Financial Liberalization and the Economic Crisis in Asia

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1 Premature liberalization and economic crisis in Thailand

Bhanupong Nidhiprabha

Introduction

The process of economic liberalization varies from country to country, depending on initial economic conditions, institutional factors, and political environment. Thailand has adopted an outward-oriented development strategy by eliminating export taxes and reducing import tariffs since the 1980s, but its trade liberalization is far from being complete. It was not until 1 January 2000 that Thailand reduced the tariff rates on certain imports from the ASEAN Free Trade Zone to a maximum of 5 per cent. In spite of tariff cuts there remain regulations that limit imports by requiring products to have at least 40 per cent local content to qualify for the rules of origin and thereby lower tariffs. Tariff rates on some imported raw materials are still kept at a high level.

In Thailand, financial liberalization began in earnest only in the early 1990s although at a faster pace than trade liberalization. The acceptance of Article VIII of the IMF Articles of Agreements was announced in 1990, when the Bank of Thailand was confident about the country's macroeconomic stability. Interest rate ceilings were abolished to enhance the allocative efficiency of savings and the capital account was opened, allowing free flow of trade and investment transactions. Underlying these policy developments was the idea that the economy would grow more rapidly with minimum public intervention and a greater reliance on market forces.

In spite of some costs involved in pursuing the goal of achieving high economic growth, the impact of the policy reforms on economic growth appear to have been favorable until the crash of 1997. The economy sustained a high growth rate for three decades, and this prosperity lulled Thai policymakers into complacency about the existing policies and institutional infrastructure. In 1996, however, external factors changed rapidly through volatility in international portfolio investment, wide fluctuations in the yen–dollar exchange rate, and a collapse in world trade and commodity prices. Given these changes, and especially the rapid and huge capital inflows, domestic macroeconomic policies (i.e. foreign exchange rates and monetary and fiscal policies) should have been changed and regulation and supervision of the financial sector should have been strengthened. The financial crisis in Thailand is a result of the failure to implement appropriate policies to deal

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with the rapidly changing world economy in the 1990s and the policy response of the government that was either too late or too ineffective to halt the ongoing crisis.

Thailand's financial liberalization that relaxed capital control with the aim of establishing Bangkok as a financial center in the region was a major policy blunder. Taken in conjunction with the removal of interest rate ceilings at a time when the domestic economy was overheating and the world money market was awash with excess liquidity, the relaxation of capital control induced huge capital inflows. Even if the Bank of Thailand wanted to check the flow of capital it had no means doing so once the interest rates ceilings were removed. With hindsight it is clear that capital control relaxation should have been undertaken in a gradual manner in combination with greater flexibility in exchange rates and that the timing, speed, and sequencing of financial liberalization are critical ingredients of a successful outcome.

Macroeconomic stability is a necessary but not a sufficient condition for successful capital convertibility. Prudential financial regulations and supervision are its preconditions. Furthermore, given the trade-off between a strong financial system and competitive efficiency the number of firms in the financial sector may need to be limited to achieve a balance between efficiency and solvency. In addition, since changing the legal framework to establish good public and corporate governance is a lengthy process, the developing countries should take a gradual approach to financial liberalization. Abrupt liberalization can produce unexpected and undesirable consequences.

The chapter begins with a discussion of interest rate liberalization in Thailand and its outcome. It is followed by an analysis of capital account liberalization with a focus on the role of the Bangkok International Banking Facilities (BIBFs) and the timing of prudential regulations. The chapter then proceeds with an analysis of the political economy of financial liberalization and a discussion of the impact of capital inflows on the vulnerability of the Thai economy to economic crisis. It ends with some concluding remarks.

Interest rate liberalization in the 1990s

Thai commercial banks have always been the most important financial intermediaries in the country, mobilizing savings from households and extending credit to investors. The degree of financial deepening measured as the ratio of quasi-money and bank credit to gross domestic product (GDP) has increased over the past two decades. In recent years, however, the intermediation role of banks has become increasingly less important as capital and bond markets have emerged from a rudimentary stage in response to financial liberalization undertaken in the early 1990s. Household savings now include other financial assets besides bank deposits, and corporate borrowers, especially large ones, now have an additional source of funds in bond and equity markets at home as well as abroad.

Between 1982 and 1990, the rate of inflation in Thailand averaged 3.5 per cent while the ceilings on the rate of interest on time deposits stayed above the inflation rate. Consequently, real interest rates on bank deposits and loans stayed in the

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positive zone even though their nominal rates were subject to ceilings. Positive real interest rates plus rapid economic growth, price stability, and a stable banking system contributed to financial deepening in Thailand even before the removal of interest rate ceilings, which was undertaken later than in some other countries.

Although ceilings were imposed on banks's lending as well as deposit rates, interbank short-term interest rates were freely determined by supply and demand – supply of reserves from surplus banks and demand from reserve-deficit banks. Gradually even the ceilings on bank interest rates were removed, beginning first with the ceilings on the rates of long-term deposits in March 1990 followed by those on short-term 'fixed' (i.e. time) deposits and savings deposits. Finally, in June 1992 ceilings were removed from all lending rates.

Prior to the interest rate liberalization, domestic interest rates adjusted infrequently in part because they were subject to ceilings, which the Bank of Thailand utilized as a monetary policy instrument. When those ceilings were removed, there was no sharp increase in interest rates since the market interest rates had been below the ceilings and the real interest rates had been positive. With the removal of the ceilings, however, domestic interest rates became more sensitive to movements in the world interest rates, adjusting quickly especially to changes in the US federal funds rate. As a consequence, the Bank of Thailand lost its control over domestic interest rates and found it exceedingly difficult to carry out its monetary policy.

Before 1992, large commercial banks were suspected of colluding on interest rates. The Thai Banker Association set the appropriate level of interest rates, making sure that there would be no cut-throat competition among member banks. The large banks acted as price leaders with smaller banks following them in setting their own interest rates. Interest rate liberalization changed all those practices, allowing each bank to set its own rates taking into account its cost structure and own market niche. In fact, in some cases small banks became leaders in the setting of interest rates.

