Thailand's Recent Financial Crisis

The recent financial crisis in Thailand is a prime example of how a gap between a state's role and its institutional capabilities could become a recipe for disaster. To be specific, the Thai state's strong but imprudent regulatory role in the financial sector, via its renowned bureaucracy, actually did not match its institutional capabilities, which could be said to be underdeveloped particularly in relation to the rapidly growing financial market. Beside, policies adopted by the state to resolve the crisis were arbitrary and shortsighted rather than rational and consensual. The result has been the spectacular failure of the Thai state in attempts to manage the workings of the financial market. This failure was further exacerbated by misguided macroeconomic policies and the fragmentation of the Thai state. It finally became imperative for Thailand to seek external financial assistance in order to rescue the country from a total financial disaster.

This paper analyzes, in particular, these two major aspects of the crisis, namely the growth of Thai financial market which started in the early 1990's and the incapability of the government to efficiently manage the financial sector. It also looks at the individual behavior of Thai policy-makers both in the government and at the Central Bank. In addition, it also considers the weakness of the Thai sate and the fragmentation of the Thai polity as contributing factors to the crisis. In the first place, it is important to bring into perspective the background of the crisis and how the course of events unfolded.

Background of the Crisis

Thailand is considered as one of the success stories of the modernization model of industrialization and infrastructure development promoted by the World Bank and the International Monetary Fund.[1] From the 1960's to the late 1970's, its economy was generated by two factors: export of primary, agricultural commodities and import-substitution industrialization. In the early

1980's, the country switched to an export-oriented policy as advised by the World Bank, Thai academics, and the export lobby. This shift in development strategy resulted in rapid economic growth.[2] Thailand's GDP growth rates were impressively high until the disaster struck in 1997: in 1992, growth rate was 7.9 %, in 1993 8.2%, in 1994 8.5% and in 1995 8.6%.[3] Both American and British Chambers of commerce in Bangkok published directories which described Thailand as "open society and dynamic economy."[4] Apparently Thailand was a dynamic Tiger Economy of Southeast Asia.

This rosy picture began to turn dismal in 1996 when the country saw some symptoms of an economic downturn and financial crisis. Thailand's economic performance and financial health in 1996 caused a widespread concern that its economic competitiveness had been eroded. The year saw a sharp economic downturn which was demonstrated by Bank of Thailand's (BOT) revised growth estimates. The bank revised its growth estimates down from 8% at the end of the 1995 to 7.8% in July 1996 to 6.7% in December 1996.

The stock market was also an indicator of Thailand's economic performance. The market began at 1,323 points at the beginning of 1996, peaked in February at 1,415, then slid gradually through the rest of the year to a low point of 815 in December.[5] There are four major problems Thai economy was confronted with since 1995. They are (a) high interest rates, (b) attacks on the Baht (Thai currency) by currency speculators, (c) the issue of insolvency among many Thai commercial banks due to bad loans made to the property sector, and (d) the current account deficit.

The issue of high interest rates has been a widely debated topic among Thai economists. One of the causes of Thailand's recent economic slowdown was the Bank of Thailand's (the central bank) tight monetary policy which emphasized on high interest rates. Since 1994, the bank pushed interest rates up in order to bring inflation under control, alleviate overheated economy and protect the Baht from currency traders.[6] Since 1994, interests rates have climbed on an uptrend starting from 11.75% for the prime rate before peaking at 14% in 1995 and falling slightly to 13.25% in January 1997.[7] The flip side of high interest rates is that they generated gruesome effects on the economy since those corporations and finance companies which have been relying on short-term funding have to pay dearly high interests and saw their profits drastically shrink or faced liquidity problems.

The second problem Thai economy was confronted with was the attacks on the Baht (Thai currency) by international currency speculators. The Baht was steadfastly pegged to the U.S. dollar and other major currencies such as Japanese Yen. The fixed exchange rate was buttressed by keeping a corresponding amount of reserves at the central bank. This policy was perhaps appropriate between the mid-1980's and the mid-1990's when U.S. dollar was weak. However, starting in the mid-1990's, the dollar strengthened significantly against the Yen and other currencies.[8] Thailand continued to maintain this policy even though the value of the Baht automatically depreciated as the dollar appreciated. Depreciation of the Baht in recent years against the U.S. dollar is as much related to the dollar's growing strength as to the export slowdown because Thailand's market share in the industrialized countries has been shrinking quickly in the face of tight competition from other exporting economies, particularly China. When it became apparent that the Baht was overvalued, currency speculators launched attacks on the currency. The central bank had to throw out almost all of its reserves in attempts to fend off the attacks throughout the crisis.

