PICKING UP THE PIECES: BANK AND CORPORATE RESTRUCTURING IN POST-1997 THAILAND

By

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"The worst [bank] loans are made at the best of times."
The Economist (2001)

A. BEFORE THE BUBBLE

The Saving-Investment Nexus before 1990

During the four decades leading to the economic crisis of 1997, the Thai economy enjoyed almost uninterrupted growth, with rates averaging in excess of 7 per cent per annum. Central to this growth was the accumulation of capital, which in the period 1972-1990 contributed 36 per cent to total observed growth of GDP (Pranee and Chalongphob 1996:25). Apparently, this contribution increased later on in 1980-1995 to 61-66 per cent, depending on the concepts of capital used (Pranee and Chalongphob 1998:22). The process by which capital was accumulated in Thailand in the period running up to the crisis needs to be understood. Indeed, apart from explaining a major portion of the growth, the process played a key role in the economic breakdown of 1997 and the weakness of the recovery thereafter.

The flow of funds accounts published regularly by the National Economic and Social Development Board provide a picture of the sources of saving in the Thai economy and which sectors absorb that saving for investment purposes. Table 1 shows some obvious features: the households as the saving sector and the non-financial incorporated enterprises forming the main investment sector. Note first that the term "incorporated enterprises" as defined in Thailand leaves out the substantial small-enterprise sector, including almost the whole of the agricultural sector. This sector is included among the "households" in the accounts. Because the table indicates surplus of saving over investment, the flow of funds into the small-enterprise sector, which may also be mediated through the financial institutions, does not appear clearly.

There are also surprises in the figures reported in Table 1. First of all, the role of foreign saving looms large. That it was very large in the 1990s is well known, but even in the 1970s and the 1980s, it was not negligible. Second, the role of the government sector underwent a remarkable shift. Until 1985, it was absorbing a large chunk of savings from the other sectors. In 1985 in particular, in the middle of a recession, it expanded its share of investment to counter the fall in private sector investment. After that, it enjoyed very large surpluses, which overshadowed even that of the household

sector. This shift is significant, among other things, in affecting at the margin the quality of the assets of the financial institutions. As the supply of government bonds shrank, banks had to begin to lend to other, less secure borrowers.

Table 1

Surplus of Saving over Investment[a] by Sectors in Thailand

Sectors	1975	1980	1985	1990	1995	1996
Net Surplus of Saving over Investment[a] (bn. Baht)						
Households[b]	28.6	69.5	66.6	127.2	149.3	88.5
Central and Local Governments	-3.5	-27.0	-50.7	113.6	165.7	140.1
Rest of the World	12.3	44.6	40.5	186.3	336.0	371.3
Non Financial Incorporated Enterprises	-35.5	-64.0	-42.6	-464.0	-712.7	-594.7
Non Financial State Enterprises	-4.1	-28.6	-21.4	-9.9	-101.1	-134.0
Consolidated Financial Enterprises	2.3	5.6	7.6	46.8	162.9	128.8
Net Surplus of Saving over Investment[a] (% of GNP)						
Households[b]	9.4	10.6	6.4	5.9	3.6	2.0
Central and Local Governments	-1.2	-4.1	-4.9	5.3	4.0	3.1
Rest of the World	4.1	6.8	3.9	8.6	8.2	8.2
Non Financial Incorporated Enterprises	-11.7	-9.7	-4.1	-21.5	-17.3	-13.2
Non Financial State Enterprises	-1.4	-4.4	-2.1	-0.5	-2.5	-3.0
Consolidated Financial Enterprises	0.8	0.9	0.7	2.2	4.0	2.9
Gross Investment of Non-Financial Enterprises as per cent of National Gross Investment	63.5	53.4	47.8	68.4	64.7	62.9

Notes: [a] Investment includes purchase of land.
[b] Households include non-profit organizations and unincorporated enterprises.

Source: National Economic and Social Development Board, *Flow of Funds Accounts of Thailand.* (various issues).

The last line of Table 1 indicates that the non-financial incorporated enterprise sector did the lion's share of investment in the economy in most of the years, except for the somewhat depressed 1980 and 1985. Table 2 addresses the question of how this

sector financed its investment. Note that the figures are on a net flow basis, and do not show gross flows.

Table 2

Sources of Financing Flows for Investments by Non-Financial Incorporated Enterprises, 1975-1996

Sectors	1975	1980	1985	1990	1995	1996
Per Cent of Gross Investment of Non-Financial Enterprises financed by Sector's Saving	26.2	35.7	70.4	30.3	37.2	51.4
Per Cent of External Finance obtained through:						
Liquid Financial Assets[a]	-10.0	-11.8	8.0	-4.5	-6.4	-9.4
Short-term Loans and Bills	44.0	37.5	16.6	20.6	22.2	23.7
Trade Credit	2.9	4.0	-17.4	-0.1	1.2	-0.9
Hire-Purchase Debts and Claims	0.0	0.0	-18.7	-5.9	-9.2	-12.8
Long-term Loans	2.3	10.5	32.5	24.2	49.1	37.5
Mortgages	0.0	0.0	-0.2	0.6	5.1	5.4
Debentures	1.6	1.6	1.8	0.1	5.0	0.6
Share Capital	12.8	12.4	35.1	16.4	18.6	19.1
Foreign Debts and Claims	41.0	47.2	31.7	44.4	21.7	39.3
Others	5.3	-1.4	10.6	4.1	-7.4	-2.6

Notes: Negative sign indicates that the sector is acquiring assets issued by (i.e. "lending" to) other sectors
[a] This item includes currency, deposits and government paper.

Source: National Economic and Social Development Board, *Flow of Funds Accounts of Thailand.* (various issues).

The first line of Table 2 shows that the share of investment funds that were internally generated was less than half in most years. Firms had to rely more on external sources to fund their investment. This is what one should expect in a developing country such as Thailand, unlike in developed countries where the share of funds internally generated is generally well over a half (Corbett and Jenkinson 1997). On the one hand, firms in a developing country do not have a large capital base to generate enough corporate saving for investment;[1] on the other hand, they were operating in a rapidly growing country, which demanded proportionately larger investments to keep pace with the growth of the economy.

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[1] Within developed countries, smaller firms tend to rely more on external funding than larger firms, presumably for the same reason (Mayer 1990).

Noteworthy also is the behavior of the internal-funding share in 1985, which, as we shall discuss below, was a year of financial distress and a mild downturn in the country's growth. That conjuncture may have led to a type of credit crunch, thus forcing firms to rely more on their own resources. A similar reaction also took place in 1996-1997, in the earlier stages of the current economic crisis.

The figures in Table 2 also indicate that in the 1970s firms relied relatively more on short-term loans and commercial bills, because manufacturing was then in its nascent stage. The sector that was drawing resources from the other sector was engaged in trading, particularly the export of agricultural goods. Although there is no firm evidence, it appears that the build-up of foreign debts and claims during the same period was also trade-related. Note, as the other side of the same coin, the relatively low level of long-term loans or indeed long-term debt of any kind, at least until the 1990s. Similarly, except for 1985, little share capital was raised.

From where did these firms obtain their external finance? It is widely believed before 1990 that they obtained most of it from the banks and, to a smaller extent, from the finance companies. Deposits at these institutions had traditionally taken up about 60 per cent of the household gross[2] financial saving in a normal year. The increase in direct holdings of equity by the households has usually been about one-sixth to one-fifth of the gross financial saving.

The banks had their origins as trade financiers, and their owners had many joint interests with traders in many ventures. The core banks were then used to provide finance for all the firms within the group (Silcock 1967:183; Rozental 1970:145-147). Many such loose bank-centered groupings eventually became large industrial conglomerates. All the great banking families would own these conglomerates, with the banks at the center. As a result insider lending was rife. Even though the expansion and increasing professionalization of the larger banks and their stricter supervision may have reduced the incidence of insider lending somewhat, it never completely disappeared and remained a problem with the smaller banks up to 1997.[3]

Another complaint against the banks of that period was their excessive fondness for investing in government bonds (Rozental 1970:124-125). This suggests an opposite tendency (of excessive conservatism) to the above charge of insider lending, exposing the banks to the risks of their owners' other businesses, to which they attach greater priority. Rozental (1970:147-148) suggests, by way of explanation, that bankers probably had an interest in limiting credit to possible competitors to their non-banking businesses. But the outcome of this behavior had been that Thai bankers never paid much attention to

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[2] That is, without netting out the increase in debts.

[3] A recurrent theme in the literature of the 1950s and 1960s is the pervasive presence of military officers on the boards of Thai banks. Since 1973, their influence has steadily receded. The influence of elected politicians has emerged in a few banks such as Bangkok Bank of Commerce (more of this bank below), but this influence is no longer as pervasive as the presence of military officers in the earlier period.

developing competence in proper evaluation when providing loans to third parties, let alone in the more modern methods of risk management. In fairness to the banks, it is somewhat difficult for modern management practices to be followed when accounting standards within most of the borrowing companies are non-transparent (mostly in order to evade taxes, more recently in order to exploit minority shareholders).

These inadequate management practices persisted into the 1980s, when Thailand began to industrialize rapidly, and more long-term loans were required. These were again mostly supplied by the banks and finance companies. Banks then got around the problem of monitoring the firms by requiring collateral for their loans in the form of land or property. Where loans are made to limited-liability companies, banks reinforced their security by requiring personal guarantees from the proprietors of such companies, in order to avoid moral hazard. Part of the reason for so doing is that, under Thai law, the punishment for personal bankruptcy was and remains quite severe, and demanding personal guarantee was thought to impose the requisite degree of discipline on the borrowers.

Thus, while pre-bubble Thailand did exhibit many features of a bank-based capitalism said to characterize much of East Asia as well as some continental European countries, notably Germany, it lacked many of the strengths of such a system. Its banks were technically weak and inadequate to the task of allocating capital, which perforce fell to them. Thus, the following two descriptions of German banks, one when Germany was still developing and the other in more recent times, would never be made about Thai banks:

> "[The Deutsche Bank of the early 20th century] has a distinct staff of some eight or nine industrial experts usually drawn from industry itself, and a highly developed department of information."
>
> "It is arguable that the success of German banks in providing industrial finance depended on their ample staffs of technical advisers, capable of assessing industrial prospects and risk." (cited in Edwards and Fischer 1994:8)

At first sight, the Thai banks appeared to follow the Japanese main-bank system, particularly in its pre-liberalization phase, playing a nurturing role and acting as a lender of last resort in the 1960s and 1970s (see Aoki et al. (1994) for a description of the Japanese banks). However, the effort put into the monitoring role in Thailand was much smaller, and the reliance on collateral much more pronounced.

If the Thai banks failed to perform an adequate developmental role in ensuring that the capital raised by people's savings was deployed efficiently and profitably, then so did the Thai State.[4] As in most developing countries, the Thai State did attempt to promote specific industries according to its perception of what was appropriate at each

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[4] Doner and Ramsay (2000) have an interesting account of the failure of government policy to regulate supplies in the textile and garment industry – and the relative success of Bangkok Bank.

stage of development. It deployed many instruments to achieve its objectives, most notably tariff protection and investment promotion through tax holidays and the like.[5] Selective credit controls to channel capital to favored industries or firms were however rarely deployed. There were four exceptions to the limited use of selective credit policies:

- Beginning in 1975, banks were directed to lend a set proportion, varying between 11 and 20 percent) of their loan portfolio to the agricultural or the rural sector.

- A specialized financial institution, the Industrial Finance Corporation of Thailand (IFCT) was set up to provide long-term loans for the industrial sector, but its relative size remained small (Warr and Bhanupong 1996:82). Its operations were only tangentially related to other governmental promotion policies.

- At certain times, there were attempts to limit credit to certain sectors where over-lending was feared, notably real estate or consumer credit, but these were for prudential rather than developmental reasons.

- The Bank of Thailand provided packing credit with favorable financing terms for specific export sectors (again agriculture was favored more than other sectors).

None of these sector-specific credit policies was framed within an overall industrial development strategy. Without guidance from the state (except as signaled by its promotional and protection policies), the allocation of capital in Thailand therefore followed a broadly laissez-faire process, with the banks playing a central role. But as mentioned, banks did not have the technical competence to evaluate long-term loans.

Unlike the so-called market-based system of the Anglo-American variety, the capital market in Thailand had no mechanism to guide the allocation of capital in a disciplined way. Table 2 shows the raising of new share capital among both listed and non-listed companies. Clearly, this source financed little of the new investment, although its role became larger during the stock market boom of the late 1980s and early 1990s. Well into the 1990s, even after the growth of the stock exchange, and with a significant amount of capital raised there, Thai corporations are almost entirely family owned (in the sense of having control rights rather than cash-flow rights). Many companies would have a group of families rather than a single one (Claessens, et al. n.d.)[6]

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[5] See Warr and Bhanupong 1996:79-81 for a brief summary of industrial policies.

