DEPARTMENT OF FOREIGN AFFAIRS AND TRADE

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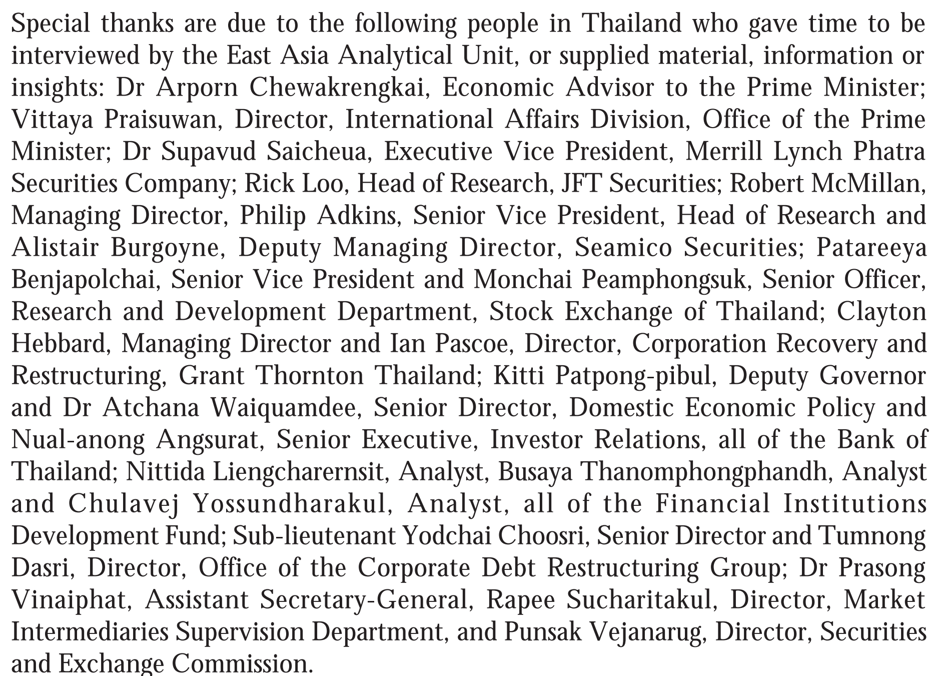
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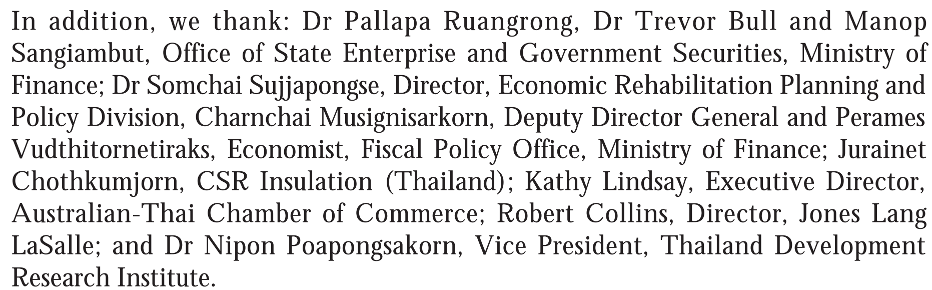

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Located within the Department of Foreign Affairs and Trade, the East Asia Analytical Unit has undertaken and commissioned 23 studies to date on a range of topics related to Australia's trade policy and economic interests in the region.

Staffed with seven professionals, the East Asia Analytical Unit also contracts a range of consultants with specific areas of expertise. It draws on a wide range of data and information sources, including reports from Australia's diplomatic and trade missions in Asia.

Reports and briefing papers produced by the East Asia Analytical Unit are intended to assist analysts and decision makers in business, the Australian Government and the academic community.

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EXECUTIVE SUMMARY

In 2000, Thailand's economy is at the crossroads; the Government's policy choices will determine how successfully Thailand sustains its recovery and grows over the next decade. Thailand has made many important structural reforms since the crisis began, facilitating recovery and generating new commercial opportunities. However, many more reforms to key economic institutions remain incomplete. In 2000 and 2001, Thai Government choices on crucial financial and corporate restructuring, economic and corporate governance, and legal, trade and investment reforms will determine if the country can grow robustly and sustainably over the next decade. Such reforms would insulate Thailand from future economic shocks and continue progress towards developed country status. This report identifies both long term prospects and short term commercial opportunities by tracking Thailand's progress in its reform task, and highlights key indicators of future policy directions.

This report is designed primarily to assist Australian business assess the long term impact of crisis driven reforms on Thailand's economy and Australian trade and investment prospects in Thailand. The report also highlights priorities of the Australian Government in bilateral relations, trade negotiations and official development assistance.

AUSTRALIAN TRADE OPPORTUNITIES

Thailand largely resisted imposing new trade barriers during the financial crisis; clearly, the Government is committed to achieving free trade. However, by regional standards, protection is still high. In 2000, the Government is encountering resistance to plans to cut tariffs further. Consequently, if the Government successfully completes planned tariff band rationalisation and cuts tariffs in 2000, it will indicate the Government can deliver the trade liberalisation essential for Thailand's future growth.

Forecast trade growth is slower than in pre-crisis years. While imports will grow by around 20 per cent in 2000, lower medium term GDP growth forecasts suggest Thai imports probably will grow only 10 to 14 per cent per year in 2001-05 compared to 18 per cent in the early 1990s; exports probably will grow only about 10 per cent, well below the 19 per cent achieved in the first half of the 1990s.

Trade liberalisation, Thai industrialisation and rising incomes, and Australia's strong comparative advantage in supplying industrial raw materials, food and niche manufactures generated A$1.4 billion of Australian-Thai trade in 1999. Throughout the decade to 1997, Australian exports to Thailand grew twice as fast as Australia's average export growth. Assuming Australia holds its current market share, Australian exports to Thailand could increase by about 10 per cent per year to exceed A$2.5 billion by 2005.

While exports to Thailand of Australian bulk commodities will remain important, Thai import demand is shifting from commodities to manufactured and higher value-added foods and services. As Thailand consolidates its recovery, significant

opportunities are emerging for Australian automotive components, information technology equipment and services, medical equipment, pharmaceutical, education, tourism and business service exports.

Australia's relatively low share of Thai imports is due partly to high trade barriers and poor recognition of Thai market opportunities. Australia's 2 per cent share of the Thai market remains small compared to its market share in comparable Asian markets, like Indonesia and the Republic of Korea (6 per cent and 4.5 per cent). Tariffs of 30 to 80 per cent on some prospective Australian agricultural and automotive exports, where local demand is potentially quite high, contribute to this low market share. In 1999, Australia was Thailand's eleventh largest import supplier, while Thailand was Australia's fourteenth largest export market and thirteenth largest trading partner.

FOREIGN INVESTMENT OPPORTUNITIES

Since 1997, Thailand has increased its efforts to attract foreign direct investment although many sectoral and ownership limits remain. Foreigners can own 100 per cent of banks, manufacturing enterprises and large scale retail outlets, but restrictions remain in agriculture, mining and many services sectors. Restrictions on foreigners owning land also have been eased. In 1998 and 1999, as the foreign investment regime became more liberal, new foreign direct investment reached around US$12 billion, more than the previous five years' total. Because of the crisis, many Thai companies are seeking foreign partners to raise capital and improve their competitiveness through new technology, management and marketing skills. As corporate structuring progresses in 2000 and 2001, opportunities for foreign investors to purchase non-core assets should increase.

However, in 1998 and 1999, a hostile Senate thwarted the Government's attempts to liberalise the alien business law; consequently, the new law is only marginally less restrictive than the old one. In mid 2000, an anticipated new investment incentive system was expected to reduce incentives to prosperous provinces closer to Bangkok and redistribute them to poorer provinces, but these reforms are now in doubt.

Australian investment in Thailand is relatively small compared with its investment in other regional countries, but reforms and restructuring triggered by Thailand's financial crisis have opened up new opportunities in the financial sector, large scale retailing, manufacturing, logistics and privatising utilities like telecommunications, transport and energy. Ongoing restrictions on foreign investment continue to deter inflows into many other sectors of potential interest to Australia, including business services, mining and agribusiness.

CRISIS CAUSES

In mid 1997, a collapse of confidence after a long period of exuberant but increasingly fragile growth caused Thailand's financial crisis, and triggered contagion in the rest of the region. From the early 1980s, successful Thai macroeconomic management and export-oriented industrialisation policies produced 8 to 9 per cent economic growth, rapidly lifting Thai living standards and reducing poverty. However, by the mid 1990s, short term foreign borrowing had flooded into speculative investments in real estate and the financial sector, causing a real estate

glut and asset price inflation. By 1996, a widening current account deficit, insolvencies among local financial institutions and declining exports signalled growing macroeconomic imbalances. By 1997, short term foreign debt reached 23 per cent of GDP and was 1.35 times foreign reserves. The term and currency mismatch in Thai corporates' short term foreign liabilities and long term baht assets finally triggered the crisis.

However, the underlying problem was a systemic failure; inadequate prudential controls allowed this mismatch to occur and the country's foreign exchange reserves were mismanaged in defending an inappropriate currency peg. Years of rapid growth had concealed financial institutions' weak risk management procedures and borrowers' poor corporate governance practices. As in Australia in the 1980s, financial sector and capital account liberalisation were not matched by strengthened prudential controls, and many corporates and financial institutions took excessive risks. In mid 1997, Thailand's miracle growth halted abruptly; when the Bank of Thailand failed in its defence of the baht's de facto US dollar peg, Thailand had to seek assistance from the International Monetary Fund. After authorities freed the baht and raised interest rates to prevent the currency's free fall, Thailand entered a severe recession, with GDP dropping 10.2 per cent in 1998.

CRISIS RESPONSES

From early 1998, to prevent Thailand's economic collapse and facilitate sustainable growth, the new Thai Government intervened in the financial sector to protect depositors, implemented many significant economic reforms and relaxed macroeconomic settings. By mid 2000, the Government's financial sector intervention had avoided systemic crisis, and restructuring had introduced more competition, including from foreigners. In 1999, these policies produced a short term recovery, with Thailand eventually achieving 4.2 per cent real GDP growth. Economic recovery and policies implemented to achieve it are generating improved business prospects in Thailand. However, many policy reforms remain incomplete and the Government faces important choices in 2000 which will determine long term prospects.

Political Tests

Crisis induced stresses tested the stability of the political system as well as economic policy making. At the time of the crisis, Thailand was undertaking major constitutional reform aimed largely at increasing governmental transparency and accountability. Consequently, Thailand's greatest achievement in recent years has been to overcome the crisis while retaining political and social stability.

RECOVERY PROSPECTS AND RISKS

In mid 2000, the recovery started in 1999 is gaining momentum. Fiscal activity is expanding; exports are growing strongly; consumer confidence is improving and investment is picking up slowly. Real GDP should grow 5 to 6 per cent in 2000 and 2001.

From 2001, some sectors will use their full industrial capacity, then their medium to long term prospects will depend on new investment, productivity growth and

international competitiveness. However, Thailand's medium to long term growth prospects still are uncertain. The reform agenda is unfinished and government debt has increased greatly; furthermore, continued reform is more difficult in 2000, an election year. Future growth will depend mostly on new investment, which will rely on domestic lending and foreign investors for funding. However, domestic and foreign bankers and portfolio investors will remain cautious until legal system, financial and corporate restructuring, and governance reforms are completed, improving transparency and reducing risk for investors and creditors. Without continued structural reform, analysts estimate Thailand's medium term growth could fall up to two percentage points below its long term potential of 7 to 8 per cent per year to only 5 to 6 per cent. Lower growth of this magnitude would forestall improvements in living standards and reduce Thai commercial opportunities.

However, if these reforms are achieved, strengthened institutions will boost Thailand's long term growth prospects. Key signals of continued reform commitment will include: accelerating progress on corporate restructuring; completion of financial sector refinancing and provisioning; solid achievements in privatising nationalised financial institutions and state enterprises; reform of tariff bands; more liberal interpretation of foreign business and visa legislation protecting business services and other sectors; passage of Bank of Thailand and other key financial institution legislation; and continued progress strengthening bankruptcy law implementation.

In the longer term, to sustain growth, Thailand also must deal with longstanding human resource and infrastructure weaknesses. In an important recent initiative, the Government is making education compulsory and free for much longer than previously, and improving workforce training. However, these reforms will not upgrade workforce skills for many years. The Government also is attempting to address infrastructure inadequacies by privatising state enterprises and encouraging private sector infrastructure provision. However, implementation problems and political resistance slow progress in private infrastructure; this could constrain long term growth prospects.

FINANCIAL RESTRUCTURING AND REFORM

While financial restructuring and refinancing has progressed reasonably well, policies employed to resuscitate the financial system were slower than approaches the Republic of Korea or Malaysia took. Since the crisis began, the Government has closed or nationalised 76 insolvent banks and finance companies, permitted foreign competition, tightened prudential regulations and required remaining institutions to recapitalise. However, the Government's private sector-led approach to recapitalisation and lenient timetables for reaching capital adequacy and provisioning requirements have slowed recapitalisation and non-performing loan write offs. Non-performing loans peaked at 50 per cent peak, but in March 2000, still 37 per cent of loans were non-performing. Rather than requiring banks to sell non-performing loans to a government owned asset management company immediately, banks were permitted to set up their own companies to remove bad loans from their books gradually and so preserve owners' control. This has slowed banks' capacity to recommence normal lending. The cost of the financial sector rescue and depositor guarantees could reach Baht 2 trillion (US$54 billion) or 35 to 40 per cent of 1999 GDP.

Foreign banks now have majority shares in four nationwide banks and are well placed to increase their market share as the recovery quickens. A fifth bank sale to foreigners was announced in May 2000. Foreign banks' innovative new products and services directly compete with Thai bank offerings. Not surprisingly, Thai commercial banks are upgrading their accounting, auditing, risk management, customer service and information systems to compete for market share. This is generating many financial service and related IT opportunities for foreign suppliers.

CORPORATE RESTRUCTURING AND GOVERNANCE

Corporate debt restructuring finally appears to be accelerating in mid 2000. The main approach uses voluntary, out-of-court debt work outs, with the Corporate Debt Restructuring Advisory Committee expediting large work outs by pressing for timebound negotiations. However, while the Corporate Debt Restructuring Advisory Committee expects restructuring to accelerate throughout 2000, by March 2000, it had resolved only one third of debt under its large case programs. Furthermore, many analysts fear a high proportion of restructured debts may reappear as non-performing loans.

In 1999, the Government strengthened bankruptcy legislation. In March 2000, the Central Bankruptcy Court found Thai Petrochemical Industry, TPI, Thailand's largest debtor, insolvent; this watershed decision should accelerate other major debt work outs. However, bankruptcy and insolvency processes still favour debtors over creditors and pursuing bankruptcy cases through Thai courts is time consuming and expensive.

Corporate governance reform is in its early stages. The financial crisis highlighted weak corporate governance; this reflects the dominant culture of family owned and managed businesses. The Government is seeking to strengthen accounting, auditing, disclosure and directors' standards. However, most of these reforms are embryonic, and will take many years to produce major improvements.

PRIVATISATION

By mid 2000, the Government had made some progress in readying state enterprises for privatisation but was well behind its ambitious 1998 reform schedule. The Government recognises strong frameworks will ensure efficient and equitable outcomes, so first it is developing appropriate legal, regulatory and market frameworks. However, by mid 2000, problems in developing and passing enabling legislation had delayed timetables 12 to 18 months. Furthermore, the Government's commitment to privatisation could waiver under strong union and management opposition, particularly in an election year. Nationalist elements also are vocal in their concerns about possible sale of state enterprise assets to foreigners.

However, if privatisation momentum resumes in 2001 and beyond, it should generate investment and participation opportunities in previously monopolised industries. Corporatising state enterprises and developing market frameworks are generating many consultancy opportunities, and as sectors open to new entrants, investment and export opportunities should increase as privatised operations upgrade and expand.

IMPLICATIONS FOR AUSTRALIA

In the short term, Australian business opportunities should grow as the Thai economy strengthens and the Thai Government continues its trade and foreign investment reforms. However, unless the Government achieves financial and corporate restructuring, vigorously pursues legal, state enterprise, regulatory trade and investment reforms, and increases the bureaucracy's capacity to develop and implement these reforms, Thailand's long term annual GDP growth could be significantly lower than its potential. This would not only lower prospects for rising incomes and living standards, but would reduce significantly Australian trade and investment opportunities in Thailand. On the other hand, if the Government successfully implements these essential structural reforms, Thailand should sustain strong growth over the coming decade, and be well placed to move closer to developed country status. It is too early to pick which path Thailand will chose; however, the report identifies key indicators of future policy directions. Reforms achieved to date, continuing progress in financial and corporate restructuring and strengthening economic indicators all are cause for cautious optimism.

Chapter 1

ECONOMIC PROSPECTS AND RISKS

Key Points

- Thailand's short term recovery prospects are good. Real gross domestic product, GDP, recovered from a 10 per cent fall in 1998 to grow by 4.2 per cent in 1999, and is expected to grow 5 to 6 per cent in 2000 and 2001. Economic recovery initially depended on increased government spending, but private consumption and exports now are picking up, and even investment is recovering.
- Short term economic recovery does not imply financial sector refinancing and corporate debt restructuring are complete, although in mid 2000 they are accelerating, after two years of slow progress.
- From 2000, capacity utilisation will rise, and from 2001, medium to long term growth will depend on new investment and productivity growth.
- Hence, by late 2000 or early 2001, the financial system must be recapitalised and the corporate sector repaying restructured debts, so banks and capital markets can finance new investment; otherwise, capacity constraints will limit future growth.
- Once the aftermath of the financial crisis is resolved, other longstanding structural weaknesses, particularly human resource development and infrastructure shortages, will need resourcing.
- A weak educational system limits human resource capabilities. In 1999, the Thai Government significantly raised the number of years of free and compulsory high school education, but it could take at least a decade for this crucial reform to noticeably improve workforce skills.
- Lack of adequate infrastructure also could retard longer term economic growth. The Government is trying to address this weakness with its state enterprise privatisation program and encouraging private sector infrastructure provision. However, slow progress is due to pressure from vested interests and implementation bottlenecks.

Thailand's economic policy making is at the crossroads in 2000; choices made now will determine the pace and nature of growth over the next decade. Important economic policy reforms in the 1980s opened the Thai economy to international trade and capital flows, producing two decades of high growth (Table 1.1). However, inadequate macroeconomic and prudential control policies in the 1990s undermined Thailand's trade competitiveness, and facilitated excessive short term capital inflows. In mid 1997, this precipitated Thailand's worst economic crisis in the post war period.

Table 1.1

Thailand's Rapid Growth

Basic Economic Indicators, 1977, 1987, 1997-99

	1977	1987	1997	1998	1999
GDP (US$ billions)	19.9	50.5	150.7	112.1	123.9
GDP per capita (current prices US$)	453	962	2 512	1 832	2 005
Structure of GDP (per cent)					
Private consumption	67.9	60.1	55.5	54.6	56.1
Government consumption	10.6	11.3	10.0	10.8	11.1
Investment	26.9	27.9	32.9	20.3	20.7
Net exports	-7.4	0.6	1.4	16.0	11.5
Key variables as ratio to GDP (per cent)					
Exports of goods and services	20.0	28.9	47.9	58.6	57.2
Imports of goods and services	27.4	28.3	46.5	42.7	45.7
Current account balance	-5.5	-0.7	-0.9	12.8	9.1
Total debt (US$ terms)	16.8	40.3	62.0	76.9	61.0
Sectoral structure of GDP (per cent)					
Agriculture	24.8	15.7	10.0	11.9	10.4
Industry[a]	26.1	30.8	37.5	36.3	37.6
Services and other	49.1	53.5	52.5	51.8	52.0
External accounts (US$ billion)					
Current account balance	-1.1	-0.4	-3.1	14.3	11.3
Exports: goods (fob)	3.5	11.6	56.7	52.9	56.8
Imports: goods (cif)	4.6	13.0	61.3	40.6	47.8
Trade balance	-1.2	-1.3	-4.6	12.2	8.9
Foreign direct investment	106	352	3 752	6 900[b]	5 200[b]
External debt	3 344	20 019	93 416	86 160	75 579
Exchange rate (Baht:US$1)	20.4	25.7	31.4	41.4	37.8
Growth rates (per cent)	**1977-87**	**1988-98**	**1997**	**1998**	**1999**
Real GDP	5.7	6.9	-1.7	-10.2	4.2
GDP per capita (US$ terms)	6.4	7.7	-17.9	-27.1	9.4
Exports goods	9.7	14.1	3.8	-6.8	7.4
Imports goods	7.9	10.3	-13.4	-33.8	17.7
Consumer price inflation	6.6	5.2	5.6	8.1	0.3
Commercial bank credits	na	3.1	16.6	6.6	-5.9
Manufacturing wages (monthly)	na	8.1[c]	7.9	7.7	na

Note: a Industry includes mining, manufacturing and construction.
b 1998 and 1999 data are adjusted to include US$2.1 billion in bank recapitalisation.
c Manufacturing wages growth rates from 1990-98.
na Means not available.

Source: CEIC, 2000; World Bank, 2000b; and Bank of Thailand, 2000.

The Government's responses to the crisis averted international payments and financial system collapse, overcame the post crisis recession and slowly addressed bank and corporate restructuring. However, further deep and ongoing reforms are needed in key economic and legal institutions to ensure the economy grows rapidly and is insulated from further major shocks.

By mid 2000, economic recovery was well underway, supported by the Government's expansionary fiscal and monetary policies, strong export growth and more confident consumers.[1] After falling 10.2 per cent in 1998, real gross domestic product, GDP, partially made good this contraction and grew by 4.2 per cent in 1999, much faster than initially expected.[2] In the year to March 2000, exports grew 25 per cent and the composite consumption index grew around 3 per cent over the same period. The Bank of Thailand forecasts real GDP will expand by 4.5 per cent in 2000, while private sector GDP growth forecasts average 5.3 per cent (Tables 1.2 and 1.3, and Figure 1.7) (Consensus Economics, 2000a; and Economist Intelligence Unit, 2000).

Table 1.2

Net Exports Negative for Economic Growth in 1999

Contribution to Real GDP Growth

	1998	1999	2000[a]
Real GDP growth	-10.2	4.2	5.3 [a]
Contributions to growth[3]			
Private consumption	-6.8	1.9	3.2 [a]
Gross fixed investment	-15.0	-0.8	1.6 [a]
Government spending	0.2	0.3	0.6 [a]
Changes in stocks	-1.6	3.1	1.5 [a]
Net exports	13.0	-2.9	-2.0 [a]
Statistical discrepancy	-0.1	2.6	0.4

Note: a GDP growth and contribution in 2000, based on Consensus Economics and Economist Intelligence Unit growth forecasts.

Source: CEIC, 2000; Consensus Economics, 2000a; Economist Intelligence Unit, 2000; and East Asia Analytical Unit estimates.

1 While the monetary base was very low and often negative in 1998, it expanded by 30 per cent in 1999. The monetary aggregate M2 (M1 plus time deposits) grew at rates close to and in excess of 10 per cent through 1998 and the first five months of 1999. M2 growth slowed after June 1999, but M1 growth increased. This divergence reflects reallocation of portfolios from more risky assets like shares into fixed term deposits, which yielded high returns and were government guaranteed.

Fiscal policy also relaxed significantly in mid 1998 and throughout 1999. The Government's budget deficit increased steadily from 3 per cent of GDP in fiscal year 1997 to 7 per cent in fiscal year 2000. (See Chapter 5 - *Crisis Responses*.)

2 Private sector forecasts in the recovery period were continually revised upwards. In May 1999, the mean GDP growth rate forecasts were 0.8 per cent for 1999 and 2.9 per cent for 2000. By early 2000, these forecasts had risen to 4.2 per cent and 5.2 per cent respectively (Consensus Economics, May 1999 and February 2000b).

3 The contribution of each aggregate to GDP is calculated by:
contribution=100x{A(t)-A(t-1)/GDP(t-1)}, where A(t) value of the aggregate in the year under consideration, A(t-1) is value of the aggregate in previous year and GDP (t-1) is the value of GDP in the previous year.

Private sector forecasters also expect 5 to 6 per cent GDP growth in 2001-05, significantly lower than the average 8.5 per cent growth achieved pre-crisis. At this growth rate, Thailand would regain pre-crisis output per capita in 2002, and pre-crisis per capita consumption in 2003 (World Bank, 2000). Pre-crisis growth was spurred by high capital inflows but (fortunately) significant speculative foreign capital flows, particularly foreign bank lending, probably will not reappear for many years. More stable capital inflows (foreign direct investment, portfolio flows from institutional investors and long term lending) at equivalent levels will not eventuate without significant new reforms to the foreign investment, corporate governance and legal framework. Consequently, analysts anticipate lower growth in the next decade (Consensus Economics, 2000a).

This chapter assesses the path of Thailand's economic recovery to date. It then analyses the short and long term economic growth prospects and risks, anticipates future potential reform and competitiveness prospects, identifies key signposts of the Government's commitment to continuing reform and draws implications for business.

ECONOMIC RECOVERY TO 2000

After 18 months of rapidly declining and sharply negative growth from mid 1997, Thailand has achieved steady economic recovery. In July 1998, the decline of manufacturing output slowed, providing the first glimmer of an imminent bottoming out of the recession.

However, manufacturing output only achieved positive year-on-year growth in January 1999, followed by double digit growth throughout the rest of 1999. By September 1999, manufacturing production had surpassed its pre-crisis peak. Due to base period effects, year-on-year manufacturing growth slowed to a more normal 10 per cent after November 1999 (Figure 1.1).

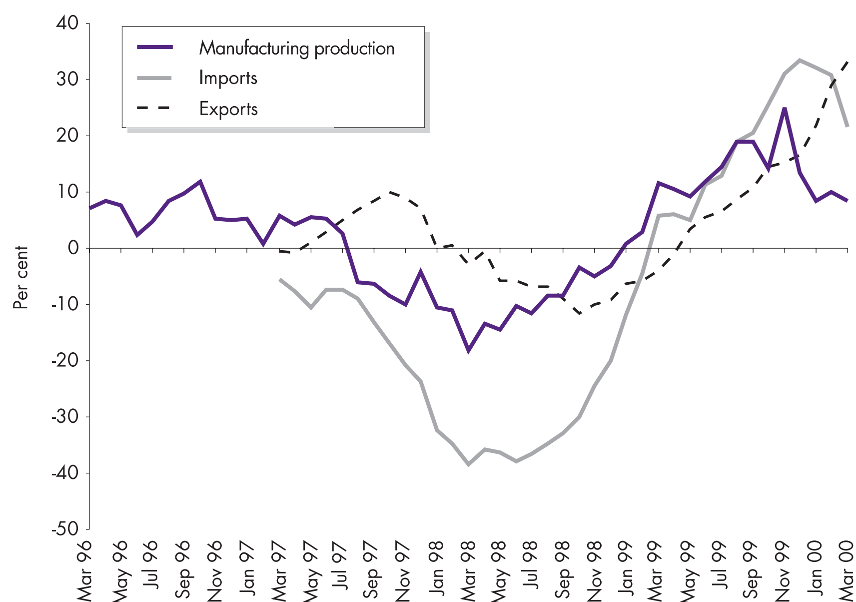
Exports were weak throughout 1998, but rebounded strongly from April 1999 (Figure 1.1). In 1999, export growth of over 7 per cent nearly doubled initial projections. While automotive exports grew rapidly in 1999, electronics, electrical appliance and jewellery exports surged (Figure 3.6). (See Chapter 3 - *Trade*.) Thailand also is benefiting from rapidly growing regional imports, with regional recovery beginning to create a virtuous circle of mutually reinforcing import demand (Figure 1.6). Throughout the crisis, import falls were far greater than export falls, but imports started to grow again in March 1999 (Figure 1.1).[4] Imports of intermediate goods, raw materials, automotives and auto parts grew particularly rapidly.

[4] The monthly current account surplus varied from US$1 billion to US$1.3 billion in late 1998 and early 1999, but began to fall in March 1999. Hence the current account surplus fell to US$11.3 billion in 1999 from US$14.3 billion in 1998 (Table 1.1).

Figure 1.1

Economic Recovery Gains Momentum

Manufacturing, Export and Import Growth, 1996 to 2000
Per cent Change on Same Month Previous Year



Note: Manufacturing production is seasonally adjusted; and export and import changes are based on a 3 month moving average of US$ values.

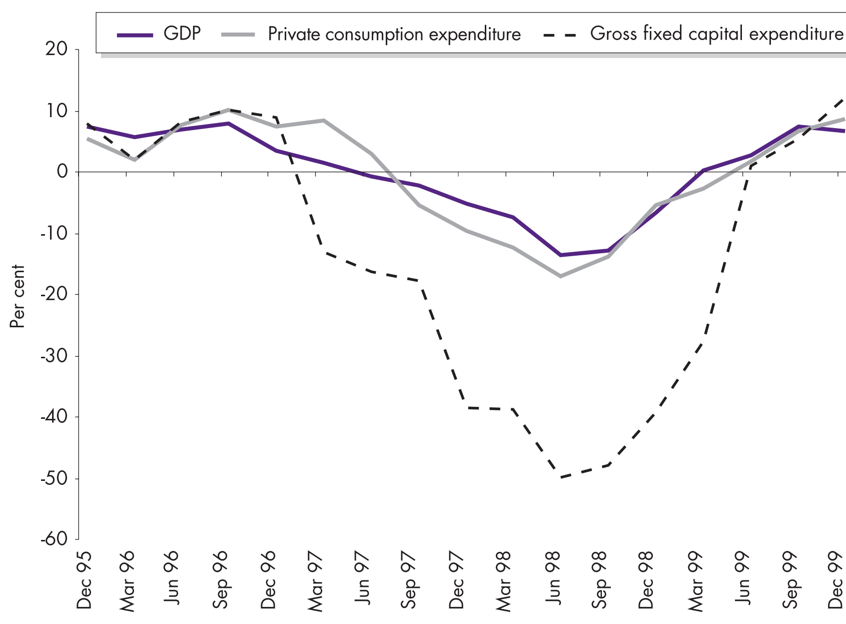
Source: CEIC, 2000.

In the first quarter of 1999, GDP grew slightly, the first positive growth since the first quarter of 1997, but by the December quarter of 1999, GDP was 6.5 per cent higher than a year earlier (Figure 1.2). Overall in 1999, 4.2 per cent GDP growth represented a good recovery from the 10.2 per cent and 1.7 per cent contractions of 1998 and 1997. This long awaited recovery was due primarily to the public sector stimulus package which produced a second half of 1999 pick up in consumption and investment spending (Figure 1.2). Growing confidence that unemployment had peaked, sharply lower interest rates, the release of demand for consumer durables after crisis induced restraint, and a temporary VAT reduction in early 1999 also stimulated consumer spending in 1999 (World Bank, 2000). As a result, consumption spending positively contributed to GDP growth in 1999 (Table 1.2).

Figure 1.2

GDP Recovery Starts March Quarter 1999

Real GDP, Consumption Spending and Investment Growth, 1995-99
Per cent Change on Same Quarter Previous Year



Source: CEIC, 2000.

Consumer price inflation peaked at about 10 per cent from March to July 1998, but has declined since then to an annual rate of 1 per cent in March 2000 (Figure 1.3). Negative to low inflation since May 1999 reflects depressed domestic demand and the impact of baht appreciation since early 1998. The exchange rate peaked at Baht 56:US$1 in January 1998, but traded at around Baht 38:US$1 for most of the time from April 1998 to May 2000 (Figure 5.2). The baht's real trade weighted exchange rate has recovered to be only 20 per cent below its June 1997 level; this appreciation has undermined some of the export competitiveness gains made in 1997 and 1998 but still left the baht at a competitive level.

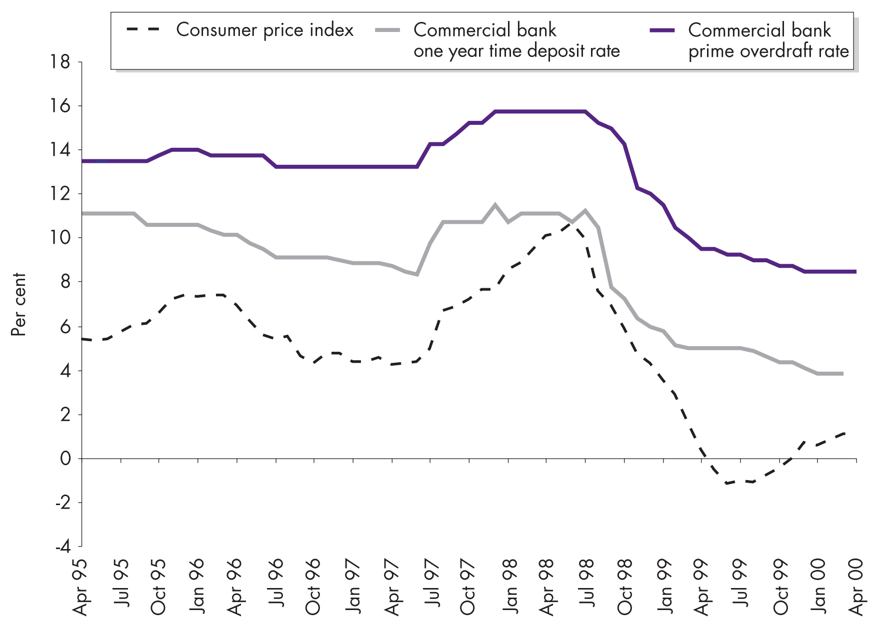
The banks' prime lending rate hovered between 15.25 and 15.5 per cent through the first half of 1998 and did not begin to fall until August 1998 when monetary policy eased. The same is true of fixed deposit rates, which were between 10 and 12.25 per cent for the first half of 1998. Interest rates continued to decline in 1999 and by April 2000, were around 8.5 per cent for prime rates and 3.9 per cent for one year fixed deposits (Figures 1.3 and 5.4).

Despite the Bank of Thailand's expansionary monetary stance, by mid 2000, banks still had not resumed lending; commercial bank credits fell by 5.9 per cent in 1999; in March 2000, commercial bank credits were still 5.2 per cent lower than in March a year earlier (Figure 1.4). Banks ceased lending because their high non-performing loan write offs meant they had difficulty reaching tightened capital adequacy ratios. As bank liquidity rose, lack of credit worthy borrowers, low credit demand and ease of investing in low risk government bonds also weakened credit growth.

Figure 1.3

Low Inflation and Falling Interest Rates

Consumer Prices Changes and Interests Rates, Per cent[a]



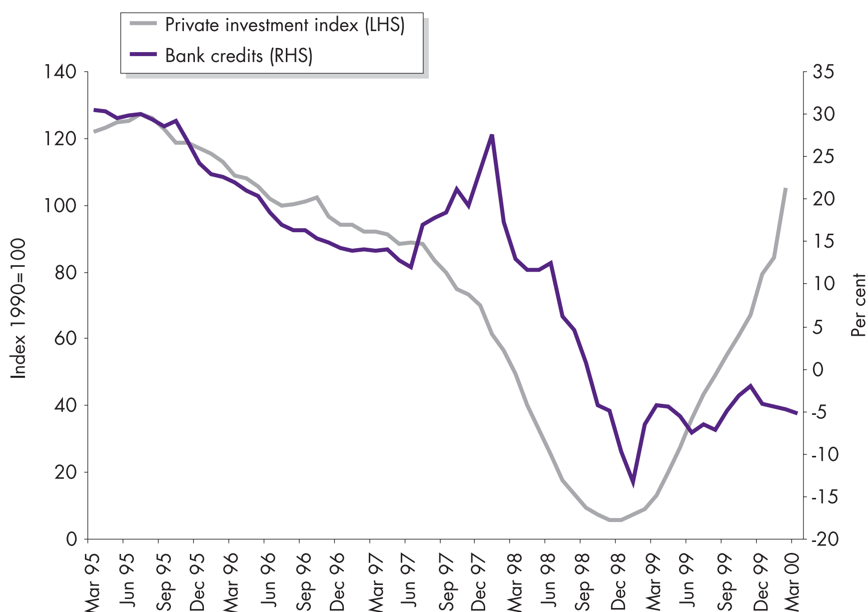
Note: a Consumer prices are per cent change on same month previous year.

Source: CEIC, 2000.

Figure 1.4

Credit Still Contracting but Private Investment Recovering

Credit Growth and Investment, 1995 to 2000



Note: Commercial bank credits include Bangkok International Banking Facility funds, per cent change on same month previous year.

Source: CEIC, 2000.

Because of the banks' liquidity crunch, alternative funding sources must finance economic recovery (World Bank, 2000). New securities and corporate bond issues have jumped, and foreign direct investment is driving manufacturing expansion (Figure 6.2). Exports, the budget deficit and improved cash flows following corporate restructuring also are funding recovery. (See Chapter 7 - *Corporate Restructuring.*)

Hence despite credit contraction, private investment spending is recovering slowly. The Bank of Thailand's aggregate private investment index (based on a range of indicators) fell 90 per cent in 1998, before bottoming in December 1998 (Figure 1.4).[5] Although this indicator then improved steadily throughout 1999, actual private investment only showed positive growth from previous low bases, from the June quarter in 1999.[6] The slow recovery in private investment is consistent with the level of capacity utilisation, which at 62.2 per cent in March 2000, remained very subdued. However, by March 2000, the private investment index was 18 per cent above mid 1997 levels (Figure 1.4).

[5] The Bank of Thailand's private investment index is based on an average of several indicators, including imported capital goods, domestic cement consumption and sale of iron sheets.

[6] In the June quarter of 1999, real investment (gross fixed capital expenditure) was 1 per cent higher than in the same quarter a year earlier, but by the December quarter of 1999, it was 12 per cent higher than in the corresponding period a year earlier. Despite this acceleration, in 1999 overall real investment fell 3.7 per cent.

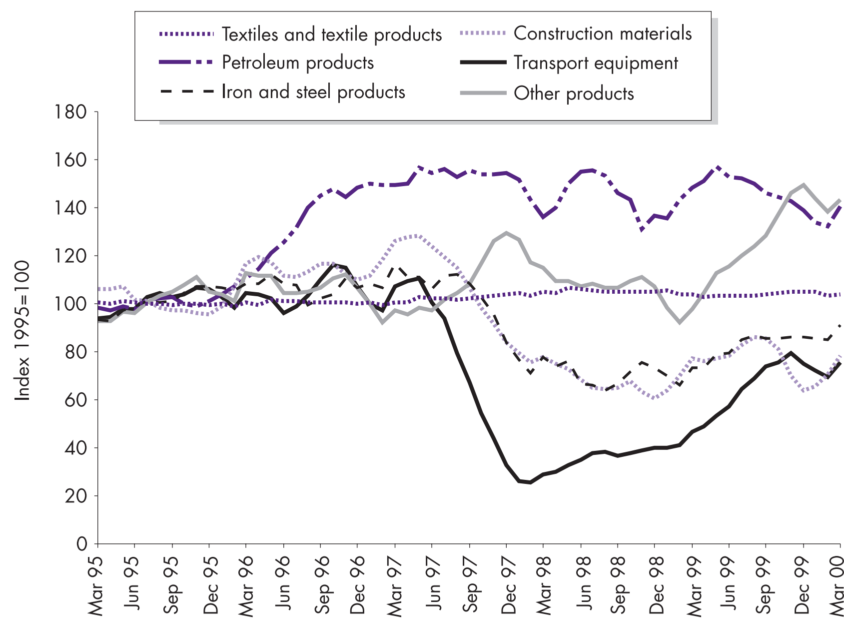
ECONOMIC PROSPECTS AND RISKS IN 2000 AND 2001

While recovery now is underway, sectors are responding at different rates. Export sectors are growing strongly; heavy industry sectors are depressed (Figure 1.5). High vacancy rates mean real estate, construction and construction material sectors will languish during 2000 and possibly longer. Nevertheless, high excess capacity in many sectors means the economy can respond speedily and at relatively low cost to increased domestic and foreign demand.

Figure 1.5

Sectoral Recovery Responses

Manufacturing Production Indexes for Selected Sectors, 1995 to 2000



Source: CEIC, 2000.

Short Term Prospects

In the short term, continuing recovery relies on domestic demand and net exports sustaining their growth. Real GDP is forecast to grow by 5.3 per cent in 2000 and 5.2 per cent in 2001.[7] The Bank of Thailand's May 2000 forecast was only 4.5 per cent, because of the relatively slow pace of economic reforms (*Bangkok Post*, 1 May 2000). The effects of the 1998-99 fiscal stimulus gradually will taper off in 2000, reflecting the more modest planned fiscal deficit in the fiscal year 2000 budget. After 2000, rising debt levels will constrain the Government's ability to provide further stimulus and by 2002, the Government probably will run budget surpluses to wind back public debt.

As recovery gains momentum, and wages start to rise, private consumption spending should continue to grow strongly in 2001 and beyond. Barring new shocks, real private consumption spending should increase by 6.6 per cent in 2000 and 6.1 per cent in 2001 (Table 1.3 and Figure 1.7). Anecdotal indicators such as the reappearance of Bangkok's renowned traffic jams, strong auto sales growth and crowded shopping malls support this view.

Inventory rebuilding also will contribute to growth. In sectors like automotives, inventory to shipment ratios were at historically low levels in early 2000. As economic recovery accelerates and export momentum builds, inventories are likely to return to pre-crisis levels, boosting growth (Table 1.2).

In 2000, analysts expect 10 per cent export growth or higher, faster than in 1999, but below levels achieved in the early 1990s (Consensus Economics, 2000a).[8] In the short term, subdued wages growth, lower asset prices, the baht's competitive exchange rate and increased credit availability will continue to help exporters. Post crisis export competitiveness also improved through reduced protection and lower costs of basic industrial raw materials, but strong vested interests are resisting further tariff cuts in these industries. Electronics exports, especially IT related ones, performed extremely well in 1999, although this volatile market is vulnerable to sudden shifts in global demand.

Imports are recovering strongly; they are expected to grow by nearly 20 per cent in 2000, and over 14 per cent in 2001. While stronger imports technically have a negative impact on growth, they also are a good leading indicator of returning consumer confidence, and industrial output and manufactured export growth.

Mainly due to the fiscal stimulus package and rising capacity utilisation in export oriented industries, private investment is forecast to grow by 7.6 per cent in 2000, from the very low base to which it fell in 1998. This recovery will produce investment's first positive contribution to growth in over two years (Table 1.2). Beyond 2000, as demand rises, banks complete recapitalisation and corporates restructure successfully, private investment spending should grow even more strongly. In 2001, most analysts expect investment to grow by 8.5 per cent (Consensus Economics, 2000a).

....

[7] Private sector analysts' real GDP forecasts range from 4.1 to 6.1 per cent in 2000 and from 4.0 to 6.5 per cent in 2001 (Consensus Economics, 2000a).

[8] Export growth averaged 19 per cent per year during 1991-95.

Table 1.3

Robust Short Term Economic Growth Forecast

Short Term Economic Forecasts, 2000-01

	1999	2000	2001
GDP	4.2	5.3	5.2
Private consumption	3.5	6.6	6.1
Gross fixed investment	-3.7	7.6	8.5
Manufacturing production	12.8	10.7	9.9
Merchandise exports	7.8	10.0	8.3
Merchandise imports	17.9	19.6	14.0
Current account balance (US$ billion)	11.3	7.7	4.9
Consumer prices	0.3	2.5	3.3
Money supply	2.1	8.6	10.0

Source: Consensus Economics, 2000a.

Short Term Risks

Continued recovery must overcome both internal and external short term risks. The principal domestic risks relate to the impact of potential financial sector instability or the declining fiscal stimulus on consumer confidence; potential external risks include reduced Japanese or US growth and Chinese yuan depreciation.

In the immediate future, continued demand recovery will depend on strong growth in consumption and net exports, and continued investment recovery. The key to sustained consumption growth is confidence, which depends ultimately on household income expectations, economic growth and security.

Investment growth is also related to market confidence. If failure to complete corporate debt restructuring and financial sector provisioning undermines market confidence, a falling stock market could threaten new investment and consumer confidence. So far, adjustment in these two areas has been relatively slow and much remains to be done. The quality of debt restructuring is problematic; up to 30 per cent of restructured debts may again become non-performing loans (Norman, 2000). Slow progress in corporate restructuring further hinders local banks, making them unwilling to extend credit because they lack credit worthy borrowers and must satisfy the Bank of Thailand's end of 2000 non-performing loan provisioning requirements. In 2000 and 2001, if more financial institutions fail, this also could destabilise markets, and undermine investor and consumer confidence. Prior commitments to bail out the financial sector and lack of political support could reduce the Government's capacity to offer the guarantees needed to ensure systemic stability.

If Japan's long awaited economic stimulus measures fail to sustain its fledgling recovery, one of Thailand's most important export markets will remain weak. Similarly, continued interest rate rises and downward stock market adjustment in the United States may threaten its seemingly endless boom posing serious problems for Thailand and the global economy. Finally, if the Chinese yuan significantly devalues, Thailand and the region could face depreciation pressures and significant export competitiveness problems. However, in mid 2000, the Chinese economy is recovering as its regional exports rebound and structural reforms bear fruit; the yuan therefore appears likely to remain at its current level in the short to medium term. While Japanese growth potential remains weak, the yen is reasonably strong and stable. The US economy shows continued strength, although recent interest rate rises will cool growth in late 2000 and 2001, and could cause continued stock and currency volatility in East Asia.

Positive Contagion: Short Term Recovery in Indonesia and Malaysia

In 2000, Thailand should benefit from expected recovery in Malaysia and Indonesia, the other South East Asian countries most adversely affected by the crisis. While discussions of the Asian financial crisis often compare Indonesia, Malaysia and Thailand, the differences are as important as the similarities,[9] but by late 1999, all three economies were experiencing short term recovery. In 1999, Malaysia's economy grew 5.4 per cent; Thailand's grew 4.2 per cent; and Indonesia's grew 0.2 per cent (Figure 1.6). Growth rates for 2000 should be more similar, with 6.6 per cent forecast for Malaysia, 5.3 per cent for Thailand and 4.2 per cent for Indonesia (Consensus Economics, 2000a).

Anticipated recovery in Malaysia and Indonesia should benefit Thailand by reinforcing investors' perceptions of the region's reduced risk. However, given the relatively low levels of trade among these economies, higher growth in Indonesia and Malaysia will not stimulate much export demand. If Indonesia were to recover rapidly, it could attract some export-oriented manufacturing investors away from Thailand.

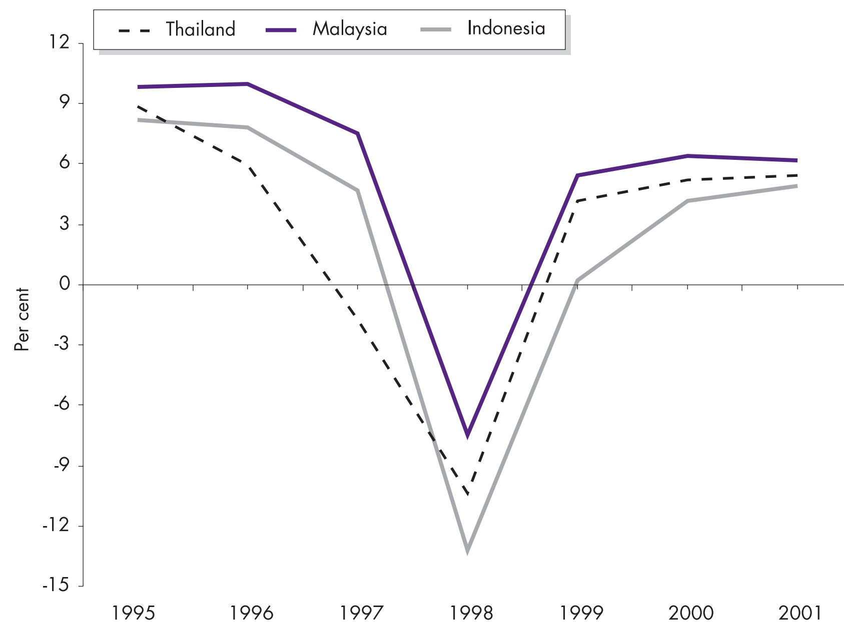
[9] Similarities included a rapid expansion of credit from domestic and foreign sources, inadequate prudential controls to ensure proper financial institution risk management, the prevalence of connected, collateral based lending, and weak corporate governance and risk management. Unlike the other two countries, Malaysia did not build up substantial short term foreign debt before the crisis. While Thailand's short term foreign debts were mostly in the banking system, Indonesia's were spread more widely across the corporate sector. Thailand suffered an export collapse before and in the early stages of the crisis; Indonesia's export performance was more resilient initially, mainly due to oil and mineral exports.

Indonesia's currency collapse was most serious, then Thailand's and Malaysia's was least serious. Indonesia and Thailand freed their exchange rates and sought IMF assistance. Malaysia was less exposed to foreign currency borrowing; hence, it did not need IMF assistance. Malaysia initially allowed the market to determine its exchange rate, but later insulated its foreign exchange market through currency controls and an exchange rate peg, at a somewhat undervalued level. Political upheaval severely exacerbated Indonesia's crisis, while an orderly and peaceful change of government occurred in Thailand. Confidence plummeted in Indonesia far more than in the other two countries, extending beyond creditors and portfolio investors to tourists and foreign buyers of Indonesian export products. Indonesia's economy contracted and its inflation grew far more than Malaysia's or Thailand's.

Figure 1.6

South East Asian Economies Rebound

Forecast and Actual Real GDP Growth, Thailand, Malaysia and Indonesia, 1995 to 2001, Per cent



Source: CEIC, 2000; and Consensus Economics, 2000a.

LONG TERM PROSPECTS AND RISKS

In the 2000s, Thailand is unlikely to return to the growth patterns of the 'Asian miracle' years of the 1980s and early 1990s, at least until major structural reforms are entrenched. By 2001 and beyond, in most sectors, easy growth based on more fully using existing capacity will be exhausted, and medium term growth will depend mainly on new investment and increased productivity.[10]

Improved productivity will require increased education levels, more efficient infrastructure and a more market driven economy open to foreign trade and competition. This will require less government ownership and intervention in resource allocation, a financial system capable of efficiently intermediating Thai savings and a more transparent, efficient and predictable bureaucracy and legal system. If Thailand could achieve these structural reforms, its prospects would be very bright.

....

10 While for some time, Thailand also can grow solidly by drawing more capital and labour into productive uses, as per capita incomes rise and surplus agricultural labour is exhausted, most growth must come from new investment and increased productivity.

From 1981 to 1995, capital accumulation accounted for 61 per cent of GDP growth, labour contributed 22 per cent and total factor productivity growth accounted for 17 per cent of growth (Tinakorn and Sussangkarn, 1998). Export-oriented reforms raised productivity growth in the 1980s considerably above 1970 levels, with productivity growth coming from improved efficiency in major sectors of the economy and the shift of resources from agriculture to industry (Kraipornsak, 1995).

How Foreign Businesses View Reform and Recovery

As a result of major post crisis economic reforms, Thailand's global 2000-04 business environment ranking improved from 28 to 27 out of 60 economies (Table 1.4), while its regional ranking remained at 8, moving above Malaysia and behind the Republic of Korea (Economist Intelligence Unit, 2000).

Thailand's strengthened position in the Economist Intelligence Unit's business environment rankings reflects the recent recovery and sustained improvements forecast over the next five years. The Economist Intelligence Unit anticipates strengthened political institutions will improve policy formulation and implementation. Over the forecast period, the analysis anticipates: GDP should grow steadily at around 5 to 6 per cent; government debt should fall; industry will continue restructuring; the services sector should expand; trade and investment barriers will be reduced; but resistance from vested interests will slow the reform process (Economist Intelligence Unit, 2000).

Table 1.4

Economist Intelligence Unit Upgrades Thailand's Business Ranking

EIU Business Environment Ranking, 2000

	Value of index (out of 10)[a]		Global rank (out of 60 economies)		Regional rank (out of 16 economies)[b]	
	1995-99	2000-04	1995-99	2000-04	1995-99	2000-04
Overall position	6.3	7.2	28	27	8	8
Political environment	6.3	6.5	29	29	9	7
Political stability	7.8	7.3	25	25	6	4
Political effectiveness	5.1	5.9	31	33	9	9
Macroeconomic environment	7.0	8.3	28	25	8	7
Market opportunities	5.3	7.1	34	18	10	8
Policy towards private enterprise and competition	5.2	7.2	38	31	9	7
Policy towards foreign investment	6.6	7.8	31	28	6	5
Foreign trade and exchange controls	7.8	8.9	19	10	7	5
Taxes	7.4	7.8	10	8	6	5
Financing	6.6	7.0	25	34	6	8
Labour market	6.2	6.7	22	30	9	9
Infrastructure	4.4	5.1	39	41	9	9

Note: a Indicators are scored on a scale of 1 (bad for business) to 10 (very good for business).
b Regional economies include Australia, China, Hong Kong, India, Indonesia, Japan. Malaysia, New Zealand, Pakistan, Philippines, Singapore, Republic of Korea, Sri Lanka, Taiwan, Thailand and Vietnam.

Source: Economist Intelligence Unit, 2000.

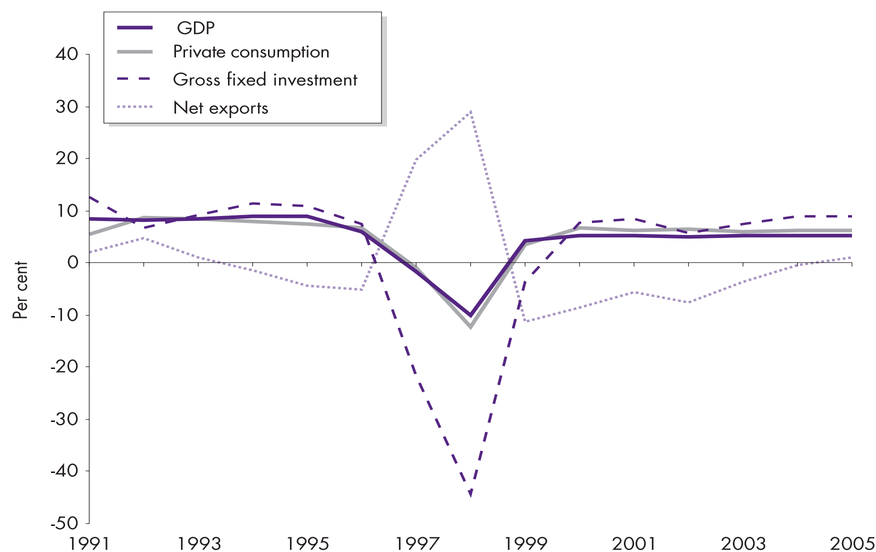
Medium Term Forecasts

While reforms are progressing, often they seem painstakingly slow. Indeed, many influential groups appear to question the efficacy of reforms, particularly increased reliance on globalisation and market forces. If these groups hold sway in 2000 and reform momentum dwindles, Thailand is likely to experience slower growth in the 2000s. If GDP grows at only around 5 per cent, improving living standards and reducing poverty would take much longer than in the 1980s and 1990s. Nevertheless, the Government remains committed to ongoing reforms, and hopefully slower growth will reinforce popular support for more reform.

