

Thailand in the context of 1997 Asian Financial Crises

Abstract

The 1997 Asian Financial Crises was a significant financial crisis due to its effects on the global economy. It began with the devaluation of the Thai Baht in mid-1997, resulting in an economic downturn, stock market declines, currency devaluation, inflation, and recession across ASEAN and beyond. The affected economies recovered quickly through international bailouts, policy and political reforms. This essay will examine the background of why currency crises occur, the unfolding of the Asian Financial Crises in the wake of the collapse of the Thai Baht, the consequences, policy responses, analyses of pre- and post-crisis data and policy recommendations in the context of Thailand.

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1. Introduction and background of the crisis

A currency crisis is a sudden and significant depreciation of a currency that has widespread negative economic consequences. It can be triggered endogenously by an oversight in avoidable imbalances in the determining economic variables such as fiscal and monetary policies, the balance of payments or output growth within the economy or exogenously by shifts in investor sentiment and other unavoidable geopolitical events. These triggers can exacerbate the existing macroeconomic and structural imbalances within the economy, leading to a currency crisis. While their occurrence has always been prominent in modern global economic history, they are not isolated events accompanying other crises, such as banking and sovereign debt crises (Glick and Hutchinson, 2011). For instance, with the Brazilian economic downturn due to the Asian Financial Crises of 1997 and The Russian Financial Crisis of 1998, investors lost confidence in Argentina's ability to manage its debt and maintain a fixed exchange rate with the US dollar, causing the peso's sharp depreciation and culminating in a sovereign debt default and Argentina's financial collapse in 2001-2002 (International Monetary Fund, 2003). Similarly, the Turkish Lira has suffered due to a large current account deficit, high inflation, and political instability in Turkey, leading to capital outflows, higher borrowing costs, and economic uncertainty. Turkey's economy faced challenges during the COVID-19 pandemic due to its reliance on foreign borrowing and vulnerability to external shocks, further worsening the Lira's depreciation (Orhangazi and Yeldan, 2021).

These examples demonstrate how internal and external factors can result in vulnerabilities that even minor disruptions can exacerbate. Thailand's 1997 experience exemplifies this concept in the context of currency crisis models. Obstfeld (1986) uses the second-generation currency crisis model to suggest that investor expectations play a crucial role in determining the outcome of a currency crisis and that high interest rates and a weak banking sector can cause speculative attacks.

In the case of Thailand, investors were apprehensive about a possible currency devaluation due to the country's significant short-term foreign debt and the de-facto fixed exchange rate peg to the US dollar, leading to a self-fulfilling prophecy by triggering a liquidity crisis and forcing Thailand to change exchange rate regime and significantly depreciate the Baht causing the onset of Asian Financial Crises.

2. Unfolding the crises

2.1. Pre-crisis period

The Investment Promotion Act of 1977 in Thailand significantly transformed investment activities from import substitution to exports and utilised local resources for growth; leather, electronics, electrical machinery, transport equipment, rubber, plastic, and textile industries contributed significantly to Thailand's manufacturing sector, output, and employment growth (Shain, 1994; Sharma, 2002; OECD, 2021). Between 1970 and 1987, the manufacturing sector's contribution to GDP increased from 16% to 21% (Neher, 1988). In the early 1990s, the Thai government aimed to establish Thailand as a regional financial centre (Nidhiprabha, 1998; Sharma, 2002) with plans designed to make financial regulations more liberal, increase opportunities for domestic banks, and improve capital adequacy standards. Capital controls were lifted, and the capital market was developed to provide easy access to funds for domestic firms and new exporters and strengthen foreign investors' confidence (Sharma, 2002; Sangusubhan, 2008). Commercial banks and exporters were authorised to conduct trade-related foreign exchange transactions and accept baht payments from non-resident accounts without prior authorisation (Panyarachun and Kittikulsingh, 2013).

Financial institutions played a crucial role in the country's economic growth (Nidhiprabha, 1998; Sharma, 2002). The Bangkok International Banking Facilities (BIBF) was established in March 1993 to develop international financial services and provide capital for regional economic growth and development. BIBF was granted tax exemptions on income tax, special business tax, and interest income tax (Sharma, 2002). Interest rate differentials, economic growth rate, financial liberalisation, and a stable exchange rate of the baht all contributed to an increasing stream of net capital inflows to Thailand and other Southeast Asian nations (King, 2001; Sharma, 2002; Panyarachun and Kittikulsingh, 2013). This increased access to foreign capital also led to domestic firms taking on massive short-term debts and channelling them into long-term projects in the economy, which created a mismatch between the maturity of funds (Sharma, 2002). By 1995, national external debt was approximately USD 100 billion, of which short-term debt comprised USD 44 billion (ADB, 2003).

