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The East Asian Miracle? Thailand Melts Down

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INTRODUCTION

On July 1, 1997, Thailand’s Prime Minister Chavalit Yongchaiyudh’s government was not yet a year old, and the economy was in turmoil. The baht had been under intense pressure from international speculators since February, and the banking system was wobbling under the weight of bad loans. Depositors, fearing a collapse of the country’s smaller financial institutions, had shifted their money to the top five banks who, in an attempt to reduce risk and to conserve capital, had repaid their international loans and were no longer lending to the business sector.[1] Moreover, the stock market, worried that many of the country’s property companies might be forced into bankruptcy, had declined by 45% since its peak in early 1996.[2]

Yongchaiyudh had insisted on defending the value of the baht as well as supporting the country’s financial institutions, many of whose owners had helped elect him to office. Now it appeared his economic policies had failed, and he had to chart a new course. Amnuay Viravan, the well respected Finance Minister, who had resigned in frustration on June 19th, probably would have insisted on a policy of continuing to defend the baht, but Thanong Bhidaya, his replacement, was not as certain of that policy.

THAILAND: AN ECONOMIC SUCCESS STORY

The Prime Minister was proud of what his country had achieved. During the 1970s, Thailand, a small country located in the center of the Southeast Asian peninsula, was an unqualified economic success story. Based on its ability to maintain high rates of saving and investment, Thailand was among the fastest growing and most successful developing countries in the world, experiencing average annual rates of growth in GDP of 7 percent or more every year. But, in the late 1970s and early 1980s, rising interest rates and oil prices led to an economic slump. Thailand’s annual GDP growth rate still remained higher than the average for middle-income countries, but its economic growth targets were not met.

Deciding that further economic growth depended on the ability of the Thai government to improve economic efficiency through development planning, the government switched from import substitution to export promotion. Thailand reduced non-tariff barriers, decreased the import surtax, and in November of 1984 devalued the currency to 25 baht per dollar. In addition, approval procedures for foreign investment projects were simplified and generous investment incentive packages were offered.

High levels of economic growth resumed. Between 1986 and 1996, the annual average rate of growth in Thailand’s gross national product (GNP) was 9.5 percent, while

GNP per capita rose by 7.9 percent.

In 1992, Thailand's central bank, the Bank of Thailand, introduced a comprehensive program of financial reforms that were designed to position Thailand as a future financial center in the region and encourage competition among the country's financial institutions. At that time, Thailand's banking system was comprised of commercial banks that handled the majority of all financial transactions in the country, and numerous finance and security companies that dealt with smaller borrowers.

The measures proposed by the Bank of Thailand included the liberalization of exchange rate controls, the removal of legal ceilings on banks' deposit and lending rates, and the improvement of prudential supervision according to international standards. In addition, the reforms began the process of developing Thailand's money and capital markets, and established the Bangkok International Banking Facilities.[3]

THAILAND: A CAUTIONARY TALE

The establishment of the Bangkok International Banking Facilities provided many of Thailand's larger firms with easy access to offshore currency markets. Businesses in Thailand found borrowing in these markets attractive because foreign interest rates, particularly U.S. rates, were lower than those in Thailand, and because Thailand's pegged exchange rate minimized currency risk. As a result, many Thai companies began to borrow dollars, convert the proceeds to baht, and invest in Thai assets. Thailand's banks and finance companies also borrowed large amounts abroad to lend at home to those smaller businesses that still did not have access to international capital markets. As a result, beginning in 1993 the amount of foreign capital, much of it short-term, flowing into Thailand began to increase steadily.

By the mid-1990s, the supply of foreign capital exceeded the country's high return investment opportunities, and a significant portion of the foreign funds started to flow into more speculative projects. Asset prices, especially stock market values, land values, and real estate prices rose rapidly.[4] Moreover, the foreign capital inflow put upward pressure on the exchange value of the baht, requiring the Bank of Thailand to intervene regularly to ensure that the baht traded in a narrow band between 25.2 to 25.6 baht to the U.S. dollar.

