The Asian Financial Crisis and Prospects for Trade and Business with Thailand

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Indeed we are in uncharted territory - we are a part of history, a period in which perhaps new policies and new systems have to be devised. If not for the toll that the crisis has taken, the situation would be a researcher's dream - the luxury of experimental methods usually denied the economics researcher.

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1. Introduction

According to Greek mythology, Achilles was invincible. That is, except for his heel. And it was an arrow through that heel that finally destroyed him.

A few years ago, Thailand looked invincible. The epitome of stable growth, Thailand was often cited as an example of sound macroeconomic management. The World Bank called Thailand the fastest-growing economy of the decade[1], including it in the group of "high-performing Asian economies".[2] The International Monetary Fund predicted that by the year 2020 Thailand's economy would grow to be the eighth largest in the world, surpassing France. Inflation was low, the government budget was in surplus, and the balance of payments was controllable. Investment soared and unemployment was virtually unheard of.The World Bank in fact lauded the achievements of the East Asian governments for successfully fine-tuning the economies with appropriate intervention and stimulus.

But Thailand had an Achilles' heel. Where that heel lies and what extent of destruction has been wreaked as the Asian financial crisis unfolds is the subject of this paper. Some argue that a crisis was brewing long before the spectacular crunch that instantly drew worldwide attention. In retrospect many believe that East Asia's development pattern actually contained the seeds of its own destruction. Others however conclude that in spite of underlying weaknesses, the crisis was not "inevitable".[3]

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1 Butler, 1997, p.42

2 World Bank, 1993. The economies included in this categorization were Japan, Republic of Korea (referred to here interchangeably as South Korea), Taiwan, Thailand, Malaysia, Singapore and Indonesia.

3 Bhattacharya, et. al., 1998

An understanding of the past is therefore required to understand the issues, and to assess the challenges and opportunities for the future. This paper examines what happened, why it happened, and why it was not foreseen. It also explores the lessons and adjustments, in the hope of preventing future crises. Finally opportunities and prospects for trade and business are examined.

2. From boom to gloom: What happened and why

Metaphors abound in describing the crisis, ranging from infection and contagion, to epicenters, aftershocks, fallouts and meltdowns. Indeed a glance at the exchange rate and the stock market indices of countries in the Asia-Pacific region can convince any observer that such dramatic language is warranted.

Figure 1 shows that from mid-April 1997 to mid-April 1998, Indonesia's currency depreciated by almost 70 per cent with little sign of a speedy recovery, while South Korea, Thailand, Malaysia and the Philippines have each been hit by currency depreciations of between 30 to 36 per cent. Figure 2 demonstrates the kind of free fall that the stock markets of the crisis countries have experienced.

Regional currencies are now showing some signs of stabilising, but the situation is still volatile as firms hit by the crisis continue to close down, and more and more Asians become jobless. South Korea's unemployment rate hit an 11-year high of 6.5 per cent in March 1998, Indonesia's jumped to 10 per cent in April and may still be climbing due to the political turmoil. Japan experienced the largest monthly rise in unemployment in 30 years in March, hitting 3.9 per cent, while Thailand expects two million workers to be out of work in 1998.

To understand what has been happening in the past 10-12 months requires an understanding of what was happening in the preceding 10 years. The crisis started in Thailand, and the paper will draw heavily from Thailand's experience, an experience that was closely mirrored by all the economies now in trouble.

The last decade saw unprecedented changes in many East Asian countries, and Thailand was no exception. The double-digit growth rates in the late 1980s were exemplary and prompted discussions of booms and miracles. Thailand pursued trade and financial liberalization in earnest, and these policies were widely welcomed. Deregulation and privatization, which had hitherto been taboo, were hailed as enlightened policy.

For at least a full decade, Thailand and other East Asian countries were attractive to invest in. Rates of return were high and capital flowed in, in response to stabilisation and reform efforts, and financial liberalization. The fixed exchange rate regime facilitated export and import. And the high interest rates that limited flexibility of the exchange rate required was extremely attractive, particularly with the declining trend in longer-term interest rates in the industrial economies over the decade and the emergence of large institutional investors in industrial countries. With low returns on domestic investments, Japanese and US banks alike needed to find new customers for loans, and they found them in the booming economies of Southeast Asia.

Massive amounts of foreign capital poured in. Japan ploughed more capital into Thailand in a single year, 1987, than it had in the previous 20 years combined. From 1986 to 1989 the flow of foreign money rose by 400 per cent. Asia as a whole in fact has had larger capital inflows than any other region, receiving more than US$160 billion per annum in 1990-96, and a total of US$107 billion in 1996. Foreign direct investment has constituted as high as 55 per cent of the total capital inflows, and some countries in the region received net inflows averaging 5-8 per cent of GDP over a substantial period of time.[4]

Japan	-2.4
China/HK	0.2
South Korea	-35.8
Australia	-15.6
Taiwan	-16.4
Indonesia	-69.1
Thailand	-34.6
Malaysia	-32.2
Singapore	-10
Philippines	-30.7
New Zealand	-12

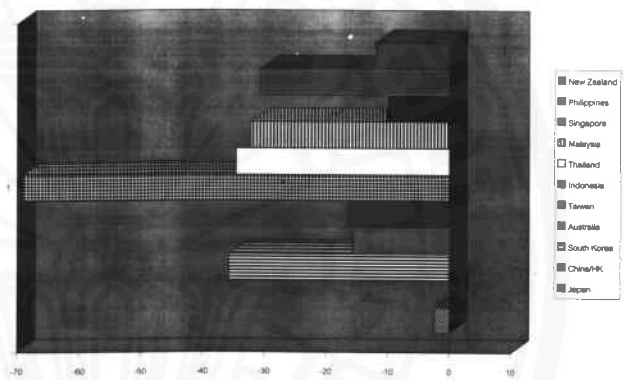
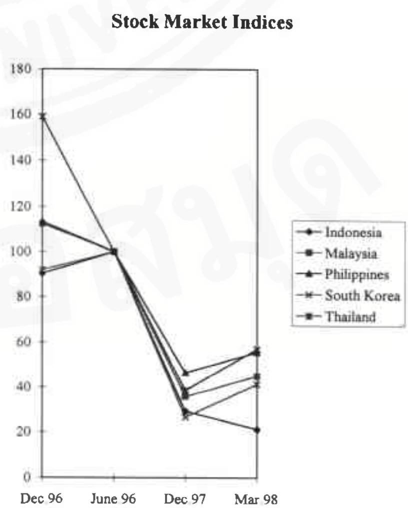


Figure 1: *Exchange Rate Changes (April 1998 compared with April 1997)*

Figure 2: *Stock Market Indices "(June 1997=100, in US$ terms)"*

	Dec.96	June.96	Dec.97	Mar.98
Indonesia	90.3	100	29.2	21.2
Malaysia	112.3	100	35.7	44.9
Philippines	113.3	100	46.5	55.8
South Korea	91.9	100	26.5	41.4
Thailand	158.9	100	38.6	57.2

Source: *Institute of International Finance*



4 Fischer, 1997

Sustained high growth endowed the growing middle class with a sense of optimism and security. It was also intoxicating. Between 1990 and 1994 real wages in Thailand increased at an astounding rate of almost 10 per cent per year,[5] and fuelled a consumption boom.

