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THAILAND: THE NEXT PHASE OF CRISIS

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Since its currency collapsed in July 1997, Thailand has made great progress, both economically and politically. It has made and implemented difficult decisions without Indonesia's bloody political crisis or Korea's labor unrest, and because of this it now appears to be the most successful of the three most seriously troubled countries (Indonesia, South Korea, Thailand). But the most important economic and political pain lie in the future, and financial markets have discounted more progress than has yet occurred.

Political Context

In all the troubled countries, there is formal agreement within the government, and between the government and the IMF, on the broad direction of economic and financial reforms. The key issue for foreign investors and foreign policy officials is which governments will have the cohesion and public support to implement needed reforms; this political will is more important than the controversial details of the various reform programs.

At first glance, Thailand would seem worst prepared for the needed discipline, which inevitably damages the interests of a broad range of interest groups. Thailand, after all, is run by an eight-party coalition, and Thai governments have a long history of fragmenting under pressure. And it is run by a prime minister who in a previous government had a Jimmy Carter-like reputation for high-minded vacillation. Paradoxically, however, Thailand has so far been the most determined and politically cohesive implementer of reforms. Neither the political coalition nor the prime minister has fulfilled widespread expectations that they would prove ineffectual. This has happened for three reasons: the changed structure of Thai politics, the benefits of experience that had accrued to Prime Minister Chuan, and the ceding of most policy authority to a particularly dynamic finance minister.

The crisis occurred at a cusp of Thai history which provides an opportunity to break the cycle of unstable me-too coalitions. Until recently Thailand was dominated by the typical politics of an underdeveloped agrarian society: shifting coalitions of local political barons who controlled blocks of voters through kinship, social hierarchy, or (mostly) bribery; political parties funded almost exclusively by bribery; and almost complete disregard of issues. Voters voted for the politician who paid the most for their votes, politicians joined the party that offered the greatest bribes for doing

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so, and the primary goal of politics was not to implement some broad policy program but rather to seize control of ministries that controlled lucrative contracts or possessed equally lucrative regulatory (i.e. squeeze) powers. By the mid-1990s, the population was almost evenly divided between traditional rural society and a more modern urban society which aspired to a different kind of politics.

The crisis crystallized the division, with the previous coalition of Prime Minister Chavalit coming to symbolize the old politics that had created the crisis and the new coalition of Prime Minister Chuan symbolizing a thrust toward modernity and reform - more democratic, more transparent, less corrupt, and more disciplined too. It is important not to exaggerate the actual degree of change that has already occurred - for instance, there probably was negligible money raised by any party for the last election which would have been legal under U.S. rules - but the vote made a clear choice of direction. Chuan successfully labeled Chavalit as the advocate of patronage politics and corruption, and not incidentally as a prime cause of the financial crisis, and he successfully labeled himself and his partners as reformist. The Chavalit team's rejoinder, which has some merit, namely that much of the financial bubble developed during Chuan's previous term, has had little political impact.

As the financial crisis developed, there was widespread support for constitutional changes intended to limit the old, corrupt money politics. Urban voters believed that the root cause of the crisis was political, not technical financial mistakes. A constitutional convention led by former Prime Minister Anand, who although not elected was revered for his probity, proposed constitutional amendments in 1997, and the lower house passed them in May 1998. Inter alia, these amendments would force political parties and politicians to make public their finances, put an independent election commission rather than the highly politicized Interior Ministry in charge of organizing elections, make it difficult for local officials to check whether voters they had paid were actually voting in the way they had been paid to do, have voters vote directly for candidates as well as for parties, reform vote counting methods, and allow the electoral commission to refer cases of abuse to the potent Corruption Commission. These reforms provide potentially powerful weapons against corruption, and they so enraged the Chavalit government that Chavalit's Interior Minister and others accused the authors of the constitutional changes of being "communists," among many other epithets, but even the sitting government was unable to block passage of the reformist amendments, which were supplemented in the last week of May 1998 by detailed legislation to implement them. The objections of the Chavalit coalition to the constitutional amendments survive only as a unique footnote to democratic theory: the notion that advocacy of clean elections makes one a communist.

