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Ijaz Nabi

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THE WORLD BANK

DIRECTIONS IN DEVELOPMENT

Back from the Brink

Thailand's Response to the 1997 Economic Crisis

IJAZ NABI
JAYASANKAR SHIVAKUMAR

22865
June 2001

FILE COPY

Back from the Brink

Thailand's Response to the 1997 Economic Crisis

This book is dedicated to the people of Thailand
for their efforts to strike a delicate balance
between the "Thai way" and
the forces of international competition.

DIRECTIONS IN DEVELOPMENT

Back from the Brink

Thailand's Response to the 1997 Economic Crisis

Ijaz Nabi
Jayasankar Shivakumar

THE WORLD BANK
WASHINGTON, D.C.

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Preface

The economic crisis of 1997 was a complex phenomenon. Although its epicenter was the financial sector, other corporations, small-scale manufacturers, wage earners, and vulnerable populations also felt shock waves. The worst of the crisis has passed, but much remains to be done to restore robust growth. This book narrates the key events of the crisis; describes the steps taken by the Thai government, other regional governments, and international financial institutions to limit crisis damage; and outlines the structural reforms that Thailand has carried out to avoid similar crises in the future. Our aim is to make essential information about the crisis available to those who influence policy, researchers, and general readers, leaving it to them to make their own judgments about the country's progress toward economic recovery.

—Ijaz Nabi, Lead Economist, and
Jayasankar Shivakumar, Country Director
The World Bank, Thailand Country Management Unit
January 8, 2001

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Our colleagues at the World Bank whose work we have drawn upon include Thomas Rose, Michael Markels, Jonathan Fiechter, Michel Cardona, Marina Moretti, Ejaz Ghani, Pedro Alba, Lars Sondergaard, Christopher Chamberlin, Nicholas Prescott, Jeffrey Hammer, Benu Bidani, Behdad Nowroozi, William Mako, Magdi Amin, Mohan Gopalan Gopal, Stefan Koeberle, Thomas Glaessner, Homi Kharas, Thang-Long Ton, Hedwig Abbey, Minna Hahn, and Melissa Fossberg.

Abbreviations and Acronyms

AMC	Asset Management Corporation
BIBF	Bangkok International Banking Facility
CDRAC	Corporate Debt Restructuring Advisory Committee
FIDF	Financial Institutions Development Fund
FRA	Financial Sector Restructuring Authority
GDP	Gross domestic product
IMF	International Monetary Fund
KTT	Krung Thai Thanakit
KTB	Krung Thai Bank

1

Fast-forward

From summer 1997 through summer 1999, Thailand's economy took a nosedive from which it is just starting to recover. This essay reviews that traumatic experience, describes the policy response, and draws lessons for the future.

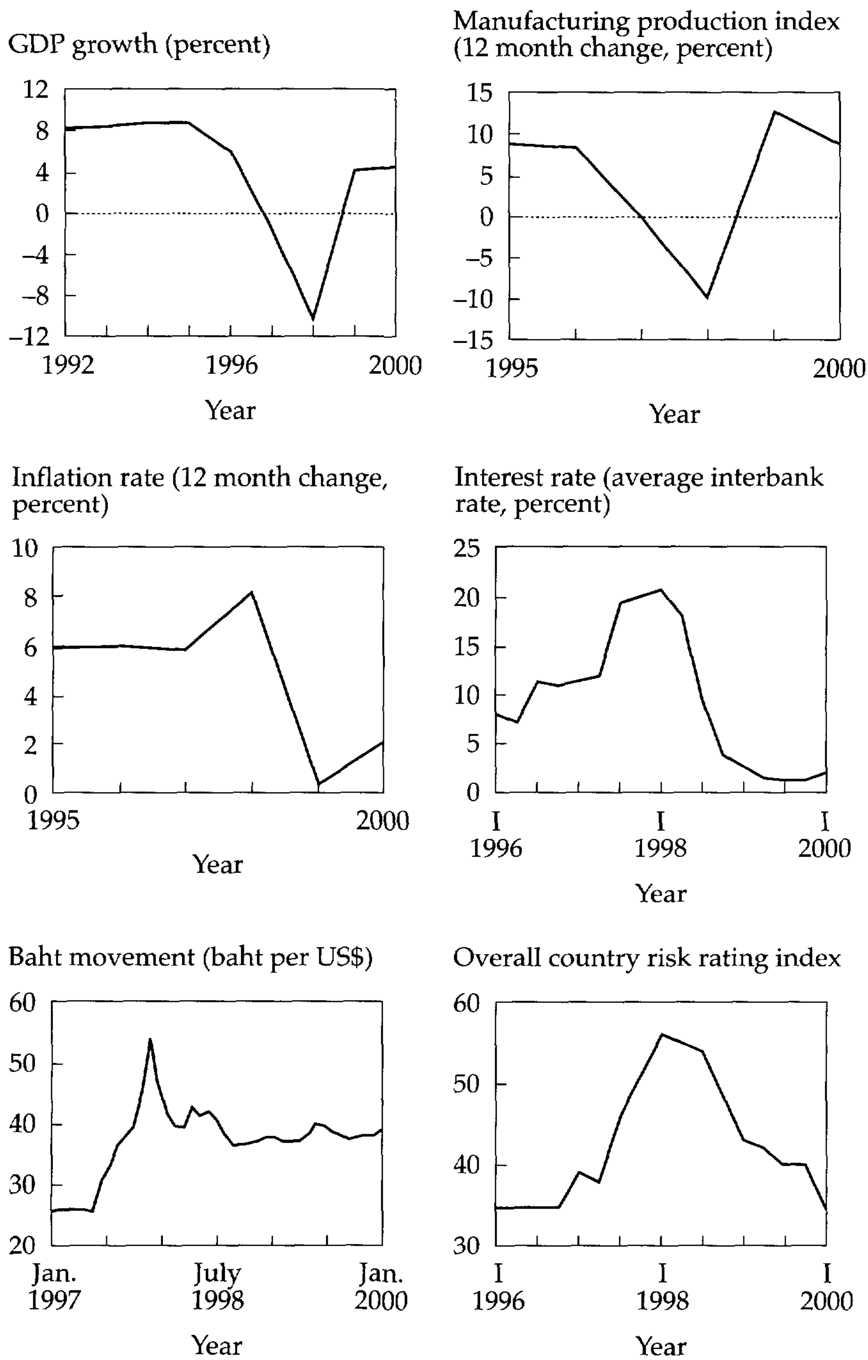
Until 1996, Thailand's economic performance was the envy of the developing world. The gross domestic product grew at consistently high rates, exports expanded rapidly, capital flowed in from abroad, and well paid employment opportunities abounded. Widespread optimism about the future was tempered only by so-called problems of success, such as the social costs of rapid urbanization, traffic congestion, and pollution.

The heady buzz of economic success turned into anxiety in the spring of 1997 as scandal and misconduct in the financial sector began to make headlines. That summer, anxiety gave way to panic as macroeconomic anchors became shaky and the economy began a steep plunge into recession. That plunge pulverized asset values and threatened to unleash large-scale unemployment.

Perhaps the darkest period was the spring of 1998. Despite a large cushion of reserves contracted from the international community, an International Monetary Fund (IMF) program to steady the nerves, and a new, more credible government in charge, all indicators of economic activity had plummeted. The macroeconomic and financial crises had spilled over into manufacturing, services, and trade. Riches to rags stories in newspapers and silent construction sites in downtown Bangkok threatened a long recession. When the contagion spread to the entire region the sense of gloom deepened. Little hope remained that a fresh wind would pick up the economy.

Over the next six months—until the fall of 1998—the definition of optimism changed in Thailand. To be an optimist was to predict that the economy had bottomed out. The rare predictions of positive growth were

Figure 1-1. The Crisis in Pictures



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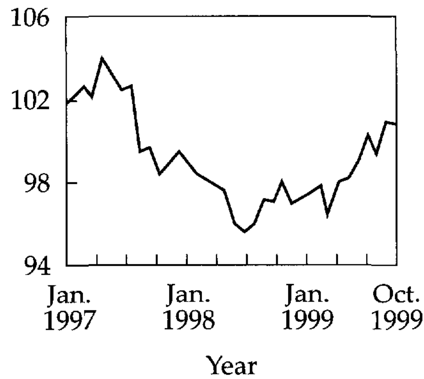
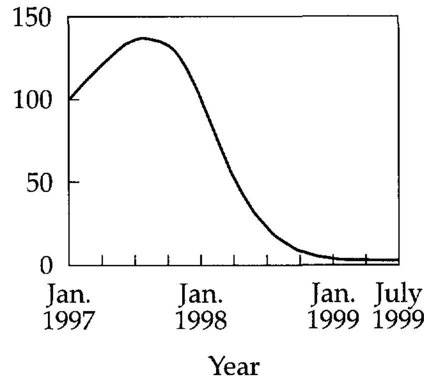
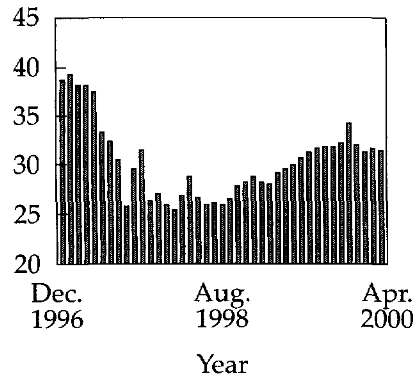
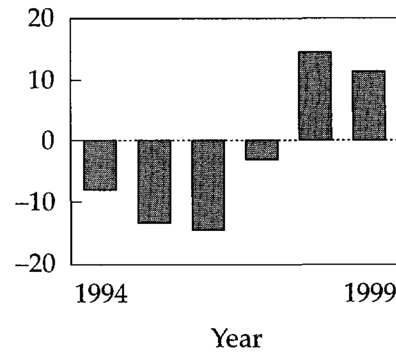
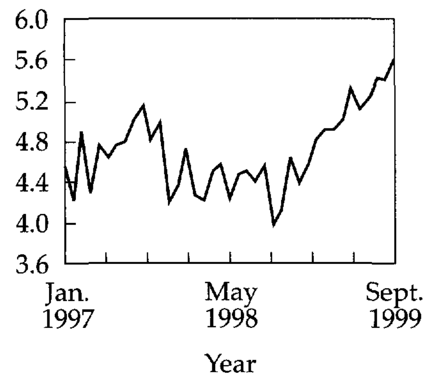
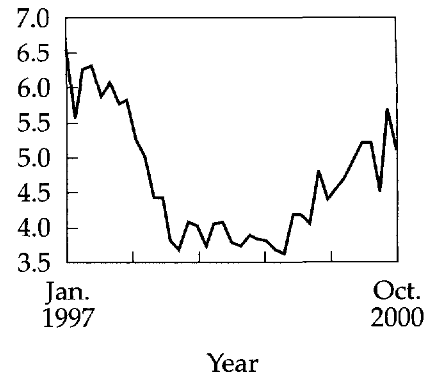












Source: Bank of Thailand, Economist Intelligence Report, IMF, and World Bank data.

greeted with gibes and challenges. The policy prescription of choice, even of free market advocates, was the "fiscal stimulus." The government—traditionally conservative in fiscal matters—was urging bureaucrats to spend, spend, spend to bolster domestic demand and make up for the anemic pace of exports.

In the spring of 1999 the first signs of a fragile, hesitant recovery appeared. Retail sales started to pick up as domestic consumption strengthened and capacity utilization began to increase. News trickled in that layoffs were not as great as originally feared. Some manufacturing and nonfinancial service corporations with a proven track record began to restructure debt and attract fresh capital. The stock market value of financial institutions began to revive following early successes with market-led capitalization.

By spring 2000 it was clear that although weaknesses persisted recovery was taking hold. Helped by the fiscal stimulus and the rise in exports as the region as a whole began to climb out of recession, aggregate demand firmed up, retail sales stabilized, and plant capacity came to be more fully utilized. However, the financial sector was still plagued by high nonperforming loans, and corporations outside the financial sector had yet to restructure their large debts. For these reasons, business confidence, although returning, was still fragile.

Was the economy's nosedive and subsequent recovery a straightforward, self-correcting business cycle? The myriad legislative, institutional, and regulatory initiatives that coincided with the recovery belie that view. The pace and depth of reform show that rapid export-led growth, although a central pillar of the strategy for welfare gains in Thailand and elsewhere, must be supported with changes in the way the private sector manages risks. A modern, streamlined public sector must ensure that private business is conducted in line with international standards and that vulnerable segments of society are not exposed to excessive risk associated with global changes.

This book narrates the run-up to the crisis, highlighting the tension and the controversy that surrounded structural reform in the eye of the storm. The ongoing legal, regulatory, and institutional reforms—all designed to ensure prudent decisionmaking by Thai bankers and corporations—are described. The book concludes with an outline of the steps needed to complete the reform program in a way that will consolidate the fragile economic recovery and allow it to flower into sustained growth. The economic history of the crisis is highlighted in figure 1-1, which shows the movements of selected key indicators of the economy during this volatile period.

2

Warning Signs

For many years leading up to the crisis, Thailand's traditionally high domestic savings were converted steadily into productive investments. New businesses emerged, anchored in the savings habit and using well understood production processes to serve familiar market segments. The phenomenal export growth of the 1970s and the 1980s showed that Thai businesses had successfully penetrated international markets that offered plenty of room for growth. High profits, rapid growth in gross domestic product (GDP), and low production costs soon attracted foreign capital. The annual inflow of foreign direct investment, which had hovered at US$100 million to US$400 million for 15 years, shot up to more than US$2 billion annually after the end of the last recession in 1987.

During the capital rush it was hard to convince people who had a stake in Thailand's miracle that trouble lurked around the corner. After all, 20 years of rapid growth had transformed Thailand into a middle-income country. Income per capita had increased to US$2,740 in 1997 from US$720 in 1980, and most people were living more comfortably. Energy use per capita was five times higher in 1997 than in 1977, life expectancy had risen from 63 to 72, and twice as many Thais had televisions and radios.

The stock market was booming as the construction sector erected glass towers in the congested streets of Bangkok. A large and flourishing financial sector stood ready to lend to investors, even those with the wildest moneymaking schemes.

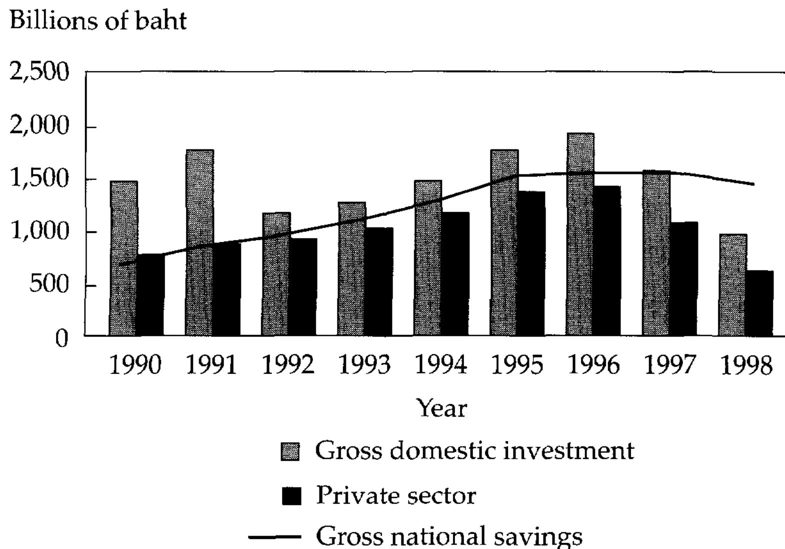
If acute observers of the economy had waved any caution flags, they probably would have been ignored. The following statements are just some of the things they might have said.

Too much foreign-denominated debt makes Thailand vulnerable to a loss of confidence...

The investment climate moved to a higher level after the relaxation of capital controls in 1990. By 1996, investment had reached 42 percent of GDP, far exceeding the already high domestic savings rate of 34 percent (figures 2-1 and 2-2). The difference in domestic savings and the demand for investment was made up by foreign capital that entered the country in ways that were increasingly difficult to monitor. Once in, capital flowed unchecked and unregulated into increasingly unproductive investments. With yearly GDP growth averaging 8 percent, the ballooning of investments meant that the efficiency of new investments had to decline.

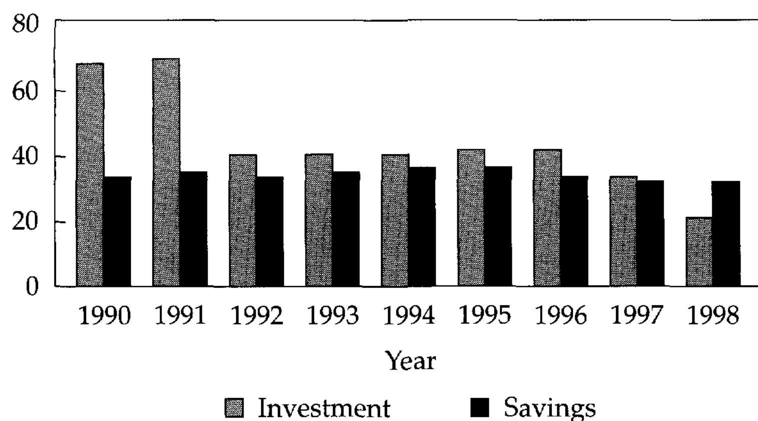
One of the new forms of capital—portfolio investments—was especially worrisome. The significance of the new instruments can be gauged from movements in the ratio of external reserves to portfolio flows (figures 2-3 and 2-4). In 1993 that ratio stood at about 4:1 (with reserves at US$25 billion), but on the eve of the crisis it had fallen to less than 2:1 (with reserves at around US$27 billion). The fact that Thailand's foreign exchange rate was fixed made reliance on portfolio investments particularly dangerous. Any loss of confidence that caused a rapid outflow of the new footloose capital would affect reserves and eventually currency value, causing debts denominated in foreign currencies to soar.

