruption are related to social relationships, which involve values, beliefs and social traditions. Patterns of social relations can be influenced by the thinking process and understanding. In my view, one of the top priority is to educate and sensitize fellow members of our society to share a common mindset, or a commonly agreed notion as to what actions constitute corruption, and what do not.

Extortion, bribery, and embezzlement are the obvious cases of corruption. But what about cases that are not so obvious? Let me give some examples. Our society values kindness and consideration. If someone does something good to us, we normally wish to give something in return. That is why we have a term 'gift of good will'. Suppose that Mr. X won a bid without any help from me—it was a clear and clean case of victory. But after winning, Mr. X came to me, supposedly a state official, and presented me with a gift. It would certainly be wrong for me to receive the gift. However, if it was a small token of appreciation, such as a pen, then this may be glossed over. But if Mr. X gave me a car or ten bars of gold, then it is clearly not a gift of good will; and provides me with unjustified benefit, albeit *ex post facto*. This benefit would bind me in future judgements. We may say that we did not ask for it; it was simply given to us, like riding with the tide. However, it is clearly wrong.

Another important issue that many people still only have a vague idea about is the concept of conflict of interest. I think this is a new concept in the Thai society. There is no synonym or direct translation of 'conflict of interest' in the Thai vocabulary, and thus there remain doubts of what it exactly is. Conflict of interest is a situation where there is a clash between personal interests and the public interest. For instance, suppose I held a position of director-general of some public department; the next day I retired and became a member of the Board of Directors of companies that used to be under my supervision when I was director-general. This is conflict of interest. Even if I joined the company two months after my retirement, as manager or chairman, whether it is a liquor or tobacco manufacturing firm or a

finance company, this is unacceptable. Suppose that I were in public service, responsible for approval of architectural blueprints. My salary was meager, so I set up my own company to earn some extra income. I then designed blueprints to which I myself had to give approval. This is clearly wrong. Or if I were a government official whose duty is to audit companies, yet I ran my own business that prepared the accounts of the companies that I, as a government official, would have to audit. That is certainly conflict of interest, and it is wrong. It is wrong because the vested interest could distort my decision as a public servant. Or if I were chief of a police station and then I set up a security guard company to provide services in the area under my jurisdiction, that is also wrong. And we have to accept that every case that I have just mentioned is not just a hypothetical example. All of them are real-life cases that have been practiced for decades, and are still in practice today.

The core theme of conflict of interest thus lies in the separation of public interest from personal interests. Even more importantly, apart from being able to separate the two, one must not let oneself get trapped into a situation where there are risks that personal interests will affect one's decision related to public interest. It is not sufficient to assume that we have good enough judgment, and can use our own individual ethical and moral standard as our protection. On the contrary, we must step out of such a situation, to prevent any accusation of potential conflict of interest.

I have heard people say that we should examine thoroughly the positive and negative effects of corruption. I believe that this way of thinking is based on a gross misconception because any positive effect that corruption might bring would only favor <u>some</u> people or <u>some</u> groups of people at the expense of others, and would cause serious damage to the society as a whole. Indeed, there might have been some notions, probably a product of the socio-political environment in the past, that if our system is very inefficient, then some corruption might help to overcome such inefficiency. In western societies and even in our Thai society, there is an idiom, 'grease in the machine.' However, if the system is inefficient, why not fix the system to weed out the inefficiency? Why resort to another kind of inefficiency and use that inefficiency to further cripple the system? This viewpoint of corruption as 'grease in the machine' must be corrected urgently. This is because once a society starts to conceptualize positive outcome from corruption, or is ready to tolerate corruption—and by using the word 'tolerate,' I mean willing or forced to accept corruption as part of society or culture—then that society has no future. It will be only rotten and eventually ruined.

It is extremely important to combat corruption with ethics, personal characters and the right values. We have to start planting the seeds of these. However, this approach is a long-term process. Therefore, for the problem at hand, we have to foster *corruption prevention at the level of structural mechanisms*. In other words, we must see to it that opportunities for corruption are lessened and that risks are higher. Risks here include both legal and social consequences, i.e., the risk of losing one's reputation and social status. In English, it is called "social sanction." There is no such term in the Thai language. The richer one gets, the more famous one becomes, despite the fact that we all know—with no evidence of a receipt of his or her corrupt transaction—the origin of wealth of that person. Corruption in our society is almost a non-risky business. We must design effective measures to increase risks and costs of corruption.

The law is an important mechanism to combat corruption. By referring to the law here, I do not mean series of laws with a purpose to prosecute. I refer to the law as a formal state apparatus in setting order and determining social relationships.

A major weakness in using the law to fight corruption is the perception that the law is there to repress and prosecute, instead of viewing the law as a tool for monitoring and prevention. A negative effect of using the law solely to repress corruption is that honest people who follow regular channels may be in a difficult position, facing inconveniences and unable to produce effective output. On the other hand, the dishonest, with much experience in avoiding rules and regulations, may still be able to find ways to bypass the law. As a result, any framework set by the law must facilitate the honest to be able to live their life with dignity and with not too much difficulty.

However, the law alone is not enough. What a society needs is <u>the rule of law</u>. That is, intentions, substance and enforcement of the law must be fair to all parties and must take into account benefits of the general public, not only certain groups of individuals. The law must ensure equality for all, and must be clear and predictable. In addition, the law must not leave decision-making power only in the hands of state officials, but must encourage widest public participation.

The present Constitution, the supreme law of the nation, has by intention created both preventive and repressive anti-corruption mechanisms, as will be presented to you in the video presentation.[5] The Constitution has designed an additional mechanism of check and balance, apart from the executive, the legislature and the judiciary power—that is, the setting up of independent organizations to monitor the use of state power of the three branches. The Election Commission monitors fair and honest elections. The NCCC monitors and acts on corruption of those holding political power and high-level officials. The State Audit Commission oversees and audits public financial spending and management. The Administrative Court provides room for the public to file formal cases against corruption by state officials. The Constitutional Court arbitrates cases of constitutional disputes. The Supreme Court of Justice's Criminal Division for Persons Holding Political Positions adjudicates criminal offense of corruption cases by those holding political office. The Constitution also provides that the Senate, with no linkage with political parties and

elected directly by the people, adopts the role of a monitoring council.

In any case, legal mechanisms alone, no matter how well-founded the rule of law is, do not suffice in the fight against corruption. We thus must establish and promote different factors in the Thai society that will support anti-corruption mechanisms.

What are these factors?

1. The society must have access to timely, complete and accurate information. To lay the same version of information openly on the table and to have a formal process to support such openness lead to clarity in decision-making. Different parties will then be able to debate or negotiate based on reasons and factual data. Disclosure of information will make corruption more difficult, as the people will know in time if some dubious incidents or deals occur. Access to timely, complete and accurate information is also an important tool in ensuring transparency.

In accessing information, both givers and receivers of information must be aware of their roles. State officials must understand that disclosure of information is a duty. Whatever the state knows, the people should know. This is because the ultimate goal of state administration is to benefit the people. As a result, disclosure of information is normal, and the government's secrecy can be only exceptional or limited to special cases. At the same time, however, determination of which cases are exceptional or special must be made clear to the public and officials, not being left to the discretionary power of the government officials alone.

2. The society needs to be transparent, for corruption usually conceals itself in the dark corners of the social milieu. In any case, mere disclosure of information by the state is not enough. The state must be able to explain to the people the rationale behind its decisions, and must develop and make use of mechanisms to support people's questioning in the event of corruption-prone incidents. The Official Information Act, disclosure of the Cabinet members' assets and liabilities, disclosure of parliamentary sessions, and disclosure of the list of donors and amounts of donations to political parties—all these exemplify the mechanisms devised to create transparency in the society.

3. The society must have accountability mechanisms. Without these, creation and sustainability of transparency are unlikely. Vice versa, transparency without accountability mechanisms hardly gets us anywhere. Accountability and check-and-balance mechanisms set up by the Constitution only constitute one side of the coin. There is another side to accountability mechanisms that needs to be established in the Thai society—that is, a spirit of monitoring in the hearts and minds of alert citizens. More often than not, a civic monitoring process results in news that this person is no good and that person is no good, or this person accuses that person. At times, people in the Thai society may get weary of these accusations and question possibilities of ulterior motives.

To me, an ulterior motive is not the point. It is natural for different groups to have different vested interests. But in a society where a process of civic and state cross-examination is legally endorsed, an act of 'accusing' or 'exposing' any person is made formal, with a clear origin and a predictable procedure, not just being aired out as gossips and fading away like waves on a shore. We, as members of society, must make use of such a formal monitoring process wisely, separating intentions of those requesting an investigation from the investigative and monitoring process and the truth behind incidents or persons being investigated. Disclosure of facts via accountability mechanisms is a society's shock treatment method, as it reveals problems and provides us with opportunity to correct them. I used to refer to an example of Singapore. In Singapore, the anti-corruption unit[6] investigates all petitions and accusations. I talked to the authority in Singapore, referring to the case of Thailand in a sense that our approach in the investigation of petitions may be partly due to our procedures and partly due to fear of unlawful threats from those in power. I asked them if the authority in Singapore would start an investigation on a case, should the petition be anonymous. They said they do, whether the requests are signed or unsigned, signed as real names or pseudonyms, ill-intentioned or out of good will. They said they investigate all cases filed. I asked them whether the workload would be too much. They said no, because proving that an accusation is untrue or unfounded does not take too much time. Anonymous letters are anonymous letters. It is not so difficult to cross-check on anonymous letters. This is the opinion and attitude of officials and judges in Singapore. Yet, they said, one in a hundred of those anonymous letters could be true, and the one that is true could be a major case. This is an issue to which we ought to give our serious thought.

4. A society needs an independent judiciary. The judiciary, or judicial system, here refers to the police, prosecutors, courts and judges, and all agencies whose duties involve law enforcement against corruption. The judicial system must not be influenced or manipulated. It must be free from corruption or external pressure, efficient and capable of probing into this complex problem. To that end, qualified experts are required, in the fields of police, accounting and investigation of evidences. Updated, useful and effective databases and information technology systems are needed. In addition, all units need to coordinate effectively.

Equally important is the fact that genuine corruption cases must end with wrongdoers exposed and appropriately punished. Society needs to be shown that corruption does not pay and is definitely not worthwhile. But at the same time, the society must not fail to reward honest people, not only in monetary terms, but also reward with honor, with pride that they are noticed and praised by society.

5. Society needs independent media, which are corruption-free and do not accept money from or doing favor to any faction. The media, particularly columnists,

must be responsible to both readers and people in the news. The news must be true and fair, and make clear distinction between facts and opinions. From what I have observed, a large number of media still present news like a flash in the pan. It is easy for an issue to become news, and equally easy for that same issue to cease from being in the news. As a reader or viewer, I would like to know clearly the conclusion of each story.

Nowadays, much attention has been given to investigative reporting as an effective tool in exposing corruption. But investigative reporting requires skills and expertise different from reporting of other news. This is because dubious sources of corruption are scattered and hidden in different kinds of information. Investigative reporters thus need to know which piece of information is a lead, and how to pull relevant leads together with the right mix that will bring the story to a proper conclusion. Recently, we have seen pieces of effective investigative reporting in our country, but no concrete measures have been pursued to support this kind of reporting. In the Philippines, there is a fund to support investigative reporting. There, reporters are able to work independently and sell their news stories and scoops, whereas in Thailand, a reporter once told me that she actually worked for an investigative reporting section, but when the political section was short of personnel, she was assigned to help and thus had no time for investigative reporting. An executive editor told me that the issue of investigative reporting depends on the priority given to it by individual editors. But if we really wish to establish effective investigative reporting in our country, we do need a more pronounced incentive system.

6. Lastly, the society needs to foster public participation, which is a powerful tool against corruption. Why? That is because ultimately the people are the losers. Even those who are corrupt will certainly be negatively affected by corruption committed by others.

Then who are the people? The 'people' are none other than you, me and every single person in this society. Politicians, government officials, business people, farmers—these are 'the people.' Once these politicians, government officials and business people take off their professional hats, they are all members of this society. Legal mechanisms in support of public participation are not enough. 'Providing' the rights, 'exercising' the rights, and 'supporting' people who exercise their rights are three different issues. In the fight against corruption, the people must be aware and alert, and must feel an urge to know and to monitor state decision-making that affects our lives. The people must support participation of others and must cooperate in building a strong civil society that is moral and ethical and has the right attitude toward the public. The society must expedite the provision of basic welfare, educational opportunities and good quality of life in order to lay the groundwork for creative public participation. Ultimately, the fight against corruption is not the government's agenda alone; we have to make it the people's agenda.

