Vol. 14 No. 4 Thailand Development Research Institute December 1999

TDRI Quarterly Review

Contents

Real estate projects, sure winners in the early 1990s, were just the seeds of what was to become the monster of Bangkok—an NPL. (See related article on page 19).

ISSN 0857-2968

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Democracy and Free Markets*

Anand Panyarachun**

I take it that the topic chosen for this talk arises from the need to reflect upon the very rapid changes taking place in our part of the world, both in the political and economic sphere, and put them in the context of the broader choices that each society has to make at various junctures in its history.

All countries, including even Cambodia during the murderous Khmer Rouge episode, claim to be "democratic." Such easy claims render the word almost meaningless. Those of us who subscribe to the liberal tradition would narrow the meaning of the term to mean a system of government whereby there exists and functions a lawful procedure by which a government can be peacefully removed, and presumably and preferably a new one, acceptable to the population, installed in its place. Elections are but one of the many possible mechanisms, whose only virtue is that they have been tried and tested in a vast number of countries.

An essential concept of the democratic system is the notion of choice. The collectivity of the governed are in theory supposed to have some choice in the matter of whom they are governed by. One of the claims to superiority of free markets is that it enables people to have a wide latitude of choice in their economic life: where they work, what they consume, how much they want to save, and so on. It is, therefore, sometimes claimed that free markets must inevitably lead to a democratic form of government—a claim much in vogue in the period since the adoption of the market system in formerly communist countries. This claim is easy to refute, as many authoritarian countries allow free markets to exist. The converse, however, many well be true, once a country has, for whatever reasons, decided to have a heavily planned economy, it is difficult to imagine such an economy surviving in a democratic environment, let alone making a success out of it.

I believe that there is no direct relationship between free markets and a democratic form of government. There are some of us who do not make that direct link between the two, but link them with a third factor, namely economic growth as well as the high standard of living that continued growth brings in its wake. It is now widely accepted that some form of a market economy is a better approach to achieve the high economic growth that is widely desired. Of course, the kind of market economy that will deliver the growth need not be the bare-knuckled capitalism that have emerged in some transitional economies. Indeed, as I shall discuss presently, that kind of capitalism is no good for anyone.

But whether that economic growth can be delivered with a democratic form of government is not as widely accepted. At one time, many of my less patient compatriots, and even now, many Asian leaders would make the claim that we should go all out for economic growth, and let democracy wait, until the fruits of growth are ploughed into things such basic services as education. THEN, when the powers that be decide that the people are good and ready, democracy will be bestowed upon them. Needless to say, these arguments are self-serving.

On the other side, for years, we also heard parallel opinions being voiced by Western businessmen. They felt they could do better business with a "stable" government than with those that are subject to the whims of the electorate. Stability of the players is equated with stability of the rules of the game, an assumption that does not pass the critical examination that it requires. Now that the old players in some countries have left the scene, so have the rules of the game, leaving the businesses and their investors in a limbo—a well-deserved limbo, I might add.

One of the unfortunate legacies of communism, and its distant cousin, socialism, is the overly sharp dichotomy sometimes drawn between a free market economy and a state managed system, and the implication that is sometimes drawn that the two are alternatives or substitutes. The freer the market, the less the state role. This assumption may well be true for a society and an economy that has had a lengthy evolution of both its market and political institutions, so that the prevailing rules of the game in both areas are more or less taken for granted. However, for a developing country like my own, and probably even more so for a transitional

* Speech delivered at the Conference Dinner hosted by the Centre for Democratic Institutions, the Australian APEC Study Centre and the Asia Society Australasia Chapter, Melbourne, 26 November 1999.

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economy, these rules of the game do not exist, and the state has to take an active role. Are the states in the region up to their task? Before they go about writing rules for others, they must be good at devising and then conforming to the rules that govern themselves.

We in Thailand are all too well aware of the failures that have attended our political system. The rate at which we have been tearing up and rewriting constitutions has made us the envy of the world. Despite the frequent changes that were made, one could not discern any improvement through an evolutionary process. Rather, we seemed to be spiraling rapidly downward to a money politics of the most blatant kind. Western economists worry about excessive intervention of government in the markets, we Thais have to worry about the intervention of the market mechanism in our system of government.

In the last two years, the logjam that had barred us from serious political reform had suddenly been broken. A new constitution was proclaimed in 1997. Although this is last of the more than a dozen that we have had over last sixty odd years, it was the first that was passed with a wide degree of public participation and entirely by constitutional means. The process was initiated by the then Parliament, the means, including the setting up of the national drafting assembly, its composition, its election, its emphasis on public hearings, were all devised by the parliament which would eventually approve or disapprove the draft constitution in toto.

The constitution mandated many institutional reforms, ranging from the auditing of government finances, to electoral supervision, to judicial reforms. It mandated specific legislation to be passed by the parliament in these and many other areas. Although many, probably most, of the current parliamentarians (elected under the old constitution) disliked both the Constitution and the mandated reforms, they swallowed hard and reluctantly voted for them, and we should not begrudge them the credit that is due.

The economic crisis that has hit us in the last two years also indicates that our market institutions, which we took for granted during the four decades of uninterrupted growth had serious flaws. Since these institutions were never "broke," no-one thought of fixing it before it was too late. Now we have no choice. During the last two years, it has become necessary for us to refashion in a hurry some of the most fundamental institutions of a market economy. These include new bankruptcy rules, new systems of corporate governance, new systems of regulation of public utilities. The most important task remains to be done, however, and that is to re-erect a financial mechanism that will link savers and investors, so that the economy can move forward. The mechanism that had served us before the crisis is now hopelessly beyond repair, but no-one seems to have any clear idea as to what is to replace it.

The changes that have been made and many that remain to be done, are changes to the fundamental institutions of the market economy, but they are not the kind of changes that the market mechanism will naturally bring about, there must be a political process. Inasmuch as these changes are taking place during a crisis, when there is no economic growth to anaesthetize the pains of adjustment, it is not surprising that there was bad temper all round. But to this day, I am glad to report that our political system is still holding out well. It is my firm belief that the reason the job was done, and that the reform was implemented was because the new political atmosphere made for a much greater participation—sometimes angry participation—by key sections of the population. And this is as it should be. We are truly engaged in a social contract with the future. It is important that all Thais are at least aware of what is being done in their name, and (God forbid) even to have an influence on the outcome.

The travails of the last two years have taught us some lessons about democracy and free markets. The first is that for an efficient, thriving market system to operate, it must be within the framework of a set of rules of the game, and yet allow for the smooth operation of the market mechanism. The state is necessarily involved in fashioning these rules of the game. But these rules in themselves have to command a broad social acceptance, the process by which they are adopted must be participatory to the broadest extent possible.

Of course, fashioning new rules of the game is by itself insufficient. Inasmuch as it is the state that created most of the important ones, it has to stand guard over them and, most importantly, ensure that they are followed and applied in the right context. In a rapidly changing world, it is inevitable that the officers of the state that will have to apply some discretion over how the rules are interpreted and applied. Their own personal probity, the integrity and transparency by which they conduct their affairs, are absolutely essential. A few—very few—authoritarian states may have officers that rise up to these standards. Many democratic states, (including my own) have signally failed to do so. But I believe that in the long run, it is only in an open, democratic state, where freedom of speech is protected and guaranteed, where such officers will emerge and survive to serve their country.

Ladies and gentlemen, as business men and women, your performance is always measured against the standards set up by the stern task master that is the market. The market test is unconditional. Businesses fail, even if the circumstances that led to the failure are beyond the control of those running them, as my colleagues in Bangkok are finding out. The market does not provide any ready excuse. Perhaps your banker may give you temporary help from your mistakes, but in a well-regulated system, he is still subject to the market test.

Politicians in less democratic, and therefore less fortunate, countries do not have any standards by which they are judged at all. But even in democratic countries, they are measured by less stringent standards than the market. The most common of this is electoral perform-

ance. But the electoral test is far less stringent than the market test, because it is hedged about by many conditions and subject to various whims and fashions, which can be manipulated. Politicians have too many alibis, and they always cite them!

It is for this reason that we need to steer clear of the interventionist hand of the state and the heavy hand of the socialism.

Having said that, let me quickly add (as my last point) that it would be a mistake to allow full play to the invisible hand of the market, except with respect to business men and women. This is because it will always be the case that some individuals will be at the losing end of the fast-paced economic changes that are constantly occurring. And many of these are weakly equipped to bear the brunt. It is essential that society (not necessarily the state) be ready to lend a helping hand to them. For Australians, this may sound "old-hat." This is because you have been living in a welfare state for close to a century, and have (I gather) even gotten tired of it. But for many Asian countries, the current crisis has caught their governments and their peoples unawares. Social safety nets are almost entirely non-existent, and the social consequences are therefore somewhat severe. One of the most important tasks that we now face in Asia is therefore to learn from your experience, and fashion a hard-headed approach to the provision of a social safety nets, but one which stays within the bounds of our modest means.

We in Thailand have already embarked on a road to a functioning democracy and a sustainable free-market system. We along the way have learned to appreciate the values of systems, and at the same time are not oblivious of the flaws. It is my personal hope that a new political culture, to be instilled and nurtured by the present constitution and the organic laws, will produce in due course a government which is truly a government of the people, for the people and by the people.

Financial Reforms in Thailand

Macroeconomic Policy Program

PATH TO CRISIS

At the beginning of the 1990s, it was envisioned that the Thai financial market would be better off if liberalization was pursued. Thailand's acceptance of the International Monetary Fund's (IMF) Article VIII in May 1990, which lifted foreign exchange controls on current account transactions, marked the beginning of a series of financial liberalization measures. On the exchange control front, the second round of liberalization abandoned most restrictions on capital account transactions in April 1991. The third round, in February 1994, gave more freedom to outward direct investment, travel expenditures, and additional channels of cross-border payments. In March 1993 the Bangkok International Banking Facilities (BIBF) were established to serve as a means to develop an international financial center. To enable BIBF to compete with other centers, BIBF transactions were granted some tax privileges (e.g., reduction of corporate income tax, exemption from special business tax and withholding tax on interest income). Furthermore, the government in January 1995 decided to allow BIBF to open up branches in upcountry provinces.

On the interest rate front, the authorities gradually removed interest rate ceilings in order to encourage savings mobilization and to make the financial system more dynamic. Interest rate ceilings on long-term time deposits were abolished in June 1989, on savings and short-term time deposits in January 1992, and on loan rates in June 1992. In addition, the central bank in 1992-93 gave commercial banks more flexibility by loosening the requirement of government bond holding as a prerequisite for opening up new branches. The obligations of commercial banks to extend credits to rural borrowers or those in the vicinity were also relaxed to cover more related occupations and wider geographical areas. Furthermore, the definition of "liquid reserves" was broadened to include Bank of Thailand and state enterprise bonds, as well as debt instruments issued by financial institutions or government agencies approved by the central bank.

Commercial banks were permitted to undertake new businesses, such as debt underwriting and dealing, acting as securities registrars and custodians, selling public sector debt instruments, mutual fund management, financial consulting, and feasibility studies. Finance and securities companies were on the same footing. Their new lines of operations included leasing, management of provident/private/mutual funds, custodial services, and foreign exchange businesses.

Meanwhile, a number of new frameworks and organizations were formulated. For example, the Securities and Exchange Act was passed in May 1992, giving qualified limited companies access to direct finance through issuing common stocks and debt instruments. The Act established the Securities and Exchange Commission (SEC) as an independent agency responsible for supervising capital market activities related to equities, bonds, and derivatives. In 1993 the government spearheaded the formation of a credit rating agency, Thai Rating and Information Services (TRIS), and in 1994 private parties organized a bond dealers' club to function as a secondary debt market, adding more liquidity to debt instruments. Regarding the payment systems, the central bank improved clearing and settlement, which helped lower transaction costs and facilitate business expansion. The BAHTNET and THAICLEAR networks were put into effect so as to better serve customers' needs. The latest development on this front was the introduction of electronic retail fund transfers through Media Clearing.

This financial liberalization was undertaken between 1988 and 1996 with the following purposes: to strengthen competition in the domestic financial system, to give more resilience to financial institutions, as preparation for the worldwide liberalization of trade and services, and to expand the role of Thailand to serve as a regional financial center.

In 1996 the Thai economy encountered a number of difficulties. Export growth abruptly came to a halt due to weak global demand while imports remained buoyant, resulting in surging current account deficits. Domestic inflation, meanwhile, was rising, reducing the country's competitiveness in the world market. Unsurprisingly, traders and speculators had growing doubts about Thailand's debt servicing capacity or creditworthiness. In addition, deteriorating positions and increasing Non Performing Loans (NPL) in Thai financial institutions further weakened foreign investors' confidence. Waves of capital outflows, representing (p)repayments of external debts and exchange rate speculation, thus occurred in the first half of 1997 to such an extent that the Bank of Thailand found it impractical to continue defending its long held basket-peg exchange rate policy, even after it resorted to considerable external borrowing to support its foreign exchange reserves. The baht was therefore

floated on July 2, 1997. Afterward, capital outflows continued to such an extent that the U.S. dollar reached a peak at 53.71 baht in January 1998 (from 25.75 baht in the first half of 1997). In 1998 Thailand's real GDP contracted by 10 percent. This severe financial crisis was not singular, as it spread to several of Thailand's neighboring countries, demonstrating the reverberating impact of weakening confidence.

ANALYTICAL SCRUTINY

Macro Perspective

It should be noted that though more freedom was given to cross-border capital flows, Thailand's exchange rate peg to a basket of currencies, adopted in 1984, remained in effect. Given the predominant weight of the U.S. dollar (85%) in the basket, the baht did not move much against the U.S. dollar, which did not correlate with the volume or direction of transactions in the Thai foreign exchange market. Instead, the central bank was the sole party which stipulated and defended the daily value of the baht against the U.S. dollar in line with the fluctuations of basket currencies' exchange rates in the world markets. Therefore, interest rate differentials between local and foreign currencies were not offset by exchange risks, so numerous private corporations, as well as financial institutions, took advantage by borrowing abroad at low interest rates without purchasing forward cover.

