Thailand, the IMF and the Economic Crisis: First in, Fast Out?

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Introduction

This paper reviews how Thailand has coped with the Asian financial crisis and discusses in particular:

- domestic reactions to the IMF conditions,
- whether the reforms are likely to be maintained, and
- the near (1 year) and intermediate term (3 to 5 year) outlook for the country's economy.

The freeing of the Thai baht on July 2, 1997 is generally viewed as the trigger for the crisis which has now spread widely in the region and beyond. In August the Thai government called in the IMF for financial assistance and for help in designing measures to deal with the crisis. Before too long, and especially after a change of government in November of the same year, Thailand came to be seen as one the IMF's star pupils. A more appropriate description would be "partner" rather than "pupil". The Royal Thai Government (RTG) has taken almost full ownership of the so-called IMF program. The Fund has shown great flexibility in acceding to Thai wishes and adapting the program to changing circumstances and to domestic political considerations.

As is now well known, the crisis has turned out to be far deeper and widespread than predicted in mid-1997. In successive Letters of Intent (LOIs) with the IMF, economic growth forecasts were revised relentlessly downwards. See Table 1. When the RTG stopped defending the baht in July 1997, it was generally thought to be overvalued

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by 10 to 15%, suggesting the need for a devaluation from the pre-crisis rate of 25 to somewhere in the range of 28 to 31 baht per dollar. By mid-July it had hit 30 to the dollar, and it continued to depreciate. It first hit 40 in late October, and in mid-January reached 56 — a depreciation of 55%.

In recent months, however, there have been signs of stabilization. The baht has recovered and remained in a range of 36 to 38 to the dollar for some time. Interest rates, which had soared in response to government attempts to lean against the wind in the foreign exchange market, have fallen substantially. Inflation, which, despite the substantial devaluation of the baht, had never gone very high (peaking at less than 10% in mid 1998) has begun to fall off. These and other indicators have prompted some observers, and certainly government spokespersons and IMF officials, to suggest that recovery is now in sight. The RTG is predicting positive growth for 1999. However, there are many reasons to believe that this is optimistic.

The paper is meant to be forward-looking. To look clearly into the future, however, it is necessary to review Thailand's policies and its relationship with the IMF in the run-up to and during the course of the crisis. Over this period there has been a complex relationship between economic events, public expectations, domestic reactions to the program, and evolution of the program itself.

Table 1

GDP Growth Projections for 1998 in Various Letters of Intent

LOI #	Date	1998 Growth (%)
1.	August 14, 1997	6.5
2.	November 25, 1997	0 to 1
3.	February 24, 1998	-3 to -3.5
4.	May 26, 1998	-4 to -5.5
5.	August 25, 1998	-7
6.	December 1, 1998	-7 to -8

Background and Run-up to the Crisis: A Case of Malign Neglect

Roots of the Crisis

The factors underlying the crisis are now fairly well understood. As characterized by Radelet and Sachs (1998), it was classic crisis of confidence brought about by several critical features of the Thai economy in 1996-97. (For a slightly longer run perspective, Table 2 provides some key annual macroeconomic data for the period 1993 to 1998.)

Rapid build-up of private short term foreign debt liabilities: This was facilitated and encouraged by the establishment in 1993 of the Bangkok International Banking Facility (BIBF) for offshore banking. Unfortunately, despite some measures to limit this, the facility ended up as a source of short term foreign denominated credits used to finance *onshore* loans, for which the ultimate security in many cases was baht-denominated revenue. This was quite different from the original intent for BIBF to establish Thailand as a regional banking center and serve as an intermediary between offshore lenders and borrowers. Short term debt liabilities were rapidly outgrowing the country's foreign exchange reserves, even more so as the latter were decimated in the government's futile defense of the baht in early 1997 (see below).

A fixed exchange rate regime: The rate had been fixed for so long relative to the dollar[2] that many market participants ignored exchange rate risk. Increased short term capital mobility arising from the BIBF made the maintenance of the fixed rate increasingly problematic. This fact appeared to be lost on most market participants. By early 1997, real effective exchange rate calculations showed the baht to be overvalued by 10 to 15%.

Weak financial system: Adherence to and enforcement of prudential rules had seemed irrelevant and unnecessary in the bubble economy of the previous decade. With annual growth rates of close to 10% for about a decade, it was difficult for bankers to make bad loans, and thus to learn or appreciate the need to assess and manage risk. The spectacular collapse of Bangkok Bank of Commerce (BBC) over 1994-96 as a result of mismanagement and fraud was a harbinger of things to come. The government's failure to appreciate the importance of the systemic problems, its decision to bail out depositors,

[2] It was, in fact, fixed against a (secret) basket of several currencies. But the dollar had by far the greatest weight in this basket (probably in excess of 90%).

creditors and shareholders of the failed bank, and its reluctance to prosecute those responsible sent dangerous signals to the financial community. Cavalier behavior of financial institutions and regulators continued, in an increasingly open fashion, until the outbreak of the crisis.

An overheating 'bubble' economy: Overheating was visible in declining export and import growth beginning in 1996, growing excess capacity in real estate markets, especially in Bangkok, and a rapid decline of the Stock Exchange of Thailand (SET) index which began in early 1996. Investments and expectations had been based for too long on extrapolations of past performance rather than on realistic assessments of actual demand and supply in goods and asset markets.[3]

The Thai economy was in an increasingly fragile state in the year or so prior to the collapse of the baht. The state of the economy was matched by similar conditions in the financial sector and in its regulatory environment.

The collapse of confidence that began in early 1997 resulted in an enormous and unprecedented reversal of capital flows, from a surplus of $19.5 billion in 1996 to an $8.7 billion deficit in 1997. Almost all of this was accounted for by private capital, which went from an inflow of $18.2 billion in 1996 to an outflow of $8.8 billion in 1997.

A key to Thailand's economic success in the 1980s and early 1990s had been her prudent macroeconomic management. This included extremely cautious fiscal policies (running a small surplus almost every year), a non-inflationary monetary policy, and a fixed exchange rate which had been quickly adjusted on the few occasions necessary. These policies, which were consistently followed under a variety of elected and non-elected governments, were largely the responsibility of a highly qualified and dedicated technocracy at the highest levels of key economic ministries and institutions, most importantly the Bank of Thailand (BOT). This system broke down in the run-up to the current crisis. The failures in the BOT were especially spectacular.[4]

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[3] The overheating and the large short term capital inflows which began in 1995 and 1996 can be attributed as well to the government's reluctance to let its clearly undervalued exchange rate appreciate in that period. This is another instance of the government's ignoring good advice from the IMF.

[4] See Ammar Siamwalla (1997).

The IMF claimed to have given many private warnings to the RTG about the country's macroeconomic imbalances and about the need for policy adjustments. Had the RTG responded appropriately to this advice, it is argued, the crisis could have been avoided or at least made much less severe. Due to the privileged nature of the communications, however, neither the Fund nor the RTG released any details of these proceedings, making it difficult to make any judgements on this claim.[5]

The publication of an RTG-commissioned study of the pre-crisis role of the BOT has shed considerable light on the roles of the IMF and the BOT in the period leading up to the crisis (Prachuabmoh *et al* 1998 (Nukul Report)). The Nukul Report provides a fascinating case study, from the inside, of a terrible policy failure. The two principal blunders were the futile and costly defense of the baht over late 1996 and the first half of 1997, and the bleeding of the RTG's Financial Institutions Development Fund (FIDF) to prop up failing financial institutions while neglecting to take other actions to remedy the underlying problems.

The Futile Defense of the Baht

Capital outflows began in the second half of 1996 and intensified in December in response to evidence of ever-weakening fundamentals, especially declining export growth and difficulties of financial institutions. Waves of outflows continued in early 1997 as economic data worsened and concerns about the real estate sector grew. The RTG used its foreign exchange reserves and forward swap interventions to fight off pressures on the baht. It made periodic denials of devaluation rumors, including written commitments not to devalue. These measures did not relieve the pressure on the baht. Foreign exchange reserves, which stood at almost $40 billion in the third quarter of 1996, had fallen to $38.1 billion at the end of February. Furthermore, the government had incurred forward obligations amounting to $12.2 billion as well. In other words, net foreign exchange reserves had fallen from $40 billion to $26 billion.