Figure 1.7

Short to Medium Term Recovery Prospects Improving

Real GDP, Private Consumption and Investment Growth, Actual 1991-99 and Forecast 2000-05, Per cent



Source: CEIC, 2000; Consensus Economics, 2000a; and Economic Intelligence Unit, 2000.

Private sector analysts forecast real GDP growth in 2002-05 at around 5.5 per cent per year.[11] Rising consumer demand, stronger private investment and exports will drive this growth (Figure 1.7). This medium term growth is expected to be significantly lower than in the pre-crisis period (two thirds the rate of the early 1990s), essentially reflecting a modest reform senario. In the absence of more thorough reforms, this slower growth would be more sustainable and reduce the economy's vulnerability to adverse economic shocks (Economist Intelligence Unit, 2000).

[11] For example, Consensus Economics forecast real GDP growth at a steady 5.3 per cent in 2002-05 while the Economist Intelligence Unit forecast growth of 5.3 per cent in 2002 rising to 5.7 per cent by 2004 (Consensus Economics, 2000b; and Economist Intelligence Unit, 2000).

However, if reform were more wide ranging, growth could safely be faster, by up to two percentage points. Slower growth in consumer demand, private investment and net exports will cause lower growth to 2005. Under this lower growth scenario, private consumption is expected to increase by approximately 6 per cent to 2005, compared to 7.5 per cent in the period 1991-96.

Private investment is projected to average by 6.5 per cent growth to 2005, compared to 10 per cent pre-crisis (Figure 1.7). Finally net export growth (export growth minus import growth) is projected to be minus 4 per cent from 2000 to 2005 compared to roughly zero prior to 1996. That is, imports are expected to grow 4 per cent faster than exports, detracting from growth.

Most longer term risks to Thai recovery prospects relate to longstanding internal structural weaknesses, although political and external risks also exist.

Financial and Corporate Sector Risks

Inadequate corporate debt restructuring and bank recapitalisation also represent a long term risk. Progress on the two issues is interdependent and strenuously opposed by many powerful interests. All market participants need a clear and efficient legal framework for the financial system, but drawing up these laws when the system is under great stress and powerful interests are at work has proved difficult.

Emotionally charged debate may lead to second best legal outcomes, and jeopardise fundamental values and attitudes underlying the development of Thailand's debt culture. Too many 'strategic' non-performing loans, public rhetoric about the inherent injustice of foreclosure and bankruptcy, and nationalistic alarm about the dangers of selling out to foreigners all indicate many Thais are unwilling to accept the legal framework needed for financial markets and contracts to work.

How far and long the recovery can proceed without a well functioning banking system is unclear, but probably not beyond the end of 2001. Recapitalising banks and restructuring corporate debts, at best, will be slow. At worst, major setbacks could undermine financial and productive economy recoveries. Superficially rescheduling many debts and inadequately restructuring business in the hope that economic recovery will obviate the need for deeper restructuring could produce a financially fragile and uncompetitive corporate sector. Small and medium sized companies are heavily indebted and particularly vulnerable. A weakened corporate sector may not withstand a tighter future fiscal environment or an economic downturn.

Another key risk is whether the Thai banking sector can move smoothly from the old system of family and group banking to one of diversified share ownership and professional management. In Thailand's traditional business environment, bankers relied on personal trust, connections and inside information to enforce contracts. In future, in a more modern, depersonalised and diversified Thai economy, more objective and arm's length accounting and information systems, and more transparent corporate governance will have to replace trust based on personal relationships. This will not be an easy transition. Greater foreign participation in the banking and corporate sectors, the inevitable result of financial restructuring and reform, and increased use of professional managers, will contribute significantly to achieving this transition.

Developing Modern Institutions

Difficulties in developing the legal, prudential and institutional foundations for a modern financial system risk constraining longer term growth potential. Congress has passed new economic laws, many long overdue, on banking, bankruptcy, foreclosure, privatisation, foreign business and competition. These will become important elements of the legal infrastructure of a modern Thai economy; however, many are untested. Furthermore, Thai courts will face heavy demands from litigation during the recovery process. With so few cases heard so far, many domestic and foreign business people remain unconvinced. Slow progress in reforming outdated bureaucratic systems also threatens the Government's capacity to implement economic reforms in prudential regulation, competition policy and privatisation, also threatening long term stability and growth.

Political Risks

Political opportunities and risks are both short and long term. Short term issues relate to the stability of the governing coalition and the likely results of the 2000 election.[12] The March 2000 Senate election and the Election Commission of Thailand's vigorous challenge to election irregularities, along with the new constitution, indicate Thailand's strong desire and new ability to address the worst elements of corruption and money politics (Economist Intelligence Unit, 2000).[13]

In the medium to long term, an increasingly open political system will provide further stimulus for reform of government processes and decision making. The Thai press is freer than most of its neighbours', and the new constitution significantly increases public access to information. While open debate does not always lead to the best policy choices, it does ensure public scrutiny of power abuses and bad policies. The monarchy has represented a focal point of reverence, respect and stability through many years of political and social change. This is especially strong during times of crisis. King Bhumibol aged 72 years, has presided over the Kingdom for 53 years. The King and other respected political figures want to ensure democratic institutions are sufficiently mature and robust to be an ongoing source of social stability.

....

12 The ruling Democrat-led Government came to power in late 1997 with a small majority; another major political group later enlarged the coalition. Some commentators believe the length and depth of the financial crisis and several domestic scandals may have damaged the Government's reputation, and the Government has failed to promote its reform program during long debates on the basic economic laws (Economist Intelligence Unit, 2000).

Under the new constitution, at the March 2000 Senate election, the Senate became an elected body with 200 seats, down from the 260 seats in the previously appointed body. The next House of Representatives election must be called by November 2000.

13 The commission found serious electoral irregularities, mainly associated with vote buying, warranted fresh elections in 78 out of 200 seats.

Long Term External Risks

The external environment presents Thailand with a range of opportunities and some risks. Thailand's long term international trade growth could decelerate if a new World Trade Organisation, WTO, round of trade liberalisation fails to materialise and this adversely affects world growth prospects. Thailand's many competitors also have learned the lessons of the Asian miracle and the crisis. They have large potential supplies of low cost labour and thus can attract substantial investments in export-oriented, labour intensive manufacturing. Many also are moving rapidly to globalise their economies. Hence, to achieve strong income growth, Thailand must implement the policies necessary to move up the product and productivity ladder, to retain its international competitiveness.

The external environment always will be a source of short term cyclical shocks. However, this is a challenge for macroeconomic policy makers and a small price to pay for the long term gains from trade, investment, technology and know-how transfer in an open economy. The extent Thailand benefits from such opportunities or is harmed by the shocks will depend mainly on domestic actions and policies. The most important risks facing Thailand are internal.

FUTURE COMPETITIVENESS AND REFORM PROSPECTS

As Thailand emerges from the crisis, the Government will have to move from short term crisis management to focus more on basic reforms needed to ensure long term competitiveness and growth. Prospects for these reforms depend on the Government's success in overcoming fiscal, policy formulation and political constraints. Special interest groups and a genuine desire to reduce the social impact of the crisis may delay and even reverse some market oriented reforms. Furthermore, as recovery becomes more secure, reform fatigue and a sense of relief at the end of the crisis could reduce commitment to further reform. Recognising and monitoring key indicators of the Government's reform commitment will help in tracking Thailand's progress.

High levels of public indebtedness will constrain new spending on education and infrastructure, increasing the urgency of taxation reform and infrastructure privatisation.[14] The taxation base could generate approximately double the current tax revenue if effectively enforced (Patpong-pibul, 2000); progress in this area therefore is an essential precondition to improving the quality and quantity of social services and facilities needed to boost Thailand's human resources and economic infrastructure.

A more market oriented economy is essential for improved economic competitiveness. Crisis program reforms including privatisation, administrative reform and further foreign investment and trade liberalisation should improve market orientation. However, reform policy design and implementation has been relatively slow and weak.

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14 Current estimates anticipate public sector debt will rise to 60 per cent of GDP by mid 2000. However, considerable uncertainty remains about these estimates until the full public cost of financial sector bail outs and other restructuring is known. The Government also recently assumed important contingent liabilities connected with the sale of banking assets to foreign buyers.

While privatisation was a priority issue in initial IMF programs, the Government and the IMF saw it as financing financial sector bail outs as much as developing productivity. Many members of the nationalistic public oppose asset sales to foreigners, and state enterprise managers and unions are using their considerable industrial muscle to maintain their state-sanctioned status and privileges. Nevertheless, authorities have achieved some progress in introducing legal and regulatory frameworks, and some electricity and airport asset sales are likely in 2000 and 2001. If privatisations produce benefits for consumers, such sales may reinforce the reform program, producing essential improvements in infrastructure service provision. Key signposts to watch for are the creation of competitive market environments for electricity and telecoms, and sales of some major electricity, telecoms and airport assets, preferably to strategic partners who can boost efficiency. (See Chapter 8 - *Privatisation.*)

Increased foreign direct investment in more sectors also should increase the market orientation of the economy. Increasing foreign presence and tightened prudential standards in the financial sector will be crucial for modernising and improving risk management in this sector. Key indicators of the Government's continued capacity to deliver reform in this sector include further sales of nationalised and state owned banks to strategic investors, opening of insurance to greater foreign ownership and liberal interpretation of the new foreign business law.

In retailing and manufacturing, greater foreign presence also should increase competition and future efficiency. However, vigorous opposition to relaxing the alien business law and the minimal reforms eventually achieved indicate the public do not appreciate fully how competition and globalisation can improve domestic competitiveness, and vested interests remain powerful in using nationalistic sentiment to protect their positions.

While theoretically the Government remains committed to trade reform, in 2000, an election year, short term progress appears stalled. (See Chapter 3 - *Trade.*) Since the onset of the crisis, the Government has reduced tariffs on over 600 items and made good progress on reducing non-tariff barriers. Major signposts to watch for are reductions of the six tariff bands to three and related tariff reductions, previously expected by mid 2000.

The Government began administrative reforms by announcing a gradual reduction in the numbers of civil servants and establishing a new agency to tackle corruption. However, corruption and inefficiency cannot be reduced until civil service salaries are raised closer to private sector levels, administrative systems are streamlined, business regulations are rationalised, and official accountability and promotion on merit are introduced. Some high profile prosecutions of corrupt public officials and private individuals also would be useful. Such reforms and prosecutions would indicate the Government is committed to pursuing administrative reforms and increasing transparency.

Longstanding Reform Priorities

The crisis does not appear to have diverted the Government from addressing other important structural weaknesses, especially human resource development. Average Thai educational attainment, particularly at secondary and higher levels, has fallen behind competitors; this is central to Thailand's inadequate skilled labour supply (Flatters, 1999).[15] However, in 1999, the Government recognised education reform was a pressing issue and introduced a new education law, making 12 years of schooling free and nine years compulsory, three more than previously.[16] Education will be more appropriate to student needs, and loans will allow students to stay at school. The Government should be able to implement this policy because the falling birth rate lowers the number of school enrolments (Rachatatanun, 2000). However, deficiencies in human resource capabilities will take a long time to overcome; they require enormous policy and institutional reforms, and many years for the new generation to participate in and benefit from reformed systems.

The Thai system for mobilising resources for collective needs has fundamental problems; infrastructure deficiencies demonstrate this. The upgrade of Bangkok's transport infrastructure aimed to overcome these difficulties by imaginatively using private market initiatives and funding. However, projects were delayed and costs escalated as politicians and well connected interests sought rents from projects. During the crisis, a major rail and road improvement project was terminated for financial reasons, while decreased traffic jams falsely suggested that problems had diminished. Development of telecoms infrastructure similarly was beset by problems of patronage and rent seeking.

The Thai Government recognises these institutional and implementation weaknesses, and genuinely tries to deal with them. However, the agenda is large, and in Thailand's emerging democracy, decisive action sometimes is difficult to achieve.

Political developments also may constrain future reform prospects. Despite its achievements in turning Thailand around after the crisis, and introducing an ambitious reform agenda in the face of entrenched opposition, the Government faces a tight electoral contest in the lower house elections in 2000.

[15] Early school leaving prevails and education quality is low. Poor school attendance is due to both push and pull factors. During the 1980s and early 1990s boom, job prospects and income levels in rural areas were low and urban employment opportunities for low skilled workers were abundant; young people did not need much education to find employment. Poor quality education results from inappropriate curriculum design, a weak education bureaucracy, low education sector wages and tolerance of vast differences in different social groups' access to education. Higher education is weak in science, engineering and technology.

[16] At present, only 40 per cent of eligible students attend high school, for which fees were charged; however, 25 per cent of the relevant age group are in universities, which are free. The Government recognises this is highly regressive as well as detrimental to building workforce skills (Rachatatanun, 2000).

Summing Up

While Thailand's macroeconomic fundamentals now are recovering relatively well, its long term economic prospects depend on rapidly solving the many corporate, financial sector and legal institution weaknesses the financial crisis exposed. Manufacturing production and exports are rising; the currency is stable; inflation is negligible; unemployment is down; interest rates are at historic lows; and the current account is in surplus. The modest rebound in private investment after two years of decline is particularly encouraging.

Short term growth prospects are very positive, with 5 to 6 per cent real GDP growth expected over the next two years. However, after this technical recovery from a low crisis induced base, the medium term outlook depends on the Government maintaining confidence in the economic recovery and demonstrating its continuing commitment to economic reform to local and foreign investors. Foreign investor confidence would benefit considerably from more rapid progress in completing financial and corporate restructuring. The crisis helped launch major reforms that emphasise enforcing business contracts through modern and transparent laws rather than personal and political connections. This is a difficult process but it has begun. A more open and transparent political system also is evolving. Political conflicts will continue and trade offs between different interests will interfere sometimes with decisive reforms and the adoption of policies needed for long term development. However, more open processes will limit significantly the kinds of abuses common in the past, and eventually should produce a more open, rules based and competitive economy able to generate strong and sustainable growth.

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Chapter 2

AUSTRALIAN BUSINESS OPPORTUNITIES IN THAILAND

Key Points

- Thailand is a very prospective market for Australian exporters. Australian-Thai export growth averaged 19 per cent per year in the decade to 1997, more than twice Australia's average export growth rate. During the crisis, Australia's exports to Thailand fell sharply, but in 1999, exports recovered by 12 per cent and continued to grow strongly in early 2000.
- Strong growth and trade reform enabled Thailand to become Australia's fourteenth largest trading partner in 1999 (up from nineteenth in 1990) and thirteenth largest export market; Australia is Thailand's eleventh largest import supplier.
- Significant Australian export opportunities exist in agrifood products, non-ferrous metals and manufactures, such as automotive parts, medical and pharmaceutical supplies, and machinery and equipment in niche markets.
- Major service export opportunities continue to be in education and tourism, but business, telecommunication, environmental, automotive and IT related service exports also show good prospects.
- Australian foreign direct investment in Thailand is minimal but opportunities exist in manufacturing, the financial sector, retailing and business services, including legal, accounting and debt work outs, and real estate.

STRATEGIC ISSUES FOR AUSTRALIAN COMPANIES

Thailand is an important export market and trading partner, yet most Australian companies still fail to recognise its full market potential. With 62 million people, growing per capita incomes, and trade and investment reform promoting more competition, Thailand is a very prospective market.

Thailand has overcome the worst of its 1997 crisis induced economic problems. Foreign investment opportunities are expanding in manufacturing, finance and retailing and, if privatisation progresses as planned, opportunities should increase in infrastructure. The Government is attempting to improve the business and foreign investment environment and is keen to attract foreign investors. Foreign direct investment increased 84 per cent in 1998 and while it dropped nearly 30 per cent

from this peak in 1999, foreign direct investment achieved a cumulative increase of over US$12 billion in two years. If nationalised bank sales and state enterprise privatisation proceed as expected, foreign investment should continue to grow rapidly over the medium term.

Rapid growth, more open trade and foreign investment policies, and reorientation towards electronics exports transformed Thailand into a major regional trading economy and market in the 1990s.[1] For a decade, import growth averaged 18 per cent per year, with goods and service imports reaching US$83 billion by 1996.[2] However, in 1997 and 1998, goods and service imports nearly halved. In 1999, as the economy recovered, merchandise imports expanded nearly 18 per cent to reach US$47.8 billion. In 2000, import demand could grow by 20 per cent and in the following four years, it could grow by an average of 10 to 14 per cent per year (Consensus Economics, 2000; and Economist Intelligence Unit, 2000).

Over the medium term, demand for imports will depend on Thailand's economic performance and ongoing market opening. Significant reforms since the crisis should enhance growth prospects, but many unresolved structural problems remain, and lower capital inflows could reduce GDP growth by two percentage points to below the levels of the early 1990s. While market opening has reduced trade and investment barriers, by regional standards, these still remain significant.

In 2000, Australia's commercial presence in Thailand is affected significantly by the recent crisis. However, as the Thai economy recovers, and the legislative and regulatory framework is implemented, Australian commercial presence should expand again to take advantage of emerging opportunities.

The following analysis highlights major opportunities and appropriate strategies to access them. It assesses strategic issues and challenges for Australian businesses entering the Thai market, and analyses major developments in Australia's trade and investment with Thailand.

TRADE PROSPECTS AND OPPORTUNITIES

New merchandise and service opportunities for Australian exporters to Thailand are emerging since the crisis. While Australian exports to Thailand fell by 22 per cent in 1998, they rebounded by 12 per cent in 1999, reflecting improving domestic demand as the recovery strengthened. Greater market access, particularly for agricultural products, better progress in corporate and financial restructuring, and ongoing privatisation efforts are producing new goods and services trade opportunities.

[1] Thailand's ratio of goods and service imports to gross domestic product, GDP, at current prices increased continuously from 34 per cent in 1988 to 46 per cent in 1996.

[2] Merchandise imports were US$71 billion.

AUSTRALIAN BUSINESS COMMUNITY PUTS THAILAND FIRST

Despite the financial crisis, Australian business sees Thailand, along with Malaysia, as the country with the most commercial opportunities in South East Asia, according to a 2000 survey by ASEAN Focus Group. Furthermore, nearly 60 per cent of survey respondents believed Thailand was over the crisis. This positive view of Thailand exists despite the crisis adversely affecting half the respondents. In South East Asia, after Malaysia and Thailand, respondents rated the Philippines, Indonesia and Vietnam as attractive commercial targets.

The international consulting firm undertook the survey in early 2000 to establish Australian business community perceptions of commercial opportunities in Thailand following the financial crisis.[3] Over 93 per cent of respondents indicated they were willing to consider business opportunities in and with Thailand; a high proportion of medium to large size companies responded. Their relative size should enable them to undertake real commercial activity.

However, most respondents still identified Thai bureaucratic shortcomings as business impediments. Other problems concerned difficulties in the marketplace and lack of working capital in local Thai companies. However, few companies were sufficiently dissuaded to reject Thailand as a business partner or investment destination.

ASEAN Focus Group provides advice and assistance to companies seeking to establish or enhance their commercial presence in Asia. The Sydney based company frequently undertakes projects on behalf of the global business community and South East Asian governments.

Source: ASEAN Focus Group, 2000.

Australian Export Prospects since the Crisis

Since mid 1999, Australian exports to Thailand have achieved a broad based recovery. From January to June 1999, Australia's exports grew just 4 per cent compared with the same period in 1998, but in the second half of 1999, they grew by a strong 20 per cent. Exports of energy, minerals and elaborately transformed manufactures, ETMs, recovered particularly strongly; ETM exports grew 43 per cent in 1999 following their 50 per cent collapse in 1998 (Table 2.1).[4]

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3 ASEAN Focus Group sent surveys to 1 500 Australian companies with some linkages to Asia. The survey response rate was 10 per cent which will impart some bias to the results.

4 Strong growth in exports of automotives and parts, machinery and telecoms equipment drove the recovery.

Table 2.1

Energy, Mineral and ETM Exports Growing Strongly

Composition of Australia's Merchandise Exports to Thailand, 1988-99[a]

	1988 A$ million	1997 A$ million	1998 A$ million	1999 A$ million	Trend growth 1988-97 per cent	Growth 1998 per cent	Growth 1999 per cent	Export share 1999 per cent
Primary products	**108**	**580**	**501**	**572**	**18**	**-14**	**14**	**40**
Unprocessed food	14	23	19	21	0	-19	13	1
Processed food	32	168	181	185	22	8	3	13
Other agricultural	43	184	241	263	18	32	8	19
Minerals	4	46	46	71	38	0	55	5
Fuels	15	159	14	32	16	-91	126	2
Manufactures	**256**	**798**	**521**	**615**	**15**	**-35**	**18**	**43**
Simply transformed manufactures	170	345	293	290	9	-15	-1	20
Elaborately transformed manufactures	86	453	228	325	23	-50	43	22
Other (including confidential)[b]	**23**	**273**	**259**	**253**	**39**	**-5**	**-2**	**17**
Total exports	**386**	**1 651**	**1 281**	**1 440**	**19**	**-22**	**12**	**100**

Note: a Based on the Trade Export Classification, TREC, using 3 digit Standard International Trade Classification Revision 3, SITCR3, data.

b Confidential items exported to Thailand included US$70 million (A$117 million) of cereals and cereal preparations in 1998, according to Thai Customs statistics. In 1999, the exchange rate averaged US$1:A$0.6453.

Source: Department of Foreign Affairs and Trade, 2000a.

Thailand's financial crisis severely affected Australian exports of ETMs and non-agricultural resources, particularly petroleum products and non-ferrous metals including aluminium, copper, lead and zinc. However, during the crisis, food and other key agricultural commodities performed well (Table 2.1). For example, while total Australian exports to Thailand fell by 22 per cent in 1998, exports of processed food grew by 8 per cent and other agricultural commodities, principally cotton, grew by 32 per cent. These exports expanded further in 1999 but weakened in the first quarter of 2000.[5]

The Thai economy should grow by over 5 per cent in 2000 (Table 1.2 and Figure 1.7). Consequently, Australian exports also should grow strongly, achieving levels closer to their long term trend (Figure 2.1).[6]

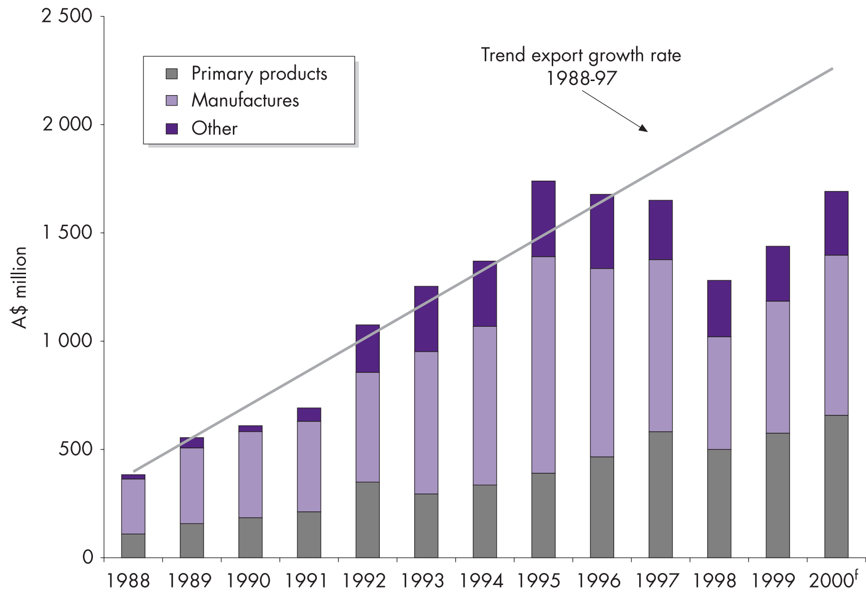
[5] In the first quarter of 2000, Australia's merchandise exports to Thailand grew 26 per cent on the same quarter a year earlier. While food and other agricultural exports fell by 7 per cent, manufactures exports rose by 43 per cent.

[6] However, even if Australia's exports grew by a strong 20 per cent in 2000, export values still would be A$600 million (or 25 per cent) below their long term trend level.

Figure 2.1

Exports Start to Recover in 1999

Australia's Merchandise Exports to Thailand, Actual and Forecast, A$ (million)



Note: f Indicates forecast, based on Thai import growth of 20 per cent in 2000.
Source: Department of Foreign Affairs and Trade, 2000a; and Consensus Economics, 2000.

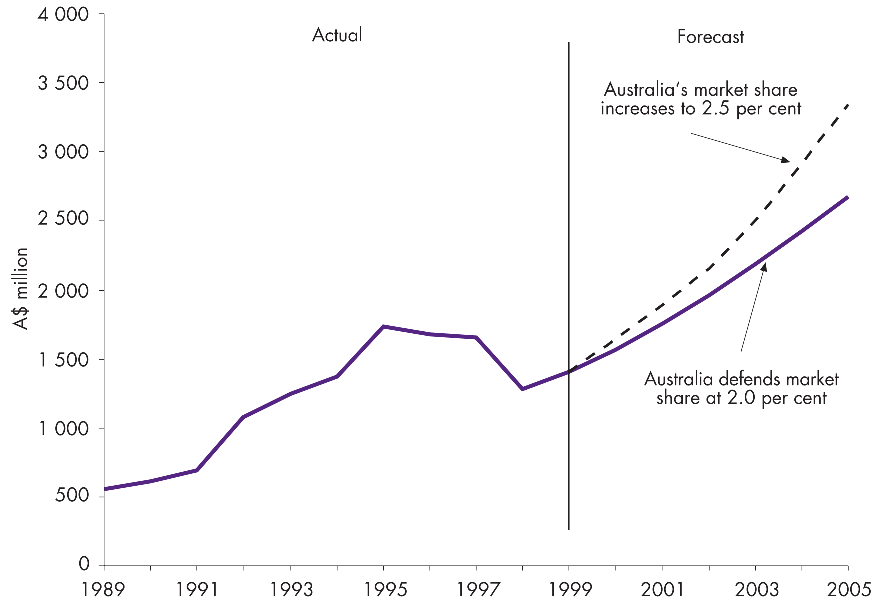
Opportunities for Australian goods and service exports should expand significantly as the Thai economic recovery continues. (See Chapter 1 - *Economic Prospects*.) Thai exports are recovering; real purchasing power is growing; fixed investment is picking up; consumer demand is more buoyant; and businesses are rebuilding stocks. In the March quarter of 2000, industrial production was 9 per cent higher than in the same quarter of 1998, and followed an increase of 17 per cent in the December quarter of 1999. In the March quarter of 2000, retail sales were 5 per cent more than in the same quarter in 1999. Combined with a rebuilding of consumer goods and producer input stocks, this growth will drive solid demand for imports (Figure 3.2) which should grow around 20 per cent in 2000 and around 15 per cent in 2001.

Consequently, Australia's future export performance in the Thai market depends mainly on Australian exporters reacting promptly to opportunities and the Australian dollar exchange rate remaining competitive. Assuming Australia maintains its market share and the overall share of imports in Thai markets slowly increases with trade liberalisation, Australia's exports to Thailand could grow from A$1.4 billion in 1999 to over A$2.5 billion by 2005, a trend growth rate of 10 per cent per year. If Australia manages to increase its market share by a modest half a percentage point to 2.5 per cent over the period, Australia's exports in 2005 could approach A$3.5 billion, with the trend export growth rate rising to 15 per cent per year (Figure 2.2).

Figure 2.2

Australian Exports to Thailand Could Exceed A$2.5 billion by 2005

Forecasts of Australian Exports, 2000-05



Note: Forecast assumes that Thailand's real GDP grows by 5 per cent per year in 2000-05, that Thailand's import penetration ratio (merchandise imports to GDP) rises to 43 per cent by the end of the period, that Australia maintains its average 1996-98 share of the import market (2.0 per cent) in the first scenario and Australia's market share gradually rises to 2.5 per cent over the period, in the second scenario, and that the exchange rate remains constant (around Baht 25:A$1).

Source: Department of Foreign Affairs and Trade, 2000a; and East Asia Analytical Unit estimates.

As the Thai recovery strengthens, Australian exporters will find good trade opportunities in:[7]

- unprocessed and processed food, and other agricultural products
- simply transformed manufactures, including metal alloys
- ETMs including automotive components, medical equipment and pharmaceutical products
- services including
    - business services
    - information technology, IT related services
    - automotive related services
    - tourism and education services
    - environmental services
    - transport, energy and telecommunication services.

These opportunities are detailed below.

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[7] This section draws on unpublished Austrade reports and the Department of Foreign Affairs and Trade's *1999 Trade Outcomes and Objectives Statement*.

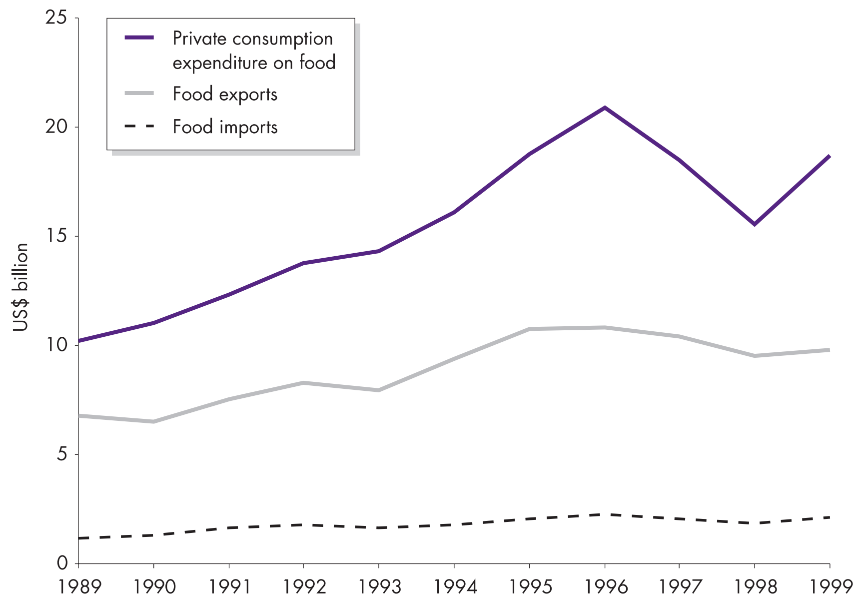
FOOD AND OTHER AGRICULTURAL PRODUCTS

Thailand is not only an important processed food exporter, but also a moderate agricultural importer. Domestic consumption of food and other agricultural products reached about US$21 billion in 1996, but the financial crisis and the baht's depreciation reduced this market to US$16 billion in 1998 (Figure 2.3). Until 1997, food and other agricultural product imports grew at a trend rate of 8 per cent per year, reaching US$5 billion by 1997. Growth weakened during the crisis, but by 1999, the total market for food and other agricultural imports was recovering to pre-crisis levels (Figure 2.3 and Table 2.2).[8]

Figure 2.3

Thailand's Food Consumption Recovers

Thailand's Food Consumption, Exports and Imports, 1990-99, US$ (billion)



Note: 1999 private food consumption expenditure is estimated.
Source: CEIC, 2000.

[8] In 1999, agriculture and agriculture related activities generated 10 per cent of Thailand's export revenue, employed around 50 per cent of the workforce and contributed 11 per cent to GDP. Thus, while manufacturing dominates, the food and agricultural sector is very important to the country's economic health.

Table 2.2

Imports from Australia Exceed World Trend Growth Rates

Thai Imports of Selected Food and Agricultural Products from Australia and the World[a]

	Import trend growth from Australia[c] 1989-97 per cent	Import trend growth from the world[c] 1989-97 per cent	Imports from Australia[b] 1997 A$ million	1998 A$ million	1999[e] A$ million	Imports from the world[c] 1999[e] US$ million[i]	Australian market share[d] 1999[e] per cent
Food[g]	**16**	**8**	**194**	**202**	**210**	**2 200**	**7**
Dairy products	17	15	127	128	128	300	27
Cereals and preparations[f]	22	17	11	27 (60)	27 (56)	240 (60)	20
Fruit and vegetables	39	18	14	9	10	150	3
Non-food agriculture[h]	**13**	**9**	**184**	**242**	**262**	**3 000**	**8**
Cotton	16	3	96	173	188	250	40
Wool	9	10	76	52	50	57	80
Total food and other agriculture	**16**	**8**	**376**	**443**	**470**	**5 200**	**8**

Note: a Based on the Trade Export Classification, TREC, using 3 digit Standard International Trade Classification Revision 3, SITCR3, data.

b Based on Australian exports to Thailand.

c Thailand's imports from the world using UN SITCR3 (US dollar) data.

d Trend growth and market share calculated from UN SITCR3 (US dollar) data. Data for 1999 are estimates.

e Estimate.

f Figures in brackets include an estimate for Australian wheat exports to Thailand which are confidential in Australian data.

g Food includes unprocessed and processed food (TREC classifications 111 and 121).

h Non-food agriculture includes textile fibres, wood, hides, skins and other crude materials (TREC classifications 114 and 124).

i In 1999, the exchange rate averaged US$1:A$0.6453.

Source: Department of Foreign Affairs and Trade, 2000a; and CIEC, 2000.

Australia's Market Position

In 1999, Thailand was Australia's thirteenth largest market for food and agricultural exports, and Australia was Thailand's third largest supplier of these commodities, after the United States and Malaysia. Over the decade 1989-99, Australia's food and agricultural exports to Thailand grew from A$124 million to A$470 million, and Australia's market share rose from about 4 per cent to 7 per cent. Bulk commodities such as cotton, wool and cereals comprise nearly two thirds of Australian agricultural exports to Thailand, with cotton exports almost doubling from 1997 to reach A$188 million in 1999 (Table 2.2).

CHANGING THAI BUSINESS CULTURE

Some Australian business people see Thailand as a difficult market. Despite greater democratisation, economic reform and recovery, they believe the business environment continues to be non-transparent and biased against foreigners. As elsewhere in Asia, an unhelpful bureaucracy and a closed and close local business network devoted to protecting its interests can hamper and frustrate foreign businesses. However, economic and public sector reforms, government attempts to strengthen and simplify the legal and regulatory regime, and gradual trade and investment liberalisation are changing many of these practices, albeit slowly.

To succeed in Thailand, Australian businesses could consider:

- studying thoroughly the potential business area, including by hiring consultants to monitor and report on opportunities and recent developments, and explain market dynamics and structure
- taking time to build relationships, trust and loyalty with Thai counterparts to create win-win or compromise solutions; business acumen often is judged by participants' ability to negotiate and reach a fair deal
- being aware of potential problems, including possible undisclosed debts in Thai companies seeking foreign partners; legislative hurdles and lack of transparency in the Thai market can test new entrants
- seeking competitive advantage through effective company structuring, and frequently examining business strategies to ensure they promote company profitability by leveraging off regulatory and marketplace changes
- ensuring local representatives are sufficiently senior to secure high level access and make final decisions; Thais observe hierarchy and become frustrated if they perceive they are dealing with someone too junior to follow through
- seeking allies to capture higher value-added and profitable business activities
- leveraging links with multinationals in Thailand and home markets to capture new opportunities
- maintaining strong links with government bodies and trade associations responsible for imports and regulations
- taking time to investigate hidden costs and allowing a 10 to 15 per cent contingency factor in every budget for unexpected problems
- developing realistic business growth strategies and taking a medium to long term view.

Taking a medium to long term view is particularly important. Since the crisis, many Australian companies have restructured their operations and downsized. A few have left the market; this may prove costly in the long term. Others, interested in investing, still are observing developments and have yet to commit themselves; and some, interested in taking advantage of asset sales, actively are investigating opportunities to enter the Thai market.

Source: Department of Foreign Affairs and Trade, 2000b; and Austrade, 2000.

Opportunities for Australia

Strong food and agricultural product demand recovery in 1999 is good news for Australian exporters of these commodities. If food import growth recovers to pre-crisis trends, the total import market for food and other agricultural products possibly could exceed US$8 billion by 2005.[9]

While Australian exports of bulk commodities will remain important, demand for consumer-ready food products continues to grow as Thai incomes rise. As a result, Australian exports to Thailand of dairy products, fruit and vegetables, other processed foods and beverages are increasing rapidly, albeit from a low base. Australian exporters are expanding their share in this extremely competitive market. During the decade 1987-97, Thai food imports from Australia grew twice as fast as imports from the rest of the world (Table 2.2).

Snack foods, health food and health care beverages, frozen foods, chilled and frozen seafood, 'ready to cook' food, citrus and fresh stone fruits and quality niche products all are areas where Australian suppliers could increase market share. Australia already supplies chilled and frozen seafood, and high quality, competitively priced Australian meat is increasingly popular for food processing.[10] With consumers becoming more sophisticated, the wine market also is growing, albeit from a low base.[11]

In addition, Thailand is becoming a food processing centre, exporting to neighbouring countries and Europe. Strong growth in the UHT and liquid milk sectors provides significant potential for Australian investment.[12] The Thai Government offers attractive investment incentives to foreign investors planning to establish food processing plants, particularly for export. (See Chapter 4 - *Foreign Investment*.)

Constraints on Agricultural Imports

Despite good consumer demand growth, restrictions on agricultural product imports, particularly processed foods and beverages, continue to limit trade. Thailand has one of the most protected agrifood sectors in ASEAN, with tariffs of 30 per cent and above for many agrifood products, strict labelling and other controls, quarantine restrictions, and outright bans on some food imports. High tariffs on luxury items, including fruit and dairy products discourage trade in a market with otherwise strong potential for Australian business. Tariffs range from 45 to 50 per cent on citrus fruits, 45 per cent on pears, 50 per cent on mangoes, and 5 to 45 per cent on dairy products. (See Chapter 3 - *Trade*.)

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9 Assumes 2000-05 import demand for food and other agricultural products will grow at the 1989-97 trend rate of 8 per cent per year.

10 In 1999, Australia exported A$4.5 million of meat to Thailand, around 40 per cent of total Thai meat imports.

11 Australia's 1999 wine exports to Thailand were A$2.5 million.

12 Market prospects appear to be brightest for drinking yoghurts and ice cream, with the market growing 25 per cent per year. Re-export of dairy products to Burma, Cambodia, Vietnam and Laos is increasing.

Australia seeks improved market access for these and other agricultural products, and in 1998 and 1999, the Thai Government reduced several obstructive tariffs. These included reduced tariffs on lupins (from 35 to 5 per cent), cheese (from 45 to 30 per cent) and cotton (from 5 to 0 per cent). However, in the wine market, tariffs and taxes can more than quadruple the landed price of wine, limiting trade opportunities.

Food and drug administration approval processes are very lengthy, significantly hampering trade. Pre-market clearance for food exported from Australia can take up to three years. Even tiny changes in a product label can take six months to approve. (See Chapter 3 - *Trade.*)

EMERGING OPPORTUNITIES FOR MANUFACTURED EXPORTS

Government policies promoting Thailand as an ASEAN regional manufacturing hub and rising consumer incomes generate opportunities for Australian manufactured exporters. Analysts consider policies promoting regional hubs for automotive, electronics and aviation industries are viable given Thailand's strategic position within the region, and its natural and human resource endowments (US State Department, 1999). However, continued trade and investment reforms are necessary to progress these plans. Australian component and equipment suppliers, such as Bendix, consultants and trainers, already have realised benefits from this policy.

In 1999, Australia's manufactured exports to Thailand, valued at A$615 million, comprised simply transformed manufactures, STMs, dominated by non-ferrous metals, and a diverse range of elaborately transformed manufactures, ETMs.

Simply Transformed Manufactures

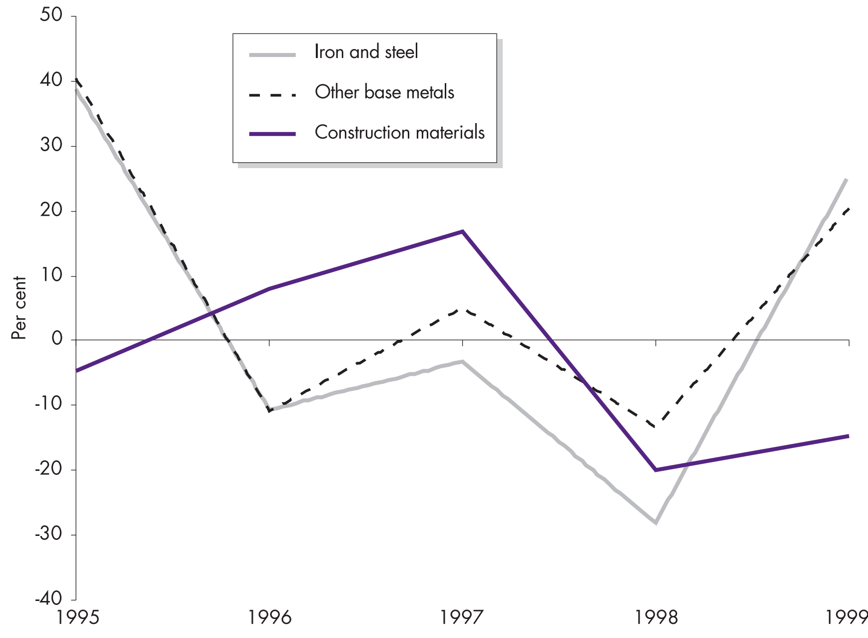
Thailand's financial crisis seriously eroded Australia's exports of STMs, which mainly supplied the construction and fabrication sectors; these exports fell by 13 per cent in 1997, fell a further 15 per cent in 1998 and remained relatively flat in 1999 (Table 2.1). Analysts estimate major problems including high indebtedness, construction industry over capacity and excessive real estate stocks could take five to seven years to resolve (*Bangkok Post,* 1999a).[13] In 1999, overall Thai construction sector imports continued to decline, although at a lower rate (Figure 2.4). However, export-oriented industry and housing should offer new opportunities as the economic recovery gathers momentum. In the medium term, improved household financial services including for mortgages, spurred by foreign bank competition, should increase housing demand. Thai tariffs on most raw materials are low and do not constrain trade. Since the crisis, the Government has cut further some construction raw material tariffs, but as many of these already were low, this is unlikely to boost significantly construction sector demand.

[13] The housing sector continues to struggle to clear inventories. The Government Housing Bank estimated 330 000 houses or units in Bangkok were unoccupied at the end of 1999 (*Bangkok Post*, 1999a). Although vacancy rates fell slightly, they remained high at 40 per cent in 1999. As a result, little new office space is likely to be built for at least two years.

Figure 2.4

Construction Material Import Growth Still Negative

Growth of Construction Material and Base Metal Imports, 1995-99, Per cent



Source: CEIC, 2000.

Elaborately Transformed Manufactures

Pre-crisis, Australian ETM exports to Thailand grew significantly faster than the world average, and assuming the Australian dollar continues to be competitive, they should maintain this performance in the short to medium term. Before the crisis, Australian ETM exports grew by over 20 per cent per year, reaching A$453 million in 1997. Exports of automotives and parts, telecommunications equipment, medicinal products and paints grew fastest. The crisis halved Australia's exports of ETMs in 1998, as Thai demand collapsed. However, strong economic recovery in 1999 helped Australia's ETM exports to recover a large part of that loss, reaching A$325 million (Table 2.3).

Table 2.3

Australian ETM Exports Performed Well

Thailand's Imports of ETMs[a]

	Trend growth imports from Australia[c] 1989-97 per cent	Trend growth imports from the world[c] 1989-97 per cent	Imports from Australia[b] 1997 A$ million	1998 A$ million	1999[e] A$ million	Imports from the world[c] 1999[e] US$ million[f]	Australian market share[d] 1999[e] per cent
Telecommunications equipment	42	16	13	9	13	2 200	0.5
Electrical equipment	29	24	53	17	12	8 500	na
Office machines	10	18	7	9	11	3 000	na
Automotive products	37	10	20	9	36	1 300	2.0
Medicines and pharmaceuticals	32	15	45	33	48	500	6.0
Pigments, paints and varnishes	18	11	25	16	26	380	5.0
Total elaborately transformed manufactures	**21**	**16**	**453**	**228**	**326**	**32 000**	**0.7**

Note: a Based on the Trade Export Classification, TREC, using 3 digit Standard International Trade Classification Revision 3, SITCR3, data.
b Based on Australian exports to Thailand using 3 digit SITCR3 data.
c Thailand's imports from the world used UN SITCR3 (US dollar) data.
d Trend growth and market share calculated from UN SITCR3 (US dollar) data.
e Estimate.
f In 1999, the exchange rate averaged US$1:A$0.6453.

Source: Department of Foreign Affairs and Trade, 2000a.

Automotive products

Australia has a small share of the Thai automotive products market; however, further significant opportunities exist to increase this share. In this competitive market, Australian exports of automotives and parts tripled in 1999, reaching A$36 million, a return to 1996 levels. Overall, Thailand's imports of automotives and parts more than doubled to US$1.3 billion in 1999, while its exports of completely built-up vehicles and parts jumped by 80 per cent to US$1.5 billion.[14] Potential for further bilateral trade growth is strong, particularly through Australian joint venture manufacturing in Thailand, supplemented by exports from Australia to supply the large Japanese, European and American car plants located in Thailand. Many international companies established in Thailand, such as Toyota, General Motors and Mitsubishi also are present in Australia.

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[14] The major exporters include Mitsubishi (48.5 per cent of shipments), AutoAlliance Thailand (a new Ford Mazda venture – 34 per cent) and Toyota (9.7 per cent). Other exporters included Honda, Isuzu, Nissan Diesel, Hino, Siam Nissan and Thai Swedish (*The Nation*, 2 February 2000).

Thailand's automotive industry expanded rapidly recently; now 15 assembly plants can produce over one million vehicles per year. While the financial crisis sharply reduced domestic demand, it did not diminish Thailand's fundamental strengths in becoming a regional automotive and parts manufacturing and export centre.

The Thai automotive industry regards Australia as having a strong automotive industry, with advanced technology that can manufacture low volumes to quality levels equivalent to suppliers in Europe and the United States. The similarity in production scale and increasing globalisation of the Australian industry also make Australia a natural partner for Thailand's automotive industry. In addition, the removal of Thai local content provisions in early 2000 provides an opportunity for Thai manufacturers to increase the level of Australian content in Thai vehicles.

NO BRAKES ON BENDIX'S THAI INVESTMENT

As Thailand emerges as a regional automotive manufacturing hub, Bendix, Australia's leading manufacturer and supplier of automotive and industrial brakes, is expanding its Thai operations. At the peak of the crisis, Bendix (Thailand), a wholly owned subsidiary of Victorian based Bendix Mintex Pacific, invested Baht 270 million (A$7 million) in a new manufacturing plant in Rayong, Thailand. The plant, producing brake linings for passenger cars and small trucks, opened in September 1998. Already, it exports more than 20 per cent of its production, mainly to South East Asian markets. This should rise to 30 per cent by the end of 2000.

Furthermore, Bendix (Thailand) has broken domestic sale records, increased production levels and improved productivity by investing a further Baht 20 million (A$5 million) in its distribution system (warehousing, logistics and customer service). Its new system allows for direct selling to domestic buyers rather than distributing to intermediaries who then on-sell. This new strategy is proving highly successful in the Thai market.

Bendix (Thailand) uses strategic alliances with local Thai firms to maximise local content and leverage costs and efficiencies. While it is cooperating with local Thai-foreign joint ventures (the original equipment manufacturers) on an intense localisation program, it also is building on successful and solid business partnerships established in Australia with AAT, General Motors Holden, BMW and Toyota.

Source: Bendix (Thailand), 2000.

Medical and pharmaceutical products

Demand for health services and pharmaceuticals is increasing with population growth and rising per capita incomes, presenting opportunities for Australian suppliers. Thailand's affluent and growing middle class expects better quality health care. The number of private hospitals is expanding, as is the market for health and beauty care services (Ministry of Commerce, 1999).[15]

Thai public and private hospitals import over 90 per cent of their medical equipment purchases, valued at around US$250 million in 1999. While US companies supply most surgical appliances and electro-medical equipment, and Japanese firms provide most disposable medical products, the hospital sector still offers opportunities for competitive Australian medical equipment exporters.

In addition, importers play a major role in the large, highly developed pharmaceutical industry. Most pharmaceuticals, around US$500 million in 1999, are imported either as ready-for-sale items or raw materials for processing in Thai facilities. The high proportion of imported pharmaceuticals makes the market very attractive to foreign suppliers, so competition is intense. However, from a low base, Australia's share of Thai medicinal and pharmaceutical imports has jumped, and strong export growth should continue (Table 2.3).

IT products and equipment

Thailand's IT sector is growing strongly, and Australian companies have achieved ready acceptance for new IT products in Thailand. Australian companies such as Mincom are winning computer system and technology contracts in niche markets. International Data Corporation Thailand estimates the total annual value of the Thai IT market at almost US$800 million. This thriving market, combined with recent tariff reductions offers new opportunities for Australian IT suppliers. In 1999, hardware purchases, including personal computers, servers, storage devices and peripherals accounted for about 60 per cent of total IT spending. Software accounted for 17 per cent of the market, followed by networking devices with 12 per cent and IT services with 11 per cent (*Bangkok Post*, 1999b). In 1999, as part of its World Trade Organisation Information Technology Agreement commitment, the Thai Government lowered tariffs on 153 IT products. This will help IT equipment exporters enter the market. Rapidly expanding Internet use also is spawning new opportunities for foreign equipment and software.

Constraints on Manufactured Exports

While tariffs will continue to fall as the Thai Government undertakes further tariff reform, many elaborately transformed manufacturers, including automotives and parts, face high tariffs which inhibit trade. For example, while the average industrial tariff declined from 23 to about 17 per cent between 1995 and 1999, tariffs on passenger vehicles and clothing increased significantly with some components' tariffs raised to 80 per cent. (See Chapter 3 - *Trade*.) The Australian Government continues to lobby to reduce tariffs on these imports, with some recent successes.

[15] Thailand has 491 private hospitals. The industry generates about US$25 million from foreign patients and is expanding by 14 per cent per year (Ministry of Commerce, 1999).

MAJOR SERVICE EXPORT OPPORTUNITIES

Service exports, principally tourism, freight and education, account for over 30 per cent of Australia's total goods and service exports to Thailand. Australia also has a small share of the professional services market. Opportunities for expansion of these service exports are good.

Service Sector

The service sector accounts for nearly half of Thailand's GDP, and before the financial crisis, it was growing at 11 per cent per year in real terms. In 1999, services recovered strongly in line with overall economic expansion. Retail and wholesale trade grew by 5.4 per cent, while the transport and distribution industry expanded by 4.4 per cent.

Business services

As a result of accelerating financial and corporate restructuring, Thai financial institutions, businesses and government ministries have boosted their demand for business services, including accountancy, legal, mergers and acquisitions, distressed property management, auditing, insolvency and due diligence services. The financial sector also provides an expanding market with opportunities in risk management, payment systems, financial monitoring and disaster recovery systems, and consultancy advice (East Asia Analytical Unit, 1999). Many major multinational and some large Thai financial, accounting and legal companies already use Australian staff and expertise. However, professional service exports could expand significantly, as Australia is a highly competitive supplier of these services.

The foreign business law and alien occupation law limit foreign participation in accountancy, law, architecture, engineering and related services. However, foreigners can participate in these sectors through joint ventures, including holding majority equity, providing they obtain appropriate approval. (See Chapter 4 - *Foreign Investment*.) For example, the world's five largest accounting firms are very active in Thailand through joint ventures.

FERRIER HODGSON HELPS RESTRUCTURE THAI DEBTS

Australian firm, Ferrier Hodgson plays a major role in helping Thai corporates restructure and recover from the crisis. This Australian firm has the lead role in assisting shareholders in Thai Petrochemical Industry, TPI, Thailand's biggest insolvent corporate, restructure TPI's US$3.5 billion debt.[16]

Since opening its Bangkok office in 1997, Ferrier Hodgson has helped restructure financial debts totaling more than US$8 billion, and has acted for major creditors, debtors and shareholders in the cement, construction and development, finance, manufacturing, petrochemical, property and telecommunication sectors.

Furthermore, both the World Bank and Bank of Thailand frequently use Ferrier Hodgson to arrange training modules for Thai banks, financial institutions and financial advisory firms, covering specialist debt restructuring and related topics. The firm provides professional advice on reconciling different banks' objectives and convincing debtors to be serious about solving their funding problems.

As Thai financial restructuring accelerates, further legal reforms are implemented and recognition increases that financial restructuring advice is a legitimate, necessary and value-added service, opportunities for foreign expertise are expanding. With four Asian offices employing 100 staff (45 of these in Bangkok), Ferrier Hodgson is well placed to be part of this process.

Source: Ferrier Hodgson (Thailand), 2000.

Financial services

The Thai financial services sector, particularly banking, finance companies, securities firms and joint venture insurance, has opened up to foreign participation since the crisis. Although due diligence obviously is essential, mergers and acquisition opportunities exist for larger Australian financial institutions. Many opportunities also are developing for smaller more targeted joint ventures, management agreements, and service and systems exports leveraged off specific technological, financial and managerial expertise (East Asia Analytical Unit, 1999).

[16] In this benchmark case, the Central Bankruptcy Court declared Thailand's biggest corporate bankrupt in April 2000, and creditors appointed a subsidiary of Ferrier Hodgson as planner for the debt restructuring.

AUSTRALIAN INSURERS ASSIST IN SETTING STANDARDS IN THE THAI MARKET

Thailand's insurance market is underdeveloped. Only 12 per cent of Thais have life insurance, but as incomes rise, this will change dramatically. While the range of products is widening, and competition between insurers is strong, the regulatory regime is not always conducive to the development of a dynamic market. At a time when Australian firms are exploring this potential, the weak solvency position of some industry players has opened opportunities for foreigners to participate in joint venture arrangements. The Thai Cabinet recently approved relaxing the limits on foreign equity participation in insurance from 25 to 49 per cent, but this still awaits parliamentary approval.

QBE Insurance (Thailand) is the oldest Australian joint venture insurer in Thailand, starting operations in 1989. More recently, Colonial entered a joint venture life insurance company with the Bank of Ayudhya family of companies in 1995. (See separate box in Chapter 6.) In 1997, AXA entered into a joint venture with the Krung Thai Bank. QBE offers personal, commercial and large industrial risk insurance; Colonial and AXA offer family protection, retirement planning, investment and savings plans, employee benefits and health care insurance. In 1998, HIH bought a 24.5 per cent share in Nam Seng Insurance, a large Thai automotive insurer, while NRMA bought an 18.4 per cent interest in Safety Insurance.

The Australian Government is supporting measures to enhance the regulatory regime in the Thai life insurance industry. It is collaborating with Australian insurers and Thai regulators in this process. For example, in 1999, Australian insurance companies involved in the region and the Australian Government jointly funded a symposium on regional life insurance regulation to improve regulators' knowledge of recent developments in the industry and of the world's best practices. This was followed by a two week intensive training workshop in Melbourne in March 2000, in which senior and middle ranking regulators from the region's life insurance agencies, including from Thailand, participated.

Source: Colonial, 2000; AXA, 1999; Australian-Thai Chamber of Commerce, 1999; and Seamico Securities, 1999.

IT related services

IT services are expanding rapidly; so too is demand for foreign IT related expertise. Rapidly growing Internet use is spawning new opportunities for foreign equipment, software and service providers. With already over one million Internet users, forecast to rise to 12 million by 2006, Australian and foreign companies are taking a greater interest in Thailand, and buying into Thai Internet portal sites. Australian firm, St Francis Mining, recently purchased a 40 per cent share (Baht 100 million or A$4 million) in EThailand.com, an Internet portal focusing on the international business community in Thailand (*Bangkok Post,* 5 April 2000).