Figure 2-1. Investment and Savings



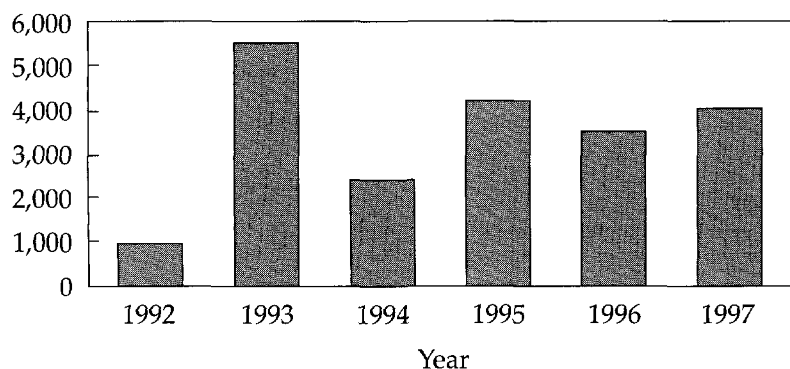
Source: Bank of Thailand data.

Figure 2-2. Investment and Savings as Share of GDP



Source: Bank of Thailand data.

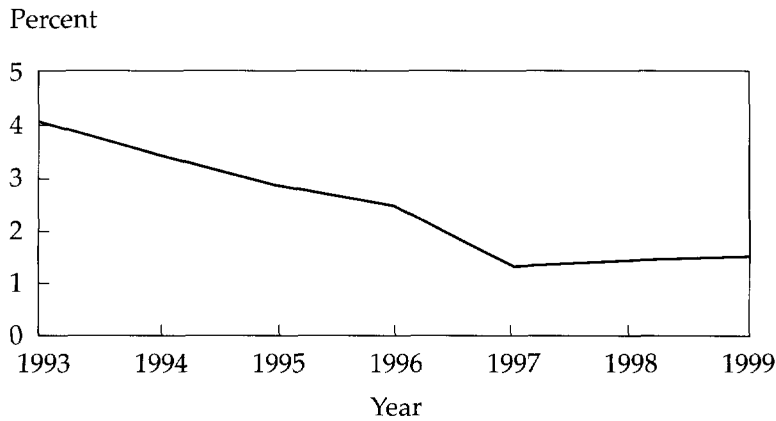
Figure 2-3. Portfolio Investment



Source: Bank of Thailand data.

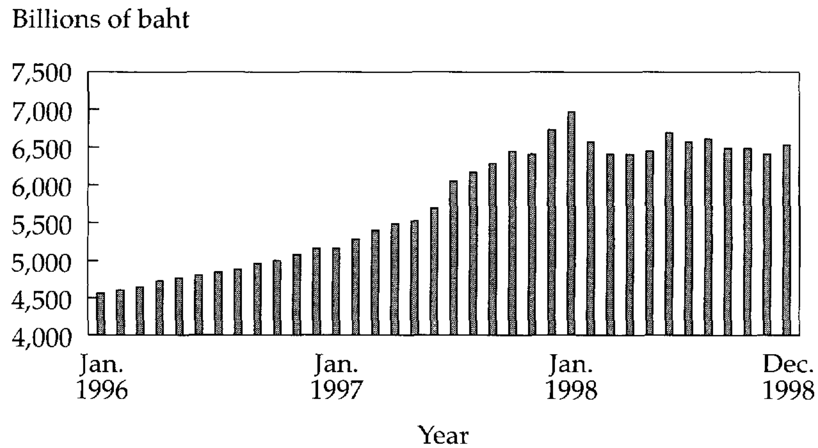
Public policy contributed to the new capital rush in many ways (figure 2-5). Perhaps the most significant was the creation of the Bangkok International Banking Facility (BIBF), the purpose of which was to facilitate access to foreign credit and thus compensate for the underdeveloped domestic equity market (figure 2-6). This facility enabled Thai investors to borrow in foreign currency at rates lower than the domestic

Figure 2-4. Ratio of Reserves to Portfolio Investment



Source: Bank of Thailand data.

Figure 2-5. Domestic Credits



Source: Bank of Thailand data.

interest rate.[1] The alternative of raising equity to finance investment would have required better standards of disclosure and corporate governance than prevailed at the time. BIBF fueled the appetite of Thai investors for bank borrowing. By the end of 1997 outstanding bank credit

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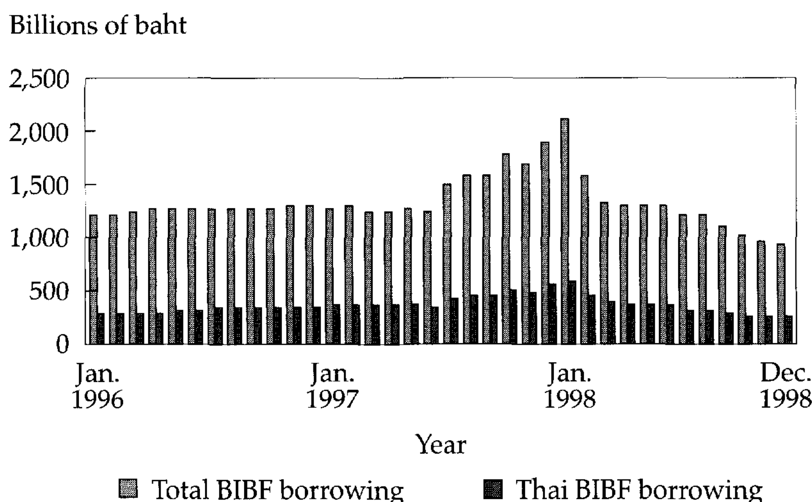
1. High domestic interest rates were the result of the Bank of Thailand pursuing a tight monetary policy to keep inflation in check. Over time, however, enough capital would

Figure 2-6. BIBF Borrowing



Source: Bank of Thailand data.

to the nonfinancial private sector totaled 5.5 trillion baht, of which 1.3 trillion—equivalent to 18 percent of Thailand's GDP—was denominated in foreign currency.

International competitiveness is declining...

By 1996 Thailand's labor-intensive manufactured goods, which constituted the bulk of exports, had lost their competitive edge. Several factors were responsible.

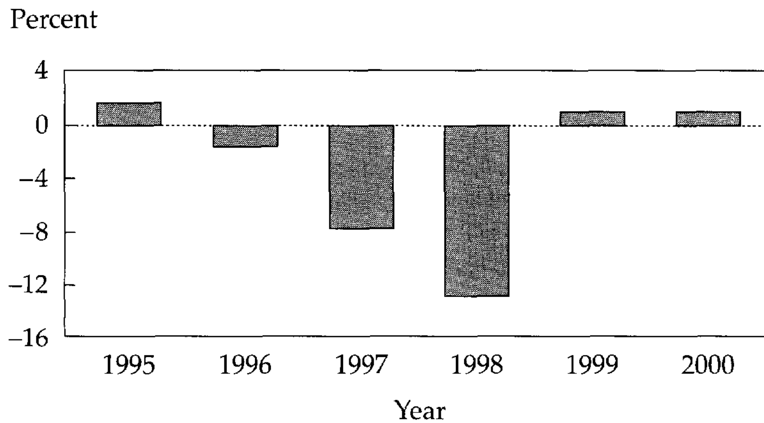
First, a rapid increase in real wages had raised unit labor costs. Between 1982 and 1990, the index of real wages increased moderately at an annual average rate of 2 percent. Over the next four years, however, the annual average increase was more than 9 percent. Labor productivity, meanwhile, had stagnated (figure 2-7).

Rising unit labor costs hurt most when the export market is stagnant. Japan, Asia's growth engine and a regular customer for Thailand's exports, was running out of steam, and by the mid-1990s its sluggish economy was no longer producing sufficient demand for the products of its Asian

---

have come into Thailand to remove the interest rate differential. To continue to meet its inflation target, the Bank of Thailand then tried to mop up liquidity (the so-called sterilization policy), but this was only partially successful. Thus, the interest rate differential persisted, and Thailand continued to attract capital until the fixed exchange rate system became untenable.

Figure 2-7. Thai Total Factor Productivity Growth Rate

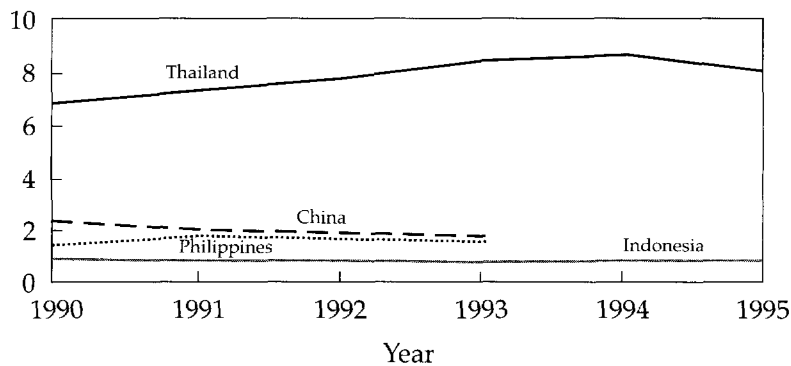


Source: Tinakorn and Sussangkarn (1998).

trading partners. Thai exporters had a hard time selling their higher-cost products in a depressed market (figure 2-8).

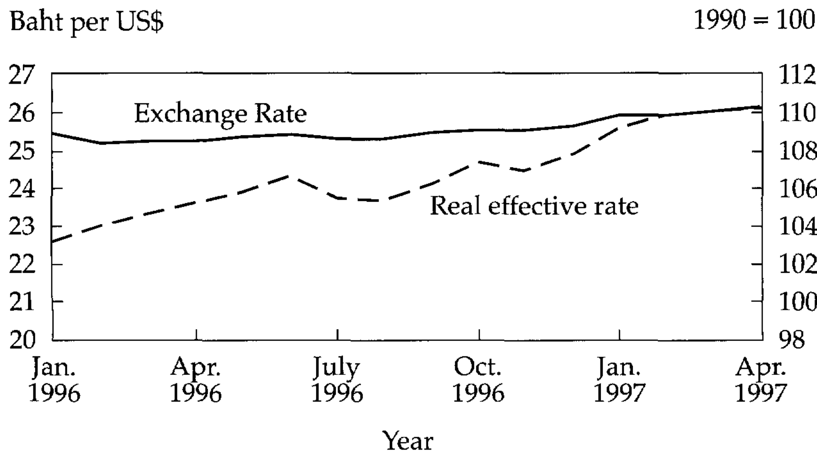
To compound matters, China—Thailand's principal competitor in labor-intensive exports—staked out a large claim in the moribund export market by devaluing its currency in the early 1990s. Thailand, by contrast, remained yoked to a fixed nominal exchange rate throughout the 1990s while the real exchange rate rose substantially (figure 2-9). Between 1990 and April 1997 the real exchange rate appreciated by 10 percent. The bulk of the appreciation occurred well before the Japanese depreciation against the U.S. dollar that began in 1995.

Figure 2-8. Unit Labor Cost Index for Selected Asian Countries



Source: Tinakorn and Sussangkarn (1998).

Figure 2-9. Exchange Rate and Real Effective Rate Follow the Performance of the Economy



Source: IMF data.

Market discipline is weak...

With the large amounts of capital that flowed into Thailand after 1990 the size and number of private transactions expanded rapidly, but the regulations and monitoring mechanisms needed for prudent risktaking did not keep pace with the changes.

An early casualty was due diligence by domestic and foreign lenders. Large loans were being made to firms, and even individuals, on the basis of family connections and reputations made during the boom years, rather than on an appropriate assessment of risk. That approach might have worked when loan demand was restricted to a few well known entities that had specialized in their lines of business for many years. By the mid-1990s, however, the number of loan applicants had grown substantially, and borrowers were seeking to establish themselves in new and risky activities.

Market discipline requires that information on corporations meet acceptable standards, that minority shareholders have the means of holding senior managers accountable, and that those who violate the standards be held accountable. As evidenced in the financial and corporate scandals that unfolded after 1996, corporate governance and regulatory oversight fell short on all of these criteria.

The Bank of Thailand, once considered a pillar of strength, no longer deserved its old reputation as a monitor of the economy and enforcer of financial discipline. The regulations and supervision practices the bank followed to ensure the soundness and safety of the financial sector had

not kept pace with the rapid growth of financial institutions. The bank's staff was poorly trained and stretched thin.

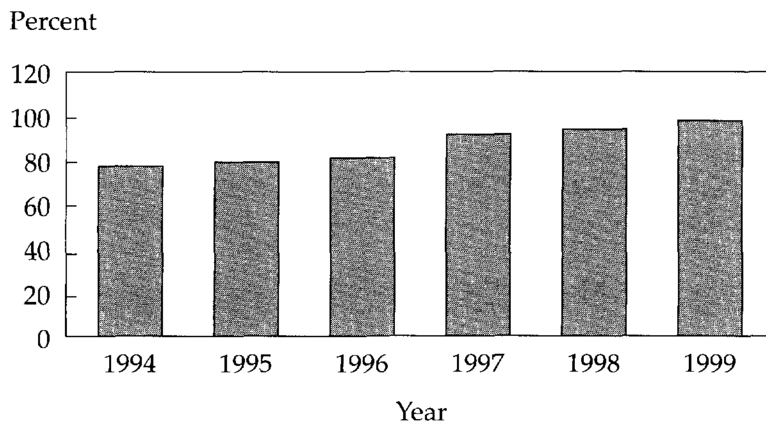
A legal regime that maintains a balance between lender and borrower interests in bankruptcy and secured lending helps to encourage prudent investment decisions. Lenders must not unduly harass borrowers in times of systemic distress, and borrowers must know that willful default will have consequences. On the eve of the crisis, Thailand's legal regime was stacked in favor of borrowers, an imbalance that encouraged the strategic defaults that would cause much harm when the crisis finally broke out.

The financial sector is accumulating excessive risk...

One measure of the size of the capital pool is the ratio of so-called broad money to GDP (figure 2-10). Between 1986 and 1996, that ratio increased from 59 to 74 percent. The economy had become highly monetized, and the financial sector had become disproportionately deep, given Thailand's level of income.

The Bank of Thailand's weak regulations and poor supervision allowed financial institutions, especially the finance companies, to take on excessive risk. Balance sheets began to show four types of problems. First, assets grew too rapidly. From 1990 to 1996 the assets of finance companies grew 12-fold. Bank assets increased seven-fold in the same period, while real GDP only doubled. Second, funds were misallocated, most notably to finance speculative investments in real estate, which accounted for 25 percent of lending (figure 2-11). Third, risk became excessively concentrated. Finally, the finance companies were borrowing on short

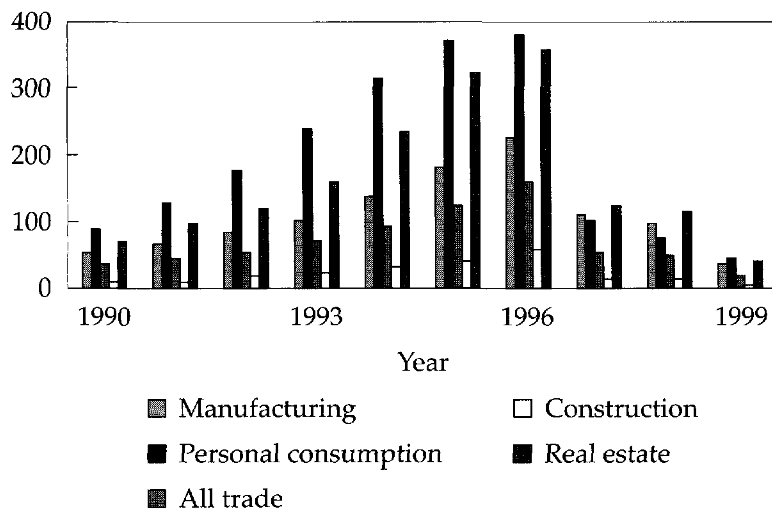
Figure 2-10. Ratio of Broad Money to GDP



Source: Bank of Thailand data.

Figure 2-11. Finance Company Loans by Purpose

Billions of baht



Source: Bank of Thailand data.

terms and lending on long. More than 35 percent of finance company loans were long term (often five- to seven-year real estate loans), whereas less than 5 percent of their total borrowing was long term.

The transformation of real estate development in the years leading up to the crisis provides an instructive example of the financial sector's overextension and imprudence. At the end of 1997 real estate-related wealth in Bangkok stood at 2.2 trillion baht, equivalent to about 45 percent of GDP and greater than the total capitalization of the country's stock exchange (1.1 trillion baht). At the height of the recession in 1998, the number of new vacant housing units stood at 350,000, a vacancy rate of 28 percent. The office market mirrored the residential market. Total office space quadrupled to 6 million square meters between 1991 and 1997. About 900,000 square meters were added to the stock each year during the period 1992–95.

The nonfinancial sector is mired in debt...

As noted earlier, Thailand's corporate sector went on a borrowing binge during the years of rapid credit expansion. Dazzled by the rapid productivity growth of the 1980s and early 1990s, corporations invested in risky ventures with inflated project costs and optimistic revenue projections. In many sectors, growth in assets outstripped sales and profit growth, although nowhere did this take place as dramatically as it did in the financial

sector. Assets in the property sector grew by 115 percent during 1993–96 as profits declined by 69 percent. Similarly, in the paper and pulp sector, assets expanded by 126 percent during the period, but profits turned into losses. As a result of the rapid buildup of assets, Thailand had one of the highest ratios of capital to output among the middle-income countries.

Despite increased activity on the stock exchange during the 1990s prior to the onset of the crisis, much of the investment was financed through debt denominated in baht and foreign currencies. The debt to equity ratios for nonfinancial firms listed on the stock exchange increased substantially in many sectors and their ability to service debt declined as seen in the falling ratio of earnings to interest expenses (table 2-1). The average debt to equity ratio increased from 145 percent at the end of 1994 to 279 percent in September 1997.