The attack on the baht resumed in May, and the BOT continued its defense. On three different days, May 8, 13 and 14, the BOT used or committed $6.1 billion, $9.7

[5] Should not the IMF have made its concerns public? The IMF responds that to have done so would have provoked the crisis that it was trying to avoid through its discreet communications with the RTG.

billion and $10 billion respectively of foreign exchange reserves. Having almost exhausted its reserves, it then reverted to the desperate measure of forbidding Thai banks from lending baht in the offshore market. This was an effective temporary measure and imposed large losses on foreign speculators with short positions in baht.

Since the baht defense was conducted largely through forward swap transactions, the country's true foreign exchange reserve position was not apparent from official figures. In fact, until late May even the Minister of Finance claims not to have been aware of the massive drain that had occurred. Even more amazing is the apparent absence of any serious discussion at high levels of government of the need to change or abandon the fixed exchange rate.

As early as December 1996 the IMF had urged the government to adjust its exchange rate system by lowering the weight of the US dollar in the fixed rate currency basket and widening the intervention bands. By late January 1997 it had become much more insistent, and in May it very specifically recommended an immediate devaluation of 10 to 15%, increased flexibility in the rate, and a number of other measures related to the government's overall macroeconomic stance and strengthening of the financial sector. The IMF's advice was delivered frequently and in a number of forms over this period. It included letters from Michel Camdessus and Stanley Fischer to the Thai Deputy PM and Finance Minister, as well as to the Prime Minister, a visit and verbal and written reports to Thai officials by an IMF mission under IMF Article 4, secret visits by Camdessus and Fischer, and numerous telephone calls between Fischer and senior BOT officials.

Further deterioration of economic news and the resignation of Finance Minister Amnuay in late June caused another speculative wave and brought about the inevitable collapse of the baht. By the end of June, the country's net foreign exchange reserves stood at only $2.8 billion, about 7% of their value in late 1996.

FIDF's Bailout of Financial Institutions

The FIDF had been set up in 1985, under the guidance of the BOT, to "rehabilitate and improve financial institutions and to improve their stability". It was funded initially by levies on financial institutions and was used primarily as a source of short term liquidity, usually in the form of temporary deposits, for banks and finance companies in short-term need. In the event that more serious assistance was needed, the principles were that shareholders would have to bear the primary burden of any necessary adjustment and that the FIDF would hold the institutions' assets as collateral against any loans.

As of August 1996 the FIDF had only extended such assistance to two institutions, in the total amount of Bt 9 billion. By the end of the year the number of recipients had risen to 7 and the amount of assistance to Bt27.5 billion. By February these numbers had grown to 15 and Bt53.8 billion respectively.

Difficulties in the finance and banking sector escalated in the face of high interest rates, a rapidly declining stock market and a deeply troubled property and real estate sector. The RTG was indecisive in developing a strategy to deal with these problems. In May 1997 10 companies were singled out for required recapitalization. In late June, 16 finance companies were suspended, while at the same time the government guaranteed both the security of all remaining banks and finance companies, and the assets all of their creditors and depositors. In early August it announced the suspension of 42 more companies. For the remainder of the year it continued to send confused and inconsistent signals about policies to clean up the growing mess. Suspensions that were originally set for 30 to 45 days were dragged on for months until final announcement about the permanent closure of almost all of the companies was made in December.

Meanwhile, deposit runs and rising levels of non-performing loans (NPLs) increased the financial sector's woes. The depreciation of the baht seriously aggravated balance sheet problems of debtors with foreign-denominated loans, with predictable effects on the banks' and finance companies' NPLs . The FIDF continued to bail out everyone that asked for assistance. The total financial commitments of the FIDF as a result of this exercise, in respect of loans to failed companies and guarantees to creditors and depositors, amounts to Bt1.2 to 1.5 trillion (between 26 and 45 billion dollars, depending on the exchange rate used). The amount of this that will eventually be recoverable is not yet known; but it will certainly be far less than 50% of the total.

As in the case of the exchange rate regime, the IMF had been warning the RTG, since at least December 1996, of the serious problems building up in the financial sector and the need for decisive action to deal with them. And, as with the exchange rate warnings, the government failed to take action or to ask for IMF assistance.

Summary

The RTG's response to the growing crisis can most generously be described as one of sustained neglect. "Malign" would be a better adjective. The huge reversal of capital flows that occurred over 1996 and 1997 called for major economic adjustments. The RTG consistently failed to heed warnings from the market, from its own macroeconomic data, and from the IMF. The IMF's advice in late 1996 and the first half of 1997 was generally ignored. Its explicit offer in May 1997 to have Thailand enter a program to deal with the exchange rate and financial sector problems was not taken up, and the IMF was not called in until August. By then the government had squandered over $35 billion of foreign exchange reserves and the FIDF had built up liabilities estimated at Bt1.3 trillion, or about $35 billion at the exchange rate of that time.

Could the crisis have been avoided with more timely and appropriate actions by Thai authorities? This is a difficult question, since some of its roots lay in systemic difficulties with the domestic financial system, the Thai economy and the global economic system.

Could the costs of the crisis have been reduced by more timely and appropriate action? There is no doubt that some of the major costs could been reduced. And a more orderly approach also would have reduced many of the subsequent secondary effects.

How effective were the IMF policy prescriptions? It is to this that we now turn.

Table 2: Basic Macroeconomic Data for Thailand, 1993 to 1998

	1993	**1994**	**1995**	**1996**	**1997**	**1998**
1. % Real GDP Growth	8.4	8.9	8.8	5.5	-0.4	-8.0
2. % Mfg. Production Growth	7.6	6.5	9.3	8.6	-0.6	-11.9
3. % Export Growth (US$)	11.6	22.2	24.7	-1.9	4.9	-6.9
4. % Import Growth (US$)	10.6	18.4	31.8	0.6	-15.7	-33.5
5. Current Account (US$ bill.)	-6.4	-8.1	-13.5	-14.7	-1.3	12.8
6. Capital Account (US$ bill.)	1.1	12.2	21.9	19.5	-8.7	--9.6
6a. Net Private Capital (US$ bill.)	10.3	12.0	20.8	18.2	-8.8	-15.6
7. % CPI Growth (Ann. Av.)	3.3	5.1	5.8	5.8	5.6	8.1
8. SET Index	1,682	1,360	1,281	832	373	356

Sources: BOT *Monthly Bulletin*, *Monthly Statistical Report*, *Key Economic Indicators*, various issues.

First Year of the IMF Program[6]

General Issues

The initial policy program that was developed with the IMF had two focal points: management of the exchange rate and restoration of financial market stability. As the crisis deepened, further programs were developed to improve social safety nets and to provide special assistance to various sectors and activities. The majority of these other measures, however, were developed in collaboration with the ADB, World Bank and bilateral donors. The first letter of intent (LOI) with the IMF was signed in August 1997. Six more have been signed since then, most recently in late March 1999.

Throughout the first half of 1997 the IMF had been urging a continuation of a pegged exchange rate, but with a widened band and less weight given to the US dollar. The fear was that a floating rate would easily swing out of control, with dire consequences for inflation, the financial system and the rest of the macroeconomy. By the end of June, however, and unbeknownst to the IMF, Thailand had almost completely exhausted its foreign exchange reserves, and so there was no alternative to floating the baht.

Nevertheless, a central goal of both the RTG and the IMF was to use fiscal and monetary levers to lean against the wind and try to stop the baht from declining precipitously. On the fiscal side, it was recognized that the FIDF obligations would require additional commitments, and these were estimated at 1% of GDP. To accommodate this and at the same time to achieve a balanced budget, a fiscal surplus on all other items in the amount of 1% of GDP was planned. This was to be achieved through a combination of expenditure cuts and tax increases (primarily an increase in the VAT rate from 7% to 10%). The capital costs of the bailouts would be covered by privatization of state enterprises, which was seen as a desirable goal on its own right. The key to the macroeconomic (read exchange rate) stabilization program, however, was to be tight money and high interest rates. The initial letters of intent with the IMF trumpeted the government's pride in its strict fiscal and monetary discipline. By this standard, monetary and fiscal policies were quite successful. An immediate symptom was the continued rise in interest rates.

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6 See also Siamwalla and Sopchokchai (1998).