The Thai Government is promoting vigorously IT and e-commerce; opportunities will be much improved when Thailand implements new laws in 2000 to cover online identity, electronic signatures, computer crime data protection and electronic funds transfer. The Australian Government is exploring a memorandum of understanding with Thailand covering e-commerce.

Automotive related services

Thailand's automotive and component industries lack sufficient skilled labour to satisfy the demands of the global automotive companies now locating in Thailand; this provides opportunities for Australian automotive and related companies and training institutions, as global companies seek higher standards from local manufacturers. The Thai Government acknowledges its workforce is under-skilled and has prioritised human resource development in this sector. Furthermore, much automotive design and development is done offshore and the Government is keen to increase local value adding. Hence opportunities exist for Australian companies and institutions providing automotive sector vocational and skills training. The General Motors Holden plant in Victoria has substantial technical capabilities and is responsible for providing technical support and adaptive design in the Asia Pacific region. Already, the plant has trained 42 Thai engineers and team leaders employed in the General Motors Holden new Thai plant that opened in May 2000 (Chamberlain, 2000). In addition, Ford Motors may invest in a regional research and technology development centre in Thailand, worth several hundred million baht (*Bangkok Post,* 21 April 2000). The parent company and Ford Australia have strong links, and Australia may benefit from spin-offs, if the investment proceeds.

Tourism

Tourism and education will continue as major areas of growth potential. The Tourism Forecasting Council predicts the numbers of Thai visitors to Australia will grow at over 18 per cent per year. In 1999, Thai arrivals recovered by 26 per cent to 62 000, although were still well below the peak of 88 900 reached in 1996 (Australian Bureau of Statistics, 1999b). Opportunities also exist for Australians in the Thai tourism industry in hotel management and tourism skills training.

Education

Thai companies, parents and students seek education and training, both in and away from Thailand. Trained professionals and skilled workers are in limited supply and command high salaries. As a geographically close and relatively affordable supplier of education, with a strong and longstanding education relationship with Thailand, Australia is an important destination for Thai students (second after the United States). While the financial crisis reduced the number of Thai students studying in Australia by 9 per cent in 1997, and even more dramatically in 1998, enrolments began to recover in 1999 when student visa numbers rose by 30 per cent. In 1999, over 6 500 Thai students studied in Australia, still fewer than the 7 369 in 1997 and 8 069 in 1996. On present trends, 10 000 Thai students could be studying in Australia by 2002.

Factors underpinning this increase include a favourable exchange rate, increasing market recognition of Australia as a quality study destination and a coherent marketing strategy by the Australian Government which is stimulating interest in Australia by parents, students and education agents who previously were US or UK focused.

Additionally, Australian educational institutions have opportunities to provide in-country courses in English, economics, commerce, IT, engineering, tourism and hospitality. Many Australian universities are active in Thailand cooperating with Thai educational institutions. Some Thai manufacturers seek complete training packages including educational services and equipment. Defence, aviation maintenance, ship building and repair, railways and port management are other industries requiring such services.

UNIVERSITY OF NSW ESTABLISHES EDUCATION JOINT VENTURE

AUSTIL, the Australian Institute of Languages, delivers English language training services to Thai educational institutions, state agencies, industry, private business and corporate and financial sectors. It also provides support services for specialist Thai based, UK and Australian post-graduate courses in engineering and business management. AUSTIL was established in Bangkok in 1995 and is a joint venture between the University of NSW and Mahanakorn University of Technology, a private university specialising in engineering and related disciplines.

Source: Australian-Thai Chamber of Commerce, 1999.

Environmental services

Environmental consulting is another potential market for Australian business. Specialists are needed in industrial waste water treatment, hazardous and solid waste collection, disposal and recycling, and use of vehicle and other emission control equipment.

Australian companies such as Sinclair Knight Merz remain committed to Thailand, despite weaker post crisis demand for environmental services. To enter the Thai market, Sinclair Knight Merz merged with Seatec International, one of Thailand's leading environmental consultants (Australian-Thai Chamber of Commerce, 1999).

Engineering and architectural services

The slump in the construction and fabrication sectors has reduced demand for architectural, construction and engineering services, and weak activity will continue to constrain demand in the short to medium term. However, new infrastructure projects are planned, and privatisation of state enterprises may provide some openings for Australian engineering consultants.

INFRASTRUCTURE AND PRIVATISATION

While the crisis slowed infrastructure development plans, forcing the Government to defer, cancel or scale down numerous projects, many still are proceeding. The Eighth National Economic Development Plan (1997-2001), prepared in mid 1997, allocated about US$70 billion for energy and other infrastructure development. Although this level of funding will not be realised, funding from the budget, World Bank, Japan Bank for International Cooperation and other international loans ensures several major projects will proceed.[17] These projects include power generation, power transmission, gas pipeline, transport and airport development projects; all are open to foreign contractors.

INFRASTRUCTURE PROJECTS FOR 2002-06 WORTH US$28 BILLION

Thailand's National Economic and Social Development Board is proposing 95 infrastructure projects worth Baht 1 086 billion (US$28 billion) in 2000-06. All projects are open to foreign contractors and include airport development, subways, new mobile phone systems, railway and expressway expansions, power plants, power transmission systems and gas pipelines.

The Government plans to commit Baht 890.3 billion (US$23 billion) and encourage the private sector to supply the remaining Baht 195.7 billion (US$5 billion).[18] Opportunities centre on:

- 15 projects (Baht 105 billion or US$2.8 billion) in irrigation
- 40 projects (Baht 626 billion or US$16.5 billion) in transport
- 6 projects (Baht 36 billion or US$950 million) in telecommunications
- 18 projects (Baht 119 billion or US$3.1 billion) in support facilities
- 16 projects (Baht 132 billion or US$3.5 billion) in energy.

Source: *Bangkok Post,* 1 May 2000.

[17] In October 1999, Japan's Overseas Economic Cooperation Fund, OECF, was merged with the Export-Import Bank of Japan and a new institution was established, called the Japan Bank for International Cooperation.

[18] In 1982-96, the Government committed Baht 1 540 billion (US$62 billion) to infrastructure investment and a further Baht 887 billion (US$22 billion) in 1997-99 (*Bangkok Post*, 1 May 2000).

Privatisation Opportunities

Government plans to privatise infrastructure and encourage more private provision of new infrastructure should create opportunities for Australian business. (See Chapter 8 - *Privatisation*.) Apart from opportunities to acquire privatised assets, deregulation and privatisation should allow foreign firms to enter many of these sectors as Thailand implements WTO trade in services obligations over the next few years. Demand for new telecommunication services will increase demand for equipment including fibre optic cable, call management systems, system upgrades and infrastructure for mobile phones and international access.

Once existing over capacity is absorbed, the privatising energy industry will provide longer term opportunities for investing in and supplying energy infrastructure and raw materials.[19] As the new Bangkok international airport is developed and other transport services are privatised and corporatised, opportunities should increase for Australian participation in airport, rail and port facility development and management.[20]

As state transport, energy, telecoms and other state enterprises become privatised and corporatised, opportunities also are emerging for a wide range of financial, legal and engineering consultants. Professional advisers are required to help corporatise state enterprises, upgrade financial and enterprise management systems, design and introduce new regulatory frameworks and regulatory bodies, run competitive tendering processes, undertake due diligence studies, manage share floats and strategic buyers, and access private financing mechanisms (East Asia Analytical Unit, 1998). The Thai Government will pay for these services with loans from international financial institutions already advanced under the IMF support program.

Australian companies offering outsourced maintenance and other operational services for state infrastructure enterprises and large private companies also should be alert to emerging opportunities. For example, Barclay Mowlem Construction is pursuing outsourcing opportunities in the rail sector (Killinger, 2000).

19 Sluggish demand and over expansion have created excessive generating capacity. Reserve margins, minimum excess capacity levels, will peak at 52 per cent in 2003 before falling to 25 per cent by 2006 (*Bangkok Post*, 1999c). This excess capacity will limit medium term opportunities to supply electricity materials and equipment.

20 The Second Bangkok International Airport should become Thailand's primary airport by 2004; the existing international airport also is being upgraded and regional airports are fast tracked for privatisation.

AUSTRALIAN FIRM WINS CONTRACT TO KEEP THAI RAIL ON TRACK

Australian firm, Barclay Mowlem Construction Limited, recently won a A$150 million contract to rehabilitate railway tracks in Thailand. The project covers 237 kilometres of line and involves upgrading rails, laying new concrete sleepers and providing modern elastic rail fastening systems. The upgrade also includes raising 196 steel bridges, and 54 concrete and rail girder bridges. The project is expected to employ over 350 expatriates and Thai employees.

Barclay Mowlem already is undertaking maintenance and construction activity in Hong Kong and Singapore. Other potential work in Thailand includes Phase 4 Track Upgrading, more double tracking and outsourced railway infrastructure maintenance.

Source: Barclay Mowlem, 2000.

Environmental Infrastructure

The Thai Government wants the private sector to participate more in environmental infrastructure projects, particularly since several were suspended during the crisis. Opportunities exist in water supply, sewerage treatment and solid and toxic waste disposal in the food processing, textiles, tanning, pulp and paper, petrochemicals and electronics industries. Australian involvement in solid waste disposal is growing well from a low base, with several companies successfully tendering to construct solid waste and waste water treatment plants for government authorities and private industry.

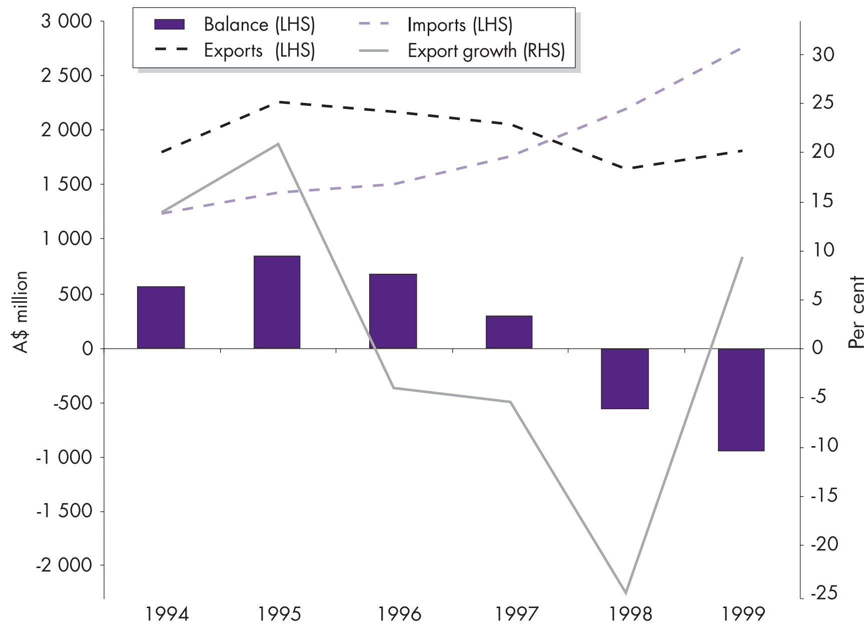
AUSTRALIA'S TRADE WITH THAILAND

Australian trade with Thailand has grown at almost double the rate of overall Australian trade in the decade before the crisis, based on strong commodity exports and growing ETM exports and imports. Australian merchandise and service exports to Thailand suffered during the crisis, while Thai goods and service exports to Australia grew strongly; as a result the bilateral trade balance became negative in 1998 (Figure 2.5).

Figure 2.5

Australian Exports to Thailand Recovering

Australia's Goods and Service Trade with Thailand, 1994-99



Source: Department of Foreign Affairs and Trade, 2000a.

AUSTRALIA'S EXPORTS TO THAILAND

Australia's goods and service exports to Thailand recovered strongly in 1999 after the slump in 1997 and 1998, and are continuing to grow well in 2000.

Merchandise Exports

Between 1995 and 1997, after several years of strong growth, Australia's annual merchandise exports to Thailand stabilised at around A$1.7 billion. However, in 1998, Thailand's sharp recession caused Australian merchandise exports to fall 22.5 per cent to A$1.3 billion (Figure 2.1). Only Australian exports to Indonesia, down 36.5 per cent and Malaysia, down 23 per cent, fell more steeply. The fall was reversed in mid 1999 as Thai domestic demand recovered; 1999 Australian merchandise exports reached over A$1.4 billion, up 12.5 per cent on 1998 (Figure 2.1). In the March quarter of 2000, Australia's exports to Thailand were up 26 per cent on the same quarter of 1999, with particularly strong growth in manufactures exports. Energy, minerals and ETM exports are expanding rapidly.

In 1999, Thailand was Australia's fourteenth largest trading partner and thirteenth largest export market. Australia is Thailand's eleventh largest source of imports. While Thailand's overall imports grew rapidly, Australia's market share grew modestly from about 1.8 per cent in the 1980s to 2.0 per cent in the 1990s (Figure 2.6). Japan and the United States are Thailand's major import suppliers, together supplying around 40 per cent of the market (Figure 3.8).[21]

Figure 2.6

Australia's Market Share Rising Modestly

Australia's Share of Thailand's Imports, Per cent

Source: Department of Foreign Affairs and Trade, 2000a; and CIEC, 2000.

[21] Japan is Thailand's biggest supplier of imported goods (23.6 per cent in 1998), followed by the United States (14.0 per cent), Singapore (5.5 per cent), Taiwan (5.2 per cent), Malaysia (5.1 per cent), Germany (4.2 per cent), China (4.2 per cent), Republic of Korea (3.5 per cent), Oman (2.6 per cent), Indonesia (2.1 per cent) and Australia (2.1 per cent).

Service Exports

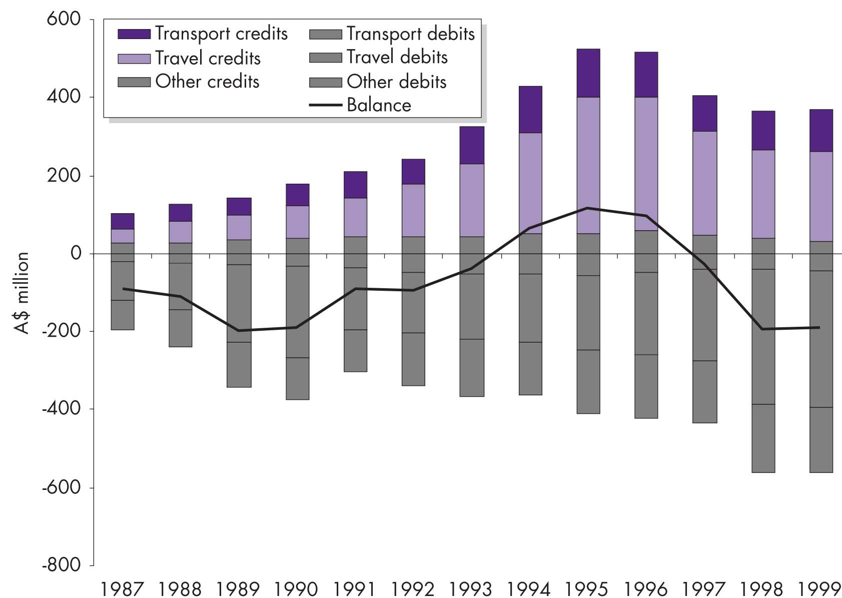
Service exports to Thailand grew rapidly before the crisis but slumped in 1997 and 1998 and recovered only slightly in 1999 (Figure 2.7). In the decade 1986-96, Australian services export growth averaged 22 per cent per year and reached A$516 million in 1996. When Thai incomes collapsed in 1997, Australia's service exports fell by 19 per cent, then a further 7 per cent in 1998, but recovered slightly in 1999 to reach around A$374 million as confidence in the recovery grew. Tourism, transport and education are Australia's most important service exports to Thailand (Figure 2.7).

In 1999, inbound tourists from Thailand increased by 26 per cent over 1998, with 62 000 Thais visiting Australia in 1999 (Australian Bureau of Statistics, 1999b).[22] Considerably more Thai visitors are expected to visit Australia in the future; with an average annual growth rate of 18 per cent, 263 000 Thais may visit Australia in 2008 (Australian Tourism Forecasting Council, 1999).

Figure 2.7

Services Exports Regained Momentum in 1999

Australia's Services Trade with Thailand, 1987-99, A$ (million)



Note: Credits are services export receipts, while debits are payments for services imports. For example, travel credits principally reflect tourist and other visitor spending in Australia; transport debits reflect freight payments to Thai shippers.

Source: Australian Bureau of Statistics, 1999a.

[22] This compares with 114 000 tourists from Malaysia (up 2 per cent), 90 000 from Indonesia (down 3 per cent) and 80 000 from the Republic of Korea (up 19 per cent) (Australian Tourism Forecasting Council, 1999).

Similarly, more Thai students again are studying in Australia. Since the baht stabilised in 1999, the number of student visas issued to Thai nationals has increased by over 30 per cent since 1998, and enquires about studying in Australia have risen substantially. Strong government links support the bilateral education and training relationship.[23]

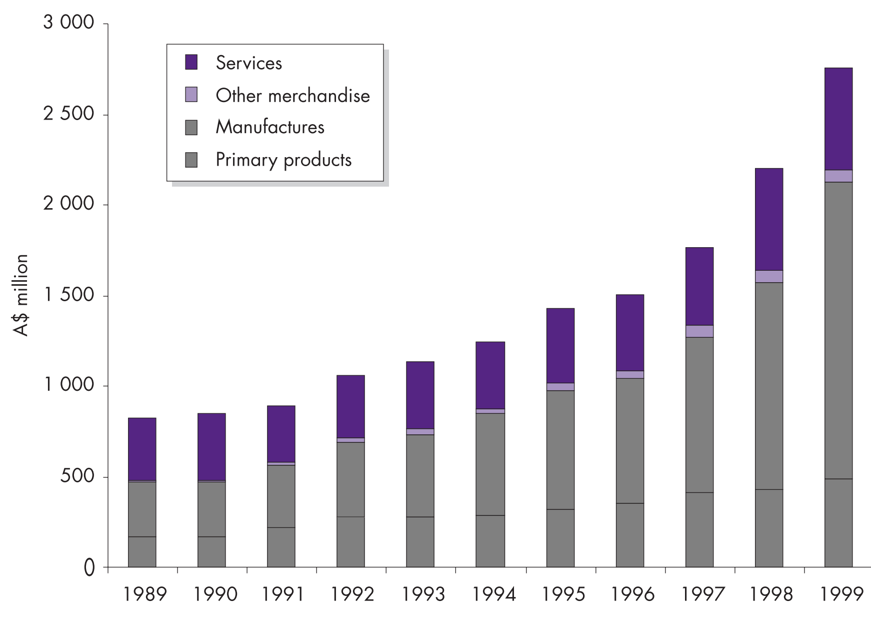
AUSTRALIA'S IMPORTS FROM THAILAND

Australia's imports of merchandise and services from Thailand have grown very rapidly since 1997. Merchandise imports, principally manufactures accelerated 34 per cent between 1998 and 1999 to A$2.2 billion. The baht's 35 per cent depreciation and falling Thai domestic demand drove this rapid growth. Australia's services imports from Thailand were flat in 1999, largely reflecting weak growth in Australian visitor numbers to Thailand (Figure 2.8).

Figure 2.8

Australia's Imports from Thailand Growing Rapidly

Total Australian Imports by Major Categories, 1989-99, A$ (million)



Source: Department of Foreign Affairs and Trade, 2000a.

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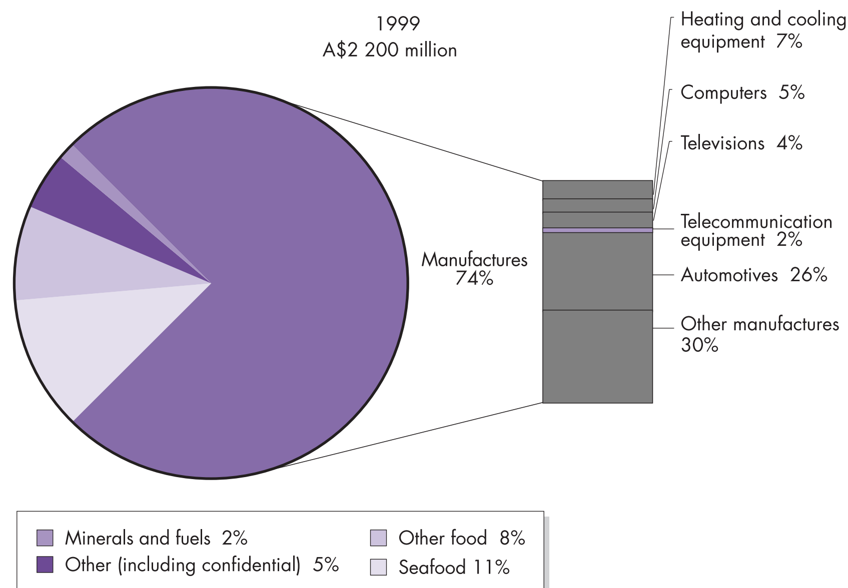
[23] The relationship was formalised in the 1991 and 1994 Memorandums of Understanding between the Australian Department of Education, Training and Youth Affairs, and the Thai Ministries of University Affairs and Education. Substantial government-to-government cooperation also occurs under the Agreement on Development Cooperation between Australia and Thailand.

Automotive imports (worth A$581 million) have grown rapidly and Australia now is the major export market for Thai fully built-up passenger cars and light commercial vehicles.[24] Seafood (A$246 million) and heating and cooling equipment (A$148 million) are other major imports. Computers, televisions and telecommunication equipment made up a further 11 per cent of imports in 1999 (Figure 2.9).[25]

Figure 2.9

Manufactures Dominate Imports from Thailand

Australia's Imports from Thailand in 1999, A$ (million), Per cent



Source: Department of Foreign Affairs and Trade, 2000a.

Thai exporters have relatively few problems accessing the Australian market. However, access for agricultural products, particularly cooked chicken meat, is an exception. Thai authorities reject the rationale for Australia's quarantine conditions on imported chicken meat. The Thai Government also has expressed concerns about Australian quarantine procedures, particularly in relation to tropical fresh fruit and frozen prawn imports.

[24] These passenger car and light vehicle imports from Thailand have displaced similar imports from Japan and the United States.

[25] With import growth accelerating in 1999, Australia's merchandise trade deficit with Thailand increased to A$754 million, up from A$519 million in 1998; in the preceding four years, Australia ran surpluses (Figure 2.5).

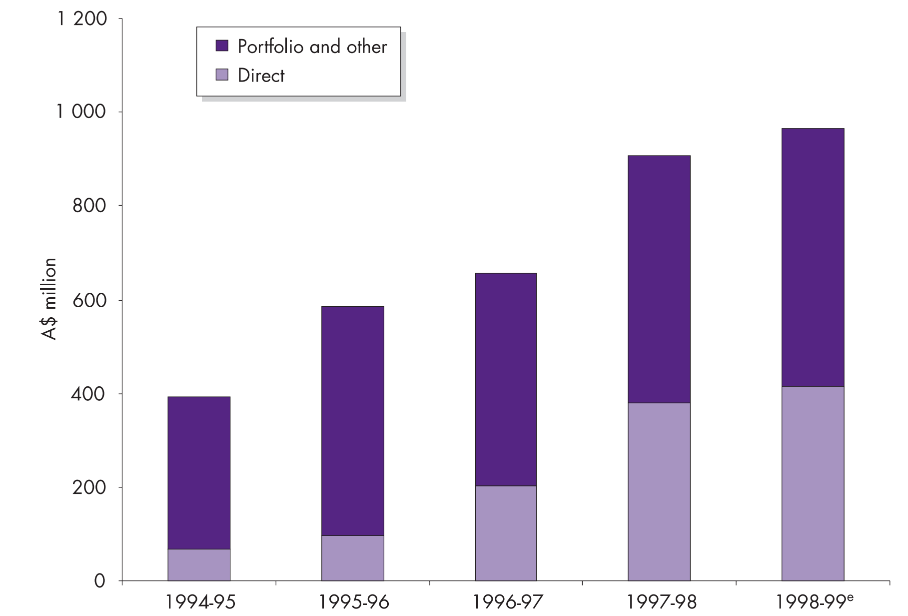
INVESTMENT OPPORTUNITIES

By the end of 1999, Australia's total investment in Thailand was about A$1 billion; about A$400 million of this was foreign direct investment (Figure 2.10).[26]

Figure 2.10

Crisis Didn't Dampen Australian Direct Investment

Australia's Stock of Foreign Investment in Thailand, A$ (million)



Note: e Is Department of Foreign Affairs and Trade estimate.

Source: Australian Bureau of Statistics, 1999c.

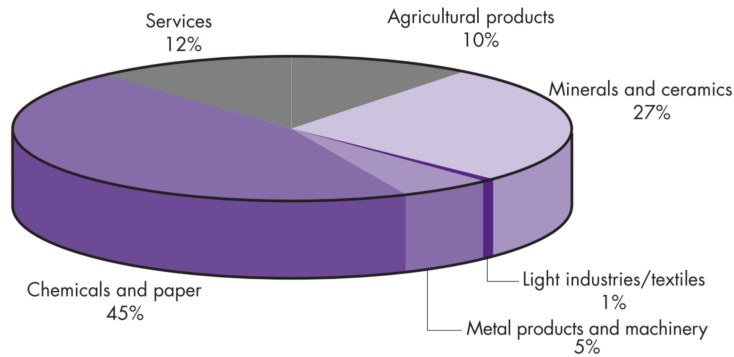
Direct investment is concentrated in chemical and paper manufacturing, minerals and ceramics, export-oriented food processing, insurance and trade support services (Figure 2.11). In 1999, Thailand's Board of Investment received 17 applications from Australian investors and approved ten projects with an investment value of over A$40 million. This followed approval in 1998 of 13 new Australian projects worth A$106 million (Board of Investment, 2000 and 1999; and CIEC, 2000).

[26] In mid 1998, Australia's A$907 million investment in Thailand consisted of A$380 million foreign direct investment, A$167 million portfolio investment and A$359 million in other investment assets, mainly bank lending (Australian Bureau of Statistics, 1999c).

Figure 2.11

Manufacturing Sector Attracts Most Australian Investment

Sectoral Distribution of Australian Investment, 1995-99, Per cent



Source: Board of Investment, 2000.

AUSTRALIAN FIRMS INVEST IN DIVERSE THAI SECTORS

Since 1997, Australian firms:

- Bendix (Thailand) invested in manufacturing automotive brake pads (A$7 million)
- BHP Steel (Thailand) invested in a new cold rolling mill (A$200 million)
- Ansell (Thailand) acquired condom manufacturer Suretex for A$50 million
- Finemore Logistics (Thailand) invested in transporting fuels and chemicals
- Laem Chabang International Terminal opened a new container berth
- Loxley-CSR commissioned a new rockwool insulation plant
- Webforge (Thailand) opened a new plant to produce industrial gratings and related products
- Australian-Thai Starches invested in modified starch production
- Colonial Mutual Group, HIH, AXA (formerly National Mutual Holdings) and NRMA made strategic investments in the insurance industry.

Source: Board of Investment, 2000; and Austrade, 2000.

NEW PLANT KEEPS BUSINESS ROLLING FOR BHP STEEL

In the midst of Thailand's financial crisis, BHP and its Thai joint venture partner, Loxley, commissioned a new A$220 million plant to supply domestic construction materials and provide cold rolled coil to BHP coating plants in Malaysia and Indonesia. Its end customers are in automotives, construction, appliance assembly, general fabrication, low end domestic roofing and a variety of formed product applications. In early 2000, BHP had a 75 per cent share in the Rayong plant, which enjoys full Board of Investment privileges.[27]

The sudden drop in domestic demand due to the crisis forced BHP to re-define company markets and strategies. By mid 2000, BHP Steel (Thailand) had successfully diversified its customer base, exporting about half its output to other Asian and European markets. For example, in mid 2000, the plant's coated product line was operating at 80 per cent of capacity. Hence, BHP considers the plant a solid investment, especially for the long term.

Source: BHP Steel (Thailand), 2000.

Thailand is recovering its strong demand for raw materials and industrial inputs, providing good investment opportunities for Australian producers of these products. Thailand is strategically located with good communication links to neighbouring economies, as well as Australia, Europe and the United States. This makes Thailand a good export base. Thailand's Board of Investment also offers incentives to companies investing in export-oriented industries. (See Chapter 4 - *Foreign Investment.*) Furthermore, many local firms seek foreign expertise and capital to update business practices and technologies, and will enter joint ventures.

The crisis is forcing many illiquid companies to reduce their debt leveraging and consider selling non-core assets; this will expand opportunities for foreign investors. In addition, the Corporate Debt Restructuring Advisory Committee and new bankruptcy laws are pushing forward corporate restructuring and making bankruptcy and foreclosure easier. Thai banks increasingly are taking control of assets and using auctions for quick sales. While such disposals have been limited to date, opportunities for foreign investors should expand as corporate restructuring accelerates in 2000 and beyond.[28]

Australian investment in Thailand is relatively low compared with its investment in other countries in the region. However, surveyed Australian companies in Thailand, on average achieve profitability after only three years of operation. They indicated Board of Investment incentives and relatively low labour costs are major attractions (Australian-Thai Chamber of Commerce, 1999). Impediments include skilled labour shortages, work permit and visa problems, high import duties on some goods and complex bureaucratic processes.

[27] The plant is located in Zone 3, which entitles BHP to the full range of Board of Investment privileges.

[28] Successful condominium auctions in 1999 encouraged further use of the auction system in Thailand (Took, 2000).

In October 1999, the Thai Government amended the alien business law, the main legislation governing foreign business participation; this marginally improved the foreign investment environment. However, the law still limits foreign ownership in many business activities and significantly restricts foreign participation in the service sector. (See Chapter 4 - *Foreign Investment*).

Nevertheless, the financial crisis has opened previously closed investment opportunities for Australian companies, particularly in the financial sector, retailing and sectors undergoing accelerated privatisation including telecommunications, transport and energy. (See Chapter 4 - *Foreign Investment*.)

Thai Investment in Australia

Thai investment in Australia is minute. Since 1994-95, official Australian Bureau of Statistics data indicate Thai companies have disinvested in Australia, reducing their level of investment from A$215 million to A$30 million by the end of June 1997. The decline was reversed partially in 1997-98 with Thai investment (most in property) recovering to around A$53 million. However, possibly the data do not capture the full extent of Thai investment.

SMALL AUSTRALIAN FIRM HAS BIG PROSPECTS IN THAILAND

Rocket Film Equipment, a small Australian manufacturer specialising in sewn textile products for the motion picture, television and photographic industries, is the smallest company in Thailand to win Board of Investment recognition. It has secured a range of Board of Investment incentives, including import duty exemption, five years' company tax exemption and eligibility to purchase property under a 25 year lease.

The Australian firm planned to move offshore in 1996 due to short Australian production runs and high domestic costs. It chose to manufacture in Thailand because Thailand offers relative political stability and a suitably skilled workforce, and the firm had previous in-country business experience.

Although the firm finally started manufacturing in 1999, its management indicated the lead up process was slow and frustrating. Board of Investment registration was complex and costly; it took nine months to process the application and US$23 000 in consultants' fees. The Thai bureaucracy remains a major hurdle; freight and customs procedures cause delays in importing raw materials and exporting finished products, disrupting production schedules; and foreign exchange transaction and banking problems make operations difficult. However, Rocket does not believe these short term problems detract from encouraging long term prospects. Product quality is good and the firm is developing staff to take on greater responsibilities and decision making.

Source: Rocket Products International, 2000.

AUSTRALIAN-THAI POLITICAL RELATIONS

Good Australian-Thai political relations form a sound framework for bilateral business relations. Thailand's industrialisation, democratisation and rising living standards have generated a strong bilateral relationship with Australia. It spans trade and investment, defence, education, narcotics control, tourism, refugee issues and development assistance. Since mid 1997, Australia has contributed US$1 billion to the IMF's stabilisation program for Thailand and expanded its bilateral development assistance program. Thailand and Australia cooperate in promoting agricultural trade liberalisation in the Cairns Group of agricultural exporting nations. They also share a common goal in WTO negotiations of freer trade and investment.

Development Cooperation

While Australia's official development assistance, ODA, program is aimed solely at promoting poverty reduction and development, some goods and services provided under the aid program also introduce Australian companies to Thailand. Before 1997, as Thai per capita incomes grew, the Australian Government planned to phase out its ODA program for Thailand. However, the crisis led Australia to extend its ODA program beyond 2000-01. In 1998-99, total ODA flows to Thailand were A$25.2 million and should reach A$26.3 million in 1999-2000 (Australian Agency for International Development, 1999). This made Thailand the eighth largest recipient of Australian ODA.

NEW FOCUS FOR AID ACTIVITIES

In July 1999, the Thai and Australian Governments agreed Australia's official development assistance program would aim to assist Thailand in rapidly and effectively recovering from the financial crisis and its social impact. New program activities focused on building effective governance capacity, rehabilitating the banking and financial sectors, and mitigating the crisis's impact on the poor and disadvantaged.[29]

In response to the crisis, the program has started new projects to:

- improve the quality and collation of macroeconomic statistics, including for the national accounts, drawing on assistance from the Australian Bureau of Statistics
- build capacity in the Bank of Thailand by supporting policy development and providing prudential supervision training
- build the technical and systems capacity of the Large Taxpayer Office to enable the Thai Government to obtain its fair share of tax from large corporates.

A A$10 million, three year capacity building facility was developed as a flexible delivery mechanism to develop and deliver short term technical assistance to build governmental policy development and implementation capacity, consistent with the Government's economic and social reform agenda.

In 1999, to support overall capacity building efforts across all sectors, Australia offered post-graduate study opportunities to 80 Thai middle level professional staff from the public sector. In 1999-2000, the program also provided 25 short courses on agreed topics to build technical and managerial capacities for Thai public sector officials.

The Australian Government also is providing support for activities to assist further development of democratic institutions, newly established or re-invigorated by the 1997 Thai constitution.

Source: Australian Agency for International Development, 1999.

[29] Current projects centre on building public sector capacities, particularly in economic governance, including the financial sector, education, natural resource management, environment and health. The three largest projects are: the Science and Engineering Assistance Project implemented in association with the World Bank, to improve the quality of science and engineering education at Thai public universities; the AIDS Ambulatory Care Project to transfer Australian methods for HIV/AIDs related outpatient care and adapt them to local conditions; and the Land Titling Project delivered in cooperation with the World Bank, to accelerate land titles' issue. This project particularly benefits small, low income, rural landholders by providing them with secure land tenure. This, in turn, encourages farmers to invest more in developing their land.

AUSTRALIAN-THAI BUSINESS LINKS

Several government and business organisations assist Australians entering the Thai market. Bilateral business organisations are a good starting point for establishing initial contacts in Thailand. Contact details for relevant business organisations and government agencies are at the end of this report.

Australian-Thai Chamber of Commerce, ATCC

The Thai based ATCC is the main Australian-Thai business organisation in Thailand. With over 270 members, it acts as a contact and resource centre for companies and individuals doing business in Thailand or Australia, providing introductions, briefings and assistance with investment and trade matters. Chamber membership includes Australian industries and services located in Thai banking, legal, accounting, transport, manufacturing, construction, travel and tourism sectors (Australian-Thai Chamber of Commerce, 1999).

Australian-Thai Business Council, ATBC

With chapters in most Australian states, ATBC is the main Australian based business organisation for Australian companies and individuals doing business in Thailand. Its counterpart organisation in Thailand is the Thai-Australia Business Council, TABC, established for Thai companies doing business in Australia. Both have close links to the Australian-Thai Chamber of Commerce. The ATBC meets regularly, and also holds a formal plenary meeting with its Thai counterpart each year, alternating between Thailand and Australia. This meeting allows representatives of industry sectors to work together to identify future trade and investment opportunities.

Austrade in Thailand

Austrade helps identify Australian export opportunities in the Thai market and assists Australian companies to capture those opportunities. Also it promotes productive two-way investment between Thailand and Australia. Two Australians and several Thais staff Austrade's Bangkok office.

Thai Trade Promotion Office, Sydney

Austrade's Thai counterpart in Australia is the Thai Trade Promotion Office in Sydney. As a Thai Government sponsored trade centre, it seeks to develop business relations with potential Australian buyers and distributors of Thai products. The office also supplies trade information and arranges appointments for Australians with their Thai counterparts.

FUTURE PROSPECTS

Strong economic trends in early 2000 point to a faster economic recovery than initially expected, although considerable reform will be required to consolidate that performance. Economic recovery, restructuring and reform are opening Thailand's economy to greater international competition. To gain early advantages, traders and investors are actively exploring new markets resulting from trade, foreign investment and corporate and financial sector reforms.

Foreign investment opportunities are expanding in manufacturing, financial and increasingly, service sectors. The Thai Government is attempting to improve the business and foreign investment environment, and is keen to attract foreign investors. However, many Australian companies still are observing developments and have yet to commit themselves. While careful due diligence is essential, investment opportunities probably will peak in 2000 as corporate restructuring gathers pace, and could tail off thereafter.

Stronger economic growth, increasing demand for imports and further trade liberalisation also are expanding opportunities for Australian traders of goods and services. Australia's merchandise exports to Thailand should grow at a trend rate of 10 per cent per year to 2005, although this would be slower than in the decade preceding the crisis. Thailand relies on exports to stimulate growth and this strategy creates opportunities for Australian exporters of raw materials and intermediate goods, including processed and unprocessed food inputs and automotive components. Imports of these products already are growing rapidly with economic recovery.

Significant opportunities also exist to export services. Demand is strong for business services, particularly in financial and corporate restructuring, mergers and acquisitions, distressed property management, insolvency, due diligence, distribution and IT services. Environmental consulting is another potential market for Australian business. The Thai Government is pushing ahead with programs to improve educational standards and workforce skills. This will provide continuing opportunities for Australian educators and vocational training suppliers, particularly as Australia is more cost competitive than major competitors in North America and Europe.

The rebound in outbound tourism from Thailand is linked directly to economic recovery and business confidence. With rising Thai per capita incomes, Australia's medium to long term prospects as a market for Thai tourists are particularly promising. Thai visitors to Australia are forecast to increase by 18 per cent per year over the next five years.

Overall, as the Thai economy recovers, and the new legislative and regulatory framework is implemented fully, Australian commercial presence should grow and be better placed to take advantage of emerging opportunities. However, the market is increasingly competitive, and Australian exporters will have to work hard to build relationships and expand market share.

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Chapter 3

TRADE POLICY, PERFORMANCE AND PROSPECTS

Key Points

- In the wake of the crisis, the Thai Government remains committed to trade reform, and plans to further restructure and cut tariffs.
- However, even though the Government reformed tariffs and non-tariff barriers in the 1990s, compared to other East Asian economies, Thailand has a relatively protectionist trade regime. Its 1999 simple average tariff rate was 17 per cent, with numerous tariffs over 30 per cent.
- Ensuring manufactured exports continue to be competitive is fundamental to Thailand's medium term economic growth. A favourable global environment should support export growth, but continuing domestic trade and microeconomic reform also will be needed.
- Assuming the Government achieves necessary reforms, Thailand could well become an ASEAN regional hub for automotive and electronics industries, expanding opportunities for import suppliers and investors in these sectors.
- Unless reforms are rapid and far-reaching, future economic growth is likely to be lower than before the crisis, so once the demand backlog is met, imports should grow more moderately than they did in the early 1990s.
- The accelerated introduction of ASEAN Free Trade Area, AFTA tariff reductions will challenge domestic industry and foreign competitors outside ASEAN.

Since the early 1980s, successive Thai governments have pursued export led growth as their basic development strategy. In 1999, the ratio of Thailand's international trade to GDP had climbed to 82 per cent from 39 per cent in 1977. Its 1999, two-way merchandise trade of US$108 billion made Thailand ASEAN's third largest trader after Singapore (US$226 billion) and Malaysia (US$150 billion). The Thai Government's continued commitment to trade liberalisation is fundamental to ensuring future Thai competitiveness and ongoing trade growth; consequently, in reducing trade barriers and helping to create a more open international trade environment, Thailand is underwriting its economic prospects.

The crisis has not weakened commitment to trade reform; the Government has stressed its basic strategy is to increasingly globalise the Thai economy. To achieve this goal, the Government has continued to reduce many tariffs and somewhat liberalised the foreign investment regime. (See Chapter 4 - *Foreign Investment*.) Although the Government imposed some temporary tariffs early in the crisis, it resisted calls from local industry to increase trade barriers permanently.

This chapter first analyses which external and internal influences are likely to most affect the trading environment and prospects of key Thai sectors. It then assesses Thai trade policy strategies and reforms, and trade performance since the crisis began.

LIKELY FUTURE TRADING ENVIRONMENT

Significant ongoing domestic reforms, international trade environment developments including potential World Trade Organisation, WTO, ASEAN Free Trade Area, AFTA, and Asia Pacific Economic Cooperation, APEC, trade and investment liberalisation will shape Thailand's medium to long term trading environment.

Domestic Reforms

Ongoing political developments, and the Government's success in sustaining economic recovery, restructuring corporates and financial sectors, and removing remaining impediments to foreign trade and investment all will influence Thailand's future trade environment.

Since present economic and trade policies have produced a credible recovery, these policies should continue for the foreseeable future, but given the complexities of Thai politics, this is not assured. The current government is determined to honour Thailand's international trade liberalisation commitments. Whether future governments will continue to incrementally open Thailand to international trade depends partly on how successfully present policy settings deliver broadly based economic recovery. In mid 2000, economic recovery seemed sustainable, even though the debt structure of domestic firms remained a problem. (See Chapter 1 - *Economic Prospects* and Chapter 7 - *Corporate Restructuring*.)

International Influences

Over the medium term, with the global economy remaining strong, the international environment broadly should favour Thai trade and foreign investment prospects (Table 3.1). Analysts expect the US economy to remain strong in 2000, although rising interest rates should slow growth in late 2000 and 2001. Stronger growth also is expected in the European Union and emerging markets (Consensus Economics, 2000). Furthermore, most of non-Japan East Asia should grow strongly in 2000 and 2001, supporting Thai exports to the region. Japan's recovery is most important in determining Thailand's export success, but in mid 2000, evidence on the sustainability of Japan's recovery was inconclusive. The relatively stable yen is, at

Table 3.1

World Economic Growth to Maintain Momentum

Real GDP Forecasts for Selected Countries and Regions, Per cent

	1998 Per cent	1999 Per cent	2000 Per cent	2001 Per cent	2002-05 Per cent
United States	4.3	4.1	4.6	3.1	3.6
Japan	-2.5	0.3	1.0	1.5	2.3
Germany	2.2	1.5	2.8	2.8	2.5
Eastern Europe	-0.4	1.1	3.2	3.9	na
Latin America	1.9	0.0	3.5	4.2	na
North East Asia	2.2	7.5	7.2	6.6	na
South East Asia	-8.0	3.1	5.1	5.3	na
World	1.7	2.5	3.4	3.1	na

Note: Consensus Economics note that their long term projections indicate sustainable potential trends, given the impact of recent economic conditions and likely future events, rather than predict precise peaks and troughs in the business cycle.
Source: Consensus Economics, 1999 and 2000.

least, a positive influence for East Asia. Another important influence on Thai exports is China's policy regarding the yuan. In mid 2000, China's continuing current account surplus, recovering exports, low inflation, high foreign exchange reserves and desire to keep WTO entry on track made yuan depreciation unlikely in the short to medium term.

COMPETITIVENESS TRENDS

Before the crisis, weak macroeconomic management put pressure on the traded sector (exporters and import competitors), undermining its competitiveness. From 1995 to mid 1997, the real trade weighted value of the baht rose 16 per cent and real labour costs also rose; these trends put labour intensive Thai exports under stiff competitive pressure from China, Indonesia and Vietnam (JP Morgan, 2000).[1] To raise competitiveness, the Government tried to help Thai industry upgrade technologies, skills and product sophistication, but this is a long term strategy and before it could have any impact, Thai exports fell sharply in 1996.

By mid 2000, the baht had depreciated 35 per cent in nominal terms against the US dollar, and 20 per cent in real trade weighted terms, since its mid 1997 float, easing pressure on Thai export competitiveness. However, many regional neighbours experienced similar depreciations. In the medium to long term, as the demand for domestic labour recovers and the baht appreciates, labour intensive exports again will be vulnerable.

....

1 Large capital inflows, the pegged baht exchange rate, yen depreciation and a strong US dollar drove this appreciation.

To avoid this threat, Thailand recognises it must move up the product ladder and upgrade its export structure to skill intensive commodities. However, as skilled labour shortages constrain such upgrading, with World Bank assistance, the Government has launched programs to upgrade Thai industrial technologies and skills.[2] In an important move, the Government also is extending the years of free and compulsory high school education. Infrastructure services, the education system, customs and tax administration, and industry's regulatory environment also must be improved to boost long term competitiveness.

Short to Medium Term Export Prospects

In the short term, 2000 and 2001, many export sectors have excess capacity and can expand output rapidly without significant new investment. However, beyond 2001, strong export growth requires new investment in export industries, infrastructure and appropriately skilled labour. Investment will occur only when investor confidence returns and bank lending resumes fully; in turn, these depend on successful financial and corporate restructuring and prudent macroeconomic management. As the recovery strengthens and trade financing improves, again shortages of transport, telecoms and electricity infrastructure and skilled labour will constrain export growth. Unless rapidly addressed, slow progress in privatisation and lack of competition in providing infrastructure could prevent new private investment from significantly relieving this problem. (See Chapter 8 - *Privatisation.*) Recent reforms to the education system eventually will help address skilled labour shortages, but valuable years were lost by inaction and new reforms may take another decade before they significantly improve the quality of the labour force.[3]

Because of these constraints to competitiveness, anticipated export growth is somewhat more modest that pre-crisis levels. Commensurate with expected projected exchange rate movements, international demand and domestic economic growth, exports should grow by 10 per cent in 2000, and possibly as high as 12.5 per cent to 2005 (Figure 3.1).

....

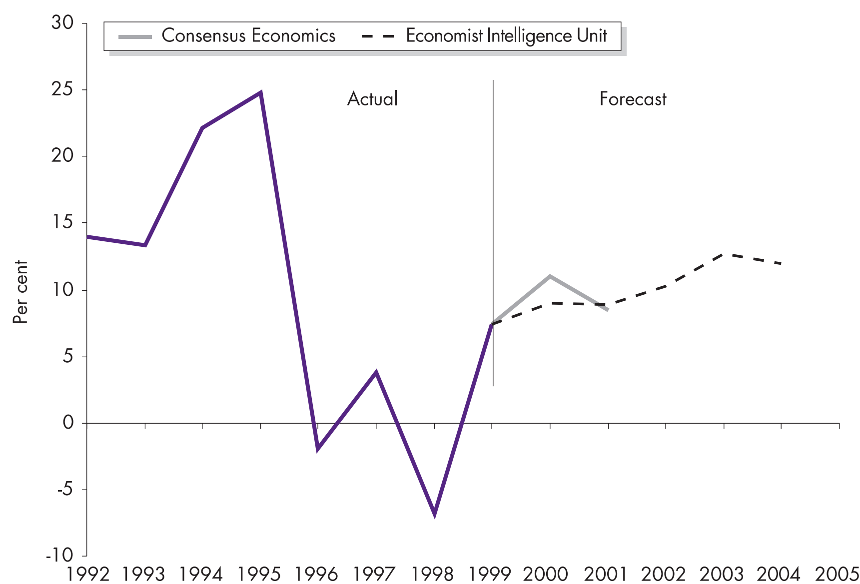
[2] An industrial restructuring plan to enhance manufacturing competitiveness targets automotives, electronic components and electrical products, textiles, pharmaceuticals and chemicals, ceramics and processed agricultural products. It aims to improve productivity, upgrade technology and enhance labour skills in targeted industries (Ministry of Industry, 1998).

[3] In 1999, the Government's new education law made nine years of schooling compulsory (three more than previously) and 12 years free. Before, parents had paid for high school and only 40 per cent of eligible students had attended (Rachatatanun, 2000).

Figure 3.1

Buoyant Merchandise Export Growth Forecast over Medium Term

Export Growth Rate, Actual and Forecast, 1992 to 2004



Source: Consensus Economics, 2000; and Economist Intelligence Unit, 2000.

SECTORAL EXPORT PROSPECTS

Strong export growth is needed to underpin Thailand's recovery, but the potential of sectors to grow is uneven and closely tied to successful reform in areas such as human resources, infrastructure and regulatory development, and investment access. Thailand competitively produces computer and electronics products, textile products and many agricultural commodities, and could well become an ASEAN regional automotive and electronics hub, if trade and other economic reforms continue. If the baht stays close to its current exchange rate, exports from labour intensive sectors also should grow strongly in 2000 and 2001.

Manufactured Exports

The key to Thailand's medium term recovery lies with manufactured exports, especially electronics, textile products and automotives remaining competitive. Export prospects are expanding rapidly for electronics, one of Thailand's main growth industries (Figure 3.6). The industry produces products ranging from low technology television tubes and computer monitors to advanced integrated circuits. However, like the vehicle industry, electronics is largely an assembly industry, with weak backward links to other economic sectors. The industry already faces intense international competition from lower labour cost economies for new investment. Thailand needs to develop a more skills based electronics industry but shortages of

skilled labour may restrict this. These labour training requirements may generate opportunities for foreign human resource development firms and educational institutions.

Thailand's automotive industry production fell sharply during the crisis, but maintained an impressive export performance.[4] It exports components and parts to other regional markets, as regional markets for assembled vehicles remain highly protected. In 2000, the Thai Automotive Industry Institute expects Thailand to export about 40 per cent of the sales of 460 000 vehicles; by 2003, production should rise to 600 000 vehicles, with half being exported (*The Nation*, 2 February 2000). However, lack of technology and indigenous expertise limit the automotive industry's prospects. The industry largely assembles imported parts to foreign designs; local content is restricted to licensed sub-contractors or foreign subsidiaries (Business Monitor International, 1999).[5] Hence foreign suppliers of design and technology intensive inputs and training will find increasing opportunities in this developing industry. (See Chapter 2 - *Australian-Thai Business*.)

Past Thai industrial and trade policies encouraged local steel, aviation and petrochemical industries. However, shortages of skilled labour, inadequate supporting infrastructure and small scale plants make many of these heavy industries internationally uncompetitive, and they require ongoing support to survive. Many of these industries were most severely affected by the crisis; they produce few exports and disadvantage local industry by increasing raw material input costs.

Agriculture

Given its abundant productive land, Thailand will remain a competitive agricultural product exporter and cost effective input supplier for Thai exporters, especially for food processors. Tinned vegetables, poultry, and frozen fish and shrimp are likely to remain competitive export earners. However, with economic recovery underway, agricultural exports' share of total exports will continue to decline; removal of agricultural subsidies, through the WTO led liberalisation process will contribute to this process.[6]

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4 From 1991 to 1996, production built up rapidly, averaging 10 per cent growth per year, to peak at 560 000 units in 1996. Production collapsed in 1997 and 1998 to 158 000 units, before recovering to 340 000 units in 1999, still dramatically below the industry's capacity of over one million units. Despite the fluctuations in production, automotive exports jumped from Baht 6 billion (US$158 million) in 1996 to Baht 33 billion (US$868 million) in 1998 to Baht 60 billion (US$1.57 billion) in 1999. (All conversions are at the mid 2000 exchange rate of Baht 38:US$1).

5 With local content rules abolished in early 2000, local sub-contractors will need to focus on innovating and adapting foreign designs to improve competitiveness.

6 The share of agricultural products in total exports declined from 28.5 per cent in 1989 to 13.5 per cent in 1998 (Ministry of Commerce, 1999).

Services

Tourism is a crucial export industry for Thailand, contributing around 10 per cent of goods and service exports. Tourist arrivals and expenditure stagnated during 1997 due to tourist concerns about social stability in the region, but recovered strongly in 1998 and 1999. Prospects are good (Figure 3.9). With the depreciated baht and a more stable society than some rival regional tourist destinations, foreigners recognise Thailand is a competitive holiday destination. Partially privatising Thai Airways International in 2000 should hasten the development of a more competitive air services market, which should reinforce tourism growth and its contribution to the economy.

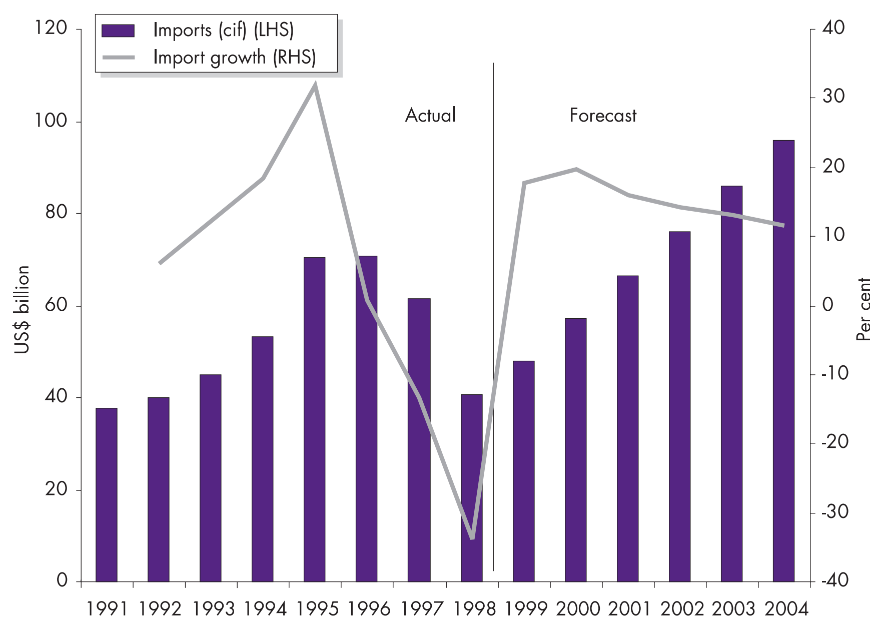
SECTORAL IMPORTING PROSPECTS

Thailand's future import structure depends largely on how much manufacturing activity grows and how quickly trade liberalisation occurs. Future economic growth is likely to be below historical levels, implying import growth also may be slower than in the past. Annual imports should grow around 20 per cent per year in 2000 and 14 per cent in 2001 to satisfy the backlog in demand (Figure 3.2). Thereafter, growth could taper off to around 11 per cent (Consensus Economics, 2000; and Economist Intelligence Unit, 2000).

Figure 3.2

Merchandise Import Growth Forecast to Remain Strong

Imports and Import Growth Rate, Actual and Forecast, 1991 to 2004



Note: Imports (cif) is the landed cost of imports including cost, insurance and freight.
The forecast growth rate averages the rates from the last two listed sources.

Source: CEIC, 2000; Consensus Economics, 2000; and Economist Intelligence Unit, 2000.

As income growth recovers, assuming trade and investment liberalisation progresses, new opportunities should strengthen for imports of agricultural and processed food products, and general consumer goods. In particular, demand for temperate zone agricultural products, such as beef, dairy products, wheat, wheat based products and alcoholic beverages including wine, should continue to rise. In the short term, potential exporters need to realise these products will be highly protected, but in the medium term, they should benefit from ongoing tariff reforms agreed with the WTO. Imports of animal feeds will continue to grow, reflecting increasing domestic demand for livestock-based agricultural products, combined with continued high levels of protection for meat and dairy products.