The Chuan government has continued to link economic revival to political reform, and has maintained its image as the probity coalition by relentless investigation of the sins of its predecessors. Although there is some risk that this witch hunt could eventually backfire, the emergence of a clear difference of image and policy thrust between the governing coalition and its opposition counterpart has given Thai politics a (possibly temporary) new stability under fire.

This relative stability has been facilitated by transformations that have occurred in the personalities and structure of the new government. Prime Minister Chuan clearly learned something from his previous term and has emerged from his previous Jimmy Carter image to a new image as a decisive and principled leader, presiding over a team that includes brilliant economic managers and former bank chief executives, namely Deputy Prime Minister Supachai Panitchapakdi and Finance Minister Tarrin Nimmanahaeminda. Beyond individual leaders, the Democrat Party under Chuan has evolved into a highly disciplined political instrument.

Another reason for policy decisiveness is the near total domination of economic and financial policy during the crisis by Finance Minister Tarrin Nimmanahaeminda, an energetic, Harvard-educated aristocrat who by force of experience and personality simply overshadows his colleagues.

Unlike Indonesia, Thailand has a government with a broad popular mandate. Having blamed the crisis on the previous government, the Chuan coalition has a great deal of legitimacy in imposing tough reforms to resolve it. Unlike fellow democracy South Korea, Thailand has a very weak and non-belligerent labor movement. Thus the Thai government is able to act decisively, at least for a time, without fear of upheaval.

Despite the financial crisis, the Chuan government is relatively immune from military intervention. There was talk of a coup toward the end of the Chavalit government, but the military is relatively uninterested in the role and would have little support from the public. The military has become more professional and less interested in intervention since the coup of 1992. Prime Minister Chuan and the current army commander share a desire to further professionalize the army and streamline its top-heavy leadership. Chuan, as the civilian, will take the heat for this while his military counterpart quietly abets him.

The Chuan government's stern advocacy of economic reform has earned Thailand the support of international financial institutions and some special aid from the United States. Its outspoken support for political reform has consolidated its forward-looking political image among the voters. In addition, the opposition coalition is burdened by more than just its reactionary image. In May 1998 the reigning head of the opposition group, former Prime Minister Chatichai, who provided the glue that held it together, died in London. Chatichai was an ironic source of coalition glue: while he built a reputation on the high economic growth that occurred during his administration, the primary legacy of his government was an increase of corruption with few parallels in modern Asia.

All these trends polarize the polity to an extent that will probably keep the Chuan government in office through the end of 1998 and possibly well beyond. Moreover, for the short run Chuan can easily increase the size of his coalition, at the cost of greater policy ferment, by bringing in the Chat Pattana Party, which is hungry to join.

However, there are some clouds on the horizon. The Chuan government has created the impression that economic reforms are likely to revive the economy at a relatively early date, and public expectations are that life will begin to get better by the end of this year. This is highly unlikely, and widespread disillusionment may occur. Second, the agreed IMF program largely protects the currency and saves the banks at the cost of shutting down virtually all credit for most Thai non-financial firms. This emphasis on currency stability at the expense of liquidity is beginning to cause friction within the government, including some semi-public disagreements between Deputy Prime Minister Supachai, who is more sensitive to the needs of the real economy, and Finance Minister Tarrin, who is more concerned about the stability of the banks. This slight crack in the senior reaches of the government is mirrored by a slight crack in the public support for Chuan's government as evidenced by small but significant demonstrations (against the IMF program and the way it is negotiated) by a weird coalition of academics, democracy advocates, environmental groups, and other NGOs under the leadership of Dr. Prawase, an apolitical friend of the king who has a reputation as a sort of social conscience - Thailand's equivalent of Ralph Nader.

