Thailand's Financial Evolution and the 1997 Crisis

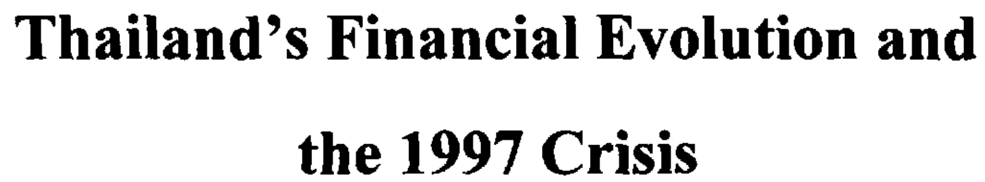

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Table of Contents

Page

INTRODUCTION 1

STRESSES AND STRAINS BETWEEN 1972 AND 1987 1

- Worldwide Liberalization of Trade and Services 2
- European Union 3
- Indochina's Market Orientation 3
- Fiscal Readiness 3

FINANCIAL LIBERALIZATION, 1988-96 4

- Interest Rates 5
- Foreign Exchange Controls 5
- Portfolio Management and Scope of Activities 6
- New Facilities and Institutions 7

EFFECTS OF LIBERALIZATION 8

- Financial System 8
- Interest Rate Structure 8
- Capital Market 11
- Financial Institution Performance 12
- Corporate Behavior 15
- Asset Quality 15
- Macroeconomic Impacts and Policy Implications 18

INTO THE STORM 20

- Immediate Outcome 20
- Detrimental External Debt 22
- Unfortunate Coincidence 25
- Extreme Predicament 29

RESOLUTION AND CONSEQUENCES 30

- Macro Aspects 30
- Micro Aspects 32

CONCLUSIONS 36

List of Tables

Page

TABLE 1	Thailand's Fiscal Balance and International Reserves	4
TABLE 2	Thailand's Major Financial Indicators	9
TABLE 3	Domestic and International Interest Rates, 1990-96	10
TABLE 4	Share of Household Savings at Financial Institutions by Type of Institution, 1989-96	12
TABLE 5	Credits Extended by Financial Institutions by Type of Institution, 1989-96	13
TABLE 6	Performance of Thai Commercial Banks, 1986-96	14
TABLE 7	Area of Construction Permitted in Municipal Zones, 1987-96	16
TABLE 8	Bills, Loans and Overdrafts of Commercial Banks Classified by Purposes	17
TABLE 9	Total Net Capital Inflows to Thailand, 1989-96	18
TABLE 10	Thailand's Current Account Balance and Domestic Inflation	26
TABLE 11	Loan-Loss Provision Requirements for Commercial Banks	35
TABLE 12	Exchange Rates of East Asian Currencies, July and December 1997	39

List of Charts

Page

Chart 1	SET Index and Net Foreign Purchases	11
Chart 2	Current Account Deficits and net Capital Inflows	19
Chart 3	Net Capital Inflows and Consumption plus Investment	20
Chart 4	Effect of Net Capital Inflows on Money Supply	21
Chart 5	Inflation and Net Capital Inflows	21
Chart 6	Swelling External Debt Outstanding	22
Chart 7	Income Payments and Current Account Deficits	22
Chart 8	Private and Public Net Capital Inflows	23
Chart 9	Growing External Debts of the Non-bank Private Sector	24
Chart 10	Short-term and Long-term External Debts	24
Chart 11	External Debts/Reserves Ratios	25
Chart 12	Bank of Thailand's Rescue Credits	27
Chart 13	Exchange Rates of U.S. Dollar and Baht	28
Chart 14	Inflation Differential and Baht Value	28
Chart 15	Net Capital Outflows and Lower Reserves	29
Chart 16	Baht Exchange Rates in 1997	30

INTRODUCTION

Thailand's financial system has been the focus of worldwide attention since the summer of 1997 when devaluation of the baht sparked a currency crisis that spread rapidly throughout Southeast Asia. The past two and a half decades have seen drastic and significant changes in Thailand's financial markets. Between 1972 and 1987 the adjustment in the financial system was very gradual. Because the Thai economy was not very open and external volatility as well as disturbances were insubstantial, foreign economic activities and financial conditions had only limited impact on Thailand and presented little difficulty for policymaking. After 1987, however, the pace of change in Thailand's financial arena picked up dramatically Globalization and liberalization became a primary policy objective and the government relaxed various rules and regulations to increase the flexibility of the financial system so that the Thai economy could survive and compete successfully in the international economic community. Deregulation brought about a deepening of the financial system, but enormous capital inflows of the 1990's and heightened market competition tempted Thai financial institutions to build up excessive exposure in several areas, resulting in bubble growth and deteriorating asset quality. A mounting current account deficit coincided with three other unfortunate circumstances and invited the currency speculation that forced the floating of the baht. Thailand is undertaking reforms to restore market confidence and return the country to its growth path. Thailand's experience clearly illustrates that financial liberalization is a precarious process and its past policy errors suggest precautions to guide policy in the future.

STRESSES AND STRAINS BETWEEN 1972 AND 1987

At the beginning of the 1970's Thailand's financial system was dominated by a few sizable commercial banks whose activities were rather clustered and centrally administered. Foreign banks had only a limited role and international transfers of funds were stringently controlled and monitored. The central authority set ceilings for interest rates on both deposits and credits. The banking system was required to allocate adequate credits to "important economic sectors" and commercial banks were

obligated to buy and hold some government securities even in the absence of genuine long-term capital markets. Informal credit markets flourished alongside this restrictive formal environment.

Prior to 1987 Thai monetary authorities did not put much emphasis on the development of the financial system, although they did initiate some changes, such as establishing a repurchase market for government securities in 1979. The monetary authorities were primarily devoted to coping with the economic repercussions of external events such as the two oil price shocks and the regional conflicts in Vietnam, Laos, and Cambodia. Most of the economic measures the government implemented were ad hoc responses to pressing problems. For instance, the government bailout of ailing finance companies in April 1984 was undertaken to preserve the stability of a trembling financial system. Also, the increasing volatility of the U.S. dollar led the central bank in November 1984 to switch its exchange rate policy from pegging solely to the dollar to pegging to a basket of currencies.

The Thai economy maintained a healthy average annual growth rate of 6.6 percent from 1972 to 1987 despite rises in both inflation and the current account deficit. The policy of sustaining domestic interest rates above inflation rate helped broaden and deepen Thailand's financial sector. The ratio of M2 money supply to GDP increased from 35.5 percent in 1972 to 62.2 percent in 1987, contributing to the mobilization of savings to finance the economic expansion. However, as apparent from the large spread between deposit and lending rates, competition did not develop along with financial deepening.

A strong development momentum aimed at enlarging Thailand's industrial base pressured the central authority to accommodate industrialization and globalization by adjusting the financial system to allow greater flexibility and lower costs. A number of other factors set the stage for the acceleration of financial reform in Thailand from 1988.

Worldwide Liberalization of Trade and Services

As a participant in negotiations in the Uruguay Round and the formation of the WTO, Thailand was required to provide access to and equal treatment of foreign financial institutions. Since Thailand would gradually have to open not only its

industrial and agricultural markets but also its financial markets, it was thought reasonable that the country start liberalizing its financial sector at the earliest possible moment to prepare for greater competition from abroad in the future.

European Union

The EU was in the process of unifying production, trade, and finance among its member countries. Once incorporated as a single market, the EU would grant privileges to financial institutions registered in its member countries. Thai commercial banks would be at a disadvantage and could not compete effectively unless they became more efficient, flexible, and dynamic.

Indochina's Market Orientation

Since the end of the 1980's Vietnam, Laos, and Cambodia began moving toward a market mechanism in lieu of central planning. Recognizing the economic potential of these neighbors, Thailand felt the need to upgrade its financial structure in order to accommodate increased trade and investment between the Indochina region and the rest of the world.

Fiscal Readiness

After years of fiscal deficits, Thailand achieved its first cash balance surplus in 1988 and maintained the surplus for the succeeding nine years (Table 1). In addition, the country's foreign exchange reserves were more than sufficient to meet the necessary expenses. Thus, the government felt ready to relax its financial regulations.

TABLE 1
Thailand's Fiscal Balance and International Reserves

	Fiscal Cash Balance % of GDP	International Reserves Months of Imports
1987	-1.4	4.7
1988	1.9	4.3
1989	3.2	5.0
1990	4.7	5.3
1991	4.9	5.8
1992	3.1	6.3
1993	2.2	6.8
1994	1.8	6.8
1995	1.0	6.3
1996	2.2	6.5

Source: Bank of Thailand.

FINANCIAL LIBERALIZATION, 1988-96

At the outset, Thailand had no explicit plan for financial reform and liberalizing measures were barely perceptible. Some foreign exchange controls were loosened in 1988 when foreign exchange deposits for transit passengers and credit card processing adjustments were authorized and in 1989 when non-resident baht accounts were permitted to accommodate foreign-borrowing settlements, stock transactions, and foreign investment.

The milestone that pinpointed the initiation of systematic and sustained financial reform was Thailand's acceptance of the obligations under the Article VIII of the International Monetary Fund's Articles of Agreement on May 21, 1990. This resulted in the lifting of foreign exchange controls on current account transactions. (The only remaining restrictions are on capital account transactions by Thai residents for outward portfolio and property investments and for outward foreign direct investment in excess of US$ 10 million per person per year.) Acceptance of Article VIII marked the inception of Thailand's first three-year financial reform plan, which covered the period 1990-92. The main objective of this first plan was to enhance the efficiency of the financial system and financial resource allocation.

Another crucial episode in Thailand's financial liberalization was the establishment of the Bangkok International Banking Facilities (BIBF) in March 1993.

BIBF was part of the second financial system development plan (1993-95), one of whose targets was to develop Thailand into a regional financial center.

Together, the first and second financial reform plans involved a wide range of deregulation measures and innovations as summarized below.

Interest Rates

In order to encourage the mobilization of domestic savings and to make the financial system more flexible, on June 1, 1989 the authority removed interest rate ceilings on commercial banks' time deposits with maturities longer than one year. Commercial banks were required to publicize their rates. Interest rate ceilings on savings deposits (7.25 percent) and short-term time deposits (9.5 percent) were removed on January 8, 1992 and ceilings on loan rates (15 percent) ended five months later on. On June 1, 1992 all interest rate ceilings were abolished for commercial banks and finance companies as well as credit fonciers. From that time, interest rates at Thai financial institutions become flexible and largely market determined. To enhance competition and protect small borrowers, in October 1993 the central bank began requiring commercial banks to announce their minimum retail rates, based on the costs of funds, as benchmark rates for small but good-quality borrowers.

Foreign Exchange Controls

Thus far, three rounds of foreign exchange liberalization have been implemented. The aim was to keep the foreign exchange regime in line with globalization of economic and financial systems and the increased international mobility of capital. The first round, instituted in May 1990, allowed commercial banks to authorize foreign exchange transactions in trade-related activities without prior approval from the Bank of Thailand and increased the limit on foreign exchange purchases to facilitate transfers and travel expenses. Commercial banks were also permitted to remit funds for debt repayment, sale of stocks, or liquidation of business within certain limits.

