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THAILAND'S FINANCIAL CRISIS OF 1997: A SURVEY AND CRITIQUE OF DOMINANT EXPLANATIONS

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THAILAND'S FINANCIAL CRISIS OF 1997
A SURVEY AND CRITIQUE OF DOMINANT EXPLANATIONS

By

Nussara Sawatsawang

Part I Introduction

Thailand has experienced uninterrupted high growth for decades. Its combination of economic success and domestic policies attracted massive inflows of foreign capital that provided a framework for strong private savings, remarkable investment and export performance. Human resource development was also on an increase as the Thai state placed great emphasis on promoting education at levels of both primary and secondary schools. The World Bank, especially, has long considered this an 'economic miracle', placing Thailand a model of development for other developing countries.

But the Thai economy collapsed in 1997, when real Gross Domestic Product (GDP) growth turned abruptly from over 7% per annum to zero or even negative. The crisis saw a direct impact on foreign-indebted banks, contraction of credit and a disruption of financial intermediaries, with more than two million people expected to be unemployed. On top of this, financial troubles forced Thailand to seek an austerity package of $17.2-billion from the International Monetary Fund (IMF). Devaluation of the Thai baht on 2 July 1997 also had a surprisingly strong contagious effect on neighbouring currencies and stock markets. The Philippines had to float the peso 11 days after the baht's devaluation, followed by Malaysia's ringgit on 14 July and Indonesia's rupiah on 14 August. Hong Kong's stock market gradually fell, and in October reached the biggest percentage fall of 10.4% in more than five years.[1] South Korea's won also dropped below 1,000 to a dollar in November and near 2,000 in December. Subsequently, the governments of Indonesia and South Korea were forced to ask for financial assistance of US$57 and US$40 billion, respectively, from the IMF.

[1] *Financial Times*, 12 January 1998, p.8.

Aside from this regional impact, the crisis has created a nation-wide disparity. A farmer's protest in early February 1998 was a good example. Thousands of Thailand's north-eastern farmers marched from their villages to Bangkok to protest unfair treatment by the government for the rich and against the poor, when hundreds of billions of baht were used to save the financial sector from collapsing in 1997. A front page picture showed their banner:"Liberation! IMF" (*Plod-aek! IMF*). An adviser to the Forum of the Poor (*Samacha-Khon Chon*), a farmer's movement organisation, reported that farmers felt they were 'abandoned', claiming that in addition to the IMF's deal, they had been suffering from other problems such as the state's encroachment of farmers' lands, dam disputes and farmers' debts. They demanded, in a joint statement issued by six organisations working for farmers, that the debt burden of US$70 billion incurred by the private sector must not be placed on the entire country. They also wanted the government to give the people a say in budget allocations and future loans to solve the economic crisis.[2]

This crisis challenges us to find out what went wrong with Thailand. It gives rise to many questions, such as why the central bank spent so much money in failed attempts to defend the baht, why public money was generated to protect a number of collapsing financial firms, what role foreign capital flows played in the country in recent years, and to what extent the IMF has capacity to respond to the financial crisis. As a Thai citizen who has to share the burden of the IMF's loans, I am entitled, like all Thai people, to know why the crisis occurred and which factors drove the country to this situation. The answers will tell not only how the 'miracle' has ended, but also what this means to ordinary people like farmers.

To answer this question, the paper assesses the arguments of the IMF, Thai and Western governments, and Thai and Western academics about Thailand's financial crisis. The IMF, as a global financial agency, and Thai and Western states play key roles in shaping domestic and international responses to today's global financial market liberalisation. Academics also offer explanations about the crisis, representing an independent voice which makes the arguments more relevant.

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[2] A joint statement issued on 29 Januray 1998 by six organisations: Forum of the Poor, the Assembly of Small-scale Northeastern Farmers (*Kloum kasetkorn rai-yoi phak I-san*), Assembly of Northeastern Farmers (*Kloum kasetkorn phak tawan-aok chiang nua)*, Alliance of Northeastern People (*Phan-thamitr chao I-san*), Thai Farmers Foundation (*Mulnithi kasetkorn Thai*), and Northeastern Agricultural Institution Front (*Naew ruam sathaban karnkaset phak tawan-aok chiang nua*). *The Bangkok Post*, 9 February 1998, p.1.

There are four assessments of Thailand's financial crisis. **First**, the crisis occurred because of imprudent macro-economic policy. The IMF, the U.S. and European governments as well as several Thai and Western academics opt for this view. Had Thailand had 'sound' macroeconomic policies which included timely policy action and efficient supervision of the financial sector, they said, the economic meltdown would not have happened. **Second**, the crisis reflected mismanagement of the Bank of Thailand. A report which has been recently endorsed by the Chuan Leekpai government accuses the central bank of misconduct in its defence of the baht, rescue plans to revive the Bangkok Bank of Commerce, and the infusion of billions of baht from the Financial Institutions Development Fund to liquidity-deficient and possibly insolvent financial firms. **Third**, Thailand has structural faultlines: e.g., poor economic structure and corruption caused the economic crisis. The country's labour-intensive strategies in development, argue some Thai and western academics, was short-lived, uncompetitive with emerging low-wage income countries, and destructive to domestic unskilled labour. Corruption is regarded to be deeply embedded in the political-economic system and a source of weakness in national policy. The situation deteriorated when the quality of the technocracy, especially the central bank, declined. The IMF attributes corruption the government's side, whereas some Thai and Western academics opt for the view that corruption is in both the government and the private sector. **Fourth,** the IMF becomes a target of critique which argues that the Fund's internal constraints, such as its nature of secrecy, and quality and quantity of staff triggered the crisis. Besides, the Fund's programmes are criticised for its appropriateness and effectiveness in applying to Thailand and other ailing Asian economies. Many academics from the West are for this argument.

Hypothesis The crisis in Thailand came from multiple sources. It was a product of interactions of related factors, thus, making one difficult to stand alone. To understand how the crisis took place, we therefore must look at national policy which encompasses policy makers, from both private sector and global financial agencies. We must also look at their relations and the structure of authority in areas of decision-making, division of labour, distribution of benefits and rewards, as well as their economic and social costs as a result.

To discuss and evaluate these arguments, the paper compares two models of the crisis. One model is based on the major arguments led by the IMF, and the other on my understanding of the crisis. It recognises that internal more than external factors accounted for the crisis; nevertheless, some essential elements, including the role of the IMF and its relations with other players should not be dismissed. The interactions among the different actors should also be addressed.

