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Ten Years After the Financial Crisis in Thailand: What Has Been Learned or Not Learned?

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The 1997 financial crisis provided many lessons about the weaknesses of Thailand's economic and financial system before the crisis, weaknesses that eventually led to the crisis. Since then, these lessons have led to many economic and financial reforms. This paper reviews the lessons and reforms that have been carried out. These include improvements to the data system needed for adequate macroeconomic monitoring, changes to the macroeconomic management framework and monetary policy regime, and various aspects of financial sector reforms. This paper also indicates the lessons that might not yet have been sufficiently learned and new risks to future economic stability. These include political interference in financial institutions, leading to inappropriate or excessive lending, and lack of transparency in fiscal liabilities that could mislead macroeconomic management.

Key words crisis, financial sector, lessons, monetary policy, reforms

1. Introduction

The 1997 financial crisis provided many lessons about the weaknesses of Thailand's economic and financial system before the crisis, weaknesses that eventually led to the crisis. Since then, these lessons have led to many economic and financial reforms. Some of the reforms, such as the floating of the baht, were necessitated by the crisis. Others evolved from lessons that were learnt from the crisis, and were designed to make the financial system stronger and more resilient to risks that could lead to a similar crisis in the future. This paper provides an overall review of the lessons and reforms that have been carried out. These include improvements to the data system needed for adequate macroeconomic monitoring, changes to the macroeconomic management framework and monetary policy regime, and various aspects of financial sector reforms. Many of these reforms are still, however, incomplete and will require additional measures or legal frameworks to make them fully effective. The paper also indicates the lessons that might not yet have been sufficiently learned and new risks to future economic stability. These include political interference in financial institutions, leading to inappropriate or excessive lending, and lack of transparency in fiscal liabilities that could mislead macroeconomic management.

The next section briefly reviews the evolution to the financial crisis in Thailand. The paper then looks at crisis resolution measures that were adopted immediately after the crisis in Section 3. Lessons and more fundamental reforms of monetary policy and the

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financial system are covered in Section 4, and the lessons that appear to have not yet been learned and new types of risks to economic stability are covered in Section 5.

2. Evolution of the Meltdown

For several decades before the crisis, Thailand's economic performance had been highly satisfactory. Average real gross domestic product (GDP) growth between 1960 and 1995 was about 7.7% per annum and the proportion of the population under the poverty line declined from about 60% to less than 15% during the same period. The country was regarded as an example of the so-called "East Asian economic miracle" (World Bank, 1993). Yet, a couple of years later, the country got into a severe financial crisis and essentially became insolvent, in terms of not having enough usable foreign reserves left to meet its obligations. Assistance from the International Monetary Fund (IMF) was needed, and a painful adjustment process to recover from the crisis had to be carried out, leading to a lost half decade of development; the average growth rate between 1996 and 2001 was just about zero.

Part of the reason for the crisis might have come from the very success that Thailand had experienced. The good economic performance over many decades led to overconfidence in the strength of the Thai economy. By the early 1990s, Thailand had become an important production center in the region, and exports were booming. To complement its role on the production side, the Thai authorities also wanted to turn Bangkok into a major regional financial center to rival Hong Kong and Singapore. A program of financial liberalization was embarked upon while the risks inherent in this process were not foreseen. The main mistakes were to pursue financial liberalization without an adequate supervisory framework on financial institutions and appropriate monetary and exchange rate policies. These mistakes substantially increased the risks to economic stability resulting eventually in the 1997 crisis.

Many financial liberalization measures were carried out and by 1993 most foreign exchange controls on current account and capital account transactions had been lifted. In March 1993, the Bangkok International Banking Facilities (BIBF) was established to serve as a means to develop Bangkok into an international financial center. Tax privileges were given to BIBF transactions to enable it to compete with other financial centers. It was hoped that the BIBF will result in a lot of in-out financial flows, so that Bangkok could become a financial center providing financing to other regional economies. Instead, most of the flows were out-in fueling the economic bubble and leading to a rapid increase in short-term foreign debt, which were the key elements bringing about the crisis.

Controls on financial institutions were also reduced. Interest rate ceilings were eliminated by mid-1992 and rules on credit extension became more relaxed. It was hoped that these liberalization measures would lead to greater competition in the domestic financial system, strengthen domestic financial institutions, and make Bangkok a leading regional financial center. However, two key issues were overlooked. First, whether existing financial institutions were ready for a more liberalized system, and second, whether the supervisory system of the authorities was adequate. It turned out that most commercial banks and finance companies in Thailand at that time lacked adequate experience or maturity, with poor corporate governance. Intra-affiliate lending was prevalent and most of their clients also lacked proper financial discipline and corporate governance. Financial mismanagement and so-called "crony capitalism" were widespread. Worse yet, the central authorities at that time did not have the capacity to effectively supervise financial institutions. Such deficiency led to widespread imprudent lending by financial institutions and contributed to widespread speculative investment, particularly in real estate projects, fueling an asset price bubble.

Another crucial mistake of the authorities was their decision to liberalize capital flows across borders while sticking to a fixed exchange rate system and also trying to pursue an independent monetary policy. This is, of course, the classic Mundell "impossible trinity" (Mundell, 1963).

Thailand had successfully used a fixed exchange rate system since the end of the Second World War. This had contributed to economic stability and was an important foundation for economic growth for many decades. However, these successes were mostly in a global environment of modest financial capital flows. The mistake was to stick to this old paradigm in the 1990s when capital flows became very large and very volatile.

