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Relationship Banking and Thailand's Crisis: The Difficult Transformation from Personal Relations to Market Relations*

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1 The Problem

The Asian crisis is generally regarded as a crisis of Asia's financial institutions. In hindsight, these institutions seem to have failed badly. According to many accounts, the failure has been so bad that this almost automatically raises the question as to how these countries survived economically in the past. To make the case even worse, the crisis-affected countries did not just survive but have been among the most prosperous economies in the world. This success seems to have some systematic roots as it has been of a longer-term character and not just a recent development. So how can countries with inefficient financial institutions grow fast?

There is an easy answer to this question put forward by several researchers, Krugman (1994) being possibly the most prominent among them. He compared the Asian economic growth with that of the former communist economies, whose growth was only driven by additional factor inputs. In this case, financial institutions did not have any relevance for the factor allocation process. A compelling implication of this view is that the process of rapid growth must come to an end as soon as the mobilization of new inputs slows down markedly. The academic sources for Krugman's popular claim have been the works of Lau (e.g. Kim and Lau 1994) and Young (1995). However, even these studies do not necessarily justify the very critical account by Krugman and others because the calculations show that the Asian growth was never accompanied by a waste of factor inputs (as in many other developing economies). Rather, the share of total factor productivity (TFP) growth (in comparison to factor inputs) – as an indicator of allocative efficiency – was lower than in industrialized countries. The prob-

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lem may be that absolute and relative levels give a different picture: Asia's TFP growth was relatively low as factor inputs increased enormously but in absolute levels TFP growth was still reasonable (see also Crafts 1998).

In this debate Thailand is a special case. First of all, TFP growth in Thailand is favorable in comparison to other Asian countries, and in particular to other South-East Asian countries (see Menkhoff 1999). Second, this allocative efficiency at a macroeconomic level is accompanied by a relatively large banking sector and by a relatively low-interventionist state. This leads directly to the conclusion that it would be very implausible to assume that Thailand's economic success story has been realized despite incompetent banks. It further leads to the interesting question how the boundless disaster of the financial institutions (see Menkhoff 1998) could occur, assuming their competence.

This paper advances the following hypothesis to bring these facts together: It is argued that Thailand's financial institutions worked efficiently in the past and basically kept their strengths until the crisis but that their working environment changed markedly. The major change has been an ambitious transformation of the old Thai-style capitalism in the financial sector, which may be called relationship banking based on personal relations, towards a more market-based form of relationship banking. The argument is not scepticism against markets in general, but that markets need a certain institutional framework to be functional. Without these institutions markets become inefficient. This seems to have happened in Thailand during the course of the 1990s and may have been a problem in other Asian countries too. It is an important implication of this line of reasoning that the Asian financial institutions as such may be much less responsible for the crisis in these countries than is often thought.

The abstract form of Thailand's financial system may be described as a system of relationship banking. Mechanisms of relationship banking are outlined in section 2, and section 3 analyzes how this works in developing economies. Then the focus turns to Thailand: in section 4 to relationship banking; section 5 gives an account of how financial liberalization changed the environment of traditional relationship banking and section 6 shows the negative impact under inadequate institutional circumstances. Finally, section 7 discusses some policy consequences.

2 The logic of relationship banking

The fulfillment of financing needs in the economy can basically be organized in two different forms: via financial markets, such as bond and stock markets, or via financial intermediaries, such as banks (see Allen and Gale 1995). In essence, these two forms of financial structure are seen to some degree as mutual substitutes. The question is then, why do both forms exist; is one better than the other, or can some circumstances be identified under which the one form is superior?

Findings hitherto agree that both forms have their respective strengths and weaknesses and neither is generally superior. For example, the United States and to some degree the United Kingdom are countries in which financial markets have greater weight, whereas continental Europe or Japan have more bank-based financial systems. Although the choice between both forms appears to be arbitrary, one should emphasize that this is not true for arbitrary mixtures of both systems. The reason is that both forms are rather complex systems of complementary institutions, consisting not only of the financial institutions but also of the legal framework and regulations (Schmidt and Tyrell 1997).