Another problem which ravaged the Thai economy was the failure of many commercial banks because of the bad loans made to real estate developers. Asia's growth miracle of late has been sustained by domestic demand, particularly for property.[9] In the case of Thailand, its financial institutions were overexposed to real estate developers due to slack banking regulations and high interest rates. As a result, unproductive real estates such as luxurious hotels and condominiums were overbuilt without considering the demand. They were also highly overpriced.

When the economy began to falter in the face of competition from other exporting economies, these real estates failed to sell and their developers defaulted on loans. Bankruptcies of property developers mushroomed, which contagiously bankrupted the banks. At the end of June 1996, non-performing loans amongst Thai commercial banks stood at 7.73% of total loans, up from 6.99% at the end of 1995.[10] A large portion of the bad loans, which was attributed to the depressed property sector, was estimated to be around 800 billion Baht.[11] In addition, unrestrained loans were also made by commercial banks to politically powerful individuals, their cronies, and top bank management personnel, as in the case of the Bangkok Bank of Commerce (BBC).

The last problem was the growing current account deficit, which is the gap between domestic investment and savings. In December 1996, the central bank released projections that the current account deficit would reach 7.9% of the GDP.[12] It was estimated to be running around 300-400 billion Baht.[13] Thailand liberalized its financial sector in the early 1990's by allowing domestic investors access to offshore funds. Thais borrowed freely and imprudently.[14] Thus the nature of the foreign capital inflow changed from direct investment to portfolio investments, bank loans and short-term loans.[15] As a result, the amount of investment grew much higher than that of savings and the current account deficit grew increasingly.

Course of Events

The year of 1997 saw Thailand struggling to overcome the aforementioned problems. The issue of bad loans had already surfaced in 1996 with the collapse of Bangkok Bank of Commerce (BBC) which shocked the Thai financial system from top to tail. The bank financed takeovers of undervalued companies expecting to turn the companies around and sell at the higher market.

However, its major customers for such transactions were mostly powerful politicians and their connections whose financial speculations did not fare as expected. The bank's claim of more than Baht 6 billion of profits in 1994 was seriously doubted by most analysts, including those of the Bank of Thailand.[16]

Large sums of loans, from 17 to 20 billion Baht, were made to the bank's top management, particularly to its chairman and his special advisor. In May 1996, Bank of Thailand bought 32% of the bank's stock, worth about 16 billion Baht, in order to stabilize the bank.[17] In the same month, opposition coalition in the parliament produced a document which revealed that BBC was beset with 77 billion Baht in low-quality high-risk debts of which 37.98 billion Baht were loans for corporate takeovers with inadequate collateral.[18] Finally, the bank was taken over by the Finance Ministry in the same month. The then Finance Minister, Suarkirat Sathirathai, was sacked in the fall out, and the issue of insolvency continued to ravage the government and the central bank.

In January 1997, an investment analyst warned that the amount of non-performing loans made by Thai commercial banks to Thai businesses could increase to between 9 and 10 percent.[19] In order to stabilize the troubled financial sector, the Thai government took some measures. On January 8, Prime Minister Chavalit agreed to an austerity plan to cut the budget for 1997 and 1998 by 50 billion Bahts each year.[20] In addition, the government tried to rescue the ailing property sector by channeling 9.5 billion Baht through the central bank. A bail-out plan was drawn with ten conditions which real estate developers had to meet in order to quality for rescue loans.[21]

In February, the Baht came under attack by currency speculators who drove the Thai currency down to a low 26.20 Baht/Dollar hoping that Thai authorities would devalue the Baht. The then Finance Minister, Tarrin Nimmanahaeminda, set up a command center to handle the crisis at the finance ministry. Thailand escaped this stormy episode, which lasted only two days, but not until the central bank had spent more than US$1 billion from its international reserves to defend the Baht.[22] Thai Bankers' association called for the public to support the high interest-rate policy which they said was a strategic weapon to fend off currency speculators.[23] In addition, the Association of Finance Companies established a sub-committee to study the mergers of non-performing finance companies as a measure to stabilize the situation.[24] These financial calamities knocked down Thai stocks across the board. On February 17, 1997, Stock Exchange of Thailand (SET) closed down at 726.01 points, losing 18.55 points.[25] To make things worse, Thailand's macroeconomic performance did not fare any better than the financial sector. Exchange Equalization Fund announced that growth of exports in February 1997 fell 5.5 percent.[26] In March, Thai government came up with another plan to rescue the property and financial sector. The government set up an asset management agency , "The Property Loan Management Organization," to manage the Baht 100 billion fund provided by the central bank.[27]

