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The Day the Miracle Came to an End

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Abstract (Abstract): Fewer than a dozen people - all in the central bank - knew the answers. For months, they had been hiding two crucial numbers from the Thai government and the public. Mr Thanong knew he was not going to get the information just by sitting in his office, as his predecessor Amnuay Viravan had done. He and three assistants climbed into the leather seats of his blue Volkswagen van and set off to demand information from Rerngchai Marakanond, governor of the Bank of Thailand .
Mr Thanong had not wanted to do this job. He was in Hong Kong when rumours of Mr Amnuay's resignation began to surface, dreading the knowledge that he would be on the short-list of replacement candidates drawn up by Chavalit Yongchaiyudh, the prime minister. But Mr Thanong got a phone call anyway, just minutes before he and his wife were about to slip off to the anonymity of Macao. In his capacity as defence minister, Mr Chavalit ordered Mr Thanong to leave the presidency of Thai Military Bank and take charge of the Thai economy.
By floating the baht, Mr Thanong avoided leading Thailand into a default on its international debt. And by letting Finance One fail, Mr Thanong started the long road towards plugging the hole in the financial system, although FIDF lending now stands at about Bt600bn and continues to climb. Of Thailand's six finance ministers in the two years preceding the baht devaluation, Mr Thanong is the only one to have left office with his reputation intact - even enhanced.

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Full text: This series describes the way economic and financial turmoil struck the Asian rim of the Pacific. It highlights a handul of crucial moments that illustrate deeper themes.
The crisis started in the over-burdened financial systems of some of the fastest growing Asian "tiger" economies. In that headlong economic growth lay the seeds of the trouble. It attracted floods of foreign investment which pushed up land and asset prices.
Lending mushroomed. Investment bankers from the west rushed in. Huge infrastructure projects - new cities, railways, roads, power stations - were under construction. Yet under the surface, economic pressures were rising.
Most of the region's currencies were pegged to the US dollar, which had been appreciating in recent years. So the successful exporters of the region were gradually becoming more uncompetitive. Many countries suffered from "crony capitalism" in which the authorities encouraged banks to lend to politically well connected businesses.
It was, perhaps, not surprising that some of the fast growing countries - Thailand, Malaysia, Indonesia - ran into difficulties. Intermittent financial crises are often a consequence of very rapid growth. This time, though, the problem had wider repercussions.
The region was entwined with western banks and investors. Its powerful export industries were both suppliers to and competitors with key western industries - cars, semiconductors, computers. And the leading tiger, South Korea, was ranked as the world's 11th biggest economy.
The crisis-struck economies are intimate neighbours of Japan, the world's second biggest economy, which is still struggling to emerge from the collapse of its 1980s bubble. Japan's financial institutions - banks, brokers, insurance companies - are fragile, burdened with bad debts nearly a decade old. They are also big lenders to the rest of the region, vulnerable to a crisis there.

On these two pages, FT writers describe the Thai origins of the crisis, and how dominoes began to fall across the region. The story is far from over; but without understanding the roots of the crisis, it is impossible to assess the hazards ahead.

On June 25, 1997 Asia's economic miracle came to an end. That was the day Thanong Bidaya, named Thailand's new finance minister five days earlier, first managed to discover the true state of his country's foreign exchange reserves and the problems in its financial system.

Fewer than a dozen people - all in the central bank - knew the answers. For months, they had been hiding two crucial numbers from the Thai government and the public. Mr Thanong knew he was not going to get the information just by sitting in his office, as his predecessor Amnuay Viravan had done. He and three assistants climbed into the leather seats of his blue Volkswagen van and set off to demand information from Rerngchai Marakanond, governor of the Bank of Thailand .

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Mr Thanong was not regarded as an especially good banker, but he knew the tricks of the trade as well as anyone. Sure enough, on his visit to the central bank that June day, Mr Thanong quickly found the numbers he was looking for. He was horrified.