By surveying and critiquing these arguments, we obtain a clearer picture of Thailand's economic crisis from different perspectives. The more the crisis is debated, the better the opportunity we have in seeking out what can be and should be done to prevent the next crisis. Learning from mistakes in the past will help us do better in the future, even though some exceptions may apply. As the crisis is still manifesting itself at the time of preparing this research, the quest of what went wrong with Thailand is just a start. The next question, the real question, is to what extent the crisis as well as the IMF's conditionality have impact on vulnerable groups: e.g., workers, children, and elderly people, who have little means to cope with this worst situation. Because the collapse of Thailand's economy saw a sharp deterioration of labour market conditions, especially in the construction, financial services and manufacturing sectors, it resulted in an abrupt decline in new hiring, a significant rise of underemployment, and the increase in open unemployment. In effect, these people will suffer from decreases in household expenditure and household consumption which affect adversely on health and education.[3]

Outline of the Research This paper is divided into four parts. Part one overviews Thailand's financial crisis of 1997. Part two examines explanations about the crisis. Part three analyses these arguments. Part four summarises and concludes the paper.

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[3] There are some studies that start to focus on the the social impact of Asia's economic crisis. See, for example, International Labour Organisation. 'The social impact of Asian financial crisis', technical report for discussion at the High-Level Tripatite Meeting on Social Responses to the Financial Crisis in East and South-East Asian Countries, Bangkok, 22-24 April 1998, and World Healh Organisation. Draft Report on Regional Consultation on Health Implications of Economic Crisis in the South-East Asia Region, Bangkok, 23-25 March 1998.

Part II Survey of Explanations

1. Deficiencies of Domestic Policy

Many attribute Thailand's economic crisis to a large current account deficit, which soared to 8% of GDP in 1997, and an outstanding of external debt estimated at US$94 billions in the same year. The IMF said that these two key factors were behind the massive reversal of capital flows that came into the country during the past few years. Driving forces behind this problem, added the Fund, were imprudent fiscal and monetary policy, failure to limit an overheating economy which was manifested in large external deficits and property and stock market bubbles, preserving pegged exchange rate regimes for too long, and a lack of prudential rules and supervision in the financial sector that deteriorated bank loan portfolios.

Besides the weak growth of Japan and Europe since the beginning of the 1990s, the IMF and two Thai economists, Ammar Siamwalla[4] and Chalongphob Sussangkarn[5] share the same view that the establishment of the Bangkok International Banking Facility (BIBF) in 1993 brought foreign capital to Thailand. The BIBF was created by the first Chuan Leekpai administration (1992-1995) with the intention of making Bangkok a financial centre for business in Southeast Asia. It permits local and foreign banks in Thailand to take deposits and loans in foreign currencies from abroad, and lend them both in country and abroad. Taking advantage of relatively low 4-6% foreign interest rates, banks and finance firms used the BIBF to facilitate lending by foreigners to Thai companies. In less than four years, the amount lent through the BIBF reportedly was as much as US$ 31.2 billion by the end of 1996.[6]

The BIBF stimulated local businesses, both in family businesses and those listed on the stock exchange, to borrow heavily due to steadily growing debts. The Stock Exchange of Thailand (SET) index rose from 612.86 in 1990 with the circulated amount of 2.63 billion baht per day, to 1,682.09 in 1993 with 8.98 billion baht daily circulated, according to the SET. A report done by the Nukul Prachuabmoh commission explained that the stock exchange

[4] Ammar Siamwallar, in 'What Went Wrong', *The Bangkok Post*, 12 November 1997, p.12.
[5] Chalongphob Sussangkarn, in 'Thailand's Debt Crisis and Economic Outlook', presented at 1998 Regional Outlook Forum, Singapore, 16 January 1998.
[6] Ammar, *ibid.*

became a bubble because of a vicious circle of money lending. Companies tended to increase capital to fund their projects by selling shares in the stock exchange. Financial firms at the same time were willing to give loans to these companies, most of them short-term, so that the projects could take off and the companies could be listed on the stock exchange. The financial firms then took profits from the initial capital gained from those sold shares to run their business and give loans to other companies. (The paper will deal with the commission in details later.)

A significant portion of this excessive debt was used to buy land and invest in real estate, which increased unrealistic asset prices. The average cost of condominium space in Bangkok was 45,000 baht per square metre, relatively high compared with the average income of people living in big cities (60,000 baht a year). The price of real estate in the capital would have increased 10% per year at the time because of increasing demands.[7]

However, the bubble economy was shorted-lived. Housing, real estate, and commercial properties quickly oversupplied the market as early as 1994 and the situation deteriorated in 1996. The fact that property development is a long-term project, but its main source of loans were short-term maturities of 366 days or less put real estate companies in trouble as their investments were not so productive to generate sufficient income to service the debt. Thailand's outstanding foreign debt was estimated to rise from only US$ 28.8 billion in 1990 to US$ 94.3 billion at the end of 1996, US$ 63 billion of which belonged to the non-bank private sector.[8] Heavy short-term foreign loans and a fall in domestic asset prices also sharply increased the fragility of the banking system. The Bank of Thailand, as a result, had to suspend operations of 58 Thai financial firms in Bangkok in 1997, 16 in June and the rest in October, out of an original 91.

Pegging exchange rates to the US dollar was also a key factor in Thailand's economic turbulence. During the 1990s, Thailand and other Southeast Asian countries held their currencies stable against a basket of currencies dominated by the US dollar.[9] According to

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[7] *The Bangkok Post*, 3 March 1998.
[8] Ammar. *ibid.*
[9] The Thai baht was delinked formally from the US dollar in November 1984, allowing it to be valued in relation to a basket of currencies. However, analysts say the US dollar accounted for about 80% of the total basket, representing Thailand's trade weight with the United States.

Steven Radelet and Jeffrey Sachs,[10] one major effect of tying the exchange rate to the US dollar was that it attracted considerable foreign capital investment many of which enhanced export potential and contributed to economic growth. The de-facto fixed exchange rate also had a negative implication, the American economists said, adding that it gave misplaced confidence to financiers that the baht could be converted into dollars anytime and that the local economy was able to earn dollars to meet the fixed obligations of the loans. This put financiers at risk as it proved later that domestic property developers were unable to repay dollar-denominated loans when property markets weakened and the baht depreciated in 1997.

The baht currency regime came under pressure after mid-1995, when the US dollar began to appreciate sharply by about 38% against the Japanese yen and 27% against the Deutsche mark in 1997. As a result, Thai and other Southeast Asian currencies also appreciated sharply against these currencies. In effect, the baht's appreciation made Thai products more expensive and therefore less competitive, especially in the Japanese market which is Thailand's major trading partner. Together with the baht's over-valuation, Thai exports also faced stiffed competition from China, which had devalued the yuan in January 1994. The growth of Thailand's exports then fell from more than 10% per annum to 0% in the second half of 1996.

This revenue shortfall and persistent large current account deficits which ended up in a sharp decline in the baht's value created doubts and lowered confidence in the Thai economy, said the IMF. Investors and foreign creditors started to withdraw money from Thailand's stock market, and Thai banks and financial companies, besides the heavy burden of non-performing loans, inevitably suffered a massive reversal of short-term foreign capital flows. The IMF and western governments concluded that a weakness of policy planning was behind the economic crisis. As Alan Greenspan, U.S. Federal Reserves Chairman pointed out, the root of the problem was ''poor public policy that has resulted in misguided investments and very weak financial sectors.''[11]

[10] In 'Asia's Reemergence' *Foreign Affairs*, Vol. 76 No.6, November/December 1997, pp.44-59.