The financial liberalization measures mentioned above caused a flood of capital into the Thai market in 1990-96, fueling investment spending, speculation, and current account deficits. Meanwhile, excessive and imprudent credit extension engendered too much risk taking and deteriorated asset quality. Evidence of this is plentiful. Net capital inflows between 1990 and 1996 averaged 10 percent of GDP each year, thus expanding the outstanding external debt from US$29 billion in 1990 to US$94 billion in 1997, or from 34 percent of GDP to 59 percent of GDP, respectively. Within such mounting foreign debts, the private short-term portion surged from 22 percent to 50 percent, generating increased vulnerability. On the part of financial institutions, speculative and imprudent lending inflated several bubble sectors, not just real estate. For example, the automotive industry, private hospitals, steel, and the petrochemical industry were also inflated. Declining asset quality therefore came as no surprise, except for its speed and extent. Distressed by possible financial panic or bank runs, the central bank could not resist extending financial aid to ailing commercial banks and finance companies. This aid aggravated macroeconomic imbalances. For instance, current account deficits climbed from 5 percent of GDP in 1993 to 8 percent of GDP in 1995-96. Meanwhile, Thailand's excess inflation in comparison to the U.S.'s surged from 0.3 percent in 1993 to 3.0 percent in 1995-96. As a result, by mid-1997 investor confidence was critically shaken. Massive capital outflows, arising from fears of an upcoming devaluation, plus widespread bankruptcies, necessitated the floating of the baht, which triggered a series of financial crises region-wide.

Exacerbated by the sharp currency depreciation, falling asset prices, and a strong downturn of economic activities, financial institutions' NPL jumped from 8 percent of credit outstanding in mid-1997 to 20 percent in December 1997 and to 45 percent in December 1998. By the end of 1998, NPL totaled 2.7 trillion baht or 59 percent of GDP. Worse yet, an emerging moral hazard was fake or strategic NPL because, in spite of their strong debt servicing capacity, numerous debtors suspended remittances of their regular debt servicing. Fake NPL were estimated at one-third of reported NPL.

Thailand's economic meltdown in mid-1997 can largely be attributed to three policy errors:

- Liberalization of foreign capital flows while keeping the exchange rate rigid
- Premature liberalization of financial institutions
- Failure to prudently supervise financial institutions

These errors clearly demonstrate the importance of policy consistency. Should foreign exchange funds be allowed to move freely across borders, their prices or exchange rates ought to be liberalized as well so as to reflect market conditions. Otherwise, an excess of inflows or outflows could easily materialize, depending upon market sentiment and expectations. The liberalization of financial institutions is an equally controversial issue. Given that domestic financial institutions are not adequately prepared or experienced, the question is whether they should be liberalized, since liberalization could bring about more risks. But once these immature entities are granted more freedom, there is no doubt that the central authority should closely monitor and carefully supervise them throughout the liberalization process, especially during the initial adjustment period.

Once the central bank recognized the danger of limited foreign exchange reserves, it did not aim for any exchange rate target. Rather, it only sought to lean against the wind or smooth exchange rate variations in order to avert a depreciation-inflation spiral. It also resorted to credit and interest rate policies, rather than direct foreign exchange interventions, as a means to restore exchange rate stability, since foreign exchange reserves were in short supply. In other words, exchange rate policy was reversed from an exchange rate target defended by reserves to stable reserves defended by the exchange rate.

Several parties called for another extreme—the creation of a currency board in which the money supply in circulation must be entirely backed by foreign exchange reserves. However, this would lead to a substantial loss of sovereignty over monetary policy, which is a highly precarious situation in the midst of financial havoc and mobile capital flows. The continuing banking crisis, the need for legal and institutional changes, and

gathering political uncertainties all argued against a currency board.

Fortunately, the Thai government has emphasized the correction of underlying weaknesses in the country's economic fundamentals, since investor confidence and the country's credibility do not hinge solely on interest rates. According to a recent survey, the seven main factors that influence investor confidence are, in order of priority:

- Political stability
- Competence of the economic management team
- External accounts, including trade balance, current account, and balance of payments
- Efficiency and stability of the financial system
- Foreign exchange reserves
- Asset quality of financial institutions
- Policy consistency or rigidity

The efforts of the Thai government to reduce distortions in fundamentals were successful to some extent, as confirmed by the rising value of the baht, its growing stability (Chart 1), and improvements in the current account (Chart 2), even though baht interest rates decreased substantially. These results demonstrate some of the government's achievements in restoring investor confidence, which does not depend on only one or a few variables, such as interest rates or the trade balance. The crisis was rather a consequence of accumulated structural weaknesses. Lasting recovery is thus contingent on comprehensive structural reform. Attempting stabilization without explicit structural reforms, especially in the financial and corporate sectors, would be a costly exercise in treating symptoms without addressing the causes of the disease. In the financial sector, as foreign commercial banks' NPL (10%) were far smaller than those of Thai banks' (42%), it is worth examining details of structural differences.

Chart 1 Thailand's Exchange Rate and Interbank Interest Rate

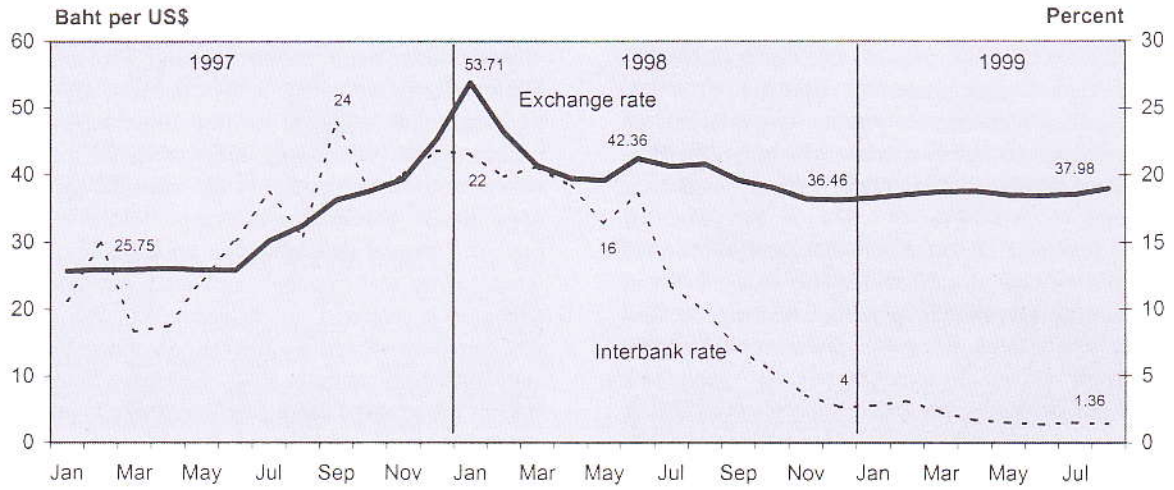
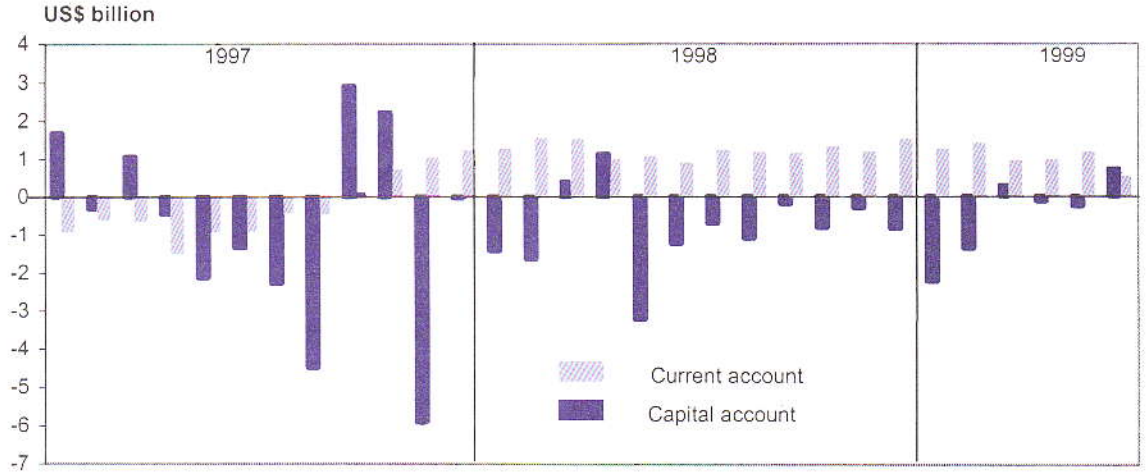


Chart 2 Thailand's Current Account and Capital Account Balance



Micro Perspective

Following international standards or adhering to principles prescribed by headquarters abroad, foreign commercial banks systematically evaluated project feasibility or the viability and debt servicing capability of prospective clients before extending credit. Their lending decisions were mostly cash flow based. Besides, they preferred not only to match maturities between sources and uses of funds, but also to cover their foreign exchange exposure. Most foreign banks are more efficient than their Thai rivals in collecting due debts and adopting advanced technology. Thai private commercial banks were at the opposite end. They paid strong attention to collateral and/or guarantees from reliable or familiar entities. Their lending decisions were asset-based, ignoring cash-flow analysis. Worse yet, they barely accounted for risks from maturity mismatching or foreign exchange exposure. Instead, nepotism and cronyism were of greater significance. Not only did their overdue debts far exceed those of their foreign rivals in proportion, but Thai commercial banks often lagged behind in terms of technology.

A ranking of the problems that Thai banks and finance companies faced before the 1997 crisis clearly demonstrates the drawbacks in the Thai financial system. First was the lack of systematic credit risk assessment. Thai financial institutions resorted to collateral to an excessive extent, and there was no standard for pricing this collateral, so skewed pricing was prevalent. In other words, feasibility studies and risk appraisal received little attention. Second, extended credit tended to be linked with affiliated businesses, shareholders, and directors. Third, credit extension was speculatively oriented, so loans grew too much in particular periods of time and/or clustered in particular sectors engendering risky bubbles. The two principal factors underlying these problems are low-caliber staff and the fact that the Thai financial sector had been protected for too long, so it was too immature to compete with foreign units, such as foreign banks and BIBF.

At this point it should be noted that though Thai commercial banks may lag behind foreign ones in several respects (e.g., technology, management tactics), they command some advantages, especially in retail banking. Examples of their edges include local networks and familiarity or acquaintance with Thai culture and traditions. Their prospects for further competition with foreign rivals are therefore not negligible. Innovative adjustments (e.g., accommodating more small and medium enterprises, economical branching) could pave the way for firm competitive positions.

Viewed from a broader perspective, managing a financial system is an intricate issue. Protection is needed if a country wishes to develop its own financial institutions and staff. But protection also generates costs, e.g., moral hazard or malpractice. After a while, liberalization consequently deserves consideration. Nevertheless, such a move can be double-edged, depending on how ready domestic financial institutions are to compete and how good the central authorities are to monitor or supervise. The crucial elements are timing and intensity. Too long a protection period or too strong a liberalization drive could easily lead to excessive inefficiency or economic bubbles, respectively.

A similar financial structure and culture is applicable to typical Thai non-bank businesses. One is thus tempted to doubt whether any attempt at rehabilitation will have quick success. Thai corporations have a strong preference toward debt, instead of equity, financing. This is true of business enterprises of all sizes. There are two underlying reasons. First, most Thai companies are family-run and they want to retain control, so they prefer debt to equity. Second, they are further induced by the tax allowances given to debt servicing but not to dividend payments. Consequently, typical Thai business enterprises are not concerned about fixed obligations or the burden of debt financing. They also ignore the susceptibility to liquidity shortages that debts can easily bring when roll-over is needed.

Thai businesses, especially small ones, tend to be shortsighted in terms of their financing. They resort to short-term funding first. For example, overdraft facilities are widely used, even for long-term projects. In other words, to them maturity mismatching is not threatening, although frequent roll-overs or refinancing occasionally lead to financial strains. Worse yet, some modern entities that resort to external funds often leave their net foreign exchange positions uncovered or unhedged, especially at times of stable exchange rates. This is in sharp contrast to foreign firms or their affiliates.

On the part of the central authorities, the main shortcomings lay in the areas of supervision and examination. These duties were carried out by two separate departments at the central bank. Regulations before 1997 explicitly stated that before any preventive or corrective actions could be undertaken, the results from an examination had to be disclosed, and be affirmative. However, due to inadequate or inefficient staff, the examination department's normal procedures took so long that by the time any action was permitted, the situation at ailing financial institutions was beyond rescue. In other words, remedial actions were made useless by regulations and inefficiency in the examination process. Moreover, the regulations contained an excessive degree of subjectivity or too much discretion was involved. For instance, the clause "in accordance with discreet standards" was often referred to.

In contrast, some bank examiners argued that the problem was not the process itself, but in what happened afterward. In other words, they knew what problems existed at which local banks, but they were asked to "tone down" the language used in official reports. That means that political interference, fears of fueling public panic or a systemic crisis, or conflict of interest led to poor coordination among regulators themselves and the inefficient resolution of banking problems.

ALREADY DONE

In 1997 the Thai government promulgated several emergency decrees to undertake a financial restructuring package. It contained the following essential elements:

- In cases of urgent need, the Bank of Thailand has the authority to order a commercial bank or finance company, without having to go through a shareholders' meeting, to write down its capital below the value stipulated by law and to allocate share increases. In addition, the Bank of Thailand, with the approval of the Minister of Finance, has the power to remove directors or executives of such commercial banks or finance companies and appoint replacements. The purpose of this additional authority is to allow for timely intervention in inefficient financial intermediaries that experience large losses endangering the public interest.
- The Bank of Thailand Act was amended to reaffirm the government's commitment to have the Financial Institutions Development Fund (FIDF) guarantee depositors and creditors, with full financial support from the government.
- Battered by the 1996 economic downturn, the sluggish property sector in Thailand led to considerable deterioration in the quality of asset and collateral at commercial banks, generating a continuous rise in NPL. The tension was exacerbated by the baht's depreciation. The Property Loan Management Organization (PLMO), set up in 1997 and upgraded in 1998, was to provide liquidity to financial institutions by purchasing their impaired property loans and to facilitate the completion of concerned projects. The PLMO's scope of business was later expanded to include securitization, operation of property mutual funds, turnover of real estate projects and property collaterals. In this context, the authority also permitted financial institutions to set up their own property loan management companies to operate in a similar fashion to the PLMO.
- The Secondary Mortgage Corporation (SMC) was established in 1997 to provide liquidity for financial institutions by purchasing retail mortgage loans, to reduce interest burdens, and to securitize purchased mortgage loans. These functions should encourage the extension of housing credits, enabling the poor to afford their own accommodation. Another underlying objective was to develop a benchmark yield curve for the bond market.
- The Financial Sector Restructuring Authority (FRA) was set up as an independent entity with the following objectives:
  - To review the rehabilitation plans of suspended finance companies
  - To assist *bona fide* depositors and creditors of suspended finance companies
  - To administer the liquidation of finance companies which the FRA considers unable to be rehabilitated.
- The Asset Management Corporation (AMC) was established to bid for or to purchase the impaired assets of finance companies that the FRA deemed no longer viable. The AMC was also empowered to enter a bid for good assets to support a competitive bidding process. The AMC manages the purchased assets in order to enhance their value, or it can foreclose the collateral and resell it as soon as possible. The AMC is entitled to receive some privileges, such as exemption of Value Added Tax (VAT) and special business taxes.
- Ratanasin Bank (RB) was set up as a "good bank" to purchase and manage the good assets of the suspended finance companies. Later, RB was assigned to merge with the ailing Laem Thong Bank as one means of financial renovation.
- The limit on the foreign ownership of shares in commercial banks and finance companies was lifted from 25 percent to 49 percent (and later to 100%), effective for up to 10 years. This was done to enlarge financial institutions' capital base and strengthen their management tactics.