Before the crisis, the baht was fixed to a basket of currencies with the US dollar having by far the largest weight in the basket resulting in a fairly stable baht/$US rate for many years before the crisis. However, Thailand also tried to pursue an independent interest rate policy. This can be seen from the gap between the Thai overnight interbank rate and the US overnight fed fund rate. This gap averaged about 3.97% between January 1989 and June 1997 (the last month before the float of the baht), and sometimes reached up to 10% (see Figure 1). With liberalized capital flow, this inevitably led to a large amount of capital flow into Thailand.

Net capital inflows between 1990 and 1996 averaged 10% of GDP each year; much higher than the average current account deficit of about 7% of GDP for the same period. As a result, the outstanding external debt rose rapidly from $US29 billion in 1990 (34% of GDP) to $US108.7 billion in 1996 (59% of GDP). Even more dangerous was the fact that short-term foreign debt (with a maturity of less than 1 year) increased very rapidly. By the end of 1996, the total short-term foreign debt was about $US47.7 billion, which was larger than the amount of official foreign reserves at the time that was about $US38.7 billion. Even after taking into account the foreign assets of the banking system, the total foreign assets (official and private) were less than the amount of short-term foreign debt of the country. If these short-term foreign debts were not rolled over, there would not be enough foreign assets in the country to service these debts.

The rapid growth of short-term foreign debt was tied to the provisioning requirement for risky assets of the Basel Capital Accord. For lending to financial institutions in developing countries, short-term lending only requires 20% provisioning whereas long-term lending requires 100% provisioning. Because of this, there was a built-in incentive for short-term lending to developing countries.

The large capital inflows spurred an investment and real estate bubble. Financial institutions were lending excessively and imprudently, leading to rapidly deteriorating asset quality. The central bank made matters worse by trying to shore up ailing financial

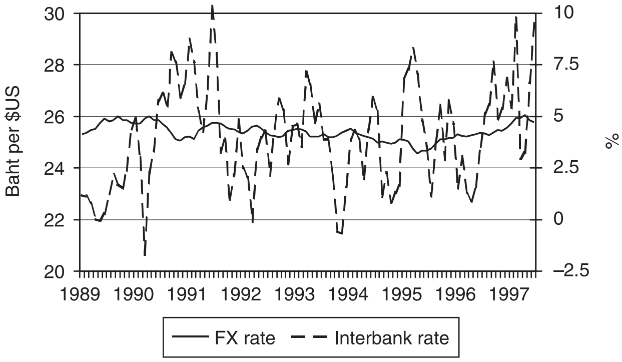

Figure 1 Foreign exchange (FX) rate and Interbank rate gap.
Source: Bank of Thailand and US Federal Reserve.

institutions. The strengthening of the US dollar relative to other major currencies starting in 1995 and China's rapid emergence into the world market also weakened Thailand's competitiveness. In 1996, exports declined by about 1.3% compared with over 20% growth in both 1994 and 1995. The weakened fundamental led to pressures on the baht and market perception was that the baht needed to be devalued, and speculators attacked the Baht in various waves. What made matters worse was that the Bank of Thailand (BOT) tried to stubbornly defend the value of the baht. By the end of June 1997 almost all of the country's reserves had been used to try to defend the value of the baht and official foreign reserves net of committed forward obligations declined to only about $US2.8 billion. The country basically became insolvent as there was still about $US48.5 billion in short-term foreign debt and the current account deficit was about $US1 billion per month. Thailand simply did not have enough foreign assets to service these obligations. As a result, the baht had to be floated on July 2, 1997, and Thailand had to seek assistance from the IMF.

3. Immediate Resolutions

The most immediate crisis resolution measure that was unavoidable because of the country's insolvency was the need to abandon the fixed exchange rate system and adopt a floating exchange rate system. Thailand also needed foreign exchange liquidity support from the IMF. The IMF package amounted to $US17.2 billion and was tied to IMF conditionality. Thailand was required to adopt many policy reforms, such as fiscal and monetary tightening, as well as structural reforms of the financial and real sectors, such as increased prudential standards, improved governance, foreign access, and privatization.

These various measures were meant to restore confidence as well as generate increases in foreign currencies so that the country could eventually recover from the insolvency position. However, the nature of the IMF conditionality that was applied to Thailand (and also to Indonesia and South Korea) was rather controversial and was much debated in the aftermath of the crisis. Critics point to a number of areas, such as[1]:

- the harsh nature of the tight fiscal and monetary policies without due regard for social or political consequences;
- unwillingness to allow non-market-based interventions such as controls on capital flows;
- imposition of full guarantees for creditors of financial institutions;
- imposition of relatively rapid structural reform measures, such as stringent financial standards and corporate restructuring as well as privatization of state-owned enterprises; and
- lack of input from within the region so that the programs did not take sufficient account of the sociopolitical realities of the affected countries.

Although many of these criticisms are valid up to a point, there is no denying that once a country becomes insolvent the solution will inevitably involve pain. The critical issue is how to turn around the foreign exchange position so that the country can fully participate in the international economic and financial system again, and what policies are necessary to do this with as little pain as possible.

In Thailand, the macroeconomic assumptions behind the initial design of the IMF program were flawed in that the IMF did not expect such a severe economic downturn or a rapid turnaround in the current account (Sussangkarn, 2002). Therefore, the initial fiscal and monetary targets were too stringent, and many other conditions were imposed in order to reduce capital outflow (full guarantees for creditors), or to generate additional foreign exchange earning (such as structural reform measures and privatization to attract foreign investment). As it became clear in 1998 that the macroeconomic assumptions were wrong, the fiscal position was eased substantially, but many of the other structural conditions continued to be maintained even though the rationale for them to help in attracting foreign exchange no longer held.

