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Globalization and Thailand's Financial Crisis

Jonathan E. Leightner

The standard, generic explanations for Asia's financial crisis inadequately explain Thailand's current crisis. Corruption, cronyism, risk taking, and weak bankruptcy/foreclosure laws made Thailand's crisis deeper and longer, but they did not cause the crisis. These problems existed while Thailand's real gross domestic product (GDP) grew by 8-13 percent between 1987 and 1995, which was one of the fastest growth rates in the world. Thailand's current crisis began when the combination of Thailand's recent success, high domestic interest rates, and fixed exchange rate led to destabilizing inflows of short-term capital after Thailand liberalized its capital account and set up an international banking center in Bangkok. These short-term capital inflows helped Thailand's banks but hurt its finance and securities companies. When Thailand's finance and securities companies started to fail, international expectations plummeted, short-term capital inflows dried up, and Thailand was forced to float its currency.

Even while enjoying one of the fastest growing GDPs in the world, Thailand worried because its labor costs were rising relative to its neighbors. Thailand knew that its mentor, Japan, experienced a similar problem in the 1960s and lost its international competitiveness in labor-intensive industries. Worried that a similar fate awaited, Thailand decided to befriend its potential future competitors. In the early 1990s, the Thai government initiated major drives to encourage joint ventures between Thailand and its neighbors. Thailand wanted to become the mentor, or patron, of the other Indo-Chinese countries.

Along with other things, a good patron promotes the growth of its clients. Thus, Thailand created the Bangkok International Banking Facility (BIBF) with the intent

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that this facility would specialize in financing growth in Indo-China. However, Thailand had to liberalize its financial and capital markets first. Thailand progressively eliminated its interest rate ceilings between June 1989 and 1992. In 1990, Thailand liberalized all current account foreign exchange transactions, followed by a relaxing of capital account restrictions [Wibulswasdi 1995, 2-3]. The BIBF officially opened in early 1993. By December 1995, all 15 domestic banks and 30 foreign banks had acquired BIBF licenses.

Due to relatively high interest rates in Thailand, BIBF's activities led to greater inflows of short-term foreign capital than the Bank of Thailand (BOT) desired [Sirithaveeporn 1997]. The inflow of foreign funds caused the spread between maximum lending rates and deposit rates at commercial banks to decline from 7.25 percent in June 1992 to 4.1 percent in June 1995. This declining spread hurt Thailand's 91 finance/securities companies, which did not have direct access to foreign funds. In contrast, Thai banks could acquire foreign funds at an interest rate 4-5 percent lower than domestic funds, which caused the effective spread between commercial banks' lending rates and their cost of funds to increase from 2.87 percent in late 1989 to 3.22 percent in late 1995 [Wibulswasdi 1995]. BIBF helped banks but hurt finance/securities companies.

Even before the BIBF, the playing field was not level between banks and finance/securities companies. Thailand's 15 domestic banks had a total of 3,000 branches, but Thailand's 91 finance/securities companies were forbidden to open branches. Thai banks could offer several different types of deposit services, but finance/securities companies were restricted to issuing promissory notes. Because of these differences, many Thais deposited their money in banks even though the interest rate paid by finance/securities companies was greater. Banks also offered a lower interest rate to borrowers; thus, potential borrowers would go first to banks for loans. Many borrowers who were turned down for bank loans due to relatively high risk would successfully obtain financing from Thailand's finance/securities companies. The structure of Thailand's financial market forced the finance/securities companies to have relatively riskier portfolios than banks because their customer base consisted of those who were turned down by the banking system. Finally, the spread between domestic lending and deposit interest rates was greater for Thai banks than it was for finance/securities companies [Leightner 1998].[1]

A speculative bubble in Thailand's property market acted as a catalyst for its current financial crisis. "About 755,000 housing units were built in Bangkok between 1992 and 1996, compared with the estimate of 382,240 needed under the seventh National Economic and Social Development Plan" [Parnsoonthorn 1997]. According to a study conducted by the Government Housing Bank, 40.4 percent of the houses built in Bangkok during this time period remained unoccupied. When builders borrow money to build houses and office buildings and then are unable to sell or lease the buildings, they have problems repaying their loans. Although 53.7

percent of 1996's outstanding property credit originated from banks and 45.7 percent originated from finance companies, property credit accounted for only 8.8 percent of commercial bank total credits but 24.4 percent of the total credit extended by finance companies [Vajragupta and Vichyanond 1998, 20]. Thus, finance companies were much more vulnerable to the speculative bubble in the property market.

In spring 1996, Bangkok Bank of Commerce collapsed under the weight of non-performing property loans that amounted to nearly half of its US $7.2 billion of assets ["Damage Control" 1996]. In February 1997, Somprasong Land company failed to make a "US $3.1 million interest payment on its Euro-convertible debentures due to cash flow constraints caused by conditions in the Thai property market" ["Fallout" 1997]. Later that month, rumors circulated that Finance One Plc was suffering from severe liquidity problems due to serious losses on property and equity investments. Finance One, Thailand's largest finance company, had assets of US $4 billion and was larger than many of Thailand's small- and medium-sized banks.