The last observation that I would like to share with you today is that, if we take a look at the Corruption Perception Index by Transparency International, we will see that top perceived corruption-free countries on the list, e.g., Finland, Denmark, Sweden and Canada, share some common features. All of them have developed a participatory and functioning democracy, both in substance and process. They have set up mechanisms which are responsive to good governance. These are the supportive elements that I urge Thailand to develop urgently. On the other hand, countries which are considered to have a high level of corruption are either governed by authoritarian leaders or are at political and social crossroads, with weak mechanisms essential for good governance. Nigeria, Yugoslavia, Ukraine and even Thailand, are some of the examples in this latter category.

I have mentioned many times elsewhere that for a society to attain sustainable development, democracy and good governance must serve as the two legs which move the society onward. Democracy and good governance allow state administration to embody both ideology and process that facilitate citizens to lead their lives with equality and according to their capability. They also give the state a tool to accurately assess its citizens' genuine happiness and suffering.

The fight against corruption is not an easy task, and by no means a short-term issue. It may bear fruit in ten or twenty years, or not even in the lifetime of some of us present here. But we must not forget one thing: every ambitious job requires patience. I find our Thai society odd in the sense that it is tolerant to some issues but appears impatient to others. Having made that comment, I would like to keep reminding you that our society must not tolerate corruption, but must tolerate the process of fighting corruption. We must start our process by promoting democracy and good governance incessantly, precisely, and with eagerness and understanding. We have to support basic social welfare, such as education and people's well-being. We have to take care of the poor and the underprivileged, foster their participation and see to it that they have their share of the wealth of the nation. And, they must not receive that share as beggars, for the poor and farmers are as dignified as any other groups. If any society or any government fails to honor human dignity of the poor and those who have been underprivileged all their lives, then problems of conflicts will persist. We have talked about being 'cheated' and being 'abused' in the process of corruption, but we must admit too that the poor and farmers in Thailand are abused by the state and the society all along. If we cannot overcome this, conflicts in the Thai society will remain. Therefore, most people in the Thai society need to change their way of thinking, to adopt a new paradigm. We have talked about poverty; that is not enough. We have talked about poverty alleviation; that is also not good enough, if we are not fully cognizant of the fact that the poor have human dignity as much as others. Do not see them at the receiving end and we at

the providing end. We have to see them as equals. If in our hearts we divide people into social classes, we will never be able to solve the problem of poverty. We must promote basic welfare services, such as education and good quality of life. Once these are achieved, corruption and the corrupt will find no place in our society. When will that day come? It depends on our taking initial steps today.

Thus I would like to express my hope and expectation that you will make full use of the following day and a half to establish a clear understanding of corruption problems that confront us. But let me stress that our purpose is not to recount problems or reveal incidents. We have a more challenging goal, and that is, joining hands in shaping our future, in designing concrete preventive measures against corruption; all in all, to jointly create a just society that honors us exactly the way we deserve to be honored.

I take this opportunity to declare the 2000 Year-end Conference open.

Thank you.

Endnotes

[1] See Nipon Poapongsakorn, Supachai Yavaprabhas, Pasuk Phongpaichit, and Sauwanee Thairungroj. 2000. *Anti-Corruption Strategy in Thailand in the Year 2000*. Bangkok: Thailand Development Research Institute.

[2] Households with monthly income of 2,501-5,000 Baht.

[3] Households with monthly income of 10,001-20,000 Baht and 20,001-50,000 Baht.

[4] Households with monthly income of more than 100,000 baht.

[5] A 14-minute video presentation on "New Anti-Corruption Mechanisms as Founded by the Present Constitution." The video and full report on the topic are available at the Publications Office, Thailand Development Research Institute.

[6] The Corrupt Practices Investigation Bureau, Singapore.

AMC: An Idea Whose Time Has Gone

Ammar Siamwalla*

questions why Thai taxpayers should pay for a nationalization of bad loans.

Corporate and bank restructuring is now at a dead end. After three years of painful sweating, everyone from the Finance Minister on down is utterly exhausted, and the numbers on non-performing loans (NPLs) have stopped showing rapid improvement. What was once considered a radical idea, the nationalization of bad loans, is now being mooted, noisily by the Thai Rak Thai Party. Even within the ruling Democrat Party, there is a push for action along these lines, in effect repudiating the policy of its own finance minister.

A MICRO LOOK

The proposed nationalization of bad loans is to be effected through the creation of a publicly owned asset management company (AMC) that will take bad loans off the banks' books, enabling the banks to capitalize faster, and hopefully, get on with granting new loans.

Moving assets around between owners implies an exchange. Since the exchange will not be like with like, good assets being in this case given for proven bad assets (i.e., the bad loans), the two parties to the transaction will have to value the assets, particularly the bad ones. Each will come to a conclusion of the problem using assumptions about the original borrower's income prospects, and his ability and willingness to part with the money. The seller of the (bad) assets, in this case the banks, usually will have a better estimate of their value than the buyer, the AMC, as the former has sweated over the debt negotiations with the borrower over the last several years. Since the buyer knows the borrower less well than the seller, he will, if he is smart, tend to mark the asset down to a level below what the seller is willing to accept. Consequently, the bid price will tend to be less than the offer price, and few transactions will take place voluntarily. This phenomenon is known in the economics profession as the problem of asymmetric information.

At the present state of play, only one private bank has voluntarily unloaded its bad loans completely to a third party, that is, the DBS Thai Danu Bank which had to take a deep discount. Another, the Thai Farmers Bank, has formed a joint venture with Goldman Sachs to set up an AMC to manage its bad loans, with the latter being essentially paid by the results achieved. A few others have set up wholly owned AMCs, which are really internal management devices of little consequence to the rest of the economy.

With attempts to manage its bad loans, the Thai Farmers' Bank has formed a joint venture with Goldman Sachs to set up an AMC.

What if the government is to be the AMC for the whole financial sector? The first thing to note is that the problem of asymmetric information would not go away. If the government is to take proper care to protect the taxpayer's interests, the right strategy for the government's AMC when estimating the asset value is also to be conservative relative to the selling bank's valuation, which *partially* removes the seller's incentive to sell. But that partiality has a further consequence.

Consider the selling bank's portfolio of bad assets, with its own valuation for each item. As mentioned, the AMC will tend to have a lower valuation, but not always. Clearly, it would be a smart move for a selling bank to unload those assets in which its valuation is lower than the AMC's. The AMC will then be saddled with only those items where it has been generous in its estimate. The probability that it will be saddled with

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loss-making transactions is therefore very high. This phenomenon is known as the adverse selection. It is a consequence of asymmetric information.

I am assuming so far that the AMC has been conducting its valuation exercise in good faith. But as should be obvious by now, valuation is a highly subjective exercise. It is possible for the AMC to be deliberately generous in its valuations, either because its officials are corrupt, or systematically as a matter of policy, to sneak in a subsidy for the non-performing borrowers. Either way, the outcome from the point of view of the taxpayers, who will ultimately bear the burden of this subsidy, cannot be satisfactory.

I have been biasing the argument in favor of AMC in another respect. I have been assuming that the transfer of assets from the banks to the AMC will not change the behavior of the borrowers. Nor will the AMC as the new creditor behave any differently toward the borrowers than the selling banks. From past experience, this is a questionable assumption. Remember that the AMC will be a state-owned entity. We can therefore use the behavior of state-owned banks to provide a clue as to how the AMC will be run. Now, state-owned bank officials are particularly conscientious in their attempts to collect from the debtors. Debtors and other creditors are united in their complaint that state banks are excessively rigid in their approach to debt renegotiations. And that conscientiousness in turn arises from the fact that the officials are held liable if they take specific actions that are detrimental to the interests of the banks to which they belong, even though these actions are in the long run in everyone's interest, including that of their banks.

In any case, despite their rigidity in application, the outcome in terms of the state-owned banks' ability to collect from their debtors is patently worse than that of private banks. With this record, it takes a lot of gall to suggest that bad assets from private banks be transferred to a state-owned entity.

THE MACRO COUNTER-ARGUMENT

The micro-economic exercise above looks at the intractable problem of valuation transaction by transaction and concludes that it would prove fatal to the AMC concept. Advocates of the AMC will argue that the micro approach misses the point. The major argument in favor of nationalizing bad loans is the expected macroeconomic consequence, with the recent Korean experience cited as a model. I shall return to the Korean case later, but let us sort out the logic first.

Consider again the problem of the valuation of the loans to be exchanged. A key ingredient in calculating their values is the expected growth of the economy, because that has a significant impact on the borrower's income prospects. If everyone's expectation is that the economy will not grow very fast, as is the norm now, the value of the loans will also be low. The low value of the loans in turn implies that the banks would have a bigger recapitalization problem. They would therefore be more cautious with lending out new money for investment. That caution would also lead to a low growth in the economy, further justifying the low valuation on the loans.

Now, supposing that by magic, someone could change the expectations of low growth in the economy, and sells everyone on the idea that good times are here again. Borrowers' income prospects would leap upward, and the loan valuations would then be higher. Less capitalization would be required of the banks. They would then be less stingy in their lending. Money would then flow again, stimulating the economy, and justifying the growth expectations and therefore the higher loan valuations.

The magic that may cause this dash-for-growth model to work, so the argument goes, is for the government to buy the bad loans from the banks at a generous price. The banks will then have less recapitalization burden, lend more and thus generate the growth that will lessen the burden of recapitalization, improving the quality of loans and justifying the higher price paid. This process may look at first like a subsidy for the purchase of the banks' bad assets, but that is a subsidy based on a valuation that assumes a low-growth scenario. If a higher growth can be achieved, the low-growth valuation would turn out to be an underestimate, and what appeared as a subsidy in the beginning would be recouped later. The taxpayers will not have to shoulder the burden after all.

This magical ability to levitate the price of bad loans rests on a long chain of logic, and like any argument of this kind, requires a piling up of assumptions upon assumptions. Here I would concentrate on the most crucial one. That assumption is: *bank lending is currently constrained only by the banks' lack of capital, and that shortfall is due to the large amount of NPLs for which they have to find adequate reserves.* There is an element of truth in this, but it is only a partial truth. Banks are sitting on a great deal of money right now, and their unwillingness to part with that money is only tenuously connected with the lack of capital. I would argue that it is due to the lack of *effective* demand. I shall explain further below what I mean by effective demand for loans.

It appears that the banks' clients fall into two quite distinct groups. One group includes the currently non-performing borrowers. Within this group, there is a further subdivision, one group is completely broke and will remain broke whatever happens to the economy, either because their owners have already sucked the companies dry, or because they made genuine mistakes, for example, by not hedging their foreign loans. Their capital is exhausted, and no self-respecting banker would lend them new money, unless someone put in new capital to make up for previous losses. The other group still has some prospects of survival, but they are badly undercapitalized, and over-indebted. They also need new capital, before they can get new loans. Trying to get the banks to lend to such firms is futile.

Thailand is an over-indebted country despite a saving rate that is quite high by international standards.

The other group not in the NPL category consists of firms that are still healthy financially. Unfortunately many of them are also flush with cash, which would normally be tied up in investments to cope with a growing economy. No growth means little new investment (remember that excess capacity is still quite high), and lower investment means a great deal of cash for those companies. The very top companies that are still investing and expanding and therefore need loans have decided to bypass the banks altogether. With the margins that banks charge to recover from their losses, it is much better for these companies to go directly to the corporate bond markets to raise money.

This is what is meant by a lack of effective demand. The word "effective" here is a crucial qualifier. Many companies claim that there is a demand for loans and that banks just refuse to lend, but few companies have enough equity base to satisfy the banks' much more rigorous standard. As long as this situation lasts, no AMC will get such borrowers out of their predicament.