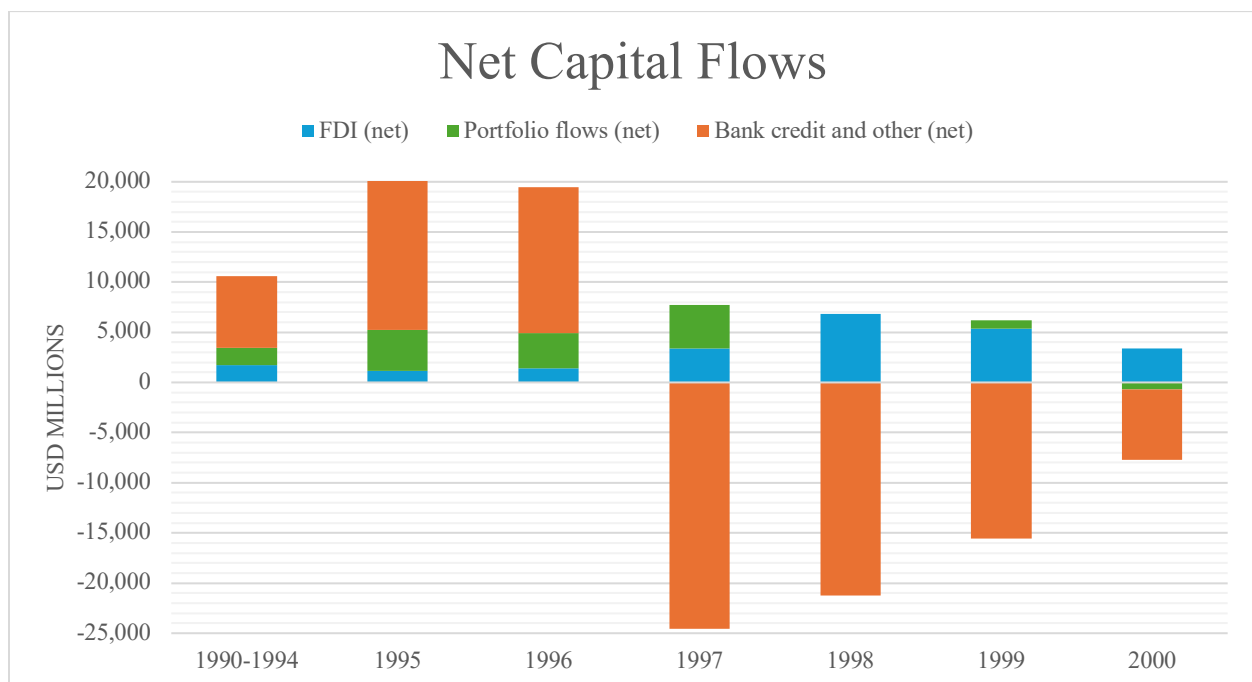


Figure 1: Net Capital Flows in Thailand from 1990 to 2000 (Source: Athukorala, 2003). The majority of capital inflows comprised bank credit and other lending, which is considered highly volatile and large inflows are frequently a leading indicator of financial crises (Reinert, 2020).

Borrowers became overconfident, and lenders became complacent and overlooked essential details due to the lack of attention given to credit analysis (Bank of International Settlements, 1998; Nidhiprabha, 1998; Sharma, 2002), which was instilled by the booming economy. The economy's growth was primarily fueled by the swift expansion of the real estate and stock markets rather than a boost in exports. This is evidenced by a rise in current account deficits during the economic boom, a hike in the real property price index and a spike in the stock index.¹ In 1996, just before the crisis, Thailand's current account deficit amounted to \$14.69 billion, equivalent to almost 8% of its GDP for that year (The World Bank, 2024a). The current account deficit was essentially funded by capital inflows, mostly short-term lending (Bank of International Settlements, 1998).