The IMF has steadfastly declared, in retrospect, that it recognized the Thai crisis to be quite different from previous balance of payments crises in Latin America and elsewhere (Lane *et al* 1999). Whereas the latter were directly linked to profligate government spending and lack of monetary control, the Thai crisis arose from a buildup of short term private debts. While the Thai government was certainly not blameless for the damage that followed, it could not be accused of monetary or fiscal profligacy in the lead-up to the crisis. Despite this crucial difference between Thailand and Latin America, the IMF's macroeconomic policy prescriptions were hard to distinguish from those offered in Latin America. Furthermore, in public pronouncements of senior IMF officials in the early days of the crisis, it was difficult to detect an appreciation of the differences between Thailand and Latin America.[7] This eventually became a major source of contention in public discussions and evaluations of the IMF program.

Restoration of financial market stability was the other top policy priority. Measures implemented or being planned included tightening of NPL reporting and provisioning rules, and deadlines for and measures to encourage recapitalization of banks and finance companies to acceptable prudential levels. The general idea was to bring performance and the regulatory framework of the financial sector to international standards.

NPL reporting requirements were tightened quite quickly. Phasing in of higher capital adequacy requirements was done much more slowly, with new standards to be met only by the year 2000. As mentioned earlier, there were confusing and conflicting signals over criteria for finance companies to remain in operation or to be permitted to reopen once closed. Part of the problem, arising from lax financial sector supervision and reporting requirements, was a lack of reliable and up-to-date information on bank and finance company performance. Nevertheless, by December 1997 the government had completed its review and made final decisions on the closures of the 58 suspended finance companies (all but two were closed).

A major problem in achieving market-based solutions to recapitalization of banks and restructuring of corporate debts was the absence of a legal and institutional

[7] One possible explanation is simply that the Fund's Asia personnel were largely ignorant of the details of what had happened in Latin America and hence were inclined to follow blindly the

framework for bankruptcy and foreclosure. Under existing laws and regulations debtors had the power to delay and forestall proceedings almost indefinitely, especially in respect of foreclosure.[8] This made foreclosure completely ineffective as a tool for creditors. NPLs could continue to grow, and banks and other creditors had no power to resolve them. Illiquid and insolvent debtors had every incentive to stall negotiations and refuse to make concessions to their creditors. Many debtors who did not face serious liquidity or solvency problems began to make their debts "strategically non-performing".

These problems were not fully appreciated in the early days of the program. It was not until the second LOI (November 1997) that the RTG committed itself to revisions of the Bankruptcy Law by March 31 1998. It was later still before it determined to try to implement a new Foreclosure Law by October 31 1998. As will be seen below, neither of these commitments, nor others related to the legal framework for the investment and the financial sector were properly met.

Initial Economic Effects and Political Reactions

The first LOI was issued by the Chavalit government, which had been so reluctant to take the IMF's advice through the first half of the year. In November, however, the ruling coalition lost the confidence of Parliament, and there was a peaceful and orderly change of government. Unlike its predecessors, the leading party in the new government, the Democrats, had a reputation for being relatively clean and corruption-free. Several widely respected and experienced economic advisors were appointed to key cabinet posts. The new government signed the second LOI with the IMF and pledged not only to honor all of the commitments of the previous government, but also "to take a number of additional measures to strengthen the policy package and reinforce public confidence in the program" (second LOI, first paragraph). With this commitment, Thailand became a full and enthusiastic partner of the IMF. In light of the discredited policies of the Chavalit government prior to the crisis, it would be fair to say that the new government

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policies that had seemed appropriate there.

[8] By simply refusing to appear for hearings, and other similar tactics, debtors could easily postpone proceedings for five to ten years. By making one interest payment they could restart the clock at any time. In such circumstances, the expected return to a creditor from pursuing foreclosure would almost never justify the costs and uncertainties involved. Asset market adjustments required by the enormous shock that had hit the Thai economy would take forever.

had quite strong and general public support in its determination to work with the IMF in developing a recovery program.

Unfortunately, the economic effects of the program did not turn out as hoped. Contagion spread in the region. Despite high and rising interest rates, and the government's adherence to strict monetary and fiscal discipline, the baht continued to fall, reaching 40 to the dollar for the first time at the end of October, en route to a level of 56 to the dollar in mid-January. Rising interest rates and the collapsing baht played havoc with debtors' balance sheets and pushed NPL rates ever higher. The negative wealth effects of the depreciation and the collapse of asset markets, together with the failure of credit markets due to the financial turmoil, depressed domestic demand. The export slump continued, as did the even more severe contraction of imports, as the current account adjusted to the huge drop in net capital outflows. GDP started to decline in the second half of 1997, and continued to do so through 1998, constantly outpacing the (also declining) official projections.

The social implications were serious.[9] Labor market adjustment took several forms. The number of unemployed tripled from 1996 until the end of 1998. There were major reductions both in hours worked and in nominal wages.[10] While the initial labor force impacts were largely in urban areas, the effects were also transmitted to the countryside through both return migration of urban workers, and reduced remittances. On the other hand, agriculture benefited from depreciation-induced increases in domestic currency prices of tradeable goods. Fortunately, CPI inflation has been remarkably low, despite the large baht depreciation.

Thailand does not have a well-developed formal social safety net. There is no unemployment insurance. Many basic social benefits, such as health care, are tied to

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[9] For a summary review of the social impacts of the crisis, and some comparisons with neighboring countries, see Flatters, Kittiprapas and Sussangkarn (1999).

[10] The incidence of significant decreases in wages and hours worked is widely acknowledged. Twenty to thirty percent wage reductions have been common in many sectors. However, poor labor market data make it difficult to make reliable quantitative estimates of the overall incidence or magnitude of these decreases. See Kakwani (1998) for some preliminary evidence on the importance of wage decreases and of underemployment in the adjustment of labor markets to the crisis.

employment and, until very recently, ceased when employment with the firm ended. The main “social insurance” systems have been the extended family and the informal labor market. These have been severely tested in the crisis. Arguably the most important government contribution to social insurance has been the severance penalties specified in Thai labor law, which make it costly for firms to lay off workers. This is the main explanation for the high proportion of labor market adjustment that has occurred through reduced wages and hours, rather than unemployment. This has ensured a certain amount of income spreading that could not have been accomplished under the formal social security system.

Early 1998

Initial forecasts had been of a speedy V-shaped recovery. By early 1998, it was clear that the recession would be deeper and longer lasting than predicted. Manufacturing production continued to decline, as did exports, imports and investment. Nevertheless, except for some gradual relaxation of fiscal targets, primarily on the revenue side, there was no fundamental change in policy direction. And the relaxed revenue projections signified, not a conscious effort to stimulate the economy, but rather a reluctant acceptance of the workings of automatic stabilizers in the tax system.

Meanwhile, the collapse of the baht, high interest rates and the declining real sector continued to create major problems in the financial sector. NPL rates rose, and banks and the remaining finance companies accumulated substantial losses. Although some institutions were hit much harder than others, none were immune.

As economic conditions deteriorated, popular discontent began to develop, and manifested itself in a variety of ways. Stories proliferated about insurmountable problems caused by the credit crunch. Business persons complained about lack of access to and/or the extremely high cost of bank credit. The complete collapse of the baht made the cost of foreign loans unbearable, thus feeding the NPL problems in the financial sector.

Summary

With the change of government in November, Thailand became a full and enthusiastic partner of the IMF. Having freed the baht, the initial focus of macroeconomic policies was to try to stop it from falling precipitously. The government planned a fiscal surplus and tight money with rising interest rates. The baht tumbled until mid-January, and the real and financial sectors of the economy continued to deteriorate. While final decisions were made about the future of the 58 suspended finance companies, little progress was made on either the deteriorating profit, NPL and capitalization problems of the remaining banks and finance companies, or restructuring of the huge numbers of defaulted or delinquent corporate debts. The real sector was reeling from the combined effects of high interest rates and crippling debt burdens.

By mid-1998, public support for the government programs was beginning to deteriorate. It was becoming clear that a fresh look and new policy initiatives were urgently required. But the choices would not be easy.

First Anniversary of the Program: Time to Change Course

Mid-1998 marked a watershed in the evolution of Thailand's IMF program. The absence of the hoped-for rapid recovery and the growing disarray in the real and financial sectors forced a re-evaluation of the program and the development of new approaches.