With the blessing of his superiors, the central bank's young and inexperienced chief currency trader, Paiboon Kittisrikangwan, had locked up most of Thailand's foreign exchange reserves in forward contracts. Thailand's reported foreign reserves of over $30bn were a myth - in fact they had dwindled to $1.14bn, equal to just two days of imports.

On top of that, the central bank's Financial Institutions Development Fund (FIDF) had lent over Bt200bn ($8bn) to struggling financial institutions. Finance One , the country's largest finance company, had alone received over Bt35bn from the fund in the first quarter of 1997. This lending had effectively drained seven years' worth of the Thai government's fiscal surpluses; the central bank was printing money to make up for the rest. The financial system had become a black hole, sucking out government money with no end in sight.

Within hours of Mr Thanong's meeting with Mr Rerngchai on that humid Wednesday came the leak. As was common with market-moving news in Thailand, no formal announcement was made. Instead, influential brokers and privileged journalists were quietly told that the FIDF would not, as it had promised in a press release exactly one month earlier, buy new shares in Finance One.

Finance One would shut down two days later, along with 15 other cash-strapped finance companies. Five days after that, July 2, Thailand was forced to free its currency from its longstanding peg to the US dollar, plunging East Asia into the financial turmoil that continues to this day.

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But there was a downside too. By abandoning Finance One, Thai authorities altered the way foreign investors assessed Thailand in such a fundamental way that when the baht was floated, it inevitably sank.

"Thailand had an open capital market and the Bank of Thailand acting as lender of last resort," says Rob Collins, head of Paribas Asia Equity , an affiliate of Finance One at the time. "That created a huge market distortion; there was no significant risk premium. It was all sovereign risk."

"When the Bank of Thailand decided it could not or would not act as a lender of last resort, the risk premium went through the roof - all the way to infinity," Mr Collins says.
Just months before Finance One collapsed, ING Bank in Thailand had lent the company money as part of a $160m syndication led by the World Bank 's International Finance Corporation . Jan Cherim, Country Manager for ING Bank in Thailand, says: "Every time we saw the Bank of Thailand they would tell us 'Finance One is OK, we're backing it all the way'. When they didn't you had to question just about everything they had ever told you."

Investors had been told both that the baht's value would remain stable, and that leading financial institutions would not be allowed to fail. Though both these propositions were open to question, the authorities had successfully persuaded investors of their validity over the preceding months. They had preserved the value of the baht, and apparently found solutions to the problems of troubled financial companies.
The first open questioning of the baht's value had come towards the end of 1996. By then, it was possible for economists to construct a strong argument that the baht's peg to the US dollar had to go. Exports, the original engine of Thailand's fantastic economic growth, had stalled only to be replaced by a financial and real estate boom that kept foreign capital coming in. This new capital was increasingly short-term in nature, making the funding of Thailand's huge current account deficit precarious.
Currency speculators recognised this and made two preliminary attacks on the baht in November and December. Yet devaluation was hardly inevitable and a number of countries in Asia, eastern Europe and Latin America showed similar signs of distress. The Thai authorities' confidence in their dollar peg won the day. In January there were even substantial flows of foreign capital into Thailand.
Similarly, towards the end of February 1997, the authorities appeared to have steered their way through a financial sector problem, when the first rumours that Finance One was in trouble started to circulate. Pin Chakkaphak, the company's managing director and president of the Association of Finance Companies , publicly denied that the company was facing any financial difficulty. None the less, he had been actively selling his own stake in the company to the tune of Bt254m during a six-month, 75 per cent plunge in Finance One shares.
Mr Pin was the undisputed hero of Thailand's bubble years. With an MBA from Pennsylvania's Wharton School of Business and experience at Citibank , he built a formidable financial empire with assets of $3.8bn by latching on to the booming stock market and exploiting the interest rate differential between the Thai baht and the US dollar. Finance One was the first Thai company to issue a eurobond, paving the way for Thai companies to become the second largest Asian issuers of such paper.
Problems at Finance One would have a wide-ranging impact. So the government stepped in at the end of February. Finance One was to merge with a small Thai bank it had once tried to take over, Thai Danu, in a deal sponsored by the central bank which would effectively amount to a bailout of the finance company. The authorities suspended trading in all financial stocks for the day as they sought to reassure investors.
"The merger between Thai Danu and Finance One will serve as an example and model for more mergers between financial institutions to come," said Thirachai Phuvanatnaranubala, director of the central bank's financial institutions supervision department. "The sooner we can get this deal completed, the sooner we can restore confidence among investors."
Over the following months, the Thai Danu deal began to unravel and "inappropriate" share dealings and loans to affiliated parties were revealed. Every plan put forward to save Finance One fell flat and it became clear that there was no comprehensive strategy to protect the financial system.
Partly this was due to the extent of the problems within the system, problems for which Finance One stood as a striking example. Nearly two-thirds of the company's loans were in three problem areas - property, hire purchase and stock margin lending. As interest rates rose and the economy slowed, Finance One's non-performing loans doubled in 1996, then doubled again in the first quarter of 1997.