[11] In a testimony before the Committee on Banking and Financial Services, U.S. House of Representatives on 30 January 1998.

The fact that appropriate domestic policies were important for policy-makers to run the country along with a liberalisation of global finance was largely debated. The Thai government, though acknowledging problems with the bubble economy and policy mismanagement, argued that handling financial liberalisation and putting in place adequate regulations were relatively new and inherently complex areas of policy. Developing countries, like Thailand, are "less well prepared and equipped to handle all the challenges of liberalisation," said Prime Minister Chuan in the remarks at the second Asia-Europe summit. Chalongphob added that a lack of sufficient discipline in debt creation of the private sector must also be taken into account. This included borrowing that exceeded the firm's capital, without considering exchange rate risks, and over-investment. American economist Paul Krugman came up with a theory of intermediaries' irresponsibility. Its moral hazard--to reap the rewards from their actions when things go well but not suffer the full consequences when things go badly--was done through borrowing an excessive short-term money from abroad and then lent that money to speculative investors largely in real estate.[12]

2. Mismanagement at the Bank of Thailand (BoT)

In an attempt to explain the crisis, the present Chuan Leekpai government focused specifically more attention on policy mismanagement at the BoT. Having resumed office for the second time, after Prime Minister Chavalit Yongchaiyudh resigned on 6 November 1997 due to political and economic pressure, the Chuan administration on 16 December appointed former finance minister Nukul Prachuabmoh to head a commission to conduct a report on malpractice in the central bank.

The 205-page report entitled "Facts about the Economic Crisis" *(Khor thed jing kieuw kab sa-thanakarn vikrit thang sethakij)* was endorsed by the cabinet on 6 May 1998. It concentrated on three areas: the baht defence against money onslaughts, the bailing out of the Bangkok Bank of Commerce, and mismanagement of the Financial Institutions Development Fund.

[12] See Paul Krugman's article 'What happenned to Asia?' January 1998, in <http://web.mit.edu/krugman/www/DISINTER.html>

2.1 Defence of the Baht

The BoT spent billions of dollars from foreign currency reserves to defend the baht from fierce attacks by money traders and speculators. The attacks, starting in December 1996 became tense a few months later and again in May 1997, were aimed to pressures Thai authorities to devalue the baht so that these speculators could make profit from the difference in exchange rates. Nevertheless, the commission said that money traders and speculators had some grounds to anticipate that a slowdown of exports which eroded the current account deficits, and investors' suspicion of borrowers' ability to service the debt, would force the Thai government to devalue the baht one day to sustain its economy. Speculators heavily sold the baht, and the game became fiercer when the BoT intervened markets by buying the baht to support its value but eventually had to give up the fight because of huge losses in the stock of foreign currency. This unsuccessful attempt almost depleted the official reserves which plunged from US$ 38.65 billion as of February 1997 to US$ 2.5 billion at the end of May, according to the commission.

According to international financial rules, a stable foreign exchange rate requires the BoT to have adequate foreign currency reserves and be prepared to spend them in purchasing or buying money upon market demand. To fend off the baht, the BoT spent US$ 4.88 billion in December 1996, US$7.8 billion in January-February 1997, and almost US$10 billion in mid-May 1997 for that purpose, according to the commission. On top of this, the BoT secretly sterilised the impact of baht attacks and the Bank's defence by borrowing the US dollar in the forward markets and from swap transactions to support its foreign reserves. Under the swap transaction deal, the BoT forwarded the baht it purchased in exchange with the US dollars, and had to return the US dollars at the exchange rate at the time the deal was terminated, probably within two days, six months or one year. In effect, the BoT had accumulated a total loss of 331 billion baht (about US$13 billion before the baht's devaluation on 2 July) from the settlement of forward and swap deals with US$ 18 billion in obligations at the end of 1997.[13]

The Bank claimed that the swap transaction was considered an effective tool in diminishing the impact of currency attacks and maintaining money circulation in the market. Had the

[13] *The Bangkok Post*, 2 May1998.

Bank bought the baht and kept it longer, this would have created deflation and high interest rates, it was argued. Moreover, when the Bank borrowed the US dollars under the swap transaction, the market would not have known the amount of foreign reserves that had been spent in its defence operations. The commission, however, argued that the swap transaction enabled the Bank to hide an aggregate figure of the reserves from the public. In practice, the BoT was unable to hide this information from its currency trading partners who represented as its agents in making up the swap contracts. These agents, including some major domestic banks and foreign financial institutions, were reported to turn to attack the baht by themselves or through their affiliated agents due to their privileged knowledge about the Bank's move, the commission pointed out.

After the great loss of foreign reserves, the BoT was forced to abandon its fixed exchange rate policy and let the market determine the currency's value. It announced a 'managed floating' of the baht on 2 July 1997. To meet short-term obligations, Thailand also had to approach the IMF in mid-August for rescue funds of US$17.2 billion. The Fund committed for US$4 billion, Japan US$4 billion, Australia, China, Hong Kong, Malaysia and Singapore US$1 billion each, and Indonesia, South Korea and Brunei US$ 0.5 billion each, and another US$2.7 billion in structural adjustment loans from the World Bank and Asian Development Bank to help cushion the social impact and restructure the financial and industrial sectors.

The commission said the baht-defending efforts without regard to foreign reserves stemmed from the BoT's stance to maintain the foreign exchange policy. The Bank resisted despite the fact that it had realised the pressure of the baht currency which derived from a slowdown of exports and a deteriorating economy, a fragile banking and financial system, and the fall of real estate. Moreover, the BoT underestimated the prevailing difficulties that it ignored the IMF's continuous calls to adjust foreign exchange policy, the commission said. It quoted a BoT report as saying that as early as 1994, the IMF suggested the BoT have a greater degree of exchange rate flexibility by expanding the bandwidth of the baht in order to ease the tense dollar-denominated foreign exchange and to limit overheating an economy that had borrowed foreign capital.[14] The calls were tense at the end of 1996 and early 1997, when the IMF ''strongly'' suggested the BoT to devalue the baht, ''otherwise it will entail the risk [of a rapid rundown in reserves] and excessive loss''. Moreover, it ''will create contagious effect

[14] See the IMF's positions regarding to the baht preservation in the report, p. 17-18, 31-34, 72-73.

to the region.''[15] The IMF's managing director Michel Camdessus himself kept contacting the government's high-level officials through private meetings, direct calls and letters, and even wrote a letter to then Prime Minister Chavalit Yongchaiyudh on 20 May about the urgent need to devalue the baht.