Macroeconomic Policies

By July 1998, there was widespread and increasingly vocal public pressure on the government to reverse its strict monetary and fiscal stance, which was seen as a major contributor to the alarming contraction of the real sector and the growth of NPLs. In the response to and in general sympathy with this view, the government began to implement a major relaxation of the macro policy regime.[11] Monetary policy was switched from exchange rate to money growth targeting, with a view to producing sharp reductions in interest rates and significant increases in bank lending. The fiscal deficit would be increased. The overall goal was to assist the real sector through lower interest rates, and to stimulate domestic demand. Lower interest rates were also seen as a means of easing

[11] The fiscal deficit targets had been gradually easing over the successive Letters of Intent (LOIs). The target in the first LOI had been for a surplus of 1 percent of GDP. In the fourth, fifth and sixth LOIs the target was reduced successively to -2.5 percent, -3.5 percent, and -5 percent of GDP, excluding the costs of financial sector assistance. Until the fifth LOI, monetary targets had been expressed primarily in terms of the interest rates needed to try to maintain exchange rate stability. The fifth LOI changed the emphasis towards a substantial easing of interest rates and liquidity in order to stimulate domestic demand.

loan payment burdens on debtors. The new policy thrust was announced in the fifth LOI (August 1998).

The most important new fiscal initiatives were funds set up for job creation, local public works and other socially beneficial community activities. Among the most important was a $300 million fund for social investment projects (SIP). The fund is being financed with loans from the ADB. To avoid problems of bureaucratic and political interference, and to ensure that the funds were actually used for genuinely useful community purposes, $120 million of these funds would be allocated directly to community-based NGOs. Special committees were set up outside of normal bureaucratic channels to evaluate proposals and award the funds. The first round of applications and approvals was set for September 1997, with further decisions to be made on a monthly basis after that.

This marked a major change of focus of fiscal and monetary policies, and it was the RTG rather than the IMF that led the way. In its recent internal assessment of its crisis programs in Indonesia, Korea and Thailand (Lane *et al* 1999), the IMF stands quite firmly behind its initial focus on tight monetary and fiscal policies to lean against the wind in the foreign exchange markets. Its only concession is to admit that it might have been appropriate for the RTG to ease up a bit earlier than it actually did. Many critics of the Thai-IMF program suggest that, in light of the huge negative aggregate demand shocks at the outset of the crisis, tight monetary and fiscal policies were wrong-headed from the beginning. A major weakness of the analysis underlying the IMF strategy certainly was its failure to predict the regional contagion that was to follow.

The Financial Sector: General Issues

The government was faced with three interrelated problems.

- How was it to deal with the assets and liabilities of the closed financial institutions, for whom the government, through the FIDF, was generally the largest creditor? The Financial Sector Rehabilitation Agency (FRA) was assigned the task of disposing of the assets of the failed institutions through a series of auctions beginning in mid-1998. The burden of the guarantees on the deposits and credits of the failed firms was assumed by the FIDF. In the absence of adequate bankruptcy, foreclosure and other commercial laws, however, there remained many thorny issues in carrying out these tasks.

- At what pace, and with what sanctions and incentives was the government to enforce new and more strict prudential standards for the remaining banks and finance companies? How was it going to facilitate the huge bank recapitalizations that were obviously required? On these issues there was considerable ambiguity, not in the least because of the public and political stature of the principals in a number of the major banks and thus the government's reluctance to impose harsh measures on them.
- How could the government assist in reducing and facilitating restructuring of the enormous numbers of bad debts in the financial system? The less speedy and efficient the debt restructuring process, the greater the problems facing the banks in meeting tightened prudential standards. The absence of an adequate legal framework, and the need to develop new rules and standards governing the obligations and rights of debtors and creditors in the midst of a protracted crisis has been one of the most difficult challenges facing the government. To define such rules and standards *ex ante*, in a "normal" situation, is very different than trying to do so at a time when enormous numbers of debts are actually in dispute and agents on the opposite sides of existing contracts have very clear, direct and conflicting interests in the outcome.

The government was being pressured by strong and conflicting political pressures. Debtors feared tougher foreclosure and bankruptcy laws, while bankers and other creditors wanted them to have more teeth. Bankers wanted assistance with recapitalization without significant capital write-downs. Domestic and international creditors certainly wanted to ensure the honoring of prior government guarantees on their loans to banks and finance companies. The government did not want to see the huge fiscal costs of its bailout policies spin further out of control.

Bank Recapitalization

In the early part of the IMF program, the RTG announced a tightening of NPL standards (loans would be deemed non-performing once interest payments were delinquent for 3 months, rather than 6 months as previously), stricter requirements for provisioning against bad loans, and an increase in capital adequacy ratios to international standards. The new NPL reporting standard was implemented almost immediately, but the other two requirements were to be phased in gradually until the end of the year 2000.

By mid-1998 the average NPL rate in the financial system was 33% and still growing (see Table 3). As NPLs and operating losses piled up, the capital adequacy of the banks steadily diminished. Accumulated losses alone were already sufficient to wipe out the equity of a number of institutions, even before provisioning for bad loans. The government was understandably anxious, on the one hand, not to force more bank or finance company closures, but on the other to force them to take some drastic measures to increase their capital. In most cases, this would require that existing shareholders take substantial losses. In the absence of adequate incentives, positive or negative, the banks were unwilling to do this. The fact that several of the major banks' major shareholders were extremely well connected and influential made the government reluctant to be very heavy-handed.

An additional concern of the government was that the banks were unwilling to issue new loans, for fear of further aggravating their NPL problems.

The compromise was a policy package issued in mid-August, which contained some carrots and some sticks to encourage recapitalization and increased lending. The banks were offered, on a non-compulsory basis, the opportunity to receive government bonds which would be treated as Tier 1 or Tier 2 capital, and which could be paid back at some later date when the banks were able to recapitalize from other sources. In return for the Tier 1 capital, however, the banks would need to implement the new loan provisioning rules immediately, and match any government capital contributions with capital raised by themselves. This would require significant write-downs of their own capital. The government also reserved the right to change senior bank management personnel. And for the Tier 2 support, they would have to increase lending and debt-restructuring at a rate proportionate to the amount of new funding taken. This was seen by bank management and major shareholders as potentially costly and very risky.

Other options considered and/or proposed included variations of the "Chilean model" whereby the government would take over the NPLs and inject its own capital into the banks and financial institutions. These proposals were rejected for two reasons. First, the government was justifiably concerned about the adverse consequences of asymmetries in information and management capabilities between the government and private lenders and borrowers. Second, there was growing political pressure for the government to switch its attention "from safety nets for the rich to safety nets for the poor". It was feared that bank rescues of the Chilean type would be viewed as further bail outs of the rich and the privileged. This would be especially true if the government did not force big "hair cuts" on the bank shareholders, something it was very reluctant to do.

Interestingly enough, the government only set aside a total of Bt300 billion for this capital support. This was only a small fraction of the total needed to meet the new capital adequacy standards. Estimates at the time suggested total recapitalization requirements ranging from Bt600 billion to Bt1.4 trillion.

Table 3

NPL Rates (%) in Second Half of 1998

	June	August	October	December
8 Private Banks	30.2	33.9	39.5	42.2
State Banks	47.2	50.3	58.3	62.5
Foreign Banks	5.5	6.6	8.1	10.0
Subtotal	31.0	34.4	40.5	43.9
35 Finance Companies	52.6	58.0	63.4	70.0
Total	32.7	36.2	43.3	45.9

Source: Bank of Thailand

Corporate Debt Restructuring

The NPL problem arises primarily because of the impact of the crisis on the income flows and balance sheets of borrowers. After a long period of almost double digit growth, Thailand has almost no experience in debt restructuring. Now that the crisis has struck, it has become clear that there are fundamental flaws in the framework of economic and commercial laws and their implementation. There are also some very serious problems of corporate governance. Without major improvements on these fronts, the prospects for speedy and efficient debt restructuring are very slim.

The main problems relate to weaknesses of creditors relative to debtors in respect of foreclosure, great reliance on personal guarantees in addition to or instead of collateral, large amounts of debt incurred with minimal or no prudential/fiduciary standards, informational problems in tracing contractual guarantees and collateral, and insufficient protection of corporate assets and minority shareholders.

There is as well a growing incidence of "strategic NPLs" — situations in which debtors take advantage of the disarray of the financial system and weaknesses in basic economic and commercial laws to simply refuse to make payments on their debts.

New initiatives in the early to middle part of 1998 were of two types: (i) a commitment to conduct a major overhaul of a number of basic economic laws related to bankruptcy, foreclosure, property rights and restrictions on foreign investors, and (ii) the development of informal, voluntary processes, assisted by a variety of tax and other incentives, to encourage arbitration without recourse to bankruptcy and foreclosure.

