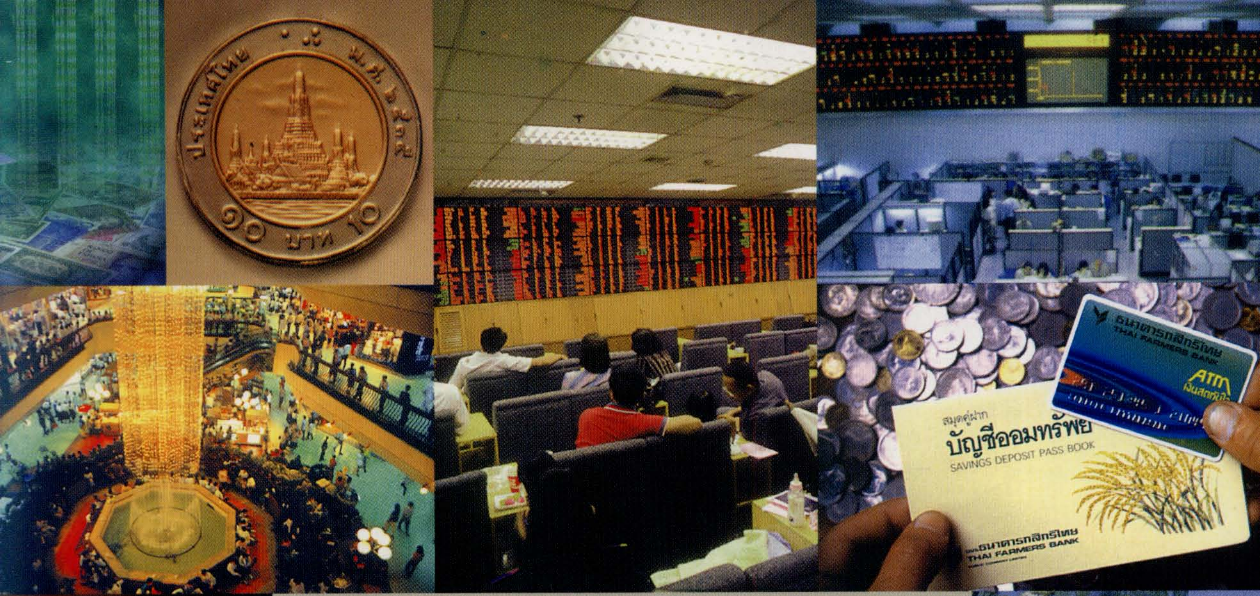

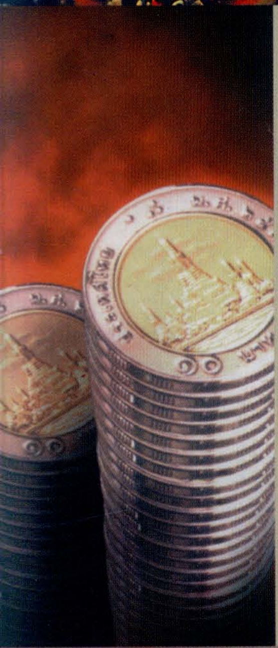

Financial Reforms in Thailand

Pakorn Vichyanond

Thailand Development Research Institute

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Contents

Page

List of Tables and Charts v

Acknowledgments vii

Executive Summary ix

บทสรุป xiii

1. Basic Concept and Foreign Experiences 1

2. Thailand's Framework 4

3. Path to Crisis 7

4. Analytical Scrutiny 9

4.1 Macro Perspective 9

4.2 Micro Perspective 12

5. Already Done 14

6. Remaining Tasks and Future Trends 24

7. Concluding Remarks 30

Annex 1: Chronology of Major Financial Reform Measures in Thailand since the Second Oil Shock 35

Annex 2: Proposed Amendments to Financial Acts 51

Annex 3: Econometric Investigation of Capital Inflows 53

References 57

List of Tables and Charts

Page

Table 1: Household Savings at Financial Institutions (Outstanding at Year-end) (Percentage Share) 5

Table 2: Credits Extended by Financial Institutions (Outstanding at Year-end) (Percentage Share) 6

Table 3: Loan-Loss Provisioning Requirements for Commercial Banks 16

Table 4: Credit Outstanding (C.O.) and NPL as of December 1998 18

Table 5: Commercial Bank Loans and Newly Issued Private Securities 21

Table 6: Government Debt as Percentage of GDP 24

Chart 1: Importance of Confidence 2

Chart 2: Thailand's Exchange Rate and Interbank Interest Rate 11

Chart 3: Thailand's Current Account and Capital Account Balance 12

Chart 4: Thailand's Net Capital Inflows 31

Chart 5: Thailand's Short-term and Long-term External Debts 31

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Executive Summary

In the first half of the 1990's a series of financial liberalization was undertaken in Thailand for the purposes of strengthening competition in the domestic financial system, giving more resilience to financial institutions so as to be able to cope with worldwide liberalization, and expanding the role of Thailand to serve as a regional financial center. Facets of liberalization include foreign exchange controls, interest rates, new businesses, and loosening of previous regulations. The financial liberalization measures led to a flood of capital inflows and a surge of investment spending, speculation, and current account deficits. Meanwhile, excessive and imprudent credit expansion engendered too much risk taking and deteriorating asset quality. The central bank's financial aid given to ailing commercial banks and finance companies aggravated macroeconomic imbalance. Eventually, weakening investor confidence spurred capital outflows to such an extent that the floating of the baht or local currency became inevitable, which triggered financial crises region-wide.

Thailand's economic meltdown in mid-1997 can largely be attributed to three policy errors: liberalization of foreign capital flows while keeping the exchange rate rigid, premature liberalization of financial institutions, and failure to prudently supervise financial institutions. These errors clearly demonstrate the importance of policy consistency. Later on, the Thai government was successful to some degree in restoring economic fundamentals, current account status, investor confidence, and stability of exchange rate. These results show the significance of investor confidence in the current global arena where capital movements are overwhelming not only in size but also in pace.

As indicated by their surging non-performing loans (NPL), domestic financial institutions were hard hit by sharp currency depreciation, falling asset prices, and a strong economic downturn. Foreign banks' branches were less distressed, because they systematically evaluated the viability of projects and debt servicing capacity of prospective clients before extending credits. Their lending decisions were mostly cash-flow based. Besides, they preferred not only to match maturities between sources and uses of funds but also to cover their foreign exchange exposure. Thai private commercial banks were at the opposite end. They paid strong attention to collateral and/or guarantee from reliable or familiar entities. Their lending decisions were asset-based. Worse yet, they barely accounted for risks from maturity mismatching or foreign exchange exposure. Instead, nepotism and cronyism were, to them, of greater importance. Unsurprisingly, private Thai commercial banks' NPL in percentage term was far higher than that of their foreign rivals, or 42 percent versus 10 percent at the end of 1998.

The Thai government promulgated several emergency decrees and established a number of institutions to undertake financial restructuring, e.g. Property Loan Management Organization, Secondary Mortgage Corporation, Financial Sector Restructuring Authority, and Asset Management Corporation. The limit on foreign ownership of shares in domestic financial institutions was lifted so as to enlarge their capital base and strengthen their management tactics. Fifty six finance companies were shut down but both depositors and creditors were provided with government guarantees. Good and bad assets of defunct finance companies were separated and handled by different agencies. Some ailing private commercial banks and finance companies were nationalized and merged with government banks or finance companies, while others were partly sold to interested parties (e.g., foreign banks) later on.

The central bank tightened regulations on asset classification, provisioning, and reporting, aiming to upgrade local financial institutions to international standards. The definition of non-performing assets was changed to cover past due loans with three or more months in arrears, instead of the previous six (or twelve) or more months. Two new loan categories, pass and special mention, require 1 percent and 2 percent provisioning, respectively. Meanwhile, commercial banks as well as finance companies have to increase provisions for substandard loans from 15 percent to 20 percent. Doubtful loans need a 50 percent provision rather than the previous 100 percent, but loss loans continue to necessitate 100 percent coverage. These new standards forced local banks to increase their capital to a large extent. The new system also called for quarterly, instead of annual, audits and credit reports. Loan portfolio reviews have to cover at least 70 percent of credit outstanding, including the top 100 clients and credits or commitments to related parties. The measures also demand that financial institutions tighten their lending practices and credit analysis procedures, focusing more on borrowers' cash flow and debt servicing capacity rather than on loan collateral. Debt restructuring or renegotiations must be subject to realistic assessment of financial viability of clients or their projects.

The government offered assistance to the financial institutions undergoing recapitalization as follows. If financial institutions commit themselves to comply with new loan loss provisioning immediately or earlier than the targeted year of 2000, they are entitled to enlarge their first-tier capital by issuing preferred shares to the government in exchange for tradable government bonds. Furthermore, as a means to motivate debt restructuring or reconciliation with problem clients, the government put forward an option to financial institutions to increase their second-tier capital by exchanging non-tradable bonds with banks' newly issued debentures, equaling the losses suffered by financial institutions in their debt restructuring.

Even though there are many ways to restructure debts (e.g., interest rate reductions, maturity stretching, partial write-offs, and debt-equity conversion), debt negotiation is not an easy task. It involves not only strong pressures from several parties (e.g., debtors, their potential new partners, local and foreign creditors, central bankers, internal revenue officers) but also legal and regulatory constraints. In this context, the government tried to help by amending bankruptcy and foreclosure laws. In addition, a bankruptcy court was established. Nevertheless, as different parties have different stakes or interests, corporate debt restructuring remains a lengthy and difficult process and represents a major stumbling block to economic recovery. Conversely, slow economic recovery makes commercial banks hesitate to roll over maturing debts or extend new credits, generating a vicious circle between NPL and economic growth.

The financial sector crisis in Thailand has proved to be systemic, requiring major restructuring, which takes many forms, i.e., separation of good and bad assets, capital enlargement, adjustment of debt overhangs, more qualified staff, improvement of management strategies (e.g., credit risk assessment, standard valuation criteria for collateral, systematic databases), legal amendments, better ethics, good governance, adoption of international standards, and upgrading of clients' financial status or viability. These components deserve equal, immediate, and simultaneous attention, as they have strong inter-relationship. Foreign financial institutions will hold more stakes and command greater influence in the previously protected banking circuit in Thailand. More competition is unquestionable. Family banking will gradually disappear, and so will connected lending. Professional management will gather momentum, and so will the role of technological adjustment.

A complete debt resolution should include not just financial restructuring, but also operation restructuring and corporate restructuring on the part of debtor companies. The former aims at more efficiency while the latter at more effective management and viability. Without these two components, financial restructuring could be in vain.

As regards regulations, financial institutions should be controlled by functions not types, as financial liberalization has allowed financial institutions to undertake the businesses that they had never before handled. The basis of laying down rules and regulations should be re-oriented toward more objectivity. Both examiners and supervisors should focus more on forward looking analysis rather than just account monitoring. More accountability should be required from bank executives or operators, and the standards on accounting, detailed information as well as transparency need to be upgraded. Should all these recommendations by pursued and each financial institution develop its own human resources as well as good corporate governance, regulations specified by the central authorities will be continually abided by, and thus automatically prevent problems. Furthermore, such comprehensive financial reforms will facilitate the real sector, making both economic recovery and financial stability more sustainable.

The two other segments of the financial system which deserve equal emphasis as banking are local capital markets and private business corporations. The former functions as a complement as well as competitor to banks and finance companies. The latter's strength and discipline primarily determines the profits and stability of financial institutions. In these two segments, the central authorities in small economies (like Thailand) ought to pay strong attention to small and medium-sized enterprises (SME), since unit-wise these SME constitute a large portion of private enterprises (90% in Thailand). Though their final output has not reached a sizable share of GDP, their future prospects are important in terms of economic development, income distribution, and social welfare.

บทสรุป

ในครึ่งแรกของทศวรรษที่ 1990 ประเทศไทยได้ดำเนินมาตรการเปิดเสรีทางการเงินเพื่อเพิ่มแรงแข่งขันในตลาดการเงินในประเทศ เพิ่มความยืดหยุ่นให้แก่สถาบันการเงินเพื่อให้สามารถต่อสู้กับแนวโน้มของตลาดโลกได้ รวมทั้งเพิ่มบทบาทของไทยที่จะเป็นศูนย์กลางทางการเงินในภูมิภาค การเปิดเสรีนี้ประกอบด้วยการผ่อนคลายข้อจำกัดทางด้านปริวรรตเงินตรา อัตราดอกเบี้ย และข้อจำกัดอื่นๆ รวมถึงการประกอบธุรกิจใหม่ๆ การเปิดเสรีทางการเงินนี้ดึงดูดเงินทุนจากต่างประเทศเป็นจำนวนมากและกระตุ้นทั้งการลงทุน การเก็งกำไร และส่วนขาดดุลบัญชีเดินสะพัด ในขณะเดียวกันสินเชื่อที่ขยายตัวมากเกินเหตุและไม่รอบคอบ นำไปสู่ความเสี่ยงที่สูงเกินควรและคุณภาพสินทรัพย์ที่ลดลง ความช่วยเหลือที่ธนาคารชาติให้แก่สถาบันการเงินที่มีปัญหายิ่งเพิ่มความไม่สมดุลทางเศรษฐกิจมหภาค ในที่สุดความเชื่อมั่นของนักลงทุนที่เสื่อมถอยลงก็กระตุ้นให้เงินทุนไหลออกจากประเทศมากจนกระทั่งทางการต้องปล่อยให้ค่าเงินบาทลอยตัว อันเป็นเหตุให้เกิดวิกฤติการณ์ทางการเงินทั้งในประเทศและในภูมิภาคอีกหลายแห่ง

ภาวะวิกฤติในกลางปี 1997 นั้น เป็นผลจากข้อผิดพลาดทางนโยบาย 3 ประการได้แก่ การอนุญาตให้เงินทุนจากต่างประเทศไหลเข้าออกอย่างเสรี แต่ไม่ปล่อยให้อัตราแลกเปลี่ยนเป็นไปตามภาวะตลาด สถาบันการเงินยังไม่พร้อมต่อการเปิดเสรีทางการเงิน และการกำกับสถาบันการเงินยังหละหลวมเกินไป ข้อผิดพลาดเหล่านี้แสดงให้เห็นถึงความสำคัญของความสอดคล้องระหว่างนโยบาย หลังจากภาวะวิกฤติรัฐก็ประสบความสำเร็จพอควรที่จะฟื้นฟูพื้นฐานทางเศรษฐกิจ ฐานะดุลบัญชีเดินสะพัด ความเชื่อมั่นของนักลงทุน และเสถียรภาพของอัตราแลกเปลี่ยน จึงแสดงให้เห็นว่าความเชื่อมั่นของนักลงทุนมีความสำคัญเป็นอันมากในเวทีเศรษฐกิจโลกที่การหมุนเวียนของเงินทุนมีอิทธิพลเป็นอันมากทั้งในด้านขนาดและความรวดเร็ว

สถาบันการเงินในประเทศได้รับผลกระทบเป็นอันมากจากค่าเงินที่ลดลงเป็นประวัติการณ์ ราคาสินทรัพย์ที่ลดลงและภาวะถดถอยทางเศรษฐกิจอย่างรุนแรง ดังที่เห็นได้จากการพุ่งขึ้นของสินเชื่อที่ไม่ก่อให้เกิดรายได้ (NPL) สาขาของธนาคารต่างประเทศประสบปัญหาน้อยกว่าเพราะธนาคารเหล่านั้นประเมินความเป็นไปได้ของโครงการและความสามารถในการชำระหนี้ของลูกหนี้อย่างมีระบบก่อนที่จะปล่อยสินเชื่อ พิจารณาการหมุนเวียนเงินทุนของลูกหนี้เป็นหลัก และมักสร้างความสมดุลของอายุชำระคืนระหว่างแหล่งที่มาและการใช้เงินทุน พร้อมทั้งป้องกันความเสี่ยงทางด้านอัตราแลกเปลี่ยน

ด้วย ส่วนธนาคารพาณิชย์ไทยกลับให้ความสำคัญแก่หลักทรัพย์ค้ำประกันจากแหล่งที่เชื่อถือได้หรือคุ้นเคยกัน การตัดสินใจปล่อยสินเชื่อขึ้นอยู่กับฐานะสินทรัพย์มากกว่าการหมุนเวียนเงินทุนของลูกหนี้ รวมทั้งไม่ค่อยพิจารณาถึงความเสี่ยงเกี่ยวกับความไม่สมดุลของอายุการชำระคืนและฐานะเงินตราต่างประเทศ แต่ความใกล้ชิดในทางเครือญาติและเพื่อนฝูงกลับได้รับความสำคัญมากกว่า จึงไม่น่าแปลกใจที่ NPL ของธนาคารพาณิชย์ไทยอยู่ในระดับที่สูงกว่าของสาขาธนาคารต่างประเทศมาก เช่น ร้อยละ 42 ต่อร้อยละ 10 ในปลายปี 1998

รัฐบาลไทยได้ประกาศใช้พระราชกำหนดหลายฉบับและจัดตั้งสถาบันขึ้นหลายแห่งเพื่อดำเนินการปฏิรูปทางการเงิน ตัวอย่างเช่น องค์การบริหารสินเชื่ออสังหาริมทรัพย์ (PLMO), ตลาดรองสินเชื่อเพื่อที่อยู่อาศัย (SMC), องค์การเพื่อการปฏิรูประบบสถาบันการเงิน (FRA), และบรรษัทบริหารสินทรัพย์สถาบันการเงิน (AMC) ทางการได้อนุญาตให้ต่างชาติถือหุ้นในสถาบันการเงินภายในประเทศได้มากขึ้น เพื่อขยายเงินกองทุนและปรับปรุงกลยุทธ์ในการบริหาร รัฐได้สั่งปิดบริษัทเงินทุน 56 แห่ง แต่ก็ให้การค้ำประกันแก่ผู้ฝากและเจ้าหนี้โดยได้แยกสินทรัพย์ดีและเสียของบริษัทเงินทุนเหล่านั้นออกไปให้แก่องค์การต่างๆ บริหาร รัฐได้เข้ายึดสถาบันการเงินบางแห่งที่มีปัญหาโดยควบกิจการเข้ากับสถาบันการเงินของรัฐ ในขณะเดียวกันก็ขายบางส่วนของสถาบันการเงินเหล่านั้นให้แก่หน่วยงานที่สนใจ เช่น ธนาคารต่างประเทศ

ธนาคารแห่งประเทศไทยได้เพิ่มความเข้มงวดกับกฎเกณฑ์ในการจัดชั้นสินทรัพย์ สำรองหนี้สูญ และรายงานฐานะ เพื่อยกระดับสถาบันการเงินสู่ระดับสากล ความหมายของสินทรัพย์ที่ไม่ก่อให้เกิดรายได้ถูกเปลี่ยนแปลงให้คลุมถึงสินเชื่อที่ไม่ถูกชำระคืนตั้งแต่ 3 เดือนขึ้นไปแทน 6 หรือ 12 เดือนดังที่เคยปฏิบัติมา ประเภทของสินเชื่อใหม่ 2 ประเภท ได้แก่ สินเชื่อจัดชั้นปกติและสินเชื่อจัดชั้นที่กล่าวถึงเป็นพิเศษจะต้องกันสำรองร้อยละ 1 และร้อยละ 2 ตามลำดับ ในขณะที่สัดส่วนการกันสำรองของสินเชื่อต่ำกว่ามาตรฐานเพิ่มขึ้นจากร้อยละ 15 เป็นร้อยละ 20 หนี้สงสัยสูญต้องกันสำรองร้อยละ 50 แทนร้อยละ 100 แต่หนี้สูญยังคงต้องกันสำรองร้อยละ 100 เช่นเดิม มาตรฐานใหม่เหล่านี้ทำให้สถาบันการเงินต้องเพิ่มเงินกองทุนเป็นอันมาก ระบบใหม่บังคับให้สถาบันการเงินจัดส่งรายงานสินเชื่อและตรวจสอบภายในเป็นรายไตรมาสแทนรายปี รายงานทบทวนโครงสร้างสินเชื่อต้องครอบคลุมอย่างน้อยร้อยละ 70 ของสินเชื่อคงค้าง รวมถึงลูกค้ารายใหญ่ 100 รายแรกและสินเชื่อหรือข้อผูกพันของหน่วยงานที่เกี่ยวข้อง มาตรการเหล่านี้ยังบังคับให้สถาบันการเงินเข้มงวดเกี่ยวกับการปล่อยสินเชื่อและขั้นตอนการวิเคราะห์สินเชื่อ โดยให้ความสำคัญแก่การหมุนเวียนของเงินทุนและความสามารถในการชำระหนี้ของลูกหนี้มากกว่าสินทรัพย์ค้ำประกัน การปรับโครงสร้างหนี้จะต้องพึ่งการประเมินความเป็นไปได้ของลูกหนี้หรือโครงการเงินกู้อย่างใกล้เคียงความเป็นจริงมากที่สุด