The strong, seemingly-invincible facade in fact masked deep underlying problems. The policy environment had radically changed. Even casual observation of the size of world exchange transactions shows how vulnerable to capital movements small countries have become. Prior to this period, shocks and disturbances from the rest of the world were transmitted to countries like Thailand mainly via trade and direct investment. With financial liberalization, capital markets become exposed to speculative attacks. Table 1 shows that the value of financial transactions now outstrip both the value of trade in goods and services as well as the total stock of foreign exchange reserves.

In 1977 foreign exchange transactions were about 3.5 times the value of trade in goods and services. By 1995 such transactions outstripped trade by almost 68 times. In 1977 daily foreign exchange turnover was about seven per cent of global foreign exchange reserves. In 1995 daily foreign exchange dealings exceeded total world foreign exchange reserves by eight per cent.

Table 1: *New global environment: value of trade, transactions and reserves.*

	1977	1995
(1)World trade in goods and services	US$1.3 trillion	$4.8 trillion
(2)World exchange transactions	$4.6 trillion	$325 trillion
(2) / (1)	3.54 times	67.70 times
(3)Combined global foreign exchange reserves	$266 billion	$1.2 trillion
(4)Daily foreign exchange dealings	$18 billion	$1.3 trillion
(4) / (3)	6.77 %	108.33 %

Source: *International Monetary Fund Statistics*

This changed environment was never perceived as a threat. Countries like Thailand were happily running up trade deficits as a normal course of affairs, and financing that deficit with foreign borrowing. Table 2 shows that Thailand's foreign debt was rising at rates well above 20 per cent per year in many of the boom years, far outstripping real GDP growth. By the time the crisis loomed, Thailand had a large trade deficit of $10 billion, as did Indonesia ($8 billion), Malaysia ($4 billion), the Philippines ($4 billion), and the Republic of Korea ($19 billion). By itself and under certain circumstances, a trade deficit can be containable (as the US case exemplifies), but in Thailand, a combination of factors were at work. It was not a lone arrow that pierced that heel.

[5] Warr, 1997

Table 2: *Thailand's Growth Rates of Foreign Debt and GDP*

	Foreign Debt US $m	Growth Rate	GDP at 1988 prices (millions of baht)	Growth Rate
1982	10,129	27.78	1,019,501	5.6
1983	11,162	10.21	1,076,432	7.3
1984	12,839	15.02	1,138,353	7.1
1985	14,699	1.49	1,191,255	3.5
1986	16,029	9.05	1,257,177	4.9
1987	17,500	9.18	1,376,847	9.5
1988	17,889	2.22	1,559,804	13.2
1989	19,417	8.5	1,751,515	12.2
1990	25,061	29.07	1,945,372	11.6
1991	33,284	32.81	2,111,862	8.5
1992	37,354	12.23	2,282,572	8.1
1993	45,705	22.36	2,437,937	8.3
1994	55,001	20.34	2,695,054	8.9
1995	68,132	23.87	2,933,168	8.7
1996	79,854	17.2	3,095,041	6.4

Source: *Bank of Thailand, Monthly Bulletins, various years.*

First, much of that borrowing was alarmingly short-term.[6] Of the non-bank private sector foreign debt of US$63 billion at the end of 1996, as much as $29.2 billion (which was more than 16 per cent of GDP) was of less than one-year duration. International comparison of the debt owed to international banks and the maturity structure (Figure 3) shows that Thailand had a larger proportion of short-term debt to GDP than any other country in the region.

By contrast, public debt was relatively small. At the end of 1996, public debt (domestic and foreign) stood at only $27.9 billion or about 15 per cent of GDP, making Thailand one of the "least publicly indebted countries in the world"[7]. International comparison in Figure 4 shows that public borrowing among the East Asian countries was small relative to total borrowing, and relative to governments in other regions.

6 The Bank of Thailand, however, maintained that it was only a cyclical phenomenon that would be corrected in 1997 (Bank of Thailand, 1997).

7 Ammar, 1997

The whole thrust coincided with the prevailing mainstream global philosophy of allowing private markets to function unfettered. Figure 5 shows that by 1994 all the ASEAN 4 [8] countries were adopting fiscal prudence, and registering budget surpluses. They were nevertheless still seeking to maintain high growth rates, so that with the savings-investment gap shown in Figure 6, the governments were effectively leaving the private sector to fund growth via foreign exchange export earnings and external borrowing.

Figure 3 : *Debt owed to international banks and maturity structure (1996-7)*

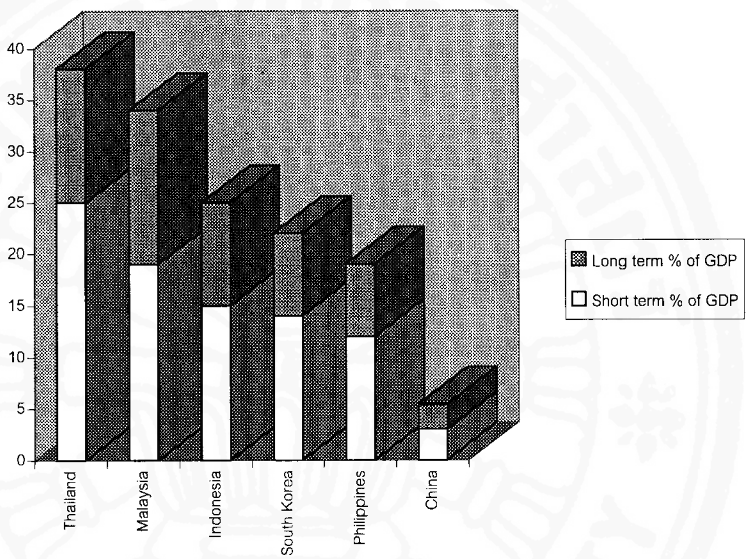
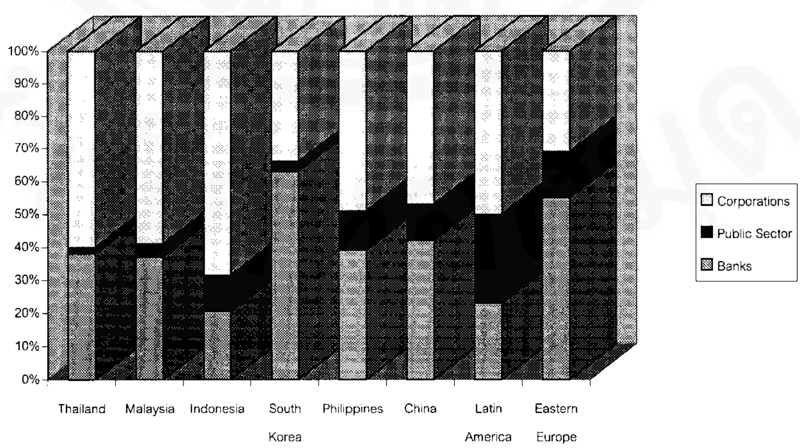


Figure 4 : *Debt distribution by sector (1996)*



[8] Indonesia, Malaysia, the Philippines and Thailand are commonly known collectively as the ASEAN 4.

