

**FINANCIAL CRISIS, BANK RESTRUCTURING
AND FOREIGN BANK ENTRY:
AN ANALYTIC CASE STUDY OF THAILAND**

by

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Abstract

The co-occurrence of banking and currency crises has been found to be the norm during the late 1980s and early 1990s. These “twin crises” have inspired a number of recent theoretical and empirical contributions to the literature on financial crises in developing countries. Much less consideration has, however, been given to analytic case studies of actual country experiences with these twin crises and their aftermath. This paper attempts to fill this gap by studying the specific case of Thailand, which was the first domino to fall, triggering the East Asian financial crisis of 1997-98. Emphasis is laid on the issue of post-crisis foreign bank entry into Thailand.

Key words: *bank internationalization, capital flows, financial sector reforms, Thailand*

JEL Classification: *F30, F32, F41*

1. Introduction

The co-occurrence of banking and currency crises has been found to be the norm during the late 1980s and early 1990s. Most frequently, banking crises appear to have taken the lead (Kaminsky and Reinhart, 1999), and these twin crises seem to be far more pervasive in developing countries than developed ones (Glick and Hutchison, 1999). Banking crises themselves appear to be more likely following financial liberalization (Demirgüç-Kunt and Detragiache, 1997 and Eichengreen and Arteta, 2000). The IMF (1998) has suggested that the greater frequency of banking crises worldwide since the 1980s is “possibly related to the financial sector liberalization that occurred in many countries during this period” (p.115). These “twin crises” have inspired a number of recent theoretical and empirical contributions to the literature on financial crises in developing countries. Much less consideration has, however, been given to analytic case studies of actual country experiences with these twin crises and their aftermath. This paper attempts to fill this gap by studying the specific case of Thailand, which was the first domino to fall, triggering the East Asian financial crisis of 1997-98. The focus of this paper is both on the crisis scenario of 1997-98 as well as the steps taken towards financial sector restructuring and liberalization post-crisis.

The remainder of paper is organized as follows. The next section highlights the mechanics of the initial crisis scenario leading to the devaluation of the Thai baht on July 2, 1997. Section 3 emphasizes the existence of financial sector fragilities, making the important distinction between *illiquidity* and *insolvency*, an issue that has hitherto divided the theoretical literature (see Rajan, 2001 and references cited within). Section 4 outlines the steps taken by Thailand specifically, as well as the other crisis-hit East Asian economies - Indonesia, Korea, Malaysia and the Philippines (henceforth referred to as Asia-5 economies) - towards financial sector restructuring. An important element of the restructuring and reform efforts in Thailand has been the liberalization of the Thai

banking sector and its opening up to foreign competitors¹. While “internationalization of the banking sector” is at a highly nascent stage, section 5 discusses the impact that the entry of foreign banks has thus far had on the Thai banking system. The final section offers a few concluding remarks on the anticipated benefits as well as risks of permitting foreign bank entry in general, relating it to the Thai context and experience. Three Annexes follows the main text. The first describes the evolution of the Thai banking sector upto the crisis of 1997-98. The second summarizes the structure of the Thai financial system. The third reproduces the Bank of Thailand’s official guidelines for equity holdings in financial institutions aimed primarily at foreign equity participation.

2. Crisis-Induced Devaluation

Thailand experienced a bursting of asset price bubble in 1994; the real estate market remained very soft since then, with residential vacancy rates of 25-30 percent and office vacancy rates of 14 percent (Lauridsen, 1998). However, the stagnant volume of transactions (particularly since much of the office construction was by companies for their own use rather than by professional property developers), along with the lack of market liquidity, resulted in very few new transaction prices being officially registered. The downward correction in real estate prices was not apparent until much later (IMF, 2000)². Given the large exposures of the domestic financial system to the real estate sector (Table 1), there was a simultaneous deterioration in the profits and financial conditions of the real estate and finance companies. Capital inflows into Thailand also slowed down sharply between 1996 and early 1997, mainly due to withdrawals of short-

¹ We use the term “foreign banks” to refer to “majority foreign-owned commercial banks”. We do not enter into the debate about whether ownership of corporates matters in this era of global markets and activity.

² It is revealing that the World Bank economists Renaud, Zhang and Koeberle (1998) have entitled their paper “*How the Thai Real Estate Boom Undid Financial Institutions...*”

term deposits held in domestic banks and other nonbank components, as well as other loans components (Table 2). We revisit the issue of financial sector weaknesses in section 3. For now though, it suffices to note that the accumulating losses by the financial institutions inevitably contributed to a stagnation in bank lending in 1996 (Rajan, 2001).

As would be expected in most developing countries, bank lending has been the dominant form of funding in Thailand³. A sustained drop in bank lending would have been severely detrimental to real economic activity. It is therefore of no surprise that the Bank of Thailand (BOT) attempted to support the ailing financial institutions through an infusion of liquidity through the Financial Institutions Development Fund (FIDF)⁴. There was, in fact, a four-fold rise (in real terms) in the liquidity provided over the next six months, with BOT credit to financial institutions rising from 2 percent of GDP in 1996 to 15 percent by the end of 1997 (World Bank, 1999). Consequently, despite the drop in international reserves, the monetary base experienced a sharp rise during that period as the fall in reserves was more than matched by the rise in domestic credit (Figures 1 and 2). MacIntyre (1999) succinctly summarizes the course of events in Thailand during this period:

(a) side effect of injecting large scale emergency funding into the...failing finance companies was blowing out the money supply...This served to sharpen the fundamental contradiction in the government's overall macroeconomic position. At the same time as it was pumping money into insolvent finance companies to keep them afloat, the central bank was

³ World Bank data on small and medium sized enterprises in Thailand suggest that bank loans accounted for some 35 percent of total working capital in Thai firms (Hallward-Driemeier, et al., 1999).

⁴ The Thai authorities established the FIDF in 1985 after the country experienced a deep financial crisis in 1983-84. The FIDF was given the mandate of providing liquidity support to ailing financial institutions. At that time, a support scheme within the FIDF - the "April 4 Lifeboat Scheme" - was created, which offered soft loans to a number of such institutions. Depositors in and a number of creditors of these institutions were generally bailed out. This historical precedence offers a credible basis for agents to have expected an implicit guarantee/strong government backup of the financial system.

also spending down reserves to prop up the exchange rate...(T)his was not a sustainable strategy (p.14).

The analytics of the crisis, based on the foregoing discussion, may be succinctly captured below using the following two identities:

$$CAD = -\Delta R + \Delta K \quad (1)$$

$$\Delta H = \Delta R + \Delta NDA \quad (2)$$

where: CAD is the current account deficit; ΔR is the change in reserves; ΔK represents capital flows; ΔH is the change in the monetary base; and ΔNDA is the change in net domestic assets. Eq. (1) is simply the balance of payments accounting identity stating that a current account deficit must be financed through drawing down international reserve holdings or through capital inflows. Eq. (2) states that changes in the monetary base must be an outcome of changes in international reserves and net domestic assets. Substituting eq. (1) into (2) we get:

$$CAD + \Delta H = \Delta NDA + \Delta K \quad (3)$$

With ΔK (ΔR) < 0 and $\Delta H = 0$ (given the costs of an interest rate hike), it follows that $\Delta NDA > 0$. If capital outflows and reserve losses are sustained, the result is inevitably that the currency will be expected to depreciate, leading to an increase in domestic interest rates. As reserves fall to some minimum level, the expected currency devaluation will become a reality. In Thailand, this happened on July 2nd 1997 (Figure 3).