On the opposition side, the old guard is increasingly being challenged by a younger group which wants to transform the opposition into a party with an ideology supporting the interests of the people against the interests of the bankers as represented by Tarrin and the IMF. Such a move to a program-based party would bring the opposition into the modern world, and such a program would potentially be quite powerful.

So far, however, the fissures in Chuan's coalition and political base are quite small, and so far the opposition old guard remains firmly in control and firmly opposed to the ideas of the younger leaders. But given the intensity of public disappointment that is likely by the end of 1998, there is a risk that the Chuan government will weaken and the opposition will reconstitute itself by 1999. This would create uncertainty regarding the path of economic reform.

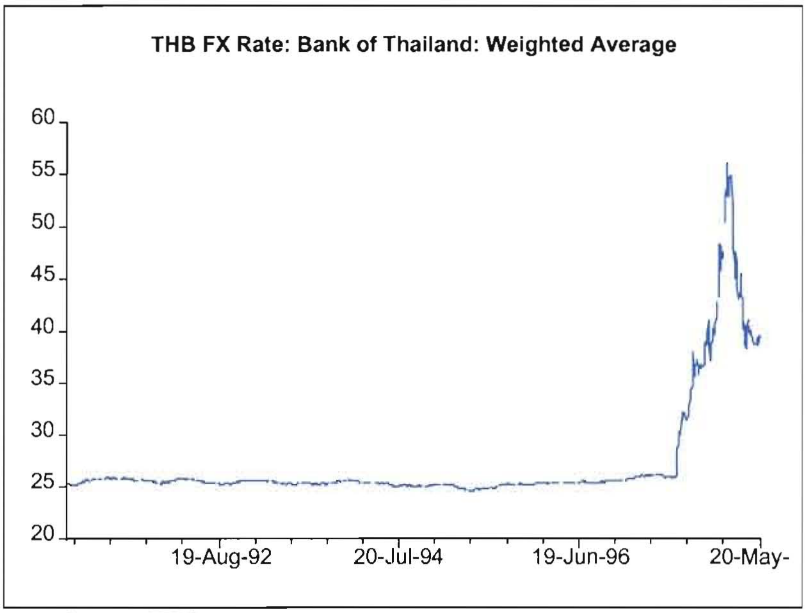
Economic Reform

The Thai financial crisis is not primarily a currency crisis, although currency problems have obviously constituted an important facet. The problem came to a head when the baht collapsed from 26 in July 1997 to 52 at its worst, but if the currency value had been the main problem the adjustments would have been much smaller (perhaps a 10 percent devaluation) and there would have been a quick revival of exports and economic growth rather than a broad economic collapse. The core of the crisis has been a property bubble, created by a currency and credit anomaly. In its years of high growth, Thailand typically kept domestic interest rates high to counter inflationary pressures. But currency liberalization allowed the inflow of foreign currencies which carried much lower interest rates. This created an overwhelming incentive for Thai companies to borrow foreign currencies, and having done so they could invest in projects that would never have been viable if they had been financed at local market interest rates. The result was a rash of overinvestment in property and heavy industry that inter alia left Bangkok with whole suburbs of shiny new apartment buildings that were completely empty.

This property bubble had to collapse. If currency speculators had not popped it open, eventually something else would have raised interest rates and punctured it. No sector which has become dependent for survival on a flow of below-market money can persist indefinitely. As it was, currency speculation drove up interest rates and burst the bubbles that depended on cheap money. The bursting of the domestic property bubble brought down the major real estate companies, along with much heavy and high-tech industry, and the foundering of the real estate companies brought down the finance companies and the banks which had both financed the property boom and done most of their lending on the basis of property collateral. The collapse of the currency then revealed the horrendous scale of foreign currency loans that Thai companies had taken on. Short-term debt had risen from $10 billion in 1990 to $41 billion. Everyone rushed to hedge these loans, driving the currency down further. Banks became aware of the scale of the resulting hangover of foreign debt and refused to roll their loans over; hence a huge foreign debt crisis emerged and the currency collapsed much further.

