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Restructuring and Forgiveness in Financial Crises B: The Asian Crisis of 1997¹

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Abstract

Asia's economy, Thailand in particular, was booming when the financial crises hit in the 1990s. However, troubles were brewing underneath the seemingly buoyant economy. With a fragile financial system and ineffective domestic government responses to these troubles, an exchange rate crisis took over Thailand, and this crisis started a financial contagion in the neighboring countries. This case reviews the background and domestic government responses to contain the crisis, and the international intervention provided by the International Monetary Fund including the assistance and the required reforms accompanying the support.

¹ This case study is one of four Yale Program on Financial Stability (YPFS) case modules considering the Restructuring and Forgiveness in Financial Crises. The others are:

- *Restructuring and Forgiveness in Financial Crises A: The Mexican Peso Crisis of 1994-95*
- *Restructuring and Forgiveness in Financial Crises C: The Swedish Banking Crisis of 1990-94*
- *Restructuring and Forgiveness in Financial Crises D: The Japanese Financial Crisis of the 1990s*

Cases are available from the *Journal of Financial Crises*.

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1. Introduction

Thailand's economy was at its peak leading up to the early 1990s. However, by the end of 1996 a downward pressure on the value of baht emerged. The government's attempt to reform the banking sector weakness in the 1980s had turned out to be ineffective, and the prudential regulation and supervision by the government was overall weak and fragmented. Financial companies and banks failed to maintain enough reserves for the portfolio they were holding. Moreover, Thailand's current account relied heavily on foreign investments, which were in turn heavily reliant on the boom of property market, and thus was short-term in nature. The current account deficit had become unsustainable by the first half of 1997.

It was not until June 1997, however, that the true state of the country's foreign reserves and the problems in the financial system were revealed. It turned out that the actual amount of reserve was only 1/30 of the previously reported number by the government since the majority was held under forward contracts. Also, the fund available to provide liquidity to troubled financial institutions was nearly depleted from the Bank of Thailand secretly providing assistance to 66 finance companies in early 1997. As Thailand's troubles started to affect other Asian countries, the International Monetary Fund (IMF), with assistance from other international community members, stepped in to support Thailand accompanied by a plan to reform the financial system.

By reviewing the government responses and international interventions, this case may provide an insight into what measures may be effective for future crises not only in the emerging markets but also in the developed and developing markets.

The remainder of the case is organized as follows: Section 2 describes the events in Thailand leading up to the baht crisis. Section 3 discusses the details, rationale, and assessment of the support package provided by the IMF. Section 4 briefly provides a comparison with the Mexican peso crisis, which is discussed separately in McNamara et al 2015.

Questions

1. What situations leading up to the crisis were different/similar between the Mexican peso crisis and the Thai baht crisis, and how did these differences/similarities affect the design of response and intervention by the international community?
2. Why did the domestic interventions fail to contain and control the crisis and what was the rationale behind those interventions at that time?
3. What intervention was effective and what would each government do differently if it were faced with the same crisis now?
4. What are the core factors to consider in designing an intervention for the current and future financial crises that are applicable across developed, developing, and emerging markets?

2. Background

Thailand joined the IMF in May 1949, and large-scale aid from the U.S. bolstered a rapid growth in its economy in the 1950s and 1960s. Political instability in the 1970s and 1980s temporarily slowed this economic progress, and the IMF provided several loans that were

paid back by mid-1990 (Boughton 2012). The Thai authorities initiated reform measures in response to this slowdown, including the creation of the Financial Institutions Development Fund (FIDF), a separate legal entity within the Bank of Thailand with a mandate to restructure, develop, and provide financial support (liquidity and solvency) to financial institutions (Lindgren et al. 1999). By 1990, Thailand's economy seemed to have strengthened and the country was referred to as one of the leading "Asian tigers" (Boughton 2012). Underneath this success, however, the quality of banks and finance companies' loan portfolios were continuously deteriorating, and these entities failed to set aside enough reserves for these portfolios. The ratio of non-performing loans in the portfolio continued to increase sharply with a large exposure to the booming property market, which was moving into a speculative bubble. Moreover, the prudential regulation and supervision by the government was overall weak and fragmented with no limits on loan concentration. Regulations on loan classification, provisioning, and accounting standards were inadequate (Lindgren et al. 1999).