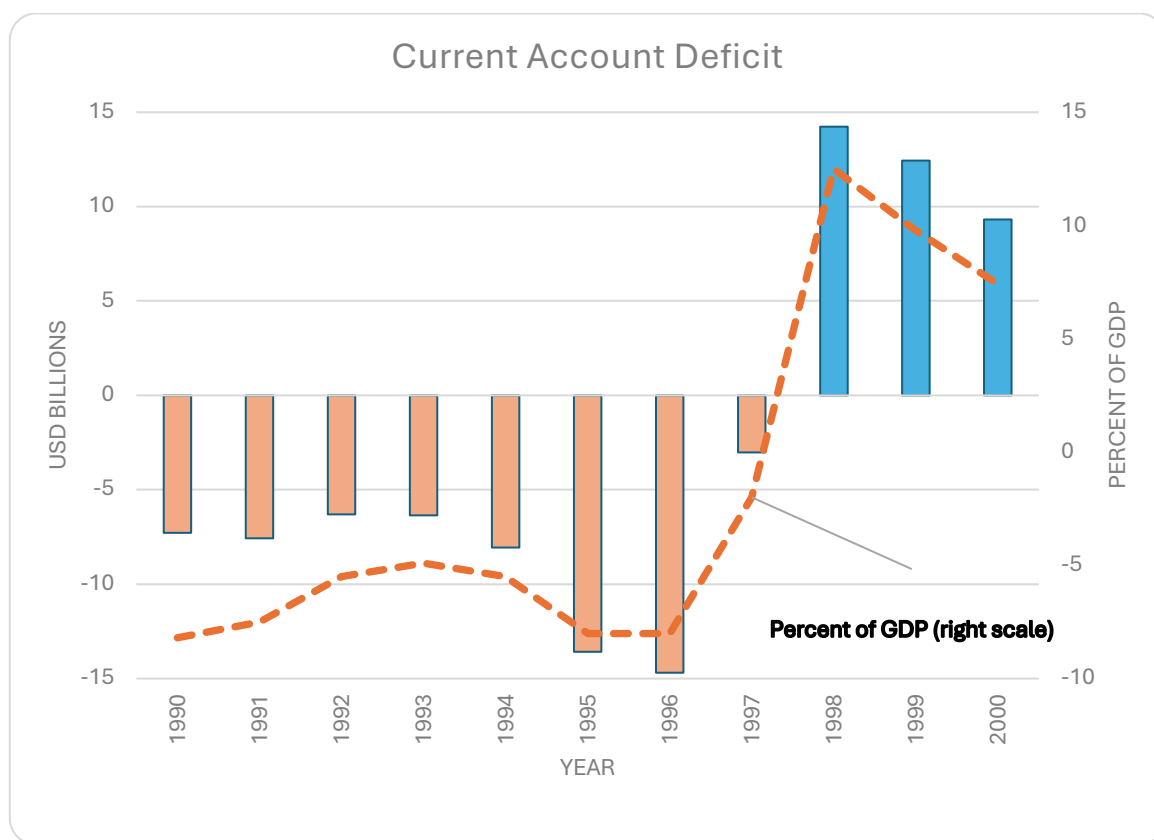


Figure 2: Current Account Deficit in USD billions and as a percentage of Thai GDP. Thailand consistently maintained a current account deficit throughout most of the 1990s decade but had a surplus of 12.5% during 1998 (Source: The World Bank, 2024a)

¹ See Figure 3, p.7

2.2. Fall of the Thai Baht

While Thailand's policy changes attracted significant foreign investment, excessive investment was made in projects in non-productive sectors, and investment asset bubbles primarily contributed to economic growth (Nidhiprabha, 1998). Between January 1990 and January 1994, the SET index grew from 899.61 points to 1,753.73 points (GFD, 2024f), and the real residential property index reached a high of 123 points in January 1993 (Bank of International Settlements, 2024).