[6] Suehiro (1989:224) in his analysis of 24 largest industrial groups concludes however that most of the firms were owned by a single family.

These family businesses also tend to be organized as conglomerates, of which some constituent companies would be listed, and others not. Such organizations lend themselves to a great deal of insider dealing and transfer pricing among the companies, usually to the detriment of the more widely held, i.e. listed, companies within the group – a process known in Thailand as "siphoning". Sometimes, the creditor banks would also participate in this process as well, with benefits accruing to the bank owners.

Most of the players in the stock markets were small investors, who could be most charitably described as "noise-traders". They were easily exploited by the majority shareholders, as controls on insider trading were ineffective for most of the period. The task of the minority shareholders and other players in the stock markets was also not facilitated by the existence of good accounting standards or aggressive financial journalism. Nor was there a sufficiently large group of major institutional investors who can exercise pressure on wayward owners/managers.

Because of this unbalanced development, it can even be argued that the emergence of the stock exchange reduced the efficiency of the capital allocation process. Banks and finance companies and the investing firms would look to the stock exchange as an easy dumping ground for their poor projects. With the availability of this dumping ground, the incentive for the banks to monitor the performance was further reduced.

How was it that a capital allocation process that supplied little information to those that provided the finance could last for decades? There were incidences of financial distress, some of which verged on being systemic, as will be discussed further below. However, these were relatively quickly resolved. What saved the situation was the strong secular growth trend, which ensured that critical asset prices (particularly land and stock prices) were also trending upward strongly, and provided both lenders and borrowers with the cushion in case of unwise decisions. That growth had "bailed out" the financial system further encouraged sloppy lending practices.

Admittedly, this explanation begs the question of what then explains Thai economic growth, which had indeed been remarkable – the more so as the capital allocation process was so poor. Unfortunately, this lies beyond the scope of the present paper.

Distress among Banks and Finance Companies in the early 1980s

Prior to 1997, Thailand experienced episodes of bank runs at an approximate rate of one per decade. Each collapse would expose malpractice by bank management, usually involving insider lending to companies affiliated to the conglomerate owned by the bank owner (Nopporn 1989:242; TDRI 1991:5-19).

Thailand has never had formal deposit insurance, that is an arrangement that involves clear legal rules allowing the exit of a failed financial institution, with compensation (perhaps with a cap) for the depositors. Consequently, the resolution that took place as a result of such a failure tended to be *ad hoc*. But they nevertheless generated a pattern of expectations as to the distribution of losses following a bank

failure, thereby affecting the behavior of bank depositors. The authorities' response to a bank run therefore merits a brief discussion. The following describes the measures undertaken by the authorities during the last bout of trouble in 1979-1982, because the institutions set in place then were what guided action during the crucial years of 1996 and 1997, when the authorities faced their biggest challenge.

The trouble with financial institutions in the late 1970s and early 1980s took place against a backdrop of more general macroeconomic shocks that hit the Thai economy, primarily impelled by the second oil shock and the increase in overseas interest rates (Warr and Bhanupong 1996:99-112). The crisis began in 1979 with the collapse of a finance and securities company,[7] later found out to have financed purchases by others of its own shares, in order to ramp up its own share price. When stock markets in the rest of the world dropped because of interest rate increases, the attempt to push up share prices could not be sustained. The firm sustained heavy losses, and in the end had to default, forcing the authorities to intervene, and to withdraw its license. Depositors were paid 20 per cent of the face value of its notes. This collapse, together with the increase in interest rates led to more general difficulties with other firms. In some cases, commercial banks took over some of the troubled firms. In a few other cases, there were unsuccessful attempts to launch a collective rescue by other financial institutions.

A second and bigger wave of failures took place in 1983-1984, which led to the closure of 20 finance companies. Depositors this time were given back the full value of their principal, but in zero-interest notes, sometimes for a period of ten years. Given the high rate of interest then prevailing, this was quite a substantial penalty. Aside from the 20 finance companies that were closed down, 25 that could be revived were put on a "life-boat" scheme, with infusions of money and management from the central bank (TDRI 1991:12-17). The net result of these changes is that the number of finance companies decreased from 112 in 1982 to 94 in 1987.

Although the problem began with the finance companies and had much of its impact on that sector, the commercial banks were not immune. In 1984, one bank (Asia Trust) collapsed outright, and had to be taken over by the central bank. The cause of the collapse was again insider lending and fraud. After an injection of capital and soft loans, the bank was allowed to operate for a few years, but was finally merged with the main state-owned bank (Krung Thai Bank). In 1986, two more banks (First Bangkok and Siam City) also ran into difficulties, and were told to increase their capital, with the central bank appointing new managements. Soft loans were also provided for them to generate enough profits to aid in the recapitalization effort (Nopporn 1989:183-200).

[7] Until 1997, the finance and securities companies were allowed both to accept deposits for investment and lending purposes, and also to trade in securities, and generally to act as investment banks. These institutions were allowed to be established in 1966, and a relaxation of the laws in 1972 resulted in a rapid growth in their numbers (reaching more than one hundred) in the early 1970s. Their growth increased the competitive pressures on the banks as well as among themselves.

It should be noted that these troubles with the banks did not come totally out of the blue. In all cases, the central bank was well aware of the problems, and took a number of actions prior to the final takeover. Thus, in 1982 and 1983, Asia Trust was told not to pay out dividends because it suspected that the bank was dressing up its accounts to show profits (Nopporn 1989:185). But, as this example shows quite clearly, the means used by the central bank to prevent failure was quite inadequate to the problem that finally emerged. In the case of First Bangkok, it also suspected problems, but was unable to track down the information completely. The inadequate auditing by the central bank was again pinpointed as a problem in the crisis of 1996-1997.

One outcome of these interventions was that the authorities began seriously to consider the introduction of a deposit insurance system, and a law to set one up was on the verge of being submitted to the parliament, but it was withdrawn by the Ministry of Finance. In its place, a Financial Institutions Development Fund (FIDF) was set up by an amendment to the Bank of Thailand Act.[8] The purpose of the Fund was really to rehabilitate and revive financial institutions, and not to arrange for their orderly exit in case of difficulties. In this respect, the fund formalizes the action taken by the authorities with respect to the banks and not with respect to the finance companies in the mid-1980s. The amended law did not give depositors any explicit guarantee. Nevertheless, the way the central bank dealt with the problems during the 1980s has generated the expectation that, in the case of commercial banks at least, their deposits there were relatively safe.

By contrast with what happened in the late 1990s, the difficulties of the early 1980s were relatively mild. There were three or four years of relatively low (but never negative) growth, but after 1987, high growth resumed. Furthermore the exchange rate adjustment that was necessary was also relatively mild, the price of dollar going up by 15 per cent in the devaluation of December 1985. Besides, at that time, the stock of private foreign debt was relatively small. Consequently, the needed balance sheet adjustment in the private sector was also quite small.

These factors combined to minimize the losses to the Bank of Thailand and the financial system. Unfortunately, they gave both the authorities and the financial community a misplaced confidence in the general soundness of the Thai financial system and their ability to tackle another crisis, should one arise. As the clouds lifted, the policy emphasis shifted from prudential regulation to liberalization and to increasing competition and liberalization.

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[8] The FIDF is a distinct juristic person from the Bank of Thailand, although its board is chaired by the latter's governor, its staff are entirely from the bank, and it is run essentially as a *de facto* department of the bank.

Financial Liberalization 1988-1997

The Thai economy recovered smartly from the crisis of the early 1980s, and went into a prolonged boom dating from the mid-1980s, and continuing on to the mid-1990s. Shadowing this boom was the expansion of the financial sectors. Total assets in commercial banks expanded five-and-a-half times in nominal terms between the end of 1985 and the end of 1995. Assets in finance companies expanded by almost twelve times, while the average daily transactions in the Stock Exchange of Thailand grew more than a hundred-fold between the same two years.[9] With these developments, which could be construed as a deepening of the Thai financial sector, the government thereby began to launch a series of liberalizing measures.

Domestically, ceilings on interest rates on deposits were removed in a series of moves between 1989 and 1992, beginning with the longer-term deposits, and then encompassing all deposits. Lending rates had already been liberalized during the surge in world interest rates in 1980.[10] There were a small number of rate restrictions on particular classes of loans (e.g. mortgage lending to low-income individuals). The policy of directed credit for the agricultural sector was broadened into a rural credit policy. While the ratio of credit that has to be given to the rural sector was increased to 20 per cent from 14 per cent, the coverage of what was included in the rural sector was expanded to include wholesale trading in agricultural commodities and regional industrial estates. Loans to farmers engaging in subsidiary non-agricultural activities could also be included in this category. Banks and finance companies were also permitted to engage in a wider range of activities, such as loan syndication, advisory services, underwriting and trading of debt instruments, and supervision and sales of mutual funds (Pakorn 1994).

As part of the same liberalization process, the capital adequacy requirement was adapted to conform to the Bank of International Settlements (BIS) standards. Attempts were made to extend coverage to contingent liabilities and off-balance sheet items. All of these increased capital requirements. Nonetheless, there were a number of weaknesses, which remained uncorrected and which were to prove troublesome when the economy began to run into heavy weather in 1996. Notably, the definition of when loans became non-performing was particularly lax. Loans were considered non-performing only when principal and interest were overdue for at least twelve months. There were also procedural weaknesses, in particular large time lags between the audit itself, the determination of irregularities, and the decision on action by the central bank (Nukul Commission 1998).

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[9] Nominal GDP grew four-fold between 1985 and 1995.

[10] The Thai civil code considered interest rate in excess of 15 per cent per annum to be usurious and prohibited it. This proved to be problematic during the period when interest rates worldwide were in double digits. A removal of this law encountered strong opposition, so a Financial Institutions Lending Rate Act was passed in 1980, which exempted financial institutions from the civil code provision.

As already mentioned, Thailand lost the chance to have an orderly exit procedure for financial institutions when it decided not to have formal deposit insurance in the mid-1980s. During the liberalization phase in the early 1990s, it never allowed new entry into either the banking sector or among finance companies, too much political sensitivity being involved in such a measure. The idea of permitting new entry gathered momentum during the bubble, the establishment of three new banks was actually approved in 1996, but the crisis intervened before they could be set up.

Of considerably more import was the liberalization of the currency market. Thailand accepted the obligations under Article VIII of the International Monetary Fund in 1990, and completed the opening up the foreign exchange market for current account transactions in 1992. As this part of the currency market had already been substantially freed, the opening up had relatively little impact. More important was the concurrent liberalization of capital account transactions, with an eye to making Bangkok into a regional financial center. The keystone of this part of the financial liberalization was the setting up of the Bangkok International Banking Facilities (BIBF) in 1993. Under this scheme, qualifying banks were issued licenses to provide international banking services. Entry into this business by foreign banks that had not set up branches in Thailand now became possible. This measure attracted all 15 domestic banks, 12 foreign banks with branches already in Thailand and 20 new foreign banks (Pakorn 1994:78).

It is easy to exaggerate the influence of the BIBF, which was credited with the huge inflow of foreign credit during the period 1993-1996. It must be borne in mind that previously the authorities had been fairly open in permitting inflow of foreign capital, but was restrictive on the outflow (Warr and Bhanupong 1996:170-171). What the BIBF did was to reduce the transactions cost of foreign borrowing. Given that the dollar rate of interest was lower than the baht rate, this reduced transaction cost thus induced a larger flow, but it could not be a major explanation. Thai firms were already borrowing in the Singapore and Hong Kong markets, many of these borrowings were now re-booked through the BIBF (Bank of Thailand 1996). Where subsidiaries of foreign firms borrowed abroad and brought the money into Thailand, the figures would have appeared as foreign direct investment (FDI), but when they borrowed from the BIBF it appeared as short-term debt and apparent FDI sharply declined.

Ironically, although the BIBF was designed to allow greater access to foreign banks, it actually strengthened the role of the Thai banks in the provision of capital for Thai businesses, as we shall demonstrate below. But given the liberalization of the domestic credit market, the banks were also facing a far more competitive environment, which led to the enormous lending boom which fueled the Great Bubble of 1993-1996.

Unlike Singapore, Thailand never had a clear policy about the use of its domestic currency overseas. Indeed, at one point, the authorities contemplated promoting the baht as an international currency, but dropped the idea after discussions with other Asian central bankers. Nevertheless, an offshore baht market began to emerge, which was to play an important role during the speculative attacks of 1996-7.