The second round, in April 1991, lifted most controls related to capital account transactions. However, outward direct investment above a certain limit and acquisition of foreign real estate or securities by Thai residents still needed approval from the Bank

of Thailand. For the first time, unincorporated Thai entities could open foreign currency accounts provided that the funds originated abroad. Exporters were allowed to accept baht payments from non-resident baht accounts without prior approval from the central bank and to use their export proceeds to service external obligations.

The third round of foreign exchange liberalization, in February 1994, raised the limit on outward transfer of direct investment by residents, increased the limit on bank notes to be taken to countries bordering Thailand including Vietnam, abolished the limit on travel expenses, and allowed residents to use foreign exchange proceeds that originated abroad to service their external payments.

The relaxation of foreign exchange controls demonstrated two target directions:

- A more active role for market forces. For instance, commercial banks were given more authority to approve transactions, except investments by Thai nationals in property and securities abroad. Meanwhile, regulations on foreign exchange receipts were loosened and commercial banks had more leeway to extend credits and accept deposits in foreign exchange to and from foreigners.
- More utilization of the baht in regional trade. Foreign nationals were permitted to hold and operate non-resident baht accounts to facilitate international trade and investment.

Portfolio Management and Scope of Activities

To give commercial banks more flexibility, the central authority reduced the proportion of outstanding deposits that they were required to hold in government bonds in order to open new branches. From 16 percent before 1988, the requirement was reduced in steps to 6.5 percent in November 1992, and to nil in May 1993. The obligations of commercial banks to extend credits to rural borrowers were expanded to cover more related occupations and wider geographical areas. Furthermore, the definition of "liquidity 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 engage in such investment banking activities as debt underwriting, dealing, fund management, and financial consulting. Finance and securities companies could participate in the same activities except financial consulting, and they could undertake leasing and mutual fund management, while qualified companies were allowed to operate foreign exchange business and/or open provincial credit offices.

New Facilities and Institutions

The Bangkok International Banking Facilities (BIBF) was established in March 1993 as a foundation for international financial services and to mobilize capital to support regional economic growth and development. BIBF may also have been formulated as a means to strengthen competition in domestic financial markets without setting up new commercial banks or finance companies. Some BIBF transactions (e.g., cross-currency trading, co-financing credit lines) receive tax privileges, while others (e.g., out-in transactions) are subject to certain requirements (e.g , minimum amounts). In May 1994 the government decided to allow BIBF to open branches in upcountry provinces. The international orientation of Thailand's financial sector was further promoted with the establishment of the Export-Import Bank of Thailand in September 1993.

The Securities and Exchange Act passed on May 16, 1992 permitted limited companies access to direct finance by issuing common stocks and debt instruments. The Act established the Securities and Exchange Commission as an independent agency responsible for supervising capital market activities, including equities, bonds, and derivatives. In 1993 the government spearheaded formation of the credit rating agency, Thai Rating and Information Services, and in 1994 private parties organized a bond dealers' club to function as a secondary debt market adding more liquidity to debt instruments.

With rapid advance in information technology, the Bank of Thailand instituted improved clearing and settlement systems that lowered transaction costs and facilitated business expansion. The BAHTNET and THAICLEAR networks were put into place to serve the needs of customers. The latest development on this front is electronic retail funds transfer through Media Clearing.

EFFECTS OF LIBERALIZATION

The drastic changes in Thailand's financial system during the 1990's affected all parties in the economy--financial intermediaries, business corporations, the government, and the general public. The financial liberalization will be evaluated in terms of its impact on the expansion of the financial system, the interest rate structure and international linkages, capital market development, financial institution performance, corporate behavior, and asset quality. In addition, macroeconomic effects and policy implications will also be examined.

Financial System

Deregulation deepened the financial system to some extent. The ratio of M2 to GDP increased from 62.2 percent in 1987 to 74.7 percent in 1992. (The comparable ratio for Australia is 60.1 percent, for the Netherlands 84.8 percent, and for Singapore 101.0 percent). In 1996 the M2 to GDP ratio stood at 79.5 percent. Similarly, the ratio of M3 to GDP rose from 73.2 percent in 1987 to 107.6 percent in 1996, demonstrating the more active role of finance companies and credit fonciers in tapping domestic savings (Table 2). The Thai financial system was broadened as well, since the number of bank branches grew from 2,016 in 1987 to 3,168 in 1996 and the population per branch fell from 26,721 in 1987 to 18,955 in 1996.

Interest Rate Structure

Dismantling foreign exchange controls led to greater mobility of capital across borders and decreased the spread between domestic and foreign interest rates. Both of these developments certify the growing international linkage of the Thai financial system. From 1989 to 1994, the difference between the one-month repurchase interest rate and the one-month Eurodollar plus forward premium narrowed as a result of the large volume of foreign exchange transactions (Table 3). Competition from foreign funds and more activities by local financial institutions drove down interest rate spreads at commercial banks. The difference between lending rates and one-year deposit rates declined from 7.25 percent in June 1992 to 6 percent in June 1994 and to 5 percent in 1995. The timing of interest rate liberalization in Thailand is noteworthy.

The authority deregulated deposit rates before lending rates and it liberalized lending rates when liquidity was plentiful. This timing helped reduce interest rate spreads and avoid sharp hikes in lending rates.

Although commercial banks eventually yielded to external market forces, their initial response was to differentiate among local customers. For instance, between 1990 and 1993 commercial banks lowered the prime lending rate by 5 percent while they reduced rates for retail clients by only 1.75 percent. Banks exploited the weaker negotiating power of retail customers in order to compensate for reduced revenues from their prime commercial borrowers. When banks were required to adopt a minimum retail rate (MRR) based on deposit rates and operating costs, the difference between the prime rate or MLR and the MRR decreased to some extent.

TABLE 2

Thailand's Major Financial Indicators
billion baht

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
GDP nominal	1,133	1,299	1,559	1,857	2,183	2,506	2,834	3,179	3,634	4,202	4,689.
% growth	--	14	20	19	17	14	13	12	14	15	11.
GDP 1988 prices	1,257	1,376	1,559	1,750	1,945	2,111	2,285.	2,481	2,702.	2,941.	3,117
% growth	-	9	13	12	11	8	8	8	8	8	6
M1	103.	132.	148	174	195	222	249	296	346	388	423.
% growth	--	28	12	17	11	13	12	18	16.	12.	9
Relative to GDP	9	10	9	9	8	8	8	9	9	9	9
M2	672	808	956	1,207	1,529	1,832	2,117	2,507	2,829	3,310	3,726
% growth	--	20	18	26	26	19	15	18	12	17	12
Relative to GDP	59	62	61	65	70	73	74	78	77	78	79
M3	810	952	1,146	1,477	1,873	2,246	2,662	3,187	3,748	4,449	5,045
% growth	--	17	20	28	26	19	18	19	17	18	13
Relative to GDP	71	73	73	79	85	89	93	100	103	105	107
Financial Assets	1,123	1,333	1,611	2,022.	2,553	3,078	3,714	4,725	6,031	7,653	8,736
% growth	--	18	20	25	26	20	20	27	27	26	14
Relative to GDP	99	102	103	108	117	122	131	148	165	182	186
CB Deposits	627	752	893	1,135	1,440	1,751	2,035	2,427	2,760	3,250	3,683
% growth	--	20	18	27	26	21	16	19	13	17	13
Relative to GDP	55.	57	57.	61	66	69	71	76	76	77	78
FC Deposits	89.	99.	135.	192	260	337	415	542	747	914	1,040
% growth	--	10	36	42	34	29	23	30	37	22.	13
Relative to GDP	7	7	8	10	11	13	14	17	20	21.	22
CB Credits	543	672	853	1,110	1,481	1,789	2,161	2,669	3,430.	4,230	4,825
% growth	--	23	26	30	33	20	20	23	28	23.	14
Relative to GDP	48	51	54	59	67	71	76	83	94	100.	102
FC Credits	102	116	154	238	314	415	547	733	1,008	1,301	1,488
% growth	--	13	32	54	32.	31	31	33	37	29	14
Relative to GDP	9	8	9	12	14	16	19	23	27.	31	31
CB+FC Credit/Deposit, %	90	93	98	102	106	106	111	115	127	133	134

Notes: CB denotes commercial banks and FC denotes finance companies.

Source: Bank of Thailand.

TABLE 3

Domestic and International Interest Rates, 1990-96
percent

	U.S. Federal Funds Rate (A)	One-Month Eurodollar Rate (B)	Bangkok Interbank Rate (C)	Bangkok-Fed Funds Differential (C-A)	Bangkok-Eurodollar Differential (C-B)	MLR
1990 Q1	8.22	8.35	10.32	2.10	1.97	14.00
Q2	8.20	8.35	12.02	3.81	3 66	14.50
Q3	8.11	8.16	14.71	6.60	6.55	14.75
Q4	7.68	8.15	14.44	6.76	6.29	16.25
Avg.	8.05	8.25	12.87	4.82	4.62	14.88
1991 Q1	6.42	6.79	13.63	7.21	6.84	16.00
Q2	5.77	6.05	12.81	7.05	6 76	15.50
Q3	5.56	5.79	10.70	5 14	4.91	16.00
Q4	4.74	5.06	7.46	2 72	2.41	14.00
Avg.	5.62	5.92	11.15	5.53	5.23	15.38
1992 Q1	3.89	4.23	5.48	1.60	1.25	12.50
Q2	3.74	3.97	7.66	3 92	3.69	12.00
Q3	3.27	3.38	7.38	4.11	4 00	12.00
Q4	3.05	3.43	7 24	4.19	3.81	11.50
Avg.	3.49	3.75	6.94	3.45	3.19	12.00
1993 Q1	3.06	3.19	8.15	5.09	4.96	11.25
Q2	2.99	3.17	8.60	5.60	5.42	11.25
Q3	3.09	3.17	6 34	3.25	3 17	11.25
Q4	2.99	3.24	3.11	0.12	-0.13	10.50
Avg.	3.04	3.19	6 55	3 51	3 36	11.06
1994 Q1	3.21	3.36	7.24	4.03	3.88	10.13
Q2	3.94	4.19	8.00	4.07	3.81	11.00
Q3	4.51	4 72	7.35	2.84	2.62	11.50
Q4	5.21	5.54	6.41	1 20	0.87	11.75
Avg.	4.22	4.45	7.25	3.03	2.80	11.09
1995 Q1	5.80	6.10	13.30	7.50	7.20	13.00
Q2	6.00	6.10	11.10	5.10	5.10	13.50
Q3	5.80	5.90	9.20	3.40	3.40	13.75
Q4	5.70	5.70	10.20	4.40	4 50	13.75
Avg.	5 80	5.90	11.00	5.10	5.00	13.50
1996 Q1	5.40	5.20	7.30	1.90	2.10	13.75
Q2	5.30	5.20	7.20	2.00	2.00	13.75
Q3	5.30	5.20	11.40	6.10	6.20	13.50
Q4	5.30	5.30	11.00	5.70	5.60	13.25
Avg.	5.30	5.30	9.20	3.90	4.00	13.56