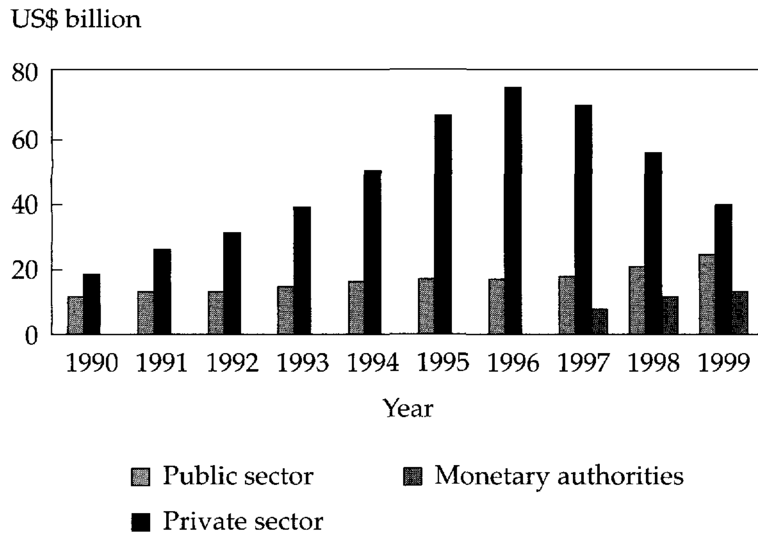
Table 2-1. Financial Health of Companies Listed on the Stock Market, 1999–96
(percent)

	EBITDA[a] to interest expense				*Liability to equity*			
Sector	*1999*	*1998*	*1997*	*1996*	*1999*	*1998*	*1997*	*1996*
Agribusiness	4.51	2.67	2.24	2.94	1.25	1.51	2.68	1.72
Building	1.37	0.89	0.56	3.01	3.72	3.14	5.14	2.78
Chemicals	0.89	1.37	0.92	3.53	3.89	2.08	5.49	1.74
Commerce	3.54	1.54	1.97	5.78	1.52	1.49	2.58	1.38
Communications	2.04	1.60	1.03	3.52	5.08	4.43	9.22	1.99
Electric production	0.77	0.11	1.03	2.74	42.89	n.a.	8.38	2.41
Electronics	12.29	3.71	6.54	7.45	0.68	0.90	1.30	1.27
Energy	4.27	3.33	2.91	3.28	2.05	1.78	2.80	1.52
Entertainment	1.98	(4.87)	9.30	18.20	0.74	0.49	0.54	0.29
Food	10.58	3.64	2.29	4.49	1.01	1.10	1.71	1.39
Health	0.72	0.33	1.01	3.55	14.76	5.14	4.92	1.42
Hotel	2.42	2.82	1.68	5.37	1.12	1.06	1.14	0.91
Household	(0.97)	0.93	1.09	3.08	77.43	3.76	3.44	1.73
Packaging	2.70	1.11	2.07	4.58	4.75	2.84	3.24	1.52
Pharmaceutical	7.22	2.16	1.73	4.41	0.45	0.48	0.76	0.64
Printing	4.08	1.53	2.18	5.04	0.96	0.29	1.52	0.89
Property	0.50	(0.40)	0.36	3.73	10.43	3.52	3.17	1.88
Pulp and paper	2.57	1.94	1.51	1.11	2.02	1.81	3.13	2.79
Textiles	1.47	1.15	1.72	1.86	2.96	2.04	3.33	1.70
Transportation	2.59	6.08	8.09	3.77	6.32	7.36	14.71	2.77
Vehicles	3.58	1.94	2.89	5.75	1.82	1.98	4.64	1.78
Miscellaneous	0.66	(2.36)	(0.07)	1.79	(8.04)	(24.19)	27.39	1.44
Total	1.69	1.25	1.66	3.42	3.58	3.16	4.34	1.93

n.a. Not available.
a. EBITDA: Earnings before interest, tax payments, depreciation, and amortization.
Source: World Bank (2000a).

A large share of the corporate sector's debt was denominated in foreign exchange—about US$49 billion at the end of 1997—equivalent to 33 percent of GDP, most of it unhedged. Almost 75 percent of the external debt was held in the form of loans, and 42 percent was in the form of loans originated in Japan. The debt was concentrated among large corporations, multinational companies, and joint ventures in manufacturing (particularly automotive and energy), real estate, and telecommunications. Figure 2-12 provides some insights into Thailand's external debt.

Figure 2-12. Thailand Debt Indicators



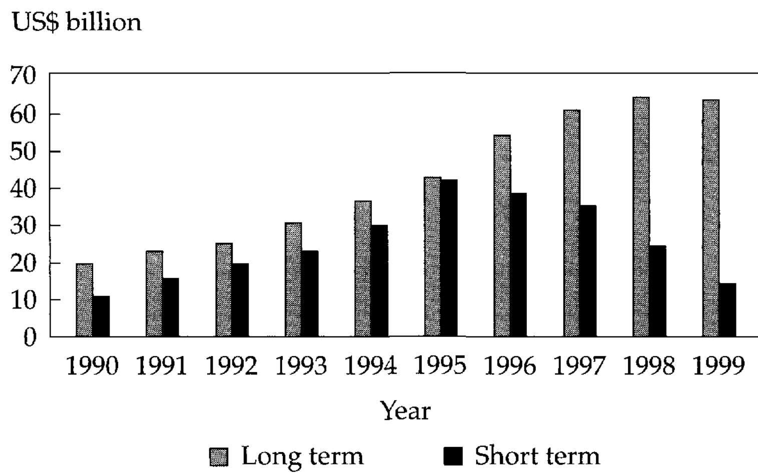


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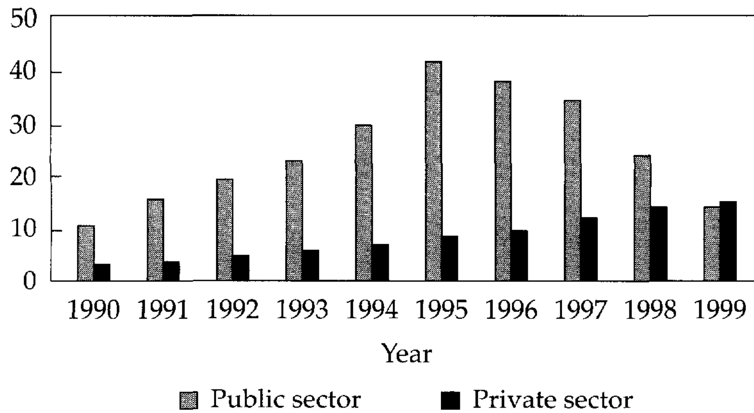
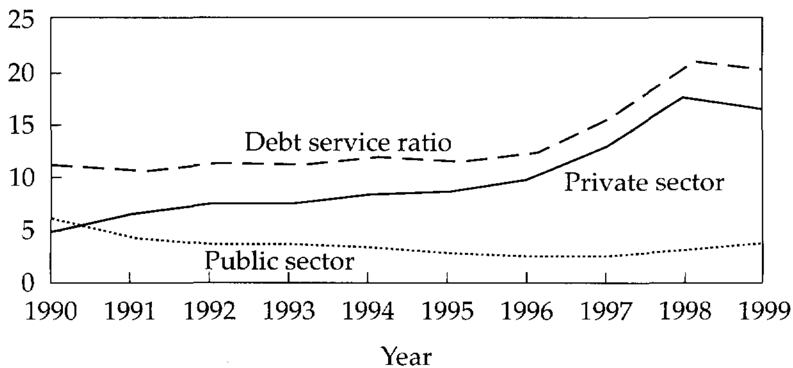
Figure 2-12 continued





Source: Bank of Thailand data.

The macroeconomic framework allowed vulnerabilities to fester until they grew too big and began to dictate the policy agenda that finally led to the crisis. Thailand's fixed exchange rate regime, designed to remove short-term uncertainty in transactions, had allowed inefficient investments to be masked. In the months leading up to the crisis, the market had sent signals that the fixed exchange rate and rapidly rising vulnerabilities could no longer coexist. Policymakers feared, however, that corporate liabilities were so large that any adjustment in the exchange rate would cause substantial damage to balance sheets. The value of the baht was declared sacrosanct and external reserves, accumulated over years of hard work, were

used as ammunition to defend the baht against several speculative onslaughts in the first half of 1997.

This proved suicidal in view of deteriorating market sentiments. Within a matter of days, the reserves were whittled down to dangerously low levels. The worst was yet to come. The forwards and swaps positions[2] taken by the Bank of Thailand to defend the baht would mature in the coming months, and foreign reserves were insufficient to honor those obligations. The stage was set for a full-blown crisis of confidence.

2. These amounted to the Bank of Thailand pledging to redeem the baht in the future at a fixed value that proved to be excessively high.

3

Crisis Countdown

A year before the onset of the crisis, newspaper headlines began to tell the story of the coming disaster. The run-up claimed four finance ministers, three central bank governors, and two prime ministers. Far from averting the crisis, the political changes resulted in piecemeal decisionmaking and left the country with an incoherent strategy for dealing with its problems and sent a poor signal to an increasingly nervous market. The following is a blow by blow account of the run-up to the crisis.

1996

May

May 10. Bangkok Bank of Commerce collapses with a negative net worth of 6.43 billion baht (US$260 million). A run on the bank results in claims of 8 billion baht. The Bank of Thailand takes over the failed bank. Waves of public criticism assail the Bank of Thailand. Shock waves run through the banking sector.

June

Exports drop by a record 11.9 percent; imports decline by 4.7 percent for the first time in more than three years.

July

July 1. Academics criticize the government's economic policy.

July 2. The Bank of Thailand's governor resigns. Rerngchai Marakanond, former deputy governor, is appointed governor.

July 6. Banks record the lowest profit growth in a decade.

July 10. The property sector reports the worst slump ever.

August

August 1. Rescue fund of 20 billion baht launched to shore up the stock exchange and restore confidence.

August 1–12. US$1 billion spent to defend the baht in regional swap markets and through domestic bond repurchase market. The Bank of Thailand rules out devaluation.

August 20. Closure of two U.S.-based offices of the Bangkok Metropolitan Bank for falsifying records and blocking inquiry.

The private investment index drops to 8 percent.

September

September 5. Widening public and parliamentary concern about the direction of the government's economic management.

September 10. Moody's downgrades Thailand's short-term debt rating. The IMF warns of the instability of short-term loans.

September 23. Embattled prime minister Banharn resigns under intense pressure. The King dissolves parliament and early elections are called.

Foreign investment approvals fall by 15.9 percent from September 1995 levels.

October

October 12. Minister of Finance Bodi Chunnananda resigns over a disagreement on public spending policy, succeeded by Chaiyawat Wibulswadi.

October 15. Prime minister rejects the Federation of Thai Industries' four-point plan, which required government commitment to restructuring industry. Prime minister offers export-promotion package instead.

November

November 17. General election held; new government is headed by Premier Chavalit Yongchaiyudh of the New Aspiration Party; Amnuay Virawan (Nam Thai Party) takes over the Ministry of Finance, slashes US$2 billion from current budget.

Major macroeconomic indicators deteriorate further: stock exchange index declines by 23 percent; imports drop further to 13.1 percent this month

(–6.4 percent in October); manufacturing output slows to a 4.1 percent annual rate from 10.5 percent in October.

December

December 13. More than half of the 500 companies on the stock exchange report declining earnings; new project announcements are at their lowest levels in three years.

The baht comes under attack again; the Bank of Thailand fends off pressures without serious damage to foreign reserves and again rules out devaluation.

Growth in bank credit and money supply drops. The annual rate of loan growth is 13.7 percent.

Growth in private consumption falls to 6.2 percent for 1996, compared with an average rate of 9.1 percent in 1988–95.

1997

January

January 15. Import slowdown grows more pronounced, undergoing 30 percent and 28 percent drops in November and December 1996; government begins review of import policies.

Private investment index falls by 7.3 percent to about half its level in January 1996.

February

February 1–7. Speculative attacks on the baht are renewed; interbank rates increase further; liquidity tightens.

February 13. The Bank of Thailand states that no financial institutions under its jurisdiction face liquidity problems.

February 14. Moody's undertakes a review of Thailand's long-term debt rating and that of five leading financial institutions and announces the possibility of a review of longer-term sovereign debt.

February 19. The Bank of Thailand firmly rules out devaluation.

March

March 2. The largest financial company, Finance One, merges with the 12th largest commercial bank, Thai Danu Bank, to overcome a sharp liquidity crunch.

March 3. The Ministry of Finance and the Bank of Thailand announce a package of measures to shore up banks and finance companies. Measures include higher provisions for substandard loans, capital mobilization for finance companies, an increase in liquidity of finance companies, and permission to diversify into new business areas such as foreign exchange trading. The government encourages mergers of finance companies. The stock exchange suspends trading in financial-sector stock for one day to stem losses. The baht again comes under pressure, but a Bank of Thailand intervention limits the fall.

March 5. Thai Rating and Information Services issues credit alert for 15 institutions.

March 9. The Bank of Thailand establishes a property loan management organization to handle the rising number of nonperforming loans.

April

April 2–3. The government unveils a plan to encourage mergers within the financial sector. Six finance companies declare themselves open to merger.

April 15. Moody's downgrades Thai long-term foreign currency debt, private bank debt, and deposit ratings.

Further budget cutbacks are announced.

May

End May. Reserves fall by a record US$4 billion to US$33.3 billion.

May 30. The merger of Finance One and Thai Danu Bank collapses due to tax and legal complications, but a large number of nonperforming loans and inability to service debt are also important reasons.

June

June 19. Minister of Finance Amnuay Virawan resigns and is succeeded by Thanong Bidaya.

June 19. Stock exchange index falls to 465, an eight-year low.

June 24. The government orders a forcible merger of inefficient finance companies and raises the limit on foreign ownership of Thai banks.

June 26. The operations of 16 finance companies are suspended.

July

July 2. The baht is floated, and its value plummets to 30.32 baht per dollar from its earlier fixed rate of 25 baht per dollar.

July 20. Repurchase rates increase to 20–25 percent from 10–15 percent.

July 28. Bank of Thailand governor Rerngchai Marakanond resigns and is succeeded by Chaiyawat Wibulswadi. The government formally requests assistance from the IMF.

July 30. The baht depreciates by 20 percent.

August

August 2. Government suspends 42 additional finance companies.

August 11. The IMF approves assistance program. Participants in the rescue package, meeting in Tokyo, announce financing package of US$17.2 billion and a macroeconomic stabilization policy.

August 18. Cabinet reshuffled. New deputy prime minister Thaksin Shinawatra assumes responsibility for the National Economic and Social Development Board. Deputy Prime Minister Virabongsa Ramangkura takes responsibility for finance.

4

The Rescue Package

Thailand and the IMF reached agreement on a 34-month standby arrangement valued at US$3.9 billion on August 11, 1997. Stand-by arrangements—designed to deal with short-term balance-of-payments problems of a temporary or cyclical nature—must be repaid within five years. In return for its assistance, the IMF may require the borrower to take steps to correct the problems that made the assistance necessary.

After a hiatus of 12 years, Thailand was again on IMF life support. The country's last stand-by arrangement, signed in June 1985, was an 18-month program that totaled SDR 400 million (US$410 million), of which only SDR 260 million was withdrawn. This time around, the rescue package would have to be much larger, and the IMF's involvement in the design of the rescue program would be considerably deeper. Both facts reflected the international financial community's concern about the depth of the crisis and its ramifications for the region.

The rescue program involved several key assumptions. Given the substantial exchange rate adjustment that had already occurred, it was assumed that exports would pick up rapidly (8.5 percent growth was predicted for 1998), while imports would be curtailed. As a result, the current account deficit was expected to fall from 7.9 percent of GDP in 1996 to 3 percent in 1998, and the services account was expected to deteriorate in the short term as receipts from tourism services that had been priced in the Thai currency fell in response to the depreciation of the baht.[1]

Because of the rapidly rising short-term liabilities, the principal source of worry, however, was the capital account (table 4-1). Nervousness about

1. In the early phase of the crisis, services were priced in baht and the baht was depreciating, resulting in fewer dollar earnings.

Table 4-1. Thailand's Financing Needs Assessed While Designing the Rescue Package
(US$ billion)

Item	*1997*	*1998*	*1999*
Current account balance	–3.0	14.3	12.0
Current account balance (as a percentage of GDP)	–1.9	12.2	8.5
Capital account balance	–15.6	–16.8	–12.0
Medium and long-term loans	9.9	4.6	0.5
Short-term capital	–25.5	–21.4	–13.6
Overall balance	–18.6	–2.5	–1.3
Identified financing (net)	8.0	5.1	5.8

Source: IMF data.

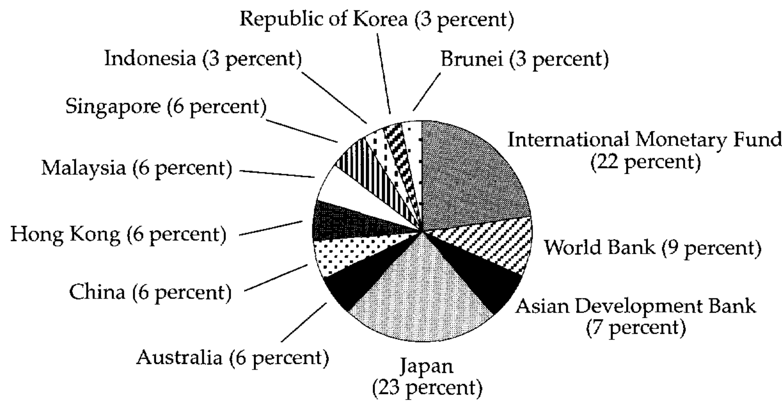
Thailand's prospects could result in substantial short-term outflows. Also, repayments on the forwards and swaps positions taken by the Bank of Thailand in its bid to defend the baht would soon be due. The net shortfall was expected to be US$25 billion in 1997 and US$3.5 billion in 1998. Additionally, analysts estimated that Thailand should maintain reserves sufficient to cover four months of imports to calm the increasingly nervous market. When the various assumptions were combined, they yielded an estimated financing package of US$16 to US$17 billion.

The IMF alone would not be able to raise the full amount needed. Prospective bilateral donors, meeting in Tokyo on August 11, 1997 (the same day the IMF approved its stand-by arrangement), chipped in. The IMF contributed US$4 billion, and the government of Japan contributed an equivalent amount. The World Bank and the Asian Development Bank pledged US$1.5 billion and US$1.2 billion, respectively. The governments of Australia, China, Hong Kong, Malaysia, and Singapore all pledged at the US$1 billion level. Indonesia and the Republic of Korea each pledged US$0.5 billion. The percentage contribution from each donor involved in the rescue package is shown in figure 4-1.

The multilateral approach was viewed as having three advantages. First, it would spread the financial burden. Second, it would expose other regional governments—Indonesia, Korea, and Malaysia, in particular—to the design of the program in case of a wider, regional contagion. Finally, it would help divide responsibility among the international financial institutions for designing appropriate responses to what appeared likely to become a multifaceted crisis.

Financial sector restructuring formed the first pillar of the stabilization program funded by the rescue package. The plan called for immediate identification and closure of insolvent financial institutions, a temporary guarantee to

Figure 4-1. The International Rescue Package



Source: World Bank data.

protect remaining financial institutions, conditional liquidity support, steps to minimize the moral hazard risks of the guarantee, and broad-based structural reform to strengthen the framework for a sound financial sector.[2]

The second pillar was *fiscal policy*. The program called for a fiscal surplus of 1 percent of GDP to meet the anticipated costs of financial sector restructuring. Given previous deficits, achieving that target would make it necessary to raise new revenues equivalent to about 2.8 percent of GDP. The IMF program prescribed that the surplus be supported by an increase in the value-added tax from 7 percent to 10 percent and by restraints on public expenditures.

