
A Good Look at the Thai Financial Crisis in 1997-98

1. Introduction

An open economy is susceptible to a speculative attack; the smaller the economy, the more severely it is likely to get hurt. Good balances in economic components are the only immunity as well as medicine to such an attack. In 1992, the European Monetary System had to be practically abolished as its member economies had been consistently hit by speculators who had seen a way to exploit economic imbalances that made possible a devaluation of the economies' currency. Two years later, Mexico had encountered calamitous, speculative attacks that had forced it to devalue the peso by more than 50%. Mexican banking and private sectors all got hurt and the economy had stopped growing for more than half a decade. On the other hand, only the central banks of the European economies had forfeited currency in their foreign reserve in order to promptly stop the crisis. Thailand was another open economy loudly hit by speculative attacks. It had enjoyed too much and too recklessly wealth in its good days, the habit which had given rise to serious imbalances of a number of the economy's components. The overoptimistic characteristic of the economy had essentially led to the deterioration of its health. With the weak body, not for a long time could it stand against outside attacks from speculators. Being depleted of its foreign currency reserve in attempts to fight against the speculative forces, on July 2, 1997, Thailand decided to switch to a flexible exchange rate regime. The Thai bath was depreciated by more than 50% by the end of that year; the Thais had experienced a collapse of their economy for the first time.

This paper was aimed to give a clear picture of the Thai financial crisis and insight thoughts on some of the issues related. The paper was divided as follow: Section(1) Introduction, Section(2) An Anatomy of the Thai Financial Crisis, Section (3) Did the Thais Ignore the Painful Lessons of the Mexico?, Section(4) An Evaluation of the Thai Government Performance along Thailand's Economic Path and in Response to the Crisis, (5) Final Remarks on the Future of the Thai Economy, Section (6) Conclusion.

2. An Anatomy of the Thai Financial Crisis

Since early 1990s, Thai economy had attracted massive volumes of capital inflow from abroad due to its accommodating economic policies, goal, healthy-looking conditions, and some other outside factors such as the stagflation of Japanese economy and the recession in European countries during 1990s. After a long period of strict financial regulations that limited credit expansion of commercial banks, starting from the beginning of 1990s, the Thai government had decided to accommodate a policy of financial market deregulation and capital account liberalization. Moreover, with an exchange rate fixed to a basket of world dominant currencies especially US dollars, the Thais had enjoyed a long period of nominal exchange rate stability as the baht had fluctuated very narrowly between 24.91-25.59 baht per dollar ([Table 1](#)), stable price level of 3.3-5.9%, and high interest rate at around 13.25% before the crisis.

The Thai government also had done a good job in keeping inflation rate low between 3.36% and 5.7% ([Table 2](#)) as well as fiscal balances surpluses ([Table 3](#)). Plus the economy had possessed a characteristic of high saving rates situated at around 33.5% of GDP while its GDP growth had stayed at an impressive level of 8.08-8.94 during 1991-95. As a result, the Thai economy had become very attractive to international speculators, many of whom had channeled their large sum of capital out of Japan which had undergone a lengthy

period of stagflation and low interest rate. And by 1995, Thailand had a net capital inflow of US\$ 14.239 billion, more than one hundred percent increase from its net capital inflow three years ago.

As a consequence of the huge overflow of capital, domestic investment had its prime years and the banking sector had expanded very rapidly. Thailand's investment rate between 1990-96 as shown in [Table 4](#) came in the first place compared to the other nations of the same region. Stock market prices rose by 175% in aggregate and by 395% in property sector. There emerged more than 50 banks and non-banks financial institutions which had been controlled and monitored much leniently by the Thai central bank—the Bank of Thailand. These financial institutions had made a large sum of money out of the economy as they had had small constraints and difficulties in borrowing quite excessively from abroad and lending with a dear interest at home. By early 1990s, Thailand's banks were ranked among the world's most profitable as the banks could charge up to 4 percentage points more interest for loans than they paid on deposits, a discrepancy which was 4 times bigger than the spreads of less than 1 percentage point in the banking system of many developed economies. And Thailand's lending boom measure calculated from the growth of bank lending as a percentage of GDP ratio was 58%, the highest in the East Asian group ([Table 5](#)).