The mistake of those who think that an AMC would help lies in the belief that only the banks are under-capitalized. Actually, the banks have gone some ways toward an adequate recapitalization to meet a much more stringent standard than previously. It is the non-financial corporate sector in Thailand as a whole that is under-capitalized. This is not just a post-crisis phenomenon; it has always been so. Companies were able to get away with little equity and lots of debt, because the high economic growth eventually lessened the burden of those debts. But a high leverage of course means that companies are highly vulnerable to economic hiccups. Thailand had a few such small hiccups before 1997, and when they did occur, as in the early 1980s, some companies had gone down, but most recovered. This time around, however, the downturn was very deep and the hurt was compounded by the sharp devaluation which wiped out the equity of many companies that had borrowed extensively abroad. It is this decapitalization of the companies that is the root cause of the problem, far more so than the decapitalization of the banks.

Thailand is an over-indebted country despite a saving rate that is quite high by international standards. Actually, the high level of indebtedness is *because* of the high saving rate, for our savers have generally contented themselves with putting their money into bank deposits, making our banks the most powerful institutions in the economy. Banks however can only lend, they do not provide equity capital. We thus end up with a savings-rich, but equity-starved economy.

THE KOREAN COUNTER-COUNTER-ARGUMENT

The Korean approach to their financial meltdown is often cited as an example. There are points of similarities between the Korea and Thailand. Korea's companies were and are as highly leveraged as Thailand's, and therefore were as dependent on bank loans. And when its economy crashed, the troubles of its corporate sector spilled over to the banking sector, just as here. But as we shall see later, there were also many differences.

What did the Koreans do, and did they succeed in solving their economic and financial problems? Briefly, the Koreans have been much more aggressive in tackling their financial problems, and have done so from the very beginning of the crisis. They moved quickly to add capital to the banks, and set up the AMC to buy out the bad loans. Most importantly, having all but taken over the banks, *the government directed them to continue lending to the corporate sector, but closely supervising where and to whom the loans are to be given.* It has consequently intervened extensively in restructuring not only the banks, but the corporate sector as well.

The result of all this is that the economy rebounded sharply, and has been doing extraordinarily well for the last two years. The recovery itself has, of course, reduced the extent of the decapitalization of the corporate sector, but it cannot be said that Korean companies are healthy. Nor are the banks. Many of the firms are on the auction block right now, most notably Daewoo Motors, and the government is finding it difficult to unload them.

Clearly, the Koreans have followed the dash-for-growth model, and apparently successfully up to this point. But is the recovery sustainable? And have the banks' problems been solved? The jury is still out on the first question. Indeed, the verdict will have to wait until the answer to the second turns into an affirmative. At the moment, Korean bank problems are far from being resolved. As of last count, the government is still pouring taxpayers' money into the banks.

SHOULD THAILAND COPY FROM KOREA?

Before going down the Korean path, we should note some essential differences between Korea and Thailand.

- The Korean economy is very strongly dominated by a handful of extremely large firms, i.e., the *chaebols*, facilitating government control of the direction and enforcement of loans. Our private sector is highly fragmented, making our (and the government's) knowledge of the economy much less secure.
- The Korean bureaucrats have had a much longer experience in controlling the economy at a very detailed level, and have built up a highly refined information system. Our government is, more often than not, blissfully blind to what is going on in the economy.
- Because of these two points, the Korean government can be and has been ruthless in forcing companies to reorganize, and selling off various assets. Any action to solve a problem requires three steps: knowing what the problem is, knowing what to do and then exhibiting a willingness to do it. Our government cannot tackle the problems of most firms because it cannot even pass the first step.
- Arguably, the damage done to the Korean economy during the bubble in the form of over-investment has been considerably less—for one thing, Korea is technologically far more advanced than is Thailand. For the set of goods and services that it produces and exports, it operates in a less crowded global environment than does Thailand, which now has to withstand fierce competition from other crisis-hit countries as well as new competitors such as China. Our firms' profit margins are therefore more strongly squeezed under almost any growth scenario, affecting their ability to service their debts and to survive.
- Above all else, the Koreans attacked their problems very early on, before the decapitalization of banks and companies had become total. We are now at a very late stage. Many companies are already well beyond repair, and the injection of more credit (without any increase in equity) would be useless.

It is a good idea to learn from other countries' successes. However, it is wrong to think of economies as uniformly constructed black boxes. Policies that yield certain outcomes in one country do not always yield similar outcomes in another. Nationalizing bad loans, accompanied by pro-active corporate rehabilitation policies may have worked in Korea (and even that is not a foregone conclusion), but similar policies will surely not work here in Thailand.

Globalization and Institution Building*

Chalongphob Sussangkarn**

Prior to the economic crisis in 1997, there was tremendous optimism on the prospects of most of the East Asian economies. Through outward-oriented development policies and using exports as the engine for growth, the East Asian economies experienced long periods of sustained high growth. Their development strategies were praised from both within the region and outside, and the "East Asian miracle" was drawn upon as an example for other developing countries to learn from and emulate. However, it would be fair to say that eventually there was too much optimism, even "irrational exuberance" about the strengths and prospects of these economies. While the East Asian economies had integrated into and benefited from the globalization process, there was insufficient understanding of the volatilities and risks arising from globalization. Comparative advantages were changing rapidly as more and more countries embarked on the export-led development path, and greater integration into the world's financial and capital markets led to increased risks from the volatile nature of these markets. Short-term external debt grew rapidly, particularly in the three crisis countries that eventually had to ask for IMF assistance: Thailand, Indonesia and South Korea. By 1995, the ratio of short-term external debt to official foreign reserves increased to more than 100 percent in Thailand and more than 170 percent in Indonesia and South Korea. In Thailand, the futile attempt to defend the currency by using huge amounts of foreign reserves simply accelerated the country's insolvency in terms of foreign exchange, and as confidence in the region plummeted Indonesia and South Korea were soon drawn into what became a regional crisis.

While numerous problems still remain to be cleared up, outputs in the region have been increasing and the recovery process is underway. However, as a direct result of the crisis, confidence on the future prospects for the region is now much more restrained. Questions are being asked about the appropriate development strategies to be pursued in order to bring about sustained broad based growth for the future while protecting against future crises. How best to benefit from globalization while protecting from the risks, and how to strengthen the institutional and governance structures so that they can better cope with the challenges of globalization? What makes things even more complicated is that, while the East Asian economies are striving to bring about a sustained recovery, the socio-economic environment in which they have to operate are changing rapidly. Challenges arising from the rapid emergence of the information technology-based new economy have to be dealt with. At the same time, the traditional governance structures are being increasingly challenged by strong participatory demands from civil society, whether at the national or global level.

Given the complexity and multi-dimensional nature of the development process, I do not believe that there are simple generalizations concerning how countries should meet these challenges. This is partly because issues concerning globalization and governance are themselves multi-dimensional, and different approaches will be needed depending on which aspects of globalization and governance one is focusing upon. The socioeconomic and political context of each country is also important, and each country will need to find solutions that are workable within its own environment.

MULTI-DIMENSIONAL ASPECTS OF GLOBALIZATION

While it would be foolish for a country to turn its back completely on globalization, as the potential benefits can be large and development outcomes for countries that have chosen not to integrate into the world economy have been fairly dismal, the risks and benefits from various aspects of globalization need to be carefully evaluated in shaping the development strategies. At least five aspects related to globalization can be distinguished.

1) Globalization of Trade. East Asian economies have been in the forefront in terms of integrating into the world trade system. Their degrees of openness are generally higher than in other parts of the world, and export has been used as a main engine for growth. Generally, this strategy is likely to continue in the future, though dubious nationalistic desires to develop world-beating domestic industries through protectionism still persist in some countries. However, countries have to be

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wary that competition in world trade is becoming fiercer and fiercer. More and more countries are trying to follow the export-led development strategies, so that comparative advantages based on transitory factors such as cheap labor cannot be expected to be maintained for long. Countries will need to identify and focus more on their comparative advantages that are based on more permanent factors. For most of the food exporting countries such as Thailand, one important source of pro-poor sustainable growth is the true globalization of trade in food and agriculture. It is ironic that while the more advanced countries have been calling for greater acceptance of globalization by the developing countries, they have not been willing to put their own food and agriculture sector to the test of full globalization. Other sources of non-tariff barriers, such as linking trade with environmental issues and labor standards, also put a strain on the move toward freer trade at the global level.

2) Globalization of Production. Much of world trade is controlled by multi-national companies, who have numerous options when it comes to locating their production facilities. Countries have competed intensively in offering all kinds of incentives to attract these foreign investors. Here again, countries should be wary about the foot-looseness of many industries. Incentives alone will not keep these industries in the country for long, as equally attractive incentives can be offered by other competing countries. There is, in fact, a danger that in the intensive competition to attract foreign direct investment, the net domestic value added to be gained from these investment may not be that much more than the foregone value of incentives given. In trying to make sure that these investment are tied to the country in the longer-term, countries need to develop the supporting infrastructures, whether physical, technological, human, or regulatory, in order to create a domestic environment conducive to efficient production, distribution and marketing. At the same time, as much beneficial spill-over from foreign direct investment into the domestic economy needs to be harnessed as possible, including technology transfer, supporting industries and managerial know-how.

3) Globalization of Currency and Financial Markets. For Thailand, the beginning of the end of the "economic miracle" came from the mistaken belief that integration into the international currency and financial markets would bring similar benefits as integration into the world trade system, and that there are no serious risks. The macroeconomic policy institutions in the country were simply not ready for financial liberalization, neither in terms of the information needed for monitoring and surveillance of potential dangers, nor in terms of understanding the risks. Prior to financial liberalization, most foreign debt was public debt, and there were intricate mechanisms for managing public sector external debt, whether they concerned the total size, the maturity profile, or the currency composition of the debt. However, almost nothing was available for managing private sector debt. In fact, as the economy began to overheat in the early- to mid-1990s, a high interest rate policy was pursued in conjunction with a fixed exchange rate. This simply led to a rapid increase in short-term debt, and instead of worrying about the size of these debts, the authorities tended to point to the increase in foreign reserves as signs of economic health. Foreign reserves were still looked at in terms of how many months of imports they could support, and there was little recognition of the necessity for reserves to back up the country's short-term foreign debt. Of course, private sector institutions were equally to blame for bringing in so much external debt without adequate analyses of the potential returns on the investment financed by these debts. However, it would be a mistake to blame only the domestic private sector, as foreign lenders did not show any more prudence in lending huge amounts to the country without adequate assessment of the risks.

As an outcome of the crisis, a consensus seems to be emerging in the region that, in order to achieve sustainable development in a world of highly volatile currency and financial markets, countries need instruments to manage capital flows, particularly short-term capital flows. The examples of Malaysia and Hong Kong, which directly intervened in the capital and stock markets to avert potential crises, also show that non-traditional approaches can work. However, a regional framework for the management of capital flows needs to be worked out. A system is needed so that risks can be minimized, while benefits from the access to the short-term capital market can still be achieved.

4) Globalization through Information Technology. The rapid emergence of the new economy is posing additional challenges to the East Asian economies. As many of these economies are only just beginning to emerge from the crisis, the resources available to upgrade the technological base of the country to integrate into the new economy are severely limited. In Thailand, simply to get computer access to a majority of the students in public schools would require enormous amounts of resources, which, given the large increase in public debt as a result of dealing with the crisis, are unlikely to be available for many years to come. Access to information technology is currently limited to those from well-to-do families, which will put additional strains on attempts to spread the benefits of development as broadly as possible. Such developments as e-commerce may also substantially increase the foot-looseness of many industries in terms of production locations.

5) Globalization of Cultural Values and Lifestyles. This is, of course, a sensitive, though legitimate issue. It is tied to other aspects of globalization, particularly the rapid global linkages provided by information technology. Cultural values and lifestyles have never stopped changing ever since people from different cultures came into contact with each other hundreds, or even thousands, of years ago. Yet the pace at which this is happening now is far more rapid than anything seen before. The challenge for virtually every

nation today is how to maintain its cultural identity while adapting to inevitable changes. International understanding of the sensitivity of this issue is also important. Many East Asian economies need to carry out numerous reforms of their socioeconomic systems, whether in governance or institution building, in order to lay the foundation for more sustainable development in the future. However, these reforms must be advocated and implemented carefully to avoid creating an erroneous public perception of external coercion for narrow economic gains, which could backfire by stirring up irrational nationalistic sentiments that will hinder the reform process entirely.