As the extent of net reserves depletion became more widely known, the baht depreciated rapidly, from 25.8 baht/$US at the end of June 1997 to about 53.8 baht/$US by the end of January 1998. The baht strengthened after that but the average exchange rate in 1998 was still about 41.4 baht/$US, a depreciation of about 38% compared with before the float. With the baht depreciation and the severe economic recession, the current account turned into a substantial surplus starting in the fourth quarter of 1997 and averaged over $US1 billion per month through the end of 1999 (Table 1). As a result, net foreign reserves increased from about $US2.8 billion in the middle of 1997 to about $US16.2 billion by the middle of 1999. In August 1999, Thailand decided to forgo further disbursement from the IMF package, about 2 years after entering into the IMF assistance program. As a result, the various conditions imposed by the IMF no longer became binding. Thus, the rationale for imposing structural reform conditions that require a long time to successfully implement is not that clear.

Although Thailand's foreign exchange position turned around relatively quickly, it took much longer to clear up problems in the economy. The baht float put a severe strain on much of the financial and real sector. Because of the large depreciation of the baht, those with unhedged foreign debt were driven to bankruptcy, and the country experienced

Table 1 Real gross domestic product (GDP) growth and current account

Year	Quarter	Real GDP growth (%)	Current account ($US million)
1995	Q1	9.56	−2 356
	Q2	12.33	−3 908
	Q3	9.57	−2 959
	Q4	5.86	−4 011
1996	Q1	4.72	−3 333
	Q2	6.53	−4 802
	Q3	7.83	−3 544
	Q4	4.61	−2 671
1997	Q1	1.00	−2 101
	Q2	−0.58	−3 134
	Q3	−1.61	−746
	Q4	−4.19	2 871
1998	Q1	−7.08	4 210
	Q2	−13.88	2 811
	Q3	−13.92	3 410
	Q4	−7.17	3 860
1999	Q1	−0.21	3 972
	Q2	3.45	2 218
	Q3	8.41	3 026
	Q4	6.42	3 250
2000	Q1	6.49	3 302
	Q2	6.13	1 677
	Q3	2.43	2 165
	Q4	4.05	2 184

Source: Bank of Thailand and Nation Economic and Social Development Board.
Note: Real GDP growth is measured on a year-on-year basis.

a deep recession in 1998 (real GDP declining by more than 10%) with broad adverse economic and social consequences throughout the economy.

After the financial crisis the Thai government undertook several measures to correct problems in the financial system. In December 1997, the authorities closed down 56 finance companies. Depositors and creditors were, however, provided with government guarantees. In March 1998, in line with the IMF conditionality, the BOT tightened regulations on asset classification, provisioning, and reporting, aiming to upgrade local financial institutions to international standards by the year 2000. These new standards forced both local banks and finance companies to increase their capital substantially and in August 1998 the government decided to nationalize six commercial banks and five finance companies. Some of these were merged with government financial institutions, while some were to be sold to interested parties later on.

Table 2 Non-performing loans (NPL) classified by financial institution groups (million baht)

	1998 December	1999 December	2000 December	2001 December	2002 December	2003 December	2004 December	2005 December
Commercial banks	2 350 842	2 004 292	822 589	458 538	742 624	619 160	570 387	470 360
(% of total loans)	(42.9)	(38.6)	(17.7)	(10.5)	(15.7)	(12.9)	(10.9)	(8.3)
Finance companies	323 691	90 133	34 752	15 453	24 022	22 250	21 485	5 925
(% of total loans)	(70.2)	(49.2)	(24.5)	(9.5)	(14.0)	(10.1)	(7.6)	(3.7)
Grand total	2 674 533	2 094 425	857 341	473 991	766 646	641 410	591 873	476 285
(% of total loans)	(45.0)	(38.9)	(17.9)	(10.5)	(15.7)	(12.7)	(10.8)	(8.2)

Source: Bank of Thailand.

Restructuring corporate debt was another crucial element for both financial sector reform and economic recovery, because successful debt restructuring will help reduce non-performing loans (NPL) of financial institutions and resuscitate economic activities simultaneously. To facilitate the process, a corporate debt restructuring advisory committee was set up in June 1998 to coordinate negotiations among debtors and creditors. The "London Approach" to debt work-outs was used under which creditors worked together, shared all information about debtors, recognized the seniority of claims, sought out-of-court solutions, and agreed to keep credit facilities in place. Examples of resolutions were interest rate reductions, maturity stretching, partial write-offs, and debt-equity conversion. However, debt negotiation was not an easy task and there were also legal and regulatory constraints. In this context, the government tried to help by amending bankruptcy and foreclosure laws and also removed tax disincentives (such as not counting debt write-off as taxable income) in order to encourage debt renegotiations. Nevertheless, corporate debt restructuring remained a lengthy and difficult process[2] and it took about 8 years before the ratio of NPL in the financial system declined to below 10% (see Table 2).

4. Lessons and Reforms

The 1997 crisis provided many lessons about potential risks and weaknesses that might not have been well understood prior to the crisis or might not have had enough attention paid to. This has led to reforms and improvements in many areas that should lessen the risk of a similar crisis in the future. However, many of these reforms are still incomplete and will require additional measures or legal frameworks to make them fully effective. This section describes some of the main areas of reforms or improvements.