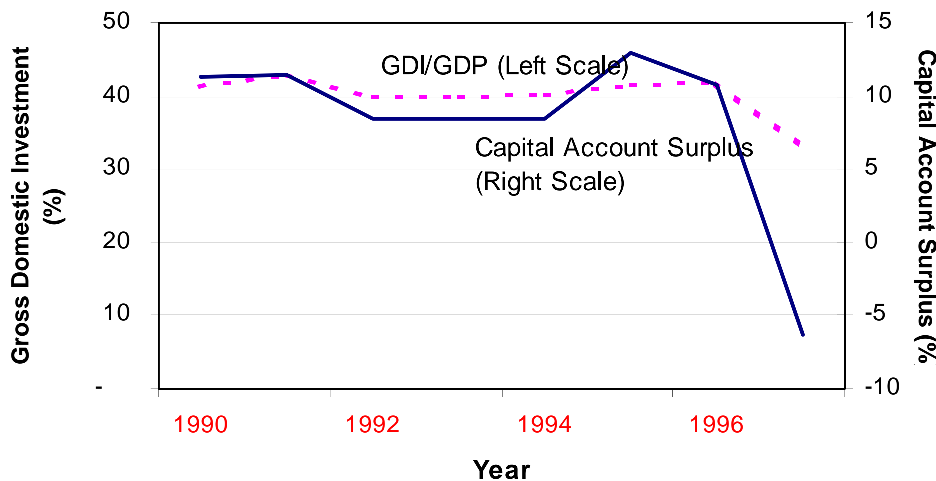
B. THE BUBBLE

The Investment Boom of 1991-1996: The Macro Picture

The boom of the late 1980s was fuelled by a large influx of foreign capital in the late 1980s, notably from Japan and Taiwan, as a result of currency realignments in the wake of the Plaza accords in 1985. This boom was unprecedented in its magnitude, with the economy enjoying double-digit growth rates for three years running between 1988 and 1990. Meanwhile, the public sector, which had shelved many infrastructure projects during the downturn of the early 1980s, began to revive these as bottlenecks began to appear with the strong growth. Many of these infrastructure projects, notably telephones and urban expressways, were granted as concessions to private companies. Consequently, the share of the corporate sector in total investment began to inch up again after the fall in the mid-1980s, while the central and local governments turned from a net deficit sector to a net surplus sector.

Even if we ignore the shift to the private sector of investments in basic infrastructures that had been traditionally in the public-sector domain, private businesses were finding that their own infrastructure, for example, office space, was in short supply, also requiring large investments. At the same time, there was also a shift in the protection policies toward the capital-intensive intermediate goods sectors, such as petrochemicals and steel. Thus the country found itself in the midst of an investment boom. The share of gross domestic capital formation in GDP began to climb from a level of around 30 per cent to a level of 40 per cent. A part of this increase was financed domestically, but an equally important part was financed from abroad, with a resultant increase in the current-account deficit (Figure 1).

Figure 1. Ratios of Gross Domestic Investment and Capital Account Surplus to Gross Domestic Product



Sources: National Economic and Social Development Board and Bank of Thailand

Figure 1 describes the aggregate rate of investment and the extent of its foreign financing; when we turn to look at the sources of the corporate sector financing, a somewhat different picture emerges. Table 3 is the same as Table 2, except that it covers the period 1991-1996.

What stand out in Table 3 are the changes that took place in 1993 and 1994. Direct borrowing by firms from foreigners became somewhat less important, indeed turning negative in 1994, before turning up again. Also long-term loans climbed up to take the lion's share of the financing for the business sector. But these long-term loans were not provided directly by foreign banks, but rather were channeled via the local banks to the business sector. While the BIBF was originally intended for facilitate entry by foreign banks into Thailand, it was open also to Thai banks. They took up with alacrity the business of intermediating between (what appeared at that time to be) cheap money in the international markets and the needs of the domestic firms. Soon they became major players in the BIBF. Table 4 presents the changes in the flow of funds going into and coming out of the banks.

Table 3

Sources of Financing Flows for Investments by Non-Financial Incorporated Enterprises, 1991-1996

Sectors	1991	1992	1993	1994	1995	1996
Per Cent of Gross Investment of Non-Financial Enterprises financed by Sector's Saving	31.4	32.5	33.1	30.4	37.2	51.4
Per Cent of External Finance obtained through:						
Liquid Financial Assets[a]	-13.4	-7.8	-21.5	-7.8	-6.4	-9.4
Short-term Loans and Bills	16.6	33.3	25.9	17.4	22.2	23.7
Trade Credit	-0.2	-0.3	-0.2	2.4	1.2	-0.9
Hire-Purchase Debts and Claims	-8.8	-15.4	-13.3	-11.2	-9.2	-12.8
Long-term Loans	29.1	27.0	61.6	71.8	49.1	37.5
Mortgages	1.5	7.6	2.1	5.2	5.1	5.4
Debentures	1.8	0.5	4.0	10.1	5.0	0.6
Share Capital	16.7	20.0	16.1	29.8	18.6	19.1
Foreign Debts and Claims	57.5	37.9	32.5	-14.9	21.7	39.3
Others	-0.7	-2.8	-7.2	-2.9	-7.4	-2.6

Notes: Negative sign indicates that the sector is acquiring assets issued by (i.e. "lending" to) other sectors
[a] This item includes currency, deposits and government paper.

Source: National Economic and Social Development Board, *Flow of Funds Accounts of Thailand.* (various issues).

These figures show that the jump in long-term loans obtained by the business sector can largely be attributed to the change that took place in the shifts in the portfolio of the banks, and that this jump was to a considerable extent financed by foreign borrowing.[11]

The consequences of the flows of funds shown in Tables 3 and 4 can be seen in the data on Thailand's *stock* of external debt, shown in Table 5. This table also has a breakdown according the term of the loans. The figures are quite striking. There was a jump in total private external debt starting in 1993, but the jump was steepest in 1995. Interestingly, for the country as a whole, there was no major shift towards the shorter end, with the relative expansion of short-term debt by the banks countered by the success of the non-bank sectors in raising long-term capital directly from foreign sources.

Table 4

Flows of Funds from and to Commercial Banks 1991-1996

Sectors	1991	1992	1993	1994	1995	1996
Acquisition of Assets (% of total)	100.0	100.0	100.0	100.0	100.0	100.0
Currency and Deposits	4.3	0.4	0.8	1.3	2.8	3.4
Government Bonds	-0.9	0.3	0.5	2.2	1.7	3.6
Short-term Loans	20.4	26.9	11.6	17.2	17.1	20.3
Long-term Loans	46.4	41.1	43.1	50.7	44.1	41.9
Commercial Bills	10.7	20.9	14.5	13.0	15.3	13.5
Share Capital	0.1	0.1	0.0	0.0	0.0	0.0
Debentures	1.8	0.0	2.3	3.7	3.0	1.5
Mortgages	8.7	10.8	9.6	10.7	6.9	9.3
Foreign Claims	3.7	-0.7	17.6	3.4	7.4	8.1
Others	4.8	0.2	0.0	1.2	1.7	-1.6
Incurrence of Liabilities (% of total)	100.0	100.0	100.0	100.0	100.0	100.0
Deposits	91.0	77.9	61.5	49.8	59.3	74.6
Short-term Loans	-1.0	-0.4	-0.9	2.3	1.3	1.4
Long-term Loans	0.0	0.1	0.1	-0.1	0.1	0.0
Commercial Bills	-0.3	0.5	-1.0	-1.1	0.8	0.5
Share Capital	3.0	2.9	2.4	0.5	2.0	6.8
Pension Funds	0.1	-0.3	0.1	0.0	0.1	0.1
Foreign Debts	1.8	12.8	32.8	53.1	41.7	30.8
Others	5.5	6.5	5.0	-4.6	-5.3	-14.2

Source: National Economic and Social Development Board, *Flow of Funds Accounts of Thailand.* (various issues).

[11] The data on finance companies, the other major lenders, show no equivalent jumps.

Nevertheless, the fact remains that the banks, both in their purely domestic capacity, and as members of BIBF, were increasing their short-term borrowing at a very rapid rate, at least until 1996, this at a time when their portfolio was going increasingly toward long-term loans. It was this maturity mismatch on the part of the banks that was to be one of the factors that led to the bursting of the bubble. As for the currency mismatch, the Bank of Thailand satisfied itself that the regulation requiring that banks (and finance companies) keep their *net* exposure in foreign exchange at a level below 20 percent of their capital was adequate. Of course, in doing so, it is shifting the primary risk to the corporate borrowers, as the local banks' had to denominate its loans in dollars to be in line with the regulation. With almost all major corporations hooked on dollar loans, the banks were exposed to the secondary credit risk arising from a devaluation of the baht.

Table 5

External Debt of Thailand 1991-1996

(billion US$)

Sectors	1991	1992	1993	1994	1995	1996
Public Sector	12.8	13.1	14.2	15.7	16.4	16.8
Private Sector	25.1	30.6	37.9	49.2	66.2	73.7
Breakdown of Private Sector Debt						
Commercial Banks	4.5	6.3	5.3	9.9	14.4	10.7
Long-term	0.3	0.7	1.3	3.5	4.4	2.3
Short-term	4.1	5.5	4.0	6.4	10.0	8.4
BIBF	0.0	0.0	7.7	18.1	27.5	31.2
Long-term	0.0	0.0	1.4	3.0	3.8	10.7
Short-term	0.0	0.0	6.4	15.1	23.7	20.5
Non-bank	13.6	24.3	24.9	21.2	24.2	31.9
Long-term	7.3	11.5	12.7	13.7	16.9	23.2
Short-term	6.2	12.8	12.3	7.4	7.3	8.7
Total	37.9	43.6	52.1	64.9	82.6	90.5
Long-term	22.5	24.7	29.5	35.7	41.5	52.9
Short-term	15.4	18.9	22.6	29.2	41.1	37.6

Source: Bank of Thailand.

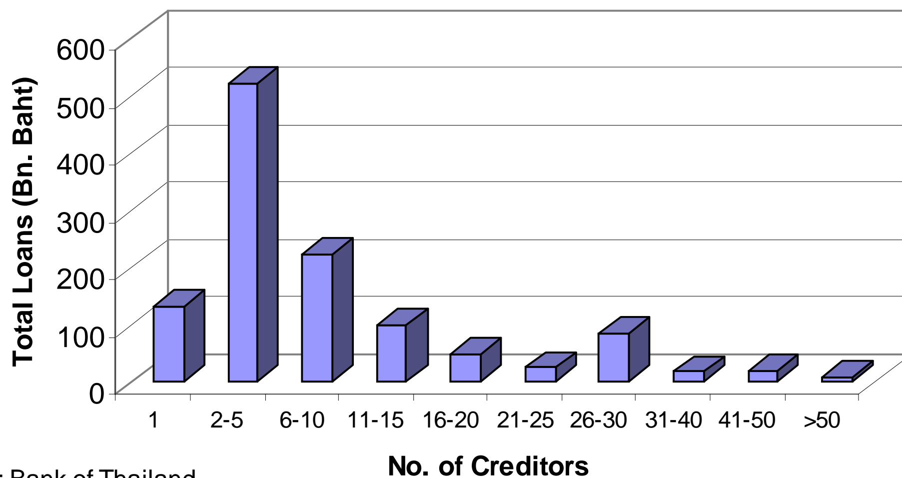
The Investment Boom of 1991-1996: The Micro Picture

The lending side. The financial liberalization led to a considerable increase in the competition among financial institutions, both Thai and foreign. Together with international pressure on the Thai authorities to open up the financial sector further, Thai institutions realized that they would soon have to compete with stronger ones from

abroad. They also realized that they were weak on technology, and they had a great deal of catching up to do, but instead of catching up on that front, most of them decided to grab as much of a market share as possible. Traditionally, they had competed to acquire as much of the deposits as possible by opening branches in all corners of the country – Thailand today is equipped with one of the densest branch networks among the developing countries. With liberalization, banks were no longer constrained to raise domestic funds, now more expensive than foreign funds; consequently, they began to rely on the latter. The focus of competition therefore shifted to the asset side of the banks' balance sheets. The business sector found itself in a borrowers' market for credit.[12] The monitoring and discipline that banks had only been lightly exerting before the bubble now went completely by the board. The Thai credit market became an arm's length market.

One indication of that appears in a set of data recently released by the Bank of Thailand, during the discussion of a proposal to put up a national asset management company.[13] This data show the number of creditors per debtor in 2001. Figure 2 shows its distribution; the unweighted average is 2.7, but the average weighted by the amount lent is 8.8.

Figure 2. Distribution of Loans by Number of Creditors, 2000



Source: Bank of Thailand.

By itself, the emergence of an arm's length market should be no cause for concern. After all, developed countries can easily accommodate arm's length markets in debt instruments, but they have adequate accounting standards and legal framework.

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[12] See Suthep (2000) for one borrower's experience during the bubble.

[13] See further below on the Thai Asset Management Company.

With multiple creditors, the transparency of the companies' accounts would be the only way for creditors to find out how exposed the borrowers are. Unfortunately, accounting standards in Thailand were very poor, even for listed companies. Oddly, neither lenders nor investors (including foreign ones) appeared to care at the time. It was only in the wake of the crash that all sorts of siphoning by the management (which in Thailand means the majority shareholders) were discovered. By then all the discovery did was to fuel the resentment by the creditors against the poor business practices of Thai companies – and which made the post crash restructuring so difficult.[14]

As to the legal framework, creditors were to discover what they should have known at the time they lent the money how inadequately protected they were by the Thai legal system. I shall return to this problem later in the paper.

