

The Financial Crisis in Thailand: Causes, Conduct and Consequences?

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Summary. — The financial crisis in Thailand was a “private sector failure,” expressing itself partly in increasing current account problems but mainly in careless lending/borrowing and the accumulation of nonperforming loans in the financial sector. During a period when the real economy showed signs of weakening with sluggish exports and an increase in the current account deficit, “hot money” flowed in and covered the deficit, but also led to careless investments. Financial liberalization in an uncontrolled financial sector resulted in misallocation and mismatching. Political instability, indecisiveness and mismanagement at the political and administrative level also contributed to the financial meltdown in Thailand. © 1998 Elsevier Science Ltd. All rights reserved.

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1. INTRODUCTION

During midsummer 1997, it became clear that Thailand, a country once described in the World Bank’s 1993 Miracle Report as a model for economic development, had entered its most serious economic crisis since WWII. In a sense it was the irony of history that Thailand, which has always been reputed for its financial orthodoxy and macroeconomic stability, should appear as “the weak link in the Asian financial chain.” In July that year, there was a fear that the Thai financial crisis could trigger a more serious financial crisis in the Asian region. As we know today, that fear was not unfounded and “bahtulism” was contagious, not just for the Philippines and South Korea but it also spread to Hong Kong, Malaysia and Indonesia, which at that time were considered fairly “safe.”

Why then did the financial crisis start in Thailand? How was a loss of confidence in the baht transformed into a loss of confidence in the whole financial system? What did the Thai state do? What did the International Monetary Fund (IMF) do? What are the costs and consequences of the financial crisis in Thailand so far, and what impact will it have upon mid- and long-term prospects for socioeconomic development in the country? These are the questions I will address in this article.

Political instability, indecisiveness and mismanagement at the political and administrative level did contribute to the financial meltdown in Thailand but classical problems such as fiscal

imbalances and excessive money supply were of minor if any importance. As we shall see, capital market liberalization policies during the early 1990s as well as the pegging of the baht against the US dollar which was increasing in value, turned out to be unwise. Nonetheless, the financial crisis in Thailand was fundamentally not a case of “state failure” originating in the alleged “statism” and “cronyism” of Asian capitalism. On the contrary, at the epicenter (Thailand) of the broader Asian financial crisis we find a *private sector failure*, expressing itself partly in increasing current account problems but mainly in careless lending/borrowing and the accumulation of nonperforming loans in the financial sector.

2. WHAT HAPPENED AND WHAT WENT WRONG IN THE FINANCIAL SECTOR?

Basically, the financial crisis in Thailand must be looked upon as the price of excessive investments — many of which turned out to be too optimistic and too unproductive. During 1990–96, the investment ratio (gross domestic investment as a percentage of GDP) was between 40% and 44%, compared to an average investment ratio of 25% and 30% during the 1980–84 and 1985–89 periods respectively.¹

Many investments were based on *money borrowed abroad*. Due to high interest rates in Thailand and a fixed exchange rate policy linking the baht to the US\$, foreign investors were eager

to place their money in Thailand. Investors were cautious and lent on short-term rates (typically for three or six months). They could obtain a 10–11% interest rate on such short-term loans. Domestic borrowers were also eager to go off-shore to borrow because this money was cheaper and the fixed exchange rate regime made people think that there was no currency risk. Thai corporate borrowers discovered they could borrow at an interest rate of 5–8% instead of paying more than 13% when borrowing domestically. They could even earn money simply by borrowing abroad and depositing the baht in Thailand.

In 1992, as part of a broader *financial liberalization package*, the Anand government deregulated foreign exchange. The Bangkok International Banking Facility (BIBF) was established to attract more foreign funds to cover the increasing current account deficits, to turn Thailand into a regional financial center, and to ensure a greater degree of competition in the banking sector. The BIBF made it possible for local and foreign commercial banks to take deposits or borrow in foreign currencies from abroad, and lend the money both in Thailand and abroad.²

As a consequence, Thailand undertook *too much off-shore borrowing*. The external debt increased from almost 40 billion US\$ in 1992 to 80 billion US\$ in March 1997. Therefore the total outstanding debt as a share of GDP increased from 34% in 1990 to 51% in 1996, an increase which was generated almost exclusively by the private sector. Of the total debt stock, 80% was private debt and almost 36% was short term, i.e. matured in 12 months or less. In August 1997, the Bank of Thailand revealed that the foreign debt was about 90 billion US\$, that 73 billion US\$ belonged private companies and that 20 billion US\$ was falling due by the end of 1997. In January 1998, Thailand Development Research Institute (TDRI) published figures showing that total short-term debt in 1996 accounted for 46% in 1996 compared to 36% in 1990 and that the ratio of short-term debt to foreign reserves increased from 0.6 in 1990 to 1.0 in 1995.³ Through its access to foreign credit via the BIBF and the Eurobond market, the private sector had obtained large amounts of foreign credit. The figures substantiate that the Thai financial crisis is primarily a “private sector” crisis.

The massive inflow of money led to a tripling in the amount of loans in the financial system and, as there were not enough places to invest them productively, a *misallocation of investments*

took place. An investment bubble of careless lending was created. A substantial part of the money was channeled into already inflated assets in the *real estate sector*. During 1992–96, a total of 755,000 housing units were built in Bangkok, which was double the estimate in the national plan. Loans from financial institutions to property developers increased, too. In 1993, the loans totaled 264 billion baht but by March 1996 they had gone up to 767 billion baht, of which 45% stemmed from finance companies and 54% from commercial banks. By 1996 it became apparent that the supply of housing was outstripping effective demand and the following year Thailand had residential vacancy rates of 25–30% and vacancy rates for offices in Bangkok of 14%.⁴ Moreover, many property owners artificially inflated the value of their assets and kept borrowing against them, and most real estate companies had poor cash flows. Lester Thurow describes the problem of inflated commercial land values which did not reflect the underlying earnings capacity in the following manner:

Bangkok, a city whose per capita productivity is about one twelfth that of San Francisco, should not have land values that are much higher than those of San Francisco. But it did — as did other Southeast Asian cities. Grossly inflated property values had to come down.⁵

When the economic recession started in 1996 and the buying power of the middle and upper classes began declining, the property bubble burst and left substantial bad debts on the balance sheets of the finance companies, which had financed their investments by borrowing abroad. In February 1997, Somprasong Land missed payment on a euro-convertible debenture worth US\$ 80 million. In March 1997, the BoT had classified Bt 100 bn of the loans owned by real estate developers as nonperforming (i.e. not having been serviced for 12 months), but the amount of bad property loans was estimated by financial agencies at Bt 300 bn (about 7.5 billion US\$).⁶ Part of the borrowed money went into large industrial complexes in steel, pulp and paper, cement and petrochemicals.

Misallocation of the loans was one problem, but a second problem was *vulnerability*. First, most of the loans — even those going to the industrial sector — were not hedged against currency fluctuations. Second, a “currency mismatch” arose when the money went massively to nontraded sectors in the economy, i.e. foreign money went to sectors with no foreign exchange receipts. Third, there was a “term mismatch” as short-term borrowing was utilized to finance long-term projects with longer term returns.

Finally, financing of equities by loans without taking the foreign exchange risk into account was not unusual.⁷

The Thai experience fits well into an historical pattern in which the boom–bust cycle of property (and stock) market(s) leads an economic cycle. Moreover, Krugman's approach to the Asian crisis seems to highlight certain aspects of the economic collapse in Thailand. According to Krugman, the price of assets (stocks and land) as well as the particular role played by financial intermediaries can explain financial excesses and financial collapse, and constitutes the core of the Asian crises.

The problem began with financial intermediaries — institutions whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems. The excessive risky lending of these institutions created inflation — not of goods but of asset prices. The overpricing of assets was sustained in part by a sort of circular process, in which the proliferation of risky lending drove up the prices of risky assets, making the financial condition of intermediaries seem sounder than it was. And then the bubble burst. The mechanism of crisis, I suggest, involved that same circular process in reverse, forcing them to cease operations, leading to further assets deflation.