According to the fifth LOI, 11 new economic laws and related regulations were to be implemented by the end of October 1998. The 11 laws can be grouped into three categories:

- liberalization of the Alien Business Law and property ownership laws for foreigners,
- a bill to facilitate privatization of state enterprises, and
- amendments to bankruptcy and foreclosure laws and procedures.

Most important and most controversial are the bankruptcy and foreclosure laws. A new bankruptcy law was passed earlier in 1998, but it had been diluted during the legislative process to the point of ineffectiveness. The main goal of the laws is to speed up debt restructuring by increasing the power of creditors relative to defaulting debtors. Among the specific objectives of the new laws are:

- to introduce a new bankruptcy court for competent, transparent and speedy execution of the new laws,
- to redress the imbalance of power of debtors over creditors with respect to foreclosure and in negotiating and enforcing debt restructuring agreements,
- to relieve bankruptcy and foreclosure of the burdens of "small" cases, and

- to reduce the role of and clarify legal responsibilities related to personal guarantees, which have traditionally played a big role in loan agreements in Thailand.

As will be seen further below, these laws have become a source of enormous contention, which is taking a long time to be resolved.

The second part of the new debt restructuring strategy was to develop a parallel, more informal and less litigious means for reaching debt restructuring agreements. To this end the RTG developed the "Bangkok approach", modeled after procedures used in the UK by the Bank of England. A Corporate Debt Restructuring Advisory Committee (CDRAC) was set up and a number of tax and other legal incentives were provided to encourage major corporate debtors to come to market-based debt workout agreements with their creditors. The BOT plays a major role in monitoring and supervising the process. A total of about 350 major corporate debtors, with debts totaling over Bt750 million, have been selected for inclusion under this program.

FRA Sales

By mid-1998 the government had already auctioned a number of the physical assets taken over as a result of the finance company closures. It was now preparing the groundwork for auctioning the more difficult financial assets over the remainder of 1998 and the first part of 1999. This required a number of legal measures to clear obstacles to asset transfers. The value of leases, hire-purchase agreements, business loans and other such assets, and the willingness of foreigners to participate in the auctions, however, would depend very much on progress on the basic economic laws.

The success of the FRA auctions would determine the size of the public sector burdens resulting from the massive FIDF bailouts in 1996 and especially 1997.

Early Results of the Mid-Course Correction

Eased Macro Policies

The easing of monetary and fiscal policies had the predicted effect on interest rates, as both lending and deposit rates fell rapidly and substantially. This has continued until the present. It is important to note, however, that deposit rates have fallen much more than lending rates. This reflects the high costs of non-performing loans, and the perceived risks in issuing new loans. Bank lending has not increased significantly; it has been virtually constant in nominal terms since March 1998 (excluding BIBF credits).

The government has been attempting, but without success, to apply moral suasion to the banks to increase lending.

Nevertheless, the new measures led to a resurgence of stock market investment and a significant "bubblet" in the SET index in the fourth quarter. Slightly more surprising was a further strengthening of the baht, which the BOT actually attempted to restrain. Falling interest rates and improvements in the baht and the Stock Exchange of Thailand (SET) index gave encouragement to policy makers and others who were predicting that the Thai economy was bottoming out and that recovery was now on the horizon. However, most of the real economic indicators — exports, imports, manufacturing output, investment, bank lending, employment — had yet to show any signs of reversal.

The government's new spending programs were implemented very slowly. Of the $120 million SIP fund set up last August, only $1 million of expenditures had been approved by February 1999. This represents about 110 small projects out of over 5,000 for which proposals have been submitted. The insistence on transparency and accountability, while having much to recommend itself on grounds of good governance, is proving to be costly in terms of delayed program implementation.

Bank Recapitalization

Throughout the remainder of 1998 there was very little progress in bank recapitalization. Not a single bank took up the government's Tier 1 or Tier 2 recapitalization offers. While two banks had recapitalized by submitting to foreign takeovers and one other had found a foreign investor (and all of these events had occurred prior to the mid-August package), the remainder of the banks have continued to avoid the government's recapitalization programs. Several banks have taken advantage of a combination of gullible depositors and loose definitions of capital to raise new quasi-equity by converting deposits to "Stapled Limited Interest Preferred Shares" (SLIPS) and "Capital Augmented Preferred Shares" (CAPS). These are both instruments that dress up combinations of subordinated debt and preferred shares to qualify as Tier 1 or Tier 2 capital, and enable the banks to raise capital without diluting original shareholders' equity.

In sum, the August package has not succeeded in facilitating recapitalization. The total amount of recapitalization required is difficult to estimate, but recent (early March) estimates of the banks' and finance companies' additional capital requirements this year range from Bt700 million to over Bt1 trillion ($19 to $27 billion).

Meanwhile, NPLs continued to rise (see Table 3 above) and by early 1999 they were being projected to rise before long to a system-wide average of 50%. Although interest rates were falling, there was very little new bank lending. This was due to both demand and supply factors. Borrowers saw very few profitable investment opportunities, and lenders, who were maintaining a growing differential between lending and borrowing rates, were very risk averse in assessing new loans. They did not want to risk further increases in NPL rates.

Recognizing the lack of success of its mid-August banking package, the government tried to apply more pressure. It used moral suasion on the banks to reduce interest rates and increase lending. While rates continued to fall, there has been no noticeable impact on lending. The government required all financial institutions to submit detailed recapitalization plans in January 1999. Unfortunately, the plans were required only for the period to June 1999, at which time the stricter loan loss provisioning requirements would apply only with respect to 60% of the value of NPLs.

Basic Economic Laws

The government had committed itself to bringing the 11 new basic economic and commercial laws into effect by October 31 1998. This deadline was not met. The issue was diplomatically skirted in the 6^{th} LOI.

Enactment of the new laws was delayed initially by problems in preparing them and presenting them to Parliament, and then by political battles between the government and various vested interests. Rural debtors, especially poor farmers in the Northeast, are justifiably alarmed at the prospects of being forced into personal bankruptcy (with very harsh consequences under the current law) on the basis of personal guarantees on loans for land or equipment purchases. A much more important barrier, however, has been the opposition of a group of very wealthy debtors, a number of whom are influential members of the Thai Senate. This group used its power both to mount a major public campaign against the new laws, and to delay their passage by Parliament.

The opposition campaign has included appeals to nationalistic fears of sellouts to foreigners and to populist sentiments related to the unfairness of small and powerless debtors being forced by rich (foreign) creditors into punitive personal bankruptcy. In order to preserve an image of broad popular support for the new laws, the government has felt it necessary to meet some of the opposition demands. In particular, it has offered concessions with respect to minimum debt limits for bankruptcy and foreclosure laws to apply, some relaxation of liabilities in respect of personal guarantees, and reducing the number of years for which sanctions would apply with respect to personal bankruptcies.[12]

The Senate only has the legal power to delay new laws. Any changes proposed by the Senate must be approved by the Lower House. If the government disagrees with such changes, it must discuss them in a joint House-Senate committee (which can meet for up to 180 days), but can ultimately pass whatever version of the laws it wishes. The current session of Parliament, scheduled to end on March 22, has been extended in the hope of enacting the laws. Following a major public showdown in mid-March the Senate passed most of them. The Senate's amendments seem, by and large, to be acceptable to the government and not to threaten the laws' basic principles and objectives. It is expected now that Parliament will be able to pass all the laws in this session.

The time taken to pass these laws has caused confusion and uncertainty for all actors involved in resolving the country's key financial sector problems. It has delayed and imposed high costs on the debt restructuring process and on the resolution of the NPL and bank recapitalization problems. Implementation issues will certainly arise as well, whenever the laws are passed.

Corporate Debt Restructuring

There has been very little progress on debt restructuring since mid-1998. By February 1999 less than 10% of the over Bt750 billion of debts under the special CDRAC program had been settled. The BOT has claimed recently that broad agreement has been reached on additional debts accounting for between 5 and 10% of this total. Debts being

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[12] On the other hand, it was not willing to yield on proposals such as one put forward in the Senate to postpone implementation of new bankruptcy laws for two years ("until the crisis is over"), and others to exempt residential property from foreclosure law and to exempt from application of the bankruptcy law any debts for which collateral had been offered and agreed, at the time of commitment, to cover the value of the loan.

restructured under the CDRAC program amount to less than 20% by face value of the total numbers of bad debts in the financial system. Progress on the 80% of debts outside the CDRAC system appears to be no faster, and probably even slower than for those in the system. International experience shows that massive debt restructuring such as being undertaken in Thailand is a long and difficult process. However, it also clear that the legal and institutional framework in Thailand is especially weak for this purpose and will remain so until new basic economic laws are passed and successfully implemented.