4.1 Better data for risk assessments and economic management

An important lesson from the crisis is the importance of having appropriate and timely data. Before the crisis, the availability of data that are essential for risk assessments and economic management was woefully inadequate. GDP data were only available on an annual basis and with a time lag of a year or so. Regularly available quarterly data or monthly data were extremely limited. And critically important data on short-term foreign debt were hardly available at all. In fact at that time the adequacy of foreign reserves was still being viewed simply by foreign currency requirements on the trade side (e.g. the number of months of imports). The importance of having enough reserves to back up the amount of short-term foreign debt is now generally accepted. However, before the crisis, data on short-term foreign debt were not collected in any systematic manner.

Significant improvements have been made since then. Many monthly and quarterly data series are now available on a timely basis. A quarterly GDP series has been developed and is now available with a one-quarter lag. Vast amount of monthly official data are now accessible for downloading through the Internet from public agencies, particularly the BOT where more than 100 data tables are available online and the data are updated every month. The availability of these data enable non-public sector organizations to better track economic developments and make more accurate risk assessments. This leads to a more balanced view compared with if most of the information is only available to the government and public sector organizations.

4.2 New monetary policy regime

A clear lesson from the crisis is that under a fixed exchange rate system, it is very difficult for governments to de-peg the currency, particularly when there is a need to devalue the currency. Protection of the value of the currency is normally regarded as an important symbol of national pride. Also, during the time when the currency is under attack, governments normally regard a devaluation as a capitulation to the speculators, and will therefore tend to be even more stubborn in defending the currency.

Thailand had to de-peg the currency in July 1997 as net foreign reserves were almost completely depleted. A managed float system was introduced and continues to be used to this day. Under such a system with liberalized capital flows, the role of monetary policy becomes very important. In order to underpin a monetary anchor under the managed float system, the BOT formally introduced an "inflation targeting" monetary policy framework on May 23, 2000. The framework targets "core" inflation, which excludes fresh food and energy prices, and the inflation target was set at 0–3.5%, a range that is still used to this day.

The inflation targeting framework is very new to Thailand, which had been under a fixed exchange rate system since the end of the Second World War. It was necessary to slowly get the market (as well as policy-makers, academics, and the public in general) to understand the system. It was also very important to establish the credibility of the system as the BOT had lost most of its credibility as a result of the crisis.

The choice of the target of 0–3.5% was to make sure that it would not be difficult to meet the target over the first few years. When the inflation targeting was introduced, NPL

Table 3 Financial liquidity, capacity utilization, and core inflation

	2000	2001	2002	2003	2004	2005
Deposits at financial institutions	6 254 280	6 595 846	6 661 003	7 123 216	7 581 132	8 086 648
Outstanding credits	5 962 163	5 686 943	5 891 727	6 145 314	6 598 061	7 106 631
Industrial capacity utilization (%)	68.4	64.4	64.4	69.7	71.7	72.4
Core inflation (%)	0.71	1.30	0.40	0.20	0.40	1.60

Source: Bank of Thailand.

were still very high; there was a lot of excess liquidity in the banking system and production capacity utilization was rather low, so core inflation was less than 1% and remained very low until fairly recently when the sharp rise in oil prices started to have spill over impacts on other prices (see Table 3).

The policy instrument for monetary policy was and is formally the 14-day repurchase rate. However, under a "managed" float system, the exchange rate is also an important variable affecting domestic inflation so this is also managed to some extent by the BOT to be consistent with the inflation target.[3]

To gain acceptance of the system, the BOT tried to establish as much transparency as possible. A monetary policy board (MPB) was set up and met about every 6 weeks, with a press conference held to announce the decision afterwards. An inflation report was published every 3 months detailing the economic analyses that provided background for the MPB. This report also included the details of the quarterly econometric model used in the analyses so that those interested could try to reproduce the results.

At the beginning all this was very novel to the financial market and it probably did not really know how serious or sustainable would the system be. However, after a while the MPB meeting and the interest decisions were accepted as the focal point of monetary policy. Media coverage expanded and now the system is well accepted with wide discussions in the media about likely interest rate trends a few days before an upcoming MPB meeting and analyses of the decision afterwards.

The development of the inflation targeting system was by no means smooth sailing. Conflicts arose after the Thaksin government came into power in early 2001. The government wanted to see a stronger and more stable baht and pressured the BOT to increase interest rates. When the BOT refused to do so, the government sacked the then governor Chatumongkol Sonakul in May 2001 and replaced him with Pridiyathorn Devakula, who then shortly hiked the 14-day repurchase rate by 1% point. This created a lot of confusion at the time and it was not clear whether the inflation targeting framework would remain or if it was going back to something like an exchange rate targeting framework. However, the BOT officially stuck to the inflation targeting framework and after a while the market regained confidence in the system and the system remains in operation to the present. In

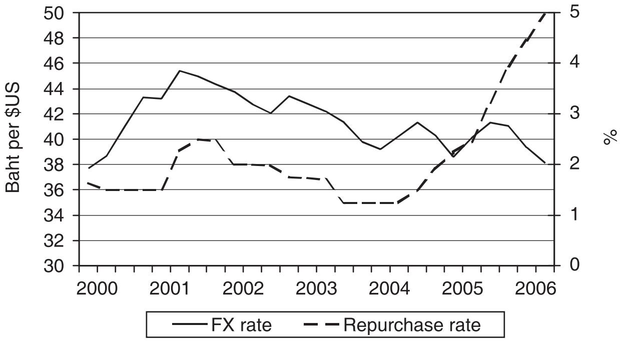

Figure 2 Foreign exchange (FX) rate and 14-day repurchase rate.
Source: Bank of Thailand.

more recent times, the policy rate has generally followed the US Federal Fund rate (with slight variations) and with rapidly increasing oil prices the exchange rate has strengthened slightly, which is consistent with the need to tame inflationary pressures (see Figure 2).