It is commonly accepted that interest rate liberalization would reduce the spread between lending and borrowing rates. But what actually happened in Thailand was an increase in the spread between the prime lending rate or the Minimum Lending Rate (MLR) and the 'fixed' deposit rate from 2.5 percentage points in 1990 to 4.0 percentage points in 1991. It is possible that this large interest spread was due to the high cost of holding government bonds or large reserves for loan-loss provisions that the banks were required to hold. Such conditions did not, however, exist in the early 1990s, and the large spread was probably due to the lack of competition and inefficiencies in the Thai banking industry. In fact, large interest rate spreads produced a high rate of return on bank capital for many banks.

For interest rate liberalization to bring about an efficient resource allocation, it must be accompanied by a higher degree of competition. But for thirty years prior to the crisis, no new banks were established in Thailand. A probable reason for this was the belief that maintaining a sound banking system required protecting the existing banks' profitability. Thus the solvency of the banking system had its own cost in terms of efficiency, as represented by wide interest-rate spreads. The banks tried to maintain a constant spread between the prime lending rate and the 'fixed'

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deposit rate (Figure 1.1). But after July 1997 they increased the spread because of the need to generate profits and retained earnings to make up for depleted capital funds caused by delinquent loans. This caused a public outcry with the banks being accused of aggravating economic hardships at a time of economic crisis, and the resulting public pressure and moral suasion from the central bank have brought down the rate spread since the third quarter of 1998.

It was proposed in 1995 that five new local bank licenses be granted in 1996 with each new bank being required to have at least 7.5 billion baht in paid-up capital. New foreign banking licenses were also to be issued as part of the commitment to the General Agreement on Tariffs and Trade (GATT) to open up the financial sector. It was hoped that the entry of new banks would break up the oligopolistic banking structure in Thailand. In the event, however, no new banking licenses were actually granted as some of the finance companies that were expected to obtain licenses went bankrupt after the July 1997 crisis. Moreover, there is now no need to issue new foreign banking licenses since after the crisis foreign banks are allowed to take over weak domestic banks.

During the liquidity shortage and the high interest rate episode of 1998, the Bank of Thailand re-introduced ceilings on deposit rates to prevent banks from competing for limited funds. As a result, the real deposit rate declined sharply, reaching a negative level in June 1998 (Figure 1.1). The rising inflation, stemming from large currency depreciation, caused the real return to turn negative, as the ceiling on the nominal deposit rate was set below the inflation rate. By mid-1998, however, the contractionary effect of devaluation began to have downward pressure on inflation, and as the recession deepened further with price deflation real interest rates began to rise despite the ceilings on interest rates. The rising real interest rates made it difficult for the central bank to stimulate the economy when such an action was needed to bring it out of recession.

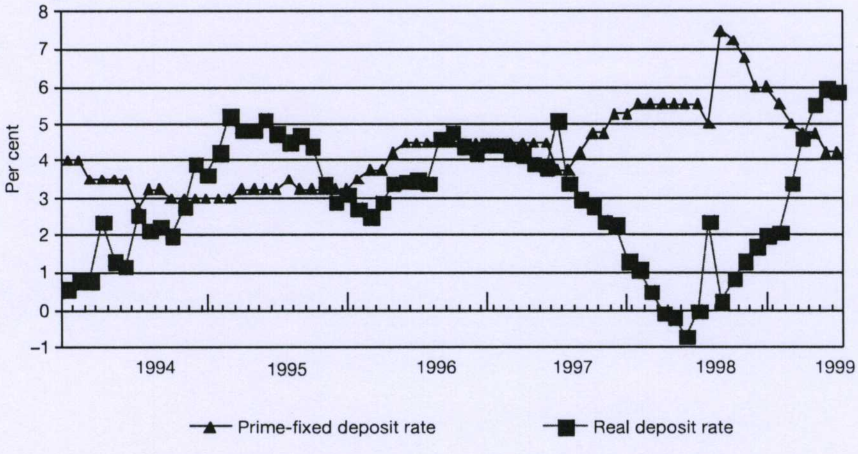

Figure 1.1 Spread between prime lending and fixed deposit rates and real deposit rate.

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Capital account opening

In May 1990, Thailand agreed to Article VIII of the IMF Agreements, and relaxed foreign exchange controls and reduced restrictions on capital account transactions. Prior approval from the Bank of Thailand was no longer required for transferring capital in the form of dividends, principal and interest payments on foreign debts. The ceiling on the net position on foreign assets (net overbought) of commercial banks was raised from 20 to 25 per cent of capital funds, while the ceiling on net position on foreign liabilities (net oversold) was lifted from 15 to 20 per cent.

Other restrictions on foreign exchange transactions were also lifted. For example, a maximum of US$20,000 per person was allowed for travel overseas, a maximum of US$500,000 was allowed per individual for the repatriation of interest earnings and dividends, and restrictions on the transfer of money overseas for educational purpose were relaxed. Prior to liberalization, foreign stock market investors were required to wait two months before they could remit their earnings from the Thai stock market; however, after liberalization, remittance took only a few days. All of these changes made equity trading easier and set the stage for a stock market boom in Thailand.

In April 1991, the Bank of Thailand launched the second stage of liberalization on foreign exchange controls, including a more liberal outward transfer of investment funds, and provision for repatriation of dividends, sales proceeds, and profits from stock market transactions. Residents were permitted to open foreign currency accounts if the funds originated from abroad. Further liberalization measures on exchange controls were made in May 1992, allowing exporters to use foreign currency receipts to repay foreign debts without prior approval from the Bank of Thailand. Nonresidents were permitted to deposit foreign currencies received from Thai residents into foreign currency accounts. These measures encouraged dollarization in Thailand although it was limited due to the stability in the baht–dollar exchange rate, which prevailed until early 1997. In September 1992, commercial banks located in Vietnam and in countries bordering Thailand were allowed to withdraw baht from their accounts at commercial banks in Thailand. In April 1995, finance companies were allowed to issue bills of exchange to raise funds at home as well as from abroad. Thus both banks and finance companies were encouraged to seek funds from world capital markets.

A decade ago, Villanueva and Mirakhor (1990) warned that macroeconomic stability and a strengthened supervisory role of the central bank must be secured before embarking on financial deregulation if it is not to bring about adverse consequences by creating an unstable banking system. Unfortunately, capital account liberalization in Thailand was undertaken in haste before adequate prudential laws and regulations could be developed and put in place.

