CHAPTER 24
THAILAND

Introduction. In January 2001, Thaksin Shinawatra and his Thai Rak Thai (Thai Loves Thai) party beat Chuan Leekpai and the Democrat Party in the biggest popular mandate and the first clear majority in nearly 70 years of electoral politics.

- Mr. Thaksin ran as a self-made telecommunications billionaire.
- He ran as a populist willing to spread Thailand's wealth to the rural masses.

Economic Inheritance

When Mr. Thaksin took power in January 2001, he inherited an economy that appeared to be doing well, at least on the surface in 1999 and 2000.

- GDP was up 4.2% in 1999 and rose again at a 4.3% clip in 2000.
- In the year 2000, trade was booming. Exports—which contribute 65% to Thai GDP—were up 10% in 2000 and served as a major force driving recovery.
- A strong current account surplus replenished lost foreign reserves. At $32B in 2000, foreign reserves were robust and near their pre-economic crisis levels.
- Inflation was only 2%.

Economic Downturn

But below the surface, homegrown economic vulnerabilities made the Thai economy ripe for a jolt. That jolt was the collapse of the U.S. demand for Thai exports.

- The collapse of U.S. demand was particularly painful to Thailand because the United States traditionally buys 25% of Thailand's exports.
- Following relatively strong growth in 2000, the economy is now losing momentum and may even dip into recession.

Exports Fall. The U.S. and global economic slowdown hammered Thai exports.

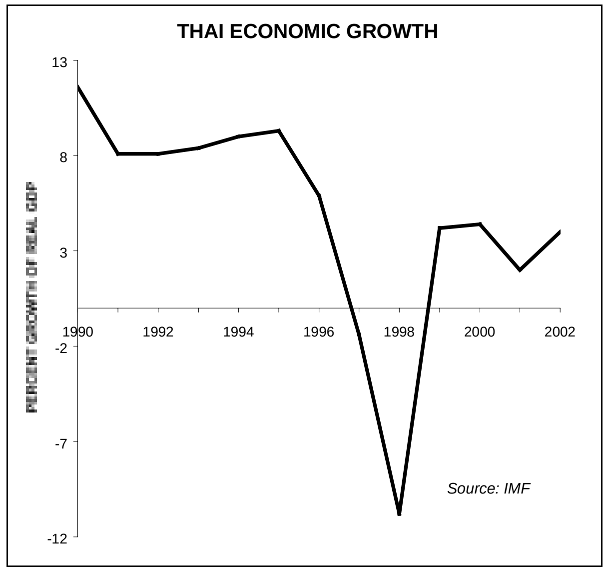
- Exports grew at a robust 19.5% in 2000.
- Since Thaksin took office in January of 2001, Thai exports have stalled. In 1Q01, exports shrank by 3.5% year-on-year.

Figure 24-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	165.8	134.4	121.0	121.9
Purchasing Power	393.0	356.9	345.4	389.0
Real Growth (%)	-1.4	-10.8	4.2	4.4
Inflation (%)	5.6	8.1	0.3	1.5
Exports	57.6	54.3	58.5	69.3
To U.S.	13.5	14.0	15.0	17.2
Imports	61.4	42.9	50.4	62.2
From U.S.	7.4	5.2	5.0	6.5
FDI from U.S.	3.5	5.7	6.8	7.1
In U.S.	0.2	0.2	0.3	0.1
Cur Account /GDP %	-2.0	12.7	10.2	7.7
Fiscal Balance /GDP %	..	-2.4	-2.8	-2.2
External Debt /GDP %	68.9	76.3	61.1	50.9

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 24-B



- Falling exports pushed Thailand's terms of trade into deficit. That export shortfall will deepen as global demand for semiconductors—which make up 35% of Thai exports—slows.
- Thailand's two chief trading partners, Japan and the United States, demonstrate signs of continued economic weakness.
- UBS Warburg in Bangkok predicts Thai exports will contract by 8% in 2001, which would almost certainly drive Thailand into a painful recession.