FRA auctions

Progress on the FRA auctions of failed bank and finance company assets has also slowed down. The December auction of business loans sold less than 50% of the assets on offer, and at prices that were much lower than received at earlier auctions of physical assets. The average sale returned only about 25% of the face value of the assets sold. And a large share of the sales that occurred were achieved only after the government made some controversial *ex post* changes in auction procedures.

The December auctions were controversial as well because of conflict-of-interest concerns. Chief among these was widely reported pre-auction collusion between bidders and the defaulted debtors whose loans were being auctioned. This was a way for debtors to bypass regulations against participating in the auctions of their own debts and for bidders to make a tidy profit without assuming any risk[13]. In the presence of such well-known arrangements, other potential bidders would be extremely wary of participating for fear of the “winner’s curse” effect. There were also reports of collusion among bidders, and concerns expressed about the propriety of allowing one of the FRA’s chief foreign advisors to bid at the auction.

Another important reason for the failure of this auction and slow progress in general on this front has been the delay in passing and implementing the new economic laws.

[13] The FRA initially rejected many bids on the grounds that the prices offered were too low. In a number of these cases it then negotiated new offers (after the auction, and solely with the company that had made each failed bid) that included a condition that all pre-auction contracts with debtors be dissolved, for at least six months. The new price in these situations also included a profit-sharing condition between the bidders and the FRA.

The most recent auction, in late March, achieved an average recovery rate of less than 20% of the face value of assets sold. A large portion of the assets, especially those of the lowest quality, was purchased by the government's Asset Management Corporation (AMC).

Summary

Mid-1998, one year after Thailand's entry into the IMF program, marked a significant mid-course correction in the country's recovery strategy. Fiscal and monetary policies were loosened, and the government launched new measures to speed up debt restructuring and bank recapitalization. By early 1999 there were some encouraging signs, especially in the form of lower interest rates and an appreciated and more stable baht. However, macroeconomic fundamentals (sectoral output data, exports, imports, employment) were not yet showing signs of improvement. The government had fallen far behind of its schedule for improving the framework for debt restructuring. New economic laws had been seriously delayed. Banks were not moving to make use of the government's recapitalization program, and were, instead, withdrawing from the market in order to avoid further risks and to avoid or delay diluting shareholders' equity. As a result of the apparent ineffectiveness of the government's program, and increasing numbers of reported scandals in various ministries, the government's support and credibility were diminishing. While the government comfortably survived a no-confidence vote in February, issues raised in the debate did not improve its reputation.

Strong pressures are being brought to bear by special interests who stand to lose from economic reforms. More importantly, increasing numbers of more objective observers are increasingly questioning some of the foundations of the government's crisis recovery strategy.

Where does that leave Thailand today? The next section provides a review of immediate prospects over the next year. The following one reviews longer term prospects.

Thailand Today: Short Term Prospects

Overview

The government has been predicting the beginning of economic recovery by the middle of 1999. Is this realistic?

For some time it was hoped that *exports* might lead the recovery. However, the strong baht, the depreciation of other Asian currencies, falling regional demand, declining prices of many basic industrial exports (20% in dollar terms for electronics over the past year or so according to industry sources) all make significant export recovery unlikely. The government had been forecasting export growth of 5% (in dollar terms) for 1999, but has begun to scale this back. Furthermore, the high import content of manufactured exports means that export growth would have a relatively small impact on overall economic activity.

Investment performance over the past year has been abysmal. Is this likely to improve in the near future? In the third quarter of 1998 (the most recent date for which figures are available), the manufacturing sector's capacity utilization was estimated to be 50.5%. In the face of such massive excess capacity, significant new investment is highly unlikely. Furthermore, even if there were investors interested in developing new projects, financing might be a major problem. The banking sector, crippled by massive undercapitalization and very high NPL rates, is very reluctant to make any new loans.

There have been weak signs recently in some segments of retail sales that *consumption* might be bottoming out. This could be due to the effects of the recent SET "bubblet" or of consumer needs to replenish stocks of certain items whose purchases had been postponed during the early stages of the crisis. But layoffs and reductions in hours, wages, and overtime are still dominating the labor market. As we shall see below, there will be significant new stresses on rural incomes over the coming months. These income uncertainties make a significant recovery of consumption unlikely.

Major Short Term Issues

Monetary and Fiscal Policies

The fifth and sixth LOIs highlighted a relaxation of the fiscal and monetary targets, and predictions of lower interest rates. These changes have not yet had the effects on the real economy that had been hoped for. Why not?

In a flexible exchange rate environment, monetary actions generally have a much greater impact than fiscal policies. Unfortunately, current monetary policies are not likely to be very effective at stimulating aggregate demand for (at least) two reasons.

First, as measured by growth in monetary aggregates, the policies are not very expansionary. Except for the month of November when it grew at 5.7%, the annual rate of growth of the monetary base has been no more than 1.5% since August 1998. While this is better than the negative growth that was prevalent prior to August, it is not very expansionary. M1 growth has been showing a similar pattern. Other monetary aggregates have been growing at higher rates, and that, together with the government's substantial withdrawal from the markets, has been the reason for declining interest rates. The prime rate (or minimum lending rate) has fallen from about 15.5% in July to about 9.5% at present, and deposit rates have fallen even more.

However, lower interest rates have not had, and are not likely to have, on their own, a significant expansionary effect on bank lending. There are several reasons for this: i) lending rates have been much slower to adjust than deposit rates; ii) undercapitalization of banks, low collateral values, and high NPLs are inducing highly risk averse lending behavior; and iii) as mentioned earlier, there remains little demand for new loans, as a result of scarcity of profitable investment opportunities. These issues are closely related to problems related to both the debt restructuring process and bank recapitalization.

In the current Thai environment (floating exchange rate with few controls on capital flows), fiscal policies will generally be much less effective than monetary policies in stimulating aggregate demand. The standard explanation is that fiscal expansion puts upward pressure on interest rates. This has two types of offsetting negative effects on aggregate demand. First, it has the direct effect of crowding out interest-sensitive private expenditures. Second, it puts upward pressure on the exchange rate, which decreases demand for domestically produced tradable goods. This would explain the IMF finding that tight fiscal policies had only a small negative impact on aggregate demand in the early stages of the IMF program.[14] The main effect of fiscal stimulus under these conditions will be to alter the composition of aggregate demand between the public and

[14] See Lane *et al* (1999).

private sectors. However, in current circumstances, with few alternative investment opportunities and with interest rates arguably relatively insensitive to changes in money supply, fiscal expansion might be more effective than would be expected in normal circumstances. To the extent that a relaxation of the fiscal stance does affect aggregate demand, the quantitative effect will depend on the size of the deficit.

Until last August, the fiscal deficit had been almost entirely passive — the result of declining government revenues from the recession. Since the fifth and sixth LOIs, the government has been attempting to implement new spending programs to provide a more direct stimulus to demand as well as to provide income relief in poor and especially needy communities. As we have seen above, disbursements have been very slow.

The government has very recently announced a new set of expenditure programs, in a total amount of about Bt53 billion ($1.45 billion), financed by loans from the World Bank ($600 million), Japan's Ex-Im Bank ($600 million) and Japan's OECF (about $250 million). Only the last of these is being offered on concessional terms.

The focus of these loans is largely on employment generation and community improvement projects in areas such as health and education. In addition, some expenditures will be earmarked for industrial promotion and administrative reform. The government has indicated that speedy expenditure of these funds is its top priority. Government ministries are expected to have proposals ready for approval before the end of March, and all funds are to be expended by the end of the fiscal year (September 1999). These new expenditures, accounting for almost 1% of GDP, will all be treated as being off-budget. In other words, they will be in addition to those making up the 5% of GDP fiscal deficit targeted in the 6th LOI.

Justifiable concerns have been expressed as to how this massive new expenditure plan can possibly be accomplished in a productive and accountable manner. The fact that over one-third of the funds are to be allocated to the Interior Ministry, widely noted in the past for the politicized nature of its expenditure allocations, adds weight to these concerns. Nevertheless, viewed simply as a pump-priming exercise, these programs should be much more successful than the previous SIP program. Speedier disbursements may or may not lead to more useful results. But old style political and bureaucratic pork might be more effective at pumping money into demand stimulation than transparent and accountable community-based spending.