As Thailand embraced the ideology of free capital markets, substantial profits realizable from huge interest rate differentials induced a large influx of foreign capital, especially into its banking sector. As shown in Table 1.1, in 1987–90, a few years preceding the capital and exchange control relaxation, the banks' share of net private foreign capital inflows was only 14.7 per cent. This share increased to 49.3

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per cent in 1995–96, more than a threefold increase in less than a decade. Foreign borrowing of the nonbank sector (i.e. 'other loans') also increased rapidly from 1.7 per cent to 15.6 per cent. In contrast, the share of foreign direct investment (FDI) in net private foreign capital inflows decreased from 25.1 per cent in 1987–90 to 5.8 per cent in 1995–96. The share of portfolio investment remained significant but nevertheless decreased from 24.2 per cent to 14.7 per cent during the same period.

The increasing reliance of Thai financial institutions on foreign funds is also shown in Table 1.2, where their funding structure for various years is compared. In 1990, domestic deposits accounted for close to 77 per cent of commercial bank liabilities but only 60 per cent in 1995–96, while commercial banks' share of foreign liabilities increased from 6.1 per cent to 22.6 per cent. Finance companies also increased their dependence on foreign funds, raising their share of foreign liabilities from 4.8 per cent in 1990 to 7.3 per cent in 1995–96.

Table 1.1 Composition of net private capital flows (as a percentage of total net private capital flows)

	1987–90	*1991–94*	*1995–96*	*1997–98**
Banks	14.7	41.7	49.3	47.4
Nonbanks	85.3	58.3	50.7	52.6
Direct investment	25.1	14.6	5.8	15.1
Other loans	1.7	1.9	15.6	16.6
Portfolio investment	24.2	15.6	14.7	7.6
Nonresident A/C	25.0	19.7	13.6	13.2

Sources: Bank of Thailand (various years).
*May 1998

Table 1.2 Funding structure of Thai financial institutions (percentage share)

	1990	*1991–94*	*1995–96*	*1997–99**
Commercial banks				
Deposits	76.9	72.0	59.9	61.6
Foreign liabilities	6.1	10.6	22.6	19.8
Liabilities to commercial banks & borrowing from other financial institutions	1.9	1.7	2.4	3.8
Capital accounts	6.2	6.9	7.9	11.9
Finance and financial & securities companies				
Borrowing from business	62.0	61.1	59.2	39.0
Foreign liabilities	4.8	5.9	7.3	5.5
Credits from commercial banks	7.5	7.8	8.7	8.0
Capital accounts	8.5	10.8	12.4	11.2

Sources: Bank of Thailand (various years).
*May 1999

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Commercial banks' foreign liabilities in baht terms steadily increased from around 100 billion baht in January 1994, peaking at around 1,200 billion baht in January 1998, and outstripped the monetary base beginning in 1995 (Figure 1.2). Such a large, steady increase in capital inflows pumped a heavy dose of liquidity into the financial system and placed increasing pressure on the central bank to prevent excessive monetary growth.

Heavy dependence of Thai banks on foreign funds prior to the crisis can be attributed to the relaxation of capital controls. Although their capital funds gradually increased over the years, the increase was less than the increase in foreign liabilities. As is evident in the falling share of deposits from 1990 to 1996, the easy access to foreign funds seems to have reduced the incentives for banks to mobilize funds from domestic sources, increasing their reliance on foreign capital and their exposure and vulnerability to foreign exchange risks.

The value of foreign debt in baht terms jumped up dramatically as the baht plunged to its lowest level in January 1998, reducing the banks' net worth. Bank capital funds shrank since sharp currency depreciation was a shock to bank capital and this capital crunch caused bank credit growth to decline from 34.5 per cent in 1997 to −1.2 per cent in 1998.

The relaxation of capital controls also facilitated the inflow of short-term foreign capital into the nonbank private sector mainly in the form of portfolio investment, nonresident baht accounts, and other loans. This influx of capital significantly altered the composition of capital inflows to Thailand, with the share of foreign direct investment dwindling while short-term flows and portfolio investment increased (Figure 1.3). Short-term flows, however, declined sharply after the crisis, while foreign direct investment rose substantially in the aftermath of the massive currency depreciation.

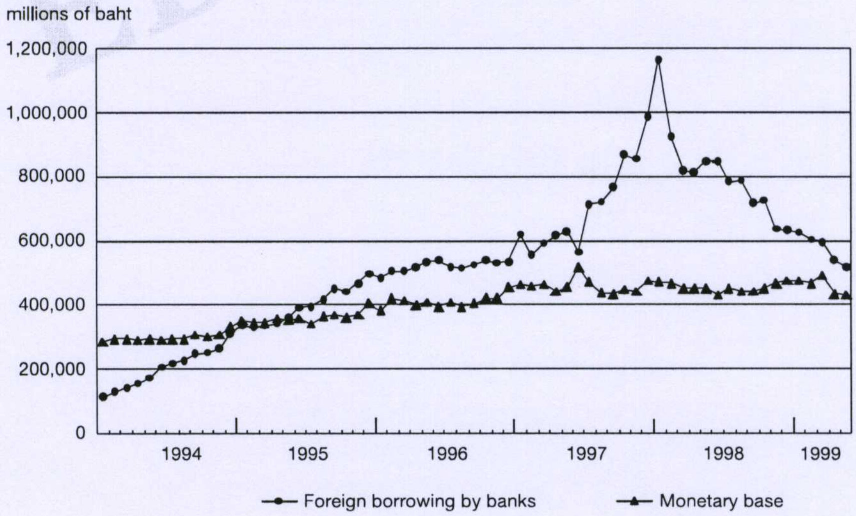

Figure 1.2 Bank foreign liabilities and monetary base.