The FRA's strategy for financial sector reform involved:

- Identifying and resolving nonviable institutions
- Protecting viable institutions
- Dealing resolutely with nonviable institutions
- Distributing the burden: Shareholders must bear losses first, pursue cases of fraud and gross negligence, not allow willful loan defaults, minimize public sector costs
- Protecting depositors

The FRA laid down the following guidelines for the rehabilitation of suspended financial institutions:

- Only the strong may reopen
- Strict asset classification and provisioning
- Adequate capital cushioning
- Suitable ownership and management
- Maturity of borrowing from the FIDF lengthened
- Conversion of FIDF debt to equity only after the write-down of existing shareholders' capital

On December 8, 1997 after examining the detailed status and proposed rehabilitation plans of all 58 suspended finance companies, the FRA decided to permanently shut down all but two. The FRA based its decision on the following criteria:

- Capital adequacy and sources of additional capital funds
- Capability in liquidity management
- Ability to repay debts to the FIDF
- Reliability or trustworthiness of executives

Both the depositors and the creditors of the 56 defunct finance companies were provided with government guarantees, while shareholders could claim the excess of assets over liabilities. The monetary authority

aimed to separate "good" and "bad" assets of the defunct finance companies. The "good" ones were handled by RB, while the "bad" ones were to be sold to and managed by the AMC.

On March 31, 1998 the Bank of Thailand tightened regulations on loan classification, provisioning, and reporting standards, aiming to upgrade local financial institutions to international levels by the year 2000. Effective July 1, 1998, the definition of non-performing assets was changed to cover loans three or more months in arrears, instead of the previous six (or 12) or more months. Two new loan categories, pass and special mention, require 1 percent and 2 percent provisioning, respectively. Meanwhile, commercial banks as well as finance companies had to increase provisions for substandard loans from 15 percent to 20 percent (Table 1). Doubtful loans required a 50 percent provision rather than the previous 100 percent, but loss loans continued to necessitate 100 percent coverage. These new standards forced local banks to increase their capital by as much as 80 billion baht by the end of 1998, on top of the 129 billion baht previously added. Finance companies needed 42 billion baht of new capital on top of the 20 billion baht recently added. Banks have to set aside up to 100 billion baht in new provisions for loan losses, while the set asides by finance companies totaled 43 billion baht.

The system adopted in March 1998 also called for quarterly, instead of annual, audits and credit reports to be submitted to the central bank. Loan portfolio reviews have to cover at least 70 percent of credit outstanding, including the top 100 clients and credits or commitments to related parties. The measures also demand that financial institutions tighten their lending practices and credit analysis procedures, focusing more on borrowers' cash flow and debt servicing ability, rather than on loan collateral. Debt restructuring or renegotiations must be subject to realistic assessments of financial viability of clients or their projects.

On August 14, 1998 the government decided to nationalize six commercial banks and five finance companies. Some of these were merged with government banks or finance companies, while some were to be sold to interested parties later on. In addition, the government offered assistance to other financial institutions undergoing recapitalization as follows. If financial institutions commit themselves to comply with new loan loss provisioning immediately or earlier than the previously targeted year of 2000, they are entitled to enlarge their first-tier capital by issuing preferred shares to the government in exchange for tradable government bonds. Furthermore, as a means to motivate debt restructuring or reconciliation with problem clients, the government put forward an option to financial institutions to increase their second-tier capital by exchanging non-tradable bonds with banks' newly issued debentures, equaling the losses suffered by financial institutions in their debt restructuring.

The underlying dual objective of the August 14 package was to reform the financial system so that new asset classification and loan loss provisioning could come into effect as soon as possible while reinvigorating the economy at the same time. If financial institutions were left by themselves, they could hardly extend credit because their huge existing NPL have to be backed up by capital funds, which were rather scarce and whose enlargement was very difficult in the midst of the prevailing economic depression. At this point, it is worth clarifying that the credit crunch is not due to liquidity shortages, as interbank interest rates dropped from 24 percent to only 1.5 percent (Chart 1). The problem was essentially caused by the inadequacy of financial institutions' back-up capital funds as demanded by the above-mentioned new loan classification and provisioning standards. Financial institutions could hardly extend credit or lower interest rates (so as to revive spending and combat the economic downturn) because NPL raise costs by compulsory provisioning. In other words, interest rates on credit do not depend only on deposit or interbank interest rates. They rely heavily on asset quality as well.

In retrospect, high domestic interest rates in the first half of 1998 were largely the consequence of substantial borrowing by the FIDF (or the rescue arm of the central bank) from short-term money markets to fund long term bail-out operations. In order to both obliterate this market distortion and provide funding channels for the August capital support facilities as stated above, the government authorized in August 1998 an emergency decree enabling the issuance of special government bonds worth 300 billion baht. This restructuring of the FIDF's liabilities certainly ameliorated the market scenario, as evidenced by the considerable decreases in the interbank interest rates. Meanwhile, better current

Table 1 Loan-Loss Provisioning Requirements for Commercial Banks

Loan Classification	Months Overdue	Previous Provisions	1998 System of Provisioning
Pass	< 1 month	-	1%
Special mention	0-3 months	-	2%
Substandard	up to 6 months	15%	20%
Doubtful	up to 1 year	100%	50%
Loss	> 1 year	100%	100%

Source: Bank of Thailand.

account balances induced investor confidence to recuperate to such an extent that the baht recovered markedly, from 47 baht/US$ in June 1998 to 36 baht/US$ in December 1998, despite plunging interest rates (Charts 1 and 2).

What should be noted is that the August 14 capital augmentation measure is voluntary, depending on the discretion of financial institutions. It turns out that few banks resorted to the capital enlargement opportunities offered by the government, particularly the Tier 1 option. This indicates that banks have been reluctant to write down their capital in return for public money and accept the dilution of ownership that would ensue. Instead, they raised capital through the issuance of preferred stocks linked with subordinated debentures, or the so-called SLIPS (Stapled Limited Interest Preferred Shares) and CAPS (Capital Augmented Preferred Shares). Though these new instruments are appealing to some savers in the presence of low deposit interest rates, they still contain some inherent risks, as concerned principals receive no government guarantee and some returns are performance-based.

Other than adjusting the positions or status of the financial institutions, restructuring corporate debt is definitely another crucial element for both financial sector reform and economic recovery, because successful debt restructuring will help resolve the NPL problems of financial institutions and resuscitate economic activities simultaneously. The government therefore set up a corporate debt restructuring advisory committee to coordinate negotiations among debtors, their potential new partners, bankers, and finance company managers. Frameworks of corporate debt work-outs are based on the "London Approach" under which creditors: work together, share all information about debtors, recognize the seniority of claims, seek out-of-court solutions, and agree to keep credit facilities in place.

Examples of resolutions are interest rate reductions, maturity stretching, partial write-offs, and debt-equity conversion. However, debt negotiation is not an easy task. It involves not only strong pressures from several parties (e.g., debtors, their potential new partners, local and foreign creditors, central bankers, internal revenue officers) but also legal and regulatory constraints. In this context, the government tried to help by amending bankruptcy and foreclosure laws. Meanwhile, the government removed tax disincentives in order to encourage debt renegotiations. Nevertheless, corporate debt restructuring remains a lengthy and difficult process and represents a major stumbling block to economic recovery.

Before examining why the debt restructuring process is difficult and lengthy, it is useful to notice some major differences between the four types of financial institutions in Thailand: the eight surviving private Thai commercial banks, the state-run commercial banks (including the ones taken over after the crisis), foreign commercial banks, and the 35 surviving finance companies (Table 2). Of the total credit outstanding as of December 1998, private Thai commercial banks commanded the largest share (51%), while finance companies had the smallest (8%). However, with regard to asset quality, the picture is almost the opposite, as finance companies' NPL were the highest at 70 percent, while private Thai commercial banks' NPL were 42 percent. The high NPL of state commercial banks (62%) should not be misinterpreted. The primary reason for this is that the government took over six ailing private commercial banks after the crisis, so their NPL raised the average of state commercial banks. Foreign commercial banks were at the other extreme, holding the lowest NPL (10%).

On the part of foreign banks, their systematic approach yielded satisfactory results or low NPL. But given their limited share in the Thai financial market (due to legal constraints on branching and new establishments), their low NPL were of little consequence to the market as a whole. And because they had extended credit on an unsecured basis (no collateral or guarantees), foreign banks were more willing than Thai banks to renegotiate with debtors after the crisis. But their small market share made this willingness less meaningful in the overall context.

Thai commercial banks, on the other hand, hesitated to pursue rescue packages for ailing debtors. The collateral and/or guarantees that they commanded tempted them to try to foreclose the concerned assets or to sue guarantors instead of petitioning for rescues. Worse yet, even though the Thai bankruptcy law was amended in June 1998 with the addition of the possibilities of rehabilitation or rescue packages (like Chapter 11

Table 2 Credit Outstanding (C.O.) and NPL as of December 1998

(Amount: billion baht)

	C.O. (1)	% share of (1)	NPL (2)	(2) ÷ (1) %
8 Private comm. banks	3,063	51	1,293	42
State comm. banks*	1,660	28	1,037	62
Foreign comm. banks	756	13	75	10
All comm. banks	5,479	92	2,405	44
35 Finance companies	461	8	322	70
Grand total	5,940	100	2,727	46

* Including private commercial banks that were nationalized after the emergence of the financial crisis.

Source: Bank of Thailand.

of the U.S. law), the rescue option requires consensus among creditors (or at least 75% of creditors' voting rights covering at least 50% of outstanding debts). This makes the Thai banks' hesitation to renegotiate debts more influential. It is thus unsurprising that 90 percent of the debt restructuring cases that experienced serious difficulties involved Thai commercial banks.

In many cases creditors tried to foreclose collateral. But in Thailand the foreclosure procedure is very lengthy. Although the foreclosure law has recently been revised, the protracted period of time involved does not make this option attractive to creditors, especially when the concerned asset prices do not appreciate much. Both secured and unsecured creditors are therefore trapped in the horns of a dilemma. Although the final outcomes of legal prosecution (foreclosure or bankruptcy) are likely to be favorable to creditors, the procedure is time-consuming and costly due to the income foregone from and the requirements of NPL. On the other hand, debt restructuring, in a genuine sense, may yield quicker results and help avert NPL-related difficulties. But relaxing the terms of loan contracts means a reduction of creditors' income as well. Given that Thai banks typically commanded collateral and/or guarantees, they prefer extending repayment schedules to accepting any loss. In other words, Thai banks are rather tough as they often insist that debtors repay 100 percent of the principal together with interest, which is drastically different from debt concessions abroad where only 50-70 percent in returns is deemed excellent.

Debtors also face a quandary. Because of their excessive borrowing in the past and excess capacity at present, they are overwhelmed by an intolerably heavy debt burden. Long acquaintances and good relationships with particular creditors often tempted debtors to favor some creditors over others in the debt restructuring process. But such bias can hardly be accepted without inter-creditor agreements. If debtors resort to new partners to share debt servicing, the new partners have to be ones whose creditworthiness is acceptable to creditors. Meanwhile, new partners are tempted to demand several conditions or methods of protection before making capital investments or in sharing debt obligations. Without new partners, either debtors could go bankrupt when sued by unsecured (foreign) creditors, or debtors' assets could be lost to foreclosure when sued by secured (Thai) creditors. Besides, inter-creditor agreements are often difficult to reach since different creditors have different conditions or back-up securities (guarantees or collateral), depending upon their loan contracts.

One resolution to debt restructuring is swapping debts to equities or shares in debtors' companies. However, some debtors are reluctant to do this as they would like to retain the family-run nature of their companies. The unwillingness of others to adopt debt-to-equity conversion as a means to rehabilitate their businesses is due to the fact that such a route would require disclosure of relevant information, some of which is deemed confidential in their family circle. Another resolution is partial or total write-off, or the so-called hair cut. Some foreign banks (such as Japanese ones) prefer to avoid this route in accordance with their headquarters' guidelines. Other banks also hesitate, as some of them hold collateral and a hair cut necessitates a capital reduction while new capital funds are now extremely difficult to tap.

Even if financial institutions allow for some write-offs, tax problems arise. For instance, commercial banks have to pay taxes on accrued interest and principal even though they have yet to collect them. In the midst of debt restructuring efforts, banks thus request tax credits or refunds on the irrecoverable portion of accumulated debt service. But the tax law demands official prosecution if the money involved exceeds 500,000 baht. As for debtors, forgiven debts are treated as income subject to the 30 percent business tax. This requirement decreases the incentives for debtors to restructure their debts. Moreover, since the Revenue Department has priority over other creditors when claiming debtors' income or assets, such priority makes creditors less willing to write off parts or all of their overdue debts.

But creditors' hesitation to restructure debts could be costly as well because, according to the new requirements on loan classification and provisioning, the longer the debts are overdue, the larger provisions or capital supports become necessary (see Table 1). And abiding by such a rule is now very painful, as financial institutions are finding capital funds scarce in their pockets and tapping them from the market represents a formidable task.