The commission blamed all those who were responsible for the Bank's failed attempt to defend the baht, which included Prime Minister Chavalit, former Finance Minister Amnuay Viravan, former Central Bank Governor Rerngchai Marakanond, then Deputy Central Bank Governor Chaiyawat Wibulsawasdi, then Assistant Central Bank Governor Siri Garnjaroendee, Director of Banking Affairs Bandhit Nijhavorn, and the BoT's Head of the Analysis and Capital Market Paibul Kittisrikanwang. It was particularly harsh in its criticism of Mr Rerngchai, saying that the former Central Bank Governor must take the biggest blame for those decisions. The conduct, the report said, was :

> ''unbecoming of the Central Bank Governor because this is a very important position described by some as even more important than that of finance minister.....This is because if the finance minister made a mistake in his decision, either on budgeting, revenue collection or loan, the damage incurred would not be as serious and extensive as in the case of the depletion of foreign reserves by the central bank. As such, there were no excuses for Mr Rerngchai to avoid the responsibility for the damage done to the central bank and the people of this country.''[16]

2.2 The BoT and measures to solve financial problems at the Bangkok Bank of Commerce (BBC) and its impact on monetary system.

The Nukul commission blamed the BoT, especially the former Central Bank Governor Vijit Supinij for indecisive measures and a lack of transparency to tackle the failed BBC, a top-ten commercial bank in Thailand.

Financial problems started to emerge at the BBC in 1991 when it was found that the bank had doubtful assets 3.6 times higher than the average for other banks. The doubtful assets

[15] According to a conversation between David Robinson, the head of IMF delegation, and Siri Garnjaroendee, assistant central bank governor during the annual meeting in March 1997, *ibid*, p.34.
[16] This version was translated into English by *the Bangkok Post*, 2 May 1998.

increased over the following years with bad debts of as much as 20 billion baht in 1994. It was discovered that part of the bad debts were loans the bank had extended to individuals to take over listed companies in which Rakesh Saxena, former treasury adviser to the BBC, had a vested interest. Rakesh, 44, has been on charges of defrauding the BBC of about US$ 62 millions involving 23 cases. He was arrested in Canada in June 1996 and has been fighting extradition on request of the Thai government.[17] Rakesh's alleged embezzlement triggered the collapse of the BBC. The public panicked at the bank's financial troubles and customers flooded to withdraw their money when the issue was raised during a no-confidence debate in parliament on 8-10 May 1996. The BoT decided to take over the BBC and fired the bank's president Krirkkiat Jalichandra.

The commission noted a big flaw in the BoT's measures. The Bank did not order the BBC to write down its capital before recapitalisation. In 1995, the central bank ordered the BBC to increase its capital by three billion baht and an additional 3.7 billion baht in the following year. The cutting down of capital before the increase requires old shareholders to take their losses and be responsible for their mismanaged operation in the past. Failure to act implied that the central bank tried to hide facts from the public, depositors and the bank's creditors, said the commission. On top of this, when capitalisation proceeded slowly, the Bank itself, through the Financial Institutions Development Fund that it monitors, and the Government Savings Bank, bought these shares.

2.3 Mismanagement of the Financial Institutions Development Fund (FIDF)

The FIDF was established in 1985 to "restore and develop a financial institutional system for security and stability", according to the Act of the Bank of Thailand. The Act's provision allows the FIDF to "do all activities about or related to" to meet this purpose. It implies that the FIDF is entitled to infuse money to revive private banks and financial institutions, according to the Nukul commission. However, problems occurred when the BoT did not separate the liquidity problems of financial firms from their poor operations which resulted in an inability to service the external debt, the commission said. It added that a lack of vision and policy planning to cushion the prevailing problems not only resulted in the use of public

[17] *The Bangkok Post*, 24 March 1997.

money for that purpose. It also led to inconsistency of measures to handle the problems, thus prompting domestic and foreign investors to have no faith in the Thai economy.

Draining the FIDF started in 1996, when it deposited money in the BBC for 25 billion baht as part of a plan to "ease the liquidity crunch." It also extended another nine-billion baht loan to the BBC and its affiliated company, Thai Fuji Finance and Securities. By the end of June 1997, the loans were increased to 300 billion baht, half of which went to 16 financial firms that were ordered to suspend their operation a few weeks earlier. At the end of 1997, the FIDF's burden was estimated at 700 billion baht for its attempt to shore up these cash-strapped financial firms.

Aside from funding troubled financial firms, the BoT ordered several firms, including Finance One, the country's largest financial companies, to increase their capital. On 14 March 1997, Finance One reached an initial agreement with the state-run Krung Thai Bank for a merger deal, but the plan did not materialise due to the company's huge financial problems. Finance One which alone had received 37.5 billion baht from the FIDF in the first quarter of 1997 was among 16 financial firms that were ordered to halt operations in June. Total assets of the suspended 58 firms, 42 of which were announced later on, were 868.1 billion baht, according to the commission.

3. Structural Fautlines

3.1 Economic structural problem.

There had been some warning flags two or three years before the crisis. American economist Paul Krugman was among those who were skeptical of Asia's economic 'miracle', saying Asia's growth, in fact, was unimpressive because it was based on investment spending and mobilisation of resources rather than efficient productivity. Workers simply work harder because they have better machinery, not because they are better managed or have more technological knowledge. Therefore, the growth in Asia has so far been mainly a matter of 'perspiration' rather than 'inspiration', Krugman said. His warning suggested that the growth would fall down eventually.

Since the early 1990s, Thailand has promoted labour-intensive manufactured goods as part of its export-oriented strategy adopted over the past three decades. This approach attracted foreign direct investment from Japan and the Asian Newly Industrial Economies (NIEs), such as Hong Kong, Taiwan, and South Korea, to relocate their plants in Thailand's labour-intensive manufacturing operations. Its export-oriented boom plus an advantage of low wage labour began with textiles and apparel and took off with electronics.

Thai wages eventually exceeded those of Indonesia, China, and the Mekong countries: Laos, Cambodia, Vietnam and Burma. For example, a Laotian worker in a garment factory earns only 1,000 kip or about 35-45 baht a day, three or four times lower than Thai workers whose minimum wage is guaranteed at 157 baht per day in Bangkok and 140 baht in provinces (one baht equalled to 30 kip before the baht's devaluation). The wage increase was because of the bubble economy, which ''has produced no longer cheap labour in labour-intensive production,'' said Rangsan Thanapornphan, a Thai economist.[18]

Foreign investment then turned to other places where labour was cheaper. In competition with China, which devalued its currency in early 1994, and a decline of demand in the world market, Thailand's exports became uncompetitive. According to the Thailand Development Research Institute, exports of garments and shoes declined by 30-40% in 1996, compared to total increases by over 20 percent in previous years.

