Part II: Country Analysis - Chapter VII Economic Reform and Financial Sector Restructuring after the Currency Crisis in Thailand

Chapter VII

Economic Reform and Financial Sector Restructuring after the Currency Crisis in Thailand

After having experienced a remarkable economic growth from the mid-1980s to 1996, Thailand suffered a sharp economic downturn with the almost zero growth of export earnings. Under speculative pressure on the baht, the Bank of Thailand could not defend the currency and the pegging-to-a-basket currencies was placed on a managed float exchange rate system on July 2, 1997. The currency crisis necessiated a request to the IFM for financial assistance. Agreement on a US$17.2 billion rescue package was reached in August 1997. There are many measures and economic conditions that the Thai Government must implement into the economic restructuring plan in order to get the approval for this stand-by arrangement loan from the IMF. I believe that in order to restructure the Thai economy, we need to implement a three-pronged approach in stages: (1) reform of the financial system, (2) dealing with the unemployment problem, and (3) improvement of the industrial structure. But due to space limitations, I will use the first section of this article to explain how Thailand has made progress in resolving the economic problems under the IMF policy conditionalities. Then, in the second section, I will take up the financial sector restructuring, one of my three proposals, and elucidate the main points.

1. Thailand's Economic Reform under the IMF Policy Conditionalities

The Thai government was forced to request financial assistance from the IMF because the official foreign reserves declined to crisis levels. Since the baht was attacked heavily in February and May of 1997 by foreign speculators known as hedge funds, the Bank of Thailand resisted with a massive intervention (swap transaction) in order to defend the old exchange rates. As a result of this, currency defences $23.4 billion was sold in forward obligations over the next 12 months and the actual magnitude of the net official reserves declined to less than $1 billion at end of August, 1997. Moreover, non-performing loans in Thailand's financial institutions rose sharply as the economy deteriorated. It was determined that a thoroughgoing economic restructuring plan under the auspices of the IMF would be needed to restore the confidence of foreign investors in the Thai economy.

1-1. Implementation of Total Demand Control Policy

In the Memorandum on Economic Policy that the Thai Government submitted to the IMF in August 1997, a key element of the program highlighted the need for an immediate tightening in fiscal and monetary policies, restructuring the financial system, and stabilizing exchange rates. In order to implement total demand control policies, the Thai government increased the value-added tax, excise and import taxes on some luxury goods and carried out retrenchment by cutting budget expenditures in the fiscal 1998 year, all with the aim of achieving a surplus of 1 percent of GDP. Moreover, the plan set an indicative range for key interest rates, aiming to stabilize exchange rates, prevent inflation, and reduce the external current account deficit. These austerity program were the similar to those that had been adopted during the Latin American external debt crisis. Initially, there were arguments that the policies might not be appropriate for Thailand, which had budget surplus, low inflation, and mostly private external debt, but it was believed that these policies did not seem particularly alien to the Thai governmental authorities, who had been pursuing conservative financial and monetary policies up to that point.

However, this total demand control program has to contend with a less favorable macroeconomic outlook than originally anticipated. As a result, government revenues are projected to decline, compared with estimates made at the time of the initial program. What was worse, new challenges that have arisen from the regional situation have resulted in the further depreciation of the baht. Even exporters, who should have been able to compete on export price, owing to a depreciation of the currency, were unable to obtain new loan, due to the credit crunch brought about by the non-performing loan problem of the financial institutions, and the recession gradually deepened. In November, the Chavalit administration, which performed poorly in economic management, lost power. The Chuan Cabinet was formed to get a better capability in handling the economy. A request to revise the conditions if environments warranted was added to the economic restructuring plan that the Chuan Cabinet had reconfirmed, but there was no change in the total demand control policies that were the fundamental framework. In other words, the principal cause for the loss of confidence in the Chavalit Cabinet was its failure to deal with the dramatic changing international economy.

1-2. Toward Revitalization of the Real Sector

The baht has fallen steadily from 25.8 to the dollar on July 1 to 56.5 baht to the dollar on January 12, 1998, but on January 30, the Central Bank invalidated the measure of market classification of foreign currency that it had introduced in May 1997 to prevent speculators from selling baht. After that, the baht suddenly rebounded, stabilizing at about 40 baht to the dollar from March.