In May 1996, the Thai finance ministry had to take over one of the country's largest banks, the Bangkok Bank of Commerce, to save it from bankruptcy. Regardless, the IMF remained only concerned about macroeconomic overheating and the vulnerability of the pegged exchange rate, and even these concerns were overshadowed by Thailand's continuing record of economic growth (Boughton 2012).

Thailand was financing its current account with foreign direct investment at the fixed exchange rate. Foreign investment in Thailand had become heavily reliant on the property market boom, and thus was short-term in nature (Lindgren et al. 1999). In September 1996, Moody's Investor Service downgraded its rating on Thailand's short-term external debt generating an outflow of private capital from banks and finance companies in Thailand (Boughton 2012). The current account deficit had become unsustainable by the first half of 1997 (Lindgren et al. 1999).

It was not until June of 1997, however, that the true state of the country's foreign reserves and the problems in the financial system were revealed. It turned out that most of Thailand's foreign exchange reserves had been locked up in a forward contract, which is a contract to buy or sell an asset at a specified price on a future date, and the actual amount of reserve shrank to about 1/30 of the previously reported number by the government (Financial Times January 1998).

Moreover, the property market bubble began to deflate in early 1997 when a major developer defaulted on its external debts (Boughton 2012). Also, it was revealed that during March to June of 1997, the Bank of Thailand had secretly provided liquidity support to 66 finance companies, which had a disproportionately large exposure to the property market, draining \$8 billion from FIDF, which equaled several years' worth of the Thai government's fiscal surpluses (Lindgren et al. 1999; Financial Times January 1998). This support was in addition to the financial-sector restructuring which had started in early March 1997 lending money to 10 unnamed finance companies, and shortly after the government assured the public that all other financial institutions had access to sufficient liquidity (Lindgren et al. 1999).

As investors became more and more wary of Thailand's economy, attack on the baht intensified and the IMF urged the government to devalue the pegged currency at once. The central bank, however, continued to deplete its foreign exchange reserve bringing the net amount close to zero (Boughton 2012).

Eventually without the IMF's involvement, on July 2, 1997, the Bank of Thailand announced it was floating the baht, and this resulted in a rapid depreciation of its value, marking the

beginning of the Asian financial crisis. The devaluation of baht hoped to stop the capital outflow and restore stability without any outside support, however, the market continued to shift towards a negative view (Ibid.).

3. IMF-supported Program and Rationale

A record by the IMF states that no country was prepared to lend to Thailand in the middle of a financial crisis without the IMF-supported policy program in place. On the other hand, the Thai government was reluctant to make a request for the IMF support, and the Bank of Thailand was still refusing to provide comprehensive data on its foreign exchange reserves (Boughton 2012). However, as concerns for the solvency of the entire financial system mounted, the Thai government finally reached out to the IMF, and negotiations for assistance started (Corsetti et al 1999). In August 1997, Thailand entered into a three-year stand-by arrangement with the IMF, supplemented with funds from the World Bank, the Asian Development Bank, Japan, and other countries (Lindgren et al. 1999). Figure 1 shows the breakdown of financing commitments by the international community in response to the crisis in Thailand.

Figure 1: Official Financing to Thailand

	In Billions U.S. Dollars	In Percent of Annual GDP
IMF	4.0	3
Asian Development Bank and World Bank	2.7	2
Other	10.5	7
Total	17.2	12

Source: Lane et al. 1999.

According to the IMF, how much of this “headline” figure would be needed, and how much would really be available if it were needed, could not be known at that time. Rather the crucial assumption that convinced the IMF that the amount would be sufficient was that its policy package—tightening monetary policy, aiming for a surplus in the government budget, and continuing to restructure the financial system—that is discussed in detail below would quickly restore confidence among both domestic and foreign investors so that a large portion of the country’s short-term external debt and the central bank’s forward obligations would be rolled over voluntarily (Boughton 2012).