Socio-economic Woes. Meanwhile, workers are still hurting:

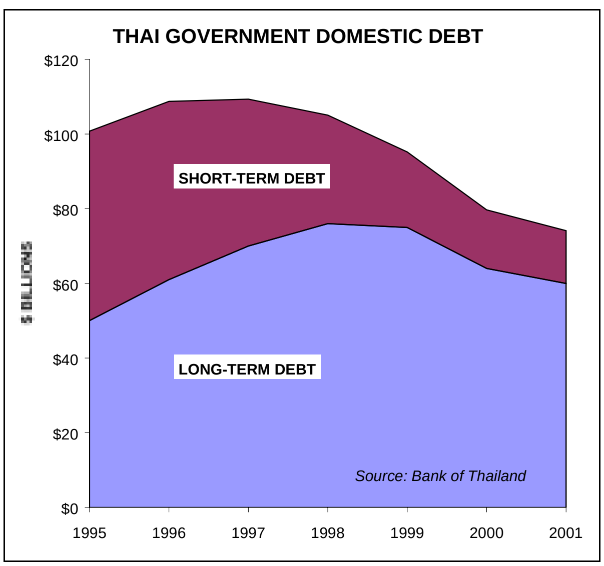
- Wages for low skilled workers dropped 13% to 20% after the crisis and have not recovered.

- While the official unemployment rate is only 4.3% (over four million people), these numbers appear to be too low. Millions more jobless don't show up in the official figures.[1]
- Private sector research is consistent with media reports from the streets of Bangkok, which give the impression of widespread unemployment.

Fiscal Constraints. Moreover, one of Thailand's prime economic drivers—government spending—is unsustainable. Why?

- During the past few years, large fiscal stimulus packages—worth over 300B baht—have temporarily been force-feeding much of the economic revival.
- However, this kind of big spending is running up huge budget deficits. The day of reckoning is near.
- The government is now burdened with a national debt that's 52% of GDP (2.6 trillion baht). (See Figure 24-C.)
- Plans for a 105B baht fiscal stimulus package for 2000/2001 will push the national debt closer to 60% of GDP—another Maastricht alarm bell for financial instability. (More on this later).
- The budget for debt service alone will increase from 9.5% of the total government budget in 2000 to 17.1% by 2003.

Figure 24-C



Negative Drivers. In addition, a number of other economic factors have weighed down the Thai economy, including:

- Rising oil prices, which require higher interest rates to offset inflationary pressures.
- Sluggish consumption at home. (A weak baht buys less).
- Political instability while Prime Minister Thaksin was on trial. (More on this later).
- Long term Thai economic growth depends on implementing deep and comprehensive structural reforms.
- Unfortunately, the cosmetic economic reforms Thailand has opted for won't work for long.
- This is particularly true in the fragile corporate and banking sectors.

The Bad Loan Problem

Vestiges of the Asian economic crisis are readily apparent in the banking sector. In fact, the most urgent problem facing Bangkok currently is tackling the mountain of bad loans that companies cannot or will not repay.

History. An excess of private rather than public capital provoked the financial crisis that began in Thailand in July 1997. Many private debts were short-term loans borrowed in foreign currencies. This money was often squandered on speculative projects, especially land and property. When property values, stocks, and the Thai baht collapsed, Thai companies were faced with massive debts, especially if they were denominated in U.S. dollars—as was frequently the case.

Corporate Debt. Some Thai companies are too broke to repay the loans. Other companies are stalling in the hope that creditors will offer better terms or write off part or all of the loans. For the moment, there is little that creditors can do about this. That's because bankruptcy proceedings can take years in Thailand, allowing ample time for assets to be spirited away.

Reluctant Banks. Consequently, Thai banks are reluctant to lend, even to deserving companies desperate to expand as the economy recovers. Thai banks are also reluctant to lend because they face a strict provisioning requirement for bad loans.