However, the growth of the capital inflow and the lending practice of the Thai financial institutions were not very healthy nor wise. A large part of the capital had been put into non-productive sectors especially real estate. Those sectors were non-productive because they produced non-tradable goods which were sold only domestically, resulting in less national volume of exports and thus weaken the economy's balance of trade as well as the capital account. A statistic showed that 10-35% of bank loans were committed to bricks and mortar. In addition, only a small portion of the capital inflow could be categorized as foreign direct investment (FDI)—a non-speculative, thus real, type of investment

that went to the build-ups of capital goods, factories, inventories and land. In [table 6](#), the percentage of contribution of inward FDI to current account financing was calculated. The proportion of FDI to the Thai economy was low and had decreased over time from 33.57% in 1990 to 15.90% in 1996, compared to that of Malaysia who had a proportion of FDI above 90% throughout the time period. In addition, the financial institutions tended to lend recklessly without a prudent procedure of lending contraction and monitoring. This was an adverse selection problem resulted from moral hazard on the side of the financial institutions as the institutions had expected a safety net provided by the Thai government or the Bank of Thailand if a bank run occurred. The same problem was also with the foreign creditors and depositors sides as they credited money to the financial institutions with little care, having in mind the government's bailout policy. As Jeffrey Sachs had presented an early analysis of the role of excessive lending driven by 'moral hazard' incentives:

"Banks and near-banks—such as Thailand's now notorious financial trusts—become intermediaries for channeling foreign capital into domestic economy. The trouble is that the newly liberalized banks and near-banks often operate under highly distorted incentives. Under-capitalized banks have incentive to borrow abroad and invest domestically with reckless abandon. If the lending works out, the bankers make money. If the lending fails, the depositors and the creditors stand to lose money, but the bank's owners bear little risk themselves because they have little capital tied up in the bank. Even the depositors and the foreign creditors may be secure from risk, if the government bails them out in the case of bank failure."[\[1\]](#)

Furthermore, it was worth noted that the lending boom was significantly larger for finance and securities companies than for banks (133% of the former as opposed to 51% of the latter). And the non-bank share of lending to the private sector was quite significant (about 33% of bank lending). As a result, Thailand

was the only country, among the countries affected by the Asian crisis, where lending to private sector was very different if we added the 'other banking' and 'non-bank financial institutions' figures. Unfortunately, these non-bank institutions tended to have a very bad lending practice. As later on, they were severely affected by the incident of non-performing loans crisis, and 56 of them were forced to close their business in a government's attempt to remedy the crisis which had gone much worse after the devaluation of the baht. Another imprudent lending practice of the financial institutions was that they lent from foreigners mostly in dollar denomination and thus needed to pay back in the foreign-nominated currency, but they relent that foreign-denominated currency in baht at home. A ratio of foreign liabilities to assets is shown in table 8. Strikingly, the ratio is far higher in the case of Thailand than that of the other countries: the ratio of Thailand before the crisis had been increasing from 6.93 in 1993 to 11.03 in 1996 whereas that of the other countries never exceeded 4.3 in the same time period. This suggested a serious mismatch between the stock of foreign liabilities and assets. The Thais would get into a really big trouble if they needed to repay those liabilities in all of a sudden. This later on would be shown to be a crucial cause of the deterioration of the nation's balance of payment and the collapse of the economy.

Unfortunately, the golden years did not last long. Starting from the year 1995, Thailand's economic growth became much slow down due to a number of factors such as the contraction in the real estate sector, the emergence of China as an intimidating competitor in international trade, the fall of world demand of semiconductor which was one of the Thai major exports in 1996, and an appreciation of the dollars after Spring 1995. As previously discussed, real estates were non-tradable; thus, there was a constraint in market demand of them. Too many houses and business buildings were built; by 1997, the commercial vacancy rate had gone up to 15% ([Table7](#)). The real estate business had become unprofitable., and the business owners, thus, had no capacity to pay

back their debts to financial institutions when the maturity came. The percentage of non-performing loans had risen up to 13% in 1996. This soar of the non-performing loans began the era of banking crisis as banks' balance sheet had been deteriorated. Besides, in international trade, Thailand had become less competitive in the existence of an emerging trader like China together with a constantly increasing trend of dollar currency (i.e. an appreciation of dollar) which had worsened Thailand's terms of trade since the Spring of 1995. (The exchange rate of yen for dollar went from 80 in Spring 1995 to over 125 yen per dollar in Summer 1997). Thailand's terms of trade had been worsened because the Thai baht needed to appreciate along with the dollar which was the major currency in the currencies basket Thailand had fixed its exchange rate to. And as the world demand of semiconductor had fallen in 1996, Thailand's volume of exports decreased, contributing to a balance of trade deficit.