Reflecting the financial turmoil, Moody's Investor Service (USA) lowered the long-term senior debt and deposit ratings of five Thai banks from A2 to A3 in April.[28] International Monetary Fund (IMF) urged Thailand to enhance its bank supervision.[29] One Week later, Moody's Investor Service downgraded three more banks.[30] In May, Bank of Thailand launched a surprise offensive against the currency speculators by ordering all 29 local banks and foreign bank branches not to engage in Baht transactions with foreign speculators. With a relatively small supply of Baht available offshore, the cost of borrowing the Baht exploded to more than 1,000 percent, resulting massive losses for currency speculators.[31] Bank of Thailand further moved to punish currency speculators by instructing all Thai commercial banks not to engage in currency transactions with foreign banks.[32] Enjoying some victory over the speculators, Thai government moved to enhance the country's macroeconomic performance. Prime Minister Chavalit promised tax reform and a revamp of the Customs and Excise Department as part of a plan to boost export competitiveness.[33]

Despite these efforts Thailand's economic performance did not fare any better as reflected by the sorry state of the stock market. In the first week of June, Thai stock market's return hit a minus 11.9 percent on par with the Cze Republic's minus 12.4 percent.[34] Amid the financial turmoil and economic downturn, Finance Minister, Dr. Amnuay Virawan, resigned from Chavalit's coalition government on June 19. The minister's departure caused dismay among the financial circles in Bangkok because he was considered to be an able person to deal with the crisis. In the last week of June, the government took a bold action in order to restore confidence to the ailing financial sector by announcing the suspension of 16 troubled financial and securities companies for 30 days and ordered them to arrange mergers.[35]

Apparently reflecting the central bank's decreasing strength to counter future currency attacks, the government announced "managed floating" of the Baht on July 02, effectively a de facto devaluation of the currency, in lieu of another round of attacks on the Baht.[36] Thus the Baht was unpegged from the U.S. Dollar and other major currencies and was allowed to float according the workings of the market. Immediately, the currency's value went down from Baht 25.85 to 29.80/Dollar following the announcement.[37] Thai stocks nosedived in the same fashion by 4 percent to 663.00 points.[38] Inflation was forecast to rise to 7.2 percent from 4.6 percent of 1996 because of the Baht's floatation.[39]

In the meantime, rumors spread in Bangkok that the government was seeking up to US$ 20 billion in loans from abroad to bolster the dwindling reserves and restore investor confidence. But Prime Minister Chavalit refused to comment on the reports.[40] Nevertheless, in the second week of July, the government sent the Finance Minister, Thanong Bidya, to Japan apparently to seek financial assistance. Japan asked the Thai minister to table a credible package of solutions to Thailand's deep-seated economic problems before it commits to providing financial assistance for rescue efforts.[41]

While the Finance Minister was in Japan, Prime Minister Chavalit ordered the raids of two foreign brokerages, including a Japanese branch company.[42] The government excuse was that these companies were spreading rumors that five more banks were expected to fail.[43] As no surprise, Bank of Thailand announced that the country's economic growth would be less than 4,8%, revising its previous estimate of 7.1%, due to negative impacts arising from the Baht floatation.[44] As the crisis deepened, Bank of Thailand governor, Rerngchai Marakanond, resigned on August 02 due to, according to him, frustration with political pressure and criticism of his performance.[45]

Finally on August 05, Thailand and IMF agreed on a rescue plan worth about US$ 18 billion which was put together by Japan.[46] The bail-out deal is a bitter pill for Thailand as it includes tough conditions which Thailand has to strictly meet. The Bank of Thailand stood to lose much of its independence and power to supervise financial institutions according to these conditions set by the IMF. The IMF wanted to limit the central bank to controlling money supply, stabilizing the Baht, and serving commercial banks.[47] On top of 16 already-suspended finance companies, the IMF demanded to shut down 42 more such companies, increasing the number of suspended finance companies to 56.

Out of the IMF-imposed conditions, the most important ones are as follows: (1) restore fiscal, monetary and economic stability immediately; (2) retain reserves equal to 3.5 months' import value, or at least US$25 billion; (3) restore confidence and trust in finance and banking industry to counter any run on funds; (4) restructure the Financial Institutions Development Fund to ease the burden on government;(5) restructure policies, amend economic reforms, and tighten financial institution operating systems and macroeconomic steps; (6) cut the current deficit from 8% of GDP in 1996 to 5% this year and 3% in 1998;(7) maintain annual economic growth at 3-4 % this year and next; (8) cap inflation at 8-9% this year; (9) maintain fiscal stability balancing income and expenditure and (10) tackle economic problems and build international credibility through financial and technical assistance from the IMF, foreign governments and foreign financial institutions.[48]

In addition to these conditions, the IMF specified action plans that Thailand must strictly follow. They are (1) take comprehensive action to deal with weak financial institutions, (2) raise value-added tax from 7% to 10% by August 16, (3) restrict spending to essentials such as education, public health, infrastructure and social welfare, (4) retain the managed float of the Baht and, (5) follow austere monetary policies. The bank of Thailand and the Financial Institutions Development Fund will provide liquidity to support the operations of the 33 financial institutions whose operations have not been suspended.[49]