รัฐได้เสนอความช่วยเหลือแก่สถาบันการเงินที่ต้องการเพิ่มทุนดังนี้ หากสถาบันการเงินยอมปฏิบัติตามกฎเกณฑ์ตั้งสำรองหนี้สูญทันทีหรือก่อนปี ค.ศ. 2000 สถาบันการเงินเหล่านั้นจะสามารถเพิ่มเงินกองทุนขั้นที่ 1 โดยออกหุ้นบุริมสิทธิขายให้แก่รัฐเพื่อแลกเปลี่ยนกับพันธบัตรรัฐบาลที่เปลี่ยนมือได้ นอกจากนั้นเพื่อกระตุ้นการปรับโครงสร้างหนี้ รัฐก็ได้อนุญาตให้สถาบันการเงินเพิ่มเงินกองทุนขั้นที่ 2 โดยแลกหุ้นกู้ออกใหม่ของธนาคารกับพันธบัตรรัฐบาลที่เปลี่ยนมือไม่ได้เป็นจำนวนเท่ากับส่วนขาดทุนของสถาบันการเงินที่เกิดขึ้นจากการปรับโครงสร้างหนี้

แม้จะมีหลายช่องทางในการปรับโครงสร้างหนี้ (เช่น ลดอัตราดอกเบี้ย ยืดอายุการชำระคืน ตัดหนี้สูญบางส่วน และแปลงหนี้เป็นทุน) แต่การต่อรองหนี้ก็ไม่ใช่เรื่องง่าย เนื่องจากมีแรงกดดันจากหลายฝ่าย (เช่น ลูกหนี้ ผู้ร่วมทุนรายใหม่ เจ้าหนี้ภายในและภายนอกประเทศ เจ้าหน้าที่ธนาคารชาติ เจ้าหน้าที่กรมสรรพากร) และยังต้องประสบข้อจำกัดทางด้านกฎหมายและกฎเกณฑ์อื่นๆ ในแง่นี้รัฐได้พยายามช่วยโดยแก้ไขกฎหมายล้มละลายและกฎหมายยึดทรัพย์ รวมทั้งจัดตั้งศาลล้มละลายด้วย อย่างไรก็ตาม แต่ละฝ่ายก็มีส่วนได้ส่วนเสียและความสนใจที่ต่างกัน การปรับโครงสร้างหนี้ของธุรกิจเอกชนจึงเป็นขั้นตอนที่ยืดเยื้อและก่อปัญหาแก่การฟื้นตัวทางเศรษฐกิจ ในทางกลับกันการฟื้นตัวทางเศรษฐกิจที่ล่าช้าทำให้ธนาคารพาณิชย์ลังเลที่จะต่ออายุสินเชื่อคงค้างหรือปล่อยสินเชื่อใหม่ทำให้เกิดวงจรอุบาทว์ระหว่าง NPL และการขยายตัวทางเศรษฐกิจ

วิกฤติการณ์ทางการเงินในประเทศไทยเกิดขึ้นจากปัญหาของทั้งระบบจึงจำเป็นต้องปฏิรูปเป็นอย่างมากหลายประการ เช่น แยกสินทรัพย์ดีและเสีย ขยายเงินกองทุน ปรับโครงสร้างหนี้คงค้าง เพิ่มบุคลากรที่มีประสิทธิภาพ ปรับปรุงกลยุทธ์ในการบริหาร (เช่น การประเมินความเสี่ยงของสินเชื่อ มาตรฐานในการตีราคาสินทรัพย์จำนอง ระบบฐานข้อมูล) การแก้ไขกฎหมายที่เกี่ยวข้อง การปรับปรุงจรรยาบรรณ การปรับปรุงธรรมาภิบาล การใช้ระบบสากล และการยกระดับฐานะของลูกค้า องค์ประกอบเหล่านี้สมควรได้รับความสำคัญเท่าเทียมกันและพร้อมกันทันที เนื่องจากมีความเกี่ยวโยงซึ่งกันและกัน สถาบันการเงินต่างชาติจะเข้าถือหุ้นและมีอิทธิพลมากขึ้นในวงการธนาคารของไทยที่เคยได้รับการคุ้มครองมาก่อน การแข่งขันจะมีมากขึ้นอย่างแน่นอน กิจการธนาคารในหมู่ครอบครัวจะค่อยๆ หายไป เช่นเดียวกับการปล่อยสินเชื่อในเครือ ในขณะที่การบริหารงานแบบมืออาชีพจะมีมากขึ้นพร้อมทั้งบทบาทของการปรับปรุงทางด้านเทคโนโลยี

การแก้ไขปัญหาหนี้ที่สมบูรณ์นั้นไม่เป็นแต่เพียงการปรับโครงสร้างทางการเงิน แต่ควรรวมถึงการปรับโครงสร้างการปฏิบัติงานและโครงสร้างธุรกิจของบริษัทลูกหนี้ด้วย จุดประสงค์ของการปรับโครงสร้างการปฏิบัติงานคือ เพื่อเพิ่มประสิทธิภาพ ในขณะที่การปรับโครงสร้างธุรกิจของบริษัทลูกหนี้

คือ เพื่อปรับปรุงการบริหารงานและความเป็นไปได้ หากไม่มีทั้งสองประการหลัง การปรับโครงสร้างทางการเงินอาจจะเปล่าประโยชน์

เนื่องจากการเปิดเสรีทางการเงินได้อนุญาตให้สถาบันการเงินประกอบธุรกิจที่ไม่เคยทำมาก่อน รัฐจึงควรควบคุมตามประเภทธุรกิจไม่ใช่ตามประเภทสถาบัน โดยกฎเกณฑ์ควบคุมเหล่านั้นไม่ควรพึ่งวิจารณญาณส่วนบุคคล ทั้งผู้ตรวจสอบและผู้กำกับควรให้ความสำคัญแก่การวิเคราะห์สถานการณ์ที่อาจเกิดขึ้นในอนาคตแทนที่จะตรวจสอบทางบัญชีแต่อย่างเดียว รัฐควรบังคับให้ผู้บริหารหรือผู้ประกอบการของสถาบันการเงินเข้ามีส่วนร่วมรับผิดชอบด้วย พร้อมทั้งปรับปรุงมาตรฐานทางบัญชี รายละเอียดและความโปร่งใสของข้อมูล หากรัฐนำข้อเสนอแนะดังกล่าวข้างต้นไปปฏิบัติและแต่ละสถาบันการเงินก็พัฒนาบุคลากรและธรรมาภิบาลของตน กฎเกณฑ์ข้อบังคับที่รัฐกำหนดก็จะได้ผลอย่างต่อเนื่อง และช่วยป้องกันปัญหาได้โดยอัตโนมัติ นอกจากนี้ การปฏิรูปทางการเงินอย่างสมบูรณ์แบบเช่นนั้นก็จะช่วยภาคเศรษฐกิจที่แท้จริง ทำให้ทั้งการฟื้นตัวทางเศรษฐกิจและเสถียรภาพทางการเงินยั่งยืนมากขึ้น

อีกสองส่วนของระบบการเงินที่รัฐควรให้ความสำคัญเท่ากับธนาคารพาณิชย์ ได้แก่ ตลาดทุนและบริษัทธุรกิจเอกชน เพราะตลาดทุนทำหน้าที่เป็นทั้งตัวประกอบพร้อมทั้งแข่งขันกับธนาคารพาณิชย์และบริษัทเงินทุน ในขณะเดียวกันความเข้มแข็งและวินัยของบริษัทธุรกิจเอกชนก็เป็นปัจจัยสำคัญที่ส่งผลกระทบต่อกำไรและเสถียรภาพของสถาบันการเงิน ในสองส่วนที่กล่าวถึงนี้หน่วยงานของรัฐในเศรษฐกิจขนาดเล็ก เช่น ไทย ควรให้ความสนใจแก่ธุรกิจขนาดกลางและขนาดย่อมเป็นพิเศษ เพราะธุรกิจเหล่านี้มีจำนวนมาก (ประมาณ 90% ในประเทศไทย) แม้ผลผลิตของธุรกิจเหล่านี้ยังไม่เป็นสัดส่วนที่สูงของผลิตภัณฑ์มวลรวมประชาชาติก็ตาม แต่อนาคตของธุรกิจเหล่านี้ก็สำคัญทั้งในแง่การพัฒนาเศรษฐกิจ การกระจายรายได้ และสวัสดิการทางสังคม

Financial Reforms in Thailand

1. Basic Concept and Foreign Experiences

In the second half of the 1990's, financial markets around the world captured strong attention because financial stability started to tremble in several countries as a result of formidable macroeconomic imbalance amid the atmosphere which had been liberalized a few years earlier. Banking crises in developing countries were particularly painful and costly, as their governments were often caught unprepared and had to rescue ailing units without many options. Public debts therefore surged to a large extent. Meanwhile, corporate debt restructuring did not proceed at a satisfactory pace, making many parties question whether a clear-cut economic recovery was forthcoming, and if so, how long it would take and whether it would be sustainable. These strong and negative consequences of banking crises demonstrate that it is worth examining their fundamental conceptual framework and some actual experiences in the past.

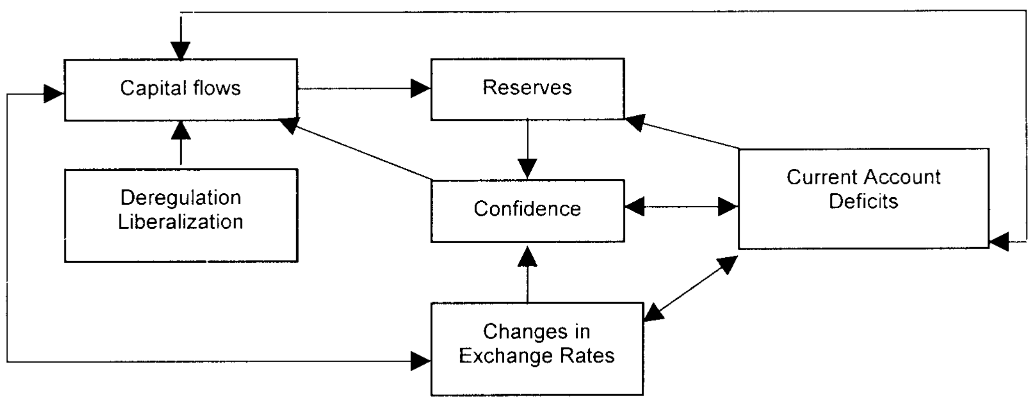
Goldstein and Turner (1996) give a very concise description of bankers' typical roles in borrowing short and lending long, operating with high leverage, and carrying illiquid loans in proportion to the perceived extent of their borrowers' creditworthiness. But a large number of factors come into play, changing expected values of relevant variables. Some of those fluctuations are externally driven while others are domestically precipitated.

On the external front, three variables deserve immediate attention: terms of trade or the extent of foreign demand, world interest rates, prevailing degree of confidence and its primary determinants. Terms of trade or foreign demand ordinarily affect performance on the current account, while interest rate differentials, exchange rate volatility, and confidence motivate capital flows. These current account and capital flows represent one crucial source of liquidity changes, which have strong impact upon financial institutions' positions or potential. For instance, deterioration of terms of trade can impair debt servicing capacity of banks' customers. Furthermore, such unlucky incident may weaken foreign investors' confidence, leading to capital outflows, exchange rate depreciation, and substantial losses to financial institutions' cash flow positions. In this context, another important item is the degree of globalization or how much the local economy is allowed to interact with the rest of the world with respect to trade and capital flows.

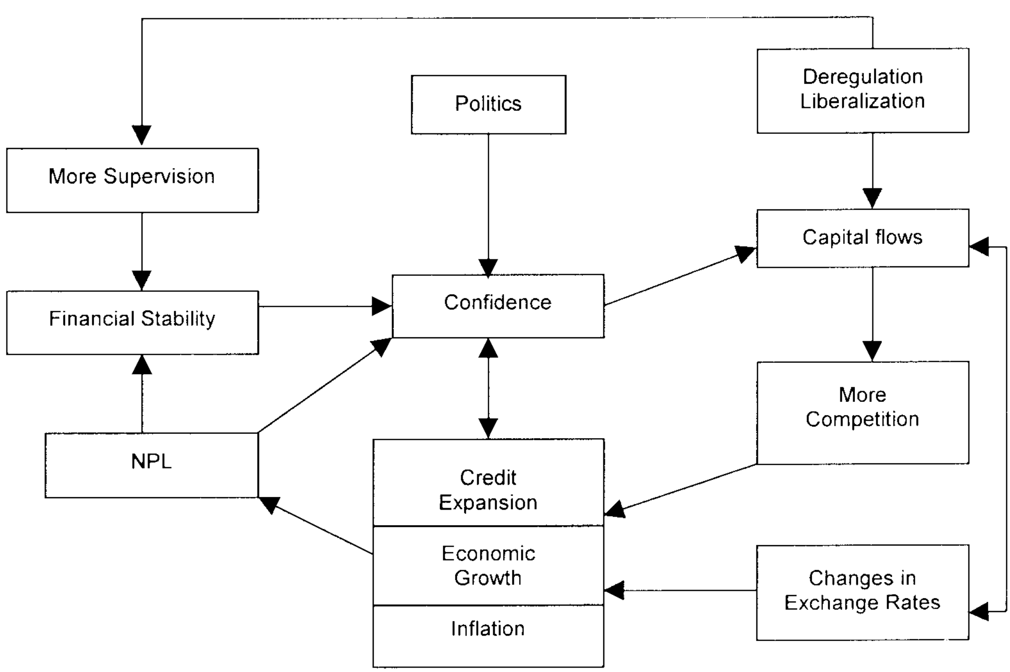
At this point, the element of "confidence" should be clarified and emphasized because it has strong and immediate impact upon capital flows and consequently financial institutions' position as well as macroeconomic status. Chart 1 displays how confidence affects variables on both the nation's external account and internal account. On the external account, after liberalization is undertaken, strong confidence in the country's debt servicing capacity easily induces capital inflows, which will help boost foreign exchange reserves. Subsequently, additional reserves will further buttress investor confidence. Two other effects should be taken into account. First, confidence affects import and export transactions, thus the net position on the current account. The converse also holds true. That is, better (or worse) current account position is an important factor which does strengthen (or weaken) investor confidence. Second, current account balance and net capital flows simultaneously affect exchange rates. And the pattern as well as extent of exchange rate fluctuations have impact upon, or repercussions back to, confidence.

Chart 1: Importance of Confidence

External Account



Internal Account



On the internal account, confidence affects behavior of both lenders and borrowers, therefore the extent and pace of credit expansion. Meanwhile, it has influence upon capital flows which can stimulate or slow down credit expansion via market competition and changes in exchange rates. The pace of credit expansion is an important determinant of not only economic growth and inflation but also the extent of non-performing loans (NPL), depending upon the quality of credit management. In any case, though NPL will impair both financial stability and confidence, the central authority can help preserve stability of the whole financial system via prudent examination and supervision. Finally, politics is also another significant domestic factor that has strong psychological impact upon investor confidence.

On the domestic front, fluctuations of growth and inflation typically make assessment of credit risks harder. Deviations of actual growth and inflation from the expected levels easily bring about more costs or even losses. Nevertheless, bankers are tempted to take risks and inadvertently magnify the amplitude of economic cycle by overextending loans during the economic upturn and accepting huge losses during the downturn. In other words, when the economy is expanding, financiers may be excessively optimistic and extend credits to investors to such an extent that excess production capacity is acquired, and vice versa. Two other facets of local markets should be taken into consideration as well: discretionary or policy actions and micro characteristics (e.g., accounting, disclosure, and legal frameworks).

Due to influence from various sources, governments in numerous developing countries decided to liberalize their financial institutions ever since 1990 regardless of whether those institutions were ready or not. Those decisions gave rise to both positive and negative outcomes, depending upon how well-prepared the financial institutions and their supervisors or central banks had been. In addition, developing countries' controlling authorities chose to undertake some market interventions, such as establishing specialized state banks, imposing requirements on specific credit extension, offering assistance to troubled financial institutions, and financing budgetary deficit. These government interventions frequently led to severe difficulties or non-performing loans (NPL), whose resolutions were very arduous.

Finally, weaknesses in developing countries' accounting, disclosure, and legal frameworks were distressing because they hindered the operations of market discipline and effective banking supervision. Examples of these weaknesses are plentiful. For example, different standards of asset classifications gave little hint to supervisors about the emergence of banking crises. The lack of uniform reporting requirements definitely impeded all efforts to distinguish healthy from unhealthy banks. Legal frameworks also mattered. Differences in the period of time involved in foreclosing or transferring collateral meant differences in loan pricing or availability. Similarly, different requirements on loan loss provisioning led to different levels of asset quality as well as profits and losses.

Kaminsky and Reinhart (1995) noted that in eighteen of the twenty-five banking crises covered in their study, the financial sector had been liberalized not more than five years before the crises emerged. This suggests that the banking crises were highly correlated with inadequate preparation for financial liberalization (e.g., in Brazil, Chile, Indonesia, Mexico, Nordic countries, the U.S., Venezuela). Government's direct participation also aggravated the problems. For instance, large portions of non-performing loans in Argentina, Brazil, China, and India in 1994 belonged to state banks.

Government involvement in banking went far beyond the operations of state-owned banks. Governments often found it inevitable to impose some requirements upon privately owned banks. Examples of such requirements as listed in Folkerts-Landau et al. (1995) were compulsory agricultural credits and local credits of new bank branches in APEC developing countries (Indonesia, Korea, Malaysia, the Philippines, and Thailand). Not only did these compulsory credits bring about large NPL, but they sometimes necessitated assistance from healthy banks (e.g., Argentina in the 1980s). In some cases (e.g., Mexico in the 1980s) reserve requirements were imposed upon banks for the purpose of budget deficit financing.

The problem of connected lending was widespread as loans were extended to banks' owners, managers, and their related businesses. In those cases, objectivity was missing in credit assessment and credit risks were often concentrated. Lindgren et al. (1996) and Sheng (1996) cited connected lending as a key factor contributing to banking problems in Argentina, Bangladesh, Brazil, Chile, Indonesia, Malaysia, Spain, and Thailand. What is more intricate is the intermingling between connected lending and macroeconomic problems. For instance, excessive credits were extended to affiliated firms in the booming period by commercial banks in anticipation of high returns or capital gain. Such overfueling was worsened by capital inflows, especially when exchange rate volatility was negligible. Consequently, the economy was overheated, resulting in threatening current account imbalance, exchange rate speculation, and capital outflows. If the country could not tolerate such outflows, exchange rate had to be floated in accordance with the prevailing market forces. This situation was applicable to Thailand in 1997.

More miserable is the vicious circle in the bust. During such period, substantial credits already offered by financial institutions were not paying off due to economic downturn. According to typical banking rules in most countries, a rise in NPL required more provisioning, which often led to less credits available to the general public. The consequential reduction in consumption and production tended to expand NPL and bring about further shrinkage of GDP. This demonstrates the vital role of financial institutions, as they can intensify the momentum and prolong the duration of economic or business cycles.