The central bank, knowing the extent of Thai companies' foreign currency obligations and the likelihood of a debt crisis if the currency devalued, had spent most of the country's foreign exchange reserves in a futile effort to defend the currency. This meant that the private sector debt crisis was augmented by a smaller public sector debt crisis.

Since the currency devaluation in July 1997 and the nadir of the currency in January 1998, Thailand has accomplished a great deal. The currency has stabilized and strengthened from 52 per US dollar in January to 40 per dollar today, and it is not likely to go into Indonesian-style free-fall, although as we shall note below there are still some sources of potential weakness. The currency recovery was accomplished through high interest rates, an austerity budget, stabilization of the financial sector, promises of far-reaching reform endorsed by the IMF, and a great deal of IMF and G-7 money.

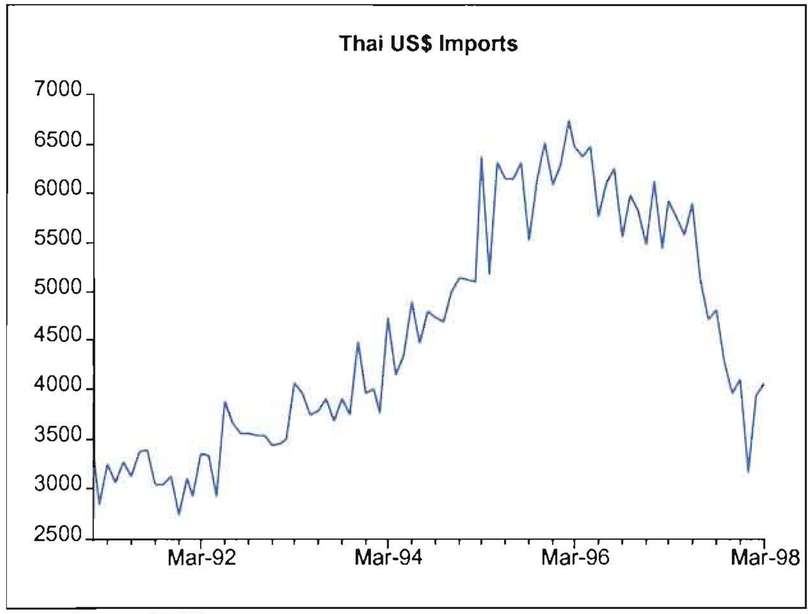


Source: CEIC

Second, panic has ceased and foreign banks are rolling over loans again. So long as the foreign banks were desperately trying to get all their money out, there was no possibility of currency stabilization. The government's firm endorsement of the IMF program, and unflinching implementation of its promises, restored international confidence much faster than occurred in Indonesia, which periodically slid back, or in South Korea, where the government seemed less cohesive and labor demonstrations periodically frightened foreign creditors.

A crucial part of the Thai reform package has been the closure of 56 failing finance companies and the government takeover of four banks. The government has guaranteed depositors and has propped up the banks, using the Financial Institutions Development Fund. Decisive action to close the defunct finance companies impressed the markets, and government guarantees to bank depositors have averted the risk of a broad financial panic.