Another vicious circle of NPL occurs when Thai commercial banks hesitate to roll over maturing debts of even good clients, as the precarious environment drives banks to retrieve most credit as soon as possible. This hesitation creates pressure on banks' clients, and they could consequently become new NPL, either out of necessity or voluntarily.

Overall, the fact that Thai commercial banks tend to resist both hair cuts as well as extending new credit makes large scale debt restructuring unsuccessful, and economic recovery delayed, if it takes place as all. Interpreted in a broader sense, commercial banks and finance companies are not earnest enough in restructuring loans. This is in sharp contrast with the American situation in the 1990s, where U.S. banks were willing to accept massive loan write-offs, which helped reverse the economic downturn, and revive property prices.

Nevertheless, strenuous efforts at financial reform in Thailand have achieved some results. These include:

- Viable financial institutions were segregated from unviable ones. Fifty-six finance companies were closed down and their assets were liquidated through the FRA's auctions. Six ailing commercial banks were handled on a case-by-case basis, i.e., integrated with state banks (FBCB, LTB, UB), their good assets transferred (BBC), recapitalized by the government for subsequent privatization (BMB, SCIB).

• The remaining financial institutions were strengthened by improvement in supervision, upgrading of loan classification and provisioning, greater foreign ownership, and recapitalization. Foreign financial institutions acquired substantial shareholding in small banks (TDB, BOA, NTB, RB) and thereby enlarged their capital base. Large Thai banks were successful in recapitalization by issuing a new hybrid between preferred shares and subordinate debentures. The so-called SLIPS and CAPS offered buyers a combination of preferred shares and debts with guaranteed minimum returns. They therefore attracted strong interest from general investors in the midst of the low-interest-rate scenario of 1999. It is thus unsurprising that large private commercial banks succeeded in augmenting their capital base to a considerable extent. As for the ones that could not do so, the FIDF stepped in and assisted. Between 14 August 1998 and 12 May 1999, financial institutions in Thailand attained the following amounts of recapitalization, either through the August capital support measure or their own efforts: private commercial banks—190.148 billion baht, state commercial banks—254.137 billion baht, finance companies—3.119 billion baht, grand total—447.404 billion baht.

• More foreign participants or shareholders in commercial banks will help upgrade the management strategy of these banks. In other words, more objective systems and a stronger cash flow will be adopted, which should result in fewer and more manageable risks.

• The process of corporate debt restructuring was successful to a certain extent. The accumulated number of successful debt restructuring cases went from 9,016 in December 1998 to 17,667 in February 1999, and to 30,763 cases in March 1999, covering 155.566 billion baht, 215.863 billion baht, and 280.936 billion baht, respectively. (Nevertheless, 2.7 trillion baht worth of NPL remains to be worked out.)

• Enhanced bankruptcy and foreclosure laws were passed. In addition, a bankruptcy court was established. These reforms will help facilitate debt restructuring, and thereby consolidate the financial system.

• In September 1999, a credit bureau was officially organized. Spearheaded by the Government Housing Bank, the bureau helps interchange debtor data among creditors. This is expected to favor creditors in reducing credit risks and in raising efficiency levels in risk assessment and management. Practically, the credit bureau is an enlargement of the central credit registration previously administered by the central bank.

• The Bank of Thailand on September 24, 1999 stipulated the limit on credit that commercial banks could offer to companies where bank executives sit in the administration. The limit is a minimum of 50 percent of client's equity, 25 percent of the client's total liabilities, and 5 percent of the creditor bank's first tier capital. Senior executives of commercial banks cannot hold more than 1 percent of subscribed stocks of a limited company. Furthermore, senior bank executives are not allowed to serve as directors in more than three limited companies. These restrictions are meant to build up good governance and transparency, which will serve to prevent NPL from occurring as a result of connected lending.

These changes, however, did not come free of charge. In fact, their costs were substantial, and they took several forms:

• The first parties to bear the cost (of writing off bad debts) were existing shareholders of financial institutions. The government utilized this channel as a prerequisite for injecting new capital support in the August measures.

• The issuance of FIDF bonds places a heavy burden on the government. By January 1999 the FIDF had issued roughly 400 billion baht of bonds, the proceeds of which were used to lend to or recapitalize ailing financial institutions. Whether they are recoverable depends on the future status or privatization of these units.

• Upgrading regulations on financial institutions (i.e., loan classification, provisioning, capital adequacy) in a short timeframe caused a vicious downward spiral on the real sector because tighter rules meant more NPL, which in turn required further provisioning and capital increases, which made banks more reluctant to lend to the real sector. This in turn led to a credit crunch in the real sector, more recession, and more NPL in the business sector. Unsurprisingly, Thailand's real GDP contracted by 10 percent in 1998, generating a myriad adverse socio-economic impacts.

• Closing down some commercial banks and finance companies meant not only laying off staff but also discontinuing credit lines to some companies. The latter led to production cuts or downsizing, which worsened the employment environment. The situation was aggravated by corporate debt restructuring since new terms of debts often necessitated adjustment of debtors' financial operations and streamlining of relevant costs, which inevitably raised unemployment. Labor ministry's statistics demonstrate the plight of workers, as the unemployment rate rose from 4.8 percent in February 1998 to 5.47 percent in February 1999. The number of laid-off employees surged from 5,015 in 1996 to 38,217 in 1997 and 51,498 in 1998. These figures are consistent with decreasing capacity utilization (72.4% in 1996, 65.0% in 1997 and 52.1% in 1998). This clearly indicates the costs of correcting the economy's external balance and in restructuring the country's financial system.

• Though successful financial reforms will lead to sustainable economic growth, the process, which involves more information disclosure, could weaken market confidence and country's credibility in the short run. Whether such confidence and credibility will be restored depends on the achievements of financial reforms in the long run.

Among all the above-mentioned costs, those that most capture the attention of the public are the ones borne by the government. This is because the

government's fiscal attempts to encourage financial sector restructuring (through capital injections) and to accelerate spending (through tax cuts and increased expenditures) sharply increase the government's outlays and indebtedness. According to World Bank projections, the pace of public debt buildup is alarming in the four crisis-hit Asian countries, particularly Indonesia and Thailand.

REMAINING TASKS

The financial sector crisis in Thailand has proved to be systemic, requiring major restructuring, which takes many forms, i.e., separation of good and bad assets, capital enlargement, adjustment of debt overhangs, more qualified staff, improvement of management strategies (e.g., credit risk assessment, standard valuation criteria for collateral, systematic databases), legal amendments, better ethics, good governance, adoption of international standards, and upgrading of clients' financial status or viability. These components deserve equal, immediate, and simultaneous attention. It is thus understandable that the pace of financial sector restructuring in Thailand has proceeded slower than envisaged.

While the government was successful in overhauling the bankruptcy and foreclosure laws, which help to expedite debt restructuring, it encountered difficulties in speeding up capital enlargement. This is understandable as investor appetite for bank equity diminished rapidly once the financial crisis emerged. Although the government decided to provide direct assistance through capital injection, capital funds alone can neither reform nor revive financial institutions. Other aspects of financial reform, as mentioned above, are also essential.

Recent experience has clearly indicated that strong foreign financial institutions will assume growing influence in the Thai financial market in all regards. They are holding larger stakes and taking greater management control in the previously protected banking circuit in Thailand. Consequently, if Thai banks are to survive, the following is likely to happen.

1. Family banking will gradually disappear, and so will connected lending.
2. The introduction of professional management will gather momentum, as will the role of technological adjustment.

The chances of survival will increase if Thai commercial banks resort more to mergers and acquisitions, because these will yield benefits from economy of scale and the increased ability to compete with foreign rivals. In the medium term, mergers and acquisitions will also help in resolving NPL, recapitalization, and technological advancement.

All of the fundamentals of Thai financial institutions need to be improved, especially the caliber of staff, management tactics, and ethics, if financial reform is to have long-lasting positive effects. This warning is applicable to all means of restructuring in the financial system in Thailand. For example, separating good and bad assets through private AMC, mergers, takeovers, or even foreign participation, may not mean much if fundamental weaknesses are not remedied. Imprudent credit extension, further NPL, and another financial crisis may recur. On the other hand, better staff, efficient management, and improved ethics can permanently upgrade and consolidate the financial system.

Specifically, recommendations for the future course of banking and finance in Thailand can be divided into two groups: involuntary and voluntary. The first is to be achieved by implementing new rules and regulations, while the second represents a gradual process of adjustment which depends upon several factors, such as government incentives, new foreign shareholders, and the banks' own discretion.

The involuntary course consists of the following.

1. Pertinent rules and regulations need overhauling. Currently, financial institutions are controlled by types (e.g., commercial banks, life insurance, and cooperatives). But financial liberalization has allowed financial institutions to pursue the businesses that they had never before handled. Therefore, financial institutions should rather be regulated by functions. Otherwise, regulations can easily become ineffective because of leakage or inefficiency. For instance, overlapping between banking and insurance or banking and cooperatives can make rules for each type of financial institution ineffective. Function-wise rules have already been adopted by some advanced countries, such as the United Kingdom and New Zealand, covering functions such as brokerage, commercial banking, and investment banking.

2. The basis of laying down rules and regulations should be re-oriented toward more objectivity. Less subjective judgement will help avoid loopholes and biases. Nevertheless, in some areas, regulators should distinguish assets of more and less risks depending upon their underlying qualities. For example, assets or debtors within the same business category may receive different weights depending upon inherent status or debt servicing capacity. This new risk weighting system corresponds to the new Bank for International Settlement (BIS) system, which is a refinement of the previous one.

3. Both examiners and supervisors should focus more on forward looking analysis rather than just monitoring bank accounts. This is essential since financial institutions have to manage volatile cash flows over a period of time. Forward looking regulators will therefore help detect whether problems may recur in the system, and if so, when and where.

4. More accountability should be required from bank executives or operators, since their actions or decisions have a strong bearing on their banks' performances. These executives should be held liable to criminal charges, or they should have to put up some of their own stake as contingent liabilities for excessive NPL. This will help motivate bank executives or operators to take

more care over the efficiency and asset quality of their banks.

5. The standards on accounting, detailed information, and transparency need to be upgraded so that the financial system will be underpinned by the following qualities: sustainability, checks and balances, and effective internal controls.

6. Once urgent problems in the Thai financial system are resolved, a deposit insurance agency should be established as a means to impose more market mechanisms on financial institutions. Otherwise, excessive risk taking or moral hazard and financial crisis could easily reappear.

The voluntary part has two components that largely depend on each financial institution's administration: human resources and good corporate governance. Development of these two items will help improve the core of the financial system. And once these two items are achieved, together with the above-mentioned accountability, accounting standards, detailed information, and transparency, regulating financial institutions will not be difficult, and examination will become unnecessary. In other words, when these six conditions hold, regulations specified by the central authorities will be continually abided by, and thus automatically prevent problems. Such a situation is certainly possible, e.g., as in New Zealand. Therefore, the central authorities should press for an improvement of human resources and corporate governance in financial institutions.

Together with the above-recommended policy actions, governments in developing countries may adopt some early warnings of banking crises. As suggested by Gonzalez-Hermosillo (1999), the ratio of capital equity plus loan reserves minus NPL to total assets, or the so-called coverage ratio, serves as one good indicator of bank fragility. However, other indicators pinpointing market risk and liquidity risk should also be considered. In short, an appropriate early warning system ought to take into account both relevant microeconomic and macroeconomic factors.

The central authorities ought to prepare local financial institutions to cope with the upcoming changes in the global financial arena. For instance, at present the Bank of Thailand requires financial institutions to maintain a capital-to-risk-asset ratio of 8.5 percent in accordance with the BIS's 1988 Capital Accord. At least half of the capital base must be in the form of tier-one capital, defined as equity (common and preferred stocks) and retained earnings. The rest, or tier-two capital, consists of subordinate debts and revaluation of assets.

In June 1998, the Basel Committee on Banking Supervision of BIS released a draft framework to replace the 1988 Accord. The new framework focuses on three areas.

- *Minimum capital requirements:* the broad, five-step risk weight system will be replaced with a credit assessment system that will more finely determine the risk of loans and other assets. Assessments will be made through external sources, such as credit agencies, or through internal bank risk models. Other types of risk, such as operational and interest rate risks, will be factored into calculating minimum capital requirements.
- *Supervisory review process:* the framework encourages early supervisory intervention to ensure that capital is sufficient for an institution's risk profile. Regulators could require different institutions to raise capital beyond minimum requirements. Internal risk management systems at banks will be regularly reviewed.
- *Effective use of market discipline:* banks will be required to disclose information about their capital structure, accounting practices, and key risk exposures.

The new framework aims at correcting long-standing weaknesses in the existing accord. For instance, interbank loans to institutions in countries within the Organization for Economic Cooperation and Development (OECD) were assigned a 20 percent risk weight, despite the fact that the actual default rate might be far higher. For non-OECD countries such as Thailand, the existing accord encourages banks to lend short-term, as loans of up to one-year maturity carry a risk weight of only 20 percent while long-term claims carry a 100 percent weight. This was one of the reasons that led to excessive short-term borrowing, the crucial element that triggered the Asian financial crisis in 1997 when investor confidence was critically shaken.

The revised capital framework could be implemented in Thailand as early as 2001, introducing tier-three capital (subordinate debts with maturities of up to five years) to supplement the existing tier-one and tier-two capital. Capital requirements would become more finely tuned to the risks taken by different banks. Calculations would factor in not just credit and market risks, but also liquidity positions, maturity structures, and operational risks taken by financial institutions.

Though the five-step risk weight system will certainly be replaced by a credit assessment system, it remains debatable as to who should be responsible for the risk assessment: external sources such as credit rating agencies, or banks themselves. Using external sources will result in ratings that are comparable worldwide. However, obtaining such ratings will certainly take more time and money, raising overall costs to borrowers. In any case, local bankers have expressed concern as to whether the timing is right to introduce new capital requirements.

Another challenging issue that the Thai monetary authorities have to cope with in the near future is the stronger momentum toward financial liberalization. The U.S., for example, has already passed the Financial Services Act of 1999 that supersedes the Glass-Steagall Act of 1933. The 1999 Act overhauls the U.S. financial system by allowing financial institutions to undertake functions that they were not previously permitted, i.e., an overlap among commercial banks, securities firms, and insurance companies. This is likely to result in more competition, efficiency and cost reductions, innovations,

and diversity of financial services. It will also raise the number of mergers and acquisitions around the world. Even though consumers will certainly benefit from this move, small developing countries (like Thailand) have to be cautious. Lessons from the 1997 financial crisis indicate that several ingredients (e.g., maturity of financial institutions and their supervisors) have to be in place for financial liberalization to be successful. Therefore, the Thai monetary authorities should be wary in coping with further liberalization in the global arena. Gradualism is typically a safe route toward successful and stable adjustment.