2. Thailand's Framework

Financial institutions in Thailand were largely predominated by private commercial banks in most respects such as asset size, geographical coverage, savings mobilization, and credit extension. Second to commercial banks were finance companies. Between 1990 and 1997 commercial banks and finance companies captured 88 percent of household savings placed at all financial institutions (Table 1). Meanwhile, their extended credits added up to 92 percent of the grand total offered by all financial institutions (Table 2). This demonstrates minor roles played by other types of private financial institutions (life insurance companies, agricultural cooperatives, savings cooperatives, pawnshops, credit foncier companies, and mutual fund management companies) as well as specialized units established by the government for particular purposes (Government Savings Bank, Bank for Agriculture and Agricultural Cooperatives, Industrial Finance Corporation of Thailand, Government Housing Bank, Small Industry Finance Corporation, Export-Import Bank of Thailand).

Table 1
Household Savings at Financial Institutions (Outstanding at Year-end)
(Percentage Share)

Billions of Baht

	1990	1991	1992	1993	1994	1995	1996	1997	1998
1. Commercial banks	1,149	1,332	1,552	1,787	1,995	2,372	2,642	3,061	3,338
	(77.3)	(76.6)	(74.7)	(73.5)	(71.7)	(71.5)	(70.5)	(76.2)	(75.6)
2. Finance companies	155	202	294	374	477	572	661	400	385
	(10.4)	(11.6)	(14.1)	(15.4)	(17.1)	(17.2)	(17.6)	(10.0)	(8.7)
3. Life insurance companies	37	45	56	67	83	99	117	140	143
	(2.5)	(2.6)	(2.7)	(2.8)	(3.0)	(3.0)	(3.1)	(3.5)	(3.2)
4. Credit foncier companies	2	2	3	5	5	5	6	5	3
	(0.1)	(0.1)	(0.1)	(0.2)	(0.2)	(0.2)	(0.2)	(0.1)	(0.1)
5. Government Savings Bank	112	119	130	142	156	179	205	235	325
	(7.5)	(6.8)	(6.3)	(5.8)	(5.6)	(5.4)	(5.5)	(5.9)	(7.4)
6. BAAC[1]	13	15	18	23	31	45	57	65	86
	(0.9)	(0.9)	(0.9)	(0.9)	(1.1)	(1.4)	(1.5)	(1.6)	(1.9)
7. IFCT[2]	-	-	-	-	-	-	-	-	-
	-	-	-	-	-	-	-	-	-
8. Government Housing Bank	18	23	25	32	36	47	59	110	134
	(1.2)	(1.3)	(1.2)	(1.3)	(1.3)	(1.4)	(1.6)	(2.7)	(3.0)
9. Small Industry Finance Corp.	-	-	-	-	-	-	-	-	-
	-	-	-	-	-	-	-	-	-
10. EXIM Bank	-	-	-	-	-	-	-	-	-
	-	-	-	-	-	-	-	-	-
Grand Total	1,486	1,738	2,078	2,430	2,783	3,319	3,747	4,016	4,414
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)

Notes: [1] BAAC = Bank for Agriculture and Agricultural Cooperatives
[2] IFCT = Industrial Finance Corporation of Thailand

Source: Bank of Thailand.

Table 2
Credits Extended by Financial Institutions (Outstanding at Year-end)
(Percentage Share)

Billions of Baht

	1990	1991	1992	1993	1994	1995	1996	1997	1998
1. Commercial banks	1,482	1,789	2,162	2,669	3,431	4,231	4,825	6,037	5,372
	(77.3)	(75.9)	(74.4)	(72.9)	(71.8)	(70.8)	(69.8)	(73.9)	(73.0)
2. Finance companies	315	416	548	733	1,008	1,301	1,488	1,284	1,120
	(16.4)	(17.6)	(18.9)	(20.0)	(21.1)	(21.8)	(21.5)	(15.7)	(15.2)
3. Life insurance companies	16	19	21	21	21	24	30	36	41
	(0.8)	(0.8)	(0.7)	(0.6)	(0.4)	(0.4)	(0.4)	(0.4)	(0.6)
4. Credit foncier companies	3	4	5	6	6	7	7	6	6
	(0.2)	(0.2)	(0.2)	(0.2)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
5. Government Savings Bank	11	15	18	31	33	39	56	118	145
	(0.6)	(0.6)	(0.6)	(0.8)	(0.7)	(0.7)	(0.8)	(1.4)	(2.0)
6. BAAC[1]	39	49	62	81	101	130	170	197	207
	(2.0)	(2.1)	(2.1)	(2.2)	(2.1)	(2.2)	(2.5)	(2.4)	(2.8)
7. IFCT[2]	21	26	36	49	59	78	104	156	132
	(1.1)	(1.1)	(1.2)	(1.3)	(1.2)	(1.3)	(1.5)	(1.9)	(1.8)
8. Government Housing Bank	30	40	54	72	101	142	198	279	296
	(1.6)	(1.7)	(1.9)	(2.0)	(2.1)	(2.4)	(2.9)	(3.4)	(4.0)
9. Small Industry Finance Corp.	-	-	-	-	-	1	1	1	2
	-	-	-	-	-	-	-	-	-
10. EXIM Bank	-	-	-	-	16	27	33	58	40
	-	-	-	-	(0.3)	(0.5)	(0.5)	(0.7)	(0.5)
Grand Total	1,917	2,358	2,906	3,662	4,776	5,980	6,912	8,172	7,361
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)

Notes: [1]BAAC = Bank for Agriculture and Agricultural Cooperatives
[2]IFCT = Industrial Finance Corporation of Thailand

Source: Bank of Thailand.

The Stock Exchange of Thailand (SET), established in 1975, oversees transactions of domestic securities and rests under the responsibility of the Ministry of Finance. However, securities firms were originally under the Bank of Thailand's supervision, resulting in a lack of unity between the policies on supervising and developing capital markets. In 1992, the Securities and Exchange Commission (SEC) was thus set up to exclusively supervise and develop capital markets in Thailand. Within the SEC, the principal departments are Department of Market

Intermediaries Supervision, Department of Investment Management Supervision, and Office of Market Supervision. The first department is responsible for supervising securities companies conducting brokerage, dealing, and underwritering businesses as well as securities-related associations. The second department's duties are to supervise securities companies conducting mutual fund management, private fund management, and investment advisory service as well as mutual fund business-related associations. The last department supervises the SET, Bangkok Stock Dealing Center, Bond Dealers' Club, clearing house and securities depository center, securities registrars and securities-related associations. It also studies and formulates measures to supervise and develop derivatives businesses.

Before 1997, the crises that Thai banks and finance companies encountered were mostly linked with mismanagement within each individual unit. For instance, the Asia Trust Bank (in 1984) lacked systematic organization as well as capable executives, and extended too much credits to affiliated firms resulting in high NPL. First Bangkok City Bank (in 1986) suffered from considerable losses in foreign exchange businesses. Siam City Bank (in 1987) faced problems due to imprudent credit extension in provincial areas, including misappropriations.

As for finance companies, Raja Finance (in 1978) offered intra-affiliated credits without sufficient collateral for the purpose of buying its own stock in SET. Once the crisis emerged in SET, the price of purchased stock tumbled to such an extent that its affiliates cannot repay the debts. The authority finally withdrew Raja's operating license. Seri Sakon Thanakit and Thanakit Credit Fonciers (in 1981-82) underwent liquidity crises due to inefficient management and malpractice of executives. Patana Finance Company (in 1983) could not repay their depositors in the presence of tight financial market and widespread run at several other finance companies. In that round of crisis, up to 20 finance companies' licenses were revoked and 25 other companies joined the April 4 rescue plan.

In contrast to crises in the Thai money market, the ones in capital market were mostly related to or sparked by external shocks. In 1978-79, for instance, the surging oil prices and foreign interest rates together with political tension between Thailand and Cambodia resulted in tight liquidity and plunging stock market index. The Black Monday event in 1987 that depressed stock prices around the world motivated foreign investors to liquidate their investments in Thailand so as to compensate for their losses abroad. The retrieval of funds had strong negative repercussions upon Thai investors' confidence in the local stock market and the economy. The 1990 Gulf War adversely affected global markets for oil, money, and stocks. The ones in Thailand were no exception, as interest rates climbed up exorbitantly worsening stock investors' sentiment.

3. Path to Crisis

At the beginning of the 1990s, it was envisioned that the Thai financial market would be better off if liberalization was pursued. Thailand's acceptance of the International Monetary Fund's (IMF) Article VIII in May 1990, which lifted foreign exchange controls on current account transactions, marked the beginning of a series of financial liberalization measures. On the exchange control front, the second round of liberalization abandoned most restrictions on capital account transactions in April

1991. The third round, in February 1994, gave more freedom to outward direct investment, travel expenditures, and additional channels of cross-border payments. In March 1993 the Bangkok International Banking Facilities (BIBF) were established to serve as a means to develop an international financial center. To enable BIBF to compete with other centers, BIBF transactions were granted some tax privileges (e.g., reduction of corporate income tax, exemption from special business tax and withholding tax on interest income). Furthermore, the government in January 1995 decided to allow BIBF to open up branches in upcountry provinces.

On the interest rate front, the authorities gradually removed interest rate ceilings in order to encourage savings mobilization and to make the financial system more dynamic. Interest rate ceilings on long-term time deposits were abolished in June 1989, on short-term time deposits in March 1990, on savings deposits in January 1992, and on loan rates in June 1992. In addition, the central bank in 1992-93 gave commercial banks more flexibility by loosening the requirement of government bond holding as a prerequisite for opening up new branches. The obligations of commercial banks to extend credits to rural borrowers or those in the vicinity were also relaxed to cover more related occupations and wider geographical areas. Furthermore, the definition of "liquid reserves" was broadened to include Bank of Thailand and state enterprise bonds, as well as debt instruments issued by the financial institutions or government agencies approved by the central bank.

Commercial banks were permitted to undertake new businesses, such as debt underwriting and dealing, acting as securities registrars and custodians, selling public sector debt instruments, mutual fund management, financial consulting, and feasibility studies. Finance and securities companies were on the same footing. Their new lines of operations included leasing, management of provident/private/mutual funds, custodial services, and foreign exchange businesses.

Meanwhile, a number of new frameworks and organizations were formulated. For example, the Securities and Exchange Act was passed in May 1992, giving qualified limited companies access to direct financing through issuance of common stocks and debt instruments. The Act established the Securities and Exchange Commission (SEC) as an independent agency responsible for supervising capital market activities related to equities, bonds, and derivatives. In 1993 the government spearheaded the formation of a credit rating agency, Thai Rating and Information Services (TRIS), and in 1994 private parties organized a bond dealers' club to function as a secondary debt market, adding more liquidity to debt instruments. Regarding the payment systems, the central bank improved clearing and settlement, which helped lower transaction costs and facilitate business expansion. The BAHTNET and THAICLEAR networks were put into effect so as to better serve customers' needs. The latest development on this front was the introduction of electronic retail fund transfers through Media Clearing.

The above-mentioned series of financial liberalization[1] was undertaken between 1988 and 1996 for the following purposes: to strengthen competition in the domestic financial system, to give more resilience to financial institutions, as preparation for the worldwide liberalization of trade and services, and to expand the role of Thailand to serve as a regional financial center.

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1 See details in Annex 1.

In 1996 the Thai economy encountered a number of difficulties. Export growth abruptly came to a halt due to weak global demand while imports remained buoyant, resulting in surging current account deficits. Domestic inflation, meanwhile, was rising, reducing the country's competitiveness in the world market. Unsurprisingly, traders and speculators had growing doubts about Thailand's debt servicing capacity or creditworthiness. In addition, deteriorating positions and increasing non-performing loans (NPL) in Thai financial institutions further weakened foreign investors' confidence. Waves of capital outflows, representing (p)repayments of external debts and exchange rate speculation, thus occurred in the first half of 1997 to such an extent that the Bank of Thailand found it impractical to continue defending its long held basket-peg exchange rate policy, even after it resorted to considerable external borrowing to support its foreign exchange reserves. The baht was therefore floated on July 2, 1997. Afterward, capital outflows continued until the U.S. dollar reached a peak at 53.71 baht in January 1998 (from 25.75 baht in the first half of 1997). In 1998 Thailand's real GDP contracted by 10 percent. This severe financial crisis was not singular, as it spread to several of Thailand's neighboring countries, demonstrating the reverberating impact of weakening confidence.

4. Analytical Scrutiny

4.1 Macro Perspective

It should be noted that though more freedom was given to cross-border capital flows, Thailand's exchange rate peg to a basket of currencies, adopted since 1984, remained in effect. Given the predominant weight of the U.S. dollar (85%) in the basket, the Thai baht did not move much against the U.S. dollar, and the movements did not correlate with the volume or direction of transactions in the Thai foreign exchange market. Instead, the central bank was the sole party which stipulated and defended the daily value of the baht against the U.S. dollar in line with the fluctuations of basket currencies' exchange rates in the world markets. Therefore, interest rate differentials between local and foreign currencies were not offset by exchange risks, so numerous private corporations, as well as financial institutions, took advantage by borrowing abroad at low interest rates without purchasing forward cover.

The financial liberalization measures mentioned above induced a flood of capital into the Thai market in 1990-96, fueling investment spending, speculation, and current account deficits. Meanwhile, excessive and imprudent credit extension engendered too much risk taking and deteriorating asset quality. Evidence of this is plentiful. Net capital inflows between 1990 and 1996 averaged 10 percent of GDP each year, thus expanding the outstanding external debt from US$29 billion in 1990 to US$94 billion in 1997, or from 34 percent of GDP to 59 percent of GDP, respectively. Within such mounting foreign debts, the private short-term portion surged from 22 percent to 50 percent, generating increased vulnerability. On the part of financial institutions, speculative and imprudent lending inflated several bubble sectors, not just real estate. For example, the automotive industry, private hospitals, steel, and the petrochemical industry were also bloated. Declining asset quality therefore came as no surprise, except for its speed and extent. Distressed by possible financial panic or bank runs, the central bank could not resist extending financial aid to ailing commercial banks and finance companies. This aid aggravated macroeconomic imbalance. For instance, current account deficits climbed from 5 percent of GDP in 1993 to 8 percent of GDP in 1995-96. Meanwhile, Thailand's excess inflation in comparison to the U.S.'s surged from 0.3 percent in 1993 to 3.0 percent in 1995-96. As a result, by mid-1997 investor confidence was critically shaken. Massive capital outflows, arising from fears of an upcoming devaluation plus widespread bankruptcies, necessitated the floating of the baht, which triggered a series of financial crises region-wide.

Exacerbated by the sharp currency depreciation, falling asset prices, and a strong downturn of economic activities, financial institutions' NPL jumped from 8 percent of credit outstanding in mid-1997 to 20 percent in December 1997 and to 45 percent in December 1998. By the end of 1998, NPL totaled 2.7 trillion baht or 59 percent of GDP. Worse yet, an emerging moral hazard was fake or strategic NPL because, in spite of their strong debt servicing capacity, numerous debtors suspended remittances of their regular debt servicing. Fake NPL were estimated at one-third of reported NPL.

Thailand's economic meltdown in mid-1997 can largely be attributed to three policy errors:

- Liberalization of foreign capital flows while keeping the exchange rate rigid
- Premature liberalization of financial institutions
- Failure to prudently supervise financial institutions.

These errors clearly demonstrate the importance of policy consistency. Should foreign exchange funds be allowed to move freely across borders, their prices or exchange rates ought to be liberalized as well so as to reflect market conditions. Otherwise, an excess of inflows or outflows could easily materialize, depending upon market sentiment and expectations. The liberalization of financial institutions is an equally controversial issue. Given that domestic financial institutions are not adequately prepared or experienced, the question is whether they should be liberalized, and if so at what pace, since liberalization could bring about more risks. But once these immature entities are granted more freedom, there is no doubt that the central authority should closely monitor and carefully supervise them throughout the liberalization process, especially during the initial adjustment period.

Once the central bank recognized the danger of limited foreign exchange reserves, it did not aim for any exchange rate target. Rather, it only sought to tone down or smooth exchange rate variations in order to avert a depreciation-inflation spiral. It also resorted to credit and interest rate policies, rather than direct foreign exchange interventions, as a means to restore exchange rate stability, since foreign exchange reserves were in short supply. In other words, exchange rate policy was reversed from an exchange rate target defended by reserves to stable reserves defended by the exchange rate.

Several parties called for another extreme—the creation of a currency board in which the money supply in circulation must be entirely backed by foreign exchange reserves. However, this would lead to a substantial loss of sovereignty over monetary policy, which is a highly precarious situation in the midst of financial havoc and mobile capital flows. The continuing banking crisis, the need for legal and institutional changes, and gathering political uncertainties all argued against a currency board.

Fortunately, the Thai government has emphasized the correction of underlying weaknesses in the country's economic fundamentals, since investor confidence and the country's credibility do not hinge much on interest rates. According to a recent survey, the seven main factors that influence investor confidence are, in order of priority:

- Political stability
- Competence of the economic management team
- External accounts, including trade balance, current account, and balance of payments
- Efficiency and stability of the financial system
- Foreign exchange reserves
- Asset quality of financial institutions
- Policy consistency or rigidity.

The efforts of the Thai government to reduce distortions in fundamentals were successful to some extent, as confirmed by the rising value of the baht, its growing stability (Chart 2), and improvements in the current account (Chart 3), even though baht interest rates decreased substantially. These results demonstrate some of the government's achievements in restoring investor confidence, which does not depend on only one or a few variables, such as interest rates or the trade balance. The crisis was rather a consequence of accumulated structural weaknesses. Lasting recovery is thus contingent on comprehensive structural reform. Attempting stabilization without explicit structural reforms, especially in the financial and corporate sectors, would be a costly exercise in treating symptoms without addressing the causes of the disease. In the financial sector, as foreign commercial banks' NPL (10%) were far smaller than those of Thai banks' (42%), it is worth examining details of structural differences.

Chart 2: Thailand's Exchange Rate and Interbank Interest Rate

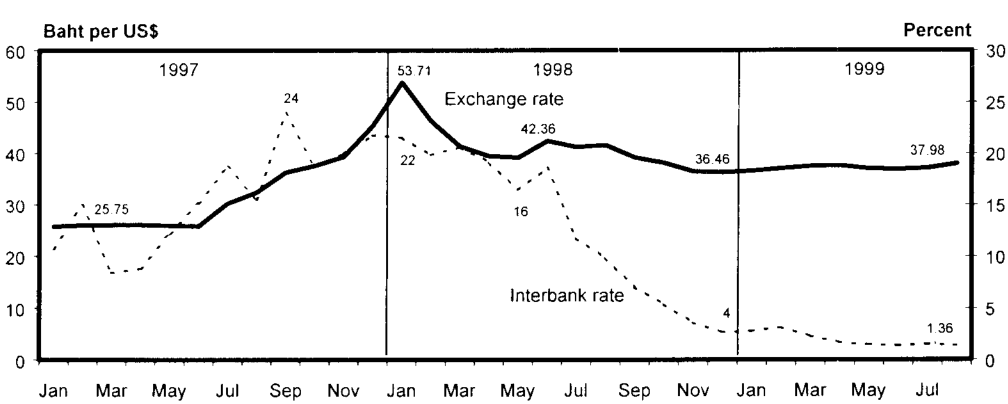
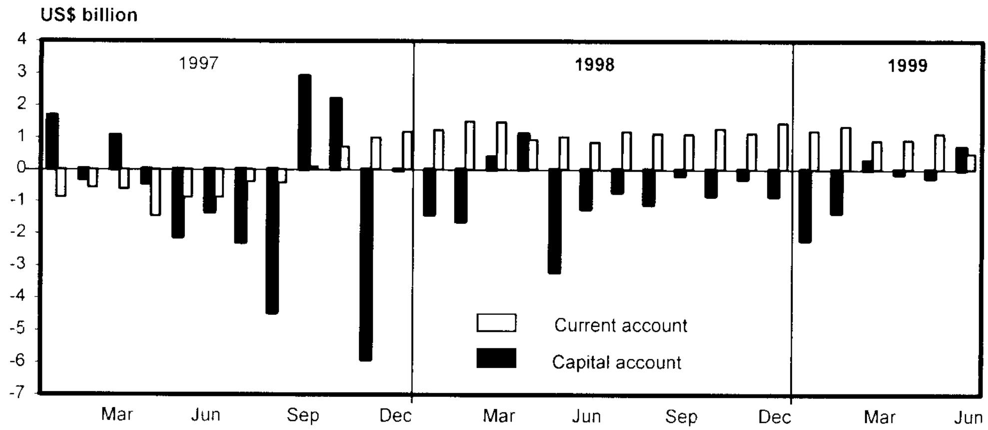


Chart 3: Thailand's Current Account and Capital Account Balance



4.2 Micro Perspective

Following international standards or adhering to principles prescribed by headquarters abroad, foreign commercial banks systematically evaluated project feasibility or the viability and debt servicing capability of prospective clients before extending credits. Their lending decisions were mostly cash-flow based. Besides, they preferred not only to match maturities between sources and uses of funds, but also to cover their foreign exchange exposure. Most foreign banks are more efficient than their Thai rivals in collecting due debts and adopting advanced technology. Thai private commercial banks were at the opposite end. They paid strong attention to collateral and/or guarantees from reliable or familiar entities. Their lending decisions were asset-based, ignoring cash-flow analysis. Worse yet, they barely accounted for risks from maturity mismatching or foreign exchange exposure. Instead, nepotism and cronyism were, to them, of greater importance. Not only did their overdue loans far exceed those of their foreign rivals in proportion, but Thai commercial banks often lagged behind in terms of technology.