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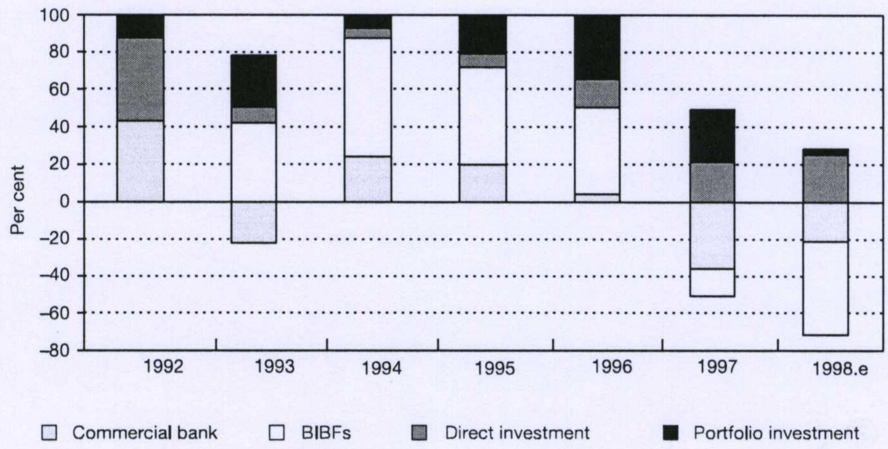

Figure 1.3 Structure of capital flows.

Establishment of the Bangkok International Banking Facilities

The real big opening of Thailand to foreign capital came with the establishment of the Bangkok International Banking Facilities (BIBFs) in March 1993. They were launched with great fanfare under the Chuan Administration with the aim of enhancing Thai financial institutions' capabilities to conduct international banking businesses. The BIBFs were to mobilize funds from overseas and extend credits only in foreign currencies. It was hoped that with the BIBFs the cost of foreign borrowing by Thai firms would be reduced. It was also hoped that they would serve as a financial gateway for neighboring countries including Myanmar and bring about an integrated financial system in the region. To accomplish these goals, the Thai government offered various tax incentives: the corporate income tax was reduced from 30 to 10 per cent; exemptions were provided for the sales tax, stamp duties, and permanent establishment tax; and the withholding tax rate on interest payments was reduced from 15 to 10 per cent for 'out-in' transactions.

BIBF licenses allowed their holders to borrow abroad in foreign currencies and then lend in foreign currencies at home ('out-in') or abroad ('out-out'). In essence, the 'out-out' BIBFs are banking services for nonresidents in foreign currencies, while 'out-in' BIBFs are banking services for domestic residents in foreign currencies only. In addition, BIBFs could guarantee any debts denominated in a foreign currency to nonresidents. They could also undertake foreign exchange transactions with nonresidents, and act as a party to loan syndication as well as a booking center for foreign currency loans.

The Thai central bank hoped that the BIBF banks would create 'out-out' business, where money raised abroad would be used to finance trade and investment outside Thailand. As it actually turns out, the size of 'out-in' lending was twice as

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large as that of 'out-out' lending. This was due to the fact that interest rates were higher in Thailand – where a strong economy generated the expectation of high rates of return on investment – than in other countries in the region and thus larger profits were expected from 'out-in' lending.

As of March 1996, three years after the launching of the BIBFs, there were 42 BIBF banks – 12 belonging to Thai banks, 11 branches of foreign banks, and 19 foreign banks with no branches in Thailand. 'Out-in' lending amounted to US$28.7 billion, representing 16.3 per cent of the total domestic credit extended by the banking system, while 'out-out' lending was US$20 billion. In 1997, 'out-in' lending of BIBFs reached a peak, amounting to almost three times as large as Thailand's monetary base (Bank of Thailand 1996).

Thanks to their international networks that facilitated offshore borrowing, foreign BIBF units dominated the BIBFs. The main players of 'out-in' and 'out-out' businesses up to 1996 were foreign bank BIBF units with no branches in Thailand (these are included in 'other BIBF units' in Figures 1.4 and 1.5). Thai banks and foreign banks with full branches in Thailand accounted for a rather small portion of 'out-out' lending in 1994, 1995 and 1996.

Some of the borrowings by foreign affiliates in Thailand, which were previously classified as FDI inflows, were now booked under BIBFs and this 'rebooking' had the effect of causing a sharp decline in FDI especially in 1994. The rebooking was especially easier for Japanese affiliates since many Japanese affiliates and BIBFs belonged to the same Japanese conglomerates.

Both FDI and BIBF lending were highly concentrated in industry, real estate, construction, and financial institutions. Since many BIBFs made domestic long-term loans with overseas short-term credit, which they were confident would be renewed, Thailand's term maturity became increasingly mismatched as its borrowings from BIBFs increased.

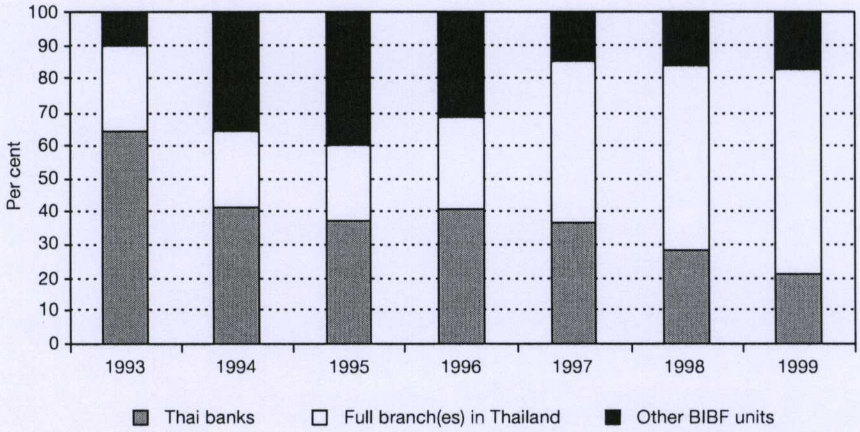

Figure 1.4 BIBF out-in loans.

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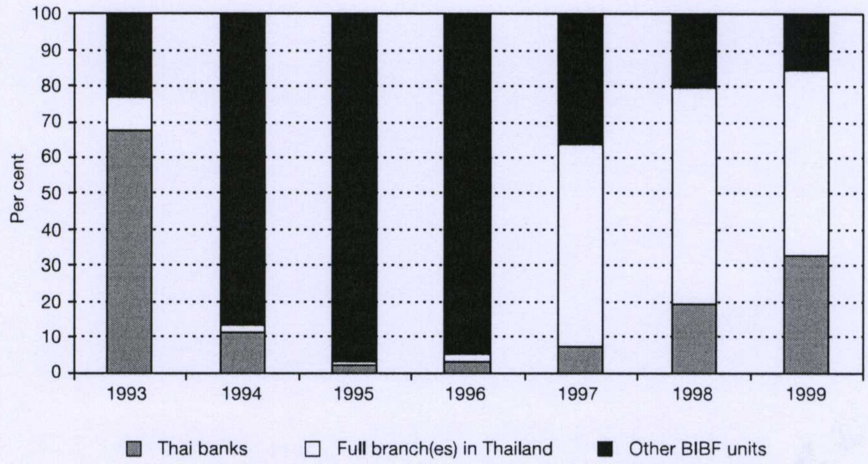

Figure 1.5 BIBF out-out loans.