3. Financial Sector Fragilities, Capital Outflows and Consequences

As the preceding section has highlighted, weaknesses in the financial system played a key role in the crisis-induced devaluation in Thailand. More specifically, the solvency problems in a number of finance companies and weaker banks led to the currency crisis (via monetary disequilibrium due to an FIDF-induced bail out). This distinction between insolvency initially of a group of finance companies pre-devaluation followed by a systemic liquidity crisis (leading to a vicious spiral culminating with financial and economic collapse) is confirmed by the time line of the problems in Thai finance companies and commercial banks; we briefly highlight it below⁵.

Prior to the IMF Stand-by arrangement in August 1997, the BOT recognized the necessity to segregate solvent/viable financial institutions from non-viable ones. Thus, the BOT and the Ministry of Finance (MOF) announced that 10 (unnamed finance companies) would need to raise capital, failing which the FIDF would effectively take control of the institutions in March 1997. Public confidence in finance companies eroded between March and June 1997, as there were deposit withdrawals by the public (but not an outright panic of the entire financial system). The FIDF provided liquidity support to 66 (of a total of 91) finance companies. The BOT suspended 16 finance companies in June (7 of which were from the March list). Notably, 43 percent of loans of these suspended companies were to the real estate sector (IMF, 2000).

With the intensifying slowdown in economic activity and growing loss of confidence in the financial system, blanket guarantees were provided to banks and the remaining finance companies by the FIDF in order to maintain public confidence in the

⁵ Of course, the distinction between *solvency* and *liquidity* is very fine. As noted by Lindgren et al. (1999) of the Thai debacle:

(t)he selection of nonviable institutions to be closed relied largely on liquidity indicators, such as borrowing from the central banks...The liquidity triggers typically included the size of central bank credit as a multiple of bank capital. Only later, as more information became available either through special audits or the supervisory process, could solvency indicators be used as criteria for choosing nonviable institutions (p.34).

financial system (i.e. “containment” policy). The MOF and BOT also issued a joint statement detailing measures to strengthen confidence government and announced that no more finance companies would be suspended beyond the 16. Such blanket guarantees obviously entail very large sovereign contingent liabilities. All these events occurred *prior to* the devaluation, at a time when external capital was still flowing into the domestic financial system.

In the period leading up to the devaluation (i.e. first quarter of 1997) only the non-bank sector experienced capital outflows (Table 2). More precisely, it was the non-resident baht accounts (NRBAs) in particular, but also the “other loans” component that recorded net outflows. NRBAs are essentially nostro accounts held in domestic banks that serve various transactions, including baht clearing for foreign currency-related transactions and stock market transactions by foreigners. Net FDI inflows remained positive throughout 1997 and portfolio flows too only changed direction in November and December 1997. Private bank capital flows turned around sharply by over \$10 billion between the first half and second halves of 1997. This reversal intensified in 1998, outflows reaching almost \$14 billion. Of significance is the fact that funds were still flowing into the country during the first half of 1997 right up to the devaluation. It was only *after* the devaluation that there was a massive exodus of these banking sector flows. Capital outflows from NRBAs were \$3.5 billion in the first half of 1997, over \$2 billion in the second half of the year, and slowed to about \$2.7 billion for the 1998 as a whole. This led to a state of national illiquidity.

The solvency crisis of selected institutions followed by the systemic liquidity crisis and resulting virtual collapse of the domestic financial system, inevitably led to a large-scale domestic “credit rationing” in Thailand. We do not enter here into the controversial debate of defining what is meant by a “credit crunch” and how it is most appropriately measured, only recognizing that credit growth reflects both the demand for and supply of

credit⁶. However, available evidence points to a high and growing risk aversion on the part of Thai financial institutions towards lending as they have been burdened by large NPLs and remain undercapitalized (IMF, 2000). There was an added dimension in Thailand, viz. the unhedged nature of the external liabilities of corporates. Thus, the rise in the baht value of external debts following the initial devaluation (Figure 3) substantially worsened the balance sheet positions of domestic corporates and banks⁷. There was, not surprisingly, a severe curtailment in aggregate demand, GDP declining by 10 per cent in 1998 after having fallen nearly 2 per cent in 1997 (Table 3).

4. Financial Sector Restructuring

Insofar as financial sector fragilities were the proximate causes of the Thai crisis and collapse, financial sector restructuring has been an essential element in structural adjustment programs in the East Asian economies. At the risk of generalizing, governments in the crisis-hit regional economies have attempted to restructure their financial systems by: closing down commercial banks and finance companies; merging some existing institutions and nationalizing others; injecting public funds to recapitalize viable banks; putting in place systematic asset resolution strategies; and permitting foreign investment into the financial sector (discussed in the next section). Table 4 provides some information on the measures taken to restructure their financial systems⁸.

⁶ For example, see IMF (2000), Lane et al. (1999), Lindgren et al. (1999), Furman and Stiglitz (1998).

⁷ Within a monetary framework, Aghion et al. (2000) show how devaluation leads to an appreciation in the local currency value of corporate debt. This curtails absorption and output, lowering money demand, consequently causing the currency to depreciate. In a bank-based economy with large-scale unhedged foreign debt, forward-looking agents will expect this outcome, leading to a vicious spiral of devaluation, insolvency and bearish expectations.

⁸ For detailed discussions of financial restructuring in the Asia-5 economies, see ADB (2000), ADB-ARIC (2000, 2001), Lindgren et al. (1999) and World Bank (2000).

With regard to asset resolution in Thailand, banks were initially made individually responsible for establishing their own asset management companies (AMCs). This was in contrast to the other East Asian economies which have transferred nonperforming loans (NPLs) from banks to centralized AMCs since the financial restructuring started. In Thailand, the government established the Financial Restructuring Authority (FRA) in October 1997 to review rehabilitation plans of the 58 suspended finance companies and to oversee their liquidation, (all but two were shut down). An AMC was also set up centrally but only as a buyer/bidder of last resort for the lowest quality assets in order to prevent a fire sale of assets of the 56 closed finance companies (which in turn could undermine the intrinsic collateral values of the financial system in general).

As capital outflows accelerated, some weaker banks were intervened in December 1997 and January 1998 (Bangkok Metropolitan Bank, First Bangkok City Bank and Siam City Bank). These three banks were together responsible for 10 percent of banking system deposits. Other banks (Thai Danu and Bank Asia) were acquired later in the year. Seven more finance companies were intervened in May 1998 and merged with a state owned finance company while two other banks (Union Bank of Bangkok and Laem Thong Bank were intervened in August 1998). These interventions, suspensions, mergers and interventions continued into 1999. The existing financial institutions were encouraged to restructure their holdings of corporate debt. The government also introduced various measures to recapitalize banks, privatize intervened banks, improve prudential regulations and supervision and formulate bankruptcy and foreclosure laws. Unlike the single public AMC for finance companies, Thai banks were individually responsible for establishing their own AMCs to remove NPLs from the bank balance sheets. The FRA auctioned most of the assets of the closed institutions and recovered about 180 billion baht by mid 1999 (MOF, 1999).

Table 5 shows that all the East Asian economies have made some headway in reducing nonperforming loans (NPLs). NPL ratios for commercial banks in Korea and Malaysia have fallen to less than 10 percent, due in part to the rapid economic recovery in 1999-2000 (i.e. banks have to some extent grown out of their problems). In contrast, NPLs have remained relatively high in Thailand (about 30 percent), possibly reflecting the Thai government's preference for a more market-oriented approach to financial restructuring. However, according to some estimates between a one fifth and a third of the NPLs in Thailand are "strategic" in the sense that borrowers, while able to repay, are unwilling to do so since legal recourse by creditors tends to be rather ineffective (World Bank, 2000). Interestingly, Thailand recently announced the establishment of a centralized AMC to carve out NPLs of the state and private banks (ADB-ARIC, 2001).