The above mentioned arbitrariness results from the fact that both forms of financial systems have to solve the same kind of problems in the economy and their specificity results from the fact that they follow different approaches. The basic problem is the antagonistic interest between those entities which invest and those which save. This controversy could be solved by a market clearing price if there did not exist information asymmetries between both parties involved. The major problem underlying financial relations is the incentive for borrowers to follow overly risky policies, because in the case of success they reap most of the advantage; but in the case of failure, the burden is substantially shared by the lender. Unfortunately, the behavior of the borrower – the agent – cannot be completely observed by the lender – the principal. From this originates the moral hazard problem (see e.g. Hartmann-Wendels et al. 1999).

It follows from this situation that lenders have to be cautious with their funds and cannot just leave them to the free disposition of the borrower. This requires some kind of monitoring, causing transaction costs. Thus it is rational that lenders, in particular smaller lenders, share the monitoring costs. This cost sharing is precisely one important justification for the existence of banks (Diamond 1984).[1] From the viewpoint of the economy the function of banks can be called that of "delegated monitoring". Banks perform the task of monitoring the borrowers on behalf of their depositors: they gain general expertise in monitoring over time and gain private knowledge regarding their customers.

[1] The relationship between depositors and banks is neglected here as the paper focuses on the credit business.

So far we have established the case for banks as a certain form of providing finance but what is then the role of relationship banking? The nature of this kind of banking is – as the term implies – a relationship between the parties involved, which provides something special, such as uniqueness, intimate knowledge, trust and duration. In theoretical literature often no difference at all is made between banking and relationship banking, as the information advantage of the bank is exclusive and not shared by any competitors (e.g. Diamond 1984). This means that banking is always regarded as a one-to-one relationship between lender and borrower and therefore necessarily covering some aspects of relationship banking. If one allows for the fact of multiple banking relations - which is the case in industrialized countries – there does not yet exist a satisfying theory justifying the coexistence of a relationship banking partnership with further banking relations. Empirical literature, however, seems to provide the proof that relationship banking really exists. Its major component may be interpreted as the provision of credit insurance in the sense that credit lines will not be cut as easily as with "normal" bank relations in the case of financial distress (Elsas and Krahnen 1998).

This economic consequence of relationship banking is important if one takes the risk aspect of investment decisions into account. The implicit insurance reduces the risk of investment and thus allows for either higher or riskier investment, both of which lead to the same macroeconomic effect. The economy is able to set up riskier and thus in the long term average more profitable enterprises, leading to an enhancement of growth.[2]

3 Relationship banking in developing economies

In the case of developing countries, there is a systematic effect on the market share of banks as opposed to that of financial markets. Banking is relatively more important than in industrialized countries. The reason for this is straightforward: by and large the informational requirements that would allow for the efficient operation of financial markets are missing. Assuming, for example, that the pricing of stocks follows a dividend discount model, where would you get a reliable estimate of profit figures from (to calculate the future dividends)? Does the central bank follow a rational policy which allows inferences on possible future interest rates to be drawn (to calculate the discount factor)? From this perspective, banking in general and relationship banking in particular is well suited to take account of the

[2] This evaluation refers to the absolute benefit from relationship banking and does not compare it to functioning alternatives, such as financial markets.

informational shortcomings of developing economies. As reliable information for outsiders is missing, only insiders are willing to provide finance to enterprises.

However, even the (imperfect) insider needs information about the business in question. What information seems suitable as a substitute for reliable accounting data, provided through accounting standards and independent auditing? Here, the relationship between lender and borrower assumes a more personal quality: the one wants to know something about the ability and integrity of the other who is applying for a loan. This focus on the person has two justifications which do not apply to the situation in industrialized countries: first, relationship banking is, typically, banking within a wider family or a group of otherwise related persons (such as friends, colleagues, religious groups or other social networks). Second, financing needs refer much more often to a state of business which would be called venture capital financing in industrialized countries.