Another item should be looked at was the country's current account balance. Thailand had had persistent current account deficit ranging from -5.08 to -8.10 % of GDP lowest among the other nations for most of the time in the sample ([table9](#)). This negative sum largely came from the country's balance of trade deficit. The value of its imports had widely exceeded its export value ([table10](#)). This high volume of imports could be expected as the country had had a high GDP growth rate ([table11](#)). However, the number could look better if Thai people had been more prudent in spending and could be more competitive exporters. During the boom period, the economy was in a bubble. Thai people had had an expectation of a long run economic growth of their country; thus, their consumption had become quite excessive especially in imported commodities and luxuries.

There came speculators who had seen Thailand's slow growth rate, bank run, and deteriorating balance of payments as signs of unprofitability for their investment. They started selling domestic assets and claimed back their foreign assets. As a result, bank balance sheets became increasingly deteriorated, and

the economy had faced a severe credit crunch problem. Even investors with productive investment opportunities could not get loans to run their business. The country's economic growth, thus, had been even more deterred. On February 5, 1997, "Somprasong" was the first Thai company to miss the repayment of its foreign debt. The situation had gone much severe that a large number of Thai financial institutions were not anymore to pay back their debts; the government's bailout operation was expected. On March 10, 1997, the Thai government announced that it would buy \$3.9 billion in bad property debt from a number of; however, it reneged the promise at the end. On May 23 the government made an attempt to save "Finance One," Thailand's largest finance company, via a merger with another financial institution. But again it could not fulfill its mission. As only one month later, the new finance minister 'discovered' that the Bank of Thailand had already used US\$ 28 billion out of US\$ 30 billion of its international reserves in the course of forward market interventions to defend the value of the baht.

Under a fixed exchange rate system, it was the responsibility of the government or the central bank to conduct policies i.e. exchange-rate changing, exchange-rate switching, and direct control, to keep its exchange rate fixed as well as to maintain a fine level of the overall condition of the economy. An exchange-rate changing policy was the first approach, constituted of a fiscal and monetary policy. As more and more capital flew out of the country or as the country had faced a balance of payments deficit the central bank needed to forfeit its foreign reserves, injecting the foreign currency into the economy to satisfy the currency's excess demand and bring the economy back to its exchange rate equilibrium. So as speculators had kept taking dollars out of the system (i.e. Thai economy) , the Bank of Thailand had a necessity to inject dollars into the system using its stock of foreign reserves. Not for a long time, however, did the central bank could do that. Its stock of foreign reserves was almost used up, and it realized that it could not, in any way, be able to supply

the foreign currency to the economy given the enormous size of foreign liabilities. (This, you can look back in table 8.) An exchange-rate switching policy, thus, soon would need to be committed. The speculators knew the situation as well and had realized a mammoth gain from a devalued baht as their foreign assets would worth much more. So there occurred the first massive speculative attack in the Thai history on May 14-15, 1997. Only in Spring of 1997, more than 90% of the country's foreign reserve had been used to defend the value of the baht, and the country was forced to finally switch its exchange rate regime. On July 2, 1997, Thailand had become under a flexible exchange rate system; the Thai baht was devalued by about 15-20 percent (28.80 baht per dollar) after the announcement. The value of the baht had continuously gone down since then and reached the bottom at 48.80 baht per dollar in December of the same year, the highest rate (lowest value of the Thai baht) ever since Thailand started keeping record in 1969.

In this world, open economies were interrelated basically through trade and capital flow, and the health of an economy essentially depended upon how well the economy had managed itself to be in a healthy balance of trade and capital flow. If the balances could not be obtained, the economy became unstable and, sooner or later, it would fall down. It might get injured seriously or not seriously dependent on its remaining strength and how and where it fell down. The Thai economy had not well managed its balances. It was too reckless in capital flow management which resulted in an imbalance of bank balance sheets of the nation's financial institutions. In trade, however, an imbalance was largely caused by outside factors which were likely to be exogenous to the Thai economy, for instance, the emergence of China in international trade, the appreciation of the dollars, and the fall of world demand of semiconductor. The Thais might be able to do things such as the abandonment of an exchange rate regime that caused the Thai baht to move in the same direction as that of the dollars, and investment in research and development to find other types of

exports that Thailand could profitably produce and export.