Looking to the future, the inflation targeting system still needs to be backed up by a legal framework. A revised *Bank of Thailand Act* has been in the works for some time, which will provide the legal framework for monetary policy and also protect the system from political interference. Apart from the legal framework, the inflation target range should also be narrowed in the future. The broad range in use up until now has helped to promote the credibility of the system.[4] However, it can also create confusion about the direction of monetary policy. If the core inflation lies well within the targeted range then many policy stances are consistent with the target. Now that the system is well established, a narrower target range (possibly something like 2.0–3.5%) should be able to guide market sentiments better.

4.3 Financial sector reform

An important lesson learned from the crisis was that with financial liberalization supervision of financial institutions needs to be even more prudent as bad lending decisions by financial institutions fueled by external capital flow can easily amplify into a bubble situation and create systemic risk to the whole economy. Many reforms have been initiated in this area although much of the required legal frameworks remain to be formally introduced. Some of the main areas are the following.

Deposit insurance

The Thai authorities have long been aware of the need to deal with distressed financial institutions to avoid financial instability. The Financial Institutions Development Fund was established in November 1985 to provide financial support for the rehabilitation and development of financial institutions in order to maintain financial stability. From the experience of its operations, particularly during the period leading up to the crisis, the Financial Institutions Development Fund has been accused of trying too much to shore up insolvent financial institutions instead of closing them down. This can lead to greater costs to the public in the end. In addition, shoring up financial institutions can lead to moral hazard by inducing financial institutions to undertake businesses that contain excessive risks.

After the crisis, the government had to provide full guarantee to depositors in order to avoid runs on financial institutions and this has remained to the present. However, it is recognized that a deposit insurance (partial) system needs to be established as a full guarantee system tends to weaken the financial discipline of depositors who focus their attention only on returns while neglecting the quality and stability of the financial institutions that they are dealing with. This can lead to many problems in the longer term.

A draft of the *Deposit Insurance Act* was approved by the cabinet in November 2004. Principally, the deposit guarantee will be reduced to a maximum of 1 million baht per depositor per financial institution (reduced gradually over a period of 4 years). This would not affect most depositors as deposits of less than 1 million baht constitute 98.6% of all deposits in the banking system (as of March 2005). This Act should go through parliament in the next year or so.

Supervision of financial institutions

The supervisory framework has been reformed in many important respects to strengthen financial institutions' ability to handle risks and promote financial stability. Some of the ingredients of supervisory reforms include:

Consolidated supervision. The central authorities will exert their best efforts to oversee all financial institutions and their affiliated units so as to monitor intra-affiliate transactions.

Risk-based supervision. In the past, a micro-oriented financial approach (or usual transaction testing) was adopted to monitor financial institutions. The approach has been broadened to be macro-oriented as well as forward looking. The involved risks are credit risk, market risk, foreign exchange risk, liquidity risk, and operational risk. The BOT will adopt "Basel II" by the end of 2008 consisting of the following three pillars: (a) minimum capital requirements; (b) supervisory review process; and (c) market discipline.

Corporate governance. In recognition of the importance of corporate governance, the BOT has taken several initiatives to improve governance of financial institutions. Examples of these initiatives are financial institution directors' handbook, structure of banks' board of directors, fit and proper test, lending to/or investing in related parties, information disclosure, and anti-money laundering.

Accommodate the expansion of financial institutions' business scope. The BOT has allowed commercial banks to engage in hire purchase, leasing, factoring, private repurchase transactions, new derivative products, and electronic money services. The permission is meant to encourage more competition, full-circuit services, and greater efficiency in the domestic financial market. These business expansions should yield various benefits such as economy of scale, more innovative products, and better customer satisfaction as well as improved performances of financial institutions.

A still unresolved issue regarding supervision is whether the BOT should still retain the role of supervising banks and finance companies. After the crisis, when much of the blame was attached to the BOT, there was a suggestion that a new agency for financial sector supervision should be established. This appears to be the position of the Ministry of Finance over the past couple of years although the BOT would like to retain the supervision role. This difference needs to be resolved before a revised *Bank of Thailand Act* and a new *Financial Institution Act* can be finalized.

With recent experiences of political interference in financial institutions (see next section) and the ability of the BOT to revive much of its credibility and independent stance, it would be difficult to establish a new supervisory agency with enough credibility to gain the confidence of the market. An effective new supervisory agency needs to have sufficient independence from political interference, which is hard to see at this stage. Therefore, it would be better to leave supervision with the BOT and the new BOT Act should be expedited in order to provide legal underpinnings to the new monetary policy regime.

Credit Bureau

Painful experiences in handling bad debts and poor credit management in the past led to the setting up of a Credit Bureau to share credit information about clients. The *Credit Bureau Act* became effective in March 2003. The Act aims to enhance information sharing among financial institutions in order to improve loan analysis and credit risk management. Simultaneously, the Act protects the owners' right regarding the accuracy and disclosure of their information. At first, two licenses were granted to operate the credit information business, namely, to the Thai Credit Bureau and the Central Credit Information Services. In August 2004, the two entities merged and became National Credit Bureau Co., Ltd.

A series of debt restructuring, improved supervision and information sharing via the Credit Bureau led to improved asset quality and financial performance of financial institutions. Net profit turned positive in 2002–2004 after net loss in 1997–2001. Figure 3 shows more profitability and efficiency of Thai commercial banks. By 2005 their return on asset moved up to the same level as the period before the crisis (i.e. 1.3% in 2005 versus 1.3% in 1991–1996). Although the improved macroeconomic climate after economic recovery from the crisis is obviously a factor, internal improvements within the financial sector are considered to be more important for the improved performance and a sustainable recovery of the financial sector.