Slow Progress. Back in 1999 bad loans amounted to nearly 50% of all loans in the financial system. Thankfully, the level of bad loans is gradually falling. But three years after the baht's collapse, Thai banks' bad loans still account for over 35% ($50B) of all outstanding loans in April 2000, largely because many restructured loans have gone bad a second and a third time. In other words, a third of the bad loans are non-performing even after being generously restructured.

Financial Millstone. Thus, the bad loans are still a millstone around the financial system's neck, choking new bank loans to a trickle and discouraging foreign investment.

- This squeeze keeps most Thai companies —particularly small and medium-sized ones—starved of the funds they need to get back on a sound footing.
- And with stocks down 37% in value in 2001, businessmen have nowhere else to turn to raise capital.

Corporate Woes

Meanwhile, the family-owned conglomerates—at the core of Thailand's manufacturing economy—remain moribund. Many such businesses operate with no profits and with factories running well below capacity, if at all.

- Rescheduling debts have helped some companies stay open. But until companies work out their debts, creditors will shy away from new loans for upgrades and modernization.
- These corporations are also largely unwilling to surrender management control and incur losses by streamlining operations. If these companies stay on life support, they are simply postponing the day of reckoning.

Tar Babies. Sadly, even those Thai businessmen who are responsibly trying to implement comprehensive corporate restructuring are getting tarred with the same brush as the deadbeats.

- They find it increasingly difficult to sell assets or raise new equity.
- That's because Thailand simply isn't high on the list of foreign investors.

The Investor's View. But investors say that until Thai companies lower their asking prices for assets, foreigners will be wary of buying in. Why?

- Bankruptcy courts still operate slowly, if at all.
- While foreigners want a discount for risk, many Thai companies still demand a premium.
- Thus there's a large valuation disparity between creditors and debtors.
- Thai companies simply don't want to part with their assets.

Needless to say, that's risky short-term thinking.

Restructuring: Lessons Learned

What does experience teach us about Thai corporate restructuring?

- Unfortunately, the quality of much of the corporate restructuring is poor.
- Some three-fourths of the so-called restructured loans has been merely rescheduled.
- Banks have swapped equity for debt to avoid writing off loans.
- Too much of the old, incompetent management responsible for the bad loans and financial crisis are still in place.
- Lack of buyers has hobbled attempts to streamline companies through the sale of non-core businesses.
- Banks have dealt with easy cases first. Future cases will be thornier.
- Many of the loans are relapsing into non-payment.

Vulnerability Factors

The China Threat. These Thai corporate problems are increasing Thai vulnerability in head-to-head competition with China.

- China is aggressively taking away many of the country's traditional, low-skill industries.
- Thailand's rote learning education and training system makes it difficult to "move up-market" into a more value-added market niche.

- In addition, the lack of progress in Thai corporate reform is sapping international confidence.

Weak Legal System. Thailand must also strengthen its weak legal system if it hopes to be economically competitive.

- In this regard, one of the chief economic challenges for Thailand is to curtail the culture of arbitrary rule that has bedeviled the country's economic development and contributed to its financial crash in 1997.
- At a minimum, the rigorous and impartial application of the law is the precondition for good economic governance in Thailand.

Thaksin's Test. The rule of law was tested in 2001 when Prime Minister Thaksin was indicted for concealing huge assets when he was Deputy Prime Minister in 1997.

- Mr. Thaksin did not dispute the charge.
- Instead, he said that the tax rules and regulations were "confusing" and that he made an "honest mistake" in concealing millions of dollars in assets, manipulating stocks and evading taxes.

Thai Sovereignty. The U.S. government correctly did not and will not take sides.

- Washington respected Thai sovereignty and viewed the indictment and legal decision as a sensitive Thai internal matter.
- Nevertheless, the market was not and will not be so sensitive to Thai sovereignty. The indictment and the legal decision have profound financial and economic consequences.

Thaksin's Acquittal. In the end, Mr. Thaksin was acquitted. What does this decision say to the market about the Thai legal system?