As will be shown in a later section, Krugman's argument concerning the working of moral hazard problems in overguaranteed but under-regulated financial intermediaries certainly makes some sense in the Thai case. The financial intermediaries in the banks and, in particular, finance companies became involved in excessive and speculative investments which can partly be explained with reference to moral hazards but partly also has to be explained by the spread of greed among the upper classes and the new middle classes. Finally, as Krugman himself mentions, access to the world capital market allowed the vicious spiral "to translate into real excess capital accumulation" just as overseas investors provided all these credits often without demanding any real security.

Moreover, Krugman argues that the Asian crisis is only incidentally about currencies and that "the boom–bust cycle created by financial excess preceded the currency crisis because the financial crisis was the real driver of the whole process, with the currency fluctuations more a symptom than a cause."⁸ Although Krugman's contribution deserves much attention, it appears to underestimate the role played by the exchange rate system, at least in the case of Thailand. Excessive and careless investments certainly were

one major part of the Thai financial crisis, but the fixed exchange rate system was another. Before dealing with the fixed exchange rate system, to put the present situation in a proper historical perspective, a short retrospect on financial crisis and financial liberalization before 1996 might be useful.

3. A FLASHBACK — FINANCIAL CRISIS IN THE 1980S AND FINANCIAL LIBERALIZATION IN THE 1990S

The present financial crisis in Thailand is not the first economic downturn since 1980. Thailand went through a serious financial crisis in 1983–85 with a substantial bailout and a *de facto* 25% devaluation of the baht. In 1986–87, Thailand's recession turned into an impressive export-driven economic boom as the cheapening of Thai export due to devaluation was succeeded by an appreciation of East Asian currencies leading to a massive flow of direct investments from Japan, Taiwan and South Korea to Southeast Asia, including Thailand. This new optimism and the stronger presence of financial technocrats in the Anand and Chuan governments (1991–95) paved the way for financial liberalization.

Thailand's organized financial system has for long been dominated by the commercial bank sector which in 1990 accounted for 71% of financial assets. The second largest group of financial institutions is finance and securities companies which that year accounted for almost 14% of financial system assets.⁹

The *commercial bank* group is divided into 15 local commercial banks with extensive branch networks accounting for 95% of bank assets in 1990 and 14 foreign banks, which are disadvantaged by a number of restrictions and only accounted for 5% of bank assets. The local commercial banks were originally set up by business groups and trading houses to finance their operations and despite government attempts to diversify ownership is still dominated by no more than 16 Sino–Thai families.¹⁰

Moreover, the commercial banking sector is highly concentrated with the five largest banks (Bangkok Bank, Krung Thai Bank, Thai Farmers Bank, Siam Commercial Bank and Bank of Ayudhya) accounting for more than two-thirds of bank assets. The concentration ratio of these five banks increased from 56% in 1962 to almost 70% in 1980. In 1990, the top five banks stood for 69% of assets, 73% of deposits and 64% of branches.¹¹

In reality, the top five commercial banks formed a powerful cartel. Warr describes the broader structure of the commercial banking industry

as a cartel-like structure with 16 banks organized loosely under the Thai Bankers Association, whereby they collectively set the standard rates of service charges and loan rates. This oligopolistic practice makes interest rates (loans and deposits) respond relatively slowly to market conditions as it takes time for all banks to agree on the same adjustment, particularly in the downward direction.¹²

Finance and security companies emerged in the early 1960s as affiliates of commercial banks and expanded rapidly during the 1970s. They were originally set up "either to provide services that the parent bank could not undertake directly or to engage in higher-margin but higher-risk consumer finance, and subsequently expanded into certain types of corporate finance."¹³

The second oil shock led to a deterioration of the trade balance and accumulation of foreign debt, and Thailand entered a period of economic stabilization and adjustment programs under the leadership of the Bretton Woods institutions. The economic recession was succeeded by a financial crisis starting in October 1983. From the perspective of the present financial crisis, it is worth emphasizing that the 1983 crisis was also triggered by large losses in a finance company and its affiliates. The financial crisis in 1983–86 affected one-third of all financial institutions accounting for one fourth of financial assets.

The crisis, which was aggravated by a slowdown in growth and a tightening of monetary policy, brought to the fore widespread pressures in the banking system and particularly among the more loosely controlled finance companies ... The pressures included weak management practices (notably the extension of credit and guarantees to businesses with which bank directors and shareholders were involved, and an overconcentration of lending to a few large-scale and interrelated industries) together with weaknesses in supervisory and regulatory framework.¹⁴

Cases of financial mismanagement in 1978–79 led to tougher banking regulations and the first formal controls of finance companies through the 1979 Commercial Banking Act. The more serious 1983–86 financial crisis led to further state initiatives. One initiative was the establishment of a Fund for the Rehabilitation and Development of Financial Institutions receiving interest-free contributions from all financial institutions. Moreover, the 1985 amendment to the Commercial Banking Act empowered the Bank of Thailand

to enforce compliance with regulations through direct intervention, to order an increase in bank capital, and to remove bank directors and officers when deemed necessary in the public interest; restrictions on transactions between financial institutions and their directors were tightened; and the Bank's powers to conduct on-site examinations were strengthened.¹⁵

During the financial crisis 15 finance companies collapsed and 32 companies were given liquidity injections through various schemes, including the so-called 'lifeboat' scheme set up in April 1984. A particular rescue mission for the commercial bank sector encompassed five banks.

The financial crisis was soon forgotten as Thailand entered an export-driven economic boom in the second half of the 1980s. Speculation in real estate and the stockmarkets led to a doubling of the value of these assets during 1986–90. But the main focus of government policy at the time was not on control and regulation but on deregulation and competition.¹⁶

During 1989–93, the financial sector went through a process of *financial reform* aiming at boosting domestic savings and foreign capital inflows, improving the capability of the financial sector to compete internationally, and eventually developing Thailand into a regional financial center. The reform process was accelerated when the military installed Anand Panyarachun as Prime Minister in February 1991. During his 13-month interim government (the Anand I government), the Bank of Thailand and the Ministry of Finance utilized their renewed independence and autonomy to pass 20 financial reform bills.¹⁷ Interest rate ceilings which had been lowered during the 1980s were abolished on the deposits side in 1990 and on the lending side in 1992. Foreign exchange transactions were also liberalized: first with respect to current account transactions (1990) and later liberalization of capital account transactions, mainly to enhance confidence among investors and to improve Thailand's credit worthiness (1991).¹⁸ The scope of business of commercial banks and finance companies was widened and in order to promote competition and introduce a kind of universal banking concept, finance companies were allowed to expand into business areas previously reserved for commercial banks, e.g., foreign exchange business.¹⁹ The Anand government also decided to support the BoT plan of 1990 for setting up offshore banking institutions under a Bangkok International Banking Facility (BIBF) to promote Thailand as a regional financial center, to ensure more (but not excessive) competition against the local commercial banks and to enable Thai business to have greater and

cheaper access to foreign loans. In foreign currencies the BIBF business was unrestricted which intensified competition in out-in lending (acquiring foreign loans for the domestic market) which had been dominated by the major Thai commercial banks before 1992.²⁰

In the field of foreign exchange policy, the guiding policy principle in Thailand has always been stability and monetary policy has been utilized to defend the exchange rate when external balance problems arose. For more than 20 years (1963–84), the Thai baht was fixed to the dollar and monetary policies was utilized to maintain low inflation and avoid balance of payment imbalances. In 1981, as the value of the dollar increased rapidly, two minor devaluations (roughly 10% together) were introduced and, during 1984, a particular political conjuncture made it possible for Prime Minister Prem to devalue the baht by almost 15% and to link the baht to a basket of currencies in which the dollar remained the major component, thus leading to further *de facto* devaluation of the baht.²¹ During the post-1984 period the baht was again stable, pegged to the above-mentioned package of currencies, that is a relatively fixed exchange rate system.