Institution Building

Numerous types of institutional reforms have and are being carried out as a result of the crisis, whether these involve reforms of the macroeconomic policy making institutions, broader public sector reforms, banking reforms, legal reforms or reforms of corporate governance. In Thailand, these have come on top of numerous constitutional reforms that were started prior to the crisis in reaction to the existence of widespread money-politics, leading to vote buying and other corrupt practices. In addition, the 8th Five-year National Development Plan, covering the period 1996-2001, also stressed the need to empower the people, to create greater transparency and people participation, and for devolution of power. With all these reforms, the country has been experiencing enormous "reform fatigue." However, many positive developments have emerged, such as improved electoral processes, more stringent political checks and balances, and greater transparency in public information and macroeconomic policy making. As the reform process continues, the country should emerge better able to cope with the challenges ahead.

At the regional level, unexpected rapid changes have come about as a result of the crisis. The ASEAN+3 group, consisting of the 10 ASEAN countries plus Japan, South Korea and China, have taken the first step in developing more concrete regional monetary cooperation arrangements, starting with the so-called "Chiang Mai Initiative," which laid the framework for foreign reserves swap arrangements between the ASEAN countries and the three northeast Asian partners. The initiative signifies a willingness of the group to work together to forge greater cooperation in order to prevent and deal with future economic crises that may affect the region. It exhibits a broad consensus among the group that East Asian countries need to cooperate more closely in order to protect themselves from volatilities and risks arising from international financial and capital markets and ensure future sustainable economic development for the region. While some may view the ASEAN+3 development as "East Asian Regionalism," I believe that the development is important since it is unlikely that each country can alone cope with the volatilities and risks arising from fluctuations in the international currency and financial markets. Even the major economies have difficulty in preventing large volatile exchange rate movements of the major currencies; US dollar, Yen and Euro. For a small-medium sized economy such as Thailand, these volatilities exert tremendous pressures on exchange rates and macroeconomic management. Thus, while the crisis has led to much institutional reforms in the various East Asian economies, the most significant institutional change may in fact eventually develop from the trend toward closer cooperation and integration of the East Asian economies. Given the historical context of the region, the monetary cooperation initiatives have developed at a much more rapid pace than could have been expected only a few years ago. The impetus obviously arose from the crisis, but the outcome could lead to a much stronger and more resilient East Asia for the future.

Thai Credit Market Failures: The 1997 Aftermath

Olarn Chaipravat*
Pongsak Hoontrakul**

I. INTRODUCTION

Thailand's full-fledged financial crisis which began with the baht float on July 2, 1997 has devastated its economy. The resulting massive devaluation has directly weakened the balance sheets in both financial and non-financial sectors and led to a significant decline in household wealth. Furthermore, collateral value has declined. This has caused a worsening of the asymmetric information problem and exposed the financial system's inexperience in rehabilitating the balance sheets. Banks are cutting back on lending to preserve their capital and liquidity against future uncertainties. Once the economy is caught in a liquidity trap, banks face a serious selection problem to locate creditworthy borrowers as well as a potential moral hazard—misuse of capital. When less funding is available to the productive real sector, adverse effects on the economy inevitably follow. Unless and until the financial system overcomes its own market failures and develops ways to extend credit properly, the economy cannot recover and attain self-sustainable growth in the long run.

This article addresses the microeconomic problems surrounding the Thai credit market and is structured as follows. The next section examines shifts in the sources of funds for firms at different stages of their life cycle, motivated by risk sharing and information difficulties, with particular reference to the role of the banks as performance monitors. Issues related to non-performing loans (NPLs), financial fragility and systemic risk are presented in the third section. Small and medium sized enterprises (SMEs), which account for over a third of all NPLs, pose a particularly serious threat to Thailand's credit system, due to the lack of proprietary information, and the sharp decline in the value of their collateral. The fourth section examines problems related to the workout of existing loans, and goes on to propose means of reviving the credit market, by employing the value chain approach, by rejuvenating SMEs, and by a pump-priming policy aimed at the housing market. Retail credit liberalization, nation-wide subsidized housing projects, a value chain system and a limited credit guarantee scheme are among the macro- and micro-economic proposals put forth in this paper to create incentive compatibility among stakeholders.

II. INFORMATION PROBLEMS, RISK SHARING AND SOURCES OF FUND FOR FIRMS

In small and open emerging economies such as Thailand, even in normal times, financial markets are far from complete and perfect. There are hardly enough market participants and depth to provide the ideal conditions for perfect competition. Asymmetric information is a common problem. There thus emerge formal and informal financial intermediaries (e.g., banks, venture capitalists, informal fund providers and mezzanine financiers) to provide delegated monitoring service to reduce risk and to overcome the information problem. Their roles differ in importance over the life cycle of firms, as will now be discussed.

1. Sources of Capital for Firms: Figure 1 illustrates the likely sources of capital for a growing firm under normal economic conditions, highlighting the correlation between firm size and information availability over the firm's life cycle. As more information about the firm is readily available and verifiable, the funding sources become more sophisticated in stages as follows:

1.1 Start Up Stage (Stage 1): In the initial stage, the firm is usually very small with no track record, no collateral and no source of capital except 'angel' or seed money (e.g., start-up capital provided by the owner, insiders, peers and relatives, etc.) and human capital.

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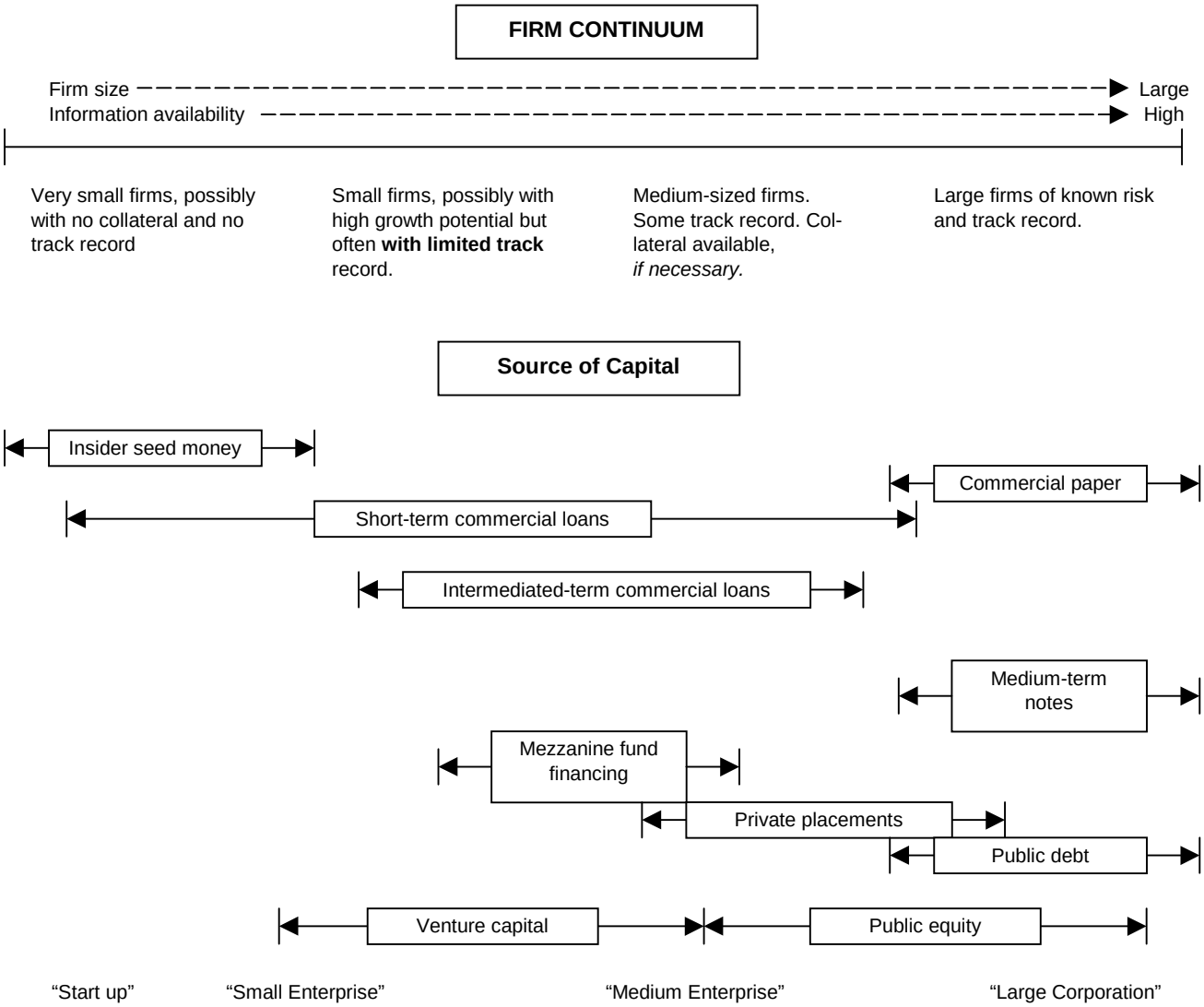
The authors thank Dr. Ammar Siamwalla for his help with the final version.

Figure 1 Sources of Capital for Firms



Source: Pongsak (1996).

Frequently information failures prevent these start-up entrepreneurs from enjoying full access to credit. Progressive lending/investment by incubators, pooling capital from friendly sources, personal credibility and sound business ideas are often the bases for the first source of capital.

1.2 Small Enterprise (Stage 2): This stage of the small enterprise (SE) is characterized by limited track record, high growth and potential. An SE will normally use external finance from trade finance, venture capitalists or other informal lenders for its short-term working capital. In the absence of collateral or institutional safeguards, informal or relationship-based finance, allows it to build up reputation, and offers a means to share a steady flow of future business (and risks) within the same network of firms.

Without conventional participatory and qualitative evaluation tools available to potential lenders, the transition from the initial stage to this stage is very difficult in most cases. These techniques include personally monitoring the entrepreneur behavior, organizational performance and 'set-piece' or 'mental model' qualitative impact performance with no 'optimal approach.' 'Social collateral,' based on peer pressure to monitor and enforce contracts in group-based lending can sometimes replace physical collateral.

1.3 Medium Enterprise (Stage 3): At this stage, the successful firm has evolved into a medium-sized enterprise (ME) with a fine credit rating and reputation. An ME may offer collateral and have some track record for quantitative analysis to provide a safeguard for the fund providers. An arm's length or formal contract-based finance should evolve for the intermediate and long terms from various conventional financial institutions (e.g., banks, leasing firms, finance companies, etc). During the 2nd and the 3rd stage, banks play a crucial role in nurturing the emergence of credit-worthy or mercantile class entrepreneurs. The key idea is for the

banks to establish a 'customer relationship' with borrowers in order to gather information about them and mitigate the effects of moral hazard.

1.4 Large Corporation (Stage 4): By now, the firm has a track record, with fewer, well-defined risks. A large corporation therefore has a lower cost of funds, needs to pledge less or no collateral and is more responsive to investment opportunity than a small firm primarily because of an abundance of information available to the lender. To achieve efficient capital structure by going public, the corporation has to maintain high accounting standards and follow international transparency procedures. Prices of the firm's various publicly issued securities (e.g., stocks, bonds, commercial papers, etc.) in the capital markets signal critical information to fund providers and other economic agents. In a well-developed financial system, the *dis*intermediation process will eventually prevail for these firms. Non-bank channels (e.g., securitized market, insurance companies, derivative issuing, etc.) will play a non-trivial role in financing such corporations.