Indirect evidence of market concerns regarding lack of progress in financial restructuring in the Asia-5 economies is captured by trends in the ratio of the financial stock index to the overall (general) stock index which are shown in Figure 4. As can be seen, this ratio recovered to its pre-crisis level only in Malaysia. At the other extreme, the ratio is only about one quarter of its pre-crisis level in Indonesia and it has deteriorated rapidly recently in the case of the Philippines. The indices in Korea and Thailand were stuck at about half their pre-crisis values even in early 2001. All of this suggests that there is continuing concern about the health of the financial systems in the Asia-5 economies, with the possible exception of Malaysia.

Evidence of the magnitude of the problems in the financial sector is proxied by the fiscal costs of restructuring (Table 6). It is important to keep in mind the caveat that such estimations of fiscal costs are undoubtedly fraught with difficulties as they are heavily dependent on a number of assumptions. This being said, it is instructive to note that the bailout and restructuring costs in Thailand are conservatively estimated at around 30 percent of GDP. This figure is much lower than the estimated costs in

Indonesia (58 percent of GDP), but much higher than those in South Korea and Malaysia (16 and 10 percent respectively) (ADB, 2000).

5. Foreign Bank Entry to the Thai Banking Sector

As a part of the financial sector restructuring process, the Thai authorities permitted foreign banks that already have a full branch or a Bangkok International Banking Facility (BIBF) to acquire a majority stake in Thai commercial banks (see Annexes 1 and 2). In connection with this, the regulation on foreign shareholding limits on Thai commercial banks was relaxed. The Commercial Banking Act B.E. 2505 was amended in June 1997, and the guidelines for foreign equity participation in Thai banks were announced in November 1997 (Annex 3). Foreign investors have been allowed to hold majority shareholding in Thai banks for up to ten years. Prior to this, 25 per cent shareholding limit was applied to foreign investors. After ten years, the foreign equity stake cannot be raised further unless it is below 49 per cent⁹.

After the government relaxed limits of foreign ownership on Thai banks in late 1997, the banking sector attracted almost US\$ 5 billion in aggregate foreign direct investment (FDI) in 1998 and 1999. This was well over half of total FDI to Thailand during this period (data from Bank of Thailand, www.bot.or.th). By the end of 1999, four commercial banks had majority foreign ownership: DBS Thai Danu Bank (DTDB) in January 1998, Bank of Asia (BOA) in June 1998, Standard Chartered Nakornthon Bank (SCBN) in September 1999, and UOB Radanasin Bank (UOB-RAB) in November 1999 (Table 7).

While the four foreign banks bought stakes in the medium-to small-sized banks, they remain rather minor participants in the Thai banking scene. Specifically, the four

⁹ Any subsequent capital injections into banks that have more than 49 foreign equity conducted after the 10 year period require the participation of Thai investors.

Thai banks with foreign major shareholders hold only 7.5 per cent of the banking system's total capital or assets as of April 2001. Their market shares in terms of loans and deposits are also rather low (Tables 8 and 9), as they are in terms of actual number of domestic branches. The four foreign banks have 287 branches or just 8 per cent of total bank branches in Thailand. Most of these branches are concentrated in the Bangkok area, in contrast to the five largest Thai banks which have built strong regional presence (Table 10).

5.1 Impact of Foreign Bank Entry in Thailand

What is the impact of foreign bank entry? There is a growing body of literature which suggests that the entry into the domestic market by foreign banks can be expected to gradually drive down the cost structure of the domestic banking sector, as state of the art technology and best practices are introduced (Levine, 1996). For instance, using bank level data for 80 countries over the period 1988-95, Claessens et al. (2001) found that the greater was the degree of foreign bank penetration, the lower was domestic bank profitability and overall expenses. Similarly, using aggregate accounting data for 14 developed countries for 1976, Terrell (1986) found that domestic banks in countries that allowed the entry of foreign banks had lower profits and greater efficiency¹⁰.

What evidence can we bring to bear on the effects of foreign bank entry in Thailand? This is, in some senses, a difficult and possibly premature question to answer since bank internationalization in Thailand is at an early stage and the presumed benefits may take time to materialize. While we are unable to undertake a systematic evaluation of cost structures and efficiency levels of the Thai banking system pre and

¹⁰ Also see the useful country case study by Dobson and Jacquet (1999).

post internationalization, it would be useful to consider available evidence based on a casual examination of recent trends and ongoing in the Thai banking system¹¹.

To begin with, Table 11 shows that after managing costs carefully and controlling operating expenses efficiently, total expenses and cost to income ratios of the Thai banking sector declined markedly in 2000. Bottom-line profits began to be shown, as indicated by net profit to total income. Return on assets (ROA) and return on equity (ROE) remained negative but lower than those in 1999.

The four banks owned and controlled by foreigners have launched a number of similar programs as part of their efforts to reduce operating costs and sharpen competitiveness. The foreign banks have been among the pioneers in new banking activities. For instance, the BOA is leading the way in consumer banking in Thailand. The DTDB has recently increased its focus on e-banking. The SCBN and UOB-RAB are emphasizing improvements in technology and employee training in customer service skills and risk management. The entry of foreign banks has also been a catalyst for change in the domestic banks as they attempt to maintain market share and profitability. For instance, the Thai Farmers Bank (TFB) launched an early retirement scheme, setting a target at 2,000 employees. The Bangkok Metropolitan Bank (BMB) launched the scheme in April 2000 with a target of more than 1,000 employees. The Bank of Ayudhya Bank (BAY) and the Bangkok Bank (BBL) both plan on launching the schemes at different target groups. The TFB and the Siam Commercial Bank (SCB) launched e-banking services in the first half of 2000. For Bank of Ayudhya (BAY), more high-tech financial products will be introduced, and branches will be upgraded in 2001. In addition, the Thai local banks have teamed up to pool resources, particularly in e-banking,

¹¹ The next two paragraphs draw partly on various reports in the Thai national newspaper, The Bangkok Post. Specific issues of the paper are: February 24, 2000, February 19, 2001, March 26, 2001, May 18, 2001, June 13, 2001 and July 8, 2000. See www.bangkokpost.net/.

customer information and staff training and technological know-how, so as to remain competitive and cost effective in the face of increasing foreign competition (IMF, 2000).

The acquisition by foreign banks has altered the corporate governance structures of the banks, with top management having been replaced. As Thai local banks face new competition from international giants, they have revamped their corporate management, risk controls and technological bases. The foreign banks have also led the way in marketing strategies. For instance, the BOA has launched mini-branches in subway stations and supermarkets, increased a number of ATMs in Bangkok area, and teamed-up with specialized state banks to increase its market share in non-Bangkok areas and with Tourist Promotion Center of Bangkok to provide financial services to tourists and local people in many tourist spots. Also, the bank launched a low interest rate program to lure credit cardholders. With a revamped approach, the SCNB has modernized 20 branches in 2001 and plans on opening 10 new ones in strategic locations. The DTDB and UOB-RAB banks have been particularly aggressive in the housing loan market as well as lending to SMEs. Once again, there have been spillover benefits to Thai domestic banks. For instance, the TFB, which successfully raised new capital in the last quarter of 1999, has also launched mini-branches in subway stations and supermarkets. The bank aims to increase the number of loans to medium- and large-sized corporate clients, focusing on export-oriented companies and those with good business potential (The Nation, March 29, 2000 and May 15, 2000). The BBL, the largest bank in terms of capital, assets and market share, planned to lend about 40 per cent of its credit to SMEs in 2000, with the balance lent to large corporations. Since the beginning of 2000, the bank has launched four mini-branches in supermarkets in both the Bangkok and non-Bangkok areas.