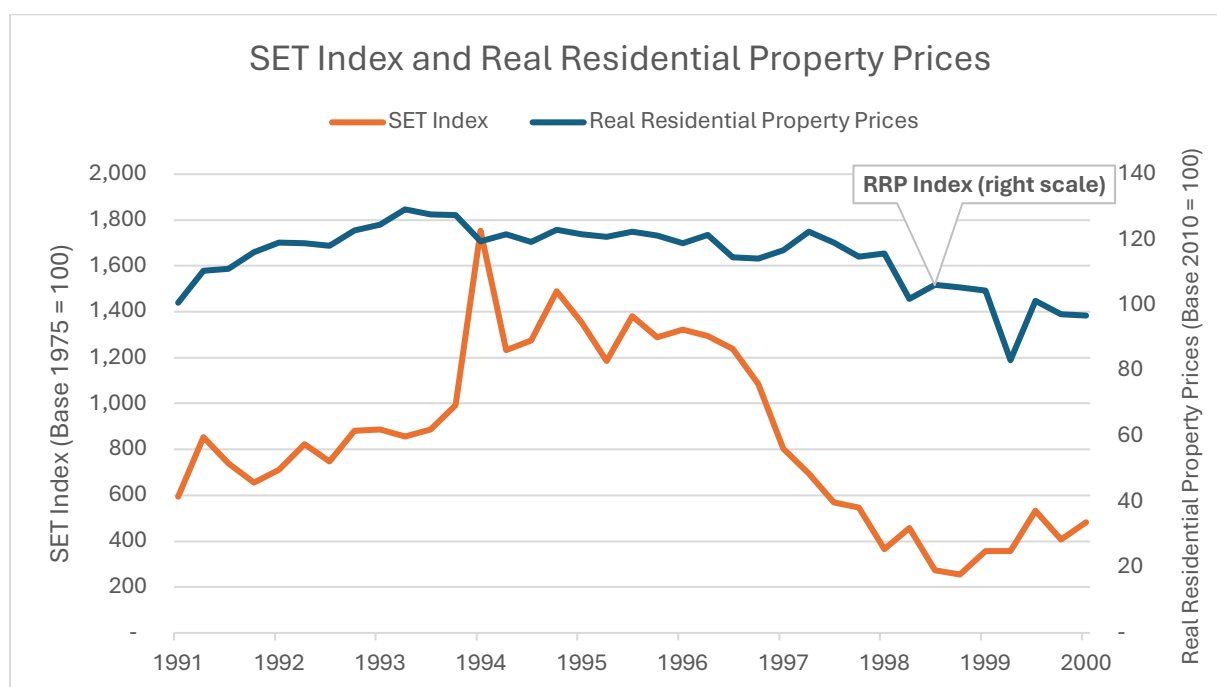


Figure 3: Thailand Stock Market Index from 1985 to 2000 (top) and Thailand Real Estate Price Index from 1991 to 2000 (bottom). The indices grew substantially during the early 1990s and peaked in 1993-1995 (Source: Bank of International Settlements, 2024; GFD, 2024f).

Equity and property price increases can often signal an upcoming financial crisis (Svirydzenka and Chen, 2021). In the mid-1990s, the United States Federal Reserve increased its interest rates, causing U.S. dollars to appreciate and capital flows to revert while also increasing pressure in its current account. Similarly, as banks invested in long-term credit facilities, the failure of these projects to materialise led to the accumulation of non-performing loans on the balance sheets of

financial institutions as domestic borrowers defaulted (Bank of International Settlements, 1998). Coupled with the need to repay short-term foreign debt, these non-performing loans became a significant issue for the institutions. By 1996, the non-performing loans in Thai financial institutions were 13% of total lending (Edwards, 1999). Eventually, the Thai government had to utilise their international reserves, which were rapidly depleting, to rescue these institutions. This fundamental issue in the financial system initiated a speculative attack on the Thai Baht.

The Thai government implemented several measures to protect against an attack as it attempted to keep Thai Baht around 26 Baht per US Dollar. Firstly, they raised interest rates to maintain the appeal of the Thai Baht to foreign investors and make it costly for speculators to borrow Baht to short-sell (Moreno, 1997). However, this approach was unsustainable and led to increased domestic borrowing costs and a slowdown in the economy. The Thai government utilised more international reserves to defend the Baht, rapidly depleting reserves from USD 37 billion in December 1996 to USD 30.90 billion in June 1997 (Moreno, 1997). On July 2nd, 1997, the Thai Baht was allowed to float freely. In August 1997, it was announced that the Thai government had forward market obligations of USD 23.4 billion, which it had spent to defend the Baht to settle, and the reserves were much lower than anticipated (Leightner, 1999).

This decision significantly impacted the previously thriving Thai economy, as the value of the Thai Baht depreciated by nearly 55% from July 1997 (24.35 THB per USD) to January 1998 (THB 55.5 per USD). The collapse of the Thai Baht raised concerns about the transparency and fundamental strength of the region's emerging and newly industrialised nations, which had previously garnered significant attention and capital flows. The Stock Exchange of Thailand (SET) Index fell from 816.79 points to 385.25 points from December 1996 to December 1997 (Punyaratabandhu, 1998), and unemployment from 0.9% in 1997 to 3.5% in 1998 (The World

Bank, 2024d). As investor caution increased, divestment spread throughout the area, and other countries were affected by this spillover effect (International Monetary Fund, 1998).

