Preface

The relevance of this book has been reinforced by recent events in U.S. and world financial markets. Even in the popular press, parallels are being drawn between the current problems of emerging market countries in Eastern Europe and those of countries such as Thailand that went through – and in the case of Thailand served as the origin point of – the Asian financial crisis in l997. Scholars such as Ken Rogoff examine these Asian countries, and the many other countries around the world that have experienced historical financial crises, to try get a sense through statistical analysis of the likely depth of the current recession and the likely rapidity of recovery, by sector. By focusing this book on historical Thai data and growth mechanics prior to l997, we better understand not only the Thai crisis, but also the Thai recovery. As such, there are lessons to be learned for other countries, including those in trouble today. We also better understand the role of government policy, not only in the crisis but also in the Thai structural transformation prior to the crisis, a period of growth that helped make Thailand another Asian miracle. Government policy and its impact post crisis are also revealing in terms of post-Asian crisis micro interventions, and the macro interventions of l997 and earlier credit crisis episodes.

Some of the parallels between today's Eastern European countries and the Asian countries of the l997 crisis are false. Though both Eastern European countries of last year and Asian countries prior to l997 all had very high growth rates, Asian countries were running fiscal surpluses, not deficits, for example. As Radelet and Sachs note, sovereign debt remained at prudent levels, savings and investment rates were high, and inflation was low. This caught the IMF by surprise and fueled the impetus for subsequent, post-Asian crisis financial sector assessment programs and early warning indices. On the other hand, both Eastern European and Asian countries share a common crisis symptom: Euro- or dollar-denominated short term loans associated with relatively large capital inflows, which, with a loss of confidence, bring capital flight and devaluations.

The consensus view of the Asian crisis is that it was, in large part, a run triggered by failing finance companies in Thailand. The Thai government had encouraged foreign capital inflow by maintaining attractive interest rates for apparently secure investments through offshore banks, all the while masking the underlying problem of non-performing loans in real estate with transfers from a relatively secret Financial Institution Development Fund. Rumors and occasional pressure on exchange rates were resisted until the Central Bank ran out of reserves. A serious recession followed the devaluation, though the onset took about six months. Despite the recession, the IMF argued for limited budget deficits and high interest rates to re-attract foreign capital. Some, such as Joseph Stiglitz, have argued that these actions amplified the recession. The US in the current recession has taken the opposite tact. In any event, Thai banks were not lending much at this time, and investment did not recover for several years. These ingredients are by now all too familiar to current observers of the U.S. and other world economies.

But this book argues that, beneath the surface, Thailand remained in good shape. It is a picture drawn with much data and hard-nosed modeling. In essence, it is a tale of two financial sectors, the bad one associated with the crisis and the good one which fueled the growth before the crisis and facilitated recovery afterward. While foreign money flowing into commercial banks was fostering a real estate boom – an apparent bubble - there was a steady expansion of financial access on the domestic extensive margin, both before and after. That is, an increasing fraction of Thai households in towns and villages were gaining access to the formal financial system as new users of both savings and credit instruments. Accounting decompositions show that this increased financial deepening, along with improved education and occupation shifts, account for a non-trivial part of the observed improvements in per capita income, changes in inequality, and poverty reduction. One structural model put forth in this book uses this expansion of the financial sector as an exogenous policy change facilitating occupation shifts from subsistence agriculture to enterprise. The model delivers most of the observed movements in Thai productivity, that is, in TFP. Another structural effort models the expansion of the financial sector as endogenous and delivers almost exactly the observed long run, smoothed trend in financial access. Occupation shifts are domestic expansions. The same models establish that foreign capital inflows had little impact on growth. Put differently, the growth of Thai GDP was not spurious. It was much more than a bubble. This seems not to have been understood by foreign investors at the time.

The Thai government's Bank for Agriculture and Agricultural Cooperatives (BAAC) played a large role in the domestic expansion of the financial sector, and hence in the increase in income and reduction in poverty over the two decades prior to l997. Unlike development banks in Latin America and other countries, the BAAC was not making large losses and has been judged by many to be largely free of corruption. Jacob Yaron shows that the bank could have been making money with a relatively small increase in its own lending rate, and some of the work presented in this book shows that the BAAC was playing a relatively successful role not only in credit but also in the provision of insurance. Unfortunately, the BAAC risk-contingent lending system, with indemnities in the form of a system of flexible overdues, was mistaken by the IMF and World Bank in the Asian crisis as symptomatic of yet another weak financial institution. External regulation at that time was inappropriate. Outsiders did not understand the

BAAC system and the insurance role it was playing. Policy makers seemed prone to jump to quick, inaccurate conclusions.