6. Concluding Remarks

There is revealing albeit unsystematic and casual evidence of the benefits of foreign bank entry in Thailand by way of reductions in cost structures, improvements in operational efficiency, introduction and application of new technologies, banking products, marketing skills and management and corporate governance structures. These early results indicate that foreign bank entry in Thailand has improved the functioning of the national banking system and provided some positive welfare gains for bank customers. Foreign bank entry brings with it added potential advantages over time that may be less obvious.

First, entry of foreign banks ought to reduce the extent of “non-commercial” or “connected” lending, as these banks are not as politically connected and less likely to “capture” regulatory authorities (Kroszner, 1998). Second, since foreign banks’ portfolios are far less concentrated in any single country, particularly in the emerging host ones, they should be much less susceptible to country-specific crises. Third, a banking system with an internationally diversified asset base may be more likely to be stable and less prone to bank runs and outright crises since the domestic branches of foreign banks are able to obtain financing from the foreign head office, which could act as a private lender of last resort¹². Fourth, bank internationalization may create domestic pressures for local banking authorities in the host countries to enhance and eventually harmonize regulatory and supervisory procedures and standards to international best practice levels (Claessens and Glaessner, 1998 and Levine, 1996).

¹² On the other hand, this could also be a source of contagious transmission of crises. For instance, in response to a crisis in one country, multinational banks might attempt to liquidate positions in other regional economies in which they have exposures in an anticipation of increased redemptions, the need to cover losses in other crisis-hit markets (“cash-in” effects), and in order to reduce portfolio risks and improve the liquidity position (“flight to safety” effects). This is broadly referred to as the “credit crunch” or “liquidity” channel, as it entails a general reduction in the availability of funds (Rajan, 2003).

The opening of Thailand's banking sector to foreign banks has resulted in the entry of some multinational and regional banks via the acquisition of local counterparts. In view of the gradual steps towards internationalization, on the one hand, and concerns about effectiveness of Thai bankruptcy laws and the judicial system in general which have limited interests of other foreign banks in acquiring Thai financial institutions (ADB-ARIC, 2000), on the other, the market structure of the Thai banking system has been only slightly altered. As noted, the five largest local banks still maintain about 70 per cent market share as of mid 2001.

There is much to be said for a gradual as opposed to "cold turkey" or "big bang" approach to financial internationalization. A graduated move towards introducing foreign competition ought to avoid any major disruptions to the domestic financial system by enticing domestic banks to opt for increasingly risky investments. If such "gambling for redemption" occurs, an increase in bad loans due to risky investments will partially offset the efficiency gains associated with greater international competition (Berger and De Young, 1997). There are other reasons to favor a gradual internationalization of the banking system as opposed to a "cold turkey" or "big bang" approach suggested by some observers. For instance, time is also needed for domestic bank consolidation if local banks are to be able to compete effectively against the multinational foreign banks which have much larger and diversified capital bases. Consistent with this, on the basis of a panel study of 53 countries for the period 1980-95, Demirgüç-Kunt and Detragiache (1998) have stressed that financial liberalization in general must be undertaken "cautiously" and only when the institutional environment is strong, there exists effective and well-developed prudential regulations and supervision, and the overall macroeconomic environment is stable¹³. Indeed, this conclusion is particularly significant

¹³ Macroeconomic instability and ill-timed or ill-sequenced banking sector liberalization may be among the reasons why some empirical studies have found that foreign bank entry has either had

and should be self-evident when one recalls that Thailand's hasty and ill-sequenced approach to capital account liberalization in the early 1990s led to the accumulation of large-scale unhedged foreign debt and "excessive" risk-taking by financial institutions and the eventual currency and economic collapse (Rajan, 2001).

As with any other structural reforms and liberalization program, bank internationalization can be expected to lead to temporary labor market disruptions, particularly in sheltered industries which are invariably over-staffed. Indeed, Crispin (2000) has pointed out that Western banks have an average staff level of ten or less employees in their branches worldwide; Thai banks had a staff level three times as much. Since liberalization, employment levels in the banking sector, which stood at about 110,000 at end-1998, fell by 13 per cent by March 2000 and are expected to fall further over the next few years (Krungthepthurakij, April 15, 2000). Inevitably, the ongoing high retrenchments in the banking sector have become a social issue. Public criticism over job insecurity in foreign-owned banks has been on the rise.

These political economy compulsions and past experiences appear to have further swayed the Thai authorities towards undertaking a gradual move towards the internationalization of the financial sector. However, the danger of such an approach to internationalization is that it may eventually "run out of steam", as opponents of the program will have an opportunity to block it. Indeed, sales of domestic Thai banks to foreign investors, particularly those that are nationalized, appear to have been put on hold, at least temporarily. The FIDF rejected two bids for a majority stake in Siam City Bank (SCIB), having failed to agree on asset pricing. Negotiations to sell Bangkok Metropolitan Bank (BMB) to the Hong Kong and Shanghai Banking Corporation (HSBC) were formally cancelled due to "irreconcilable differences" on how taxes would be

no discernible impact on overall efficiency of the national banking system or even led to an observable decline (for instance, see Denizer, et al., 2000).

treated for restructured loans. Efforts to sell both SCIB and BMB to foreign investors were also formally cancelled in December 2000¹⁴.

Dobson and Jacquet (1999) have emphasized the importance of making “credible and binding commitments to pursue full reform...(as)..a necessary complement to any gradual sequence, as it helps contain hostile domestic interests.” Under the terms of Thailand’s IMF structural agreement and the WTO financial services offer, the absolute amount of investments by foreign financial institutions that enter the Thai market until 2007 will be permanently grand fathered. This ought to ensure there is at least partial commitment by the Thai authorities towards opening up the banking sector over time.

¹⁴ The SCIB and BMB are medium-sized banks, ranked between 7th and 9th in terms of total capitals, total assets, loans, deposits, and number of domestic branches. Their branches are relatively concentrated in non-Bangkok areas. If these two banks are sold to foreign investors, the total number of foreign-majority-ownership banks will be 6, out of the current 13 commercial banks. In aggregate, their market shares will be around 16 per cent and in the 7th to 13th rank. Almost 60 per cent of their customer base will be scattered outside of the Bangkok area.

Annex 1: Thai Banking Sector Before and During the Crisis

In some senses, foreign bank entry is not a new concept in Thailand. The Thai banking sector got off the ground in 1888 with the establishment of a foreign bank branch. The Hong Kong and Shanghai Bank Corporation set up the first banking office in Thai capital, Bangkok, in December 1888, followed by the Chartered Bank (1894) and Banque de L'Indochine (1897). The "Book Club" was established in 1904 and the name was changed to "Siam Commercial Bank" in 1906. This was the first domestic commercial bank in Thailand, followed by Wang Lee Bank (1933), Tan Peng Chuan Bank (1934), and Bank of Asia (1939). An increasing number of Thai banks and foreign bank branches were established over the decades that followed. The most recent Thai bank was Radanasin Bank which was set up in 1998.