The policy of supporting the pegged exchange rate was pursued in order to maintain Thailand's competitive position in the region. Rising wages and other costs had already forced many of Thailand's low cost assembly businesses to move to countries with cheaper labor.[5] The recession in Japan had cut into demand for Thailand's products, and China, a rising competitor in the region, had devalued its currency in 1990, 1991, and again in 1994. The rising baht compounded these problems, particularly during the 1995 to 1997 period when the U.S. dollar gained 50 percent against the yen. Export growth slumped badly in 1996, and a large and growing current account imbalance emerged.[6]

THAILAND: A COUNTRY IN CRISIS

By the end of 1996, Thailand's external debt levels were rising. According to the Bank for International Settlements (BIS), foreign currency debt with a maturity of less than two years was equal to about 120 percent of Thailand's foreign exchange reserves.[7] In addition, Thailand's trade deficit was 8% of GDP. As investor concern about these figures rose, (some observers pointed to the fact that Mexico's trade deficit was 8 percent of GDP when its currency collapsed), the Thai government countered that neither circumstance presented Thailand with a serious long-term problem. External debts, it claimed, were not a threat because unlike Mexico they did not result from large public-sector imbalances or excessive consumption spending. Thailand's foreign borrowing was being used mainly to increase investment.[8] Furthermore, the government claimed, Thailand had successfully financed large current account deficits for several years, and its high growth and high savings economy suggested no compelling reason that this could not continue.[9]

Thai authorities pointed to the fact that savings were 35.3 percent of GDP, and that GDP growth, equal to 6.7 percent in 1996, had grown at a rate of 8.5 percent between 1990 and 1995. The government budget surplus equaled 1.5 percent of GDP, and the inflation rate was 5.8 percent. Moreover, the country's debt was rated A3,[10] and according to the Bank of Thailand, at the end of 1996 non-performing loans of the six largest commercial banks altogether accounted for only 6.98 percent of the total lending, a ratio that was not high by regional standards.[11]

Crisis in the Banking Industry

The banking crisis began on February 5, 1997, when Somprasong Land, a Thai property developer, announced that it had failed to make a scheduled $3.1 million interest payment on an $80 billion eurobond loan.[12] Thai banks tended to be particularly vulnerable to collapsing property values because they made loans against collateral, not cash flow, and that collateral often was speculative real estate. Figures released in December by the Bank of Thailand suggested that non-performing loans of all the country's commercial banks had only grown from 6.92 percent to 7.73 percent of the total in the first six months of 1996.[13] But, many observers believed that those figures were optimistic and that 10 percent or more of all commercial bank loans were probably bad. They based these opinions on the fact that loans secured against property were not classified as bad until interest payments were a full year in arrears,[14] as well as the fact that the property crisis was deepening. At the beginning of 1997, empty property was estimated to be approximately 350,000 units in Bangkok and 850,000 units nationwide with more construction underway.[15]

The problems in the country's finance companies were thought to be even more severe despite the central bank's assurances that the finance companies were in good condition.[16] [17]

The Government's Response

On March 3rd, the Bank of Thailand and the Ministry of Finance introduced new regulations designed "to prevent the problem of asset quality from casting doubts on financial institutions and to further strengthen the overall health of the financial sector."

These regulations required all financial institutions to make full provision against possible loan losses. In addition, financial institutions with insufficient liquidity were ordered to increase their capital immediately. Any institution that was unable to increase its capital by itself was encouraged to turn to the Financial Institutions Development Fund,[18] which would step in to purchase the increased shares.[19]

The Financial Institutions Development Fund (The Fund) was a separate legal entity managed by the Bank of Thailand. The Fund collected annual contributions from all financial institutions under the supervision of the Bank of Thailand at the ratio of 0.2% of deposits, and under certain circumstances, was allowed to borrow from the Bank of Thailand. The Fund also was permitted to lend money, take equities in certain institutions, and bail out troubled institutions by purchasing their non-performing assets.[20]