During the early 1990s, portfolio investment and short-term private borrowing grew. Portfolio investments increased from 23.5 billion baht in 1992 to 138 billion baht in 1993, a six-fold increase.²² The relatively fixed exchange rate constrained monetary policy though some economist pointed to the potentially destabilizing influence of short-term inflows.

While the authorities may wish to keep the Thai baht fixed to the US dollar in keeping with the past practice, they will find the supply of money increasingly difficult to control. For example, attempts to tighten the domestic money supply, leading to increases in domestic interest rates, will only induce greater capital inflows, which will eventually restore the differential between domestic and foreign interest rates. In the extreme case, monetary policy will not be able to influence domestic money supply and price levels if interest rates are exogenously determined and the exchange rate is fixed ... Shielding the domestic economy from external instability and restoring the effectiveness of monetary policy can be attained only by greater willingness on the part of the Thai authorities to accept increased fluctuations in the exchange rate.²³

The economic meltdown in Thailand was a mixture of a financial and currency crisis. After 12 years (1984–96) of relatively fixed exchange rate policy, the currency issue again became pressing during 1996.

4. ECONOMIC SLOWDOWN AND PRELIMINARY ATTACKS ON THE BAHT IN 1996

During 1996 it became clear that the Thai economy had lost its momentum. The economy was slowing down, heading toward the lowest rate of growth in GDP in a decade. Thailand suddenly experienced negative export growth and export sales of labor-intensive goods such as footwear, textiles, garments and plastic products.²⁴ As imports kept growing the current account deficit was booming. Meanwhile, the stock exchange lost around one-fifth of its value during the first nine months of 1996, implying that a stock market collapse occurred prior to the currency crises, as suggested by Krugman. Finally, the Board of Investment registered a downward trend in foreign investments.

It was also generally believed that the instability and incompetence of first the Banharn government (1995–96) and later the Chavalit government (1996–97) repeatedly undermined the confidence of both foreign and domestic investors. The poor economic performance led to an increasing and widespread awareness that Thailand — due to the stronger baht, higher wages and competition from low cost producers such as China — was losing its traditional competitiveness in labor-intensive industries. Consequently, it became obvious that a transition to more sophisticated, higher technology industries was required and that some kind of structural reform was needed — a reform that addressed among other things such issues as the low technological capability, the low skilled labor force and the inadequate infrastructure.

Moreover, the technocrats in the Ministry of Finance and the Bank of Thailand became worried about the large inflow of hot money and about the fact that Thailand's system of pegging the baht against a basket made up of US dollars, Japanese yen and German marks made such short-term speculative investments "too secure."²⁵ Nonetheless, the stable baht was crucial in order to attract the long-term investments needed to finance the country's current account deficit just as there were strong vested interests (i.e. large corporations with high external indebtedness) that would lobby against a more flexible exchange rate regime.

In the second half of 1995, the US dollar began to appreciate sharply *vis-à-vis* the yen and other major currencies. As a result, the Thai Baht (and other Southeast Asian currencies) which were mostly pegged to the dollar followed that trend. During 1996, there were repeated

rumors that the baht would be devalued. Instead, the Bank of Thailand continued the tight monetary policy it had already introduced in 1995, but due to high domestic interest rates and the free flow of capital through the offshore banking facilities established in 1993, the policy proved ineffective. Therefore, in the middle of 1996, the BoT imposed a requirement for bank and finance companies to hold higher cash reserves on short-term deposits by foreigners. The tight monetary policy also led to a further deterioration of assets quality held by the financial sector.²⁶

Many analysts however, kept on predicting at least a widening of the band within which the baht was allowed to fluctuate. Gordon Fairclough of the *Far Eastern Economic Review* drew the following conclusion in May 1996:

In the long-term, however, the problem remains. With, the baht pegged so firmly, the central bank's hands are largely tied when it comes to trying to control the money supply, and thereby rein in inflation, and the current account deficit. Eventually, change must come.²⁷

Furthermore, the investment-rating company Moody's downgraded Thailand's rating on short-term debt, arguing that Thailand's overreliance on short-term funds from overseas made it vulnerable to a Mexico-style financial shock. In June, the IMF warned about the large and increasing current account deficit and suggested more exchange rate flexibility.²⁸ In mid-July, bankers and financial analysts warned that the failure to lower the high current account deficit and the heavy reliance on short term financing might shake the confidence of foreign investors in the Thai economy.²⁹

In its October cover story on Thailand, *Asiaweek* pointed at Thailand as the region's worst performer in 1996 and further stated:

Between 1994 and 1996, the current account deficit was ballooning an average of 40% every six months. As the share of GDP, the deficit may well top 8% this year, as it did in 1995, causing observers to draw unfavorable comparisons with Mexico's 1994 currency meltdown, which occurred when the current account deficit passed 8% of GDP.³⁰

Therefore, it was hardly surprising that currency traders made some preliminary attacks on the baht in November–December 1996. It looked as though currency traders had become obsessed by the 8% current account deficit (as a percentage of GDP) after the Mexican crisis in 1995, a limit which Thailand had exceeded in 1990 when its deficit amounted to 8.5% of GDP without currency problems.³¹ While currency traders became fixated on the current account deficit,

those corporations with unhedged borrowing had a crucial interest in the retention of quasi-fixed foreign exchange system, and The Bank of Thailand persisted in pegging the baht to a basket of currencies, defending the baht and keeping interest rates high.

The political conjuncture was also quite different to that of 1984, when Prime Minister General Prem and the economic technocrats succeeded in a depreciation enterprise. In the meantime, parliamentary democracy with a strong influence of provincial businessmen had replaced an authoritarian Bangkok-based semi-democracy and political instability prevailed. In September 1996, Prime Minister Banharn Silpaarcha was forced to resign after pressure from both inside and outside the coalition government. Banharn had chosen as his ministers mostly provincial bosses and the shifting short-term policies of the government were mainly driven by the logic of patronage and particularistic connections. Besides not being able or willing to address the problem of the current account deficit, the Banharn government was involved in two developments which came to affect the financial crisis in 1997. The first development was the declining autonomy of and the increasing interference in the working of the macroeconomic agencies and in particular in the activities of the Bank of Thailand. The second and related development was the Bangkok Bank of Commerce (BBC) scandal.

5. THE DECLINING AUTONOMY OF THE MACROECONOMIC TECHNOCRATS

During the Banharn administration's one year and four months in office there was much political turmoil. Of particular importance here is the fact that the heads of three core macroeconomic agencies — The Bank of Thailand, the Securities and Exchange Commission and the Ministry of Finance — were fired. In fact there were in all three Finance Ministers during that period. It started with the firing of the popular secretary-general of the Securities and Exchange Commission (SEC) Ekamol Khirawat in December 1995. He was also fired as deputy governor of the Bank of Thailand (BoT). When strong public reaction arose, the head of the BoT, Vijit Supinit, probably influenced by the Finance Minister Surakiat, gave his consent to the sacking of Ekamol.

While the Ekamol affair was still going on, the Democrat Party raised the Bangkok Bank of Commerce issue. The Bangkok Bank of Commerce (BBC) had run into deep financial

troubles with a Baht 78 billion of doubtful debts, mostly caused by the provision of loans with insufficient collateral to companies owned by the bank's top executives and top advisors as well as loans to a group of politicians — the so-called group of 16' fraction of Banharn's Chart Chai party. The Bank of Thailand was criticized for not taking appropriate action in the BBC case. Moreover when Mr Vijit's professional ethics (due his close personal link to the BBC's chief executive) were questioned, and the Central Bank's economic forecasts suddenly became systematically inaccurate, the head of BoT was forced to resign, as was Finance Minister Surakiat, accused of having used his political influence with the BoT governor over the firing of Ekamol and in the BBC affair.³²

As a consequence, the independence and credibility of the central bank had eroded and some of the doubtful practices of the banking sector had been revealed. In early 1998, an article in *International Herald Tribune* argued that the BBC scandal was the starting point of the financial crisis in Asia as it signaled that the Thai banking sector was seriously out of control.