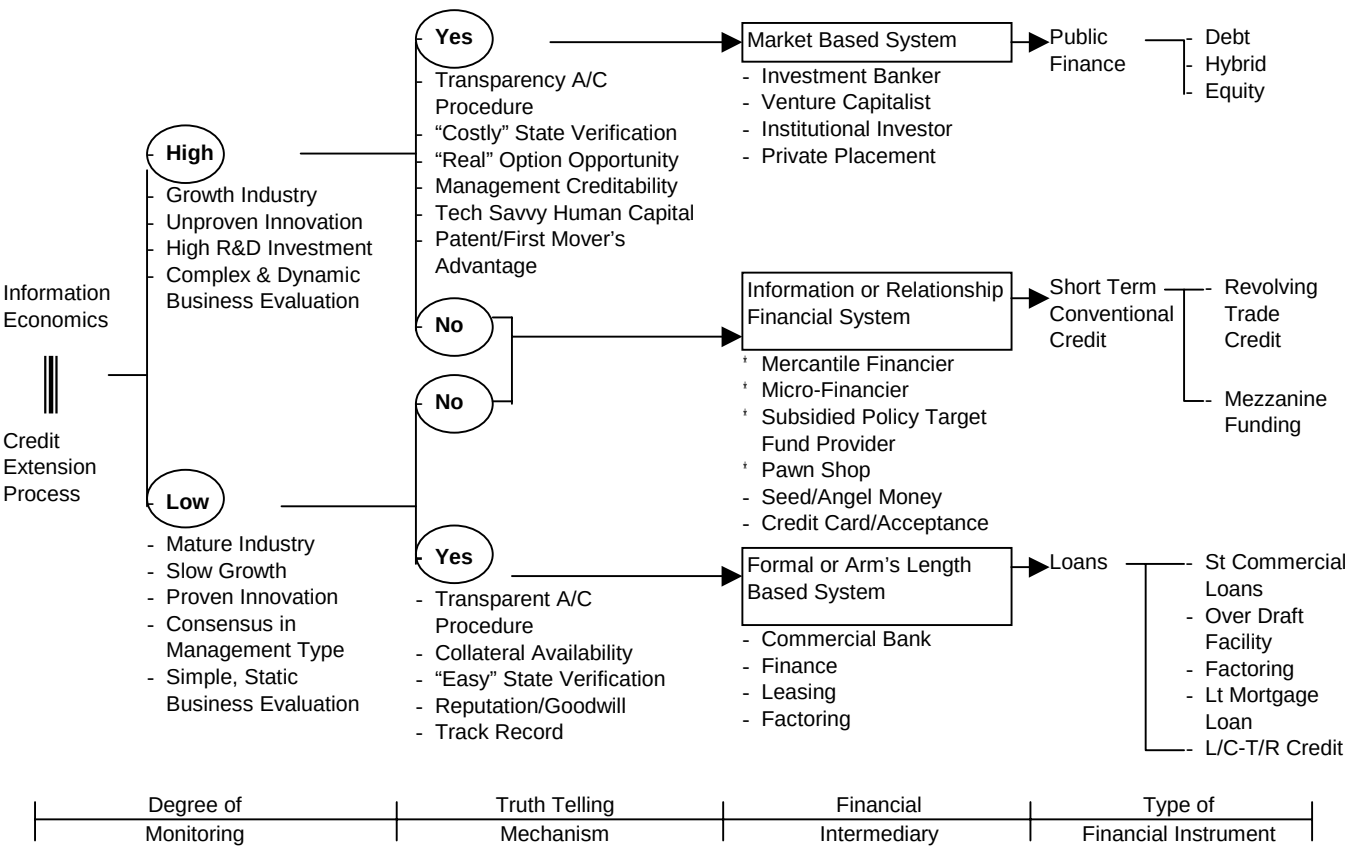
2. Information Economics, Degree of Monitoring and Risk Sharing: Information is the lifeblood of financial markets. All fund suppliers need it to assess the net present value of the fund users' promises. In the loan market borrowers rarely find abundance of fund providers owing to an undersupply of information available to the latter. To gather information on each borrower's specific attributes and data is costly. To transform such information into productive or useful knowledge requires even more expensive know-how.

The lending market is essentially different from other traded securities market. It cannot operate as a simple auction market. Price discovery or the willingness to pay interest is not an indication of creditworthiness. A typical information problem of verifying quality project or fund user, monitoring and enforcing the debt contract naturally arises.

Obtaining information on large corporations offers economies of scale and entails little cost. For retail lending with small amounts per loans but high volumes of relatively simple transactions, credit-scoring software packages to process and to monitor vast amounts of information are readily available. For SMEs, however, the undersupply of information is serious and puts them strongly at a disadvantage.

Apart from the relationship between the firm's size and information availability discussed above, the nature of its business also matters in the credit market. Different types of industries and organizations require different degrees of performance monitoring from different sources of funding and for different patterns of risk sharing (see Figure 2). The different roles of banks and capital markets and the different types of risk-sharing arrangements may be further explained based on the country's economic development, as follows:[1]

Figure 2 Information Economics Credit Extension Process and Degree of Monitoring



2.1 Low Degree of Monitoring Intensity: An industry requiring low monitoring can be characterized as competitive and mature, with slow growth, a short business cycle, proven production technology/innovation and whose management process is fairly standard. For firms in such an industry a simple evaluation can be sufficient. Agricultural processors, textile and shoe manufacturers, foundries, wholesale and retail distributors are among those requiring a low degree of monitoring. Moreover, when reliable mechanisms (e.g., collateral, personal guarantee, transparent accounting procedures, etc.) to avoid *ex-ante* adverse selection are available, banks are in an ideal position to create incentive compatibility for all risk sharing agents. With a *comparative* advantage of economies of scale in monitoring and low costs of delegation, banks play an important role in preventing opportunistic behavior of borrowers, both interim (moral hazard) or ex-post (auditing). Thus, banks are instrumental in providing long term intertemporal risk sharing services for *depositors* and in nurturing emergent credit-worthy *entrepreneurs*.

2.2 High Degree of Monitoring Intensity: Capital markets (e.g., stocks, debentures, etc.) are adapted for risk sharing among all market participants, but are not a quick source of capital. Industries suitable for security listing would be those that require continual performance monitoring by security analysts and astute fund providers. Pricing signals in the market place also provide critical positive information externality, and therefore draws in larger supplies of capital. Firms requiring a high degree of monitoring are typically dynamic and highly idiosyncratic, innovative and experiencing ever-changing technology and high growth, thus requiring complex business evaluation. Some instances are e-commerce, internet portal sites, hardware and software industries, telecommunications, large conglomerates and state-owned enterprises. It is worth noting that firms requiring a low degree of monitoring have never been successful in the stock market in Thailand either before or after the collapse, despite their high profitability.

III. NPLs, FINANCIAL FRAGILITY, SYSTEMIC RISK

Financial fragility prevails in virtually all Asian countries including Thailand, where the current weakness is a direct result of poor balance sheets due to massive currency devaluation. This weakness has been exacerbated by the economic downturn, interest rate hikes and the deteriorating collateral value. Indeed, Thai (or Asian) traditional collateral-based lending has amplified the economic disaster: as values fall, loans get called, forcing more real estate onto the market, which further depresses prices. The Thai financial landscape has been drastically changed and the credit extension process has been systemically impaired. By mid 1999, approximately half of Thai banks' loan portfolio consisted NPLs, which can be classified into three categories as follows (see also Table 1).

1. Large Corporate Sector: About 1,200 large corporations with head offices in Bangkok account for nearly half of the total 5.3 trillion baht bank lending with an average account of 2,166.67 million baht per firm. Approximately 35 percent of these loans, which are concentrated mostly in the six largest Thai banks and almost all foreign banks in Thailand, are NPLs. Public information on these firms is readily available. Professional corporate managers are willing to work out solutions with their fund providers to maintain their own reputation and job security. Lenders, particularly from abroad, can provide expertise in handling these NPLs, while strategic foreign direct investors (FDIs) are keen to take over corporations with good potential. Reform of bankruptcy laws and procedures has been enacted. The government is facilitating deal making between lenders and debtors with many types of tax and regulatory

Table 1 Thailand Total Estimated Banking Loans Characteristic As of December 30, 1998

Loan Type	No. of Accounts	Total Banking Loans (Trillion Bahts)	Average A/C (Million Bahts)	%	% NPL	Method of Work out Problem Loan
1. Large Corporates - Short to Long Term Loan - Commercial Paper - BIBF	1,200	2.6	2,166.67	49.06	35	Incentive Compatible Contract &Financial Innovation
2. Individual Loans - Consumer Loan - Credit Card - Mortgage Loan	1,000,000	0.8	1.25	15.09	50	Retail Credit Liberalization For Growth & Nation Wide Housing Project
3. Small Medium Enterprise - Trade Credit - Short Term Overdraft - Industrial Dt. - Mercantile Jobber	300,000	1.9	6.33	35.85	65	Value Chain Approach
Total		5.3		100.00	Ave ≅ 50	

Source: The Siam Commercial Bank Public Company Limited.

incentives. Consequently, slow but positive progress has been made in working out most problem loans in this sector. All the information and incentive compatibility issues for all stakeholders are in place. The workouts are normally done by the techniques of debt restructuring, debt-equity swap, buy-back option and other financial innovations with a possibility of foreign participation. Sahaviriya Steel Industries Plc provides a recent example of a successful 21.2 billion baht capital restructuring deal with bondholders and creditors, while the 1998 acquisition of the Thai Danu Bank Plc (which has now become DBS Thai Danu Bank Plc) was a positive indication of the benefits of such a move.

2. Personal Sector: In contrast to the experiences of other countries, personal-sector indebtedness and default is *not* a major cause of the Thai financial turmoil due to high household savings. Less than 2 percent of the 60 million Thais owe money to the banking system for consumer loans amounting to 0.8 trillion baht (15% of the total loans) with an average debt of a little over 1 million baht. Close to half of this retail borrowing is currently non-performing. More than three quarters of these loans are mortgage loans and the rest are credit card and other consumer loans. Still, the overall personal wealth loss has been significant in the aftermath of the crisis. The prospects of job loss and the bleak outlook for the economy have imposed serious major liquidity constraints on individuals, making them unable or reluctant to repay their debts. The household's propensity to consume is low at a time when domestic consumption needs a boost to counterbalance the downturn in the economy. That is, the constrained marginal propensity to consume should be less than that of unconstrained consumers. The foremost policy implication is how to provide fund or credit extension to the 'have-nots,' not the rich, to jump start the economy.

3. Small and Medium Enterprise (SME) Sector: SMEs are the backbone of the Thai economy. More than 300,000 SMEs account for close to 35 percent of all outstanding bank loans, of which more than 65 percent are hard-to-recover NPLs. Note that actual SME lending may exceed a half of GNP, possibly as a result of a growing 'black' SME market after the introduction of value added tax (VAT) in 1994, the subsequent VAT rate increase in 1997 and the credit crunch from 1996-8. Given their relatively small size with an average account of 6.33 million baht, public information on SMEs is rarely available, while SME entrepreneurs have incentives to conceal their proprietary information to avoid tax and to protect their business secrets from competitors. Thus, to solve the information problem, lending is normally based on collateral or personal guarantees.