The introduction of new banking regulations was followed on March 10th by an announcement from the Thai government that it would buy $3.9 billion in bad property debt from its financial institutions.[21] To fund this buyout, the Cabinet approved the establishment of the Property Loan Management Organization (PLMO) to purchase property loans with collateral from financial institutions for the purpose of managing and enhancing their value. The PLMO was to be established with registered capital of 1 million baht to be appropriated from the government budget. Its working capital, up to 100,000 million baht, was to be raised through the sale of government-guaranteed bonds as approved by the Cabinet. The bonds were to be sold to general investors.[22]

The government argued that because the funds to finance the PLMO would come from market sources the measure was consistent with the government’s policy of maintaining strict fiscal and monetary discipline. Financial institutions’ non-performing loans would be reduced while the public that bought property units would be protected by the continuation of the projects. The authorities stated that they were “confident that this measure would positively strengthen the financial condition of the property sector while further strengthening the soundness of Thailand’s financial institutions.”[23]

Thailand’s support of its financial institutions was not universally acclaimed. A typical criticism was voiced by a German banker who noted that “The Thai mentality is that everything gets bailed out. It isn’t good for market discipline, and it isn’t good for the banking system. Market forces only work half way in Thailand.”[24]

Thai Finance Minister Amnuay Virawan defended the government’s policies by saying, “We don’t take things to extremes. We need to do things in between the Japanese and U.S. way.”[25] Michel Camdessus, the Managing Director of the International Monetary Fund (IMF), responded to Thailand’s measures by saying, “I don’t see any reason for this crisis to develop further.”[26]

On April 2nd, the Bank of Thailand took yet another step to stabilize the banking industry by endorsing the Thai Danu Bank and Finance One merger.[27] Finance One, Thailand’s largest finance company, had pioneered the practice of issuing eurobonds denominated in U.S. dollars and using the proceeds to finance lending to the country’s property developers. The strategy was profitable so long as property values continued to rise, but when the property market began to collapse in 1996, and developers could not repay their loans, Finance One’s non-performing loans quadrupled.[28] Estimates placed Finance One’s bad debt and investments at $600 million.[29]

The merger with Thai Danu was intended to save Finance One from failing and was seen as a precedent for future consolidations among other Thai financial institutions, which over time would result in a stronger and more efficient financial system. Consequently, the government was prepared to facilitate the process by encouraging the Finance Ministry to clear tax obstacles that might prevent the merger from proceeding. In addition, the Financial Institutions Development Fund was expected to provide liquidity assistance and the Property Loan Management Organization to assist with any non-performing property loans.[30]

Nevertheless on May 23, 1997, the Boards of Finance One and Thai Danu called off the merger because of legal problems and differing due diligence. The Bank of Thailand immediately ordered Finance One to make provisions for sufficient reserves to cover their losses and to increase its capital.[31]

Crisis in the Currency Market

Although both foreign and local investors had begun to withdraw funds from Thailand’s financial markets in 1996,[32] the currency crisis did not begin until February 14, 1997. At that time, many Thai borrowers began to hedge their currency exposure by entering forward contracts that obligated them to sell a specific amount of baht in the future in exchange for dollars at the current forward rate. In addition, currency speculators, believing the Bank of Thailand did not have sufficient reserves to defend the currency, began to short sell the baht, hoping to force a devaluation.[33]

In order to short sell the currency, the speculators borrowed baht from a financial institution and immediately resold those baht in the foreign exchange market for dollars. Counting on the value of the baht falling, the speculators expected to make a profit by spending fewer dollars to repay the financial institution than they received from the initial sale of the baht. If, however, the baht did not fall but rose, the speculators stood to lose substantial sums of money.

The Bank of Thailand responded to the attack by raising interest rates and instructing Thailand’s banks to limit the availability of the baht. The Bank spent an estimated $500 million of its $39 billion in reserves defending the currency, and was believed to have bought several billion dollars worth of baht in the forward markets as well.[34]

Faced with a shortage of baht, the speculators were forced to scramble for overseas baht in Singapore’s market in order to secure sufficient currency to meet their commitments. The value of the baht peaked at 22-23 baht per dollar.[35]

Despite the punishment inflicted on the speculators in February, by May

Thailand’s currency was again under attack. This time the attack was triggered by a comment made by a senior economic advisor who, following a month of rumors that the Bank of Thailand had lost tens of billions of dollars defending the baht,[36] suggested that devaluation might be necessary.[37]