The scandal, at the Bangkok Bank of Commerce, involved billions of dollars in questionable loans. The bank's managers disguised their malfeasance using financial shell games, such as backing loans with vastly overvalued property. The mess at the Bangkok Bank exposed the weakness of Thailand's banks and the lack of government oversight in a deregulated financial system run amok.³³

6. FINANCIAL CRISIS, CURRENCY CRISIS AND POLICY RESPONSE PRIOR TO THE IMF BAIL-OUT

The November election in 1996 brought another representative of old-style Thai politics to power. After a total expenditure on vote buying in the range of 700–1000 million US\$, the majority of which was spent by the NAP in north-eastern and central regions, the NAP leader Chavalit Yongchaiyudh could finally step in as Prime Minister in a six-party coalition. In late 1996, it looked as though the ministers responsible for recreating investor's confidence would be given non-MP ministers of — Dr Amnuay Viravan and Dr Narongchai Akrasanee — with the former taking the posts of finance minister and economic tsar (deputy Prime Minister with responsibility for finance). The Chart Pattana party (CP) that wanted to be in charge of economic policy tried to block this arrangement but in the first instance failed. But in May 1997, after having realized that, as a

non-MP he had no negotiating power, Amnuay resigned and the Chavalit government looked like a copy of the former Banharn government, unable to take care of long-term issues of social and economic development or solve the credibility crisis.

The currency crisis hit Thailand in early March after a speculative attack on the baht in February had driven up the interbank rates and made liquidity tighter. Speculators realized that the Thai currency was overvalued, and there was reason to believe that speculative attacks could lead to a lowering in the value of the baht. Similarly, some local investors began selling baht for dollars in order to hedge against a possible devaluation and exporters saw an advantage in waiting a while before converting their export earnings into baht. As a consequence there was a huge supply of baht in the money market.

The high interest rate policy had an impact upon the *crisis in the financial sector*. Although in mid-February the central bank had assured the public that no financial institutions under its supervision faced liquidity problems, it was suddenly obvious that several of Thailand's finance companies (fincos) were overinvolved in property and hire-purchase sectors.

The Ministry of Finance and the central bank reacted fairly rapidly. The largest finance company, Finance One, was ordered to merge with Thailand's 12th largest commercial bank, Thai Danu Bank. Meanwhile, the Finance Institutions Development Fund injected Baht 40 bn into Finance One.³⁴ Nine other finance companies and a credit foncier (housing loans broker) with high exposure to property loans were ordered to raise their registered capital. The remaining finance companies were asked to find further Bt 26 bn as debt cover and the banks were asked to raise their provisions against bad loans.

The main strategy of the BoT was a merger between Thailand's 91 finance companies and 18 banks. In early March, the central bank also announced the creation of a Property Loan Management Organization (PLMO) to provide Baht 100 bn in five-year loans to ailing property firms. The funds should be raised by issuing seven-year, zero-coupon bonds guaranteed by the government. Finally, the cabinet accepted a Baht 106 bn down-sizing in the 1996–97 budget. Through these initiatives, the government seemed to have averted a devaluation of the baht and a deep financial crisis.³⁵

The implementation of these initiatives was not easy. Lacking clear guidelines for the chosen merger strategy and with Chart Pattana ministers

as major shareholders in some of the worst performing finance companies, merging and closing finance companies was difficult. When the Finance One/Thai Danu merger, which was considered as a model for further mergers, collapsed in late May, the strategy also collapsed. Finance One was the largest and most well-known finance company with involvement in real estate, hire-purchase and stock margin lending. The fate of Finance One was a striking example of the state of all finance companies but it was still believed that the Bank of Thailand would act as a lender of last resort. The bank itself was weakened however, when three senior officials (including a deputy governor) were suspended because the BoT failed to act in the BBC case within the 12-month limit and therefore had to drop the charges against BBC executives. Finally, the PLMO initiative also failed because of lack of interest in the financing scheme.³⁶

In May, with severe problems in the financial sector unsolved and with no sign of economic recovery a *new series of attacks on the baht* took place and the central bank spent billions of dollars on defending the baht. There were reports that international hedge funds and currency speculators were betting up to US\$ 10 billion on a devaluation of the baht. The BoT spent US\$ 4 billion in the spot market and, as came to light later, had also accepted more than US\$ 23 billion in forward obligations.³⁷ Furthermore, the government introduced currency control by limiting offshore trading with the baht to deter speculation, and a baht 50 bn stock market rescue fund was set up in cooperation with the banking sector. During May and June, it seems that the economic tsar — Amnuay — tried to convince the cabinet to introduce a managed float foreign exchange system, a radical financial sector reform and some minor tax increases but failed, in particular due to resistance from the Chart Pattana party (CP). As a consequence, Amnuay who was considered the most qualified member of the economic team, resigned on June 19.³⁸

After month of indecisiveness, the new finance minister Thanong Bidaya, the fifth in just two years, took more firm action. When he looked into the coffers of the central bank, he discovered that US\$ 8 bn had been lent out to debt-ridden finance companies through the Financial Institutions Development Fund (FIDF) and that foreign reserves were in a serious condition and were probably below the legal level (total reserves had according to a 1940 statute to be equal to the value of local currency in circulation).

On June 27, it was decided to suspend 16 finance companies (including Finance One) for 30 days and they were ordered to come up with merger plans or close. On July 1 the Prime Minister declared “I will never allow the baht to devalue. We will all become poor,” but the following day — July 2 — the Finance Minister announced that the introduction of a managed floating system and the baht slipped from 26 to 32 for one US\$ in just two weeks.

The financial sector measures did not restore confidence in the finance sector. First, questions were raised as to whether vested interests had affected the selection of the 16 fincos and left some even more troubled companies out. Second, the government did not follow its own deadline and extended the suspension. In the press, this was linked to the presence of major shareholders among senior cabinet members. Third, the Bank of Thailand sent contradictory signals as to whether it backed the finance companies as it had done with the largest finance company — Finance One — since 1996. Finally, financial analysts did not believe the government when it insisted upon that only the 16 suspended fincos were unsound.³⁹

That the government had chosen the usual “too-little-too-late approach” became clear on August 5 when, after negotiations with the IMF, it suspended the operations of a further 42 finance companies, leaving only 33 finance companies open. This time the conditions were clear — creditors and debtors would be protected while shareholders would lose their investments.

The seriousness of the situation and the scale of the useless state interventions became clear when it was revealed that the Bank of Thailand had utilized a substantial part of Thailand's foreign reserves to save the baht and had more than US\$ 23 bn committed to forward contracts defending the baht against speculators. Furthermore, it was disclosed that BoT through the FIDF had extended more than US\$ 8 billion or, more precisely, 430 billion baht (or 10% of GDP) through the FIDF to rescue troubled finance companies.⁴⁰

In late July, the two pillars of investor's confidence which had kept the baht and the financial sector floating during the first half of 1997 broke down. The stable value of the baht was history and the Bank of Thailand was no longer a safety net for the leading financial institutions, just as the confidence in the BoT itself had fallen to a low level. In early August, with alarmingly low foreign reserves and a private sector weighed down with foreign debt, it was obvious that some

kind of foreign assistance was needed and when the Japanese were not willing to provide this alone, the IMF was called in.⁴¹