Under the 'flying geese' model which was initiated by Japanese Kaname Akamatsu in the 1930s, Radelet and Sachs suggested that developing countries gradually move up in technological development by following in the pattern of countries just ahead of them in the development process.[19] South Korea and Taiwan adopted this model by taking over the textile and apparel industries from Japan. The Thai government has been well aware of the need to move up the manufactured industries to higher-valued products with technological incentives. But Nidhi Eow-sriwong, a well-known Thai sociologist, expressed doubts over how far Thailand can achieve this goal as Thai workers are unskilled and research and

[18] In 'The Three Aspects of Thailand's Economic Crisis' (*Sam vikrit karn sethakij Thai*), *Manager Daily*, 27 August 1997, p.6.
[19] *Ibid*, p.52.

development have not been improved so far.[20] These workers are regarded as one of the most vulnerable groups as the crisis saw the closure of a number of factories and construction sites. Worse still, Nidhi said, these people cannot go back to their home in the upcountry because family-based agricultural industry had already collapsed as a result of Thailand's industrialisation process.

3.2 Corruption

The IMF, Thai and Western academics regard corruption as a crucial factor that stimulated the crisis. The IMF emphasised that the government's lack of transparency, and its close link with banks and corporations must be cleared away under the global theme of 'Good Governance'.[21] Thai academics acknowledge that corruption or economic rent has been growing along with Thailand's rapid economic pace. Economic rent, as Nidhi defines it, is a bribe that entrepreneurs pay to politicians, public servants, and local influential figures, so that their business can run smoothly. Bribery appears not only at the beginning of bidding for project investment, but also in the whole process of doing business. This economic rent put an additional cost on Thai products which made them less competitive in the international market, Nidhi said. According to Chai-Anan, mega-projects' prices were 150 percent higher than the real cost during the economic boom.[22] With respect to the economic crisis, Rangsan said, corrupt politics and deficiencies of the decision-making process made politicians, the Bank of Thailand and the Ministry of Finance ignore, or dismiss a need to prepare an efficient mechanism to handle financial account liberalisation.[23] Thailand is paying now for its corruption.

Corruption was reinforced when the Bank of Thailand, which once had a reputation for incorruptibility and enjoyed considerable autonomy, eroded in quality, said Ammar.[24] A faulty management structure of the BoT was considered a major constraint of this decline of

[20] See Nidhi Eow-sriwong. 'The National Agenda in Economic Approaches' (*Vara-haengchat thang sethakij*), *Matichon Daily*, 15 August 1997, p.13.
[21] See, for example, 'The IMF and Good Gobvernance' Address by Michel Camdessus, the IMF's Managing Director at Transparency International. Paris, France,
21 January 1998, in <http://www.imf.org/external/np/speeches/1998/012198.htm>
[22] Chai-Anan Samudavanija, 'Good Governance (GG=Go! Go!)' *Matichon Daily*, 9 August 1997, p.17.
[23] *Ibid.*
[24] *Ibid.*

technocracy. He pointed out that the Bank gave the governor too much power and that led to fights among top management for the post which undermined effective teamwork. This has happened since the appointment of Vijit Supinij in the early 1990s. In addition, central bank governors also tended to follow the current political line and to be accountable only to the Minister of Finance who has the absolute authority to fire them. Ammar calls this practice "implicit intervention" by the Minister of Finance. The Thai baht's devaluation was a case of such implicit intervention. At the beginning, the central bank and the Ministry of Finance tended to minimise conflict by gravitating towards a fixed exchange rate regime. But when the time came to alter the pegged rate at the beginning of 1997, the BoT was reluctant to do so because of fear of political repercussions, according to him.

Krugman related corruption to the role of financial intermediaries which were central players in the crisis. He said strong political connections of the owners of most such institutions were "implicit guarantees" for creditors and depositors to lend money to them. This facilitated the underregulated financial companies to borrow excessively short-term loans from abroad and then re-lend that money to speculative investors largely in real estate.

Nidhi, Rangsan, Ammar and Chai-Anan attribute corruption to the vicious circle of local politics which greatly affected the national political system. Would-be-politician businessmen would buy votes to gain a seat in general elections. Once elected, they would not pay much attention to national policy issues, but look for chances to recover money which they would then spend at election time. They also tended to generate as much as possible public expenditures for development projects in their own constituency. Such projects generate benefits to the rural elite who are quite active in the construction business, said Ammar, adding that politicians and rural elite cooperate in buying votes.

4. Critique of International Factors

Besides the domestic environment, there are critiques regarding international factors, especially the role of the IMF. These attacks focus on the Fund's secrecy, lack of quality and quantity staff, the appropriateness of the fund package for the Asian economies, and the programmes' implications. Rudi Dornbusch expressed concerns over the Fund's failure to make Thailand's economic meltdown public in terms of its current accounts deficit, the deeply damaged banking system and large unhedged foreign loans.[25] In addition, Sachs related these structural constraints to the IMF's legitimacy, saying a lack of public debate, comment, scrutiny, or substantive public documentation of its decisions was unjustified with taxpayers' money and the faith of 350 million people in three Asian countries that the Fund dictated. He also criticised the Fund's 1997 annual report which yet praised Thailand's "remarkable and the authorities' consistent record of sound macroeconomic policies." on the eve of the crisis. The IMF staff who prepared the report, half of the total 1,000 economists responsible for as many as 75 countries, may not have deep knowledge of the real situation and of the country's financial system, he accused.[26]

In view that Asia's financial crisis was merely a matter of panicky investors, Sachs advocated more expansionary fiscal programmes to offset the economic slowdown. He complained that the Fund's orthodox financial conditions, such as cutting budget deficits, raising sharply interest rates, and restricting central bank credits, did more harm than good to engender confidence. He also cited the IMF's calls for bank closings as worsening investors fled from the region. Another American economist, Martin Feldstein, shares this view, saying that the IMF's remedy applied to Asia was not different from that employed in Eastern Europe and former Soviet Union in the late 1980s.[27] Instead of imposing conditionality of reforms, he urged the Fund to give technical advice and limited financial assistance in dealing with the crisis, and leave alone the legitimate political institutions of the country to determine the nation's economic structure. The reforms that are claimed to restore the country's access to international capital market, Feldstein implies, were simply to take the open trade and investment agenda of the United States and major countries' into the IMF's funding conditions.[28] Moreover, substantial financial backing by cushioning the losses of investors, could exacerbate a moral hazard problem as the Fund's loans will encourage creditors to maintain the debt payment, according to him. Because the IMF's credit package is served to

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[25] Dornbusch, Rudi. 'Asian Crisis Themes' in <http://web.mit.edu/rudi/www/asianc.html> February 1998.
[26] Sachs, Jeffrey, 'The Wrong Medicine for Asia', *New York Times*, 3 November 1997, and 'IMF is a Power unto Itself', *Financial Times*, 11 December 1997.
[27] In 'Refocusing the IMF', *Foreign Affairs*, Vol.77. No.2, March/April 1998, pp.20-33.
[28] A link between the IMF and major industrialised countries could be seen in the Fund's structure of contribution and voting power which results in a chain of command. The United States, for example, obtains 265,000 votes from the approximate of US$38 billion, or about 18 percent of the total of IMF quotas. For additional information. See, for example, David Driscoll,'What is the International Monetary Fund'. in <http://www.imf.org/external/pubs/ft/exrp/what.htm#6>

meet the country's obligation to foreign creditors, these creditors would consider this availability of dollars to be guaranteed by the IMF. As a result, again, they will take excessive foreign exchange risks of the debtor countries, he reasoned. Rather, he suggested that both borrowers and lending bankers bear primary responsibility for resolving these problems when their corporations cannot meet the international debt obligation.