Figure 5 : *Government budgetary positions (1991-6)*

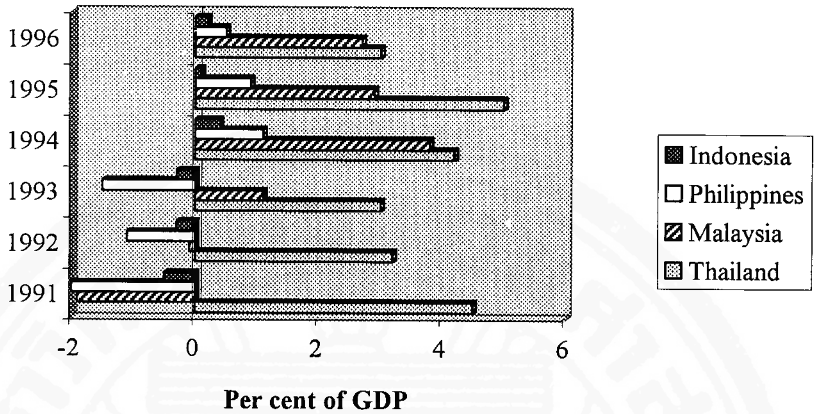
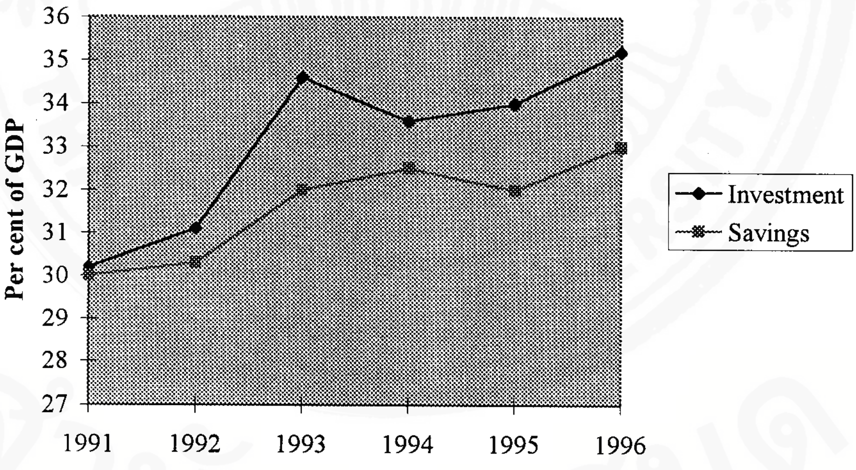


Figure 6 : *Savings-Investment Gap of SEA Countries (1991-6)*



The sheer magnitude of private short-term debt can be seen in Table 3. The excessive short-term borrowing was facilitated by the opening up of the capital account and the establishment of the Bangkok International Banking Facility (BIBF) in 1993, that accommodated purely foreign-denominated loans. At the same time, foreign lenders were anxious to take advantage of the high domestic interest rates.

Table 3 shows that private capital inflow through the BIBF began to dwarf other kinds of inflow. Many of the external loans of the commercial banks as well as non-bank overseas direct loans were now channelled through BIBF, and substantial non-bank debt was repaid using the lower-interest BIBF loans.

In addition many of the direct investment loans from overseas parent companies were repaid and re-financed through BIBF because of the more favourable interest rates. The influx of private capital brought added risks. As can be seen in Table 4, the debt service ratio started to shoot up in 1996 from around 11 in preceding years to 12.3 for 1996 as a whole, with the ratio escalating in the last two quarters. This was no doubt brought about in part by the staggering decline in export performance that registered close-to-zero growth in 1996. The debt service ratio now hovers around 16.

Adding fuel to the problem was the fact that while borrowings were increasingly short-term, investments on the other hand were mostly long-term. A large portion of the capital inflow went into real estate deals, and land prices in Thailand in the late 1980s and mid-90s soared to levels far above economic sustainability. Fortunes were made overnight, fuelling conspicuous consumption and further real estate investments (read: speculation). The use of land as collateral for loans further allowed the floating of more debt as land prices escalated. Euphoria filled the air. The stock market surged and the makings of a debt pyramid were in place. Short-run opportunities to obtain huge returns overwhelmed mere rational calculations. With short-term borrowing financing long-term investment, the makings of a crisis were building up.

Table 3: *External Debt (1994 - 1998) in millions of US$*

	1994	1995	1996	1997 P/	1997				1998
					Q1 P/	Q2 P/	Q3 P/	Q4 P/	Jan. P/
Total Debt Stocks (End of Period)									
Public Sector	15,714	16,402	16,805	17,166	16,162	17,354	17,021	17,166	17,390
Long-term	15,534	16,317	16,751	17,146	16,142	17,334	17,001	17,146	17,370
Short-term 1/	180	85	54	20	20	20	20	20	20
Private Sector	49,152	66,166	73,731	67,323	76,351	75,602	71,760	67,323	65,321
Long-term	20,153	25,155	36,172	38,102	38,463	39,066	39,296	38,102	37,572
Short-term	28,999	41,011	37,559	29,221	37,888	36,536	32,464	29,221	27,749
Commercial Bank	9,865	14,436	10,682	8,164	12,206	11,762	9,886	8,164	7,687
Long-term	3,451	4,443	2,314	2,545	2,934	3,276	3,071	2,545	2,415
Short-term	6,414	9,993	8,368	5,619	9,272	8,486	6,815	5,619	5,272
BIBF 2/	18,111	27,503	31,187	30,097	32,187	32,568	31,116	30,037	29,478
Long-term	2,969	3,799	10,697	11,009	11,723	11,399	11,407	11,009	10,789
Short-term	15,142	23,704	20,490	19,070	20,464	21,169	19,759	19,070	18,689
Non-Bank	21,176	24,227	31,862	29,080	31,958	31,272	30,708	29,080	28,156
Long-term	13,733	16,913	23,161	24,548	23,806	24,391	24,818	24,548	24,368
Short-term	7,443	7,314	8,701	4,532	8,152	6,881	5,890	4,532	3,788
Monetary Authorities	-	-	-	7,292	-	-	4,482	7,292	8,035
Use of IMF credit	-	-	-	2,427	-	-	1,618	2,427	2,427
Others	-	-	-	4,865	-	-	2,864	4,865	5,608
Total	64,866	82,568	90,536	91,781	92,513	92,956	93,263	91,781	90,746
Long-term	35,687	41,472	52,923	62,540	54,605	56,400	60,779	62,540	62,977
Short-term 1/	29,179	41,096	37,613	29,241	37,908	36,556	32,484	29,241	27,769
Bank foreign assets	9,672	9,672	4,745	6,369	4,966	4,500	5,085	6,369	6,603
Gross official reserves	37,027	37,027	38,725	26,968	38,066	32,353	29,612	26,968	26,724

1/ Short-term external debt is defined as debt that has an original maturity of one year or less.