A ranking of the problems that Thai banks and finance companies faced before the 1997 crisis clearly demonstrates the drawbacks in the Thai financial system. First was the lack of systematic credit risk assessment. Thai financial institutions resorted to collateral to an excessive extent, and there was no standard for pricing this collateral, so skewed pricing was prevalent. In other words, feasibility studies and risk appraisal received little attention. Second, extended credits tended to be linked with affiliated businesses, shareholders, and directors. Third, credit extension was speculatively oriented, so loans grew too much in particular periods of time and/or clustered in particular sectors engendering risky bubbles. The two principal factors underlying these problems were low-caliber staff and the fact that the Thai financial sector had been protected for too long, so it was too immature to compete with foreign units, such as foreign banks and BIBF.

At this point it should be noted that though Thai commercial banks may lag behind foreign ones in several respects (e.g., technology, management tactics), they command some advantages, especially in retail banking. Examples of their edges include local networks and familiarity or acquaintance with Thai culture and traditions. Their prospects for further competition with foreign rivals are therefore not negligible. Innovative adjustments (e.g., accommodating more small and medium-sized enterprises, economical branching) could pave the way for firm competitive positions.

Viewed from a broader perspective, managing a financial system is an intricate issue. Protection is needed if a country wishes to develop its own financial institutions and staff. But protection also generates costs, e.g., moral hazard or malpractice. After a while, liberalization consequently deserves consideration. Nevertheless, such a move can be double-edged, depending on how ready domestic financial institutions are to compete and how good the central authorities are to monitor or supervise. The crucial elements are timing and intensity. Too long a protection period or too strong a liberalization drive could easily lead to excessive inefficiency or economic bubbles, respectively.

A similar financial structure and culture is applicable to typical Thai non-bank businesses. One is thus tempted to doubt whether any attempt at rehabilitation will have quick success. Thai corporations have a strong preference toward debt, instead of equity, financing. This is true of business enterprises of all sizes. There are two underlying reasons. First, most Thai companies are family-run and they want to retain control, so they prefer debt to equity. Second, they are further induced by the tax allowances given to debt servicing but not to dividend payments. Consequently, typical Thai business enterprises are not much concerned about fixed obligations or the burden of debt financing. They also ignore the susceptibility to liquidity shortages that debts can easily bring when roll-over is needed.

Thai businesses, especially the small ones, tend to be shortsighted in terms of their financing. They resort to short-term funding first. For example, overdraft facilities are widely used, even for long-term projects. In other words, to them, maturity mismatching is not threatening, although frequent roll-overs or refinancing occasionally lead to financial strains. Worse yet, some modern entities that resort to external funds often leave their net foreign exchange positions uncovered or unhedged, especially at times of stable exchange rates. This is in sharp contrast to foreign firms or their affiliates.

On the part of the central authorities, the main shortcomings lay in the areas of supervision and examination. These duties were carried out by two separate departments at the central bank. Regulations before 1997 explicitly stated that before any preventive or corrective actions could be undertaken, the results from an examination had to be disclosed, and be affirmative. However, due to inadequate or inefficient staff, the examination department's normal procedures took so long that by the time any action was permitted, the situation at ailing financial institutions was beyond rescue. In other words, remedial actions were made useless by regulations and inefficiency in the examination process. Moreover, the regulations contained an excessive degree of subjectivity, or too much discretion was involved. For instance, the clause "in accordance with discreet standards" was often referred to.

In contrast, some bank examiners argued that the problem was not the process itself, but in what happened afterward. In other words, they knew what problems existed at which local banks, but they were asked to "tone down" the language used in official reports. That means that political interference, fears of fueling public panic or a systemic crisis, or conflict of interest led to poor coordination among regulators themselves and the inefficient resolution of banking problems.

5. Already Done

In 1997 the Thai government promulgated several emergency decrees to undertake a financial restructuring package. It contained the following essential elements:

- In cases of urgent need, the Bank of Thailand has the authority to order a commercial bank or finance company, without having to go through a shareholders' meeting, to write down its capital below the value stipulated by law and to allocate share increases. In addition, the Bank of Thailand, with the approval of the Minister of Finance, has the power to remove directors or executives of such commercial banks or finance companies and appoint replacements. The purpose of this additional authority is to allow for timely intervention in inefficient financial intermediaries that experience large losses endangering the public interest.
- The Bank of Thailand Act was amended to reaffirm the government's commitment to have the Financial Institutions Development Fund (FIDF) guarantee depositors and creditors, with full financial support from the government.
- Battered by the 1996 economic downturn, the sluggish property sector in Thailand led to considerable deterioration in the quality of asset and collateral at commercial banks, generating a continuous rise in NPL. The tension was exacerbated by the baht's depreciation. The Property Loan Management Organization (PLMO), set up in 1997 and upgraded in 1998, was to provide liquidity to financial institutions by purchasing their impaired property loans and to facilitate the completion of concerned projects. The PLMO's scope of business was later expanded to include securitization, operation of property mutual funds, turnover of real estate projects and property collateral. In this context, the authority also permitted financial institutions to set up their own property loan management companies to operate in a similar fashion to the PLMO.
- The Secondary Mortgage Corporation was established in 1997 to provide liquidity for financial institutions by purchasing retail mortgage loans, reducing interest burdens, and securitizing purchased mortgage loans. These functions should encourage the extension of housing credits, enabling the poor to afford their own accommodation. Another underlying objective was to develop a benchmark yield curve for the bond market.
- The Financial Sector Restructuring Authority (FRA) was set up as an independent entity with the following objectives:
  - To review the rehabilitation plans of suspended finance companies
  - To assist *bona fide* depositors and creditors of suspended finance companies

- To administer the liquidation of finance companies which the FRA considers unable to be rehabilitated.

- The Asset Management Corporation (AMC) was established to bid for or to purchase the impaired assets of finance companies that the FRA deemed no longer viable. The AMC was also empowered to enter a bid for good assets to support a competitive bidding process. The AMC manages the purchased assets in order to enhance their value, or it can foreclose the collateral and resell it as soon as possible. The AMC is entitled to receive some privileges, such as exemption of value added tax and special business taxes.
- Ratanasin Bank (RB) was set up as a "good bank" to purchase and manage the good assets of the suspended finance companies. Later, RB was assigned to merge with the ailing Laem Thong Bank as one means of financial renovation.
- The limit on the foreign ownership of shares in commercial banks and finance companies was lifted from 25 percent to 49 percent (and later to 100%), effective for up to 10 years. This was done to enlarge financial institutions' capital base and strengthen their management tactics.

The FRA's strategy for financial sector reform involved:

- Identifying and resolving nonviable institutions
- Protecting viable institutions
- Dealing resolutely with nonviable institutions
- Distributing the burden: Shareholders must bear losses first, pursue cases of fraud and gross negligence, not allow willful loan defaults, minimize public sector costs
- Protecting depositors.

The FRA laid down the following guidelines for the rehabilitation of suspended financial institutions:

- Only the strong may reopen
- Strict asset classification and provisioning
- Adequate capital cushioning
- Suitable ownership and management
- Maturity of borrowing from the FIDF lengthened
- Conversion of FIDF debt to equity only after the write-down of existing shareholders' capital.

On December 8, 1997 after examining the detailed status and proposed rehabilitation plans of all 58 suspended finance companies, the FRA decided to permanently shut down all but two. The FRA based its decision on the following criteria:

- Capital adequacy and sources of additional capital funds
- Capability in liquidity management

- Ability to repay debts to the FIDF
- Reliability or trustworthiness of executives.

Both the depositors and the creditors of the 56 defunct finance companies were provided with government guarantees, while shareholders could claim the excess of assets over liabilities. The monetary authority aimed to separate "good" and "bad" assets of the defunct finance companies. The "good" ones were handled by RB, while the "bad" ones were to be sold to and managed by the AMC.

On March 31, 1998 the Bank of Thailand tightened regulations on asset classification, provisioning, and reporting, aiming to upgrade local financial institutions to international standards by the year 2000. Effective July 1, 1998, the definition of non-performing assets was changed to cover past due loans with three or more months in arrears, instead of the previous six (or 12) or more months. Two new loan categories, pass and special mention, require 1 percent and 2 percent provisioning, respectively. Meanwhile, commercial banks as well as finance companies have to increase provisions for substandard loans from 15 percent to 20 percent (Table 3). Doubtful loans need a 50 percent provision rather than the previous 100 percent, but loss loans continue to necessitate 100 percent coverage. These new standards forced local banks to increase their capital by as much as 80 billion baht by the end of 1998, on top of the 129 billion baht previously added. Finance companies needed 42 billion baht of new capital on top of the 20 billion baht recently added. Banks had to set aside up to 100 billion baht in new provisions for loan losses, while the set asides by finance companies totaled 43 billion baht.

Table 3
Loan-Loss Provisioning Requirements for Commercial Banks

Loan Classification	Months Overdue	Previous Provisions	1998 System of Provisioning
Pass	< 1 month	-	1%
Special mention	0-3 months	-	2%
Substandard	up to 6 months	15%	20%
Doubtful	up to 1 year	100%	50%
Loss	> 1 year	100%	100%

Source: Bank of Thailand.

The system adopted in March 1998 also called for quarterly, instead of annual, audits and credit reports to be submitted to the central bank. Loan portfolio reviews have to cover at least 70 percent of credit outstanding, including the top 100 clients and credits or commitments to related parties. The measures also demand that financial institutions tighten their lending practices and credit analysis procedures, focusing more on borrowers' cash flow and debt servicing ability rather than on loan collateral. Debt restructuring or renegotiations must be subject to realistic assessment of financial viability of clients or their projects.

On August 14, 1998 the government decided to nationalize six commercial banks and five finance companies. Some of these were merged with government banks or finance companies, while some were to be sold to interested parties later on. In addition, the government offered assistance to other financial institutions undergoing recapitalization as follows. If financial institutions commit themselves to comply with new loan loss provisioning immediately or earlier than the targeted year of 2000, they are entitled to enlarge their first-tier capital by issuing preferred shares to the government in exchange for tradable government bonds. Furthermore, as a means to motivate debt restructuring or reconciliation with problem clients, the government put forward an option to financial institutions to increase their second-tier capital by exchanging non-tradable bonds with banks' newly issued debentures, equaling the losses suffered by financial institutions in their debt restructuring.

The underlying dual objective of the August 14 package was to reform the financial system so that new asset classification and loan loss provisioning could come into effect as soon as possible while reinvigorating the economy at the same time. If financial institutions were left by themselves, they could hardly extend credits because their huge existing NPL have to be backed up by capital funds, which were rather scarce and whose enlargement was very difficult in the midst of the prevailing economic depression. At this point, it is worth clarifying that the credit crunch was not due to liquidity shortages, as interbank interest rates dropped from 24 percent to only 1.5 percent (Chart 2). The problem was essentially caused by the inadequacy of financial institutions' back-up capital funds as demanded by the above-mentioned new asset classification and provisioning standards. Financial institutions could barely extend credits or lower interest rates (so as to revive spending and combat the economic downturn) because NPL raise costs by compulsory provisioning. In other words, interest rates on credits do not depend only on deposit or interbank interest rates. They rely heavily on asset quality as well.

In retrospect, high domestic interest rates in the first half of 1998 were largely the consequence of substantial borrowing by the FIDF (or the rescue arm of the central bank) from short-term money markets to fund long term bail-out operations. In order to both obliterate this market distortion and provide funding channels for the August capital support facilities as stated above, the government authorized in August 1998 an emergency decree enabling the issuance of special government bonds worth 300 billion baht. This restructuring of the FIDF's liabilities certainly ameliorated the market scenario, as evidenced by the considerable decreases in the interbank interest rates. Meanwhile, better current account balance induced investor confidence to recuperate to such an extent that the baht recovered markedly, from 47 baht/US$ in June 1998 to 36 baht/US$ in December 1998, despite plunging interest rates (Charts 2 and 3).

What should be noted is that the August 14 capital augmentation measure is voluntary, depending on the discretion of financial institutions. It turns out that few banks resorted to the capital enlargement opportunities offered by the government, particularly the tier-1 option. This indicates that banks have been reluctant to write down their capital in return for public money and accept the dilution of ownership that would ensue. Instead, they raised capital through the issuance of preferred stocks linked with subordinated debentures, or the so-called SLIPS (Stapled Limited Interest Preferred Shares) and CAPS (Capital Augmented Preferred Shares). Though these new instruments are appealing to some savers in the presence of low deposit interest rates, they still contain some inherent risks, as concerned principals receive no government guarantee and some returns are performance-based.

Other than adjusting the positions or status of the financial institutions, restructuring corporate debt is definitely another crucial element for both financial sector reform and economic recovery, because successful debt restructuring will help resolve the NPL problems of financial institutions and resuscitate economic activities simultaneously. The government therefore set up a corporate debt restructuring advisory committee to coordinate negotiations among debtors, their potential new partners, bankers, and finance company managers. Frameworks of corporate debt work-outs are based on the "London Approach" under which creditors: work together, share all information about debtors, recognize the seniority of claims, seek out-of-court solutions, and agree to keep credit facilities in place.

Examples of resolutions are interest rate reductions, maturity stretching, partial write-offs, and debt-equity conversion. However, debt negotiation is not an easy task. It involves not only strong pressures from several parties (e.g., debtors, their potential new partners, local and foreign creditors, central bankers, internal revenue officers) but also legal and regulatory constraints. In this context, the government tried to help by amending bankruptcy and foreclosure laws. Meanwhile, the government removed tax disincentives in order to encourage debt renegotiations. Nevertheless, corporate debt restructuring remains a lengthy and difficult process and represents a major stumbling block to economic recovery.

Before examining why the debt restructuring process is difficult and lengthy, it is useful to notice some major differences between the four types of financial institutions in Thailand: the eight surviving private Thai commercial banks, the state-run commercial banks (including the ones taken over after the crisis), foreign commercial banks, and the 35 surviving finance companies (Table 4). Of the total credit outstanding as of December 1998, private Thai commercial banks commanded the largest share (51%), while finance companies had the smallest (8%). However, with regard to asset quality, the picture is almost the opposite, as finance companies' NPL were the highest at 70 percent, while private Thai commercial banks' NPL were 42 percent. The high NPL of state commercial banks (62%) should not be misinterpreted. The primary reason for this is that the government took over six ailing private commercial banks after the crisis, so their NPL raised the average of state commercial banks'. Foreign commercial banks were at the other extreme, holding the lowest NPL (10%).

Table 4
Credit Outstanding (C.O.) and NPL as of December 1998

(Amount: Billion Baht)

	C.O. (1)	% Share of (1)	NPL (2)	(2) ÷ (1) %
8 Private comm. Banks	3,063	51	1,293	42
State comm. banks*	1,660	28	1,037	62
Foreign comm. banks	756	13	75	10
All comm. banks	5,479	92	2,405	44
35 Finance companies	461	8	322	70
Grand total	**5,940**	**100**	**2,727**	**46**

* Including private commercial banks that were nationalized after the emergence of the financial crisis.

Source: Bank of Thailand.

On the part of foreign banks, their systematic approach yielded satisfactory results or low NPL. But given their limited share in the Thai financial market (due to legal constraints on branching and new establishments), their low NPL were of little consequence to the market as a whole. And because they had extended credits on an unsecured basis (no collateral or guarantees), foreign banks were more willing than Thai banks to renegotiate with debtors after the crisis. But their small market share made this willingness less meaningful in the overall context.

Thai commercial banks, on the other hand, hesitated to pursue rescue packages for ailing debtors. The collateral and/or guarantees that they commanded tempted them to try to foreclose the concerned assets or to sue guarantors instead of petitioning for rescues. Worse yet, even though the Thai bankruptcy law was amended in June 1998 with the addition of the possibilities of rehabilitation or rescue packages (like Chapter 11 of the U.S. law), the rescue option requires consensus among creditors (or at least 75% of creditors' voting rights covering at least 50% of outstanding debts). This makes the Thai banks' hesitation to renegotiate debts more influential. It is thus unsurprising that 90 percent of the debt restructuring cases that experienced serious difficulties involved Thai commercial banks.

In many cases creditors tried to foreclose collateral. But in Thailand the foreclosure procedure is very lengthy. Although the foreclosure law has recently been revised, the protracted period of time involved does not make this option attractive to creditors, especially when the concerned asset prices do not appreciate much. Both secured and unsecured creditors are therefore trapped in the horns of a dilemma. Although the final outcomes of legal prosecution (foreclosure or bankruptcy) are likely to be favorable to creditors, the procedure is time-consuming and costly due to the income foregone from and the requirements of NPL. On the other hand, debt restructuring, in a genuine sense, may yield quicker results and help avert NPL-related difficulties. But relaxing the terms of loan contracts means a reduction of creditors' income as well. Given that Thai banks typically commanded collateral and/or guarantees, they prefer extending repayment schedules to accepting any loss. In other words, Thai banks are rather tough as they often insist that debtors repay 100 percent of the principal together with interest, which is drastically different from debt concessions abroad where only 50-70 percent in returns is deemed excellent.

Debtors also face a quandary. Because of their excessive borrowing in the past and excess capacity at present, they are overwhelmed by an intolerably heavy debt burden. Long acquaintances and good relationships with particular creditors often tempted debtors to favor some creditors over others in the debt restructuring process. But such bias can hardly be accepted without inter-creditor agreements. If debtors resort to new partners to share debt servicing, the new partners have to be ones whose creditworthiness is acceptable to creditors. Meanwhile, new partners are tempted to demand several conditions or methods of protection before making capital investments or sharing debt obligations. Without new partners, either debtors could go bankrupt when sued by unsecured (foreign) creditors, or debtors' assets could be lost to foreclosure when sued by secured (Thai) creditors. Besides, inter-creditor agreements are often difficult to reach since different creditors have different conditions or back-up securities (guarantees or collateral), depending upon their loan contracts.

One resolution to debt restructuring is swapping debts to equities or shares in debtors' companies. However, some debtors are reluctant to do this as they would like to retain the family-run nature of their companies. The unwillingness of others to adopt debt-to-equity conversion as a means to rehabilitate their businesses is due to the fact that such a route would require disclosure of relevant information, some of which is deemed confidential in their family circle. Another resolution is partial or total write-off, or the so-called hair cut. Some foreign banks (such as Japanese ones) prefer to avoid this route in accordance with their headquarters' guidelines. Other banks also hesitate, as some of them hold collateral and a hair cut necessitates a capital reduction while new capital funds are now extremely difficult to tap.

Ordinarily, commercial banks have to pay taxes on accrued interest and principal even though they have yet to collect them. In the midst of debt restructuring efforts, banks thus request tax credits or refunds on the irrecoverable portion of accumulated debt service. But the tax law demands official prosecution if the money involved exceeds 500,000 baht. As for debtors, forgiven debts are treated as income subject to the 30 percent business tax. This requirement decreases the incentives for debtors to restructure their debts. Moreover, since the Revenue Department has priority over other creditors when claiming debtors' income or assets, such priority makes creditors less willing to write off parts or all of their overdue loans.