Lending by BIBFs and commercial banks in foreign currencies was treated as 'foreign assets' since BIBFs were treated as part of Thailand's banking system. As a result, regulation on the maximum level of the net oversold position was less effective, allowing Thailand's short-term external debt to increase. The country's short-term external debt rose from US$18.9 billion in 1992 to US$41 billion in 1995, 58 per cent of which belonged to BIBFs. The share of short-term debt to total debt of BIBFs was 86 per cent in 1995 (Bank of Thailand 1996).

In August 1994, Thailand's International Banking Facilities were expanded beyond the Bangkok area into provinces with the granting of thirty-seven licenses of the Provincial International Banking Facilities (PIBFs). The offices of the PIBFs were to be located outside Bangkok and its vicinity, and their funding was to come from overseas. They were permitted to lend in baht as well as in foreign currencies. In March 1996, there were twenty-nine PIBFs in operation.

Although foreign capital inflows can make a positive contribution to economic growth, they can also inflict severe problems on a country especially when the inflows are large and sudden. Savings can be reduced as consumption expenditures increase with the relaxation of liquidity constraints. Furthermore, if capital inflows are in the nontraded goods sector, there will be a real appreciation, causing deterioration in the current account. 'Irrational exuberance' can bring about excessive investment in the nontrade sector, and it is not surprising that the sectors in Thailand that suffered most from the crisis were the real estate, construction, and service sectors.

The prospects of achieving a narrow spread between lending and deposit rates did not materialize with the establishment of BIBFs, and the government's wishful thinking that the 'out-in' business would promote exports and thus reduce the current account deficit did not come true. Instead, BIBFs worsened the deficit by

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financing investments in the nontraded sector with their 'out-in' loans. In sum, it may be concluded that BIBFs raised the vulnerability of the Thai economy to crisis by increasing the risk exposure to currency and maturity mismatch, encouraging highly leveraged businesses, overborrowing in foreign currencies, expanding credit excessively to the nontrade sector, and shortening maturity of capital inflows.

Ill-timed prudential regulations

In June 1991, the reserve requirement was changed into a liquid asset requirement with the required ratio set at 7 per cent of deposits. Liquid assets included deposits at the Bank of Thailand, cash, and securities such as bonds issued by the government, the Bank of Thailand, and state enterprises. The Securities and Exchange Commission (SEC) was established in May 1992, after the launching of phase II of capital control relaxation. The Bank of Thailand also increased the minimum paid-up capital requirement for finance companies from 60 million to 100 million baht by July 1993 and to 150 million baht by July 1995.

In January 1993, the Bank of Thailand imposed the BIS capital adequacy ratio on commercial banks. The minimum capital-risk asset ratio was set at 7 per cent for domestic banks and a more favorable ratio of 6 per cent for foreign banks. This BIS standard was announced two months prior to the launching of BIBFs in March 1993. In December 1993, the adequacy ratio was raised to 7.5 per cent for domestic banks and 6.5 per cent for foreign banks.

The aforementioned prudential measures were undertaken step by step so as not to place too heavy a burden of adjustment on financial institutions. They are all good measures but are the kinds that should have been implemented before rather than after the capital control relaxation in 1990. The timing of the implementation was such that the measures could not prevent the overlending that took place in Thailand. The commercial banks tended to extend credit before raising capital funds, and a large number of them were not able to satisfy the prudential regulations.[1]

It was not until February 1994 that finance companies were subjected to the 25 per cent first-tier capital requirement on the overbought foreign exchange position and the 20 per cent requirement on the oversold position. Commercial banks were required to provide a minimum reserve of 50 per cent for questionable debts. This requirement was raised to 75 per cent in June 1994 and 100 per cent in December 1995. Commercial banks that operated BIBFs were required to provide reserves for questionable debts only in May 1995, suggesting that BIBF activities were given special treatment compared to local banking activities.

In April 1996, finance and securities companies were required to maintain liquidity reserves at 7 per cent of nonresident baht borrowing with maturity of less than one year, including promissory notes, the bill of exchange, and nonnegotiable certificates of deposit. The Bank of Thailand seems to have finally realized the danger of relying on short-term foreign capital, although there were very long recognition lags and decision lags in implementing policies to cope with capital inflows that were too large and too fast. In June 1996, the Bank stipulated that

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commercial banks and BIBFs must also maintain cash reserves of 7 per cent of total short-term borrowing and deposits from abroad. Thus, until then, commercial banks received a special cost advantage in tapping foreign funds – a fact that suggests a pro-foreign capital bias on the part of the monetary authorities.

In 1995, realizing that a high degree of capital mobility and sudden surges in capital flows may not be desirable, the Bank of Thailand imposed capital control measures to restrict short-term capital inflows, interrupting capital account liberalization. To prevent banks from extending loans that require foreign borrowing, a maximum credit-to-deposit ratio was introduced, and the ceiling on the loan growth rate was set at 24 per cent in 1995, which then was lowered to 21 per cent in 1996. Other measures included provisioning reserves for 'out-in' loans of BIBFs, increasing the cash reserve requirement from 2 to 7 per cent for nonresident baht accounts, and raising the minimum requirement of loans from a half million baht to 2 million baht. All of these measures were not prohibitive; they simply raised the cost of foreign borrowing.

In July 1996, the Bank of Thailand was still busy issuing guidelines for the application of second-round BIBF licenses. The urge to establish Bangkok as a financial center was so strong that the Bank of Thailand did not foresee any danger in inducing foreign capital inflows. Nevertheless, as a precautionary measure, the Bank issued Financial Institutions Development Fund bonds, which could be used as part of liquid assets of commercial banks in case some of the banks were short of liquidity and required a fresh injection of funds.