2/ BIBF's debt, which was compiled according to remaining maturity since the establishment of BIBF's activities in 1993 has been adjusted to original maturity basis since January, 1996, consistent with other external debt items.

P/ Preliminary

Source : *Bank of Thailand, Table 45, Monthly Bulletins September 1997 and March 1998*

Table 4: *Thailand's Debt Service (1994-1997)*

	1994	1995	1996	1996		1997		
				Q3	Q4	Q1P/	Q2 P/	Q3 P/
Bank foreign assets	6,856	9,672	4,745	5,447	4,745	4,916	4,489	5,091
Gross official reserves	30,279	37,027	38,725	39,537	38,725	38,066	32,353	29,612
Debt Service Payments	6,707	8,253	9,024	2,301	2,625	2,748	3,098	2,796
Principal	3,933	4,059	3,822	940	1,301	1,290	1,624	1,426
Interest	2,774	4,194	5,202	1,361	1,324	1,458	1,474	1,370
Public sector	1,943	2,029	1,845	576	420	553	368	607
Principal	1,106	1,125	987	318	247	300	195	366
Interest	837	904	858	258	173	253	173	241
Private sector	4,764	6,224	7,179	1,725	2,205	2,195	2,730	2,189
Principal	2,827	2,934	2,835	622	1,054	990	1,429	1,060
Interest	1,937	3,290	4,344	1,103	1,151	1,205	1,301	1,129
Export of goods and services	57,580	72,287	73,533	17,892	18,931	18,775	18,613	18,382
Debt Service Ratio	11.7	11.4	12.3	12.8	13.9	14.6	16.6	15.2
Public sector	3.4	2.8	2.5	3.2	2.2	2.9	2.0	3.3
Private sector	8.3	8.6	9.8	9.6	11.7	11.7	14.6	11.9

P/ preliminary
Source: *Bank of Thailand*

Table 5 shows that there was a shift in relative importance from direct investment to short-term capital. In 1993 and 1994 direct investment actually declined.

Table 5: *Thailand's Private Capital Influx 1991-1996 (US$billion)*

	1991	1992	1993	1994	1995
1. Banking sector	-0.3	1.9	3.6	13.9	11.2
Commercial banks	-0.3	1.9	-4.1	3.8	3.1
BIBF	-	-	7.7	10.1	8.1
2. Non-banking sector	10.6	7.6	6.7	-1.9	9.6
Direct investment	2.0	2.2	1.7	1.3	2.0
Portfolio investment	0.2	0.6	4.9	1.1	3.3
Non-bank loans	5.7	2.8	-2.4	-5.8	1.5
Others	2.7	2.0	2.5	1.5	2.8
3. Total	10.3	9.5	10.3	12.0	20.8

Source: *Bank of Thailand Economic Focus, Vol.1, No.3, July-September 1996*

The extent of foreign indebtedness exposed Thailand to a position of vulnerability. By the mid 1990s oversupply of real estate was already choking the market and stock prices plunged as foreign portfolio investment switched elsewhere. By 1996 a current account deficit reaching a level of eight per cent of GDP was becoming problematic.

Add to that the botched attempt to deal with fraudulent practices in a medium-sized commercial bank (the Bangkok Bank of Commerce) which cost the authorities billions of Baht, the rumours of insolvency of major finance companies, political instability and the lack of confidence in the government, and plummeting exports through loss of competitiveness, particularly apparent in 1996, and the crisis was under way.

Rumours of insolvency among the finance companies were treated by the Bank of Thailand as a mere liquidity problem, and some US$30 billion was used up as loans to these companies through the Financial Institutions Development Fund (FIDF). Furthermore, the inflexibility in the exchange-rate regime and the feeble attempts by the Bank of Thailand to defend the currency against speculative attacks used up another US$30 billion of foreign exchange reserves, and left Thailand bankrupt.

With the now-saturated real estate market, a stock market in the slumps and falling asset prices, companies started to record huge losses on their investment portfolio. With falling asset prices, what had been good loans became bad. Adequate collateral became inadequate. Loans were called. Foreign lenders got jittery and easy money from abroad dried up. Wary of defaults and short of liquidity themselves, banks now refuse to renew the loans that previously would have been routinely rolled over. Working capital dries up. Suppliers demand cash before delivery. Even financially sound firms find that they cannot pay their bills, since they are unexpectedly and suddenly asked to make loan repayments and pre-pay suppliers. Businesses that cannot finance themselves become insolvent.

Capital flight becomes inevitable when currencies are expected to depreciate. Openness and full convertibility facilitates the process. Vast amounts of money leave the country. The Bank of Thailand dried up foreign exchange reserves trying futilely to defend a fixed exchange rate against speculative attacks. As the central bank starts running out of foreign exchange reserves, the currency plunges. The real costs of repaying international loans rises. Credit markets freeze up, and contagion effects spread.

3. Why were the problems not detected?

The nagging question is why the crisis was not foreseen. In the aftermath, and with the benefit of hindsight, many of the warning signs now seem obvious. But even in early 1996 seasoned pundits were predicting continued prosperity. Credit rating agencies were still giving the crisis economies good ratings up until the July devaluation of the Baht. Although the IMF expressed some concern about the huge capital inflows, it had not been particularly worried about the situation and was still praising Thai authorities for their "consistent record of sound macroeconomic management policies", even as late as the latter half of 1996. Jeffrey Sachs of Harvard University scathingly commented that the IMF arrived in Thailand in July 1997 "with ostentatious declarations that all was wrong and that fundamental surgery was needed, when in fact the ink was not even dry on the IMF's 1997 annual report, which gave Thailand and its neighbours high marks on economic management!"

Perhaps it was difficult to foresee doom and gloom, or to convince anyone of it, when the economies appeared vibrant and the profits were rolling in. Even the most level-headed of gurus have difficulty resisting the temptation to follow along during a heady price build-up and the possibility of lost opportunities. In the investors' constant tug-of-war between fear and greed, when greed wins, another kind of fear takes over: the fear of lost opportunities, of missing the bus, of losing the chance to make further gains.

But more importantly, perhaps the usual macroeconomic indicators were inadequate in the new environment of massive financial flows. Thailand's foreign exchange reserves had been rapidly accumulating, from about US$16.5 billion in 1990 to US$46.7 billion in 1995. These foreign reserves covered over six months of imports, and this was the usual indicator relied upon to measure the health of the economy. In actual fact, careful scrutiny of Table 3 above shows that external debt was also rising rapidly: the seemingly healthy increase in reserves was merely the result of debt creation, much of which was short-term. The ratio of short-term debt to foreign reserves rose from 0.62 in 1990 to 0.88 in 1995. As the Bank of Thailand battled currency speculators with forward swap contracts, actual (uncommitted) reserves were in fact much less than official reports indicated. If net foreign reserves are compared with outstanding short-term debt, it would have been clear that the country was virtually bankrupt at the end of June 1997. The lesson is that financial flows do matter and that new sets of indicators must be used. Bhattacharya (1998) quotes an intriguing "financial fragility" index compiled by Goldman-Sachs which conceivably could help predict vulnerability, but its construction requires a wealth of information that has to be accumulated over a lengthy period of time.