But creditors' hesitation to restructure debts could be costly as well because, according to the new requirements on asset classification and provisioning, the longer the debts are overdue, the larger provisions or capital supports become necessary (see Table 3). And abiding by such a rule is now very painful, as financial institutions are finding capital funds scarce in their pockets and tapping them from the market represents a formidable task.

Another vicious circle of NPL occurs when Thai commercial banks hesitate to roll over maturing debts of even good clients, as the precarious environment drives banks to retrieve most credits as soon as possible. This hesitation creates pressure on banks' clients, and they could consequently become new NPL, either out of necessity or voluntarily.

After the financial crisis in 1997 a large number of reputable private firms in Thailand resorted to securities issuance instead of bank loans. As demonstrated in Table 5, the growth rate of bank loans declined from 30.1 percent in 1994 to 23.4 percent in 1997 and –9.7 percent in 1998, while that of newly issued private securities jumped from –23.6 percent in 1997 to 161.3 percent in 1998. This was due to several reasons such as the following: large NPL of commercial banks, their limited capital funds, more stringent regulations on banks and finance companies, desire to restructure corporate debt profiles (e.g., lengthening maturities, reducing interest rates, swapping currencies). Viewed from a broader angle, this movement helped develop the local bond market, which is another crucial ingredient of the financial system.

Overall, the fact that Thai commercial banks tend to resist both hair cuts as well as extending new credits makes large scale debt restructuring unsuccessful, and economic recovery delayed, if it takes place as all. Interpreted in a broader sense, commercial banks and finance companies are not earnest enough in restructuring loans. This is in sharp contrast with the American situation in the 1990's, when U.S. banks' willingness to accept massive loan write-offs helped reverse the economic downturn and revive property prices.

Table 5
Commercial Bank Loans and Newly Issued Private Securities

Billions of Baht

	1994	1995	1996	1997	1998	1999 (8 months)
Commercial bank loans	3,463.3	4,300.9	4,911.4	6,060.9	5,472.7	5,336.5
	(30.1)	(24.2)	(14.2)	(23.4)	(-9.7)	(-7.1)
Private securities	272.1	226.0	214.0	163.4	427.0	660.0
		(-16.9)	(-5.3)	(-23.6)	(161.3)	(137.5)
- Common shares	137.2	129.6	117.9	63.3	330.0	394.6
- Unit trusts	68.4	39.9	39.7	81.7	64.6	62.8
- Warrants	7.6	4.1	2.6	-	-	22.7
- Debentures	58.9	52.4	53.8	18.4	32.4	179.9

Note: Figures in parentheses represent percentage changes from the same period of the previous year.

Source: Bank of Thailand's Key Economic Indicators.

Nevertheless, strenuous efforts at financial reform in Thailand have achieved some results. These include:

- Viable financial institutions were segregated from unviable ones. Fifty-six finance companies were closed down and their assets were liquidated through the FRA's auctions. Six ailing commercial banks were handled on a case-by-case basis, i.e., integrated with state banks (FBCB, LTB, UB), their good assets transferred (BBC), recapitalized by the government for subsequent privatization (BMB, SCIB).
- The remaining financial institutions were strengthened by improvement in supervision, upgrading of asset classification and provisioning, greater foreign ownership, and recapitalization. Foreign financial institutions acquired substantial shareholding in small banks (TDB, BOA, NTB, RB) and thereby enlarged their capital base.[2] Large Thai banks were successful in recapitalization by issuing a new hybrid between preferred shares and subordinate debentures. The so-called SLIPS and CAPS offered buyers a combination of preferred shares and debts with guaranteed minimum returns. They therefore attracted strong interest from general investors in the midst of the low-interest-rate scenario of 1999. It is thus unsurprising that large private commercial banks succeeded in augmenting their capital base to a considerable extent. As for the ones that could not do so, the FIDF stepped in and assisted.

[2] Nevertheless, the government has to bear massive financial burden since the means to attract new foreign shareholders is to shift bad debts of ailing banks to the government's AMC.

Between 14 August 1998 and 12 May 1999, financial institutions in Thailand attained the following amounts of recapitalization, either through the August capital support measure or their own efforts: private commercial banks—190.148 billion baht, state commercial banks—254.137 billion baht, finance companies—3.119 billion baht, grand total—447.404 billion baht.

- More foreign participants or shareholders in commercial banks will help upgrade the management strategy of these banks. In other words, more objective systems and cash-flow orientation will be adopted, which should result in fewer and more manageable risks.[3]
- The process of corporate debt restructuring was successful to a certain extent. The accumulated number of successful debt restructuring cases went from 9,016 in December 1998 to 17,667 in February 1999, and to 30,763 cases in March 1999, covering 155.566 billion baht, 215.863 billion baht, and 280.936 billion baht, respectively. (Nevertheless, 2.7 trillion baht worth of NPL remains to be worked out.)
- Enhanced bankruptcy and foreclosure laws were passed. In addition, a bankruptcy court was established. These legal reforms will help facilitate debt restructuring, and thereby consolidate the financial system.
- In September 1999, a credit bureau was officially organized. Spearheaded by the Government Housing Bank, the bureau's function is to interchange debtor data among creditors. This is expected to favor creditors in reducing credit risks and raising efficiency levels in risk assessment and management. Practically, the credit bureau is an enlargement of the central credit registration previously administered by the central bank.
- The Bank of Thailand on September 24, 1999 stipulated the limit on credits that commercial banks could offer to the companies where those banks' executives sit in the administration. The limit is a minimum of 50 percent of client's equity, 25 percent of the client's total liabilities, and 5 percent of the creditor bank's first tier capital. Senior executives of commercial banks cannot hold more than 1 percent of subscribed stocks of a limited company. Furthermore, senior bank executives are not allowed to serve as directors in more than three limited companies. These restrictions are meant to build up good governance and transparency, which will serve to prevent NPL from occurring as a result of connected lending.

[3] Although more roles of foreign financial institutions will help improve the Thai financial system in several respects (e.g., professional management, modern technology), they may not help in facilitating economic development (e.g., rural credit extension) because of less acquaintance with Thai culture, more sensitivity to risks or profits, and stringent regulations stipulated by their headquarters overseas. Therefore, only the government's banks (i.e., Bank for Agriculture and Agricultural Cooperatives, Government Housing Bank, Government Savings Bank) will accommodate informal requests (e.g., rural credit extension, purchase of government securities).

These changes, however, did not come free of charge. In fact, their costs were substantial, and they took several forms:

- The first parties to bear the cost (of writing off bad debts) were existing shareholders of financial institutions. The government utilized this channel as a prerequisite for injecting new capital support in the August measure.
- The issuance of FIDF bonds places a heavy burden on the government. By January 1999 the FIDF had issued roughly 400 billion baht of bonds, the proceeds of which were used to lend to or recapitalize ailing financial institutions. Whether they are recoverable depends on the future status or privatization of these units.
- Upgrading regulations on financial institutions (i.e., asset classification, provisioning, capital adequacy) in a short timeframe caused a vicious downward spiral on the real sector because tighter rules meant more NPL, which in turn required further provisioning and capital increases, which made banks more reluctant to lend to the real sector. This in turn led to a credit crunch in the real sector, more recession, and more NPL in the business sector. Unsurprisingly, Thailand's real GDP contracted by 10 percent in 1998, generating a myriad of adverse socio-economic impacts.
- Closing down some commercial banks and finance companies meant not only laying off staff but also discontinuing credit lines to some companies. The latter led to production cuts or downsizing, which worsened the employment environment. The situation was aggravated by corporate debt restructuring since new terms of debts often necessitated adjustment of debtors' financial operations and streamlining of relevant costs, which inevitably raised unemployment. Labor ministry's statistics demonstrate the plight of workers, as the unemployment rate rose from 4.8 percent in February 1998 to 5.47 percent in February 1999. The number of laid-off employees surged from 5,015 in 1996 to 38,217 in 1997 and 51,498 in 1998. These figures are consistent with decreasing capacity utilization (72.4% in 1996, 65.0% in 1997, and 52.1% in 1998). This clearly indicates the costs of correcting the economy's external balance and in restructuring the country's financial system.
- Though successful financial reforms will lead to sustainable economic growth, the process, which involves more information disclosure, could weaken market confidence and country's credibility in the short run. Whether such confidence and credibility will be restored depends on the achievements of financial reforms in the long run.

Among all the above-mentioned costs, those that most capture the attention of the public are the ones borne by the government. This is because the government's fiscal attempts to encourage financial sector restructuring (through capital injections) and to accelerate spending (through tax cuts and increased expenditures) sharply increase the government's outlays and indebtedness. According to World Bank projections (Table 6), the pace of public debt buildup is alarming in the four crisis-hit Asian countries, particularly Indonesia and Thailand.

Table 6
Government Debt as Percentage of GDP

	1996	1999p	2000p
Indonesia	**51.1**	**93.0**	**98.3**
Domestic	25.1	57.0	64.3
Foreign	26.0	36.0	34.0
Malaysia	**47.7**	**59.5**	**63.3**
Domestic	31.7	36.5	39.3
Foreign	16.0	23.0	24.0
South Korea	**28.2**	**41.3**	**40.7**
Domestic	19.2	25.3	24.7
Foreign	9.0	16.0	16.0
Thailand	**11.0**	**55.4**	**52.7**
Domestic	2.0	26.4	24.7
Foreign	9.0	29.0	28.0

Source: World Bank, p = projected.

6. Remaining Tasks and Future Trends

The financial sector crisis in Thailand has proved to be systemic, requiring major restructuring, which takes many forms, i.e., separation of good and bad assets, capital enlargement, adjustment of debt overhangs, more qualified staff, improvement of (asset) management strategies (e.g., credit risk assessment, standard valuation criteria for collateral, systematic databases), legal amendments, better ethics, good governance, adoption of international standards, and upgrading of clients' financial status or viability. These components deserve equal, immediate, and simultaneous attention, as they have strong inter-relationship. For instance, separation of good and bad assets will be useful only if bad assets are handled by the asset management companies (AMC) that have expertise in debt collection, while good assets are managed by the banks that have expertise in credit and deposit management. Furthermore, once assets are properly separated, recapitalization should be done only at viable banks, instead of all problematic banks. The two underlying reasons are that recapitalization is ordinarily costly and that recapitalizing the banks whose fundamental structure plus management is poor or beyond rescue will be a useless attempt. Finally, restructuring the financial system will be successful only if remedial actions are undertaken in proper sequence. It is thus understandable that the pace of financial sector restructuring in Thailand has proceeded slower than envisaged.

While the government was successful in overhauling the bankruptcy and foreclosure laws, which help expedite debt restructuring, it encountered difficulties in speeding up capital enlargement. This is also understandable as investor appetite for bank equity diminished rapidly after the financial crisis emerged. Although the government decided to provide direct assistance through capital injection, capital funds alone can neither reform nor revive financial institutions. Other aspects of financial reform, as mentioned above, are also essential.

Recent experience has clearly indicated that strong foreign financial institutions will assume growing influence in the Thai financial market in all regards. They are holding larger stakes and taking greater management control in the previously protected banking circuit in Thailand. The most important challenge is the emergence of quasi-banks and non-banks, such as GE Capital, Ford, GM, Microsoft, and Intel, all of whom have strong networks and lend to businesses directly. More attention will be focused on marketing strategies instead of branching, and on commission fees instead of interest spreads. Foreign-owned banks will make the best use of their own specialties or advantages, e.g., in financial consulting, investment banking, worldwide networks, as a means to maximize profits and grow in the Thai market. Globalization and universal banking will prevail and induce large banks to reduce costs so as to seek or retain their platforms. Even the monetary authorities will be pressured by foreign entities to further relax prevailing regulations and allow new activities to be undertaken. More competition is unquestionable. Consequently, if Thai banks are to survive, the following is likely to happen.

1. Family banking will gradually disappear, and so will connected lending.
2. Professional management will gather momentum, and so will the role of technological adjustment.

The chances of survival will increase if Thai commercial banks resort more to mergers and acquisitions, because these will yield benefits from economy of scale and the increased ability to compete with foreign rivals. In this context, mergers and acquisitions should not be misinterpreted. They concern only ownership and rights in management. They do not imply enlargement of each operating unit. On the contrary, they could lead to downsizing of some operating units in order to reduce costs or maximize profits. In the medium term, mergers and acquisitions will also help in resolving NPL, recapitalization, and technological advancement.

Another important issue that Thai financial institutions should be cautious about is the debt restructuring, utilized as one means to resolve NPL. Some restructuring represented only postponement of repayments. In such cases, problems can easily recur in the future when repayments fall due but neither does the full-fledged economic recovery nor successful business performances of debtors. In fact, financial restructuring represents only one component of complete debt resolution. Two other essential ingredients, which are often neglected, are operation restructuring and corporate restructuring on the part of debtor companies. The former refers to adjustment of their operating mechanism, aiming at more efficiency, while the latter is meant to disentangle excessively intricate cross-holding of shares among affiliated firms so that more effective management is achievable and ongoing projects become more viable. Without operating and corporate restructuring, financial restructuring could easily be in vain, especially when sturdy economic recovery has not arrived.

All fundamentals of Thai financial institutions need to be improved, especially the caliber of staff, management tactics, and ethics, if financial reform is to have long-lasting positive effects. This warning is applicable to all means of restructuring in the financial system in Thailand. For example, separating good and bad assets through private AMC, mergers, takeovers, or even foreign participation, may not mean much if fundamental weaknesses are not remedied. Imprudent credit extension, further NPL, and another financial crisis may recur. On the other hand, should human resources be improved to such an extent that they can efficiently handle financial services (e.g., assessment of creditworthiness), outdated systems (e.g., collateral base) will disappear. The AMC which purchase and handle bad assets should have genuine expertise in debt management and should not belong to the banks which previously possessed those assets. Such AMC represent a proper and justifiable method of resolving NPL problems. In short, better staff, efficient management, and improved ethics can permanently upgrade and consolidate the financial system.

Specifically, recommendations for the future course of banking and finance in Thailand can be divided into two groups: involuntary and voluntary. The first is to be achieved by implementing new rules and regulations, while the second represents a gradual process of adjustment which depends upon several factors, such as government incentives, new foreign shareholders, and the banks' own discretion.

The involuntary course consists of the following.

1. Pertinent rules and regulations need overhauling.[4] Currently, financial institutions are controlled by types of operating units (e.g., commercial banks, life insurance companies, and cooperatives). But financial liberalization has allowed financial institutions to pursue the businesses that they had never before handled. Therefore, financial institutions should rather be regulated by functions. Otherwise, regulations can easily become ineffective because of loopholes or inefficiency. For instance, overlapping between banking and insurance or banking and cooperatives can make rules for each type of financial institution ineffective. Function-wise rules have already been adopted by some advanced countries, such as the United Kingdom and New Zealand, covering functions such as brokerage, commercial banking, and investment banking.

2. The basis of laying down rules and regulations should be re-oriented toward more objectivity. Less subjective judgement will help avoid loopholes and biases. Nevertheless, in some areas, regulators should distinguish assets of more and less risks depending upon their underlying qualities. For example, assets or debtors within the same business category may receive different weights depending upon inherent status or debt servicing capacity. This new risk weighting system corresponds to the new Bank for International Settlements (BIS) system, which is a refinement of the previous one.

3. Both examiners and supervisors should focus more on forward looking analysis rather than just monitoring bank accounts. This is essential since financial institutions have to manage volatile cash flows over a period of time. Forward looking regulators will therefore help detect whether problems may recur in the system, and if so, when and where.

4. More accountability should be required from bank executives or operators, since their actions or decisions have a strong bearing on their banks'

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4 At the beginning of the year 2000, the Bank of Thailand proposed several amendments to prevailing financial Acts. These amendments, which will be discussed and finalized by the parliament, are summarized in Annex 2.

performances. These executives should be held liable to criminal charges, or they should have to put up some of their own stake as contingent liabilities for excessive NPL. This will help motivate bank executives or operators to exert more caution on the efficiency and asset quality of their banks.

5. The standards on accounting, detailed information, and transparency need to be upgraded so that the financial system will be underpinned by the following qualities: sustainability, checks and balances, and effective internal controls.
6. Once urgent problems in the Thai financial system are resolved, a deposit insurance agency should be established as a means to impose more market mechanisms on financial institutions. Otherwise, excessive risk taking or moral hazard and financial crisis could easily reappear.

The voluntary part has two components that largely depend on each financial institution's administration: human resources and good corporate governance. Development of these two items will help improve the core of the financial system. And after these two items are achieved, together with the above-mentioned accountability, accounting standards, detailed information, and transparency, regulating financial institutions will not be difficult, and examination will become unnecessary. In other words, when these six conditions hold, regulations specified by the central authorities will be continually abided by, and thus automatically prevent problems. Such a situation is certainly possible, e.g., as in New Zealand. Therefore, the central authorities should press for an improvement of human resources and corporate governance in financial institutions.

Together with the above-recommended policy actions, governments in developing countries may adopt some early warnings of banking crises. As suggested by Gonzalez-Hermosillo (1999), the ratio of capital equity plus loan reserves minus NPL to total assets, or the so-called coverage ratio, serves as one good indicator of bank fragility. However, other indicators pinpointing market risks and liquidity risks should also be considered. In short, an appropriate early warning system ought to take into account both relevant microeconomic and macroeconomic factors.

The central authorities ought to prepare local financial institutions to cope with the upcoming changes in the global financial arena. For instance, at present the Bank of Thailand requires financial institutions to maintain a capital-to-risk-asset ratio of 8.5 percent in accordance with the BIS's 1988 Capital Accord. At least half of the capital base must be in the form of tier-one capital, defined as equity (common and preferred stocks) and retained earnings. The rest, or tier-two capital, consists of subordinate debts and revaluation of assets.

In June 1998, the Basel Committee on Banking Supervision of BIS released a draft framework to replace the 1988 Accord. The new framework focuses on three areas.

- *Minimum capital requirements*: the broad, five-step risk weight system will be replaced with a credit assessment system that will more finely determine the risks of loans and other assets. Assessment will be made through external sources, such as credit agencies, or through internal bank risk models. Other types of risks, such as operational and interest rate risks, will be factored into the calculation of minimum capital requirements.

- *Supervisory review process:* the framework encourages early supervisory intervention to ensure that capital is sufficient for an institution's risk profile. Regulators could require different institutions to raise capital beyond minimum requirements. Internal risk management systems at banks will be regularly reviewed.
- *Effective use of market discipline:* banks will be required to disclose information about their capital structure, accounting practices, and key risk exposures.

The new framework aims at correcting longstanding weaknesses in the previous accord. For instance, interbank loans to institutions in countries within the Organization for Economic Cooperation and Development (OECD) were assigned a 20 percent risk weight, despite the fact that the actual default rate might be far higher. For non-OECD countries such as Thailand, such accord encourages banks to lend short-term, as loans of up to one-year maturity carry a risk weight of only 20 percent while long-term claims carry a 100 percent weight. This was one of the reasons that led to excessive short-term borrowing, the crucial element that triggered the Asian financial crisis in 1997 when investor confidence was critically shaken.

The revised capital framework could be implemented in Thailand as early as 2001, introducing tier-three capital (subordinate debts with maturities of up to five years) to supplement the existing tier-one and tier-two capital. Capital requirements would become more finely tuned to the risks taken by different banks. Calculations would factor in not just credit and market risks, but also liquidity positions, maturity structures, and operational risks taken by financial institutions.

Though the five-step risk weight system will be replaced by a credit assessment system, it remains debatable as to who should be responsible for the risk assessment: external sources such as credit rating agencies, or banks themselves. Using external sources will result in ratings that are comparable worldwide. However, obtaining such ratings will certainly take more time and money, raising overall costs to borrowers. In any case, local bankers have expressed concern as to whether the timing is right to introduce new capital requirements.

Another challenging issue that the Thai monetary authorities have to cope with in the near future is the stronger momentum toward financial liberalization. The U.S., for example, has already passed the Financial Services Act of 1999 that supersedes the Glass-Steagall Act of 1933. The 1999 Act overhauls the U.S. financial system by allowing financial institutions to undertake functions that they were not previously permitted, i.e., an overlap among commercial banks, securities firms, and insurance companies. This is likely to result in more competition, efficiency or cost reductions, innovations, and diversity of financial services. It will also raise the number of mergers and acquisitions around the world. Even though consumers will certainly benefit from this move, small developing countries (like Thailand) have to be cautious. Lessons from the 1997 financial crisis indicate that several ingredients (e.g., maturity of financial institutions and their supervisors) have to be in place for financial liberalization to be successful. Therefore, the Thai monetary authorities should be wary in coping with further liberalization in the global arena. Gradualism is typically a safe route toward successful and stable adjustment.