- The fact that Prime Minister was actually hauled into court shows how far Thai law has come in recent years.
- Such an anti-corruption indictment would have been unthinkable not long ago.

Immediate Impact. Initially, stock market investors greeted the acquittal with relief, pushing the stock market up 4%.

- The acquittal removed the biggest cloud over the prime minister and thus reduced Thai political instability in the short run.
- Mr.Thaksin is now free to focus on reviving the economy.
- The court paved the way for a rebound in domestic sentiment, which could spur fresh consumption.

Long Term Impact. On the other hand, investors say that the impact of the acquittal may not be altogether favorable in the long run. Why? The perception is business as usual in Thai politics.

Alternative Scenario. In contrast, what if Mr. Thaksin had been found guilty?

- What would investor perceptions be like?
- In the short run, political instability would increase.
- Over the longer run, the market may well have seen it as heralding in a new era of political reform.
- Either way, many potential foreign investors are stymied by the confused separation of powers between executive and judicial functions.
- These investors seek reassurance that the rule of law applies to government officials and businessmen alike.

Interest Rate Battle. Many foreign investors are losing confidence in the Thai government for other reasons as well.

- Prime Minister Thaksin's firing of central bank governor Chatu Mongol Sonakul has worsened investor concerns about Thai financial policy.
- At a time when the Thai economy is on the verge of recession, the economy faces an obvious shortfall in aggregate demand.
- In response, the Harvard-trained Chatu Mongol was following a low interest rate policy that any sensible central banker would pursue to boost aggregate demand.
- In fact, the Fed is pursuing a similar low interest rate policy to fight slow growth in the United States. This is Keynesian Economics 101.
- When Thai central bank governor Chatu Mongol Sonakul refused to cave into to Prime Minister Thaksin's pressure to raise

interest rates, Mr. Thaksin fired him in late May 2001.

Monetary Policy

Monetary U-Turn. Thailand's new central bank governor Pridiyathorn Devakula radically reversed the low interest rate policy of his predecessor and announced that inter-bank rates would be raised.

- What is Thaksin's rationale to push the "Herbert Hoover" button and tighten monetary policy in the midst of weak growth/recession?
- Thaksin voiced concern in June 2001 that the Thai exchange rate is 45 baht to the dollar—a decline of 15% since the spring of 2000.
- To help stabilize the baht, Mr.Thaksin decided to use high interest rates to limit capital outflow and keep foreign reserves at around $32B.[2]
- Thailand's new central bank governor Pridiyathorn Devakula also says he wants to "manage" the value of the baht and reduce currency volatility.

At best, this nonsensical economic theory will only work in the short run.[3]

Monetary Mistake. The decision to raise interest rates in the midst of weak growth/recession is a huge mistake. Why? Higher interest rates:

- Shrink aggregate demand even more, thus making it increasingly likely that that weak growth will turn into a recession.
- Force banks to charge more for loans—making it more expensive to finance everything from car purchases to new factories.
- Discourage fresh investment.
- Raise government financing costs, thus crowding out discretionary spending.
- Add to the woes of the debt-burdened corporate sector.
- Stop Thailand's recovering banks in their tracks.

Crippling Bad Loans. In this regard, higher interest rates will spell disaster for the profit margins of embattled private banks, which face a stagnant lending environment and a dearth of non-interest income streams. The banks' weakened state is seen in a number of ways.

- Non-performing loans (NPLs) account for nearly 20% of the total loan book or Bt854.7B—down from the peak of 48% in May 1999, according to official figures.
- However, the published balance sheets tell only part of the story. The banks are reportedly heavily under-reporting NPLs.
- The headline NPL figures do not include loans secured with dubiously valued collateral or loans that have been "restructured" with token, extended repayments.
- As a result, the banks' average yield on assets remains poor and the net spread between deposit and lending rates is a narrow 1.8% on average.
- The level of non-performing loans could grow to twice the current levels.