Monetary and exchange rate policy constituted the third pillar of the program. The exchange rate system was changed to a managed float with interventions prescribed only to smooth out fluctuations. Broad money growth was restrained to 7 percent in 1997 and 11 percent in 1998. A floor on the net reserves of the Bank of Thailand and a ceiling on its net domestic assets were to provide an effective nominal anchor until capital inflows resumed. Given volatility in money demand, interest rates were to be monitored closely to fine-tune monetary targets as events unfolded.

This program was endorsed enthusiastically by the participants at the Tokyo meeting. Thailand now had an internationally endorsed program of stabilization supported by adequate financing. Before long, however, the program was subjected to considerable controversy.

2. Guarantees may encourage those guaranteed to make riskier decisions than they would without the guarantee. Such perverse incentives are known as moral hazards.

5

Buckling Down

The patience of Thailand's citizens was put to the test in the first five months of the crisis. The proud nation was subjected to the Tokyo "handout" (as some local newspapers put it), and the role of international technocrats in Thailand's economic management increased. This came at a time when the popular mood favored profound changes in the country's constitution to decentralize decisionmaking and accommodate greater community participation. The gulf between the reality of international intervention and aspirations toward self-management was acceptable only because people believed that the international intervention would be short-lived.

Events unfolded otherwise. All indicators of economic activity took a nosedive in the first months of the crisis. In January 1998 the exchange rate collapsed to 55.5 baht to the dollar despite a rapid rise in short-term interest rates (the overnight central bank repurchase rate reached 22 percent). The stock exchange index, on a downward trend for several years, fell to 356 in December 1997, having lost half its value since the onset of the crisis. Worse still, consumption and investment indexes showed sharp reversals, suggesting a much deeper recession than had been anticipated in August when the rescue program was put in place. The following is a review of the details of the program as it was taking shape.

In the first four months of the crisis (September–December 1997), policymakers focused their energies on fine-tuning the stabilization program. Their primary objective was to signal to the market that the government was again firmly in charge and that the days of indecision were over. To renew confidence in the safety and soundness of financial institutions a process for cleaning up the mess in the banks and finance companies was initiated. The government's earlier commitments to providing liquidity support for troubled financial institutions and to a comprehensive guarantee to depositors were clarified and reaffirmed. In the end, neither the liquidity support nor the comprehensive guarantee helped to bolster confidence.

Liquidity Support and the Comprehensive Guarantee

The Financial Institutions Development Fund (FIDF) provided nearly 400 billion baht in liquidity support to troubled financial institutions in the months preceding the suspension of 58 finance companies in June and August 1997. The infusions did not succeed in arresting the loss of confidence in the financial sector, however, because they were provided without obtaining commitments from the recipient finance companies on a multitude of issues. These issues included stabilization strategies, changes in management and shareholder rights, collateralization and subordination to other creditors, contingency plans for exit in the event the cash infusions proved inadequate, penal interest charges for resorting to support from the lender of last resort, and transition to a limited deposit insurance regime.

Despite, or perhaps because of, the potentially large fiscal cost of the government's emergency guarantee of deposits, the market did not view the move as credible. Doubt shrouded the government's willingness to honor the commitment, the exact liabilities that it covered, and the mechanisms for funding the guarantee and executing it with respect to individual liability holders.

To redress the deficiencies in the liquidity support and deposit guarantee schemes—and to stem depositors' flight to quality and the associated instability in the financial sector—the government took aggressive steps.

The FIDF raised the interest rates on loans to financial institutions to the central bank repurchase rate plus 1 percent. The rate climbed to 2.5 percent depending on the borrower's uncollateralized lending and level of indebtedness. At more than 20 percent per year in nominal terms (as of October 1997), the rate of interest on liquidity support was well above the highest deposit rates.

The conditions of liquidity support were amended to trigger one of two possible consequences, depending on the extent of borrowing. The first consequence was the cessation of all dividend payments, bonuses, and benefits to directors and executives. Once borrowing from the FIDF reached 75 percent of Tier One capital (which can absorb losses without banks being required to cease trading), the fund could assign a representative to the borrower's board of directors, restrict asset growth, and take additional actions.

The government announced a thorough review of the objectives, roles, and functions of the FIDF. The review was to include an assessment of the FIDF's role in liquidity support, resolution programs, and procedures for taking collateral and converting advances to capital and quasi-capital. Recommendations for reforming the FIDF based on the review were to be presented by the end of 1998.

On October 25, 1997, a decree clarified the liability holders covered by the deposit guarantee, defined depositors and creditors, and specified that subordinated debtholders, off-balance-sheet creditors, and shareholders'

funds were not covered. The decree promised additional government support to the FIDF to enable it to administer the guarantee program, which was to be funded by a fee of 0.4 percent per year on all covered liabilities.

Deposit rates were capped at 3 percent more than the average deposit rates of the five largest commercial banks to prevent weak, liquidity-constrained institutions from paying rates that were higher than lending rates. Imposition of the cap had the effect of boosting interest rates throughout the financial system.

The authorities also announced an action plan—to be completed by the end of 1998—to introduce a permanent but limited deposit-insurance system to replace the comprehensive guarantee.

Financial Sector Reform

The overarching goal of the program for restructuring Thailand's financial sector was to encourage faltering institutions to leave the market in an orderly way, subject all players to tighter supervision, and provide sufficient information to allow market participants to weigh the risk of available options. The ultimate objective of the program was to restructure the sector so as to avoid the recurrence of similar crises. This vision was to be realized by settling the fate of the finance companies whose operations had been suspended over the summer and reestablishing the rest of the financial sector on a sound footing.

Resolution of suspended finance companies

Rapid and credible resolution of the 58 suspended finance companies was critical to restoring confidence. Continuing delays were damaging already weak loan portfolios. Market estimates indicated that as many as 50 suspended companies had a negative net worth.

To be credible the resolution process had to ensure that assets controlled by the affected institutions were not impaired, that owners were held accountable for their mistakes, and that fiscal costs were kept at manageable levels to avoid burdening the taxpayer. All of this had to be done in an orderly and transparent manner. The timeframe for action was equally important—and equally delicate. Excessive delay would impair assets, affect the availability and terms of credit (the "credit culture"), and threaten the viability of the remaining financial institutions. Excessive haste, on the other hand, might render the process less credible. The following details the key elements of the resolution process.

The first step was to create the legal and institutional framework for resolution. To that end, the government issued six emergency decrees in October 1997. The decrees established two new institutions—the Financial Sector Restructuring Authority (FRA) and the Asset Management Corporation (AMC)—to serve as the focal points for resolving the suspended

companies. The FRA was assigned the responsibility of reviewing rehabilitation proposals submitted by the companies and to oversee the closure of companies whose proposals were rejected.

The AMC became the buyer of last resort for impaired assets. It was to be staffed with qualified personnel who would manage the impaired assets in accordance with a business plan and capital and funding strategies. The government authorized 1 billion baht in capital for the new corporation, of which 250 million baht was approved immediately.

The second step in the resolution process was for the FRA to announce clear criteria for assessing the finance companies' rehabilitation proposals. The criteria were to include the ability of new and existing owners to meet recapitalization needs; conversion of FIDF debt into equity; full writing down of existing shares; imposition of upper limits on allowed conversions; and allowance of up to 100 percent foreign equity investment for 10 years. At the same time, the Bank of Thailand announced criteria for assessing new management and fresh sources of capital for finance companies whose rehabilitation plans were approved by the FRA.

The third step was to adopt a well understood process for reviewing rehabilitation proposals. The process had three stages: a modeling framework for evaluating rehabilitation plans, validation of asset valuations implicit in the rehabilitation proposals, and approval by an independent third party to ensure that the process met acceptable standards.

The fourth step was to announce which finance companies would be closed and which would be allowed to operate. The fifth was to establish a framework for the disposal of the assets of shuttered finance companies. The sixth and final step was to develop a timetable for the entire process. To instill confidence in the resolution process, the timetable would have to be followed strictly.

On December 8, 1997, the authorities announced that only two of the 38 rehabilitation plans submitted to the FRA had been approved; the other 36 had been rejected. Thus, 56 of the 58 companies suspended over the summer were to be closed down and their assets sold by the end of 1998. That decision, and the process by which the decision was arrived at, were widely welcomed by the international financial community.

The boards of directors of the affected companies were replaced by specially constituted committees consisting of representatives from the Ministry of Finance, the Bank of Thailand, the FRA, and the FIDF. The committees in turn appointed special managers to take control of each company, categorize assets by quality, and recommend specific resolution options to a special advisory board of the FRA known as the Sales Group. To ensure the integrity of the asset disposal process, the government established the Financial Restructuring Authority Coordination Unit on December 15, 1997. The Financial Restructuring Authority Coordination Unit would monitor the committees and managers as they disposed of assets.

Claims on the suspended finance companies

The claims of depositors and creditors of the suspended finance companies required immediate attention. Substantial claims existed in the form of promissory notes, negotiable certificates of deposit, and bills of exchange. When 16 finance companies were suspended on June 27, 1997, the government announced that depositors' claims on the companies would receive priority but that creditors' claims would not. When 42 more finance companies were suspended on August 5, both creditors and depositors received priority.

Eligible claimants were given the option of exchanging their claims for notes issued by two publicly controlled financial institutions, the Krung Thai Thanakit (KTT) and the Krung Thai Bank (KTB), under two distinct note-exchange schemes. Creditors of the first 16 suspended finance companies did not have the option of exchanging their claims and had to modify their claims under a shareholder rehabilitation program or try to collect from the proceeds of the FRA's liquidation of assets. Although the KTT and the KTB were in charge of administering the note-exchange programs, the FIDF was made responsible for servicing payments of interest and principal on the notes.

Fiscal impact of the resolution process

The costs of restructuring finance companies were potentially large and far from transparent. It would be important to monitor them closely to minimize the burden on the taxpayer.

Contributing to the uncertainty over the potential cost of restructuring were the risks that the FIDF's liquidity support could become "solvency support" and that its restructuring commitments would be more costly than anticipated. Those commitments included debt-to-equity conversions and interest and principal payments on KTB and KTT notes held by depositors and creditors. At the same time, it was feared that repayments of FIDF liquidity loans would slip. The government's contribution to the AMC's initial capital and its contingent liabilities related to the AMC also raised cost concerns.

To reduce uncertainty about the costs of resolution, the government established a fiscal monitoring framework for the restructuring program under which the costs incurred by FIDF, the AMC, and all other agencies involved in the resolution process were to be reflected explicitly in the budget.

Reestablishing Financial Institutions on Sound Footing

Even the country's banks and finance companies that had not been suspended faced significant risks. Their loan portfolios were heavily concentrated in

high-risk lending arenas, such as real estate, consumer loans, and securities. With the tightening money market, an increase in interest rates, and rapid depreciation of the baht, most clients were being converted into marginal borrowers. The nervousness about the financial health of banks was manifest in depositors' flight to larger, more secure Thai and foreign banks, which further weakened many of the surviving financial institutions.

The Bank of Thailand tried to shore up confidence with a three-pronged program.

Identifying and addressing problems

Following a series of examinations and reviews, the Bank of Thailand stratified the country's 33 operating finance companies based on classification and provisioning requirements made effective December 31, 1997. Institutions were stratified according to their actual and projected capital adequacy, the seriousness of their problems, and the financial strength of their principal shareholders.

The Bank of Thailand then began to act on its findings. Under the new intervention powers created by amendments to the Finance Company Act and the Banking Act in October, the central bank closed one finance company where fraud had been discovered, replaced the management of a second company that was experiencing serious liquidity problems, and, on December 31, 1997, signed memoranda of understanding with companies identified as having serious problems. The central bank carefully monitored compliance with those memoranda of understanding and took increasingly stronger actions in response to serious noncompliance. To help monitor the signatories of these memoranda, the central bank conducted periodic diagnostic reviews.

At the same time, the Bank of Thailand announced that it would intervene in undercapitalized financial institutions that proved unable to propose an acceptable recapitalization plan, fell out of compliance with an approved plan, or were forced to borrow excessively or repeatedly from FIDF. The bank established the principle that when it intervened in a financial institution, it would take one or more of the following actions: replace management, reduce capital in such a way that existing shareholders were the first to take losses, and convert FIDF funding into capital or subordinated loans. This principle removed some of the uncertainty associated with interventions and eventually made them acceptable as remedial measures.

Strengthening prudential regulations

On the eve of the crisis, the prudential regulations followed by the finance companies had been less stringent than those observed by commercial banks, even though their operations were significantly and unavoidably

riskier than those of commercial banks. The regulations were strengthened as part of the restructuring process.

Finance companies were required to limit their exposure to any single risk to 25 percent of Tier One capital, their maximum net long-term foreign exchange position to 20 percent of Tier One capital, and their net short foreign exchange position to 15 percent of Tier One capital. They were also required to reduce their investment in equity shares to 20 percent of capital.

The new regulations obliged finance companies, like banks, to submit semi-annual credit plans to the Bank of Thailand that reflected portfolio diversification, risk profile, and growth planning and to issue loan-to-deposit, or promissory note, ratio guidelines.

Other prudential regulations covering both banks and finance companies were strengthened as well.

To bring Thai practices up to international standards by the end of 2000, the rules governing loan classification and provisioning were made more stringent. Loan classification was tightened by requiring provisioning for, and prohibiting accrual of interest on, all loans more than six months overdue. The new rules—announced March 31, 1998, but effective as of the end of 1997—included guidelines for restructuring troubled debt.

The Bank of Thailand issued guidelines for the assessment of existing owners, board members, and managers in merged finance companies and new institutions resulting from the resolution process. The bank proposed amendments to the Banking Act and the Finance Company Act that would empower it and the Ministry of Finance to take the measures necessary to perform assessments under the guidelines. The Bank of Thailand also issued guidelines for a comprehensive set of licensing procedures for both banks and finance companies in line with international standards. These procedures applied to licensing of new institutions and approval of major changes in capital structure and senior management of existing institutions.

Strengthening supervision

Poor supervision of financial institutions had permitted the excessive risktaking that hobbled banks and finance companies in the months before the crisis and that eventually destroyed many institutions. The restructuring program included steps to strengthen supervision.

The government established an interagency task force to review and recommend changes in the legal and regulatory framework for supervision and announced that the Ministry of Finance, the Bank of Thailand, and the Securities and Exchange Commission would develop and issue regulations to consolidate supervision of financial groups, including banks, finance companies, and securities companies. The Bank of Thailand announced a medium term institutional development plan for

strengthening its supervisory capacity. The plan aimed to improve on-site and off-site supervision as well as enforcement procedures.

To limit the costs of delays in dealing with the finance companies, the central bank established criteria and procedures that supervisors could use to promptly address financial weaknesses, management deficiencies, and rule violations as these were detected. By May 1998 the bank intended to develop and implement internal guidelines for prompt corrective action based on specified triggers, including capitalization ratios and need for liquidity support. At the same time, it declared that it would propose legal amendments to strengthen the applicability and enforcement of its internal guidelines.

New prudential regulatory and accounting standards for specialized banks were developed, paralleling those for commercial banks. The new standards addressed loan classification, provisioning, and interest accrual requirements.

Disappointing Results

By January 1998 prominent reforms of the financial sector were well under way. Thailand had adopted a stabilization program and acquired an appropriate financing cushion. Tough measures for restructuring the economy were being announced. However, market confidence, instead of bouncing back, continued to erode.

The economic news was disturbing. The baht hit an all-time low against the dollar in January 1998, having lost 55 percent of its value since being floated on July 2, 1997. Exports declined by 7.9 percent in the same month, and interest rates reached a record 20.6 percent. At the end of February the country's reserves stood at US$25.5 billion, the lowest level since the beginning of the crisis. Thailand's stock exchange had lost 57 percent of its value during 1997 and GDP was expected to drop 11 percent in 1998. The rollover rate of short-term debt was declining, capital flight intensifying, and the ratio of reserves to short-term external debt falling to its lowest level in years. Not surprisingly, the country risk rating by the Economist Intelligence Unit peaked in the first quarter of 1998 (Economist Intelligence Unit 1998).

What had gone wrong? Was the market rejecting the macroeconomic framework?

In the winter of 1997–98, the news from the region was discouraging. Korea, until recently Southeast Asia's engine of growth, had virtually declared bankruptcy in December 1997 and requested a rescue program nearly three times the size of Thailand's. Indonesia was teetering, its ethnic harmony in ruins. Malaysia was in trouble but in denial.

In Thailand, a fragile coalition government was managing the reform program's far-reaching measures, making parliamentary measures slow

and risky. The alternative of obtaining a royal decree was quicker, but was viewed as a sign of weakness that might trigger a vote of no confidence in the parliament.

In this gloomy setting, doubts emerged about the basic design of the rescue program. Could it be that the decision to intervene and close down troubled financial institutions had not correctly anticipated the difficulties in implementation? Thailand did not have a clear, well understood mechanism for closing down financial institutions. Developing the necessary legal framework and bolstering the institutional capacity of the Bank of Thailand were causing costly delays in time-sensitive matters such as resolving the fate of suspended financial institutions. Such delays caused asset values to drop and caused debtors to conclude that they could walk away from their obligations.

Could it be that the tight fiscal and monetary stance was propelling the economy toward a low-level equilibrium and that the market was anticipating that unhappy outcome? The argument went as follows. Tight monetary policy reduced credit for the private sector and raised interest rates, which reduced output. Tight fiscal policy reduced incomes and therefore lowered total demand. With weak exports, the lowering of output and income trapped the economy in a new low equilibrium. Doubts were also being expressed regarding the intended impact of the macroeconomic framework on the exchange rate. High interest rates were supposed to be an incentive to keep money in Thailand and thus counter the trend of capital flight that was putting pressure on the baht. However, could it be that the market was anticipating the ill effects of high interest rates on output and responding by moving capital out of the country?

The underlying assumption of the tight fiscal stance had been that the foreign exchange correction would stimulate external demand and get recovery going. With the benefit of hindsight, it is clear that the program did not correctly anticipate the regionwide recession, the weakening of the country's terms of trade, or the collapse in domestic private consumption. In the immediate future, therefore, the role of fiscal policy would have to change. Instead of contraction, a fiscal expansion was needed to stimulate aggregate demand.