Equally challenging is the course of capital market development in Thailand. In order to assure general investors of the honesty and reliability of the performances of listed companies, the Stock Exchange of Thailand (SET) stipulates detailed prerequisites for new entrants, e.g., minimum profits for a certain number of consecutive years, a minimum number of shareholders, etc. But these requirements are seldom met by small and medium-sized enterprises (SME) in Thailand. Most SME, therefore, have to rely on debt financing from commercial banks plus finance companies, and funds from informal money markets or crony connections. What is more worrisome is the number of these SME. Unit-wise, SME total about 90 percent of all Thai private enterprises. Even though their final output has not reached a sizable share of GDP, their future prospects are important in terms of economic development, income distribution, and social welfare. At present, although there are a few specialized financial institutions designed specifically for SME, i.e., the Small Industry Finance Corporation and the Small Industry Credit Guarantee Corporation, due to their limited capital funds and branches, they have not been able to satisfy the financial needs of the majority of SME.

Two possible solutions to the SME plight are the following. First, developing domestic debt markets will help reduce the excessive reliance on banks and finance companies as the principal vehicles for term financing. More developed domestic debt markets would also lower the risks of maturity mismatching. Second, special purpose vehicles (SPV), such as those in Japan, may be set up to issue asset backed bonds directly marketed to savers. These SPV may need guarantees from the central authorities in order to gain enough confidence of savers. Once in operation, SPV can immediately serve SME effectively, as SPV should be able to pool risks and develop expertise in efficiently handling SME. SPV will help reduce the NPL of both commercial banks and finance companies, while invigorating the economy. Similar to SPV is the Debtor Rehabilitation Fund (DRF). Its main objective is to revive ailing firms or almost bankrupt debtors who have strong or promising economic prospects, or whose projects will benefit the community at large. The DRF is meant to restructure the debt profiles of potential corporations or entrepreneurs who do not receive adequate attention or credits from private financial institutions.

As regards other facets of capital market development, listed firms on the SET ought to be continually and closely monitored to ensure the continued efficiency of their management. Trustworthiness and reliable internal controls will help ensure that the stock market function as a competent rival to commercial banks and finance companies in serving savers, investors, and the development of the financial system. However, a study by the World Bank shows that recently 16 percent of the firms listed on the SET have been controlled by single-family shareholders. Five large family groups have dominated up to 50-60 percent of listed firms. This lack of diversity in shareholding often impedes sound internal controls and risk management. Corporate restructuring is thus an immediate task since building up good corporate governance normally takes a long time.

Another reason to develop local capital markets is that bank loans are intrinsically volatile. Before 1997, about 70-80 percent of all financial intermediation in Asia was bank credit-based, compared to 40-50 percent in Latin America. Bank lending has also been blamed for corporate over-leveraging during periods of growth in asset prices. The bulk of the US$125 billion of funds withdrawn from Asia during the region's crisis comprised bank lending, particularly the short term. In other words, the herd was in banks, not in the capital markets, so a shift from bank-led to market-based intermediation will result in less volatility and greater focus on profits as well as economic fundamentals.

According to the IMF's 172-page report entitled "Financial Sector Crisis and Restructuring: Lessons from Asia," the following items deserve strong attention from monetary authorities, especially those in developing countries.

- Take prompt and decisive action to deal with banking problems, including pre-emptive restructuring action.
- National authorities should have full ownership of all aspects of the financial restructuring effort.
- Transparency in government action is needed to make restructuring credible and successful.
- Valuation of bank assets in the absence of clear market values amid fluctuating economic conditions is difficult but necessary.
- Solving banking and corporate sector crises must go hand-in-hand.
- In good times, financial institutions should build up a "cushion" of capital.

While the economy is recuperating, one clear-cut lesson from the crisis is that the central authorities should closely monitor the operations and status of financial institutions, corporate financing, SME, and capital flows, as these items have grave consequences for the country as a whole. In addition, the authorities should pursue consistent policies on these items in order to achieve proper targets and restore confidence. Strong attention should be focused on capital flows, since they are not only huge and powerful but also very mobile and sensitive. A special task force may be set up to meticulously monitor the extent, composition, and usage of capital inflows in comparison with the existing debt service profile, debt servicing capacity, and prevailing economic policies. Detailed and rapid information from that task force will be extremely useful, as there is no cure-all measure or regulation that can always prevent crises. Instead, the recommended information will reveal actual motives behind capital flows and suggest not only the likelihood of possible problems but also correct means or measures that can forestall the emergence of those problems.

7. Concluding Remarks

The recent financial crisis, which was largely attributed to financial liberalization and the opening up of capital account, clearly demonstrates the powerful influence of capital flows across border. Their size and volatility is unquestionably threatening to small economies even though such economies may possess strong and favorable growth prospects. For instance, in the case of Thailand, after its exchange controls were lifted in 1991, net capital inflows grew rapidly and considerably in size, i.e., from 2.1 percent of GDP in 1987 to 10.8 percent p.a. in 1991-96 (Chart 4). Moreover, these foreign capital contained a high degree of volatility, as suggested by a growing short-term portion of the country's external debt outstanding, from 15 percent in 1987 to 50 percent in 1995 (Chart 5). Substantial capital inflows were due to stable exchange rate and promising economic potential of the country, while the short-term maturities were preferred by lenders for the sake of more flexibility and lower weight in risk calculation.

Chart 4: Thailand's Net Capital Inflows

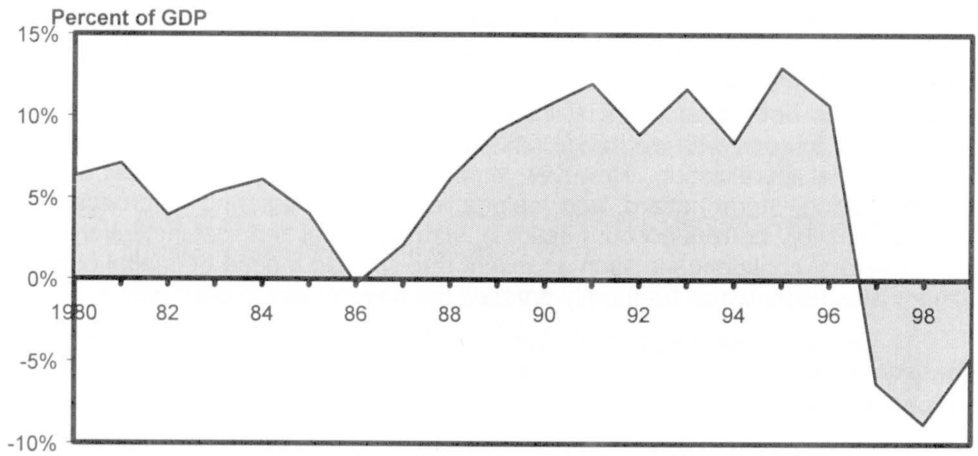
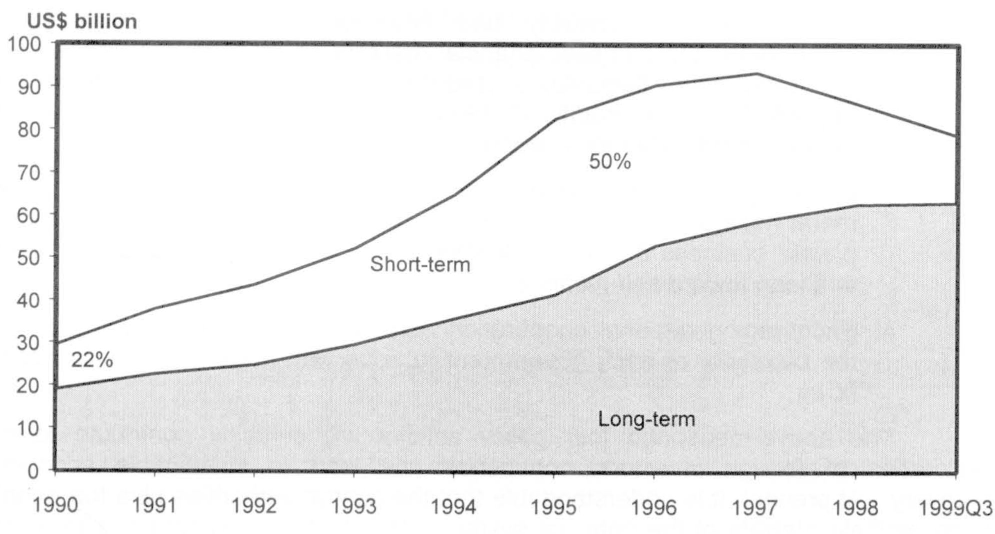


Chart 5: Thailand's Short-term and Long-term External Debts



Although these capital inflows enabled Thailand to grow rapidly or beyond expectation in 1990-95, they engendered an evil cycle. That is, at the early stage rapid growth attracted more foreign funds, especially in the presence of rather rigid exchange rate. But later on incoming foreign funds heavily contributed to excessive spending, which, together with export stagnation, generated formidably large current account deficits. Those deficits, together with trembling stability of the financial system, weakened foreign investors' confidence and triggered capital outflows to such an extent that the baht currency had to be floated in the middle of 1997. This clearly demonstrates that too early and rapid financial liberalization for too small and young economies can easily lead too much exposure and danger.

In retrospect, one may wonder that before the crisis why the Thai government kept the exchange rate rigid and offered various forms of assistance to both local financial institutions and non-bank businesses (e.g., bail-out funds, credit subsidies, rediscount facilities) in spite of the looming macroeconomic imbalance. Those policies must have been meant to support financial stability and economic development, as both local financial institutions and private business corporations were not ready to cope with exchange risks on top of more foreign competition as a result of financial liberalization. However, stable exchange rate and frequent aids led to over-borrowing, moral hazard, and malpractice, which worsened macroeconomic imbalance (inflation, current account deficits), status of local financial institutions, and foreign investors' confidence to such an extent that spurred a flood of capital outflows and financial tension, which frequently pressed the government to offer aids again.

Therefore, in the midst of predominant and turbulent global finance, if small and emerging countries (like Thailand) are to achieve sustainable economic survival, they probably cannot avoid the following.

1. Strengthening local financial institutions via various means, such as mergers and acquisitions, more foreign participation in ownership and management, adopting more objective and internationally accepted rules or standards, improving caliber of staff and technology.
2. Buttressing the capability and financial status of local business corporations via domestic financial markets so that they can cope more effectively with fluctuations, reduce unnecessary foreign borrowing, upgrade their own creditworthiness, and thus ameliorate asset quality of local financial institutions later on.
3. Curtailing government assistance or rescue measures, which will lessen moral hazard, malpractice, and macroeconomic imbalance, while stirring private business entities to develop their own professional management and lean toward self-reliance.
4. Encouraging regional cooperation across countries, which will enhance the capability of each government to cope with huge and volatile capital flows.

The above-mentioned four policy actions will certainly contribute to the restoration of foreign investors' confidence and lead to sustainable economic recovery. At present, it is understandable that the central authorities give top priority to rehabilitate stability of the financial system. The next primary target is to rectify fundamental drawbacks in the real sector. After basic problems on economic fundamentals are resolved, the government may gradually adopt exchange rate volatility as a means to subdue some capital flows, since empirical studies reveal that exchange risk is a highly influential determinant of most capital flows.[5] Nevertheless, the government should exert strong caution, as exchange rate is a very sensitive policy instrument which can have widespread repercussions on confidence, current account, inflation, and economic growth (as illustrated in Chart 1).

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5 See, for example, Annex 3.

As for the role of financial market authorities, the Bank for International Settlements (BIS) gives the following guideline[6] for risk prevention and risk mitigation in order to successfully handle contingencies after the year 2000:

- obtain reliable data on transactions, asset and liability positions of market participants
- possess enough and capable staff who can readily deal with difficulties arising at financial institutions
- encourage financial institutions to have sufficient access to, as well as to diversify sources of, market liquidity
- promote public confidence via effective public communication (in order to minimize irrational and potentially destabilizing behavior)
- improve the degree and quality of information sharing among market participants via requirements on disclosure or transparency
- establish communication channels for exchanging information between the public and private sectors and between market authorities (including cross-border)
- arrange an ongoing dialogue with the private sector in order to achieve a cooperative approach to contingency planning
- review the legal structures so as to provide the authorities with enough flexibility to respond to a wide range of issues or problems that may arise.

The above-mentioned recommendations of the BIS are applicable and helpful to contingency planning for all components of the financial system, including banking, payment and settlement, insurance, and securities.

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6 See details in "Planning by Financial Market Authorities for Year 2000 Contingencies," Bank for International Settlements, February 1999.

Annex 1
Chronology of Major Financial Reform Measures in Thailand since the Second Oil Shock

1975 **Apr.**	– The Securities Exchange of Thailand began trading (its name was changed to the Stock Exchange of Thailand (SET) in 1991).
1979	– The repurchase market was established by the Bank of Thailand (BOT) to serve as a channel for conducting open market operations, and to facilitate money market development by providing financial institutions with addition means of adjusting their liquidity positions.
1980	– Ceilings on lending interest rates charged by commercial banks and finance companies were freed from the 15 percent limit previously imposed by the Civil and Commercial Code of 1924. This measure provided the BOT with more flexibility in adjusting interest rate ceilings in line with monetary policy stance and external financial conditions.
1984 **Nov.**	– To facilitate international trade and to improve Thailand's current account balance, the official exchange rate regime was changed from pegging the Thai baht solely to the U.S. dollar to pegging the Thai baht to a basket of major currencies. The Thai baht was also effectively devalued by 15 percent against the U.S. dollar. – A joint private-public fund called "Small Industries Credit Guarantee Fund" was established to provide credit guarantee to small industries with fixed assets of less than 10 million baht. (The Fund had been operated within the Industrial Finance Corporation of Thailand up until 1993 when it became an independent financial institution).
1985 **Feb.**	– Imposing a 50 million baht limit on overdraft loan to any person. This was intended to improve the loan structure of commercial banks.
Mar.	– The BOT encouraged commercial banks to introduce the BIBOR (Bangkok Interbank Offered Rate) quoting system to facilitate money market transactions and to obtain benchmark money market rates.
May	– Control on the opening of letters of credits was lifted.
Nov.	– The Financial Institution Development Fund (FIDF) was established within the BOT to gain more flexibility in providing assistance to ailing financial institutions.
1986	– Separate interest rate ceiling for loans to priority sector was lifted. – To encourage mergers between finance companies, the authorities relaxed branching restrictions on newly-merged companies, as previously financial companies could operate only 1 branch office. – To enable credit foncier companies to mobilize funds from the public more efficiently, the minimum maturity of promissory notes issued by credit foncier companies was reduced from 3 years to only 1 year, without early redemption.

1987	– The list of authorized businesses for commercial banks and finance companies was broadened to include the following: - Custodial service - Loan syndication - Advisory service regarding mergers and acquisitions - Feasibility study
1988	– To help increase competitiveness of smaller banks, the BOT encouraged them to open "mini-branches" in certain regions of the country to reduce operating costs.
1989 **Jun.**	– Interest rate ceiling on commercial banks' time deposits of 1 year and over was lifted, marking the first step toward a full interest rate liberalization.
Jul.	– Prior approval from the BOT was no longer needed for transfer of capital outflows regarding dividend repatriation and interest/principal payments on foreign debts.
1990 **Mar.**	– Abolishing interest rate ceiling on commercial banks' time deposits of less than 1 year.
May	– Phase I of exchange control liberalization began when Thailand formally accepted obligations under Article VIII of the IMF's Articles of Agreement, which resulted in complete liberalization of current account transactions and fewer restrictions on capital outflows.
Nov.	– Branch-opening requirement for commercial banks to hold government bonds as a minimum proportion of total deposits was reduced from 16 percent to 9.5 percent. – Relaxing commercial banks' end-of-day net foreign exchange position limit from 20 percent to 25 percent of capital on net overbought, while the limit on net oversold remained at 20 percent of capital.
1991 **Jan.**	– Adjusting commercial banks' reserve requirement calculation from weekly to fortnightly lag basis, to allow more flexibility in managing liquidity. – Broadening definition of targeted "rural credits" under the rural credit requirement to include credits for crop wholesaling and industrial estates in rural areas.
Apr.	– Phase II of exchange control liberalization began, allowing freer outflows of capital for overseas investment, repatriation of dividends and proceeds from sale of stocks by foreigners. Resident individuals or juristic entities were allowed to open foreign currency accounts, subject to certain conditions, for example, the funds must have originated from overseas (e.g., export receipts).
May	– Increasing the minimum amount of assets which each foreign bank branch must maintain in Thailand from 5 million baht to 125 million baht. – Expanding the list of securities to be maintained by foreign bank branches to include debt securities guaranteed by the Ministry of Finance, debentures, bonds and debt instruments issued by state organizations or state enterprises established under special laws, or other state enterprises as approved by the BOT on a case-by-case basis.

Jun.	– Expanding the list of securities to be held by commercial banks under branch-opening requirement to include bonds and debentures issued by state enterprises without guarantee by the Ministry of Finance. – Changing reserve requirement to liquid asset requirement (banks still have to maintain at least 7% of deposits in securities and cash) and expanding the list of eligible securities to include bonds issued by the BOT, debentures and bonds issued by state organizations or state enterprises established under special laws or as approved by the BOT.
Jul.	– Expanding service hour for ATM and authorized foreign exchange representatives from 7.00 a.m. to 10.00 p.m.
Sep.	– Branch-opening requirement for commercial banks to hold eligible securities as a minimum proportion of total deposits was reduced from 9.5 percent to 8 percent. – Securities guaranteed by the Ministry of Finance became eligible under liquid asset requirement for commercial banks.
Dec.	– Allowing finance companies to operate leasing business.
1992 **Jan.**	– Relaxing rural credit requirement as follows: 1. Broadening the definition of targeted rural credits to include credits for farmers' secondary occupation, and credits for agricultural product wholesaling and exporting. 2. Definition of targeted small industrial credits was widened from those with net asset outstanding under 5 million baht to 10 million baht. 3. Excluding interbank deposits from the deposit base under rural credit requirement.
Feb.	– Abolishing interest rate ceiling on commercial banks' saving deposits. – Relaxing branch-opening requirement for commercial bank to hold eligible securities as a minimum proportion of total deposits from 8 percent to 7 percent.
Mar.	– Allowing commercial banks to operate: 1. as selling agents for debt instruments issued by the government and state enterprises 2. information service 3. financial consulting service – Allowing finance companies to operate: 1. as selling agents for debt instruments issued by the government and state enterprises 2. information service 3. sponsoring service, i.e., preparing necessary documents for companies applying for listing in the stock exchange – Allowing securities companies to operate: 1. custodial service 2. as registrars and paying agents for securities 3. information service 4. sponsoring service

May	– Further liberalization of exchange controls which included: 1. Allowing exporters to be paid in baht from non-resident baht accounts without prior approval from the BOT. 2. Allowing exporters to use foreign currencies from exports to repay foreign debts without prior approval from the BOT, or to pay for imports without having to transfer foreign currencies into the country, as previously required. 3. Allowing the use of foreign currency accounts to settle foreign debts of depositors' affiliates. 4. Allowing government and state agencies to deposit unlimited amount of foreign currencies into their foreign currency accounts. 5. Allowing non-residents to deposit foreign currencies received from Thai residents into their foreign currency accounts. – Establishing the Securities and Exchange Commission (SEC) of Thailand to oversee capital market regulations and development.
Jun.	– Abolishing ceiling on commercial banks' lending rates, finance companies' promissory note rates and lending rates, and credit foncier companies' lending rates. – Allowing commercial banks to operate the following businesses: 1. arranging, underwriting, and dealing in debt instruments 2. representative of secured debenture holder 3. trustee of mutual funds 4. securities registrar 5. selling agent for investment units – Increasing minimum paid-up capital requirement for finance companies and credit foncier companies as follows: – Finance companies: from 60 million baht to 100 million baht by July 1993, and to 150 million baht by July 1995 – Credit foncier companies: from 30 million baht to 50 million baht by July 1993, to 75 million baht by July 1994, and to 100 million baht by July 1995
Jul.	– Allowing commercial banks to issue NCD with maturities of 3 months to 3 years, with minimum denomination of 500,000 baht or more (increasing by the multiples of 100,000 baht).
Aug.	– Allowing credit foncier companies to invest in debt instruments guaranteed by the Ministry of Finance up to 20 percent of capital fund.
Sep.	– Further relaxation of foreign exchange controls. Commercial banks located in Vietnam and countries bordering Thailand were allowed to withdraw the baht from their accounts at commercial banks in Thailand freely up to the maximum outstanding balance, excluding borrowed funds. – Allowing finance companies and finance and securities companies to operate the following businesses (subject to certain requirements): 1. Representative of debenture holder 2. Trustee of mutual funds – Allowing debentures and secured bonds issued by the Industrial Finance Corporation of Thailand to become eligible assets under the liquid asset requirement for commercial banks. – A scripless clearing and settlement system is introduced on the SET.