- The first rationale of relationship banking in developing countries is the fact that the lender ideally gets a personal impression of the borrower. The value of such a personal view becomes evident if one realizes that even in the modern world of computerized balance sheet analysis, Western banks would hesitate to make larger loans just on the basis of an anonymous analysis. Obviously, the personal impression has something extra to offer in addition to data.
- It may be a side-aspect of personal acquaintance that the tendency to fraud is lowered. It seems plausible that people hesitate to willingly cheat those they have known for some time.
- The personal impression is of particular importance when it comes to the financing of newly-started enterprises. In these cases the founding person or group of persons is regarded as the central factor of success.

The information about credit applicants is most important but not sufficient. Two other relevant elements of typical credit contracts are loan collateral and rules of enforcement (see Figure 1 for an overview). As regards collateral, it may be self-evident that, in the case of an industrialized country, there will be collateral available which can be evaluated properly and transferred in case of insolvency to a lender. In developing countries this form of credit contracts is much less realistic. Formalized agreements on collateral can be as good as useless as there is no functioning mechanism to work through an agreed transfer of collateral, i.e. mostly property. Therefore, it becomes clear why personal guarantees have been so important in the past: They worked as a substitute for formalized collateral and were all the more useful, the closer the family ties were.

Figure 1: Relationship banking in industrialized and developing economies

problem	solution	realization: industr. economies	realization: developing econ.
• conflict of interest between lenders and borrowers • asymmetric information between both parties moral hazard incentive for borrowers	delegated monitoring performed by banks (Diamond 1984) credit contracts with requirements on: (1) information verification (2) collateral (3) enforcement	(1) accounting standards; independent auditing (2) land registration; bankruptcy and foreclosure laws (3) functioning legal system market relations	(1) personal relationship (2) personal guarantee (3) social networks personal relations

The fragile character of formalized agreements hints at the third point of credit contracts (after information and collateral), i.e. the enforcement of the contract. The problem is not only one of the transfer of collateral but more generally one of a weak legal system. No matter what has been agreed on in the contract, it can scarcely be enforced in many developing countries. That does not mean that there is no legal system at all but it is enough that the system does not work smoothly. If a legal battle takes an inappropriate amount of time and if the outcome can hardly be anticipated or may even be dependent on good relations and monetary bargaining power, then the system becomes inefficient in supporting markets. The consequence is – as in the other issues discussed above – that substitutes will be developed and practiced. As to enforcement, the lenders need a different way of securing their rights.

One possible solution is to lend only to those persons who stem from the same social network as the lender. Then there are additional incentives for the borrower to fulfill his/her obligations. This mechanism will be greatly enhanced if there are norms in society which support the payback of a loan as a sign of good reputation. Finally, incentives and norms will work best if the problem of moral hazard is put into a multi-period frame. A borrower who defaults once in an improper manner will then never get a loan in future (nor will his close relatives).

These arguments can be understood as a substantiation for the rationality of an old-fashioned system of close relationship banking. The question relevant to the realities of developing countries may not be whether a modern market environment could be more efficient than current practice but which kind of financing system may work in an efficient way at all.

4 Traditional relationship banking in Thailand

The case of the so-called Thai-style capitalism (Siamwalla and Sobchokchai 1998), practiced until the early 1990s, fits quite well into the picture outlined above. Thailand is a good example for a developing country where the process of capital allocation is largely organized through a mainly privately owned banking system. There are examples in history that such an organization can work quite well, Germany being regarded as one such case (Cable 1985, Tilly 1989). Thailand also received some credit for the quality of the allocation process, as mentioned in the introduction. The World Bank (1993) in its East Asian Miracle study, for example, even counted Thailand among the efficiency-driven economies as opposed to the input-driven economies. The banks would, however, only receive credentials for this favorable development if they really had an important position in the process of capital allocation.

Figure 2: The development of the credit volume coefficient in Thailand, Germany, Japan and USA 1950–1997

Source: IMF, International Financial Statistics: Deposit Money Banks, Claims on Private Sector (line 22d); Gross Domestic Product (line 99B.C.)

The importance of banking may be recognized from two ratios: The first puts the volume of outstanding loans in relation to the GDP of the same year, which is called the credit-volume-coefficient (CVC). The CVC reveals the financial deepening as far as financial intermediaries are concerned. It is well known, moreover, that the CVC increases with GDP per capita. Thus, to learn about the position of banking in a country, one should not just look at the CVC but at the CVC in comparison to other countries. For example, countries with higher per capita income such as Germany, Japan or the USA would be expected to have higher CVC values than an emerging economy. Figure 2 gives information for the period 1953-1997. It shows that bank credits have been growing extremely fast in Thailand and that their levels during the "old world" of the 1980s and 1990s were unusually high.

