THAILAND'S FINANCIAL EVOLUTION AND THE 1997 CRISIS
Abstract

Yos Vajragupta and Pakorn Vichyanond
Thailand Development Research Institute

Thailand's financial system has been the focus of worldwide attention since the summer of 1997 when devaluation of the baht sparked a currency crisis that spread rapidly throughout Southeast Asia. The past two and a half decades have seen drastic and significant changes in Thailand's financial markets. This paper examines the evolution of Thailand's financial system from 1972 to the present. It examines the policy changes and the impact they had on the financial system; the outcomes of reform on Thai financial markets, and the other circumstances that came into play in the 1990s that led up to the 1997 crisis. The paper attributes the crisis largely to two policy mistakes and it concludes with suggestions to guide policy making in the future.

Background. Between 1972 and 1987 Thailand's financial system underwent very gradual adjustment. Emphasis was given to resolving immediate problems that depressed the economy and/or disturbed its stability, e.g., oil price crises, finance company bailout, and U.S. dollar exchange rate volatility. After 1987 a series of international measures to liberalize trade and services, together with the Thai government's fiscal readiness, pressured Thailand to open up various facets of its financial market, including interest rates, foreign exchange controls, portfolio management, scope of activities, and new facilities and institutions.

Effects. Deregulation helped deepen the financial system to a large extent. More mobility of capital funds across borders and narrower interest rate spreads became distinct in the first half of the 1990s. Financial liberalization also led to more long-term credits, fee-based income earning activities, and capital market transactions. However, enormous capital inflows and market competition tempted Thai financial institutions to build up excessive exposure in several areas, resulting in bubble growth (similar to Japan's in the late 1980s) and deteriorating asset quality. Worse yet, on the macroeconomic balance sheet net capital inflows propelled investment momentum in Thailand to such an extent that its current account deficits reached a hazardous level in 1995-96.

Unfortunate Coincidence. This disequilibrium coincided with three other intimidating circumstances, –the Bank of Thailand's assistance to ailing finance firms, the surging value of the U.S. dollar as well as the baht, and growing excess inflation. This combination of circumstances caused widespread speculation of baht devaluation in the middle of 1997, triggering a flood of capital outflows and a plunge in Thailand's foreign exchange reserves. It became inevitable that the baht exchange rate would be floated and this happened on July 2, 1997 after 13 years of pegging with a U.S. dollar-dominated currency basket. The floatation engendered steep depreciation of the local currency to a record low level.

Resolution and Consequences. Eventually, the Thai government resorted to IMF (International Monetary Fund) rescue which came with a series of stringent conditionalities stipulated to rectify Thailand's economic fundamentals. These included budgetary cash surplus, tight monetary policy, privatization of some state enterprises, and various financial reforms.

On the macroeconomic level, the substantial depreciation of the baht together with the rigid IMF conditions generated economic difficulties; the higher cost of imported inputs reduced production and increased inflation; tight liquidity and the foreign debt burden caused numerous companies to reduce employment and pay; the reduction in purchasing power together with the economic downturn gave rise to more bad debt and bankruptcies which harmed national credibility. Economic recuperation requires restoration of confidence to attract foreign capital.

On the microeconomic level the Financial Sector Restructuring Authority and the Bank of Thailand have taken steps to restructure the financial sector, to tighten regulation and supervision, and resolve the problem of bad assets. In the short run, these moves mean a continued credit crunch and more corporate closures and bankruptcies, they pave the way for essential financial reform which will help prevent future financial turmoil.

Conclusions. In retrospect, Thailand's crisis can be attributed largely to two simultaneous policy mistakes--liberalizing foreign capital flows while keeping exchange rates rigid and indiscreet supervision of financial institutions. The Thai experience clearly illustrates that financial liberalization is a precarious process. Past policy errors suggest the following three precautions to guide policy in the future–ensure consistency among all policy actions, ensure readiness of all concerned parties, and undertake continual policy adjustments.