The borrowing side. The open-handed willingness of banks and finance companies to lend naturally had a major impact on the non-financial firms' balance sheets. The average debt/equity ratio for listed non-financial firms crept up from 1.6 in 1988 to 2.4 in 1996, so that at the later date Thai firms had the third highest ratio in East Asia, exceeded only by Japan and Korea (Claessens and Djankov 1999: Table 7). This occurred despite the fact that stock prices at the time were rising rapidly and companies were willing to tap the stock markets for funds as well.

The extremely high investment rate that followed this plentiful supply of funds (see Figure 1 above) was however yielding diminishing returns. The real rate of return on assets (in local currency) for the median company drifted down from 10.8 per cent in 1988 to 7.4 per cent in 1996 (Claessens and Djankov 1999: Table 2). The end result of this was a decline in the interest cover[15], and a greatly increased vulnerability of Thai companies. By 1996, they were the second most vulnerable among Asian countries, after Korea (Claessens and Djankov: Figure 5) – and this is without including the exchange risk facing these companies.

Policy Responses

With the resulting overheating of the economy, the appropriate policy to follow for a country with an exchange rate regime such as Thailand's is to run a more stringent fiscal policy. The government at the time was running a fiscal surplus, but the surplus was getting smaller. In 1994, just as the boom was at its peak, the government of the time began to run a fiscal deficit, ignoring the central bank's plea to run a more stringent fiscal policy.

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[14] Borrowers, on the other hand, reported that banks sometimes encouraged them to borrow more or to divert money especially to buy land, as it can be used to leverage into larger loans.

[15] This is defined as the ratio of earnings before interest and tax (but adding back depreciation) divided by interest expenses.

The Bank of Thailand then began to implement a stringent monetary policy on its own. It raised domestic interest rates in 1994, it attempted to influence the direction of credit by financial institutions,[16] and it increased the compulsory deposit requirement for capital inflows (a Chile-like measure which it had in place) from 7 to 10 per cent. None had any effect, since financial institutions and firms can easily get around them by turning to dollar loans, increasing the country's vulnerability even further. As to the compulsory deposit requirement, the tax equivalent of the measure was so small relative to the interest differential that most borrowers ignored it (Nukul Commission 1998: paras. 34-37).

C. INTO THE CRISIS

With the exception of the property sector, signs of trouble were not obvious until 1996, when there was a perceptible slowdown in exports. They had been growing at double-digit figures for the previous ten years, when quite suddenly the growth in total export dropped to near-zero level. And this slowdown took place not only in Thailand, but throughout Asia with the exception of China. I shall not dwell on the causes of this slowdown (see Chapter 2 of World Bank (1998) for an analysis). Its consequences were however profound, for it signaled a sharp end to the investment boom, with serious consequences for the financial institutions. Their previous phenomenal growth, which had appeared unstoppable, now looked decidedly wobbly, and their future looked highly insecure. The problems of the financial institutions were heralded by the case of the Bangkok Bank of Commerce (BBC). Exceptional in some respects though the case may be, it, and the way the Bank of Thailand dealt with it, set the stage for the events of 1997-1998.

The case of BBC[17]

BBC's travails went back a long way. From being a conservatively run bank owned and run by Thai aristocratic families, it went through several teams that mismanaged the banks until it required some liquidity injection from the Bank of Thailand during the previous bout of financial distress in 1984. Matters did not improve, and an audit of the bank in 1991 showed the level of classified loans standing at 26.2 per cent of total assets. It was told by the central bank to increase its capital by 800 million baht immediately, and to have a capital-raising plan for the period 1992-1994. Later on in September 1992, the Bangkok Bank of Commerce decided to reorganize its management team by appointing as managing director a member of one of the owning families who also happened at that time to be on the staff of the central bank. Two additional staff members of the central bank were appointed to senior positions in BBC.

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[16] The means it used to do so was to ask financial institutions to submit their lending plans for the following six months on which it would make comments. There is no sanction in cases if the institutions chose to ignore the central bank.

[17] Information in this section is mostly drawn from Nukul Commission (1998: Chapter 4)

Far from improving matters, these appointments accelerated the deterioration. The situation as of 31st March 1993 (reported to the Governor of the Bank of Thailand ten months later) showed a more than doubling of the proportion of substandard loans to 39.6 per cent of assets. The Governor thereupon decided that the only way out was to take over the bank and ordered another audit of the bank with a view to a takeover. The report for March 1994 (this time submitted with a time lag of slightly more than a year) showed a further deterioration. The central bank further discovered that one influential figure in the bank (whose official title in BBC was merely "advisor") was using the bank's funds to engage in various speculative merger activities in the stock exchange. Loans were also granted to politicians to engage in stock market and land speculation backed by grossly over-valued collateral – later on, a property valuer was found guilty of collaborating with the bank's management in the scam.

As a result of these audits, BBC was ordered to increase its capital, by 3 billion baht in 1995 and another 3.7 billion baht in 1996. It was also told not to have any further dealings with the "advisor". These capital increases were to be carried out without writing down existing capital. Naturally the bank found few takers. Eventually, the FIDF and the Government Savings Bank had to step in twice, at the end of 1995 and again in 1996. At no time were the existing shareholders and the management, except perhaps the "advisor",[18] punished for having run down the bank. The management was not replaced. The excuse given by the central bank was that it was needed in order to collect on the bad loans.

All transactions between the central bank and BBC were up to this point confidential. The *denouement* came in May 1996 when, in the course of a no-confidence debate, opposition members of parliament revealed many questionable practices in BBC, including a loan granted to the Governor of the central bank, sparking a run on the bank. Within a week, the Finance Minister was forced to take over the bank.

The Bank of Thailand, as the supervisor of financial institutions, was sharply criticized for its mishandling of the case. It was clumsily slow in detecting evidence of fraud, was excessively forbearing when the fraud was detected, and unduly lenient when it did begin to take action. The indulgence shown by the Bank of Thailand did a great deal to undermine the public's trust in the probity of its personnel. Until this point, the Bank's reputation for integrity was unique among Thai public institutions. This reputation has been beneficial both for the bank and for the country. After the BBC affair, that reputation was lost.[19]

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[18] He is now (May 2001) in Canada, resisting in its courts Thailand's request for extradition, a case that has been dragging on for more than three years.

[19] The further history of the BBC can be briefly summarized as follows. At the beginning of 1997, after lengthy negotiations, the Industrial Finance Corporation of Thailand (IFCT) was asked to take over the - management of BBC. Both before and after the takeover, IFCT conducted an investigation and then due diligence. At each, further bad loans were discovered and reported, requiring massive recapitalization. Investors willing to put up the capital could not be found, hardly surprising in view of the murky

Meltdown in the Finance Company Sector

The lesson drawn by the finance industry from the BBC affair was important, because by the second half of 1996, it became clear that many finance companies were in serious trouble, mostly through their exposure to property loans,[20] but with a significant admixture of fraud in a number of firms. There was a run on one finance company, a subsidiary of BBC.

The government at first tackled the problem by attempting to support the property market, to which the finance companies were particularly exposed. It first floated a soft-loan scheme for civil servants and other worthy groups to purchase property, and then to promote a secondary market by setting up a Secondary Mortgage Corporation. The first measure was too puny and the second was a developmental measure, not a crisis management tool. Not surprisingly, they failed to have any impact. Finally, in March 1997, the government set up a Property Loan Management Organization to buy out problem loans from the financial institutions. Given the liquidity crunch at the time (the central bank was at that time facing battle on many fronts, including a severe attack on the currency), this organization could not obtain enough funds to begin to tackle the problem before it was overtaken by events (Renaud, Zhang and Koeberle 1998).

By the beginning of 1997, the Bank of Thailand felt it had to take drastic action to tackle the finance companies' problems. In March it publicly announced that ten firms had been asked to increase their capital,[21] sparking a run on them. To aid these companies, the central bank announced that the FIDF would help in providing them with capital, should they fail to raise it. They did fail, but no funding was forthcoming from the FIDF. FIDF also began to act as a marriage broker in order to induce mergers of some of the weaker companies with some of the (hopefully) stronger ones including some banks, without any success.

Economic conditions deteriorated further: there was a major attack on the baht in the middle of May, the third, and the most damaging, in a series that began in November 1996. The run on these ten finance companies, as well as others, continued unabated. Finally, on 27th June 1997, days before the baht was floated, the government suspended the operations of sixteen finance companies, including eight of the ten that were told to increase their capital. As in the mid-1980s, depositors at these finance companies were mildly punished. They were given promissory notes with maturity of three to five years,

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conditions of the bank, and the murkier intentions of the authorities. Finally, in August 1998, the Finance Ministry put BBC out of its misery by announcing that the bank would be closed down, and asset management company set up to manage whatever remains of its assets.

[20] A quarter of loans from finance companies, but only 8.8 percent from banks, went to property (Yos and Pakorn 2001).

[21] This was the first time ever that the central bank (or rather the Minister of Finance) made a public announcement of a demand for capital increase. Its wisdom is now much questioned, as it only served to generate panic.

at slightly below-market interest rates. The government's assurance that these sixteen would be the last to be in any way affected was predictably ignored, and the run continued, with the FIDF continuing to pour in money. On 5th August, one month after the baht float, and on the eve of Thailand's entry into the IMF program, 42 more finance companies were suspended. The affected companies were to submit financial plans for their recapitalization, after which their fate would be decided. Four months later, the authorities decided to close down 56 of the 58 (that is sixteen plus forty-two) companies that were suspended.

On 5th August 1997, the same day that the government suspended the 42 companies, it issued a decree guaranteeing deposits *and loans granted by creditors* (which were mostly foreign banks) at these and all the remaining financial institutions. Creditors to the first sixteen that were closed in June were however excluded from the guarantee. It was hoped that the blanket guarantee would stop further runs on the remaining financial institutions, but they continued nonetheless, now beginning to affect the smaller commercial banks as well as the remaining finance companies. It was only toward the end of the year that the run subsided.

The withdrawal of funds by the general public from the financial institutions was made good by the provision of liquidity from the FIDF. Until the end of 1997, the central bank, which ran the FIDF, persisted in the fiction that the suspended finance companies were not essentially bankrupt, but were suffering from illiquidity, and could presumably raise some capital. With the FIDF pumping liquidity into these institutions, it had to obtain funds from the money markets. These were provided by the larger banks, where depositors took refuge after withdrawing from the suspect companies. Luckily, the run was not against the financial system as a whole, but against specific institutions. The FIDF was therefore engaged in re-circulating those funds back to the finance companies. However the same cannot be said about the run by foreign creditors to the financial system as we shall see.

Interestingly, in lending to institutions facing a run, the FIDF as lender of last resort, did not levy a penalty rate of interest, but charged a below-market rate of interest. Many of them later claimed that they took advantage of the lower rate, even though they were not desperately in need. They, or at least the forty-two suspended in August 1997, were surprised by the criteria allegedly used by the authorities to undertake the action. It appears that the ratios of the advances by FIDF to capital were used to deem the companies to be at risk and to suspend them.

These policy decisions led to a complete skewing of the balance sheets of the Bank of Thailand (including the FIDF). Table 6 shows the sources and use of FIDF funds at different dates in the years 1996 and 1997. The figures indicate that by August, within a space of a few months injected slightly more than ten per cent of GNP to shore up the finance companies. The asset value in the FIDF balance sheet is highly questionable. The FIDF's balance sheets shown in Table 6 were not public until the Nukul Commission, which had access to these records, published them April 1998. Meanwhile, the market could only observe what the FIDF and the Bank of Thailand were

doing, but it had little idea of the global magnitude, and could only draw its own conclusion. The conclusion it chose to draw was one of panic.

Table 6

Sources and Uses of FIDF Funds

(billion baht)

Sources and Uses	Jun 96	Sep 96	Dec 96	Mar 97	Jun 97	Aug 97
Sources:						
Advance from BOT	25.8	25.8	35.8	31.8	45.8	45.8
Contribution from BOT	3.3	3.6	3.6	3.6	3.9	3.9
Income	19.1	19.1	21.1	21.1	23.3	23.4
Contribution from Govt	0.0	0.6	0.0	0.2	48.0	48.1
Bonds and Bills	0.0	8.0	15.0	24.0	31.4	23.4
Repurchase Agreement	0.0	0.0	0.0	83.3	232.5	445.3
Interbank Loans	0.0	9.3	6.0	24.2	5.2	44.4
Reserves	0.0	0.0	0.0	0.0	18.3	18.3
Accumulated Surplus	18.0	18.5	19.8	21.2	3.0	0.0
Uses:						
Purchase of Bank Shares	15.2	34.2	34.2	34.2	27.5	27.5
Purchase of Other Shares	1.0	1.0	1.0	1.1	1.1	1.1
Loans to Finance Cos.	0.7	13.2	16.1	121.5	272.6	363.9
Repurchase Loans	0.0	0.0	0.0	0.0	0.0	3.1
Bank Deposits	21.5	5.3	5.3	11.8	16.7	110.9
Loans to Banks	4.4	3.3	3.3	3.1	4.0	3.9
Purchase of Bank Loans	4.5	4.5	4.5	4.5	51.6	90.9
Notes	2.5	2.5	2.5	0.1	0.1	0.1
Property awaiting sale	6.3	6.3	6.3	6.3	6.3	6.3
Account Receivable	0.0	0.0	0.0	0.0	6.2	6.2
Short-term Investments	10.0	14.5	24.3	25.9	25.4	39.2
Total	66.2	84.8	101.3	209.3	411.5	653.1

Source: Nukul Commission (1998:191-192) [This table is available only in the Thai-language version of the report, and is not reproduced in the translated version].