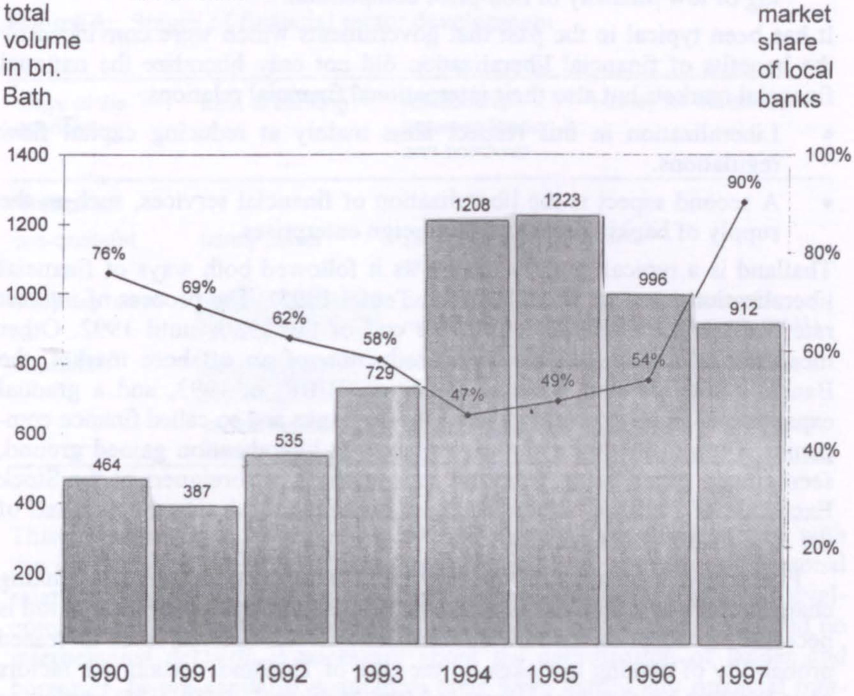
The second measure of the importance of banking in Thailand roughly estimates the share of banks in providing new external funds for private non-bank enterprises. Although the data given in Figure 3 are necessarily based on estimations, systematic measurement errors tend rather to underestimate the true market share of banks. The reason is that bank credits are calculated as the difference between year end stock volumes (net increase), whereas the capital market financing is calculated as the flow during the respective year (gross increase). The latter seems to be reasonable enough as this channel increased dramatically during the 1990s, so redemption may be neglected. It becomes evident that banking provided the major new external funds for private enterprises and thus dominated the allocation of capital available to alternative uses.

Some major elements of this bank-driven development model in Thailand are the following (see e.g. Phongpaichit and Baker 1998):

- Business groups centered around families and other social relations founded their bank or became related to a certain bank. The result of this process is similar to conglomerates as in other countries, e.g. Japan or Korea.
- The banks functioned as much more than just a provider of finance. They also worked as a kind of in-house consulting unit.
- Collateral was unimportant during the earlier stages when business was mainly trade finance. In the further stages of industrialization, when longer-term investments played a greater role, property and personal guarantees grew as collateral. According to information from interviews conducted in Bangkok, the guarantees were regarded as even more important as they established or enforced the personal relation between lender and borrower. Property had a rather complementary character to ensure that the guarantees were of some economic value.
- Social norms helped to support the system of relationship banking.

- From a macroeconomic point of view, the high importance of banks in the economy brings the disadvantage that the unavoidable fragility of banks is translated into a comparatively high fragility of the economy. Therefore it may be a logical complementary measure that the state played a major role in stabilizing the macroeconomic environment not least for the sake of the large banking sector (see Wade 1998).

Figure 3: New external funds for private non-bank enterprises in the years 1990–1997



Note: For the exact calculation see the note in Menkhoff (1999, Table 3).