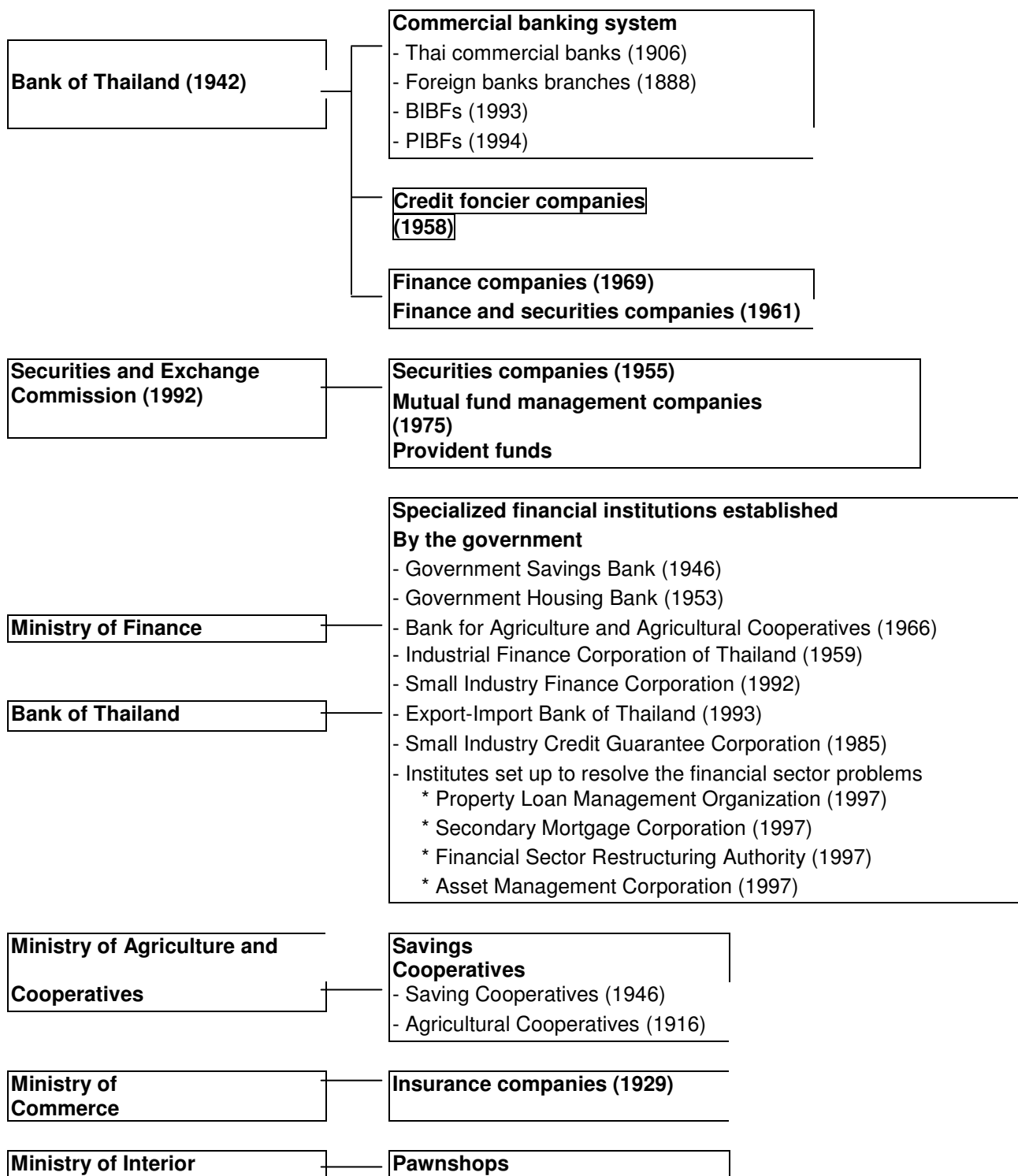
By the end of 1998, there were 13 Thai banks with 3,246 full branches, and 21 full foreign bank branches as well as 37 bank representative offices operating in Thailand (Table 12). Activities of banking business have gradually expanded over time. Traditionally, banking activities covered only acceptance of deposits, credit extension, and foreign exchange facilities. In the early 1970s Thailand's financial system was dominated by a few sizeable Thai banks whose activities were rather clustered and centrally administered. Foreign bank branches played only a limited role. The Bank of Thailand (BOT) was established in 1942 to supervise the operation of banks in the local market (Vajaragupta and Vichyanond, 2000).

To develop Thailand as a regional financial center, the BOT permitted qualified financial institutions to operate the International Banking Facilities in Bangkok (BIBFs) since 1993 and in other provinces (PIBFs) since 1994 (see Annex 2). A license for international banking facilities permits domestic commercial banks and foreign bank branches to provide the following activities: acceptance of deposits in foreign currencies, lending in foreign currencies to both residents (out-in lending) and non-residents (out-out

lending), and foreign exchange transactions. In 1998, 10 Thai banks and 35 foreign bank branches were granted permission to establish BIBF offices and 23 foreign bank branches were allowed to get PIBF licenses in other provinces. Financial institutions under the BIBF and PIBF were authorized to accept deposits and loans from abroad in foreign currency and extend loans to both overseas - but mainly - local markets (so-called "out-in" lending) and engage in cross-currency foreign currency trading and loan syndication. Foreign capital inflows were encouraged by the fact that loans through the BIBF were exempt from the withholding tax (of 10 percent). The BIBF institutions also benefited from reduced corporate income tax rates (10 percent as opposed to 30 percent) and exemptions from stamp duties, the permanent establishment tax, and a number of sales taxes (BOT, 1996, 1999). The establishment of these international facilities provided the impetus for large-scale capital inflow boom into Thailand and the subsequent bust (Rajan, 2001).

Annex 2: Structure of Financial Institutions in Thailand

Regulatory Agency



Source: Bank of Thailand

Note: Figures in parenthesis show the year of establishment

Annex 3: Guidelines for Equity Holdings in Financial Institutions

The Ministry of Finance and the Bank of Thailand have recently announced the measure to restore confidence in the financial sector by requiring commercial banks and finance companies currently in operation to increase their capital as a cushion against any potential loss from asset deterioration. All financial institutions are encouraged to take early action so as to prevent problem in the future.

To facilitate and expedite financial institutions' capital increase, the Bank of Thailand, with the approval of the Minister of Finance, has set the following guidelines for the financial institution's capital increase:

1. Guidelines for foreign equity participation in Thai financial institutions

1.1 Foreign investors that have sound financial status and high potential to help increase the efficiency in the management of the financial institution shall be allowed to hold more than 49% of the share in the 15 commercial banks, 33 finance companies, and 12 credit foncier companies for a period of 10 years. After 10 years, foreign investors will not be forced to sell their shares but may not purchase any additional shares, unless the amount of foreign shareholdings is less than 49% of total shares. Additional shares may be acquired to bring foreign shareholdings to 49% of total shares.

For the holding of shares of the 58 suspended finance companies, the Financial Sector Restructuring Agency (FRA) shall follow the guideline of the Committee to Supervise the Merger and Acquisition of Financial Institutions announced on 13 October 1997. The guideline allows unlimited amount of shareholding by foreign shareholders up to period of 10 years. After 10 years, foreign investors may not purchase any more shares unless the amount held is less than 49% of total shares in which case additional shares maybe acquired until the 49% mark is reached.

1.2 The guideline shall be the same for foreign investors that are banks. The foreign bank that already has a full branch or a Bangkok International Banking Facility will be allowed to continue their existing operation. However, the authorities reserve the right not to allow a foreign bank that has more than 49% stake in a Thai bank to have an additional full branch in Thailand.

2. Thai financial institutions' holdings of shares in other financial institutions

The authorities have the intention to apply the same guideline for Thai commercial banks and finance companies with sound financial status that wish to hold shares in other banks and finance companies. Nonetheless, there are legal limitations which prohibit a domestically incorporated commercial bank from holding other bank's shares unless approved by the Finance Minister on a case-by-case basis, and with a specified timeframe. Finance companies are also subject to the same legal constraints.

Therefore, the guideline regarding the shareholding in other financial institutions by domestically incorporated banks and finance companies will be as follows:

The authorities will allow domestically incorporated banks and finance companies with sound financial status to have more than 49% stake in other financial institutions for a period of 10 years. After 10 years if the banks or finance companies request to maintain their ownership, the extension will be approved on the ten-year basis. During the extension period, banks and finance companies will not be forced to sell their shares. Additional shares maybe acquired to bring their shareholdings to 49% of total shares.