Oct.	– Allowing finance companies to operate, with prior approval from the BOT, the businesses of: 1. custodial service for NCDs and debt instruments 2. selling agent 3. registrar and paying agent for securities 4. arranging the issuance, underwriting, and dealing of debt instruments – Allowing ATM stations to operate 24 hours a day.
Nov.	– Branch-opening requirement for commercial banks to hold eligible securities as a minimum proportion of total deposits was reduced from 7 percent to 6.5 percent. Finance companies were allowed to issue NCD.
1993 Jan.	– Imposing the BIS capital adequacy standard on commercial banks. Initially, the minimum capital-to-risk-asset ratio was 7 percent for domestic banks, and 6 percent for foreign banks.
Feb.	– Branch-opening requirement for commercial banks to hold eligible securities as a minimum proportion of total deposits was reduced from 6.5 percent to 5.5 percent.
Mar.	– Establishing the Bangkok International Banking Facilities (BIBF) which may provide three types of services: banking to nonresidents in foreign currencies and baht ("out-out" transactions), banking to domestic residents in foreign currencies only ("out-in" transactions), and international financial and investment banking services. The 46 off-shore banking licenses were issued to domestic banks, foreign bank branches in Thailand, and other financial institutions from overseas. The BIBF units must mobilize funds from overseas and extend credits only in foreign currencies. – Increasing the maximum amount of the baht an individual may carry to Vietnam or countries bordering Thailand to 250,000 baht.
May	– Abolishing branch-opening requirement for commercial banks to hold eligible securities as a minimum proportion of total deposits.
Jul.	– The BOT established a special refinancing facility for small and medium-sized investment projects that had received investment privileges from the Board of Investment in promotional areas outside Bangkok and nearby provinces (Zone 3). – The first credit rating agency in Thailand-the Thai Rating and Information Service (TRIS)-was established.
Aug.	– Financial institutions were allowed to apply for licenses to trade debt securities. – The Export-Import Bank of Thailand Act, 1993, was promulgated. (The EXIM bank was established in February 1994).
Oct.	– Commercial banks were required to announce the Minimum Retail Rate (MRR), calculated from actual cost of deposits and operating costs, as reference lending rates for prime retail borrowers.
Nov.	– Allowing insurance companies to invest in stocks and unit trusts up to 60 percent of total assets. They were also allowed to provide the following services: leasing, provident fund management, and mutual fund management.

Dec.	– Increasing the minimum capital-to-risk-asset ratio from 7 percent to 7.5 percent for domestic banks, and 6 percent to 6.5 percent for foreign banks. – Imposing the 7 percent minimum capital-to-risk-asset ratio on finance companies, with grace period up to July 1, 1994.
1994 Jan.	– Allowing commercial banks to hold ACN issued by the Industrial Finance Corporation of Thailand (IFCT) as eligible assets under the liquid asset requirement. – Allowing finance companies and credit foncier companies to hold baht-denominated ACN issued by the IFCT and bonds issued by state enterprises in overseas markets as eligible assets under the liquid asset requirement.
Feb.	– Further liberalization of foreign exchange controls. 1. Increasing the maximum amount of the baht an individual may carry to Vietnam or countries bordering Thailand from 250,000 baht to 500,000 baht. 2. Abolishing the limit on the maximum amount of foreign currencies that may be taken out of the country when traveling abroad. 3. Increasing the maximum amount of foreign investment by Thai residents without having to seek prior approval from the BOT from US$5 million to US$10 million per year. 4. Allowing Thai residents to use foreign currencies received from abroad to settle foreign obligations without having to surrender them to commercial banks in Thailand first.
Mar.	– Allowing finance companies to apply for permission to open credit offices outside Bangkok and nearby provinces.
Jun.	– Imposing net foreign exchange position limit on finance companies (25% of first-tier capital on the overbought side and 20% of first-tier capital on the oversold side). – Increasing commercial banks' minimum reserve for doubtful debts from 50 percent to 75 percent by June 30, 1994, and to 100 percent by December 31, 1995.
Aug.	– Allowing finance companies to open representative offices abroad. – Allowing existing BIBF units to apply for licenses to operate Provincial International Banking Facilities (PIBF) in areas outside Bangkok. The PIBF's funding must be from overseas as in the case of the BIBF. However, the PIBF can extend credits both in baht and in foreign currencies, while the BIBF can extend credits only in foreign currencies. – Issuing guidelines to separate the finance business from the security business within a typical finance and securities company.
Sep.	– Allowing commercial banks to open ATM without seeking approval. – Allowing commercial banks to invest in any business, or in its shares, of not more than 10 percent of the total amount of shares sold. – Establishing the Bond Dealers Club (BDC) as a secondary market for debt instruments. Its trading system operates under an established code of conduct and standardized dealing and settlement procedures.

Nov.	- Reducing the ceiling of commercial banks' net position of foreign assets and liabilities to capital to 20 percent and 15 percent, respectively, or US$5 million, whichever is greater. - Allowing BIBF to mobilize funds by issuing NCDs.
1995 Feb.	- The cabinet approved the Financial System Development Plan (1995-2000), drawn up jointly by the BOT, the Ministry of Financial, and the Securities and Exchange Commission.
Mar.	- Adjusting the new calculation of MRR based on total deposit costs. - Commercial banks have to submit the details of risks and their management on the trading of foreign currencies and their derivatives. - Finance companies and finance and securities companies with capital exceeding 20 billion baht must submit credit plans to the BOT.
Apr.	- Increasing the minimum amount of each withdrawal transaction of the out-in BIBF loans from US$ 500,000 to US$ 2,000,000, effective October 18, 1995.
May	- Issuing a guideline in managing derivative risks by discouraging leveraged contracts. - Allowing finance companies to mobilize funds from the public by issuing Bill of Exchange (B/E). The minimum amount of each domestic B/E is 10 million baht. Finance companies may also issue B/E abroad after seeking approval from the BOT. - Foreign bank branches, BIBF, and large finance companies have to submit credit plans and out-in credit plans, respectively to the BOT. - Allowing credit foncier companies to operate as loan service agents. - Issuing guidelines for savings mobilization in the form of contractual savings. - Adopting the BIS guideline for commercial banks on risk management of derivative trading. - Commercial banks operating international banking facilities were required to put aside reserves for doubtful assets which may be worthless or irrecoverable as has been practiced by commercial banks. - The Ministry of Commerce issued a notification prescribing conditions for the establishment of a limited company or a limited public company to undertake life or non-life insurance businesses in 1995. Applications should be submitted within 3 months from June 8, 1995.
Jun.	- The SEC issued a notification stipulating rules, conditions, and procedures of allowing securities company to purchase or hold shares.
Jul.	- Allowing commercial banks to act as customers' representatives of unsecured debenture holders.
Aug.	- Issuing short-term BOT bonds worth 10,000 million baht on a weekly basis to absorb excess liquidity in the money market. The maturities of bonds are 1 month, 3 months, and 6 months. - Adjustment in calculation of liquidity assets of commercial banks on non-resident baht account from 7 percent of liquid assets to 7 percent depositing at the BOT.

Sep.	– Requiring finance and securities companies to allocate capital reserve for security business not more than 25 percent of their tier-1 capital. – Adjusting the measurement of net foreign exchange exposure of Thai banks. – Issuing guidelines for upgrading the existing BIBF to full branches. 1. Must be a large commercial bank with well-established contracts with the Government and private entities in Thailand. 2. Must have a minimum funding of 2,000 million baht, with at least 1,000 million baht upon initial operation and 2,000 million baht within one year. – Issuing a notification on types of contract that finance companies can take for hedging exchange rate risk.
Oct.	– Increasing the minimum amount of each withdrawal from the BIBF from US$ 500,000 to US$ 2,000,000. – Adjusting the measurement of net foreign exchange exposure of foreign bank branches, with the exception of trade credits. – Allowing finance companies issue Bill of Exchange (B/E) and Certificate of Deposits (CDs) in foreign currencies to be offered in offshore markets with maturities of not less than 1 year.
Nov.	– Issuing guidelines for new banks' application.
1996 **Jan.**	– Adopting new guidelines for BOT lending to commercial banks, finance companies, and finance and securities companies. The loan window is now operated under repurchase agreements instead of securities pledging.
Mar.	– Announcing the issuance of long-term BOT bonds: 1) Bonds with maturities of 1 year were to be auctioned every 2 months for 1,000 million baht each, effective April 1996. 2) Bonds with maturities of 2 years were to be auctioned every quarter for 500 million baht each, effective June 1996. Qualified institutions to participate in the auction include commercial banks, finance companies, the Government Savings Bank and Financial Institutions Development Fund.
Apr.	– Requiring finance and finance and securities companies to maintain liquidity reserves at the BOT at 7 percent of non-resident baht borrowing or deposit with maturities less than 1 year, including the issuance of P/N, B/E, or NCDs.
May	– Adopting the provision against doubtful debt ratio of 100 percent for finance companies, finance and securities companies, and credit foncier companies.
Jun.	– Requiring commercial banks and BIBF to maintain the cash reserve of 7 percent of total short-term borrowings or deposits from abroad. – Requiring finance and finance and securities companies to maintain cash reserve of 7 percent of short-term borrowings or deposits from abroad (in baht and foreign currencies). – Allowing BIBF of foreign commercial banks to include cash reserve as part of foreign assets.

Jul.	– Issuing guidelines for the application of second-round BIBF licenses. – The new electronic clearing system (ECS) began operation. – Issuing branch-opening guidelines for foreign banks.
Aug.	– Issuing the Financial Institutions Development Fund (FIDF) bonds. – Allowing bonds issued by the FIDF to be part of liquid assets.
Sep.	– Adjusting the definition of the capital funds of commercial banks and finance companies: income form cumulative preferred stocks will be counted as second-tier capital instead of first-tier capital.
Oct.	– Increasing the first-tier capital funds to risk asset ratio of commercial banks from 5.5 to 6 percent, and the overall capital-to-risk-asset ratio of finance companies from 7.0 to 7.5 percent. (From January 1, 1998, the overall capital to risk asset ratio will increase to 8%, with the ratio for the first-tier capital remaining at 5.5%.) – Changing the R/P market's operational mechanism from "Dutch Auction" to "Continuous Matching," which shows real-time information in the R/P market condition through REUTERS and BISNEWS.
Dec.	– Allowing finance companies, finance and securities companies, and credit foncier companies to count debentures, bonds, and debt instruments guaranteed by the FIDF as past of the liquidity assets.
1997 Jan.	– Requiring commercial banks to submit monthly reports on real estate credits for those projects with outstanding credits or approved capital exceeding 100 million baht. – Changing the reporting format for the balance sheet and income statement of finance companies, finance and securities companies, and credit foncier company in the same format as public company limited. – Announcing the approval for the 3 groups of applicants to set up new domestic banks. – Opening of the Media Clearing System, the small transaction clearing system.
Feb.	– Issuing the guideline for capital adequacy reserve for market risk.
Mar.	– Announcing the requirement for financial institutions to set aside reserves against sub-standard assets for every half-year accounting period at 15 percent for commercial banks, and 20 percent for finance companies and credit foncier companies, effective June 1997. – Announcing the establishment of the Property Loan Management Organization (PLMO) to purchase property loans with collateral from financial institutions for the purpose of managing and enhancing their value. The PLMO is to have the initial capital of 1 million baht to be appropriated from the budget with the working capital of up to 100,000 million baht to be mobilized through the sale of government-guaranteed bonds. – Requiring finance companies to submit reports on items pertaining to B/E transactions, for example, the maximum lending or investment amount, to reduce risk in their overall operations. – Requiring the provision against sub-standard assets at a ratio 15 percent of capital funds for commercial banks, and 20 percent for finance companies, finance and securities companies, and credit foncier companies (starting at end-June 1997 and the finance institutions can accumulate the provisions within 5 years).

Apr.	– BOT appointed 10 financial institutions (8 commercial banks and 2 finance companies) as primary dealers to trade and make market in government securities. – BOT issued notification on mergers and acquisitions of financial institutions. – SEC issued the notification on the features of bills deemed as "securities" which must comply with normal investor protection regulations. – SEC launched a new instrument called short-term debenture for financing short-term funds.
May	– Announcing a change in the method of computing commercial bank lending rates by replacing the formula for calculating the Minimum Retail Rate (MRR) previously linked to deposit costs, to be linked to the Minimum Lending Rate (MLR). In this respect, the maximum rate charged to general customers will be MLR plus a margin of no more than 4 percent. This method of calculating lending rates will enable the MLR to move in line with market conditions. – PLMO started mobilizing funds through issuance of zero coupon bond valued 1,000 million baht.
Jun.	– Issuing the guidelines for commercial banks on determining interest rates and discounts to temporarily set a ceiling on deposit interest rates. Saving deposits with passbook as evidence of deposit/withdrawal and with no use of cheques as a method of withdrawal shall be paid interest as amounted by commercial banks themselves. As for time deposits of 3 months and above, the interest paid shall be no more than 12 percent per annum. – Announcing the guidelines for finance companies on determining interest rates and discounts. All finance companies are required to adopt the following guidelines: 1) The interest rate/discount rate on term promissory notes shall be set at the level of not more than 14 percent per annum. In the case of early redemption, the interest rate shall be set at no more than 7 percent per annum. 2) The interest rate on call loans from the public shall be set at no more than 11 percent per annum. 3) Finance companies are required to announce interest rates on call loans and discounts on NCDs classified by amount, maturity of borrowing or deposits, conditions, and formula used in computing the rate which the finance companies are prepared to trade in NCDs. – BOT requested commercial banks not to sell Thai baht in offshore markets. – Permission was granted to commercial banks, finance companies, finance and securities companies to set up property loan management companies. – Issuing the guideline on liquidity reserve requirement by (1) allowing debt instruments issued by the FIDF to be eligible to fulfill the liquid asset ratio (2) excluding from the computation of the liability base of the BIBF, deposits for out-out transactions.

	– To facilitate financial sector reform, issuance of 4 emergency decrees: (1) amending the Commercial Banking Act B.E. 2505 to relax regulations on foreign shareholding limit (2) amending the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business B.E. 2522 (No.3) B.E. 2540 (1997) to encourage, and remove the obstacles to the mergers and acquisitions of financial institutions which have been approved by the Minister of Finance (3) to facilitate establishment of the juristic entity to operate securitization business (4) establishing the Secondary Mortgage Corporation – Ordered 16 finance companies to suspend their operations for 30 days and to submit rehabilitation plans to the authorities (starting June 27, 1997, and on July 25, 1997, the period was extended to September 29, 1997). In the meantime, finance companies resume a limited type of operations. – SEC issued the guideline for the setting up of bond dealing centers.
Jul.	– Thailand's exchange rate system will, from July 2, 1997 onward, be switched from basket peg to a managed float whereby the value of the baht will be determined by market forces to reflect economic fundamentals. – BOT issued notification requiring that any Thai banks incurring windfall gains from net foreign exchange on the spot and forward positions on June 30, 1997 to sell such proceeds to the BOT within August 1997. – Requesting financial institutions to sell baht to non-residents only when such residents have business in Thailand. In addition, debt redemption for non-resident holders should made in US dollar only, except for instruments with maturities of more than 6 months. – Increasing the BOT's discount rate or the so-called bank rate from 10.5 percent to 12.5 percent. – Allowing commercial banks and finance companies to act as credit collecting representatives for property loans. – Raising the interest rate ceiling of finance companies from 11 percent to 13 percent for at-call-borrowing, and from 14 percent to 17 percent for time-borrowing, and commercial banks from 12 percent to 14 percent for over 3 months time-deposit account.
Aug.	– Ordered 42 finance companies to suspend their operations for 60 days (allowed to continue some business as necessary) and submit the rehabilitation plan to the Committee on Supervision of Merger and Acquisition within the same timeframe. – Establishing a liquidity recycling scheme by requiring financial institutions with surplus liquidity incremental of their deposit as of August 4, to lend the surplus funds to other financial institutions façing liquidity run. The FIDF, as the manager of the scheme, will lend to liquidity-short financial institutions by charging at the rate of R/P 7 days rate + 1.5 percent per annum.
Sep.	– Reducing the liquid asset requirement ratio on deposit and borrowing from 7 percent to 6 percent which comprises deposit at BOT not less than 2 percent, cash in hand not more than 2.5 percent and the rest as financial instruments. In addition, the cash reserve ratio on short-term deposit and borrowing was also reduced to 6 percent.

	– Issuing the guideline on interest rate which banks and finance companies should pay to or collect from their customers by using the average interest rate charged by five large Thai commercial banks as benchmark. For the maturities longer than 3 months, a margin of no more than 3 percent can be added. – Issuing the guideline of account practice on foreign exchange by using BOT reference rates.
Oct.	– Raising the interest rate which finance companies should pay to or collect from their customers by using average of the interest rate charged by five large Thai commercial banks as benchmark plus margin. For maturities of less than 7 days, the margin should not be more than 5 percent, otherwise the same margin of 3 percent applies. – Issuing the guideline on the adjustment in interest rate which finance companies can charge or pay to their customers by more or less 0.5 percent of the announced rate, but not more than the official ceiling rate. – Enactment of 6 emergency decrees to remove the obstacles, including legal, procedural, tax rigidities and infrastructural bottlenecks to the normal resolution of business and financial institutions as follows: - Establishment of the Financial Restructuring Authority (FRA) to review the financial rehabilitation plans for the closed finance companies - Establishment of the Asset Management Corporation (AMC) to ensure the orderly sale of assets of companies taken over by the FRA - Amendment of the Commercial Banking Act by empowering the BOT to undertake prompt corrective actions in situations of financial distress by changing management and expediting the process of recapitalization - Amendment of the Act on the Undertaking of Finance Business in the same spirit and principle as the amendment of the Commercial Banking Act - Amendment of the BOT Act to entrust the FIDF to guarantee depositors and creditors of all financial institutions - Amendment of the Revenue Code to permit financial institutions tax deduction for funds set aside for provisioning. – Adjusting the account practice for commercial banks, finance companies, finance and securities companies and credit foncier by allowing full tax deductibility on income for loan loss provision effective from the accounting year beginning January 1, 1998. – Tightening loan classification rules and issuing the guideline on the standard for monitoring financial institutions as follows: - Prohibit recognition of interest income for nonperforming loans more than six months overdue, effective January 1, 1998 - For sub-standard assets as of end-June 1997, financial institutions have to set aside provision not less than 50 percent of their capital funds by the second half of 1997, and not less than 75 percent within the first half of 1998 - Require provisioning for all loans more than six months overdue, effective December 31, 1997

	– Expedite the recapitalization of financial institutions, tighten guidelines for fit and proper assessment of financial institution owners and management. – Adjusting the guideline on application to operate more types of businesses and more branches for finance companies, finance and securities companies, and credit foncier companies which are planning a merger or acquisition by requiring that the joint investor pass the fit and proper criteria for both Thai person and foreign juristic entity. For prospective joint investors which are financial institutions, they must have been assigned a good credit rating by international credit rating agency. – Improving the guideline for the application for a commercial bank license by defining the qualification of the joint investor and core investor which needs to pass the fit and proper criteria for Thai person, or Thai or foreign juristic entity. For prospective joint investors which are financial institutions, they must have been assigned a good credit rating by international credit rating agency. In order to apply for the license, core investors have to enclose the list of the members of the Board of Directors along with the application form and evidence. – Increasing foreign participation in locally incorporated financial institutions by allowing foreign investors to take majority stakes and management control for up to 10 years, after which they would be grandfathered with respect to the absolute amount of their equity holding. In other words, they may not increase their equity holding in capital increment until the ratio of their holdings are brought down to 49 percent.
Dec.	– Announcement of the FRA's decision on the 58 suspended finance companies, of which only 2 rehabilitation plans were approved, and the remaining 56 companies were to be permanently closed. – AMC operating rules and guidelines were finalized, including procedures and safeguards for determining the prices of doubtful assets to be purchased by the AMC.
1998 **Jan.**	– Adjustment in the qualification of persons eligible to apply for a credit card, to a uniform standard (applicable to both civil servants and private citizens) of more than 240,000 baht in income per annum, and additional 60,000 baht per annum for a supplement card whereby the holders must not be less than 22 years old. In addition, the minimum payment must be no less than 10 percent of the outstanding, and not less than 2,000 baht. – Amending exchange control regulations as follows: (1) export proceeds must be brought into the country immediately upon receipt of payments or no longer than 120 days (previously 180 days) ; and (2) shortening the period of surrender requirement (i.e., foreign currencies must be converted into baht) from 15 days to 7 days. – Ministry of Finance's announcement on the establishment of a new commercial bank (good bank) to participate in the bidding of assets of the 56 closed finance companies. The new commercial bank "Radhanasin" will have one finance company and one securities company as subsidiaries. – BOT ordered the capital write-down and immediate recapitalization of the Bangkok Metropolitan Bank Public Company Limited (BMB) – Lifting of two-tier foreign exchange market. Financial institutions are now able to engage freely in spot foreign exchange transactions involving Thai baht with non-residents. All restrictions pertaining to transfer of Thai baht from the sale by non-residents of domestic securities have also been lifted.