The Financial Sector Restructuring Agency (FRA)

In December 1998, after the authorities made the decision to close down 56 of the suspended finance companies, their assets were transferred to a newly formed Financial Sector Restructuring Agency, to be disposed within one year. All the proceeds were to go to repay the FIDF and any remaining creditors of the defunct finance companies. The FRA proceeded to do so, by auctioning the assets off to any bidder except the original

debtor (in order, it was said, to avoid moral hazard). In order to place a floor on the price of the assets, the government set up a parallel agency, the Asset Management Corporation, to participate in the bids. The results of the auctions are shown in Table 7.

Table 7

Value of Winning Bids for the FRA's Auction of Assets as Percent of Face Value

(Percent)

Winner Group	Foreign		AMC		Other Thai		Total	
Sector	Wt.[a]	% of Face Value	Wt.[a]	% of Face Value	Wt.[a]	% of Face Value	Wt.[a]	% of Face Value
Hire Purchase	*7.2*	49.1	-	-	*1.4*	42.5	*8.7*	48.0
Housing Loans	*4.1*	46.8	-	-	-	-	*4.1*	46.8
Business Loans I	*19.5*	22.4	-	-	*3.6*	26.8	*23.1*	23.1
Business Loans II	*2.0*	18.3	*30.7*	16.8	*4.1*	28.9	*36.7*	18.2
Construction Loans	-	-	*0.2*	14.3	*0.1*	5.1	*0.2*	12.2
Commercial Loans I	*17.5*	22.0	*0.4*	33.4	*3.6*	32.7	*21.5*	24.0
Commercial Loans II	-	-	*1.4*	19.8	*1.4*	46.0	*2.7*	32.9
Unsolicited Bids	-	-	-	-	*2.9*	40.5	*2.9*	40.5
Total	***50.3***	**27.9**	***32.7***	**17.1**	***17.1***	**33.7**	***100.0***	**25.4**

[a] Share in total face value for all assets that were auctioned off.

Source: Financial Sector Restructuring Authority

The FRA auctions yielded a disappointingly low recovery rate of only a quarter of the face value. The FRA defends itself by pointing to low or lower returns obtained on such asset sales from various asset disposal agencies in other countries. Be that as it may, the main problem with the FRA lay rather with the timing of these sales, rather than corruption or mismanagement. This arose from the Thai legal system, which was really not up to the task of enforcing loan contracts in a satisfactory manner. In the past, that had not mattered much, as growth would cover up the consequences of mis-investment and little recourse to the bankruptcy courts was needed. But it was becoming increasingly clear as time went on that this time around, the scale of the downturn would not be like anything seen before, and the duration will also be much longer. Under the then current legal system, to enforce or foreclose on loan contracts would take a long time. Legal reform was therefore essential, and was soon put to the parliament, but a long battle would be fought over it (see below). Meanwhile, the FRA auctions were proceeding, with the bidders not yet clear whether there would be any reform and what form it would take. With such uncertainty heavy discounting was to be expected.

Another feature of this solution to managing the bad financial assets was that the new creditors did not perform any banking functions. While some debtors were no doubt due to disappear from the scene in any case, many others could be nursed back to health,

given time and, above all working capital. It was clear that neither would be forthcoming from the bid winners. In reaction, government policies toward bad loans in the next few years would be obsessed with the idea of keeping the loans in the hands of the original lenders for as long as possible.

D. PICKING UP THE PIECES

The Collapse of the Baht and the Entry of the International Monetary Fund (IMF)

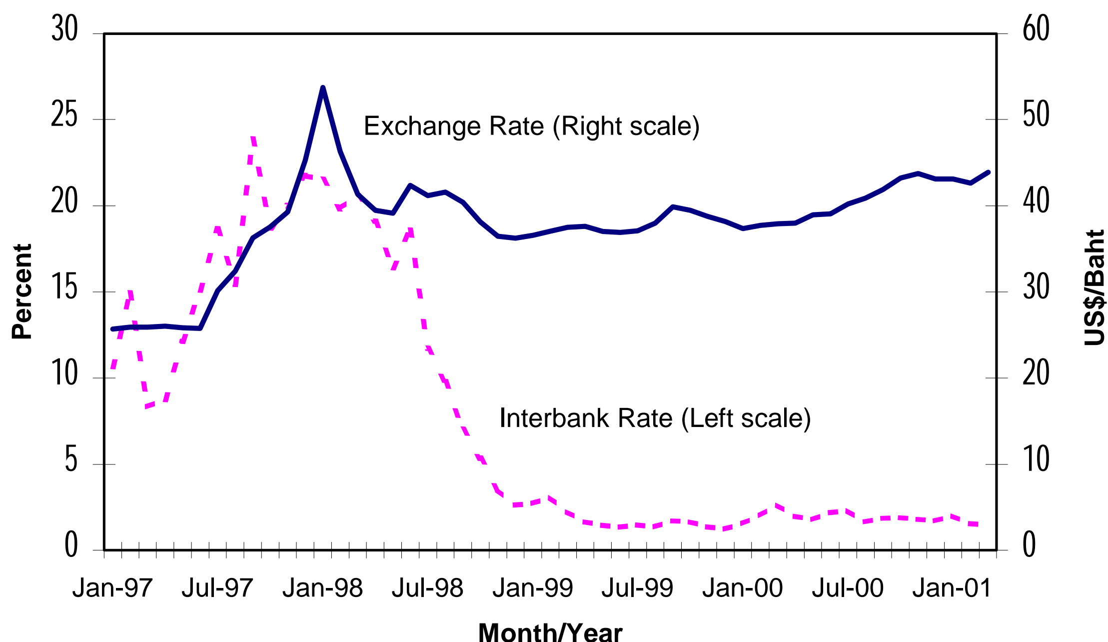
The early stages of the meltdown of the finance company sector described above occurred simultaneously with increasingly severe attacks against the baht in the currency market. The futile defense mounted by the Bank of Thailand, culminating in the decision to float the baht is well-trodden ground (Nukul Commission 1998: Chapters 1 and 2), and will not be repeated here. The flotation however was followed by considerable turmoil in the financial markets, largely induced by very rapid capital outflow. Table 8 shows the rate at which capital was fleeing Thailand in the second half of 1997 into the first half of 1998.

Table 8. Current Account and Net Flows of Private Financial Account 1997-2000 (Millions of US$)

Year	Current account balance (Bn US$)	Bank			Non-bank						TOTAL
		Commercial bank	of which Recapitalization	BIBFs	Direct investment	Other loans	Portfolio investment	Non-resident baht account	Trade credits	Others	
1997-Q1	**-3.6**	1,158	0	1,267	529	-92	501	-1,680	356	-66	**1,973**
1997-Q2	**-4.8**	-581	0	-136	568	-836	1,231	-1,805	-144	13	**-1,690**
1997-Q3	**-3.6**	-3,327	0	-828	1,147	-849	2,431	-3,973	-69	218	**-5,250**
1997-Q4	**-2.8**	-2,462	0	-808	936	-1,911	387	1,646	-525	81	**-2,656**
1998-Q1	**-2.0**	1,049	955	-2,014	1,191	-1,880	438	-2,264	-308	156	**-2,677**
1998-Q2	**-3.2**	-1,651	1,155	-1,617	1,373	-776	41	1,108	-51	-50	**-468**
1998-Q3	**-0.6**	-1,726	181	-2,293	1,183	-458	-99	200	-171	128	**-3,055**
1998-Q4	**2.6**	-944	0	-3,527	1,272	-599	42	-3,344	119	-11	**-6,992**
1999-Q1	**4.8**	-3,305	21	-2,127	939	-854	-60	-1,092	25	-41	**-6,494**
1999-Q2	**2.6**	92	1,214	-2,556	658	-817	131	-1,836	383	53	**-2,678**
1999-Q3	**3.5**	730	411	-3,074	701	-1,242	166	-178	76	31	**-2,379**
1999-Q4	**3.9**	1,218	942	-1,595	920	-1,446	154	-98	135	73	**303**
2000-Q1	**3.4**	-1,448	105	-1,048	619	-1,250	300	-359	-708	-104	**-3,893**
2000-Q2	**2.6**	42	272	-968	364	-1,122	246	-590	-175	-128	**-2,059**
2000-Q3	**2.7**	-277	0	-1,358	758	-834	-330	340	176	51	**-1,474**

Source : Bank of Thailand, and NESDB

Figure 3. Monthly Exchange Rate and Interest Rate Movements Jan 1997- Mar 2001



Source : Bank of Thailand

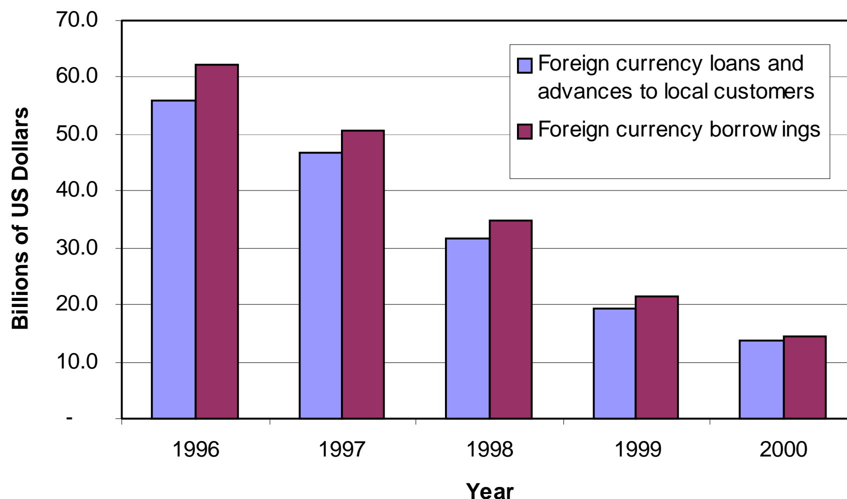
Notwithstanding the guarantee provided to depositors and creditors of the banks and finance companies, banks bore the brunt of the capital flight. This outward rush of capital necessitated Thailand's request for the International Monetary Fund's facilities, and its entry into the latter's program. To stem the outflow, which was also leading to a rapid depreciation of the baht, the Fund introduced a very tough monetary policy that pushed interest rates up. Because of the backwash effect of the broader Asian crisis, neither the resources provided by the IMF nor the tough monetary policy was sufficient to stop the baht slide to a level of more than 54 baht per dollar – more than halving its value. It was only in April 1998 that the situation stabilized somewhat when the baht settled at a level of around 40 baht to the dollar (Figure 3).

Even without the strain caused directly by the withdrawal of funds, financial and non-financial firms saw their cash flow and their balance sheets deteriorating. The depreciation of the baht and the jump in interest rates had an immediate impact on the cash flow. Just as importantly, the swift turnaround of the economy from a normal 7-8 per cent growth to a decline of 1.7 per cent in 1997 and 10.1 per cent in 1998 also adversely affected the cash flow.

The deterioration of the baht also had a catastrophic impact on most large and medium-sized firms' balance sheets, because of their exposure to unhedged dollar debts.

Figure 4 shows the impact of the withdrawal on the banks' dollar borrowings, and these were mostly of short maturity. As dollar borrowings by banks in Thailand plunged in 1997-1998 because of capital flight, they had to balance their net currency exposure, in keeping with the Bank of Thailand's regulations. They achieved this balance by requiring their debtors to convert the dollar loans to baht. Unfortunately, from the debtors' point of view, these conversions were taking place at a time when the baht was at its lowest values. With an average debt/equity ratio of 2.4 a doubling of the debt could, and in many cases did, force companies into insolvency, or at the very least into illiquidity. It is hardly surprising then that the proportion of non-performing loans (NPLs) began to rise inexorably until it peaked at the astounding level of 47 per cent in the second quarter of 1999. Throughout the period from about the middle of 1998, the NPL ratio became the central measure of Thailand's economic sickness.