In the last week of August, Thailand sought an extra US$3.3 billion in aid from the IMF, making the rescue package worth about US$ 20 billion.[50] After securing the much needed financial assistance, Bank of Thailand stunned financial markets by disclosing that it faced obligations of US$23.4 billion from its failed defense of the Baht.[51] Though the Baht went down to Baht 34/Dollar following the bank's disclosure, Thai economy and stock market began to stabilize in the first week September 1997 thanks to the IMF rescue package. Thai stocks (SET Index) gained 5.9 percent closing at 572.30 points and the Baht recovered to about Baht 36 per Dollar form the pervious days' Baht 38.4 per Dollar.[52] The stocks rose again as the IMF confirmed that Thailand was meeting conditions for the rescue plan.[53]

Of late, as the rescue measures are still in the process of implementation, market confidence in the Thai currency have not settled yet. This is evident in attempts by exporters and corporate firms to buy dollar. Thus the Baht is expected to slide further to over Baht 40/Dollar. But the stocks rose by 0.5% in the first week of November in contrast the Baht's slide to Baht 41.15/Dollar.[54] On the part of the government, it was working on a restructuring package in order to rebuild public confidence and prevent future meltdowns in the financial sector. The decrees being drafted at the present time call for the establishment of an Asset Management Company and a Financial Restructuring Agency to mange bad debt and insure depositors and creditors of local finance companies and commercial banks.[55]

Institutional Capability and State's Role

In order to achieve sustained development, governments must strive to match what they do to their institutional capability.[56] Harmony between the state's role and its institutional capability is even more important as a country, such as Thailand, integrates increasingly into the world economy. Where markets for goods and capital are open, the state has a hard time managing the consequences of monetary indiscipline.[57] A state's difficulty in handling growing financial markets can be further exacerbated by lack of sufficient institutional capability. This is exactly what has happened in Thailand when its financial sector was set free and unconditionally exposed to international capital, giving rise to a process of financial indiscipline. The World Bank defined institutional capability as administrative and technical capacity of state officials to undertake collective actions at least cost to society. The bank elaborates that such a capacity derives from the deeper, institutional mechanisms that give politicians and civil servants the flexibility, rules and restraints to enable them to act in the collective actions.[58]

Since the early 1990's, international financial markets have been expanding and integrating, leading to surges in private capital flows to developing countries. The initial impetus for this phenomenon was the cyclical downturn in global interest rates. In addition, other factors - such as decreasing costs of communication, higher long-term rates of return, and the opportunities for investment diversification through investments in prospective developing countries - accelerated international capital flow to developing countries.[59] In the period from 1990 to 1996, Thailand, Indonesia, and Malaysia each received about US$ 65 billion in net private capital from international investors.[60]

The roots of Thailand's financial crisis span as far back as the early 1990's when such a flood of international capital began to flow into many developing countries and when the country opened its doors to it. In contrast to the private capital flows of the 1970's and early 1980's, funds now go to the private sector, as opposed to official agencies.[61] As regards to Thailand, influx of foreign capital went into the private hands since the early 1990's. The Thai government liberalized the financial sector by allowing domestic investors access to cheaper and easier foreign funds. In 1992 Bangkok International Banking Facility was opened for this very purpose. Thais borrowed freely and imprudently without considering hedging.[62] Such a borrowing spree seemed perhaps to impose no immediate risk since the Thai baht was steadfastly pegged to the U.S. Dollar, backed by sufficient amount of reserves, and the country's export boom looked endless.

The Thai central bank at the time made a light-hearted, neoclassical justification that the process of financial liberalization focused on a free market mechanism with minimum supervision by the government. Its rationale was that it was necessary, in order to establish an efficient financial system, to provide the public with more convenient financial services, given the dramatic growth of domestic investment and the rising volume of exports.[63]

The depth of a country's financial sector is a powerful indicator and driver of development.[64] In the post-war years, many countries adopted control-oriented regulation policy regarding their financial sectors, which basically diverted subsidized credits to favored sectors at negative real interest rates. This policy limited the sectoral and geographic diversification of financial institutions and often impeded financial deepening. Thus, most countries veered away from this policy and embarked on a process of financial liberalization. The purpose is changed from channeling credits in preferred directions to safeguarding and facilitating the financial system with prudent regulatory policies.[65]

Thailand's financial liberalization has not been the one in that sense. Throughout the liberalization process, which started in the early 1990's, it has failed to develop appropriate institutional mechanisms, prudent regulatory policies and ability on the part of the government to engage in concerted, collective actions in handling financial issues at the least cost to society. Rather, the process of financial liberalization was just an unbridled process of deregulation in disguise. No rules whatsoever were established as to the nature, amount, and purpose of loans from international creditors.