The third letter of intent agreed upon with the IMF in February not only evaluated the Thai government's steady performance in external current account adjustment and meeting the numerical targets for inflation but also revised the economic growth rate for 1997 downward to minus 0.4 percent, acknowledging the fact of weaker economic activity. In recognition of adverse economic conditions, the IMF also admitted a projected central government deficit of 2 percent of GDP, instead of the 1 percent of GDP surplus originally programmed and even discussed the possibility of bringing down interest rates after the exchange rates showed sustained stability. Even though external current account adjustment has proceeded more quickly than envisaged, this was, in fact, due to reflecting the sharp reduction of import demand, and the IMF was forced to revise its conditions in light of revitalizing the real sector.

Furthermore, in the fourth letter of intent, signed in May, a policy was hammered out which placed a greater priority on minimizing any further decline in the economy and bringing about an early recovery. The exchange rate stabilized since March allowed a steady lowering of short-term interest rates and somewhat higher monetary growth rate in line with recovering monetary demand. Distortions in the money market created by the Financial Institutions Fund (FIDF) were also reduced by raising more long-term funds to substitute for its short-term borrowing. The government also used the proceeds of the sovereign bond issue to strengthen the specialized bank and increase their credit needs of key sectors. The overall public sector deficit target was proposed to be changed from 2 percent of GDP to 3 percent of GDP. The government also developed concrete measures to strengthen the social safety net and increase well-targeted public works programs, and have allocated an additional 0.5 percent of GDP in the 1998 budget for this purpose. On the other hand, to recover contingent on effective corporate debt restructuring, the legal and institutional framework was being strengthened and made more supportive through reform of bankruptcy act, foreclosure procedures, and other laws.

1-3. Two Thinkings Regarding Economic Policies

The Thai government's programs for economic restructuring are shifting from total demand control policies to an emphasis on measures aiming for recovery of liquidity, but the Cabinet's policies have not completely moved away from their emphasis on economic growth. In fact, according to the Thai newspaper, there is disagreement about economic policies between Finance Minister Tarrin, who emphasizes economic stability, and Deputy Prime Minister and Minister of Commerce Supachai, whose major goal is recovery. The faction favoring stability see stabilization of exchange rates as the primary goal of the macroeconomy. The measures to accomplish that end is maintaining interest rates at a high level, and recovery the real sector is a second-best policy goal to be dealt with from the financial side. This position is exactly the policy that

Table 1 Macroeconomic Framework in Thailand

	1996	1997			1998						1999
	actual	LOI1	LOI2	actual	LOI1	LOI2	LOI3	LOI4	LOI5	LOI6	outlook
		(Aug.97)	(Nov.97)		(Aug.97)	(Nov.97)	(Feb.98)	(May.98)	(Aug.98)	(Dec.98)	
Real GDP Growth (%)	5.5	2.5	0.6	-0.4	3.5	0.1	-3~-3.5	-4~-4.5	-7.0	-7~-8	1.0
CPI Inflation (period average, %)	5.9	7.0	6.0	5.6	8.0	10.0	11.6	10.5	9.2	8.0	2.5~3.0
External Account (Billions of US.dollars)											
Exports (f.o.b.)	54.7	56.2	56.4	56.7	61.0	60.9	60.1	57.5		55.0	
Imports (c.i.f.)	70.8	66.5	64.2	61.3	67.6	64.3	56.8	50.5		41.5	
Current account balance	-14.4	-9.0	-6.4	-3.0	-5.3	-2.5	4.4	8.5	11~12	13.5	11.0
(In percent of GDP)	-7.9	-5.0	-3.9	-2.0	-3.0	-1.8	3.9	6.9	10.0	11.0	8.5
Gross official reserves (end-year)	38.7	23.0	23.0	27.0	24.5	24.8	23~25	26~28	26~28	28.5	32~34
(in months of imports)	6.6	4.2	4.3	5.3	4.3	4.6	4.9~5.3	6.2~6.7	7~7.5	8.25	8.5
(In percent of short-term debt)	103	69	75	127	74	87	109~118	114~123	115	113	178
Forward position of BOT	-4.9		-18.0	-18.0		-9	-9	-9		-10	-3~-4

Source: Letter of Intent to IMF, Government of Thailand

the IMF has been advocating until now, and most technocrats of the Thai government hold a similar view. However, there has been a storm of criticism from manufacturing sector, which have been hit not only by the withdrawal of support from local financial institutions, but also the burden of servicing their foreign debts.