Future demand for industrial raw materials will remain tied to levels of manufacturing activity, and the overall levels of export and domestic demand. As economic recovery gains momentum, the medium term prospects for competitive exporters of commodities like wool, cotton and non-ferrous metals remain sound. In the medium term, automotive production should continue to grow faster than textile product production (Figure 3.6), favouring mineral and energy exporters more than cotton and wool exporters.

Demand for capital goods imports also will remain tied to future levels of economic activity. In 1999, despite low levels of investment, capital goods principally from Japan, the United States and European Union, constituted nearly 50 per cent of merchandise imports. Capital equipment imports including transport equipment and parts, and machinery and components for the electronics industry, will remain particularly important. Sectoral opportunities for Australian exporters are detailed further in Chapter 2 - *Australian-Thai Business*.

TRADE POLICY STRATEGIES

The Government has announced a wide ranging reform agenda to globalise the Thai economy, reduce protection and strengthen markets and basic legal and economic institutions, so future growth is based more on market decisions. The Government's commitment to freer trade is clear; despite the financial crisis, it continued with tariff reductions, largely resisted new protectionist measures and has reversed many tariffs temporarily increased in 1997.

Since the mid 1970s, successive Thai governments have pursued export-oriented trade strategies. Lower unskilled labour costs attracted labour intensive export oriented processes from Japan, Taiwan, the Republic of Korea, Hong Kong, Singapore, Europe and the United States. As in Malaysia in the 1960s and 1970s, and Indonesia in the 1980s, Thailand's exports of labour intensive manufactures surged. The strength of this sector partly buffered Thailand during the crisis. However, before the crisis, rising labour costs, the strong baht and lack of skilled labour and new technologies were weakening Thailand's competitive advantage. The consequent damage the crisis caused to Thai exports and the wider economy has strengthened the Government's commitment to increasing Thailand's competitiveness through more open and transparent trade strategies.

Before the crisis, Thai growth relied on promoting exports rather than truly globalising the Thai economy. Throughout the early 1990s, while trade reforms lowered tariff and non-tariff barriers, the average tariff level remained high by international standards. Particularly high tariff and non-tariff barriers applied to many agricultural products and targeted manufactures like automotives. Foreign investment barriers also prevented foreigners from participating in many business sectors. To compensate for high import costs and other disincentives to export, Thai governments offered generous export incentives, administered by the Board of Investment. These incentives also encouraged investment in preferred sectors, including in recent years, heavy industry. (See Chapter 4 - *Foreign Investment*.) The exchange rate was pegged informally to the US dollar to increase certainty for exporters and those borrowing abroad. These approaches had more in common with the state interventionist and export promotion development strategies of Japan and the Republic of Korea than the free trade strategies of Hong Kong and Singapore.

The crisis made flaws in such development strategies more obvious. The most protected sectors, particularly the financial and heavy industry sectors were worst affected by the crisis. Light industry and agriculture survived the crisis reasonably well, supplying increasing volumes of exports.

THAILAND'S SIMPLIFIED TARIFF BANDS

Thailand's six band tariff system operates on the principle of value-added tariff escalation.[7] The six bands are:

- 0 per cent for most industrial raw materials and essential goods, such as medical equipment
- 1 per cent for selected raw materials, electronic parts and vehicles for international transport
- 5 per cent for primary and capital goods
- 10 per cent for intermediate goods
- 20 per cent for finished products
- 30 per cent for goods needing special protection.

However, current tariffs exceed 30 per cent in significant import lines. For example, motor vehicles attract tariffs of up to 80 per cent; rice attracts a 52 per cent tariff; and dairy products attract a 216 per cent tariff.[8]

Source: World Trade Organisation, 1999b.

[7] That is, the higher imports' foreign value-added component, the higher their tariff.

[8] Likely developments in highly protected agricultural areas are discussed further, later in this chapter.

TRADE REFORMS

Thailand had removed some trade barriers before the crisis. In the early 1990s, Thailand began restructuring and reducing tariffs to fulfil its WTO and AFTA commitments. In December 1994, the Government started to reduce manufacturing trade barriers and tariff band numbers from 39 to six; it completed this phased reduction by 1997. The next step is to reduce the number of bands from six to three. Completing this reduction and concurrent planned tariff cuts will indicate commitment to continue trade reform.

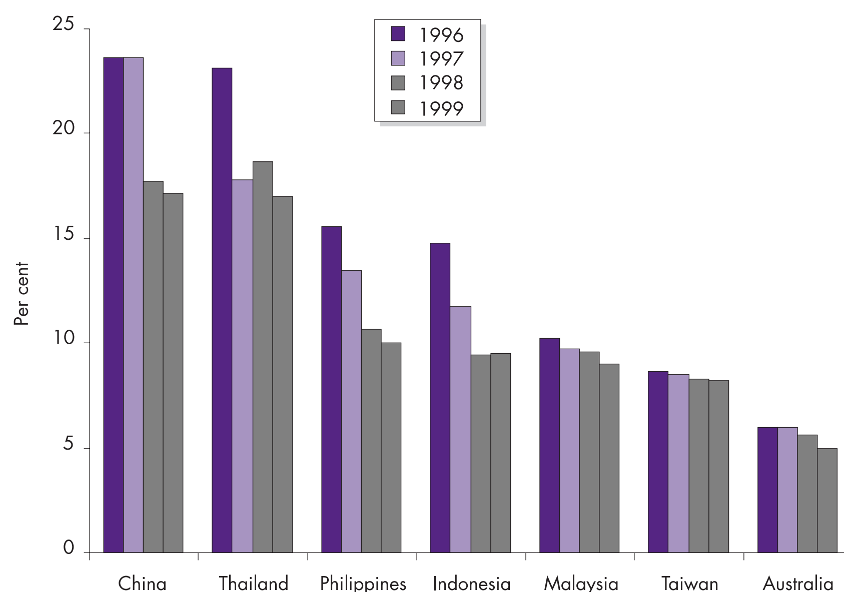
Following its 1990s reforms, Thailand's simple average tariff rate declined from 44 per cent in 1991 to 17 per cent by 1997.[9] Furthermore, Thailand's complex system of duty exemptions means over half of Thailand's imports are admitted with reduced or zero duty, many because of the investment incentives programs the Board of Investment administers. (See Chapter 4 - *Foreign Investment*.) Hence, in 1999, Thailand's effective tariff rate measured as the ratio of customs revenue to merchandise imports was only 3.8 per cent, compared to the simple average applied tariff rate of 17 per cent (CEIC, 2000; and World Trade Organisation, 1999a).

Nevertheless, compared to other emerging East Asian economies, Thailand still operates a quite protectionist trade regime. In 1999, Thailand and China had the region's highest simple average tariff rate. The Thai rate was twice the Malaysian rate and 60 to 70 per cent higher than Philippine and Indonesian tariffs (Figure 3.3).

Figure 3.3

Thailand's Tariff Rates Still High by Regional Standards

Simple Average Tariff Rates in Selected Economies, Per cent



Source: Department of Foreign Affairs and Trade, 2000.

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[9] In 1999, the simple average applied industrial tariff was around 14 per cent, down from 43 per cent in 1991.

Post Crisis Liberalisation

The need to convert Thailand's large current account deficit into a surplus after 1997 could have undermined official commitment to trade liberalisation. However, the Government announced it would adhere to all existing trade policy reform commitments and continue trade reforms. The Government recognised trade liberalisation had not caused the crisis and concluded capital account liberalisation combined with a fixed exchange rate had. (See Chapter 6 - *Financial Restructuring*.) As a result, the Government introduced a flexible exchange rate policy and reintroduced some capital controls, but essentially maintained its commitment to liberalising trade.

However, in 1998, because the crisis caused government revenue to drop, the Government imposed a temporary 10 per cent surcharge on most imports and significantly increased tariffs on automotives and some luxury goods.[10] The crisis also made it difficult for the Government to initiate major new trade reforms in industries adversely affected by the crisis. These included some highly protected heavy and manufacturing industries, such as petrochemicals and automotives, several service sectors and, to some extent, agriculture.[11]

With trade liberalisation on the agenda, in December 1998, the Ministry of Finance established a Tariff Restructuring Committee to reform further tariff rates and bands. Consequently, as part of the August 1999 measures to promote economic recovery and competitiveness, the Government reduced tariffs on over 630 capital goods, raw materials and other imports, and eliminated the 10 per cent import duty surcharge. (See Chapter 5 - *Crisis Responses*.)

In mid 2000, the Tariff Restructuring Committee was examining the tariff structure to simplify it further from six to three bands. Under one option, tariffs would range from 0 to 1 per cent on raw materials, 5 per cent on intermediate goods, and 15 to 20 per cent on finished goods. The Government planned to set up the new structure in the first half of 2000, cutting tariffs on up to 9 000 items. However, in mid 2000 further reform had stalled; 2000 is an election year and vested interests in the steel, petrochemicals and agrifood sectors oppose further tariff cuts.

WTO and APEC Commitments

The Thai Government actively participates in the WTO, urging members to improve commitments, comply with agreed tariff reductions and eliminate other market access restrictions. It is committed to adhering to its existing international agreements. Thailand also is active in the Cairns Group of agricultural exporters, urging freer agricultural trade. It wants the next WTO round to be broad based and focused on market access. The Government was disappointed by the Seattle

10 The 10 per cent surcharge applied to all imports with a customs duty of over 5 per cent; therefore an import duty of 20 per cent rose to 22 per cent. Tariffs also were raised on tobacco and clothing from 30 to 60 per cent, and on woollen textiles, perfumes, cosmetics and some leather products from 10 to 40 per cent.

11 The recent five sector study of the chemicals, pulp and paper, textiles, steel and ceramics industries recommended extra help to these sectors to help achieve necessary foreign and domestic debt restructuring and gain international competitiveness. The study indicated these industries should survive, but may need to merge and expand to achieve economies of scale. It also recommended removing tariffs on their imported inputs rather than extra tariffs (Brimble, 2000).

meeting's failure to finalise a negotiating agenda and launch a new round of world trade liberalisation negotiations. Like the Australian Government, the Thai Government rejects attempts at back door protectionism, which could make developing country trade access to developed economies conditional on unreasonably high labour and environmental standards (Kittistaporn, 2000).

The Thai Government recognises Thailand would benefit substantially from full liberalisation under APEC, so it strongly supports this process. While lack of progress at recent APEC meetings has disappointed Thai leaders, the Government remains committed to trade liberalisation within the APEC framework.

AFTA Liberalisation Acceleration

Thailand is strongly committed to AFTA, which it believes will generate many economic and political benefits; its success remains a key priority for Thailand. Thailand has made AFTA tariff cuts on sensitive products and is expected to continue doing so. As AFTA is fully implemented, increased trade opportunities should benefit gems and jewellery, ceramics, automotives, electrical appliances, pharmaceuticals and some chemical industry sectors (Business Monitor International, 1999).

In 1993, ASEAN members began reducing tariffs under the Common Effective Preferential Tariff, CEPT scheme. This scheme aimed to reduce all tariffs on intra-ASEAN trade to between 0 and 5 per cent over a maximum of 15 years, and eliminate all other trade barriers among members, thereby creating AFTA, a free trade area within ASEAN.

Successive revisions to AFTA have truncated trade liberalisation schedules to 2002.[12] The original ASEAN members committed to placing:

- at least 85 per cent of import categories in the inclusion list[13] at tariffs of 0 to 5 per cent by 2000
- at least 90 per cent of import categories in the inclusion list at tariffs of 0 to 5 per cent by 2001
- 100 per cent of import categories in the inclusion list at tariffs of 0 to 5 per cent by 2002.

The timetable for new ASEAN members, Vietnam, Laos, Burma and Cambodia, is extended by up to eight years (ASEAN Secretariat, 2000).[14]

12 In 1995, the ASEAN Summit advanced the completion of AFTA for the six original signatories to the CEPT from 2008 to 2003, and in December 1998, ASEAN leaders again accelerated AFTA to 2002, to be completed in stages.

13 The inclusion list contains all products included in the CEPT scheme. Each member also submitted a list of products temporarily excluded from the CEPT scheme (mostly chemical, plastic and automotive products). Products that would not be part of the CEPT scheme were included in the general exclusion list. This list includes industries deemed to be important for security or cultural reasons and industries which are politically sensitive.

14 Vietnam will implement the agreement by 2006, Laos and Burma by 2008 and Cambodia by 2010.

ASEAN members also agreed to accelerate the transfer of products currently not in the scheme into the inclusion list and remove all non-tariff barriers among member countries. However, some ASEAN members do not want to accelerate liberalisation for sensitive industries. Malaysia refuses to lower automotive tariffs under AFTA; in these circumstances, Thailand would not give Malaysia access to its lower automotive tariffs, although it would drop them for other ASEAN members (Kittistaporn, 2000).

Thailand's comprehensive CEPT package includes 99.5 per cent of all tariff lines. By 2000, Thailand's AFTA simple tariffs averaged 7.3 per cent, significantly below its 17 per cent most favoured nation, MFN, simple tariff average (World Trade Organisation, 1999b).

However, the widening gap between AFTA and MFN tariffs could disadvantage Thais by diverting import purchases from cheaper exporters outside ASEAN to more costly ASEAN exporters (Thailand Development Research Institute, 1999). Unless these AFTA-MFN gaps have a short and well defined timeframe, AFTA may encourage inefficient ASEAN investments in industries which cannot become internationally competitive and these investors, in turn, may become new vested interests lobbying against future trade liberalisation.

REMAINING TRADE BARRIERS

Despite ongoing liberalisation, non-tariff barriers and high tariffs continue to constrain trade in several significant sectors. To pursue more market oriented development, the Government has prioritised the dismantling of these barriers. However, while Thailand adheres to agreed WTO and AFTA liberalisation schedules, vested interests in heavily protected sectors resist faster reform timetables.

Non-tariff Barriers

Major non-tariff barriers include inconsistently applied customs regulations, duties and imported product price assessments, and excessively detailed tariff classifications (Department of Foreign Affairs and Trade, 1999).[15] Lack of time limits on customs clearance, delays in obtaining duty drawbacks on imports used for exports and excessive documentation are further barriers.

The Thai Government is committed to solving these problems. Since 1997, the customs modernisation program has succeeded in simplifying procedures and expedited clearance. This has increased procedural transparency and simplicity, as has computerising most customs systems in 1999 and implementing the WTO agreement on customs valuation in January 2000.[16]

[15] This problem has eased with the implementation of a harmonised classification system.

[16] To bring Thailand's export and import systems up to international standards, the Government introduced Electronic Data Interchange, EDI, in 1999, amended the customs law and implemented the WTO Customs Valuation Agreement on 1 January 2000.

However, Thailand's stringent food labelling regulations continue to deter potential traders. The current approval processes is complicated, protracted and obstructive.[17] Other than Laos, Thailand is the only ASEAN country with mandatory pre-market certification of labels on most processed foods.

Agricultural Trade Barriers

Although Thailand competitively exports many agricultural products, many agricultural imports face high entry barriers. Most agricultural products were excluded from tariff reduction programs in the 1990s but these exclusions now are unnecessary, especially with the baht's sharp depreciation since 1997. While the Government complies with WTO agricultural tariff reduction commitments by easing tariffs and other barriers on selected agricultural products, tariffs remain high on many high value, fresh and processed food products, particularly those of interest to Australia.[18]

The 32 per cent average applied agricultural tariff is nearly double the simple average tariff for all goods, and agricultural products comprise three quarters of all tariffs exceeding 50 per cent.[19] Even though average agricultural tariffs will fall 33 per cent under WTO obligations, most rates still will be 30 to 40 per cent by 2004; this is high compared with Malaysia, Singapore and Indonesia (US State Department, 1999).

Heavily Protected Manufacturing Sectors

The Government raised tariffs on some crisis affected industries in October 1997. For example, tariffs rose on completely knocked down, CKD, kits for passenger cars from 22 to 33 per cent; tariffs rose on completely built up, CBU, cars from 68.5 to 80 per cent; and tariffs on automotive components remained a high 42 per cent.

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[17] Many exporters regard this as a trade barrier, particularly when registered products must repeat the entire registration process if labels are changed slightly. For example, imports must be re-registered if importers change package sizes or include promotional material in the packaging.

[18] Following the Uruguay Round commitments, the average rate of tariffs applying to agricultural imports fell from 49 to 36 per cent. Frozen meat and beef tariffs fell from 60 to 50 per cent; average dairy product tariffs on milk, cream, powdered milk and milk fats fell from 240 to 216 per cent; and average rice tariffs fell from 58 to 52 per cent. Although Thailand is an active member the Cairns Group of agricultural exporting countries, Thailand is not an agricultural commodity, free trader. Local opposition to liberalising soybean, palm oil, rubber, rice and sugar imports remains especially strong.

[19] In 1999, tariff reductions on some agricultural products, including lupins, alfalfa, lanolin and cotton, improved market access for exporters. However, access for wine, mangoes, citrus, confectionery and cheese is highly restricted. Cheese attracts a luxury tariff of 45 per cent, citrus 45 to 50 per cent, pears 45 per cent and mangoes 50 per cent. Pears are not produced in Thailand, while mangoes are counter-seasonal to Thai production, so pose no threat to the fresh Thai product. While authorities have improved the dairy import quota allocation system, they could further lift its transparency and predictability by allocating annual import quotas. A 57 per cent wine tariff and high indirect taxes add 400 per cent to the landed price of wine.

Services Trade Restrictions

Under the WTO General Agreement on Trade in Services, GATS, the Government slowly is opening up its financial services sector to foreign investment, particularly banking and insurance. By 2006, it must open its telecoms sector to foreign competition. However, Thailand continues to restrict imports of professional services such as engineering, accounting, legal and architectural services. (See Chapter 2 - *Australian-Thai Business* and Chapter 4 - *Foreign Investment.*)

TRADE PERFORMANCE

To sustain economic recovery, the Thai Government recognises it must help exporters regain the trade growth achieved in the mid 1980s and early 1990s, by encouraging competition and increasing industrial efficiency. Then, due to outward oriented trade and economic policies, the US dollar value of exports grew about 17 per cent per year and real GDP grew about 8 per cent. However, in the two years before the crisis, an overvalued baht and booming economy undermined Thai industrial competitiveness, causing exports to stagnate and imports to rise sharply. As the current account deficit grew to 8 per cent of GDP, creditors lost confidence in the Thai economy (Figure 5.6).

The crisis cut the US dollar value of two-way Thai trade by 5 per cent in 1997 and a further 21 per cent in 1998, as domestic demand for raw materials, equipment and consumer goods plunged sharply (Figure 3.4). In 1999, as Thai and East Asian demand grew and trade finance improved, the US dollar value of Thai trade increased 12 per cent to US$105 billion; still this was 17 per cent below the 1996 level of US$125 billion.

Merchandise Export Trends

In the aftermath of the crisis, exports appear to be recovering well, underpinning growth. Exports suffered much less than imports during the crisis and continued to grow by 3.8 per cent in 1997. As Asian demand contracted and trade finance dried up in 1998, exports fell 6.8 per cent, but in 1999, they recovered quickly to grow by over 7 per cent to US$56.8 billion and match their 1997 level (Figure 3.4).[20] By 1999, reputable exporters increasingly found trade finance and rising East Asian demand allowed them to capitalise on the earlier baht depreciation. The Government's raw material duty refund schemes also stimulated export growth.[21]

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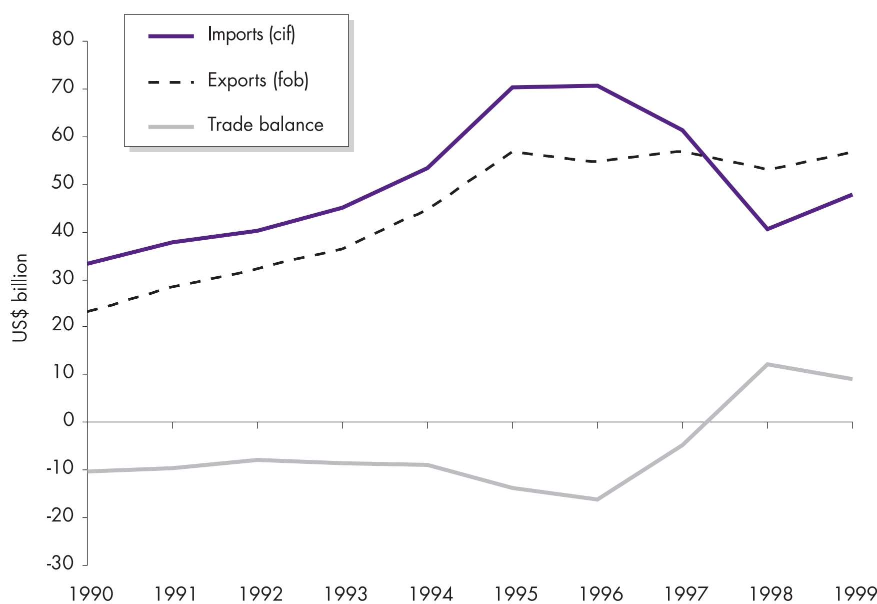
[20] Export performance was poor in 1998, despite the baht's 40 per cent depreciation, due to high real interest rates caused by exchange rate uncertainty and monetary tightness, and a credit crunch due to high financial system non-performing loans. Trade finance evaporated and domestic corporates were unable to invest to exploit new export opportunities. Foreign owned exporters in Thailand were less exposed as they could access internal trade credit facilities.

[21] In November 1999, exporters applied for Board of Investment import duty tax exemptions worth Baht 183 billion (US$4.8 billion), up 33 per cent on a year earlier, and the Customs Department received applications for Baht 749 million (US$20 million) of import tax refunds, up by 113 per cent (*The Nation*, 16 December 1999).

Figure 3.4

Weak Exports Contribute to the Crisis, Then Imports Plunge after the Crisis

Exports, Imports and the Balance of Trade, 1990-99, US$ (billion)



Note: Imports (cif) is the landed cost of imports including cost, insurance and freight.
Exports (fob) is the value of exports free on board, at their point of departure.

Source: CEIC, 2000.

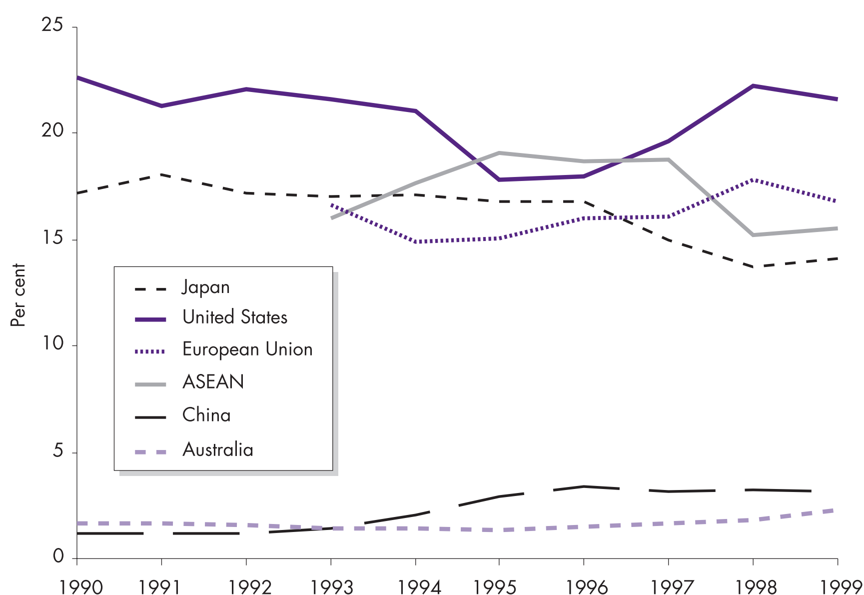
From 1996 to 1998, major Asian markets for Thai exports weakened, reflecting slower economic growth and reduced imports, particularly in Japan and Singapore. However, Thai exporters successfully redirected most of these exports to the United States, Europe, Australia and China (Figure 3.5). In 1997 and 1998, the US share of Thai exports grew particularly well, reflecting buoyant consumer demand there; the United States remains Thailand's major export market.

Latest monthly trends show very strong export recovery. In March 2000, exports (US dollar, three month moving average basis) were 33 per cent higher than a year earlier (Figure 1.1). Throughout 2000, exports should grow around 10 per cent or higher (Consensus Economics, 2000).

Figure 3.5

The United States Still Thailand's Biggest Export Market

Thai Export Shares Going to Selected Destinations, Per cent



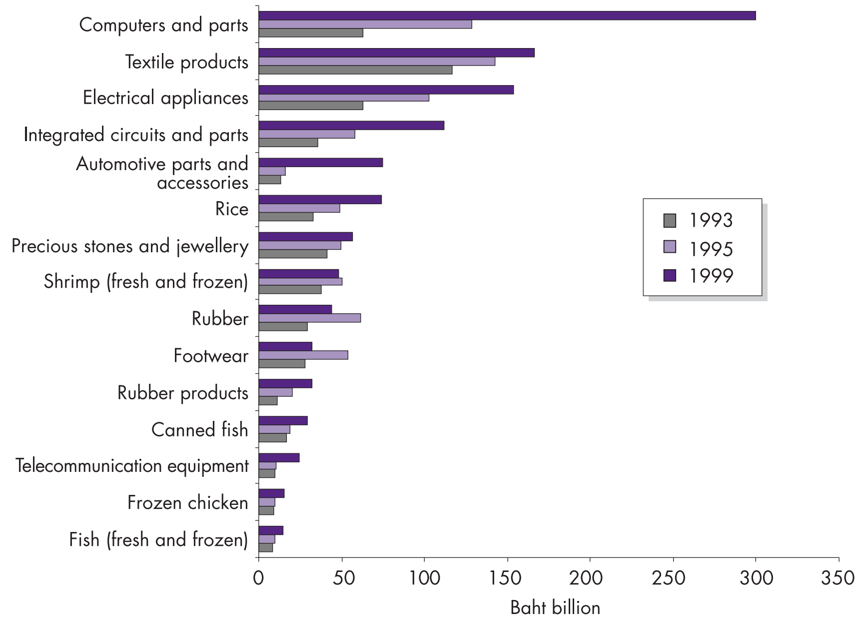
Source: CEIC, 2000.

Before the crisis, computers, electrical apparatus, integrated circuits, machinery, mechanical appliances, plastic products and automotive parts were the fastest growing Thai exports. The crisis did not change dramatically the structure of exports, and export recovery was broadly based. However, the share of clothing, textiles and some light consumer exports declined as the share of computers and electronics rose (Figure 3.6).

Figure 3.6

Electronics and Electrical Appliances Drive Exports

Thailand's Principal Exports, 1993, 1995 and 1999, Baht (billion)



Note: 1999 data is an estimate based on ten months' data to October 1999.
Source: CEIC, 2000.

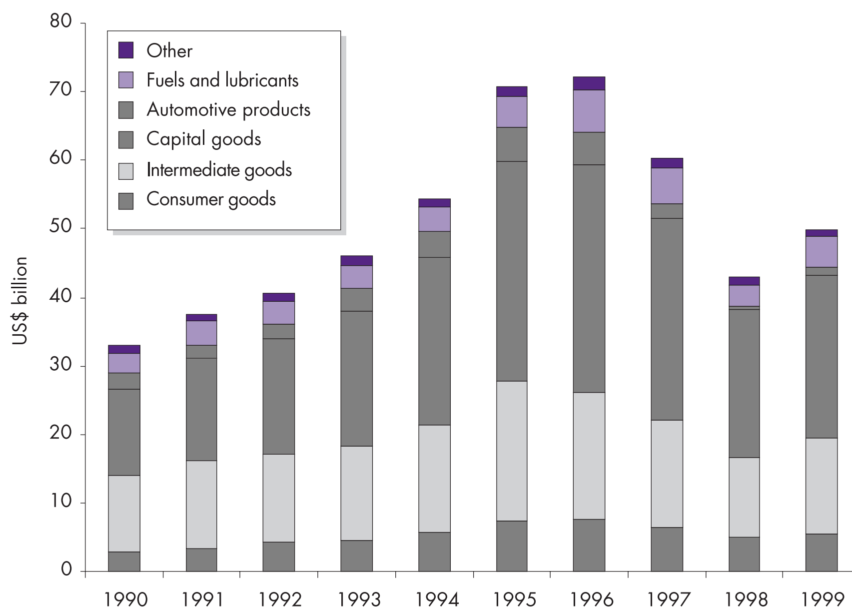
Merchandise Import Trends

Thailand's balance of payments adjustment hit imports hardest, with the US dollar value of merchandise imports almost halving from US$71 billion in 1996 to US$41 billion in 1998 (Figure 3.4). From mid 1997 to the end of 1998, real domestic consumer demand fell by 10.6 per cent, real investment fell 34 per cent and industrial production fell 6.5 per cent, dramatically reducing import demand. In 1997 and 1998, imports of capital equipment, raw materials, mineral fuels and lubricants fell heavily as producers cut back production for the domestic market and depleted inventories, anticipating a baht recovery (Figure 3.7).

Figure 3.7

Capital Goods Dominate Imports; Autos and Fuels Collapse

Thailand's Principal Imports, 1990-99, US$ (billion)



Source: CEIC, 2000.

As economic recovery strengthened throughout 1999, import values recovered across the board, increasing by 18 per cent to US$47.8 billion by December 1999.[22] In March 2000, imports (US dollar, three month moving average basis) were 22 per cent higher than a year earlier. Nevertheless, the US dollar value of imports in 1999 was still 32 per cent below the 1996 level. Imports are expected to grow about 20 per cent in 2000.

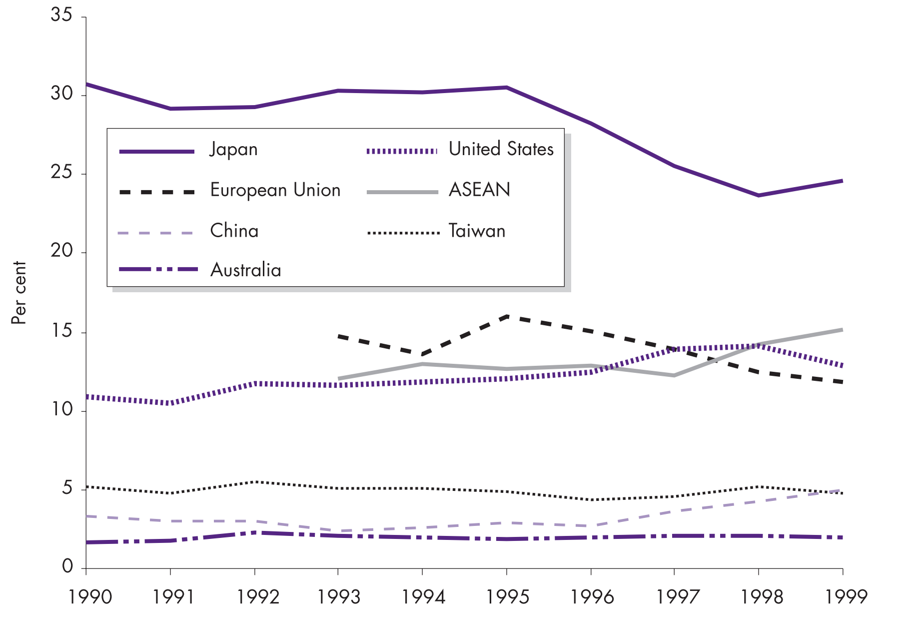
Japan is the major source of Thai imports (Figure 3.8). However, Japan's relative share fell between 1996 and 1999, as collapsing investment cut demand for Japanese machinery and falling demand from export industries cut demand for imported Japanese components. Consequently, ASEAN countries' import share increased between 1996 and 1999. Apart from the depreciation of their exchange rates, the ASEAN Free Trade Area may have diverted imports to ASEAN suppliers (World Trade Organisation, 1999b).

[22] Import volumes rose by 23.5 per cent in 1999; US dollar prices of imports fell by 5 per cent, while in baht terms, the prices fell by 13 per cent.

Figure 3.8

Japan Is Thailand's Biggest Import Supplier

Sources of Thai Imports by Economy and Region, Per cent



Source: CEIC, 2000.

Services Trade Trends

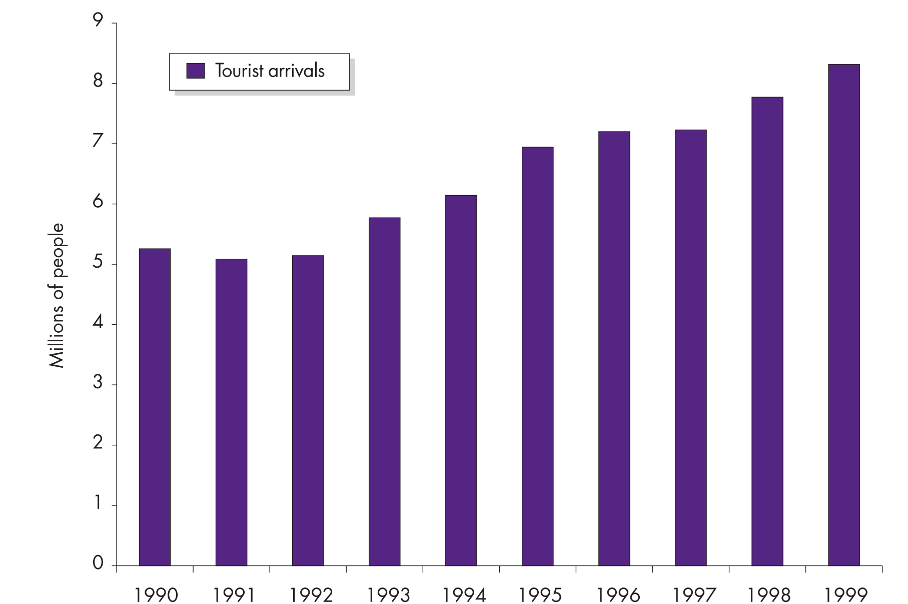
In the past, the thriving tourism industry ensured Thailand's services trade was in surplus. However, tourist arrivals stagnated in 1996 due to the strong baht and in 1997 due to financial crisis uncertainties, but rebounded strongly in 1998 and 1999 (Figure 3.9). In 1999, over eight million tourists visited Thailand generating US$7 billion in revenue (CIEC, 2000).[23] Transport revenue, mainly freight carried on Thai ships and aircraft, also contributes substantially to Thailand's services balance, netting over US$2 billion in 1999 (Bank of Thailand, 1999).

[23] Tourism revenues peaked at US$8.6 billion in 1996 when the exchange rate averaged Baht 25.3:US$1.

Figure 3.9

Tourist Arrivals Jump Post Crisis

Tourist Arrivals (million) in Thailand, 1990-99



Source: CEIC, 2000.

IMPLICATIONS FOR BUSINESS

Thailand is a potentially important market for Australia. As Thailand's economic recovery gains momentum and Thailand globalises its economy, new trade opportunities should emerge for exporters. Continued reform will be important to ensure expanding economic growth prospects, and thus import demand. Securing advantage from trade, foreign investment, financial and corporate sector reforms will be the key challenge for Australian traders and investors in this increasingly competitive and dynamic market.

Notwithstanding temporary imposts introduced during the crisis, Thailand gradually is reducing trade barriers; economic imperatives indicate this policy should continue. The Government also continues to address non-tariff barriers by easing import licensing restrictions and streamlining customs procedures. AFTA tariff reductions will increase competition from ASEAN partners. Assuming the Government presses on with trade and other major economic reforms, particularly those strengthening transparency, governance, prudential supervision and the legal framework, Thailand should become a fairer and more accessible market for traders and investors.

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Chapter 4

NEW OPPORTUNITIES FOR FOREIGN INVESTORS

Key Points

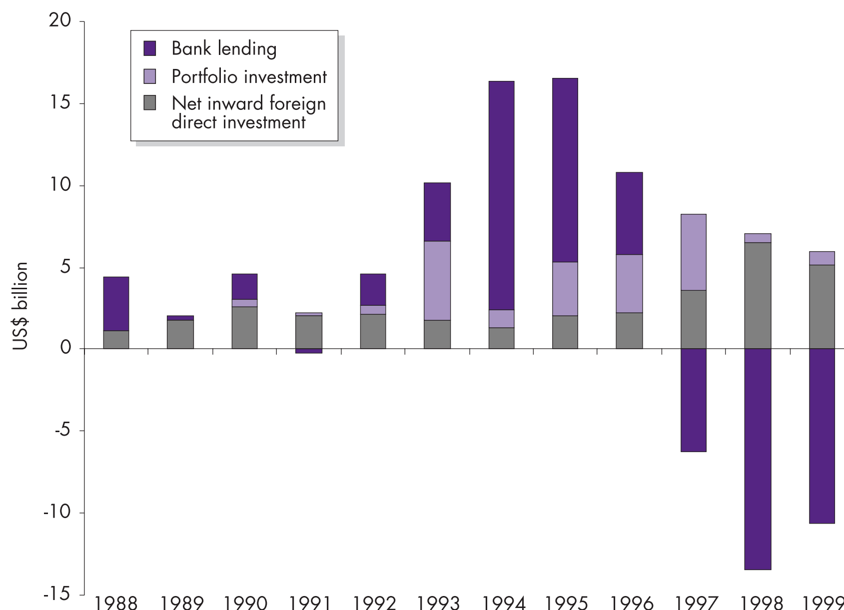
- Thailand's foreign investment regime is more open now than before the crisis, generating new investment opportunities, but remaining sectoral and ownership restrictions still limit the potential of foreign direct investment, FDI, to contribute to Thai economic development.
- Possible future reforms, including permanent permission for foreigners to own 100 per cent of Board of Investment promoted manufacturing enterprises, which may be announced in mid 2000, would point to a more liberal regime and expand future investment opportunities.
- The weaker baht and sector opening reforms since the crisis helped Thailand's FDI grow a strong 84 per cent in 1998 to US$7 billion; FDI in 1999 was US$5 billion, 38 per cent above the 1997 level.
- Financial sectors like banking, securities and finance companies, and large scale retailing now are very open to foreign investment.
- Laws allowing foreigners to own land are more liberal.
- The investment outlook is improving, and improved implementation of legal and FDI reforms should stabilise the framework for making business investment decisions.
- However, the foreign investment regime is in flux, as new laws and regulations have yet to be tested; furthermore, the new foreign business law which controls foreign access to many sectors may open up some business service areas, but this remains unproven.
- The Government's 2000 review of its generous but complex investment incentives system was expected to reduce relative benefits for companies located in wealthier provinces, including those near Bangkok, although now these reforms may be diluted.

A more liberal investment regime is fundamental to ensuring robust and sustainable growth; less restrictive laws on foreign ownership, equity levels and sectoral participation would signal to foreign investors that Thailand genuinely seeks their capital and expertise, not just to obtain foreign exchange but to increase Thai competitiveness in the long term. Attracting FDI is a key development strategy for Thailand. Foreign direct investments in factories, offices and other projects provide more stable capital inflows than bank lending and portfolio investment; foreigners bear the commercial and foreign exchange risks involved; and FDI usually involves useful technology, managerial and marketing skill transfers.

Figure 4.1

FDI Recovered Rapidly Post Crisis

Long Term Trends in FDI



Source: Bank of Thailand, 1999.

FDI is a significant component of Thai capital inflows and has contributed to domestic investment and growth.[1] However, in the decade before the crisis, FDI levels had stagnated (Figure 4.1).

Since the financial crisis, Thailand has sought more FDI to support financial and corporate restructuring and economic recovery; this has stimulated much higher inflows. In 1997-98, Thailand received more FDI than any other East Asian economy except China. In 1998, FDI to the region fell 11 per cent to US$85 billion, but FDI to Thailand jumped 84 per cent to nearly US$7 billion (United Nations Conference on Trade and Development, 1999).[2] While 1999 inflows did not match this upsurge, they were still high by past standards (Figure 4.1).

Recent FDI growth reflects the recapitalising of financial institutions now that FDI access to this sector is more liberal, and the easing of joint venture restrictions has increased industrial investment (Figure 4.4 and Table 4.2). FDI in 1998 largely resulted from foreign companies taking advantage of the depreciated baht, falls in

1 FDI's contribution to total investment increased from an average of 5 per cent between 1970 and 1986 to about 10 per cent between 1987 and the early 1990s.

2 FDI inflow to Malaysia fell 27 per cent and to Singapore fell 26 per cent during the same period. Indonesia fared even worse; FDI inflow fell from US$4.7 billion in 1997 to US$356 million in 1998. In contrast, foreign investment into the Republic of Korea grew by 81 per cent to US$5.1 billion in 1998 (United Nations Conference on Trade and Development, 1999).

asset prices and new temporary regulations allowing 100 per cent foreign ownership of Thai based manufacturing subsidiaries receiving Board of Investment, BOI incentives.[3] Weaker FDI in 1999 suggests regulatory changes governing foreign ownership rather than strong new investment prospects prompted the increase (World Trade Organisation, 1999). While the number of BOI promoted project applications rose in 1999, the value of projects declined.

Since 1997, government attempts to overhaul the foreign investment regime and investment promotion privileges have had mixed success. The Senate undermined efforts to liberalise the alien business law, which limits foreign investor access to many economic activities, and relax laws restricting foreign ownership of land. Consequent changes were only marginally more liberal than previously.

To help Thailand remain an attractive investment destination during the crisis, the BOI relaxed export performance criteria on BOI promoted projects and offered all investors a duty exemption on raw material imports. In 1998, the BOI began reviewing the foreign investment incentives system so the new structure could be announced by June 2000.

This chapter examines the effectiveness of government initiatives to encourage FDI since 1997 and assesses the progress in removing impediments to foreign investment. To identify emerging opportunities, it analyses recent FDI trends, including changing sources and sectoral distribution. Finally, the chapter examines remaining FDI barriers and likely future prospects for FDI into Thailand.

THE FOREIGN INVESTMENT REGIME

Since the crisis, the Government has liberalised several elements of Thailand's foreign investment regime, expanding the sectors open to foreign investment and liberalising foreign ownership of land. However, the effectiveness of these initiatives in attracting foreign investment also depends on the Government implementing effectively broader legal and economic reforms, so investors are confident Thailand's recovery is sustainable and their investments are secure.

Throughout most of the 1990s, the *Alien Business Act, 1972* and the *Investment Promotion Act, 1977* governed FDI in Thailand. The alien business law restricted foreign access to many business sectors, including agriculture, manufacturing, construction, retailing, real estate and most business, professional and financial services.[4] Appendix Table 4.1 outlines alien business law restrictions before and after the recent amendments. The investment promotion law provided incentives, including tax holidays and capital goods duty waivers, to both foreign and local investors investing in priority regions and sectors. These incentives are administered by the BOI, which also oversees foreign investment policy.

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3 The BOI supervises foreign investment policy and provides investment incentives for approved local and foreign projects.

4 Under the alien business law, Category A business activities were closed to foreigners and reserved for Thai citizens; such activities included rice farming, building construction, and most professional services such as real estate, legal, accounting, brokerage, architectural and advertising services. Foreign businesses could own up to 49 per cent of Category B businesses activities, unless a royal decree permitted otherwise. For example, a royal decree in 1973 allowed up to 100 per cent foreign ownership of projects promoted by the BOI. Category C businesses were open to foreigners, but before they started operating, the Ministry of Commerce had to grant approval case by case.

Since the early 1990s, BOI incentives have shifted from promoting exports to decentralising industry to poorer regions outside Bangkok, and have encouraged heavy industry, infrastructure provision and other selected activities. After the crisis induced fall in Thai exports, export promotion was re-emphasised to assist economic recovery (World Trade Organisation, 1999).

RECENT FDI LIBERALISATION

Since mid 1997, the Government with IMF support has introduced a series of new laws to facilitate FDI:

- the new foreign business law and financial sector reforms somewhat broaden areas in which foreign investors can participate, and ease foreign ownership ceilings and other restrictions
- the alien land law amendments extend the circumstances under which foreigners can own and mortgage land.

In addition, the new foreclosure and bankruptcy laws and the new bankruptcy court should strengthen the legal framework underlying financial markets and improve the lending environment. (See Chapter 7 - *Corporate Restructuring*.) Various constitutional, legal and administrative reforms also should reduce corruption and increase transparency in government. (See also Chapter 5 - *Crisis Responses* and Table 7.1.)

New Foreign Business Law and Financial Sector Reforms

In October 1999, after deliberating for seven years, the Thai Parliament finally replaced the restrictive alien business law first introduced in 1972. The new law should have made it easier for foreigners to obtain business licences and hold larger shares of local businesses, facilitating increased FDI. However, while the new law reduces the number of restricted business sectors from 63 to 43, it still extensively restricts foreign majority participation in many economic activities. (See Appendix Table 4.1 for a detailed list.) The new foreign business law does amend usefully the definition of an alien, now defined as any juristic person (including companies and properly registered partnerships) in which foreigners hold 50 per cent or more of the value of the shares.[5]

[5] The previous law also defined as an alien any juridical entity in which at least half of the *number* of shareholders, partners or members were foreigners, notwithstanding their share of capital.

NEW LAW STILL RESTRICTIVE

Like its predecessor, the new *Foreign Business Act, 1999* contains three sectoral lists specifying levels of foreign participation.

List 1: Business not allowing foreign participation

This list includes the media, farming, livestock raising, forestry, fishing, trade in ancient Thai objects and land vending. Only Parliament can amend this list.

List 2: Business requiring prior cabinet approval for foreign participation

This list includes activities related to national security or safety, including arms and explosives production, domestic land, water or air transport, art and culture creation, native handicraft manufacture and natural resource or environmental exploitation (sugar production, salt farming, mining or timber extraction). In future, firms in these sectors must have at least 40 per cent Thai ownership, but with cabinet approval, this could be lowered to 25 per cent. Only a royal decree can amend this list.[6]

List 3: Business requiring foreigners to obtain Ministry of Commerce approval before competing with Thai nationals

This list includes businesses and professions such as accounting, engineering, architecture, legal practice, general brokerage (except dealing in futures, derivatives and equities), small construction contracting, auctioning, small scale retail and wholesale trade, advertising, hotel business and tourism, and all other services. Foreigners cannot enter List 3 sectors unless the Director-General of the Department of Commercial Registration, Ministry of Commerce, grants permission on the advice of the Foreign Business Committee. Approval will allow majority foreign ownership. Only a royal decree can amend this list.[7]

Other laws override the foreign business law

Foreign firms can undertake activities in List 2 or 3 if the BOI or the Industrial Estate Authority promotes their projects, or if other laws, such as laws allowing FDI in banks, exempt these activities.

Source: Board of Investment, 1999a.

The foreign business law does not apply to firms from countries like the United States, which have preferential treatment under existing bilateral treaties.[8] However, the new law requires reciprocal arrangements, so Thai companies must be free to undertake comparable businesses in preferentially treated countries.

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6 For businesses in List 2, the Minister of Commerce must approve the business activity before cabinet approval is sought.

7 The Permanent Secretary of Commerce chairs this board which includes representatives of government ministries and private agencies.

8 Under the *US Treaty of Amity and Economic Relations*, signed in 1966, US companies receive the same treatment as Thai companies. Consequently, 100 per cent US owned companies can operate in sectors where other foreign companies generally are restricted to 60 per cent foreign ownership.

Foreign professional access could be restricted in many service related activities other than those actually proscribed in List 3 because of the open wording, prohibiting FDI in 'other services'.[9] Many investors are awaiting some decisions under the new act to assess how its provisions will be interpreted in practice. Foreigners regard Toyota's application to operate leasing services in Thailand, still before the Foreign Business Board in mid 2000, as a test case of how liberal the new law will be.

The new law also has several new restrictions. Foreign investors now must invest at least Baht 3 million (US$79 000) in foreign currency in a proscribed business to gain permission to enter it; the previous law did not set a minimum foreign currency investment. The new law also roughly doubles the fine, to between Baht 100 000 and 1 000 000 (US$2 600 to $26 000) for foreigners engaging in a restricted business, and offenders can be imprisoned for up to three years.

However, some aspects of the new law are less prohibitive than previously. For example, the new law stipulates foreigners cannot undertake retail business with a capital investment less than Baht 100 million (US$2.6 million) or operate retail stores worth less than Baht 20 million (US$526 000). By inference, foreign companies can engage in retail business with foreign equity over Baht 100 million (US$2.6 million) and several large retailers already have entered Thailand. In addition, Thailand has relaxed regulations so foreign investors can own 100 per cent of banks, finance companies and security houses. (See Chapter 6 - *Financial Restructuring*.)

In June 2000, the Government is expected to announce foreign investors permanently can own 100 per cent of BOI promoted manufacturing projects, without requiring export or locational conditions.[10] If this occurs, it will indicate an important willingness to further liberalise FDI, signalling increasing opportunities in future.

Alien Occupation Act

Foreign investors also find the *Alien Occupation Act, 1978*, restricts FDI by limiting the visas issued to foreigners wishing to work in Thailand. Many occupations theoretically are closed to foreigners, including auditing and accounting, architecture, law and engineering but visas can be obtained, in certain circumstances. Foreigners working in unrestricted occupations also must have work permits from the Immigration Bureau and the Ministry of Labor and Social Welfare.

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[9] It is still unclear how this will be administered. The Department of Commercial Registration in the Ministry of Commerce which advises the Foreign Business Committee, chaired by the Ministry of Commerce indicated it will look favourably on applications from foreign service providers seeking to establish businesses in List 3 sectors (Chintana, 2000).

[10] For BOI promoted manufacturing projects, if production is mainly for the domestic market, Thai nationals are normally required to hold at least 51 per cent of total registered capital. Projects located in remote areas are exempted; there, 100 per cent foreign ownership is considered case by case. These provisions were suspended temporarily in 1998 to encourage foreign investment, but by May 2000, the Government had not made the change permanent. For manufacturing and other commercial activities not seeking BOI promotion, 100 per cent foreign ownership is permitted if the business is not restricted under the foreign business law or other national laws.

However, foreigners working in selected activities, including in BOI promoted investment projects, can obtain visas and work permits relatively easily (Board of Investment, 1999b).[11] In June 1997, the BOI facilitated visa issues by opening the One-stop Service Centre for visas and work permits.[12]

Land Ownership Reforms

Land ownership reforms also are important to improve the foreign investment climate. Before the crisis, only foreign businesses with BOI investment promotion privileges could own land. However, under the *Land Code Amendment Act, 1999*, foreigners investing a minimum Baht 40 million (US$1.05 million) and meeting other conditions can own up to 1 600 square metres of residential land.[13]

The new *Condominium Act, 1999*, allows foreigners to purchase a unit, providing they do not own more than 49 per cent of the total floor area of any condominium complex. However, with the massive oversupply of condominiums in the Bangkok metropolitan area, the Government has relaxed this restriction for five years for condominiums in Bangkok and other specified areas (Board of Investment, 1999c).[14] Few foreigners have taken up this opportunity, as prices are still very high (Took, 2000).

Foreigners also can lease commercial or industrial property for 50 years under the *Property Lease and Rights Act, 1999*. This law adds 20 years to the old lease period, and allows lease renewal for up to 50 years after the initial term is completed (Board of Investment, 1999c). However, the new agreement must be made with the original vendor, who may prove to be difficult to find after so long, so this relaxation may have limited benefits for leasees (Took, 2000).

[11] As well, foreigners working for Thai Government, certain international organisations and foreign embassies automatically receive visa approval. Foreigners entering Thailand to undertake 'urgent and essential' work are exempt from work permit requirements as long as their work period is under 15 days.

[12] To expedite approvals, officials from the Immigration Bureau and Ministry of Labour and Social Welfare are co-located in the centre. If applicants collect all supporting documentation before they apply, the centre can process visa and work permit applications in three hours.

[13] The land acquisition must comply with ministerial regulations, benefit the Thai economy, and be in the Bangkok metropolitan area, Pattaya, or other municipalities or areas as specified in the town planning law, and the related foreign investment must remain in Thailand for at least three years.

[14] However, after five years, foreign owners must sell units exceeding the 49 per cent maximum.

BOI FOREIGN INVESTMENT PROMOTION

Thailand's extensive system of FDI incentives dates back to the late 1950s when the BOI became the main investment promotion agency.[15] Investors can apply for BOI investment incentives via the Investment Services Centre at the Office of the BOI.[16] The need to stimulate FDI and exports during the crisis and to save revenue led the BOI to enhance several incentives but tighten others; the revamped scheme extends national treatment to all BOI supported firms operating in Thailand, without discrimination.

Scope of BOI Incentives

BOI incentives for approved projects include generous income tax holidays and exemptions from or reductions in import duty on machinery, equipment and raw materials used in production. These incentives reduce Thailand's marginal effective income tax rate for supported projects from 46 to 7 per cent, making incentives very attractive compared with the 20 per cent or so tax rates imposed by regional competitors such as Malaysia and the Philippines (Foreign Investment Advisory Service, 1999).[17] BOI supported projects also are exempt from sectoral restrictions under the alien business law; give foreign employees easier access to work visas; and allow project related land ownership.

Incentives aim to align Thailand's industrial development with government policies. BOI incentives supported import substitution industries in the 1960s and the 1970s, export-oriented industries in 1980s, and greater decentralisation and heavy industry

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[15] The BOI is governed by the *Investment Promotion Act, 1993* and chaired by the Prime Minister, with economic ministers, public servants and business representatives serving as board members. The Office of the BOI under the Prime Minister's Office implements promotion activities (Board of Investment, 1998a). Other agencies also play a role in setting national foreign investment policy, including the Ministry of Commerce, which administers the *Foreign Business Act, 1999*. The National Economic and Social Development Board, the Ministry of Finance and the Ministry of Industry also formulate industry policy. Changes to the BOI's investment promotion schemes do not require parliamentary approval so long as they fall within the Investment Promotion Act. Consequently, the BOI has introduced frequent changes to the scheme through simple ministerial notifications (World Trade Organisation, 1999).

[16] Investors can obtain application forms from the Investment Services Centre at the Office of BOI. Investors must submit two completed sets of application forms, and arrange to meet BOI officials to discuss project specifics. The BOI then reviews the application and notifies the investor whether it has been approved, declined, or returned for additional documentation. For projects with an investment of under Baht 200 million (US$5.9 million), the review is performed within 60 days by a BOI sub-committee. If the project exceeds Baht 200 million, the full BOI Board considers the proposal and decides within 90 days of the application's submission.

[17] The marginal effective tax rate is an estimate of the effective tax rate levied on income, received by an investor, generated by the last marginal baht invested. It is a function of the corporate tax rate, personal tax rates on interest and dividend income, import duty on capital goods, depreciation allowances and certain macroeconomic variables, including nominal interest rates and the rate of inflation.

in the early 1990s.[18] Since 1997, the BOI has reintroduced incentives to encourage FDI to bolster foreign exchange reserves. For example, in November 1998, the BOI temporarily removed export performance criteria for BOI supported projects in all zones. In 1999, the Government considered modifying decentralisation incentives to further advantage more isolated, low income provinces and reducing incentives to investors in provinces surrounding Bangkok (Brimble, 2000). However, investors in industrial estates in some provinces who expected to receive significantly fewer incentives urged the Government to reconsider this policy change. In early 2000, the final outcome of this debate was uncertain, but a March press release indicates the BOI may make relatively few changes to the incentive system (Board of Investment, 2000a).