Thailand embarked on the process of financial deregulation by allowing domestic investors easy access international capital, but it has failed to come up with the establishment of appropriate mechanisms and regulation which could have otherwise constrained imprudent borrowing by Thai investors or at least channeled the borrowed capital into productive sectors other than unproductive property sector. Even though the system was deregulated, it seemed that the powerful cartel formed by the big five commercial banks, which enjoyed cosy relationship with the central bank though political, personal and social ties, had better position than other borrowers to exploit the inflow of foreign capital. If deepening of the financial system was the purpose of the financial liberalization, it could be said that this purpose has been achieved only superficially.

Bringing more participants into the financial market and facilitating financial companies to engage in a broader range of activities might have diverted a considerable amount of capital from the unproductive real estate sector. A huge amount of foreign capital had been flowing into the system, until the disaster struck, without anywhere to go other than the property sector.[66] In 1995, Thailand's total foreign debt was US$ 82.6 billion (Bt 2,065 billion at the fixed exchange rate), of which only 19.9% belonged to the public sector and 80.1% to the private sector. Bangkok International Banking Facility' activities, which was opened in 1992 following the financial deregulation, accounted for 42% of total debt.[67] Most of the privately borrowed money went into the property sector. As of May 1997, it was estimated that the amount of non-performing loans, which belonged to the property sector, could be as much as 1 trillion Baht.[68]

If one is to point out the most important institution responsible for enforcing financial discipline and establishing mechanisms for the financial sector, it is none other than the prestigious Bank of Thailand. The bank was established in 1942 and is empowered by the Banking Act of 1945 to act as the central bank and regulate commercial banks. Balances of commercial banks were required by the law to maintain under the supervision of the Bank of Thailand.[69]

The bank's reputation and professionalism had not been questioned until financial disaster struck. The bank in fact is a legacy of the country's past as the bureaucratic polity and perhaps the showcase of Thailand's traditional patron-client ties. Its employees are the country's best and brightest. They are highly trained and dedicated. Its officials are rarely transferred to other branches of the civil service, and they tend to marry each other. There are some 200 interrelated families at the bank.[70]

The recent financial crisis and the extent to which the central bank has been held responsible reveal that the bank has been fraught with flaws. It has not been restructured to meet the challenges of open financial markets. Rather, it has continued to maintain not only its high degree of institutional autonomy, which is buttressed by political connections, but also autonomy among its separate departments and personnel. According to the insiders at the bank, the governor's deputies, assistants and department chiefs were still working independently of each other even during the critical times. As a result, the bank's focus was never clear throughout the crisis: macroeconomic performance or immediate financial stability.[71]

The bank's remarkable degree of autonomy led to single-handed methods in handling the crisis. When the Baht was set afloat in July, it was criticized for adopting the floating exchange rate in the absence of a set of comprehensive measures to deal with it.[72] Imminent attacks on the Baht were temporarily deflected but the real cause of the crisis - liquidity crisis of businesses and banks -

remained unresolved. Instead of attempting to effectively resolve the more basic problems of the financial system, the bank's top echelon instead was obsessed with currency speculators and stubbornly engaged in secret defensive activities and counter attacks, eventually losing a large chunk of the reserves.

One serious flaw which most analysts attributed to the central bank was its failure to develop transparency regarding its operations as well as commercial banks which are under its jurisdiction. Throughout the crisis until the IMF rescue package was on the way, the bank maintained that its foreign exchange reserves were about US$ 28-32 billion which was in fact not true. Only after the deal with IMF was struck, did the bank amaze everyone admitting that it had commitments totaling US$23.4 billion in outstanding currency forward obligations and admitted that it needed US$15 billion to keep the reserves at the level of US$23 billion.[73]

Similarly, commercial banks did not seriously regard the need to be transparent. Their lack of transparency was bolstered by slack regulation. Thai banks were allowed a degree of regulatory forbearance in such matters as the need to create loan loss reserves and regarding the non-accrual of loans. Thai banks usually do not disclose their level of non-performing loans. Only when the crisis became acute, did the central bank request commercial banks to disclose their actual performance and state of financial affairs.[74] After all, Bank of Thailand's institutional flaws are well reflected in the IMF's requirements for the bank itself to meet. The IMF prescribed that the Bank of Thailand must cut lifelines to ailing financial institutions, tighten the classification of nonperforming loans and disclose the size of the reserves every two weeks.[75]

In addition to the institutional flaws of the central bank, the Thai financial system is also deficient in other crucial aspects such as bankruptcy law. Thailand's bankruptcy law is extremely underdeveloped. It was enacted in 1946 and is highly incompatible with today's economic environment. The law does not allow debtors facing the problem of poor financial liquidity a grace period for their businesses to recover. As a result, increasing number of businesses were ordered bankrupt by court during the crisis beyond the capacity of the justice department to resolve. Only when the problem grew serious, Thai parliament began to consider a new law which would allow businesses with debts of at least 10 million Baht and debt-payment deadlines drawing close to file for a court order for a grace period. This law has yet to be passed.[76]