Figure 4. Foreign-Currency Denominated Loans and Borrowings of Thai Banks



Source : Bank of Thailand

Note : Including IBF, EXIM bank, IFCT and Asia Credit Finance Company transactions

All of these changes naturally implied a sharp curtailment of investment. Real investment declined by 53 per cent between 1996 and 1998, and the investment to GDP ratio sank from a level of 41 per cent in 1996 to 20 per cent in 1998. The multiplier effect of this drop could not but be profound. The fall in domestic demand put a further stress on the cash-flow of many companies. The sharp drop in the growth rate was thus both cause and consequence of the deterioration of the firms' cash flow and balance sheets wrought by the monetary changes of 1997 and 1998.

Cleaning the Balance Sheets: A Thought Experiment

To anyone surveying the Thai economic scene in, say the second quarter of 1998, it would have been clear that the critical problem was the quality of the balance sheets. If proper valuations were done on the assets in the balance sheets, almost all financial institutions and almost all corporations would be insolvent. This arose because when investments in these assets were made (mostly during the bubble), an overly optimistic scenario was imagined by the investors, and by the lenders who put up the money for the project. By 1998, these expectations were known to have been false. The assets that were bought during the bubble would now be overvalued, and at that valuation, they would not be competitive. On the liability side, for companies that borrowed overseas, the jump in the debt due to the exchange rate change rate is sometimes sufficient to make the firm insolvent. If the servicing of the capital (debt and equity) used to acquire these assets were to be at the old set of values, firms would immediately run into severe cash-flow problems, and would be unable to continue to function.

Nonetheless, the physical capital was there – indeed, Thailand at that point had brand-new equipment in many industries embodying the latest technology. The problem was the valuation in their owners' balance sheets. Clearly, these balance sheets would have to be cleaned up. One useful way to conceptualize this cleanup problem is to conduct the following thought experiment.

Imagine an omniscient supercomputer with detailed knowledge of the Thai and the global economy, the details including assets and liabilities of every firm. This computer would be asked to compute the general equilibrium of the economy at full employment, given information available at a certain date, say in mid-1998. This computation would yield current and future prices for outputs and inputs, and therefore the values of all the physical assets in the economy. Most of these physical assets would be under the control of some firms or households, which would now receive new valuations. Included in the outcomes of the calculations would be the exchange and interest rates ruling in the economy.[22]

Once that was done for the assets of all the non-financial firms, it will be found that many of them would be insolvent, or would have unhealthy debt/equity ratios. Adjustments to the liabilities would now have to be made, with the shareholders' equity naturally taking the first hit. Should that equity be reduced to a negative level, then the ownership pattern would have to be changed, after which the debts would have to be written down. Some conversion from debt to equity may have to take place. The computer will be programmed to make all these adjustments, with the following constraints imposed: the combined balance sheets of the firms must be such as to generate sufficient new investment to ensure full employment from that point on. At the

[22] Krugman (1999) has shown that in a simplified but similar model that multiple equilibria are possible, which could lead to a jump between equilibria characteristic of crises. For our purposes, it suffices that our omniscient computer will select the full-employment equilibrium, which will fix the exchange rate.

equilibrium exchange rate, interest rate, wage rate and other factor prices to be calculated by the computer, some firms may have to be closed down as being unviable under these new circumstances.

The adjustments on some of the firms' debts just described would naturally have an impact on their lenders' assets. The banks' balance sheets will now have to be adjusted downwards. A decline in the asset values would require a recapitalization of the banking system. Part of this would be diverted from household savings, channeled through the capital markets to the banks. But where the financial institutions become bankrupt, the recapitalization will in most cases have to be done by the government, on account of the deposit guarantee. This in turn will impose liabilities on the taxpayers. Some of the taxpayers will be households, but some of whom may be the corporations whose balance sheets had already been adjusted. A new adjustment would have to be incorporated in order to accommodate the new tax liabilities. This leads us naturally to the next iteration.

Once all the computations are done, the omniscient computer would have the "true" valuation of the items in everyone's balance sheets. If the task could be performed overnight, and if everyone obediently follows the computer's instructions immediately, then the economy would just as promptly be on the new equilibrium path, which was set by design to be at full employment.[23] There would then be no recession.

In the Thailand of 1998 however, there was no omniscient computer. The adjustments were taking place in real time, and not in computer time. Company owners, managers, bankers who had lent to them, and the government that taxed them or underwrote deposit guarantees had to struggle with their own and others' ignorance to come up with some sort of "true" equilibrium valuation of assets – in a situation where it was not at all clear if there was any equilibrium. They then would have to struggle with one another, in countless meetings and in the courts, to effect transfers of ownership of various assets and eventually of bankrupt firms, at some prices. While these struggles are taking place, the clock would still be ticking, and some transactions had willy-nilly to take place, all at the current prices at the time. More to the point, some transactions would be *prevented* from taking place, because the balance sheets had not been cleaned up. The out-of-equilibrium economy would be more demand constrained than at equilibrium and would thus be working at less than full employment level.[24] Specifically, because many borrowers' balance sheets, not having been cleaned, would show them to be insolvent, they would not be able to borrow from the banks, nor obtain new capital

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[23] Theoretically inclined readers may wish to compare the above thought experiment with Walras' tatonnement process.

[24] Theoretically inclined readers may notice the similarities of this argument with the group of models pioneered by Clower (1965) and Barro and Grossman (1971), but these concentrate on non-clearing labor markets, while the problem cited above concerns non-clearing real asset markets. Actually, if such an approach is taken further, and different degrees of rigidity or flexibility in the asset markets introduced, then Dornbusch's (1975) analysis of exchange rate dynamics can perhaps be adapted to cover the currency market turmoil in the year after the baht was floated.

from equity investors. A great deal of new investments could not take place, keeping the economy depressed.

In this view therefore, the downturn in the economy and the consequent delay in economic recovery was entirely due to the delay in adjusting the wrong valuations in the balance sheets. If the adjustments were taking place in real time, the "true" balance sheet values (that is, those calculated by our omniscient computer and which assume instantaneous adjustment) would recede into insignificance. The values as they emerged from the actual cleanup process may not even move toward the "true" equilibrium value generated by the computer, but would be affected by the time taken to get there and the events that took place during the delay. The more delay there was, the greater the departure from the "true" values. It was indeed possible that the economy may get sucked into a vicious cycle, as the delay in balance-sheet cleanup caused asset values to decline, making the cleanup slower and more contentious, causing them to decline further. This was the root cause of asset price deflation, or, even worse, of the asset market freezing up into immobility altogether.

From this analysis, one strategy suggests itself. This strategy, which I shall call the neoclassical strategy (sometimes also called the market-based approach), was to mimic as much as possible the computer procedure outlined above, that is, have everyone go through the process of bankruptcy procedures, foreclosure, asset sales, debt write-downs, recapitalization and all the rest. But the government had to make sure that the adjustment processes were as speedy as possible. More concretely, legal reform of the antiquated bankruptcy and foreclosure laws should be rapidly implemented. This was, by and large, the route taken by the Thai government, at least when Tarrin Nimmanhaeminda was finance minister, with the support and encouragement of the International Monetary Fund. In a sense, the auctioning off of assets from the closed finance companies by the FRA described above was also in keeping with this approach.

The alternative strategy would have been to "warehouse" temporarily all the bad loans somewhere in the system, and have the banks resume their operations unaffected by the state at least of their own balance sheets, or even of their customers' balance sheets. Indeed, if the affected firms ran into working capital shortage, the banks would continue to supply them with liquidity. Similarly, the central bank would also continue to supply the banks with liquidity for this exercise. This allows non-financial firms to continue investing without being unduly affected by their current debt status. The economy would thus continue ticking over and indeed start to recover immediately, completely ignoring the misaligned values of the balance sheets in the system.

After taking over the assets from the banks, the organization that serves as the "warehouse" could tackle the cleanup of the balance sheets. But by rearranging the sequence does not imply that the pace of the cleanup work could be slowed down. Warehousing the bad loans should not be the excuse for postponing the cleanup process indefinitely. That work must be done expeditiously, else the assets would sharply deteriorate.

In this approach, there is in the beginning no loss in income and little loss in value that arises from awaiting the resolution of the debt workout, and on this ground it has much to commend it. Because of its appreciation of the problems raised by real-time equilibrating process, and the role of income rather than price adjustment, this approach is best described as Keynesian, although, as far as I am aware, the great man never pronounced anything on this subject.

However, the Keynesian approach has its own set of problems, the main one being moral hazard. First of all, the temptation would be very strong to forget the problem-loans that has been warehoused – a case of "out of sight and therefore out of mind". No one really has an interest in worrying about them, clearly not the insolvent firms; not the banks, now that the government has taken the load off them; and not the government, for trying to clean up the balance sheets also entails some very unpleasant and unpopular decisions.

Second, even if somebody does worry over the loans, there is an inherent contradiction in this approach. To keep the recovery going, borrowers cannot be penalized while the workout process is going on – they have to be supplied with liquidity to continue operations at the old level. Under such circumstances, they can use the new borrowing to acquire new assets and move them around, while stripping the pre-existing assets down to minimize repayments on the original loans.

Now, combine these moral hazard problems with the fact that the warehouse usually would have belonged to the government, which in Thailand is particularly prone to corruption, and it can be seen why there was a reluctance to apply the Keynesian approach here. Nevertheless, since the advent of the Thai Rak Thai government in January 2001, this approach is being revived, and a Thai Asset Management Company has been set up. I shall return to this issue later in the paper.

Cleaning up the Financial Sector's Balance Sheets

The approach of the previous government has been to adopt the neoclassical approach of trying to adjust the values in the balance sheets as quickly as possible. In the above thought experiment, the logical place to begin the process of adjustment should have been with the non-financial firms, because they hold the real physical wealth of which the financial assets are merely derivative forms.

However, the Thai authorities decided to tackle the problem by starting with the financial sector, for two very good reasons. First, the authorities were legally empowered to effect changes in the balance sheets of financial firms more than with non-financial firms (although as in the case of the BBC, they did not use that power wisely). The Thai government had seldom intervened in the internal affairs of individual non-financial firms, and had little claim or knowledge to make drastic changes in their capital structure. Indeed, as will be shown below, Thailand had a highly inefficient legal framework for anyone to force changes in the non-financial firms' balance sheets. Secondly, because of the deposit guarantee, the government and the taxpayers were more directly exposed to bank and finance companies' bankruptcy than to that of non-financial firms. The

incentive to work first with the financial sector was therefore overwhelming. It was expected throughout that the financial sector would be charged with the task of forcing changes on the balance sheets of the non-financial firms.

To force the banks and finance companies to take the initiative in cleaning up their own and their borrowers' balance sheets, the government made the definition of non-performing loans (NPLs) stricter (three months of non-payment instead of six months).[25] Also, banks were prohibited from accruing interest on NPLs to income. The provisioning requirement to cover the NPLs was also changed.[26] In order to allow banks time to adjust to these changes, they were given until the end of 2000 to complete the provisioning. More important than these changes was a stricter and speedier auditing of banks by the central bank.

On 14th August 1998, the government made a major announcement to assist in the recapitalization of private banks. The government undertook to match the banks' success in raising both Tier-1 and Tier-2 capital for banks, and set aside for the exercise 300 billion baht for which it will issue bonds. It also relaxed the requirement somewhat. The 8.5 per cent requirement used to be divided into 6:2.5 ratio between Tier-1 and Tier-2, but was now changed into 4.25:4.25 ratio. Participating banks had to meet the provisioning requirements immediately upon receipt of the capital injection, without a phase-in period.

The problem of weak finance companies did not go away after the closure of 56 of them in December 1997, and the government had to take over a dozen more, as well as two small banks. On 14th August, the government announced a total restructuring of what had become state banks. First, it took over two more banks, merged a number of banks, closed down three finance companies and two banks (including the infamous BBC), and combined one bank, twelve private finance companies that had been taken over and an existing state-owned one to become a new state-owned bank. Even after this rationalization, the government had in its hands six banks, four of which were to be recapitalized, and dressed up for sale. As of this writing, two have been sold to foreign banks, and negotiations have been fitfully going on for the other two, whose assets are rapidly depreciating.

With the announcement of 14th August 1998, the government reckoned that the task of cleaning the financial sector's balance sheets was fully mapped out. It sat back and waited until the banks finished the tasks of recapitalizing themselves by the set deadline of December 2000. The banks managed to do so, raising altogether some 959 billion baht in the process (Bank of Thailand 2000). Of this sum, the government provided 293 billion, of which 241 billion baht went to state banks (including private

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[25] The government also wished to revive foreign investors' confidence.

[26] For loans which are overdue by 12 months, the provisioning requirement was changed from 15 per cent of the face value of the loans and 100 per cent of the net book value of the loan (face value minus the value of the collateral to 100 per cent of the net book value.