Criteria for Project Approval

The BOI criteria for projects seeking investment incentives are complex. They differ depending on size of investment, ownership structure and sector in which the investment takes place.[19]

Priority Activities

The Government and BOI also prioritise investments in particular sectors, including transport, public utilities, environmental protection and/or restoration, and projects involving high technology transfers. While relevant government ministries are responsible for determining foreign ownership limits in these sectors, the BOI still provides incentives. These include corporate income tax exemption for eight years regardless of location, a 50 per cent import duty reduction for projects located in Zones 1 or 2, and full import duty exemption on machinery for projects in Zone 3.

To encourage decentralisation, the BOI also can grant incentives to projects which relocate from Zone 1 to Zone 2 or 3, or from Zone 2 to Zone 3.

....

18 Decentralisation incentives involved dividing Thailand into three zones, with the level of incentive rising the further the promoted activity was from Bangkok (Board of Investment, 1998a). Zone 1 includes the Bangkok metropolitan area and neighbouring central region; Zone 2 includes ten provinces surrounding Zone 1; and Zone 3 includes the remaining provinces. Since the early 1990s, the BOI has given the greatest investment privileges to Zone 3. For example, a project located in Zone 1 that exports more than 80 per cent of sales normally is eligible for a three-year corporate tax holiday. In addition, it receives a 50 per cent exemption on import duties on machinery and a one-year exemption on import duties on raw materials used in exports. A similar project in Zone 3 is eligible for an eight-year corporate tax exemption, is fully exempt from import duties on machinery and receives a five-year exemption on import duties on raw materials used in exports. Zone 3 projects also receive other special tax privileges, granted case by case. These include a 50 per cent reduction in corporate income tax for a further five years, double deduction of water, electricity and transports costs from taxable income for ten years, and a 25 per cent deduction from net profit of the costs of installation and construction associated with the project's infrastructure facilities.

19 For example, investment projects with an investment under Baht 200 million (US$5.3 million) excluding the cost of land and working capital, must have value added of at least 20 per cent of sales, except for projects which export 80 per cent of sales. Other criteria relate to the size of registered capital and the use of modern machinery and production processes. Where the investment exceeds Baht 200 million (US$5.3 million), the BOI also considers the impact of the project on Thai industry, government revenue and consumers.

FOREIGN EQUITY PARTICIPATION RULES

The BOI uses the following criteria to determine permitted foreign equity limits in promoted investment projects:

Sector	Maximum foreign participation (per cent)
Fisheries, mineral exploration, mining and services	
• five years after start up, the project must become majority Thai owned, except for large projects where invested capital exceeds Baht 1 billion (US$26 million)	49
Manufacturing[a]	
• mainly for the domestic market	49 (now 100[a])
• mainly for domestic market and located in Zone 3	100
• if at least 50 per cent for export	majority shareholding allowed
• if at least 80 per cent for export	100

Note: a In 1998, the BOI temporarily allowed 100 per cent foreign ownership in BOI supported manufacturing projects, irrespective of export performance or location.

Source: Board of Investment, 1998a; and German-Thai Chamber of Commerce, 1999.

Incentives for Technology Upgrading and R&D

The BOI also grants incentives to invest in R&D and upgrade technology.[20] It gives an additional three-year corporate income tax holiday for introducing advanced technology, improving product quality and developing new products. However, the total corporate tax exemption period cannot exceed eight years.

To accelerate the upgrading of industrial technology, many new BOI supported projects must reach internationally agreed quality standards. This applies to projects which invest a minimum of Baht 40 million (US$1 million) in either engineering or basic industries, or in industries which export more than 80 per cent of sales. The BOI applies penalties if companies do not reach these standards.[21]

[20] To improve the competitiveness of basic industries, the BOI also extended the time from two to five years for BOI promoted companies to import tax free equipment to manufacture electrical products and components, effective from January 2000 (Board of Investment, 1999e).

[21] For example, if promoted companies fail to achieve a certified international standard such as the ISO 9000, which sets standards for the design, installation and operation of quality management systems, within two years after operations begin, the BOI will reduce the period of the corporate income tax holiday by two years. To facilitate the process of obtaining certification within two years, the BOI asks the Thai Industrial Standards Institute to assign priority to reviewing ISO 9000 applications from BOI approved projects.

Short Term, Post Crisis Incentives

Since 1997, many new short term BOI measures have aimed to promote export growth, attract FDI, promote the efficiency and competitiveness of Thai industries and reduce unemployment. While measures to encourage industrial decentralisation remain, they have been relaxed considerably to attract new FDI. Apart from allowing new manufacturing projects to be 100 per cent foreign owned, the BOI liberalised joint venture criteria so foreign shareholders in BOI sponsored projects can take over a majority share in a project if Thai shareholders consent.

Streamlining Procedures and One-stop Service Centre

BOI operations recently became more service oriented; the BOI believes streamlined activities have almost halved transaction processing times. Apart from providing visas for BOI promoted companies, the One-stop Service Centre also can issue investment licences and permits. These permits cover permission to establish, operate and expand factories, produce and sell medicine and foodstuffs, and construct operational buildings and structures.

To encourage the formation of partnerships, the BOI compiles information about Thai investment opportunities and operates a free Investment Matchmaking and Information Centre. It also provides updated investment information on the BOI home page, *www.BOI.go.th*.

REVIEW OF INVESTMENT INCENTIVES

Since the financial crisis began, domestic and external groups have pressured the Government to review investment incentive policies to limit government revenue losses, and ensure promotion incentives are consistent with WTO obligations (Board of Investment, 1998b).[22] Consequently, the BOI commissioned the Thailand Development Research Institute to examine whether investment incentives were appropriate for Thailand and how Thai incentives compared with those other countries in the region offered. It also commissioned the Foreign Investment Advisory Service under the World Bank to review Thailand's incentives system and recommend possible improvements (Board of Investment, 1998b).

Government is considering these reports and consulting with business, other government agencies and academia. In late 1999, the BOI was considering a new scheme that reclassified provinces by per capita income, infrastructure facilities and average education levels rather than proximity to Bangkok (Board of Investment, 1999d). However, by March 2000, the Board of Investment had moved away from a more radical approach, and was recommending a scheme only marginally different from the existing scheme (Board of Investment, 2000a). Enhancing Thailand's long term competitiveness through human resource development and technological capability, industrial decentralisation and foreign investment facilitation will continue as key objectives of the BOI incentive system.

The new structure probably will retain three investment promotion zones. Investment projects in Zone 3 still will receive the greatest privileges (Table 4.1).

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[22] The WTO estimates the duty concessions and exemptions of machinery and raw materials cost Thailand around Baht 72 billion (US$200 million) in 1998.

Table 4.1

Zone 3 Still Will Receive the Biggest Incentives

Revised Scheme for Granting Incentives for BOI Promoted Projects

	Zone 1 (unchanged – Bangkok and five provinces in the central region)	Zone 2 (increased to 12 provinces – Rayong and Phuket moved from Zone 3)	Zone 3 (remaining 58 provinces, plus industrial estates in Rayong)
Import duty exemption	50 per cent import duty exemption on machinery. Three-year import duty exemption on raw materials used in manufacturing exports.	50 per cent import duty exemption on machinery. Three-year import duty exemption on raw materials used in manufacturing exports.	Full import duty exemption on machinery. Three-year import duty exemption on raw materials used in manufacturing exports.
Corporate tax exemption	Three-year corporate tax exemption if in an industrial estate (previously applied to all projects).	Five-year corporate tax exemption if in an industrial estate (previously seven years) and three years if outside an industrial estate (unchanged).	Eight-year corporate tax exemption (unchanged).
International Standard Organisation, ISO, certification	Projects over Baht 100 million (US$2.6 million) must achieve ISO, or other certification within two years or corporate tax exemption reduced by one year (new).	Projects over Baht 100 million (US$2.6 million) must achieve ISO, or other certification within two years or corporate tax exemption reduced by one year (new).	Projects over Baht 100 million (US$2.6 million) must achieve ISO, or other certification within two years or corporate tax exemption reduced by one year (new).
Other	Nil.	Nil.	Additional incentives may be provided to 18 remote border provinces in Zone 3.

Source: Board of Investment, 2000a.

The new policy package should become effective in June 2000 and be applied on a most favoured nation basis. The package will not affect existing investment projects already receiving incentives. Most conditions for projects seeking BOI promotion will remain unchanged.[23] The BOI will remove 35 business activities from its promotion list.[24] Five new business activities will be promoted: herbal product manufacturing, machinery and industrial equipment maintenance, e-commerce,

[23] However, The BOI will cancel import tax exemptions for non-exporting companies. Also, the value-added component of projects with less than Baht 500 million (US$13 million) must be at least 20 per cent of revenue. Feasibility studies will be required for projects over Baht 500 million. Projects must be majority Thai owned in agriculture, livestock, fisheries, mining and exploration and services, except for those falling under the foreign business law where foreign majority ownership may be permitted.

[24] Businesses removed include operations such as abattoirs, drinking water production, hydroponics farming, marble and granite mining, ship assembling, paints, warehousing container production and joint land-railway transport.

electronics and electrical appliance maintenance, and recycling of waste or chemicals. The BOI also will continue to grant special privileges to businesses involving public utilities, infrastructure services, environmental protection and conservation, and technological and human resource development. It will exempt such businesses from import duties on machinery and grant an eight-year corporate tax exemption, irrespective of locality or level of foreign ownership. However, given the transfer of Rayong and Phuket from Zone 3 to Zone 2, the overall level of incentives paid for BOI promoted projects is likely to fall.

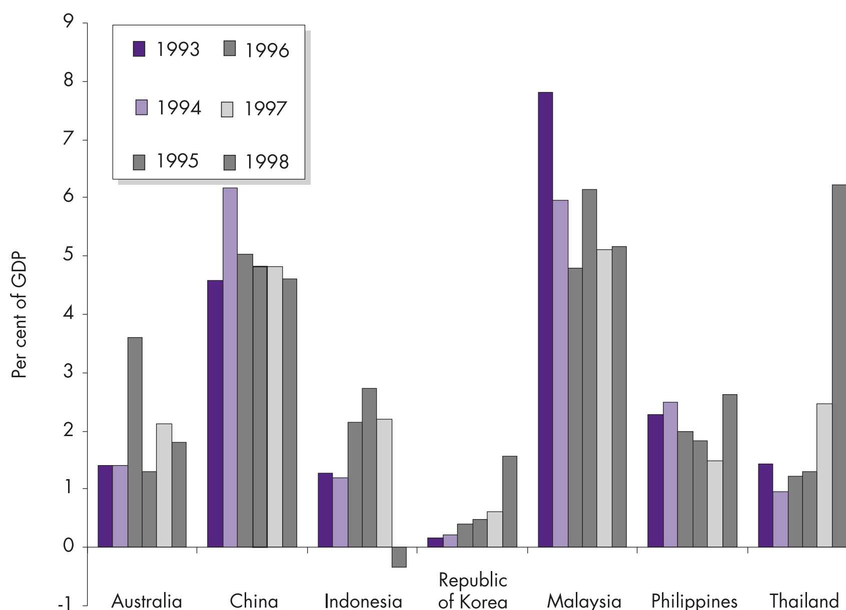
TRENDS IN FDI

In the decade before 1997, Thailand's high real GDP growth and relative economic policy and political stability attracted solid but not spectacular net FDI inflows (Figure 4.1). Relatively low wages and good market access to developed economies under the Generalised System of Preferences encouraged this inflow. Throughout the early 1990s, Thailand's restrictions on FDI caused its FDI to GDP share to remain below most regional partners except the Republic of Korea (whose pre-crisis FDI regime was even more restrictive than Thailand's). In 1998, liberalisation of foreign ownership limits and sectoral entry raised Thailand's FDI to GDP share to around 6 per cent, higher than all other countries in the region (Figure 4.2). However, by 1999 Thai FDI had fallen to approximately 4 per cent of GDP.

Figure 4.2

Thailand Attracts a Bigger Share of Regional FDI

FDI as a Share of GDP, Selected Countries, 1993-98, Per cent



Source: CEIC, 2000; United Nations Conference on Trade and Development, 1999; and Department of Foreign Affairs and Trade, 1998.

Longer Term Trends in FDI

In the late 1980s and early 1990s, FDI routinely represented about a half of Thailand's total capital inflows. However, by the 1990s, FDI's share of capital inflows declined as portfolio investment, then private borrowing by bank and corporate sectors exploded following the establishment of the Bangkok International Banking Facility and the opening of Thailand's capital account (Figure 4.1). Thai labour, land and other costs rose and the real trade weighted baht appreciated, reducing Thailand's attractiveness as an FDI destination; inflows of FDI fell from US$2.6 billion in 1990 to US$1.3 billion in 1994.[25] As in other Asian economies severely affected by the financial crisis, the relative fall in FDI and rise in more volatile and risky short term foreign borrowing and portfolio flows greatly increased Thailand's vulnerability to the crisis (East Asia Analytical Unit, 1999).

From 1997, FDI again began to grow significantly as foreign companies took advantage of exchange rate depreciation, new incentives and relaxed foreign investment regulations (World Trade Organisation, 1999). With relaxed FDI access rules, FDI reached US$7 billion in 1998, (up from US$2 billion in 1995) and US$5 billion in 1999. By 1999, Thailand's total stock of FDI was estimated at over US$35 billion (Economist Intelligence Unit, 1999).

Sources of FDI

Japan was the largest source of FDI, but the European Union has taken this position since 1997. In the late 1980s, Japan provided more than 40 per cent of FDI inflows (Figure 4.3). Japan's high wages and strong exchange rate forced many Japanese firms to relocate more labour intensive processes to economies with lower labour costs. Japanese FDI to Thailand was concentrated in the automotive and electronics industries. However, Japan's investment share fell to around 20 per cent in the early 1990s as Japanese companies relocating processes overseas favoured economies with lower effective labour costs such as China, India and Mexico (Urata and Kawai, 1998). During the financial crisis, Japanese investment in Thailand recovered; it accounted for around 30 per cent of all inflows in 1997 and 1998. This mainly reflected existing Japanese investors taking advantage of new foreign investment guidelines to buy out local partners. In 1999, as this activity decreased, Japan's share of FDI again fell to below 20 per cent.

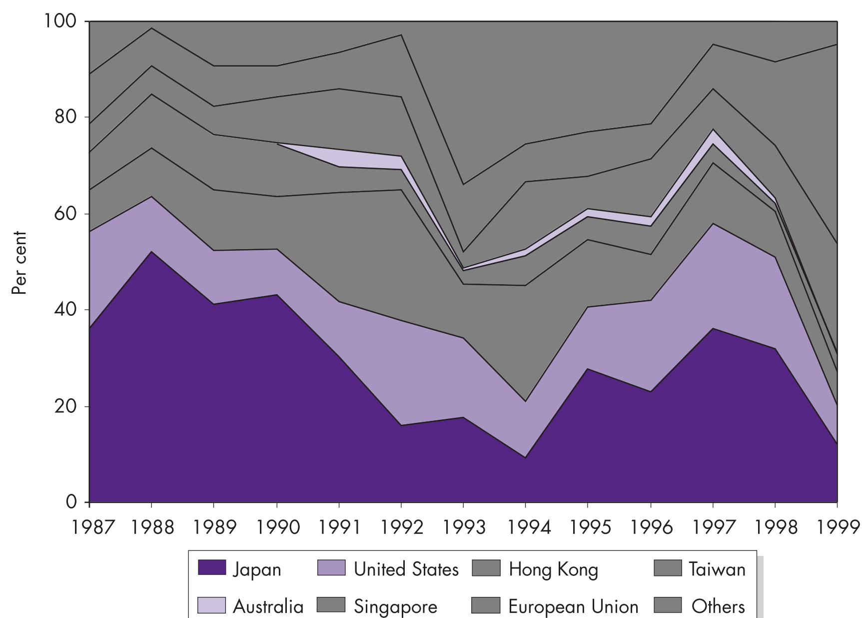
Other important sources of Thai FDI are the United States, Hong Kong and Singapore. During the 1990s, FDI from Singapore grew very rapidly and Singaporean purchases of two Thai banks helped push Singapore's FDI share to 27 per cent in 1999. More recently, the European Union has invested strongly in Thailand, also aided by two bank purchases (Figure 4.3 and Table 4.1).

[25] However, reclassification of data associated with the start up of the Bangkok International Banking Facility accounted for part of this decline.

Figure 4.3

Singapore, United States and European Union Compete with Japan as Major Investors

Composition of FDI Inflows, Per cent



Source: Bank of Thailand, 1999.

Sectoral Distribution of FDI

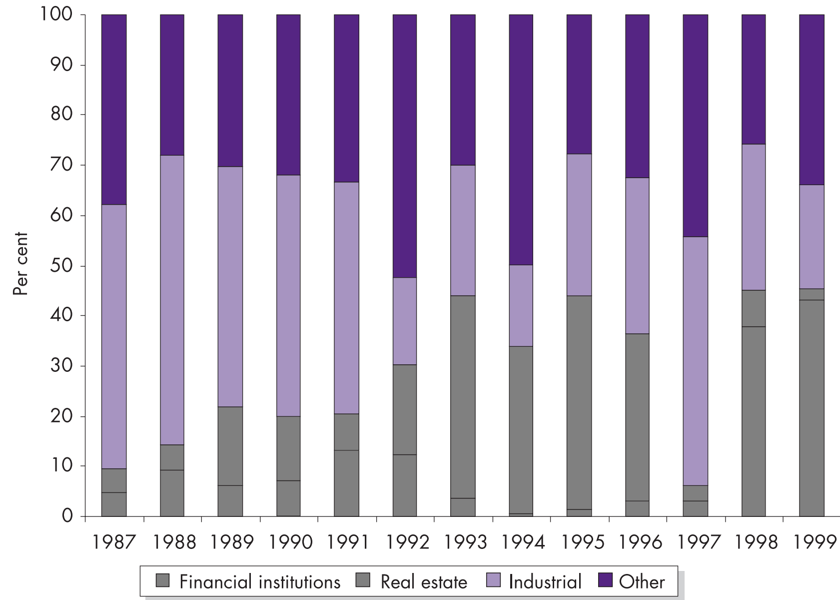
In the late 1980s, about half of inward FDI went to the manufacturing sector, particularly electronics and other labour intensive, export-oriented industries (Figure 4.4 and Table 4.2).

During the 1990s, as Thai industry became less competitive, real estate boomed and private infrastructure increased, the composition of inward FDI shifted significantly to real estate and ‘other’ sectors, which included infrastructure. From 1994 to 1996, almost 40 per cent of net FDI went to real estate (Figure 4.4). More recently, the manufacturing sector and, responding to bank recapitalisation needs, the financial sector, have attracted most FDI.

Figure 4.4

Financial Sector FDI Increases Share after 1997

Longer Term Sectoral Composition of FDI, Per cent



Source: Bank of Thailand, 1999.

Another recent trend is the smaller scale of new FDI projects. In 1999, the BOI received 992 project applications or 44 per cent more than a year earlier. However, total proposed capital investment in these projects fell 5 per cent.[26]

[26] The average investment capital in new project applications in 1999 was US$5.5 million compared to US$8.5 million in 1998.

Table 4.2

Manufacturing's FDI Share Falls as Banks Attract Capital

Recent FDI by Industry Sector

Sector	1997		1998		1999	
	Amount (US$ million)[a]	Share (per cent)	Amount (US$ million)[a]	Share (per cent)	Amount (US$ million)[a]	Share (per cent)
Primary production	22	1	60	1	-80	-2
Mining and quarrying	21	1	59	1	-82	-2
Agriculture	1	0	1	0	2	0
Manufacturing	**1 863**	**50**	**2 022**	**29**	**1 075**	**21**
Food and sugar	223	6	72	1	-20	0
Textiles	48	1	90	1	19	0
Metals and non-metals	211	6	323	5	226	4
Electrical appliances	589	16	248	4	418	8
Machinery and transport	411	11	659	10	397	8
Chemicals	193	5	213	3	36	1
Petroleum products	14	0	308	4	6	0
Construction materials	-13	0	-2	0	22	0
Other manufacturing	186	5	110	2	-29	-1
Services	**1 788**	**48**	**4 393**	**62**	**3 852**	**74**
Financial institutions[b]	119	3	2628	38	2 243	43
Retail and wholesale trade	1 084	29	828	12	1 152	22
Construction	185	5	149	2	-137	-3
Services	290	8	293	4	474	9
Real estate	111	3	494	7	120	2
Other	**85**	**2**	**450**	**7**	**354**	**7**
Total FDI	**3 758**	**100**	**6 925**	**100**	**5 201**	**100**

Note: a CEIC data from the Bank of Thailand are converted into US dollars using the average yearly exchange rate.
b 1998 and 1999 figures include US$2.2 billion in bank recapitalisation. The Bank of Thailand plans to update its statistics so that FDI for 1998 will be approximately US$7 billion (World Bank, 2000).

Source: CEIC, 2000.

MERGER AND ACQUISTION ACTIVITY

Merger and acquisitions have increased substantially since the financial crisis began, with new regulations allowing full foreign ownership of locally registered, BOI supported manufacturers and many local financial institutions. Financially distressed Thai corporates have shed non-core assets and excess capacity through cross-border mergers and acquisitions. Nearly all these cross-border mergers and acquisitions involve foreign strategic partners (*The Nation*, 25 June 1999). Firms also are positioning themselves in the services sector, anticipating economic recovery.

STRONG MERGER AND ACQUISITION ACTIVITY

Since the 1997 financial crisis, the value of mergers and acquisitions has almost quadrupled from US$1.3 billion in 1991-95 to over US$5 billion in 1996-98 (Board of Investment, 1999e). Major completed transactions include:

- Tesco (UK) acquired the Lotus Supercentre chain from the Charoen Pokphand Group (US$350 million)
- Casino (France) acquired Central Group's Big C Superstores and plans to invest Baht 10 billion (US$263 million) constructing 20 new stores
- Holderbank (Switzerland) acquired 25 per cent of Siam City Cement (US$156 million)
- ABN-Amro (Netherlands) acquired the Bank of Asia (US$200 million)
- Development Bank Singapore acquired control of Thai Danu Bank (Baht 10.5 billion or US$276 million)
- Standard Chartered Bank acquired 75 per cent of Nakornthon Bank (Baht 12.4 billion or US$326 million)
- Merrill Lynch (United States) purchased 51 per cent of Phatra Securities (US$78 million)
- HIH (Australia) acquired 25 per cent of Nam Seng Insurance (Baht 367 million or US$10 million)
- NRMA Insurance (Australia) took an 18 per cent interest in Safety Insurance (Baht 156 million or US$4 million)
- Procter and Gamble (United States), BMW (Germany), General Electric (United States), Fujitsu (Japan), Lucent Technologies (United States) and Del Monte (United States) also made significant acquisitions.

Source: *The Nation*, 25 June 1999; and Seamico Securities, 1999a.

REMAINING CONSTRAINTS TO FDI

While the Government has increased FDI access to financial services and retailing since the crisis, foreign investors still face significant sectoral access and labour visa restrictions. Investor judgements regarding the reform program's likely effectiveness in achieving sustainable economic recovery also constrain FDI. Failure to complete reforms or effectively implement them would create a drag on the economy that would weaken investor confidence. Unrealistic asset pricing and slow progress in reducing non-performing loans, recapitalising banks and restructuring corporates also may dampen investor sentiment (Seamico Securities, 1999b).

Poor corporate and governance transparency contributed to Thailand's financial crisis; this failure still deters potential FDI. When fully implemented, several recent reforms to increase corporate and government transparency should help reduce the risk of doing business in Thailand.[27] However, corporate and public governance will not improve rapidly. (See Chapter 7 - *Corporate Restructuring*.)

PROSPECTS FOR FDI

Thailand's medium to long term foreign investment outlook depends on the successful implementation of domestic structural reforms, the external environment, including regional competition for foreign capital, the depth of future FDI regime liberalisation and investment promotion restructuring.

External Factors

China's WTO entry could significantly affect longer term FDI flows to South East Asia. During the 1990s, China's low effective labour costs attracted substantial FDI, and its attractiveness should increase following its WTO accession in 2001 (World Trade Organisation, 1999). However, China's WTO accession also should reduce trade barriers between Thailand and China. Growing incomes and consumer demand in China should stimulate demand for Thai exports, which could increase somewhat FDI in Thailand.

Domestic Factors

Apart from the economy's medium term recovery, the pace of deregulation and corporate and financial restructuring, three key factors will determine the level of foreign investor interest in Thailand:[28]

- how fast remaining constraints to FDI are removed
- how fast state enterprise privatisation and government regulatory streamlining occurs
- how FDI promotion measures change.

Apart from the few major sectoral opening reforms achieved during the crisis, FDI regime reform has been very slow and restrictions remain considerable compared to regional competitors like the Republic of Korea, China, Malaysia and Indonesia. Public, media and political support given to nationalistic elements opposing further FDI reform imply slow future liberalisation, possibly no more than required under WTO agreements.

....

[27] For example, the Government is providing funds to improve data bases and statistical reporting in many government agencies. This should improve information flow and timeliness and accuracy of statistics so foreign businesses can better assess market conditions. The Government revamped foreign investment rules and regulations, and streamlined investment licence approval processes and other bureaucratic procedures, so decision making is less discretionary and more rules based. These changes give greater certainty to foreign investors. More open bank and non-bank private sectors, with improved accounting and financial reporting, and better corporate governance also will improve overall investor confidence (Political and Economic Risk Consultancy, 1998).

[28] Reform and restructuring efforts since the financial crisis have boosted foreign inflows into Thailand and the Republic of Korea (*Bangkok Post*, 27 December 1999d). Of 12 Asian economies surveyed, only Japan, Thailand and the Republic of Korea had improved their foreign investment scores since 1998.

Analysts predict the next wave of FDI into Thailand will be associated with privatisation of state enterprises (*Bangkok Post*, 16 December 1999). Privatisation timetables slipped in 1999, given delays in passing crucial legislation to support privatisation, the establishment of new regulatory regimes in each sector and public sector union resistance. However, the Government remains committed to privatisation. About US$6 billion worth of state enterprises are being readied for privatisation over the period to 2005; if this proceeds, it will attract considerable FDI. (See Chapter 8 - *Privatisation*.)

Investment incentives probably are the least significant factor and their effectiveness uncertain. Proximity to markets, availability of low cost skilled and unskilled labour, adequacy of basic infrastructure and a stable economic, political and regulatory environment influence investment decisions more than tax breaks and customs duty exemptions (World Trade Organisation, 1999).[29] Nevertheless, all Thailand's regional competitors offer investment incentives and Thailand will retain an attractive investment incentive regime, particularly if other reforms are slow.[30]

Beyond possible large scale investments in privatised industries, the BOI sees export potential in light industries, including textiles, garments and luggage, especially high value products. Opportunities will continue in the agrifood sector for frozen food, processed food and vegetables. Other areas of high potential include parts and component manufacturing for electronics and electrical appliances; exports of these are forecast to grow rapidly over the short to medium term. In the automotive industry, exports nearly doubled in 1999. The service sector also should grow rapidly during the next decade, both in Thailand and the region, partly fuelled by implementing ASEAN's Framework Agreement on an ASEAN Investment Area.

ATTRACTING INVESTMENT TO ASEAN

In 1998, to attract greater investment into ASEAN through more open and transparent foreign investment regimes, members signed the Framework Agreement on an ASEAN Investment Area. The agreement covers manufacturing, agriculture, mining, fisheries, forestry and related services, but has significant exclusions. Under the original agreement, ASEAN investors in all industries will receive national treatment by 2010 (2013 for Vietnam and 2015 for Cambodia, Laos and Burma) and with certain exceptions, all investors will receive national treatment by 2020.[31] However, Thailand campaigned to accelerate implementation of the agreement, and succeeded in shortening the timetable from 2010 to 2003 for the original six ASEAN members.

Source: ASEAN Secretariat, 2000.

[29] A foreign investment model developed by an EAAU consultant showed low real wages was the major factor driving inward FDI flows to Thailand. If Thailand cannot maintain relatively cheap labour or skill levels do not increase substantially, Thailand will not be able to maintain the rate of inward FDI. In the model, the baht:US$ and baht:yen exchange rates also significantly affected FDI, but not to the extent of the wages variable. Baht depreciation led to fewer imports and increased FDI inflows (Kraipornsak, 1999).

[30] In 1999, 48 per cent of new BOI promoted foreign investment was in export-oriented industries. Zone 3, covering the remotest provinces, remained the most attractive location, accounting for 42 per cent of new projects (Board of Investment, 2000b).

[31] An extensive 'sensitive list' includes corporate equity ownership restrictions, land ownership, work permits for foreign nationals and licensing requirements. Foreign investment in service sectors also is restricted.

IMPLICATIONS FOR BUSINESS

Foreign investors in Thailand need to recognise the FDI regime is in flux as new laws and regulations are bedded down. However, the investment outlook is improving slowly, and reforms should provide a more stable framework for business investment decisions. An expected Government decision in mid 2000 to permanently permit 100 per cent foreign ownership of all BOI supported manufacturing projects will be an important pointer to future liberalisation and increased foreign investment opportunities.

Thailand will remain attractive as a production base for many foreign firms so long as the policy framework is conducive. A strong domestic market is re-emerging as the economy recovers and per capita incomes rise. Thailand's location at the junction of Indochina and South East Asia, its large and increasingly wealthy population, its relatively low labour costs, particularly since the 1997 depreciation, its strong natural resource base and its desire to serve as a regional transport and manufacturing hub will remain attractive to foreign investors. Many Thai corporates and multinationals operating in Thailand seek foreign partners to raise capital and improve industry competitiveness through introducing new technology, developing R&D and boosting managerial and technical skills. Regaining and maintaining international competitiveness by drawing on foreign resources and skills will be critical to Thailand's medium term economic recovery.

However, ongoing liberalisation of the foreign investment regime and related economic and legal reforms are necessary to ensure Thailand can compete with other regional FDI destinations like the Republic of Korea, Malaysia, the Philippines and China. The post 1997 strengthening of FDI inflows may not be sustained unless sectoral barriers are removed and the business environment becomes more transparent.

Appendix Table 4.1

Comparison of Restrictions in New Foreign Business Law with Earlier Alien Business Law

List 1: Businesses in which aliens are not permitted to operate for special reasons

Foreign business law	Alien business law - previously in:
Newspaper undertakings and *radio or television undertakings*	Annex B[a]
Lowland farming, upland farming or horticulture	Annex A/ Annex B
Raising of animals	Annex B
Forestry and timber *conversions from natural forest*	Annex B
Fishing *for aquatic animals in Thai waters and Thailand's Exclusive Economic Zone*	Annex B
Extraction of Thai medicinal herbs	None
Trade in and auctioning of *Thai ancient objects or ancient objects of national historical value*	Annex A
Making or casing Buddha images and making monks' bowls	Annex B
Dealing in land.	Annex A

List 2: Businesses which affect national security or safety or adversely affect art and culture, customs, native manufactures or handicrafts, natural resources or the environment

Foreign business law	Alien business law - previously in:
Group 1: Businesses relating to national security or safety	
Production, disposal (sale) and overhaul of firearms, ammunition, gunpowder and explosives	None
Domestic transport by land, water or air, *including domestic aviation.*	Annex B
Group 2: Businesses affecting arts and culture, and folk handicrafts	
Dealing in antiques or objects of art, and Thai handicrafts	Annex B
Production of wood carvings	Annex B
Silkworm farming, production of Thai silk thread and weaving of Thai silk, or Thai silk pattern printing	Annex B
Production of Thai musical instruments	None
Production of articles of gold or silver, nickel-bronze ware or lacquer ware	Annex B
Production of crockery and terracotta ware of Thai arts and culture.	None
Group 3: Businesses concerning natural resources and the environment	
Production of sugar *from sugar cane*	Annex B
Salt farming, *including underground salt*	Annex A
Rock salt mining	Annex C
Mining	Annex B/ Annex C
Timber *fabrication to make furniture and articles of wood.*	Annex B

List 3: Businesses in which Thais are not yet ready to compete with foreigners

Foreign business law	Alien business law - previously in:
Rice milling and flour production from rice and farm produce	Annex B
Fishery, limited to propagation of *aquatic animals*	Annex B
Forestry *from forestation*	Annex B
Production of plywood, wood veneer, chipboard or hardboard	Annex B
Production of (natural) lime	Annex B
Accounting services business	Annex A
Legal services business	Annex A
Architectural services business	Annex A
Engineering services business	Annex C
Construction[b]	New concept/ Annex A/ Annex C
Brokerage or agency business[c]	New concept/ Annex A
Auctioning[d]	Annex A
Domestic trade concerning indigenous agricultural produce or products *not prohibited by any present law*	Annex A
Retail trade in all kinds of *goods with an aggregated minimum capital of less than Baht 100 million or a minimum capital for each store of less than Baht 20 million*	New concept/ Annex B/ Annex C
Wholesale trade in all kinds of goods *with a minimum capital for each store of less than Baht 100 million*	New concept/ Annex C
Advertising business	Annex A
Hotel business	Annex B
Tourism	Annex B
Sale of food or beverages	Annex C
Plant cultivation and propagation business	None
Other services business *except for service businesses prescribed in Ministerial Regulations*.	Annex C

Note: Text in italics means new concept.

a The alien business law contained three annexes that defined foreign business participation. Foreigners were prohibited from engaging in activities in Annex A. For businesses under Annex B, Thailand allowed foreign participation up to 49 per cent unless a royal decree permitted otherwise. Most other activities were included in Annex C, where foreign nationals could invest only after receiving a permit from the Department of Commercial Registration at the Ministry of Commerce, granted on a case-by-case basis.

b Some construction activities that provide basic services to public utilities or communications are not included in List 2.

c Some specific brokerage activities, such as trading in securities or futures are not included in List 2.

d Except international bidding.

Source: Board of Investment, 1999a.

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Chapter 5

POLICY RESPONSES TO THE CRISIS

Key Points

- Thailand's crisis was caused by a severe collapse of market confidence due to Thai corporates and financial institutions mismatching the maturity and currency of their foreign borrowings and local assets, falling asset prices following an earlier boom and declining international competitiveness.
- With IMF advice, the Government initially tightened monetary and fiscal policy to defend the baht and restore confidence, but as the 1998 recession deepened unexpectedly, the Government significantly relaxed its macroeconomic stance.
- Government measures to restore financial market stability relied mainly on market oriented mechanisms. Its policies aimed to liquidate or nationalise insolvent financial institutions, require viable institutions to recapitalise using foreign or domestic private funds, overhaul prudential regulations, strengthen transparency and disclosure requirements, facilitate corporate restructuring and improve corporate governance.
- Thailand survived the crisis while retaining political and social stability. The Government responded pragmatically to changing economic circumstances to achieve relatively quickly, short term economic recovery.
- However, the resultant large public debt burden from fiscal stimulus packages and financial sector bail outs could constrain medium term growth.
- Furthermore, many major financial and corporate sector restructurings, legal reforms and improvements to corporate governance are incomplete; until these issues are resolved, the Thai economy will remain vulnerable to further shocks and experience lower growth.
- If fully implemented, these reforms will produce a more robust economy, with a higher more sustainable growth rate and more attractive foreign and domestic investment opportunities.

Inadequate macroeconomic and prudential control policies in the 1990s undermined Thailand's trade competitiveness, and facilitated excessive foreign capital inflows, particularly short term speculative borrowing. In mid 1997, this precipitated Thailand's worst economic crisis in the post war period. However, working closely with the IMF, Thai government responses to the crisis averted international

payments and financial system collapse, overcame the post crisis recession and slowly addressed bank and corporate restructuring. By mid 2000, Thailand was recovering strongly. However, the events of 1997-98 highlighted serious structural weaknesses in key economic and legal institutions. Despite considerable reform achievements since 1997, many aspects of economic governance, the corporate sector, and financial and legal systems need deep and ongoing reform to enable Thailand to avoid a repeat of the crisis, produce more sustainable growth and stimulate renewed investment and commercial opportunities.

This chapter analyses the origins, and short and long term effects of the financial crisis. It then examines the political forces shaping the economic reform process, assesses the Government's economic policy responses to the crisis, and identifies successes and remaining challenges.

ORIGINS OF THE CRISIS

Thailand's financial crisis was caused by plummeting creditor confidence following a long period of exuberant but increasingly fragile growth (Radelet and Sachs, 1998). Rapidly growing short term foreign debt, increasing difficulties in local financial institutions, and signs of overheating, including a sharply sliding stock market index and declining export competitiveness, signalled the emerging crisis.

Increasing short term foreign indebtedness was an unintended result of the Bangkok International Banking Facility's operations. Rather than serving its intended role as an intermediary between offshore borrowers and lenders, after 1993, it encouraged Thai nationals to seek foreign denominated loans for projects with primarily baht denominated revenue streams.[1] Short term private debt built up rapidly from 1993 (Figure 5.1).

[1] The Bangkok International Banking Facility was established during a fixed exchange rate regime and promoted risky foreign borrowing by giving significant tax incentives to those using it, including a lower corporate tax rate, 10 per cent, compared to the standard rate of 30 per cent. Domestic spreads and interest rates were high compared to international rates. Politicians at the time did not recognise the danger; the government sector seemed to believe foreign borrowing was a private sector decision, and business had sufficient incentive to adequately manage their risks. The Bank of Thailand also believed the borrowing was for productive investment which would generate sufficient returns to repay debt and cover risks. However, the Bank of Thailand's supervision was weak, and it failed to recognise how much capital was flowing into real estate and baht denominated lending. While the authorities tried to limit real estate lending, they failed to realise borrowers were circumventing controls. For example, many manufacturers borrowed funds, allegedly for manufacturing investments but instead built bigger offices and invested in more land than their projects required (Patpong-pibul, 2000).

Figure 5.1

Foreign Debt Is Falling

Private Short and Long Term Foreign Debt, and as a Ratio of Foreign Exchange Reserves, 1992-99

Source: CEIC, 2000; and World Bank, 2000a.

Lenders based credit assessments on firms' past economic performance and expectations of continued exchange rate stability (Figure 5.2).[2] By facilitating increased short term capital mobility, the offshore banking facility ultimately generated exchange rate volatility.

The growing mismatch in the currency denomination of Thai corporate assets and liabilities caused financial system distress in 1996 and 1997. However, the underlying problem was the systemic failure of risk management systems and prudential controls that enabled this to occur. Years of rapid growth had covered up weaknesses in financial institutions' risk management procedures and borrowers' corporate governance. The Government had bailed out depositors, creditors and shareholders of the failed Bangkok Bank of Commerce in the mid 1990s, then failed to prosecute those responsible. This response significantly aggravated the problems.[3]

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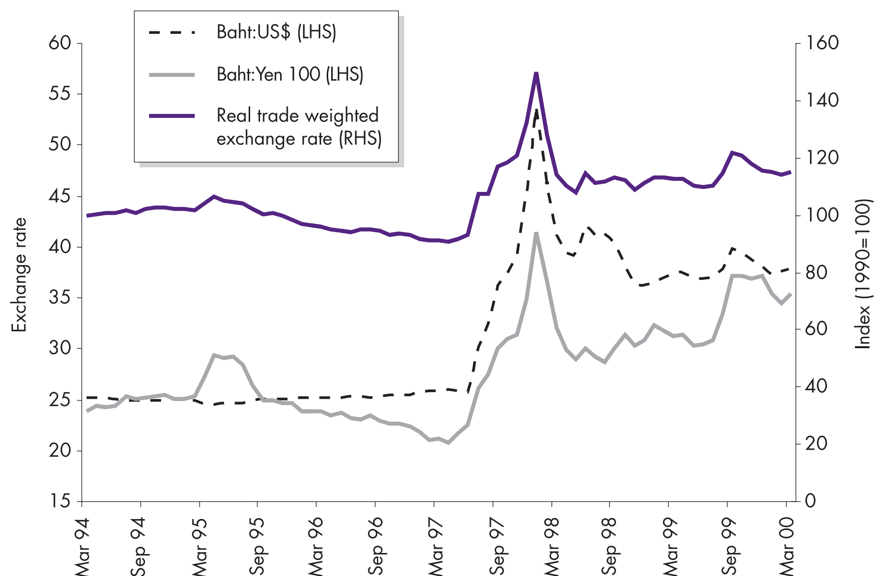
[2] Since the mid 1980s, the exchange rate regime was officially called a managed float against a basket of currencies. While the composition of and weights in the basket were secret, the US dollar clearly dominated. Despite US dollar exchange rates varying considerably against the yen and European currencies, the baht:US dollar exchange rate had not changed significantly from Baht 25:US$1 since 1985. Most market participants therefore treated the exchange rate as fixed against the US dollar.

[3] Bangkok Bank of Commerce failed under a growing mountain of bad loans; many had been issued imprudently, and violated Bank of Thailand security and related lending regulations.

Figure 5.2

Exchange Rates Stabilise

Thai Baht:US Dollar, Yen and Trade Weighted Exchange Rates, 1994 to 2000



Note: An upward movement in the graph is a depreciation, and a downward movement is an appreciation.
Source: JP Morgan, 2000; and CEIC, 2000.

By the mid 1990s, after years of near double digit growth, the Thai economy was overheating. The most obvious financial market indicator was the stock market collapse in 1996. In the real economy, export growth, which exceeded 20 per cent in 1994 and 1995, fell by 2 per cent in 1996.[4] Reflecting the fall in exports, import growth (mainly in components) plummeted from over 30 per cent in 1995 to less than 1 per cent in 1996. After years of feverish construction, the Bangkok real estate market faced a glut in 1996.[5] Economic predictions based on simply extrapolating past growth became increasingly inappropriate.

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[4] The sharp decline in export growth, which was similar qualitatively but more serious quantitatively than occurred in other economies in the region, was attributed to a number of causes. These include an overvalued baht due partly to a sharply depreciating Japanese yen after mid 1995, falling world prices of electronics and other key export products, rising labour costs, insufficient investment and productivity growth in more skill intensive exports, and increasing competition from neighbouring countries in traditional labour intensive exports.

[5] In early 1998, some 300 000 Bangkok housing units were unoccupied and a third of the Bangkok's commercial office space was empty (US State Department, 1999).

IMMEDIATE IMPACT OF THE CRISIS

The looming crisis first hit the foreign exchange market and banking system. The Government failed to deal with these threats, thereby helping to precipitate the crisis in Thailand and the region.[6]

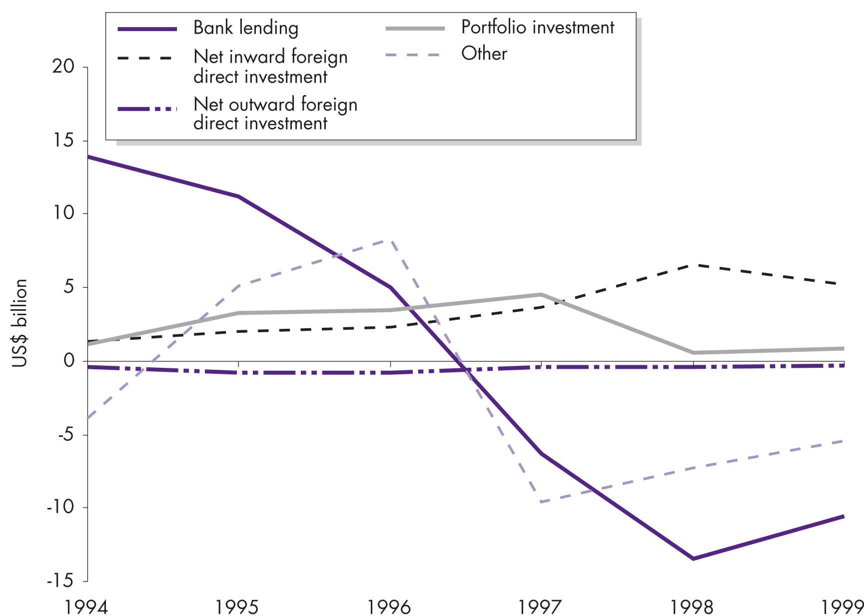
Foreign Capital Exodus

In response to emerging economic and financial weaknesses, massive 'capital flight' began in late 1996, and accelerated in the first half of 1997. This caused the stock exchange to collapse and depleted foreign exchange reserves. Between 1996 and 1997, the capital account swung from a surplus of US$19.5 billion to a deficit of US$8.7 billion. Private capital outflows accounted for most of this reversal (Figure 5.3).

Figure 5.3

Thailand's Capital Flows Volatile

Net Flows of Foreign Direct Investment, Portfolio Investment and Foreign Bank Lending, 1994-99



Note: 1999 is an estimate on based data to the third quarter 1999.
Net inward foreign direct investment is FDI inflows minus FDI outflows and includes estimates for inflows associated with bank recapitalisation in 1998 and 1999.
'Other' includes non-bank loans, non-resident baht accounts and trade credits.

Source: CEIC, 2000.

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[6] See Flatters, 1999 for a more complete review of these issues. The Nukul Report (Nukul, 1998) reviews these problems from a Thai perspective, providing considerable insight into immediate pre-crisis relations between the Government and IMF. The report, which the Government requested, documents policy failures leading to the crisis, reviews the communications between the IMF and the Thai Government, and notes the Thai Government's failure to respond, in the period preceding the devaluation.

The baht clearly was overvalued and the IMF warned the Government the foreign exchange regime needed adjusting. However, the Thai Government would not depreciate the baht by relaxing the unofficial peg (Nukul, 1998).[7] Instead, it tried to use reserves, swap market interventions and some mild capital controls to defend the exchange rate. In the third quarter of 1996, net foreign exchange reserves stood at almost US$40 billion, equal to seven months of imports. By the end of February 1997, they had fallen to little more than US$26 billion. On three days in May, the Government used or committed almost US$26 billion of its reserves in defending the baht. Most of this involved forward swap transactions, so official reserve figures did not alert markets to the depth of the problem. Economic data further deteriorated and the Finance Minister resigned in June 1997; this induced a final wave of capital flight. On 2 July 1997, with its foreign exchange reserves exhausted, the Government floated the baht, which then depreciated sharply.[8] With a risk of defaulting on foreign payments and capital flight accelerating, the Government requested IMF assistance; its first Letter of Intent was signed and approved in August 1997.[9]

Banking System Crisis

The crisis next hit the banking system. As the real economy slowed rapidly in 1997, stock and property markets collapsed, and authorities raised real interest rates to defend the baht (Figure 5.4). These developments aggravated bank and finance company liquidity and solvency problems; already, many had poor quality loan portfolios due to risky lending based only on collateral and name lending.[10]

7 Analysts estimate the baht was overvalued by about 12 per cent in early 1997 (Flatters, 1999). The IMF gave explicit warnings and offered assistance in dealing with the emerging crisis. However, throughout the six to 12 months before 2 July 1997, the Government failed to act on IMF warnings, did not accept its offers of help and pursued financial and exchange rate policies that precipitated a crisis which was more severe than necessary (Nukul, 1998).

8 On 30 June 1997, net reserves stood at only US$2.8 billion, about 7 per cent of their value in late 1996.

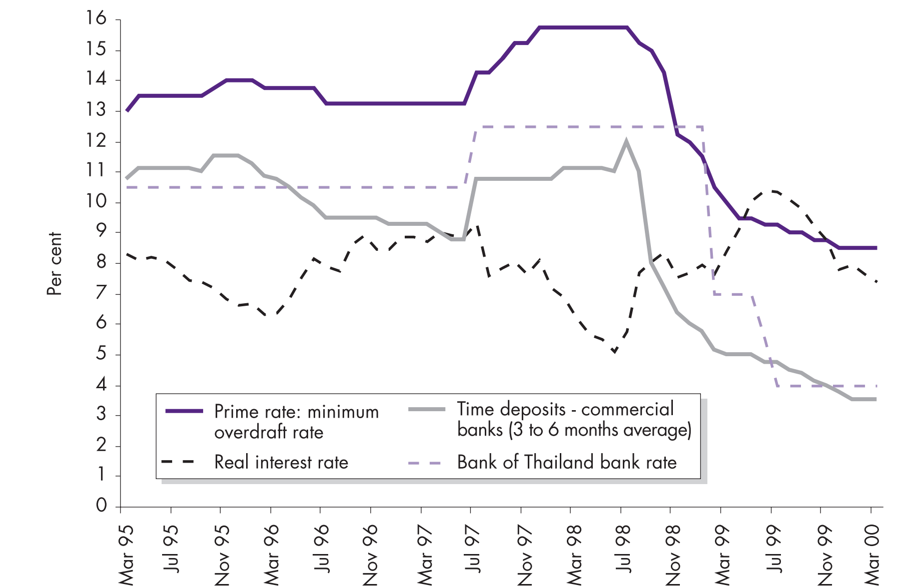
9 Direct financial support under the IMF program comprised a commitment of loans totalling US$17.2 billion, including US$1 billion from Australia, which were used to replenish foreign exchange reserves. Additional funds from other sources were committed subsequently, to support social assistance, fiscal stimulus and economic reform programs.

10 The baht value of the US$70 billion privately held in foreign debt had doubled by early 1998, when the exchange rate reached Baht 50:US$1 doubling from mid 1997, when it was Baht 25:US$1.

Figure 5.4

High Interest Rates Exacerbated Liquidity Problems

Interest Rate Movements, 1995 to 2000



Note: Real interest rate is the prime rate adjusted by the consumer price index.
Bank of Thailand bank rate is the central bank discount rate.

Source: CEIC, 2000.

Government policy responses were indecisive. Initially, the Government offered financial institutions liquidity support through its Financial Institutions Development Fund, FIDF.[11] However, as liquidity problems spread, the Government tried to identify the weakest financial institutions to force them to recapitalise. In late June 1997, it suspended 16 finance companies. To prevent widespread financial panic, the Government guaranteed deposits with all remaining banks and finance companies. FIDF liquidity support continued mostly unconditional and open ended.

By December 1997, the Government had suspended another 58 financial institutions, and the FIDF had committed about Baht 1.3 trillion (US$34 billion) in loans to struggling banks and finance companies; this cost excluded government guarantees to depositors and creditors of failed institutions. These massive short term loans did little to improve the structural integrity of the banking system; furthermore, the FIDF probably will recover only a small portion of them.[12] As

[11] The FIDF was set up in 1985 and placed under the guidance of the Bank of Thailand. It aimed to rehabilitate and improve financial institutions, and improve their stability. It was funded initially by levies on financial institutions and was used primarily as an emergency source of short term liquidity. If an institution needed more serious long term assistance, shareholders would have to bear the primary burden of necessary adjustment, and the FIDF would hold the institution's assets as collateral against any loans.

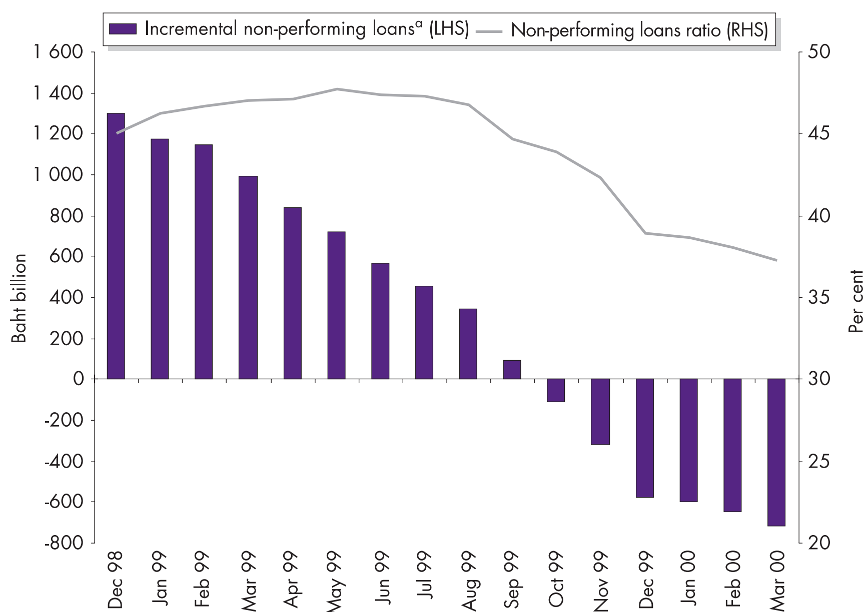
[12] Auctions of 56 failed finance companies' assets recovered about 25 per cent of their face value. The sale of intervened banks will bring in some additional revenue, but most will be paid back to the buyers through commitments on yield maintenance and NPL loss sharing agreements. Hence, only 10 to 15 per cent of FIDF commitments are likely to be recovered (Flatters, 1999).

interest rates rose, so did bank losses and the proportion of non-performing loans in bank portfolios (Figure 5.5). The Government struggled to formulate a coherent policy to deal with the financial sector.

Figure 5.5

Non-performing Loan Ratio Peaked in 1999

Incremental Non-performing Loans and Total Non-performing Loans, 1998 to 2000



Note: a Change in non-performing loan values on same month year a earlier. The Bank of Thailand defines a non-performing loan as one on which debtors have made no repayments in over six months.

Source: CEIC, 2000.

POLITICAL ECONOMY OF THE CRISIS

The crisis tested not only Thailand's economic policy making but also its political system. Unlike Indonesia and Malaysia, which had experienced several decades of political stability before the crisis, Thailand's frequent changes of government included several military coups. 'Money politics', with widespread vote buying and the sale and purchase of government concessions, tax and regulatory assistance typified Thai democracy (Siamwalla, 1997).

However, a high level technocracy in key ministries and agencies, especially the Ministry of Finance and the Bank of Thailand, had preserved economic stability through prudent macroeconomic management.[13] The crisis therefore signalled the technocratic macroeconomic management regime had failed, mainly because politicians had interfered in these key economic policy institutions (Siamwalla, 1997).[14]

At the time of the crisis, Thailand was implementing major constitutional change to increase government transparency and accountability. The new electoral system expands membership of both houses and introduces direct senate elections. By mid 1997, Thailand had adopted the new constitution, but the Government was drafting some implementing laws and still had to pass others. Meanwhile, the Chavalit Government, a coalition of old style Thai political parties, failed to deal with or prevent the crisis; thus it lost a vote of confidence in early November 1997. A few days later, the Democratic Party formed a governing coalition with a small parliamentary majority. Based on the relatively untainted reputation of its leader, Chuan Leekpai and the appointment of seemingly honest and competent key economic ministers, this new Government secured a broad popular mandate to deal with the crisis. This peaceful and legitimate change of government, at a time of great political and economic stress, was almost unprecedented in Thai history. One of the new Government's first actions was to fully endorse the program agreed with the IMF.

Political Reactions to the IMF Reform Program

Key components of the IMF program dealt explicitly with measures to strengthen economic governance, including commiting to administrative reform and accelerating plans to privatise state enterprises.[15] As the crisis evolved, the Government and the IMF identified other important reforms closely related to developing governance capabilities, improving competitiveness of Thai industries, developing social safety nets, and reforming and rehabilitating the financial sector. In all these areas, government measures heightened tensions among interests affected by planned policy reforms. Not surprisingly, financial sector and associated business law reforms caused stark conflicts between debtors and creditors. Consequently, powerful interests have delayed, diluted and sometimes reversed planned reforms.[16]

Cutting staff, freezing wages and removing powers and privileges were public service administrative reforms. However, unions and management strongly resisted these policies, and measures to privatise state enterprises. Weak labour markets and generous public sector employment conditions meant affected groups had a lot to lose, so these groups were particularly vigorous in their opposition.