For the first time in the 21-year history of Thailand's stock exchange, the Thai government suspended trading on the stock exchange for all banking and finance companies on March 3, 1997. On that day, the government announced higher reserve requirements for all financial institutions ["Market Freeze" 1997]. Authorities also named 10 undercapitalized finance companies and gave these firms no more than 60 days to increase their capital by a total of US $328 million ["Investors Fear" 1997]. Subsequently, there was a US $1.2 billion run on deposits of finance companies. The majority of this run was borne by the 10 named companies, resulting in an approximately 40 percent loss of their total deposits ["Withdrawals" 1997; "Shape Up" 1997].

Fearing that they would be the last ones paid if Thailand's banking system collapsed, foreigners withdrew almost all new dollar inflows into Thailand. The then prime minister of Thailand, Chavalit Yongchaiyudh, tried to restore foreign and domestic confidence in the banking system by repeatedly promising that no additional financial firms would be shut down. The government broke this promise when it shut down 48 more finance/securities companies between March and August 1997, resulting in a suspension of 64 percent of the finance/securities market and a fall in foreign and domestic confidence in the government.

Meanwhile, the BOT insisted that the Thai baht would not be devalued, in spite of mounting economic pressure to the contrary[2] [Vajragupta and Vichyanond 1998, 30-34]. For 13 years, which included periods of political unrest (like in 1992), Thailand successfully maintained an exchange rate of 25 baht to the U.S. dollar, largely because its interest rates were sufficiently higher than world interest rates to deter capital flight. However, in 1997, Thailand's relatively high interest rates hurt its financial firms by further depressing property and equity markets, causing even more borrowers to not meet their obligations to their lenders. Thus, the Thai government was faced with a dilemma: maintaining high interest rates makes the finan-

cial crisis worse, but lowering the interest rate makes defending the Thai baht even more difficult.

In January 1997, Thailand's official foreign reserves stood at $39.2 billion, equaling 6.6 months of imports. In May 1997, Thailand suffered a massive speculative attack on the baht. International hedge funds took short positions in spot, forward, and options markets, betting as much as $10 billion on Thailand devaluing [Bunyamanee and Nivatupumin 1998]. The BOT spent $4 billion defending the baht and imposed selective capital controls with the intent of cutting offshore speculators' access to the baht.[3] On July 2, 1997, the BOT floated the baht, which promptly fell by 20 percent against the dollar. By the end of June, Thailand's foreign reserves officially stood at $32.4 billion (a decrease of $6.8 billion from January), and in August it was revealed that the BOT had committed at least US $23.4 billion in forward obligations to swap dollars for baht.

Thailand's patron, Japan, turned down its request for unilateral help, insisting that the IMF arrange for assistance. On August 19, 1997, Thailand announced it was accepting $17.2 billion from the IMF and the World Bank. The IMF imposed strict conditions on receiving this money, including Thailand agreeing to restructure its financial sector and not rescuing any more of its financial institutions. In October, the financial restructuring package was revealed, an unpopular one baht per liter tax on oil products imposed, and foreign ownership restrictions on financial institutions were waived for 10 years. Three days after the package was announced, Prime Minister Chavalit bowed to public pressure and rescinded the oil tax. This was the last straw, as no one could trust anything that Chavalit said; he had not told the truth about shutting down more finance/securities companies, about not devaluing the baht, and now about the restructuring package. His finance minister resigned, the baht dropped sharply past 40 baht to the dollar, and rumors spread that Chavalit had Alzheimer's disease.

On November 3, Prime Minister Chavalit resigned, Chuan Leekpai took over as the next prime minister, and the baht rebounded sharply to 37 baht per dollar.[4] Chuan, educated as a lawyer, had been prime minister once before—from September 1992 to May 1995. During his first term in office, he had been lauded as an unusually clean politician (a reputation he has maintained) but was criticized for being too risk adverse and slow. Aware of this reputation, Chuan pledged to act firmly and swiftly to correct Thailand's problems. On December 8, 1997, the government announced that only two of the 58 suspended finance/securities companies would be allowed to reopen, a stringent decision praised by the IMF.

Meanwhile, Thailand's financial sector experienced a strong "flight to quality." Between January and October 1997, deposits fell by 35.3 percent at Bangkok Metropolitan Bank, 18.73 percent at Laem Thong Bank, 11.16 percent at First Bangkok City Bank, 10.82 percent at Bangkok Bank of Commerce, and 6.2 percent at Siam City Bank. In contrast, deposits increased by 34.16 percent at Siam Commercial

Bank, 22.16 percent at Thai Military Bank, and 19.07 percent at Bangkok Bank. Regulators seized four of Thailand's 15 domestic banks: Bangkok Bank of Commerce in 1995, Bangkok Metropolitan Bank in December 1997, and Siam City and First Bangkok City Banks in February 1998. All of these banks were forced to write down capital. For some of them, the value of their shares was dropped to 1/1,000th of their previous value [Polkwamdee et al. 1998]. Furthermore, the prime minister issued a stern warning that similar action would be taken against any other financial institution that did not get its house in order.[5]