There is still, however, no longer-term recovery. Foreign banks are rolling over their existing loans but are not providing substantial net new funds. The domestic financial system remains substantially frozen, with little money being available to most Thai companies. The domestic economy is declining at a rate the IMF projects at negative 5 to 6 percent for 1998. The trade balance has improved because of a decline in imports:



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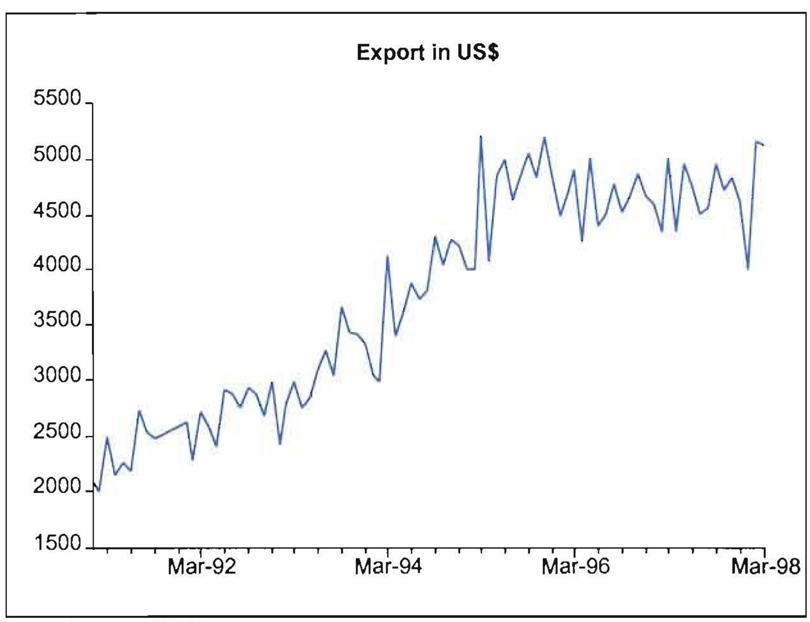
But exports remain flat despite the huge currency depreciation:



Source: CEIC

In April 1998, exports of $4.27 billion were 12% below April 1997, while imports were down 36%. Only in a very narrow sense is this an improvement. The sources of this stagnation and decline do not lie in the competitiveness of the real economy. Thai agriculture, manufacturing and services are highly diversified and competitive. Nor do they lie in the value of the currency, which potentially makes Thai exports highly competitive. Part of the problem lies with the stagnation of the Japanese market, which typically has absorbed about a quarter of Thai exports; in the first quarter, Thai exports to Japan declined by one-sixth compared to the previous year. But the main problem lies in the freeze-up of Thailand's financial system. Money just isn't flowing.

Two kinds of money aren't flowing. foreign money and domestic money. On the surface it is surprising that foreign money isn't flowing. Bangkok hotels are saturated with Western investors looking for bargains, and the market prices of Thai assets are unquestionably at levels that would make them extremely attractive. But so far investors face insuperable hurdles: they cannot value most of the assets, they cannot own the majority of the most important assets, and they do not have effective recourse if they lend money to Thai entities. So most of them fly home without either buying or lending.

The lack of recourse was supposed to have been solved by the passage of a bankruptcy law. However, the new bankruptcy law does not allow creditors to impose a reorganization plan without the consent of the original debtor, and it bars any attempt to seize the assets for seven years - after which the likelihood of actually getting any of the assets would still be dubious. There is supposed to be a further improvement of the bankruptcy law in September, but the details remain unclear. In any case, foreigners are still barred from owning land, and land is a principal asset of many companies. Hence foreign lenders are not lending.

Likewise, the excitement of foreign buyers soon cools. They are unable to figure out the market value of Thai assets. In the case of the Thai banks, layers of circular transactions - property bought with a loan from the bank, other credits from that bank or others then collateralized with the property, and so forth - make it exceedingly difficult to evaluate bank portfolios. And the Thais are exceedingly reluctant to concede managerial power over their larger banks to foreigners. In the case of non-financial companies, property is a crucial asset, often the principal asset. The market has been frozen, with very few transactions in the past few years, and in the absence of benchmark transactions foreign companies cannot figure out what the property is really worth. The Thai government has deliberately worsened this problem by announcing that it will not make public the prices obtained for properties sold in the process of cleaning out the assets of the closed finance companies. In other words, both private and public sectors are conspiring to ensure that the property market does not clear; they are still hoping that somehow they can continue to prop up the market and avoid realizing their losses. Worst of all, most of the assets available for purchase are property, and foreigners can purchase the cash flows associated with the properties but are not allowed to own the properties themselves. Until the Thais decide to let the market clear, and to allow foreigners to own the most important assets, the foreigners just aren't going to come to the table. When normal Western market standards of transparency and recourse are met, as they were in the recent Soros-led purchase of a Thai steel company, the money flows quickly, but such instances remain rare.