7. AUSTERITY POLICY AND FINANCIAL RESTRUCTURING PLANS

Thailand's financial and currency crisis led, in August 1997, to what was the second largest bailout in history. Under the umbrella of IMF a 17.2 billion US\$ stand-by credit was collected, in particular among Asian countries. The funds were meant for balance-of-payment support and disbursement would be made quarterly over almost three years and be contingent on Thailand meeting the IMF performance requirements. The total sum also included US\$ 2.7 billion from the World Bank and the Asian Development Bank to be used to enhance industrial competitiveness, improve capital markets and mitigate social problems arising from the austerity program. It is worth mentioning that China decided to utilize 1 billion US\$ of its foreign exchange reserves for this purpose, while the United States did not make any direct contribution. In contrast with the Mexican crisis (1994–95) which led to a 50 billion US\$ bail out, the Thai crisis was left to IMF and Japan, which contributed US\$ 4 bn each. According to the Bank of International Settlement (BIS), Japan stood for more than half of Thailand's debt to foreign commercial banks (US\$ 37.5 bn). In the light of this information and when measured against the hope of Japanese economic leadership in the region, the Japanese contribution appears modest.⁴²

The IMF demanded that Thailand adopt an *austerity program*, which included an increase in the national value-added tax from 7% to 10%; a 1% surplus in the public budget to cover restructuring costs in the financial sector implying a cut in fiscal spending (in all sectors apart from education and health) of Bt 100 bn in the 1997-98 budget; the ending of subsidies to state companies; a tight monetary policy to keep inflation at 9.5% in 1997 and 5% in 1998; a reduction of the current account deficit to 5% in 1997 and 3% in 1998 as compared with the 8.2% deficit in 1996; a continuation of "the managed float" foreign exchange system; maintaining reserves at a level that provide over three month' import cover (US\$ 23 bn in 1997 and US\$ 25 bn in 1998), and finally a clean up in the finance industry and discontinuation of the practice of rescuing ailing finance companies by printing money.⁴³

The Bank of Thailand followed the IMF requirements and, as mentioned above, suspended 42 debt-ridden finance companies in addition to the 16 suspended in June. The *plan for restructuring of the financial sector* was worked out with technical assistance from more than 15 IMF and World Bank officials and was finally announced on October 15 — two weeks behind the original IMF deadline. The financial restructuring package contained the following main elements: (a) the setting up of two new agencies, the Financial Restructuring Agency (FRA) to supervise the 58 suspended fincos and evaluate the rehabilitation plans submitted by these firms before the end of October, and the Asset Management Corporation (AMC) to buy the bad assets and then manage, restructure and sell them under the direction of FRA; (b) tightening the loan classification by lowering the period after which a loan is nonperforming from 12 to six months and keeping a high capital-to-risk assets ratio (12–15% compared to the international norm of 8.5%) in order to "gradually bring the sector into line with international standards by 2000;" (c) new rules that allow foreigners to take a majority stake in all financial institutions for a 10-year period, after which their share has to be lowered to less than a majority through capital increases available only to Thais; (d) a full government guarantee to both depositors and creditors in the country's 15 local banks and the remaining 33 finance companies; (e) acceptance of equal claims of all creditors by giving up its preferential claim to the collateral of finance firms (the collateral was utilized when the BoT gave a Bt 430 bn injection into the 58 fincos); (f) enactment of new laws allowing the Bank of Thailand to take control of troubled financial institutions, ordering changes in management, and to write down its shares to pay for the losses, improving the bankruptcy laws so that debtors can collect their collateral faster, and ensuring that the Bank of Thailand gives a monthly announcement on its forward commitments in foreign currency.⁴⁴

In addition to the six royal decrees containing the financial reform package, the government also announced further cuts in public spending and new taxes so that it could reach the 1% surplus in the 1997-98 budget agreed with the IMF in August.

The new loan classification made it almost impossible to save the 58 finance companies. The suspended companies had loan assets of 1.3 trillion baht, the majority of which were nonperforming under the new classification standard and collectively they carried US\$ 16 billion in

loans from foreign lenders.⁴⁵ The new policies were not implemented promptly due to indecisiveness and government instability. One of the coalition partners, the Chart Pattana (CP) utilized the weakness of Chavalit to take over responsibility for economic affairs. CP was known to have large interests in the financial sector, including some of the suspended finance companies. So CP was eager to get control over FRA and AMC, and the issuing of the six royal decrees was delayed. Soon after, the CP pushed for a government reshuffle but the composition of the new government was not sufficient to restore confidence. On the last day of October, the baht passed the US\$ 1:40 Bt threshold and on November 3, Chavalit announced that he would resign three days later.⁴⁶

8. FINANCIAL CLEAN UP AND EASING OF IMF CONDITIONS DURING THE CHUAN GOVERNMENT

A new government, under the leadership of former Prime Minister Chuan Leekpai, took office on November 15. Chuan, who leads a six-party coalition, installed his own economic team headed by two highly estimated technocrats from his own party (the Democrats) — Supachai Panitchpakdi (a former central bank governor) as deputy prime minister and minister of commerce, and Tarrin Nimmanahaeminda (former Finance Minister) as Finance Minister.

The new government sent a *letter of intent* to the IMF confirming that it would adhere to the earlier IMF conditions as well as specifying the further measures that would be taken to reestablish confidence in the economy. The letter of intent stipulated that the new government work towards a 1% surplus in the 1997-98 budget by increasing indirect taxes, cutting investments programs of state enterprises, raising utility prices, lowering real wages in the public sector, just as further cuts in expenditure were announced. Other measures included an accelerated and extensive privatization program, an upgrading in the regulatory framework of the financial system, which will include more liberal rules for foreign investors, and an accelerated and in-depth financial restructuring following the October guidelines.⁴⁷

The *financial restructuring* "was done according to the strongest possible criteria" when it was announced on December 8, that only two of the suspended 58 finance companies had had their rehabilitation plans approved. The remaining 56 companies would be permanently closed. Their good assets will be transferred to one or two new

banks while the bad assets will be managed by the FRA and AMC. The bad assets are meant to be sold to the state-supported AMC for gradual market liquidation. Creditors were assured that they would be treated equally and *in pari passu* with the Financial Institutions Development Fund (FIDF). In August, creditors of the 42 finance companies were guaranteed by the government and can either take an equity stake in the good bank(s) or exchange their claims for negotiable certificates of deposit issued by the Krung Thai Bank with an interest rate of 2% and terms of five years. By contrast, creditors of the 16 finance companies suspended in late June have to negotiate a debt repayment scheme with FRA and FIDF. The liquidation scheme was announced in February 1998 and in the final scheme assets were not classified into good and bad assets as the evaluation of the quality of assets was left to bidders at the auctions. But assets were split into core assets (outstanding loans) and noncore assets (company assets, cars etc.) with auctioning of the latter starting in late February. The book value of the assets was 866 bn baht of which an expected 30-60% would return from auctioning, to be shared among creditors. During the auctioning process AMC are meant to compete and buy assets at a price set by creditors and the AMC.⁴⁸

The Minister of Finance further announced that the government and the Bank of Thailand would "take firm action against any institutions that endangers the public interest," that legal changes in the banking act would take place in 1998 and that a committee would be set up to restore the credibility of the Bank of Thailand. The committee should also investigate the role of the Bank of Thailand in the events leading to the collapse of the Thai economy, i.e. into such things as the BBC scandal and the granting of Bt 430 billion baht to the 58 suspended finance companies.⁴⁹

Finally, the Chuan government took radical action when it *nationalized four medium-sized banks* in order to prepare them for sale to foreign financial institutions — Bangkok Metropolitan Bank, First City Bank, Siam City Bank and Bangkok Bank of Commerce. The procedure appeared to be inspired by that utilized in the United States with the Saving and Loans banking industry bail-out in the 1980s, as the Bank of Thailand first wrote off the shareholder's capital to almost nothing and then converted its short-term loans (through the FIDF) into equity whereby FIDF obtained an almost total ownership of the banks. As a bail-out arm of the Bank of Thailand, the FIDF had by late January

channeled more than bn 500 baht into the banking sector (in addition to the 430 billion that went to the suspended finance companies). The Bangkok Metropolitan Bank (BMB), which had more than 43% of its loan as nonperforming at the end of November 1997 and more than half of its funding was reported to depend on short-term liquidity provided by FIDF, was taken over by the central bank in late January 1998. The take over included a write off of 11 billion baht in bad loans and the Techapaibul family had to register a 3.8 billion baht loss. The BMB model was then utilized when the three other banks were forced on to the same trajectory.⁵⁰

