Globalization and Development Strategy:
A Case Study of Thailand's Financial Sector

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I. Introduction

Globalization is a process of economic integration that facilitates international "exchange" of goods, services, and capital, and it is often accompanied by "conversion" of economic transaction structures (such as regulatory and contract systems) of various countries to a common framework. Globalization originally took place among industrial countries in the context of promotion of trade and investment as it was in their own interests to negotiate a set of rules to promote mutually beneficial exchanges. In contrast, notable features of the current wave of globalization are that (i) the aspect of conversion to international standards is gaining importance; and (ii) an increasing number of developing countries are joining the trend.

The early, "exchange" phase of globalization accelerated after the World War II. Creation of the General Agreement on Tariffs and Trade (GATT) was an international effort to establish a common trade framework under which individual countries could exploit their comparative advantages. The function of the GATT as a trade-enhancing forum has been succeeded by the World Trade Organization (WTO). The current phase of globalization, on the other hand, has witnessed a greater focus on the "conversion" factor in developing countries. Industrial countries demand that the regulatory framework in developing countries be revised so that their goods and capital can flow in the latter's markets more easily. The financial sector regulation is one of the target areas for conversion with the purpose of lowering the entry barrier into developing countries' financial markets.

The purpose of this paper is to investigate the consequences of the conversion-based globalization in Thailand. At the time of the Currency Crisis in 1997, Thailand was required to implement several economic policy measures in return for the financial aid package coordinated by the International Monetary Fund (IMF). The IMF was particularly interested in promoting the financial sector restructuring, by which it

claimed to install the “international standards” for the Thai regulatory framework. This case is significant because the initiative for conversion was not taken by the Thai government. Rather, it was “imposed” on them by the outside force. This is a rare case of “involuntary” globalization whose intention was explicitly declared by the party that promoted it.

This “involuntary” or “forced” nature of current globalization may bring harmful consequences to developing countries. Governments of developing countries have a distinctive policy objective, i.e., promotion of economic development as a means to improve people’s standards of living. This development priority makes their economic policies qualitatively different from the ones pursued in industrial countries: they are often designed to create fundamental economic institutions that would enable efficient resources allocation in the economy. To the extent that globalization implies adoption of economic systems existing mainly in rich countries where basic economic institutions have been firmly established, there is a gap between preconditions of globalization and environments surrounding developing countries. If globalization on the conversion dimension is imposed on them, developing countries may have to forgo opportunities to create economic institutions that are essential to profit from their comparative advantages.

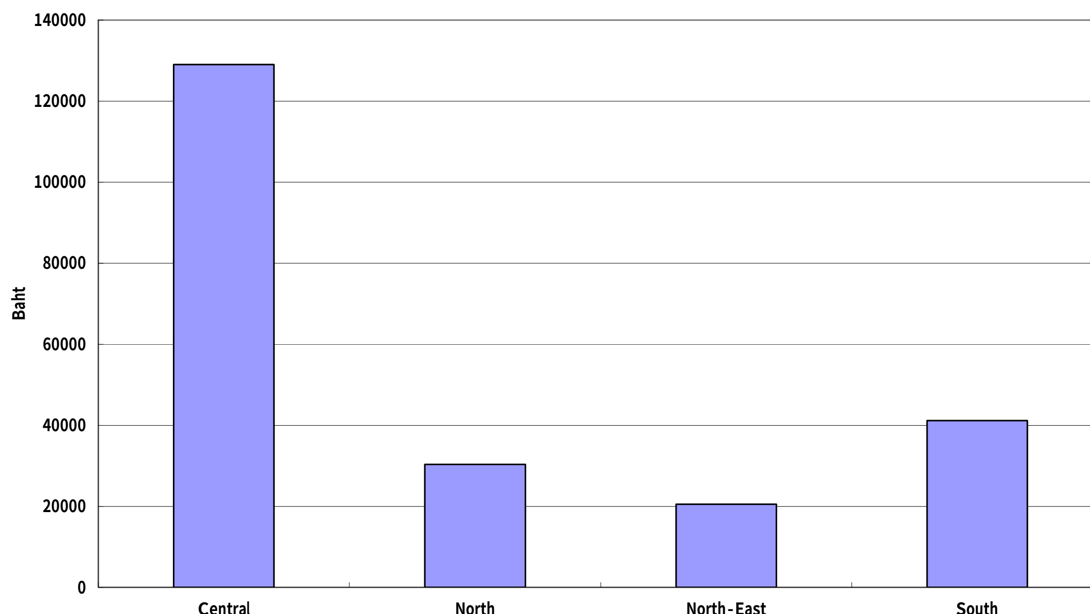
The next Section discusses the policy that the Government of Thailand had pursued in their effort to promote financial sector development broadly in the country. Section III describes the economic programs adopted after the Crisis, which is followed by analysis of their consequences on the behavior of the banking sector as well as re-orientation of the government’s development policy. The concluding Section summarizes the findings.