3. Do the Thais Ignore the Painful Lessons of Mexico?

The Thai financial crisis appeared to be very similar to the Mexican financial crisis of 1994-95. In both cases, an enormous amount of capital was injected into the economies, of which a large part was speculative. The capital had caused overlending syndrome of financial institutions that were loosely monitored by the central bank. The central bank, on the other hand, promised to bailout financial institutions that failed in operation, a policy which had created moral hazard in the financial institutions as well as the creditors and depositors. Then, good years had passed; the economies had experienced slow economic growth and capital outflow. The outflow of capital had caused a bank run which later developed to be a banking crisis. And the necessity of the central bank to get the economy going by supplying foreign currency out of its reserves had been proved to be too huge a task that the central bank finally had to commit to an exchange-rate switching policy, and the economies had to suffer a long period of recession afterwards.

(Points of argument which would follow were products of an attempt to understand and explain some of the behaviors of the economy. The points were only suggestive, not necessarily true. Plus, the points were essentially based on psychological aspects of the issue, and, thus, should be considered together with tangible aspects which were believed to be more rational. For example, as the reader realized that Thailand had believed that it would be after Japan not Mexico, the reader should also have in mind the fact that the Thais had not felt carefree as they must have seen their country's statistics, for example, persistent current account deficits, problematically mismatching ratio of foreign liabilities to foreign assets, which indicated a fragile condition of the country.)

So do the Thais forget the painful lessons of Mexico? I would say "yes, but without many choices." By the time that Mexico had entered into the

financial crisis (1994-95), the Thai economy had begun to get used to a new style of economic liberalization. Thai people had earned more income and had become more and more proud of the growth of their economy. A set of government who came in and suddenly made the economy less appreciable would become unpopular. Thus, the governments in power during that period had preferred not to change the picture of the economy much. So, political concerns did have impacts on the direction of the economic policies. Besides, the Thai economy had had one characteristic much contributing to the rationale of the economy along its path. It believed in a miracle, and that it could make things different. As commented by Paul Krugman:

“Well, maybe the revelation that Asian nations do, in fact, live in the same economic universe as the rest of us will provoke some much-needed reflection on the realities of the Asian economic “miracle.”” [\[2\]](#)

The Asian countries were believed to have Japan as a model for their economic development. After World War II, Japan could quickly and profitably expand its economy especially its manufacturing sector, and became the second largest economy of the world in only less than four decades afterwards. It started from exporting low-technical goods such as watches and electronic appliances. Only shortly afterward, it shifted to produce merchandises which required higher level of technology, for example, automobiles, computers. Then, it moved on to cross-border investment, and not long afterwards, it became the biggest creditor of the world. The Asian countries had observed the success of Japanese economy and believed that they, as well, could do the same thing. Thailand, for example, had started with producing and exporting electronic and automobile parts, then moved on to real estate investment, and planned to do good at capital investment. In less than a decade, the country had grown so much that it believed that it had been on a right path, a path which would lead it to the prosperity that Japan had enjoyed. Investment boom and the rise of cities were evident in the path of the growth. Ten years ago, if you traveled along Chao-Pra-

Ya river, a main river in Bangkok, you would see only vast rice fields along both sides of the river. Today, however, the rice fields had turned to be tall business buildings, hotels, and restaurants. This sort of phenomenon also happened to some other provinces in Thailand which had grown to be cities as the economy had expanded so much that Bangkok could not alone accommodate all the businesses and industries. And in 1994-95, Thailand must observe the economic crisis and collapse of the Mexican economy. Unfortunately, it probably would have seen itself after Japan and not Mexico. Miraculously successful as it had seen itself to be, it believed that it would not fall.

4. An Evaluation of the Thai Government Performance along Thailand's Economic Path and in Response to the Crisis.

The Thai governments had not done a very good job. They had not dared to be far-sighted as they were still concerned much about politics. They had stuck to the goal held since the first time of capital account liberalization, a goal which had aimed at the expansion of the economy. The economy did expand, however, not quite healthily. It was like a bubble, continuously inflated, but the bigger it became, the more easily it would explode even with a soft touch of a rough surface.

The liberalization of the financial sector had been proved to be too reckless. Statistics such as ratio of foreign liabilities to foreign assets, non-performing loans, contribution of inward FDI to current account financing, had been evidences of the recklessness. However, even a good statistics like high GDP growth could not have made the economy joyful. Thailand's GDP growth had been high at around 8.5% during the first half of 1990s. Nevertheless, a large contribution of the growth had come from production of non-tradable good and from pure speculative capital inflow. The structure of the Thai economy was still not ready for that large amount of capital not to be used in real investment. If Thailand had run current account surplus and balance of trade surplus as high

as that of Taiwan or Singapore (table 9 and table 10), it might have a reason and want to liberate itself that much in the financial world.