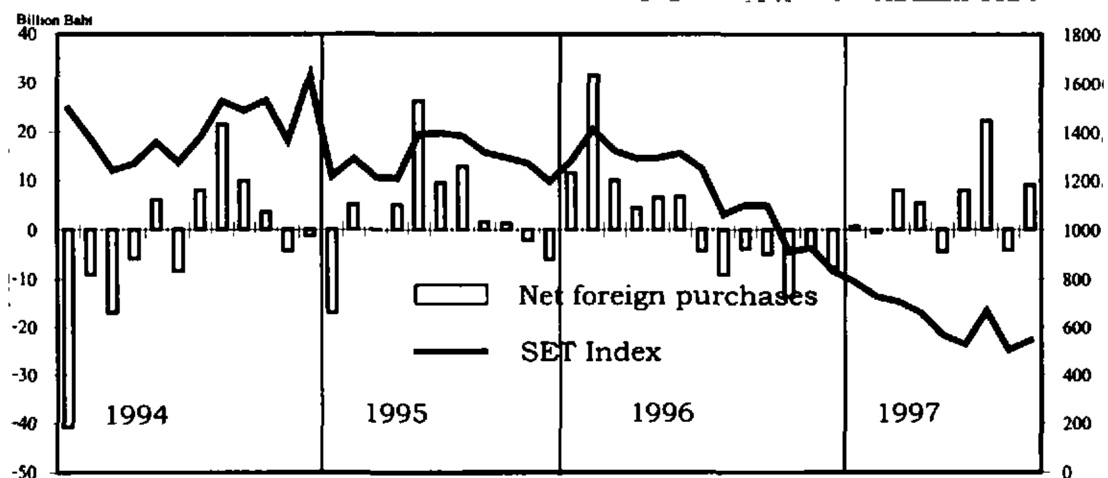
Source: Bank of Thailand

Capital Market

New capital raised in the Stock Exchange of Thailand (SET) surged from 17.5 billion baht in 1990 to 55 million baht per year in 1991-93 and to 130 billion baht per year in 1994-95. Market capitalization therefore expanded remarkably, from 29.4 percent of GDP in 1990 to 85.9 percent in 1995. The SET index rose from 612.9 in 1990 to a peak of 1,682.9 in 1993 and settled at 1,280.8 in 1995 in line with the pace of economic activities. Meanwhile, investors became increasingly diversified to consist of not only retail buyers but also institutional ones such as provident funds, mutual funds, and insurance companies. In parallel, private debt markets captured much attention. Domestic issues of debentures skyrocketed from 6.3 billion baht in 1991 to 50.5 billion baht in 1995. Convertible debentures increased fourfold from 1993 to 1995.

As one consequence of the liberalization process, increasing capital mobility encouraged overseas placement. The total fixed-income instruments issued abroad rose from 58.8 billion baht in 1993 to 103.4 billion baht in 1995. On the local front, foreign investment, or net capital inflows, became exceedingly prominent in the Thai capital market. Influenced both by external factors (e.g., the Mexican financial crisis, the collapse of Barings, the depreciation of the U.S. dollar versus the yen, and the Asian financial turmoil) and by internal factors (e.g., political instability), net foreign purchases of shares functioned as a prime mover of the SET index (Chart 1). Moreover, the huge magnitude of net foreign capital flows had unrivaled repercussions on the money market as well as on the economy as a whole.

Chart 1: SET Index and Net Foreign Purchases



Financial Institution Performance

Stronger competition as a result of liberalization reduced commercial banks' share of household savings. The proportion of household savings deposited at commercial banks declined from 73.35 percent in 1989 to 70.71 percent in 1993 and to 66.95 percent in 1996, while the share of savings placed with finance companies surged from 10.30 percent to 14.78 percent and 16.75 percent in the same period (Table 4). Moreover, new mutual fund management companies organized a large number of funds to attract local savers. The picture was the same on the credit side. The market share of commercial banks shrank from 75.48 percent in 1989 to 70.51 percent in 1993 and to 67.41 percent in 1996, while that of finance companies rose from 14.97 percent to 19.37 percent and to 20.79 percent in the same period (Table 5).

TABLE 4

Share of Household Savings at Financial Institutions by Type of Institution, 1989-96

percent

	1989	1990	1991	1992	1993	1994	1995	1996
Commercial banks	73.35	75.14	74.40	72.22	70.71	68.64	68.36	66.95
Finance companies	10.30	10.11	11.27	13.68	14.78	16.43	16.48	16.75
Life insurance companies	2.47	2.40	2.51	2.59	2.67	2.84	2.71	2.96
Agricultural cooperatives	0.36	0.34	0.34	0.34	0.37	0.40	0.43	0.43
Savings cooperatives	2.69	2.52	2.56	2.96	3.49	3.83	4.07	4.60
Credit foncier companies	0.15	0.12	0 14	0.16	0.18	0.17	0.15	0.16
Government Savings Bank	8.80	7.31	6.66	6 05	5.62	5.38	5.16	5.20
Bank for Agriculture & Agricultural Cooperatives	0 69	0.85	0.84	0.82	0.90	1.07	1.29	1.45
Government Housing Bank	1 19	1.21	1.28	1.18	1.28	1.24	1.35	1 50

Source: Bank of Thailand.

TABLE 5

Credits Extended by Financial Institutions by Type of Institution, 1989-96

percent

	1989	1990	1991	1992	1993	1994	1995	1996
Commercial banks	75.48	74.90	73.78	71.89	70.51	69.63	68.48	67.41
Finance companies	14.97	15.64	16.74	18.21	19.37	20.46	21.07	20.79
Life insurance	0.77	0.83	0.78	0.70	0.55	0.44	0.40	0.44
Agricultural cooperatives	0.53	0.51	0 49	0.47	0.44	0.37	0.41	0.33
Savings cooperatives	2.73	2.50	2.39	2.61	2.73	2.62	2.68	2.97
Pawnshops	0.40	0.35	0.32	0.29	0.24	0.22	0.20	0.20
Credit foncier companies	0.19	0.16	0 15	0.17	0.16	0.12	0 11	0.09
Government Savings Bank	0.41	0.58	0.61	0.61	0 82	0 66	0.64	0.79
BAAC	2.03	1.96	2.01	2.06	2 05	1 96	2.03	2.31
Industrial Finance Corporation of Thailand	1.02	1.07	1.08	1.20	1.23	1 16	1 24	1.44
Government Housing Bank	1.47	1.50	1.64	1.78	1.90	2.04	2.30	2.77
Small Industrial Finance Corporation	0.00	0.00	0.01	0.00	0.00	0.01	0.01	0.10
Export-Import Bank	-	-	-	-	-	0.31	0.43	0.45

Source: Bank of Thailand.

Greater competition as a consequence of deregulation motivated commercial banks to economize on their operating expenses. Thai commercial banks' ratio of operating expenses to total assets decreased from *11.06 percent in 1990 to* 9.52 percent in 1996, resulting in a rise of net profits from 0.7 percent of total assets in 1989 to 1.28 percent in 1996 (Table 6). Commercial banks put more effort into fee-based income earning activities, reflecting bank interest in additional opportunities. Their fee-based income grew from 4.16 percent of total income in 1988 to 6.84 percent in 1996.

Nevertheless, Thai financial institutions did not catch up with the booming real sector in the late 1980's and the early 1990's. The Thai economy then was advancing at a very rapid pace, demanding more complicated financial services and instruments which could not be offered by local banks and finance companies. For instance, domestic financial institutions lagged behind in long-term project financing capability and maturity matching tactics. Unsurprisingly, in the presence of stable local currency a large number of credible corporations and agencies resorted to foreign sources of funds and financial services.

TABLE 6

Performance of Thai Commercial Banks, 1987-96
percent

	Income/Total Assets	Expenses/Total Assets	Net Profits/Total Assets
1987	9.62	8.57	0 68
1988	9.51	8.36	0.68
1989	10 75	9.54	0 70
1990	12.65	11.06	0.98
1991	12.98	11.29	0 89
1992	12.51	10.44	1 32
1993	10.62	8.46	1.44
1994	10.72	8.22	1.86
1995	12.09	9.36	1.82
1996	12.00	9 52	1.28

Source: Bank of Thailand.

Domestic commercial banks and finance companies hardly tapped long-term deposits on variable interest rates so as to fund long-term credits. Even though there was no benchmark rate or government securities yield to refer to (because the government attained cash surplus in nine consecutive years between 1988-96), banks could have innovated various schemes of returns to attract long-term deposits. Due to this shortfall and conservative attitude, bank clients heavily hinged upon overdrafts, instead of long-term credits, for long-term fund uses, entailing liquidity risks to borrowers and contingent bad debt risks to original lenders. Similar maturity mismatch also prevailed when foreign credits were resorted to via BIBF. Whenever creditors doubt about creditworthiness of debtors or debtor country, credit roll-over may not be possible, engendering liquidity shortages among borrowers as widely experienced in the 1997 financial crisis.

What is more distressing is that domestic banks and finance companies were weak at the fundamental core. Their operating staff were rarely efficient in evaluating credit applications or project feasibility. Instead, they frequently based their decisions upon collaterals or back-up assets or connections. Worse yet, the central authority was rather deficient in examining and supervising local banks and finance companies. Consequently, Thai commercial banks' and finance companies' asset quality was largely fragile or highly vulnerable to macroeconomic disturbances. In this respect, one may conclude that financial liberalization was, to some extent, too early, as the supporting system was not yet ready to cope with drastic and rapid changes.

Corporate Behavior

After the financial crisis several criticisms, such as the the following, were raised against private corporations or business entities: excessive investment even in areas where comparative advantage or expertise was missing, too much foreign borrowing especially without forward over, and maturity mismatching such as short-term borrowing for long-term uses. But if all pertinent factors are examined, one can see that not all errors should be attributed to business undertakers. Normally, private businesses are profit maximizers. They were thus tempted to invest when the economy was booming and when they had easy access to cheap foreign funding in the midst of stable exchange rates while local financial institutions did not offer them much opportunities. Therefore, though corporates' decision framework may seem imprudent with respect to allocation of capital and efficiency in capital utilization, part of the blame should be put upon privileges given by investment promotion agency, liberalized (foreign exchange) capital account under rigid exchange rates, and weak decision framework of, as well as protracted process at, local financial institutions to begin with.

Asset Quality

Financial liberalization fueled a spree of excessive or speculative spending and investment in several sectors of Thailand's economy. Funded largely by foreign borrowing, enterprises in these "bubble" sectors became vulnerable to unfavorable exchange rate changes, unwillingness of creditors to roll over maturing debts, and the possibility that the business itself flopped. Negative impacts of the financial liberalization on the financial system did not emerge until the mid-1990's. Since those enterprises were also considerably accommodated by domestic commercial banks and finance companies, the asset quality of local financial institutions deteriorated to an alarming extent. For example, the non-performing loans of Thai commercial banks jumped from 8 percent of total loans in June 1997 to 20 percent in December 1997 and 45 percent in December 1998.

The course of the boom in the property market, for example, can be inferred from the data on the area of construction permitted in municipal zones (Table 7). From 1987 to 1988, area under construction increased 65.8 percent for Thailand as a whole and for the Bangkok metropolis it almost doubled (98.8 percent increase). The situation

was quite different a few years later. From 1993 to 1994, construction area declined 5 percent in the country as a whole and 12.2 percent in the Bangkok metropolis. Restrictive monetary measures implemented after mid-1995 to contain inflation drove interest rates up, putting real estate enterprises in a predicament. Construction area plunged 28.8 percent in the country as a whole from 1995 to 1996 and it fell 37.5 percent in Bangkok.