These criticisms have drawn some responses from the IMF. In terms of its acknowledge of an impending crisis since 1996, the IMF argued that it could not make that information public because doing so would have made it lose access to information and its ability to act as a confidential adviser to governments. Moreover, it could create a crisis that otherwise would not have happened.[29] The IMF also defended its tightening fiscal and monetary programmes as well as the closing of insolvent banks to make up for functional problems in a particular country. Although it admitted that Asia's financial crisis was based on swings of investor confidence, it argued that causes of the crisis in Thailand were a large current account deficit, weak financial institutions and inadequate bank regulations and supervision. Therefore, its programmes were aimed to solve these problems. Besides, as the Fund's loans come from member states' contributions, it lends that money that must be repaid. This is the ultimate purpose of its loans.[30] Western and Thai governments support the Fund. The Group of Seven which consists of Britain, Canada, France, Germany, Japan, Italy, and the United States made it clear that the IMF should take the lead in giving financial assistance to Asia's economic recovery.[31] Also, the Thai government pledged to continue working closely with the Fund in improving its economic policies, strengthening Thailand's fiscal and monetary discipline, and take tough actions to restructure financial institutions.[32]

Summary of the Crisis's Explanations

There are two camps of current explanations of Thailand's economic crisis. The major arguments, advocated by the IMF, Thai and Western governments, and some academics, say that Thailand's financial troubles stemmed from internal rather than external factors. Local businesses unwisely used foreign capital flows in a non-productive investment and real

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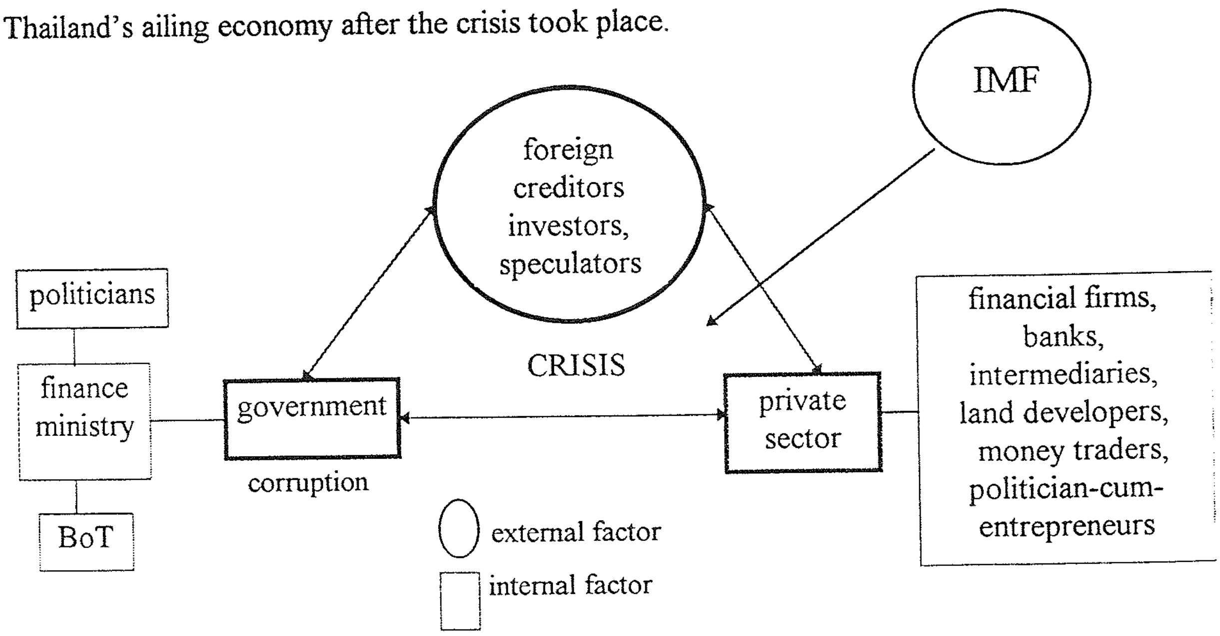
[29] See Stanley Fischer, IMF First Deputy Managing Director. 'The IMF and the Asian Crisis' in <http.//www.imf.org/external/np/external/np/speeches/1998/032098.HTM> Los Angeles, 20 March 1998.
[30] *Ibid.*
[31] According to G-7 Communique, 21 February 1998.
[32] Prime Minister Chuan Leekpai's address at the World Economic Forum in Davos, Switzerland, 30 January 1998.

estate sector which caused huge corporate debts and imbalance of payment. The situation deteriorated when appropriate policies, such as devaluation of the baht, were not introduced in time and corruption was rife. Loss of foreign reserves in defending the baht was also huge such that the Thai government had to call in the IMF to provide it a credit in supporting foreign reserves in order to meet short-term obligation loans and build confidence for investors. The rest of the arguments, which is a minority and mainly advocated by academics from both Thailand and the West, differ over the internal and external factors. Some emphasise the problem at Thailand's short-term growth that promoted labour-intensive productions for exports. They argue that Thailand failed to sustain this strategy because of lack of improving workers' skills and research and development to catch up with higher-valued manufactured industries, competition with emerging low-wage income developing countries, and a decline of demand in the world market. This camp also recognises corruption as driving force of the crisis. Others look at international factors, saying the IMF must take the blames for its secrecy and inappropriateness of its programmes.