Equally challenging is the course of capital market development in Thailand. In order to assure general investors of the honesty and reliability of the performances of listed companies, the Stock Exchange of Thailand (SET) stipulates detailed prerequisites for new entrants, e.g., minimum profits for a certain number of consecutive years, a minimum number of shareholders, etc. But these requirements are seldom met by small and medium-sized enterprises (SME) in Thailand. Most SME, therefore, have to rely on debt financing from commercial banks plus finance companies, and funds from informal money markets or crony connections. What is more worrisome is the number of these SME. Unit-wise, SME total about 90 percent of all Thai private enterprises. Even though their final output has not reached a sizable share of GDP, their future prospects are important in terms of economic development, income distribution, and social welfare. At present, although there are a few specialized financial institutions designed specifically for SME, i.e., the Small Industry Finance Corporation and the Small Industry Credit Guarantee Corporation, due to their limited capital funds and branches, they have not been able to satisfy the financial needs of the majority of SME.

Two possible solutions to the SME plight are the following. First, developing domestic debt markets will help reduce the excessive reliance on banks and finance companies as the principal vehicles for term financing. More developed domestic debt markets would also lower the risks of maturity mismatching. Second, special purpose vehicles (SPV), such as those in Japan, may be set up to issue asset backed bonds directly marketed to savers. These SPV may need guarantees from the central authorities in order to gain enough confidence of savers. Once in operation, SPV can immediately serve SME effectively, as SPV should be able to pool risks and develop expertise in efficiently handling SME. SPV will help reduce the NPL of both commercial banks and finance companies, while invigorating the economy. Similar to SPV is the Debtor Rehabilitation Fund (DRF). Its main objective is to revive ailing firms or almost bankrupt debtors who have strong or promising economic prospects, or whose projects will benefit the community at large. The DRF is meant to restructure the debt profiles of potential corporations or entrepreneurs who do not receive adequate attention or credit from private financial institutions.

As regards other facets of capital market development, listed firms on the SET ought to be continually and closely monitored to ensure the continued efficiency of their management. Trustworthiness and reliable internal controls will help ensure that the stock market function as a competent rival to commercial banks and finance companies in serving savers, investors, and the development of the financial system. However, a study by the World Bank shows that 16 percent of the firms listed on the SET are controlled by single-family shareholders. Five large family groups dominate up to 50-60 percent of listed firms. This lack of diversity in shareholding often impedes sound internal controls and risk management. Corporate restructuring is thus an immediate task since building up good corporate governance normally takes a long time.

Another reason to develop local capital markets is that bank loans are intrinsically volatile. Before 1997, about 70-80 percent of all financial intermediation in Asia was bank credit-based, compared to 40-50 percent in Latin America. Bank lending has also been blamed for corporate over-leveraging during periods of growth in asset prices. The bulk of the US$125 billion of funds withdrawn from Asia during the region's crisis comprised bank lending, particularly short term. In other words, the herd was in banks, not in the capital markets, so a shift from bank-led to market-based intermediation will result in less volatility and greater focus on profits, as well as healthier economic growth.

According to the IMF's 172-page report entitled "Financial Sector Crisis and Restructuring: Lessons from Asia," the following items deserve strong attention from monetary authorities, especially those in developing countries.

- Take prompt and decisive action to deal with banking problems, including preemptive restructuring action.
- National authorities should have full ownership of all aspects of the financial restructuring effort.
- Transparency in government action is needed to make restructuring credible and successful.
- Valuation of bank assets in the absence of clear market values and fluctuating economic conditions is difficult but necessary.
- Solving banking and corporate sector crises must go hand-in-hand.
- In good times, financial institutions should build up a "cushion" of capital.

While the economy is recuperating, one clear-cut lesson from the crisis is that the central authorities should closely monitor the operations and status of financial institutions, corporate financing, SME, and capital flows, as these items have grave consequences for the country as a whole. In addition, the authorities should maintain consistent policies in order to achieve proper targets and restore confidence.

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Non Performing Loans (NPLs): The Borrower's Viewpoint

Suthep Kittikulsingh*

A bright hotel banquet room crowded with bankers, clients and their friends in business suits bumping into each other to the sounds of clinking glasses of scotch and soda—this was the scene at the launch of yet another property development. A miniature representation of the project, enclosed in a glass case and lit up by spotlights, lay in the center of the room for all to view. It was a sprawling complex—clean geometric lines, a large area of well manicured grass—and it overlooked a blue river.

A project like this in the early 1990s in Bangkok was a sure winner. Fifty percent of the available units had been sold, and the buyers were already reselling some of the purchased units at a profit. The developer was withholding further sales until he received the right price. The bankers felt fortunate to be in on this deal. It had been a hard, long negotiation and the interest rate spread was rather slim (especially considering that half the loan was to be in US dollars). However, the instructions from the top had been, somehow, to clinch the deal. Getting a share of this project was important because it would be the bankers' passport to the monumental one the same developer was to unveil in five months time.

But too many successful deals by too many developers and bankers were tilting the resources the wrong way and creating an ugly, oversized bubble. There was a huge mountain of real estate development based on a molehill of market research. Unknown to everybody present in the banquet room, they had just sown the seeds of what was to become the monster of Bangkok—an NPL.

NON-PERFORMING LOANS: CAUSES

The Bubble Economy

Did the bubble have to burst? If the answer is a definitive yes, then the assumption is that bubbles are recognizable and predictable. Charles Kindleberger, the economist, thought otherwise, and said that a bubble was defined by its bursting. Now that it has burst, it is easy to reminisce on how real estate prices were climbing every week and how there was always that gut feeling that the climb was not going to last forever. To some extent, the bubble was acknowledged, but its existence was only confirmed once it burst. The same gut feeling now makes us queasy about the Dow Jones Industrial Average. Let us hope that bubble (?) never gets defined.

When prices of a commodity move up fast (like 10% per month), a disaster is waiting to happen. It is a pity that there is no system to check the prices of specific goods that are spiraling out of control, because if checked at this early stage, it is easier to contain the problem before it starts to infect the price of other goods. A micro solution (taxation to reduce demand of the product in question or reduction of import duties on competing products to spur competition etc.) can be used to contain these micro problems. But if they remain unchecked, the virus spreads and it could well become a macro problem of the overall price level or inflation. Then the sharpshooter's rifle will not do. Nothing less than a machine gun (the interest rate) will do the job. Unfortunately, the machine gun will kill many innocent victims along with the criminals. Industries already suffering from anemic demand will fall victim to the anti-inflation gun, and their plight will worsen.

In any case, regulators face a hard choice, in fact, a no-win situation. When bubbles burst naturally, then the regulators have been asleep at the wheel. When the regulators cause them to burst, then they become responsible for having labeled healthy growth a bubble and then killing it, or at least for not having engineered a soft landing.

All that is history now—the Thai bubble finally burst. In a speech a few days back, US Federal Reserve Board Chairman Alan Greenspan said that financial crises are unpredictable, their consequences are unknowable in advance and that the current generation of risk models is not equipped to handle these events. "In a real crisis, investors can recklessly sell everything, even assets they know to be perfectly fine," he said. Just as there was not much the Thai regulators did to control the bubble in the initial formative stages, there was not much they did to mitigate its effects after it burst

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(though, admittedly, after the crisis, their hands were tied).

When the Bubble Burst

By the end of 1994 through 1996 price pressures were being felt across the country across many industries. Exports were not getting much stronger, but pre-committed export-directed investment continued. The 1996 merchandise export figures showed a disturbing 0 percent growth. To some extent, the slowdown was an Asia-wide affair. Thailand was ahead of the pack in the growth race but it was over financed—like an athlete on steroids with not much of his own internal strength. Once the effects wore off, it was the first to stumble. Weaknesses in the real estate sector were being felt though buildings were still being built because land had been procured and financing had been arranged. Doubts started to surface in the minds of the entrepreneurs that these were the twilight days of easy money. Interest costs and other costs were high. Competent personnel could not be hired because they were too expensive and too busy hopping from one job to another. Engineers were in very short supply. The euphoria among the business community was waning and passion was fading. Selling prices of manufactured products faced intense competitive pressures. Listed companies started losing money. The Stock Exchange of Thailand (SET) index had been in decline since 1995. In May 1996, the Bangkok Bank of Commerce scandal was exposed in parliament when the Democrats in opposition tried to score points against the government in a no-confidence debate. That marked the turning point in confidence in Thai financial institutions in general and in the regulatory process in particular. It turned out to be a missile aimed directly at the Bank of Thailand (BOT). By November 1996 the first attack on the baht was reported.

The pressure on businesses to pay back their loans had started. The bigger the financial institution, the less they valued long-term relationships with individual clients. The smaller institutions were desperate because their loans (borrowed from abroad or from the bigger institutions locally) were being recalled. Financial institutions that were previously taken for granted were suddenly undependable and relationships with them were now on an on-call basis. Initially, businesses responded by juggling the loans around, borrowing from one institution to pay off another. As more and more institutions made the same demands, the game drew to a close. When the repayments slowly ground to a halt (there was really nowhere else to borrow from), and requests by the borrowers for a little more time fell on deaf ears, high short term interest rates were imposed—by then, short-term rates based on the interbank rate had made an acquaintance with the stratosphere. Between November 1996 and July 1997 quite a number of attacks on the baht had taken place and interest rates rose in response. The rates were crazy and businesses either paid back some of their loans, paid the crazy interest rates or lost their credit rating. Many did all the three in sequence.

The damage to business was more than just higher interest costs affecting the bottom line. The sudden withdrawal of funds demonstrated the marked difference between the money market and the goods markets in a crisis. Less supply of any product should normally increase the relative demand, which would automatically increase the price and bring in more supply, which would restore the balance (as in the classic demand-supply graph). But the equations for money in a crisis are not so straightforward. Less supply increased relative demand and consequently higher interest rates, but the higher the rate paid by the borrower, the worse his credit rating became and the higher the rate that he would have to keep on paying—the equilibrium price (interest rate) on the supply-demand graph for him just kept shifting upwards. He was being sucked into a black hole through which he was going to be blasted into oblivion if he did not act to save himself.

Though prices of products, especially commodities, move up and down continuously and are a major cause of business tension, and even of business success or failure, the goods market is not as perfect or efficient as the money market or the stock market. Stocks are expected to oscillate within a certain range every day and dealers take the profits and losses from their stock trades in their stride. But when price swings are much greater than expected (and this is especially so with products whose prices do not swing that rapidly), the number of defaults are higher because of the surprise or shock factor. For example, some customers who had a perfectly good record of honoring their contracts for years, backed out when Value Added Tax (VAT) was suddenly increased from 7 percent to 10 percent because of the 3 percent additional tax they would have to pay, claiming that this was *force majeure*—a situation that could finally be resolved only by price re-negotiation. Shocks and defaults became commonplace until there was no more shock in a default.

The withdrawal of funds from the money market had a devastating effect on sales. Businesses were busy trying to bridge gaps in their cash flows—more time was spent on reducing inventories at a discount and collecting payments than on promoting new business—in their own way they were doing exactly what the banks were doing. Lower sales led to lower prices. Lower prices led to panic sales in anticipation of even lower prices, and so the downward spiral continued.

Meanwhile, more and more fronts were opening up in the battle for the baht. Importers and exporters were hedging their payments and proceeds, while banks, hedge funds and other funds were short selling the baht outright. The BOT was resisting the attack by funneling dollars to the spot and to the forward markets. By the end of June 1997 the game was up and the BOT had surrendered. The baht was finally floated, jeopardizing Thailand's ability to repay about 90 billion dollars of private and public sector foreign debt.

The business community was shaken up. Many of the big borrowers knew all would be lost if the devaluation was not contained. Initially, there was a slight feeling of relief that the war was over—you were only safe from a devaluation after it had occurred. The general view was that the baht would not weaken more than 10 to 20 percent—but that turned out to be just the calm before the storm.

The BOT, after having unsuccessfully tapped the international market for some bridging finance, appealed to the International Monetary Fund (IMF). It is the IMF's job to see that countries do not default on their international debts. The standard IMF recipe for solving these supposedly short term problems is to extend a credit line (to revive confidence rather than to refill the coffers) and to ensure that a punishingly high domestic interest rate is enforced to curb borrowing for speculative purposes, with a side effect of killing inflation. But the IMF, with all the wisdom gleaned from its South American and Mexican experience, looked at Thailand with disdain and decided that the country needed more than just short term medication. It needed major surgery to ensure that it could make do with a minimum amount of financial assistance, and so that it would not keep coming back to the IMF for more assistance.

The solution for Thailand was simple. Support only what was commercially viable and shut everything else down. Start with the finance companies and banks that were feeding off the BOT"s Financial Institutions Development Fund (FIDF). Then restructure the viable companies and close the rest. Let the country concentrate on where it had a comparative advantage—like agriculture. Privatize state enterprises so that the same tough rules could be applied to them, and to reduce public sector debt and to increase forex reserves. Downsize the unwieldy government bureaucracy. Ensure that government spending was reduced by setting a target budget surplus of 1 percent of GDP. Increase VAT from 7 percent to 10 percent to increase mandatory savings and reduce aggregate demand. Ensure that the currency was spared from speculative attacks by increasing interest rates. This would, supposedly, have the beneficial side effects of curbing economic activity, downsizing the private sector that had been hyperactive over the last decade, and in reducing the current account deficit. Open up the market to foreign investors in all sectors, especially in the real estate sector. Targets for foreign exchange reserves and a ceiling for the current account deficit were set. Loan disbursements by the IMF would be contingent upon Thailand meeting those targets. It was not the Thai economy that the IMF was worried about. It was Thailand's ability to service its international debts.