Deregulating key product markets, especially removing price subsidies or import protection also threatened local producers as domestic demand was weak. This complicated government moves to reduce heavy industry tariffs and cut price subsidies for agricultural products.

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13 However, some other departments and agencies had worked more closely with the old style political parties and special interest groups to create and distribute rents through regulating the economy and providing key services.

14 This study is the first clear review of institutional failures in the macroeconomic management regime before the crisis.

15 See Flatters, 1999 for a more detailed review of the evolution of the Thai/IMF crisis program.

16 Planned changes to the bankruptcy and alien business laws are prime examples.

Impact on Transparency

The new Thai Government explicitly targeted the sources of economic and administrative mismanagement and corruption. The report it commissioned subsequently identified many areas of neglect and mismanagement in the Bank of Thailand and the financial sector. This resulted in major internal changes in the Bank of Thailand (Nukul, 1998).

However, despite the lessons of the Bangkok Bank of Commerce affair, authorities have prosecuted few allegedly corrupt and/or criminal financial sector actors.[17] Until mid 1999, 'strategic' non-performing loans grew steadily, seriously threatening Thailand's debt culture. Well connected business people were among the most serious debtors.

ECONOMIC POLICY RESPONSES TO THE CRISIS

The two main policy elements of the initial crisis recovery program sought to:

- stabilise the macroeconomy through monetary, fiscal and exchange rate policies
- restore financial market stability.

These policy strategies evolved flexibly in response to changing economic developments and political pressures (Flatters, 1999; and Lane et al, 1999). However, the financial sector recovery program remains controversial.

MACROECONOMIC POLICIES

The macroeconomic policy regime developed with the IMF went through three relatively distinct phases from August 1997. Phase 1 was the standard IMF fiscal and monetary austerity program, using fiscal and monetary levers to try to prevent the baht from plummeting. Money was tight; consequently interest rates were high. The initial IMF program also called for a budget surplus of 2 per cent of GDP, based on what turned out to be excessively optimistic growth forecasts for 1998.[18]

....

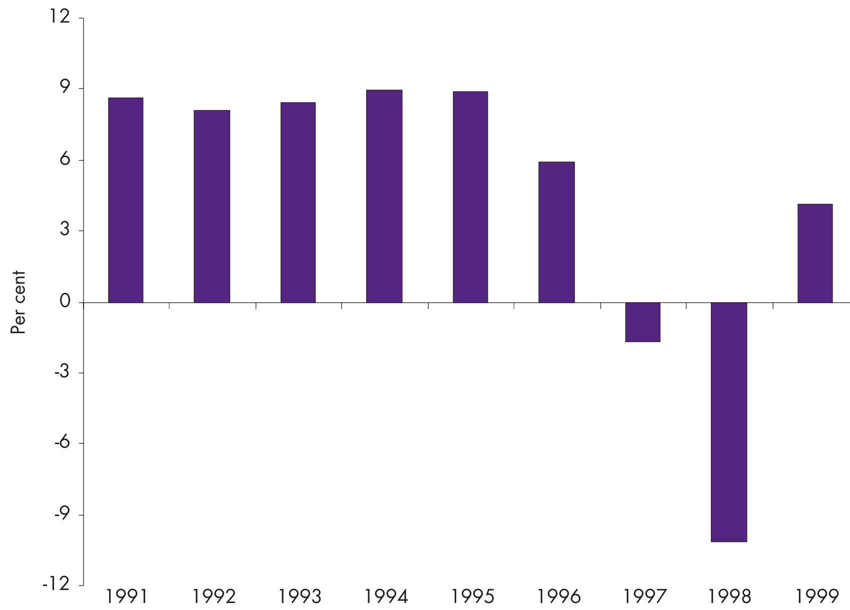
[17] The bank collapsed in 1995 due to corrupt and weak management. However, no executives were prosecuted and the Government bailed out depositors and creditors, creating expectations that such behaviour would be tolerated in future.

[18] The program anticipated that in 1998, Thailand would achieve fiscal balance, including the interest costs of FIDF commitments to financial institutions, via expenditure cuts and tax increases (principally a VAT increase from 7 to 10 per cent). The program anticipated the proceeds of privatising state enterprises would cover the capital costs of FIDF bail outs.

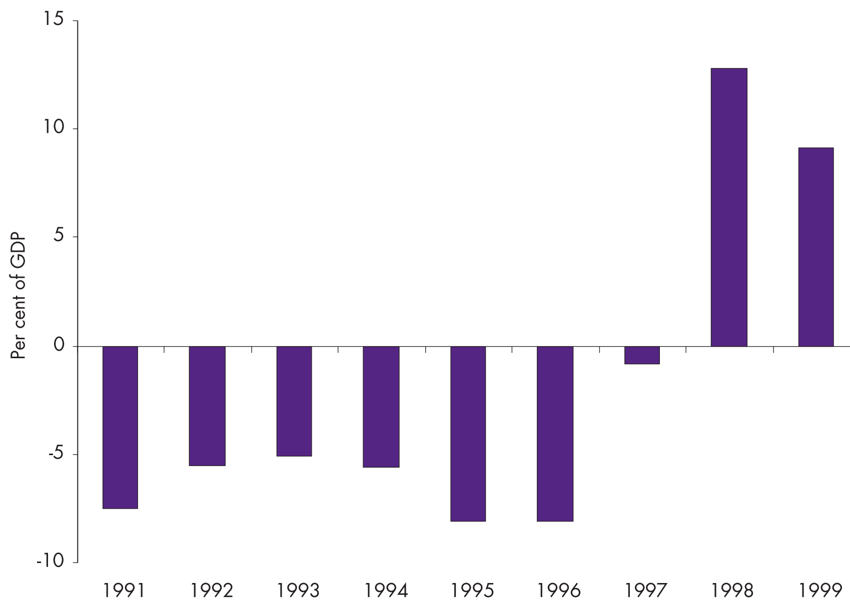
Figure 5.6

Economic Contraction Turned Current Account Positive

Real GDP Growth Rate, Per cent



Current Account, Per cent of GDP



Source: CEIC, 2000.

This initial macroeconomic strategy failed to stabilise the baht, largely because of the unpredicted contagion in the region. Despite extremely high interest rates, the baht fell continuously till it bottomed at Baht 56:US$1 in mid January 1998. Rising interest rates combined with the collapsing baht put increasing numbers of debtors in serious financial difficulty and aggravated the banks' non-performing loan rates (Figure 5.5). Domestic demand and exports continued to contract. Imports collapsed even more rapidly than exports, producing the current account surplus necessary to accommodate ongoing capital outflows (Figure 5.6).

Relaxation of Macro Policy in 1998 and 1999

While the baht began to stabilise and recover some its lost value in early 1998 (Figure 5.2), the real economy and financial sector continued to collapse. Thailand entered a recession; its severity was not fully appreciated until mid 1998. Within a year of freeing the baht, the Government faced strong domestic pressure to ease its fiscal and monetary stance. In the second and third Letters of Intent with the IMF, the Government served notice of small budgetary deficits, but this recognised the serious impact of the crisis on government revenues rather than actively relaxing the policy stance.[19]

In the second phase of macroeconomic policy, public pressure and concern about the depth of the recession caused the Government to relax significantly monetary policy from mid 1998. Subsequently, the total budget deficit increased steadily from 3 per cent of GDP in fiscal year 1997 to 7 per cent in fiscal year 2000 (Figure 5.7). Instead of maintaining the exchange rate, monetary policy switched to promoting monetary growth. This enabled interest rates to fall, relieving pressure on the financial sector, promoting domestic lending and stimulating domestic demand.

At the same time, the Government launched new and more active fiscal initiatives to create jobs and provide social relief through public works and community development projects. Nominal interest rates responded as expected to these new measures, falling quickly and continuously for the remainder of the year and through most of 1999 (Figure 5.4). Due to falling inflation, real interest rates took longer to respond, and did not start falling until May 1999.

Despite more relaxed macroeconomic policy settings, almost all major economic indicators continued to stagnate throughout 1998.[20] Monetary expansion failed to stimulate a quicker recovery because of three factors. Firstly, banks were struggling under increasing levels of non-performing loans, high foreign currency losses and tightened capital adequacy ratios, which made them very risk averse in assessing new loans.[21] Secondly, the long period of depressed demand created high levels of excess capacity in most sectors, curtailing profitable new investment opportunities.[22] Thirdly, consumers saved more and cut consumption because of employment anxieties.

[19] By the third Letter of Intent, in March 1998, the Government and IMF were forecasting a budget deficit of 2 per cent of GDP for the fiscal year 1998-99.

[20] The principal exception was the stock market index, which staged a small 'boomlet' in late 1998.

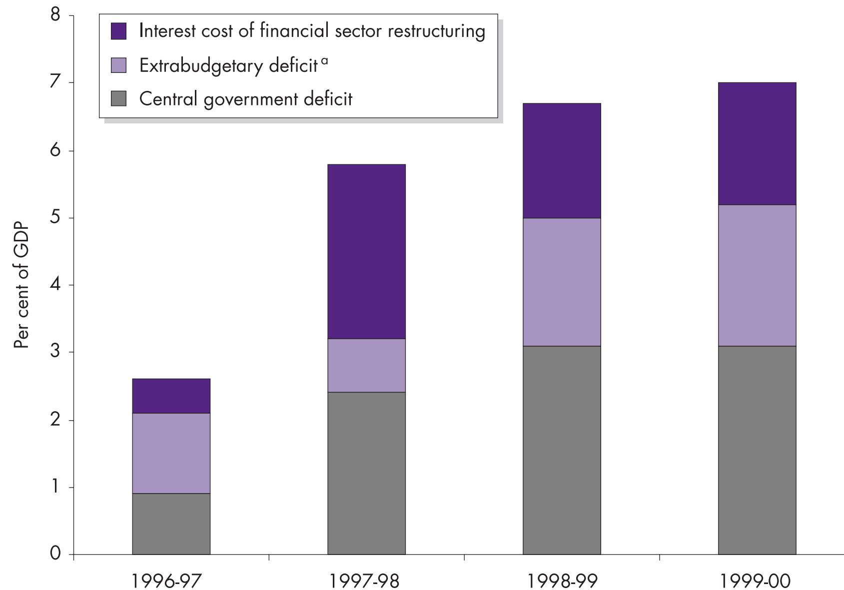
[21] The existence of much safer lending possibilities in the form of FIDF bonds and the poor credit worthiness of Thai corporates further reduced their willingness to lend.

[22] Nevertheless, many corporates needed to borrow trade finance and working capital to tide them over cash flow problems but funding frequently was not forthcoming.

F i g u r e   5 . 7

Thailand's Public Sector Deficit Increased Sharply

Central Government and Extrabudgetary Balances as Per cent of GDP



Note: a Extrabudgetary deficit includes local deficits plus balances of non-financial public enterprises.
Source: World Bank, 2000a.

With its expectations of a fairly speedy recovery unfulfilled, the Government launched a further macroeconomic stimulus package in March 1999, its third macroeconomic policy phase. In early 1999, some macroeconomic indicators appeared to have bottomed out, or their rate of decline slowed. However, manufacturing production, investment and exports all continued to fall. A major element of the package involved social off-budget expenditures equal to about 1 per cent of GDP, partly funded by large foreign loans from international agencies and Japan.[23] The 1998-99 fiscal deficit was 6 per cent of GDP, not including the new off-budget items (the so-called 'Miyazawa Plan' expenditures).[24] The Government's consolidated budget deficit for 1999-2000, including state enterprise and FIDF spending, is expected to reach 7 per cent of GDP (Figure 5.7).

....

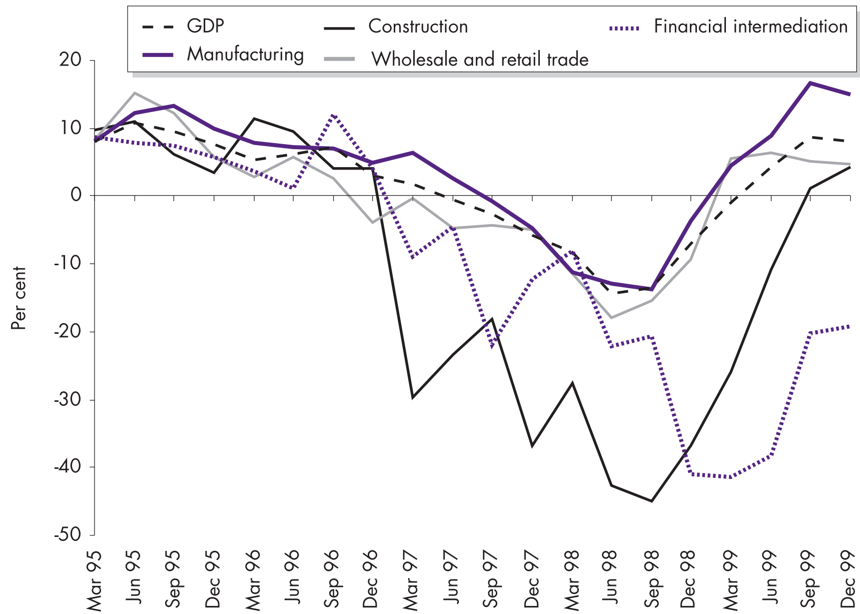
[23] The Government implemented these programs outside the budget and aimed to complete disbursements in six months by October 1999. The fiscal relaxation also cut the VAT rate from 10 to 7 per cent, cut other taxes and established several special funds earmarked for loans and subsidies to selected sectors and activities.

[24] The 'Miyazawa Plan' involved off-budget expenditures of Baht 53 billion (US$1.45 billion, or 1 per cent of GDP) financed by loans from the World Bank (US$600 million), Japan's Export-Import Bank (US$250 million) and Japan's Overseas Economic Cooperation Fund, OECF (US$250 million). (The latter two institutions are now merged into the Japan Bank for International Cooperation.) These funds were all to be spent in the remaining six months of fiscal year 1998-99. The expenditures were targeted at employment creation and community improvement projects. Only the OECF loans were offered on concessional terms. Some analysts criticised financing the deficit largely from foreign sources, especially given the massive excess liquidity in the domestic market, but the Government sought to build up foreign exchange reserves.

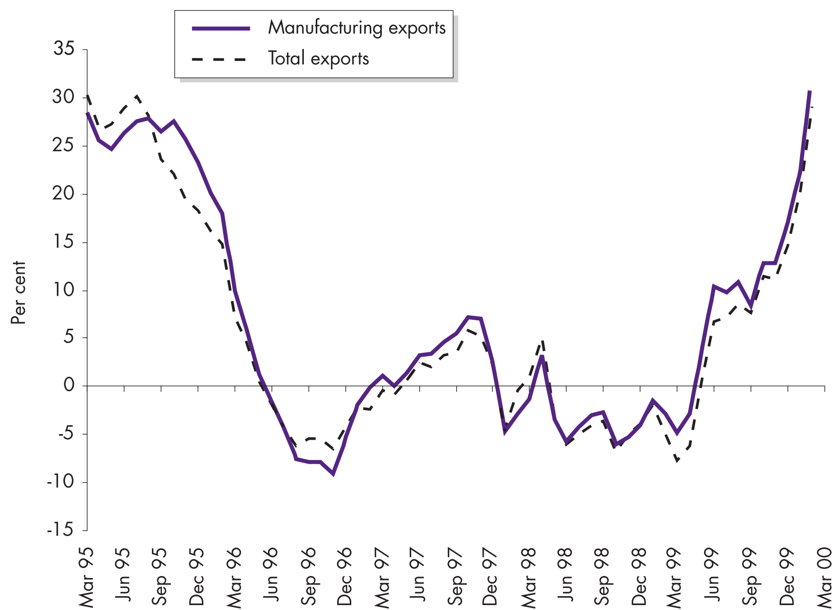
Figure 5.8

Manufacturing and Exports Led GDP Recovery

Real GDP Growth by Sector, 1995-99
Per cent Change on Same Quarter Previous Year



Export Growth 1995 to 2000 (Per cent, Smoothed Series)
Per cent Change on Same Month Previous Year



Source: CEIC, 2000.

The fiscal stimulus package suffered implementation lags with expenditure running consistently and significantly behind schedule.[25] However, from mid 1999, the improved macroeconomic policy environment began to stimulate domestic demand and economic activity. Real GDP growth turned positive, led by manufacturing production, exports and consumer spending. (See Chapter 1 - *Economic Prospects*.) Recovery in other East Asian markets assisted exports and reinforced Thailand's recovery.

Fiscal Consolidation

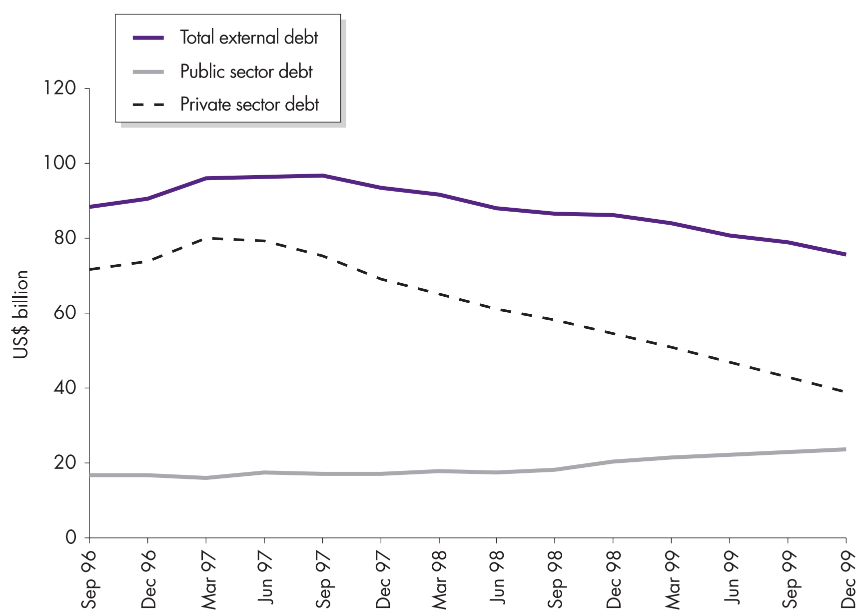
The large fiscal stimulus and the fiscal cost of financial restructuring has sharply increased gross public sector debt; it jumped from under 15 per cent of GDP in 1995-96 to 56 per cent in 1998-99, and is likely to peak at 64 per cent in 2000-01. In contrast, private sector debt has dropped steadily over the past two years, reflecting government bail outs and business deleveraging (Figure 5.9). Unless the deficit is dealt with reasonably quickly, servicing public debt could constrain future economic growth. However, the World Bank believes the budget deficit is likely to shrink with full economic recovery and the Government is well positioned to stabilise, then reduce public debt once the crisis is over, so the debt problem should be manageable (World Bank, 2000a). Significantly, the Government has shifted from foreign towards domestic sources of public sector financing, preferring not to draw on remaining tranches of funds available from the IMF. In fiscal year 1999, the Government funded an estimated 60 per cent of its 1999 deficit domestically, and this will rise to 66 per cent in 2000 (World Bank, 2000a). Greater recourse to domestic funds should help develop local capital markets and instil greater confidence in economic recovery.

25 Efforts to ensure accountability and normal institutional rigidities delayed early implementation. Although the 'Miyazawa Plan' expenditure program was to short circuit normal budgetary processes, these delays made it impossible to meet expenditure targets within the fiscal year deadline. Some analysts were concerned about the disbursement processes for Miyazawa funds, given the Government's aim of increasing transparency and accountability.

Figure 5.9

Private External Debt Turned into Public Debt

Thai Private and Public Sector External Debt, US$ (billion)



Source: CEIC, 2000.

RESTORING FINANCIAL MARKET STABILITY

To restore financial market stability, the Government needed to rectify two closely related problems – bank and financial institution insolvency and corporate sector bad debts. Constraining options in resolving these problems is the large public sector obligation assumed via the FIDF's support of financial institutions and government guarantee of their depositors and creditors. (See Chapter 6 - *Financial Restructuring* and Chapter 7 - *Corporate Restructuring*.)

Bank Restructuring and Refinancing

Financial sector restructuring is well underway with nationalised banks proceeding towards re-privatisation and most remaining private banks progressing well with recapitalisation. State banks remain the major problem with high non-performing loans and major recapitalisation needs. By the end of 1999, the Government had closed 59 insolvent finance companies and nationalised seven banks. After the initial round of closures in 1997, financial institution non-performing loans rose rapidly and depositor confidence diminished. To increase investor confidence in the banking system, the Government provided a blanket guarantee for depositors and some creditors. It also tightened the rules for establishing capital adequacy, and defining and provisioning non-performing loans.

To regain financial system stability, the Government relied mainly on market mechanisms. Many assets of closed finance companies were auctioned relatively quickly. Non-performing loans of banks and finance companies that remained open were left with these institutions, rather than being sold to public asset management companies, as in the Republic of Korea and Malaysia. Marginal banks had to seek new capital themselves.[26] Foreign interests were allowed to take over several smaller private banks, and the Government also sold to foreign banks two local banks nationalised during the crisis. With this significant restructuring, Thai banking system competition and efficiency should increase substantially. (See Chapter 6 - *Financial Restructuring*.)

Debt Restructuring Promotion Policies

Corporate restructuring has proceeded much more slowly, encountering significant resistance from well connected debtors, but by mid 2000, finally appeared to be making more progress. (See Chapter 7 - *Corporate Restructuring*.) Thailand's pre-crisis legal and judicial systems were ill equipped to handle bankruptcy or foreclosure; consequently, corporate debt work outs faced serious difficulties. To increase incentives for debt repayment and permit liquidation of insolvent companies, the Government passed a set of 'basic economic laws' to strengthen bankruptcy, foreclosure and related laws. Despite vested interests in the former Senate creating delays, amended versions of essential legislation were passed in early 1999.

A second element of the financial restructuring policy package was to encourage major debtors and their creditors to restructure debts voluntarily. The Bank of Thailand's Corporate Debt Restructuring Advisory Committee identified 700 of the largest non-performing loans eligible for this process, and persuaded debtors and creditors to meet timetables to complete work outs. While the program started slowly, by mid 2000 it was achieving results. However, some debt restructuring may be superficial, merely rescheduling debts rather than reducing debt leveraging or fundamentally restructuring corporate operations and management.

PROSPECTS AND IMPLICATIONS

Thailand's greatest achievement was to survive the economic crisis with political and social stability intact. A discredited government was replaced peacefully and constitutionally at a time of considerable socio-economic stress. Despite resistance from many powerful vested interests, the Government designed and implemented wide ranging economic reforms. While economic and governance outcomes have not always been ideal, the robust debate and Government's ability to adjust its programs in response to political realities signal the vigour of Thailand's emerging political institutions.

[26] As officially sponsored bank recapitalisation often would have removed control from existing owners, many used their influence to avoid this approach. Faced with such pressures, the Government waivered between using positive incentives and sanctions to force adjustment.

The Government responded pragmatically to changing perceptions of economic circumstances, adjusting its macroeconomic programs. Failure to predict the regional contagion and the resulting depth of the macroeconomic shock were costly, but the IMF and many other experts share responsibility for that failure. However, the large public debt burden arising from the financial sector bail out and fiscal stimulus packages, and slow progress in privatising state enterprises constrain Thailand's medium term fiscal outlook.

In mid 2000, financial sector and corporate restructuring programs are progressing reasonably well. The effectiveness of the short term strategy in facilitating and encouraging necessary adjustments by creditors and debtors remains contentious. Over the long term, new basic economic laws and court system reforms will contribute to developing a modern economy. However, weak institutional capacity to implement these laws could reduce their short term benefits. Tightened prudential rules and increased foreign ownership and management of financial institutions are positive steps. The longer term reform of corporate governance practices will be an important government priority. While financial and legal reforms will take some time to become effective, assuming they are implemented fully, they will produce an economic environment that will be much more attractive to foreign and domestic business people.

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Chapter 6

FINANCIAL SECTOR REFORM AND RESTRUCTURING

Key Points

- Crisis led reforms and restructuring are driving significant change in the Thai financial sector, generating many opportunities for investors and service providers, but some major reforms are incomplete.
- Since the crisis, foreign financial institutions can own 100 per cent of banks, securities firms and finance companies, and are competing with Thai institutions.
- As foreign institutions offer innovative new products and services, Thai firms are boosting their investment in accounting, auditing, risk management, customer service and information systems to compete. This will increase opportunities for foreign business, financial and IT service providers.
- The Government has freed the exchange rate regime, upgraded prudential supervision and is trying to strengthen financial sector supervision.
- While post crisis financial sector restructuring and refinancing is progressing, the pace is slow and significant weaknesses remain, including the high proportion of non-performing loans, NPLs, and slow bank refinancing.
- Financial sector recovery also is constrained by slow corporate restructuring; this makes domestic banks less willing to extend new credit to underpin economic recovery and few foreign banks will consider new Thai corporate lending.
- In mid 2000, the passage of new financial sector laws and the sale of one nationalised and several state owned banks still is pending; successfully implementing these policies will indicate continued government commitment to financial sector reform.

Thailand's financial sector felt the main impact of the crisis; the Government and market pressures have shut, nationalised and merged many financial institutions, and foreign participation has increased significantly. Prudential controls now are much stronger, and competitive forces should improve risk management, services and efficiency. These major changes create increased opportunities for foreign financial institutions and service suppliers.

The Government's mainly market oriented approach to financial sector restructuring and refinancing has avoided system collapse, but is incomplete, and has been quite slow assisting financial institutions resume normal lending patterns. In 2000, the Government's commitment to further financial sector reform will be tested in several key areas, including selling nationalised banks, passing key financial sector legislation and adhering to banks' December 2000 bad debt provisioning deadline. Choices made in these areas will determine the strength of Thailand's economic recovery and the extent of commercial opportunities for foreign financial sector investors and service suppliers.

Increased foreign participation should boost financial sector efficiency and generate significant commercial opportunities for foreign financial institutions and service providers. Improved risk management, better customer service, and lending based on cash flow and credit analysis, rather than connections and collateral, should strengthen financial service delivery and reduce the risk of future financial crises. Many foreign financial institutions already have entered the Thai market or are considering options for doing so.

This chapter analyses how foreign financial institution competition, capital, technology and skills will influence the financial sector and open up opportunities. It reviews post crisis progress on prudential control strengthening and financial sector reform and restructuring, and anticipates future planned reforms.

FOREIGN PARTICIPATION IN THE FINANCIAL SECTOR

Crisis related reforms are remodelling the Thai financial sector landscape, most noticeably by permitting far greater foreign participation. In 1998, the Government opened banking, securities and finance company business to 100 per cent foreign ownership, producing immediate benefits. Furthermore, the Thai Cabinet has approved raising the foreign ownership limit on insurance companies from 25 to 49 per cent. Relaxing foreign ownership restrictions expanded these institutions' access to capital, management expertise and technology. Before the crisis, foreigners could participate only in the insurance sector (with maximum equity set at 25 per cent). With increased financial sector foreign investment, Thai financial institutions face a more competitive business environment. Already, a stronger foreign presence is forcing Thai commercial banks to upgrade their accounting, auditing, risk management, customer service and information systems to compete. Also, new entrants are introducing new products and technologies, like electronic and Internet banking and securities trading, increasing pressure on local institutions to do likewise (East Asia Analytical Unit, 1999a). For example, Bangkok Bank, the largest private Thai commercial bank, purchased new IBM mainframes to provide around-the-clock electronic and e-business banking services (*Bangkok Post*, 16 December 1999). Also, over the next three years, it will apply a new 18 point rating system for borrowers as part of a new risk management scheme introduced in June 1999 (*Bangkok Post*, 7 December 1999).

COLONIAL'S THAI MARKET PARTICIPATION

Ayudhya Group and CMG Asia (a subsidiary of Colonial Limited), formed a joint venture in 1995, Ayudhya CMG Life Assurance, ACMG. ACMG now is the fastest growing life company in Thailand, employing over 6 000 agents in over 60 locations. ACMG, is Thailand's largest public joint venture insurer and third largest insurance company. In mid 2000, CMG held a 45 per cent share in the joint venture.

Since 1997, the Thai market has become increasingly competitive. Twenty five life companies compete in a relatively open market. Eight foreign joint ventures with local partners and one wholly foreign owned insurer compete for an annual market of Baht 57 billion (A$2.2 billion). The top five companies, including ACMG, hold 90 per cent of the market.

Colonial is committed to developing business in Thailand. ACMG's approach is to work with Thai regulators to help introduce products providing policy holders with variable returns based on investment earnings, thus reducing the likelihood of solvency problems in the future.

Colonial believes in universal financial institutions. In Thailand, this means developing new business to grow as a diverse financial services company. The company's greatest challenge in pursuing this strategy in Thailand is achieving regulatory support for such diversification. With increased competition, Thailand could follow the worldwide regulatory trend of allowing market forces to dictate premium rates and product features, while regulators move away from micro-management to focus on ensuring industry solvency and transparency.

Source: Colonial, 2000.

To assist financial sector recapitalisation, the Government raised the foreign ownership limit on Thai banks, finance and securities companies from 25 to 100 per cent for the next ten years.[1] As a result, in 1998, the banking sector attracted US$2.1 billion in foreign direct investment, or 30 per cent of total foreign direct investment (Bank of Thailand, 1999a). By January 2000, four commercial banks had majority foreign ownership, as did numerous securities and mutual funds management companies. Since 1997, privately Thai owned Bank of Asia has sold a 75 per cent share to strategic foreign partner Dutch Bank ABN-Amro. Thai Danu Bank also took a strategic foreign partner and now is majority owned by the Development Bank of Singapore. The Government sold a majority share of nationalised Nakornthon Bank to Standard Chartered Bank in September 1999, and 75 per cent of state owned Radanasin Bank to Singapore's United Overseas Bank in October 1999 (Table 6.3).[2]

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1 After ten years, new capital injections must come from Thai entities unless the foreign holding has fallen to below 49 per cent. However, international financial liberalisation agreements between 1997 and 2007 may well make these sell-down provisions redundant. Foreign investors also can become major shareholders of mutual fund management companies.

2 Using Baht 4 billion of public funds, the Government established Radanasin Bank in January 1998, to purchase and manage the good assets of suspended finance companies and prevent the sale of domestic assets at 'fire sale' prices, considered likely because of the tight time constraint placed on the liquidation process. Radanasin Bank merged with Laem Thong Bank, which the Government nationalised on 14 August 1998, thereby obtaining a nationwide branch network. The Government intervened in and nationalised Nakorthorn Bank when it became illiquid in 1998.

The Government indicated it intends to privatise the remaining nationalised banks, Siam City Bank, Bangkok Metropolitan Bank and possibly BankThai and state owned commercial bank, Krung Thai Bank. Successful sales of Siam City Bank and Bangkok Metropolitan Bank to foreign strategic partners will indicate strong ongoing commitment to reforming the financial sector. In May 2000, the Government agreed, in principle, to sell 75 per cent of Bangkok Metropolitan Bank to Hong Kong and Shanghai Banking Corporation, HSBC. The Government is reviewing conditions for the sale of Siam City Bank to make it more attractive to foreign investors (*The Nation*, 17 May 2000).[3]

For the first time in Thai banking history, foreign banks now control branch networks competing directly with Thai banks (World Bank, 1999b). Foreign banks hold over 15 per cent of assets, but in the near future, this should grow to 30 per cent, when the last nationalised bank, Siam City Bank, is sold to a strategic partner (Vichyanond, 2000). Foreign banks also are attracting deposits away from local banks.

HSBC ACQUIRES BANGKOK METROPOLITAN BANK

Bangkok Metropolitan Bank is one of four recently nationalised banks the Thai Government has offered for sale since 1998. The bank is Thailand's eighth largest with 180 branches but has non-performing loans of Baht 150 billion (US$4 billion). In May 2000, Hong Kong and Shanghai Banking Corporation, HSBC reached in principle agreement with the Financial Institution Development Fund to acquire a 75 per cent share in Bangkok Metropolitan Bank for Baht 36.6 billion (US$940 million). This represents a premium of 96 per cent per share. Completion of the sale is subject to approval of the Minister of Finance and finalisation of legal issues.

HSBC's planned reorganisation and recapitalisation of Bangkok Metropolitan Bank will provide it with a capital base of Baht 10 billion (US$257 million) but resolution of non-performing loans remains a major task. Analysts estimate that only 45 per cent of the bank's non-performing loans are recoverable, with the remainder, about Baht 70 billion to 80 billion (US$1.8 billion to 2.1 billion) irrecoverable (*The Nation*, 15 May 2000). As in the case of previous nationalised bank sales, the Financial Institution Development Fund will compensate HSBC for potential losses via a loss/gain sharing scheme.

HSBC, the longest established foreign bank in Thailand, believes its strong capital base, management expertise and e-business development experience, combined with Bangkok Metropolitan Bank's strong branch network will provide a strong base to develop retail and commercial banking business in Thailand.

Source: *The Nation*, 15 May 2000.

[3] Previously, three bidders, Newbridge Capital, the US subsidiary fund of Nova Scotia and GE Capital had expressed interest in Siam City Bank (*The Nation*, 17 May 2000).

CHANGING FINANCIAL MARKET STRUCTURE

Post crisis reforms also have re-balanced the structure of the financial sector. After 1997, finance companies' share of commercial banks, finance and credit foncier company assets fell from more than 24 per cent to less than 5 per cent of the total assets of this group of companies (Table 6.1). The importance of commercial banks in providing corporate finance is likely to decline relative to share and bond markets and funds management service providers.

Table 6.1

Finance Company Role Declines after Restructuring

Assets of Thai Commercial Banks, Finance Companies and Credit Foncier Companies, Baht (billion)

	Commercial banks		Finance companies		Credit foncier companies		Total
	Baht (billion)	per cent	Baht (billion)	per cent	Baht (billion)	per cent	Baht (billion)
1996	5 536.3	75.7	1 767.9	24.2	7.5	0.1	7 311.7
June 1999	6 397.4	95.4	306.2	4.6	5.0	0.1	6 708.6

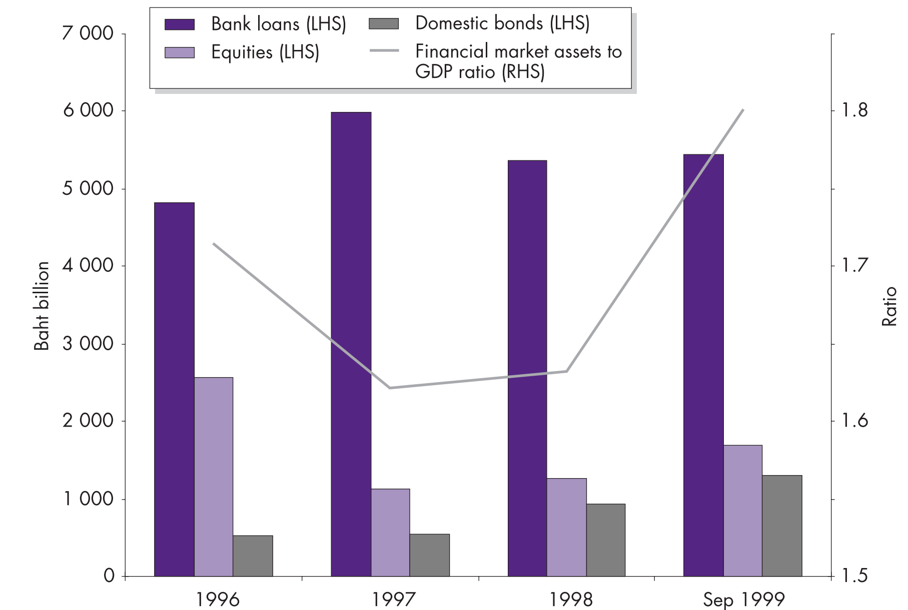
Source: Bank of Thailand, 1999b.

Compared with other emerging market economies, Thailand's financial system is deep; its 180 per cent financial assets to GDP ratio in 1999 is high compared to most developing economies. However, including insurance and funds management, more than 70 per cent of financial sector assets, are in the banking sector (Figure 6.1). In June 1998, outstanding bond market issues equalled only 12.5 per cent of GDP and stock market capitalisation equalled 19 per cent of GDP (World Bank, 1999b).

Figure 6.1

Bank Lending Dominates Domestic Capital Market

Size of Domestic Capital Markets,[a] Baht (billion)



Note: a Figure shows levels of outstanding loans, and equities and bonds issued.

Source: World Bank, 2000; and CEIC, 2000.

With the ratio of non-performing to total loans still high, financial institutions remain reluctant to inject liquidity into the real sector, so many firms are turning to securities and bond markets for finance. At present, only the best large companies can access stock and bond markets, but as more securities instruments are introduced, well managed medium sized firms also may have better access to direct financing.

With securities markets supplying more corporate finance, the Thai economy is likely to become more stable. In the pre-crisis era, the capital market was underdeveloped and many majority family owned and managed corporates were unwilling to issue equity that would dilute their management control. Consequently, most domestic corporations were over-leveraged, relying heavily on financial institution funding, particularly short term borrowing, including foreign borrowing. Domestic corporations therefore were vulnerable to suddenly rising interest rates, significantly contracting financial sector credit and a depreciating baht. When financial institutions no longer could provide credit, a vicious circle of non-performing loans began.

Bond Market Development

The crisis highlighted the need to deepen Thailand's equity and bond markets to reduce reliance on domestic and foreign bank lending. Corporate bond market development now is a government priority; several recent government initiatives are assisting this process. The Government removed the taxation bias against bond issues by introducing a flat tax rate of 15 per cent on all individuals' bank and bond interest earnings (30 per cent for corporations). It also developed a benchmark yield curve from its government bond issues.

Prior to the crisis, Thailand ran budget surpluses for many years and rarely needed to issue government bonds; this constrained the development of a benchmark yield curve for the corporate bond market. Government bond issues now are significant, more than doubling to Baht 429 billion (US$11 billion) in 1996-99. The Government is using this opportunity to develop a benchmark yield curve by issuing one, three, five, seven, 12 and 15 year government bonds and ensuring frequent government bonds turnover (Patpong-pibul, 2000).

While corporate bond markets raised only 3.8 per cent of the Baht 4.5 trillion (US$118 billion) the financial system supplied in 1999, these issues are rising rapidly (Figure 6.2). Non-bank corporate bond issues were Baht 60 billion to 70 billion (US$1.6 billion to 1.8 billion) in 1999, and banks issued another Baht 100 billion (US$2.6 billion) of SLIPS and CAPS (Waiquambee, 2000).[4] Apart from banks, several big companies like Siam Cement successfully issued bonds in 1999 and 2000. Liquidity in the secondary bond market is small but increasing steadily.

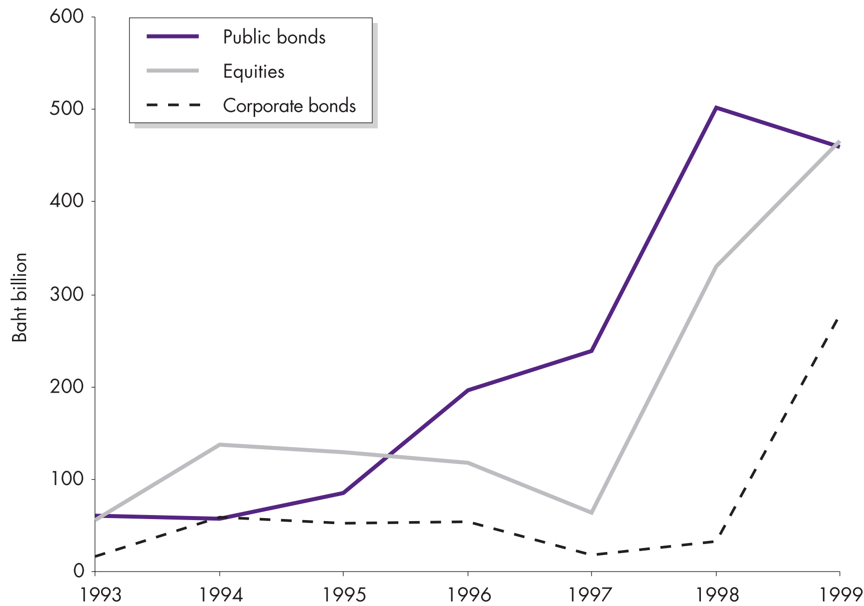
The Securities and Exchange Commission regulates the government and corporate bond market. The commission has approved amendments to the public offering rules, emphasising a disclosure based approach rather than a merit based approach to certain listing criteria; this allows investors to judge which companies are worth investing in (Securities and Exchange Commission, 1998). It also has tightened listing criteria and is implementing a range of initiatives to improve corporate governance (Sucharitakul, 2000). (See Chapter 7 - *Corporate Restructuring*.)

[4] Stapled limited interest preferred structures, SLIPS, are non-cumulative preferred shares, which qualify as tier 1 capital when calculating bank capital adequacy, while capital augmented preferred securities, CAPS, are subordinated debentures.

Figure 6.2

Corporate Bond Market Issues Expanding Rapidly

Public Bond, Equity and Corporate Bond Issues, 1993-99, Baht (billion)[a]



Note: a Figure shows new annual issues of public and corporate bonds, and equities.
Source: CEIC, 2000.

CRISIS MANAGEMENT POLICIES

Crisis inspired reforms eventually should help Thailand's financial sector become more efficient, transparent and internationally competitive; it also should present many opportunities for foreign financial institutions. The Thai Government sought maximum private sector participation in its crisis responses. It intervened where necessary to strengthen market controls, but mainly adopted a market approach to financial sector restructuring. It closed and nationalised many non-viable financial institutions and tightened loan classification standards and provisioning rules; it also developed the legal and institutional framework to support a credit culture. At the same time, it increased competition from foreign financial institutions and allowed most privately owned banks to recapitalise using their own resources. However, allowing banks to rely on their own initiative slowed recapitalisation; by mid 2000, bank credit still was not growing (Figure 6.4).

Background to the Crisis

During the 1990s, Thai governments attempted to open up the economy to international capital flows, but did not increase prudential controls commensurately. As in Australia during the early stages of financial market deregulation, Thai governments reduced controls on financial institutions' interest rates, portfolio allocation and foreign borrowing but failed to ensure their risk management was adequate.[5] Consequently, after 1994, the newly opened Bangkok International Banking Facility and the fixed exchange rate regime inadvertently encouraged financial institutions to undertake increasingly risky borrowing and lending. A rapidly expanding but poor quality private sector loan portfolio, biased heavily to overpriced real estate, made Thailand's financial sector vulnerable to external shocks.[6] For example, PricewaterhouseCoopers audited Krung Thai Bank, and found widespread weaknesses in lending practices, risk management and information systems (*Bangkok Post*, 9 November 1999).[7] Furthermore, financial institutions could not undertake client credit analyses because of the lack of credit bureaus. Conflicts of interest also arose because bankers sat on many of their clients' boards.[8]

Many financial institutions became insolvent when the economy slowed and real estate prices fell from 1996; this accelerated dramatically when the baht collapsed in mid 1997. By May 1997, financial institutions had started to fail, with the largest finance company, Finance One, leading the collapse.

Immediate Responses

The Government's initial responses eventually succeeded in preventing financial and international payments system panic. To prevent major bank runs, in June and August 1997, the Government suspended the operation of 58 finance companies, then in October 1997, issued depositor guarantees to the remaining financial institutions (Table 6.2). Initially, shareholders and to some extent, creditors bore the losses of the suspended finance companies while depositor claims were fully

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5 Weak financial regulation resulted in inadequate rules on loan classifications, provisioning and accounting, and no prudential limits on loan concentration by sector or borrower (Balino et al, 1999).

6 Local Thai banks base their lending on personal ties and collateral, mostly real estate, often without analysing debtors' loan-servicing capabilities. This is because, historically, Thai banks were more trade oriented, providing short term loans to finance trade rather than long term loans to finance investment.

7 The auditor estimated non-performing loans were 84 per cent of outstanding loans, far above the bank's official estimate of 59 per cent at the end of June 1999. A second investigation by a committee headed by Kamchorn Sathirakul, former central bank governor, concluded that while weaknesses were present, lending procedures in Krung Thai were in line with Bank of Thailand standards and prevailing banking sector practices. Implicitly, this questions the credibility of the Bank of Thailand as supervisor and examiner of the financial system. In addition, the PricewaterhouseCoopers' report indicates no Thai bank is on par with foreign banks in terms of risk management systems (*Bangkok Post*, 9 November 1999).

8 In July 1999, M.F. Chatu Mongol Sonakul, Governor of the Bank of Thailand, indicated the Bank of Thailand found shared directorships between 58 bank executives and 272 client companies. Some bank executives served on the boards of up to 29 companies.

Table 6.2

Sharp Cut to Number of Finance Companies

Consolidation in the Domestic Financial Sector, 1997-99

	Pre-crisis (June 1997)	October 1999	Change
Domestic private banks	14	9[a]	-5
State owned banks	1	4[b]	3
Foreign banks	14	20	6
Finance companies	91	21	-70
Total number of financial institutions	120	54	-66

Note: a Includes Bank of Asia, DBS Thai Danu Bank, Nakornthon Bank and Radanasin Bank.
b Does not include Bangkok Bank of Commerce (wound down), First City Bangkok Bank (merged with Krung Thai Bank) and Laemthong Bank (merged with Radanasin Bank).
Source: World Bank, 2000.

protected. However, for financial institutions that failed later, the Government honoured the claims of both depositors and creditors through the Financial Institutions Development Fund.[9] The Government also announced it would introduce a self-financed, limited deposit insurance scheme to replace its depositor and creditor guarantee, once the financial system was stable and restructured.[10] However, by mid 2000, this legislation was in abeyance.

In October 1997, the Government established the Financial Restructuring Authority, and the Asset Management Corporation. The Financial Restructuring Authority reviewed the rehabilitation plans of suspended finance companies and oversaw their liquidation. The authority auctioned most of the closed finance companies' Baht 584 billion (US$15 billion) of assets in 1998 and 1999, netting around 25 per cent of their book value (East Asia Analytical Unit, 1999a). To prevent a 'fire sale', the Asset Management Corporation acted as buyer of last resort of finance companies' lower quality assets, and the new, government owned Radanasin Bank bought some of their higher quality assets.

In 1997 and 1998, to meet IMF conditionally, the Thai Government passed several emergency amendments to the Bank of Thailand Act, the Commercial Banking Act and the legislation governing the operation of other financial institutions. These amendments enabled the Bank of Thailand to intervene in financial institutions that had become severely undercapitalised and non-viable.

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[9] The Financial Institutions Development Fund was established in 1985 to provide financial and managerial assistance to financial institutions facing difficulties. The fund was to provide liquidity assistance to financial institutions; provide guarantees to depositors and creditors; act on behalf of the authorities in exchanging promissory notes for depositors and creditors; and source liquidity for this scheme. Hence it performed the role of a de facto deposit insurance scheme and its activities were funded by a levy on deposits (Panpiemras, 2000). In 1997, the Government also introduced temporary limits on excessive risk-taking by placing a ceiling on deposit rates, limiting foreign borrowing and undertaking prudential monitoring of asset growth (Ministry of Finance, 1997).

[10] In early 2000, the Government was developing a law on deposit insurance, but some analysts believed it was no longer a high priority (Panpiemras, 2000).

Table 6.3

Major Restructuring of Thai Commercial Banks

Pre and Post Crisis Status of Thailand's Commercial Banks

Commercial banks at the end of 1996	Restructuring from 1998 to 2000	Commercial banks at the start of 2000
15		13
Private Thai banks		
Bangkok Bank	Recapitalised through security and bond markets	Bangkok Bank
Siam Commercial Bank	Recapitalised through security and bond markets	Siam Commercial Bank
Thai Farmers Bank	Recapitalised through security and bond markets	Thai Farmers Bank
Bank of Ayudhya	Recapitalised through security and bond markets	Bank of Ayudhya
Thai Military Bank	Recapitalised through security and bond markets	Thai Military Bank
Private banks, majority foreign owned		
Bank of Asia	Found strategic foreign partner in Dutch Bank ABN-Amro, which now holds a 75 per cent share	Bank of Asia
Thai Danu Bank	Found strategic foreign partner in Development Bank of Singapore, which now has majority ownership	DBS Thai Danu Bank
Laem Thong Bank	Government intervened in 1998, then recapitalised it and integrated it with the new state owned Radanasin Bank, established in 1998 and privatised in October 1999. After the merger, Singapore's United Overseas Bank had majority ownership	UOB Radanasin Bank
Nakornthon Bank	Government intervened in 1989, recapitalised it, then privatised it in 1999. Now Standard Chartered Bank has majority ownership	Nakornthon Bank
State owned banks		
First Bangkok City Bank	Government intervened in 1998, recapitalised it, then integrated it with state owned Krung Thai Bank	Krung Thai Bank
Bangkok Bank of Commerce	Government intervened in 1998, wound it down, then transferred its performing assets and liabilities to Krung Thai Bank	Krung Thai Bank
Siam City Bank	Government intervened in 1998, then recapitalised it and is preparing it for privatisation in 2000	Siam City Bank
Bangkok Metropolitan Bank	Government intervened in 1998, then recapitalised it. In May 2000 the Government agreed to sell a 75 per cent share to HSBC	Bangkok Metropolitan Bank (HSBC)
Union Bank of Bangkok	Government intervened in 1998, recapitalised it, then merged it with Krung Thai Thanakit and several other intervened finance companies to form BankThai. The new BankThai may be privatised through a public share offer in 2000	BankThai
Krung Thai Bank	Government injected Baht 185 billion (US$5 billion) to recapitalise Krung Thai Bank, Thailand's largest state owned bank, then readied it for possible privatisation in 2000	Krung Thai Bank

Source: Ministry of Finance, 1998 and 1999b; *Bangkok Post,* 19 October 1999; and *The Nation*, 15 May 2000.

Six commercial banks and a further 12 finance companies were suspended in 1998, and one commercial bank and one finance company in 1999. Consolidations, including mergers, reduced the number of commercial banks from 15 at the end of 1996 to 13 by early 2000 (Tables 6.2 and 6.3) and finance company numbers from 91 to 21 (World Bank, 2000).

UPGRADING PRUDENTIAL CONTROLS

As another important crisis response, the Government tightened prudential regulations and supervision to restore confidence in the financial system, reduce the risk of insolvency among financial institutions during future shocks and increase financial sector transparency and competition (East Asia Analytical Unit, 1999a). Financial institutions now must publish timely data on non-performing loans, NPLs, debt restructuring and capital adequacy ratios. However, the Bank of Thailand still is developing the supervisory capacity to enforce new regulations. Successful passage of a new financial institution law and a new law to increase Bank of Thailand independence will be further important indicators of continued government commitment to financial sector reform.

New Prudential Regulations

From 1997 to 2000, the Bank of Thailand gradually tightened capital adequacy, loan classification and provisioning rules, increasing their effectiveness. Commercial banks now must maintain capital adequacy ratios of at least 8.5 per cent of outstanding loans and finance companies must maintain ratios of 8 per cent (Bank of Thailand, 1999a). From 1 January 1998, the definition of NPLs was tightened to loans that were more than six months overdue (down from 12 months), and banks had to provision for all NPLs under the six-month definition. From 1 January 1999, the definition of NPLs was further tightened to three months overdue. In March 1998, the Government required banks to classify their loans according to the standard international five tier system by the end of 1998; this meant banks stopped accruing interest income on NPLs from January 1999. In 1998, the Government also introduced tax benefits to encourage loan loss provisioning, tightened eligibility guidelines for owners and managers of financial institutions and limited the number of directorships senior bank executives or board members could hold.[11]

By December 2000, commercial banks must meet new tighter provisioning requirements for newly classified loans. This extended deadline slowed bank recapitalisation and possibly recovery. However, some analysts argue forcing banks to reach provisioning standards earlier could have precipitated wholesale bank failures and nationalisations, further undermining confidence and raising the fiscal

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[11] For example, bank directors now can own no more than 1 per cent of the shares in companies to which the bank lends. While the new provisioning guidelines are tighter than previously, they still fall short of international best practice standards. International accounting standards require problem loans to be marked down to the present value of their expected future cash flow, discounted at the effective interest rate on the loan contract. The Bank of Thailand guidelines are backward looking: loans are classified on the number of months payments are overdue. Furthermore, provisions are calculated net of collateral value, which is primarily derived from property, and may be subject to inflated valuations. In the past, these differences produced a significant time lag in recognising loan losses and caused banks to underestimate provisioning requirements (World Bank, 1999b). However, the Government is trying to rectify this situation.

burden. The Bank of Thailand, BOT, expects this deadline will make banks pressure NPL holders to reschedule or repay debts. Some banks also may have to seek foreign equity investment, issue more domestic bonds or shares, or access the Government's August 1998 bank refinancing offer, discussed in the recapitalisation section below (Patpong-pibul, 2000).

To increase transparency, the BOT and the Ministry of Finance have tried to speed up disseminating information on financial institution NPLs, capital adequacy ratios and ownership structures, in line with the IMF's Special Data Dissemination Standards.[12] This helps markets monitor financial sector restructuring and discipline market participants. Since July 1998, all financial institutions have done quarterly loan portfolio reviews and submitted data to the BOT on their loan classifications and provisioning. In January 1999, the Government also introduced stricter financial institution auditing, disclosure and accounting practice requirements, consistent with international standards.

Apart from reforms to improve financial system risk control, other government reforms should increase financial sector efficiency and competition. For example, in 1999, the Government removed branching restrictions on commercial banks, an historic reform for the banking sector. This also significantly increases commercial opportunities for foreign commercial banks considering entering the market.

Effectiveness of Bank of Thailand, BOT, Supervision

While strengthening the human capital and systems in supervisory agencies will take some years, the Government is making progress. In the long term, strengthened supervision will contribute substantially to a more stable and more predictable financial system and business environment.

In 1997 and 1998, emergency amendments to the BOT, commercial banking and finance company laws enabled the BOT to deal promptly with failing financial institutions: the BOT could change distressed financial institutions' management, recapitalise them and ultimately, suspend their operating licences. By January 1999, the BOT had reviewed comprehensively the legal and regulatory framework for financial sector supervision (Ministry of Finance, 1999b). Subsequently, the Government drafted further amendments to the Bank of Thailand Act to enhance the BOT's accountability and a new financial institutions law to enhance the supervision of commercial banks and other financial institutions.

In mid 2000, the Ministry of Finance and BOT were finalising these and several other key draft bills to go before Parliament in 2000. This legislation faced delays due in part to disagreements between the BOT and Ministry of Finance.[13] A new concern is that a potential third round election for the Senate also could delay passage of key laws until mid 2001 (*Bangkok Post*, 11 May 2000).

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[12] The IMF introduced these standards in response to the financial crisis and established a joint project with the World Bank to encourage member economies to provide relevant statistics on their financial and balance of payments position for publication on a new web site, a subdirectory of www.imf.org.

[13] The BOT opposed the Ministry of Finance's proposal to use excess foreign reserves to consolidate the Government's accounts. The ministry wanted the BOT to use these reserves to pay debts the Financial Institutions Development Fund incurred in assisting the financial sector (*Bangkok Post*, 18 April 2000). According to media reports, in mid May 2000, the BOT and Ministry of Finance agreed to allocate an unspecified portion of foreign exchange reserves to the Financial Institution Development Fund (*The Nation*, 15 May 2000).