Additional Japanese OECF funds are likely to be made available to support major infrastructure projects, including roads, dams, transport systems and the new Bangkok airport. Neither the exact amount nor details on projects that will be supported under this loan are known yet. However, the government has expressed strong willingness to utilize whatever funds are made available, and to do so as quickly as possible.

After earlier insisting on improvements in accountability, transparency and improved productivity of public spending, it is remarkable how willing international donors and agencies now seem to be to sign on to "blank check" programs such as these to provide short term stimulus to the Thai economy. Some local observers note that, in light of the large amounts of excess domestic liquidity and the lack of interest in new private investments right now, Thailand might be much further ahead to finance new stimulus packages locally. Bringing in large amounts of foreign funds will put further upward pressure on the baht, which will make recovery of domestic export and import-competing industries even more difficult.

The government has also announced further fiscal stimulus measures on the revenue side, primarily in the form of a reduction in the VAT rate from 10 to 7%,[15] and some reductions in income taxes. The revenue stimulus provided by these measures is projected to be slightly larger than the expenditure increases funded by the World Bank and Japanese loans – i.e. more than one percent of GDP.

Rural Incomes

During the first year and a half of the crisis, traditionally poor rural areas have done relatively well. This was due to a combination of good crop yields and substantially higher baht prices as a result of the depreciation of the baht and increases in dollar prices of some key products. This was especially fortunate in light of the role of the villages in providing a social safety net for laid off urban workers. This year, however, will be substantially different. Most importantly,

- a serious drought will mean substantial decreases in crop yields, and

[15] This reverses the increase in the VAT announced in the first LOI.

- recovery of the baht and falling dollar prices will result in substantially lower domestic crop prices.

There is no way to avoid substantial decreases in rural incomes this year. This will put a serious drag on any potential recovery. The stimulative impact of a 5% (of GDP) government deficit will be barely sufficient to offset the likely fall in rural incomes this year. Declining rural incomes will not only affect aggregate demand, but will also have serious implications for the informal social safety net provided by the villages. This could pose a serious threat to social and political stability.

Passage and Implementation of Basic Laws

Long delays in drafting and passing the new basic economic laws have been an enormous and costly hindrance to the adjustment of asset markets required by the crisis. It appears that the laws might finally be on the verge of being passed. Any further delays would certainly impede short term recovery prospects. The next issue that will arise will be with respect to their implementation. For example, a variety of concerns have been expressed about the competence of Thai courts to deal with bankruptcy and foreclosure cases in a timely, fair and efficient manner. It is for this reason that the laws provide for a special new bankruptcy court and that crash training programs are being put into place for court officials.

In any case, it will still be many months before the new laws are enacted and begin to be put to the test.[16] Therefore, the effectiveness of the new laws will be a greater factor in the long run than in shaping the short term recovery. The main short term impact will be in the confidence-building (or diminishing) effects of changing public perceptions of the government's progress in dealing with major issues.

Bank Recapitalization

The bank recapitalization problem is far from solved. The government has been unable to decide whether to be tough or easy on the remaining banks. Under the original IMF program, an Asset Management Corporation (AMC) had been set up, with the intention that it would somehow take over the bad debts in the banking system. As described earlier, the Democrats had decided to leave the NPLs with the banks. The

[16] A new obstacle has recently emerged in the form of a suit by a group of influential senators to contest the constitutionality of the new laws.

problem has become far worse than had been imagined when this decision was made. The government is now coming under increasing criticism for simultaneously leaving the NPLs in the banks, enforcing stricter NPL reporting and provisioning rules, and imposing higher capital adequacy standards. The critics argue that these are impossible burdens, and that it is far more important to simply get the credit system operating again than to try to meet these impossible international standards.

Whatever the merits of these suggestions, the government's indecision has left the bank recapitalization problem unsolved. This is possibly the most important item on the government's short term policy agenda.

Political Stability

Last October the government increased its slim ruling majority by bringing a major opposition party into the coalition. This was necessary to ensure passage of the new economic laws. For the moment, therefore, the government is relatively stable, and recently survived a no-confidence debate in Parliament. However, the no-confidence debate and a number of scandals within the government have tarnished its credibility. The personal reputation of Finance Minister Tarrin has certainly suffered.

The government will have to call an election by next year, and is counting heavily on an early economic recovery before it has to go to the electorate. The greater the delay in the recovery, the greater will be the pressures on the government, and the less success is it likely to have in the polls. The "old style" opposition parties still have considerable support outside of Bangkok, and this will increase with continued recession and with likely economic problems in rural areas. A well known wealthy businessman and former cabinet member has started a new political party that could be a threat to the Democrats in urban areas.

Continued economic difficulties will increase medium term political uncertainties. The next election could be a major test of the effectiveness of the new constitution in reforming Thailand's old-style "money politics".

External Risks

Thailand has undertaken many measures to prepare the domestic economy for recovery. There remain a number of potentially dangerous external threats related to demand for Thai products in world markets, supply and cost of foreign capital, and competition for Thai-produced goods.

The most important danger is the precariousness of the Japanese economy. Failure of recovery measures now under way there would have serious implications for external demand for Thai goods and for the supply capital and loans to support the Thai recovery. In China, further banking and financial difficulties could lead to serious economic problems and a devaluation of the yuan, which could have a devastating effect on the competitiveness of Thai exports. Any weakness in the US economy, triggered by a stock market correction, for instance, would affect demand for exports and the supply of capital everywhere. The recent collapse in Brazil, even if spreads to other countries in Latin America, would not have much effect on demand or capital supplies; but it will increase competition and lower prices even further for some key Thai exports, such as electronics.

Summary

Short term recovery this year is far from certain. Despite falling interest rates and inflation, and a stabilizing baht, recovery driven by exports, investment or domestic demand will be very difficult. New fiscal measures might begin to have some effect in the second half of the year. But that would require a major break from recent patterns and failures. There remain serious threats of difficulties in rural areas and of domestic political instability. There are potential external threats in the form of falling demand and increased competition for Thai exports. Foreign supplies of capital remain uncertain. For the first time since the beginning of the crisis, some close observers of the Thai economy are alluding to the threat of a prolonged deflation rather than the hope of a speedy recovery. Falling popularity of the government is going hand-in-hand with criticisms of and dissatisfaction with its IMF program.

Longer Term Prospects

Prospects for longer term recovery of growth and competitiveness depend on a number of factors. Some of the more important ones are discussed here under three major headings.

Long Term Costs of Major Shocks and Policy Errors

The initial shocks that hit the Thai economy in 1996/97, and some of the policies followed in its early stages imposed very large costs on the economy. These costs will be borne over an extended period of time, and will be a burden on longer term recovery.

The huge reversal of capital flows in 1997 has deprived Thailand of the services of substantial amounts of capital, which has continued at least until the present. Some of this is now being made up by official loans from a number of sources, which will be discussed further in a moment. The huge drain on foreign exchange reserves from the failed defense of the baht is being gradually made up. The cost is not, of course the total amount of reserves, but is related rather to the difference between their value when they were sold and when they are reacquired.

The costs of financial restructuring will be very large. When Thailand first entered the IMF program, it was estimated that the interest costs of debts incurred in respect of FIDF bailouts would amount to roughly 1% of GDP for a number of years, and that the capital costs could be met from the proceeds of privatization of state enterprises. The costs have escalated considerably since then, and the state enterprise privatization program is no longer viewed as a means of financing them. The latest government/IMF estimates of the annual interest costs alone are about 4% of GDP. To meet the capital costs incurred by the FIDF, it has been announced that substantial new bond issues will be required, in addition to the Bt500 billion already authorized.

Under various rescue packages from the IMF, World Bank, ADB and bilateral donors, the RTG has taken on and is in the process of assuming large new debt burdens. While some of these have been taken on concessional terms, most have not. The ultimate burden of these loans will depend in large part on how productively the funds are employed. Lack of transparency and accountability and reckless speed in planning and executing new expenditure programs raise serious questions about their likely long term benefits to the Thai economy.

Finally, Thailand, especially Bangkok, is now littered with the skeletons of large numbers of partially completed construction projects — condominiums, office towers, residential complexes and transport infrastructure. Many of these are deteriorating rapidly from exposure to the elements. Not only do these represent unfortunate sunk costs; many of them will now require demolition — a costly and sometimes dangerous activity. These are additional costs that will have to be borne out of Thailand's future growth.