Picture, hypothetically, the Thai economy successfully disassembled and remodeled by the IMF. There would be fewer banks and finance companies (at least fewer belonging to Thais). Many of the financial institutions would have been auctioned off to foreign investors who would bring in much needed banking professionalism and foreign exchange. There would be a much leaner and efficient government with the biggest state enterprises efficiency-enhanced by the entrance of foreign private companies and bolstered by more foreign capital. Many private companies would have been restructured financially and operationally with the help of new foreign financial or strategic partners, bringing in even more foreign exchange. The non-viable companies would have folded and stopped being a drag on the economy. Exports would have boomed with the new supercharged baht trading at about 33 to the dollar. The current account deficit would be within manageable limits and would keep reducing from year to year as more export-oriented ventures took off. Foreign direct investment would be boosted with the opening up to foreigners of all the previously closed sectors and because of the economy's new-found vibrancy. With so much foreign exchange flooding in, reserves would be replenished and the economy would stabilize. Thailand's external debt problem would be solved. QED.

Now picture the real Thailand ravaged by IMF policies. It was far easier to disassemble the economy than envisaged, since it was barely hanging in the balance. Putting Humpty-Dumpty back again, though, was something else. It was no great feat pushing the economy downhill—the problem was going to be hauling it back uphill. Once at the bottom of the hill, there was no question about restraining the current account deficit. Shrinking imports created a massive current account surplus such as the country had never seen before. Thai manufacturers, finding their domestic markets shrivel, desperately tried to export their way out of trouble, but now that Indonesia, Malaysia, Korea and other countries were in much the same predicament, it was like a dozen drowning men grabbing the same little plank to save themselves. Unemployment—oops! the IMF forgot about that—zoomed. Privatization hit a stumbling block—the labor unions, and of course politicians, suddenly finding an opportunity for some free publicity.

As for the baht, it was knocked senseless. When it finally managed to crawl back on its feet, the IMF and the government took the credit for stabilizing the currency. Yes, foreign direct investment shot up, but only because multinationals, under pressure from banks, had to bail out their Thai subsidiaries. Thailand became a smaller economy, battered and bruised. The current account deficit in the years before the crisis was the crime. The current account surplus after the crisis was the punishment. The savings investment gap had reversed. While the government claimed success in bringing down interest rates, they received considerable help from the banks and their clients. The loans to deposits ratio had receded to 1993 levels. The banks did not want to lend money; the clients did not know what to do with the money.

NON-PERFORMING LOANS: FANNING THE FLAMES

The weak baht and the high interest rates made the IMF more successful than even they had dared to hope. Inflation was unexpectedly mild despite the fact that the baht had disappeared off the screen. The current account deficit dropped to zero and then moved into surplus territory, but every successful move by the IMF was at the expense of the corporates who were collectively sliding toward their doom.

The government had ordered the closure of 56 finance companies (out of a total of 91) over a period of about eight months. These finance companies were financing clients less than refinancing themselves to handle runs by jittery depositors, so removing them from the economy was not such a bad idea. However, by closing these companies, the government slammed the door on their clients, of which there were two groups, the tired and the wishful. The tired ones were exhausted from running from pillar to post trying to arrange loan repayments to the finance companies, but mainly in trying to plead with them for more time and for lower interest rates. The wishful ones still had projects in the pipeline partially complete, only partially financed and awaiting further loan draw-downs from the closed companies. The former had lost hope of recovering their credit lines anyway, and the latter (the wishful group) had a rude awakening and were instantly flung smack into reality.

After the closure, the finance companies suddenly became incommunicado. Nobody seems authorized to deal with clients on any terms except for collecting repayments with punitive interest rates, failing which, then for sending out legal notices—no surprise that the only defense left for the corporates was to stop paying and to wait for someone with authority to come forward for meaningful negotiations. Unfortunately, during the interminable wait for some sensible compromise with the closed finance companies, the other IMF measures started to bite and intentions to pay were eclipsed by the need for self-preservation. Soon after, the Financial Restructuring Authority (FRA), mandated to sell off the finance companies' assets, openly published in the newspapers (on quite a few occasions) the list of borrowers, putting the spotlight on the NPLs Anonymous. The NPLs, now an officially recognized body, attracted more and more members to their ranks. They found themselves in the very good company of the ex-high and the ex-mighty. Could a company that used to make tens of millions of baht in each quarter (with results audited by an international auditor) also be an NPL? By the time the finance companies' assets (loans) were auctioned off, all their clients were non-performing, some possibly feigning, but the majority just incapable of paying. By then, most NPLs understood that it could not just be their own bad management that eroded their capacity to service debts—could every company be poorly managed?

When a client is in financial trouble, most suppliers will panic and offer discounts or more lenient payment terms in order to recover their money. Only the Revenue Department and the banking industry expect additional payments as punishment for a client's incapacity to pay, because they have always been in a position of power and face little or no competition. They are also out of touch with the real world and always equate incapacity with unwillingness—hence tax fines and punitive interest rates. It is not surprising that when the baht was floated and dropped to levels that caught everybody unawares, bankers forced the clients that could not pay back their dollar loans to convert them into baht loans at the new low exchange rates. To add insult to injury, they demanded high short term baht interest rates on the newly converted loans. So a US$5 million loan on which the client was paying 8 percent annual interest, or about 10,000,000 baht per annum before the baht was floated, was suddenly converted at 40 baht per US dollar into a baht loan with a 20 percent interest rate, resulting in an annual interest amount of 40,000,000 baht per annum—an increase of 300 percent. Is it that difficult to understand NPLs?

With NPLs increasing by the day, the banks had to stop functioning. When new Thai Farmer's Bank (TFB) shares were first sold after the crisis had struck, the proceeds were promptly deposited with the FIDF, which was paying high short term interest rates. No business could afford to pay that kind of interest rate because, unlike the FIDF, they were not backed by the note printing authority. This happened before the IMF saw the error in its ways, and reversed course to allow the country to run a budget deficit and to reduce VAT back to 7 percent from 10 percent.

When interest rates are this high, no business wants to pay interest if it can help it. They would rather dump their inventory, induce their customers to pay a little earlier by offering generous cash discounts, keep delaying payments to their suppliers and attempt to reduce their expenses. While it is a good tactic for one business, it backfires when every business and every household starts to reduce expenses. The result is a drop in income for all and no increased savings. Thailand's real GDP dropped by about 1 percent in 1997 and a further 10 percent in 1998. The IMF inflation targets were bettered (or worsened, depending on your point of view). By the first quarter of 1999, there was disinflation and worries about a Japanese-type of deflation. Businesses slashed prices to levels at which sales brought relief but no profit (in many cases no gross profit, let alone net profit). If the real GDP figure for 1998 had been –15 percent instead of –10 percent, there would be no performing loans and no banking system left. At –10 percent, half the loans are non-performing and more than the total equity in the banking system has been wiped out. The Bank for International Settlement's (BIS) ratios have been maintained by the BOT's staggered provisioning requirements, hybrid equity issues by

the major banks and debt equity swaps by the FIDF for the smaller ones.

The losses are more than the GDP figures depict. With so many of the marginal producers closed down and so many buildings not complete, there is a big possibility that even when the economy gets back on track, many of these ventures will not be revived. Many factories will be auctioned off piece meal and many buildings torn down. The difference between GDP and Net Domestic Product—NDP (gross domestic product less depreciation) would be considerably wider than is usually the case. NDP is not usually a consideration except when there is a massive destruction of national assets. Of course, some of this asset depletion will be compensated by "haircuts on loans" made by offshore lenders directly to the private sector.

A good way out of this economic trap should have been exports. But exports were constrained by quite a few problems, some external and some self created. Credit lines were fixed in baht (based on 25 baht to the dollar), while export business was in dollars. The squeeze on working capital resulted in lower selling prices in a catch-up game to meet payments. Export volumes shot up as businesses tried to get rid of their production and inventory, but this was achieved at the expense of price, so export values were stickier. It was taking time to find new markets and new customers for the increased volume of exports and any door that Thai manufacturers knocked on, they found Indonesian, Korean, Malaysian and Chinese exporters behind them. Credit the IMF for an Asian-wide economic failure because they found it too expensive to ease Thailand down for a soft landing. Besides this, the Revenue Department had an agenda of its own, which it thought was paramount to the government's efforts of turning the economy around.

Many small and even some of the bigger exporters had to pack up because they could not claim their VAT refunds. The Revenue Department was alleging that the overload of work in checking the records was preventing it from making prompt refunds. But exporters knew that it was merely an excuse for a lack of intention. VAT had increased to 10 percent, which was more than exporters made in profits. Many exporters have not been paid for nine months. The BOT has announced that three months default of interest or principal was to be considered a default. That made the Revenue Department the biggest NPL (see Box 1). Considering that the Revenue Department was paying no interest on the extra taxes it had collected and was supposed to refund, it was, in effect, responsible for a good chunk of the punitive interest charges that banks were billing the exporters.

The Revenue Department had set a VAT collection target for each area based on past records. The fact that domestic sales were dwindling and exports were replacing them was totally lost on the department. Exports meant 0 percent VAT and more exports meant less VAT. Instead of cheering for an export-led recovery, the department was more concerned about its targets and more interested in hassling the VAT-exempt exporters. Every few months, academics, the Board of Trade, the Federation of Thai Industries and others would meet to discuss the slow progress in the Thai economic recovery. The finger would always be pointed at the Revenue Department, which, for many years, had wax in its ears. (Maybe, with a bit of technical assistance from the Labor Congress of Thailand, exporters should have set up tents, put their lament to music and serenaded outside the department to grab more attention). Anyway, within a few weeks of those meetings, the department would start clearing up its arrears after clever negotiations in which it would force the exporters to leave behind 20 percent of the refundable amount as additional tax for underreporting sales. This was a clever tactic as far as the department was concerned, but it was quite dumb when looked at in terms of the damage done to the economy as a whole. After the arrears were cleared, the department would go back to its old ways. Only crooks do not pay taxes, it thought, and exports were just a convenient tax loophole.

BOX 1: NPL

NPL (Non-performing Loan): A loan on which interest was not being paid or was only partially being paid on the date that the interest payment was due. Initially, the interest had to be overdue for six months for the loan to be classified an NPL. After the baht crisis led to a banking collapse, international pressure mounted on the BOT to improve its banking supervision. That prompted the BOT to reduce the delinquency period from six months to three months. Subsequent to that, there was another BOT ruling that any one NPL loan by a borrower automatically made all his other loans (interest overdue or not) into NPLs. The BOT issued various directives (it seems, though, that many of the banks thought that they were only suggestions) on how to set aside provisions for NPLs based on the time period that the loans had not been serviced and on the market value of the underlying collateral. As international pressure intensified, some of the rules were tightened and as the economy nose-dived, some other rules were relaxed (for example nonpayment of the loan principal while the interest was being serviced is now no longer considered an NPL). With these policy flip-flops, many banks lost their way and by August 1999, two years into the crisis, the BOT had to clear up the semantic confusion by issuing an official definition of a non-performing loan. In this article, (using an older BOT definition which has subsequently been changed), NPLs refer to both delinquent loans and to delinquent borrowers.

Textile producers had to contend with Indonesia, a country of 200 million people in dire straits for whom suddenly textiles were a dispensable luxury product. The textile industry in Indonesia was modern, large and desperate. The Indonesian rupiah was wild, unruly and unpredictable. Indonesian manufacturers had every incentive to sell at any price as long as they landed the right exchange rate at shipment time. Thai manufacturers found it difficult to complete. The baht was steadier and strengthening, so leveraging on the currency was not an option. As far as customers were concerned, desperation was equal to competitiveness. If there was anything more painful than the losses due to the baht's loss in value, it was the new round of losses due to the strengthening baht. The non-performing prices had to lead to NPLs.

NPLS: DESPERATION, DEFENSE OR STRATEGY?

First there was pain, then a build up of resistance and finally a scheme to counter the threat of extinction. Desperation, defense or strategy? The answer could be: all of the above in sequence if not a little bit of each in concert.

After the desperation exacerbated by the attitude of the finance companies and the banks, the defense fell in place automatically. Most sensible manufacturers logically identified and prioritized their obligations thus:

Priority 1	Obligations to their workers for wages and salaries
Priority 2	Obligations to export customers (who had established letter of credits (L/Cs) for their purchases) to ensure that goods were shipped to them as contracted
Priority 3	Obligations to domestic customers and to raw material suppliers (to ensure that their factories kept running)
Priority 4	Obligations to financial institutions that were prepared to keep working with them (in order to keep credit lines open without causing a financial drain)
Priority 5	Obligations to financial institutions that were not prepared to keep working with them but only wished to have their money back
Priority 6	Dividends to shareholders.

The first three obligations were necessary for maintaining a going concern. The fourth would have been a nice touch if the financial institutions had had the foresight to understand that, by cooperating with their customers, they could keep alive both their clients and their chances of recovering the amounts due from them. Unfortunately, most banks were unable to see far enough in the future. They had become over-regulated and their appetite for risk was a fraction of what it used to be. At any sign of a default (e.g., an exporter's customer not establishing an L/C on time, making the packing credit overdue), they would react by debiting the customer's account by the overdue amount immediately. In a market hit by nearly worldwide recession, customers backing out of, or delaying fulfillment of contracts, was commonplace—but the banks were not having any of this. Any and every excuse was proffered by the banks to limit the customer's credit line, to the extent that paying off a previous credit became a strict precondition for availing of some new credit.

Each bank had its own terms and ruled its own territory without competition—after all, where could these partially-performing customers in a non-performing economy go? They imposed exorbitant interest rates and exploited the clients with impunity. The BOT put the fear of God in the financial institutions. Suddenly, the BOT was beyond any political interference and it had the right to close any of the weaker ones as it saw fit, especially the ones that kept on knocking on the FIDF's doors. For the banks and finance companies, reeling in all the credits had a twofold benefit—it improved their cash flows and it reduced the need for bigger capital and reserves on which the operations were based—freeing up some of that capital for NPL provisions and saving them that much recapitalizing effort. Performance in the financial sector was reduced to an ability to down-size fast and the finance industry kept on tightening the noose around their customers' necks.

For the clients, it became too expensive a luxury to maintain these banking connections—something that had distinguished the ordinary businessman from the business tycoon in the bubble era. It was common practice for businesses in Thailand to have two sets of account books, one for the shareholders and one for the Revenue Department. The banks were now so nervous that any rumors or any bad news about any clients was enough for them to freeze credit to those customers. They were now practically warning customers that they would not tolerate any surprises in the year-end accounts, so customers obliged by giving them a third set of account books that lived up to their expectations. The banks would then be content to continue business as usual (part of which was to keep complaining that they had no way of knowing whether the accounts were correct).