Lenders to these real estate firms were battered by the subsequent negative chain reaction. In 1996, commercial banks absorbed 53.7 percent of all property credit outstanding, followed by finance companies with a 45.7 percent share. However, for commercial banks property credits added up to only 8.8 percent of their total credits, but property credits amounted to almost one-fourth (24.4 percent) of total credits extended by finance companies (Table 8). In other words, finance companies were more vulnerable than commercial banks to the real estate bust. In the end, when the currency crisis critically weakened Thailand's economy, fifty-six finance companies had to be shut down in December 1997 and four commercial banks were taken over by the government in February 1998.

TABLE 7

Area of Construction Permitted in Municipal Zones, 1987-96

million square meters

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Residential	7.23	12.13	15.48	20.34	19.88	18.80	21.45	24.38	23.11	16.08
% change	-	67.8	27.6	31.4	- 2.3	- 5.4	14.1	13.7	- 5.2	- 30.4
Commercial	3.82	5.73	10.39	14.04	18.24	14.30	14.05	8.06	10.71	8.12
% change	-	50.2	81.2	35.1	29.9	- 21.6	- 1.8	- 42.7	32.9	- 24.2
Industrial & other	1.05	2.20	2 63	3 85	3.21	3.13	2.52	3.70	2.95	1.96
% change	-	108.7	19.6	46.3	- 16.4	- 2.6	- 19.4	46.7	- 20.2	- 33.5
Whole kingdom	12.10	20.06	28.50	38 23	41.33	36.23	38.02	36.14	36.77	26.16
% change	-	65.8	42.0	34.1	8 1	- 12.3	5.0	- 5.0	1.7	- 28.8
Bangkok metropolis	6.84	13.59	19.37	25.86	32.71	27.24	29.72	26.11	25 38	15.85
% change	-	98 8	42.5	33.5	26.5	- 16.7	9.1	- 12.2	-2.8	-37.5

Source: Bank of Thailand.

TABLE 8

Bills, Loans and Overdrafts of Commercial Banks Classified by Purposes
million baht

	1995		1996		1997	
	Dec.	Share	Dec.	Share	Dec.	Share
Agriculture	158,940	3.7	164,019	3.4	161,695	2.7
Mining	24,985	0.6	24,476	0 5	36,000	0.6
Manufacturing	1,097,338	25.8	1,313,546	27.1	1,872,325	30.9
Construction	185,850	4.4	236,341	4.9	273,064	4.5
Real estate business	400,184	9 4	426,100	8.8	490,521	8.1
Imports	139,976	3.3	146,409	3.0	174,443	2.9
Exports	182,710	4.3	196,056	4.0	218,899	3.6
Wholesale and retail trade	756,799	17.8	870,225	17.9	1,037,812	17.1
Public utilities	108,106	2.5	142,751	2.9	197,128	3.3
Banking and other financial business	339,204	8.0	345,330	7.1	487,514	8.0
Services	333,296	7.8	377,839	7.8	458,037	7.6
Personal consumption	523,437	12.3	612,595	12.6	652,516	10.8
Total	4,250,825	100	4,855,688	100	6,059,956	100

Source: Bank of Thailand.

Real estate was not the only sector in which bubble growth caused deterioration in the asset quality of financial institutions. There was considerable oversupply in other Thai industries as well. In 1996 supply was 192 percent of domestic demand in the automotive industry, private hospital beds were 300 percent of demand, supply of steel bars was 150 percent of demand, and supply of petrochemicals was 195 percent of demand[1]. These imbalances were created in part by investment incentives given by various public authorities, but to the extent that domestic financial institutions lent to firms in these sectors, their assets became vulnerable to the course of the bubble.

Another cause of the decline in asset quality at domestic financial institutions was financial mismanagement by Thai businesses. For example, maturity mismatching required firms to roll over debt frequently and uncovered net foreign exchange positions generated onerous burdens and great risks when exchange rates fluctuated widely. At the same time, unlisted firms that relied heavily on debt financing were highly susceptible to liquidity shortage. Overall, such business practices among borrowers lowered the asset quality of Thai banks and finance companies to a considerable extent in the mid-1990's. A final reason for the decline in the overall quality of financial institutions' assets was the increase in the proportion of small clients, who brought

about greater risks, compared to large borrowers, since large borrowers have more credit access as a result of liberalization.

Macroeconomic Impacts and Policy Implications

Exchange rate stability was a major factor promoting capital inflows. Before July 1997, Thai monetary authorities were extremely conservative in their exchange rate policy. The baht had long been pegged to the U.S. dollar. Daily fixings did not move the baht value against the U.S. dollar to any significant extent from 1978 to 1981. Neither did the basket pegging system in use from 1984 to 1997, since the U.S. dollar commanded the preponderant weight in the basket. (Between 1981 and 1984 the baht was fixed against the U.S. dollar). As a result of this exchange rate policy, foreign borrowing denominated in U.S. dollars entailed negligible exchange risk. In the absence of a well-developed domestic debt market, the stability of the baht exchange rate together with lower interest rates abroad motivated private Thai businesses to tap foreign funds recklessly without hedging. To external creditors, Thailand's exchange rate stability together with the impressive record of real GDP growth offered appealing opportunities for interest arbitrage and speculation. The net capital inflows to Thailand rose from 8 percent of GDP in 1990 to 14 percent of GDP in 1995 (Table 9).

TABLE 9

Total Net Capital Inflows to Thailand, 1989-96

US$ billion

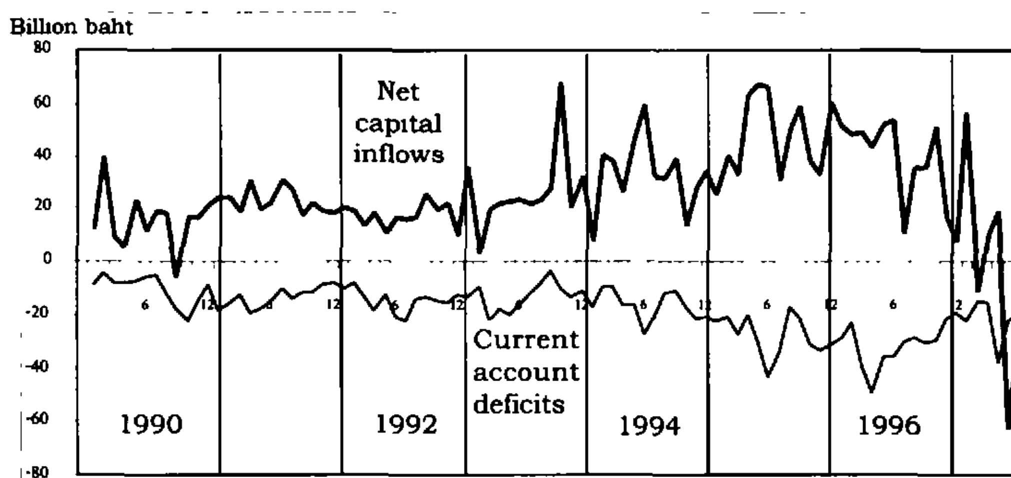
	1985	1986	1987	1988	1989	1990
Net inflows	1.9	0.4	0.8	2.9	6.6	7.2
% of GDP	5	1	1	5	9	8
	1991	**1992**	**1993**	**1994**	**1995**	**1996**
Net inflows	10.6	8.1	12.6	15.8	22.8	18.1
% of GDP	11	7	1	13	14	10

Source: Bank of Thailand.

The influx of foreign capital as a consequence of financial liberalization had two crucial macroeconomic repercussions. First, it ominously magnified the momentum of the spending spree. Furthermore, given that money is extremely fungible, there was no way for the government to guarantee that the foreign borrowings were directed to productive uses. A substantial part of the run up in stock and property prices in the

first half of the 1990s was attributed to imported capital, in spite of some central bank regulations. From a macroeconomic viewpoint, foreign funds enlarged the country's current account deficits (Chart 2). The second repercussion was that the large volume of capital inflows, especially the short-term ones, increased Thailand's balance-of-payments vulnerability. Because of the short time frame or high mobility of their funds, foreign fund lenders were highly sensitive to changes or disruptions in conditions. Whether they would roll over or retrieve credits means volatility to the country's balance of payments.

Chart 2: Current Account Deficits and Net Capital Inflows

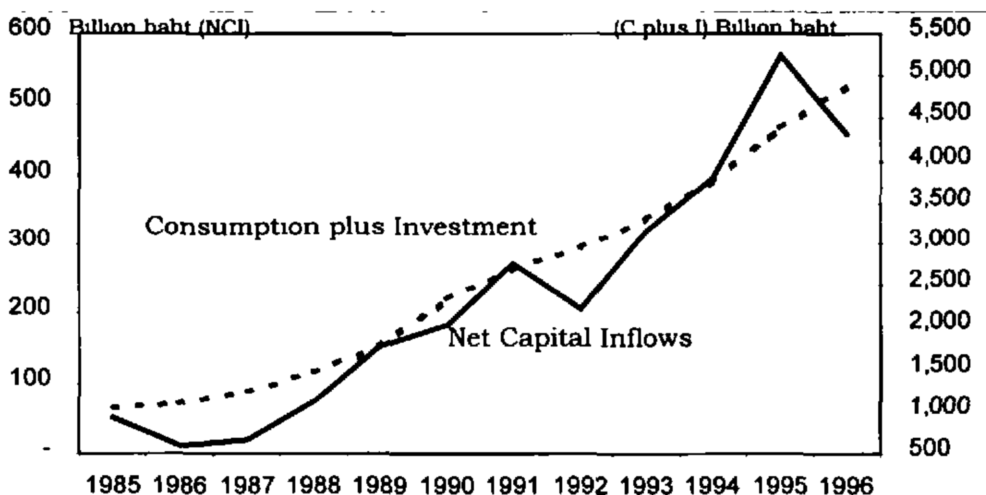


Financial liberalization engenders a number of policy trade-offs. Opening up the financial border means more competition and hopefully more efficient use of funds, but it also reduces the autonomy of policymakers with respect to interest rates. Domestic interest rates become subject to international market pressures, while new financial instruments mean that monetary aggregates, such as M2, less accurately reflect the actual condition of the economy. For instance, in 1994 when Thailand's M2 growth fell to 12.9 percent a year from its previous rate of 18.4 percent, both inflation and the current account deficits were on the rise. In addition, a country cannot maintain a fixed exchange rate policy once the capital account is opened, because reserves of foreign exchange are finite. In other words, the benefit of liberal capital movement comes at the expense of exchange rate stability. Altogether, financial deregulation stimulates the degree of competition in financial resource mobilization, increases the volatility of domestic liquidity due to foreign fund flows, and compounds the difficulty of macroeconomic policymaking.

INTO THE STORM

Net capital inflows perform two functions; they finance current account deficits and they fuel economic activities. Foreign capital is essential in most developing countries where foreign exchange reserves are usually insufficient to finance continuing current account deficits. But inflow of foreign capital, if excessive and not sterilized by the central bank, can engender both superfluous spending or investment (Chart 3) and debt service that leads to future current account deficits. Thus, developing countries must handle capital inflows carefully. At the current stage of globalization, foreign capital has become virtually intractable. Its high mobility, volatility, and large volumes have made it overwhelmingly powerful. *Developing countries should be forewarned* about reliance upon foreign capital funds: "too little may bring about today's pain, but too much may nullify tomorrow's gain."