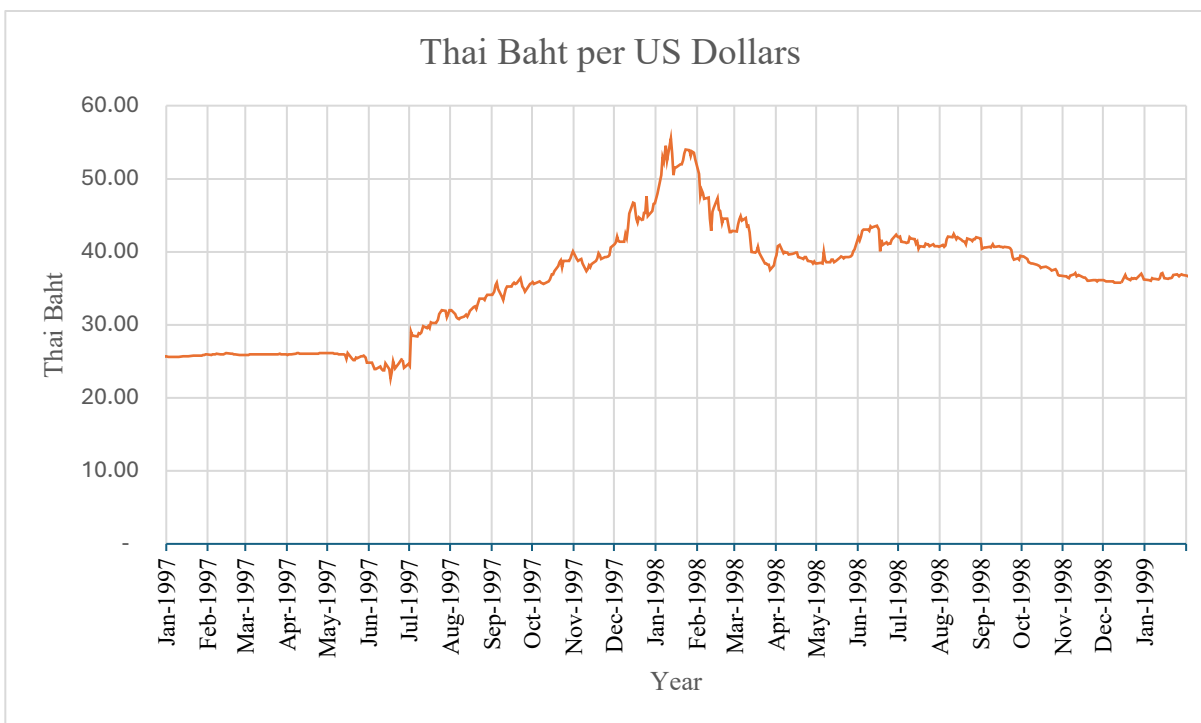


Figure 4: Exchange rate for Thai Baht (THB) per U.S. Dollar. On July 02, 1997, Thailand announced that it was letting the Thai Baht float. The Thai Baht depreciated by almost 16% in a single day (GFD, 2024h).

2.3. Spillover effects in ASEAN and beyond

The devaluation of the Thai Baht triggered the spillover effect in Southeast Asia. Malaysia experienced a speculative attack on the Malaysian Ringgit (MYR) after the Thai Baht, causing it to depreciate from MYR 2.52 per USD to MYR 4.62 per USD from July 1997 to January 1998 (GFD, 2024b). Malaysian government resorted to unusual capital controls, which involved restricting foreign currency's outflow and limiting its currency's trading abroad. The government also later fixed a peg of MYR 3.8 per USD, which, in hindsight, was crucial in increasing the competitiveness of its exports and uplifting the Malaysian economy from a total meltdown

(Nambiar, 2006). Likewise, the banking industry in Indonesia experienced a significant downturn due to political games, inadequate transparency, and inefficiencies. Speculative attacks began in July 1997, and the Indonesian Rupiah (IDR) continued to depreciate from IDR 2,430, reaching a low of IDR 14,550 by January 1998. Inflation soared to 85% in July 1998, and GDP growth plummeted to -13% in 1998 (GFD, 2024a; The World Bank, 2024b), making Indonesia one of the most severely impacted nations.

South Korea and the Philippines also encountered considerable financial difficulties. South Korea's weak regulations and inadequate supervision of financial institutions, particularly its highly leveraged family-owned conglomerates - *chaebols*, resulted in defaulted loans and divestments (Coe and Kim, 2002). The Won also suffered a 51% depreciation (GFD, 2024d). On the other hand, the Philippines faced speculative attacks that caused a 40% depreciation of the Peso, with 3-month interbank rates climbing to 31% by January 1998 (GFD, 2024c).

2.4. IMF intervention and post-crises reforms

The freefall of the Thai Baht continued after Thailand cancelled the de-facto fixed exchange rate regime and switched to a floating rate regime in July 1997. After that, it sought assistance from the IMF for a stand-by credit line and bilateral loans (Sharma, 2002). In mid-August 1997, bilateral assistance led by the IMF pledged an assistance package of USD 17.2 billion. The IMF approved a credit line of USD 3.9 billion in tranches over 34 months to support Thailand's economic recovery (International Monetary Fund, 2000). The assistance from the IMF was conditional on policy changes in the country.

A key policy was financial sector restructuring (Leightner, 1999; International Monetary Fund, 2000) and improving the regulation and supervision of financial institutions (International

Monetary Fund, 2000). For instance, The Thai authorities introduced a comprehensive plan to reform the financial sector to meet these conditions. The Financial Sector Restructuring Authority (FRA) and the Thai Asset Management Corporation (TAMC) were established to restructure the financial industry by recapitalising or merging struggling finance companies, guaranteeing deposits and loans, purchasing, managing and facilitating the sale of failed finance companies' assets (Mallory, 2021). The IMF also proposed a series of reforms to address the issue of overspending in the economy. Austerity measures were a crucial component of these reforms, which required adjustments to macroeconomic policies (Ito, 2000). The primary focus was reducing government and private expenditures. One significant fiscal policy adjustment to raise revenue and meet bailout conditions was to amend the Value Added Tax (VAT) rate for domestic consumption (excluding basic staples) from 7% to 10% (U.S. Department of State, 1998; Matsumoto, 2018).