Meanwhile, the terms of Finance One's assets and liabilities were the most mismatched of any of the top 10 finance companies. It held substantial stakes in several smaller finance and securities companies which themselves were even more vulnerable to the dual pressures of high interest rates and a falling stock market. There was little surprise when Thai Danu walked away from the deal.

"Finance One was the symbol of all the excesses Thailand had built up," says Nikhil Srinivasan, vice-president of Morgan Stanley , which also had a joint venture with a Finance One affiliate company. "Through it you saw the rise and fall of a system where people thought raising capital every year was a substitute for cash flow."

When the deal with Thai Danu fell apart, shares of Finance One resumed trading after a three-month suspension. They fell 70 per cent - and in a sign of just how bad sentiment was on the Thai bourse, brokers were pleased that the shares fared so well. Some people, foolishly it turned out, still believed in the central bank guarantee.

Among those were a group of US investors who bought $600m in Yankee bonds issued in April at 90 basis points above treasury rates. Those bonds are now rated as junk bonds, and many institutions are forced to liquidate them at fire-sale prices.

These days, Mr Amnuay - the finance minister who resigned in June - spends his time playing golf, after suffering a mild stroke in Hong Kong just two days before the baht was floated. Mr Rerngchai resigned the Bank of Thailand governership on the day the country turned to the IMF . He is due to receive a bonus from the central bank, rewarding him for his nearly three decades of service. Mr Thanong has returned to the presidency of Thai Military Bank , his own resignation as finance minister having precipitated the collapse of the Chavalit government.

Mr Pin splits his time between Boston and the UK, steering clear of Thailand, where the authorities might seek to make an example of him. Thai Danu was bought by the Development Bank of Singapore last month.

But even though most of the major players of those crucial days are out of the picture - save the current Bank of Thailand governor, Chaiyawat Wibulswasdi, one of the targets of a government investigation into mismanagement at the central bank - the baht continues to sag, partly because the saga of Finance One is not over.

Finance One's assets, along with those of other finance companies totalling Bt930bn, are now in the hands of the Thai government's Financial Restructuring Authority . Until a system for disposing of them is devised and implemented, few investors will believe that the Thai financial system is safe. Few Thai companies will have access to the working capital needed to pull the economy out of recession.

Thailand has negotiated a rescue package with the International Monetary Fund , then discovered that its economic outlook is worse than it thought. It will need a dispensation from the IMF if the next instalments of the rescue loans are to arrive as promised. Sweeping reforms of the economy - especially the financial sector - are under way. And the external value of the baht has halved since the day Mr Thanong clambered into his Volkswagen van to start that journey to the Bank of Thailand.

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