Financial Sector Master Plan

The BOT commissioned a nationwide survey in 2002 to appraise client satisfaction with available financial services. The result of the survey was rather discouraging because, although depositors were well served by the system, clients often encountered problems on access to credit. The Thai financial sector focused its services on the advanced sectors, with little attention paid to the less privileged groups. For example, roughly 23% of small- and medium-sized enterprises (SME) lacked access to credit from the financial system, and so

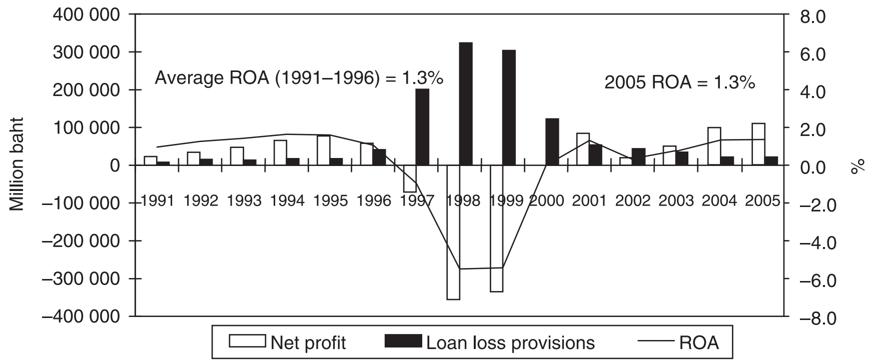

Figure 3 Thai commercial banks' net profit, loan loss provisions, and return on asset (ROA), 1991–2005. Source: Bank of Thailand.

did 58% of the people who had low income (below $US5 000 per annum). They could only get credit if they had adequate and reliable guarantee or collateral. These underserved groups had to resort to informal sources of funds as well as cooperatives. These shortcomings, together with distressing consequences of the 1997 crisis, induced the BOT to formulate a Financial Sector Master Plan (FSMP) so as to serve as a guideline for restructuring and development of the Thai financial system over the next 5–10 years. This FSMP pays special attention to domestic supply of financial services. It consists of the following three main principles.

1 *Broadly disseminate financial services* so that ordinary people (e.g. those with low income and SME) have access to fundamental financial services (deposits, credits, and transfers). Possible means include widening the role of the Bank for Agriculture and Agricultural Cooperatives into a rural development bank, establishing a committee for promotion of grassroots financial services, and encouraging financial institutions to enhance their financial services to poor people.
2 *Strengthen efficiency of the financial system by three channels.*
   a. *Restructure the formats and roles of financial institutions* so that they can better serve customers' demand, achieve greater efficiency, attain more stability, and become more competitive. As for *Thai financial institutions*, there will be only two types. *Commercial banks* may provide financial services to all groups of customers and undertake all types of financial transactions, except issuing insurance policies and underwriting/brokering/trading equity securities. *Retail banks*, in contrast, are expected to exclusively serve retail customers and SME, subject to lending limit per customer and other conditions as specified by the BOT. As for *foreign financial institutions*, there will be only two types as well. *Subsidiaries* of foreign banks will enjoy the same scope as commercial banks and can open up to four branches. *Full branches* of foreign banks, however, cannot open any branches, even though they will have the same business scope as commercial banks.

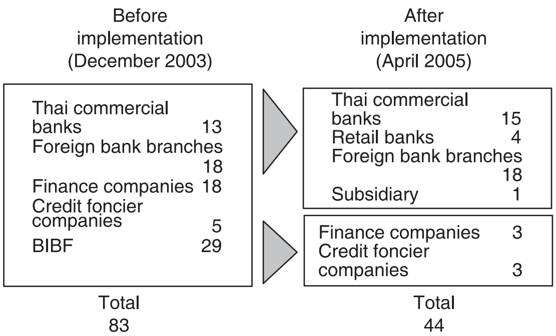

Figure 4 Number of financial institutions before and after the implementation of the financial sector master plan. BIBF, Bangkok International Banking Facilities.
Source: Bank of Thailand (2004; p. 37).

b. *One-presence policy* intends to eliminate duplications of services offered by different types of financial institutions within one conglomerate so that financial institutions fully benefit from economy of scale. Thus, there can only be one type of deposit-taking institution in a financial conglomerate. A financial group that possesses more than one deposit-taking institutions has to merge or liquidate those units until it has only one deposit-taking channel.

c. *Promote efficiency of financial institutions' operations* by various means such as the following: relaxing tax constraints on mergers, loosening rules on opening up or closing down bank branches, revising the process of authorizing new financial transactions from individual product to product group authorization, relaxing the limit on the number of foreign staff, and encouraging financial institutions to use efficiency enhancing business models.

3 *Protect consumers* by requiring all regulated financial institutions to comply with rules on interest, discount, and service charges in a transparent fashion so that consumers can make comprehensive comparisons before making selection. Deposit insurance scheme is to be implemented at an appropriate time and in a proper format.

After the FSMP went into effect in January 2004, several financial institutions requested an adjustment of their status – that is, from financial companies or credit fonciers to commercial banks (e.g. Tata Iron and Steel Co Ltd, Kiatnakin, Asia Credit) or retail banks (e.g. GE Money, AIG Finance, Thai Keha, Land and House). Two BIBF were allowed to convert to full branches (Société Générale and UFJ), whereas one full branch of foreign bank was upgraded to a subsidiary (International Commercial Bank of China). Overall, the implementation of FSMP together with its one-presence policy has downsized Thailand's financial institution system by almost half, from 83 units to 44 units (see Figure 4). This consolidation should help to increase financial stability in the longer term.