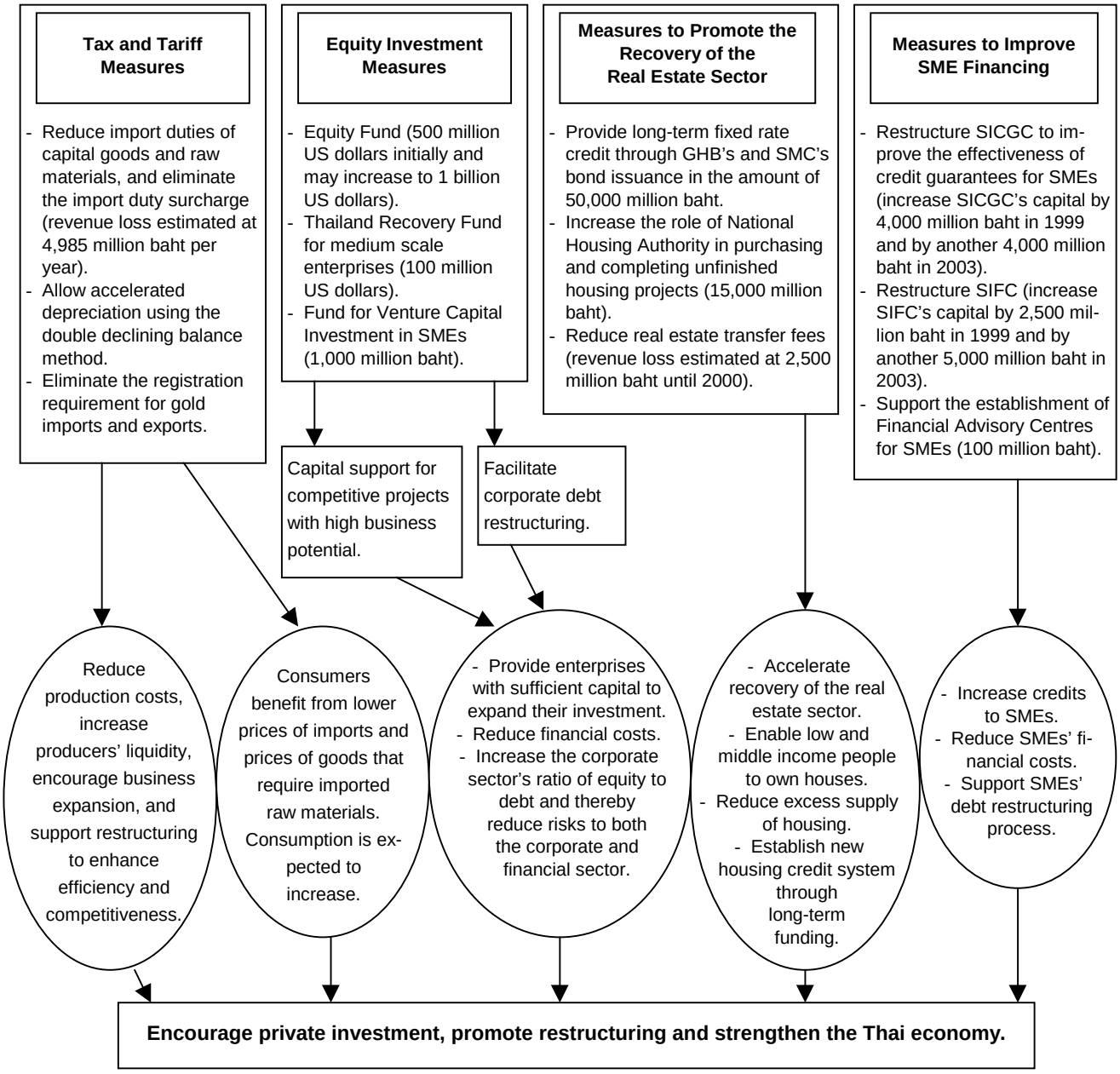
Shrinking asset values cause a total breakdown in credit to this sector. The higher degree of monitoring required for SME accounts in a financially distressed environment becomes a deterrent to new lending or even to the refinancing of old debts. There is little or no interest from foreign or large fund providers and strategic FDIs because of the lack of economy of scale. Balance-sheet problems in SMEs are further complicated by an increase in a risk aversion tendency among lending officers, who have seen their earlier lending decisions fail. If there are 'fresh' loans available, the bank fears the SME will use the funds to repay someone else. And if the bank does not provide new loans, the borrowing SME has all the incentive to default on existing loans. As a result, the rational lending officer does nothing or withdraws the SME's credit line. The rational action for SME operators is to default in all cases to preserve liquidity because the survival of SME business determines their family well being and welfare. Although the latest (third) scheme of the Ministry of Finance (MoF), announced on August 10, 1999, to mitigate the impact of the current economic crisis (Figure 3) by injecting credit and funds for SMEs is very good in concept, the implementation process is not well thought out,[2] because the issues of information problems and the banks' inexperience in rehabilitating balance sheets as well as the incentive compatibility problem are not addressed.[3]

The SME sector is well known to be very flexible and a hardy survivor in a fast changing environment. Generally SMEs are quick to adapt to new technology, innovation and trends. When the credit system collapses, the SME moves to a cash basis community. Using the physical input method, Austrian Prof. Schneider says that the Thai shadow or underground economy is the world's second largest, worth of more than 70 percent of the country's official GDP.[4] The larger the underworld SMEs become, the harder it is for the government to fine-tune its economic policy by traditional macro-economic measures (e.g., tax cut, loose monetary policy, etc). This increases the *systemic risk* in the Thai credit market. Without the SMEs back on track, it is hard to imagine how the Thai economy can return to its long-run sustainable growth of around 5-6 percent. One solution may be to give SMEs a chance to return to the formal economy by providing a tax pardon scheme and a 'fresh' start. However, the question remains: how to jump start the SME economy in the midst of the turmoil in Thailand.

IV. SOME PROPOSED MEASURES

Given the growing competition Thailand faces in the world market, it is obvious by now that the Thai economic recovery must be fueled by an increase in domestic consumption and investment, not export. Reflating asset prices will result in a medium- to long-term tragedy because it will add no productivity to the economic structure, and encourage asset speculation and increased imports of luxury goods for consumption. Because the Thai government traditionally has a small budget (accounting for roughly 15% of the GDP) and is highly bureaucratic, large fiscal spending in the Keynesian style would have a long time lag with small

Figure 3 Measures to Encourage Private Investment (10 August 1999)



Notes: GHB: Government Housing Bank
SIFC: Small Industry Finance Corporation
SMC: Secondary Mortgage Corporation
SICGC: Small Industry Credit Guarantee Corporation

Source: Ministry of Finance, Thailand.

impact on the economy. Undesirable side-effects include leakage on imported goods and high debt accumulation in the public sector. That the Thai and Asian economies bounced back in the third quarter of 1999 is predominantly due to a regionally simultaneous pump priming via fiscal and monetary expansionary policies. This bounce-back is a necessary, but *not* a sufficient condition for self-sustainable recovery. Therefore, to have a domestic consumption-led recovery, the Thai government should lubricate demand by revitalizing personal consumption and by extending credit to stimulate SME investments, simultaneously. Some policy implications and proposed measures are as follows:

1. Workout Progress: From our experience at the Siam Commercial Bank Plc (SCB) after full recapitalization in April 1999 for all NPL provisions, working out NPLs at present cannot be compared to the way it was done during normal times when NPLs accounted for less than 10 percent of all loans. When NPLs become a systemic problem, usual debt rescheduling which calls for quick loan repayment or increased collateral is not realistic.

1.1 *S-Curve and NPL Projection*: Incomplete information on troubled firms and inexperience of economic agents in rehabilitating the balance sheets pose major obstacles to restoring the financial system. Data

are often scarce and inadequate. And given the complexity of the many types of workout processes in a dynamic environment, translating data into knowledge is very difficult. Knowledge takes time to evolve, be disseminated and accepted into the decision making process, and become part of the banks' experience. Knowledge and information can also get lost. Next, the internal as well as external political process matters as much as the learning process of all economic agents in such a dysfunctional credit system.

In SCB's case, about a quarter of all NPLs had to be liquidated with about 70 percent recovery rate. Working out corporate repayment was the first priority due to its size, information availability and affordable expertise. It proceeded with full bank guidelines to the banking officers in June 1998, and it took six months to climb the initial steep learning curve in disseminating this knowledge among SCB associates, as illustrated in Figures 4a and 4b. As it turns out, the classical S-curve applies in SCB's multi-layer loan restructuring process from the top management down to account officers. Given the comprehensive policy initiatives in January 1999 and assuming no prominent foreseeable information problem, restructuring SME and retail loans should be completed in June 2000.[5] Taking SCB as a benchmark, one can project the percentage of individual private banks' NPLs to reach a self sustaining level within December 2000 as illustrated in Figure 5.

Figure 4a Projected SCB Loan Restructuring S-Curve

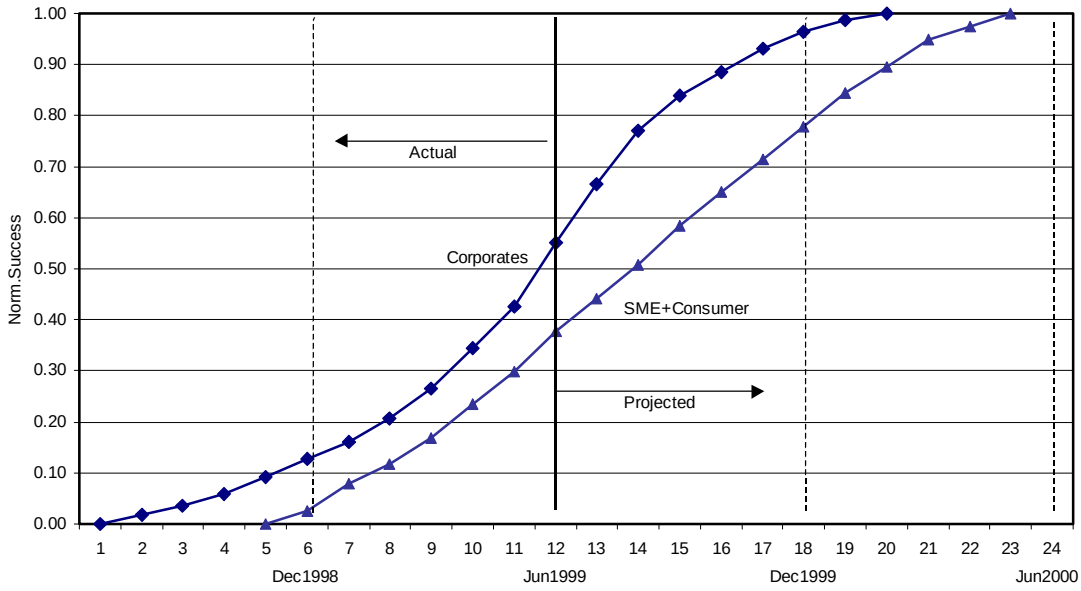
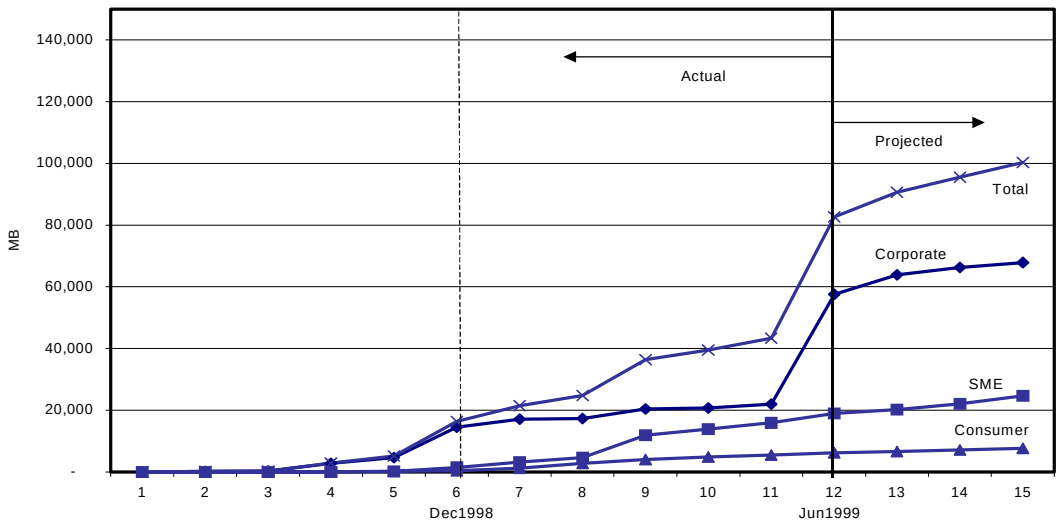
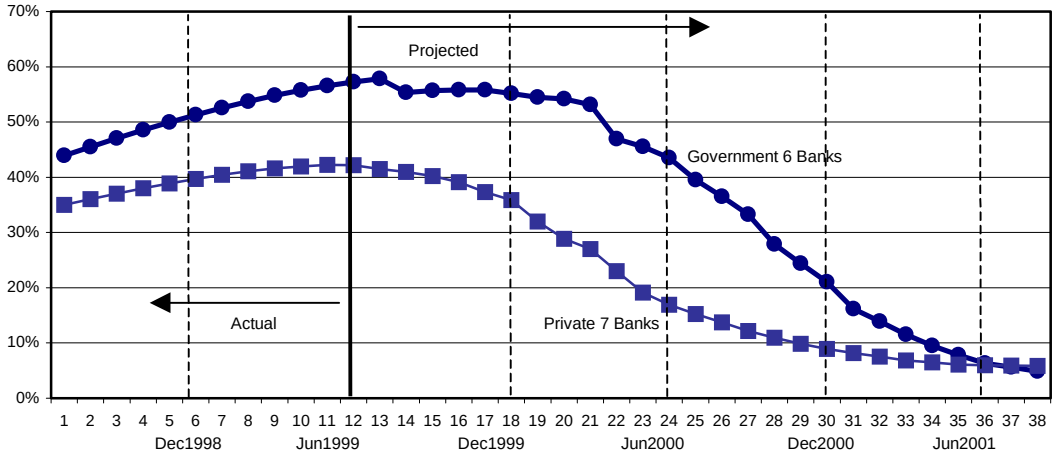


Figure 4b SCB Loan Restructuring Progress



Source: The Siam Commercial Bank Public Company Limited.

Figure 5 Percentage of NPLs of Total Loans



Note: Actual data are from the Bank of Thailand. Using the SCB learning curve as a benchmark, one can project the work out progress number.