U.S. Department of State (1998) reports that before the economic reforms, the Thai government had prioritised trade liberalisation and had aligned its policies and commitments with those of WTO and ASEAN, and they began reducing tariffs on over 4,000 items as early as 1997; however, in compliance with the IMF's requirements, the government implemented higher surcharges and excise taxes on luxury items and alcohol, and this impacted luxury goods manufacturers in the country, including American wine and beer exporters. Punyaratabandhu (1998) documents that the Thai government took adequate steps to reduce excessive consumption and enhance government revenue to achieve a budget surplus of 1% of GDP for 1997 and 1998 (Actual: deficit of 1.8% and 2.7%, respectively). These measures were aimed at export promotion while simultaneously curbing the demand for imports due to the weak economy influenced by the austerity policies. As per the IMF guidelines, this created an expectation of reducing the current

account deficit to 5% of GDP by 1997 (Actual: 2.01%) and 3% by 1998 (Actual: Surplus 12.50%). However, it came with added issues of a high unemployment rate (3% in 1999) and reduced social welfare, a significant critique of the measures imposed as a part of the IMF bailout (Ramesh, 2009; The World Bank, 2024d).

Between June 1997 and January 1998, the Thai government took measures to manage inflation and stabilise the Thai Baht's value by raising interest rates (Bank of Thailand, n.d.). This significantly increased 10-year government bond yields by 451 basis points from 10.13% to 14.64% (GFD, 2024f). Money market rates rose by 300 basis points from 9.25% to 12.25% (GFD, 2024e). These high interest rates remained in place until June 1998, owing to the rising inflation rate, which climbed from 4.39% to 8.57%, peaking at 10.66% in June 1998 (GFD, 2024g). Regarding capital outflows, the government responded by implementing capital controls, such as restrictions on repatriating Baht proceeds from Thai asset sales (Sharma, 2002), among other measures.

During 1998, capital flows experienced a boost due to higher interest rates, although not as substantial as prior to the crisis. Nevertheless, in June 1998, the Thai Baht faced another depreciation owing to the reduction of interest rates. To revive the faltering economy, the Thai government implemented a stimulus package in May 1998 and agreed to increase the fiscal deficit to 2.4% of GDP, using foreign aid as a funding source for economic recovery (Japan International Corporation Agency, 1999). As the economy began to improve, the current account surplus was recorded at USD 14 billion in 1998, USD 12 billion in 1999, and USD 9 billion in 2000 (ADB, 2003). However, the effects of austerity measures were felt in the economy, as GDP growth was -7.60% for the year, followed by slower but positive growth rates of 4.6% in 1999, 4.5% in 2000 and thereafter (The World Bank, 2024c).

3. Pre- and post-crises analysis of macroeconomic indicators

Numerous indicators and determinants have significantly contributed to understanding the crisis's cause and reflecting upon what changes were seen after the policy changes in the aftermath of the crisis. Based on examinations by Peltonen (2006) and Salvatore and Campano (2010) of determinants of currency crises, and my own opinion, some of these factors have been descriptively summarised below. The data is sourced from The World Bank database and Key Indicators for Asia and the Pacific by ADB for 2003 and 2020.

Table 1: Descriptive Statistics for pre-crisis and post-crisis period of Asian Financial Crisis in Thailand

	<i>N</i>	<i>Mean</i>	<i>SD</i>	<i>Median</i>	<i>Range</i>	<i>Min</i>	<i>Max</i>
<i>PRE-CRISIS, 1992 to 1996</i>							
Real GDP Growth Rate (%)	5	7.62%	1.10%	8.08%	2.60%	5.65%	8.25%
M2 to GDP (%)	5	78.38%	2.24%	79.08%	6.01%	74.81%	80.82%
Fiscal surplus/(deficit) to GDP (%)	5	2.30%	0.98%	2.60%	2.50%	0.80%	3.30%
Inflation (%)	5	4.82%	1.09%	5.05%	2.51%	3.31%	5.82%
Short term debt to Total debt (%)	5	41.83%	3.78%	43.00%	9.28%	35.25%	44.53%
Current Account to GDP (%)	5	-6.43%	1.48%	-5.66%	3.10%	-8.03%	-4.93%
Current Account (\$m)	5	-9,799	4,031	-8,085	8,388	-14,691	-6,303
<i>POST CRISIS, 1999 to 2003</i>							
Real GDP Growth Rate (%)	5	5.16%	1.49%	4.57%	3.74%	3.44%	7.19%
M2 to GDP (%)	5	115.38%	7.61%	115.20%	18.11%	104.69%	122.80%
Fiscal surplus/(deficit) to GDP (%)	5	-1.92%	1.29%	-2.20%	3.30%	-3.00%	0.30%
Inflation (%)	5	1.20%	0.67%	1.59%	1.52%	0.28%	1.80%
Short term debt to Total debt (%)	5	20.02%	2.37%	18.90%	5.53%	18.67%	24.20%
Current Account to GDP (%)	5	5.60%	2.89%	4.24%	6.68%	3.13%	9.81%
Current Account (\$m)	5	8,582	2,443	7,965	6,236	6,192	12,428