On the other hand, the faction emphasizing recovery first pursue economic growth with their policies, and they profess to leave exchange rates up to the market. Since the effects of fiscal policies are limited under a system of floating exchange rates, their specific policies make it easier to move forward with economic restructuring by increasing the money supply and lowering interest rates. However, the actual implementation of these policies leads to side effects. An excess money supply invites inflation, and if the Central Bank were to increase the money supply based on dollars, there would be a scarcity of dollars on the foreign currency markets, and the baht would devaluate. In the end, it will be necessary to keep a constant watch on economic conditions, set target indicator for inflation rate and exchange rate, and implement policy mix dynamically. That is to say, even if they make economic recovery a priority, they will need to pay attention to economic stability as they implement their policies.

1-4. Future Concerns

In the fifth letter of intent, signed with the IMF in August 1998, estimation of the 1998 economic growth rate was further revised downward to minus 7.0 percent, and the deepening recession has become more serious. On the other hand, steady progress in implementing the program has restored net international reserves to comfortable levels and helped stabilize the baht. The government also expected inflation to be lower and the external current account surplus higher than previously forecast. As a result of these improvements in the macroeconomic indicators, money market interest rates, have already declined substantially from over 20 percent earlier this year to below 10 percent. We may say that the restructuring of the Thai economy has moved into its second stage, alleviating the effects on society and promoting recovery of the real economy.

Ever since the second half of 1997, decreased domestic demand brought about by the currency crisis led to a fall in output at facilities such as automobile assembly plants, which laid off many workers. Labor dispute concerning severance pay has occurred at textile factories that were being closed. The problem of unemployment appears to be steadily worsening along with the economic slowdown, and there is an urgent need to provide a social safety net that enables workers to afford unemployment for a long duration. Moreover, an export recovery was emerging in the latter half of 1997, due to the depreciation in the baht, but in 1998, dollar exports are projected to decline because of the falling in export prices and depressed regional demand. Yet there is no doubt that increasing the competitiveness of exports is a fundamental problem. Plans have been drawn up for structural improvements aimed at enhancing industrial competitiveness, particularly in the Ministry of Industry, but effect implementation remains a task for the future. I will discuss these points again in another article.

2. Plans for Financial Sector Restructuring and Consolidation of Financial Institutions

Among the characteristics of the current Thai economy crisis are the fact that the financial institutions are holding a large amount of non-performing loans and have disappeared their profit margins, and the fact that foreign investors have lost their confidence in the Thai economy all at once. In other words, Thai financial institutions had been borrowing foreign short-term funds from the offshore markets (BIBF) and lending them in the property sector, but when the property market became devastating and the Bank of Thailand tightened monetary policies considerably to curb credit growth, developers came under increasing cash flow difficulties as local financial institutions cut back their financing lines. The non-performing loans were primarily sunk in the property sector when financial institutions over-extended themselves to developers during the property boom without careful consideration of real market demand or the risks involved. Thus the Thai government's financial restructuring plans first need to implement reform of the financial system and restore the confidence of foreign investors. The IMF policy conditionalities also highlighted the development of the institutional framework for the systematic financial restructuring, and thus make it more prepared to withstand international competition.

2-1. The Closure of 56 Finance Companies

In March 1997, in order to deal with the problem of the deteriorating asset quality, the Bank of Thailand ordered 10 finance companies to boost their capital and then announced the suspension of 16 finance companies which had large amounts of non-performing assets in June. Since public confidence was shaken by the suspensions and they were concerned about whether more firms were waiting in the wings, and there were widespread deposit runs. Thus, in August, the Bank of Thailand announced the suspension of 42 more finance companies which was insolvent and liquidity strapped. With this, a total of 58 out of 91 finance companies were subject to such measures, and they were required to submit rehabilitation plans to the authority, who envisaged these companies merging with stronger firms at that time. In October, two important institutions were established for restructuring of the 58 finance companies, namely the Financial Restructuring Authority (FRA) and the Asset Management Corporation (AMC).

The FRA was supposed to oversee the screening of rehabilitation plans submitted by the 58 finance companies, but in fact, international accounting and consulting firms designated by the IMF and the World Bank took charge of the inspections. The results of these inspections were announced by the FRA in December, and only two of the 58 suspended companies would be allowed to reopen, while the remaining 56 companies were subjected to a stringent measure: liquidation. The assets of the 56 closed finance companies were transferred to the FRA and classified. In January 1998, the highest quality assets were handed over to the Radanasin Bank, newly set up as a good bank. On the other hand, the AMC was entrusted with responsibility of bidding for the lowest quality assets of the closed companies. The FRA has auctioned assets, comprising core assets (financial loans and securities loans) and non-core assets (foreclosed assets and companies' assets), and proceeds subsequently repaid to the creditors.