May 1998 found the finance/security market in tatters; of the original 91 companies, 35 remained, of which 7 additional firms were taken over by the BOT, which ordered management changes and a write down of shares to one satang each (≅ 0.03 ¢). In August 1998, it was announced that (1) Krung Thai Bank would absorb two of the banks that the state took over earlier (Bangkok Bank of Commerce and First Bangkok City Bank), making Krung Thai the largest bank in the country with assets exceeding 1.2 trillion baht (≅ US $33 billion);[6] (2) Laem Thong Bank would merge with Radanasin Bank; (3) Krung Thai Thanakit Finance and Securities would take over Union Bank's license and absorb five finance companies; and (4) the government would assist banks with tier one or tier two capital. However, accepting government assistance probably would require changes in management and/or write downs of capital ["Banking Sector's New Look" 1998]. As of November 1998, only Siam Commercial Bank had applied for government assistance. The IMF argued that this dearth of applications was due to the severity of the conditions imposed by the government and has urged the Thai government to go easier on its banks [Bunyamanee and Ingsrisawang 1998].

The standard explanations of Thailand's financial crisis are inadequate. Corruption, cronyism, and weak bankruptcy/foreclosure laws made the crisis deeper and longer, but they did not cause the crisis. These problems existed while Thailand was one of the fastest growing countries in the world from 1987 to 1995. In retrospect, Thai financial institutions did take unwise risks, but why? First, when looking forward from the fantastic growth of the 1980s, the risks were not unreasonable. Second, the increasingly unlevel playing field between banks and finance/securities companies presented finance/securities companies with a choice: grow as much as possible in the hopes of gaining a banking license or continuously remain a second-class citizen on the verge of failing [Leightner forthcoming]. No matter what finance companies did, tremendous risks were involved.

The Thai case teaches us that liberalizing the capital account can lead to destabilizing inflows of short-term capital, especially if the country has a fixed exchange rate that is supported by high domestic interest rates and a solid record of success. Second, globalization can make playing fields less level if certain institutions gain benefits (like Thailand's banks) while others (like Thailand's finance/securities companies) only lose due to increased competition. The resulting inequities can destroy

the weaker sector, causing international expectations to plummet. Third, the loss of an international reputation is a public "bad"—all firms pay a price for the mistakes of a few firms when short-term capital flows drastically fall. Fourth, crises have a life of their own. Even strong medicine in the form of increased reserve requirements, capital write downs, and IMF conditionality may not immediately stop a financial crisis.

Notes

1. Thailand's financial market is not as separable as implied here because many banks have strong connections to its finance/securities companies. It is unknown how much of the foreign capital inflow was funneled through banks into the finance/securities companies connected to them.
2. These pressures included the negative effects on expectations of (1) Thailand's increasing current account deficit financed by short-term capital inflows, (2) the BOT's assistance to financial companies expanding the money supply, (3) a strengthening of the U.S. dollar in the world (from April 1995 to June 1997, the U.S. dollar gained 38 percent against the yen and 27 percent against the mark), and (4) Thai inflation exceeded U.S. inflation by 2.5 percent in 1994 and by 3 percent in 1995/1996. Furthermore, effects (3) and (4) reduce the competitiveness of Thai exports.
3. These capital controls effectively split the onshore market for the baht from the offshore market. In spite of this split, offshore speculators were squeezed to close positions when offshore interest rates for borrowing baht rocketed to as much as 1,300 percent.
4. In January 1998, the baht hit an all-time low of 56.7 baht to the dollar (a 79 percent drop from its value of 25 baht/dollar for 13 years). In spite of this, at the end of January 1998, the Thai government eliminated the capital controls that had split the onshore and offshore baht markets since May. By February, the baht had rebounded to 46 baht/dollar. By March, Thailand enjoyed a balance of payment surplus. The baht continued on a rocky course through the first half of 1998 due to perceived instability in other Asian countries. However, during the second half of 1998, the baht stabilized and slowly climbed to 36 baht/dollar. *Ceteris paribus*, the baht should appreciate in 1999 due to foreigners needing baht for two reasons: (1) to settle their 1997 swap agreements with the BOT, and (2) to purchase the core assets of the 56 closed finance companies that are being auctioned between December 1998 and March 1999.
5. The resulting recapitalization efforts often (but not always) involved giving foreigners more control of Thailand's banks. For example, Thailand's largest bank, Bangkok Bank, went from 25 percent foreign owned at the beginning of 1998 to 47.9 percent foreign owned by mid-1998 [Polkwamdee et al. 1998]. Many Thai nationals are upset by this trend.
6. Some argued that it was unfair that Krung Thai Bank be singled out for this honor. However, since its inception, Krung Thai has been a government bank, often forced to support government programs in ways contrary to profit maximization. Leightner and Lovell [1998] calculate the relative efficiency of banks in Thailand by size classification for 1989-1994. Although not reported in that paper, no matter what efficiency measure was used, Krung Thai bank was always less efficient than similar-sized banks. Given the use of Krung Thai bank as a policy tool, this efficiency result and the honor given in August 1998 were expected.

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