Besides, according to the old bankruptcy law, process of foreclosure is both lengthy and uncertain, making resolution of conflicting claims difficult and acrimonious. International creditors claimed that Thai creditors were being favored by the ambiguous law in many cases. For instance, Somprasong Land company made payments to its local bankers while defaulting on the payments it owed overseas creditors. Moreover, many troubled finance companies stripped themselves of any descent assets so that by the time competing claims were adjudicated in the lengthy process, there was nothing left at the troubled companies for the overseas creditors to acquire.[77]

Another deficiency in the legal system which is significant to financial affairs is the weak property laws. Weaknesses of Thai property laws have been obviously exploited by property developers. They are not constrained by the law as to price, quality and payments for real estates. Property developers enjoyed the freedom to charge whatever the market would bear during the boom times and made huge profits. Real estate prices skyrocketed as a result. For instance, at around Baht 45,000 per square meter for a condominium space in the city center, many analysts believe it is 30% or 40% above its true market value.[78]

Unscrupulous developers used their stronger financial strength and greater knowledge of the legal system to force innocent consumers to take possession of homes laden with defects. Neglecting safety regulations is not an uncommon practice among Thai property developers. Many home buyers, under current Thai property laws, have little protections against developers who mix home buyers' deposits with other company funds. With economic downturn, troubled developers have been unable to fund new projects though home buyers have made deposits for their homes.[79] If the property sector, which has been the driving force behind most Asian economies, is to be resuscitated, home buyer confidence has to be restored by correcting defective property laws.

Thailand's deficiency in regulatory capacity regarding the financial sector can be best described by the case of the Bangkok Bank of Commerce (BBC). BBC went bankrupt due to the atmospheric level of bad loans. Its diabolic customers included its top management, politicians, certain officials of the central bank and their lackeys. One way to secure loans was as follows. Lenders were allowed to purchase property on an overdraft, after which their land was assessed at many times its real value. The land was later used as collateral to finance other larger loans.[80] There was no systematic regulation whatsoever to curb this kind of financial crimes.

Apart from slack regulation and outmoded laws, Thailand has to develop better legal arrangements to deal with the complicated nature of today's investment capital. Securitization is one important law in that regard. This law is still in the process of being legislated. Securitization is a process of transforming assets or cash flows which are not liquid or tradeable to securities for sale to the capital market. The assets which can be securitized range from housing mortgages and hire-purchase loan receivables to credit card receivables. Assets, transformed into tradeable securities, are offered to investors. Transferring the assets, financial institutions or so-called loan originators could clean their balance sheets. They no longer need to reserve against defaults and with higher equity against risk assets, they could borrow more.[81]

This process was introduced in the United States decades ago and is functioning successfully. In 1995, mortgage loans worth US$ 600 were securitized in the U.S. Despite the possibility of acquiring easier resolution of the liquidity problem, Thailand never pushed for the law because of high liquidity in the market in the past. When in need of more capital, Thai domestic investors resorted to overseas investors. When loans were about to exceed their capital bases, new shares were issued which were welcomed by shareholders when the stock market was in good health. As the country faces the raw reality of open financial markets, such helpful financial arrangements as securitization need to be developed.

Put in a nutshell, Thailand has not developed appropriate mechanisms and prudent regulation to meet the challenges of today's open financial markets. The windfall of international investment capital basically ended up in unproductive property sector. The country has missed a precious opportunity for upgrading its manufacturing industries, which would have sharpened its export competitiveness. Legal mechanisms such as bankruptcy law, property law and the like have not been updated to be compatible with new economic environment. If innovative legal arrangements, such as securitization law, were developed, it could have been easier and efficient in resolving liquidity problem. Above all, Bank of Thailand (the central bank) remained a closed, bureaucratic institution based on patron-client and family ties. The bank should have been drastically restructured to enable it to manage and regulate the much changed financial sector. In brief, institutional capability of Thai state has not been developed in proportion to the increasingly growing and ever more complicated nature of open financial markets.