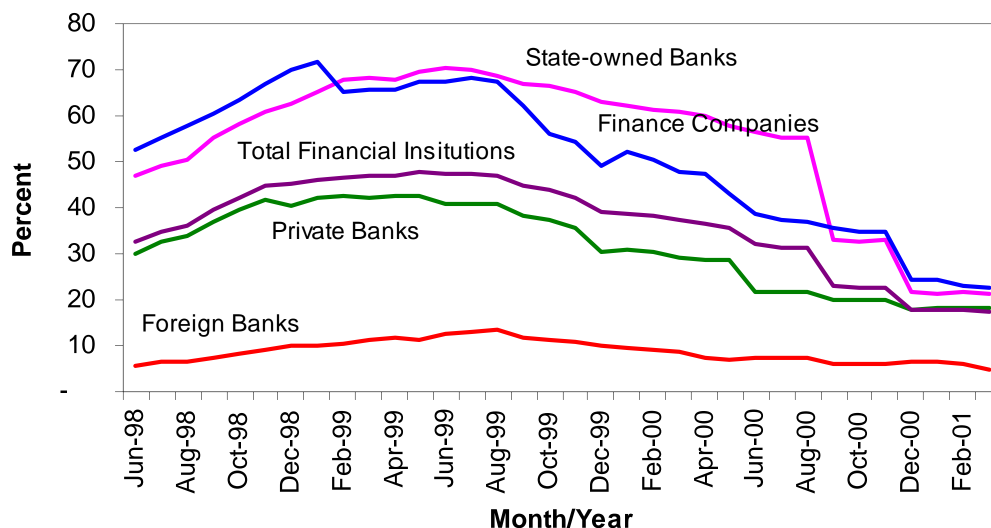
banks that were taken over) (Tarrin, Pichet and Phisit 2001:88). In addition to the capital provided for the banks, another 10 billion was provided to a number of finance companies. Most privately owned banks did not take advantage of the capital injection program. The only two that did, the Siam Commercial Bank and the Thai Military Bank had traditionally been semi-public banks – the Crown Property Office had a large interest in the first, and the armed forces in the second.

By putting the major task of cleaning the financial sector's balance sheets on the banks themselves, and minimizing its own role except for the provision of the capital, the government constrained the banks' future behavior in various ways. Most obviously, the banks limited their lending, fearing that borrowers would become non-performing again. They also charged a higher margin in order to generate enough operating profits to pay for the provisioning.

By steadfastly refusing to buy out the bad loans from the banks, the government forced financial institutions to tackle the balance sheets of the non-financial sector. But at the same time, it constrained them severely. In negotiating with debtors, Thai banks were quite reluctant to write down their debts ("take haircuts"), because that would mean that they would have to set aside more money for recapitalization. Instead, what many of them did was to reschedule the loans by stretching them out, rather than to restructure them. But from the debtors' point of view, this did nothing to improve their own balance sheets. Many perfectly good businesses, for example those that made the mistake of borrowing in dollars, could not become healthy again to invest and expand.

But as far as soundness of the banking system is concerned, then a great deal appears to have been achieved during the last three years to put Thai financial institutions on a firm foundation. By the end of 2000, Thai private banks have met their provisioning requirements in full. Finance companies have even exceeded those requirements, thus meeting the targets set out in the 14th August measures. The non-performing loans that

Figure 5. NPLs as Percent of Total Loans Outstanding



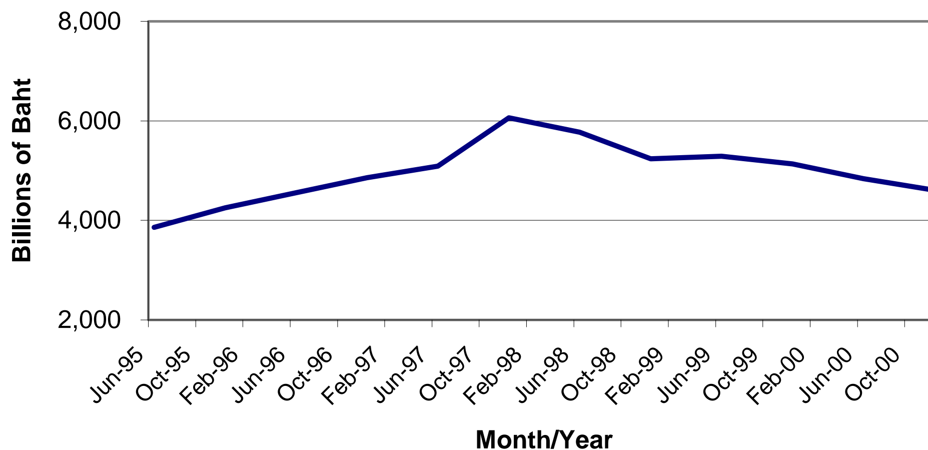
Source : Bank of Thailand

still remain on the banks' and finance companies' books (i.e. that have not been written off or transferred to the an asset management subsidiary) after having peaked at almost a half, have slowly been whittled down until they stand at less than a quarter. Figure 5 shows this improvement, but it must be quickly added that the great strides that were apparently made in 2000 were partly illusory. As banks made provisions, bad loans were sometimes taken off the books altogether. Sometimes they were put in an asset management company. These would disappear from the statistics, but the NPL problem remains, although the banks are now cushioned.

These apparent achievements must be set against one fear and one fact. The fear is that much of the reduction of the NPLs may not be real, because, as mentioned, many of the debts have merely been rescheduled. The corporate sector in Thailand still remains over-leveraged, which makes it highly vulnerable to any downturn. Whether this fear is justified will probably be proven in this year (2001), because the worldwide economic downturn will test the soundness of the corporations, and with it of the financial institutions. Already there is some evidence that no further gains are being made. Relapse of renegotiated debt and new NPLs are appearing in the statistics at the same rate as the exit of existing NPLs (Table 9)

That the reduction of NPLs is fragile is proven by the following fact. Three years after the crisis, commercial bank loans have not recovered from the steady slide it has undergone since the spurious jump at the end of 1997 (on account of the increase in baht terms of dollar-denominated loans) (Figure 6). The banks are now awash in liquidity, as Thai households still pile in their savings for the banks and the latter have no one to lend to. If the banks are sound, then a valid question to ask is: sound to what purpose?

Figure 6. Bills, Loans, and Overdrafts of Commercial Banks



Source : Bank of Thailand

Table 9. Movements of NPLs Jul 2000 - Mar 2001

Increase in NPLs

Unit : Million Baht

	2000						2001		
	Jul	Aug	Sep	Oct	Nov	Dec	Jan*	Feb*	Mar*
New NPLs									
Private banks	8,970	8,363	10,998	9,912	6,926	16,000	8,237	5,178	9,920
State-owned banks	6,852	6,737	5,731	4,075	4,879	7,094	3,339	3,876	5,210
Foreign banks (full branch)	7,105	1,301	1,405	1,732	860	996	1,156	788	1,517
Finance companies	682	604	722	899	933	408	218	271	234
Total	**23,609**	**17,005**	**18,856**	**16,618**	**13,598**	**24,498**	**12,950**	**10,113**	**16,881**
Re-Entry NPLs									
Private banks	13,495	11,367	10,879	13,525	11,933	13,808	12,021	8,396	15,814
State-owned banks	3,898	12,870	2,385	3,503	7,934	13,113	4,901	3,549	6,851
Foreign banks (full branch)	14	394	1	77	60	1,217	137	49	109
Finance companies	706	683	494	687	694	814	1,119	290	973
Total	**18,113**	**25,314**	**13,759**	**17,792**	**20,621**	**28,952**	**18,178**	**12,284**	**23,747**
Total Increasing Amount	**41,722**	**42,319**	**32,615**	**34,410**	**34,219**	**53,450**	**31,128**	**22,397**	**40,628**

Decrease in NPLs

Unit : Million Baht

	2000						2001		
	Jul	Aug	Sep	Oct	Nov	Dec	Jan*	Feb*	Mar*
Debt Restructuring									
Private banks	14,261	12,608	26,324	14,915	15,994	47,064	10,195	9,987	14,519
State-owned banks	27,722	19,354	11,543	11,467	7,343	24,551	7,918	3,812	7,447
Foreign banks (full branch)	1,910	1,475	457	716	138	1,297	558	2,301	6,741
Finance companies	1,725	1,198	1,851	1,741	667	3,359	1,403	1,156	873
Total	**45,618**	**34,635**	**40,175**	**28,839**	**24,142**	**76,271**	**20,074**	**17,256**	**29,580**
Others [1]									
Private banks	6,446	5,513	41,245	5,023	6,232	34,836	4,655	3,859	11,335
State-owned banks	5,346	4,704	418,367	5,107	2,954	175,576	3,947	2,357	5,474
Foreign banks (full branch)	1,245	689	8,343	351	1,489	2,085	693	161	2,882
Finance companies	1,530	556	434	175	619	20,358	451	1,003	591
Total	**14,567**	**11,462**	**468,389**	**10,656**	**11,294**	**232,855**	**9,746**	**7,380**	**20,282**
Total Decreasing Amount	**60,185**	**46,097**	**508,564**	**39,495**	**35,436**	**309,126**	**29,820**	**24,636**	**49,862**
[1] Other reasons consist of									
- Transfer to performing loans category	8,030	6,192	7,780	9,356	5,181	8,010	4,635	4,317	6,743
- Transfer to AMC	-	-	438,525	-	-	3,852	-	-	-
- Bad Debt Write-off	966	-	4,318	438	843	78,347	3,195	396	10,772
- Others, for example, principal repayments, write-off from losing right of claim and selling of debt, etc.	5,571	5,270	17,766	862	5,270	142,646	1,916	2,667	2,767
Others	14,567	11,462	468,389	10,656	11,294	232,855	9,746	7,380	20,282

*Preliminary Data

Source : Bank of Thailand

Cleaning up the Corporate Sector's Balance Sheets

By the middle of 1998, it became clear that the problem with many Thai firms was no longer a severe liquidity shortage, an illusion entertained by many in the year after the crisis, but insolvency on a widespread scale. Under such circumstances, large-scale involuntary transfers of assets and liabilities would have to take place. The Thai social and political system was quite unprepared for this task. The legal system in particular was quite out of date. But over and above the legal limitations (which will be discussed separately below), there was also the crucial absence of many markets. This absence is obviously critical to a workout scheme billed as "market-based". The land and property market is notoriously less than perfect in every country, but in Thailand, this imperfection was even more pronounced. Commenting on the characteristics of the office property market during the bubble, a World Bank study has this to say:

> "The extraordinarily high BMR [Bangkok Metropolitan Region] office vacancy rates reflect the fact that the Thai real estate industry is immature. … The majority of office buildings in the BMR have not been built by specialized property companies who understand the specificity of real estate risks, and the dynamics of cycles, but rather by a variety of business companies with very different core business. The management of these corporations has limited knowledge of – or interest in – the field of corporate real estate management. Their investment decisions were not driven by sustainable rents and yields, but by easy access to credit, tax considerations, a "trophy" mentality, and euphoria." (Renaud, Zhang and Koeberle 1998).

With such an immature industry, it can hardly be expected that there would be a mature market to match. Interestingly, the residential housing market, which was commended by the same study as having somewhat more professional developers have been the first sub-market within the property sector to recover.

But if the property market was under-developed, the market for corporate control and management was non-existent. In advanced countries, a fundamental rule of the game is that equity holders stand last in seniority to all creditors. Consequently, when a company becomes insolvent and debts have to be written off, the first and the most to suffer would be the equity holders. They stand to lose all before creditors even begin to write off their loans. But in Thailand, the market for equity is inextricably linked to the market for corporate control, since almost all firms in Thailand are family-owned and family-managed. It is consequently difficult to eject the equity holders without ejecting the management. Because of the non-transparent modes of conducting business endemic to Thailand, it is also very difficult for management to be completely replaced.[27] All of this not only gives considerable bargaining power to the owners of the indebted companies, but makes the struggle over rehabilitation so bitter and long drawn out.

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[27] Thus, one of the reasons cited by the Bank of Thailand for not ejecting the top management of BBC, even though widespread fraud was suspected, was that it was needed to lead them to the various skeletons in BBC's cupboard.

Legal Reforms

Before 1998, Thai laws relating to bankruptcy allowed only the liquidation of a company that was declared bankrupt. There was no rehabilitation procedure to keep the company intact as a going concern. Because the measure was considered quite drastic, the law and the judges defined what constituted bankrupt companies quite restrictively to protect the debtor. In particular, non-payment of debts was insufficient to determine bankruptcy, the plaintiff had to prove that the company had negative net worth, an exercise that could lead to endlessly creative accounting, in a country where strict accounting standards were quite new and are still somewhat alien. Procedurally, Thai courts were far too lenient with no-shows of litigants, allowing them to string out the case indefinitely. In this instance, the leniency clearly favored the debtors, as they had an interest in delay.

Against this, the law however was merciless toward a declared bankrupt person. For as long as his debt remained unpaid, he would suffer from considerable civil disabilities, and creditors could, for as long as he lived, claim his possessions, even those that he may have acquired afterwards. Because of this feature of Thai law, lenders in Thailand had a fondness for personal guarantees, even in loans to companies, because they felt that this was their ultimate threat.