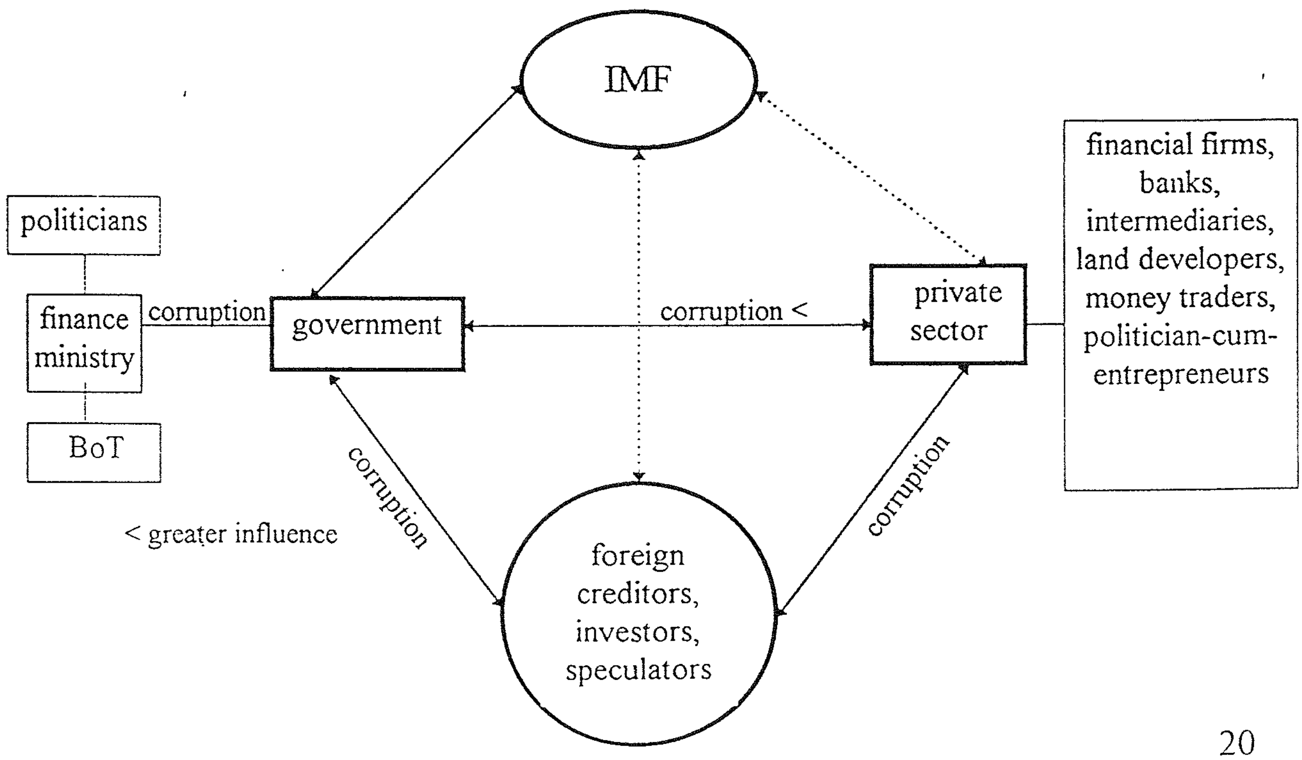
This paper looks at the dominant arguments which play an important role in providing the public of understanding about Thailand's economic crisis. To have a clearer picture, these assessments are represented by Model A as below. It shows a triangle relationship among the Thai government, the private sector and external factors such as foreign creditors, investors and speculators, whose interactions led to the crisis. The corruption is tense on the government side. The IMF is regarded as an outsider who comes to the scene to cure Thailand's ailing economy after the crisis took place.



Part III Evaluation and Critique

Model A provides certain facts, but is inadequate for a thorough understanding of Thailand's economic crisis. There are two arguments I want to raise in response to Model A. First, in Model A only some actors: the government, the private sector and some external factors are accountable for the crisis, which is in part not true. Instead, the IMF should be included in this process of interaction among relevant actors. The post-mortem on Thailand's economic crisis has proven that the Fund played a crucial role in giving policy recommendations to the Thai government, particularly at the onset of the crisis. The IMF, therefore, certainly influences Thailand's policy, affecting other players it involved. It also witnessed a gradual development of Thailand's economic deterioration. Second, Model A does not provide sufficient understanding of the relationship among the relevant actors. Among other things, its vague assumption that only the government is corrupt is inadequate. In the process of these interactions, corruption, in fact, could take place either among state agencies, or between the government and private sector, or even between the private sector and external forces. These practices are founded everywhere, creating a failure of policy implementation and instability in both political and economic system.

To elaborate my arguments, I set up another model, called Model B, which is based on my understanding of the crisis. See Model B below;



Unlike Model A, Model B provides a framework of relationships among actors that include the IMF, and a more complex of interactions among these players. It gives an analysis missing in Model A in three aspects. **First**, the IMF plays a central role in providing advice and responding to the Thai government on national fiscal and monetary policy. In effect, the Fund's policy recommendations will have an impact on the private sector. The Fund and the private sector therefore have an implicit relationship. This relationship is related to the crisis when the Fund suggested the BoT devalue the baht, but was rejected by the latter for fear of negative implications on the private sector. There is also an implicit relationship between the IMF and foreign creditors and investors as the Fund's loans come from these creditors through industrial countries' governments that hold major stakes in the Fund. Their relations are seen in the Fund's credit package extending to the Thai government which was aimed to guarantee the country's debt obligation to these foreign creditors. In the end, the Fund's programmes are also to be ensured that the debt is serviced so that the Fund can return money to these creditors.

Second, the government and private sectors have equal status, prestige and access to information. In terms of policy formulation and implementation, the private sector influences the government more than the other way round. One major reason is that many politicians on the government side are also entrepreneurs at the same time, or they and officials have their hands in the pocket of some banks or businesses. Thus, they use their connection to influence policies for the interests of themselves and their associates. This led to political interference which certainly affected national policy and continuously caused reshuffling among the top ranks of economic policy makers, hindering policy shift at the BoT and the Finance Ministry.[33]

[33] Amnuay Viravan regined as Finance Minister in June 1997 in a protest at insufficient support for an increased tax on certain consumer goods. Finance Ministry's Permanent Secretary M.R. Chatumongkol Sonakul resigned in July after being ordered to be transferred to Office of the Prime Minister, followed by then Central Bank Governor Rerngchai Marakanond who was forced to quit on July 28 for responsibility of his mismanagement at the BoT. Amnuay's successor Thanong Bidaya also quitted in October for failure to increase oil tax in order to meet the Fund's requirement. Kosit Panpiemras then took the office until then Prime Minister Chavalit Yongchaiyudh stepped down on 6 November 1997.

Third, rewards, sharing of benefits and corruption are related to the second arguments, but they are located in almost every process of relations among the government, private sector, and foreign creditors and investors. The BBC case is a good example of some big holes in the complicated relationship between politicians and businessmen that led to the eventual fragility of the banking system. Although a total of 23 cases of the failed bank are still in the legal process, reports suggest that fugitive banker Rakesh Saxena, who has been charged with cheating the BBC for billions of baht, had established political connections and contributed money to some key politicians in both the opposition party and the government side.[34] Besides, Suchart Tancharoen, Thai Party's sole parliament representative and former deputy interior minister has been accused of placing over-priced land as collateral for loans from this debt-plagued bank. He was also reported to have threatened Mr Rakesh's life were he return to Thailand.[35]

The central bank's spending foreign reserves in defending the baht represents a complex of relationship among the Bank's officials, its commercial banks' representatives and money traders. The Nukul commission's report suggested that some of the central bank's trading agents in swap markets also acted as currency traders and turned to attack the baht. This means they had privileged knowledge about the Bank's move on the baht's defence and the amount of money to be spent. How many people benefited from this process of interactions?