In October 1996, the first-tier capital fund-to-risk asset ratio (CAR) of commercial banks was raised from 5.5 to 6 per cent and the CAR for finance companies was raised from 7 to 7.5 per cent. The latter was again raised to 8 per cent in January 1998. Starting in January 1997, commercial banks were required to submit a monthly report on real estate credit for large projects with outstanding credits exceeding 100 million baht. At the same time, the Bank of Thailand announced the approval of three domestic groups to set up new domestic banks. Ironically, some of the new banks-to-be were finance companies that were closed down in 1998. By March 1997, while defending the baht the Bank of Thailand required finance companies to submit reports on bills-of-exchange transactions. Commercial banks were required to set aside at least 15 per cent of their capital funds for substandard loans. For finance companies the requirement was 20 per cent. In June 1997, a month before the float, the Bank of Thailand requested that commercial banks not sell baht in offshore markets to prevent speculative attacks on the baht. Measures such as these confirm our contention that rules and regulations were introduced too late to have been of any use in preventing the crisis.

The experience of Thailand supports the observation made by Johnson (1998) that in many developing countries, local financial institutions have limited capabilities for assessing and managing risks related to huge capital inflows. They need to first develop sound financial institutions, markets, and policy instruments before they can durably liberalize capital account transactions. Until then, it may be necessary to maintain some restrictions on capital account transactions while developing prudential standards and appropriate supervisory arrangements.

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In Thailand, once BIBFs' activities were in full swing the Bank of Thailand had lost its ability to control the money supply and, consequently, the burden of adjusting the money supply to capital surges fell on fiscal policy. Some part of capital inflows was absorbed by the public sector, contributing to a budget surplus that lasted for eight years preceding the crisis. The increase in public savings mitigated the rise in the monetary base but it reduced, at the same time, the amount of government bonds held by the Bank of Thailand. As a result, the Bank of Thailand could not carry out open market operation to the extent necessary to sterilize capital inflows. The Bank made some attempts to issue its own bonds but the amount issued was not significant enough to have much effect on liquidity.

The political economy of financial liberalization

In 1990, the Thailand Development Research Institute (TDRI), an independent think-tank, predicted that Thailand would repay all of its debt by 1992 and would graduate into a net creditor or a newly industrializing country like South Korea. It also predicted that the structure of capital inflows would be in the form of foreign direct and portfolio investment rather than foreign borrowing. Phaichitr Uathavikul, President of TDRI and former Finance Minister and executive officer of the World Bank, saw no obstacle to Thailand's becoming a net lender country, barring political interference that might create instability. According to Phaichitr, exchange control liberalization could fulfill Thailand's desire to become a commercial and financial center for the fast-growing region, and unrestricted access to the Thai market by foreign banks would bring about a competitive environment and advanced technology. Sanoh Unakul, former Governor of the Bank of Thailand, former Secretary General of the National Economic and Development Board, and chairman of TDRI in 1990, also argued that there was growing evidence of Thailand becoming the region's trade and financial center (*The Nation*, May 15, 1990).

When in 1990 the Bank of Thailand was holding talks on the strategy for liberalizing exchange controls with the IMF, the latter had been calling for the Thai government to liberalize exchange controls, arguing that the robust Thai economy would entail rapid exchange control liberalization. Chavalit Thanachanan, Governor of the Bank of Thailand, basically concurred, stating that exchange control liberalization would send a signal to the rest of the world that Thailand was ready to facilitate trade and financial flows and to join the club of sixty countries that had adopted exchange control liberalization. The US$12 billion level of international reserves was considered sufficiently large to relax foreign exchange control.[2]

In 1990, Prime Minister Chatichai Choonahavan argued for Thailand's compliance with the IMF rules of Article VIII by saying that Thailand was now financially mature and should thus meet the conditions under the Article. Pramual Sabhavasu, Finance Minister, also argued that the level of international reserves was sufficiently high since it covered five months of imports without any earnings from exports. According to Pramual, the announcement of the acceptance was a prelude to the upcoming 1991 IMF meeting of central bank governors in Bangkok (*The Nation*, 17 May, 1990).

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The global trend toward financial liberalization and the globalization of financial markets prompted Thailand to accelerate the development of financial institutions to serve the increasingly sophisticated needs of international trade and investment. As director of the Bank of Thailand's supervision and development department in 1995, Thirachai Phuvanatnaranubala argued that Bangkok had a future as a leading international banking center in the region, replacing Hong Kong and Singapore. As he saw it, Hong Kong would be returned to China in 1997 and Singapore would be disadvantaged with rising operating costs. He thus pushed the Bank of Thailand to promote BIBFs' 'out-in' business in the form of loan syndication because it would serve, he contended, as a stepping-stone for expansion into their 'out-out' business once Thailand overcame its shortage of human resources (*The Nation*, 29 May, 1995).

Loans extended by BIBFs grew substantially from 200 billion baht in 1993 to 1.2 trillion baht in 1997, and peaked in 1997 at 1.88 trillion baht. At the end of 1999, the amount declined to just 600 billion baht, as the local interest rate declined to its lowest level in decades, resulting in the disappearance of the financial advantages of foreign borrowing through BIBFs.

Wade (1998) blamed the IMF for its pressure on developing countries to open the capital account without an adequate framework of regulation. In the case of Thailand, the IMF was in fact a major influence behind the push for financial liberalization and there was a trace of the Washington Treasury complex (Bhagwati 1998). But also important for Thailand's drive for financial liberalization was the consensus among domestic players such as central bankers, commercial bankers, and independent think-tank economists, who walked in and out between the public domain of regulatory agencies and private financial institutions. For example, Tarrin Nimmanahaeminda, Finance Minister under the Chuan Administration in 1993 and an advocate of the idea of establishing Bangkok as a financial center for the region, was once the president of Siam Commercial bank.

This network of influential players shared the IMF's ethos of free market ideology. Furthermore, the IMF gave them indirect support by providing the standby loan agreement in case of capital outflows after exchange control liberalization and thus encouraged the perception that nothing could go wrong with an open capital account. It should be noted, however, that the IMF influence alone was not sufficient to push for complete financial liberalization. Had central bankers and bankers-turned-finance ministers not subscribed to financial liberalization, the pace and shape of liberalization in Thailand would have produced a different outcome. There was also an environment of 'irrational exuberance' that was inflated by large accumulated international reserves and an unrealistic dream of becoming a financial center in the region.