Chart 3: Net Capital Inflows and Consumption plus Investment



Immediate Outcome

The striking appreciation of the yen and the currencies of the NICs that followed the 1985 Plaza Accord triggered enormous flows of capital to developing countries, including Thailand. Foreign investment helped raise Thailand's economic growth rate to over 10 percent per year in 1988-90. The consequence was widespread speculation in both real estate and capital markets. Property prices rose to unprecedented level, pushed by the increased capital market activities and real estate demand. The economy

slowed down somewhat in the early 1990's, but the growth rate was still a robust 8.1-8.5 percent per year (Table 2). The economy was re-invigorated in the second half of 1993 by a decline in world interest rates and by the commencement of BIBF. Again, an influx of foreign capital fueled both capital market transactions and property speculation.

The net inflows of capital considerably increased the supply of money in circulation in Thailand (Chart 4). The inflows were also clearly reflected in a growing extent of current account deficits and inflation (Charts 2 and 5). From a low of 3 percent in 1993, inflation climbed to 6 percent at the end of 1994 and peaked at 7 percent in early 1996. In other words, while the foreign capital helped propel the pace of economic expansion, it also stoked looming macroeconomic peril.

Chart 4: Effect of Net Capital Inflows on Money Supply

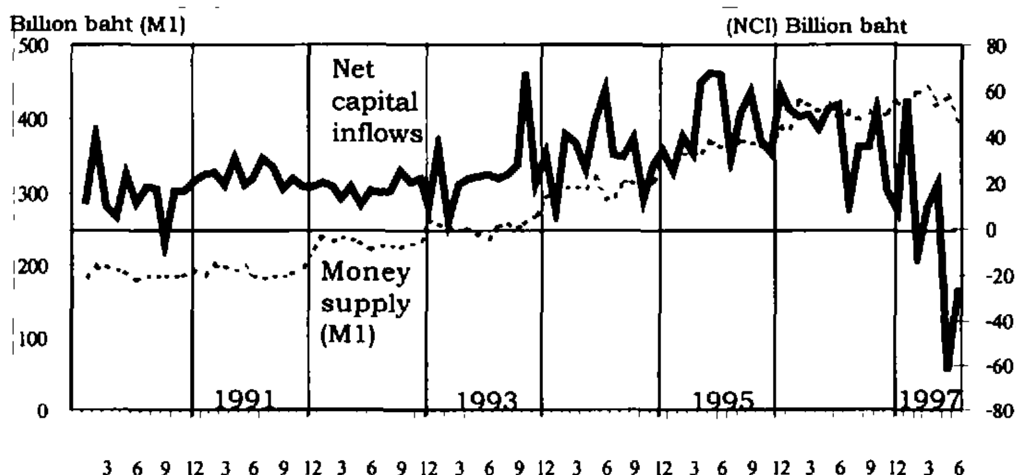
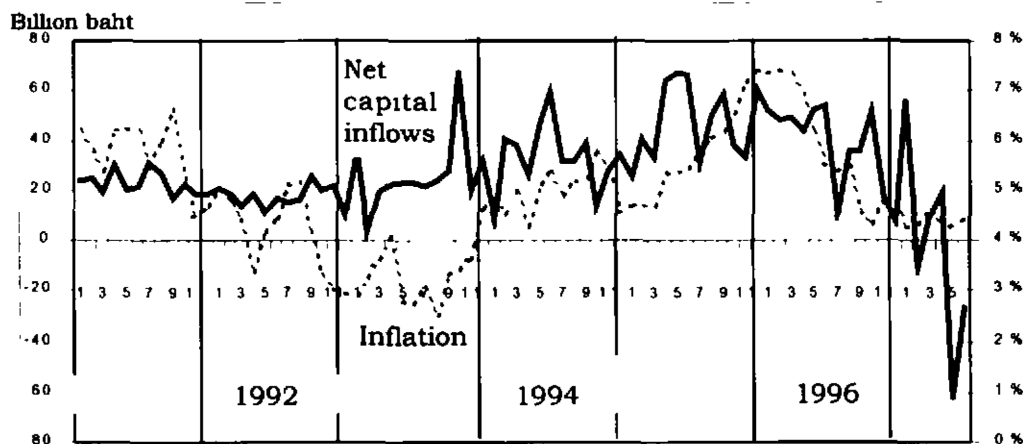


Chart 5: Inflation and Net Capital Inflows



Detrimental External Debt

The vigorous foreign borrowing that followed financial liberalization was reflected in Thailand's swelling external debt outstanding, which more than tripled from US$29 billion in 1990 to US$94 billion in the middle of 1997. In relative terms, total external debt outstanding exploded from 34 percent of GDP in 1990 to 59 percent of GDP in mid-1997 (Chart 6). Not only did these surging foreign debts fuel the trade deficits or the savings-investment gap but they also brought about increasing debt service which worsened current account deficits in subsequent years. The vicious circle generated by external debt is shown by the fact that the proportion of Thailand's current account deficits that were due to debt service grew quite markedly from 1990. Income payments rose from 37 percent of the current account deficits in 1990 to 50 percent in 1996 (Chart 7).

Chart 6: Swelling External Debt Outstanding

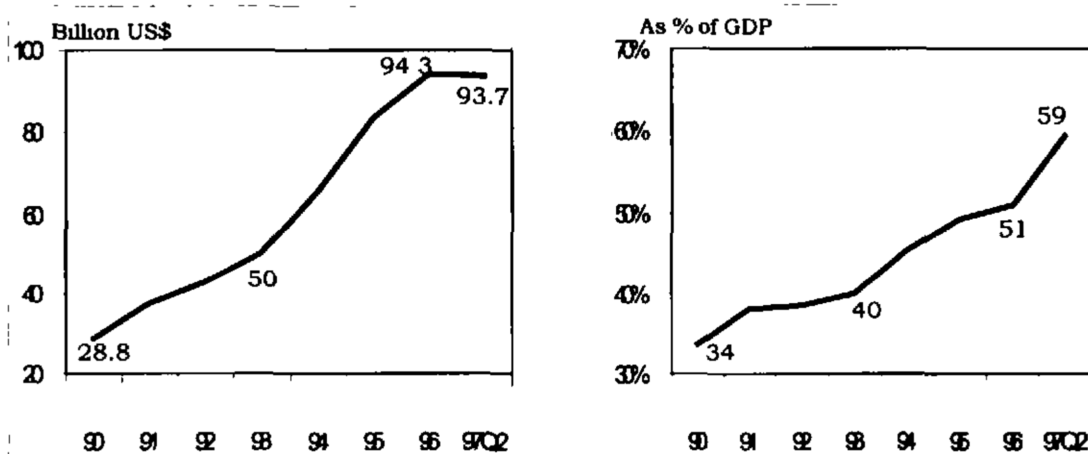
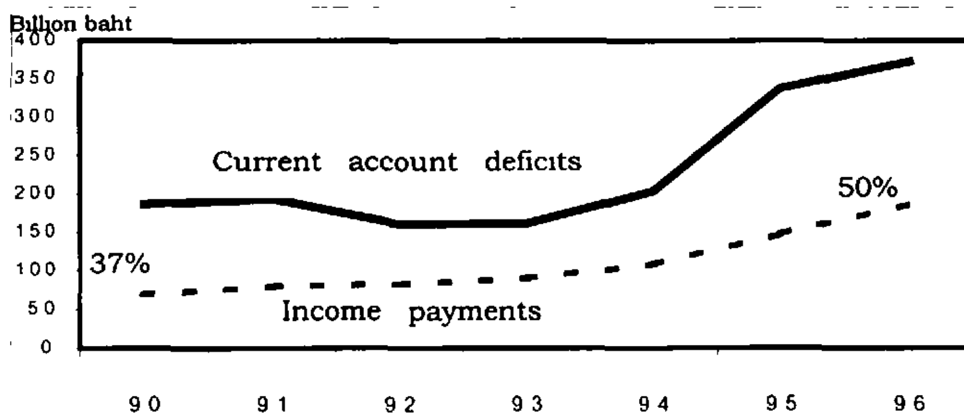


Chart 7: Income Payments and Current Account Deficits



Private external debt can be particularly detrimental to the current account. Private debt is typically charged at higher interest rates, for shorter maturities, and applied to riskier commercial projects than bilateral assistance or normal external borrowing by public agencies. Unfortunately, private debts predominated in Thailand. From 1990 to 1996 the Thai government commanded a continual cash surplus so its capital inflow was virtually nil (Chart 8). Almost all of these private debts belonged to the non-bank sector because Thai commercial banks were subject to limitations on their net foreign exchange positions (Chart 9).[2] Furthermore, the non-bank private sector's share in Thailand's external debt outstanding was not only large but also expanding, from 51 percent in 1990 to 72 percent in mid-1997. Given the typical time frame of private borrowers, the short-term portion of the country's external debts ballooned from 22 percent in 1990 to 50 percent in 1995-96 (Chart 10). The short-term nature of the external claims put both individual borrowers and the country at risk of a liquidity shortage should creditors decide not to roll over maturing debts.