The fact that international credit rating agencies were still giving the countries of the region high ratings is further evidence that standard indicators must have been faulty. It can be seen from Chart 1 below that Thailand and Indonesia were classified in the "investment" category right on the eve of Thailand's *de facto* devaluation. The rating of course has dropped to "speculative" grade since then.

Chart 1: *Long-term Foreign Currency Debt Rating (as of June 30, 1997)*

MOODY'S (Investment grade)		Standard & Poor's (Investment grade)	
Aaa	Japan	AAA	Singapore, Japan
Aa1	Singapore, NZ	AA+	NZ, Taiwan
Aa2	Australia	AA	Australia
Aa3	Taiwan	AA-	South Korea
A1	Malaysia, South Korea	A+	Malaysia, HK
A2	Thailand	A	Thailand
A3	China, Hong Kong	A-	
Baa1		BBB+	China
Baa2		BBB	Indonesia
Baa3	Indonesia, India	BBB-	

4. Fallout from the crisis: Is Asia entering a new era?

What was worse for Thailand was that everybody miscalculated. The IMF admitted that its bailout package of a now meagre-looking US$17.2 billion to Thailand did not anticipate the repercussions of the Baht flotation on the rest of Asia. And worse, nobody knows exactly what to do. Some say "let Asia grow its way out with lower interest rates and higher government spending and budget deficits." But Malaysia showed that low interest rates led to capital flight and the associated currency depreciation. Thailand, on the other hand, has maintained high interest rates, killing off many previously viable businesses, and the currency free-fall was not halted. The IMF sets broad targets, but the country's own resources have to be relied on for day-to-day trouble-shooting and crisis management.[9] It was only when decontrol of the currency market was announced by the Bank of Thailand in late January 1998, that the currency was strengthened somewhat by foreign investors selling dollars to take advantage of the Thai stock prices depressed by some 40 per cent since July 1997. This resulted in a welcome surge, allowing investors to rake in profits from both the stock prices and the exchange rate.

The fallout from the crisis - slower growth, bankruptcies, unemployment - is just beginning. Table 6 shows that in Thailand, production of several major industries in the months of August-October 1997 were showing negative growth compared with the same period in the preceding year. The high interest rates needed to address capital flight, the resultant tight liquidity concomitant with the re-definition of non-performing loans, new rules for provision for doubtful debt, and the high cost of imported raw materials and equipment combine to create recessionary pressures.

The major and immediate problem now is the liquidity crunch that the real sectors in the crisis economies are experiencing. The high interest rates required for currency stability, and the unwillingness of banks to lend to manufacturers for fear of default have caused a severe shortage of liquidity. In Thailand, deposit rates are now more than 15 per cent, with lending rates in excess of 20 per cent. The situation in Thailand has been exacerbated by the borrowing requirements of the Financial Institutions Development Fund (FIDF), which has become the major borrower in the money market. Commercial banks, even with liquidity, prefer to lend to the FIDF without risk, rather than lending to manufacturers who might default and burden the banks with more non-performing loans. The issue of long-term government bonds is seen as a way out, but this is also problematic, as it is seen as another bail-out attempt using funds from sale of public enterprises and subscription by the general public.

Meanwhile, Asia's engine of growth, Japan, appears to be sputtering. Also adding to the woes are recent indications that the Chinese currency may be devalued.

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9 Adding to the crisis was the perception that the IMF had a hidden agenda, of trying to look after the interests of the foreign creditors more than the state of the local economy. This perception tends to erode confidence even further.

Table 6: *Industrial Production by major industry groups (August-October 1997): Rate of change over same period in preceding year (per cent)*

	1997		
	August	September	October
Industrial production index (1988 = 100)[a]	-5.1	-6.7	-12.3
1. Food	-2.3	11.0	11.1
2. Beverages	23.1	8.8	-1.7
3. Tobacco products	4.3	1.3	-27.5
4. Construction materials	0.8	-12.0	-14.4
5. Vehicles	-48.5	-52.4	-62.4
6. Textiles	1.4	2.2	3.1
7. Petroleum products	-1.1	7.2	4.8
8. Others	17.1	14.8	5.7
Mining			
1. Tin	-57.5	-3.4	-32.0
2. Natural gas	27.9	20.2	12.1
Services			
1. Number of tourists	-0.8	2.9	-8.1
2. Rate of occupancy of first-class hotels in Bangkok	56.8	59.0	62.0

a/ 34 industrial products
Source: *Bank of Thailand, Monthly Bulletin, November 1997*

At the same time Indonesia is experiencing by far the most important developments in the region. What began as a seemingly simple currency problem has now deepened into a full-blown crisis, progressively aggravated by the extraordinary depreciation of the rupiah and the political unrest. On January 22, 1998 the currency fell to a (then) record low of about Rp 17,000/ US$1, amounting to a devaluation of more than 80 per cent since the rupiah was floated on August 14, 1997. The crisis continued to worsen in May 1998, until the resignation of President Suharto, which nevertheless still leaves the economic problems to be solved. Just as in Thailand, the crisis exposed the country's weak financial system and the tangled web of cronyism and nepotism, and has brought the economy to a halt. The stock market has collapsed (as had the Thai stock market been comatose), many national banks are in serious trouble, and increasing numbers of local companies face bankruptcy.

In the third quarter of 1997 economic growth slowed to an annualized 3.4 per cent, significantly below the first semester's growth rate of 7.3 per cent. Preliminary estimates suggest that Indonesia's economic growth rate in the fourth quarter of 1997 was zero. Prices increased by six per cent in the last four months of the year alone, resulting in double-digit inflation for the whole year (Thailand has been able to maintain inflation at just below 10 per cent so far).

In January 1998 prices in Indonesia jumped by 6.9 per cent relative to the previous month, the highest monthly increase in 15 years, surpassing the rate for the whole of 1996 (6.5 per cent). Workers are being laid off, especially from industrial and construction activity.

The outlook of greatest uncertainty may be in Indonesia. On the whole, however, the East Asian economies will be entering a new era of slower growth. Jobs are being lost throughout Asia, even in Japan where employment was once a lifelong contract. Since July 1997 some 150 financial institutions across the region have been suspended, taken over, shut down, or placed under the care of a government restructuring agency, ironically the very same governments accused of policy bungling during the crisis. Others numbering in the 50s have announced intentions to merge, but so far few concrete results have materialised. Survivors and mergers alike desperately need capital to avoid going under. But the same hindrances crop up everywhere, namely the sheer volume of money required, the difficulty of valuing ailing firms' assets while bad loans continue to mount, and a reluctance to lose control to foreigners.

Nevertheless the crisis provides an opportunity to reform the economic management system and set the "real fundamentals" right. And indeed the new era can be characterised by greater strength than in the past.

5. Lessons, adjustments and opportunities: Can future crises be prevented?

Hindsight brings considerable wisdom, and the crisis has provided numerous lessons and raised important questions, placing several critical issues on the policy agenda. These inter-related issues include: (i) good governance; (ii) financial liberalization and volatility of capital movements; (iii) financial sector strengthening; (iv) macro management; and, (v) development strategies and reform.