2-2. Mergers and Consolidation of Commercial Banks

From March 1997, the Bank of Thailand,

pressed by foreign investors and IMF into tightening supervision, has said that loan classification and provisioning and recapitalization will be upgraded to international standards. Provisioning requirements for all financial institutions were tightened with accounting standards for non-performing loans to be changed as loans with accrued interest over six months, regardless of the underlying collateral held. The authorities, which intended the financial institutions to foster their recapitalization, announced in November that the restriction on foreign ownership was also relaxed, thereby allowing foreign investors to acquire majority shareholding in local financial institutions for up to 10 years which will be grandfathered. However, some small and medium-sized banks, whose large holdings of non-performing assets made them funding difficulties, failed in their recapitalization plan. The Bank of Thailand nationalized four banks and ordered to change management. Equity in four banks was forced to write down and recapitalized by the central bank's Financial Institutions Development Fund First to fall were Bangkok Metropolitan Bank in January 1998, and then First Bangkok City Bank, Bangkok Bank of Commerce, and Siam City Bank in February. In May, a further seven finance companies failed to complete recapitalization plans, and were taken over by Krungthai Thanakit, a subsidiary of the government-owned Krung Thai Bank.

On the other hand, some small and medium-sized commercial banks have made considerable progress in recapitalization due to the strategic partnerships with foreign banks. Among the banks that have come under the umbrella of foreign banks are Thai Danu Bank whose major shareholder is DBS Singapore and Bank of Asia which sale 75% stake to Dutch banking ABN-Amro. Moreover, even such large banks as Bangkok Bank and Thai Farmers Bank raised major international share issues, although not so much that foreigners hold the majority of shares. In March 1998, the Bank of Thailand further announced regulatory changes which would increase the amount of provisions and new capital required by financial institutions. All institutions will have to adopt a new five-tier classification scheme for loan assets, namely, special mention, sub-standard, doubtful, doubtful of loss and losses. Non-performing loans will also use a three-months past-due definition, instead of the six-months previously allowed. At the same time, the new provisioning rule provides latitude for the gradual phased-in provisioning requirements of 5 accounting period from the end of 1998 to the end of 2000. This new requirement inevitably poses a burden on financial institutions in raising capital.

2-3. Outline of Financial Sector Restructuring Package

In August 1998, the Bank of Thailand and the Ministry of Finance announced a comprehensive financial restructuring package to provide resolute actions to address the outstanding weakness in the financial sector. This program included the provision of public funds to recapitalize financial institutions. As the first aspect of this plan, several financial institutions remained unable to recapitalize according to the timeframe, intervened by the government as follows: (1) First Bangkok City Bank would be merged with the government-owned Krung Thai Bank. Performing assets of Bangkok Bank of Commerce would likewise be transferred to Krung Thai Bank. Bangkok Bank of Commerce would have its banking license revoked and its distressed assets were transferred into its own asset management corporation. (2) The government intervened in two more small-sized banks Laem Thong Bank and Bangkok Union Bank as it had with the four banks nationalized in January and February, and the FIDF recapitalized written-down share by the authority. Laem Thong Bank would be merged with the government-owned Radanasin Bank, and Bangkok Union Bank would be merged with Krungthai Thanakit. Krungthai Thanakit would also take over five more finance companies, in addition to seven financial companies merged in May. The new firm, renamed Bank Thai, would be restructured and privatized. (3) By the middle of 1999, Bangkok Metropolitan Bank and Siam City Bank, nationalized in January and February, would be sold to new investors, most likely foreign financial institutions. In considering the selection of financial institutions to be intervened and merged, the government took each bank's risk assets ratio into consideration, and the measures were finally draughted with the assistance of JP Morgan, the World Bank and the IMF.

As the second aspect of the financial restructuring plan, the government announced the measures of capital support to assist remaining financial institutions in the recapitalization efforts. Recogniz-