Chart 8: Private and Public Net Capital Inflows

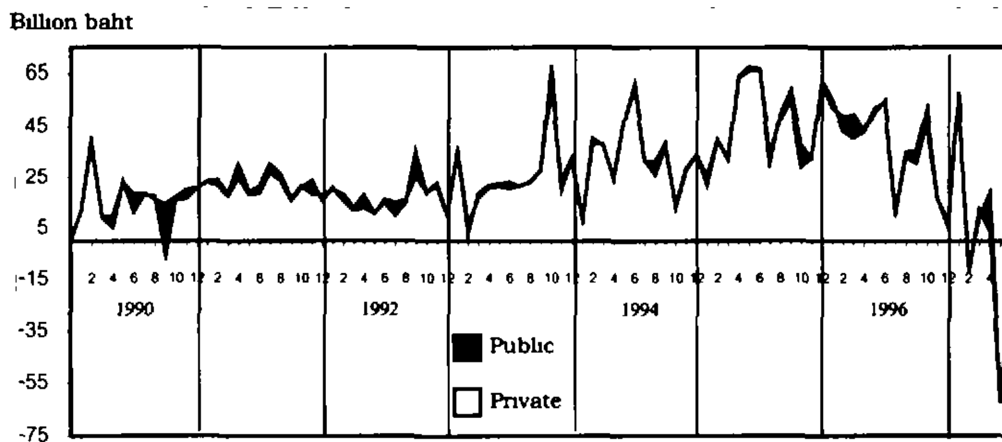


Chart 9: Growing External Debts of the Non-bank Private Sector

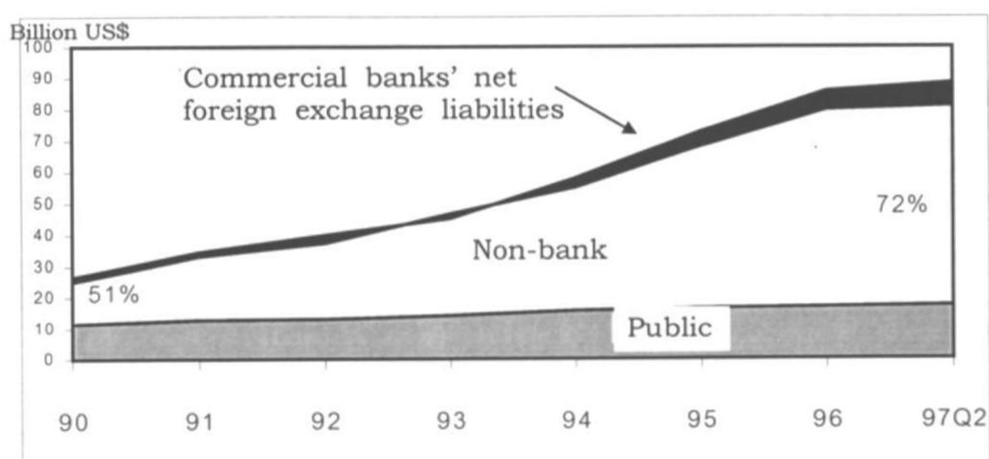
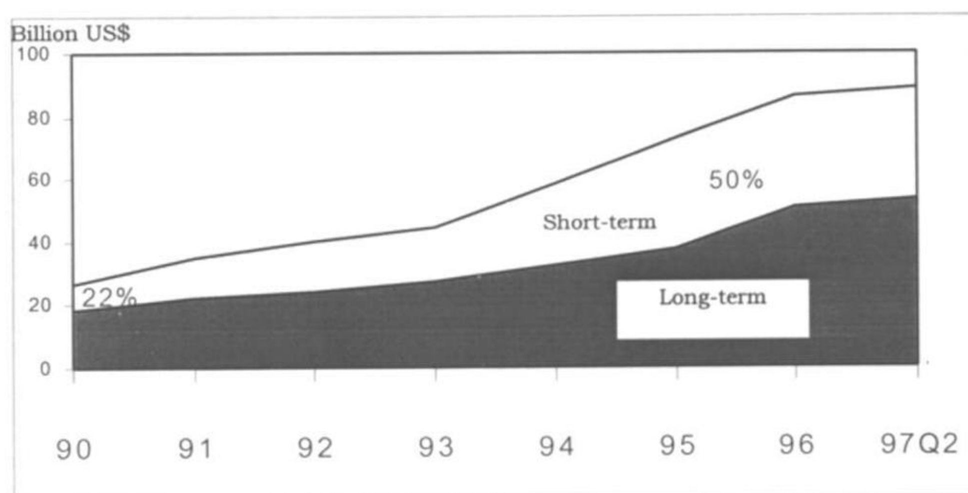
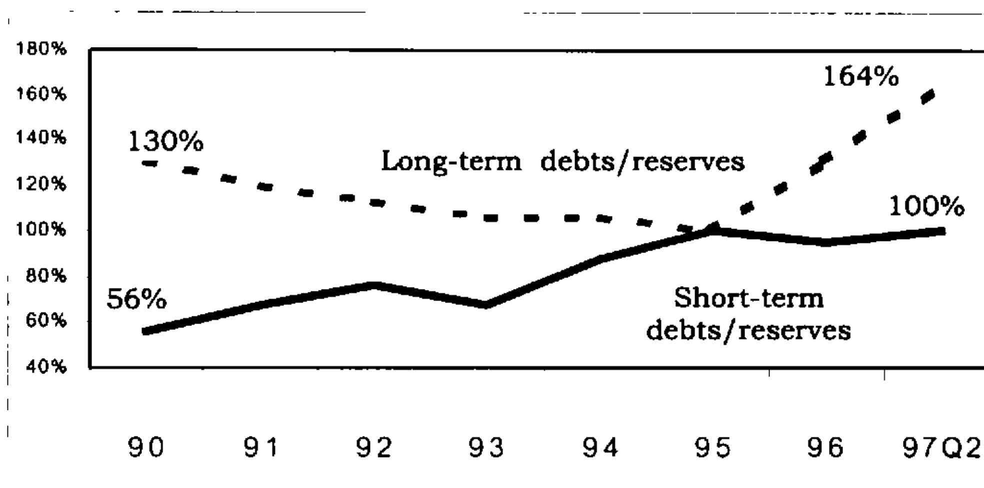


Chart 10: Short-term and Long-term External Debts



With very few controls on capital inflows[3], Thai external debts surged ominously, even relative to the government's foreign exchange reserves. Since a sizable part of those reserves came from net capital inflows or foreign borrowings, the adequacy of these reserves should be judged by comparing them to external debt outstanding, not just to months of imports. The ratio of Thailand's external debts to reserves indicates extreme vulnerability. Even though the ratio of long-term debts to reserves rose only slightly, the ratio of short-term debts to reserves almost doubled, so that the ratio of long- plus short-term debts to reserves grew from 186 percent in 1990 to 264 percent in mid-1997 (Chart 11).

Chart 11: External Debts/Reserves Ratios



Unfortunate Coincidence

The precarious spending spree financed largely by short-term private borrowing was followed by the unfortunate coincidence of four events. The first was the emergence of macroeconomic disequilibrium. Prior to 1993, Thailand had succeeded in maintaining macroeconomic stability, if stability means that the current account balance is low relative to GDP. Between 1982 and 1992 Thailand's current account deficit had reached the 8 percent level only once, in 1990 (Table 10). After 1993, however, the current account deficit started to increase menacingly. In both 1995 and 1996 the external deficit surpassed 8 percent again. Apparently, the current account deficits were pushed upward by the powerful inflows of foreign capital (Chart 2). In other words, the financial liberalization and the consequent capital inflows eventually disturbed Thailand's macroeconomic stability.

TABLE 10

Thailand's Current Account Balance and Domestic Inflation

	Current Account Balance as a % of GDP	Thai-U.S. Inflation Differential percent
1982	-3.2	-1.0
1983	-7.8	0.6
1984	-5.1	-3.4
1985	-4.1	-1 2
1986	0.6	0.0
1987	-0.8	-1.2
1988	-2.6	-0.3
1989	-3.5	0.6
1990	-8.5	0.6
1991	-7.7	1.5
1992	-5.7	1.0
1993	-5.1	0.3
1994	-5.6	2.5
1995	-8.1	3.0
1996	-8.0	3.0

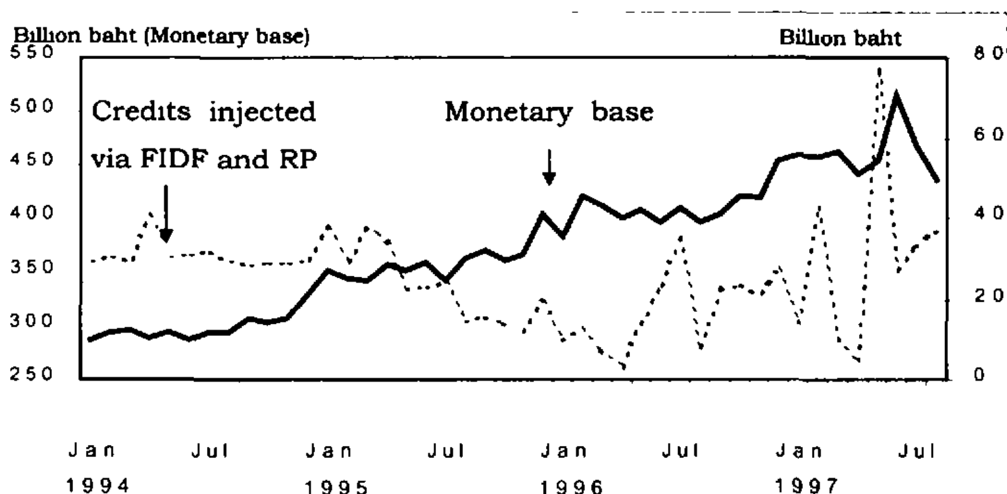
Source: Bank of Thailand.

Macroeconomic disequilibrium was aggravated by a second incident--the Bank of Thailand's extension of financial assistance to ailing finance companies and commercial banks in order to preserve the stability of these financial institutions during 1996 and 1997. Problems, such as excessive credit extension, non-performing loans, low asset quality, inadequate capital and loan-loss provisions, that stemmed from the liberal capital inflows, stable exchange rates, outdated rules, and supervisory inefficiency were causing many Thai financial institutions to falter. The cheap and easily accessible foreign credits had spurred domestic finance firms and banks to compete among themselves for clients and this resulted in their imprudent extension of too much credits. Worse yet, supervision of financial institutions was poor in several respects including classification of non-performing assets, loan-loss provisions, financial disclosure, corporate governance, cronyism, and bankruptcy laws. Worst of all were the absence of a market-oriented deposit insurance system and the widely held belief that financial institutions almost never go bankrupt or shut down. In the presence of the weaknesses in the financial sector and rising political tensions, the Bank of Thailand could not resist coming to the rescue of financial institutions that were short of liquidity as a result of poor asset quality and mismanagement between 1996 and 1997.

The Bank of Thailand rescue conflicted with the appropriate strategies for restoring macroeconomic stability. The narrow scope of the repurchase market in Thailand limited the amount of sterilization that the central bank can conduct. As a result, the bailout of the financial institutions tended to enlarge the money supply. Credits injected by the Financial Institutions Development Fund, the rescue arm of the central bank, together with the repurchase market was highly correlated with monetary base growth from September 1996 to September 1997 (Chart 12). The growing money supply fueled further spending and exacerbated both the current account deficits and domestic inflation.

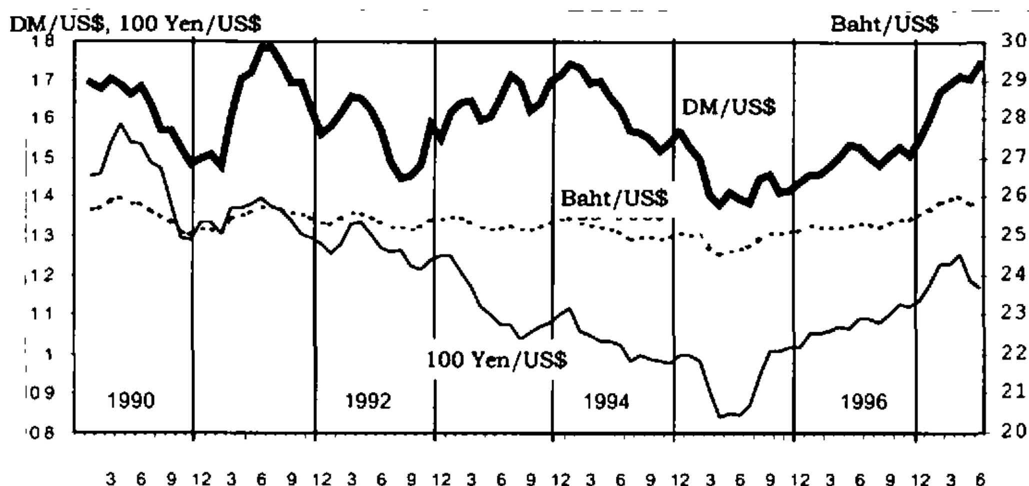
In addition, the central bank's frequent rescue measures signified the instability of financial system, which shook confidence of foreign creditors to a large extent, as a sizable portion of their overseas credits were extended to financial institutions. Some creditors began to question the nation's credibility while others started to retrieve their funds instead of rolling over.