During the pre-crisis period, Thailand experienced a persistent current account deficit, with an average current account deficit to GDP of 6.43%. In contrast, the average surplus post-crisis is 5.6% of the GDP. Before the crisis, the deficit was financed by hot money flows and external loans; however, as the current account deficit was one of the significant causes, policies for economic reforms and financial restructuring policies implemented in the country post-crisis, including a depreciation of the Thai baht, made exports more competitive and contracted domestic demand which reduced imports. Similarly, the high proportion (41.13%) of credit growth being financed by short-term debts corroborates that short-term debts were used to fund long-term projects, leading to maturity mismatch and corporate defaults that eventually led to the crisis. This was also dealt with as a part of comprehensive financial restructuring, leading to the lower holding of short-term debt as short-term debt. The average short-term debt-to-total debt ratio (20.02%) was significantly reduced after the crisis. There was a need to reduce the country's reliance on short-term external borrowing and significant efforts to maintain a fiscal surplus following the crisis. It can be inferred that the high short-term debt ratio and persistent current account deficit, which can strain international reserves, had a significant role in building the crisis.

It is also noteworthy that despite the high average real GDP growth rate (7.62%), the average M2 to GDP ratio (78.38%) was comparatively lower before the crisis. This suggests that despite the high economic growth, less liquidity and high prices caused by asset bubbles fueled the economic growth as it significantly hiked the output figure for Thailand before the crisis. This is also substantiated by the low average inflation level (4.82%), which is unusual as very high real GDP growth rates accompany it. The M2 to GDP has significantly increased post-crisis, averaging 115.38%, reflecting the government's stimulus injected into the economy after the recession during the crisis period. However, it is accompanied by low average inflation of 1.20%, which is

supported by the financial restructuring taking place during the time, in which the increase in broad money was possibly used for improving the liquidity and recapitalisation of financial institutions rather than increasing aggregate demand, as stylised by the low average real GDP growth rate (5.16%) dragged down by the crisis.

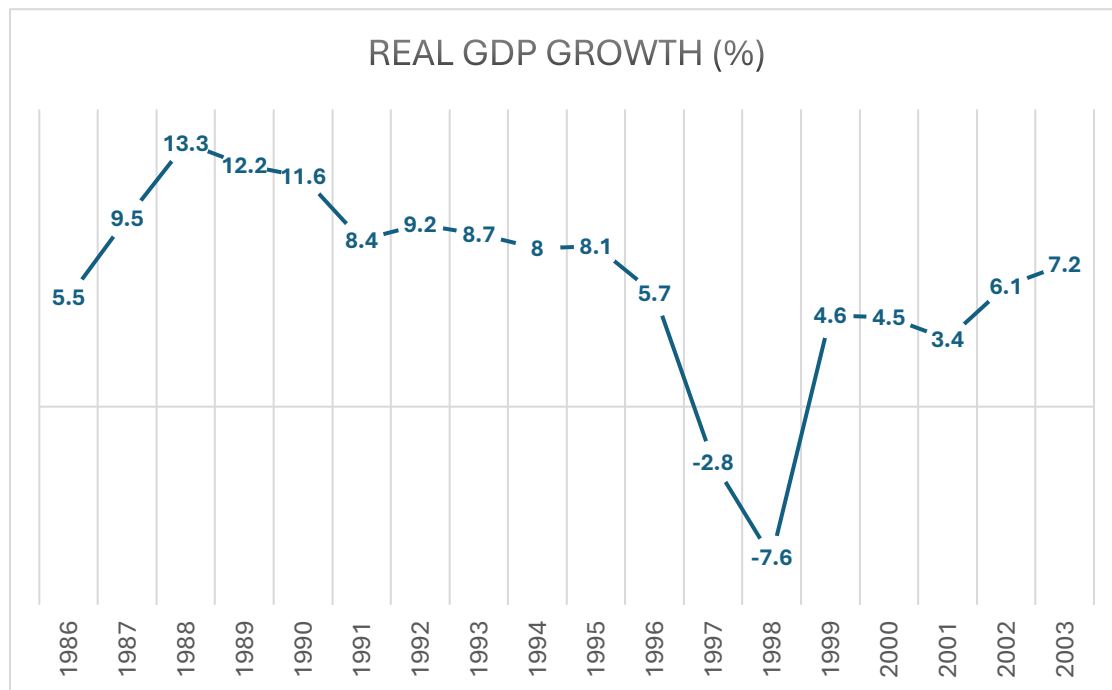


Figure 5: Real GDP growth of Thailand from 1986 to 2003. The growth rates were positive until the year before the crash (Source: The World Bank, 2024c).