Despite the disappointing outcomes on the stabilization front, solid foundations had been laid for a return of confidence and future recovery. By early 1998 a credible framework for resolving failed institutions and better supervising surviving institutions was in place. The fruits of these important beginnings would be reaped down the road.

Despite its parliamentary weakness, the government that assumed power in November 1997 had brought a change in economic leadership, giving the markets, the international financial institutions, and bilateral partners confidence regarding Thailand's commitment to reform and its ability to stay the course.

6

The Financial-Corporate Nexus

The crisis entered a critical phase in the spring of 1998. The contagion had spread to the entire region, and export recovery, as envisaged in the stabilization program, seemed unlikely. Meanwhile, the bitter pill of monetary and fiscal restraint began to slow down economic activity. Tighter prudential regulations and increased scrutiny curtailed lending by financial institutions. Manufacturing and nonfinancial service corporations were hit with the triple whammy of high interest rates, sharp devaluation (which increased foreign currency obligations), and shrinking revenue as global and domestic demand fell. The financial crisis had driven the baht so low and interest rates so high that most manufacturing firms had started to curtail their activities. The fates of the financial and corporate sectors were now inseparably linked, a fact that could have serious ramifications for urban unemployment and lead to political unrest. The program for stabilization and recovery was thus in need of major adjustments.

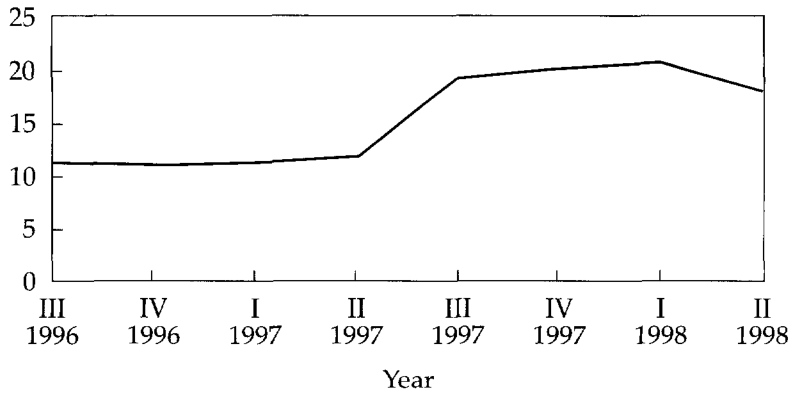
A Semblance of Stability

Signs were mixed in the spring of 1998. On the positive side, the exchange rate had appreciated to around 40 from a low of 55.5 in January 1998, and daily volatility had declined. The stock exchange index, too, had recovered somewhat by the first quarter of 1998, though it soon fell again to a low of 314 in early June.

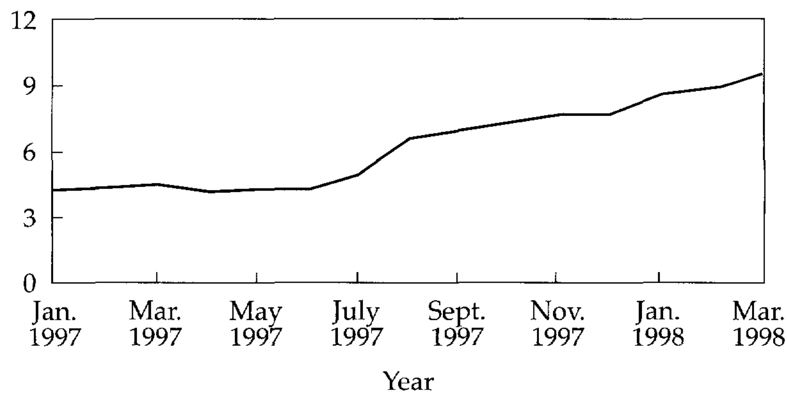
At the same time, domestic interest rates—which had risen sharply following the float of the baht, the increase in the country's risk ratings, and tight credit and monetary policies—began to moderate (figure 6-1). Deposit rates, on the other hand, did not increase appreciably because the market perceived the upward trend in the short-term money market rate to be temporary. Also, large banks were happily attracting deposits from customers fleeing the weaker banks and therefore had little incentive to

Figure 6-1. Selected Indicators

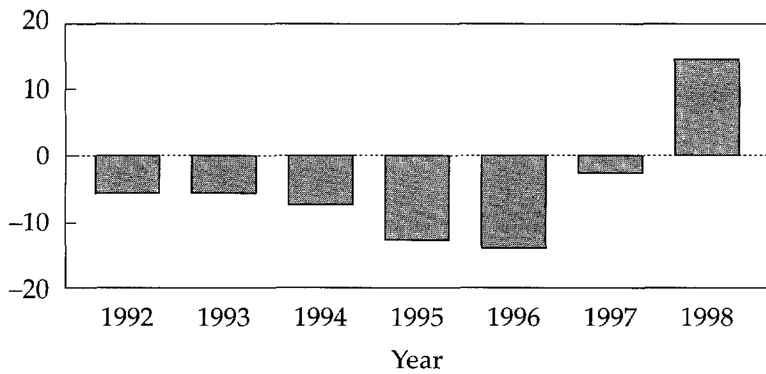
Interest rate (average interbank rate, percent)



Inflation rate (percent)



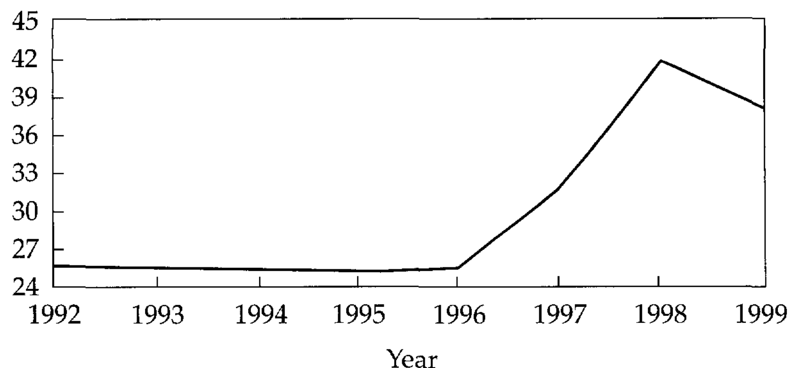
Current account balance (US$ billion)



(figure continues on following page)

Figure 6-1 continued

Movements of the baht (baht per US$)



Source: Bank of Thailand data.

increase the rates they paid. Private credit expansion had slowed to less than 5 percent per year, as banks became reluctant to lend in an uncertain environment. The scarcity of credit contributed to a liquidity crunch from which many companies were beginning to suffer.

Although the baht had depreciated 40 percent since June 1997 and wages had fallen and although consumer goods were a small part of total imports, the consumer price index nevertheless increased from 4.4 percent in June 1997 to 10.1 percent in April 1998 (figure 6-1).

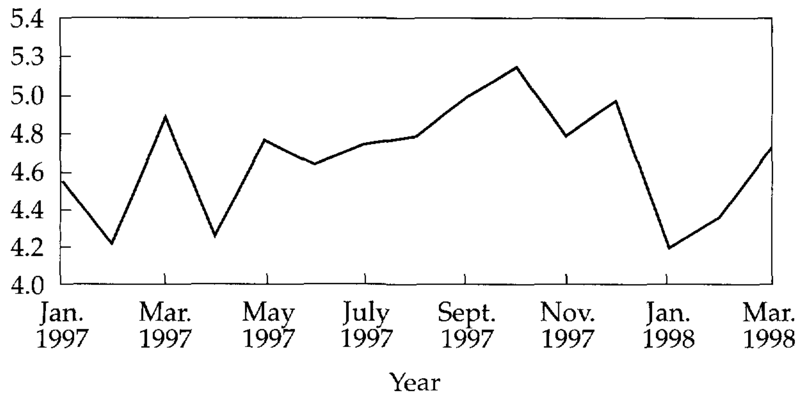
The current account balance underwent rapid adjustment due to the slowdown in economic activity. A surplus of US$2.2 billion was recorded in the second half of 1997 (compared to a deficit in 1996), largely due to the collapse in imports (–17.3 percent in U.S. dollar terms).

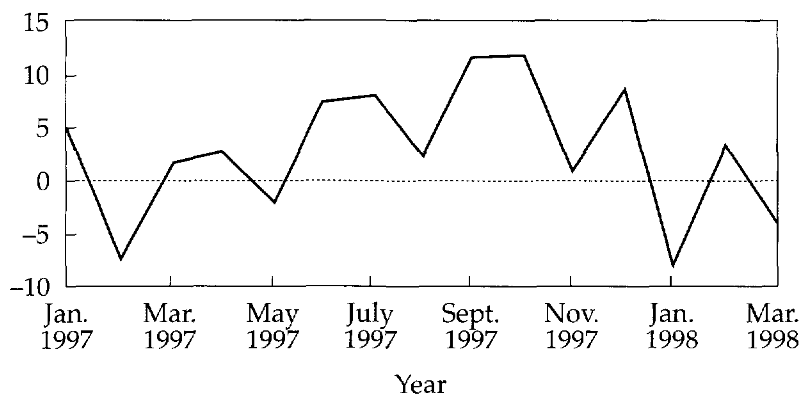
Despite these broadly favorable developments, the collapse of aggregate demand fed doubts about the program. Private consumption was falling sharply, and retail sales had plummeted.

Rapid recovery of exports, which was to have stimulated growth through expansion of external demand, had not materialized (figure 6-2). Export growth remained substantially below Thailand's outstanding performance up to 1995. One reason for the disappointing performance was the steep reduction in regional trade related to the slow recovery of the Japanese economy. In addition, as other economies in the region increased their exports of competing products, prices declined, offsetting the volume effect of the exchange rate correction (figure 6-1).

Furthermore, considerable uncertainty enveloped the capital account. Given regionwide pessimism and the downgrading of sovereign risk, analysts feared that rollover rates on short-term debt might decline. An increase in payments would deplete resources and put renewed pressure on the baht.

Figure 6-2. Thailand Export Performance





Source: Bank of Thailand data.

Almost a year into the crisis the consensus view was that real GDP would shrink by 4 to 5.5 percent in 1998 and that the economy would not bottom out before the end of the year. Recovery might not begin until 1999, and then only if confidence returned. The pessimism fueled anxiety about the social impact of the crisis.

Unemployment had already risen to nearly 7 percent. Retrenchment was particularly acute in the financial sector, where up to 80,000 workers had been laid off, and in the construction industry, where the collapse of the real estate markets had slashed jobs. It was feared that overall job creation would drop significantly, making it harder to absorb 400,000 fresh

graduates. The burden of job cuts fell mainly on young, rural workers and on unskilled construction workers.

A Broader Program for Recovery

In the spring and summer of 1998, the strategy for economic recovery was broadened to halt the collapse of aggregate demand. The goal would be met by relaxing contractionary fiscal policy, extending the ongoing reform of the financial sector, addressing the emerging problems of Thai firms mired in debt, strengthening corporate governance, and reforming state enterprises in preparation for privatization.

A neutral fiscal stance

By the spring of 1998, the fiscal outlook had deteriorated due to a sharp decline in the revenue base (income, output, and sales all were falling steeply) and cutbacks in public expenditures. The sharp turnaround in the external balance, meanwhile, reflected a much larger adjustment in the balance between private savings and investment than had been anticipated. In this setting, further fiscal tightening would deepen the recession, worsen corporations' ability to service debt, and exacerbate the crisis in the financial sector.

The authorities thus decided to relax the contractionary fiscal stance by increasing the consolidated deficit of the public sector to about 3 percent of GDP in 1997–98. Proposals for an even larger fiscal deficit—which would have constituted a frankly expansionary stance—were rejected because funds would likely be needed to meet the costs of financial sector restructuring. However, the authorities agreed to review the fiscal stance over the following months, implying that further deepening of the recession would trigger stronger counter-cyclical measures.

Continued financial sector restructuring

The government took several tough measures to consolidate reform of the financial sector. Following the decision to close down 56 finance companies, impressive progress was made in the sale of assets. As noted in chapter 5, the prudential and regulatory framework for the remaining financial institutions was strengthened. Tougher loan classification standards were adopted and provisioning rules tightened. The Bank of Thailand intervened in several weak banks and finance companies, removing managers and directors, wiping out claims of existing shareholders, and converting FIDF claims into equity shares.

New targets were declared for restructuring financial institutions that required massive recapitalization to repair the effects of irresponsible past credit policies and meet the strict new loan classification and provisioning

rules. New memoranda of understanding were signed with banks and finance companies to phase in recapitalization by the December 2000 deadline. In parallel, the Bank of Thailand, with expert assistance, began to conduct more thorough and extensive on-site examinations of all nonintervened domestic commercial banks. It was hoped that these measures would increase transparency of financial institutions, attract much needed foreign investment, and reduce the need for public funds.

Corporate debt workout

As the recession deepened, the distressed corporate sector required more attention. The depreciation of the baht and the rise in interest rates had severely hurt balance sheets and income statements. Corporations in good credit standing, including exporters, were reporting increased collateral requirements, severe cuts in maturities, and declines in supplier credits. Even large firms were affected. Many of the 50 largest firms on the stock exchange (ranked by market capital) were in severe financial distress at the end of 1997; some had debt to equity ratios of more than nine to one. The average quick ratios and inventories of the largest listed firms had declined in 1997 because companies had delayed payments and reduced inventories to increase liquidity.

It was clear now that loan performance and bank balance sheets were unlikely to improve significantly as long as the highly leveraged Thai corporations remained distressed. However, the converse was also true: corporate distress aggravated and prolonged the distress of financial institutions. Thailand's banks held nearly 400,000 classified loans in nearly every business sector. Manufacturing and real estate were the hardest hit. Most of the impaired credit, by value, consisted of approximately 700 large loans of more than 500 million baht each and some 5,000 medium sized loans of 50 to 500 million baht.

Clearly a comprehensive program for corporate debt workouts was urgently needed to restore the health of financial institutions, provide breathing space to indebted corporations, and bring about badly needed operational restructuring. In keeping with political realities, Thailand adopted a nonintrusive market-led strategy for debt restructuring based on tax relief for restructuring companies; liberalization of rules on foreign direct investment and ownership of real estate; out-of-court mechanisms for voluntary workouts; and improvements in the country's bankruptcy, foreclosure, and secured-lending laws.

Tax relief for debt restructuring concluded between January 1, 1998 and December 31, 1999 was extended until the end of 2001. Rules on foreign direct investment and foreign ownership of real estate were liberalized. A disclosure-based approach to listing on the stock exchange was adopted to accommodate companies whose profitability had been hurt by the crisis.

Such actions were a useful beginning, but remaining tax, legal, and regulatory rigidities continued to impede corporate restructuring. For example, noncash corporate reorganizations that involved share swaps or mergers could create an immediate tax liability. In addition, under Thailand's Civil and Commercial Code and Public Limited Companies Act creditors still had six months to object to a merger and demand immediate payment. Perhaps most important, under Article 157 of the State-Owned Enterprise Legal Code, employees could be held liable for losses resulting from debt restructuring.

In cases where corporate restructuring would entail changes in ownership and control, mechanisms were needed to impose losses on debtors (for example, through foreclosure and insolvency) and on creditors (for example, through forced asset transfers and interventions).

A great deal of effort and attention was focused on creating out-of-court mechanisms for voluntary workouts. A framework of voluntary principles and timelines for voluntary workouts known as the Bangkok Rules was announced in September 1998. Several months earlier, in June 1998, the government had formed the Corporate Debt Restructuring Advisory Committee (CDRAC), chaired by the governor of the Bank of Thailand and including representatives from the Federation of Thai Industries, the Thai Bankers Association, the Board of Trade, the Foreign Bankers Association, and the Association of Finance Companies. A CDRAC office was opened within the Bank of Thailand in January 1999 to monitor progress on more than 700 high-priority cases. In March the central bank and CDRAC promulgated a model debtor-creditor agreement that was later signed by 84 financial institutions and more than 568 debtors. That same month 84 financial institutions signed an intercreditor agreement on the restructuring plan that CDRAC and the central bank had issued.

Among other things, signatories to the debtor-creditor and intercreditor instruments agreed to specific procedures for case entry, a 6-8 month process for developing and agreeing on a workout plan, and a threshold for plan approval of 75 percent of outstanding credits. The agreements provided for CDRAC-arranged mediation and intercreditor arbitration and empowered the Bank of Thailand to enforce creditor compliance through warnings and fines. Creditors were obliged to file court petitions if a proposed workout received less than 50 percent creditor approval or if a debtor refused to accede to the agreement.

The government made a considerable effort to reform Thailand's legal framework for insolvency, foreclosure, and secured lending. The 1940 Bankruptcy Act was amended in April 1998 and again in March 1999, first to permit and later to facilitate court-supervised reorganizations. The Code of Civil Procedure was amended in March 1999 to provide for legal execution and to deal with petty cases. In June 1999 a central bankruptcy court was established.

Although the amendments reduced the time required for a court-supervised process from ten to two years, that was still too long to induce

debtors to cooperate readily in voluntary restructuring. Additional uncertainties remained as well. First, an uncooperative debtor could rebut the presumption of insolvency and induce dismissal of a reorganization petition. Second, because selection of the bankruptcy planner or receiver is so important for controlling the company and shaping the reorganization, debtors might be reluctant to seek reorganization without support from holders of one-third of the outstanding credits. In addition, creditors might be similarly reluctant to seek reorganization without controlling two-thirds of the credits. Finally, provisions for exit from court-supervised reorganization or conversion to liquidation remained unclear.

Financial accountability and corporate governance

Good corporate governance promotes relationships of accountability among the primary corporate participants to enhance corporate performance. It holds management accountable to boards and boards accountable to shareholders. The East Asia crisis showed how macroeconomic difficulties could be exacerbated by systemic failures of corporate governance stemming from weak or ineffective regulatory systems, poor accounting and auditing practices, ineffective oversight by boards of directors, and a disregard of minority shareholder rights. International comparisons reveal that Thailand's provisions for shareholder protection, legal enforcement, and accounting and auditing practices need to be strengthened (table 6-1).