Table 4 Domestic bond market data: Thailand (million $US)

Year	Average daily trading value	Total outstanding value	Private outstanding value
1995	8.4	3 922.40	3 581.30
1996	32.4	5 866.90	5 136.90
1997	13.7	5 389.80	4 226.40
1998	7.2	18 460.90	3 041.80
1999	46.5	28 662.50	4 740.60
2000	136.8	31 611.10	5 225.90
2001	145.6	33 875.60	5 659.60
2002	203.6	38 301.40	6 525.60
2003	254.4	45 681.40	9 093.90
2004	301.3	59 724.30	9 578.70
2005	394.2	77 641.20	12 123.80

Source: Thai Bond Market Association.

Development of long-term capital markets

The crisis showed that attention needs to be paid to developing a well-functioning long-term capital market as alternative financing sources to bank lending. In particular, if the country has a saving deficit (current account deficit), the deficit needs to be filled from foreign borrowing, and if these borrowings are mainly from bank lending then most of them will necessarily be short-term (because of the Basel Capital Accord provisioning requirement) and create a lot of risks. Therefore, policies that will build up the capacities of domestic companies to raise external long-term capital in place of a reliance on foreign bank lending is crucial to prevent another similar crisis.

Before the crisis, the domestic bond markets in Thailand (and most of the emerging economies in the region) were very thin or almost non-existent. The Thai government ran a budget surplus for nine consecutive years before the crisis, so the supply of government bonds to provide liquidity and benchmarks to the market was not available. However, the situation is now very different. After the crisis, the government had to incur large clean up costs. The domestic bond market is now much deeper and more liquid than before (Table 4).

Given the more active bond market, it is now easier for the private sector to raise long-term funding through the bond market. However, the total value of outstanding private sector bonds is still only about 8% of the outstanding borrowing of the private sector from commercial banks. Thus, much more can be done to increase the ability of the private sector to raise funds through the bond market, both by improving the domestic regulatory frameworks and by regional cooperation initiatives.

At the regional level, through the Asian Bond Market Initiative of the Association of Southeast Asian Nations and China, Japan, and South Korea group (ASEAN Plus Three) and the development of the Asian Bond Funds by the Executives' Meeting of East Asia–Pacific Central Banks group of 11 central banks (comprising Australia, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand), there have been some concrete recent developments that can pave the way to more robust capital markets in the region. However, these are still early steps on the way to fully realizing the goal of an effective long-term capital market that can reduce the risk of a future dependence on short-term foreign borrowing once countries in the region start getting into current account deficits again.[5]

5. Lessons Not Yet Learnt and New Risks

The impact of the financial crisis was so severe and widespread and there have been so many analyses and debates about the underlying causes of the crisis and appropriate resolution measures that it would be hard not to have learned a lot from the crisis. One can say that the probability of a similar crisis occurring in the region again is very low. However, if another crisis were to occur, then it will almost certainly not be a crisis of a similar nature to the previous one. It is therefore important to try to identify sources of new risks to economic stability (if any) even though these might not yet have led to significant problems. In the case of Thailand, there are a number of potential problem areas that need to be carefully monitored.

The first issue has to do with *political interference* in financial institutions. The main targets for political interference are the state-owned commercial banks and the specialized public financial institutions. These could be used to extend credit in imprudent manner to those well connected politically or to appease the policy of the government. Both of these appeared to have been the case in Thailand under the Thaksin government and should certainly be a cause for concern. The need to control imprudent lending was clearly an important lesson from the crisis. If the state is the cause of imprudent lending itself then the risk to economic stability increases significantly.

A key policy agenda of the Thaksin administration was to pump credit into the grassroots and the SME sector in order to gain popular support. As part of these "populist" policies, numerous schemes have been initiated, such as the 1 million baht village fund, people's bank, SME promotion, small-medium-large village fund, and uncounted number of subsidized products and social welfare schemes. The state-owned banks and the specialized public financial institutions have been key instruments of these populist policies. They have been providing "state-directed" lending to serve these policies. A number of incidents indicate the potential risks inherent in this approach.

In 2004, there was high tension between the BOT and the Ministry of Finance over the reappointment of Viroj Nualkhair as the President of Krung Thai Bank, a state-owned bank that is also Thailand's largest commercial bank. The BOT alleged that Krung Thai Bank imprudently lent 46 billion Baht (about $US1.1 billion) in the second quarter of 2001 and that Viroj should be held accountable for this lapse and blocked his reappointment to a second term. The Minister of Finance, who was the one who appointed Viroj, sided with Viroj and tensions between the BOT and the Ministry of Finance dragged on for weeks. Eventually, Thaksin had to go along with the BOT's position in order to minimize political costs. This episode clearly showed the risks of political interference in state-owned banks.

An even more direct interference is the use of specialized public financial institutions (SFI) to carry out the government policy of widespread credit extension to the grassroots and SME. Banks such as the Government Savings Bank, the Government Housing Bank, and the SME Development Bank played important roles in this policy. Between 2000 and 2005, lending of these SFI to households and businesses expanded by 15.2% on average compared to an average growth of only 4.2% for lending by commercial banks and finance companies to the same group. The lending of Government Savings Bank and SME Development Bank to households and business grew particularly rapidly at an average of 32.2% and 72.4% per annum, respectively, between 2000 and 2005. Total lending of the SFI to households and businesses increased from 13.3% of GDP in 2000 to 18.7% of GDP in 2005.