When Thailand’s central bank finally provided the data revealing the extent to which the foreign exchange reserve was being held in forward swaps, the IMF was reluctant to make this data public for fear that it would exacerbate the outflow of investors even further, and the Thai government was against making such data public. However, the IMF record stated that Lawrence H. Summers, the deputy secretary of the U.S. Treasury, insisted that revealing the numbers was more likely to calm the market. The IMF seemed to have interpreted this

insistence as an implication that “U.S. support for the stand-by arrangement would depend on these numbers being publicized,” and the numbers were publicized (Ibid.).

Unfortunately, the Clinton administration was not prepared to expend the considerable political capital necessary to try to persuade the U.S. Congress to approve a financial package for Thailand. It could not provide significant emergency financing without a Congress approval because it had imposed restrictions on the use of the U.S. Treasury’s own funds in response to the bailout of Mexico in 1995 (Ibid.). Bailout of Mexico was provided through the Exchange Stabilization Fund, which is discussed further in McNamara et al 2015.

The Managing Director of the IMF, Michel Camdessus, stated as follows in explaining the philosophy of the IMF’s involvement in the Thailand crisis:

as soon as it was called upon, the IMF moved quickly to help Thailand, ... formulate reform programs aimed at tackling the roots of their problems and restoring investor confidence. In view of the nature of the crisis, these programs had to go far beyond addressing the major fiscal, monetary, or external balances. Their aim is to strengthen financial systems, improve governance and transparency, restore economic competitiveness, and modernize the legal and regulatory environment. (Corsetti et al 1999)

The IMF stated in a 2012 record that the keys to resolving the crisis were (A) to restore confidence among domestic and international investors sufficiently to enable the country to finance its external deficit, (B) to stabilize and strengthen macroeconomic policies, and (C) to restructure the financial system. It admits that they lacked good choices and “had to do as well as possible with limited tools” (Boughton 2012).

Monetary Policy

Allowing the exchange rate to adjust flexibly, the monetary policy was initially centered on stabilizing conditions in the exchange market (Letter of Intent August 14). The IMF explains that to prevent the flight of investors, monetary policy was to be adjusted to set the interest rate at a competitive level; central bank had to maintain adequate foreign exchange reserves; and the exchange rate had to be maintained without further depreciation (Boughton 2012). Once the exchange market conditions settled, there was to be a downward adjustment of interest rates (Letter of Intent August 14). The IMF later stated that deciding the extent and the period to which interest rates need to be raised was “at least as much an art as it is a science” (Video Conference 1999).

At the beginning of the crisis, Thai monetary authority resisted letting the domestic interest rate to increase. The central bank was concerned that an increase in the interest rate would further compromise the financial conditions of already heavily indebted corporations and financial institutions. Only after a significant depreciation in baht did the monetary authority tighten its monetary policy, and such monetary contraction resulted in a credit squeeze exacerbating financial problems for the finance companies and banks (Corsetti et al 1999).

Restructuring the Financial Companies and Banks and Tightening Fiscal Policy

The design for initial measures in restructuring the financial system was based on the following three steps:

- (i) exit of all unviable financial institutions;

(ii) issuance of a temporary blanket guarantee protecting all depositors and creditors in the remaining financial institutions, aimed at giving confidence to the public that, after weaker institutions have been isolated, the remainder of the financial system is sound; and

(iii) developing the institutional framework for the systemic restructuring as well as comprehensive reforms aimed at strengthening the efficiency, profitability, and solvency of the system, thus making it more prepared to withstand international competition (Letter of Intent August 14).

The first step was based on the principle that the public costs of this intervention will be strictly minimized through burden sharing among the claimants of unviable institutions. Separation of viable and unviable institutions was based on these three criteria: (a) magnitude of liquidity support needed from FIDF, (b) deterioration of capital, and (c) the size of non-performing loans. Creditors and depositors of all remaining finance companies were guaranteed by the government with a fee, which was to “defray the public cost of support” (Letter of Intent August 14). Overall, 58 out of 91 finance companies had their operations suspended (Letter of Intent November 25; Boughton 2012).