Table 6-1. Legal Protection for External Financiers of Firms, Selected Countries and Regions

Countries and regions	*Shareholder protection*[a]	*Creditor protection*[a]	*Degree of judicial enforcement*[b]	*Accounting standards*[c]
Thailand	3.0	3	5.9	64
Malaysia	3.0	4	7.7	76
Korea, Republic of	2.0	3	6.7	62
Latin America	2.5	1	6.2	53
United States	5.0	1	9.5	71
United Kingdom	4.0	4	9.4	78
Japan	3.0	2	9.4	65
Germany	1.0	4	9.4	62

a. For shareholder and creditor protection measures, the scale is from 1 to 5, with 5 representing the strongest protections and 1 the weakest.

b. For enforcement, the scale is from 1 to 10, with 10 representing the highest degree of judicial enforcement and 1 the lowest.

c. For accounting standards, the higher the measure, the higher the standards. The entry for Latin America represents the average for Argentina, Brazil, Chile, and Mexico.

Source: La Porta and others (1998).

The challenge was to establish and enforce legal standards to govern the relationships among shareholders, directors, and managers. The government's reform strategy for corporate governance focused on streamlining institutional arrangements, enhancing the reliability and transparency of financial information and disclosures, improving corporate board oversight and effectiveness, and improving the legal and regulatory framework for the enforcement of company laws and regulations. Specific steps included the following:

- Establishing the Thailand Financial Accounting Standards Board as an independent organization with authority to set accounting standards, subject to parliamentary approval.
- Making the Institute of Certified Accountants and Auditors of Thailand a fully operational, self-regulatory professional body.
- Implementing measures, through the Securities and Exchange Commission and the Institute of Certified Accountants and Auditors of Thailand, to more effectively discipline accountants who breach their professional duties.
- Removing a burdensome statutory requirement for submitting audit reports to authorities for about 200,000 limited partnerships.
- Aligning the rules for becoming listed on the stock exchange with international best practice, especially rules governing the type and quality of disclosure to the investing public and regulators that cover party transactions, insider trading, and compensation and ownership of officers and members of boards of directors.
- Submitting to parliament appropriate changes to the Public Companies Act and Securities Exchange Act to improve the process for appointing directors and holding them accountable and liable through explicit reference to the comprehensive fiduciary duty of directors, sanctions for breach of fiduciary duty, and cost-effective legal redress for shareholders; reduce thresholds for the exercise of minority shareholder rights; introduce shareholder approval requirements for major transactions and connected transactions; make explicit the legal liabilities of accountants in case of negligence and fraud; and strengthen insider trading rules, with severe sanctions for insiders for false and misleading disclosures.
- Putting into effect the revised guidelines for the code of best practice for listed company directors and the requirement that listed companies disclose in annual reports whether they comply with the code of best practice and explain noncompliance in detail.
- Putting into effect the amended notification of the qualifications and role of audit committees.
- Reviewing the effectiveness of the arrangements among the stock exchange, the Securities and Exchange Commission, and the Ministry of Commerce, including a determination of whether it would be more

effective for the Public Companies Act and Securities Exchange Act to be supervised by the same agency or ministry.

- Streamlining the enforcement process for violations of the legislation named above.
- Issuing new rules on accounting, auditing, and financial disclosure for banks, finance companies, and specialized financial institutions in line with international best practice.
- Ensuring that financial statements are prepared and audited in accordance with applicable standards by all listed companies, large nonlisted public companies, and banks and financial institutions with assets of more than 1 billion baht.
- Ensuring that requirements for the audit committees of boards of directors and internal controls for listed companies, including committee roles and responsibilities, are consistent with international best practice.

Reform and privatization of public enterprises

Thailand's 65 state-owned enterprises operate in four infrastructure sectors, which include energy, telecommunications, transportation, and water, and in banking, services, and manufacturing (table 6-2). In 1998, state enterprises employed just over 1 percent of the labor force and had revenues equivalent to approximately 14 percent of the country's 1997 gross national product. Most of the activities of these enterprises are generally considered to be outside core government functions and involve services that could be delivered by the private sector, which would free up government resources, widen the tax base, spur economic activity, and produce gains in efficiency.

The central argument for reducing the role of the state in public infrastructure enterprises has been that doing so would help create a competitive market for services, thereby reducing subsidies, lowering costs to consumers, and raising efficiency through better access to management know-how and technology. However, it was clear from the start that complex regulatory reforms would have to accompany privatization and that depressed asset markets would have to recover before substantial asset divestitures could take place.

All through the crisis, the government made state enterprise reform and privatization a key plank of its economic reform program. The September 1998 master plan for state enterprise reform provided a detailed roadmap for privatization in the communications, water, energy, and transport sectors. The government commissioned studies to create a framework for reform and made slow but measured progress on reform initiatives in key sectors. Regulatory guidelines were drafted, along with restructuring plans for the transport, water, and energy sectors. Privatization began on certain key enterprises—including Thai Airways and the Airport Authority of Thailand.

Table 6-2. Public Enterprise Financial Indicators for 1998
(billions of baht)

Sector	*Number of firms*	*Assets*	*Liabilities*	*Net assets*	*Revenue*	*Earnings*	*Profits/ assets (percent)*	*Profits/ net assets (percent)*	*Profits/ sales (percent)*	*Number of employees*
Energy	7	644.9	388.6	256.3	465.8	54.8	8.5	21.4	11.8	93,578
Transport	5	178.7	127.1	51.6	18.1	–2.4	–1.3	–4.7	–13.3	57,376
Marine transport	4	18.2	5.3	12.9	9.6	3.1	17.0	24.0	32.3	10,168
Aviation	4	160.4	108.9	51.5	89.3	8.9	5.5	17.3	10.0	32,001
Communications	3	254.9	61.7	193.2	71.3	29.6	11.6	15.3	41.5	54,580
Water and housing	4	96.7	62.0	34.7	15.2	2.5	2.6	7.2	16.4	16,610
Industrial manufacturing	13	37.1	9.5	27.6	44.0	5.4	14.6	19.6	12.3	16,321
Agriculture	9	12.8	8.3	4.5	6.4	–1.2	–9.4	–26.7	–18.8	9,550
Services	11	12.3	4.1	8.2	20.4	1.1	8.9	13.4	5.4	5,122
Subtotal	60	1416.0	775.5	640.5	740.1	101.8	7.2	15.9	13.8	295,306
Financial institutions	5	1,407.1	1,304.4	102.7	144.1	24.5	n.a.	23.9	17.0	41,342
Total	65	2,823.1	2,079.9	743.2	884.2	126.3	n.a.	n.a.	n.a.	336,648

n.a. Not applicable.
Source: Government of Thailand data.

Nevertheless, the pace of privatization during the first years of the economic crisis was slow and opposition to privatization has increased. The government still needs to effectively communicate the benefits of privatization to concerned labor groups and to the public at large. The failure to define the authority of the Office of State Enterprises and to adequately fund its activities has also impeded progress.

Nonetheless, by the summer of 1998 a foundation had been laid for broad-based structural reform capable of restoring the economy's long-term competitiveness. By initiating regulatory and institutional reform, the government signaled to the market that it had a clear strategy for long-term growth and the will to implement that strategy.

7

Pump Priming and Protecting the Poor

The government's stabilization and structural reform efforts began to bear fruit in the winter of 1998–99. Evidence that the economy was finally bottoming out emerged in the fourth quarter of 1998 (box 7-1). Production in the manufacturing sector stabilized somewhat and even expanded in a few sectors. On the demand side, retail sales also showed improvement. From May to September 1998 the exchange rate was stable, ranging between 41–42 baht to the dollar. By the end of the year, reflecting the country's improved balance of payments, the baht appreciated to 36-38 against the dollar and remained at that level through early 1999. As confidence in the currency and the country's riskworthiness improved, money market interest rates fell rapidly from 18 to 19 percent in June 1998 to around 3 to 4 percent in January 1999. Lending rates also fell considerably, from 15.4 percent in March 1997 to 11 to 12 percent in January 1999. These signs of recovery and stronger investor confidence were fragile, however, and further improvement depended on continued expansion of demand and the resolute implementation of the structural adjustment program.

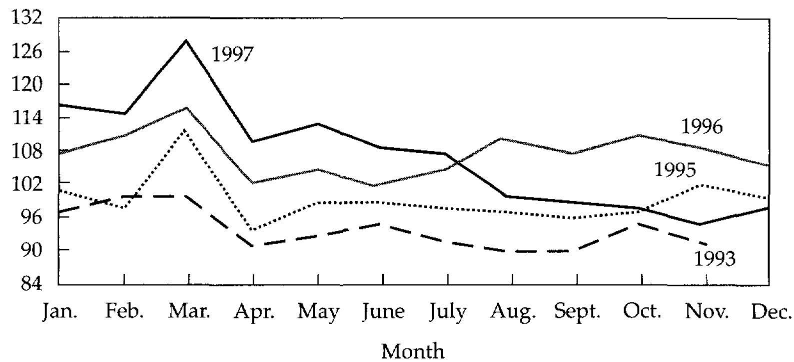
The Problems of Market-Driven Recapitalization

In the summer of 1998, as the recession deepened and nonperforming loans mounted, the fragility of undercapitalized financial institutions became hard to ignore. The expectation that increased transparency would attract new domestic and foreign investors to the country's financial institutions and thereby restore the capital base was proving unfounded, making it increasingly clear that government support would be required to supplement market-driven recapitalization.

On August 14, 1998, the government announced a plan for the recapitalization of troubled and intervened financial institutions. The new plan

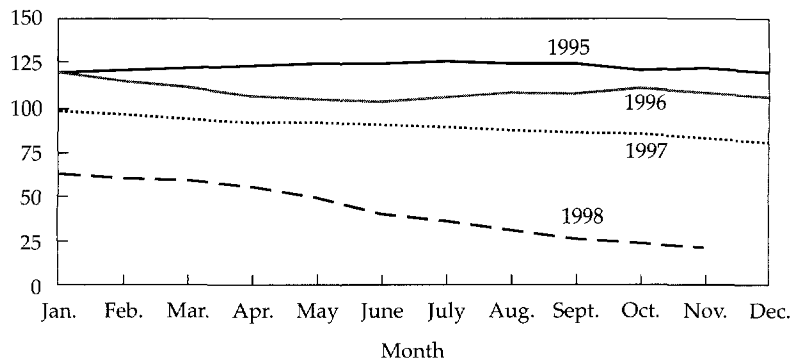
Box 7-1. Bottoming Out

Box Figure 7-1. Manufacturing Production Index



Source: Bank of Thailand data.

Box Figure 7-2. Private Investment Index



Source: Bank of Thailand data.

Throughout the crisis, export-oriented sectors performed better than domestically oriented sectors. Some of the manufacturing sectors that started to improve in 1999 included vehicles and transportation, which had shifted from domestic to foreign markets. The textiles industry was one of the few manufacturing industries that expanded throughout the crisis.

Outside of the manufacturing sector, data are limited, but available evidence suggests that the agricultural sector, representing 11–13 percent of

(box continues on following page)

Box 7-1 continued

GDP, expanded by 2–3 percent in 1998, while the construction, gas, electricity, and water sectors contracted substantially.

Although real retail sales peaked in the summer of 1996 and fell almost continuously thereafter, data for 1998 suggest a bottoming out. Retail sales in 1998 remained stable at a level corresponding to 82 percent of 1997 sales. The contraction in car sales also stabilized. The year-on-year decline continued to be a staggering 70 percent, but sales had settled at a monthly average of approximately 4,000 cars, compared with approximately 14,000 prior to the crisis.

Private investment began to show signs of improvement in 1999. Although the Bank of Thailand's private investment index continued to record high contractions, improvements show up only after considerable lag, because the index is a 12-month moving average of six different proxies of investment. The large contraction in the index conceals the fact that four key components bottomed out in early 2000, including domestic cement sales, imports of capital goods, construction in municipal zones, and credit for construction and manufacturing.

aimed to reward companies that restructured their debt. Some of its provisions were refinements of earlier efforts; others were new. The salient features of the plan were as follows:

- Public recognition of the problem
- Commitment of up to 300 billion baht to assist in the restructuring of potentially viable financial institutions
- Incentives to lenders to accelerate restructuring of borrower debt and to enable new lending
- Efficient management of nonperforming assets
- Sale, merger, or closure of nonviable institutions
- Equitable loss-sharing arrangements, containment of public sector costs, and avoidance of moral hazards
- Strengthening of prudential supervision and accelerated adoption of loss provisioning rules
- Operational restructuring of state-owned banks and preparation for their eventual privatization
- Writing down of shareholder capital, and conversion of FIDF liquidity support to new capital.

Banks did not significantly take up the August 1998 plan, despite the fanfare surrounding its announcement, largely because owners feared losing control to the government. However, the plan did introduce two innovative forms of capitalization—Stapled Limited Interest Preferred

Securities and Capital Augmented Preferred Securities—that were used to convert deposits into "capital," although at high interest rates.

Perhaps the greatest disappointment in the anticontractionary phase of the crisis was the extremely slow pace of bankruptcy reform. As noted in chapter 6, the excellent voluntary framework that had been put in place needed the threat of court-supervised action to bring recalcitrant debtors and creditors to the negotiation table, but the Bankruptcy Act of 1940 still had to be amended to restore a balance between debtor and creditor interests. The existing process could tie parties up in years of expensive court procedures. The courts, meanwhile, were clearly unprepared to deal with the large volume of potential cases. A separate bankruptcy court would have to be established and judges trained in modern bankruptcy procedures.

The provisions of the Code of Civil Procedures affecting secured lending needed to be rewritten to enforce the secured rights of creditors. Revisions would have to streamline the law, create new security interests, and establish an automated registry system.

The legislative agenda moved at a snail's pace because of procedural delays in the Ministry of Justice and because debtors and creditors were reluctant to take losses. The market correctly perceived this reluctance, and market-led capitalization came to a halt.

Macroeconomic Policy in a Severely Constrained Monetary Environment

With slow progress on bank recapitalization and insufficient bite in the legal framework, macroeconomic policy would have to carry the major burden of adjustment to stimulate recovery. The challenges were daunting indeed.

First, although the export sector had been a key source of growth in the past, it was unlikely to play the same role at this stage of the crisis. The protracted crisis in East Asia had spread to other emerging markets, and increased competition from Asian and Latin American competitors posed increasing difficulties for Thai exports. Despite a shift to Europe and the United States during 1998, export figures continued to disappoint. Year-on-year export volumes even declined slightly in October and November 1998.

Second, weaknesses in the financial system constrained the ability of the authorities to use monetary policy to stimulate domestic demand. With reduced risk of macroeconomic instability and improvement in investor confidence, the authorities had successfully engineered nominal exchange rate stability and a decrease in short-term repurchase rates to below their precrisis levels. Lending rates had also declined, as previously noted. However, monetary policy had been rendered less effective as stress in the financial system reduced the supply of bank credit to the private sector. The major

bottleneck to renewed credit expansion remained the slow progress on corporate restructuring and bank recapitalization.

Third, the country's ability to use fiscal policy to stimulate demand and mitigate the impact of the crisis on the poor was constrained in several ways. Among the constraints to raising expenditures was the fact that much of the stimulus had to be foreign-financed, and there was reluctance to remit funds quickly in view of slow progress on the reform program. There were institutional constraints, as well. Line ministries used to restraint and caution found it hard to change their habits and spend money quickly. Finally, the growing costs of financial sector restructuring raised concerns about the sustainability of fiscal policy. These points are discussed in greater detail below.

The Fiscal Stimulus and Social Protection

Fiscal policy had been loosened over the course of 1998. Automatic stabilizers on the revenue side had provided some stimulus, but their effect was more than offset by the decline in expenditures. The time had come to revisit the fiscal stance and make it truly counter-cyclical. The government's supplemental budget for 1998–99 contained additional central government expenditures equivalent to approximately 1 to 1.5 percent of GDP. The additional expenditures were designed to improve social safety nets and to stimulate consumption of domestically produced goods by putting more wage money in the hands of the poor.

The government concluded that the new fiscal policy was sustainable over the medium term, despite the higher estimated costs of financial sector restructuring. The interest cost of restructuring was estimated to be on the order of 3 percent of GDP, and debt-to-GDP levels were believed likely to rise to some 60 percent of GDP over the next two years. The IMF estimated, however, that as real growth strengthened and real interest rates declined, and as assets were recovered, debt levels would decline to around 40 percent of GDP by 2002–03, a level that compared favorably with those of high- and middle-income countries.

At least 40 percent of the increase in public expenditure would be allocated to protecting the poor. In a typical year, the specific composition of the deficit (that is, the mix of expenditures that make up the deficit) would be guided by the degree to which expenditure items improved the functioning of the economy and the conditions of the poor. The need to inject a fiscal stimulus, however, added a further set of considerations involving the speed at which funds were spent and the degree to which spending could be reversed after the crisis. The National Economic and Social Development Board, the Ministry of Finance, and the Bureau of the Budget assigned high priority to expenditures that met several criteria at once. Priority expenditures should alleviate social and economic problems of

targeted groups, be susceptible to rapid execution and disbursement, raise productivity, fall within the responsibility of the most capable government agencies, be transparent and monitorable, and not carry over significantly to subsequent fiscal years.

The government took two approaches to developing projects that met the stated conditions. Some bottom-up proposals were made by the agencies that would eventually implement them. These were submitted to the Bureau of the Budget. At the same time, the Ministry of Finance, the National Economic and Social Development Board, and the Bureau of the Budget directly financed other top-down projects.

Creating a safety net

Until the onset of the crisis, Thailand had relied mainly on rapid growth and full employment to improve standards of living. The economic crisis forced a review of that approach, revealing serious structural inadequacies in Thailand's social protection policies and pointing to the urgent need to protect against the loss of family income.

Preliminary analysis of Thailand's 1998 socioeconomic survey by the National Economic and Social Development Board and the Asian Development Bank indicates that by the first quarter of 1998 the number of poor people had increased to 13 percent of the population from 11.8 percent in the first quarter of 1996 (NESDB 1999). Rural areas experienced the largest increase in poverty, from 14.9 percent in 1996 to 16.6 percent in the second quarter of 1998. The worst affected region was the Northeast, where poverty increased from 19.3 percent in 1996 to 22.7 percent in the second quarter of 1998. (The percentage of people in poverty in Bangkok—0.6 percent in 1996—changed little.)