Politics seemed to be much influential in policy making of the government. The majority of Thai people who walked on the street had been made to see only a prosper side of the economy. It had only been shown to them the growing of the cities and business sectors, and statistics such as high GDP growth, high saving rate, government fiscal balance surpluses, high volume of exports, a claim that Thailand had become one of the Asian Tigers. But it had not been shown to them how serious the country had become indebted, and how recklessly capital had been transferred and used in the economy. Thai people should be better informed and made sophisticated. The Thai government had tried to maintain its popularity even in the last minute when it decided not to ask IMF for a rescue package immediately after the devaluation of the baht was announced, but waited until 26 days later to eventually called in the IMF. This delay had a serious consequence as it exacerbated the situation of bank run. According to Frederic S. Mishkin, it was believed that the faster the lending was done, the lower was the amount that actually had to be lent.^[3] The action of the government, thus, was highly disadvantageous to the economy. Whereas the US Federal Reserve Bank could engage in a lender of last resort operation in a day in the event of stock market crash of 1987, the Bank of Thailand had postponed for another 26 days before it engaged in a lending operation.

Another government conduct worth to be discussed was its loose monetary policy during the period right after the first devaluation of the baht. Committing to that policy, the government showed its steadfast attempt to promote the production and thus the growth of the economy, an objective which had never been set aside. It had kept interest rate low so that the amount of money supply in the economy would be high which would encourage domestic consumption and investment. This conformed to the 'Laffer curve' condition saying that a fall not a rise of interest rate would have strengthen the economy

and restored confidence. Unfortunately, the problem of bank panic was so serious that no matter how much money supply the economy had, the creditors would attempt their best to take money out of the system and did not invest. This resulted in a continuous spiral of currency depreciation that dramatically increased the real burden of the foreign-currency liabilities. Seeing that a loose monetary did not work, the government later on had switched to tighten its monetary policy. It raised domestic interest rate, hoping to retain money in the system. However, the policy turned out to be propelling a more serious contraction of the Thai economy and credit crunch.

5. Final Remarks on the Future of the Thai Economy.

The Thai financial crisis was built upon macroeconomic imbalances of the country, and those imbalances were essentially attributable to the faulty structure of the nation's financial sector. A financial restructuring thus became the first episode of its road to discovery. Beside that it would be ensured that a similar type of financial crisis would not happen again in the future, the financial restructuring would have an immediate or short term benefit to the economy as it would beef up the investors' confidence to bring in credits or capital into the Thai economy in order to make the economy move again.

The next step was that Thailand needed to try to have a reliable and capable institution which could give it a safety net when such a crisis occurred. Unlike the Fed, the Bank of Thailand had a constraint on its foreign-currency reserves which were to be used to pay the nation's debt. So the Bank of Thailand, at least in this ten or fifteen years, would not be able to function as a lender-of-last-resort. This job, therefore, needed to be given to a powerful international institution like IMF. The Bank of Thailand, however, should be reconstructed so that it became independent to the government in its policy making since politics was proved to be a crucial source of the unhealthiness of the economy.

Beside a strong financial structure and a good supporting institution in case of a future financial crisis, from this point on, Thailand needed to be careful in keeping things in a well order. For instance, current account deficit should not be much in excess of 5% of GDP especially if the deficit was financed in a way that could lead to rapid reversals according to the US Deputy Treasury Secretary Lawrence Summers[4]; Banks should be restricted in how fast their borrowing could grow (Mishkin)[5].

6. Conclusion

To achieve Macroeconomic balances, great care and prudent policy management are needed. To be prudent was to be far-sighted and realistic. In the Thai financial crisis case, policies had not been prudently thought out. The collapse of the economy was a very tough lesson for the Thais. It would take long for the economy to recover. (It was predicted to be longer than that of Mexico concisely because the other countries of the region were also hit. Thus, Thailand could not gain much terms of trade after the devaluation of the baht to help improving its economy. Plus, the slow down of Japanese economy had made it unable to give much aid to Thailand unlike Mexico who had a huge support from the US for the road to its recovery.) But hopefully, during that long road, the Thais would maximally utilize the time to thought out wise policies and beef up a real strength so that when the next storm came, it would not turn over again.

[1] *Financial Times*, July 30, 1997.

[2] *Time*, September 29, 1997.

[3] Mishkin, F.S., 1999. Lessons from the Asian Crisis. NBER Working Paper No.7102.

[4] *The Economist*, Jan 5, 1996, pp. 46-48.

[5] Mishkin, F.S., 1999. Lessons from the Asian Crisis. NBER Working Paper No.7102.