II. Financial Sector Development in Provinces: Priority of the Thai Government

Since the 1950s, Thailand had enjoyed an extended period of stable economic expansion. For over three decades from 1951 to 1984, its annual gross domestic product (GDP) growth averaged 6.71 percent and never fell below 4 percent after 1958. This impressive long-term macroeconomic performance was accompanied by improvements in people’s living standards. For example, percentage of population below the poverty line, which stood at 59 percent in 1962, was down to 26 percent in 1986. Life expectancy at birth was 68 years in 1990, compared with 52 in 1960. The economic growth further accelerated in the mid-1980s. The average GDP growth rate between 1985 and 1996 was 8.69%, and the economy expanded even at double digit rates from 1988-1990.

A large part of the expansion of economic activities was, however, concentrated in Bangkok and its surrounding provinces. Although the government succeeded in attracting foreign direct investment (FDI) to the country as a catalyst to growth, a majority of FDI-financed enterprises was established in the Central Region of the country that includes Bangkok. This has resulted in widening income gap between the central part and the rest of the country. As is demonstrated in Figure 1, per capita GDP in 1994 was 129,072 baht for the central part of the country, while it was 20,568 baht for the North-Eastern Region, 30,350 baht for the Northern and 41,186 baht for the Southern Region.[1] This inequality creates a host of problems such as mass labor migration to Bangkok from provinces in North-Eastern, Northern, and Southern Regions, which in turn results in air and water pollution and traffic congestion in Bangkok. Hence, the government added an emphasis on the importance of the balanced development and alleviation of income inequality in its development agenda.

One of the policy measures to address the Bangkok-provinces development gap was the financial sector development in poor regions. For local economies to transform



[1] Thailand has 76 provinces as administrative units, and the North-Eastern Region covers 19 provinces, Northern Region consists of 17 provinces, and Southern 14 provinces. These three regions (50 provinces) represent about two-thirds of the nation's population.

themselves through industrialization, it is important to have the mechanism of financial intermediary. Those who aspire to start viable projects should have access to finance. In provincial Thailand, however, this condition has been hard to meet. All commercial banks in Thailand are headquartered in Bangkok, which reflects the capital's dominance in the modern Thai economic history. As profit-seeking entities, these banks do not have incentives to establish themselves in poor provinces unless they are convinced that there are opportunities to provide financial services at profit. The dilemma for the policy-makers as well as potential entrepreneurs in provinces is that, without opportunities to obtain finances, economic activities will be severely constrained, which in turn will discourage banks to provide their services.

In an effort to tackle this vicious circle, the Thai government requested assistance from local commercial banks to extend financial services to less-developed rural parts of the country. In 1975 the central government, Bank of Thailand (BOT), introduced a mandatory agriculture credit system, under which it was required that a specified share of bank loans be allocated to agriculture-related activities. The percentage requirement was initially set at 5 percent, which was gradually raised up to 13 percent in the middle of the 1980s. The BOT also used its authority to approve branch opening application for the benefit of poor regions. It encouraged banks to open branches in areas which did not have financial infrastructure by preparing a list of target districts.[2] Individual banks' cooperation in establishing branches in these locations was an important factor in the BOT approval process of new branches in Bangkok. The BOT further required banks to lend a certain share (60%) of the fund they received as deposits from provincial branches to be lent back to finance economic activities in the same region.[3]

The government could expect the banking sector's cooperation for their policy of financial development in provinces for the following reasons. First, the government protected the domestic banks from competition, which led to guaranteed profits for them. The government had not approved new entry to the banking industry since 1966. Nor did they approve entry of overseas banks into the Thai market. Under this environment, local banks had resources to extend support to the government's development priority. Second, the government also restricted foreigner's equity participation in the local commercial banks. The maximum shareholding allowed was 25 percent, which made it difficult for non-Thai owners to exercise control over

[2] Each province is divided into districts. As of 2000, there were 795 districts in the country.