Similarly, domestic money isn't flowing either. Bad debts are estimated to total about 20% of GNP, and the banks hold most of these debts. The banks' total non-performing loans are widely projected to hit 30 percent of total assets by the end of 1998. Hence the banks are terrified of taking on further risk. As part of the IMF plan to stabilize the currency, interest rates are very high - around 20% for good credits. Most companies cannot afford such rates. Moreover, even at those rates, most banks will not lend to any but a handful of top companies. Government efforts to bail out the financial sector tend to absorb whatever liquidity there is. Specifically, bailout funds for the finance companies and the banks, mainly through the FIDF, plus loans assumed by the government-owned Krung Thai Bank, are believed by diplomatic sources to have totaled about 1.1 trillion baht (US$27.5 billion at an exchange rate of 40) by the end of April 1998. Banks can lend to the FIDF, and receive 18-20% essentially risk-free. Under these circumstances, it would be imprudent for banks to take the risk of lending to companies. Thus even exporters cannot get operating capital and letters of credit. (Statistics showing that bank lending grew 15% last year are believed by analysts to reflect accrued interest on non-performing loans, not new loans.) The country therefore cannot increase exports as it needs to do in order to pay its foreign debt, and it cannot increase production as it needs to do to halt the rise of unemployment, the decline of growth, and the deterioration of more and more companies toward bankruptcy.

The situation is dire. Consultants report that typical companies' interest expense is rising by factors of four to five compared with earlier years and that debt to equity ratios of typical companies are heading toward 4:1 or 5:1. Although the country particularly needs healthy exporters to earn foreign exchange and pay off the national debt, exporters, who typically borrowed more in dollars and yen, have been particularly hard hit.

There has been important progress. At the top tier of the banking system, the two best banks, Bangkok Bank and Thai Farmers Bank, have successfully recapitalized by selling securities to foreign investors. In the middle tier of the Thai banking system, ABN AMRO bought a controlling interest in Bank of Asia, and DBS and GSIC have bought a controlling interest in Thai Danu Bank. Among the weaker banks, delays in making offerings to foreigners have encountered fatal delays. A year ago, foreign investors would have snapped up shares of these banks on very good terms. This year, Citibank took a close look at First Bangkok City Bank and decided the values of the assets were so unclear that it could not go forward. The result so far is an inflow of about $3 billion for asset sales to foreigners against an overall $34 billion problem.

The government hopes to increase the inflows by selling the assets of the closed finance companies, with book value of 866 billion baht, through an agency called the Financial Restructuring Authority or FRA. Theoretically, all these assets must be sold, mostly in US$100 million lots, by the end of 1998. But most observers believe the deadline to be impossible. The assets constitute 17% of GDP, as compared with the assets of failed U.S. savings and loan institutions which constituted only 2-3% of GDP and took years to sell off. The FRA assets are hard to value, and they come in packages of diverse assets that may put off investors with more focused interests. They often comprise companies that cannot be reorganized by creditors without the consent of the debtors, and consist heavily of land that cannot be owned by foreigners. This is a recipe for delay at best and failure at worst. Moreover, there is some suspicion that all these problems will facilitate a sham whereby debtors will be allowed to buy back their own assets at a few cents on the dollar.