These new laws are needed to strengthen the framework for BOT financial supervision, and raise financial sector efficiency and transparency. The new Bank of Thailand Act would increase significantly the BOT's authority and its independence from political interference in executing monetary policy and supervising financial institutions.

Since the release of the Nukul Report (1998), the BOT's new governor has streamlined structures, and recruited and trained staff to enhance the bank's operating procedures and capacity to enforce the newly tightened financial regulations.[14] These efforts are being supported by technical assistance from the IMF; the World Bank; the US Federal Reserve Board, which has set up a supervisors' school; Australia's Reserve Bank, which is assisting with IT development; and other central banks.

The BOT and World Bank recognise the major prudential areas requiring strengthening include:

- methods and procedures for off-site monitoring and on-site examination
- requirements for consolidating supervision
- revision and streamlining of commercial bank reports
- design of banks' and finance companies' public disclosure data
- enforcement of strengthened prudential controls (Ministry of Finance, 1999a, 1999b and 1999c).

At present, the BOT supervises using a rules based approach but plans to rely more on disclosure based supervision. Presently supervisors collect and attempt to scrutinise large volumes of detailed financial data. However, increasingly well informed market players will impose market discipline on financial institutions. Institutions will have to disclose information on capital adequacy ratios, non-performing loans and provisioning to markets, and rating agencies will be more important in assessing listed companies (Patpong-pibul, 2000). The Securities and Exchange Commission also recognises markets more effectively discipline firms (Sucharitakul, 2000).

Credit Bureaus

During the crisis, Thailand had no credit bureaus to help financial institutions analyse the credit risk of potential borrowers; this undermined the capacity of financial institutions to manage risk and lend on any basis except collateral. Hence, in December 1999, the Government and commercial banks established Thailand's

[14] The Nukul Report criticised the BOT's role in the lead up to the crisis, citing failure of its prudential supervision and foreign exchange management strategies.

In November 1999, the BOT assigned additional staff to supervise financial institutions to improve effectiveness, transparency and continuity. It established a working team with staff solely responsible for the daily on-site and off-site supervision of financial institutions. It also required financial institutions to submit detailed reports to the team every month. The leader of the working team will be replaced every three years and one fifth of team members will be changed every six months. At the end of the fifth year, the team will consist of only new members. This should ensure staff cannot be compromised.

first credit bureau under the auspices of the Ministry of Finance. Owned jointly by 13 Thai commercial banks, it analyses information provided by them and 22 full branch foreign banks. After a trial period, the bureau will expand to cover finance companies and other financial institutions.[15] The Thai Banker's Association also plans to launch its own credit bureau scrutinising information from classified reports on corporate loans filed with the BOT. These credit bureaus should contribute significantly to increasing the quality of bank loan portfolios.

RECAPITALISING FINANCIAL INSTITUTIONS

From 1997 to 1999, the financial crisis wrote off a large share of equity capital in the banking system and other financial institutions; this must be replenished before normal lending levels can resume. Write offs of extensive NPLs, losses from foreign currency borrowing and non-receipt of interest and capital depleted financial institutions' capital.[16] By December 2000, banks must reach tightened capital adequacy ratio and bad loan provisioning rules, further increasing their demand for capital. Because private Thai banks needed to replenish their capital, at least two foreign banks, ABN-Amro and Development Bank of Singapore, were able to enter the Thai market in 1999. Unless banks secure debt work outs and reduce their stock of NPLs in 2000, some will have to seek more foreign or domestic equity, issue more special purpose SLIPS or CAPS, or access the Government's equity offer.

Recapitalisation efforts can succeed only when NPLs decline; NPLs now are falling slowing from a high level, reflecting slow progress in corporate debt work outs. NPLs rose from 15 per cent of outstanding credit in 1997 to peak at 47.7 per cent in May 1999 before falling to 37 per cent, or Baht 2 trillion (US$53 billion), by March 2000 (Figure 6.3).[17] The BOT forecasts NPLs will fall to 10 per cent of outstanding loans by December 2000 (*Bangkok Post*, 11 April 2000). However, this will require banks to move most NPLs to their own asset management companies in 2000.

The August 1998 Package

In August 1998, the Government announced a voluntary Baht 300 billion (US$7 billion) program to expedite financial institution recapitalisation, but by mid 2000, few financial institutions had taken up the offer. The Government offered to match public funds with private funds injected into financial institutions that satisfied specified prudential conditions. To receive a public injection of tier 1 capital, financial institutions had to achieve immediately the December 2000 loan classification, capital adequacy and provisioning standards, with existing shareholders bearing the associated costs. To receive public tier 2 capital, they had to enter legally binding debt restructuring agreements with their debtors (Ministry of Finance, 1999a). Public capital injections would buy government equity in these banks; in some cases, banks' founder owners would have lost control.

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15 Foreign representative banks and investment funds need to supply information to the bureau before they can access the system (*Bangkok Post*, 30 November 1999).

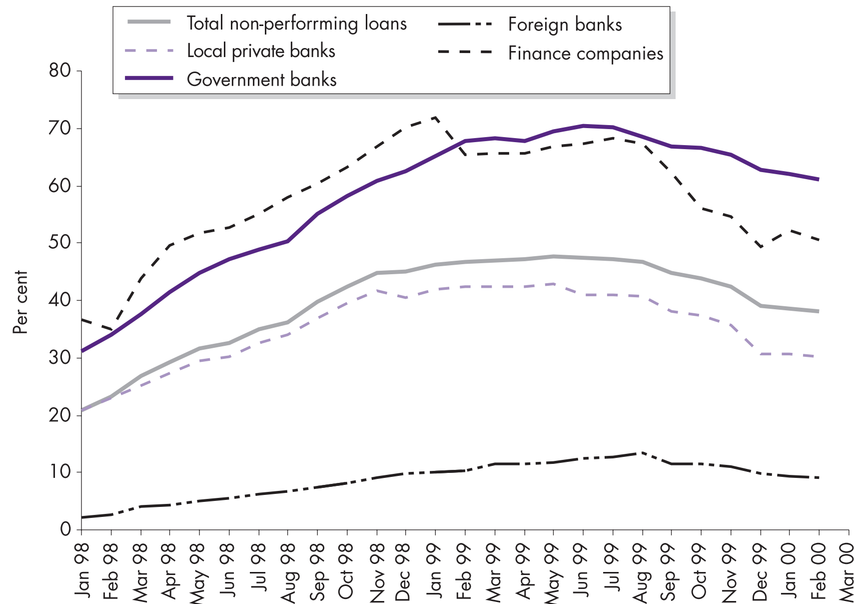
16 Commercial banks in Thailand made losses of Baht 63 billion in 1997 and Baht 349 billion in 1998 (Bank of Thailand, 1999a). While some commercial banks made operational profits in the third quarter of 1999, the banking sector registered a net loss due to provisions for NPLs. Given the amount of NPLs, the Thai banking sector is not likely to return to reasonable profitability until 2001.

17 The tightened definition of NPLs also contributed to the sharp rise in their value.

Figure 6.3

NPL Rates Falling

NPLs as a Percentage of Total Loans by Financial Institutions



Source: CEIC, 2000.

Consequently, by late 1999, only three financial institutions had accessed this program; two banks and one finance company obtained Baht 41 billion (US$1.1 billion) of tier 1 capital assistance and a total of Baht 49 billion (US$1.3 billion) was disbursed (*Bangkok Post*, 22 November 1999). Most bank owners would not relinquish control of their banks to the Government, or meet the stringent prudential conditions imposed.

Private Banks' Recapitalisation Efforts

While the process has been slow, most surviving private financial institutions are recapitalising. Between January 1998 and October 1999, many private commercial banks partly recapitalised, raising Baht 358 billion (US$9 billion) in new capital (Table 6.4). Hence by December 2000, analysts estimate they will need only Baht 41 billion to 94 billion (US$1.1 billion to 2.5 billion) in new capital to meet provisioning requirements.

Table 6.4

Banks Achieve Significant Recapitalisation

New Capital Raised by Thai Financial Institutions between January 1998 and October 1999, Baht (billion)

	Tier 1	Tier 2	Total
Total commercial banks	732.30	53.24	785.54
Private commercial banks	305.16	53.24	358.40
State owned commercial banks	427.13	–	427.13
Finance companies	29.83	1.31	31.51
Total financial institutions	762.13	54.55	816.69

Source: Bank of Thailand, 1999a.

To recapitalise, major private banks attracted direct equity investments from strategic foreign partners and issued share and capital securities, such as SLIPS and CAPS.[18] However, SLIPS and CAPS are expensive for banks as they offer investors an annual return of between 11 and 22 per cent, much higher than current bank lending rates, and compress bank profit margins. Thai Farmers Bank, Bank of Ayudhya, Bangkok Bank and Thai Military Bank issued such securities in 1998 and 1999. In 1998, Bangkok Bank, Thailand's largest private commercial bank, issued US$1.2 billion in shares and in 1999, Bank of Asia issued shares worth US$33.5 million (East Asia Analytical Unit, 1999a).[19] Bank of Asia and Thai Danu Bank found strategic foreign partners and now are majority foreign owned (Tables 6.3 and 6.4). In 2000, Thai Danu Bank plans to raise Baht 13.5 billion (US$350 million) through a rights issue and private placement to new investors (*Bangkok Post*, 29 April 2000).

Asset Management Companies

The Republic of Korea and Malaysia, (and before them, the United States and Sweden) established government owned asset management companies to accelerate NPL write offs, but Thailand made little use of this technique.[20] The Thai state owned asset management company only disposed of the assets of failed finance companies.

Instead, the Government encouraged private banks to set up their own asset management companies to dispose of their NPLs. An August 1998 emergency decree enables financial institutions to remove NPLs from their balance sheets by establishing asset management companies. Financial institutions were required to hold more than 50 per cent of shares in these asset management companies but this

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18 Bank owners favour these funding instruments because these securities usually are non-voting and do not dilute banks' existing ownership structures. They have a maturity of up to seven years, although issuers can repay them after three years. Holders receive fixed payments for the life of the security. Banks cannot hold more than one third of tier 1 capital in this form (World Bank, 1999a).

19 The shares were offered to existing shareholders with Bank Asia's foreign owner, ABN-Armo, promising to take up any shares not purchased by other shareholders.

20 Asset management companies buy distressed financial institutions' NPLs, usually at a significant discount on face value, to clear them off banks' balance sheets and help banks resume normal lending more quickly.

provision subsequently was relaxed. By allowing experts to handle NPLs, asset management companies can reduce losses incurred from NPL disposal and free bank managers to focus on extending new loans.[21] In October 1999, the Government added tax incentives and waivers to encourage NPL disposal through asset management companies.

However, commercial banks still must raise new capital to write off NPLs through their asset management companies; consequently progress will be slow. By early 2000, only Thai Farmers Bank, Bangkok Bank, Siam Commercial Bank and Singapore's United Overseas Bank had established asset management companies; three more banks, including the state owned Krung Thai Bank, announced they intended to do so soon.[22]

State and Nationalised Bank Recapitalisation

Government banks have by far the highest NPLs and hence need the most funds for recapitalisation (Figure 6.3). The Government plans to issue public shares to privatise BankThai, the largest Thai bank, formed in 1998 from merging several banks and finance companies (Table 6.3). Although the Government has spent Baht 185 billion (US$5 billion) recapitalising Krung Thai Bank, it may require further capital injections. Krung Thai Bank's extremely weak financial position is making it difficult to privatise, and this process may take up to three years, according to bank president, Singh Tangtatsawas (*Bangkok Post*, 7 September 1999).

From January 1998 to October 1999, state owned banks raised Baht 427 billion (US$11 billion) in new capital, mainly from privatisation sales (Tables 6.3 and 6.4). However, the Financial Institutions Development Fund covers privatised state bank bad loan losses in confidential loss-sharing and yield-maintenance agreements with the new private owners. These expose the Government to significant, as yet unquantified contingent liabilities and could reduce significantly net proceeds from bank sales.[23]

Costs of Financial System Restructuring and Refinancing

The cost of restructuring and recapitalising Thailand's financial system are huge. Government estimates the total cost of supporting banks and finance companies, and repaying depositors will be Baht 1.4 trillion (US$37 billion) (Patpong-pibul, 2000) but private sector analysts estimate up to Baht 2 trillion (US$53 billion) or

[21] Asset management companies also can pay higher salaries than banks normally pay staff (Patpong-pibul, 2000) and readily employ foreign experts. However, Bangkok Bank expected its asset management company would have minimal impact on the bank, because it already operated a separate section staffed by expatriates that disposed of NPLs and organised debt work outs (Panpiemras, 2000). Thai Farmers Bank has transferred, at around 55 per cent of book value, one third of its NPLs to a wholly owned asset management company. Although these loans were provisioned to the Bank of Thailand level, provisioning did not cover the incremental loss from marking down NPLs to approximate market value. Thai Farmers Bank plans to issue Baht 24 billion worth of common shares to cover this incremental loss (World Bank, 1999a).

[22] In the second half of 2000, Krung Thai Bank plans to transfer Baht 537 billion (US$14 billion) of non-performing loans to a new asset management company wholly owned by the Financial Institutions Development Fund (*The Nation*, 8 May 2000).

[23] When international banks buy a major share in distressed or nationalised Thai banks, the Bank of Thailand typically has agreed to pay around 85 per cent of the losses incurred by banks' asset management companies in disposing of NPLs (East Asia Analytical Unit, 1999a).

35 to 40 per cent of projected 1999 GDP (Fitch IBCA, 1999). Estimates of capital required to fully provision surviving financial institutions' NPL losses range from Baht 300 billion to 400 billion (US$7.9 billion to 10.5 billion) (Ministry of Finance, 1999c) to Baht 700 billion to 1 trillion (US$18.4 billion to 26.3 billion) (Flatters, 1999). The IMF/Thai Government's latest estimate of the annual interest cost of financial restructuring bonds is 4 per cent of GDP (Flatters, 1999).

To date, the Government has issued bonds to finance:

- the Financial Sector Restructuring Agency which manages the affairs of failed finance companies
- the Asset Management Corporation, which purchased the lowest quality assets of failed finance companies
- capital injections to Nakornthon and Krung Thai Banks
- the Financial Institutions Development Fund, which supplied huge amounts of liquidity support to weak financial institutions.[24]

Privatising nationalised banks, liquidating closed financial institution assets and writing down private investors' equity will meet some of this cost, but Thai taxpayers will bear most of it. Privatising state enterprises will not generate sufficient funds to repay the capital costs of bond issues, and in any case, the Government now appears to consider privatisation a medium term objective. However, fiscal imperatives should ensure many financial institution and other privatisations do proceed eventually.

PROSPECTS FOR FINANCIAL SECTOR RECOVERY

The private sector-led approach to recapitalisation has slowed recovery of the Thai financial sector, but from 2001, the sector should function more normally. Lenient timetables for provisioning have slowed recapitalisation and NPL write offs, compared to arrangements in the Republic of Korea and Malaysia (East Asia Analytical Unit, 1999a and 1999b).[25] Thai banks have been cautious in extending new loans for fear they will breach capital adequacy limits and accumulate more NPLs. Nevertheless, by December 2000, banks must be fully recapitalised and provisioned; the corporate debt work out process should be progressing; and by 2001, banks should be in a position to resume normal lending. Improved financial sector health will boost trade and investment prospects for local and foreign business.

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[24] The Financial Institutions Development Fund also guaranteed ailing financial institutions' deposits and other liabilities. Financial institutions with excess liquidity had to deposit it with the Financial Institutions Development Fund. In the eight weeks before mid July 1997, the fund lent financial institutions Baht 160 billion (US$5.2 billion). By early 2000, the fund had accumulated liabilities of over Baht 1.4 trillion (US$37 billion) on behalf of the Government (Patpong-pibul, 2000). Analysts expect the Government will recover no more than one quarter of these funds.

[25] NPLs fell from their May 1999 peak to 42 per cent by early 2000 mainly because of write offs by foreign controlled banks. Foreign owned bank NPLs now stand at only 10 per cent of loans (Vichyanond, 2000).

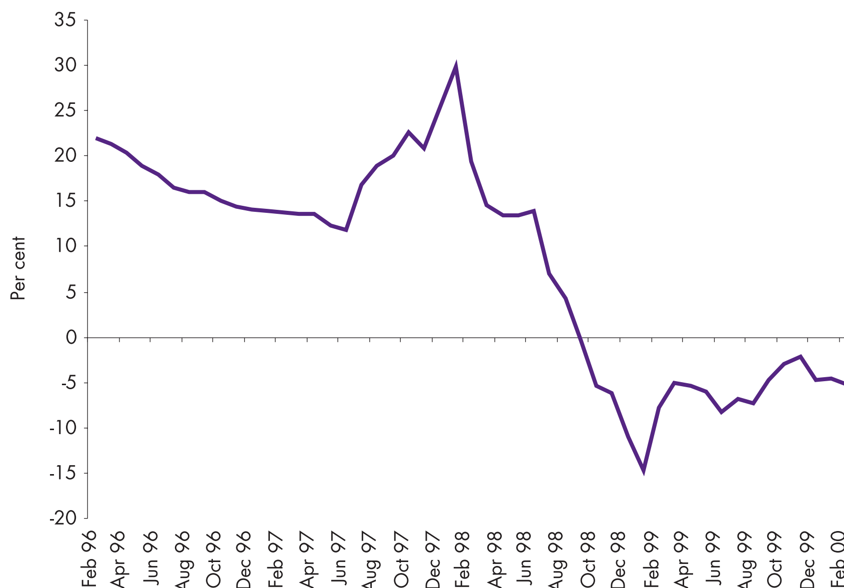
Credit Growth

Thailand's economic recovery is closely related to financial institutions resuming normal lending levels. In 1998 and 1999, the supply of bank lending to the corporate sector contracted due to high levels of NPLs, increased capital adequacy ratio requirements, a shortage of viable borrowers and a lack of demand for new investment funds. Commercial bank lending continued to contract, by 5 per cent, over the year to February 2000 (Figure 6.4). Furthermore, as banks must reach capital adequacy ratios and provisioning standards by December 2000, they may remain uninclined to lend throughout 2000.

Figure 6.4

Commercial Banks Reluctant to Lend

Thai Commercial Bank Lending (Loans, Bills and Overdrafts)
Per cent Change on Same Month Previous Year



Source: CEIC, 2000.

In 1999, rather than from new credit, the non-financial corporate sector accessed liquidity mainly from foreign direct investment, the government fiscal stimulus package, the trade account surplus, government small and medium sized business credit assistance channels and direct financing from the bond and securities markets (Patpong-pibul, 2000). A large part of capital inflows into securities markets and from foreign direct investment went to recapitalising financial institutions, so most other companies remained starved for working capital.

In the short term, demand for credit growth for new investment will remain weak in non-export oriented sectors. Only around 60 per cent of Thailand's productive capacity currently is being used; bankable projects are scarce outside the export-oriented sector; and many highly leveraged businesses are issuing shares and repaying

loans to reduce their debts. Real interest rates have fallen but remain relatively high (Figure 5.4). However, some larger companies are refinancing foreign loans with domestic borrowing and others want to raise finance to buy the assets of distressed companies (Panpiemras, 2000).

A recent BOT survey of credit needs found while credit supply is not strong, viable firms can access credit (Waiquambee, 2000). By early 2000, the BOT found exporters had little trouble obtaining sufficient credit from banks; however, most small and medium sized businesses have NPLs which prevent them from obtaining credit through BOT funded facilities operated by the banks (Waiquambee, 2000). Stronger, larger companies can raise cash through securities and bond issues. Banks cite a shortage of viable borrowers, so many are putting their funds into government bonds.

In the medium term, demand for bank borrowing will expand more strongly, and assuming corporate and financial sector restructuring is sufficiently advanced, banks should be more willing to lend. As export recovery gathers pace, export and import competing sectors will need to expand capacity. With improving macroeconomic conditions and debt work outs, the BOT expects 2 per cent credit growth in 2000, and private commercial bank credit should grow 5 per cent (Waiquambee, 2000; and Rachatatanun, 2000). However, if NPL write offs and bank recapitalisation progress insufficiently in 2000, the banking system may be unable to recommence normal lending, constraining sustainable economic recovery.

Prospects

While financial sector reform and restructuring are generating opportunities for financial service suppliers and investors, Thailand faces crucial choices in 2000 which will determine its future financial sector prospects. Without continued thorough structural reforms, Thailand probably will only ‘muddle through’ and sustain 4 to 5 per cent growth in the medium term (Vichyanond, 2000). Thailand technically is recovering, but the depth of financial and related corporate sector reforms, and hence the sustainability of robust recovery, still is uncertain. Indecisive financial and corporate restructuring would retard medium to long term growth rates below otherwise attainable levels.[26]

In 2000, significant indicators of government commitment to ongoing financial sector reform will include:

- the successful sale of Siam City Bank to a strategic investor, completion of the sale of Bangkok Metropolitan Bank to HSBC and privatisation of BankThai
- the successful passage of the proposed Bank of Thailand and financial institution laws, without significant amendments
- continued progress in creating a debt culture, enabling accelerated success on corporate debt work outs, led by the recent satisfactory resolution of the TPI case in the bankruptcy court

[26] Many analysts believe trend medium to long term growth could be as low as 4 per cent. With population growth now averaging about 1 per cent per year, Thai per capita income growth will be almost half of that before the crisis, and for some, living standards will fall. Eventually, this could lead to a second round of reforms. However, in the interim, Thailand could lose valuable years of higher growth of 6 to 7 per cent.

- strict enforcement of the December 2000 deadline for bank provisioning and recapitalisation
- formally raising the 25 per cent foreign equity limit for insurance companies to 49 per cent.

Assuming the Government achieves most of these reforms, by 2001, banks should reduce NPLs to more manageable levels and advance more normal levels of credit. The significantly increased role of foreign financial institutions should impose valuable competitive pressure on domestic financial institutions, which eventually should become more efficient and viable. Local financial institutions' need to compete also should increase their demand for a range of IT, management and related services to upgrade their operations. In 2000 and beyond, all these factors should increase financial sector performance, as well as opportunities for foreign investors and service suppliers.

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Chapter 7

CORPORATE RESTRUCTURING AND GOVERNANCE

Key Points

- Weak governance and risk management in Thailand's corporate sector contributed significantly to the crisis; many companies were highly leveraged, including with short term foreign denominated loans but held long term baht denominated assets.
- Post crisis reforms include stronger bankruptcy and foreclosure laws, an improved bankruptcy enforcement framework and streamlined institutional arrangements for corporate debt work outs.
- Poor corporate transparency, risk management and shareholder protection increase the risk and reduce the profitability of foreign traders, investors and creditors doing business in Thailand; recent reforms therefore should improve Thailand's attractiveness to foreign business.
- Vested interests have delayed and diluted much of the reform legislation, and a weak institutional capacity to implement corporate restructuring has retarded recovery, compared to the Republic of Korea and Malaysia.
- However, corporate debt restructuring was accelerating by mid 2000; the Government's Corporate Debt Restructuring Advisory Committee contributed to this acceleration.
- Poor quality debt restructuring may cause a significant proportion of restructured loans to reappear as non performing loans.
- The Government is implementing reforms to strengthen corporate governance, requiring better accounting and auditing practices, and vetting company directors; it also plans to strengthen minority shareholder rights. However, these reforms will take some years to implement effectively; several conflict with the dominant culture of family run companies.

In the lead up to the crisis, corporates' weak capacity to manage risk and poor governance exposed Thailand's private sector to excessive foreign currency and interest rate risk, and undermined market confidence. As a result of the plunging baht, skyrocketing interest rates and collapsing asset values, a high proportion of Thai businesses faced insolvency by early 1998, precipitating a financial sector crisis, as many corporates could not repay their loans. Weak bankruptcy mechanisms,

difficulty in enforcing contracts, and poor corporate transparency and governance standards also make Thailand a riskier business environment for foreign traders, creditors and investors. Improvements in legal sanctions and corporate governance eventually should contribute to improving the Thai business environment, and hence the profitability of doing business with Thailand.

In 2000 and 2001, recovery of the Thai financial sector and the overall economy depends on corporates and creditors successfully restructuring non-performing debt so banks can resume lending. New lending is needed to finance investment which will replace the Government's fiscal stimulus package in driving growth. Long term sustainable recovery also requires the development of a healthy debt culture, where viable debtors repay debts, and unviable ones rapidly enter debt work outs or bankruptcy procedures. Without this, international banks will be unwilling to extend loans to Thai corporates and the cost of borrowing will be higher.

By early 1998, the Government recognised corporate debt work outs were essential to control non-performing loans and achieve recovery, so accorded it high priority (Ministry of Finance, 1998). It introduced legal and tax reforms to establish an appropriate debt restructuring framework and encourage voluntary, market oriented processes within this framework. It also advocated out-of-court settlements through the 1998 bankruptcy law amendments and a debt work out framework. Corporate debt restructuring has accelerated since Parliament finally passed new bankruptcy laws and faster out-of-court settlement procedures. While the bankruptcy court has been slow in implementing these new laws, their passage probably reduced non-performing loan rates from their May 1999 peak.

The Government also recognises sustained, long term recovery requires stronger corporate governance performance. Improved corporate transparency, accountability to shareholders, ethical and accountancy standards and increased competition are essential to prevent a repeat of the poor corporate risk management which exposed Thailand to the crisis. The Government is introducing several reforms in this important area.

This chapter analyses the major improvements to the legal framework supporting corporate restructuring and the nature and progress of new out-of-court debt work outs and corporate governance reforms. The analysis then draws commercial implications for business from recent and anticipated corporate work outs and corporate governance developments.

LEGAL REFORM

Since 1997, to expedite recovery and help address fundamental institutional weaknesses, the Government has overhauled the legal and regulatory framework for economic activities; this also will assist foreign business. By January 2000, it had passed and enacted nine basic economic reform bills.[1] At least five more economic bills await Minister for Finance approval and should be submitted to the Parliament in 2000 (Table 7.1).

[1] The last passed was the State Enterprises Corporatisation Bill which was approved by the Thai Constitutional Court in October 1999.

Table 7.1

Economic Laws Undergoing Major Overhaul

Economic Reform Laws and Their Status, Mid 2000

Area of economic reform	Legal changes	Status
Bankruptcy and foreclosure procedures	Amended bankruptcy law	Passed into law in 1999
	Bankruptcy court and bankruptcy procedures law	Passed into law in 1999
	Amended civil code procedure law	Passed into law in 1999
	Secured lending law	In process[a]
Foreign direct investment and related legislation to liberalise ownership of land and buildings	Amended alien business law	Passed into law in 1999
	Amended land code law	Passed into law in 1999
	Property lease rights law	Passed into law in 1999
	Condominium law	Passed into law in 1999
Financial supervision	Banking, finance and credit fonciers businesses law (also known as financial institutions law)	In process[a]
	Bank of Thailand law	In process[b]
Privatisation of state enterprises	Corporatisation law	Passed into law in 1999
Capital market development	Emergency decree on securitisation	Passed into law in 1977
	Derivatives law	In process[b]
	Amended securities and exchange law	In process[c]
Deposit insurance	Deposit insurance law	In process[c]
Social safety net	Amended social security law	Passed into law in 1999
Management of foreign exchange reserves	Currency law	In process[d]

Note: a Draft bill approved by Cabinet, now under consideration by the Office of the Council of State. Still requires parliamentary approval.
b Approved by the Office of the Council of State and awaiting re-submission to the Cabinet.
c Ministry of Finance finalising draft.
d Awaiting submission to Parliament.

Source: Bank of Thailand, 1999; Securities Exchange Commission 1998a and 1998b; Stock Exchange of Thailand, 1999c; Ministry of Finance, 1998, 1999a and 1999b; World Bank, 1999; Patpong-pibul, 2000; and Bull, 2000.

1998 Amendments to the Bankruptcy Law

Stronger bankruptcy laws are fundamental to corporate restructuring. Initial amendments to the bankruptcy law increased the scope for out-of-court work outs and corporate debt reorganisations. Financially distressed companies could have their businesses reorganised through transparent court supervised procedures. Under the amended law, either creditors or debtors of an insolvent company could petition the court for a reorganisation order.[2] The insolvent company had up to five years to rehabilitate its business before being declared bankrupt. The Government pursued this relatively lenient approach to creditors to cap rising unemployment and prevent bankrupting businesses with temporary liquidity problems due to the financial crisis (Bank of Thailand, 1998).

1999 Bankruptcy Law Reforms

However, as the crisis deepened and the number of non-performing loans and insolvent businesses rose, the Government recognised initial amendments were inadequate. In late 1998, the Bank of Thailand reviewed bankruptcy, foreclosure and related laws to devise an appropriate legal framework for debt restructuring. As a result of Bank of Thailand recommendations, in March 1999 the Government substantively amended the bankruptcy legislation and removed tax disincentives for asset transfers, share acquisitions and mergers. These changes provided Thailand with a sound legal framework for bankruptcy, foreclosure and out-of-court debt restructuring for financial institutions and the corporate sector; they were important breakthroughs for debt restructuring. The amended civil code procedure law should further expedite the process of claim, judgement, execution and collection during foreclosures.[3]

The New Bankruptcy Court

The Central Bankruptcy Court opened in June 1999 to adjudicate liquidation proceedings and formal reorganisation under the amended bankruptcy law. However, the court's interpretation of the amended laws has not yet increased business liquidations; by April 2000, only one of the 49 companies undergoing bankruptcy procedures in the new court had been finalised (*Bangkok Post*, 3 May 2000).[4]

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[2] Once a reorganisation order is issued, the court appoints a planner to prepare a reorganisation plan. Planners can run the business during the reorganisation program, under official receivers and court supervision. However their powers are very limited compared to those of administrators in western jurisdictions. For example, Thai planners cannot dispose of assets or take on new debt, even essential working capital loans, to enhance the value of assets, like buildings under construction (Norman, 2000). Creditors must vote on the proposed plan within three months and a majority must approve it.

[3] Previously, debtors could appeal judgements and delay execution indefinitely. Appeals now are limited to the court of first appeals, and the discretionary power of judges to rescind auction sales is limited. Simple case procedure also was improved, expediting the enforcement of security interests.

[4] By the end of January 2000, the new court had handled over 441 bankruptcy suits. However, only 27 were business bankruptcy or rehabilitation cases worth over Baht 160 billion; the remainder were personal bankruptcy cases totalling Baht 10 billion. Creditors filed 15 of the 27 business cases and creditors and debtors jointly filed two. Among the personal bankruptcy cases, the court has made 210 rulings to date, with 170 people declared bankrupt, 17 cases found in favour of the defendant and 26 cases dismissed. Among the corporate cases, over 17 rehabilitation plans were approved, including for Thai Petrochemical Industry, TPI, and Siam Cement (*Bangkok Post*, 11 January 2000; and Norman, 2000).

While experts consider Thailand's bankruptcy laws now are coherent and relatively complete, creditors fear the courts' interpretation of these laws still heavily favours debtors (Shivakumar, 2000; and Norman, 2000). However, the March 2000 Central Bankruptcy Court's ruling that Thai Petrochemical Industry was insolvent has set a new benchmark for future bankruptcy and restructuring cases in Thailand. Many analysts believe the ruling will help make future corporate restructuring more effective (*Bangkok Post*, 17 March 2000).

THAI PETROCHEMICAL INDUSTRY GROUP, TPI, DECLARED INSOLVENT

TPI is Thailand's largest non-performing debtor, with outstanding non-performing loans of US$3.5 billion. TPI's 140-plus creditor banks want its debts restructured. Over two years of negotiation, TPI consistently amended agreements reached with creditors, leading to an impasse between the parties. By February 2000, TPI was questioning the creditors' claims that debt restructuring was even necessary, and the company objected to creditors' claims that TPI was insolvent (Business Monitor International, 2000).

Ultimately, Thailand's Central Bankruptcy Court resolved the case. In a landmark decision announced on 15 March 2000, the court ruled that TPI was insolvent. In its finding, the court discounted TPI's balance sheet as the basis for valuing assets, arguing the company had failed to rebut the creditors' valuation based on cash flow and ability to pay debts. In April 2000, creditors selected Effective Planning, a subsidiary of Australian firm, Ferrier Hodgson, to oversee TPI's debt restructuring.

Declaring TPI insolvent was a major win for Thailand's new bankruptcy law and the Central Bankruptcy Court. The decision provides an important precedent for determining insolvency directly applicable to other insolvent companies and to strategic bad debtors. Importantly, the court shifted its interpretation of insolvency from a balance sheet test to one that includes the company's ongoing business condition and ability to service debts, as is the procedure in western jurisdictions. In doing so, the court overcame what many considered the major shortcoming under Thailand's revised bankruptcy law. Nevertheless, legal experts agree the bankruptcy law still needs amending to define insolvency clearly, rather than to leave the issue to the court (*Bangkok Post*, 17 March 2000).

Impact of Weak Foreclosure Procedures

Despite this ruling, the courts' interpretation of foreclosure laws remains problematic. Courts are very reluctant to allow creditors to foreclose on debtors' land and property; this means debtors are not keen to negotiate work outs and have strong leverage to demand debt forgiveness in agreed work outs (Norman, 2000; and Took, 2000). Ultimately, this weakness will increase the cost of lending in Thailand, raising interest rates for all borrowers. For example, many western banks are pulling out of Thailand because of problems with bankruptcy and foreclosure laws; Bank of America, ANZ and the National Australia Bank are withdrawing or scaling back their operations (Norman, 2000; and White, 2000).

Weak interpretation of bankruptcy and foreclosure laws also creates solvent debtors who simply halt loan repayments to save money. In 1999, strategic non-performing loans, where borrowers refuse to pay debt despite their ability to do so, may have comprised one third of Thai non-performing loans (*Bangkok Post*, 29 September 1999). However, anecdotal evidence indicates strategic non-performing loans have fallen in 2000 as interest rates have fallen, and should fall further as large corporates negotiate out-of-court debt work outs (Panpiemras, 2000).

THE DEBT WORK OUT FRAMEWORK

Formal debt work out procedures were virtually non-existent before the crisis, but after a slow start in 1998 and 1999, were functioning better by mid 2000; this development should expedite capacity to undertake future work outs, improving the business environment and the financial sector prospects. In August 1998, the Bank of Thailand and five industry associations[5] signed a Framework for Corporate Debt Restructuring, the so-called Bangkok Approach, modelled on the London Approach to debt work outs. In June 1998, the Government established a Corporate Debt Restructuring Advisory Committee, CDRAC, chaired by the Bank of Thailand Governor to accelerate work outs. By early 1999, CDRAC had established a framework to monitor and facilitate debt work outs (Choosri, 2000).[6] It encourages banks, represented by senior management, to form voluntary creditor committees, so they can exchange information on corporate debt restructuring, establish debt work out units with international expert assistance and set deadlines for debt restructuring or liquidation.[7] CDRAC requires creditors to choose between voluntary restructuring, court supervised reorganisation or bankruptcy within 90 days of the initial meeting between main or lead creditors and debtors.[8]

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5 These were the Board of Trade, Federation of Thai Industries (representing debtor companies), the Thai Bankers' Association, Association of Finance Companies and the Foreign Banks' Association (representing creditor groups).

6 In early 1999, CDRAC developed guidelines for initiating inter-creditor and creditor-debtor mediation and arbitration, strengthening the framework for debt work outs. CDRAC uses two civil contracts, debtor-creditor agreements and inter-creditor agreements. Debtor-creditor agreements define procedures for case entry, information sharing, negotiations, and 75 per cent majority voting approval by creditors.

7 For example, Bangkok Bank has a team of Australian experts in its debt work out unit (Panpiemras, 2000).

8 This process is intended to produce agreement on a restructuring plan, submission to inter-creditor arbitration, or petitions for foreclosure or insolvency within six to eight months. Inter-creditor agreements define a process for inter-creditor arbitration within certain time limits. They also empower the Bank of Thailand to enforce creditor compliance through warnings and monetary penalties. If creditors are unable to agree on a restructuring plan, the Bank of Thailand can use its own authority to resolve disputes among financial institution creditors, and fine creditors. CDRAC provides trained mediators to facilitate the debt negotiation process (Corporate Debt Restructuring Advisory Committee, 1999).

1998 FRAMEWORK FOR CORPORATE DEBT WORK OUTS

The corporate debt work out framework established in 1998:

- initially assessed debtor viability and decided whether or not firms should continue operating
- elected a lead bank and steering committee in complex multi-creditor cases
- required lead banks to establish goals and schedules, organise inter-creditor discussions and head negotiations with debtors
- required agreement from creditors on debt 'standstill' during active restructuring talks
- obliged debtors to provide creditors with full and accurate information, including audited accounts if necessary
- accepted credit extended above existing exposures on specified terms during standstill would have seniority
- anticipated CDRAC would review regulatory and supervisory frameworks and monitor restructuring agreements.

Source: Ministry of Finance, 1998.

Recent Debt Restructuring Progress

The establishment of CDRAC and the March 1999 bankruptcy law amendments coincided with accelerated corporate debt restructuring. During 1998, only Baht 157 billion of debt was restructured covering 9 015 large and small cases; however, by March 2000, nearly Baht 1 286 billion (US$34 billion) of debt had been restructured, covering 210 394 cases and a further Baht 931 million was being negotiated (Figure 7.1 and Table 7.2).

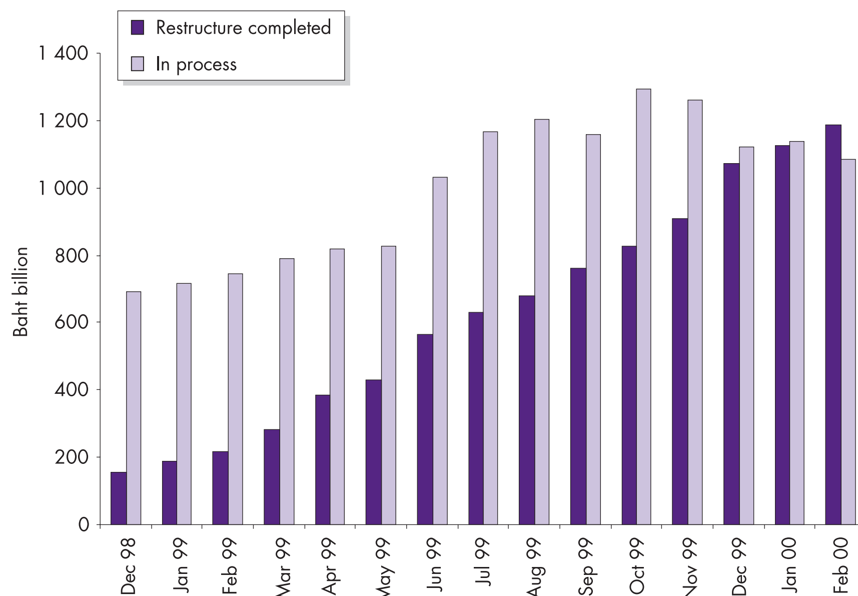
CDRAC has supervised much of this restructuring. Over 60 per cent of completed debt restructuring and almost 50 per cent of debts currently being negotiated involve CDRAC initiated processes. By the end of March 2000, CDRAC had taken on 1 776 large debtor non-performing loan cases, covering Baht 2.16 trillion (US$57 billion) of outstanding debt. Of this number, 316 large debtors had successfully reached restructuring agreements (Baht 718 billion or 34 per cent of outstanding debt) and 450 cases (Baht 315 billion or 15 per cent) are in the restructuring process. The remaining 1 010 cases (Baht 1 125 billion or 51 per cent of outstanding debt) are expected new cases, cases filed but still to reach agreement and unsuccessful restructuring cases being readied for court (Figure 7.2).

Faster corporate debt restructuring has contributed to the falling non-performing loan rate since May 1999 (Figure 6.3).

Figure 7.1

Debt Restructuring Has Accelerated

Restructured Debt Completed and in Process, Baht (billion)



Source: CEIC, 2000.

Non-performing Loan Recidivism

However, analysts fear much of the debt restructuring so far achieved may not be sustainable, as many restructured firms may be unable to generate sufficient cash flow to service rescheduled debts (World Bank, 1999; and Norman, 2000). Many debts are rescheduled rather than restructured, and later may become non-performing again (Shivakumar, 1999). Already 15 per cent of rescheduled debt is non-performing again, and some analysts believe eventually this could exceed 30 per cent (Norman, 2000).

To investigate the effectiveness of corporate debt restructuring, the Bank of Thailand commissioned a study of ten completed restructuring cases from various business sectors with Baht 63 billion (US$1.7 billion) of outstanding debt.[9] The ten cases fell into three categories:

- four cases covering about 79 per cent of the sample's outstanding debt; these were unlikely to need restructuring again
- four cases covering about 12 per cent of the sample's outstanding debt; possibly these could need restructuring
- two cases covering about 9 per cent of the sample's outstanding debt; most likely these would need restructuring again.

[9] International Project Finance Limited undertook the study.

The World Bank also commissioned a report on the effectiveness of debt restructuring, finding that significant de-leveraging had occurred between 1997 and 1999. From a sample of around 400 companies (excluding the financial sector), the average debt to equity ratio declined from 3.29 in 1997 to 2.04 in mid 1999. In particular, the electronics, machinery exports and services sectors significantly de-leveraged their debt by increasing foreign investment, issuing equity and restructuring debts. Real estate, machine tools and transport industries remained mired in debt and achieved least de-leveraging (World Bank, 2000).

Table 7.2

Domestic Banks Progress Significantly in Debt Restructuring

Value and Number of Debt Restructuring Cases Completed and in Progress, Values in Baht (billion)

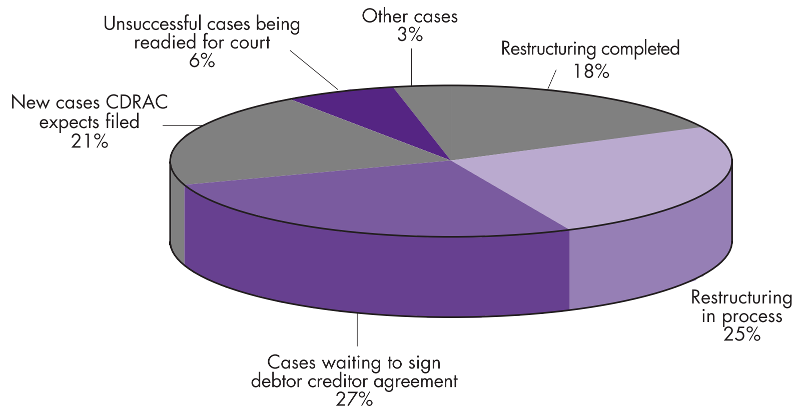
	Cases completed			Cases in progress			Total in progress and completed
	Thai domestic banks	Foreign banks	Total Financial institutions[a]	Thai domestic banks	Foreign banks	Total Financial institutions	Total financial institutions[a]
Dec 1998							
Value	137	11	157	491	102	691	848
Number	7 482	1 173	9 015	5 542	660	7 405	16 420
Jun 1999							
Value	500	39	566	836	109	1 031	1 597
Number	74 634	341	75 937	18 198	694	20 146	96 083
Dec 1999							
Value	945	66	1 072	995	77	1 121	2 193
Number	170 890	631	173 709	24 815	494	26 199	199 908
Mar 2000							
Value	1 141	73	1 286	824	69	931	2 217[b]
Number	210 394	728	213 791	30 298	396	31 472	245 263
Mar 2000 case values as per cent of total outstanding non-performing loans	51	3	58	37	3	42	100

Note: a Total financial institutions also include new finance companies and credit fonciers.
b Thai Government estimates of total outstanding non-performing loans are close to this figure.
Source: CEIC, 2000.

Figure 7.2

CDRAC Making Progress in Its Large Target Cases[a]

Case Numbers of Debt Restructured and Underway under CDRAC, March 2000



Note: a The number of large target cases is 1 776.

Source: Corporate Debt Restructuring Advisory Committee, 2000.

CORPORATE GOVERNANCE

Since the crisis, the Government has prioritised improving corporate governance (Sucharitakul, 2000). The Government is working to strengthen the institutional framework for accounting and auditing practices, improve the quality and reliability of corporate financial and non-financial information, strengthen boards of directors and intensify enforcement. This is a long term program but when implemented, will benefit significantly Thai and foreign investors.

Concentrated ownership significantly weakens Thai corporate governance. Most Thai companies began as family businesses, so shareholding and management structures are concentrated in family members or a single shareholder. Many companies do not yet have professional managers; this slows corporate governance improvement (Sucharitakul, 2000). While management by majority shareholders can increase flexibility and reactions to changing circumstances, it also can reduce incentives to provide reliable information to minority shareholders, including foreign investors. Furthermore, cross shareholding among major shareholders and their affiliates can reduce transparency and increase opportunities for illicit asset stripping.

The Securities and Exchange Commission, which is responsible for improving corporate governance, recognises markets enforce corporate governance best, so believes government's role should be to make markets work better. It also recognises institutional shareholders are important in enforcing market discipline on listed companies' management because they have greater power than small individual shareholders (Sucharitakul, 2000). Hence to protect social stability and the public interest, government regulatory bodies are seeking to strengthen corporate governance by boosting accounting, auditing, disclosure and risk control standards, enabling markets to better monitor and discipline firms' behaviour.

Recent Corporate Governance Reforms

While the Securities and Exchange Commission's main role is to oversee capital market development, it also spearheads the Government's efforts to improve corporate governance. As the crisis unfolded in 1998 and 1999, the Securities and Exchange Commission stepped up efforts to strengthen corporate governance. To increase the confidence of foreign investors in listed companies, it raised the requirements for listed companies to disclose complete and accurate information. Listed firms now must disclose to the Securities and Exchange Commission and Stock Exchange of Thailand consolidated financial statements revealing all external and off-balance sheet liabilities. In addition, by the end of 1998, financial statements of listed companies had to meet international accounting standards (Ministry of Finance, 1998). In early 1999, the Securities and Exchange Commission established a Committee on Good Corporate Governance which drafted a corporate good governance framework for listed and unlisted private companies, and state enterprises.

Since January 1999, the Securities and Exchange Commission has publicly disclosed information on companies failing to meet the new requirements including:

- companies violating the securities and exchange law, including those who delay submitting reports and participate in insider trading or manipulate prices
- companies whose listing or licences have been revoked
- auditors, securities company managers, financial advisers or fund managers who are on probation or whose licences have been suspended or revoked
- companies whose management or internal controls have failed.

To protect shareholders from fraud, managerial or controlling shareholder self-dealing and insider trading, the Stock Exchange of Thailand also inspects and gathers evidence on suspicious securities trading practices (Stock Exchange of Thailand, 1999a).[10] The Stock Exchange of Thailand has issued a Code of Best Practices for directors of listed companies and is collecting the records of directors' offences as part of its ongoing supervision.

[10] While the Securities and Exchange Commission approves major Stock Exchange of Thailand regulations, such as listing and delisting rules and commission fee structures, the Stock Exchange of Thailand undertakes daily supervision of stock market participants.

Now all listed companies must appoint audit committees to supervise operations, and companies applying to list on Thailand's stock exchange also must have audit committees.[11] Companies that established audit committees before the December 1999 deadline received special annual fee deductions while companies that failed to comply, face sanctions. By the end of June 1999, 140 out of 399 listed companies had audit committees and by the end of 1999, virtually all companies had complied (Stock Exchange of Thailand, 1999b; and Sucharitakul, 2000).

In May 1999, the Securities and Exchange Commission approved draft rules for the Stock Exchange of Thailand allowing it to blacklist people who have caused companies and shareholders serious damage, so they cannot manage listed companies in future. The Securities and Exchange Commission also is establishing an Institute of Directors, so directors and managers have professional education in their duties and ethical standards; this should spread knowledge of corporate governance (Sucharitakul, 2000).

In parallel to regulating corporate governance, the Securities and Exchange Commission is promoting the education of managers, directors, shareholders and related parties, to increase awareness of the importance of good corporate governance. It has launched an educational campaign for shareholders, so they understand their legal rights and the protection available to them. The Government also is drafting a law to allow class actions by 5 per cent of shareholders (Sucharitakul, 2000).

IMPACT OF REFORMS ON THE BUSINESS ENVIRONMENT

Post crisis corporate reforms will improve significantly aspects of the Thai business environment, including overhauling the legal and regulatory framework for business and tightening accounting, auditing and prudential standards, especially in banking. The crisis also made Thai firms more aware of the benefits of feasibility studies and risk control capacity, increasing opportunities for foreign suppliers of these and related business services. Accelerating debt work outs are increasing opportunities for foreign investors interested in mergers, acquisitions and joint ventures and also for debt work out experts; many Australians already are providing these services in Thailand.

However, in sectors not exposed to direct competition, Thai business culture retains many traditional characteristics, including the dominance of family firms. Consequently, corporate culture is unlikely to change rapidly. While recent reforms should increase transparency, only more diversified share ownership and professional management are likely to improve corporate governance dramatically (Sucharitakul, 2000).

[11] Directors with managerial responsibility or related to major shareholders cannot be members of the audit committee. The audit committee oversees a company's financial reporting process and financial information disclosure, reviews internal control procedures and ensures the company complies with all relevant laws.

Foreign Presence

Ongoing restructuring and market opening has increased significantly foreign presence in financial and to a lesser extent, corporate sectors. Increased competition eventually should force local companies to rely more on professional managers, modernise business practices, de-leverage and streamline operations and improve corporate culture and governance. Sectors most open to competition, like banking and retailing, will reap most benefits.

However, unlike the Republic of Korea, which since 1997 has used foreign direct investment to increase local industry efficiency, Thailand's post crisis foreign investment regime remains relatively restrictive. Alien business law amendments will do relatively little to relax restrictions on foreign direct investment in sectors outside finance, retailing and possibly manufacturing; large sections of the service sector remain protected. Related amendments to legislation on land ownership and work visas introduced only modest reforms. (See Chapter 4 - *Foreign Investment*.)

If current plans are executed, state enterprise privatisation could expand opportunities for domestic and foreign direct investment in key infrastructure sectors, significantly improving efficiency and corporate governance in energy, water, power and telecommunication sectors. (See Chapter 8 - *Privatisation*.)

Future Prospects

Corporate debt restructuring progressed very slowly in 1998 and 1999, but in 2000 is accelerating. The current pace of corporate restructuring should be sufficient to enable financial institutions to recommence lending in 2001 to sustain economic recovery. Nevertheless, creditors still confront considerable obstacles and solid results are emerging only slowly. Key issues remain the need for restructured corporates to de-leverage further and improve their core profitability through thorough operational restructuring, rather than just rescheduling debts.

While key regulatory agencies are implementing many reforms to strengthen corporate governance, in the long run, enhanced transparency requirements, and increased domestic and foreign competition will drive better corporate governance standards. In future, as a result of completed and ongoing corporate governance reforms, foreign investors, creditors and traders should expect an improved business environment.

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Chapter 8

STATE ENTERPRISE PRIVATISATION

Key Points

- The Government's slow but measured progress in privatising state enterprises eventually should produce significant efficiency gains and commercial opportunities.
- Privatisation is most advanced in the air transport, energy and telecoms sectors.
- To increase efficiency and boost consumers' and potential purchasers' confidence, the Government recognises infrastructure privatisation cannot proceed without well defined market and regulatory frameworks.
- Limited bureaucratic capacity and an overloaded drafting program means the process of preparing market frameworks is slow, and timetables have slipped by 12 to 18 months.
- Vested interests, particularly state enterprise employees and management, and other nationalistic elements strongly oppose privatisation, challenging the Government's political will to proceed with it.
- Commitment to privatisation could falter in the face of sustained opposition, improving economic conditions and forthcoming parliamentary elections.
- However, the Government has announced it remains committed to state enterprise privatisations, to offset the high cost of financial sector bail outs and increase infrastructure efficiency.
- Despite the privatisation timetable slipping in 1999, foreign investors should assess opportunities likely to arise in 2000 and beyond, prepare for sales and gear up to supply privatised enterprises.

Successful privatisation of Thailand's large state enterprise, SE, sector would generate enormous benefits for the economy and generate many opportunities for local and foreign private investors. The Government recognises privatisation would reduce the ongoing fiscal burden of subsidising SEs, reduce the deficit through sales revenue and provide new infrastructure without relying on limited public resources. Private infrastructure provision in a competitive market environment usually is more efficient and produces higher quality services for consumers than SE provision. Consequently, in 1998, the Thai Government announced an ambitious SE privatisation master plan.

While the financial crisis initially made SE privatisation efforts more urgent, and the Government achieved some progress in 1998, by 2000 privatisation had become a medium term reform priority. Bureaucratic bottlenecks are retarding progress in developing competitive market frameworks, and political opposition has delayed the passing of enabling legislation. The upcoming 2000 elections and SE union and management resistance also threaten the privatisation program. However, in April 2000, the Minister of Finance refuted press claims political priority for privatisation had waned (Bull, 2000).

This chapter outlines the Government's sectoral privatisation plans and reports on progress up to May 2000. It also assesses planned regulatory, market and legal frameworks, potential risks to successful privatisation and opportunities for Australian participation in the privatisation process.

THE ROLE OF STATE ENTERPRISES IN THE THAI ECONOMY

SEs play a significant role in the Thai economy.[1] In 1998, they employed almost 300 000 workers, or 2 per cent of non-agricultural workers, and provided around 2 per cent of Thai Government net revenue, after subsidies. Since 1961, governments have sold 40 SEs but four decades after reforms began, government still owns 59 SEs; several monopolise their sector.

Table 8.1

SEs Significant in the Economy

Key Indicators for State Enterprise Sectors in 1998

Sector[a]	Number of enterprises	Revenue Baht (billion)	Profit/loss[b] Baht (billion)	Remittances Baht (billion)	Subsidy Baht (billion)	Employees ('000)
Telecommunications	3	82	22	22	0	52
Water	3	14	1	0	3	13
Transport	14	154	7	4	19	86
Energy	5	591	46	11	0	78
Financial	5	190	-49	1	0	44
Industrial	8	44	6	2	0	9
Commercial and services	5	19	1	7	3	2
Agricultural	8	10	-1	0	1	8
Social and technology	8	8	1	0	4	7
Total	**59**	**1 112**	**34**	**47**	**30**	**299**

Note: a This list does not include SE subsidiaries, enterprises undergoing liquidation or financial institutions temporarily under Bank of Thailand supervision.
b Profit/loss means net profit before remittances to government, but after losses from foreign exchange dealings and other extraordinary items.

Source: Ministry of Finance, 2000a.

1 The *Budget Procedure Act B.E. 2 502, 1978* and the *Act Governing Private Sector Participation in or Operation of State Activities B.E. 2 535, 1992* define a SE as: an organisation or business unit owned entirely by the government; or a limited company or registered partnership of which at least 50 per cent of the share capital is owned by ministries, government departments or public bodies of equal status, or other state enterprises.

Thailand's largest SEs are in the telecommunications, water, energy transport and financial sectors, but smaller ones operate in industrial, social welfare, technological, commercial and agricultural sectors (Table 8.1).[2]

In 1998, non-financial SEs held Baht 1.7 trillion (US$45 billion) in assets and generated Baht 1.1 trillion (US$29 billion) in gross revenue. However, they received subsidies of Baht 30 billion, so they remitted only net Baht 17 billion (US$450 million) to the Government; this return was only 1 per cent of assets. While SE employment has fallen in recent years, the strategic sectoral location of SEs gives their workers significant industrial and political muscle.