If the banks were not extending additional credit, if they were only returning to the customer as a new loan (and that too, at steep interest rates) only the funds that he was paying back, if for every late payment they were charging a penalty and if, for any excuse, they were attempting to reduce his credit line, then it made perfect sense for the customer to freeze the repayments and the banking relationship. It was a tough environment to do business in and it was a battle on every front. It was difficult enough fighting to retain customers complaining about high prices, suppliers complaining about late

payments, employees complaining about bonus cuts and the Revenue Department claiming more taxes and refusing to refund what was due to the businesses. In the scheme of things, the banks were comparatively dispensable—and once dispensed with, then one battle less to fight. The banks had become inflexible and refused to acknowledge the changed business circumstances, so good clients rebelled and their accounts suddenly became defensive NPLs.

As for the banks fitting Priority 5, they made no bones about only wanting their money back. The clients, in turn, wanting to escape an early death, were not chickening out from refusing them.

THE BANKS FIGHT BACK

The legal departments of the banks and finance companies had their hands full. Legal notices started to fly all over town. Some minor interest rate compromises were made, some interest and loan repayments made, but mainly, borrowers pleaded for more time. Every day's delay was costing the banks in lost interest but, more importantly, in NPL provisioning. The simple escape for the banks would have been to reduce interest rates to the level that the customer could, or claimed that he could, afford, but this was not acceptable to the BOT. Any interest rate reduction below market rates was a *de facto* payment by the banks of the reduced interest amount in lieu of the customer—something that was construed as an illegal escape from NPL provisioning. The only reason for an interest rate reduction acceptable to the BOT was a debt workout plan (a business plan with a debt repayment schedule) that established the inability of the borrower to pay the market rate of interest. The plan was meant to be drawn up by an independent financial advisor and approved by a majority of the creditors. This was called the Debt Restructuring Plan (preferably following a Corporate Restructuring Plan). Debt Restructuring was on every banker's lips—an imported idea that stalled any compromise between lender and borrower, a one-lane road that created the biggest NPL traffic jam in history.

The concept of the Debt Restructuring Plan was the logical means of resolving the deadlock between lenders and borrowers. But it was an ambitious, far-fetched idea devised without considering the realities on the ground in Thailand. The Thai economy was afflicted way beyond the available medical capacity to treat it. There were not enough practitioners available to make Corporate Restructuring and Debt Restructuring Plans. That was not the only problem. Since banks had stopped lending money for quite some time, the cleansing of the corporate scene of nonviable companies with negative cash flows had already taken its toll. Many of these companies had disappeared and would never be restructured. The rest of the companies considered the whole concept of official debt restructuring with a public display of corporate X-rays as a conspiracy by the finance industry against them and resisted with creative delaying tactics.

Meanwhile, the Thai economy seemed to be wasting away. Foreign financial analysts kept claiming that Thailand was being kept in the slow lane by the leisurely pace of corporate debt restructuring. The Finance Ministry and the BOT were under more and more foreign pressure to do something about bank recapitalization and corporate debt restructuring. The answer to the former was to pressure the banks to recapitalize at the peril of nationalization, and the answer to the latter was to pressure the corporates to agree to restructuring at the peril of being declared bankrupt by the court. There were legal problems in achieving both these aims and the government machinery moved to address these problems. In August 1998 new regulations for recapitalizing banks were issued by the BOT. They basically allowed more flexibility to the banks in attracting capital, but they put strict guidelines and a definite time frame for the assessment and completion of the recapitalization. For the banks that could not muster the capital (or expensive convertible loans disguised as capital) within the stipulated time frame, the BOT would step in. Should the BOT be forced to step in, it would be a day of reckoning for the bank, and there would be a massive house cleaning resulting in a smaller, stronger balance sheet and, in all probability, a dismissal of errant bank executives. Bankruptcy laws, foreclosure laws, an express Bankruptcy Court along with other laws allowing for more foreign ownership of assets (what was the point of foreclosing if you could not have ownership?) were pushed through the legislative process with heated debates colored by US-model winner-take-all capitalism on one side and a mix of socialism, nationalism and every other economic and political "ism" on the other.

In September 1998 the BOT set up a committee called the Corporate Debt Restructuring Advisory Committee (CDRAC). The first job of this body was to pressure the finance industry, which was, in turn, to pressure clients to undertake debt restructuring under its auspices. Companies that failed to respond were to be sued for bankruptcy. The CDRAC process was an attempt to get banks and their clients, under BOT pressure, to sign up to a rigid six-month timetable for a debt restructuring process outside the judicial system. The process involved an official meeting of the debtor and creditors, the appointment of a financial advisor, preferably a creditor's steering committee, a debt restructuring plan, and finally a vote of approval for the plan by the creditors. Failing this, a second plan could be presented for another vote—all this within a fixed number of days from the date of the debtor-creditor agreement. If the second plan was shot down, there was a provision for arbitration, and if that failed too, then there would no longer be any excuse not to run the company through the judicial system. The court would decide whether the company was to be rehabilitated or

declared bankrupt and auctioned off piece by piece. The CDRAC process was resisted by both creditors and debtors, not so much for the fixed timetable for each part of the process itself, but for the inevitable court procedure in case that the final plan failed to win creditor approval. A bankrupt company would have been a disaster for both the creditors and the debtor, a lose-lose situation for both.

The BOT was too powerful not to win. With banks unsure about their future or how much they would need the BOT to assure that future, and with the newly conceived Bankruptcy Court sniffing for victims, no banks or borrowers were about to risk the BOT's ire. All the banks based in the country, both local and foreign, and about 360 major debtors signed up in the CDRAC's first sweep. This was followed by a second sweep of about 500 companies a few months later. Meanwhile, the economy seemed stuck to the floor, as Thailand, all battered and bruised, was slowly lifting itself up after regaining consciousness. Foreign analysts, looking disappointedly for a Korean type of economic rebound, kept on blaming the authorities about the way bank recapitalization and corporate debt restructuring was being handled. By then, the BOT had lost its nerve and just wanted to get this job over with, but nobody else seemed to be in a hurry. Plans were made, rejected and were being made all over again. Debt restructuring, even in fast-track mode, was not so simple after all.

Debt restructuring hinged on the issues and problems listed below:

1. Projected revenue growth and projected EBITDA (see Box 2) growth based on historical company data, on general economic growth forecasts and on specific industry growth forecasts. Historical company data in Thailand was not such a sure thing, and growth forecasts of particular industries, or of the overall economy for the next 10 years (in many restructurings, the forecasts had to extend to 20 years to cover debt repayments) were even less certain. The pessimists thought that real GDP growth rate for the country would not exceed 4 percent to 5 percent per year for the next 10 years, while the optimist thought that it would surely bounce back to 8 percent within 1 or 2 years. As for specific industry estimates, there seemed to be less available information, so it was anybody's guess.

2. Determining the level of sustainable debt. This was based on an interest rate level and the number of years allowed for debt repayment. Both were contentious issues. Nobody knew what interest rate to use or how many years of debt repayment was realistic. Interbank rates were at historically low levels, deposit rates were political rates (set grudgingly higher to avoid a public backlash against high bank interest rate spreads) and the Minimum Lending Rate (MLR) and the Minimum Overdraft Rate (MOR) had no basis in reality. There was no equilibrium interest rate in Thailand as a good portion of the funds were out of play and banks were not lending. Borrowers had no choice of banks to approach to refinance their loans, and were captive customers of their regular banks which charged them whatever rates they wanted. For the customers who had decided to throw in the towel, the banks had became their captive lenders and were paid whatever the borrowers wished—usually no interest. These money market conditions were not conducive to defining the equilibrium interest rate. The only real market interest rate in which borrowing and lending was done at freely negotiated rates was the interbank rate. In debt workout negotiations, borrowers liked referring to the interbank rate and the deposit rates, while lenders preferred to refer to the MLR. Since the two rates were miles apart, the drive toward a mid point was a long and tiresome affair. The borrowers had a stronger argument though. If a borrower who was classified as an NPL because he could only pay half the official MLR rate, suddenly managed to dispose off some assets and repaid his loan, the bank would be at a loss in placing these new funds profitably with any other borrower. Most credit worthy customers did not want to borrow money. The bank would have no choice but to lend into the interbank market, depressing the interbank rate even further. So an NPL borrower paying 4 percent per annum interest instead of the 9 percent per annum demanded by the bank, could, in effect, increase operational losses for the bank if he paid back his loan. (Of course, the bank could show profits by reversing the provisions for the NPL because of this borrower's sudden resurrection.) Anyway, this is only a theoretical assumption and was very unlikely to happen. For the NPL to pay back, he would have to first settle the accrued (punitive) interest overdue which would probably be much more than any assets that he owned.

BOX 2: EBITDA

EBITDA: Acronym for Earnings before Interest, Tax, Depreciation and Amortization. Most people had not heard of this acronym before half the country's loans had been put up for restructuring. This is possibly the most important figure in the income statement and most borrowers knew what their EBITDA was before the crisis, even though they may not have known the term. That was because taxes were not such a sure thing in Thailand and depreciation could be disregarded because loans were being recycled anyway. Borrowers knew that if they did not have enough funds to pay interest, then they were certainly in big trouble. But they also knew that if they could pay the interest but could not provide for depreciation or taxes, that was not something to lose sleep over because some banker or other would come to their rescue. As for bankers in the era of collateral lending, there was no evidence that they knew anything about EBITDA.

3. Viability. The viability of a company was usually considered as the profitability of the company. The many ways of determining this profitability are listed below:

A. Under normal conditions, the profits had to cover expenses, depreciation, debt servicing and taxes with something remaining for the shareholders.

B. The terms for post-crisis viability were understandably relaxed. Companies that were not NPLs became super-prime viable companies because they could pay all their expenses and even interest on their loans. Not being able to provide for depreciation and for loan principal repayments no longer made the companies unviable, as principal repayments could always be rescheduled.

C. Companies that could not cover even their operational costs were certainly not viable. They either had to reduce costs or go out of business. However, just reducing some costs to remain in business was not the same thing as being viable if they could not afford to pay any interest at all. But many companies thought that they could suddenly become viable again by becoming NPLs and by stopping interest payments completely—except that the banks did not agree on this definition of viability.

D. A compromise definition of viability became available—a debt restructuring to restore viability. Of course, the condition was that the company had to have a positive future cash stream that it was prepared to divert to its lenders. The cash flow, when discounted to its net present value, had to exceed what the creditors would recover in a liquidation of the company. That would make the option of liquidation less attractive than waiting it out for the company to deliver its projected cash flows. It also demanded a new appraisal of the company to determine its liquidation value (after allowing for employee retrenchment costs), and more importantly, it required that the loan be brought down to a level that reflected this revised viability.

4. Liquidation analysis. When creditors kept threatening to bankrupt the company, it was finally the liquidation analysis that knocked some sense into them. This analysis usually showed a value much lower than what the creditors, and certainly less than what the owners thought they were worth as a gone concern (as opposed to a going concern). Appraisal companies tended to be a little more careful when they worked out the liquidation analysis of a company because for once, their valuation skills could be put to a quick test if the debt workout failed. Asset appraisals for loans, on the other hand, were seldom tested immediately—normally it would take a few years for a loan to go bad, and by then the asset valuation would be out of date.

5. Discount Rate. If banks could not decide the current interest rate that was staring them in the face, what chance was there of their making a forecast of what interest rates would be in the next 10 years or 20 years. But when loans were to be paid back over a 10 year or 20 year period, then it would have been useful to have been able to predict interest rates in the future as a basis (though it needs not have been the only basis) for determining the discount rate. This was the rate at which all the future cash flows were to be discounted to determine the Net Present Value of those flows for comparison with the Liquidation Value. No two banks worked on the same discount rate and this complicated debt restructuring.

6. Hair cut. The main reason that analysts kept harping that bank recapitalization was the necessary condition for corporate debt restructuring was that bald men do not take kindly to haircuts. Recapitalizing on the grand scale that was required by the banking industry was a cat and mouse game. As banks recapitalized, good loans kept pace by becoming sour, necessitating further recapitalization. The chase has not ended by far. A recent Standard and Poor's (S&P) report showed a worst case requirement for an additional US$30 billion besides the fancy hybrid equity issues which they thought tilted more toward debt than equity. In the aftermath of the crisis, foreign banks lost confidence fast and wanted a quick exit. They were prepared to offer substantial discounts (up to 75% of principal for unsecured loans) if they could be paid within a short period. Thai banks and finance companies were not so well endowed or so hopelessly dispirited as to offer such major write-offs. Of course, they too acknowledged the depth of the recession and were prepared to accept sub-market rates of interest for a few years, as long as they could collect the principal over the long run (sometimes stretching to 20 years, which was how long, in many cases, it would have taken to make full repayments of loans plus subsidized interest based on very optimistic EBITDA forecasts).

7. Creditor's Steering Committee Meetings, General Creditors' Meetings and a Creditors' vote for a restructuring plan. All these were necessary parts of the restructuring process and the number of these were in direct proportion to the time taken for any decision. As the number of restructuring cases has now exceeded the collective executive decision taking capacity of the whole banking industry, it seems that an amnesty for delinquent borrowers and another one for poor banking decisions may have to be considered if we want to move at foreign analyst-approved speed.

THE THAI ECONOMY: NPLS TO THE RESCUE

So the economy, for all intents and purposes is doomed. The banking sector is crippled, dysfunctional and largely irrelevant to the economy. Half the loans are in arrears. Surely the other half must mainly consist of loans other than corporate term loans (short term working capital loans, interbank and inter-finance loans, housing loans, auto-loans for cars that escaped repossession etc.). Interest rates are more strategic, defensive and political than market driven and, as a result, are as widely divergent as each bank's need or strategy. Productive capacity is running at about 60 percent, which is 25 percent less than normal utilization. Analysts say the economy cannot improve unless the banking sector is sorted out. Only then, they contend, can the corporate sector revive. Private investment, that used to be the engine of this economy, is still dropping but at a slower pace—again supposedly awaiting the recovery of the corporate sector.