(I) Good governance

As the crisis began to unfold, attention turned from the immediate triggers to more fundamental problems of endemic corruption, slow policy responses and mistakes, complacency, non-transparency of policy-making processes, human resource development and, yes, good governance.

The kind of haphazard crisis management that occurred reflects the fundamental flaws that altogether contribute to "bad governance". Because of this, many of Thailand's problems can be traced to the following factors: the lack of clear division between public and private matters, so that the tendency to use public resources for private gain is not counteracted; the failure to set up a clear legal framework whereby government action can be predicted and arbitrary behaviour prevented; the failure to set up regulatory frameworks that prevent rent-seeking behaviour from becoming pervasive; and, the failure to ensure priorities in development that encourage efficiency in resource use.

With the policy environment so radically transformed, past ways of doing things just could not be relied upon. Indeed good governance, including corporate governance, has now become the catch-phrase

Good governance is an amorphous concept, but can perhaps be defined as the existence of mechanisms and legal frameworks that ensure transparency, accountability, financial prudence, good management and accounting practices, and sound policy. It could also cover mechanisms to deal with the responsibilities of shareholders, directors and corporate management.

During a downswing, international capital flows tend to be highly sensitive to the conduct of macroeconomic policies, the perceived soundness of the domestic banking system, and unforeseen economic and political developments. The flows can also suddenly become sensitive to the way of conducting business, perceived cronyism and practices hitherto tolerated or ignored in the name of high returns. Domestically there is a strong awareness now, more than at any other time in Thailand's history, that these things do matter and that corruption and scandals can paralyse any agency at a time when it needs to do its job most.

Political reform is seen as the key, and steps in this direction have already been taken in Thailand with the passage of the new constitution in 1997. The extent to which the constitution results in actual reform however remains to be seen. It also has to be noted that the path from good governance to economic stability may be a tortuous one. Even economies claiming to have good governance like the United States are not immune to financial crises, as the savings and loan scandal in the 1980s demonstrates.

(ii) Financial liberalization and volatility in capital movements

Questions have inevitably been raised about the costs and benefits of opening up the capital account. The market turbulence in the region - the attacks on the Thai baht and its depreciation, the subsequent devaluations of other currencies in the region, and the contagion effects in East Asia, on the surface similar to occurrences in Latin America in 1995, and perhaps also in Europe in 1993 - brings into question the desirability of capital account liberalization.

Indeed we are in uncharted territory - we are a part of history, a period in which perhaps new policies and new systems have to be devised. If not for the toll that the crisis has taken, the situation would be a researcher's dream - the luxury of experimental methods usually denied the economics researcher.

Some lessons however are clear. Thailand has learnt the hard way that countries need to prepare well for capital account liberalization. The financial system, as well as economic policies and institutions, need to be adapted to operate in a world of liberalised capital markets. Thailand has now learnt that financial liberalization and maintenance of a fixed exchange rate regime are incompatible.

The question still remains as to the extent of preparedness that would be sufficient to ward off massive attacks on the currency. Capital account liberalization increases the susceptibility of the economy to swings in market sentiment. Though markets are mostly rational, they are not always right. Rumours are often heeded without verification. And there are limits to the market's efficiency and rationality. Inflows can become excessive, and sustained for too long as the Thai case exemplifies. Outflows can similarly be extreme. When a currency devalues, the equilibrium exchange rate for its competitors may reasonably fall, but markets often do over-react and compound the contagion effects. Furthermore sustained attacks usually will turn into self-fulfilling prophecies that fuel further damaging speculation. Fractional reserve banking in itself is inherently unstable and no financial institution can withstand a run.

Consequently there have been discussions of the wisdom of closed economies, the appropriateness of currency boards, Tobin taxes, and inward-focusing strategies. A growing chorus is now being heard that small developing countries need to regulate short-term foreign capital movements. The question is how. Thailand's experience with an unmitigated flow of foreign capital has been a bitter one. And the need for proper surveillance, financial supervision, broad macro- and micro-risk management is widely recognised. However there is also concern over whether an individual country's actions would be sufficient, given today's massive financial flows.

The real interest rates in developing countries tend to be higher than in developed countries. This attracts foreign money, and as capital flows in, real interest rates should fall to developed-countries' levels. However, this can only occur in the short run if there is a massive rise in the country's asset prices. Free capital flows are therefore likely to lead to stock-market and property bubbles.

Analysts are now focusing attention on the Chilean model. Chile has three types of capital controls: 30 per cent of all non-equity capital entering the country must be deposited without interest at the central bank for one year. This is a tax which would become very high if the capital remained in the country for a brief period. Second, Chilean firms and banks are allowed to tap international capital markets only if two bond-rating agencies rate their paper as high as Chile's own government bonds. Third, any foreign money coming into Chile must stay in the country for at least one year, a requirement that has discouraged many hedge funds and pension funds from investing in Chile. The price of course would be lower capital inflows, and possible action from the World Trade Organisation, but many developing countries may now feel that it is a price they are willing to pay.

It is clear that for emerging economies, long-term capital flows should be encouraged and short-term flows discouraged. Opponents argue that loopholes will be found, and controls would be impossible unless all countries agreed to a common system. Discussions at the global level should nevertheless take place.

(iii) Financial sector strengthening

Policy makers now have broad indications of what needs to be done to strengthen the financial system. Putting policy into practice, however, is Sisyphean in nature, because such measures ideally should be put in place during normal times, not during a crisis. It is now widely recognised that supervision and prudential standards need to be improved, that banks need to meet capital requirements, that provision for bad loans need to become stricter, that hedging against risk should be done, that connected lending should be limited or even eliminated, that informative financial information needs to be published, and that the rules of the game be clarified so that companies and institutions are forewarned that insolvency will not be rewarded.[10]

The decision to close down 56 ailing finance and securities in Thailand was widely lauded, and showed a decisiveness in policy decisions that had previously been absent. However, it is unfortunate that the criteria used to penalise companies failed to distinguish between faulty financial management, and management in terms of organisational structure and set-up. Financial criteria dominated the decision to close the 56 finance companies, so that those remaining in operation are not necessarily those with superior management practices. The task of due diligence and later review of assets and liabilities by "special managers" also proved ineffectual. Many of the special managers were incapable of conducting any reviews and massive amounts subsequently had to be paid to foreign accounting firms to carry out the task.

(iv) Macro management

The most important lesson for macroeconomic management lies in the need to pursue sound macroeconomic policies and avoid policies that can cause rapid capital flow reversals. Efforts have to be made to attract longer-term foreign capital and in particular foreign direct investment to finance current account deficits. Sizeable deficits financed largely by short-term capital flows are to be avoided.

The dilemma here is that high domestic interest rates may be needed to attract capital inflows (or at least to stem capital flight), but these flows are likely to be short-term and difficult to deal with.

Juggling capital inflows, inflation, fiscal policy and exchange rate flexibility is no easy task. Even the major currencies have seen excessive movements when rates are freely floating, and such fluctuations can be difficult to handle for a small developing country. Private businesses participating in world trade have to learn how to manage foreign exchange.