Table 2 Key Figures of Local Commercial Banks in Thailand

Bank	Deposits	Loans	Assets	Liabilities	Capital funds	Recapitalization plan
Bangkok Bank	969,780	850,468	1,306,192	1,183,547	122,645	rasing overseas common shares
Krung Thai Bank (KTB)	803,716	813,900	851,864	806,057	45,806	merged with FBCB and perfoming assets of BBC
Thai Farmers Bank	579,333	490,672	733,272	665,235	68,037	rasing overseas common shares
Siam Commercial Bank	591,150	516,156	699,658	662,180	37,479	capital injection of government funds
Bank of Ayudha	403,896	354,498	482,257	454,504	28,024	share placement with foreign partner
Thai Military Bank	281,104	278,117	361,596	339,553	22,043	share placement with foreign partner
First Bangkok City Bank (FBCB)			294,773	287,747	7,026	integrated with KTB
Siam City Bank	208,724	189,670	258,055	238,467	19,587	taken over by foreign invester
Bangkok Bank of Commerce (BBC)						transformed to a non-bank financial institution (AMC)
Bangkok Metropolitan Bank	166,920	114,239	174,092	169,349	4,743	taken over by foreign invester
Bank of Asia	115,629	116,682	156,246	146,579	12,660	sale 75% stake to Dutch banking ABN-Amro
Thai Danu Bank	109,103	97,222	142,279	131,787	10,492	sale 50.1% stake to DBS Singapore
Nakornthon Bank	60,958	48,540	77,073	75,566	1,507	capital injection of government funds
Union Bank	62,438*	44,047*	73,073	72,592	481	integrated with Krungthai Thanakit (Bank Thai Bank)
Laem Thong Bank	40,446**	29,685**	56,185	53,973	3,488	integrated with Radanasin Bank
Total	4,393,197	3,943,895	5,666,616	5,287,136	384,019	

Unit: Billion Baht (Deposit and Loans as of December 1998), Million Baht (Assets, Liabilities, and Capital funds as of September 1998)
Notes: * Bank Thai Bank, ** Radanasin Bank
Source: Thai Bankers' Association, Stock Exchange of Thailand, and Thai newspapers

ing the need to strengthen capital bases to cushion against further deteriorating loan portfolio, the Bank of Thailand required commercial banks to maintain their capital adequacy ratio at a minimum of 8.5 percent (8 percent for finance companies), a figure above the BIS regulations. The highlight of this package was the measures to set up incentives for recapitalization, so that capital provision of public funds may be obtained upon request. The government decided to issue government bonds and provide this recapitalization scheme.

The first incentive for maintaining capital adequacy ratio was that firms would be able to issue new preferred shares, counted as tier-one capital, in exchange for 10 year government bond. This scheme was aimed at catalyzing entry of private capital. New injections of public and private capital would have preferred status over existing shareholders, thus ensuring that the existing shareholders would be the first to bear costs and losses associated with the implementation of tough loan classification and provisioning requirements. The government or the new investor would also have the right to change existing management. A restructuring plan would also have to be approved by them. The second incentive was injections of public funds aimed at stimulating early corporate debt restructuring. Financial institutions would be able to issue new subordinated debentures, raising tier-two capital, in return for government bonds state capital is tied to losses taken by firms through corporate debt restructuring for borrowers up to a maximum of 2% of risk assets. The third incentive was that capital injections was tied to institution's new lending. One cause of the economic slowdown is that the banks have been unwilling to increase their non-performing loans and have frozen new loans, causing a credit crunch. Therefore, the total amount eligible for tier-two capital injection would comprise 20 percent of the net increase in outstanding loans to private sector, the aim being to facilitate corporate recovery.

2-4. Problems in Restructuring the Thai Financial Sector

The financial restructuring program that the Thai government has been carrying out under the policy conditionality with the IMF must be implemented for their own sake, but some argue that there is no need to implement them during this period of serious economic depression. However, in the early 1990s, when the government was accelerating to liberalize its financial system, the permission of opening new commercial banks was left to the last, and under protection from the government, existing commercial banks became more apt to provide loans more readily without sufficient collateral. It has been pointed out that some financial loans were of great benefit to politicians and bureaucrats. These kinds of excessive and improper lending led to the massive non-performing loans of financial institutions after the collapse of the bubble, and they are linked to bring about the current economic crisis. In addition, the Bank of Thailand, which is an organization to inspect and monitor the financial institutions, cannot be absolved of responsibility.

The family business operations of Thailand's financial institutions have finally come to a deadlock. The closing of fifty-six finance companies and Bangkok Bank of Commerce were announced, and orders of management changes, capital write down and recapitalization by the fund to 6 medium and small sized commercial banks and 12 finance companies were enforced, both implemented under the policy conditionality with the IMF. The responsibilities of managers and stockholders, which were kept vague through protective administration, have been clarified, and substantial reform of the financial sector has just finally started. Yet the problem is that when financial restructuring program has implemented drastically, Thailand's financial institutions, with their weak management base and their lack of financial know-how, may be taken over by foreign banks that are superior in every respect. The next task is to figure out which fields each Thai financial institution will be able to operate with its management resource and to carry out policies that will support these endeavors.

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