Since the Finance Ministry controlled the number of foreign banks in Thailand, foreign banks that wished to enter the Thai market had to seek a BIBF license for full services. Given that there were large economic rents from having the license (tax privileges and the possibility of illegally siphoning money to offshore branches in locations like the Cayman Islands), there was keen competition for the license among foreign banks. This competition took the form of demonstrating their willingness to enter the Thai market by showing an impressive lending volume and thus resulted

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in their excessive lending despite the low interest spread and high default risks. Thus it is not surprising that foreign banks' lending volume increased more rapidly than Thai banks.

Capital inflows and vunerability to economic crisis

Favorable events such as rapidly rising growth rates of exports and GDP generated the expectation of continued prosperity. Asset prices were bid up by the linear expectation of continued prosperity, and credit from financial institutions only added fuel to the bidding-up process to the extent that asset prices far exceeded their fundamental values. For instance, whereas in 1986 the share of bank credit allocated to real estate was only 3.8 per cent of total bank loans, it went up to 10.5 per cent in 1994 to decline slightly to 8.8 per cent in 1996 (Table 1.3).

Once psychological factors such as the herd instinct took over the sensibility of market participants, asset prices became highly overvalued. Greed and euphoria kept the level of 'paper profits' high. Capital control relaxation coincided with the boom in the real sector of the economy. Thus with the cheap funds they were able to obtain abroad financial institutions pumped credit and margin loans, fueling the bubble. What further weakened the financial fragility was that credit extension was concentrated in the nontrade sector. The open capital account also allowed large portfolio capital inflows from international investors who wished to diversify their portfolios, thus pushing up share prices further.[3]

Unlike foreign direct investment, which can be labeled 'cold money,' portfolio investment, other short-term loans, and nonresident baht deposits at Thai commercial banks are 'hot money.'[4] Realizing the high volatility of such money, the Bank of Thailand introduced certain measures to curtail its inflow in the second half of 1995. The measures adopted were, however, too lenient to preclude significantly the inflows of hot money, in particular, short-term borrowings by the nonbank private sector. Between 1995–96 and 1997–98 the share of portfolio investment in total private inflows nevertheless dropped from 14.7 per cent to 7.6 per cent while the share of nonresident baht decreased from 13.6 per cent to 13.2 per cent (Table 1.1).

The linear perception of market participants prevailed in the foreign exchange markets as well. To encourage the baht as a vehicle currency for regional trade and

Table 1.3 Lending structure of Thai commercial banks (percentage)

	1986	*1990*	*1994*	*1996*	*1998*
Manufacturing	22.8	25.1	24.2	27.1	30.7
Wholesale and retail trade	23.2	17.6	18.2	17.9	16.6
Real estate business	3.8	11.9	10.5	8.8	9.7
Personal consumption	8.8	10.6	12.7	12.6	11.3
Exports	1.8	1.1	0.9	0.8	3.3
Imports	4.1	2.0	1.5	1.8	3.7

Sources: Bank of Thailand (various years).

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investment transactions, the value of the baht was maintained in line with the US dollar. After the 1984 devaluation the Bank of Thailand employed a basket of currencies to set the baht–dollar exchange rate on a daily basis. The weight of the dollar in the basket gradually increased from 52 per cent in January 1985 to 79 per cent in 1992 but was reduced secretly when the dollar subsequently gained strength in the world market (Warr and Nidhiprabha 1996).

This system of a basket of currencies brought about stability in the baht–dollar exchange rate, which in turn led to the perception that devaluation was unlikely as long as the level of international reserves was growing.[5] Furthermore, both domestic and international investors underestimated the possibility of devaluation since they believed that devaluation would be too costly for Thailand because of its large high US dollar-denominated debts. This underestimation was evidenced in the small yield spread between debentures issued by Thai property firms in international markets and US treasury bills.

Currency and maturity mismatches are a common cause of financial institutions' vulnerability to crisis. As reported in Table 1.4, the maturity structure of sources of funds for Thai commercial banks and finance companies shared the common feature of relying on short-term borrowing. In December 1996, commercial banks had 89 per cent of their domestic borrowing in maturity of less than 12 months, 47 per cent of their foreign borrowing in short-term maturity and 16 per cent in deposits from nonresidents. A similar pattern was found for the finance companies as of February 1997.

This precarious borrowing structure – largely short-term – was a sign of a financial distress to come when foreign lenders changed their perception about Thailand's country risks (Nixon and Walters 1999). When unfavorable events took place, public confidence in the strength of the Thai economy began to dwindle,[6] and investors began to realize that asset prices had been overvalued. As a matter of fact,

Table 1.4 Maturity structure of borrowing (percentage share)

	Commercial banks (December 1996)	*Finance companies (February 1997)*
Domestic borrowing		
Saving deposits	22	–
Call	3	23
Less than 3 months	60	51
3 to less than 12 months	3	15
12 months	11	5
More than 12 months	1	6
Foreign borrowing		
Foreign borrowing		
Short-term	47	46
Long-term	37	53
Deposits from nonresidents	16	–

Sources: Bank of Thailand (various years).

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the stock market index in Thailand had been continuously declining since 1994 (Figure 1.6), way ahead of the collapse in real GDP in 1997, and the self-fulfilling prophecy would add to a sharp decline in the stock market as domestic investors overreacted to the declining prices.

During the bull market, foreign investors were leaders in the market with their net buying positions sending a buying signal to local investors. In contrast, during the bear market it was local investors who were the market leaders. They were the ones who lost confidence after the baht had hit its lowest level in January 1998, and it was they who initiated the large plunge in stock prices in 1998. Following domestic investors, panicky international investors also sold their shares and pushed down the stock index to its lowest level.

The boom and bust in the property sector in Thailand was closely related to the cyclical excess in bank lending. As Sachs *et al.* (1996) argue, lending booms and exchange rate overvaluation are some of the main culprits for financial crisis. The peak of the lending boom in real estate occurred between 1987 and 1990, when the growth rate of loan to the real estate sector rose faster than total credit expansion. As loans to this sector were monitored by the central bank, loans extended to the construction sector began to outpace total credit expansion. Lending to these sectors is likely to generate profit to banks and finance companies during boom years since their activities are pro-cyclical. The property-lending boom of finance companies continued even after the end of the boom years in the stock market in 1993, as if they expected that property prices would never collapse.