At the same time export-led growth can be relied upon less and less. World demand is sluggish, particularly with Japan still reeling from an inability to revive its own economy. In addition, protectionist sentiment has already been stirred and talk of "European markets being swarmed with low price Asian exports" abound - with the concomitant charges of dumping and anti-dumping action.

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[10] Fischer, 1997

(v) Development strategies and reform

Even before the current crisis, the pursuit of growth in the past three decades of Thailand's development raised repeated questions about the ability of the economy to sustain past performance, to distribute the gains of development more equitably, to reverse environmental degradation, and to enhance overall social well-being. Pockets of poverty remained in spite of double-digit growth. Among other problems, it was becoming increasingly clear that in Thailand, a well-working system of representative government would require the kind of well-informed voting public that is difficult to create out of a high-growth, but economically polarised, society.

In the wake of the crisis, Thailand has reverberated with renewed calls for reforms in (a) the political system, (b) the public sector, (c) in education[11], and (d) development strategy. But reform must be categorised. There are urgent short-term tasks, medium-term and long-term measures that must be put in place. In the long-run, it is likely that insulation from disruptive outside forces will be sought through greater self-reliance, particularly at the lower levels, and greater emphasis on the "social capital" that Thailand possesses.

Reform of the Bank of Thailand's management structure and responsibilities are currently under way. A specific machinery for monetary policy is also being proposed since, "with a flexible exchange rate, the task of formulating monetary policy is no longer trivial, as it was in the past".[12] Reform of the system of financial supervision and regulation, and a deposit insurance scheme is being discussed. Reform of the machinery for fiscal policy formulation, and the establishment of a mechanism to link fiscal and monetary policy is also being proposed.

6. Prospects for trade and business: Are there any silver linings?

The necessary macroeconomic adjustments and the IMF conditions (reduction of current account deficit, and fiscal and monetary discipline) are likely to increase unemployment, depress wages, and contribute to the rising cost of living at least in the medium term. The weaker currency also means less imports, especially of heavy capital equipment and high technology. It would be easy to present a dismal view of Thailand regarding all economic and financial matters, but within every down market, there are always opportunities. Policy makers and industry leaders are already trying to look towards the calm after the storm, and use the tough lessons learned to push forward. In general a far more cautious attitude toward lending and borrowing will prevail.

The question is what will be salvageable after the hurricane passes, and whether there is a comeback in sight. As in any crisis, there are both windows of opportunity as well as pits of disaster.

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[11] Reform in education is considered in more detail in Sirilaksana (1997).

[12] Ammar, 1997

Several steps have already been taken to rehabilitate the economy and revive the ailing financial sector, and these should have a positive impact on trade and business. The country achieved a $1 billion current-account surplus in November 1997, but that was less the result of rising exports, which increased by one per cent than of a 30 per cent drop in imports. Nevertheless there was a spurt of investor confidence in mid-February 1998.

The problem of lack of mature and liquid debt markets and an inability to attract long-term capital inflows is being recognised and addressed. The fall from grace of Thailand's credit rating into junk bond territory in December 1997 can perhaps be mitigated by private placement of new debt issues or syndicated loans. The need to develop effective debt market instruments and mobilise medium and long-term savings is recognised. There are suggestions to increase the trading liquidity of the secondary market and encourage the development and use of debt instruments, which will hopefully make local firms less dependent on bank loans and the stock market for financing. The effective establishment of a liquid government and corporate bonds market through amendment of legislation to allow regular issue of public bonds is seen as a move in the right direction. The Asian Development Bank and the World Bank are lending US$650 million to fund development and restructuring programs for the capital market. Moves are being made to facilitate use of related financial instruments, such as short-term commercial paper and securities debt instruments. The development of long-term, domestic institutional investors is another goal. The need to develop effective hedging instruments and derivatives, including covered warrants, short-selling and securities lending, is recognised.

There are also measures to tighten loan-classification rules, re-define non-performing loans, ensure adequate provision for bad debt, strengthen bankruptcy laws, and extensively relax foreign shareholding limits in local institutions. The Financial Restructuring Authority (FRA) and Asset Management Corporation (AMC) are giving favourable treatment to foreign creditors, a move designed to woo back international investors. Even though deep-rooted problems remain and need to be addressed, the government has shown willingness to share the cost of writing off bad loans to encourage foreign banks to take over ailing institutions.

In the meantime, companies are beginning to restructure their outstanding loans and expenditures and to recapitalise. Foreign investors with fresh funds are being wooed. Many companies have strong prospects for future growth but currently lack liquidity. Opportunities for business abound. Processes that are under way to enhance the supervisory and regulatory system, auditing and accounting standards is really a boon to foreign accounting firms.

The IMF package also requires an improvement in state enterprises' financial positions to accommodate the target of fiscal discipline and medium-term surplus. There are measures to increase private participation in infrastructure development, especially in the transportation and energy sectors, privatise state enterprises operating in the energy, transportation, public services and communication sectors, and end monopolies.

Foreign exchange controls, slapped on while the central bank was desperately defending the currency in early 1997, have now been removed. This has apparently boosted investor confidence, with gains in both the stock market and the value of the currency immediately after the Chinese New Year.

Transition economies can take advantage of lower-priced imports from the crisis-hit market economies. Developed economies can take advantage of prospects in finance, consultancies in financial regulation, accounting practices, and supervision. The deregulation of foreign ownership will virtually transform many company's debt-equity ratio, previously kept high by family businesses reluctant to relinquish control through equity dilution. The way of doing business has changed, with more opportunities open to foreign investors.

Foreign investors could also take advantage of the structural shift in industrial manufacturing and exports. Table 7 shows that from 1990 to 1994 the share of labour-intensive exports declined by about four per cent. Technology-intensive exports showed a high growth rate of almost 12 per cent over the period, with its share reaching almost 43 per cent by 1994. Electronics played a key role, accounting for about 27 per cent of total exports in 1994. By 1995, computers and related parts displaced clothing as the top export earner, as shown in Table 8.

Even though the situation is still volatile, analysts tend to concur that it pays to invest in depressed markets. Selective investment is thus the key. Good candidates are companies restructuring for recovery, honing their competitive edge. These are likely to emerge on stronger footing. There will be hardship, corporate failures, and macroeconomic consolidation, but some of the stronger companies will be repositioning for recovery and reengineering for greater efficiency and profitability.

Hardship puts strain on companies, forcing them to think about competitiveness and efficiency. Some will show evidence of restructuring: introduction of new products, strengthening through mergers and acquisitions, hiring of new management, undertaking measures to improve efficiency. Industry deregulation and policy shifts could also make many sectors more attractive. Some may benefit from the weak exchange rate, and some strong cash-flow companies may even emerge stronger.

The time is now ripe for many changes. In Thailand, government planners are currently set to overhaul medical services for some two million public sector officials (plus five dependants each), which could mean tighter controls on treatment quality and pricing as well as cutbacks in the number of beneficiaries covered by the current system. This has been prompted by the average annual increase of about 20 per cent for government health care expenditures, from 5.4 billion Baht in 1992 to 14 billion Baht in 1997. The plan is to introduce group health insurance (particularly for parents), and eventually transform medical service for government officials and their dependants into a fully-fledged health insurance system. This would expand the market for health insurance and be another avenue for foreign investment.