4. Policy Recommendations

The economic crisis in Thailand resulted from several factors, including unchecked credit growth, volatile hot money flows, lack of proper financial regulations, the formation of asset bubbles, and a high GDP growth rate that lacked substantial output. This led to a significant increase in the current account deficit and a shift in investor sentiment, ultimately triggering a speculative attack on the currency and straining international reserves. While reforms addressed these issues, the crisis could have been prevented or managed better with additional policies.

Firstly, Thailand attempted to achieve and sustain the 'impossible trinity' before the crisis. They pegged their currency, controlled their monetary policy, and allowed free capital movements, but this was not viable in the long run as it became vulnerable to speculative attacks (Glick and Hutchinson, 2011). To prevent the crisis, Thailand should have allowed the currency to float freely earlier than it did. Additionally, the current account deficit should have been kept in check so as not to let it increase as drastically as it did. Floating the currency earlier could have corrected the imbalance by discouraging imports.

Secondly, The Thai government should have promoted output growth in the manufacturing sector after the capital influx while properly regulating the financial institutions to control excessive credit growth. To achieve this, it is recommended that more macroprudential policies be implemented to require the banks to maintain capital buffers in economic downturns to make them self-sustained, and regulatory bodies should be strengthened to ensure proper supervision of financial institutions to prevent fraudulent and irrational activities. Tax benefits should be given to the agricultural and manufacturing sectors compared to the financial industry to increase their output, and regulatory trade barriers should be reduced to facilitate trade, which can increase trade surplus. Similarly, policies should also be developed to reduce the level of foreign debt, such as imposing a limit on borrowing by a domestic firm from outside the country.

Last but not least, the Thai government could have adopted an unusual capital control policy like Malaysia did during the crisis. Nambiar (2006) documents that Malaysia imposed capital controls following the crisis, which included restrictions on short-term capital outflow, repatriation of asset sales proceeds for a certain period, and other measures to control offshore trading and short-selling of Malaysian Ringitt. These restrictions restored confidence in domestic businesses, restricted speculation on the Ringitt and provided space for internal restructuring,

which helped the Malaysian economy bounce back very strongly after the crisis. However, these policies should be carefully weighed before implementing, as there may be negative consequences such as creating a segmented capital market, loss of investor confidence and discouragement of FDIs, creating a false sense of security and being complacent in making reforms to prevent this from happening again.

Lessons from the crisis highlight the things that can go wrong in an emerging economy and can contribute to formulating a solid strategy for adequate financial regulation, promoting output-led economic growth and prudential macroeconomic policies. It also gives an idea and guidance on what other measures could be implemented should this type of crisis occur for the global community since there has been a significant increase in the number of emerging economies, such as Bangladesh, South Africa, Taiwan and Romania in recent period.

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Appendix

Year	Real GDP Growth Rate	M2 to GDP	Inflation	Fiscal surplus/(deficit) to GDP%	Short term debt to Total debt	Current Account to GDP (%)	Current Account (\$m)
1992	8.08%	74.81%	4.14%	2.60%	35.25%	-5.66%	-6,303
1993	8.25%	79.21%	3.31%	1.90%	43.00%	-4.93%	-6,364
1994	8.00%	77.96%	5.05%	2.90%	44.53%	-5.49%	-8,085
1995	8.12%	79.08%	5.82%	3.30%	44.08%	-8.02%	-13,554
1996	5.65%	80.82%	5.81%	0.80%	42.29%	-8.03%	-14,691
1997	-2.75%	91.69%	5.63%	-1.80%	34.49%	-2.01%	-3,021
1998	-7.63%	102.74%	7.99%	-2.70%	28.27%	12.53%	14,243
1999	4.57%	104.69%	0.28%	-2.60%	24.20%	9.81%	12,428
2000	4.46%	122.40%	1.59%	-2.10%	18.67%	7.37%	9,313
2001	3.44%	122.80%	1.63%	-2.20%	19.62%	4.24%	6,192
2002	6.15%	115.20%	0.70%	-3.00%	18.90%	3.47%	7,014
2003	7.19%	111.80%	1.80%	0.30%	18.70%	3.13%	7,965