When assets were to be disposed of, or foreclosed, it was the Legal Execution Department, a branch of the court that arranged the sale. This procedure took a long time, and allowed frivolous filing of counter-claims aimed at delaying the sale, with the result that typically foreclosure could take anywhere from three to five years.

In 1998, the government proposed a major overhaul of the bankruptcy and foreclosure laws. The following provides only the salient features of the proposed reforms, which were in fact quite detailed:

- The establishment of a Central Bankruptcy Court which, simply because it moved away from the rest of the exceedingly conservative judicial system, could also establish its own, much more modern method of conducting and recording trials.

- The introduction of a rehabilitative procedure.

- Changes in foreclosure procedures in order to prevent delays.

The reform of the bankruptcy and foreclosure laws ran into many roadblocks. The most important group opposing the new laws was in the Senate, which at that time was an appointive body, and had among its members some very vocal debt defaulters. Some of these indeed stood to see their entire business empire collapsing. Their campaign was aided by the fact that these reforms of bankruptcy and foreclosure were presented to the parliament as part of a package of eleven bills, which included bills to open up various professions to foreigners, to set up a process of privatizing state enterprises, and a number of other laws all of which stimulated much xenophobic

sentiments. For the government, it did not help that some of these laws were included in a letter of intent to the IMF, as part of its commitment. Nonetheless, the substance of the reforms remained in the law that was eventually enacted, as the Senate only had the power to delay, but not to override the decisions of the lower house.

In addition to the legal reforms, there was a reform of the accounting profession as well. The Thai General Accepted Accounting Practice Standards (Thai GAAP) was introduced, modeled after the GAAP used in the United States. The Stock Exchange of Thailand has launched a program to improve corporate governance among Thai companies, and is beginning to tighten up its regulations and more disclosure requirements on listed companies. It also required external directors and the setting up of an audit committee in all listed companies. The results have been mixed: these moves have led a number of companies to request a delisting.

Among the actions taken by the Thai government, the one with the most impact was the establishment of the Corporate Debt Restructuring Advisory Committee (CDRAC) in June 1998, to oversee a voluntary debt-restructuring channel opened up by the Bank of Thailand. It set up a framework jointly drafted and signed by domestic and foreign financial institutions, two trade associations (one for commerce and one for industry), in order to facilitate off-court debt workout in multiple-creditor cases. Each debtor had to accede to the CDRAC process at the beginning, as did his creditors, each side signaling its intention to attempt to keep to the standard deadlines set up by CDRAC, and not to have recourse to the courts, until the CDRAC process was exhausted. There was also an agreement not to resort to the courts should a creditor be outvoted on the final plan, although an exception was made for creditors with outstanding loans exceeding 1 billion baht. The voting mechanism is the same as in the new Bankruptcy Act. The role of the central bank in whose offices the CDRAC secretariat resided is purely advisory, although in fact that advice carried considerable weight, coming as it did from the supervisor of the financial institutions. In many cases, even if agreement was reached within the CDRAC framework, the matter still had to be taken to the bankruptcy court for enforcement against creditors outside the CDRAC framework (for example, trade creditors).

Despite the weakness that the CDRAC process could not cover creditors who were not financial institutions, it had chalked up good success in its work. It had seen some 12,000 debtors with debts totaling 2.6 trillion baht going through its process, of which about half (6,200 debtors owing 1.1 trillion baht) have completed it. It claims that most debt workouts under its supervision were done within five to seven months (Bank of Thailand 2000).

Aside from its involvement in the debt restructuring of individual debtors, CDRAC has been instrumental in negotiating with other government agencies, particularly the tax departments to amend and relax rules for cases that have gone through its process.

Debtors' Strategy

Faced with the closure of many financial institutions with whom they were doing their business or their transfer to public ownership with a very different management culture, a severe liquidity shortage induced by the exit of foreign creditors, a surge in debt servicing requirements induced by the devaluation of the baht and the increase in interest rates, and a sharply deteriorating economy, many Thai firms were in desperate straits by the first quarter of 1998. Their strategy was therefore to conserve as much cash-flow as they could, by severely restricting the outflows of funds. Repayment of debts and even payments of interest were considered items that could be dispensed with in such difficult times (Suthep 1999).

Since the crisis, there has been many complaints about "strategic NPL", using the term to mean "dishonest default", that is, the debtor has the ability to repay, but has withheld payment, hoping to force creditors to take a "haircut". Many firms did indeed enter into the NPL status strategically, but the term "strategic" ought to be used strictly and not as a synonym for "dishonest". For many firms, faithfully paying the creditors would imply a closing down of operations within months, for by the end of 1997 banks were not willing to put in new money, even for working capital. Where possible, firms quickly built up a large hoard of cash reserves to sustain themselves during the interim. This gave them considerable bargaining power vis-à-vis their creditors.

A number of lessons were quickly learnt as a result of the debt negotiations process. The first was that injection of new capital was not always easy. Most firms that entered into debt renegotiations were bankrupt – their true net worth was negative. The owners were not in a position to find new capital. Finding a strategic investor was not an option for most Thai firms. Banks and owners were locked in an essentially constant-sum struggle over the future cash-flow of the firms, and to get a third party to take out a share of that cash-flow made the problem worse for both. And from the point of view of the strategic investor, the rate of return to paying someone else's debt was not going to be all that exciting.

One thing that the crisis did was to force financial institutions to look at the cash-flow of the firms they lent to. Trivial as this might seem to Western bankers, this was a radical departure for Thai financial institutions. But even after they looked at the cash-flow, debtors complained that the financial institutions were very reluctant to adjust their demands to be in keeping with the ability to pay, that is, to take haircuts. In terms of their "reasonableness", the debtors' rankings were quite similar: most eager to take a haircut and get out were the foreign banks, most reluctant to accept any haircuts whatsoever were the state banks, with Thai private banks in between the two. There were good reasons for this. Thai private banks were under pressure to recapitalize. Employees of state banks, on the other hand, were under a blanket regulation that made them liable to make good any loss that occurs to the state as a result of their decisions. It was of course possible, indeed likely, that this regulation would not apply to the NPLs of 1997-98, but the regulation as it stands is quite vague, and it was a brave man who wished to test its limits.

A threat that many debtors found useful was to hand the company over to the creditors, knowing that creditors would not be able to take up the offer. Indeed in most cases, creditors desperately needed the management of the indebted firms to continue, considerably reducing their bargaining power (even if the law had been strict). As frequent outcome of the bargain, the *de facto* contractual relationship between creditors and debtors evolved into one between employers (i.e. the creditors) and employees (i.e. the old management), with a stock option – in many cases, the conversion of debt into equity had a buy-back option.

A Sting at the Tail: the Thai Asset Management Company (TAMC)

The government of Prime Minister Chuan Leekpai and Finance Minister Tarrin Nimmanhaemind, who advocated the neoclassical approach to cleaning up balance sheets, went down to defeat in the elections of 6th January 2001. The Thai Rak Thai Party, winners of that election, campaigned that they would bring in an asset management company to buy out bad loans from the banks. It is their belief that cleaning out the banks' balance sheets by this method would make the banks lend again, and bring economic recovery. Normally, this measure would signal the adoption of a Keynesian approach to debt restructuring described above. Such an interpretation would be valid at the start of a financial meltdown, not three years afterwards, when the economy had already paid the price of great income losses in the interim.

The precise model of what TAMC is to look like has been under fierce debate ever since the new government came to power. Now that a decree chartering the TAMC has been promulgated, the fog has lifted somewhat. The main thrust of the TAMC is to clean up the state banks' balance sheets. While the private banks have gone a long way in cleaning up their balance sheets since Mr. Tarrin's 14th August measures, the state banks are mired still in a large pile of bad debts, which require a much more effective management than is possible under present regulations. The TAMC is therefore mandated to take over the entire NPL portfolio of the state banks, which at the moment totals 1.1 trillion baht. In addition, the staff and the governing board at the TAMC are exempted from the government regulations that would hold them liable to any damage caused to the public wealth by their decisions – a problem that has hampered the state banks' negotiations with their debtors up to this point. This consolidation of the entire state banks' portfolio would by itself justify the creation of the TAMC.

But the TAMC also is taking over part of the NPL portfolio of the private banks. This part is valued at approximately 250 billion baht worth. These will be those secured and still unstructured loans that were deemed to be non-performing on the 30th December 2000, for which there are multiple creditors, and for which the debtors were owing (to all financial institutions) more than 5 million baht. Banks are given the option to come in or stay out of the TAMC program, but if they decide to come in, the entire portfolio of bad loans that meet the stated criteria has to be turned over.

For these debts, the TAMC will pay the net book value of the loans, which is essentially the collateral value of the debt, as the (private) banks have written off or provided for 100 per cent of the uncollateralized portion of the loan, in accordance with

the regulations of central bank[28]. The TAMC will pay the banks in non-transferable ten-year FIDF-guaranteed bonds, carrying a floating interest equal to the interest rate on bank deposits. There are, in addition, two gain/loss sharing payments at the end of the five and ten years.[29]

By itself, transferring loans from the private banks to the TAMC should not significantly increase the recovery rate of the loans. There is of course, the reduction of inter-creditor conflicts that arise from the consolidation of the loans, but the real sting, and the real value added of TAMC lies in the legal provisions. TAMC will have very wide enforcement powers to collect from the banks' debtors. In cases where debtors do not cooperate with TAMC, it can ask the courts to foreclose on the collateral or on the personal guarantee, which the courts must grant without any further investigation. Where rehabilitation of the debtors' business is to be considered, the planning of the rehabilitation can proceed almost unilaterally. Debtors can appeal the plan, but only to the governing board of the TAMC. And as far as the debtors are concerned, that is the last point of appeal, for when the rehabilitation plan is submitted to the Bankruptcy Court for enforcement, it is to proceed to judgement without hearing the debtors' case. One sop to the debtors is that if they have been well-behaved (TAMC's board will decide on that), they can retain management control during rehabilitation.

The TAMC appears to be a step forward in hastening the cleaning of balance sheets, but it is essentially an emergency procedure, somewhat akin to the declaration of martial law, where certain constitutional and legal provisions protecting the rights of citizens are suspended. The current laws relating to bankruptcy and foreclosure, vastly improved though they may be as a result of the 1998 reforms, still fall short of what is needed to re-establish a working creditor-debtor relationship. It is hoped that the TAMC solution to Thailand's immediate problem would not sidetrack the government from engaging in further reforms of these laws.

Epilogue

This essay began with a description of the saving-investment nexus that gave Thailand almost four decades of reasonably stable growth. Now three years after the crisis broke out, the saving-investment nexus appears to be completely severed, although it had begun to fray already during the heady days of the bubble.

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[28] To the extent that state banks still have not provisioned fully, there would merely be transfers among organizations that are effectively owned by FIDF.

[29] In case of gains, the TAMC and the banks from which the loans were transferred will share the first twenty percent equally; beyond that twenty percent, the banks will get the entire gains, but not exceeding the difference between the face value and the collateral value. In case of losses, for the first twenty percent, the banks will take the whole of the loss; they will share the losses for the next twenty percent equally with the TMC; and any further losses will be borne by the TAMC.

With the severance of that nexus, it has become very difficult for savers (or their banks) to find investment outlets, and for investors to obtain funding. The path by which the Thai economy will emerge from the crisis looks decidedly rocky, and the putative Thai recovery is beginning to look more and more like the Japanese "recovery". The environment is almost the same: a situation of liquidity trap, with a level of interest rates that could not possibly reflect long-term factors of thrift and productivity unless there is severe price deflation – also not a very pleasant prospect. The resultant policy to get out of the mire is the same; fiscal stimulus, although luckily Thailand is not (yet) constrained by the very high stock of public debt nor the burden of a rapidly aging population. Both countries are at a dead end.

With the problems of this magnitude, the current battle cry for good corporate governance is sensible, but does appear slow and puny. However, this must be seen in the broader context of what the Thai economy of the future is to look like. The current legal and institutional regime still biases the economy towards a bank-based system. But its performance during the decade leading to the crisis led to an explosion of debts among Thai corporations, fueled by the liberalization. Further fuel was added, albeit unintentionally through the devaluation of the baht. The equity base of Thai companies of all sizes has dwindled to zero and needs to be re-established, a difficult feat given the depressed economy. This needs to be done even if Thailand were to continue on the path of bank-based capitalism. For with the current leverage of many Thai companies, it would be a foolhardy lender who would finance their further expansion.

Good corporate governance can, in principle, facilitate the rebuilding of that base, but progress has been slow. The stock exchange has been performing poorly and, corporations do not see the immediate reward from improving their governance. Consequently, whatever progress has been made on rebuilding the equity base has occurred because of the conversion of debts to equity by the banks, which have their own private means of enforcing proper corporate governance.

While improving corporate governance may be essential to prevent the economy from getting into the next recession, getting it out of the current one is on the top of policy-makers' agenda. For this latter task, improving governance cannot be the right solution, and occasionally may even be a distraction.

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