[3] The BOT defined 9 "regions" for this regulatory purpose. Bangkok and surrounding 5 provinces are not covered by this rule.

management decisions. This might have contained resistance from shareholders against expanding branch network that itself could be unprofitable.

The third factor was the convention of Thai banks to extend credit based on collaterals such as real estate and stocks. Provincial bank clients often lacked modern managerial skills to provide cash flow or risk analysis, and banks' reliance on collateral provided opportunities for them to gain access to credit. Finally, banks complied with the central bank's request for branch expansion as it was also in their own interests at that time. Credit demand in booming Bangkok and its vicinity exceeded deposits that banks could mobilize in their metropolitan branches, and they found it to their benefit to open provincial branches to mobilize extra deposits.

As a result, the number of bank branches increased in provinces, together with deposits that banks were able to mobilize as well as credits extended to clients there. This would have constituted a shift in the direction of removing the development obstacles that poor regions had been facing.

III. Currency Crisis of 1997 and Impacts on Commercial Bank Operations

In the process of rapid economic growth, however, the Thai economy had fallen into a trap that set the stage for speculative attack on its currency, baht. The inflow of short-term capital that had financed an asset price bubble of the early 1990s was sustainable only as far as overseas investors had trust in the peg regime, i.e., a fixed exchange rate between baht and dollar. This confidence in the peg was crucial for the continued flow of overseas capital to Thailand particularly because the country was running large current account deficits, a factor usually associated with devaluation of a currency. Contraction of Thai exports in 1996, however, reminded investors of the risk of betting on the peg system. Prices of real assets stopped growing about the same time, and finance companies that borrowed heavily from abroad in order to lend to property development fell into serious solvency problems in early 1997. These events led to a shift in perceptions that the exchange rate adjustment was imminent, provoking massive capital outflows. The BOT attempted to defend the baht-dollar peg by selling its dollar. When its foreign reserve was almost depleted, however, the government yielded to the market forces and abandoned the peg in July 1997.[4]

The Thai government asked the IMF for financial assistance in order to obtain foreign reserves. The IMF arranged a rescue package that combined credit of billions of

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[4] For a complete exposition of events that led to the Crisis, see Pasuk Phongpaichit and Chris Baker, *Thailand's Crisis*, Chiang Mai: Silkworm Books, 2000.

dollars with policy conditions that the government must comply with. The government was required to raise taxes and reduce its spending in order to deliver a budget surplus, as well as to raise interest rates to pursue a tight monetary policy. On top of these routine austere macroeconomic measures that the IMF had regularly imposed on crisis countries, it also asked the Thai government to carry out various programs including financial liberalization and privatization of state enterprises. It was an effort to transform the Thai economy from the Asian “crony capitalism” to the American economic system of open markets. The IMF believed that conforming to the international standards would be in the best interest of Thailand, especially in the area of financial sector management.