The Bank of Thailand emphatically denied that any change in the exchange rate mechanism was being considered and reaffirmed the government’s commitment to maintain the stability of the baht.[38] [39] Nevertheless, rumors that Finance Minister Amnuay Viravan would soon be dismissed and exchange rate policies would be changed persisted.[40] The impression of confusion was “heightened by an emergency meeting on May 11, when the Prime Minister, Chavalit Yongchaiyudh, announced that he was going to take personal charge of the economy.”[41]

To counter the attack on the currency, Thailand engaged in a joint action with Singapore in the foreign exchange market on May 14th, spending nearly $7 billion defending the baht’s peg. The amount of reserves that the Bank committed at this time for future purchases of the baht was not disclosed, but rumors again put the figure in the billions.[42]

The Bank also imposed informal exchange controls by prohibiting onshore financial institutions from lending baht to the offshore market. This action effectively created a two-tier currency market, with one tier in Thailand and the other offshore, a situation that allowed offshore interest rates to soar. In fact, in the offshore market, where speculators faced a sudden and severe shortage of baht, interest rates rose to 400 percent.[43] “I think they are using the big stick approach,” said Wong Yit Fan, Chief Economist for Southeast Asia at Standard Chartered Bank in Singapore. “They want to hit speculators so very hard that they won’t think about speculating on the currency for another six months.”[44]

The fact that the central bank chose to quell the currency speculation by imposing exchange controls made it clear that the government was unwilling to increase domestic interest rates by enough to slow the capital outflow. In fact, on May 26th the Bank made the following statement as part of its Economic Outlook for 1997:

“Progressive improvement has been observed on the stability front, both as regard inflation and the current account balance which are expected to continue. Moreover, the Government has announced clear-cut measures to maintain fiscal discipline such as expenditure cutting from the 1997 budget and cautious budgeting for the 1998 budget, as well as measures to increase revenue to ensure a balanced budget for 1998.

Consequently, to achieve an appropriate policy mix between fiscal and monetary policy under present economic circumstances, the Bank of Thailand wishes to confirm that the Bank will closely monitor the situation and ensure sufficient liquidity in the system to finance normal economic and investment activities.”[45]

The refusal of the central bank’s authorities to tighten further was grounded in their belief that the tight monetary policy followed by the Bank of Thailand since 1995 to contain inflation and increases in the current account had worked as expected. But, the coincidental sharp slowdown of exports and capital inflows in 1996, together with problems in some of Thailand's financial institutions, had resulted in a rapid deceleration of investment and economic growth.[46] Higher interest rates would surely result in a recession or worse.

In addition, the central bank continued to blame many of their economic problems on external factors such as the press coverage of the crisis and the activities of currency speculators. "They blame the ills of the country, not on press freedom but on abuse of that freedom," said Chatchai Yenbamrung, a media adviser to Chavalit and editor of *Business Day*, a Bangkok based daily.[47] Mr. Amnuay Viravan, when asked about the crisis, claimed that Thailand was "facing a major threat from very greedy people."[48]

He was not alone in that sentiment. Many people in Thailand were furious that wealthy foreigners were trying to bankrupt the country for personal gain.[49] Thai authorities singled out George Soros, a well-known currency speculator, in particular, and in June it was reported that government authorities "gloated gleefully" over the losses its foreign exchange policies caused the speculators in May.[50]

THE THAI CRISIS: END GAME

The month of June opened with the Bank of Thailand disputing inaccurate reports and defending the government's policies. On June 1, the Bank categorically denied a report that it had proposed to the government that it should issue a special decree to force 30 finance companies to merge.[51] And, on June 11th, it derided a negative report about Thailand's growth rate published by Credit Lyonnais Securities Asia.