The IMF records show that there was a large dispute among its staff on the issue of this guarantee. Some saw it as necessary to prevent the shutdowns from leading to a massive run on commercial banks, but others saw it as an inappropriate bailout of risky and speculative investments. The issue was resolved internally “only because the U.S. Treasury expressed a strong view in favor of a guarantee.” In a meeting with Timothy F. Geithner from the U.S. Treasury and Edwin M. Truman from the U.S. Federal Reserve Board, they argued that the first priority was to prevent a financial collapse. This view eventually outweighed the concerns held by IMF officials at headquarters about the deposit guarantees (Boughton 2012).

In order to support these policy measures and increase the amount of the reserves, the fiscal target was set at a surplus of 1% of GDP in 1998 (Letter of Intent August 14). This policy was later adjusted and relaxed as baht began to regain its value (Letter of Intent Feb 24). In order to maintain investor confidence, the IMF emphasized that this adjustment was “in recognition of the adverse effect of the recession on revenues and the need to raise spending on the social safety net,” rather than the IMF prematurely abandoning the policy under pressure (Boughton 2012). It stressed the importance of remaining flexible on the fiscal side since the effectiveness of the policy depended upon macroeconomic assumptions and projections (Video Conference 1999). Figure 2 summarizes the timeline of major events in the IMF support package to Thailand and the strategies and measures implemented by the government as a part of the support package.

The stand-by arrangement remained in effect until June 2000, but Thailand did not draw on it after June 1999. As of June 1999, Thailand had drawn \$3.4 billion from the arrangement and borrowed \$14.3 billion from other international participants in the support package. (Boughton 2012).

As of the end of 1998, the public sector contribution for financial sector restructuring was close to 25 percent of GDP (Figure 3). The largest portion of this was used for liquidity support (Lindgren et al. 1999).

Figure 2: Timeline of the IMF Intervention

August 20, 1997	Three-year Stand-By Arrangement with IMF approved. The package called for maintaining gross official reserves at the equivalent of 4.2 months of imports in 1997 and 4.4 months in 1998; limiting the end-period rate of inflation to 9.5% in 1997 and 5% in 1998; targeting a small overall fiscal surplus by 1998 through an increase in the rate of the value-added-tax and selective expenditure cuts; initiating a credible and up-front restructuring of the financial sector, focused on the identification and closure of nonviable financial companies.
October 1997	Financial sector restructuring strategy announced; Financial Sector Restructuring Agency and asset management company established to assess and liquidate nonviable financial companies; blanket guarantee strengthened; new powers to intervene in banks. Emergency decrees to facilitate financial sector restructuring.
Mid-November 1997	Change in government. Significant strengthening of economic reform program.
November 25, 1997	A second IMF package for Thailand is approved. The new plan included additional measures to maintain the targeted fiscal surplus of 1% of GDP, the establishment of a timetable for financial sector restructuring, and plans to protect the weaker sectors of society.
December 4, 1997	56 suspended finance companies are permanently closed.
December 31, 1997	Bank of Thailand intervention in a commercial bank; shareholders' stakes eliminated.
February 24, 1998	The fiscal policy target is adjusted from a surplus of 1% of GDP to a deficit of 2% of GDP.
May 26, 1998	Another modification to the bailout package was agreed on, and the main priority was to prevent any further slowdown of the economy and foster an early recovery. It called for cautious and gradual reductions of interest rates, higher monetary growth rates, a looser fiscal deficit target at 3% of GDP, and accelerated corporate debt restructuring with financial sector reforms.
August 14, 1998	Comprehensive financial sector restructuring plan announced, including facilities for public support of bank recapitalization. Intervention in two banks and five finance companies; shareholders' stakes eliminated.
August 25, 1998	The package is further modified to incorporate a more comprehensive approach to bank and corporate restructuring. The fiscal deficit target is still at 3% of GDP, for both 1998 and 1999, but this target excludes the costs of financial sector restructuring.

Source: Corsetti et al 1999.

Figure 3: Public Cost for Financial Sector Restructuring (as of the end of 1998)

	% of GDP	U.S. Dollars (in billions)
Liquidity support	15	20
Recapitalization	8	11
Purchases of nonperforming loans	0	0
Interest cost	2	3
Total	25	34

Source: Lindgren et al. 1999.