Of course there were distortions, both micro and macro. On the micro side, the same structural models show that while the BAAC was initially more prevalent in the same areas as commercial banks, the industrialized corridor stretching north out of Bangkok it eventually expanded into the outer provinces, targeting rural areas and those off the main roads. Meanwhile, for reasons that are somewhat speculative, commercial banks remained much more prevalent in the industrial corridor. Only a tiny fraction of households in the Townsend Thai rural surveys shows up as having commercial bank loans. So the model, which delivers a path of costly but Pareto optimal financial deepening, under predicts lending in rural areas and over predicts lending in towns. It is almost as if Thai policy makers, following a financial sector plan, had created a hole in parts of formerly rural areas, now home to an increasing and unanticipated middle class of entrepreneurs.

In any event, the interplay between the BAAC and commercial banks in the end determined the actual financial landscape, and the next generation of models will try to understand that interaction more deeply. This book will try to better understand the policy motivation behind the observed geographic expansion of BAAC branches. The Thai government maintains a role in the continuing structural transformation, and industrial organization models. Not-for-profit financial sector participants are needed to understand that role, especially if one is to offer policy advice. Likewise, the U.S. is unlikely to re-emerge from crisis without a substantial government role, inclusive in real estate, as with Fannie Mae and Freddie Mac. Indeed, the spread of mortgages to lower income segments of the population is now understood by many to be a key part of the cause of the U.S. financial crisis, in contrast to Thailand's history. Again, BAAC lending was driving TFP and growth. Ironically, though, the U.S. does not have the panel data that Thailand does, namely the Townsend Thai data used in this book. These data can be used to create appropriate monitoring and evaluation systems of government and commercial financial institutions. There is a need to link the impact that financial institutions have on households and businesses to financial accounts for households and small businesses that can be created with collected micro survey data. This process is well underway in Thailand, as described in the chapters to follow.

Distortions on the macro side are also apparent. Government involvement in the financial sector, though well-intended, can lead to repressions and, again, to crises themselves. We focus in Thailand not only on the l997 crisis, but also on a revealing episode in the early 1980's. In those days, interest rates were fixed by regulation, both on deposits and loans. Oil price shocks led to inflation and negative real interest rates, ex post. Savings deposits left the banking system, while lending at existing fixed loan rates was inefficient. Eventually, financial institutions required intervention, with the government acquiring a large chunk of the banking system, both ownership via shares and a claim on resources, via government debt. One surmises that government finance of projects is not efficient, and a structural model, when calibrated with transactions costs and distortions around this observed extent of government involvement, delivers a period of stagnation at this time. Likewise, liberalization in late l980 is associated with some growth and substantial welfare gains, though these are not evenly distributed in the population.

It takes models and data to judge whether government policy is helpful or harmful. After the l997 crisis, with limited commercial bank lending and few finance companies left, the Thai government took a lead role in creating financial infrastructure. In this case, it funded village-level savings and loans, at $24,000 per village in over 70,000 Thai villages, or 1.5 percent of GDP. This is in effect one of the world's largest micro finance interventions, replete with joint liability loans. As is illustrated in the chapters to follow, it can be evaluated using the essentially exogenous way the program was implemented, with varying numbers of households in villages. This million baht program increased consumption, overall lending, the frequency of investment, profits of those in business and local wages, while at the same time raising interest rates and defaults. A structural model conveys the logic of the movement of these variables and the distribution of welfare gains. The larger point is that the Thai financial system is not yet perfect, and this is why government policies, in the presence of otherwise limited banking, can play a role. In this instance, the role is mostly positive, though an overall efficient design has yet to be determined. Further work is underway to understand the nature of the obstacles to trade which create these fine-tuned policy gains and losses, work which is illustrated in the closing chapters of this book.

There is an eerie similarity between the discussions today of what has gone wrong in the US, and elsewhere, and the discussion of causes and policy implications of the Asian crisis written between 1997 and 2000. In the case of Asia, there was an unsubstantial follow up as the world seemed to stabilize and memory dimmed. A deeper integrated understanding of the financial structure of emerging market countries, and advanced industrialized countries, is as relevant today as it was before. Achieving that goal is the motivation for this book.