Institutional/Governance Framework

In Thailand, as in other countries in the region, the crisis has exposed weaknesses and put great strains on institutional and governance structures. This threatens future development possibilities. On the other hand, constructive responses to these pressures can yield great dividends for the future.

In some respects, Thailand has been extremely fortunate in this regard. Already one of the most open regimes in the region, at the time the crisis struck Thailand was in the final stages of a major and popular constitutional reform. The purpose was to consolidate democratic institutions and try to eliminate the basis for at least the most egregious aspects of her old-style "money-politics" regime. At possibly the most vulnerable time in the early days of the crisis Thailand experienced a peaceful, speedy and fully legitimate change of government. As well as fully embracing the economic reforms initiated under IMF guidance, the new government took full responsibility for completing the constitutional reforms. Regardless of the short term difficulties caused for implementing the government's reform program, there was a full and open debate about the key features of the new basic economic laws. This certainly enhances the legitimacy of both the political processes and the new legislative framework.

The government has made and continues to make major changes in the rules and regulations facing the financial sector. It has amended old laws and introduced new ones governing basic economic institutions. It is in the process of opening the economy to greater competition, domestic and foreign. Successful continuation of this process will create a much more sound and productive financial sector and a system of corporate governance that will enhance investment, productivity and the interests of Thai workers and consumers.

None of these prospects is guaranteed. On the negative side, there is no assurance that the constitutional reforms will succeed in eliminating "money-politics". There are many forces in the governing coalition and in the opposition that have long experience with the old system and will try to exploit it in the next election. Declining popularity of the current government could restore these forces to power.

It is too early to know how effectively the legal reforms in the financial and corporate sectors will be implemented. The government is far from resolving the complex problems of bank recapitalization and debt restructuring. There is still some danger, for instance, that slip-ups in implementation, in part or in whole under pressure from vested interests, could derail recovery and cause long term damage to Thailand's debt culture, resulting in increasing non-payment of debts, even for healthy borrowers. The process of reforming deep-seated practices of corporate governance has just begun. It is far too early to predict that this will proceed in the best interests of Thailand's long term development.

The economic stress caused by the crisis has given rise to major social tensions. These will increase the longer is the delay in the recovery. Protracted debates and confrontations over basic issues of creditor and debtor rights have been at least temporarily resolved by passage of basic economic laws. However, the differences could still linger and not only cause difficulties in implementation of the new laws, but in the process also tear further at the country's social fabric.

Basic Problems of Long Run Competitiveness[17]

Even before the crisis, Thailand faced serious problems with long run competitiveness. While overall productivity growth was moderate, most of it was in agriculture or arose from inter-industry shifts. There was little indication of growth of technological capabilities, or movements “up the ladder of comparative advantage”.[18] Among the widely recognized barriers to growth in competitiveness were very low levels and quality of education, serious deficiencies in infrastructure development and environmental management, and a policy regime at the micro level which was too much geared to creating and preserving rents rather than fostering market competition.[19]

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[17] This section draws on Flatters (1999).

[18] See Tinakorn and Sussankarn (1996).

[19] For an early review of these challenges to Thailand's competitiveness see Akrasanee, Dapice and Flatters (1991).

Monopolies in basic services (e.g. telecommunications) and protection of upstream industries (steel and petrochemicals) were among the most obvious and egregious examples of misguided protectionism.[20] While prudent macroeconomic policies had always been regarded as an area of strength in Thailand, the financial and macro mismanagement that led up to the crisis has called that into question as well. Political and bureaucratic corruption has been another continuing source of concern.

While the crisis has drawn attention to some of these issues and provoked some policy improvements, many of the problems have been left “on hold” and some have become worse. One immediate effect of the crisis has been a reduction in school enrolments, which will lower rather then raise future education levels. While the government has attempted to exempt major export industries from the costs of upstream protection, it has done little to attack the protection problem directly. The crisis seems to have fed the long-standing inclination to solve any adjustment or competitiveness problem in the real sector by creating a special government fund to throw public money at it. Unfortunately the IMF, other international agencies and bilateral donors seem far too willing to accept and promote such policies. There has been considerable talk and some action in dealing with corruption in various ministries, and yet there has been little progress in systematic public service reform and introduction of realistic wage and incentive systems.

Resolution of these problems is essential to restoration and sustainability of Thailand’s long term growth and competitiveness.

Conclusion

The short term and longer term prognosis for the Thai recovery are dealt with in the previous two sections. While first into the crisis, Thailand’s process of recovery has not yet been and is not likely to be fast. Longer term prospects depend on some major

[20] The government’s unwillingness to include pricing of irrigation water or to move agricultural prices to a more market-oriented regime, as part of a $600 million ADB-funded agricultural loan program, is a worrisome sign of a continuation of a subsidy-dominated sectoral policy regime. The same inclinations are revealed in a recent refusal to eliminate state subsidies from a new credit program for SMEs.

issues whose resolution is not yet known. Relative to other countries in the region, Thailand still has the potential to be a strong performer in the longer term.

The remainder of the conclusion will focus on domestic reactions to the IMF program and on the prospects for long term sustainability of the reforms. These are certainly related issues.

Domestic reactions have evolved with the program and with economic events. In tracing their path it is sometimes useful and important to distinguish among various groups in Thailand — in particular, the government, various vested interests, critical observers, and the electorate.

The most important reaction to the IMF in the period immediately prior to the crisis was the government's apparent unwillingness to listen to warnings about the weaknesses of the exchange rate regime and the financial system. Failure to heed these warnings has imposed large costs on the Thai economy. When the IMF was finally asked for assistance, it was out of sheer necessity.

Following the change of government in November 1997, Thailand became a full and willing partner of the IMF. The new government bought fully into the IMF program initiated under its predecessors, and it is fair to say that most of the public gave at least grudging acceptance to the program, if only because of the clear failures and general discrediting of the policies of the previous government.

As the economy fell deeper into recession in the first part of 1998, voices of discontent became louder and more frequent. The collapsing baht and escalating interest rates put increased pressure on the real sector, and the true weakness of the financial system became more apparent. By mid-1998 many critical observers were advocating a major change of policy direction. It is in response to these pressures, more than anything else, that the government made a major correction in the course of its macroeconomic program. At the same time, vested interests in the financial sector made it difficult for the government to be equally decisive in its financial sector reform programs. As a result, it chose a number of soft, voluntary options. It ran into similar problems with its program of legal and regulatory reform for debt restructuring and, as a result, important deadlines were missed. This created considerable social tension as vested interests representing the opposite sides of delinquent loan agreements fought over laws related to the balance of powers between debtors and creditors.

It appears that the battles over these basic economic laws are almost over, and that the integrity of this part of the program will be preserved. However, there remain major implementation issues which will take some time to be sorted out. And the government is still struggling with its unwillingness to confront major vested interests in the banking sector over principles of bank recapitalization. Most importantly, delays in banking reform and debt restructuring have imposed large costs and have been a major barrier to economic recovery.

The longer the recession (and some critics are now warning of the dangers of extended deflation), the greater are the manifestations of social tension due to the real economic distress faced by many people. The government, IMF and other international agencies are responding to this with less and less well-considered social assistance and restructuring programs. The initial program principles of transparency, accountability and market-based incentives to lead Thailand to short term recovery and long term sustainable growth are being increasingly ignored. In the rush to defuse social tension, the government continues to back away from some important hard decisions. The principles of the reforms are being threatened, and the end result could still be the replacement of the current government by one similar to the one that got Thailand into this mess in the first place.

What, can be said, therefore, about the sustainability of Thailand's reform program? It is clear from what has been said already that "the reform program" is an elusive and fast-moving target. A desirable feature of any crisis management program, of course, is flexibility and the ability to adapt to new information and changing circumstances. By this standard, Thailand and the IMF are not deficient. However, underlying the reforms are a number of important principles of economic management. It is still too early to say whether Thailand will continue to agree on and abide by these principles. It is not clear either how much the IMF will be willing to bend its own principles in order to continue its special relationship with and bask in the reflected glory of one of its star pupils.

Thailand is at a critical point in its constitutional, political, social and economic development. This was true even before the crisis. There is no doubt that she is well placed to make major steps forward on all these fronts and become an even greater and more successful participant in the Asia's development. The economic crisis could be argued to have given Thailand the opportunity (and the need) to push forward with its reforms even more quickly than otherwise. However, there are limits to the resilience of the social, political and economic fabric. It remains to be seen whether the country's response to the crisis strengthens this fabric or tears it apart.

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