Government Response

The government has sought to facilitate their recovery, in part by:

- Bailing out some of the banks.
- Aiding sales of other banks.
- Unveiling the National Asset Management Corporation (NAMC).

State Bank Bailout. A key element of Prime Minister Thaksin's economic program is the NAMC, a government asset management company whose job is to carve out bad debts from the banks.

- The mission of the NAMC is to absorb up to Bt1,350B ($30B) of NPLs from the balance sheets of banks.
- The good news is that NAMC has strong powers to force restructuring.
- However, bailing out sick and inefficient state run banks all too easily degenerates into politicians giving breaks on "political loans" to influential borrowers.
- That sends the wrong signal to private companies struggling to repay commercial loans to private run banks.

***Private Bank Bailout*.** To rectify this preference for state run banks, the Thai government extended the bad loan bailout plan to private banks.

- The government said that it intended to give strong powers to an Asset Management Corporation (AMC) to force defaulting borrowers to restructure their debts. These powers would include the ability to seize assets swiftly.
- The plan calls for the AMC to buy up all bad loans at state banks and up to Bt250B worth of bad loans from private banks, paying net book value for the assets.

Funding Bad Debt Buy-Out. Another problem is how to pay for the government's bad debt buy-out. The buy-out fund will place a great strain on public finances.

- Recent government budget deficits have been approaching the 3%-of-GDP alarm bell established by Maastricht as a rule of thumb for financial instability.
- An enlarged budget deficit to finance the bank loan bailouts should only be implemented after consideration of the long-term implications of deficit financing for public debt.
- Public debt has skyrocketed from 48% of GDP to 58% in just one year.
- If this accelerating public debt buildup continues, the government debt would easily spillover over the Maastricht alarm bell for financial instability—government debt over 60% of GDP.
- Certainly Prime Minister Thaksin's plans to boost government spending for the bailout should not be allowed to push the budget deficit in excess of 4% of the country's GDP, or it could hurt the state's ability to manage public debt.
- To get around this alarm bell, Mr.Thaksin may push his newly politicized central bank to print money to fund the bailouts as well as his health care and rural development programs.
- This course of action could trigger inflation.

The Way Ahead

Prime Minister Thaksin was elected as a big-spending populist.

- Many observers assumed from his business acumen that he supported open markets. Now people are wondering if he will roll back reforms.
- The biggest fear is that Mr.Thaksin's desire for a strong baht will result in capital controls, as Malaysia did in 1998.
- The specter of Thai capital controls and a pegged exchange rate regime have become a distinct possibility.
- That would send investors fleeing.
- If Thailand is to increase its long-term economic security, Mr.Thaksin must stay the course and deepen economic reforms.

Conclusions

The Thai economy is on the verge of a recession. The major negative driver has been the collapse of the U.S. appetite for Thai exports. The resulting bad news includes a falling baht, nose-diving stocks, low wages and unofficial reports of higher unemployment.

Meanwhile, a strong recovery is unsustainable due to homegrown economic faultlines, which include high budget deficits, a large national debt, sluggish consumption, political uncertainty and weak economic reforms. High oil prices compound these problems.

The most urgent problem facing Bangkok is the mountain of bad loans. Bad loans choke off new bank loans and discourage foreign investment, thus slowing down long-term economic growth. While the government has come up with generous plans for loan bailouts of the state and private banks, it's not clear how the government can pay for these plans without straining public finances.

Finally, it will also be no easy task to change the mindset of the crony capitalists and their iron triangle of politicians, businessmen, and politicized bankers. For the foreseeable future, the Thai bad loan problem will continue to be a millstone around the neck of the financial system and therefore a huge constraint on long term economic growth.

Endnotes

---

1 Thai Farmers Bank Research Center (TFBRC).

2 Prime Minister Thaksin's decision to have a politicized central bank under his thumb could well contribute to the capital outflow that so concerns the government. Conversely, a strong, independent central bank would attract capital inflow.

3 See the first two chapters for why currency micro-management is a bad idea.