As Table 2 shows, the NPLs of the state-owned banks are much higher than the private banks' since the informational and organizational capital of the former has not been well preserved.[6] Because information remained with individuals who collected and managed it, departed or retired bank officials and managers cannot be perfectly substituted by others. The government's attempt to bail out ailing banks has sadly proven to be a prohibitively expensive proposition. One valuable lesson from the bail-out policy is the need to ensure that information capital residing in the bank and the flow of credit are maintained. Once more, workout know-how has to be efficiently and quickly transferred to the state owned banks. This is an enormous task which cannot be lightly undertaken. The most optimistic forecast for the loan restructuring process for the state-owned bank to be completed is by mid-2001, unless drastic and effective measures are introduced. One such measure would be to sell one or more of these state-owned banks to foreigners and hope that they would clean up the banks more rapidly and their presence will help improve the efficiency of the local banking industry. Nonetheless, as pointed out earlier, most likely the foreign bankers are here to reap profits from their expertise in corporate and retail banking based on their knowledge of information economics and access to advanced technology. If so, it appears that the SMEs will again be left out of the picture.

1.2 Addressing Information Problems for New Loans: Heavy reliance on fixed asset collateral or personal guarantee as a mechanism in the lending process can increase the fragility and vulnerability of the economy as well as limiting the availability of credit to the borrowers. Collateral allows banks to avoid rather than address the relevant information problems. The focus of the government should be on shifting toward risk assessment and sharing the information burden. Risk assessment involves setting policy rules to better realign the incentives of all economic agents with common social good. New lending and government support can be based on group lending with a self-selection process. Community groups, industry federations and consumer associations can exert peer pressure on members to act responsibly. Providing incentives for group borrowers and 'social collateral' to repay and help avoid *ex ante* adverse selection of borrowers will be useful in improving loan recovery rates. Group lending also provides good enforcement of loan contracts by peer pressure to avoid loan default cost. As one of the 10 August 1999 measures to support business restructuring efforts, the MoF established three new funds: 1) the US$500 million Equity Fund, 2) the US$100 million Thailand Recovery Fund and 3) the US$26.5 million Fund for Venture Capital Investment in SMEs. The MoF has set up a separate committee comprising the representatives of the Federation of Thai Industries and the Thai Chamber of Commerce to select a private company to manage the fund. It would be even better if the group lending process via value chain approach (see below) is also implemented and information economic problems are addressed. It is particularly noteworthy that equity investment requires even *more* information and knowledge than normal lending activities because of its lowest priority claim risk.

Reconciling the market-based and regulatory approaches may mitigate information problems, specifically for SMEs. Well functioning market-based approaches are generally more efficient in processing information and allocating goods and services. But when information is scarce during distressed periods, the transaction costs of generating, disseminating and using information and knowledge are substantial. Thus, the market tends to malfunction during the turmoil due to this friction.

Table 2 Summary Table of Financial Instability

	Sweden 1991-2	EU.Bond 1992-4	Japan 1992-9	Thailand 1997
Debt Accumulation	Yes	Yes	Yes	Very High
Asset Speculation	Yes	Yes	Yes	Very High
Concertration of Risk	Yes	-	Yes	No ?
FX Regime Shift	Yes	Yes	Yes	Yes - Fix to Float
New Entry/Competition	Yes	Yes	Yes	Yes - BIBF
Financial Innovation	-	Yes	-	Yes - Thai Baht P/N BIBF
Monetary Tightening	Yes	-	Yes	Yes - 1997-8
Credit Rationing/Run	Yes	-	Yes	Yes
Declining Capital Ratio	Yes	Yes	Yes	Yes
Contagion Between Market	-	-	-	Yes
International Transmission	-	Yes	-	Yes
Action By Authority	Yes	Yes	Yes	Yes
Disfunction of Finance/ Economic Collapse	-	-	-	Yes

Sources: The Siam Commercial Bank Public Company Limited; Davis (1995).

Figure 6a NPL Value (All 13 banks except BBC & FBCB)

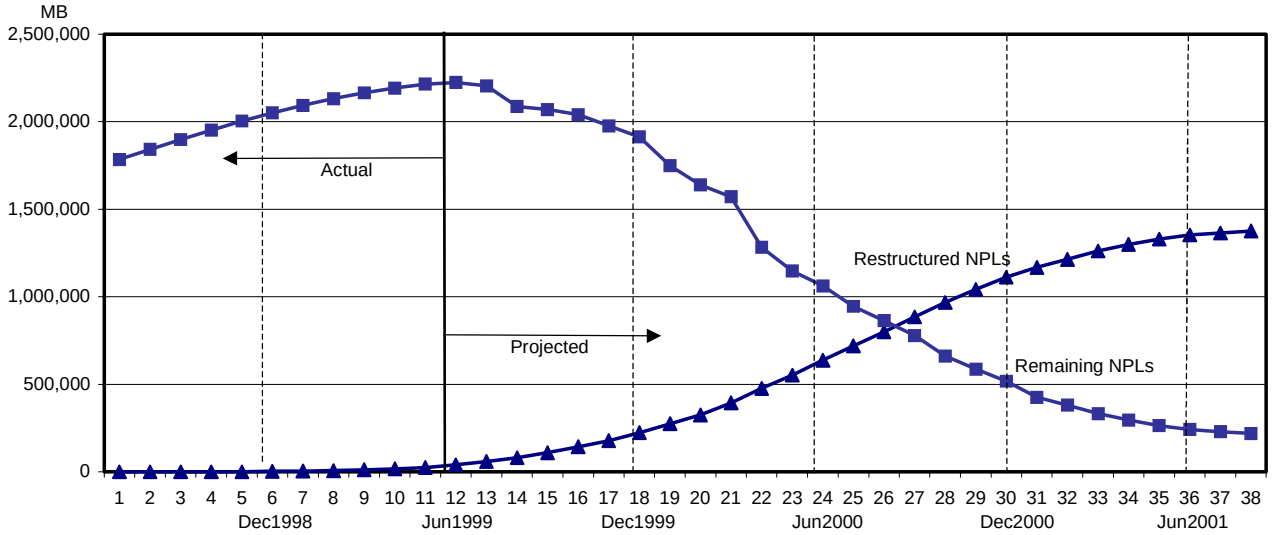
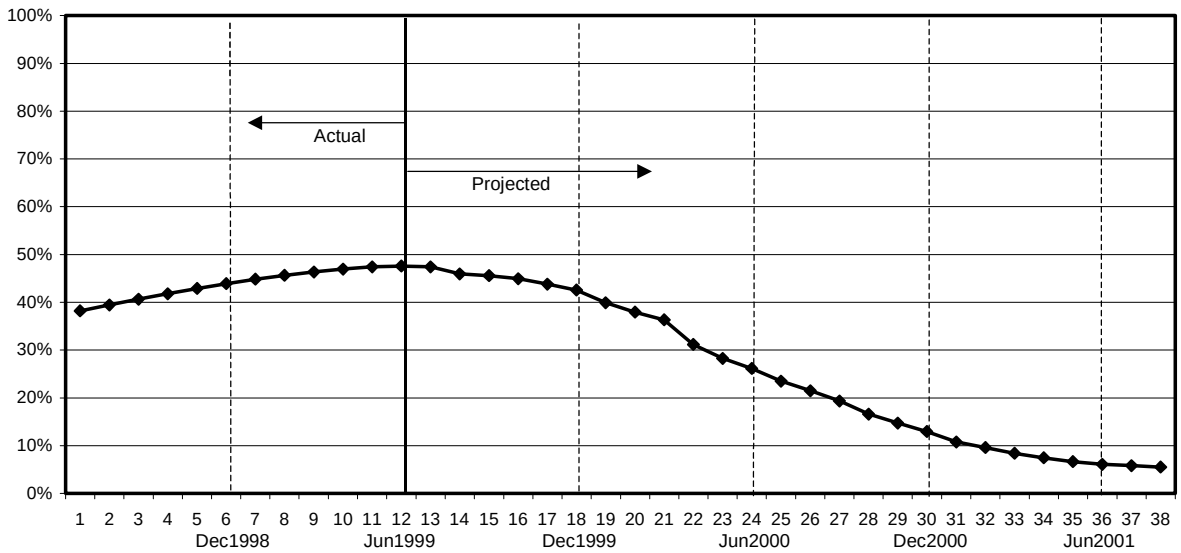


Figure 6b Percentage of NPL to Loan (All 13 banks except BBC & FBCB)



Notes: BBC = Bangkok Bank of Commerce Pcl.; FBCB = First Bangkok City Bank Pcl.

Source: The Siam Commercial Bank Public Company Limited.

One way to realign risk and reward sharing and hence to narrow the information gap between fund providers and users is for the government to provide limited credit guarantees to SMEs' entire loan portfolio extension for local fund providers. A limited credit guarantee will, for instance, cover only partial losses for fund providers, with a sliding scale premium based on performance as is common in the insurance industry. This is to share the costs due to adverse selection and moral hazard and to give an incentive for the information collection process on the demand side. If unsound lending or investments are made, then the fund provider suffers some partial loan losses and premiums will increase progressively. If the loan or investment is good, then the fund provider receives most of the benefits including reduction in premium in the sliding scale fashion. A limited time guarantee on individual firms and/or entire portfolios can help avoid the 'free rider' problem. This time limitation would provide only enough time and flexibility for SME fund users to establish sound credit reputation with fund providers.

2. Pump-priming by Stimulating Housing Demand: Selling Thai real estate in an already depressed market does more harm than good as effective collateral value in the financial system shrinks. Massive selling causes a non-linear disruption in financial markets by constituting a flawed, deep-discounted asset price benchmark. For a token of foreign investor capital, the fire sale excessively adds more balance sheet problems to the entire asset-backed credit system, since the borrowers have more incentive not to repay the loan when the collateral falls far below the original loan. Selling the nationalized banks to foreign investors cheaply or fully recapitalizing existing banks does *not* solve the credit market failure problem, especially on the SMEs.

After nationalizing nearly half of the existing banks, the Thai government can easily start a nationwide subsidized housing project (NSHP) for the poor and first home buyers by using its enormous foreclosed land bank and uncompleted real estate project, on hand. Giving soft, long term and fixed rate loans as in the MoF's third scheme alone may *not* work if all economic agents in the real estate system are being denied credit. If houses cannot be built massively because of the credit system failure, there will be virtually no market for the MoF's soft loans. Asking state-run agencies such as the National Housing Authority to expedite the real estate recovery is a forbidding task. Perhaps, the Thai government can use private, instead of state, mechanism of <u>value chain approach</u> (see more discussion below) to create incentive compatibility for all stakeholders—the home buyer, building material supplier, construction contractor, home appliance manufacturer and real estate developer. The developer receives a bonus for an 'on budget, on time' delivery. The supplier and contractor receive growth and profitability from sales. The buyer has a home of his/her dream. And the banker has the book cleaned up with performing loans (see the 'Chantima Park' example below). This housing project is equivalent to land reform, but it is politically more acceptable because this enhances quality of life for the entire nation, not just one particular interest group. This is truly a Social Investment Program (SIP) where community members participate in each and every multi-layer decision process from endowment to project management. The combination may prove to be a major locomotive to pull Thailand out of the recession. Housing purchases by long-term loans subsidized by the government would be a good start of a primary loan originating market. Collateral for house purchase is immediately available in the form of title-deed to the property to *minimize* credit extension problem arising from information asymmetry and incomplete contract during financial woes. The government can further help in the establishment of a strong and liquid secondary market as evidenced in Clause 3 of the 10 August 1999 measure. Note that historically, the foundation of the secondary Mortgage Backed Securities (MBS) market in the US can be traced back to the Great Depression. It was a direct result of the National Housing Act of 1934 and the creation of the Federal Housing Administration (FHA) and the Federal National Mortgage Association (Fannie Mae).[7] To resolve liquidity problems in mortgage 'banking' and to pursue the primary objective of adequate and affordable housing, the Act did two critical things. First, it enacted FHA guarantees on all mortgage defaults to reduce credit risk to investors. Furthermore, FHA began to develop and promote a mortgage design for the borrower. Second, a government-sponsored agency, Fannie Mae, was set up to create a liquid secondary market for mortgages mainly by purchasing FHA mortgages. In short, the reduction in credit risk and liquidity in the secondary market are two key elements for success in the long run for the MBS market. Indeed, there has never been a privately led secondary market, even in the US.