3. Common directors

Thai commercial banks and finance companies that are allowed to hold shares in other financial institutions according to 2 above may have the same directors as the financial institutions in which they hold shares for no more than 3 years. Further extension may be allowed if necessary.

The Bank of Thailand believes that the above guidelines will assist in the capital increase of financial institutions and will provide equal treatment between Thai and foreign investors.

*Bank of Thailand
11 November 1997*

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Table 1
Banking System Risk Exposure in East Asia
(per cent of Assets), End 1997

	Property Exposure	Non-Performing Loans	Capital-Asset Ratio	Net Foreign Liabilities towards BIS Reporting Banks ^a
Indonesia	25-30	11	8 - 10	15.8
Malaysia	30-40	7.5	8 - 14	4.3
Philippines	15-20	5.5	15 - 18	4.6
Thailand	30-40	15	6 - 10	59.9

Note: a) billions of dollars
Source: Corsetti et al. (1999)

Table 2
Composition of Net Private Capital Flows to Thailand
(billions of dollars), 1997-1999

	1997	1998	1998		1999
			Q1	Q4	
Banks	-6,640	-13,944	1,244	-4,368	-5,497
Commercial banks	-1,727	-4,310	881	-2,445	-3,375
of which Recapitalization	0	1,986	952	0	21
BIBFs	-1,913	-9,634	-2,125	-1,924	-2,123
Non-banks	-1,912	-2,024	-2,777	1,248	-469
Direct Investment	3,201	4,688	1,066	1,218	902
Foreign direct investment ^a	3,641	4,810	1,067	1,248	996
Thai direct investment abroad	-440	-123	-1	-30	-94
Other Loans	-3,783	-4,279	-1,981	-734	-1,239
Portfolio investment	4,494	539	437	-15	221
Equity securities	3,869	354	434	-75	230
Debt securities	625	185	3	60	-9
Non-resident baht account	-5,839	-2,714	-2,269	779	-315
Trade Credits	-242	-494	-186	-160	0
Others	256	237	156	160	-38
Total	-8,552	-15,967	-4,021	-3,120	-5,966

Notes a) excluding \$2.1 billion in bank recapitalization
Source: Bank of Thailand

Table 3
Components of GDP Growth in Thailand
(per cent change), 1991-99

	1991-94 (Average)	1996	1997	1998p	1999p
Real GDP	8.5	5.9	-1.8	-10.3	4.2
Domestic Demand	8.2	7.2	-9.5	-24.2	7.9
Consumption	7.5	7.5	-1.2	-12.0	5.5
Private	7.6	6.8	-1.2	-11.5	4.0
Public	6.5	11.9	-0.3	3.6	0.9
Gross Investment	9.5	6.8	-21.7	-50.3	7.2
Gross Fixed Investment	10.0	7.4	-20.3	-38.1	3.0
Private	8.0	3.4	-29.7	-44.3	-1.2
Public	20.1	21.9	9.2	-25.7	9.3
Exports of goods & services	14.0	-5.5	8.3	6.5	9.9
Imports of goods & services	12.4	-0.5	-11.4	-21.7	10.6

Source: ADB-ARIC website (www.aric.org)

Table 4
Summary of Measures to Deal with the Financial Crisis in East Asia

Measures	Indonesia	Korea	Malaysia	Philippines	Thailand
Containment Measures					
Liquidity support	Yes	Yes	Yes	Yes	Yes
Introduction of a blanket guarantee	Yes	Yes	Yes	No	Yes
Institutional measures					
Establishment of an over-arching restructuring authority	Yes	Yes	Yes ^a	No	No
Establishment of a separate bank restructuring authority	Yes	No	Yes	No	No
Establishment of a centralized asset management corporation	Yes	Yes ^b	Yes	No	No ^c
Adoption of a special corporate debt restructuring framework	Yes	Yes	Yes	No	Yes
Operational autonomy of restructuring Agencies	Limited	Yes	Yes	n.a.	n.a.
Restructuring measures					
Intervention in financial institutions that were weak or insolvent. This would include:	Yes	Yes	Yes	Yes	Yes
- Mergers of weak institutions	Yes ^d	Yes	Yes	Yes	Yes ^d
- Closure of insolvent institutions	Yes	Yes	No	Yes	Yes
Use of public funds to purchase non-performing assets	Yes	Yes	Yes	No	No
Use of public funds to recapitalize institutions including:	Yes	Yes	Yes	No	Yes
- State intervention in banks	Yes	Yes	Yes	No	Yes
Elimination or dilution of current shareholder stakes of insolvent banks	Yes	Yes	Yes	Yes	Yes
Other measures					
Measures to encourage corporate restructuring	Yes	Yes	Yes	Yes	Yes
Steps to improve prudential supervision and regulation	Yes	Yes	Yes	Yes	Yes

Notes: a) steering committee chaired by the central banks; b) the powers of pre-existing AMC were substantially increased; c) the FRA was established to illiquidate 56 closed finance companies, and the AMC to deal with residual FRA assets; d) between government owned intervened institutions

Sources: Lindgren et al. (1999)

Table 5
Non-performing Loan (NPL) Ratios in East Asia (percent), 1997-1999

Share of NPLs to Total Loans (official estimate)			Share of NPLs to Total Loans (unofficial estimate)	
	End 1997	End 1998	September 1999	Peak Level
Indonesia	n.a.	n.a.	n.a.	60 - 85
Korea	n.a.	7.6	6.6	20 - 30
Malaysia	n.a.	18.9	17.8	20 - 30
Philippines	5.4	11.0	13.4	15 - 25
Thailand	19.8	45.0	44.7	50 - 70

Notes: NPLs are measured on a three-month basis; and the unofficial estimate includes assets carved out for sale by the AMCs

Source: ADB (2000)

Table 6
Public Debt, Restructuring Costs, and the Fiscal Impact in Thailand
(per cent of 1998 GDP unless otherwise noted)

	Amount (% of GDP)
Public debt, 1997	6.5
Fiscal recapitalization cost to date	17.4
Expected additional fiscal cost	15.4
Total expected public debt burden	39.3
Annual interest payment on this burden	1.2
Interest payment as % of 1998 revenue	6.5
Memo Item	
Fiscal deficit (% of GDP), 1999	5.0
Interest rate used (%)	3.0
Revenue/GDP (%), 1998	18.4

Source: Claessens et al. (1999)

Table 7
Foreign Shareholdings in Thai Commercial Banks, 1997 and 2000

Banks	Foreign Ownership (%)	
	March 1997	May 2000
<i>Banks acquired by foreign banks</i>		
Bank of Asia	6	77
DBS Thai Danu Bank	9	62
Standard Chartered Nakornthon Bank	6	75
UOB Radanasin Bank	...	75
<i>Banks with Thai majority ownership</i>		
Bangkok Bank	25	49
Bang of Ayudhya	25	32
Siam Commercial Bank	25	45
Thai Farmers Bank	25	49

Source: World Bank, Thailand Economic Monitor, February 2000 and Thai Farmers Research Center's Database, May 2000