Although lending to the grassroots and SME can provide tremendous benefits to those who can make good use of the lending, too much lending will inevitably cause more harm than good. Parts of the lending were not used for productive investment, some were spent on consumer products, and some of those that were invested in commodity production (some in so-called One Tambon [Sub-district] One Product projects) led to oversupply of similar products in the country. Although these lendings have led to increases in NPL for some of the SFI, the extent of the increases have not been large. The main reason is that most of these lendings are for relatively modest amounts, and when the payments are due, borrowers can normally borrow from somewhere (such as informal money lenders) to repay the loan and then take out a new loan again. So the balance sheet of the SFI are not too adversely affected. However, the indebtedness of the grassroots gradually increases.

This already happened in the past. When the Thaksin government first came into power in 2001, one of its first policy platforms was to forgive farmers' debt. Almost 2.8 million farmers participated in that scheme. At the time, the NPL ratio of the Bank for Agriculture and Agricultural Cooperatives (BAAC) was not very high. This meant that farmers could find money to borrow short-term to repay the loan when the due date came and then simply re-borrowed the money from the BAAC again. However, the farmers became more and more indebted over time. This seems to be what is happening at present.

More worrying is that grassroots borrowers now appear to expect that the government will always come in and write off their debt if they cannot service it themselves. Cases of mobs demanding debt forgiveness (and getting it) are becoming regular events. In October 2005, more than 5 000 farmers marched in the government house area to demand debt relief. A week or so later, the government approved a debt restructuring scheme covering more than 50 000 farmers. In April 2006, another 2 500 farmers marched on the Ministry of Agriculture demanding debt relief, again the government rewarded them with what they demanded. These scenarios are very worrying. There is a risk of a loss of financial discipline in the whole system if the government continues to forever pursue a policy of pushing out credit and then forgiving debt. If this becomes the norm, then there is no reason to be prudent with any borrowing or investment. Although the current problem is still relatively limited in scope, from the lesson of the crisis, this kind of situation should never have been allowed to happen, let alone brought about by government policy.

Another important problem before the crisis was the use of the wrong paradigm to judge the inherent risks in the situation. The clearest case was the inattention paid to short-term foreign debt. The adequacy of foreign reserves was still being judged using a paradigm of current account problems, so foreign reserves were being compared to months of imports. However, the problem that was developing at the time was a capital account problem, so reserves should have also been compared to the amount of short-term foreign debt that the reserves might have to service if the debt were nor rolled over. Therefore, even though the ratios of short-term debt to foreign reserves were greater than one in all the three countries that eventually had to seek IMF assistance, the danger of a crisis was not foreseen simply because the right kind of data were not looked at.

In Thailand under Thaksin, a similar kind of inattention to appropriate data seemed to have occurred again, this time on the fiscal side. The Thaksin government often claimed that the fiscal position of the public sector was very healthy. It cited the fact that the budget was never much in deficit and the ratio of public sector debt to GDP had declined from 57% at the end of fiscal year 2000 (September 2000) to only around 46% at the end of fiscal year 2005 (September 2005).

The situation was, however, much more complicated. Many of the Thaksin's government policies, both populist or otherwise, have been carried out through non-budgetary means, so they do not show up in the traditional budgetary or public debt measures. If one only pays attention to the normal budget and public debt figures, it would be like looking at foreign reserves only in relation to the number of months of imports like before the crisis. This would be dangerous. There are many reasons why one needs to look beyond the regular budget and public debt figures.

First, the cycle of grassroots and SME expanded lending and debt forgiveness as discussed above is likely to create substantial contingent liability for the government eventually. This has not been factored into the official public debt figures. In addition, in developing various mass-transit projects, promises have been made to the public that fares will be very low; for example, only 15 baht ($US0.40) per journey. It is most likely that if this were really the case, a substantial subsidy will be required to keep the system going once built. These subsidies again do not appear anywhere in the projected public debt.

There were also cases of creative financing, or creative accounting depending on how one looks at it. Some major investment projects were done through securitization and the use of special purpose vehicles (SPV) in a way that committed future liabilities did not show up as public debt. A good example is a project to develop a new government administrative center in the north of Bangkok. An SPV was set up with nominal paid-up capital, which is more than 50% privately owned so that it was not a state enterprise. The SPV issued bonds to raise money to construct and develop the administrative center. These bonds were backed by a long-term lease given to a government department with guaranteed rental. These rental payments (stretching to more than 30 years) clearly were committed liabilities of the government, yet they were not included in the public debt figures.

The above indicates that one needs to be very careful in judging the fiscal or quasi-fiscal position of the country. The way many policies were carried out under the Thaksin government tends to hide the true future liabilities of the government. If true lessons have been learned from the crisis, this should not have happened. The best approach is to be very transparent about what is happening, what are the commitments and what are the risks. If government policies are shrouded by obscurity, there is a clear danger that before the risks to economic stability can be clearly seen, the problems might have already become too big to be easily handled.

Notes

1 For various discussions, see, for example, Sachs (1997), Feldstein (1998), Krugman (1998), Stiglitz (1998), United Nations Conference on Trade and Development (1998; Chapter 4), and Stiglitz (2002).

2 See Vichyanond (2001, 2002) for discussions of complications involved in debt restructuring.

3 Officially of course the central bank will almost always say that the exchange rate is determined by market forces.

4 If the target could not be met shortly after the system was introduced then it would be very difficult to establish credibility for the system.

5 For discussions of the status and directions of regional financial cooperation, see Sussangkarn and Vichyanond (2007).

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