Even these measures and signals did not stop the large net outflow of capital from Thailand nor stabilize the foreign exchange rate. When the exchange rate passed the US\$1:50 baht threshold in early January 1998, talks about reviewing the IMF terms came up again. Prime Minister Chuan Leekpai stressed that the IMF had been too optimistic about the economy when they drew up austerity measures, and he pointed to the high interest rate policy and the economic growth predictions as issues of discussion with the IMF. A downward revision of the latter could make it easier for Thailand to achieve the 1% fiscal surplus goal in spite of an expected revenue shortfall of about Bt 100 billion in 1998. Similar reservations about certain aspects of the IMF program were expressed by Deputy Prime Minister Supachai Panichpakdi and Finance Minister Tarrin.⁵¹ After a visit by Tarrin to Washington and during the second IMF quarterly review of Thailand's performance under the rescue package, the IMF Asia-Pacific director Hubert Neiss announced that IMF would ease the conditions of the economic bailout. Thailand would be allowed to run a budget deficit of about 1–2% of GDP in the financial year ending September 30, 1998, instead of the previously stated target of a 1% surplus. When the IMF decided to change its conditions the baht was fluctuating in the rage of one US\$ to 41–47 baht and an ease in the high interest policy was postponed to "sometimes after the currency market stabilizes."⁵²

9. THE COSTS AND CONSEQUENCES OF THE FINANCIAL CRISIS

The immediate effects of currency depreciation, capital flight, closing down of 56 finance companies and cuts in the budget have been recession and a decline in imports which has improved the balance of trade. During the last quarter of 1997, Thailand had a current account

surplus and in 1998 and 1999 a sizable surplus is expected, providing foreign exchange funds for debt repayment. Further, Thailand is expected to enjoy negative growth in 1998 and probably longer. Some sectors have been, and will be, hit harder than others.

Problems in the *property market* are still there and default by more property developers is expected. In the *financial sector*, the restructuring of 56 finance companies through FRA is proceeding and the local small and medium-sized commercial banks (some of which were also in severe difficulties during the mid-1980s financial crisis) have seen their deposits moving to safer sites in the foreign banks and the large local commercial banks and some of them have been nationalized or denationalized. Thai Danu Bank was bought by the Development Bank of Singapore, while the writing off of equity and the nationalization of four medium-sized banks with liquidity problems and with relatively high exposure to property loans have taken place. Thus the financial crisis has so far tended to favor the top five local commercial banks. But even these banks open their doors for foreign investors in their recapitalization plans

One immediate consequence of financial sector restructuring is disintermediation in the financial sector. Another is huge public costs. In addition to the write-off of shareholders' equities, the costs of financial restructuring of loans in finance companies and banks are expected to be in the range of 12–15% of GDP to be funded by the state budget (taxpayers money) and by the banks through their (higher) contributions to the Financial Institutions Development Fund (FIDF). But the capacity of the fund is weak after its rescue operations in both the finance company and the banking sector.⁵³ Recapitalization of the financial sector will require US\$ 10–20 billion over the next several years and as local funds are tight and foreign investors now are allowed to take a majority stake, increased sales of equity to foreign financial institutions is the trajectory chosen.

In the *manufacturing industry* some sectors and some types of enterprises are more affected than others. One main problem is the high import-intensity in manufacturing. The lower value of the baht makes Thai exports more competitive but the cost of imported components and raw materials have gone up too. The import content is high in "sunrise" industries such as computer and electronics and in the automotive industry, which was expected to be the future backbone of Thai industry. The large Japanese automobile

producers who rely on the domestic market have suffered and closed plants, while US automakers — Ford, GM and Chrysler — that had decided to use Thailand as their regional platform have had to “postpone” their plans. A study showed that a decline in the baht from 26 baht to a dollar to the expected equilibrium exchange rate of 32 baht to a dollar would raise production costs of 20 export products by almost 15%. In early January 1998, the exchange rate was 56 baht to the a dollar.⁵⁴ In 1997, exports of automobiles and autoparts as well as some types of electrical and electronics products expanded in baht as well as dollars but the long-term prospects will depend on the extent to which assembly firms can increase the local content of their production.

In contrast, more “sunset” industries — the traditional export industries such paper and pulp, textiles, garments, footwear and food products — are expected to benefit from the baht devaluation but that again will depend on the extent of competitive devaluation in other Asian countries and trade policy in EU and United States. Garments export which declined in 1996 improved substantially in 1997.

The baht's depreciation has also had a severe impact of the profits of *large companies and conglomerates* with unhedged foreign loans. A study of the impact of foreign exchange losses on corporate earning in October 1997 revealed that companies in construction and petrochemicals were most vulnerable and among the big losers were giants such as Thai Petrochemical Industry (TPI) and Siam Cement Company (which belong to the Crown Property Bureau i.e. the Royal Family). Some of the large companies have stopped paying principals but continue to pay interest, but the extent of bankruptcy in the corporate sector will probably be limited as the present (not yet amended) bankruptcy law makes it very difficult for collapsed companies to go bankrupt. Therefore, debt restructuring involving debt-to-equity swaps combined with discount trading with so called “distressed corporate debt” is more likely.⁵⁵

Generally, credit is drying up in Thailand and the liquidity problem is not only found among large enterprises. The suspension and later closure of 56 finance companies has in particular affected *small and medium-sized enterprises* (SMEs) that have obtained their working capital from these sources.

Closing the finance companies imposed a heavy strain on local economy, which relied on the noncollateral loans they issued for working capital. “They were the lubricating mechanism for the trading

sector all over Thailand,” says a senior economic advisor to the government.⁵⁶

Thailand's economic crisis might to some extent be cushioned by other sectors such as *agriculture and tourism*. Tourism is still the largest foreign exchange earner but the growth of arrivals in 1997 was less than 1% (well below the 7% forecast earlier), partly because travel from Asia was affected by the financial crisis. Few believe that the Amazing Thailand campaign 1998–99 will achieve its revenue target of 600 billion baht.⁵⁷ Although weather conditions have not been the best in 1997, high prices and regional demand for tapioca and rice have given Thailand higher export earnings than in the year before.

The wider socioeconomic consequences have already shown up. Many “nouveau rich” Thai entrepreneurs and middle-class people operating in the local investment markets have become “nouveau poor,” and expensive cars and luxury items are sold cheap in order to obtain hard cash.⁵⁸ Cases of suicide as a consequence of the financial crisis have been reported, too. Even middle class consumers are changing their spending habits, cutting back on luxury items and in particular on imported goods. In October, Marks & Spencer had already reported that their sales had dropped over 30% and the retail market is generally expected to have declined in 1997.⁵⁹

The main factors affecting ordinary people's living standard are inflation and unemployment. Due to the slow growth in the economy and available stocks of imported goods *inflation* was just 5.7% in 1997 but it is expected to increase to 18% in 1998. The final level of inflation will depend on whether the exchange rate stays grossly undervalued and whether the government introduces the suggested increase in taxes on gasoline or not. Price increases on vegetable oil and rice have already affected living conditions of poor families, and the World Bank has entered with a US\$ 300 million social safety net program.⁶⁰ *Unemployment* is growing too, mainly in the finance and real estate sectors, in construction and in industries that manufacture goods with a high import content. It is estimated that around 600 000 people have already lost their jobs. More specifically, it is estimated that 20 000–30 000 workers have lost their jobs in the financial sector, and that there are 300 000–400 000 fewer construction workers. The car industry has reported almost 29 000 lay-offs. Further, it is estimated that small businesses have lost around 70 000 and that another 500 000 people can expect to become unemployed next year. Generally, public data on unemployment

are highly unreliable as there is no reporting system for job losses. The urban centers have been hit hardest. More than half of the labor force in Thailand is still engaged in agriculture but the rural areas are affected by the decline in the flow of income from relatives working in Bangkok just as unemployed workers will survive by returning to the homes of their parents. Service and manufacturing enterprises outside Bangkok are also affected by the closing down of the 56 finance companies and the drying up of SME financing.⁶¹