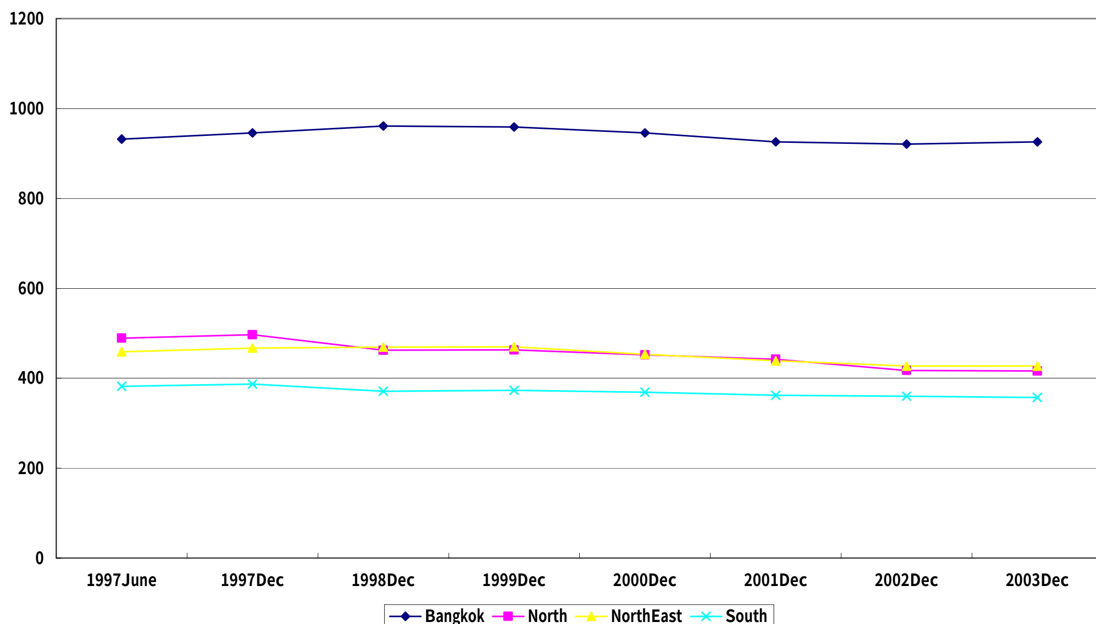
The government, under pressure from the IMF, moved to overhaul the financial system. Bank ownership restriction was removed in October 1997, allowing foreign ownership of commercial banks. Banks were forced to disclose the amount of their non-performing loans with stricter criteria and to negotiate debt restructuring with their clients. The government closed down 56 finance companies in December 1997, and their assets were auctioned at a discount. As a result, the financial industry was the most severely affected sector of the Thai economy by the currency crisis and the IMF package. Before the Crisis, there were 15 commercial banks and 92 finance companies in Thailand. By the beginning of 2000, the majority of banks were either acquired by foreign banks or taken over by the central bank for a subsequent sale. Only 6 largest banks (2 of which were government-owned) maintained the existing management control. As for the finance company, 23 remained in operation at the start of 2000, only a quarter in number of its pre-crisis size.

The change in the prudential regulation was substantial as the IMF judged the existing operations of local banks were not up to the “international” standards. Thai banks used to declare loans “non-performing” only after their repayments were overdue more than 12 months, and prepare provisions in anticipation of loss of the assets. The IMF told the central bank to strengthen the criteria and to require banks to adopt a 3-month benchmark. This regulatory change substantially increased the amount of non-performing loans (NPLs) among bank assets. As a large amount of capital had to be set aside for the potential loss, banks were forced to seek for sources of additional capital in order to meet the asset-capital standards specified by the Bank for International Settlements (BIS). Removal of foreign ownership restriction in banks, another IMF-related measure, proved useful for foreign investors to make inroads into the Thai financial market by assisting local banks to raise capital. In the process three local banks were purchased by foreign financial institutions.

Operations of commercial banks were revamped with apparent consequences on credit accessibility for clients in provinces. First, loan approval authority was removed from branches, to be concentrated at their headquarters. Before the Crisis, branch managers had the power to make decisions on loan application up to a certain limit specified by the bank headquarters. Under the new regulatory environments, these managers were stripped of this authority. The bank management found it necessary to exert greater control over the quality of loan portfolio in order to reduce the possibility to provide credit to risky clients. As credit evaluation function was centralized and the role of branch managers diminished, information-transmission from clients in provinces became more difficult.

Second, the branch network was restructured. As banks now face greater competition from overseas financial institutions as well as among each other, they do not have extra resources to assist the government and establish provincial branches for the development purpose. Presence of foreign shareholders with a greater monitoring power over bank managers provides similar disincentives to maintain unprofitable branches. The change in branch numbers in Bangkok and three Regions (in Figure 2) confirms this point. Between June 1997 and December 2003, the bank branch network in Bangkok was maintained with reduction of only 6 branches (from 932 to 926

Figure 2. Number of Bank Branches in Bangkok and Three Regions



branches). On the other hand, banks closed as many as 130 branches (from 1,330 to 1,200 branches) in the Northern, North-Eastern and Southern Regions combined. It has become difficult for the government (and the central bank) to create financial sector base in provinces with assistance from commercial banks.