But yet, surprisingly, this economy is moving, and slowly picking up speed. The facts do not seem to add up. The facts show that we should be trapped in the swamp for years. It was not the Miyazawa Fund[1] or the reduction of VAT that roused the economy from its stupor, even though they did help to stop the continuous decline. Nevertheless, something is moving this economy. Amazingly, it is a combination of corporate sector recovery (despite the financial sector) and the carnage in the domestic market (still depressed by the real estate sector) pushing the country inevitably toward an export-led recovery. The newspaper *Business Day* (5 November, 1999) carried a caption: "World Bank: Recovery at Risk on Account of Bad Loans." It seems the World Bank hit the nail on the thumb. Ouch! The real risk is poor restructuring of the bad loans while the banking sector is not functioning and acting merely as a vacuum cleaner for funds required to keep the economy ticking.

The corporate sector now consists of two parts, the performers and the NPLs. The latter have won a reprieve from heavy interest payments and are, presently, (for the most part) cash positive. They are, today, as capable as the former in performing a function for the economy. Suddenly, we seem to have a stronger corporate sector (somewhat at the expense of the banks and finance companies) that is capable of turning this economy around without any additional financial help. Economically, for the NPLs, it may be a short term pilferage of viability—but then, if the NPLs were non functional, this turnaround could never have happened. If the NPLs had not applied the corporate equivalent of Mahathir-style currency controls when the withdrawals of funds threatened their survival, today there would only be half a corporate sector left. Could half a corporate sector have brought life back to the economy, even if the banking sector was still healthy—and besides, why even contemplate the existence of a banking sector if half the corporate sector has disappeared? Could the country have survived the massive blockage that banks created in its financial artery if the NPLs had not bypassed it to keep the blood flowing through the economy?

The NPLs may be overdue on interest but they still pay wages, buy raw materials and export products. As far as the economy is concerned, the NPLs are now performing companies that have not yet resumed interest payments. And they play nearly as important a part in the economy as do the companies that have managed to maintain interest payments. In fact, the interest not paid to the banks can be considered as the required impetus for the economy and its multiplier effect is even greater than that of the Miyazawa Fund. Any money moving from the real economy into the financial sector is now totally sucked out of the available money supply by a factor of the multiplier because banks are not re-lending. On the other hand, money retained by the corporate sector, NPLs or not, are moving the economy, albeit with a slower velocity than before the crisis. Even a low 2 percent interest rate on 2.7 trillion baht of NPLs (if we assume that 2% is all that they can afford to pay) will yield an amount equivalent to the Miyazawa Fund within one year—and it is certainly money more usefully spent in keeping private companies alive. If these companies failed, the economy would demand many more handouts to keep it twitching—fiscal plans that would be unsustainable if the performing companies could not fill the vacuum left by the failed NPLs. You cannot create a replacement entrepreneurial class overnight.

So what will happen if the NPLs are restructured. Bank recapitalization makes sense, not because by doing so they will be able to afford generous hair cuts and lower interest rates on restructured loans, but in order to equip them with the incentive to re-lend the money that they will have collected as interest. If the re-lending does not occur, recapitalizing of banks and restructuring of corporate loans will not help. Rather, it will hinder the turn around of the economy and disturb the already fragile *status quo*. If the interest payments are not reinvested, then the NPLs, un-restructured as they are today, remain in a better position to move the economy than the banks are. After restructuring, the NPLs will have their wings clipped, and it will then be the banks' responsibility to push economic growth.

Successful restructuring should result in strong balance sheets. This can only happen if banks stop the denial and accept losses. Owners must, in return, be prepared to disclose all relevant information for the banks to allow them to take correct decisions with regards to their companies. Audit committees would not be out of place as a confidence measure for the creditors and as compensation for the reduction in loan principal and interest. Debt-equity swaps are a possibility for listed companies, and better than a complete write-off. For non-listed companies, prompt loan and interest repayments over the rescheduled and restructured payment lifetime should be a condition for waiving the

unsustainable part of the debt. Interest rates must be a realistic compromise between the lenders and the borrowers while there is no real market rate on which to base it.

With strong balance sheets, companies can grow again, and along with them, the economy should be able to grow too. However, there is still a lot of opportunity for the authorities to derail the nascent recovery. Besides badly restructured loans, ill conceived plans to expel cheap (competitive) foreign labor rather than to regulate it, allowing the baht to strengthen relative to the Indonesian rupiah, the Philippine peso or the Singapore dollar (never mind the US. dollar), there are plenty of other possibilities for the authorities to throw a spanner in the works.

Analysts are waiting for a dramatic rebound and if we touch 8 percent GDP growth again next year, imports could shoot up even more and the current account surplus could disappear. Inflation could rear its head again, the real estate sector could splutter into life, labor shortages could become evident again, while more tax collection should contain the fiscal deficit—all familiar pre-crisis symptoms and everything required by the rating agencies to upgrade Thailand's sovereign ratings. Rating agencies follow bubbles closely. The ratings go up when the bubble increases and promptly readjust downward after it bursts. After that, the agencies want an assurance that the bubble is well in place again before they make a new upward reassessment. There is little danger of another bubble occurring so soon after the last one because the climate of doubt still hangs over borrower and lender, both of whom have lost their nerve and appetite for debt. For the long term, hopefully, some lessons will have been learnt from the last crisis, but you can never say. We learn from history that we do not learn from history.

EPILOGUE: A DEVIL'S DICTIONARY OF FINANCIAL TERMS

arbitrage: Smart dealers of stocks or foreign currencies can find price discrepancies and make money by making nearly simultaneous purchases and sales to take advantage of these tiny price gaps before they get bridged by other dealers. The interest difference on baht loans and dollar loans was not a tiny gap—it was a gaping hole and banks, finance companies and corporates could not resist trying to make money on the difference. Of course, it was not strictly arbitrage because the profit could only be made if they left themselves exposed. But then again, it could have been considered as arbitrage if the baht was meant to be practically pegged to the dollar and the BOT (with the help of the prime minister at the time) was guaranteeing that peg with frequent pronouncements. Even banks that had actually engaged in riskless arbitrage found out after the peg broke that it took two to tango, and the arbitrage was only as good as the counterparty. The lesson: stick to horse racing. It is more fun and your chances of making money are as slim.

asset growth: Since the flow of money from abroad was multiplying every month during the bubble, there was a great opportunity for banks and finance companies to grow. The banks and finance companies coped with the increase in the supply of funds by setting high lending targets (asset growth) of about 20 percent per year. The marketing departments of the financial institutions were the heroes who had to achieve this growth and the credit departments (whose job was to ensure quality growth) eclipsed into the background as sore losers in the race to the top of the corporate ladder. You could not grow at 20 percent per year if you were going to listen to a wise credit guy who knew all the facts—he would stop every move you made.

collateral: Experienced bankers knew that to trust a client's cash flow projections was immature. The smaller companies did not have a clue about projections and the big companies were far too smart not to get the projections perfect. So bankers preferred collateral lending i.e., using the borrower's property as security for loans. Collateral in the order of the bankers' preference was usually (a) land (b) buildings and (c) plant and machinery. Cash flow projections may have been unreliable but nobody predicted a total collapse of the real estate market, which made collateral lending almost like a commitment by the banks to buy every empty building in Bangkok.

debt-equity ratio: When a banker wanted to calculate how much money you, as the borrower, were prepared to lose on your risky project, before they would have to start losing on it, they would work out the debt:equity ratio of the project. There was no hard or fast rule as to what the ratio should be. The ratio rule could be relaxed for very credit worthy borrowers, especially if they were prepared to tender personal guarantees or cross company guarantees. Banks have always given debt-equity ratios more importance than they deserved. If they were so crucial to financial health, then adherence to BIS ratios should have shielded the financial sector from the currency crisis. This just goes to prove that it is not what equity you have that counts. It is what you do with the equity that you have. The baht crisis has shown that for a business, there is really only one safe debt:equity ratio—and that is 0:1

good corporate governance and international best practices: Other terms that have surfaced, quite often in discussions about the reasons for our famous meltdown. These, or actually, the lack of these, are supposed to the primary reason for the crisis. The terms apply to both the lenders and the borrowers. Preaching about good corporate governance and about international best practices is normally done by auditing companies, consultants and foreign banks who have not lost money in Asia. Foreign banks that have lost money here will not admit to being guilty, and will usually shift the

blame to the corporates and complain about their "lack of transparency." It is surprising that foreign banks which had been doing a thriving business and making money in Asia for umpteen years suddenly realized that companies were less than transparent. If they had had their glasses on, they could not possibly have failed to notice the very transparent fact there was lack of transparency everywhere.

hedging: Gambling in reverse. To reduce their forex exposure, prudent borrowers supposedly were meant to buy currency insurance. This was done by buying foreign currency for delivery some time in the future. The trouble with this kind of insurance is that the premium is only low when you do not think you need it, but when you suddenly feel an urgent need for it, you realize that the whole country has the same compelling need, by which time it is too expensive to insure. Many borrowers remembered that in the last devaluation, the baht plummeted from 23 to the dollar to 27 to the dollar before slowly climbing back to 25, and they thought they knew everything there was to know about devaluations. Exporters thought they had a natural hedge because of their dollar income stream. The hedge turned out to be as effective as a garden hedge that is supposed to stop floodwaters from destroying the garden. The lesson from the currency crisis is that a natural hedge means not borrowing in foreign currencies.

moral hazard: A term which has become very popular ever since the Asian financial meltdown. It refers to the circumstances which have propelled what is now seen as reckless lending. Central bank support for commercial banks was supposed to give them enough comfort and back-up to embark on risky lending ventures with juicy interest rate spreads. Central banks, supposedly, in turn, were obliviously content to let the commercial banks continue their joy ride with the comfort of knowing that Daddy IMF was always there to bail them out when the going got too rough. But that is a rather simplistic view of the situation. Bankers may have been reckless, but they were not so hell-bent on self-destruction as it appeared at the time of the events. With the wisdom of hindsight, it is easier to pass authoritative judgments about what lending was unwise. The real problem was that the foreign money deluge had blown aggregate lending beyond the country's capacity to offer viable projects to absorb those funds. So the funds homed in on marginal projects. The moral hazard was that losses in any one project were financed by funds drawn down for the next project or for some other purpose—and the funds kept on coming. The finance industry was so busy stuffing money down clients' throats that they failed to notice that many of them had long stopped breathing.

short term loan: Any loans that were repaid were a nuisance for the banks. It made it more difficult for them to meet the lending target. So a manufacturer who made a timely repayment of his machinery loan on the date due would be asked by the bank if he needed more working capital. The bank, if pressured enough, was suddenly able to advance the working capital without the machinery as collateral. A string of short term loans, one following another, becomes a long term loan. Overdrafts, which are supposed to be temporary facilities, and availed of only in case of unexpected cash flow hitches, became permanent loans requiring no repayment at all. If not for the annual agreement-signing ritual, the borrower might well have forgotten that the money belonged to the bank. In the boom years there were only two kinds of loans:

1. Long term loans
2. Long term loans that were called Short term loans or Overdrafts

ENDNOTE

[1] In conjunction with the World Bank, Japan pledged 53 billion baht in 1999 to create jobs and support other social sector activities.

NEWSBRIEF

RESEARCH PROJECTS COMPLETED

HRS Program

1. *Transportation Master Plan 1999-2006, Final Report and Executive Summary,* Ministry of Transport and Communications, January 1999
2. *Short-Term Financial Strategy Development, Final Report and Executive Summary*, State Railway of Thailand, June & October 1999

MEP Program

3. *Foreign Capital Flows to Thailand: Determinants and Impact*, Institute of Development Studies, University of Sussex, UK.
4. *Financial Reform in Thailand*, sponsored by the Government of New Zealand

NEW CONTRACTS

HRS Program

1. *Feasibility Study on Re-Establishing Bangkok-Aranyaprathet-Phnom Penh Railway Line Project*, State Railway of Thailand, November 1999 – April 2000
2. *A Model to Forecast Quarterly Labor Force and Employment.* The project is to build a model to forecast quarterly supply of and demand for labor by age, sex and education of the labor. A user-friendly software for the model will be developed and installed at NESDB. The model will assist NESDB staff to better assess quarterly unemployment (underemployment) problem and be able to plan more effectively.

RESEARCH PROJECTS IN PROGRESS

HRS Program

Improvements in Policy Formulation Through Improved Thailand Labour Force Surveys

The project aims at assisting Thai policy makers to improve formulation of policy and programs by describing the value and importance of good quality statistics, especially those from Labour Force Survey.

Project status: The draft report has been submitted to ILO/EASMAT. The project will offer three seminars for various levels of related government agencies in the middle of January 2000.

Project to Apply Manpower Master Plan to Support Industrial Development

This project is being carried out for the Department of Industrial Economics, Ministry of Industry. The project aims to set up a pilot project to explore the possibility of linking between demand for labor of five selected groups of industries (electronics, electrical supply, automotive assembly, automotive parts, and food processing) and supply of manpower from education and training institutes. The pilot project has started in three provinces namely Ayuthaya, Pathum Thani and Nakhon Pathom.

Project status: The project has started since May 1999. It will be completed by February 2000.

The 1999 Year-end Conference on *"Por Piang" Economy*

December 18-19, 1999
Ambassador City, Chomtien, Chon Buri

The Chai Pattana Foundation, the Thailand Development Research Institute Foundation, in cooperation with the Office of the National Economic and Social Development Board, the National Research Council of Thailand and the National Institute of Development Administration, will jointly organize the 1999 Year-end Conference on the theme of ***"Por Piang* Economy"** (เศรษฐกิจพอเพียง) at the Ambassador City, Chomtien, Chon Buri, from December 18-19, 1999.

CONFERENCE OBJECTIVES

1. To present studies and to brainstorm for the understanding of the philosophy of *Por Piang* Economy.
2. To discuss appropriate implementation of the philosophy for the country's future development.

CONFERENCE FRAMEWORK

The Conference will examine different aspects of the *Por Piang* Economy, its philosophy, conceptualization, and application. Four major issues around the *Por Piang* Economy will be presented and discussed.

1. **What is *Por Piang* Economy?** This is to understand the philosophy and conceptualization of the *Por Piang* Economy, both from the economic and social perspectives.
2. ***Por Piang* Economy and Agricultural and Rural Development**. This is to discuss the application of *Por Piang* Economy to agriculture and rural development.
3. ***Por Piang* Economy and the Development of Industries and Services.** This is to discuss the application of *Por Piang* Economy to the development of industrial and service sectors.
4. ***Por Piang* Economy and External Shocks.** This is to analyze desirable economic protection and warning measures against external volatilities based on the philosophy of *Por Piang* Economy.

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