Foreign workers are a particularly vulnerable group. In January 1998, Thailand's Labor Minister declared "This is our country and we want to take it back," when he announced that the government planned to repatriate almost one million illegal foreign workers coming mostly from Myanmar and to refrain from renewing work permits of almost 300,000 legally registered workers.⁶²

The *political consequences* are still to be seen, but in a short-term perspective the financial crisis seems to have been conducive to further democratization. When the financial crisis hit Thailand, a political and constitutional crisis was already occurring. In mid-August the Constitution Drafting Assembly (CDA) approved a new draft constitution which aimed at promoting honesty and eradicating "money politics," introducing fairer election practices, increasing political accountability, ensuring individual rights and improving local democracy. The draft met strong opposition within the Chavalit government and the opposition included the main fraction in Chavalit's New Aspiration Party (NAP). The combined effort of public protest in Bangkok and other big cities, direct pressure from the military and technocrats on Chavalit, and not at least the fear of a negative reaction from the foreign exchange markets finally forced the opponents to give up. Although it is only one step toward the consolidation of democracy in Thailand and with the laws implementing the constitution still not passed, the new constitution undoubtedly is a step forward toward consolidation of democracy in Thailand.⁶³

10. THE ECONOMIC CRISIS IN THAILAND — SOME CONCLUDING REMARKS

The financial crisis in Thailand developed through 1996 before coming to the surface first in March 1997 and later in early July 1997. During a period when the real economy showed

signs of weakening with sluggish export and an increase in the current account deficit, "hot money" flowed in and covered the deficit, but also led to careless investments. Financial liberalization in an uncontrolled financial sector led to misallocation and mismatching. As suggested by Krugman a boom–bust cycle of property and stock markets preceded the financial crisis. Although Krugman's analysis point at a crucial aspect, other factors also contributed to Thailand's economic crisis.

The gradual loss of competitiveness during the 1990s was aggravated by the foreign exchange regime which tied the baht to a strengthened US\$. The current account deficit widened and reached a level that worried currency traders in the post "tequila-crisis" period.

The Bank of Thailand (as well as the Ministry of Finance), that once was reputed for its autonomy from politicians and its macro-economic prudence, has gradually (since 1993) lost this autonomy, and has been pushed and pulled by politicians during the Barnharn and Chavalit governments. The bank responded to the unfolding financial crisis by spending almost all its reserves on defending the baht, by putting tight control on money supply to keep interest rates high, and by trying to solve the bad debts problems in the finance companies by pumping money into them. Both the defense against devaluation and the 430 billion baht pumped into the finance companies to rescue not just depositors and creditors but also investors proved to be both costly and useless.

The Barnharn and the Chavalit governments were fundamentally unstable and unable to present a reliable macroeconomic policy. When the government intervened it was in a "too-late-too-little-fashion," normally with strong policy formulation followed by weak policy implementation. The political crisis aggravated the financial crisis by undermining investors' confidence. The two governments — as the governments before them — proved to be unable to implement more long-term strategies that could improve productivity in and upgrading of the industrial sector — restructuring away from low cost assembly manufacturing toward higher value-added production areas. Major issues such as the low level of basic education, the shortage of skilled labor and technical skills, high interest rates and the powerful commercial banks, an inefficient bureaucracy, an insufficient infrastructure, and a low technological capacity in private companies were never addressed in any consistent manner by the state. "Short-termism" also prevailed in the private sector where investors

went for "easy profits" in the financial and property sectors or invested in joint ventures with foreign capital in manufacturing.

Financial liberalization and the free flow of capital into an economy with an uncontrolled financial sector has aggravated these deficiencies in the Thai model of accumulation as has globalization of financial capital. Mobile finance capital was quick to reward open economies during the early 1990s but equally quick to punish them when current account balances became "too large" and investments in the stock and real estate markets too risky.

In the last quarter of 1997 an IMF-driven austerity and financial sector restructuring policy

was introduced and implemented. This policy aimed at restoring foreign investor confidence and if this policy works out, Thailand will in some years return to the economic growth pattern which fueled growth during the decade prior to 1996. Although the devaluation of the baht will make it easier to exploit static comparative advantages, based on relatively cheap but productive labor and abundant natural resources, long-term economic development will still depend on its ability to develop dynamic competitive advantages, just as its broader social and political development will depend on its ability to solve its problems of regional and social inequality in the country.

NOTES

1. The investment ratio was also above 40% during 1990–92. Domestic savings increased too. The domestic savings ratio went up from 23% in 1985, to 32% in 1990 and to 36% in 1995 (Bank of Thailand data). See Muscat (1994), p. 294, OBI, 1993 (September, p. 3), OBI, 1996 (May, p. 3).
2. Chaiyasoot (1995), p. 172.
3. EIU Country Report: Thailand (1997:4), *Bangkok Post* (August 12, 1997), *The Nation* (October 3, 1997). Sussangkarn (1998). TDRI included foreign liabilities of commercial banks in short-term debt and total reserves included currency assets of commercial banks.
4. Warnings about oversupply in the property sector came as early as 1992–93. See for instance Ywin (1993) [Kenneth Ywin, "Beware of the boom," *The Nation. Year In Review 1992* (January, 1993)].
5. Thurow (1998).
6. Parnsoonthorn (1997) and Terdudomtham (1998).
7. *Bangkok Post* (October 6 and October 7, 1997); *EIU Country Report: Thailand, 1997:3*; *EIU Country Report: Thailand, 1997:4*. It should be noted that the debt–equity ratio was substantially lower than in, for instance, South Korea. According to Paribas Asia Equity, the debt–equity ratio for all unlisted nonfinancial companies was 139% in 1995 but increased to 170% in 1996 (EIU Country Report: Thailand, 1997:3, pp. 35–36. Although financing of equity through loans was not unusual in the corporate sector and though the debt–equity ratio went up, the Thai financial crisis does not conform to the "The Asia High Debt Model" suggested by Robert Wade and Frank Veneroso. The debt–equity ratio was not particularly high and Thailand has developed through a fairly open economy in which government-directed credits have played a very limited role as the state chose a hand-off posture and left credit allocation to powerful private banks. Wade and Veneroso (1998).
8. Krugman (1998).
9. Robinson *et al.* (1991), pp. 20–21.
10. Suehiro (1985); Suehiro (1992); Hewison (1989).
11. Doner and Unger, 1993 (p. 106). By the end of October 1997 the top five banks accounted for 70% of bank assets, 75% of bank deposits and 68% of bank loans (Ingrisawan and Yuthamanop, 1998).
12. Warr (1993), p. 24.
13. Robinson *et al.* (1991), p. 20.
14. Robinson *et al.* (1991), p. 22.
15. Robinson *et al.* (1991), p. 22. See also Doner and Unger (1993), pp. 115–116.
16. Chaiyasoot (1995), p.163.
17. Doner and Unger (1993), p. 121.
18. The remaining restrictions covered capital outflows by Thais in the form of portfolio investments and real estate investments abroad.
19. For details see Lertwinyu (1992), pp. 51–52 and Chaiyasoot (1995), pp. 171–174.
20. For business in baht, the BIBF was not allowed to lend in baht to the domestic market (out-in). Lertwinyu (1992), p. 52, and Chaiyasoot (1995), p. 172.
21. See Doner and Laothamatas (1994), pp. 423–424. For details on the politics of devaluation during this period, see Doner and Unger (1993), pp. 113–114; Muscat (1994); Phongpaichit and Baker (1995), pp. 149–151 and pp. 346–349.
22. Office of the Board of Investment (May 1996, p. 3; OBI, 1996) The intrinsic instability of the portfolio investments was demonstrated the following year when the net flow of equity securities (due to large negative netflows to the United Kingdom and the Netherlands) was minus 10 billion baht compared to plus 68 billion baht in 1993 (Quarterly Bulletin, 1996, June, p. 83).
23. Chaiyasoot (1995), pp. 177–178.
24. Thai exports declined by 1.3% in 1996, which should be compared with a 24% growth rate in 1995.