State's Response To The Financial Crisis

Despite its deficiency in institutional capability, Thai state has assumed a strong regulatory role throughout the financial crisis, which is more of arbitrary nature than prudent. The state's strong role in banking regulation has developed along with the country's banking law. Prior to 1962, there were two such laws in existence: the 1937 Act for the Control of Business Banking and the Commercial Banking Act of 1945. The 1939 Act vaguely defined a bank[82] and established flexible parameters within which a bank was required to submit a confidential monthly statement of its activities and maintain a paid-up capital of only Baht 250,000. The 1945 Act established the

Bank of Thailand as the central bank.[83] In order to encourage domestic savings and coincide with the first economic plan of the 1960's, a new act was introduced in 1962.[84]

The 1962 Commercial Banking Act empowered Thai state to assume a strong role in managing banking industry. By the Session 50 of the act, the Ministry of Finance have complete charge and control over the execution of this law. Therefore, banking regulation was implemented by both the law and the various ministerial regulations issued by the Ministry of Finance. In addition, the Governor of Bank of Thailand could recommend certain steps to the Ministry of Finance for approval.[85] Thus, Thai state has both legal and institutional venues to effect its policies as regard to commercial banking.

Irrational Policy-makers

Throughout the financial crisis, Thai state made use of these venues in attempts to resolve the crisis, particularly through the central bank and Ministry of Finance. Rather than rational and consensual, the government's policies were heavy-handed and arbitrary. If a rational decision-making is defined as a process which involves ranking one's preferences, assessing available options and choosing the best possible outcome, the decisions made by the Thai policy-makers during the financial crisis could be said to be irrational.

In the first place, the issue to be resolved itself is a complicated phenomenon which could baffle anyone attempting to find a rational solution. For instance, there existed a conflict between the solutions to the macroeconomic problems and the financial stability. Thailand's economy is based on export industry, which has been depressed by the problem of decreasing exports. If the Baht was devalued and unpegged from the major currencies, Thai exports would become cheaper and more competitive at the international market. Attacks by the currency speculators would virtually cease because the devalued and floating Baht would reflect its real value. The flip side was that devaluation of the Baht would cause the prices of imported goods to shoot up. In addition, domestic bankers who made unhedged loans from foreign creditors would be hurt by the inflated debt. If the Baht was not valued, it would continue to be, as it was, targeted by the speculators because of its being overvalued and Thai exports would continue to lose to the cheaper Chinese goods.

By way of hindsight, the best plausible action out of available options would have been the early devaluation of the Baht. However, policy-makers in the government and at the central bank chose to retain the Baht's value at any rate by engaging in counterattacks against the speculators - a policy which caused spending and losing much of the currency reserves. Instead of the concentrating on the more basic problems such as the need to enhance export competitiveness, lack of prudent regulation of both financial and real estate sector, Thai policy-makers went after the currency speculators. The polices adopted were irrational in the sense that they did not represent the best options.

After some initial attacks on the Baht by currency speculators, the central bank launched a counterattack in July in a mercantilist fashion. The bank ordered 29 local banks and foreign bank branches not to engage in Baht transactions with foreign speculators. Because foreign speculators were not able to get their hand on the Baht at Bangkok market, they had to scramble for the Baht from the offshore markets, such as Singapore, Hong Kong, London or New York. With a relatively small supply available offshore, the cost of borrowing Baht skyrocketed to more than 1,000 percent, resulting in massive losses for speculators.[86] It was the only round the central bank won over currency speculators thanks to its institutional power to bar the selling of the Baht.

Nevertheless, this kind of irrational and arbitrary action is detrimental to long-term economic interests since foreign investors were alienated by such a hawkish policy. This episode demonstrated how the state became so irrationally arbitrary as to break the rules of the market.

Without institutional capability to resolve fundamental problems, the state has relied on its arbitrary power. Thai state's reliance on such a heavy-handed policy at the time culminated with the raids of foreign currency brokerages in July. Prime minister Chavalit's office ordered the raids on one Japanese affiliate company and a Dutch-American company on the allegation that these financial companies were spreading rumors that five commercial banks were in line for bankruptcy.[87] Nevertheless, the real motive behind raids was to intimidate foreign currency companies into abstaining from trading the Thai currency.

It was criticized that, instead of resolving financial turmoil rationally, the government and its financial regulators were after rumor-mongers, currency speculators and policy critics in the press. In the final analysis, it can be said that Thai state's arbitrary role in managing financial affairs has been disproportionally greater than its underdeveloped institutional capability. The state's institutional capability did not match its presumptuous role in handling the crisis. The result has been virtually a financial disaster as the country was left with half the amount of required reserves, half of its financial institutions defunct, and the property sector in turmoil. In a wider perspective, major causes of the crisis, such as government indecision, flawed policies and financial indiscipline, are as much related to the underdeveloped institutional capability of the state as to the fragmented nature of Thai state.[88]

Inefficient State

If a strong state is defined as the one which takes on responsibilities and generally carries them out effectively, then the Thai state is positively a weak one.[89] Since World War II, the Thai state was dominated by the military, bureaucracy and politicians. Thai bureaucracy has traditionally been as much cohesive and strong as the military and the country was dubbed as bureaucratic polity in the past. In such a polity, few autonomous groups outside the bureaucracy played much of a role in the political system. As the military's power waned significantly following the 1992 democratic uprising, the Thai state has become an arena for politicians and bureaucrats.