Chart 12: Bank of Thailand's Rescue Credits



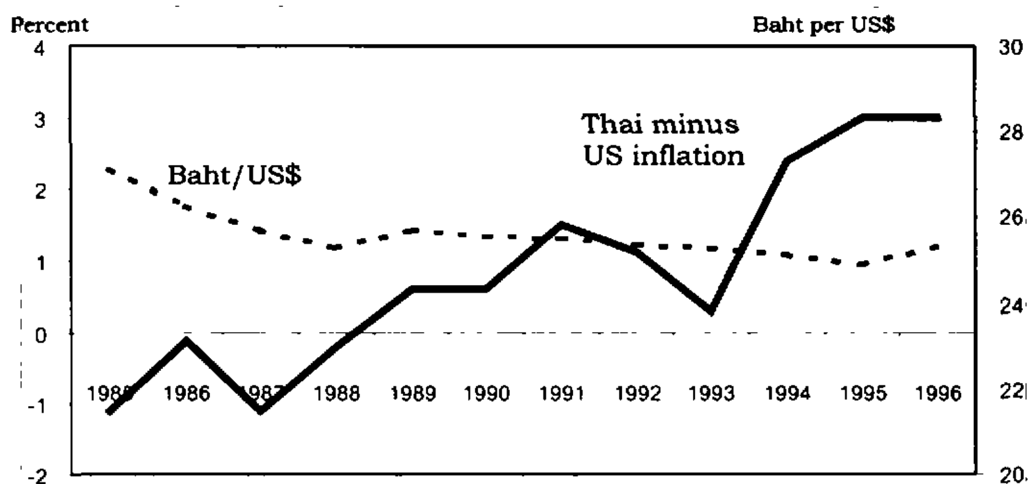
The third unfortunate event occurred on the exchange rate front when the value of the U.S. dollar began surging from April 1995 onward (Chart 13). Between April 1995 and June 1997 the U.S. currency appreciated 38 percent against the yen, from 84 to 116 yen, and 27 percent against the deutschmark, from 1.38 DM to 1.75 DM. The baht value rose in tandem because it was tightly pegged to a currency basket dominated by the U.S. dollar. Such appreciation of the baht definitely worked against Thailand's deteriorating current account deficits.

Chart 13: Exchange Rates of U.S. Dollar and Baht



The fourth and final event occurred on the price-level front. The excess of Thai inflation over the U.S. inflation rate began growing conspicuously from 1993 (Chart 14). Because the pegged exchange rate regime held the baht-dollar exchange rate virtually stable, the increase in domestic inflation caused overvaluation of the baht. The higher inflationary differential made Thai commodities less competitive in international markets if the baht did not depreciate to compensate. In fact, the currency did not depreciate at all against the U.S. dollar in spite of the growing deficits on Thailand's current account.

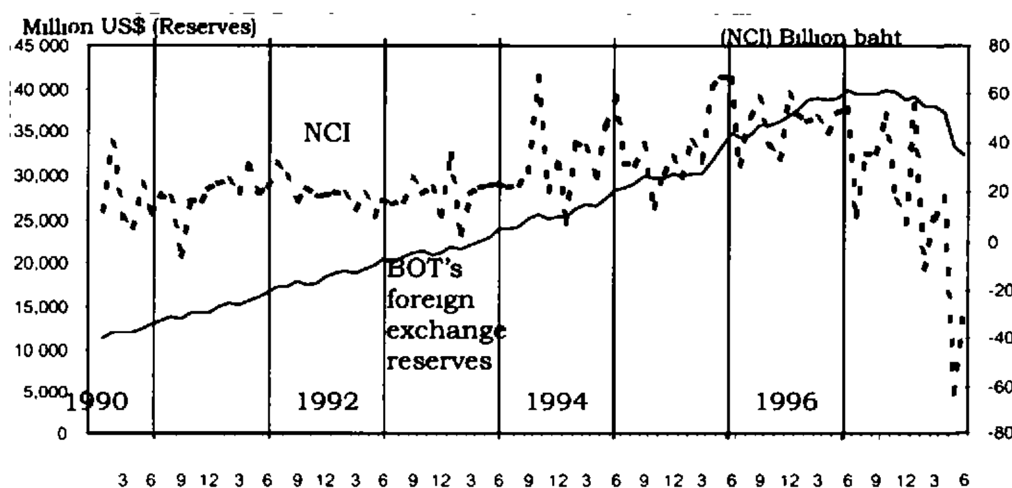
Chart 14: Inflation Differential and Baht Value



Extreme Predicament

The combination of these four events—threatening current account deficits, Bank of Thailand's assistance to ailing banks and finance firms, appreciation of the dollar and the baht, and growing excess inflation—weakened investor confidence to a large degree and caused widespread expectations in the middle of 1997 that the central bank would not defend the baht much longer. The anticipated baht devaluation triggered a flood of capital outflows to liquidate short-term foreign debts or to speculate against the baht. The capital outflows resulted in a plunge in the Bank of Thailand's foreign exchange reserves (Chart 15). Finally, the baht was floated on July 2, 1997.

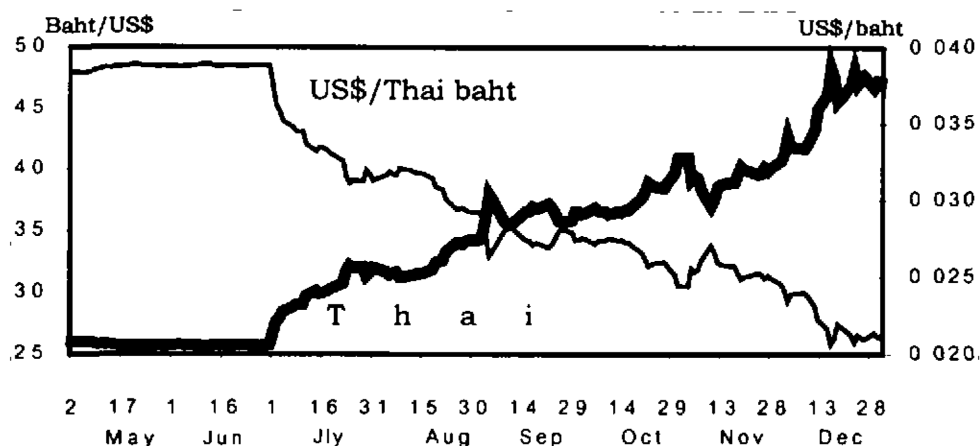
Chart 15 : Net Capital Outflows and Lower Reserves



The outflows of capital were extreme. Daily baht transactions in foreign exchange markets in 1997 amounted to US$4 billion or 3.6 percent of Thailand's 4,990 billion baht nominal GDP for 1997 at an average exchange rate of 45 baht per dollar. The annual turnover volume was equivalent to 950 percent of GDP. This huge volume of capital flows drew the country's foreign exchange reserves down to such an extent that exchange rate flotation became a must.

After the exchange rate was floated, the currency nosedived from 26 baht per U.S. dollar on June 30, 1997 to 38 on September 4, 1997 and to 47 on December 31, 1997, 45 percent down from June (Chart 16). By the beginning of January 1998, the U.S. dollar had climbed to 56 baht but it stabilized around 36 baht at the end of the year.

Chart 16: Baht Exchange Rates in 1997



RESOLUTION AND CONSEQUENCES

Macro Aspects

Thai monetary authorities succeeded in obtaining a rescue package worth US$17.2 billion from the International Monetary Fund (IMF) in August 1997. This aid came with a series of stringent conditionalities to rectify Thailand's economic fundamentals. Examples of those requirements are budgetary cash surplus, tight monetary policy, privatization of some state enterprises, and various financial reforms including adoption of international standards for asset classification, loan-loss provisions, capital adequacy, bankruptcy, and deposit insurance.

The drastic depreciation of the baht, together with rigid IMF conditions, generated extreme economic difficulties. Higher costs of inputs from abroad led to production cutbacks and higher inflation. Tight liquidity and heavy foreign debt burden aggravated the situation, so numerous companies opted to downsize their operations reducing employment as well as pay scales. Declining purchasing power together with the economic downturn gave rise to more bad debts and a growing number of bankruptcies, which have adverse impact upon national credibility. Foreign capital continued to shun Thailand and new lenders hesitated due to the spread of the crisis to other Southeast Asian countries. This slackening stream of capital inflows exacerbated the tight domestic liquidity as demanded by the IMF.

Foreign capital is an indispensable fuel for economic growth in developing countries like Thailand, and capital inflows require both confidence and stable exchange rates. In other words, Thailand's economic recuperation depends on restoring confidence on the part of international capital markets. According to a recent survey, the five main factors affecting investor confidence in priority order are:

1. Political stability
2. Competence of economic management team
3. External account, including trade balance, current account, and balance-of-payments
4. Efficiency and stability in the financial system
5. Foreign exchange reserves

Thus, to mend confidence, Thailand, and other ailing countries, must repair their macroeconomic fundamentals as soon as possible. They need to achieve a balanced fiscal budget, to narrow excess spending, and to renovate weak and unstable financial systems. The ultimate target of these efforts is a manageable current account balance and inflation. In a world of rapid information technology and rational expectations, once such a target is reached, market confidence will return together with exchange rate stability and capital inflows, which will allow for gradual reduction of domestic interest rates to facilitate further economic recovery.

Given that efficiency and stability in the financial system represents one primary factor affecting investor confidence, a promising channel to buttress investor confidence is through a market-oriented deposit insurance mechanism. Deposit insurance is a controversial and intricate issue. If mishandled, it could bring about moral hazard and vicious cycle as evidenced in several industrial countries in the past. What should be pursued simultaneously is transparency and pricing insurance premium and/or offering insurance coverage in accordance with actual market risks. Such market-oriented deposit insurance, together with efficient examination and supervision to be conducted by the central monetary authorities, will not only upgrade the caliber of domestic financial institutions but also bolster public confidence (which is extremely indispensable) in the financial system.

Micro Aspects

In the second half of 1997 the Thai government promulgated emergency decrees to undertake a financial restructuring package. The package had five essential elements.

1. Whenever there is an urgent need, the Bank of Thailand shall have 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 as stipulated by law and to allocate share increases. In addition, the Bank of Thailand with the approval of the Minister of Finance shall have power to remove directors or executives of such commercial bank or finance company and appoint replacements. The purpose of the additional authority is to allow timely intervention into inefficient financial intermediaries that experience large losses that endanger the public interest.
2. The Bank of Thailand Act was amended to reaffirm the government's commitment to have the Financial Institutions Development Fund (FIDF) guarantee for depositors and creditors, with full financial support from the government.
3. The Financial Sector Restructuring Authority (FRA) is established 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.
4. The Asset Management Corporation (AMC) is set up to bid for or to purchase impaired assets of finance companies that the FRA deems not viable. The AMC is also empowered to enter a bid for good assets to support a competitive bidding process. The AMC will manage the purchased assets in order to enhance their value or will foreclose the collateral and resell them as soon as possible.

5. The limit on foreign ownership of shares in commercial banks and finance companies is lifted from 25 percent to 49 percent (and later on 100 percent) and can be effective for up to 10 years. This is to enlarge financial institutions' capital base and strengthen their management tactics.

The FRA's strategy for financial sector reform involves

- identifying and resolving nonviable institutions
- protecting viable institutions
- dealing resolutely with nonviable institutions
- distributing the burden
  - shareholders must bear losses first
  - pursue fraud and gross negligence
  - do not allow willful loan defaults
  - minimize public sector cost
- protecting depositors

The FRA established the following criteria for the rehabilitation of suspended financial institutions:

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

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 FIDF,
- reliability or trustworthiness of executives.