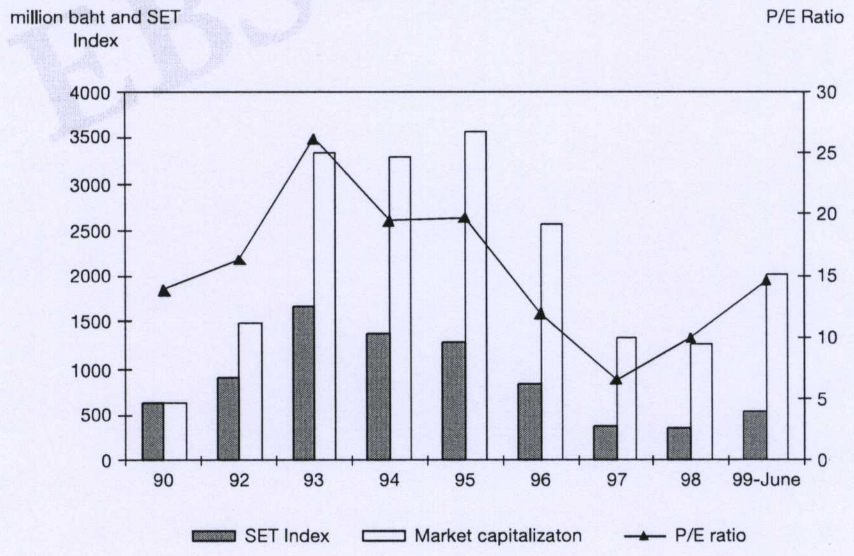

Figure 1.6 Asset price bubbles.

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Concluding remarks

The rapid growth of exports and GDP that lasted throughout the 1980s and the first half of the 1990s generated expectations of continued prosperity in Thailand. Investors, expecting a continued increase in land and share prices into the future, bid up asset prices, and credit from financial institutions fueled this bidding-up process with funds obtained abroad after capital control relaxation.

Currency and maturity mismatches became pronounced: In December 1996 commercial banks' long-term domestic sources of funds – twelve months or longer – were only 12 per cent and the remainder of the funds came from sources of shorter maturity and their foreign long-term borrowing was 37 per cent, the rest being short-term foreign borrowing and deposits of nonresidents. The structure of borrowing of finance companies was similar: Only 11 per cent of their domestic borrowing was of maturity of twelve months or longer, and their long-term foreign borrowing was 46 per cent.

This precarious borrowing structure foretold a financial distress that would come when foreign lenders changed their perception about Thailand's country risks. In 1996, Moody's Investors Service downgraded three top Thai commercial banks because of their large short-term foreign currency debt. This prompted a decline in public confidence in the strength of the Thai economy, and in a self-fulfilling prophecy there was a sharp decline in the stock market with the overreaction of domestic investors.

Financial liberalization in Thailand, in particular capital control relaxation, was premature, as it was undertaken before adequate prudential rules and regulations for financial institutions had been established. The desire to establish Bangkok as the region's financial center in the absence of such regulatory infrastructure has proved to be disastrous and costly. Thailand was not ready for such a center since there was no effective mechanism for dealing with excessive capital inflows induced by offshore borrowing units created by BIBFs.

In Thailand, the bond market was not sufficiently developed to provide facilities for the monetary authorities to perform the sterilization of capital inflows. Furthermore, the Bank of Thailand could not invest its foreign exchange reserves in world capital markets because of the Central Banking Act, which prohibited such investment. Furthermore, what made the situation worse in Thailand was that the exchange rate of the baht was tied closely to the US dollar.

Capital account liberalization in Thailand was ill timed. Capital control was relaxed when interest rates in Thailand were high in comparison with those in world markets. The inflow of foreign capital was expected to lower domestic interest rates, and the expectation of declining interest rates led to the shortening of debt maturity. An overheated economy ensued with rising inflationary pressure and a widening current account deficit. The crisis could have been, however, avoided if the capital account had been opened gradually so as to allow time to create preventive measures that could protect the real economy against mismanagement in the financial sector. Such measures would have included a capital adequacy ratio, provisions for substandard loans, reserve requirement for banks' foreign borrowings, and effective bankruptcy and foreclosure laws.

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If the motivation behind capital account opening was to promote economic growth by inducing foreign capital inflows, then Thailand could have achieved that objective by reducing capital impediments step by step without completely deregulating capital controls. As long as capital controls were of the kind that only affected the transaction cost (e.g. the bank's net foreign liability ratio) and did not prohibit capital inflows or impose quantitative limits, a large spread between domestic and foreign interest rates would have provided sufficient arbitrage incentives to capital flows. But by going for a big-bang liberalization instead the country risked a surge of unsustainable capital inflows especially when domestic interest rates were rising.

Premature liberalization of the capital account can increase vulnerability to crisis. Sequencing is important because liberalizing the capital account cannot be done without allowing market forces to determine the foreign exchange rate. Synchronization of the speed of liberalization must be made in the trade sector, money market, and foreign exchange market. Rapid relaxation of capital controls can lead to capital inflows that are too large and too fast, while the building of institutional infrastructure to cope with new problems is a slow, time-consuming process. Thailand's saga of capital account liberalization is a warning to be heeded seriously by advocates of capital convertibility.

Notes

1 Out of the total of fifteen Thai banks, three large banks were able to get capital injection from abroad while some foreign banks took over 75 per cent of the share of three small banks. Three medium-sized banks were nationalized while one was closed down.

2 The strength of the US dollar at 153 Japanese yen at that time also contributed to the ample amount of reserves for Thailand.

3 Large capital inflows can be observed at the peak of the bull market. The share of portfolio investment to total flows of net private capital rose from 1.9 per cent in 1991–94 to 15.6 per cent in two years prior to the crisis in 1997 (Table 1.1).

4 See Claessens, *et al.* (1995) for a discussion on the role of hot and cold money.

5 Thailand's international reserves averaged at $7.3 billion in 1985–90 and $28.5 billion in 1991–96, a period after capital control liberalization.

6 In 1996, Moody's Investors Service downgraded three top Thai commercial banks because of their large short-term foreign currency debts.

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