Thus, there is no adequate information available to assess the crisis in model A. Indeed, it fails to recognise the essential role of the IMF, which has long involved in Thailand's fiscal and monetary policy until the crisis took place, not only came to give financial assistance when it was called in. As the crisis encompassed different players, it is also necessary to understand the structural relationship among these players. This is neither presented in Model A. On the other hand, Model A that points to poor governance with corruption behind the economic malaise gives us an impression that once more efficient and effective policies with a good governing state would fare better in a global economy. The truth lies somewhere in between.

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[34] *The Bangkok Post*, 21 September 1996.
[35] *The Bangkok Post*, 22 April 1998.

Many questions arise under the framework of Model B, which provides certain information missing in Model A. Among other things is whether, and to what extent the role of the IMF should be evaluated. The Fund's limited engagement with certain key state agencies and its lack of transparency had a high price to pay. It was unfortunate that the Fund's useful recommendations of Thailand's need to adjust the foreign exchange rate was not made available to the public, even though it raised a warning flag to the central bank as early as 1994. Had the Fund opened a dialogue with the public or civil society along with the government, would the economy have still collapsed or collapsed as severely? Lack of transparency should also be attributed to the Thai government. Its secretive dialogues with the Fund tend to continue in form of loan agreements. The Thai government is reluctant to provide proper information to the public about this agreement, a comprehensive plan for economic recovery, and even the burden and hardship that all Thai people have to share.[36] With respect to secrecy, Nidhi blames both the government and Thailand's social structure that have limited the Thai people's access to know the deal in details and its implication. He says: "We are implicitly forced to accept the IMF's choices. It's because of a decline of our political system that prevent us from decision-making process. It's also because of the society's shallow knowledge system which created this limited choice."[37]

Although the private sector as well as speculators and money traders play on a level playing field of market economy, it is doubtful to what extent supervision can be strengthened on these underregulated market operations, and whether certain regulations can be imposed on these short-term foreign capital flows which at present play crucial roles for a country's economic stability. ,

However, both Model A and B suggest that only certain groups benefited from Thailand's political and economic arrangements. Politicians, technocrats, owners of banks, financial firms, property developers and some members of the middle class were among a privileged minority that cooperated and enjoyed these economically exclusive conditions during the boom period. These exclusive privileges are found in the rising and unrealistic prices of land and the assets of the elite through the BIBF's financial liberalisation, the government's reluctance to devalue the baht in time for fear of negative impact on some businesses,

[36] At the time of writing this research, academics, non-governmental organisations and some civil groups have urged the government to reveal the details of the IMF's loans.

[37] Nidhi Eow-sriwong, 'Invisible Feet' *(Teen thi mong mai hen) Matichon Daily*, 26 September 1997, p.17.

defence of the baht to protect collapsing real estate sector from paying added debt, and the fuel of money from the FIDF to carry weak financial institutions. It is doubtful even now how much this privileged minority will suffer.

Farmers and workers, on the other hand, were excluded from this economic system, though they account for the majority of Thailand's labour force which is still predominantly in the agricultural sector.[38] This exclusion is deeply rooted in Thailand's political and economic structure and developed over time in the country's democratic path, according to Chai-Anan.[39] State-bureaucrats and politicians rule resulted in top-down policies of national development which emphasised high-productivity investment areas, he says. Subsequently, this development planning sucked farmers into an industrialisation process that served exports rather than domestic consumption. It also created related problems such as child labour and prostitution, and a conflict with natural resources among the rural population. It was a social cost that planners could not calculate how much damage industrialisation caused to the Thai society. Worse still, these people suffered the most from the immediate and long-term effects of the economic downturn because they had little means to cope with the situation. A bad sign came. As a result of loss of employment, at least 188,000 unemployed workers returned to rural areas in early 1998, according to the ILO.[40] This return movement put pressure on the Thai agricultural sector which was hard hit by drought in the north and northeast of Thailand.

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[38] According to Medhi Krongkaew. (ed.) (1995) Thailand's Industrialization and its Consequences. New York : St. Martin's Press.
[39] In 'Economic Development and Democracy', Medhi Krongkaew. (ed) (1995) Thailand's Industrialisation and its Consequences. pp.235-250.
[40] *Ibid*, p.18.

Part IV Summary and Conclusion

Explanations of Thailand's economic crisis concentrated on four areas: deficiencies of macroeconomic policy, mismanagement of the Bank of Thailand, structural weaknesses in Thailand's economy such as corruption, and international factors, particularly the IMF. The IMF, Thai and Western governments and some academics tend to emphasise the first two reasons. As for policy failures, it is argued that Thailand did not have timely action and efficient supervision of financial sector to properly handle the massive capital inflows. Second, the BoT was accused of committing misconduct in its defence of the baht which depleted foreign reserves, and a lack of transparency in rescue plans to tackle financial problems at the Bangkok Bank of Commerce, and the funding of a number of failed financial firms. Third, the crisis reflected Thailand's poor economic structure which is based on labour-intensive strategies in development. This resulted in failure to compete with emerging developing countries that provide cheaper labour to attract investors. Many academics from both Thailand and the West advocate this view. Corrupt practices in both political and economic system are also regarded by many including the IMF as sources of the crisis. Fourth, some Western critiques attribute the crisis to the IMF, e.g., its lack of transparency and traditional conditionality applied to Thailand and other Asian countries.

But the sources of Thailand's economic crisis were multiple. However, having compared the two models which analyse the relationship of actors involved in the crisis, the paper argues that there are some missing elements in the dominant explanations: the exclusion of the IMF and the lack of a more sophisticated understanding of the relationship among the relevant actors. Instead of placing the IMF outside the assessment, the paper includes the IMF, arguing that the IMF should be regarded as a factor that cultivated the growth of troubles because of its explicit and implicit relationship with the other actors. In addition, interactions among the government, private sector and external sources such as foreign creditors, investors and speculators must be carefully addressed. Corruption which is widely concerned to have become a source of the crisis did not take place only on the government side. Rather, it appears everywhere during the process of interaction among these players. Nevertheless, the paper finds that there is a lack of lower-level participation, such as farmers and workers, who benefit less than the elite class in this political and economic arrangement, but who end up bearing the majority of the burden for the economy's reform and recovery.

The problems must be tackled through international cooperation, and from within. Some resolutions are left to the international community which at the time of doing this research is still looking for an effective and efficient ''mechanism'' to cope with the challenge of global financial liberalisation. Many suggest, for example, establishing of an early-warning system, collective surveillance of monetary systems, and measures to strengthen the IMF's capacity to respond to financial crisis. This paper, in addition, suggests internal reforms. Among other things, the passage of a new constitution in 1997 is a good sign. This new constitution offers some provisions that radically depart from previous ones, thus giving hope that corrupt politician-cum-entrepreneurs would be unable to find an easy way to gain seats in general elections. Other reforms include promises by the Chuan Leekpai administration to disclose information to the public effectively and transparently.[41] These promises sound good, but we will have to wait for their implementation to see how effective they are.

[41] In Prime Minister Chuan Leekpai's address at the World Economic Forum, *ibid.*

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