The Bank claimed that "Any forecast of a negative growth rate for Thailand this year is simply "**absurd"** and "**irresponsible,"** especially when the conclusion has been drawn from pure speculation and prejudice, without any due regard for proper macroeconomic analysis." The Bank insisted that the government's fiscal and monetary policies were working as expected, including the exchange controls imposed in May, and that any economic slowdown was a "**natural outcome**" after a decade of high growth.[52]

On June 19th, Thailand's Finance Minister, Mr. Amnuay Virawan, frustrated by his inability to convince the Cabinet to raise taxes to help close an impending budget deficit, resigned. The Thai stock market fell 2 percent on hearing the news.[53] The Prime Minister said that he would step in as acting Finance Minister, while ruling out a devaluation of the baht. "We will never devalue the baht," he said, and blamed the market for exaggerating the extent of Thailand's difficulties.[54] Nevertheless, some of the market's worries seemed to be "shared by the International Monetary Fund (IMF), whose director on June 17th urged Thailand to take strong measures 'as rapidly as possible.'"[55] Mr. Thanong Bhidaya, a man relatively unknown in Thai politics, was named Finance Minister on June 20th.

On June 27th, the central bank suspended the operations of 16 finance companies and ordered them to submit merger or consolidation plans.[56] This order was confirmed on June 29th, when the Bank reported that it would not suspend any more finance and securities companies. It also announced that the Minister of Finance and the Governor of the Bank of Thailand would make public statements on June 30, 1997 giving details of additional measures to ensure stability in the banking system, and that these plans would be submitted to the Cabinet for approval on July 1, 1997.[57]

The suspension of the finance companies came as a shock to many international bankers. Throughout the month of June, the Bank of Thailand had urged foreign bankers to continue lending to the finance companies, promising that they would be protected if any of those companies experienced problems. Furthermore, the list appeared arbitrary, and rumors swept Bangkok that it was meant to be far more comprehensive. "They shot themselves in the foot." declared the branch manager for one international bank. "If they had done it right, the list would have been far larger. But there was a lot of lobbying by politicians who had stakes in some of the finance companies to have their names eliminated."[58]

On June 30th, the Prime Minister appeared on television and assured the nation that there would be no devaluation of the baht, lest Thais "all become poor."[59] Nevertheless, on July 2nd, the government of Thailand made the following announcement:

NOTIFICATION OF THE MINISTRY OF FINANCE

Re: Change of Foreign Exchange System

By virtue of the power conferred upon him under section 8 Paragraph Three of the Currency Act, B.E. 2501, as amended by The Currency Act (No. 4), B.E. 2516,

The Minister of Finance, upon the recommendation of the Bank of Thailand, hereby issues this notification as follows:

The Notification of the Ministry of Finance dated 2 November B.E. 2527 Re: Change of Foreign Exchange System is hereby repealed.

1. The foreign exchange system shall be such that the value of the Baht is set by conditions in foreign exchange markets.
2. The Bank of Thailand shall engage in buying and selling of foreign currency for the purpose of maintaining the stability of the Baht under the system mentioned in 2.
3. The Bank of Thailand shall from time to time as deemed necessary, publish the exchange rates between the Baht and foreign currencies for use as a reference rate in conversion of foreign currencies into Baht.

Given on 2 nd July B.E. 2540
(signed) Thanong Bhidaya
Minister of Finance[60]

Following the announcement, the value of the baht fell 20 percent, igniting an economic crisis. Devaluation meant that the country's foreign currency debt, much of which was unhedged, had suddenly became considerably more costly to service. Given the long-lived stability of the baht, borrowers had expected the baht-dollar exchange to remain fixed. Now, with the baht being allowed to float, those borrowers had to pay significantly more in baht to service their foreign loans, causing some firms to close with many others facing imminent bankruptcy.[61] Prime Minister Chavalit Yongchaiyudh, after initially balking at the idea, sought help from the IMF.