Ameliorating the liquidity crisis will require Thailand to encourage both foreign and domestic flows of money. Attracting large-scale foreign investments in the non-financial sector will require the Thai government to allow creditors to foreclose on debtors and to allow foreigners to own land. Attracting large-scale foreign investment in the financial sector will require Thailand to permit foreigners to obtain substantial management control of some of the larger financial institutions. In both financial and non-financial areas, foreign investors will require a much higher level of transparency, and there can be no real transparency without letting the property market clear.

Freeing up domestic credit flows will require Thailand to reduce interest rates and to create an environment where banks have incentives to lend to more than a handful of companies. Reducing interest rates will probably require accepting even more deterioration of the foreign exchange rate. And getting banks to lend to companies will require termination of the current situation where the FIDF soaks up available liquidity and gives banks high interest rates with minimal risk. The obvious way to do this would be to shut down or sell to foreigners the banks now being supported by the FIDF. (Selling to foreigners would require much greater concessions and incentives, as discussed above.)

Beyond this, the financial system will remain frozen until various markets are allowed to clear. Property has already been mentioned. In addition, banks and other creditors will have to recognize their losses. Consultants cited one case where creditors had clearly lost at least 95% of their assets in one foundered company but generally carried the credits on their books at the original value; that is still the standard practice. Creditors and debtors have yet to get together, take the necessary haircuts, and thereby position themselves to move forward. Much of this will not happen until the law is changed to allow creditors to foreclose.

So far, the emphasis of both the government and the IMF has been support of the currency and the banks. The IMF believes currency stabilization and financial system stability to be the top priority. The central bank wants a relatively strong baht in order to reduce losses on its huge dollar forward positions, which amounted to $13.8 billion at the end of May. Two of the government's top three officials are ex-CEOs of banks. But the liquidity squeeze is so severe, and the negative implications for Thailand's corporate viability, its exports, and ultimately its ability to return to creditworthiness and growth, are so great that we believe one can predict with considerable confidence further weakness in the baht and further drastic action to curtail the financial sector's absorption of liquidity.

Overview

Thailand has made impressive progress in an extraordinarily difficult environment. It has followed through on tough decisions, particularly an austerity budget, high interest rates, and the closure of 56 finance companies. It has been the most forthright of the troubled countries in adopting IMF programs, and it has exhibited far greater political cohesion in facing these difficult decisions than most observers would have believed possible. The top leadership of the government is conspicuously honest and conspicuously committed to the principles of financial reform. This is an impressive start.

At the same time, the difficult times lie ahead; the recession is just beginning to really hurt the middle class and the farmers. The situation of Thai companies and banks is deteriorating rapidly and the fundamentals of recovery, most notably an acceleration of exports, are not in place. There is a risk that the government's political base will deteriorate just as the most difficult decisions need to be made. Skeptics note that many of the promises to the IMF are in the form of commitments to recommend laws for passage - for instance, the bankruptcy law, regulatory restructurings, removal of education from the civil service, and privatizations. Some of these things are moving ahead well, but there are delays and instances of backsliding. For instance, the bankruptcy law was a sound one for three readings and passed the lower house in good shape, but was amended and crippled in the Senate where some of the country's most notorious debtors made amendments specifically to protect themselves. Some new laws are moving in the wrong direction. New legislation provides for a high minimum wage, for six months' severance pay, and for employees of sub-contractor companies to be treated as employees of the original contractor.

We recommend being neither optimistic nor pessimistic about the ultimate outcome of reform. At this point, Thailand offers few portfolio investments of clear value and few direct investments of clear value. There is a definite risk of a second round of currency attacks and market deterioration. Japan's situation shows that it is possible to fall into a trap where slow implementation of reforms creates many years of stagnation. There is also the possibility that necessary reforms allowing foreclosure, foreign ownership of land, greater foreign management of local banks, and greater ability of local land and securities markets to clear, will be put in place in coming months. Investors should use each of these reforms as clear benchmarks and move in decisively when, and only when, it is clear that they are falling into place.