A prosperous housing market also has significant <u>multiplier effects</u> on other markets, such as household appliances. The above policy to stimulate the housing market may be supplemented by another, namely a liberalization of the retail credit market to fuel consumer demand. The target may be the middle-aged consumer and lower-middle income family. Consumer loans, credit cards and mortgages, for instance, may be allowed to be granted by non-financial sectors (e.g., department store, life insurance companies, oil and gas firms, agencies facilitating internet cross-border e-lending, etc.).

3. Value Chain Approach and SME Rejuvenation: Most recent financial economic crises have similar origins in high debt accumulation, asset inflation and shift in the financial regime after financial liberalization. But few other small open economies have experienced a collapse of SMEs equal to Thailand during the current fiasco. How can one restore SMEs to function normally again in the Thai economy after such a massive shock? We proposed a new approach which we shall call the value chain approach, which is best understood from the examples below.

3.1 The Case of Housing Projects: The government's NSHP initiative can easily bring together all involved parties (e.g., suppliers, builders, buyers, bankers, etc.) to participate as stakeholders in each individual feasible real estate project under the nationalized banks. The type and the number of housing projects can be decided at the provincial level on the basis of the number of potential buyers and their buying power. Seed money for project partnership can be provided from government funding in the form of land, uncompleted projects and cash on hand; some may come from the local beneficiary. The project will have a limited life span with a specified beginning and end. Profit and loss will be shared among stakeholders at the end of the project. The management team will be given explicit incentives to deliver on time and within the budget.

One successful example of group lending is **'Chantima Park,'** an actual case from the SCB portfolio successfully concluded recently. The real estate developer was unable to complete this multi-million-baht single residential housing project in Nakhon Pathom (near Bangkok). SCB had basically two choices: either to foreclose on the property and liquidate as an uncompleted project or to continue the project at the request of the potential buyers who had already made down payments. Fortunately, the bank management was able to organize a group of stakeholders—builders, suppliers, buyers, developers—to agree on the common goal of the 'Chantima Park' project's completion. The project itself was transferred under the bank's full control with stakeholders' consensus in exchange for clearing most of the original shareholders' liability. The buyers continued to make their obligatory installment payments to the bank with assurance of quality and timely delivery because the bank's reputation was at stake. The suppliers delivered building material on the strength of the bank's credit. Both developers and builders were hired on a contractual basis with incentives to be on budget and on time. Essentially, the bank created an incentive compatibility among all stakeholders. In the end, the bank had its book cleaned up with performing mortgage loans; the buyers had their homes completed; and the suppliers, developers and builders got their payments. A true win-win situation.

3.2 The Case of Consumer and Industrial Goods: SMEs cannot be built overnight, and to treat SMEs as homogeneous is very dangerous. Unlike Japan, most Thai SMEs are not small and medium industries (SMI) such as car component suppliers, lathe and machine shops or tool and die makers. In fact, 60 percent of Thai SMEs are consumer and industrial goods distributors; only about 25 percent are SMIs, while the remaining include construction subcontractors and other services. To disregard these old 'brick and mortar' distributors for the fast changing virtual electronic commerce in the middle of a crisis is not practical. The government should utilize the combined marketing concept and the value chain approach for this distributive sector.

Figure 7 illustrates the bottom-up or customer-driven approach to move goods from producers to consumers. These marketing channels overcome the time, place and possession gaps that separate goods and services from those who would use them. The risk-taking and the finance or credit process for acquisition and allocation of funds required to finance inventories keep the market channels open and well-lubricated. When banks change their role from delegated monitoring of cash or payment transaction (as in 7.3) to ensure the title flow (as in 7.2) from channel levels in form of invoice factoring, the credit system becomes a group lending again for the entire sector. If the retail credit market is liberalized, acceptance, factoring and supplying credit can be performed by various fund providers at the local, national and/or international level. The entire chain can be a partnership between various economic agents along the chain. Again, profit and loss sharing will be according to their value added contribution and the chain's performance. The Miyazawa plan can perhaps be implemented to partially fund the chain instead of funding only infrastructure related projects, if Japanese components (e.g., raw and semi-finished goods, spare parts, etc.) are involved.

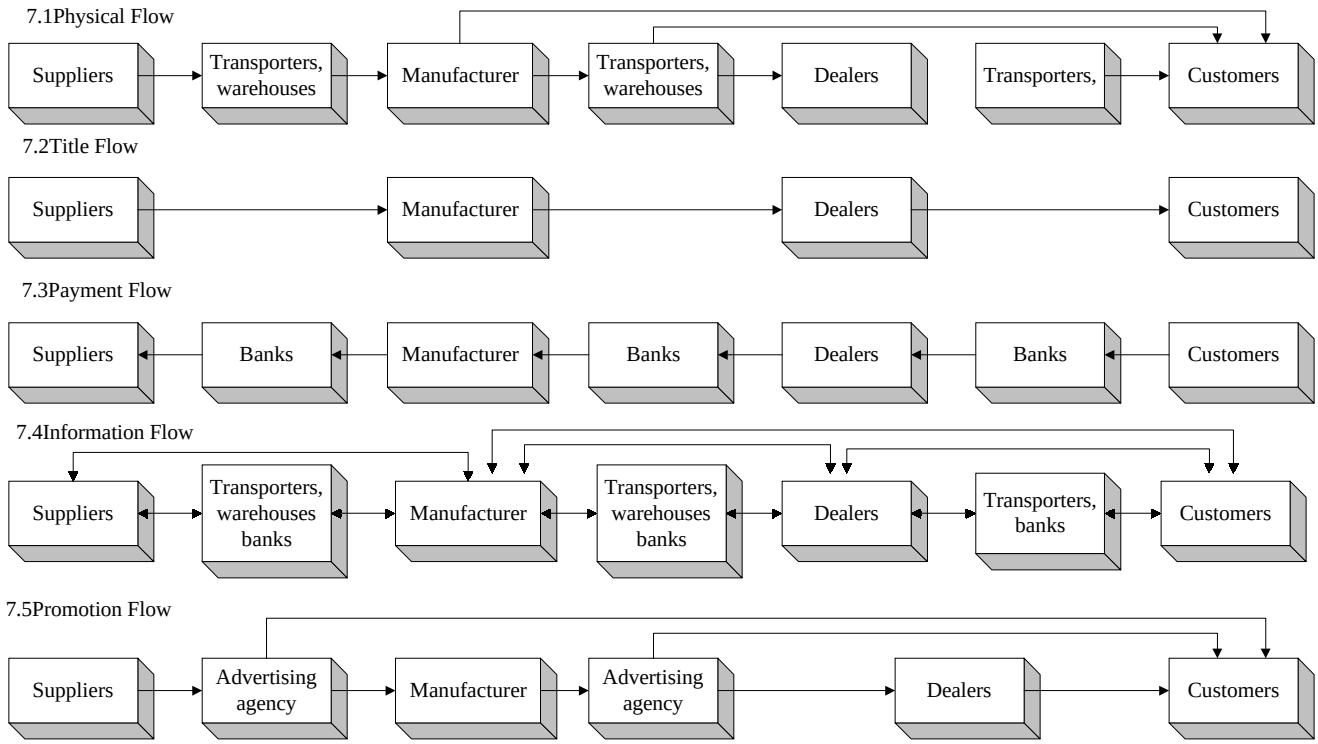
In fact, this approach has already been implemented in Thailand by global companies in the automobile sector. Strategic FDIs from the multinational parent firms (e.g., Toyota, Honda, DaimlerChrysler, etc.) have taken over the whole chains, from manufacturing the parts to financing the consumers who purchase the final product. Information gaps along the chain have been plugged up.

3.3 New Financial Paradigm and Credit Market: A new financial and economic paradigm may need a new re-intermediation process in at least three areas. First, if the secondary market for housing loans is initiated, then MBS or an asset-backed securities market is needed. Second, if the economic structure of Thailand is moving from traditional low-tech to knowledge-based industries, a Thai version of NASDAQ may be realistic. However, without providing (1) a wired infrastructure, (2) a proper legal system, (3) cheap funding to nurture knowledge-based industries, (4) liberalized telecommunications, and (5) tech-savvy human capital, merely listing traditional Thai SMEs will not work owing to their small size, low growth and low degree of monitoring. Third, a liberalized retail credit market may create the undesirable side effect of overspending. Reintroducing interest rate ceilings to prevent excessive risk-taking by the intermediary and sharing personal databases are two possible preventive measures.

V. CONCLUSION

Central to Thai credit market failures in the aftermath of the 1997 debacle are information problems, inexperience in rehabilitating the balance sheets badly affected by the massive devaluation, and the declining value of collateral.

Figure 7 Five Different and Simplified Marketing Flows in the Marketing Channel for Typical Manufacturing Goods



Source: "Marketing Management" by Kotler (1992, pp.510-511).

Incomplete information on troubled firms and inexperience among economic agents in rehabilitating balance sheets pose major obstacles to the recovery of the financial system. Data are often scarce and inadequate. And given the complexity of many types of proposed solutions in a dynamic environment, translating data into knowledge is very difficult. Knowledge takes time to evolve, be disseminated and be accepted into the decision making process, and become part of the banks' experience. Knowledge and information can also get lost. Internal as well as external political process matters as much as learning progress of all economic agents in this dysfunctional credit system. As it turns out, the classical 'S' learning curve demonstrates itself clearly in the SCB's multi-layer loan restructuring process from the top management down to account officers. Taking SCB as a benchmark, one can project the percentage of individual private banks' NPLs to reach a self sustaining level in December 2000.

Since the informational and organizational capital of state-owned financial intermediaries has not been well preserved, their state-owned bank's NPLs are much higher than private banks'. Because information is limited, departed bank officials and managers *cannot* be perfectly substituted by others. For the government to operate the nationalized banks is a *prohibitively* expensive proposition. One valuable lesson in bail-out policy responses to bank failures is the need to ensure that information capital residing in the banks and the flow of credit are maintained. Workout know-how needs to be efficiently transferred to the state-owned banks. This is a huge task which cannot be taken lightly. The most optimistic assumption for the loan restructuring process for state-owned banks is that it will be completed by the middle of 2001 at the earliest.

Collateral simplifies, but does not address, the relevant information problem. The focus of the government should be on shifting toward risk assessment and sharing the information burden. Risk assessment involves setting up policy rules to better realign the incentives of all economic agents with the common social good. New lending and government support can be based on group lending with self selection. Sharing the information burden involves reconciling market-based and regulatory approaches which may mitigate information problems, particularly among the SMEs. One way to realign risk and incentive sharing, and hence narrow the information gap between fund providers and users, is for the government to provide partial credit guarantees to the SME loan portfolio of private fund providers (e.g., lenders, venture capitalists, equity and bond holders, etc.) for a limited time.

In summary, the primary impact of the systemic failure in the credit market has been on the SME sector, while personal consumption can be a major factor in the Thai economic recovery process. Given that 60 percent

of the Thai SMEs are consumer and industrial goods distributors, the value chain approach suggested above, together with subsidized housing projects and retail credit liberalization are among the macro- and micro-economic proposals to overcome the Thai credit market failures. With time, flexibility and growth via financial innovation it may be possible to jump-start the SMEs and put Thailand on the road to self-sustainable recovery.

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ENDNOTES

1 For further discussion see Pongsak (1996).

2 The first major measure taken by the Thai Ministry of Finance (MoF) on 14 August 1998 was principally on the 'Banking Recapitalization Assistance' program. The other important measure which the MoF pledged on 30 March 1999 was a consumption stimulus package (e.g., VAT cuts, gasoline and electricity tariff reductions, etc.).

3 For more discussion on the incentive compatibility problem see Pongsak (1997).

4 From an article in The Economist, 28 August 1999 issue, p. 63.

5 Any deviations from this estimated completion date should reflect the deviation in work out problem loan practice from our benchmark case in SCB.

6 Figures 5 and 6 are aggregated illustrations, based on the authors' judgement. However, each individual bank's NPL projection is available upon request from the authors, subject to confidentiality.

7 Fannie Mae was divided into two organizations in 1968: (1) the current Fannie Mae and 2) the Government National Mortgage Association (Ginnie Mae). Ginnie Mae's function is to support FHA only. Later on it created the Federal Home Loan Mortgage Corporation ('Freddie Mac') to further support FHA mortgage loans.