Feb.	– Ordering a capital write-down and immediate recapitalization of Siam City Bank Public Company Limited (SCIB). Two other commercial banks have also been ordered to write down the accumulated losses and recapitalize: (1) Bangkok Bank of Commerce Public Company Limited (BBC) and (2) First Bangkok City Bank Public Company Limited (FBCB). – The cabinet agreed to the proposal to further develop and widen the operation of the PLMO as follows: - to conduct securitization and property fund management - to issue government guaranteed bonds and short-term debt instruments - to upgrade the PLMO to a status of "Corporation." – To facilitate the bidding process for the assets of the 56 closed finance companies, the BOT allowed commercial banks to undertake the business of purchase or transfer of loans from other financial institutions under the following criteria: (1) a) baht denominated loans from financial institutions in Thailand or the Asset Management Corporation (AMC), b) foreign currency denominated loans from financial institutions in Thailand, foreign incorporated financial institutions or the AMC (2) the purchase or transfer of loans must be an outright purchase and in line with its actual status as regards the quality or classification of assets, principal and interest accrued. – To facilitate the process of bidding for the assets of the 56 closed finance companies and alleviate the liquidity crunch situation, the BOT allowed BIBF to purchase or transfer foreign currency loans from financial institutions in Thailand, foreign incorporated financial institutions or the AMC whereby each disbursement shall not be less than US$2 million or equivalent. This minimum shall not be applied in the case of a last disbursement. The sale must be outright. – To expand the scope of operation of commercial banks in line with the Islamic faith, the BOT has granted approval for commercial banks to operate Interest-Free Units whereby the applicant must have no less than 1 billion baht in assets.
Mar.	– Adjusting risk weight of exporting loans to 20 percent for loan under pre-shipment L/C and loans under other documents (including D/P and D/A) which are guaranteed by commercial banks. – Issuance of new provisioning and asset classification regulations with an aim to further strengthen financial supervision and bring supervisory regulations in line with international standards by the end of year 2000, as follows: (1) Accrual of interest: Starting on January 1, 1999, financial institutions must cease accruing interest as income on any account where interests due have not been received within three months from the due date. Interest recorded as income on nonaccrual accounts must be reversed out of income starting on January 1, 2000. (2) Classification criteria: Effective from the second accounting period of 1998, all accounts, both on-balance sheet and off-balance sheet, shall be classified into five categories, i.e., pass, special mention, substandard, doubtful, and loss. The classification should primarily be done by using qualitative criteria. However, when a loan has been overdue for a number of periods, as specified for each category, the loan should be classified accordingly.

	(3) Provisioning requirements for classified loans are as follows: pass 1 percent, special mention 2 percent, substandard 20 percent, doubtful 50 percent, and loss 100 percent or write off. The provisioning requirement will be phased in; starting from the second accounting period of 1998, and will be fully maintained by the second accounting period of 2000. (4) Collateral valuation: Classification of loans does not take collateral into consideration. However, properly valued collateral may be deducted from the loan when determining the amount of provisioning. Financial institutions are encouraged to mark-to-market and appraise their collateral more frequently to better reflect market value. The BOT will further issue detailed guidelines for collateral valuation and will make an announcement in the second accounting period of 1998. (5) Loan restructuring: Any renegotiation of debts must be subject to realized assessment and new terms. All such renegotiations including detailed criteria must be properly documented, and such documentation must be made available to the BOT when requested. The basis for renegotiation would be to restructure the loans or obligations to conform with the debt servicing capacity of the counterparty. In principle, renegotiation of debt should result in provisions for all expected losses. The new guideline shall become effective from July 1, 1998 onward. – Loan portfolio review: From July 1, 1998, financial institutions shall conduct qualitative reviews of their portfolios, both on- and off-balance sheet commitments. A summary of the results of the loan portfolio reviews, including data on classifications and provisioning requirements, must be submitted to the BOT at the end of each calendar quarter.
Apr.	– The amended Bankruptcy Act becomes effective after publication in the Government Gazette. – Modifications of the BIBF businesses are as follows: (1) Reduction of the minimum loan disbursement from US$2,000,000 to US$ 500,000 for credits extended to exporters or customers whose income from exports is twice the amount of their entire income (2) Allowing the BIBF to purchase export-related foreign currency dominated instruments at discount from Thai exporters only (3) Allowing BIBF to underwrite or aval loans denominated in foreign currencies from financial institutions by limiting the amount to US$2,000,000 for customers and US$500,000 for exporters as defined in (1) (4) Increase the baht asset which the BIBF need to reserve for their operating expenses in Thailand from 100 million baht to 200 million baht.
May	– The BOT ordered 7 finance companies to write-down capital, and recapitalized them by converting FIDF debt into equity. The management teams of these 7 finance companies and finance and securities companies were also replaced: (1) Union Asia Finance and Securities Plc. Ltd. (2) Nava Finance and Securities Plc. Ltd. (3) Mahatun Finance Co. Ltd. (4) Bangkok Asian Finance Co. Ltd. (5) Ksit Finance and Securities Plc. Ltd. (6) Erawan Trust Co. Ltd. and (7) Progressive Finance Co.Ltd.

Jun.	– Issuance of regulations for debt restructuring and collateral appraisal as follows. *Debt restructuring regulations:* (1) Financial institutions are required to establish a formal strategy for debt restructuring to cover every stage of the restructuring process and clearly define each individual's responsibility and accountability for restructuring from the onset. (2) When a financial institution, troubled by debt restructuring, grants a concession to the debtor, resulting in a loss (to the financial institution), the institution must recognize the loss from restructuring in its profit and loss statement for that accounting period following internationally accepted accounting standards. (3) Following the restructuring, financial institutions may re-classify loans originally classified as "doubtful" or "loss" as "substandard." After the debtor has serviced and paid the agreed interest on the restructured loan for a minimum of three months or has made at least three repayments on the restructured debts, the financial institution may re-classify the loan as normal. *Regulations for collateral valuation and appraisal:* (1) Financial institutions are required to use independent appraisers to estimate the collateral value in certain cases, depending on the book value of loans and sizes of the institutions' capital funds. In-house appraisers must conform to generally accepted appraisal standards and codes of conduct set by professional asset appraisal associations. In addition, financial institutions must carry out collateral appraisals or valuations at least once a year. When the collateral appraisal was carried out within the 6 previous months, financial institutions may deduct the book value of the loans by up to 90 percent of the collateral value. When the appraisal was carried out over the 6 previous months, institutions may deduct the book value of the loans by up to 50 percent of the collateral value. – Enlarging the scope of BIBF businesses as follows. (1) Allowing BIBF to open L/C denominated in foreign currencies to domestic importers by limiting the minimum amount to US$ 2,000,000 for customers and US$500,000 for importers whose income from exports is at least half the amount of their entire income (2) Allowing BIBF to lend against trust receipts (T/R) denominated in foreign currencies to importers by limiting the amount to US$2,000,000 for customers and US$500,000 for importers as defined in (1). – Allowing BIBF to hold up to 2 percent as government bonds and the remaining 4 percent as cash, and also to hold an unlimited amount of assets in baht terms which must be in government bonds only.

Source: "Financial Institutions and Markets in Thailand," Economic Research Department, Bank of Thailand, 1999.

Annex 2
Proposed Amendments to Financial Acts

1. Financial Institution Act. This Act is to integrate Commercial Bangkok Act and the Act on the Undertaking of Financial Business, Securities Business and Credit Foncier Business. The aims of revision are:

- to broaden activities of financial institutions
- to accommodate the worldwide trend toward universal banking
- to be more clear-cut about foreign participation
- to allow for financial group consolidation but the resultant holding companies will be subject to discreet and comprehensive examination as well as risk-based supervision
- to standardize the stringency of regulations and achieve consistency or avoid loopholes
- to give opportunities for prompt corrective actions
- to encourage good governance and collective accountability
- to require more transparency for the sake of consumer protection and anti-frauds

2. Bank of Thailand Act. The revision of this act is to give more independence to the Bank of Thailand in several respects. For instance, the central bank is not bound to underwrite issuances of government securities so that it can retain its discretion on monetary policy. The four-year term of governor is to be less interfered by politics. More transparency and accountability will be demanded.

3. Currency Act. This outdated Act hampers the management of the country's foreign exchange reserves by imposing some rigidities, e.g., asset pricing, separation of accounts. The proposed revision is intended to add more resilience or flexibility to reserve management.

4. Deposit Insurance Act. This proposed Act is meant to build up and strengthen financial stability by insuring depositors of their deposits. The deposit insurance institute, to be established as an independent entity, will handle settlements of accounts at the financial institutions whose operating licenses are withdrawn. For the sake of financial stability and viability, the institute will require all deposit-taking agencies to be its members and those members to be given credit rating in accordance with their actual financial status plus performances. The rating will indicate different levels of risks and therefore membership fees. Previously, the Financial Institution Development Fund has to request for permission from the Bankruptcy Court before undertaking decisive actions. But the deposit insurance institute will be enabled to liquidate pertinent assets once its own final decision is reached.

In the long run, after the current economic and financial troubles are settled, it is suggested that the duties concerning the stability of financial institutions, i.e., examination and supervision, be handled by the deposit insurance institute, while the Bank of Thailand will be responsible for only monetary policy or duties concerning macroeconomic features. (At present, the Bank of Thailand is managing both financial institutions' stability and monetary policy.) That separation of duties will give more autonomy to the central bank or release the central bank from the recurring dilemma (of whether to favor stability of financial institutions or stability of the economy).

Annex 3
Econometric Investigation of Capital Inflows*

While there are several forms of capital inflows (e.g., foreign direct investment, portfolio investment, loans, non-resident baht account), there are various factors as well affecting these inflows (e.g., economic growth potential, stock market returns, interest rate differentials, exchange rate volatility, and macroeconomic stability). These factors influence capital inflows either directly (e.g., interest rate on loans) or indirectly (e.g., affecting investor confidence in recipient economy). Though there are numerous theoretical assertions about how each factor affect each type of capital inflows, there is little empirical work. This investigation thus has two objectives: (a) to test statistically the influences of each factor on different kinds of capital inflows, (b) to pinpoint the different degrees of those influences.

The degree of influence is measured by standardized coefficients obtained from OLS estimated equations, which link each type of capital inflow to possibly pertinent explanatory variables $(FC_i = d + \sum_{i=1}^{n} B_i X_i)$. The estimation utilizes monthly data from January 1988 to June 1998. The tested explanatory variables are:

- Interest rate differentials
- Returns from the Stock Exchange of Thailand
- Volatility of baht exchange rates versus U.S. dollar, yen, Singapore dollar
- Forward cover or swap premium
- Indicators of macroeconomic stability, e.g., current account deficits, inflation differentials, foreign exchange reserves/imports ratio
- Indicators of economic activities, e.g., private sector's electricity consumption, manufacturing production index

Besides, some dummies were also included to reflect crucial impact of economic or political changes, e.g., government turnover, shifts in exchange rate system, and variations of country's credibility as evaluated by credit rating agencies. Results of this econometric investigation as shown in Tables 16-19 are close to expectations for each type of capital inflows. Meanwhile, the following points deserve some attention.

Foreign direct investment (Table 7) Export performance is the most significant explanatory variable, demonstrating the long-term relationship and the Board of Investment's role. Current account deficit, or the second rank, is probably there because it correlates with foreign investors' confidence. As for the exchange rates, volatility of baht per yen has stronger impact than those versus other currencies. That could be partly due to the fact that Japan accounted for 38 percent of all foreign direct investment, or more than other countries.

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* *Source:* Foreign Capital Flows to Thailand: Determinants and Impact, TDRI, November 1999, p.26-29.

Table 7
Foreign Direct Investment Inflows

	Variables	Standardized Coefficients	T-Statistics
1st	Export Performance[1]	0.308**	6.094
2nd	Current Account Deficit	-0.158**	-3.968
3rd	Growth Performance[2]	0.041*	1.895
4th	Baht per Yen Volatility	-0.035*	-1.551

* Significant at 10% level, ** Significant at 5% level

R^2 adjusted = 0.962 D.W. = 2.23

1 Export value is used as a proxy for the export performance.

2 Due to lack of monthly data, the private sector use of electricity is used as a proxy for the growth performance.

Portfolio investment (Table 8) Economic fundamental factors (e.g., manufacturing production index, stock exchange index) are equally important to technical factors (e.g., baht per U.S. dollar volatility, forward cover, and interest rate differentials). In contrast, the adequacy of foreign exchange reserves (in terms of import expenses) is not very meaningful to foreigners in the stock market as well as direct investment.

Table 8
Portfolio Investment Inflows

	Variables	Standardized Coefficients	T-Statistics
1st	Growth Performance[1]	0.267**	4.203
2nd	Baht per Dollar Volatility	-0.245**	-2.750
3rd	Stock Market Performance[2]	0.244**	5.545
4th	Swap Rate	-0.236**	-2.399
5th	Interest Rate Differential	0.224**	2.311

* Significant at 10% level, ** Significant at 5% level

R^2 adjusted = 0.842 D.W. = 2.11

1 Due to lack of monthly data, manufacturing index is used as a proxy for the growth performance.

2 Stock Exchange of Thailand (SET) index is used as a proxy for the stock market performance.

Loans (Table 9) Interest rate differentials and exchange risks are primary determinants of loan inflows. But it is notable that the latter commands more weight than the former. In other words, in negotiating cross-border credits, lenders and borrowers gave more attention to exchange rate stability than to differences of interest rates. This outcome is particularly consistent with the actual situation in

1997-98. During such period, exorbitant interest rates of the baht could not attract much capital inflows because the baht value was under heavy pressure. And when the baht retrieved its stability, even though Thai interest rates were less than a half, there were more capital inflows than during the crisis.

Table 9
Loan Inflows

	Variables	Standardized Coefficients	T-Statistics
1st	Swap Rate	-0.405**	-4.272
2nd	Interest Rate Differential	0.302**	2.514
3rd	Baht per Dollar Volatility	-0.173**	-1.933
4th	Reserves to Imports Ratio	0.148*	1.701

* Significant at 10% level, ** Significant at 5% level

R^2 adjusted = 0.764 D.W. = 1.96

Non-resident baht account (Table 10) It is unsurprising that deposit rate differentials, forward cover or swap rate, and stock market index represent important determinants as to whether foreign investors will shift their funds to invest in Thailand or not. But the following three points are noticeable.

- The foreign exchange reserves to imports ratio, which in a way signifies investor confidence as to how much the debtor country can satisfy its external debt obligations, receives the heaviest weight from foreign investors, and more than that of interest rate differentials. This corresponds well with the fact that these non-resident baht deposits (the amounts of which exceeded those of other types of capital inflows) tended to have short maturities and easily fluctuated depending whether there was any news affecting investor confidence or not.
- Interest rate differentials are more important than the stock market index.
- The deposit rate differential which is statistically significant is the one between that of baht and that of Singapore dollar, not U.S. dollar or yen. Furthermore, the baht volatility which is statistically important is the baht versus Singapore dollar, not U.S. dollar or yen. That corresponds well with the fact that most (roughly 60%) of all non-resident baht deposits came from Singapore.

Table 10
Non-Resident Baht Account Inflows

	Variables	Standardized Coefficients	T-Statistics
1st	Reserves to Imports	0.124**	2.075
2nd	Deposit Rate Differential	0.112**	3.028
3rd	Swap Rate	-0.084*	-1.777
4th	Stock Market Performance	0.071*	1.804
5th	Baht to Sing. Dollar Volatility	-0.061*	-1.623

* Significant at 10% level, ** Significant at 5% level

R^2 adjusted = 0.922 D.W. = 2.23

Foreign investors' confidence represents a very crucial determinant of capital inflows to Thailand. That is immediately evident from the weight of current account deficit in case of foreign direct investment (Table 7) growth performance in case of portfolio investment (Table 8), reserves to imports ratio in both cases of loans (Table 9) and non-resident baht account (Table 10).

Inflation differences between those in Thailand and abroad are not statistically significant. That may be because Thailand was successful in keeping its price stability most of the time in the past, so this factor hardly affected foreign investors' confidence.

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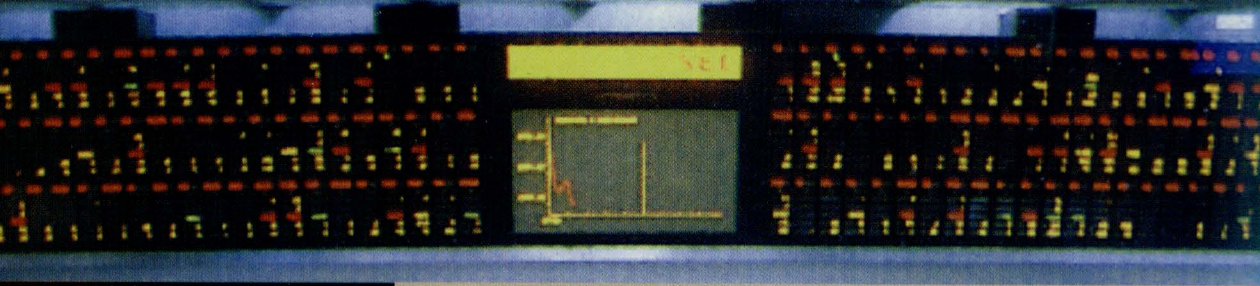

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Financial Reforms in Thailand

The 1997 financial crisis in Thailand was largely due to mismanagement of financial liberalization. Policy consistency and readiness of financial institutions as well as their regulators prove to be extremely essential or prerequisites before any change is to be introduced. After the crisis, the authorities were fairly successful in segregating viable financial institutions from unviable ones, improving supervision, upgrading asset classification and provisioning, encouraging mergers and acquisitions, allowing more foreign participation, and recapitalization. In addition, prudent macroeconomic policy was undertaken despite the economic downturn and social outcry. All these efforts resulted in greater foreign investors' confidence and exchange rate stability. Nevertheless, to cope well with future dynamism in global financial markets, better regulations and supervision are equally important and needed as development of financial institutions' human resources and good corporate governance. In addition, local capital markets as well as private business corporations, especially the SME, should not be neglected.

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