Table 8
Total Capital and Total Assets of Commercial Banks

Commercial Banks	Total Capitals 1/				Total Assets 1/			
	Dec-96		Apr-01		Dec-96		Apr-01	
	Rank	% Share	Rank	% Share	Rank	% Share	Rank	% Share
Thai Major Shareholders:								
First Five Largest Banks 2/	1-5	68.2	1-5	81.2	1-5	68.4	1-5	81.2
Foreign Major Shareholders:								
<i>A. Viable Private Banks:</i>								
- Bank of Asia	11	2.5	10	3.1	11	2.5	10	3.1
- DBS Thai Danu Bank	12	2.3	11	1.7	12	2.3	11	1.7
<i>Sub-Total (A)</i>	11-12	4.8	10-11	4.8	11-12	4.8	10-11	4.8
<i>B. Privatized Banks:</i>								
- Standard Chartered Nakornthon Bank	14	1.3	12	1.5	14	1.3	12	1.5
- UOB Radanasin Bank	15	0.8	13	1.2	15	0.8	13	1.2
<i>Sub-Total (B)</i>	14-15	2.1	12-13	2.7	14-15	2.1	12-13	2.7
<i>C. Banks on Privatization Process:</i>								
- Siam City Bank	8	4.6	7	5.0	8	4.6	7	5.0
- Bangkok Metropolitan Bank	9	3.9	9	3.0	9	3.8	9	3.0
<i>Sub-Total (C)</i>	8-9	8.5	7-9	8.1	8-9	8.4	7-9	8.1
<i>Sum (A) + (B)</i>	11-15	6.9	10-13	7.5	11-15	6.9	10-13	7.5
<i>Sum (A) + (B) + (C)</i>	8-15	15.4	7-13	15.6	8-15	15.3	7-13	15.6

Notes: 1) 15 banks in 1997 and 13 banks in 1998

2) Bangkok Bank, Thai Farmers Bank, Krung Thai Bank, Siam Commercial Bank, and Bank of Ayudhya

Source: CEIC database

Table 9
Loans and Deposits of Commercial Banks

Commercial Banks	Loans 1/ 2/				Deposits1/			
	Dec-96		May-01		Dec-96		May-01	
	Rank	% Share	Rank	% Share	Rank	% Share	Rank	% Share
Thai Major Shareholders:								
First Five Largest Banks 3/	1-5	68.1	1-5	69.9	1-5	71.4	1-5	75.3
Foreign Major Shareholders:								
<i>A. Viable Private Banks:</i>								
- Bank of Asia	11	2.5	10	3.3	11	2.3	10	2.9
- DBS Thai Danu Bank	12	2.4	11	2.0	12	2.2	11	1.5
<i>Sub-Total (A)</i>	11-12	4.9	10-11	5.3	11-12	4.5	10-11	4.4
<i>B. Privatized Banks:</i>								
- Standard Chartered Nakornthon Bank	13	1.2	12	1.6	13	1.3	12	1.3
- UOB Radanasin Bank	15	0.8	13	0.5	15	0.8	13	0.9
<i>Sub-Total (B)</i>	13-15	2.0	12-13	2.1	14-15	2.1	12-13	2.2
<i>C. Banks on Privatization Process:</i>								
- Siam City Bank	8	4.4	7	5.1	8	4.6	7	5.0
- Bangkok Metropolitan Bank	9	3.8	9	3.5	9	3.9	9	3.4
<i>Sub-Total (C)</i>	8-9	8.2	7-9	8.6	8-9	8.5	7-9	8.4
<i>Sum (A) + (B)</i>	11-15	6.9	10-13	7.4	11-15	6.6	10-13	6.6
<i>Sum (A) + (B) + (C)</i>	8-15	15.1	7-13	16.0	8-15	15.1	7-13	15.0

Notes: 1) 15 banks in 1997 and 13 banks in 1998

2) Loans, less allowance for loan loss

3) Bangkok Bank, Thai Farmers Bank, Krung Thai Bank, Siam Commercial Bank, and Bank of Ayudhya

Source: CEIC database

Table 10
Number of Domestic Branches of Commercial Banks

Commercial Banks	Number of Domestic Branches 1/							
	Dec-97				May-01			
	Rank	% Share		Number	Rank	% Share		Number
	Bangkok	Others		Bangkok	Others			
Thai Major Shareholders:								
First Five Largest Banks 2/	1-5	27.5	72.5	2453	1-5	27.7	72.3	2591
Foreign Major Shareholders:								
<i>A. Viable Private Banks:</i>								
- Bank of Asia	9	53.2	46.8	110	9	59.8	40.2	117
- DBS Thai Danu Bank	11	45.3	54.7	95	11	53.2	46.8	62
<i>Sub-Total (A)</i>	9-11	49.8	50.2	205	9-11	57.5	42.5	179
<i>B. Privatized Banks:</i>								
- Standard Chartered Nakornthon Bank	13	56.7	43.3	67	12	68.5	31.5	54
- UOB Radanasin Bank	15	45.6	54.4	54	12	44.4	55.6	54
<i>Sub-Total (B)</i>	13-15	51.1	48.9	121	12	56.5	43.5	108
<i>C. Banks under the Privatization Process:</i>								
- Siam City Bank	7	30.3	69.7	209	7	30.3	69.7	211
- Bangkok Metropolitan Bank	8	36.7	63.3	173	8	36.7	63.3	177
<i>Sub-Total (C)</i>	7-8	33.2	66.8	382	7-8	33.2	66.8	388
<i>Sum (A) + (B)</i>	9-15	50.3	49.7	326	9-12	57.1	42.9	287
<i>Sum (A) + (B) + (C)</i>	7-15	41.4	58.6	708	7-12	43.4	56.6	675

Notes: 1) 15 banks in 1997 and 13 banks in 1998
2) Bangkok Bank, Thai Farmers Bank, Krung Thai Bank, Siam Commercial Bank, and Bank of Ayudhya

Source: CEIC database

Table 11
Financial Ratios of Thai Commercial Banks

	Total Expenses (Million Baht)		Cost to Income (%)		ROA (%)		ROE (%)		Net Profit to Total Income (%)	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
Thai Commercial Banks:										
- <i>Thai Major Shareholders</i>										
BBL	81,976	68,868	70.5	60.5	-4.7	-1.5	-78.6	-47.1	-62.5	-21.9
TFB	57,264	46,799	130.7	88.1	-7.6	0.2	-156.0	5.4	-108.0	2.6
KTB	62,666	48,608	159.8	81.2	-8.9	7.7	-99.6	91.5	-166.8	160.7
SCB	44,841	35,395	75.5	59.2	-5.1	0.5	-79.9	6.2	-71.8	7.9
BAY	35,185	25,832	217.8	126.0	-4.8	-2.0	-87.6	-44.5	-76.1	-37.9
- <i>Foreign Major Shareholders</i>										
BOA	10,357	8,782	122.1	86.5	-7.6	-2.6	-105.5	-34.7	-339.7	-43.7
DTDB	11,449	5,950	278.0	94.3	-10.8	-12.9	-213.9	-334.5	-162.9	-207.1
UOB-RAB	-8,881	3,329		...	18.5	2.2	91.0	-13.2	858.8	-62.6
				...						
Thai Banking Sector:										
- Thai Commercial Banks (13 banks)	396,364	310,040	171.7	97.0	-6.2	-2.1	-101.4	-41.6	-98.4	-3.6
- Foreign Bank Branches (20 branches)	49,461	52,857	46.3	57.1	...	2.0	...	4.4	-2.5	16.5

Notes: Total expenses = interest income + non-interest income; Cost to income = non-interest expenses/(net interest income+non-interest income)
ROA = pre-tax profit/total average assets; ROE = pre-tax profit/average shareholders' equity