IV. Government's Financial Development Effort Revised

The government development initiative to promote financial intermediary in provinces had to be revised as the IMF imposed "globalization" at the time of 1997 Currency Crisis. Local commercial banks could no longer be persuaded to help the government, nor did they have the capacity. As the government remained convinced that bringing the financial services to the people outside Bangkok is an important development priority, it decided to use its own finance arms. They turned to policy-based financial institutions, such as Government Savings Bank (GSB) and Government Housing Bank (GHB). Although these financial institutions have been in existence for a long time, they were not given a prominent role in the past. The government started channeling funds to provinces through these public financial institutions.

There was another means for the government to direct credit to provinces. After the completion of the IMF program, three banks were under the government ownership. The largest, Krung Thai Bank (KTB), which was originally established as a state-owned bank in 1966, expanded substantially in size as the government used the bank to absorb assets of insolvent financial institutions. The Siam City Bank (SCIB) was nationalized after it became insolvent, and later merged with the Bangkok Metropolitan Bank that was also nationalized earlier. The smallest government bank, the Bank Thai (BT) was created through combining assets of collapsed financial companies. The share of these government-owned banks in the banking sector at the end of 2003 exceeded 30% in terms of assets, which is more than double the pre-Crisis level of 14% (as of the end of 1996). The government found these banks easy tool for their development initiatives. They particularly relied on KTB, as it is one of the largest commercial banks in Thailand with an extensive branch network in the nation.

This situation is, however, quite paradoxical in view of the ideology behind the IMF program. The IMF embarked on restructuring of the Thai financial sector based on the conviction that a sound financial sector is a pre-requisite for the sustainable economic growth where market forces allocate funds among competing demands. After the IMF program was implemented and Thailand repaid all its debt in July 2003,

however, the government has ended up with a greater presence in the banking sector. This consequence is quite ironical in view of another IMF conviction that the government should not interfere with the operations of the financial sector (apart from the role as regulator).

V. Concluding Remarks

The recent experience of the banking sector in Thailand can be summarized as follows. Initially the government protected it, and used it as a means to establish financial infrastructure in provinces. Then came the Currency Crisis, and the IMF forced “globalization” under which regulatory framework was revised to conform to that of industrial countries. The structure of the sector that emerged after the IMF program was, however, characterized by a greater role of the government itself, which is using state banks as a vehicle of development policies.

The issue is whether the enlarged government presence in the financial sector is desirable for the Thai economy in the long run. The answer is unambiguously negative as bureaucratic intervention in the banking operation is usually associated with inefficiency and very often with corruption.[5] The previous policy of encouraging (or coercing) commercial banks in the direction of banking in provinces had the merit of maintaining elements of private sector decision making. Even if banks were guided toward operations in otherwise unprofitable locations, selection of lending projects was at least based on commercial viability. Local clients' exposure to this banking principal must have been valuable, as they were able to develop managerial skills through interactions with bankers. This benefit would be lost when financial development is carried out by government-owned banks.

Thailand was in a rapid path to economic development, and the government tried to create basic institutions of financial intermediary in the provincial area with assistance from the banking sector. Arguably, the banks would be less efficient due to potentially unprofitable operations in the provinces, for which the government compensated by way of preferential treatment of existing banks. The sequence envisioned must have been to install the financial system in the provinces first, then bring the whole sector gradually up to a stricter prudential standards at a later stage. Intervention by the IMF, however, upset this sequence, and left the government with no

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[5] For example, it is reported that there have been cases of “lending irregularities” at Krung Thai Bank (*Bangkok Post*, September 11, 2004) that leads to deterioration of its loan portfolio. The BOT subsequently rejected contract extension for the bank's president to the second term (*Bangkok Post*, September 28, 2004).

options but to play a more active role by itself. This experience points to the danger that globalization, if forced from outside, may have a negative impact that would hinder exiting development effort of a country.