The IMF extended a $10 billion loan to Thailand and helped Bangkok arrange up to $5 billion more from other sources, most of them Japanese banks. The money was to be used to boost Thailand's foreign-currency reserves and to help fund the current-account deficit. The prevailing sentiment was that the existence of the loan would be enough to stem the crisis. "The actual money is unimportant," said one government official, "Whether it was $5 billion or $50 billion would hardly make a difference. Once we accept IMF austerity measures and impose fiscal discipline, banks around the world would be willing to lend us what we need."[62]

For its part the government began to follow the IMF's advice. On Aug 5th, it suspended the operations of 42 finance companies, bringing the total number temporarily closed since June to 58. Bangkok also promised to abide by an austerity program that required the government to trim the budget by $3.1 billion, cut the current account deficit to 5 percent of GDP in 1997 and 3 percent in 1998, keep foreign reserves above $25 million, and raise taxes. They also agreed to speed up the privatization of state assets and to allow foreigners to own a majority state in the country's financial institutions.[63]

Thailand's neighbors welcomed the IMF bailout. Should Thailand implode, they would have had considerable difficulty convincing the world that their currencies and economies were not next in line. Many feared that Thailand's politicians would not have the political courage to tackle the country's property glut and banking crisis. "This is the bitter medicine Thailand needs," said U.S. based Ismail Dalla, a Thai-born Indian fund manager who once worked with the World Bank. "What the IMF is doing is forcing on Thailand the fiscal discipline it has always lacked."[64]

Exhibit 1
Thailand: Major Economic Indicators

	1990	1993	1994	1995	1996
Growth, Investment, Savings & Consumption:					
Annual % Growth in GDP[1]	11.75	8.34	8.79	9.24	6.41
GDP, constant prices, billion baht[2]	1,945	2,473	2,695	2,933	3,095
GDP, current prices, billion baht[2]	2,183	3,170	3,630	4,188	4,598
GDP per capita, current prices, baht[2]	39,104	54,650	61,840	70,520	76,634
GDP per capita, PPP, current $[1]	4,000	5,325	5,827	6,492	6,873
Gross Capital Formation, % of GDP[1]	41.1	40.0	40.3	42.1	41.8
Gross Domestic Savings, % of GDP[1]	33.8	35.8	35.4	35.4	35.5
Total Consumption, % of GDP[1]	66.4	63.9	63.7	63.8	64.7
Government Finance[2]					
Overall Budget Surplus/Deficit, million baht	105,505	59,713	97,368	126,247	43,303
Domestic Borrowing, net, million baht	-11,864	-44,347	-58,872	-30,574	-25,123
Foreign Borrowing, net, million baht	-39,217	-4,353	-17,426	-4,855	-3,665
Money and Banking					
Money & Quasi Money Growth, annual %[1]	26.68	18.38	12.86	17.01	12.57
Real Interest Rate, %[1]	10.25	11.84	9.42	n.a.	n.a.
Commercial Rate, %[2]	19.00	14.50	14.38	16.25	15.25
Deposit Interest Rate, %[2]	12.25	8.62	8.45	11.58	10.33
Inflation, Consumer Prices, annual %[1]	5.97	3.38	5.16	5.16	5.71
Foreign Sector					
Exports, goods & Services, annual % growth[1]	11.7	12.3	14.6	14.8	2.4
Exports as a % of GDP	34.1	38.0	38.9	41.8	39.3
Imports as a % of GDP	41.7	42.2	43.7	48.6	45.5
Merchandise Exports, million US$[2]	22,881	36,553	44,649	55,731	54,677
Merchandise Imports, US$[2]	-29,493	-40,606	-48,041	-63,360	-63,834
Direct Investment & other Long-Term Capital, million US$[2]	3,195	3,268	-622	4,887	7,390
Portfolio Investment & Other Short-Term Capital, million US$[2]	4,946	6,813	-1,089	5,795	7,111
Gross International Reserves, billion US$[1]	14.26	25.44	30.28	36.94	38.64
Official Exchange Rate, baht per $, average[1]	25.59	25.32	25.15	24.92	25.34
External Indebtedness, Total, million US$[2]	28,088	52,668	65,522	83,166	90,824
External Indebtedness, Long-term, million US$[2]	19,765	30,034	36,343	42,071	53,210
External Indebtedness, Short-term, million US$[2]	8,322	22,634	29,179	41,095	37,613

Sources: 1. World Bank, World Development Indicators, CD-ROM, 1998; 2. Asian Development Bank, http://internotes.asiandevbank.org/notes/tha/THAFIN.htm, and /THANACT.htm.

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