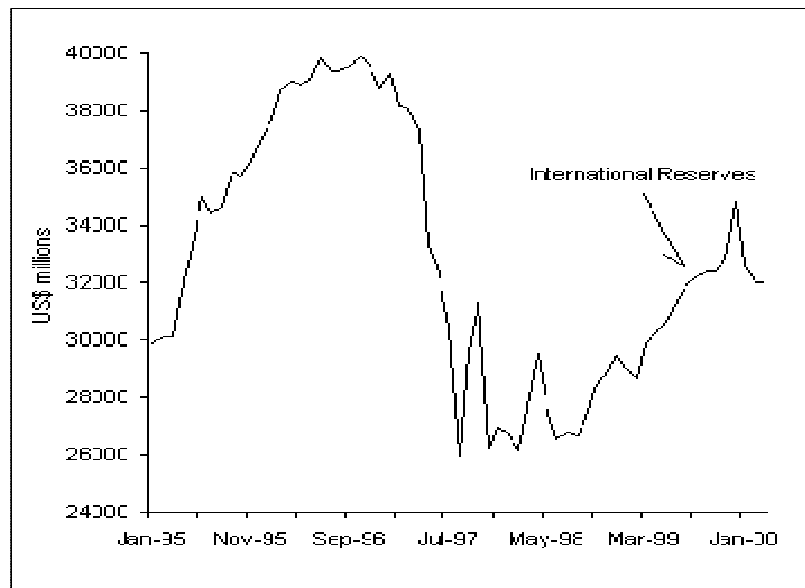
Sources: CEIC database, Bank of Thailand website (www.bot.or.th), and websites of each Thai commercial bank

Table 12
Number of Commercial Banks, 1993-1998

	Thai Commercial Banks				Foreign Bank Branch			
	No.	Full Branches	BIBF	PIBF	Full Branches	Representatives	BIBF	PIBF
1993	15	2,658	11	...	14	41	23	...
1994	15	2,823	11	...	14	37	29	...
1995	15	2,957	12	...	14	44	30	26
1996	15	3,138	12	...	14	45	30	30
1997	15	3,284	12	...	20	40	36	30
1998	13	3,246	10	...	21	37	35	23

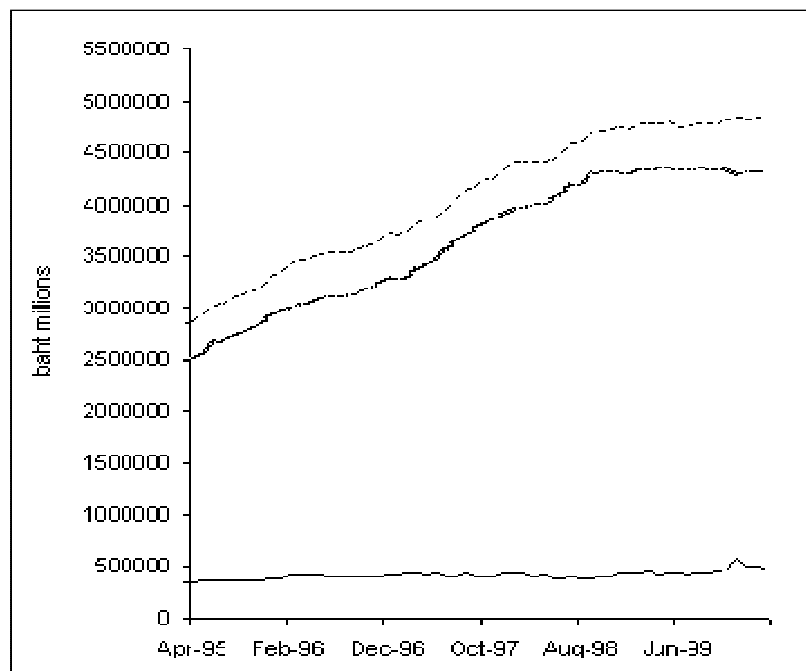
Source: Bank of Thailand

Figure 1
International Reserves in Thailand, January 1995 - January 2000



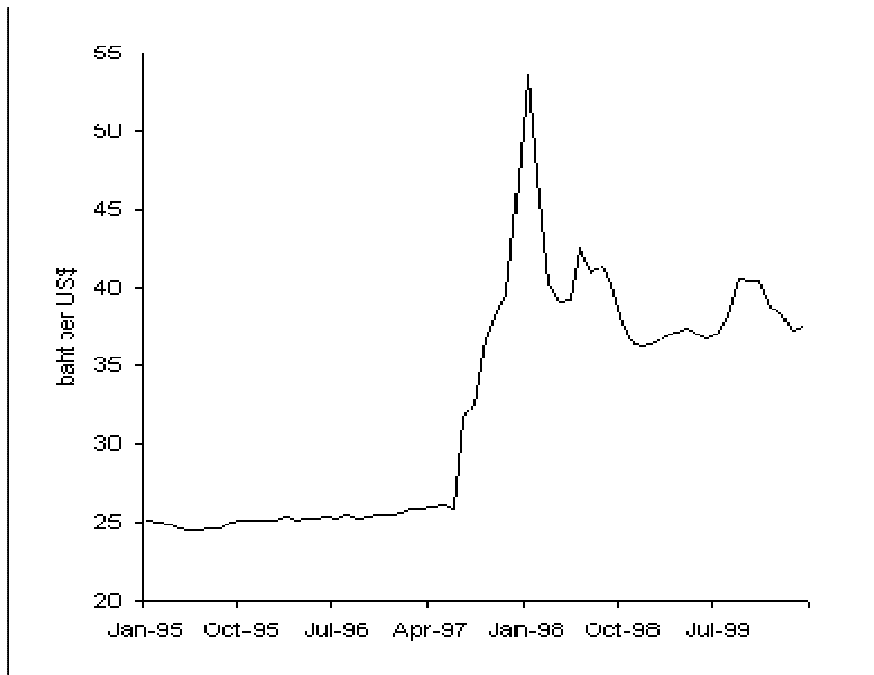
Source: CEIC database

Figure 2
Money Supply in Thailand, April 1995 - April 1999



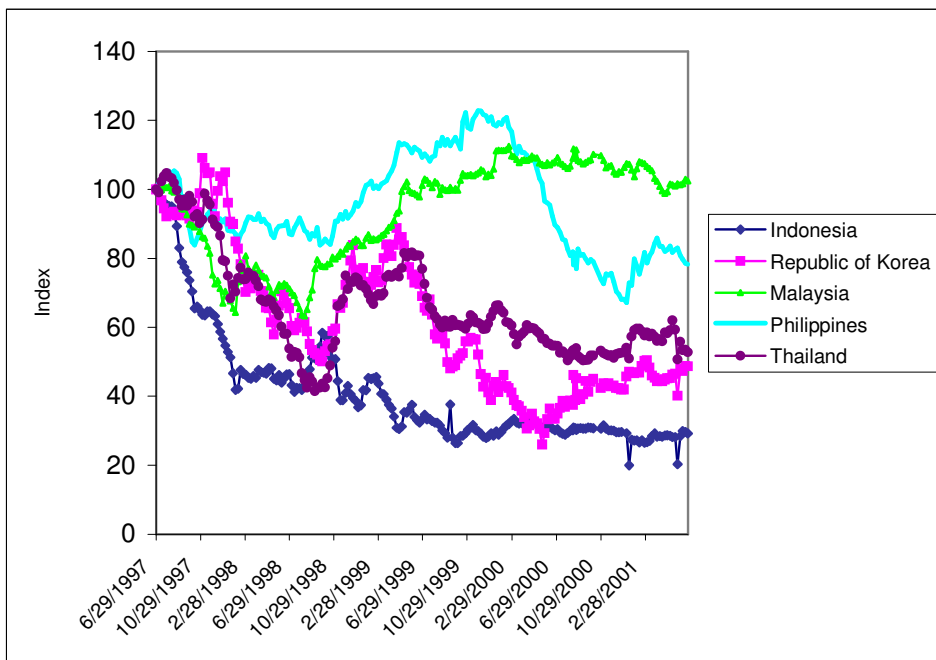
Source: CEIC database

Figure 3
Baht/US\$ Exchange Rate, January 1995 – April 1999



Source: CEIC database

Figure 4
Ratio of Financial Stock Index to General Stock Index (Last Week of June 1997 = 100)



Source: CEIC website