Assessment of IMF-supported Program

A later review by the IMF of its program in Thailand and a statement by Jack Boorman, the Director of the Policy Development and Review Department, emphasizes that if the IMF were making the decisions again, especially with regards to the monetary policy and the use of interest rates, it would call for “prompter and more aggressive action” along similar lines. Boorman assesses that the aggressive move in the interest rate was to protect the currency and signal to the market that Thailand was going to hold the interest rates until the currencies appreciated, and this strategy “substantially worked” (Video Conference 1999).

Some, on the other hand, argued that the policies in calling for higher interest rates, tightening government budget deficits, or closing down financial institutions were too tight. The IMF responds that timely forceful tightening of interest rates, as learned from the Latin American crisis in 1994, was effective in fending off attacks on the currency. Additionally, it also states that at the outset of the crisis, countries need to firm their fiscal positions, to deal both with the future costs of financial restructuring and the need to reduce the current account deficit (Fischer 1998).

Other criticisms include moral hazard concerns. However, the IMF emphasizes that the notion that the availability of its support program encourages reckless behavior by countries is “far-fetched: no country would deliberately court such a crisis even if it thought international assistance would be forthcoming.” Also, the global growth relies on an economically strong Asia that imports as well as exports (Ibid.).

4. Comparison between Mexico and Thailand

Similarities

Both crises were preceded by a thriving financial market from major inflows of capital, and a high external current account deficit. However, these capital inflows were short-term and at the first sign of troubles in the country, investors changed their attitude, pulling their investments out from the market and quickly depleting the international reserve of each country and interrupting the normal function of the domestic financial system and companies. For example, in Mexico the major proportion of the capital inflows was through investment in bonds, and in Thailand the major proportion was for investments in the real

estate sector through its financial system, both short-term and easily exited in case of panic (IMF 1998).

Another similar feature is the existence of an exchange rate peg. It has been pointed out by the IMF that this type of arrangement makes it very difficult for the country to defend against speculative attacks by investors and can cause distortions of risks in the financial system. For example, to the extent that the exchange rate peg is considered a guarantee against currency depreciation, it can encourage the investors, the financial and business sector, and the market to take excessive exchange risk without appropriate hedging. Moreover, the guarantee is tied to the availability of the international reserve and the country's ability to access credit, and any sign of trouble in either element could cause panic and run (Ibid.).

Therefore, increasing current account deficits, inadequate supervision and regulation of the financial system, and political scandals and difficulties in both countries led to speculative attack on the countries' currencies. Under the downward pressure on the currency, both countries eventually floated the exchange rate, resulting in a dramatic devaluation of the currencies (IMF 1998).

Differences

In Thailand, the capital inflows financed increases in investment, whereas in Mexico the inflows sustained increases in private consumption. The rate of investment in Thailand steadily increased from 28% of GDP on average in 1983-89 to 40% of GDP in 1990 and fluctuated around the 40% mark throughout the 1990s. At the same time, domestic saving did increase, but it still remained short of the high level of investment, and to fill the large gap between domestic saving and investment it was reliant on the high level of net capital inflows, which eventually led to large current account deficits (IMF 1997).

This rise in investment for Thailand was shared between the public and private sectors. Public sector investment was concentrated on infrastructure projects, and private investment was focused to build industrial capacity and participate in the booming real estate market. However, as the level of rapid growth in both the industrial capacity and the real estate value became unsustainable as inflation and overheated market started to cool. As investors became concerned about the ability of the economy to maintain a high level of return for their investment, a decrease in capital inflow was triggered (Ibid.).

In Mexico, the large current account deficit and growth in private sector credit was considered largely a result of sustained increases in private consumption. In the years preceding the crisis, inflation reduced and the economic outlook improved. This led to great increase in private consumption and an associated decline in private saving. The rate of private sector savings fell from about 20% of GDP in 1988 to about 11% of GDP in 1994. Unlike Thailand, the rate of investment fluctuated around 21% of GDP throughout the pre-crisis period. The gap between investment and domestic savings widened continuously, and as was the case of Thailand, this led to an increase in current account deficit from around 1% of GDP in 1988 to 7% in 1994 since the current account had been financed mostly by private capital inflows (Ibid.).

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