Education is another area where foreign participation has been welcome and will continue to be so. The easing of controls on private initiative and the infusion of private-sector discipline into public schools and universities has already begun. As Thai students abroad feel the pinch of the currency devaluation, there will be added demand and opportunities for joint ventures in educational institutions in Thailand. Fewer students will be going overseas, but the need for human resource development is well recognised. The Ministry of Science, Technology and Environment (1996) estimates that domestic production of technical personnel falls considerably short of its demand. The demand and supply figures in Table 9 show a clear and escalating deficit.

Table 7: *Change in the Structure of Export Product Categories (Thailand)*

	Growth rate over the previous year				Export shares				Change in Export Shares '90-'94
	1991	1992	1993	1994	1990	1992	1993	1994	
Industrial products	**25.6**	**14.7**	**18.6**	**22.5**	**74.7**	**76.9**	**80.4**	**81.1**	6.4
Labor-intensive	21.7	5.6	6.3	16.6	25.1	23	21.6	20.7	-4.4
Resource-processing	11	9.9	-0.8	30.8	11.6	10.1	8.8	8.8	-2.8
Mid-and-high-level technology-intensive	31.3	22.8	30.4	26.9	30.8	35.5	40.8	42.6	11.8
Electronic components	35	25.4	22.2	34.7	18.8	22.7	24.5	27.1	8.3
Other industrial products	38.7	15.7	25.9	18.6	7.2	8.3	9.2	9	1.8
Fisheries	**34.4**	**11.6**	**14.1**	**21.9**	**5.5**	**5.9**	**6**	**6**	0.5
Agricultural products	**9.3**	**13.3**	**-10.6**	**17**	**17**	**15**	**11.8**	**11.4**	-5.6
Other products	**15.1**	**-9.3**	**-4.2**	**2.4**	**2.8**	**2.2**	**1.8**	**1.5**	-1.3
Total	**23**	**13.6**	**13.5**	**21.5**	**100**	**100**	**100**	**100**	-

Source: *Bank of Thailand Monthly Bulletins, various years.*

Table 8: *Growth Rates of Thailand's Top 20 Export Product Categories. (per cent)*

	1992	1993	1994	1995	1992-95 average	1996
Computers and computer parts	19.2	13.1	44.9	38.7	24.7	31.1
Garments	0.1	3.3	12.4	1.3	3.4	-21.7
Rubber	15.9	0.9	43.3	46.5	21.3	2.3
Integrated circuits	11.0	24.2	27.5	28.4	18.2	1.8
Jewellery and precious stones	2.9	10.8	8.3	11.5	6.7	7.0
Rice	18.7	-9.0	18.9	24.1	10.5	8.1
Shrimp	18.8	19.3	29.9	2.3	14.1	-16.3
Sugar	28.0	-35.6	41.2	67.2	20.2	11.5
Radios, TVs, and related parts	44.8	9.1	26.2	12.7	18.6	12.9
Shoes and shoe components	7.7	9.0	40.5	37.0	18.8	-40.7
Canned seafood	-5.1	5.1	24.7	4.1	5.7	-0.2
Air conditioners and related parts	49.0	13.4	62.1	49.6	34.8	28.8
Plastic products	32.5	160.0	-29.1	102.2	53.1	-57.3
Textiles	11.8	5.1	4.5	22.1	8.7	-3.8
Tapioca	19.0	-26.6	-13.6	-2.8	-4.8	19.0
Rubber products	27.9	24.2	13.6	58.6	24.9	-11.9
Furniture and furniture parts	12.9	18.1	20.0	6.9	11.6	1.0
Video and audio equipment and parts	12.1	-9.1	56.9	2.4	12.5	-24.3
Steel products	5.2	35.2	28.4	21.8	18.1	-2.4
Canned and processed fruit	5.2	-6.2	-2.2	2.2	-0.2	26.6

Ranking of product categories is based on actual performance in 1996.

Source: *Department of Business Economics, Ministry of Commerce*

Table 9: *Supply and Demand Estimates of University Graduates in Technical Fields in Thailand.*

	1995	1996	1997	1998	1999	2000	2001
Supply	10,630	11,770	12,970	13,620	14,450	15,200	15,470
Demand	13,750	15,720	16,330	18,610	21,030	23,900	27,080
Deficit	3,120	3,950	3,360	4,990	6,580	8,700	11,610

Source: *Ministry of Science, Technology and Environment (1996)*

In Thailand measures to promote research and development (R&D) have been adopted, such as the establishment of a technical development fund, exemption from taxes of a sum equivalent to 150 per cent of R&D expenditure, and reduced taxes on equipment purchases. The time is ripe for structural adjustments towards higher technology production or information-intensive production.

Thailand has learned the hard way that the quality of human resources and the social institutions to deal with transmitted disturbances from the world economy, as well as domestically-generated crises, is crucial. With weaknesses in human resource development, the required critical mass to push forward reform in social institutions has not been created. An overhauling of the education system opens up possibilities for new vision and participation.

7. Conclusions

Many policy makers and industrial leaders, and possibly many of the region's investors and business people, are opting to put the economic disaster behind them and look towards what the future has to offer. Given the pressures on the government to clean up corruption and reduce questionable business practices, things are likely to improve in 1998 and beyond. International opinion seems to be in favour of the direction that current governments are taking to enact laws aimed at decreasing the amount of questionable business practices. Tighter bankruptcy laws will cause questionable companies to close, but the new legislation to deal with debt-ridden businesses also offers them an opportunity to recover.

While it is not clear which particular companies will bow to the pressures of recession, bargains are certain to be found in the stock market as well as in the real sector, as the economies go through painful adjustments. The initial decline that had been too much, too fast, had made adjustments more difficult. But even though many difficulties lie ahead, many analysts still point to the region's strengths, namely the world's highest savings rate, the tradition of long-term planning, and the innate ability to absorb technology.

The industrial and farming base of many countries is likely to be strong enough to spark a turnaround, if the liquidity problem can be eased. Companies which are able to survive the tough times will be poised to benefit from a better regulated business environment, and investors with a realistic long-term outlook stand to benefit. Companies across the board are beginning to shake off deeply entrenched ideas, such as family control, and the safety of property investment. Companies with no foreign debt, which have their prices linked to the world market, such as chemicals and the agricultural sectors are in a good position. Companies that can cater to an export market while their labour and other costs have fallen or at least remained fixed in local currency, are well-placed.

There will likely be fewer incidences of problems caused by over-zealous executives, lethargic regulators, predatory politicians, and an unconcerned public. Some companies may be able to cash in on strong overseas connections and emerge as victors. Many of the world's more stable economies will be also be able to profit from Southeast Asia's failings.

It is also important to emphasise that if the developed world would heed their own maxim of allowing trade rather than giving aid, then the turnaround would be speeded. If protection of agriculture and light manufactures can be lifted or reduced, so that international comparative advantage in production is allowed to manifest itself, then long-term benefits can be reaped all round.

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