Both depositors and creditors of the 56 defunct finance companies are provided with a government guarantee, whereas the shareholders may claim the excess of assets over liabilities. The monetary authority aims to segregate the "good" and "bad" assets of the defunct finance companies. The "good" assets will be handled by one or two new "good" banks to be set up in the near future, while "bad" assets will be sold to and managed by the newly established AMC.

The Thai authorities' clear-cut approach to resolving the problem of questionable finance firms will contribute to the revival of faith or confidence in Thai financial institutions because

- it removes the uncertainty concerning the 58 suspended finance companies;
- it allows only finance companies with adequate capital and good quality assets to continue operations;
- it provides for sufficient liquidity and accommodates the reliable debtors of defunct finance companies by turning over good assets to be managed by new commercial banks; and
- it will protect the benefits of creditors and shareholders through efficient management.

The alternative of entertaining various merger plans would have made the process more time-consuming and would have left core companies with the predicament of handling the dubious assets and liabilities of their merging affiliates.

At the end of 1997 the Thai government decided on a number of means to strengthen the financial system. Commercial banks and finance companies are encouraged to re-capitalize to support risky assets and to adopt a dividend moratorium for 1997 and 1998. Strict loan classifications are to be adopted. Actual loan losses must be recognized, but they were made tax deductible. Foreign capital is welcome and long-term investment is no longer limited. That channel should help enhance the capital base as well as management capabilities or technology. The central bank puts special emphasis upon the role of financial institution management.

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 more months. Two new loan categories, pass and special mention, require 1 percent and 2 percent provisioning, respectively. Meanwhile, commercial banks must increase provisions for substandard loans from 15 percent to 20 percent, the same as for finance companies (Table 11). Doubtful loans require 50 percent provision instead of the previous 100 percent, but loss loans continue to require 100 percent coverage.

These new standards will force local banks to increase capital by as much as 80 billion baht by the end of 1998, on top of the 129 billion baht already added. Finance companies will need 42 billion baht of new capital on top of the 20 billion baht recently added. Banks must set aside up to 100 billion baht in new provisions for loan losses, while the set asides by finance companies total 43 billion baht.

TABLE 11

Loan-Loss Provision 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.

The system adopted in March 1998 also calls for quarterly, instead of annual, audits and for credit reports to be submitted to the central bank. Loan portfolio reviews must 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 the borrowers' cash flow and ability to service debt, rather than on loan collaterals. Debt restructuring or renegotiations must be subject to realistic assessment of the financial viability of the clients or their projects.

On August 14, 1998 the government decided to nationalize 6 commercial banks and 5 finance companies. Some of these are merged with government banks or finance

companies, while some will be sold to interested parties later on. In addition, the government offered assistance to other financial institutions in the following steps of recapitalization. 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, equalling the losses suffered by financial institutions in their debt restructuring. The underlying dual objective of this August 14 package is to reform the financial system so that new asset classification and loan loss provisioning comes into effect as soon as possible, while reinvigorating the economy. If financial institutions were left by themselves, they could hardly extend credits, because their huge existing NPL's have to be backed up by capital funds, which are rather scarce and whose enlargement is very difficult in the midst of the current economic depression. What should be noted is that this August 14 program is voluntary, so the extent of participation or success of the plan depends on the discretion of financial institutions.

Later on, the central bank will announce new methods for collateral valuation and a plan to establish a deposit insurance agency. At the same time a new bankruptcy law that contains more options and flexibility will become effective. In the short run, these moves may worsen the credit crunch, but they pave the way for an essential and appropriate financial reform. Once accomplished, the financial reform together with improved supervision of financial institutions will help to prevent financial turmoil in the future.

CONCLUSIONS

The strenuous effort that Thailand had to exert to restore the confidence of foreign lenders and domestic savers clearly illustrates the precariousness of the financial liberalization process. Liberalization strengthens market competition and accelerates development in the financial system, but it involves many actors and

conditions that may conflict with one another. Furthermore, every party in the prevailing financial atmosphere must be both ready and willing before liberalization is undertaken.

In the first half of 1990's foreign capital flooded the Thai financial market as a result of financial liberalization and optimistic expectations. These funds fueled exuberant and/or speculative spending or lending, creating microeconomic imbalances among borrowing entities and disequilibrium in the macroeconomy. In order to preserve stability in the financial system, the central authority offered assistance to ailing financial institutions, despite the fact that such assistance could easily lead to moral hazard among financial executives. Later on, the excessive spending and lending aggravated the country's current account deficits and inflation to such an extent that the government finally deemed that a flexible exchange rate system and an IMF–led rescue package be inevitable. Otherwise, the country's financial credibility would be endangered. In retrospect, the crisis can be largely attributed to three policy errors:

- liberalizing foreign capital flows while keeping exchange rates rigid,
- liberalizing financial institutions when they were not yet ready, and
- failing to prudently supervise financial institutions.

The inconsistency between capital account liberalization and fixed exchange rates is obvious from basic economic theory. When the supply of any commodity is allowed to vary without constraint, its price should change depending on the relative size of demand and supply. Otherwise, either a glut or a shortage could arise and disturb demanders, suppliers, and overall market conditions. Given the glut of capital inflows in 1996 and the first half of 1997, it should come as no surprise to hear an excuse for not floating the baht then that it could lead to revaluation, not devaluation, which would weaken the export sector or economic fundamentals. The key error was in not having introduced some exchange rate flexibility into the system from the time that cross-border capital flows were first liberalized. If this had been done, market participants would have taken exchange risks adequately into account and neither a capital glut nor export overvaluation would have resulted.

In this context, some may argue that under a currency board system such as the one in Hong Kong, fixed exchange rate can be operated together with liberal capital

flows. However, one essential prerequisite of currency board is that the volume of monetary aggregates in circulation must be in strict proportion to foreign exchange reserves. And since Thailand cannot comply with this requirement, fixed exchange rate can hardly co-exist with liberal capital flows on a sustainable basis.

The second error, immaturity or unreadiness of domestic financial institutions for liberalization, can be damaging to each financial firm or bank and the financial system as a whole. Local staff tended to be uneducated and/or inexperienced. They therefore can hardly perform in the increasingly competitive financial circuit. Worse yet, most domestic financial institutions did not have a well-diversified network of financial services and branches. Risks from financial liberalization were thus not well-scattered.

The third error, or indiscreet supervision of financial institutions, was harmful in at least four ways during the period of financial liberalization. First, financial liberalization ordinarily leads to more competition, which increases the level of risks. New market participants who may not have enough expertise or experience to handle these risks need to be cautiously supervised. Second, some market participants may have experience not only in business management but also in concealing risk in reporting. Third, financial liberalization broadens the scope of financial institution activities, and some institutions may undertake new activities with which they are not familiar or in which the market is so thin that the risks are quite high. Fourth, supervisors themselves may lack skills to monitor and advise the financial institutions that are the front-runners in the liberalization.

The prevalence of financial crisis in East Asia during 1997 demonstrates that pursuing dynamic growth has become an increasingly intricate task for any developing country. Impressive growth records, though alluring to foreign creditors, often give rise to growing current account deficits that can cause creditors to worry if they become too large relative to GDP or to foreign exchange reserves. Similarly, the sentiments of local and foreign investors can also turn negative if such deficits persist for too long or external debt difficulties loom large, given that most investors now command rational expectations. Once creditors become concerned about a liquidity shortage, or devaluation, or even default, they may decide not to renew or to roll over short-term loans, pressuring borrowers to immediately (p)repay outstanding debts. The decline of confidence could result in a credit squeeze, not only to those debtors but also to the

central bank. The worry may spread to other debtors who opt to prepay their debts instead of carrying the risk of future exchange losses. Worse yet, such an externally financed bubble crisis can permeate to other countries in the region that have adopted similar paths of excessively debt-driven growth. Indeed, with the highly advanced modes of foreign exchange transactions, the contagion of financial crises in 1997 led to depreciation of many East Asian currencies to record low levels (Table 12).

TABLE 12

Exchange Rates of East Asian Currencies, July and December 1997

per US$

	Exchange rate on July 1997	Exchange rate on December 15, 1997	Depreciation %
Indonesian rupiah	2,650	5,750	53.9
Thai baht	25.88	47.95	46.0
Korean won	880	1,564	43.7
Malaysian ringgit	2.504	3.925	36.2
Philippine peso	26.38	38.85	32.1

Source: Bank of Thailand

In short, though foreign capital enhances the capacity of borrowing countries to grow more than they could by their own resources, it makes them vulnerable to abrupt changes in sentiment by lenders, especially when the borrowing countries are small. The widespread financial strains plaguing several Asian countries in 1997 confirm the fact that reliance on short-term "hot money" for funding longer-term investment is inherently destabilizing, since changes in sentiment and confidence can result in quick reversals in capital flows. In other words, pinning growth on external funding means increasing fragility, because it is extremely difficult to restore business confidence, once it has been impaired or withdrawn, especially within a short time frame. Successful rehabilitation depends on a number of reliable parties, a large amount of rescue funds, and a lengthy period of time.

One lesson from the Asian financial turmoil is that without strong economic fundamentals, a well-functioning market mechanism, and healthy financial institutions, hasty capital account liberalization may be overwhelmingly hazardous to the national economy. The painful yet effective path to recovery, in an era of information technology, is to rectify economic fundamentals and upgrade the status of

financial institutions as recommended by the IMF, since these measures are likely to have positive impact over the long run.

The errors of the past suggest three precautions to guide financial policy in the future. First, policymakers should steadily aim at consistency among all policy actions. When a new measure is to be implemented, related policies or regulations should be amended to avoid conflicts, even if such amendment may spark political opposition. Second, before adopting a new policy stance, policymakers should assure that all affected parties and institutions are ready to cope with any potential or expected changes. This readiness applies to market players, market supervisors, and market conditions or maturity. In case a participant or element is not ready, the sequencing of policy actions should be adjusted to avoid negative impact or repercussions. For instance, diversifying the system so that it includes enough foreign-owned financial institutions will help serve as a safety valve against shock waves in the course of capital account liberalization. Third, policymakers should undertake liberalization gradually in order to minimize chances of error or crisis. A gradual pace will help both players and regulators prepare themselves for the more flexible financial atmosphere. Policymakers also need to devise reliable systems to monitor complex and intricate situations. Logit and discriminant indicators devised for analyzing external debt problems are examples of such early warning systems.

In summary, to survive in the current era of globalization and economic dynamism requires continual adjustment together with the three precautions mentioned above. In other words, financial disasters or crashes can be averted only by countries that do not always yield to conservatism or political opposition.

ENDNOTES

[1] "The Way Out of Economic Crisis," September 20, 1997.

[2] For commercial banks, their net foreign exchange assets cannot exceed 20 percent of their capital funds and net foreign exchange liabilities 15 percent.

[3] In 1995 the minimum BIBF borrowing was raised from US$500,000 to US$2 million in order to screen out small borrowers. In 1997 a 7 percent marginal reserve requirement was imposed on BIBF credits that have maturities under 1 year in order to encourage a long-term profile and reduce the degree of fund mobility in the short run.

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