To address the problems of poverty, the government began a program to improve the strategic design and coordination of social policy, provide protection to the poor and the elderly, strengthen social protection of workers, and improve monitoring of living standards.[1]

Given the increase in the number of people in poverty and the administrative difficulty of identifying all those in need, self-selecting participation in public workfare programs was found to be an effective way of delivering targeted income support. Rural public works programs were expanded to generate employment opportunities, especially for the rural poor in the Northeast. Additional funds were allocated for that purpose, and their regional allocation reflected the regional distribution of the poor. Existing workfare programs, which had low labor intensities

1. The government decided in early 1999 to allocate additional funds to implement the 1999 socioeconomic survey and to conduct an additional fourth round of its labor force survey. Measures were taken to improve the policy relevance of both surveys by shortening their turnaround time to three months. Nevertheless, better monitoring of changes in living standards in different socioeconomic groups is needed to improve the effectiveness of future programs designed to mitigate the social impacts of economic cycles.

and offered higher-than-market wages, were made more labor-intensive. By offering lower wages the revised programs induced only the most needy to self-select. The programs' effectiveness was monitored through well-designed surveys of participants.

To protect vulnerable individuals who might not be able to work, the government implemented a variety of means-tested cash transfer programs, including income support for the poor aged over 60 and for needy families.

Besides cash transfer programs, the government also provided a variety of in-kind transfer programs, including a medical care program targeted to poor adults and a school-lunch program for needy students in primary schools. Because both of these programs had the same weaknesses as the cash-transfer programs, additional funds were allocated to them. The government also instituted scholarships targeted to children deemed likely to drop out of school.

With respect to the elderly, in particular, the new safety net was far from perfect. The monthly value of the subsistence allowance for the elderly in fiscal year 1999 was 200 baht per person, or less than one-third of the income that defines the official poverty line for the elderly, which was around 700 baht per month in 1997. Even at this low value the 1999 budget allocation of 763 million baht covered only 320,000 beneficiaries, or about one-half of the elderly poor in 1996.

Social protection for workers

The effects of the crisis on employment were profound. Between August 1997 and August 1998, 700,000 people fell into unemployment and real wages declined by 12 percent in some regions and up to 24 percent in others. A large component of the fiscal stimulus package was allocated to strengthening labor demand, increasing employment, and halting further decline in real wages.

Before the crisis Thailand did not have an unemployment insurance scheme to maintain income during periods of unemployment. Workers laid off from the formal private sector became entitled to severance pay according to provisions of the Labor Protection Act of 1998. The amount of the severance payment was based on length of service up to a maximum of 10 months of earnings. Because this new liability was unfunded, however, it ran the risk of not being paid or paid only after unacceptable time lags. The government therefore established an employee welfare account to partially fund unpaid severance claims.

A variety of labor market policies were implemented to promote re-employment of laid-off workers through training and job placement services. The government established a task force, with representation from workers, employers, and government, to design, target, and rigorously evaluate the cost-effectiveness of training programs for unemployed workers.

Reform of social security

By law the Social Security Office was to begin collecting contributions for old age and child benefits at the end of 1998. Equal contributions from employers, employees, and the government were to increase over time to the mandated level of 3 percent of wages. The proposed pension benefit structure was not fiscally sustainable, however, because the required contributions from the national budget would have benefited only 18 percent of the labor force and meant lower wages for workers whose earnings had already sharply declined. Because of these shortcomings, the government decided to delay implementation of the pension system until economic growth had resumed and the scheduled benefits could be restructured properly.

About 20 percent of social security contributors contributed to tax-exempt, employer-sponsored savings plans. International experience shows that such funds increase the domestic savings rate, deepen capital market development, and reduce excessive leverage of the corporate sector. However, Thailand's funds were unsupervised and unregulated. They made lump-sum payments when employees left the firm, were not portable across jobs, and offered no annuities. In early 1999 the government established a taskforce to develop a regulatory structure for voluntary savings funds and to provide for portability across funds and employers. The recommendations of the task force are to be phased in over the next several years.

8

At Last, Recovery

Pessimism about the prospects for recovery began to lift in the summer of 1999 as the economy picked up. In June, annual growth in manufacturing was a robust 8 percent—although it sagged again later. Export volumes turned positive and imports started to pick up, trends that continued over the next six months. In December the government revised its GDP growth estimate for 1999 up to 3–4 percent, mainly due to the strong performance of manufacturing, which registered annual growth of 15 percent.

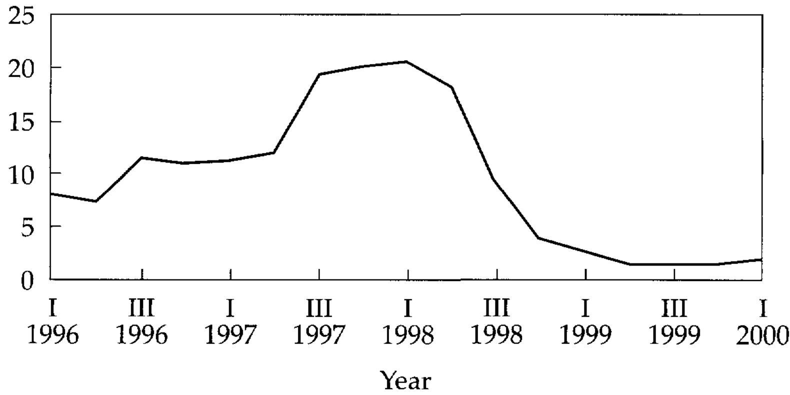
The fiscal stimulus had an important psychological and social impact in propping up domestic demand, which had begun to initiate the following improvements in external demand, although the impact would have been larger had it been implemented earlier. Nonetheless, the overall size of the fiscal deficit, 7 percent of GDP, was important even at this stage of the crisis and so were the specific initiatives that boosted demand. These included employment-generating projects under the so-called Miyazawa initiative that increased employment and income opportunities for nearly 4.5 million workers. The cash and in-kind transfer programs for the poor were complemented by a temporary cut in the value-added tax rate from 10 to 7 percent, which strengthened consumption.

Growth broadened, and the Bank of Thailand's composite private consumption index—which measures sales of cars and other consumer items—was up nearly 8 percent from the previous year. Private investment had been dormant throughout the crisis, but now it also began to stir, and the private investment index—composed of imported capital goods, domestic cement consumption, foreign equity inflows, and sales of iron sheets, among other things—registered steady improvement. Other signs—including interest rates, the exchange rate, the consumer price index, and reserves—showed improvement as well (figure 8-1).

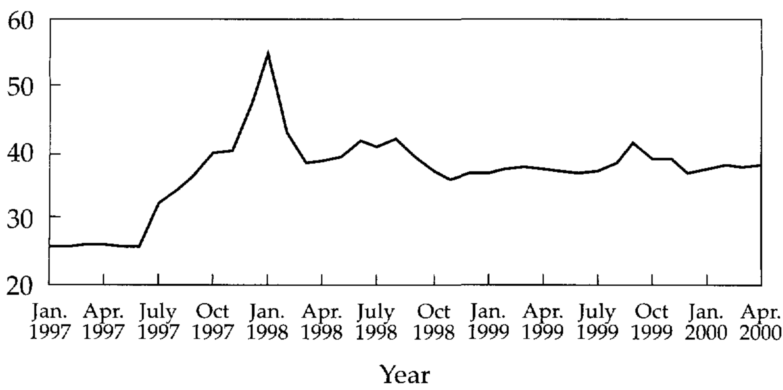
External demand was also turning around (figure 8-2). In contrast to the contraction of 7 percent in 1998, exports in 1999 expanded by 5–6

Figure 8-1. Thailand Selected Indicators

Interest rate (average interbank rate, percent)



Exchange rate (baht per US$)



Consumer price index (12 month growth rate, percent)

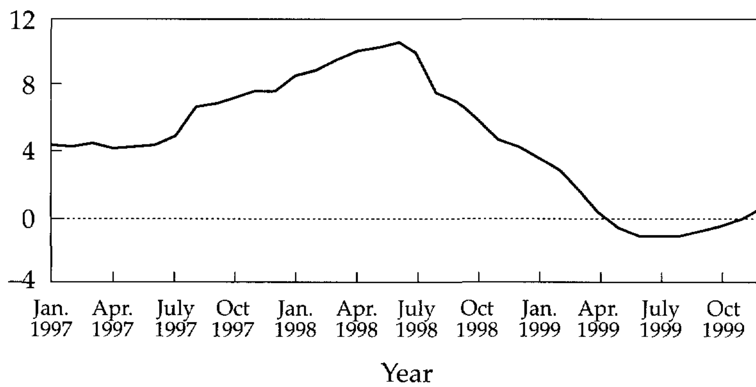


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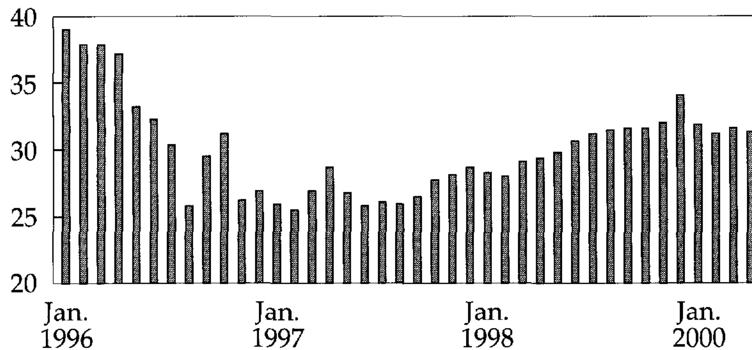
Figure 8-1 continued

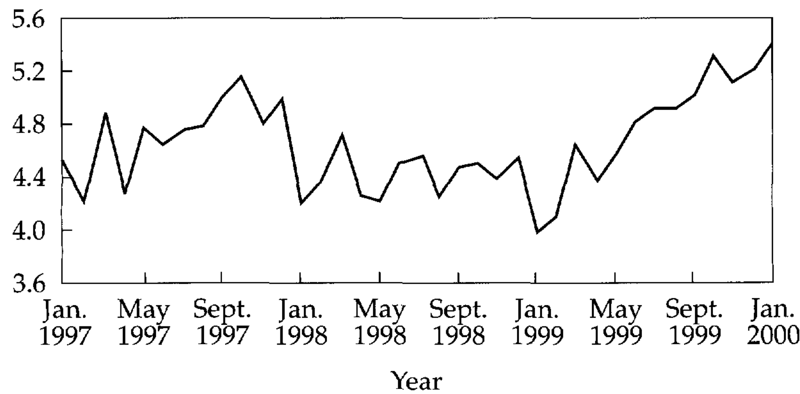
Reserves (US$ billions)



Source: Bank of Thailand data.

Figure 8-2. Exports

fob US$ billion



Source: Bank of Thailand data.

percent. The U.S. and European Union markets had picked up earlier, and now even the Japanese and the regional markets were stirring as recovery began to take hold throughout the region. Exports to these markets increased by a hefty 19 percent and 23 percent, respectively, between October 1998 and October 1999. Foreign direct investment, strong throughout the crisis, was diversifying into exports and services, which improved prospects for these sectors.

The macroeconomic framework continued to provide a stable environment as the exchange rate held, interest rates fell, and reserves accumulated.

The key questions now were whether the recovery would be sustained, whether the income and employment losses suffered in the crisis years would be recouped, and whether healthy growth would resume. The answer lay in progress toward completing the structural reform that would put the financial and corporate sectors back in working order.

Reform of the Financial Sector

The government focused on the financial sector throughout the crisis. Some of the measures taken to stop the hemorrhaging in financial institutions and reverse the loss of confidence were bold and dramatic, but most were incremental. Over time, the small steps added up to an impressive restructuring effort (table 8-1).

The government intervened in troubled banks, some of which were wound down, such as the Bangkok Bank of Commerce, and others merged. The latter include First Bangkok City, which merged with KTB; Union Bank, which merged with KTT to form BankThai; and Laemthong, which merged with Radanasin Bank. Some of the nationalized banks were privatized, such as Nakornthon, Radanasin Bank, Bangkok Metropolitan, and Siam City; others, such as BankThai and KTB, would be privatized in the longer term.

Participation of foreign banks increased as the government temporarily relaxed limits on foreign ownership and allowed foreign banks access to branch networks. Acquisition of Thai banks by foreign banks and investors increased substantially. As a result of increased competition, automated teller machines, online banking, and other innovative products and services were introduced or made more readily accessible. Customer service and the quality of financial disclosure improved as well.

Table 8-1. Consolidation of the Financial Sector during the Crisis

Item	*Precrisis (June 1997)*	*October 1999*	*Change*
Domestic private banks	14	9[a]	–5
State-owned banks	1	4[b]	3
Foreign (single branch) banks	14	20	6
Finance companies	91	21	–70
All financial institutions	120	54	–66

a. Includes Bank of Asia Public Company Limited, DBS Thai Danu Bank Public Company Limited, Nakornthon Bank, and Radanasin Bank which now have majority foreign ownership.

b. Does not include Bangkok Bank of Commerce, which wound down; First Bangkok City Bank, which merged with Krung Thai Bank; and Laemthong Bank, which merged with Radanasin Bank.

Source: World Bank (2000a).

The finance company sector was restructured by closing failed institutions and establishing the FRA, as noted in chapter 5. As of December 2000, the FRA had disposed of 86 percent of the assets from failed finance companies. Creditor claims have been adjudicated for the first eight of the 56 closed finance companies. The FRA auctioned off noncore assets such as securities and automobiles with a book value of 65 billion baht at an average bid price of 53 percent.

Recapitalization and nonperforming loans

Restructuring efforts also aimed to restore the soundness of financial institutions through recapitalization and by addressing nonperforming loans, developing a strategy for the sector, strengthening the supervisory capacity of the Bank of Thailand, and introducing legislation to improve discipline within and among financial institutions. Progress in these areas has been mixed.

The banks met their recapitalization needs mostly through the market, including through Stapled Limited Interest Preferred Securities and Capital Augmented Preferred Securities (see chapter 7). Institutions that were unable to raise capital in the market or could not qualify for the government's August 1998 capital support scheme were intervened or merged into state banks. Although only 45 billion baht were raised through the capital support scheme, the environment for market-led recapitalization improved after the government announced the scheme and made known its commitment to refinance the FIDF, which provided liquidity for distressed institutions.

Recently the environment has proven difficult for some issuers, and attempts by some weaker banks to raise capital in the market have been less than successful. The market is discouraged by continued high levels of nonperforming loans and by the difficulties in passing and implementing laws that clarify and expedite debt collection and bankruptcy procedures.

By December 1999 the overall level of nonperforming loans had declined to 38.5 percent after a year at the 45–48 percent level, but state-owned intervened banks and finance companies still had high levels of nonperforming loans (61.6 percent and 49.2 percent, respectively). Although high levels of nonperforming loans do not appear to have resulted in a growth-stifling credit crunch in the short term, they may impede future bank lending. Nonperforming loans also have a negative impact on market-based recapitalization, as mentioned before.

Recent positive developments—including the revival of the economy, progress in setting up private asset management companies, and loan write-offs—had reduced the number of nonperforming loans to around 20 percent by the end of 2000. However, the quality of loan workouts is poor, generally reflecting cosmetic rescheduling, especially for unlisted, middle-market, and the small and medium sized borrowers who account

for approximately 85 percent of outstanding loans. A more genuine restructuring of the debt of listed firms is taking place through larger, syndicated loans with participation by foreign banks.

The cabinet recently improved the climate for bank-owned asset management companies by eliminating many cost and tax disincentives for the capitalization, asset transfer, and operation of such entities. Three institutions have set up wholly owned asset management companies to receive a portion of their nonperforming loan portfolio. In one of the three institutions, additional capital raised from current shareholders is facilitating the process of marking the nonperforming loans at market levels, or approximately 50 percent of their book value, and transferring them to the asset management company. Private banks would like to see additional tax incentives, but thus far the government has not been willing to provide them.

Toward a national strategy for the financial sector

To encourage development of a five-year strategy for the financial sector, the government has established a Financial Services Task Force composed of senior management officials of the Bank of Thailand, the Ministry of Finance, and the Securities and Exchange Commission. The Task Force produced a preliminary report at the end of 1999. Key messages include a level playing field for financial institutions, prompt exit for weak institutions, consolidation in the financial sector, and focus on risk-based consolidated supervision.

The Bank of Thailand has been reorganized to provide better supervision of the financial sector. Training programs for examiners, including a commissioning process, are being developed, as are manuals for examiners. Supervision capacity has been benchmarked against the Basel Core Principles so that improvement can be monitored.

Legislation to improve discipline among financial institutions was expected in 2000. One bill aims to standardize the regulatory framework for banks, finance companies, and credit foncier, which is a company licensed for the purpose of carrying out improvements by means of loans and advances upon real securities. The draft has been sent to industry officials for comments. Another piece of legislation would strengthen the independence and flexibility of the Bank of Thailand while enhancing its transparency and accountability. A third would allow the Bank of Thailand to manage its accounts on a consolidated basis. Finally, a deposit-insurance bill to replace the existing government guarantee is under review, but the timing of the legislation is uncertain.

Financial disclosure and corporate governance

International accounting standards are gradually being adopted throughout the country, and specific rules on accounting and reporting for

financial institutions are being developed. Improved guidelines for implementing the ethical code for directors of listed companies have been issued, and an Institute of Directors has been established. Finally, the regulatory framework for enforcement of regulations related to public companies is being streamlined.

The domestic capital market and comprehensive debt management

Equities and bonds as a percentage of total bank loans increased by September 1999 to 31 percent and 24 percent, respectively, up from 19 percent and 9 percent in 1997. The growing reliance on nonbank resources for meeting capital needs is a welcome development that should serve to diversify risk.

The Ministry of Finance has established a committee to build a domestic bond market. The primary focus of the Domestic Bond Market Committee is the government securities market. The committee has established task forces to cover eight major areas, including debt management.

A new Public Debt Management Office has been established, and a road map for strengthening the office—including asset liability management, a resource plan, and an information technology development plan—is being developed.

Corporate Debt Restructuring

The Bank of Thailand reported that about 1.8 trillion baht in corporate restructuring transactions had been completed by October 2000 (table 8-2). The pace of corporate restructuring has accelerated somewhat. From December 1998 through June 1999, completed transactions averaged 63 billion baht per month. Over the next sixteen months, the average was 80 billion baht per month.

As of September 2000, the CDRAC was tracking 2,773 large and medium sized restructuring cases that together accounted for 2.3 trillion baht in debt (table 8-3).

Of these high-priority cases, 825—accounting for 1,170 billion baht, or 51 percent of outstanding debt—were complete or essentially complete in

Table 8-2. Value of Completed Debt Restructuring
(millions of baht)

Complete	*December 1998*	*June 1999*	*Increase*	*October 2000*	*Increase*
Total	154,155	534,814	380,659	1,809,047	794,135

Source: Bank of Thailand CDRAC Office data.