25. The weight of the US dollar in the basket was 80%, while the Japanese yen and the German mark had a 12% and 8% weight, respectively.
26. Bangkok Post Year-end 96 Economic Review (1997); *Asia 1997 Economic Yearbook: Far Eastern Economic Review* (1997), p. 218.
27. *Far Eastern Economic Review* (May 16, 1996).
28. "The stability of the baht had served the Thai economy well in the past, but directors recommended a greater degree of exchange rate flexibility to improve monetary autonomy and to reduce the incentive for short-term capital inflows," IMF paper quoted from Bunyamane and Nivatupumin (1998). The IMF suggested more flexibility but did not suggest a free floating baht.
29. *Bangkok Post* (July 23, 1996).
30. Asiaweek (1996, October 4, p. 25).
31. OBI (1996, May, p. 3).
32. *Bangkok Post Year-end 96 Economic Review* (January 1997); *Asia 1997 Yearbook: Far Eastern Economic Review* (1997), p. 216. The autonomy was also eroded by The Economic Stability and Security Committee that tried to interfere in BoT interest rate policy and tried to change the way housing loans were categorised, probably in a move to bail-out troubled but well-connected investors in the property sector. *Bangkok Post* (July 23, 1996).
33. *International Herald Tribune* (January 5, 1998).
34. On the rise of Mr Pin Chakkaphak and his Finance One as the leading finance company in Thailand and on its growing problems in 1996 and 1997, see *Financial Times* (January 12 1998), pp. 6–7.
35. EIU Country Report: Thailand, 1997:2.
36. *EIU Country Report: Thailand 1997:2*; *EIU Country Report: Thailand 1997:3*.
37. When Amnuay testified before the Finance Committee in February 1998, he insisted that he had no knowledge about the disastrous build-up of foreign exchange contracts. He explained that the currency deal occurred in the banking department of the Bank of Thailand and not in the exchange equalization fund responsible for the daily setting of the value of the baht. Amnuay also stated that "the central bank is too independent. The central bank did (swap contracts) without the knowledge of the Finance Ministry, which only learnt about the matter afterwards when everything was too late," *The Nation* (February 10, 1998).
38. *EIU Country Report: Thailand 1997:3*; *Far Eastern Economic Review* (1997, May 29).
39. *EIU Country Report: Thailand 1997:3*; *Far Eastern Economic Review* (June 26, 1997) *Far Eastern Economic Review* (July 3, 1997), *Far Eastern Economic Review* (July 10, 1997), *Far Eastern Economic Review* (July 31, 1997) and *Far Eastern Economic Review* (September 25, 1997).
40. FIDF had injected 200 billion Baht in the first group of 16 suspended fincos (including Finance One) and 230 billion in the second group of 42 fincos. Polkwamdee (1998).
41. *EIU Country Report: Thailand 1997:3*; *Far Eastern Economic Review* (August 14, 1997). *Far Eastern Economic Review* (August 21, 1997) and *Far Eastern Economic Review* (September 4, 1997); *Bangkok Post* (August 11, 1997), *Bangkok Post* (August 12, 1997), *Bangkok Post* (August 13, 1997), *Bangkok Post* (August 14, 1997).
42. For more information on contributions from individual countries, see *EIU Country Report: Thailand, 1993:3*, p. 19; *Bangkok Post* (August 12, 1997) and *Bangkok Post* (August 13, 1997).
43. *Far Eastern Economic Review* (August 14, 1997); *Far Eastern Economic Review* (August 21, 1997), p. 85; *Bangkok Post* (August 12, 1997); *EIU Country Report: Thailand 1997:3*, pp. 18–19.
44. *Bangkok Post* (October 14, 1997), *Financial Times* (October 15, 1997) and *EIU Country Report: Thailand 1997:4*, pp. 15–17 and pp. 31–34.
45. *Bangkok Post* (December 8, 1997).
46. *Far Eastern Economic Review* (November 6, 1997), pp. 20–21; *Far Eastern Economic Review* (November 13, 1997), pp. 14–15; *EIU Country Report: Thailand, 1997:4*, pp. 13–17.
47. For details, see *EIU Country Report: Thailand 1997:4*, pp. 15.
48. *Bangkok Post* (February 14, 1998). The liabilities of the finance firms amounted to 430 bn baht to FIDF and 855 bn baht to local and overseas investors.
49. *Bangkok Post* (December 8, 1997) and speech of the FRA chairman Dr Twatchai Yongkittikul (Yongkittikul, 1997) and speech of Minister of Finance, Mr Tarrin (Nimmanahaeminda, 1997); *Bangkok Post* (December 21, 1997). The new committee was the second appointed in 1997 to investigate the procedures of the Bank of Thailand, In July, then — Finance Minister Thanong appointed the so called Suthee Committee to evaluate the central bank's supervisory and examination procedures. Ingsrisawan and Yuthamanop (1998).
50. *Financial Times* (January 22, 1998); *Financial Times* (January 24, 1998), *Bangkok Post* (January 26, 1998); *Bangkok Post* (January 27, 1998); *Bangkok Post* (January 28, 1998), *Bangkok Post* (February 6, 1998), *Bangkok Post* (February 10, 1998), *Bangkok Post* (February 14, 1998). Siam City Bank also had to write down capital during the 1983–86 financial crisis.
51. *Bangkok Post* (January 7, 1998).
52. *Far Eastern Economic Review* (January 22, 1998), p. 21; *Bangkok Post* (February 13, 1998); *Bangkok Post* (February 14, 1998). The IMF explained their new policy by referring to the danger that their continued austerity regime might induce a new economic crisis. While the softening of conditions did "save" the Chuan government that was unable to cut public sector expenses and raise taxes sufficiently to reach the previous target, the increasing protests from the

business community against the high interest rates did not initially change the IMF position on that issue. It should also be noted that the revised IMF approach came after the Chuan government had made its firm move to clean-up the four mid-sized banks and on January 30, 1998 had eased the foreign exchange controls it introduced in May 1997 to protect the value of the baht.

53. *EIU Country Report: Thailand, 1997*; *Far Eastern Economic Review* (December 4, 1997).

54. *Bangkok Post* (October 25, 1997); *Bangkok Post* (January 11, 1998); *Bangkok Post* (January 13, 1998).

55. *Bangkok Post* (October 24, 1997); *EIU Country Report: Thailand 1997:3*; *Financial Times* (January 14, 1998).

56. *Far Eastern Economic Review* (September 4, 1997). See also *EIU Country Report: Thailand 1997:3*, p. 32.

57. *Bangkok Post* (December 4, 1997); *Bangkok Post* (January 2, 1998); Jariyasombat (1998).

58. In 1995, new Mercedes Benz sales in Thailand ranked third in the world. Polkwamdee (1998).

59. For details see *Bangkok Post* (October 26, 1997); *Far Eastern Economic Review* (December 11, 1997).

60. *Bangkok Post* (February 6, 1998); *Bangkok Post* (February 10, 1998); Sussangkarn (1998).

61. *Far Eastern Economic Review* (October 23, 1997); *Far Eastern Economic Review* (October 30, 1997); *EIU Country Report: Thailand 1997:4*, p. 22; *The Nation* (December 8, 1997).

62. *Financial Times* (January 13, 1998); *Far Eastern Economic Review* (January 22, 1998).

63. *Far Eastern Economic Review* (August 7, 1997); *Far Eastern Economic Review* (September 11, 1997) and *Far Eastern Economic Review* (September 18, 1997); *Bangkok Post* (August 31, 1997); *EIU Country Report: Thailand 1997:3*, pp. 10.

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