THE CURRENT PRIVATISATION AGENDA

For 40 years, Thailand's five-year development plans have included SE privatisation, but vested interests have stymied numerous political and bureaucratic attempts to progress this agenda. The financial crisis precipitated the first serious attempt at wide ranging privatisation, presenting an opportunity to overcome entrenched interests. The IMF's initial Standby Agreement with Thailand included SE privatisation, with revenues from sales earmarked to repay government debt incurred in financial system bail outs, including part of the US$17.2 billion loan from the IMF.

Some progress is evident. The corporatisation act passed in late 1999 allows SEs to be corporatised ready for privatisation, and Cabinet has approved regulatory framework guidelines. However, each sector now needs to complete market studies before starting work on legislation for the regulators. The telecoms sector regulator will commence in November 2000 and the energy sector has begun drafting legislation for privatisation. Transport will complete its preliminary market study by June 2000 (Bull, 2000).

The Government recognises that rather than merely raising revenue, the privatisation program must raise the productivity of SE assets, reduce unsustainable subsidies, increase infrastructure service quality and reduce the cost of running SEs. Consequently, revenue raising no longer is the primary aim of privatisation. Important aims include promoting economic growth by attracting private capital, and improving management skills and technology in the infrastructure sector. The Government also wants privatisation to promote social objectives, including expanding social services, health and education, and ensuring more equitable regional distribution of infrastructure services (Ministry of Finance, 2000b). While these aims are laudable, attempts to meet all these goals may become an excuse for inaction, and over time, the Government's political will to achieve wide scale privatisation may diminish. As the crisis has passed, the legislative and regulatory work load also has delayed achieving initial ambitious privatisation targets. However, while the privatisation program is progressing very slowly, if investors are patient, substantial opportunities should emerge.

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[2] The Comptroller-General's Department, Ministry of Finance recorded 67 SEs but of these, three have ceased operating, four have been dissolved and one is under review (Ministry of Finance, 1998).

THE MASTER PLAN FOR SE SECTOR REFORM

In 1998, the Ministry of Finance assisted by the World Bank prepared an ambitious master plan for achieving privatisation goals.[3] The master plan provides a comprehensive framework for privatisation, outlining new regulatory structures, guidelines and timetables.

In addition to publishing the master plan, the Government announced it would prepare an annual reform report to review program performance and an annual action plan to outline objectives and targets for the forthcoming year. However, while the first annual reform report and action plan were due in October 1999, internal delays will prevent their release before mid 2000 (Bull, 2000).

The Planned Privatisation Process

The bureaucratic machinery to promote privatisation is now well established. The State Enterprise Policy Commission, chaired by Deputy Prime Minister Supachai, heads the privatisation process in telecoms, transport and water; the National Energy Policy Council steers the reform of energy sector enterprises.[4] Investors also can develop plans to invest in existing SEs or new projects, and submit them to SEs, responsible line ministries or the State Enterprise Policy Commission (Ministry of Finance, 1998).[5]

REGULATORY FRAMEWORK

The Government recognises a well defined regulatory framework is needed so the privatisation process is credible to consumers and potential purchasers. In April 1999, the Government established a sub-committee of the State Enterprise Policy Commission to prepare regulatory framework guidelines. The commission approved final draft guidelines in August 1999 and Cabinet approved them in October 1999 (Ministry of Finance, 1999).[6]

As part of this framework, independent regulatory bodies will be created in each sector to promote competition, protect consumers and advise the government. The Government is concerned monopolies or dominant suppliers do not exploit market power or charge excessive prices, but provide quality services and fulfil social obligations (Ministry of Finance, 2000c).

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[3] Cabinet approved the State Enterprise Sector Reform Master Plan in September 1998, updating the master plan the State Enterprise Policy Commission approved in January 1998 (Ministry of Finance, 1998).

[4] The State Enterprise Policy Commission reviews SE and ministry privatisation plans, ensuring consistency with overall program objectives, approving or requesting amendments to plans, forwarding plans to Cabinet for approval, and overseeing implementation. The Ministry of Finance's Office of State Enterprises and the National Economic and Social Development Board, acting jointly as Secretariat to the State Enterprise Policy Commission, conducts technical reviews of all plans on behalf of the Commission and oversees plan implementation.

[5] The Government will establish a privatisation program information clearing house to ensure all interested investors have equal access to information on proposed timing, form and conditions of divestiture on specific SEs (Ministry of Finance, 1998).

[6] The focus of the sub-committee was on key issues in regulatory reform, including the roles and responsibilities of regulators, jurisdictional overlap and institutional framework, oversight, monitoring and accountability of the new regulatory bodies, dispute resolution and human resources.

KEY ASPECTS OF THE REFORM PROCESS

The master plan identifies six elements for successful privatisation for consumers, investors and the Government:

- **legal reform** - legislation must be amended to enable private competition and authorise new regulatory structures
- **regulatory reform** - independent regulatory bodies must be created that are funded adequately and empowered to ensure fair and open competition
- **divestiture** - state operations/assets must be transferred transparently and openly through sale, lease or other means so the private sector can manage them more efficiently
- **new entry** - transparent and efficient new market frameworks should ensure greater private sector participation in previously closed sectors
- **international best practice** - enterprises remaining in state hands need to operate at best practice standards
- **performance monitoring/measurement** - the reform process as a whole, and state and private enterprise performance must be assessed to ensure efficient operation.

Source: Ministry of Finance, 1998 and 2000b.

LEGISLATIVE REFORM

Full privatisation of SEs requires major changes to the current legal framework and the passage of several new laws.

The Corporatisation Law

Privatisation reform depends on successful implementation of the corporatisation law. The law finally was passed in November 1999 and cleared the way for SEs to be corporatised prior to privatisation.[7] In late 1999, the law was challenged unsuccessfully in the Constitutional Court by the parliamentary opposition and in early 2000 received Royal Assent. During that time, many SEs prepared for corporatisation.

[7] As separate legislation applies to each SE, each one must be corporatised before it can be privatised; this law overcame the need for separate legislation to corporatise each enterprise. The law converts the SE to a public company under Thailand's Civil and Commercial Code. Initially, the Ministry of Finance will hold all the shares in the corporate entity. The enterprise then will be privatised through share sales. The Government can then sell all or part of a SE by selling strategic shares (for example, to an international telecommunications company as is planned for the Telephone Organisation of Thailand or to an international airline as is planned for Thai Airways International), share parcels to corporate or institutional investors, or shares to the public through an initial public offer and subsequent share issues.

Other Legislative Reforms

While delays in passing key legislation have postponed privatisation, some legislation started to emerge in early 2000. Amendments to the aviation act to allow the sale of a further share of Thai Airways International passed its first reading in Parliament in late 1999. In December 1999, Parliament passed the Senate's amendments to an act governing telecommunications, radio and television regulation and allocating frequencies for these media.[8] The principal telecommunications law was approved by the Thai Cabinet in mid March, and in mid May was being considered by the Office of the Council of State. The law still requires final Cabinet and parliamentary approval. Passage of the law is essential to establish a regulator.

To facilitate privatisation, the Government also is working on amendments to the Public Companies Act, the Stock Exchange Act and other legislation. These amendments, combined with establishing the Trade Competition Commission in 1999, are intended to strengthen corporate governance.[9] However, legislative amendments are taking considerable time to draft, pass through the parliament and implement.

PRIVATISATION REVENUES

Proceeds from privatisation should contribute substantially to reducing Thailand's rapidly escalating public debt. Likely privatisation revenue is difficult to estimate because of program delays and problems of realistically valuing assets since the crisis. However, the Thai Securities Exchange Commission estimates the value of SEs being primed for privatisation over the next few years is around US$6 billion (Business Monitor International, 1999).

Not all privatisation proceeds will offset the Government's huge financial restructuring expenses. Instead, the Government has pledged half will fund new education, public health, labour welfare and agricultural services. It also intends to use some privatisation revenue to create a central employee fund to compensate retrenched SE employees. Each privatisation also will involve the sale of a percentage of shares to SE workers.

PRIVATISATION PLANS AND PROGRESS

In 1999, to accelerate privatisation, the Government identified enterprises in the energy, telecoms and transport sectors suited to 'fast track' privatisation (Table 8.2).

However, even fast track candidates have several delays. After several delays, the sales process has begun for Thai Airways International, Ratchaburi power station, Esso and Airport Authority of Thailand. Sales of the Communications Authority of Thailand, CAT, and Telecommunications Organisation of Thailand, TOT, will begin in 2001. Nonetheless, the Government announced it remains committed to reform and privatisation based on consensus with all stakeholders.

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8 The *Allocation and Supervision of Telecommunications and Broadcasting Frequencies Act, 1999* took effect in March 2000.

9 The consultants who prepared the master plan proposed a wide range of legislative changes, including laws on competition, foreign ownership, taxation, intellectual property, employment and land ownership. Changes to all these laws were not feasible in the timeframe. Instead, as SEs corporatise, many of these issues will be identified and dealt with, not necessarily through changes in law (Bull, 2000).

Table 8.2

Transport, Energy and Telecoms Main Privatisation Priorities

Planned Divestitures of Fast Track Privatisation Candidates

State enterprise	Ministry of Finance shareholding (per cent) before	after
Transport Sector		
Thai Airways International	93	70
Thai Maritime Navigation Company	100	30
Airports Authority of Thailand	100	70
Four regional airports (Airports Authority of Thailand subsidiaries)	100	25
Energy Sector		
Bangchak Petroleum Public Company	80	40
Esso (Thailand)	12.5	0
Ratchaburi power station (EGAT subsidiary)	100	49
Telecoms Sector		
Communications Authority of Thailand	100	75
Telecommunications Organisation of Thailand	100	75

Source: Ministry of Finance, 1999a.

Telecommunications

Although Thailand's rapidly growing telecoms sector already has attracted significant private investment, progress with full privatisation in a competitive market is hindered by regulatory responsibilities of telecom SEs, existing private concessions and the commercial problems of private concessionaires. Both TOT, which provides domestic telephone services and CAT, which provides postal and international telephone services, have contracts with private sector service suppliers complicating privatisation. These SEs also have operational and regulatory responsibilities which must be separated before privatisation.

Thailand initiated telecoms privatisation under the 1997-2006 Telecommunications Master Plan (Ministry of Transport and Communications, 1997a), and subsequently incorporated this strategy into the 1998 master plan for overall SE privatisation. This plan acknowledges WTO agreements anticipating full telecommunications sector liberalisation by 2006.[10] The 1998 master plan outlines timetables to privatise CAT and TOT, establish an independent regulator, and set interconnection and licensing standards and regulations.[11] The plan also lists modifications telecommunications

10 To comply with its WTO commitments, Thailand must open up its telecommunications market by 2006. From this date, foreign companies will be allowed to own up to a 20 per cent share in basic service companies and a 40 per cent share in value-added services.

11 The 1998 master plan timetable for the privatisation of TOT and CAT includes: converting private telecoms concession arrangements (by December 1998); corporatising TOT and CAT; separating the postal business of CAT; making full market valuations of TOT and CAT (by December 1999); identifying strategic partners (July to December 1999); and finally, privatising TOT and CAT through placements with strategic investors (by December 2000).

legislation will require, anticipates a universal service fund to subsidise basic and public telephone services, and recommends a moratorium on further private sector concessions.

The indebtedness of several private telecom companies also hinders reform. Two major telecom operators entered debt restructuring deals in the second half of 1999, and most other private operators also face financial difficulties.[12] These problems are detrimental to concession conversion and privatisation plans.

CONCESSIONS INHIBIT PRIVATISATION

As in electricity, pre-existing private telephone concessions and problems converting existing build, transfer and operate concession contracts into a competitive private market impede telecoms privatisation. Previous private sector concessions or joint ventures with TOT or CAT gave concessionaires exclusive rights to certain services and markets. In 1997, around 48 concessionaires and joint ventures provided basic telephone, public telephone, long distance fixed-line, data communications, mobile telephone, paging, trunk mobile radio, satellite communication, satellite telephone, satellite operation and Internet services. Most significant were the basic telephone concessions to TelecomAsia Corp (2.6 million lines in Bangkok) and to Thai Telephone and Telecommunication Public Company (1.5 million lines in the provinces).[13]

Concessions complicate privatisation, as they must be revoked to enable full telecom privatisation. Concession holders will require compensation, and determining compensation is a major impediment, as prospective investors will require finalised conversion agreements so they can assess the value of their proposed investment. The State Enterprises Policy Commission pledged to deal with telecom concessions by mid 2000, but Thailand's reputation as a foreign investment destination requires a mutually acceptable resolution of this issue.

Source: Tara Siam Business Information, 1997; and World Bank, 2000.

12 Thailand's ten major telecommunications companies, all listed on the stock exchange, reported combined third quarter 1999 losses of Baht 17.4 billion (US$460 million) against earnings of Baht 5.5 billion (US$145 million) a year earlier.

13 The concessions provide revenue sharing with telecom SEs. During the economic downturn, these revenue sharing requirements became an unsustainable burden for many concessionaires (World Bank, 2000).

Progress to early 2000

Despite difficulties facing the telecommunication sector, strategic shares in TOT and CAT were readied for sale in 1999. In October 1999, the State Enterprise Policy Commission endorsed a final report by the Thai Development Research Institute on proposed telecom market structure and concession conversion. The report proposes a competitive market framework, principles for converting telecom concessions and a process for determining compensation of private concession holders or state telecom agencies.[14]

By early 2000, supportive legislation, including a law to establish an independent regulator, provided the legal basis for telecoms privatisation. The Government's first priority is to partly privatise TOT. The State Enterprise Policy Commission already has called tenders for management consultants to assist TOT in privatising, and has launched plans to establish a telecommunications regulator by October 2000 and start selling shares in 2001.

Water

Despite completion of several studies on the two major water service providers, the Metropolitan Waterworks Authority and the Provincial Waterworks Authority, water sector privatisation also is progressing slowly.

The 1998 master plan identified two options for privatising the Metropolitan Waterworks Authority to improve service quality and water supply. The first option was to split it into the East Bangkok Company, a corporatised and restructured authority, and West Bangkok Company, a long term private sector concessionaire. The second option was to fully corporatise the Metropolitan Waterworks Authority and sell shares to a strategic partner. Both options envisaged a government agency, such as the Ministry of Interior, would grant concessions, and a newly established regulator would administer licences, determine tariff structures and set service standards. The master plan also envisaged horizontally unbundling the Provincial Waterworks Authority, which serves the remainder of Thailand, into several regional water utilities, allowing the private sector to participate on a case-by-case basis. Detailed sectoral analysis would determine the exact nature of the unbundling.

By early 2000, the water privatisation timetable had slipped at least 12 months. To expedite the process, the Ministry of Interior gradually increased its role in water privatisation; it now shares responsibility with the Minister of Finance for reviewing alternative strategies.[15] The Ministry of Interior also chairs a new Water Steering

[14] A key principle is to terminate monopoly power (either by a sole operator or single dominant operator) and foster competition in the telecommunications industry by opening the market to new entrants. It seems likely that where concession conversion occurs, the private concessionaire will be awarded an operating licence covering the same scope of services as the build transfer operate, concession arrangement. However, private concessionaires will need to compensate the government should their revenue stream increase as a result of concession conversion. Where revenue streams decrease following conversion, the Government will compensate concessionaires.

[15] Under the initial master plan, the water sector's reform program timetable included defining the role and scope of the regulatory body, analysing the tariff and market structures, and reviewing privatisation options (by March 1999); addressing the legal and regulatory issues, establishing the regulator and starting the regulator's operations (by December 1999); and preparing a detailed privatisation plan, reviewing and approving the plan, and starting implementation (by December 1999).

Committee, charged with formulating policy initiatives, managing resources and addressing public health and environment issues (Bull, 2000). In October 1999, the steering committee approved the terms of reference for a major new water sector study to set out privatisation strategies, including options for private sector participation, tariff settings and regulation.[16] The committee expects the study to be completed by March 2001 (Bull, 2000). Recommendations for employing private sector water suppliers should follow.

Energy

Energy sector privatisation plans have progressed faster than many other sectors, and provide a model for them. Nevertheless, they also are behind schedule. The oil sector has open private sector entry but significant SE participation. The gas sector is close to liberalisation and the government owned Electricity Generating Authority of Thailand, EGAT, and Petroleum Authority of Thailand are on the fast track privatisation list.

Electricity

The corporatising and privatising of EGAT began in the early 1990s but made slow progress.[17] The 1997 crisis gave new impetus to these plans. The 1998 master plan envisaged a power generation and retail market fully open to competition and guaranteed third party access to a regulated distribution network. It anticipated corporatising and restructuring EGAT, selling individual power plants and subsidiaries, and establishing a competitive power pool market by 2003.[18] These private sector investments should reduce government expenditure and public debt, and promote competition and efficiency in generating electricity.

As with telecoms concessions, private sector participation in the Thai electricity market through the independent power producer and the small power producer programs will complicate the movement to a fully competitive power pooling arrangement. In recent years, EGAT has signed fixed tariff power purchase agreements with seven independent power producers and over 50 small power producers. The Government bears all the risk of private operators as EGAT must pay

16 Australian consultants, Tasman Institute, which assisted in privatising Manila's water supply, are shortlisted for this project.

17 Since 1992, EGAT has implemented around 52 small power producer and seven independent power producer projects, and established the Electricity Generating Company, initially as a subsidiary of EGAT, which held a 25 per cent share. In mid 1998, EGAT sold a 14.9 per cent share in the Electricity Generating Company.

18 EGAT dominates Thai electricity generation, transmission and bulk energy sale to distributors. Other privatisation candidates are the Metropolitan Electricity Authority and the Provincial Electricity Authority. The electricity sector reform program envisages a three stage process:

Stage I: corporatising EGAT as a single entity with autonomous business units operating as profit centres, selling the new Ratchaburi power plant and establishing regulatory controls under the corporatisation law (from 2000 until 2001). The Ratchaburi power plant is a large (approximately 3.5MW) power plant being built in southern Thailand. During Stage 1, all three electricity authorities will substantially retain their current positions.

Stage II: corporatising EGAT's profitable business centres and gradually introducing third party access to the transmission subsidiary's grid (from 2001 to 2003). As a holding company, EGAT will retain its position as central supplier of electricity, with a subsidiary transmission operator.

Stage III: allowing new generating companies to compete in a power pool offering individual contracts to major customers (2003 onwards).

for power generated at pre-arranged tariffs, irrespective of whether demand exists for this power or the market clearing price for electricity. Consequently, these independent power producers now hinder full privatisation, as their power supply contracts must be paid out before a competitive electricity market is established.

During the financial crisis, electricity demand plummeted, causing the National Energy Policy Office, responsible for electricity restructuring and privatisation, to reassess the previous strategy for privatising power generation, restructuring tariffs and regulating the sector.[19] Nevertheless, legislation establishing a regulator could be introduced during the May 2000 session of Parliament.

The Government also has faced stiff employee resistance to privatising EGAT. Real privatisation will not begin until the Government sells EGAT's operating Powergen1 and Powergen3 power stations, staffed by EGAT personnel. Even selling Ratchaburi, Thailand's third largest power station, but a new plant with no workers, has proved difficult. EGAT employees concerned about jobs and local interest groups anxious about the environmental impact and possible regional revenue loss strongly oppose the proposed Ratchaburi sale. The Government has responded to union demands; Ratchaburi will not be sold to a strategic Thai or foreign investor but to the general public, with a significant allocation of shares to EGAT staff (Business Monitor International, 1999).[20] Later in 2000, Ratchaburi Holding Company should be listed on the Stock Exchange of Thailand. Nevertheless, if proposed sales and market restructuring do eventually go ahead as planned, they will dramatically change Thailand's electricity sector, opening up many commercial opportunities for consultants, private power generators, distributors and retailers.

Oil

While the private sector already is active in the oil industry, the Petroleum Authority of Thailand remains a major player in refining, retail distribution and international oil procurement. It now faces privatisation.[21] Two options for the authority's corporate restructuring involve floating it on the stock exchange as an integrated oil and gas company or separating out the natural gas business for initial public offer. The Government adopted the first option, contingent on legally separating Petroleum Authority of Thailand's gas trading and distribution (Bull, 2000).

Sale of a 32 per cent share in 80 per cent government owned Bangchak Petroleum Public Company and a 12.5 per cent share in Esso (Thailand) are two fast track privatisation proposals. In March 1999, the State Enterprise Policy Commission resolved to sell 16 per cent of government shares in Bangchak through strategic sale and 16 per cent by domestic public offer. However, Bangchak management is resisting these sales.

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19 Building on the master plan, a consultancy team is advising the Government on competitive wholesale and retail electricity market structures and operation, restructuring and privatising the three electricity authorities, and establishing the independent regulator.

20 Forty per cent of shares will be offered to the public (at Baht 20 per share); EGAT staff and their provident fund will receive 15 per cent (at Baht 10 per share); and EGAT will retain the remaining 45 per cent (or more). The Government expects to receive up to Baht 60 billion (US$1.6 billion) from the sale (*Bangkok Post*, 1 December 1999).

21 While the Petroleum Authority of Thailand does not refine oil directly, it holds equity in four of the five refiners. In 1997, it held 49 per cent of Thai Oil Company, 80 per cent of Bangchak Petroleum Public Company, 36 per cent of Rayong Refinery Company and 36 per cent of Star Petroleum Refining Company. The government holds shares in Bangchak through the Ministry of Finance (48 per cent), Petroleum Authority of Thailand (24 per cent) and Krung Thai Bank (around 8 per cent).

Natural gas

The Government wants privatisation in the natural gas industry to follow competitive international gas supply models. It will unbundle the Petroleum Authority of Thailand's integrated monopoly into exploration, production, trading and retailing companies. Private sector participants will be able to trade gas (Ministry of Finance, 1998). Initially, the natural gas industry's new structure was to be determined by December 1998; a detailed study of the industry undertaken and a third party access regime established by mid 1999; and open market competition underway by January 2000. However, this program is at least 12 months behind schedule. In early 2000, ongoing work focused on defining the third party access regime; full privatisation is unlikely to occur before 2001.

Transport

The private sector already participates extensively in the transport industry through concession and licensing arrangements; however, privatising the 14 transport SEs and rationalising transport policy planning, regulation and operations could generate major benefits. The Government seeks effective private sector participation to improve transport efficiency and service quality, but privatisation is progressing slowly.

Transport sector reform builds on strategies and recommendations outlined in the Transportation Master Plan 1997-2006 (Ministry of Transport and Communications, 1997b). In mid 2000, a newly formed transport sub-committee under the State Enterprise Policy Commission was detailing action plans for each transport sector. Progress in air transport resulted in the rescheduling of Thai Airways International's additional 23 per cent share sale to the first half of 2000. In early 2000, the Government listed 7 per cent of Thai Airways, but the fast track proposal will raise this to 30 per cent. In 2000, the Government also expects to privatise the Airports Authority of Thailand.

As many SEs in this sector also are regulators, before privatisation, the Government plans to establish independent expressway, railway, mass transit, civil aviation, port and harbour regulators. The Ministry of Finance and Ministry of Transport and Communications hoped to have the regulatory framework ready for Cabinet by mid 2000 and pass legislation by mid 2002.

Other SEs

The master plan also gives privatisation details for another 34 SEs, five in banking, eight in industry, five in commerce, eight in agriculture and eight in social welfare and technology.[22] The Bank of Thailand's financial restructuring program includes the five government banks, but the state banks' high non-performing loan ratios are complicating privatisation plans. (See Chapter 6 - *Financial Restructuring*.) Excluding the banks, the largest SEs in this group are the Thailand Tobacco Monopoly and the Government Lottery Office, which together account for nearly 70 per cent of revenue and 30 per cent of the group's employment. Other smaller but still

[22] This list includes the Bank for Agriculture and Agricultural Cooperatives, Government Savings Bank, Government Housing Bank, Krung Thai Bank and the Export Import Bank of Thailand, but excludes other banks temporarily nationalised and under Bank of Thailand supervision. (See Chapter 6 - *Financial Restructuring*.)

significant SEs include the Glass Organisation, the Dairy Farming Promotion Organisation, the Forestry Industry Organisation and the Government Pharmaceutical Organisation. The Government plans to privatise, wholly or partially, these non-core SEs, choosing the simplest ones first.

RISKS AND CONSTRAINTS TO SUCCESSFUL PRIVATISATION

The privatisation program faces considerable threats from the political arena. As the economy improves, political will to undertake unpopular privatisation could wane. Legislative and practical constraints also impede privatisation.

Political Constraints

Although privatisation was a key plank of the Government's IMF economic reform arrangements, with the IMF standby agreement terminated, the privatisation program lacks political direction.[23] Privatisation has never had a strong political champion; political commitment will be particularly weak in 2000, an election year. However, the bureaucracy plays a significant role in all aspects of Thai government, including progressing privatisation and hopefully, this will provide continuity.

A greater concern is that the Government's commitment to privatisation could falter further as opposition is sustained, economic conditions improve and the 2000 elections become imminent. Over the past two years, SE employees, opposition politicians and other vested interests have campaigned strongly against privatisation, delaying its progress.[24] SE employees enjoy more secure employment and remuneration standards than private sector employees; consequently, they are the strongest opponents. These workers believe privatisation will erode their existing benefits, and predict major job losses. SE staff in electricity and air transport already have demonstrated considerable capacity to delay privatisation plans.[25]

SE staff concerns are not mirrored in the wider community. The public generally is not very sympathetic to SE employees, who fared better than average workers during the financial crisis. Recent disclosures of widespread SE employee abuse of generous perks, particularly within EGAT, have hardened public attitudes. However, the Thai public is strongly nationalistic and opposes infrastructure sales to foreigners. Influential elements of the public suggest the Government is selling the 'family silver' at fire sale prices to foreigners; to some Thais, this is a form of foreign colonisation (Business Monitor International, 1999).

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23 However, bureaucrats involved in writing the fifth IMF Letter of Intent stress the IMF did not force privatisation on Thailand. While the IMF added structure to privatisation plans, this was replaced later by the master plan.

24 Examples of such opposition include daily protests at a number of SEs, and opposition politicians presiding over well attended, anti-privatisation rallies in the countryside. Opposition parties in regional areas claim privatisation will benefit Bangkok at the expense of rural and regional areas.

25 For example, power sector workers vigorously oppose the Ratchaburi power plant sale, including by stopping power supplies, and industrial action by Thai Airways International maintenance and engine staff have forced it to scrap a plan to privatise its Baht 3 billion (US$80 million) second maintenance facility at U-Tapao International Airport (*The Nation*, 19 October 1999).

The Government admits it sometimes has not espoused effectively how privatisation will produce efficiency and equity benefits, or built a national consensus for the program. These failings have contributed to public opposition to privatisation. The Government now requires privatisation plans to include a full public awareness campaign, stressing that competitive markets will lead to better and lower cost services, eliminate wasteful government spending and remove poor management. With public consultation and seminars, the public increasingly understands the potential benefits to industry and consumers of far reaching privatisation reforms.

Legislative and Practical Constraints

Several pieces of key legislation were passed by mid 2000; however, many other legislative changes still are equally necessary. The volume of amendments to current laws and new legislative drafting considerably burdens legislators. Furthermore, so private investors gain confidence, Thai courts quickly must master complex concepts in new legislation, such as competition policy and economic efficiency. Precedent doctrine is not binding in Thailand, further complicating this process.

More practical constraints include limits on how much practitioners actually understand technical issues, and how many documents and processes are required to prepare enterprises for corporatisation and privatisation. Successful privatisation also requires a shift in Thailand's commercial culture. Market oriented competition is strong, but dependence on concessions and government favours still pervades business culture, particularly in monopoly state enterprises. Many business people have an interest in maintaining this commercial culture.

Despite real concerns about significant delays in the privatisation program, international experience indicates privatisation often is a protracted process.[26] Delays should be expected, given Thailand's difficult economic environment and its developing legal and regulatory framework.

OPPORTUNITIES FROM PRIVATISATION

Assuming progress is maintained, Thailand's SE privatisation program should provide good opportunities for private investors, consultants and service providers in previously monopolised sectors. Divestiture mostly involves selling around 25 per cent of SE shares. The Government's long term privatisation revenue target of US$15 billion indicates the significance of this program for the economy and foreign investors.

Despite the slipped timetables of 1999, foreign investors should assess opportunities likely to arise in 2000 and beyond, and prepare for potential participation. EGAT's corporatisation and privatisation should provide significant opportunities for foreign investors. If privatisation adheres to its current timetable, EGAT should be corporatised and the Ratchaburi power plant sold by the end of 2000.

[26] For example, in Australia, the New South Wales Government's power sector privatisation has been delayed for several years since initial attempts, and in the United Kingdom, the Thatcher Government took five years from taking office till it achieved its first major privatisations.

Privatising telecom services also should open new opportunities for foreign investors. TOT and CAT shares should go on sale in 2001. By late 2001, the Government is likely to own less than 50 per cent of these telecom agencies.[27] Ultimately it aims to own less than 33 per cent of CAT and TOT shares.

Opportunities also exist in transport, particularly with the planned sale in 2000 of a 23 per cent share in Thai Airways International and the Airport Authority of Thailand, including regional airports. Private investors can also propose privatisations and new greenfield private infrastructure projects in many of these sectors.

As privatisation occurs, privatised enterprises are likely to increase demand for goods, services and investment equipment; foreign suppliers should anticipate this need. Privatisation of power, rail and telecoms in Latin America caused new investment in these sectors to surge (East Asia Analytical Unit, 1998). Procurement processes should become more transparent, and as additional capital is injected into privatised SEs, they should expand their capacity and upgrade services.

Consultancies offer another area of opportunity; already consultants operate in all SE sectors undergoing corporatisation and privatisation. As SEs adjust to a competitive environment, Australian consultants could work on privatisation issues in large international accounting and legal firms, their own capacity or international teams. (See Chapter 2 - *Australia-Thai Business*).

Looking Forward

The Government's privatisation strategy emphasises structural reform and establishing effective market frameworks. The Government has progressed in setting regulatory guidelines in some sectors and detailing restructuring plans for telecommunications and energy sectors, although each has encountered obstacles along the way. Progress is likely to remain slow, particularly with a 2000 election. However, if the political environment remains supportive, privatisation should accelerate from 2001 onwards as the Government and bureaucracy overcome bottlenecks.

[27] Around 25 per cent could be sold in 2001 to a strategic partner, 22 per cent placed privately, and not less than 3 per cent distributed to existing staff.

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Chapter 9

THAILAND'S CHOICES AND AUSTRALIA'S OPPORTUNITIES

Key Points

- Post crisis reforms are producing new commercial opportunities for Australian business; if the Thai Government chooses to pursue vigorously its full economic reform agenda, Thailand will grow more strongly and become a considerably more attractive trade and investment destination.
- Modest two-way trade is due partially to difficult market access for many products Australia competitively supplies; while access is improving, it still is restricted.
- Foreign investment barriers also limit Australian investment in Thailand. Recently relaxed foreign investment barriers, corporate restructuring and improving corporate governance should expand investment opportunities.
- New business opportunities also are developing as a result of financial sector restructuring, trade liberalisation and privatisation of state enterprises.
- By building on existing markets, good opportunities also exist in food and agribusiness products, automotives and parts, business and financial services, IT and communications, medical and pharmaceutical products and services, tourism, training and education.
- Many Australian consultants, service providers and government institutions are participating in Australia's post crisis development assistance program for Thailand, prioritising stronger economic governance.
- Thailand is a key country in South East Asia; its vibrant democracy and close coalition of strategic, trade and economic interests with Australia ensures a close, and strengthening, bilateral relationship.

In 2000, Thailand is deciding whether to reshape decisively key economic and legal institutions, and ensure future growth is robust and sustainable. These choices will affect significantly commercial opportunities for Australian business in Thailand. This chapter highlights the key policy choices confronting the Thai Government in financial sector restructuring, trade, foreign investment, corporate restructuring and privatisation. It identifies major signposts to future policy directions in these areas, and draws implications for Australian commercial opportunities flowing from these policy choices.

Thailand's bilateral relationship is important to Australia. As a US ally, with the closest links to China of all ASEAN countries and current chair of ASEAN, Thailand is a key country in South East Asia. Both Thailand and Australia are active members of the Cairns Group of agricultural exporters, with similar interests in global agricultural trade liberalisation. Hence, Thailand's political, trade policy and other economic choices will have significant implications for Australia.

POLICY DIRECTIONS AND BUSINESS OPPORTUNITIES

Thailand already has made many reforms and started the long process of restructuring its economy; this is generating many business opportunities. However, in mid 2000, the Thai Government is still making many choices which will have crucial implications for Australian business. This section highlights key indicators business can use to identify future directions in Thai policy, and the commercial opportunities flowing from them.

FINANCIAL SECTOR DIRECTIONS AND OPPORTUNITIES

Sustainable economic growth in 2001 will require normally functioning Thai financial institutions; these must be able to expand credit for new investments. To do this, institutions must have completed their restructuring and refinancing, and advanced significantly the bulk of corporate debt work outs. Without adequate financial and corporate restructuring, the economic recovery witnessed in 2000 could falter.

By mid 2000, Thai banks were progressing well with refinancing and restructuring, and the Government had introduced important prudential, corporate governance and legal reforms to increase the viability of the financial sector. Significantly stronger prudential regulation includes ensuring financial institutions reach international provisioning and capital adequacy ratio standards by December 2000. Furthermore, the Government's reorganisation of the Bank of Thailand increases the central bank's capacity to implement prudential controls. Tighter listing requirements for companies and more market discipline for financial institutions should increase market confidence in Thai corporates and financial institutions. Foreign investors can own up to 100 per cent of Thai banks for the next decade and 100 per cent of securities firms and finance companies. Cabinet has approved raising the foreign equity limit on insurers from 25 to 49 per cent.

The Government has reformed macroeconomic policy management, particularly the exchange rate regime, so it can operate more effective monetary policy and ultimately reduce the riskiness of financial sector business. In mid 1997, the Government abandoned its informal peg to the US dollar, allowing the market to determine the baht exchange rate. The new floating exchange rate regime should reduce exposure to major shocks due to the exchange rate moving away from market fundamentals, and increase recognition by Thai businesses that they need to hedge exchange rate risks.

Commercial Opportunities

In the short term, these reforms should generate many opportunities for Australian financial institutions looking to enter the Thai market. Already, Colonial, AXA, HIH, NRMA and QBE are developing and expanding their insurances businesses in Thailand.

Opening the financial sector to foreign investors has increased competitive pressure on Thai financial institutions, and will raise significantly demand for new financial sector technologies and management advice. Financial service suppliers, consultants and IT suppliers are finding a ready market for their services. Demand is strong for business services, particularly related to financial and corporate restructuring, mergers and acquisitions, insolvency, due diligence, accounting, auditing, legal advice and distressed property management. Both foreign and domestic financial institutions and corporates are major consumers of these services; Australia is a very competitive supplier of these.

Many related reforms and developments also are generating demand for Australian financial service expertise. Recently accelerated corporate debt and operational restructuring will raise demand for debt work out and risk management skills, already a major area of demand for Australian professionals. The floating exchange rate and increased awareness of interest and exchange rate risks should spur development of derivatives and future markets. With a more cautious and capital strapped state banking sector, share and bond markets are becoming more popular sources of corporate finance. These developments also should generate opportunities for Australian capital market expertise and systems.

Future Reform Priorities

In mid 2000, repair and reform of the financial system still is not complete:

- two privatised banks have been sold to foreign institutions, but sales of two others are pending (on 16 May 2000, the HSBC announced its in principle agreement with the Government to buy one of these, Bangkok Metropolitan Bank)
- Bank of Thailand and other regulatory bodies still are developing their capacity to implement rigorously prudential regulations; this could take several years to achieve fully
- several important financial sector laws are awaiting Minister of Finance or parliamentary approval, including new laws enhancing Bank of Thailand independence, and regulating and reforming financial institutions and markets (Table 7.1)
- bank refinancing is progressing steadily but very slowly; banks' asset management companies are just starting to write off non-performing loans
- until parliamentary approval is gained, foreign investors can own only 25 per cent of insurance companies

- the foreign business and alien occupation laws still limit the supply of financial services from foreign accountants, auditors and analysts
- implementation of bankruptcy laws generally favours debtors, making bank lending a risky and necessarily high margin business.

Over 2000-01, markets will look for progress in most of these areas to indicate continued government commitment to financial sector restructuring and reform. If such reforms were achieved, many more Australian financial institutions and service providers would find it profitable to enter the Thai market.

TRADE REFORMS AND OPPORTUNITIES

Already, Thailand is reducing agricultural and other protection in line with its WTO obligations, and has undertaken further trade reform during the crisis. Responding to the crisis, the Government reduced the price impact of baht depreciation on importers and improved exporters' competitiveness by maintaining, and in some cases, accelerating trade liberalisation. Most temporary tariffs on luxury consumer goods imposed in 1998, later were removed. Successive rounds of tariff reforms reduced the simple average tariff rate from 44 to 17 per cent between 1991 and 1999. The Government has announced it plans further trade liberalisation in 2000, reducing six tariff bands to three and concurrently cutting average tariffs.

Trade Opportunities

Australian trade opportunities should continue to expand as Thailand fully recovers from the crisis and undertakes further trade, foreign investment and microeconomic reforms. In the decade before the crisis, Australian exports to Thailand grew 19 per cent per year, twice as fast as Australia's average export growth, and in 1999, exports grew 12 per cent. Food and basic agricultural commodities comprise around half of this trade, but elaborately transformed manufactures and higher value-added food items comprise a growing share.

Sectors of the Thai market presenting particular opportunities include:

- *agribusiness* – Australia is a competitive supplier of agribusiness products, services and technology. While significant trade barriers remain in some high value-added areas like dairy products, bulk commodities like cotton and wool face few restrictions. In 2000, Australian agribusiness exports should continue to grow strongly. Australian exporters are well placed to participate more in the processed food, agricultural equipment and services, animal feed, seed and livestock industries. As large scale food retailing now is open to unrestricted foreign entry, and some major European retailers already have entered the market, new opportunities are emerging to supply hypermarkets, supermarkets and the food service sector generally, by-passing traditional, more closed distribution networks
- *automotives and related services* – despite high tariff barriers, opportunities exist throughout the entire automotive supply chain, from delivering full vehicle systems and components, to manufacturing in country, and supplying auto

related design, engineering tooling and training services. Thailand can produce one million vehicles per year and the sector is strongly export oriented. Opportunities exist to develop Australian-Thai joint venture manufacturing, and supply of Australian components to Japanese, European and US car plants in Thailand is expanding

- *information technology and communications* – while exports to this sector shrank by more than 40 per cent in 1998, they were recovering strongly by mid 2000. Deregulating and privatising telephone and communications organisations, lowering tariffs on IT imports and systems, and upgrading equipment are generating new commercial opportunities. Good prospects exist to supply financial IT equipment and software packages, telecom equipment, outsourced IT and telecom services, systems development and applications, and training in all these areas
- *health care, medical and pharmaceutical products and services* – demand for these expands as middle class incomes grow. An expanding health and beauty care industry focused on foreigners attracted to Thai private hospitals also is opening new opportunities for Australian exporters
- *tourism and education* – although severely affected by the crisis, tourism and education remain Australia's major service sector exports, and they show promising signs of recovery. Tourism rebounded strongly in 1999 as Thai confidence in income and employment security returned. The Australian Tourism Forecasting Council expects Thai arrivals to grow by 18 per cent per year over the next decade. Opportunities also are expanding for Australian supported academic and vocational training courses and campuses in Thailand. The Thai Government's high priority of strengthening Thai scientific, engineering and technical training institutions will increase these opportunities. As recovery strengthens, Australian based courses also should become more attractive; the Australian dollar's depreciation against the US dollar increases the competitiveness of Australian educational service suppliers, at a time when Thai parents are seeking value for money.

Future Reform Priorities

In mid 2000, progress on collapsing the six tariff bands to three and reducing average tariffs appeared stalled, in the face of protests from domestic stakeholders. Heavily protected agriculture and automotive sectors were resisting tariff cuts, and sectors hard hit by the crisis, like basic materials and heavy industry, were lobbying for increased protection. While authorities have reduced non-tariff barriers in recent years, tariff barriers still remain significant.

The first significant indicator of continued government commitment to trade reform will be to adhere to the previously announced plan to reduce the tariff bands to three and concurrently reduce tariffs. If this reform is implemented before the 2000 elections, it will demonstrate traders can expect more significant liberalisation in the short to medium term, and investors can anticipate related efficiency and competition gains.

FOREIGN INVESTMENT DIRECTIONS AND OPPORTUNITIES

During the crisis, the Thai Government quickly recognised the need to bolster foreign exchange reserves and encourage more foreign direct investment to compensate for contracting domestic investment. The Board of Investment announced new incentives to boost investment in export industries, including allowing 100 per cent ownership of Board of Investment promoted manufacturing activities in all regions. In 1998 and 1999, the Government also permitted 100 per cent foreign ownership of banking, securities and large scale retailing, and liberalised some land ownership restrictions on foreigners. Although outcomes did not always meet foreign investors' expectations, the Thai Government also sought to liberalise the legislative framework restricting foreign business activity, and strengthen bankruptcy and foreclosure laws.

Largely because sectoral entry barriers were lowered, including some temporary relaxations, foreign direct investment inflows increased strongly in 1998 and 1999. Thailand's relative political and social stability, rapidly growing middle class, slowly improving legal and regulatory environment, and enhanced position as a low cost Asian manufacturing base following baht depreciation reinforced investor decisions.

While the Thai business environment is considered tough, restructuring the banking and corporate sector should increase foreign competition, and impose market and legal discipline on Thai corporates. As banks become less important intermediaries, Thai corporates increasingly will seek to access share and bond markets. This will enhance shareholder and bondholder scrutiny and discipline, particularly from institutional investors. Combined with official efforts to improve accounting and disclosure standards and upgrade commercial law, these developments eventually should raise Thai corporate governance standards, improving the environment for Australian traders and investors.

Australian Investment Opportunities

Potential problems and risks, including possible high levels of hidden debt in Thai companies seeking foreign partners, legislative hurdles, opaque bidding processes and a general lack of transparency in the Thai market, have dissuaded many Australian companies from pursuing investment opportunities. However, many Australian companies have done well in Thailand by undertaking thorough market analyses and forming links with well connected and financially astute Thai partners.

Major areas of opportunity include financial services, transport and logistics, agribusiness, and manufacturing for the domestic and ASEAN regional market. Recent Australian investments have been in automotive component production, building products, rubber products and fabricated steel products.

Future Reform Priorities

Thailand's foreign direct investment regime now is less liberal than those of major competitors for investment, Indonesia, the Republic of Korea and China. Restrictions on 100 per cent foreign ownership are outdated and inappropriate in a globalising world economy. Limiting competitive pressures on local enterprises encourages low efficiency and high cost structures, eventually undermining export competitiveness. The Korean Government recognised this and now enthusiastically

courts foreign investment, encouraging it in virtually all sectors of its economy. However, while some groups in Thai society still are wedded to the nationalist rhetoric of the past, restrictive foreign investment policies eventually benefit no one, not even the sectoral interests which feel most threatened by foreign competition.[1] Foreign direct investment also is an important conduit for new technology, management and marketing skills.

The first important indicator of future foreign investment liberalisation trends will be confirming that foreign investors permanently can own 100 per cent of Board of Investment promoted manufacturing enterprises, irrespective of their location or export orientation. Another significant signal will be to lift to 49 per cent and eventually to remove the 25 per cent shareholding limit on foreign insurance companies. A third important indicator will be to deepen reform of the foreign business law, initially increasing access to business services, mining and agribusiness, and eventually limiting restrictions only to national security related sectors. Liberalising any, or all, of these areas would increase significantly opportunities for Australian investors.

CORPORATE RESTRUCTURING DIRECTIONS AND OPPORTUNITIES

Thailand has progressed slowly on debt work outs, but by mid 2000, this process appeared to be accelerating. Senate resistance delayed passage of stronger bankruptcy laws and establishment of the new bankruptcy court until mid 1999, and only then did the Corporate Debt Restructuring Advisory Committee start to make real progress. By shifting the previous voluntary approach to a timebound process, the committee appears to be encouraging more debtors and creditors to negotiate work outs.

While bankruptcy proceedings still are slow and perceived to be biased against creditors, the crucial March 2000 Central Bankruptcy Court decision in favour of creditors of Thai Petroleum Industry, TPI, Thailand's largest corporate debtor, indicates a breakthrough in this crucial area. The decision declaring TPI insolvent and the appointment of an independent external planner, should accelerate corporate debt work outs, and reassure foreign investors Thailand's reforms are on track.

To strengthen corporate governance, the Securities and Exchange Commission has tightened company listing requirements and is developing a black list of corrupt company directors. The Government now requires firms to reach international accounting standards and plans to increase minority shareholders' rights. However, changing the corporate culture of the dominant, family owned firms will take many years.

Commercial Opportunities

Accelerated corporate debt work outs provide many consulting opportunities for Australian experts. Also, during work outs, many Thai corporates will shed non-core assets to lower their debt leveraging to manageable levels. For example, more real estate in Bangkok is being offered at auction. Throughout 2000 and 2001, these

[1] Australia's experience with liberalising foreign direct investment indicates previously protected domestic firms mostly do raise their efficiency to meet international competition, lifting their domestic and international performance, thereby benefiting domestic consumers and shareholders, and enhancing export revenues.

divestitures should provide significant opportunities for Australian investors looking to enter the Thai market. Interested parties would be well advised to start due diligence analyses.

Future Reform Priorities

The major signal that corporate restructuring is on track will be the Corporate Debt Restructuring Advisory Committee's success in getting large debtors to complete debt work outs in 2000. If the committee's ongoing negotiations with the largest Thai debtors do not produce completed debt work outs by the companies involved, the Government will need to consider moving away from a voluntary approach. In cases where debtors refuse to negotiate, the Corporate Debt Restructuring Advisory Committee will need to promptly refer the matter to the Central Bankruptcy Court where the case should be dealt with as quickly as possible. To increase the credibility of the threat facing debtors, and force recalcitrant debtors and creditors to the negotiating table, courts will need to accelerate the timeframes of ongoing bankruptcy and foreclosure cases. This is likely to require additional legislation and new implementing regulations for the courts.

Progress in these areas will be important. By helping to build a modern credit culture, these achievements would increase certainty for foreign and domestic creditors and investors alike.

PRIVATISATION DIRECTIONS AND OPPORTUNITIES

The Government has endorsed an ambitious state enterprise privatisation master plan and started work on a supporting legal and market framework, but progress is behind schedule. The legal aspects are complex and strain the bureaucracy's limited drafting, policy making and negotiating capacity. Vested interests in parliament and state enterprises also are delaying progress. However, the important corporatisation law allowing state enterprises to be corporatised now is passed, and privatisation planning is progressing in air transport, airports, electricity, gas, oil and telecoms.

Commercial Opportunities

Privatisation preparations are generating a strong demand for consultancies related to developing appropriate regulatory and legal frameworks, infrastructure unbundling to maximise competition, corporatisation, competitive bidding and risk management. In addition, as privatisation expands, Australian firms should be able to bid to buy assets from former state enterprises and supply outsourced services.

If state enterprise privatisation picks up in 2000 and 2001, demand for architectural, engineering and financing services also will grow, providing good opportunities for Australian consultants. Many infrastructure projects were delayed or downsized during the financial crisis, but with economic recovery, infrastructure development is regaining priority. Some 95 new infrastructure projects, worth US$28 billion are in the pipeline.

The transport and environmental service sectors are particularly prospective:

- *transport* – corporatising and privatising transport services should enhance commercial opportunities in airport, rail and port development and management. Australian companies are well positioned to supply services and products
- *waste management* – while the financial crisis reduced public spending in this sector, ongoing public and private industrial opportunities exist to win construction contracts, supply services and provide training for water supply, sewerage treatment, and solid and toxic waste disposal.

Future Reform Priorities and Indicators

Key indicators that the privatisation program is back on track will be the sale of provincial airports, shares in Thai Airways International, some core EGAT generating assets, including the Ratchaburi power station, and the unbundling and sale of telecoms provider, Telecommunications Organisation of Thailand. Overly generous share pay outs for state enterprise workers would erode taxpayers' benefit from the sales and encourage the lobbying efforts of vested interests in future. However, successful sales that produce benefits for consumers and augment government revenue should stimulate increased public and political support for privatisation.

Accelerated progress on privatisation also will boost commercial opportunities for Australian consultants, potential buyers and competitive operators in newly opened sectors, and suppliers of goods and services to newly privatised enterprises.

AUSTRALIAN-THAI RELATIONS AND OPPORTUNITIES

Thailand is a significant nation in South East Asia, and its relationship with Australia is very important. Thailand's strategic location, increasingly vibrant democracy and potentially strong economy contribute to its importance. It plays a key role as a moderate democratic state in ASEAN, while its alliance with the United States and close friendship with China also add to its standing in the region. Since the Asian crisis, major changes in the region have positioned Thailand to exert more influence than it did previously. Continued commitment to economic and trade liberalisation will enhance Thailand's economic potential and regional strategic role.

Australian-Thai bilateral political and economic relations are close, and if anything, the crisis has strengthened them. Growing trade links based on mutual trade liberalisation and rising Thai incomes underpin the bilateral economic relationship. Thailand's maturing democracy and similar Thai and Australian strategic and trade liberalisation interests provide the basis for a strong political relationship. Australia's strong support for Thailand during the crisis via its contribution to the IMF standby program, the visit by the Prime Minister, Mr Howard in April 1998, and Australia's enhanced development assistance program reaffirm the close bilateral relationship.

The strong bilateral political relationship is apparent in the number and range of ministerial visits. Apart from the Prime Minister's visit, 12 Australian ministers visited Thailand in the year to April 2000, including several visits by both the Foreign Minister and the Trade Minister. In the same period, 15 Thai ministers including the Deputy Prime Minister and Foreign Minister visited Australia. Such exchanges boost the bilateral relationship and where practicable, governments should encourage business delegations to participate in ministerial visits. Such missions raise awareness of business opportunities in both countries, and help identify potential trade prospects, joint venture partners and investment opportunities.

Australia and Thailand stand to benefit significantly from deepening their already close relationship. A peaceful and prosperous Asian Pacific region enhances both Australian and Thai strategic and economic interests. Australia and Thailand also hold similar positions in multilateral economic forums like the World Trade Organisation and APEC.

Trade Negotiations and Market Access

Despite the close economic and political relationship at ministerial and official levels, several trade access issues impede stronger trade relations and greater mutual benefits.

Several key sectors of interest to Australian exporters, such as automotives and components, and high value-added food items, attract tariffs of up to 80 per cent. Despite the Thai Government's commitment to improved market access, Thailand's 17 per cent average tariff rate in 1999 was higher than all major Asian economies except China's. Thai agriculture remains heavily protected, despite the international competitiveness of many agricultural sectors. Vested interests continue to obstruct trade reform. These barriers restrict further growth of Thai-Australian trade.

Improving market access therefore remains a high priority for the Australian Government. Regular consultations are underway at ministerial and official levels on wide ranging issues, including tariff reductions, agricultural market access, quarantine, automotive sector cooperation and services industry access. These trade liberalisation and market access issues also are pursued through the WTO and APEC. Market access for agricultural products, particularly processed food and beverages, remains a high priority. Representations will continue to focus on access for these products, despite some recent successes in reducing tariffs on lupins, alfalfa, lanolin and cotton. Thai food processors and consumers also would benefit from lower prices for imported agricultural inputs and consumer goods, as these imports are inputs for many producers and put competitive pressure on Thai agriculture to remain internationally competitive.

In the manufacturing sector, lowering tariffs in the automotive sector would increase trade flows. Australian Government promotions for automotive component companies have made Thai manufacturers more aware of Australia's world class supply capacity and usefully could be applied to other sectors, including education and food exports.

The Australian Government attaches high priority to Thailand further liberalising its foreign investment laws, and encourages the Thai Government to open several service sectors, including business and legal services, to foreign participation. Equally, the Government supports implementing the bankruptcy law more fairly and efficiently, as failure to do so undermines Thai credit culture and discourages foreign investors and creditors. Despite some progress in 1999, the Australian Government recognises reforms to date have hardly benefited Australian investors, so it will continue to urge greater liberalisation.

WTO, APEC and Cairns Group

The Australian Government values its close cooperation with Thailand in the WTO and APEC. Like Australia, Thailand, a fellow Cairns Group member, participates actively in the WTO, including in mandated negotiations, and other work to promote the early launch of a new WTO round of multilateral trade negotiations. Thai and Australian objectives in the WTO Cairns Group of agricultural exporters generally coincide closely. At the November 1999 WTO meeting in Seattle, Thailand took a leading role, bringing together developed and developing country perspectives. Since the Seattle meeting did not finalise a negotiating agenda and launch a new round of negotiations, both governments can usefully continue to cooperate in the lead up to the APEC leaders' meeting in November 2000, urging a united APEC approach to further trade liberalisation and support for the multilateral trading system.

Australia's Aid Program

AusAID's country strategy for Thailand, agreed between both governments in July 1999, focuses on helping the Thai Government to strengthen economic and social governance, and ameliorate the impact of the crisis on the poor. Australia learnt many lessons from its late 1980s financial market crisis that are applicable in Asian crisis economies. Australia's strong regulatory, financial market and economic management performance throughout the crisis demonstrated regulatory reforms made in the 1980s were effective and enhanced its capacity to provide advice and expertise. The aid program allows numerous Australian government institutions to work with Thai government agencies to improve their governance performance:

- the Australian Prudential Regulatory Authority helps train Bank of Thailand officials in supervising financial institutions and developing prudential regulations
- the Reserve Bank of Australia assists the Bank of Thailand with its IT requirements
- the Australian Stock Exchange seconds officials to the Stock Exchange of Thailand to draw up good corporate governance guidelines
- the Australian Bureau of Statistics provides technical support and skill transfers to strengthen the quality and timeliness of Thai macroeconomic statistics
- the Commonwealth Government Public Service and Merit Protection Commission advises the Thai Government on public sector management and fiscal monitoring reforms
- the Australian Taxation Office helps build capacity in the newly established Large Taxpayer Office to assist in raising government revenue.

Australia's provision of technical advice and training assistance in economic and legal governance is a significant part of Australia's overall development assistance program. The new A$10 million capacity building facility provides ongoing opportunities to match Thai needs with Australian expertise in priority areas of economic governance reform and human resource development.

Given Thailand's ongoing need to improve governance and Australia's relevant capacity to assist, the development cooperation program will prioritise future assistance in this area. For example, further opportunities to support development of Thailand's public administration capacity, as well as economic, democratic and legal institutions could be examined. Such assistance may include support through the Australian Development Scholarship Scheme and short course training targeting specific knowledge requirements.

Future Prospects

While the Thai Government has used the crisis to push through reforms vital for Thailand's next stage of economic and political development, and achieved much since assuming office in late 1997, its work still is not finished. It faces many important policy choices in 2000 and beyond in key economic policy, governance and legal areas. Failure to complete these crucial reforms would undermine significantly Thailand's future economic prospects and aspirations for higher living standards and reduced poverty. However, a strong commitment to and success in resolving core structural weaknesses in financial and corporate restructuring, economic governance, policy implementation, the legal system and education, and accelerating trade and investment liberalisation should set Thailand on a sustainable economic growth path over the next decade and beyond. Achieving these key reforms also will enhance significantly already strong Australia-Thai political and economic relations and opportunities.

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