Such an elite-dominated state has been weak basically due to, among other factors, the fragmented nature of Thai political party system. Thai parties are organized, not around ideologies or policy issues, but around personalities without mass basses or assets. Each election has witnessed the birth of several new parties as well as the death of one or more parties. A significant number of candidates usually do party-switching to secure financially and politically strong patrons. During election times, popular candidates are offered more money and political corruption and vote-buying have become major problems.[90]

In addition, Thai political parties are fraught with factions. The factionalism is attributed both to Thai political culture in general and and, technically, to the quota system in the cabinet composition. The country's multiparty, multi-member electoral district system entails coalition governments. Cabinet seats and other important position below the cabinet are divided among the coalition members based on the number of seats they hold in the parliament. Such a system gives rise to different factions within parties and the coalition, which strive for more power through group interaction and competition. In addition, the Thai cultural system of patron-client ties also reinforced the growth of factions in the government.[91] Politicians in power almost always try to recoup the expenses of vote-buying, sponsoring candidates and maintaining patron-client networks by resorting to various forms of corruption. Thus, the Thai polity is fragmented and corrupt, and the Thai state has been inefficient, indecisive, and corrupt as a result.

Government corruption and inefficiency have in fact played a large role in exacerbating the financial crisis. For instance, the government has been indecisive as regards to the issue of exchange rate. If the Baht is devalued, Thai exports would become cheaper and competitive at the international market. But it would hurt importers and domestic investors who made unhedged loans from foreign creditors. If the exchange rate was maintained, the export sector would keep sinking.

Different factions in the government were connected to different patron-client networks and no articulate decision was made until it was too late. The Baht was at last virtually devalued in July by letting it float against other currencies.

Besides, government corruption was connected to the issue of bad loans. The issue of the Bangkok Bank of Commerce (BBC) is a case in point. The bank collapsed in 1996 with bad loans of approximately US$ 3 billion. Questionably, the Thai government tried to resuscitate the bank by channeling large amounts of capital through the central bank. In April 1996, the central bank bought bad stocks of the BBC worth about 16 billion Baht. In April 1997, the bank injected another dose of capital into the ailing BBC, worth about Baht 48 billion.[92] Such a questionable policy on the part of the government has much to do with the connections between the top politicians and the BBC. After all, the BBC had made loans to politicians with shady collaterals. The politically powerful could even ask banks to deliver cash to their homes without having to go to the bank. Sources at the BBC claimed that certain senior officials at the central bank themselves were involved in financial deals with the senior management at BBC.[93]

Discussions and Conclusion

In the final analysis, the genesis of Thailand's financial crisis can be said to have originated in the unregulated liberalization of its financial sector in the early 1990's. When troubles ensued due to a slack regulation and weak legal framework, Thai state resorted to single-minded, arbitrary, irrational methods to resolve the crisis. Without sufficient level of institutional capability, the crisis was not resolved and finally led to a virtual disaster and the subsequent IMF rescue. Such a crisis was even more exacerbated by general inefficiency of the state as generated by political corruption and fragmented nature of Thai polity. The result has been the damages afflicted almost at all sectors of the country's economy and the loss of a large chunk of sovereignty to the IMF.

This study has focused on Thailand's low institutional capacity and misguided policies as the fundamental causes of the financial crisis. Other than these internal factors, some important external factors could have been at play in causing and exacerbating the crisis. One such factor is the fluidity of investment capital in today's globalized economy. In the past, investment capital had national character and was, more or less, subject to national policies. Today, investment capital has assumed an international character and is largely freed from national policies. Its transnational movement has been even more facilitated by modern communication and computer technologies. Thus, just as the global capital quickly into Southeast Asian countries in the early 1990's, it has now flew out of the region as quick as it entered. The capital's new haven for the time being has been China where labor is cheaper, export sector looks prospective and domestic market is large and growing as correctly called a BEM (big emerging market). Because international financial markets are increasingly integrated and interlocked, financial crises have become highly contagious. Collapse of Thai commercials instantly affected its foreign creditor banks, especially those in South Korea and Japan. This new nature of international capital obviously requires even more measures of structural adjustment in globalized economies.

As regards to Thailand, such measures are expected to be facilitated by future governments which would be chosen according to the new constitution. The new constitution is drafted basically to cure the country's deep-rooted political vices: party-fragmentation, vote-buying, cronyism, military coups, influence of special interest and so on. Indirectly, the constitution might be able help bring about better institutional capability, efficient financial laws and regulations which are prudent. As for now, Thailand has to clean up the mess the financial storm has left and institutionalize the new rules of game which the new constitution has introduced. As regards to its economic future, like other Southeast Asian tigers, its survival would depend on how well it would manage to ward off the formidable competition from the latest but not least dragon - China.

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