Table 8-3. Corporate Debt Restructuring Advisory Committee Cases as of September 2000

Cases	*Number*	*Outstanding credits (billions of baht)*	*Share of outstanding credits (percent)*
Completed cases	825	1,170.0	51
Cases in restructuring process	336	90.3	4
Troublesome cases for legal action	1,612	1,038.0	45
Total CDRAC cases	2,773	2,298.0	100

Source: Bank of Thailand CDRAC Office data.

the sense that they had returned to normal status or been resolved under the voluntary CDRAC–Bangkok Rules framework or a debtor-creditor agreement. Another 1,948 cases representing 1,128 billion baht, or 49 percent of the total, were in process. Of these, 336 were undergoing a restructuring process. A total of 1,612 cases, or 45 percent of the total, are in the process of legal action.

As explained in chapter 6, debtor-creditor and intercreditor agreements emerged as a contractual response to Thailand's weak regime governing insolvency and foreclosure. For formal out-of-court restructuring efforts to work in Thailand, the Bank of Thailand must ensure that these contracts are enforced and that in cases where a debtor refuses to cooperate or the workout process breaks down, creditors sue for collection of debt, foreclosure, or court-supervised insolvency.

Under current Thai law court-supervised reorganization generally cannot occur without the debtor's consent. Nevertheless, an amendment to the country's bankruptcy law has provided a useful mechanism for obtaining approval for workouts sanctioned by at least 75 percent of a company's creditors. The pace of court-supervised reorganization cases has increased since the amendment was adopted in March 1999. Reorganization petitions averaged 7 billion baht per month between April 1998 and April 1999, then increased to an average of 34 billion baht per month between May and December 1999. The remaining weaknesses in the law still limit incentives for debtors to seek relief and for creditors to seek redress through court-supervised reorganization.

Thailand has begun to restructure its financial and corporate sectors to meet the challenges of more open, globally competitive growth. Much remains to be done to complete this restructuring, however, as explained in chapter 9.

9

Much Remains to Be Done

Although Thailand's recovery is well advanced, a sense of unease remains about its sustainability. Financial institutions continue to be plagued by high levels of nonperforming loans. The Thai stock market, dominated by financial stocks, is depressed, and investor interest has sagged. The much-anticipated operational restructuring of nonfinancial corporations has not occurred.

The specter of another round of retrenchments still looms on the horizon. If growth falters in the United States, slowing Thailand's exports, or if supply shocks such as the recent oil price hike are repeated or sustained, the remaining financial and corporate weaknesses could well assume a much larger profile and lead to another instance of confidence lost and growth forgone.

Seven challenges must be met to address the remaining weaknesses.

Provide Fiscal Stimulus As and When Needed to Sustain Growth

The eighteen months since the summer of 1999 when economic recovery began have shown that economic growth is likely to remain below its potential while structural reforms drag on and until the investment climate is fully restored. Positive economic growth, even if anemic, creates the breathing space needed to undertake the painful restructuring of the economy. To this end, the government announced a set of new measures to provide additional fiscal stimulus to the economy (box 9-1). The need for fiscal stimulus to stimulate aggregate demand and sustain the growth momentum will continue to be felt until the private investment climate is restored. The debt implications of such stimulus should be monitored regularly.

Financial Institutions Must Be Adequately Capitalized

To ensure that banks are adequately capitalized, market-led capitalization may well have to be supplemented with government support. As

Box 9-1. A New Fiscal Stimulus Package

On October 31, 2000 the Thai cabinet approved a new economic package to stimulate aggregate demand and sustain the growth momentum. The key measures include:

1. Two-year deferment of the pending 3-percentage-points increase in contribution rates to the Social Security Fund (evenly split between the employer and employee) to support lower income workers and to lower employer costs.
2. Two billion baht added to the Fund for Farmers' Assistance and recapitalization of the Bank of Agriculture and Agricultural Cooperatives in the amount of two billion to expand small farmer credit.
3. An additional fund in the amount of about 3 billion baht allocated to support the second phase, which spans 1998–2001, of the Poverty Alleviation Project to cover an additional 10,000 villages.
4. Two hundred million baht added to the Revolving Fund for Debt Remedy for Government School Teachers.
5. Tariffs on 73 items, mainly industrial raw materials, reduced substantially to lower industry costs amounting to revenue loss of approximately two billion baht.
6. A Retirement Mutual Fund set up to enable self-employed workers to save their income contractually through provident funds by providing similar tax treatment of such savings as that accorded to savings in other provident funds. This will help deepen the capital market.
7. A support plan for small and medium enterprises set up in the Ministry of Finance to provide lending and guarantees worth about 52 billion baht (loan support of about 51 billion baht and guarantee support of 1.7 billion baht).
8. Small and medium enterprise Financial Advisory Centers (SFAC), approved to provide advisory services to small and medium enterprise entrepreneurs regarding funding sources and debt restructuring, extended to 30th September 2003 with additional government funding of 200 million baht.

Source: Ministry of Finance (2000).

nonperforming loans are addressed, losses recognized, and full provisions constituted, undercapitalized institutions will be at risk. If the economy continues to grow and interest rates remain low, further recapitalization and reductions in nonperforming loans are likely. If, on the other hand, worldwide or regional economic conditions weaken, market-driven recapitalization efforts are likely to falter. The government must be prepared to supplement that strategy with greater public support.

Any assessment of the banks' capitalization needs must be based on correct valuation of loan losses. Two reasons exist to suspect that loan losses

are understated. First, provisioning guidelines are backward looking. Second, provisions are calculated net of the value of collateral, which is primarily property, and collateral is only gradually being marked down to market value. International accounting standards, by contrast, require that impaired loans be marked down to the present value of future expected cash flow from the loan, discounted at the effective interest rate on the loan contract. The effect of this difference in practices is a significant time lag before realistic figures appear in Thailand and, meanwhile, a shortfall in the recognition of loan losses.

The Level of Nonperforming Loans Must Be Reduced

For credibility, it is important to report the true reduction in nonperforming loans. Much of the recent reduction in nonperforming loan numbers is due to the transfer of assets to private and government-run asset management companies and to debt rescheduling. Such transfers only reduce the number of nonperforming loans in the banking system as defined by the Bank of Thailand. Reporting on a monthly instead of a quarterly basis on the number and amount of loans classified by regulatory category would give a better picture of the quality of loan portfolios over time than does the present practice of citing the aggregate number of nonperforming loans.

The government must provide appropriate guidance to ensure transparency in asset pricing at the time of transfer to an asset management company and speedy resolution of transferred assets. The government adopted a regulation on January 7, 2000 that allows banks to transfer nonperforming loans at net book value instead of fair market value. Such a practice is contrary to Thai and international accounting standards and, if the regulation stands, will result in further qualifications of bank balance sheets by auditors. To improve the quality and reliability of reductions in nonperforming loans, professional asset managers should be engaged to run the asset management companies under appropriate incentive structures.

The government must be much more aggressive in addressing the nonperforming loans of state-owned institutions. Presently, government-owned institutions not only have the highest level of nonperforming loans, but also appear to be the least likely to resolve them in the near future. Many state employees are deferring decisions that might later be interpreted as having caused a loss to the government and that might invite a lawsuit against them.

Regulatory Forbearance Must Be Balanced with Rapid, Thorough Debt Restructuring

During the crisis, loan classification and provisioning standards were raised to international norms, but loss recognition based on these tougher standards was introduced only gradually, with the last phase taking effect at

the end of 2000. In addition, although the capital adequacy ratio for financial institutions was maintained at 8.5 percent, the Tier One component was reduced in August 1998 from 6 percent to 4.25 percent. These circumstances allowed banks to delay raising sufficient capital and to slow their debt restructuring efforts with their corporate clients. The government should consider an expanded scheme of public support for recapitalization that provides incentives for action.

Voluntary Debt Restructuring Must Be Encouraged

Debtor-creditor and intercreditor agreements need to be monitored and enforced scrupulously. Creditors must be encouraged by Bank of Thailand supervisors to pursue court remedies when debtors are uncooperative or when a proposed workout lacks creditor support or otherwise fails to materialize.

The State-Owned Enterprises Act should be amended to enable employees at state-owned banks to agree to debt restructuring losses without fear of personal liability, and the Civil and Commercial Code and Public Limited Companies Act should be amended to facilitate corporate mergers and acquisitions. Meanwhile, tax relief should be provided for noncash corporate acquisitions and mergers, and tax privileges currently available to asset management companies that are majority-owned by financial institutions should be extended to similar companies that are minority-owned by financial institutions. The objective is to encourage banks to structure their asset management companies such that third-party asset managers have their own money at risk in the company, thereby aligning the bank's incentives with those of the asset manager.

The Credit Culture Must Be Strengthened

The decision to suspend operations of finance companies in the summer of 1997 without instituting a quick resolution process and without servicing the loans for more than a year caused collection efforts to slow or stop. In addition, it may have led some debtors to conclude that they could drive creditors out of business through a pernicious practice known as strategic defaulting. Throughout Thailand's recent history, strategic defaulters have been permitted to plague the financial system free of pressure from legislation, the courts, the press, the public, and even the government. This must change.

Although the resolution process is now complete, the legal regime for debt collection remains weak, which further damages the terms and availability of credit in Thailand. To prevent a similar crisis in the future the country's credit culture must be strengthened. Creditors need to focus on improving their risk management methods, while debtors make efforts to reduce their reliance on bank loans, refrain from undertaking

debt that exceeds their repayment abilities, and adjust their expectations to realistic levels.

The Legal Regime for Bankruptcy and Secured Lending Must Be Reformed

The current regime for bankruptcy and secured lending has several critical weaknesses.

Thailand's legal system lacks any mechanism for collecting debts or enforcing security interests outside of bankruptcy law. The absence of debt collection tools, such as mortgage foreclosures, results in creditors that seek the lowest possible threshold for bankruptcy, while debtors find no advantage in seeking protection under bankruptcy.

Under current conditions, the same law deals with personal insolvency, corporate bankruptcy, and reorganization, and the same test of insolvency applies to all three cases. As a result, the courts have adopted a cautious and conservative entry criterion for insolvency that has the effect of depriving creditors of any effective means to encourage debtors to submit voluntarily to reorganization. The conservative criterion also effectively constrains debtors from applying for reorganization, because it requires them to admit insolvency with all its negative consequences.

Under the present reorganization process, it is possible that even in a consensual or voluntary case a corporate debtor may lose total control of management and of the process of preparing a reorganization plan. Shareholdings of family-owned corporations may be heavily diluted. These considerations are widely regarded as deterrents to voluntary reorganization.

Finally, considerable dissension appears to exist between creditors and corporate debtors over the role and powers of the planner in reorganization cases. Such dissension always causes delay, and it often prevents the parties from reaching a resolution.

These weaknesses must be addressed to allow market-led restructuring—Thailand's chosen route—to work. The activities of the government committee that is currently preparing proposals for comprehensive reform of bankruptcy and related laws need to be expanded, expedited, and placed within the framework of a monitorable, time-bound plan. Based on international experience, the reforms should take about two years. The following explains some of the points that the reforms should cover.

- Separation of personal insolvency from corporate insolvency and reorganization
- Adjustment of the current test for insolvency to bring it fully into alignment with international best practice, which defines insolvency as the inability to pay debts as they fall due; legislation is the best way to make this change

- Revision of the provisions governing corporate control to enable a debtor to maintain some powers of corporate management whether or not the debtor's management is the planner or plan administrator
- Revision of the provisions governing reorganization plans to allow debtors to remain involved in planning even if its nominee is not the planner
- Reconsideration of the criteria for the appointment, position, power, payment, and indemnification of planners.

A detailed plan for comprehensive reform of bankruptcy and related laws is urgently required. It should set out the scope and objectives of issues to be addressed and the resources required, including specialized expertise, a process, and a schedule.

An expert advisory committee led by Thai experts (legal and others) that includes global experts from major legal traditions should be set up to achieve the vital objective of reforming the country's insolvency laws and practices. Insolvency law is a highly technical area that allows for a variety of approaches even in industrial countries, and about which a clear consensus on key issues is often lacking. Legal norms and mechanisms are political bargains, however, and the laws governing insolvency, in particular, are continually evolving and being reviewed everywhere in the world. Therefore on the one hand considerable risk may accompany reliance on ad hoc expert advice or on any one international source or model without due regard to local realities. On the other hand, there is benefit in obtaining advice from a broad range of international experts and from filtering that advice through Thai experts.

Pending the comprehensive review suggested above, consideration should be given to adopting as the criterion for corporate reorganization the general inability to pay debts as they fall due, which is presently an international best practice benchmark. Admissions of insolvency by debtors would no longer be necessary under such a standard. The new criterion should not be extended to personal insolvency or corporate bankruptcy until the issue of the social and financial stigma arising from insolvency is addressed, because unless and until the latter issues are addressed, courts are likely to apply any new criterion as narrowly as possible. The change in the definition of corporate insolvency should be considered on an urgent basis as a short-term measure to provide easier and quicker access to reorganization and thereby increase the chances of successful rehabilitation.

The need for stronger procedures for debt collection and security enforcement is equally urgent. The government should consider what actions are needed to supplement the November 1999 revisions of the civil procedure laws and the ongoing revisions of secured lending laws governing movable property.

By adequately addressing these challenges; enforcing regulatory and institutional changes in corporate governance that affect financial disclosure, minority shareholder rights, and the conduct of senior managers in public companies; and moving forward with the program to strengthen private sector competitiveness, Thailand can restructure the debt and operations of its companies and financial institutions. The economic crisis has provided an opportunity to implement far-reaching reforms that have the potential to raise Thailand's investment climate to global standards.

10

The Lessons of Experience

The crisis of 1997–2000 in Thailand was the result of the excesses of the private sector. Large sums were diverted to projects of poor quality that had been justified on the basis of highly exaggerated projections of demand and profitability. Mistakes such as these had taken place because neither the vast majority of shareholders nor the financial institutions that funded the projects exercised due diligence to restrain senior managers and directors of corporations.

Government failures also contributed to the crisis. Those failures bore little resemblance to the public debt problems of Latin American governments in the 1980s, however. On the contrary, the Thai government—like others in Southeast Asia—was and remains fiscally prudent. On the eve of the crisis, Thailand had relatively low public debt, both external and internal, after several years of fiscal surpluses. The failure lay in forbearance; that is, in overlooking the excesses being committed by banks, finance companies, and corporations and thus increasing the risk that private sector liabilities would become liabilities of the government.

These public and private failures resulted in poor financial intermediation and declining rates of return on investments. Thus, even though Thailand had a large pool of domestic savings, it had to borrow heavily abroad to support GDP growth. Changing the mindset that leads to poor financial intermediation has been a primary objective of Thailand's structural reform. The review presented in this book shows that an important beginning has been made to achieve that end. Nevertheless, continued commitment to the reform program will be needed to bring about lasting change in business attitudes. The most important reforms and changes—which reflect the lessons of bitter experience—are summarized below.

- Prudential regulations for banks are being raised to international standards, as are the standards for central bank supervision of financial institutions.

- Financial intermediaries understand the penalties for noncompliance with the new standards and for excessive risktaking better than ever before. These penalties include the threat of intervention and possible closure by the Bank of Thailand.
- Financial disclosure and shareholder voice—both critical for prudent decisionmaking—are being strengthened through reform of corporate governance.
- The capital market is being deepened to provide alternatives to debt finance, thus increasing the financing options available to corporations and the savings instruments available to households.
- The risk associated with forbearance—namely the fiscal burden of contingent liabilities—is now well understood by the government, which is now promoting management of contingent liability.
- There is a keen understanding and appreciation of the legal and judicial frameworks that maintain the balance between the interests of debtors and creditors. That balance is being restored to encourage prudent behavior by all.
- It is now well understood that a rational macroeconomic framework that maintains realistic, market-determined exchange rates promotes prudent risktaking. Such a framework has become the cornerstone of macroeconomic management.

The crisis starkly revealed that financial sector meltdown, corporate morbidity, and the misery of prolonged unemployment and wage cuts were tightly entwined. Thailand's leaders now appear to understand the need to respond quickly to minimize the social costs of future economic crises.

Declaring victory would be premature. Much remains to be done. Progress on corporate restructuring has so far been modest. The formidable task of bank recapitalization is far from complete. Important legal and judicial reforms have just begun. The government will need to remain proactively engaged to ensure that the hard won structural reform takes hold and that Thailand's corporate leaders and firm managers respond energetically and constructively to pressures from better informed and empowered shareholders, creditors, and workers.

Finally, the crisis has shown that substantial costs, such as loss of employment and earnings for workers and loss of asset values for capital owners, and transfer of assets among domestic investors and between domestic and foreign owners of assets are associated with any rescue and restructuring of the economy. Costs are rarely recovered from precisely those groups in society who initiated the crisis. This is partly because of the difficulty of precisely assigning costs, but also because crises are often caused by society-wide failures. Inevitably, therefore, the costs of the rescue programs and economic restructuring are met through taxation. To

avoid shifting the bulk of the costs to lower income groups and future generations, it is critical that the tax structure be fair across income groups and across generations. Prudent debt management and tax reform will thus continue to demand government attention.

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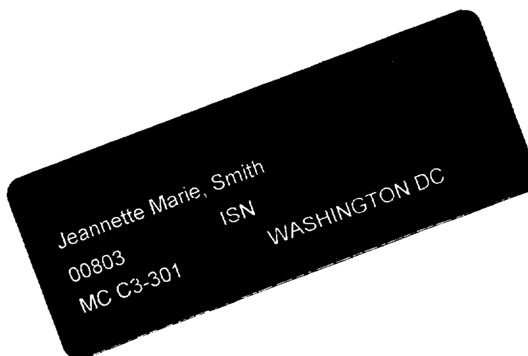
Although the financial sector was the epicenter of Thailand's economic crisis in 1997, the corporate sector, small-scale manufacturers, wage earners, and other vulnerable groups also felt its effects. This resulted in a widespread loss of confidence that threatened to undo the prosperity of several decades of hard work.

This book provides an analysis of the crisis and the struggle to find solutions. It examines key crisis events and policy measures for damage control. It also describes in detail Thailand's stabilization programs and steps taken to prevent similar crises in the future, such as structural reforms in the financial and corporate sectors. Future challenges to the country are also outlined.

The information presented here will help readers to draw their own conclusions about the crisis and assess how far Thailand has recovered.



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