5 The effect of financial liberalization on the banking business

Financial liberalization is introduced in order to make markets work better. One could say that liberalization aims at "freeing the forces of dynamic competition". However, if dynamism increases, there is a trade-off between higher efficiency and higher risk. Before this trade-off is described in more detail, however, typical elements of this process with regard to the national financial sector are enumerated as follows:

- The end of interest rates fixed by the state.
- The end of direct credit control and relaxation of the allocative direction of bank credit.
- The relaxation of any regulation concerning the separation of markets leading to lower barriers of entry into markets with oligopolistic pricing or low intensity of non-price competition.

It has been typical in the past that governments which were convinced by the benefits of financial liberalization did not only liberalize the national financial markets but also their international financial relations:

- Liberalization in this respect aims mainly at reducing capital flow regulations.
- A second aspect is the liberalization of financial services, such as the supply of banking services by foreign enterprises.

Thailand is a typical country insofar as it followed both ways of financial liberalization (see e.g. Menkhoff and Teufel 1995). The process of interest rate liberalization extended from the end of the 1980s until 1992. Other measures followed, such as the introduction of an offshore market, the Bangkok International Banking Facilities (BIBF) in 1993, and a gradual expansion of legally permitted activities for banks and so-called finance companies. During the 1990s the capital account liberalization gained ground, seen among other things from the trading share of foreigners at the Stock Exchange of Thailand, which increased continuously during the first half of the 1990s from about 10 % to 40 %.

Financial liberalization means inevitably that the environment of banking changes and this alone makes it plausible to assume that a learning period is necessary to adapt to this new environment. Learning leads to an increased probability of making mistakes. In the case of Thailand, certain risk factors have increased rather than decreased (see Menkhoff 1999). This applies to interest rate risk and – via the higher international integration of the economy - to the extent of exchange rate risk. Another aspect of this process has been that the massive inflow of foreign capital may have reduced the awareness of risk: Foreigners possibly underestimated the riskiness of banking because of a lack of information about their customers and local institutions felt assured by the huge investments of foreigners attributed with high expertise in financial matters.

Another very important channel from financial liberalization to credit risk is directly related to relationship banking. If markets are to work, they may even substitute non-market institutions. Traditional relationship banking is based on such an "old-fashioned" non-market institution, i.e. personal relations between lender and borrower. The strength of this relation is the use of private knowledge to reduce the inherent moral hazard component of credit risk. The problem of this relation from the viewpoint of allocative efficiency is the restriction of personal relations for the allocation of capital. The broader the scope of possible projects to be financed, the greater the chance that the most efficient users of capital funds will be selected.

Figure 4: Stages of financial sector development

stage of the economy	form of banking	relationship between lender and borrower	money for transactions
"Robinson"	-	-	-
pre-capitalist	hardly banks	strong personal relations	coins
early capitalism	relationship banking	personal relations	monetary base plus demand deposits (=M1)
capitalism	(relationship) banking	market relations	M1 plus time deposits (=M2)
"	capital market based	anonymous	M2 plus money market funds

This consideration may be put into a broader perspective. Concomitant with the increasing importance of markets is the reduced relevance of personal relations. With regard to financial markets, there are several stages of development (see Figure 4): in the Robinson economy of a single household no interpersonal decision is necessary about the coordination of lender and borrower. In pre-capitalist economies there were hardly any financial markets as most households did not save anything in financial terms and only few entities basically financed themselves through internal savings. Then there came the spread of financing within personal networks, such as large families etc., the stage of Thailand's old system. Later on, personal relations were replaced by market relations and, finally, possibly by anonymous financial markets (although the possible "competition" between bank-based versus market-based systems is not yet decided; see e.g. Neuberger 1999).

It is quite evident that the quality of capital allocation can increase during this process. However, risks also develop with the average increase in the distance between both parties involved. This may lead to moral hazard problems which have to be limited by some kind of contractual arrangement. To simplify the point, one could say that each stage of development is characterized by an appropriate kind of financial contract. Contracts are institutional arrangements requiring further institutional settings to become functional. A critical situation develops if – e.g. through institutional changes, such as a liberalization process - this overall setting is no longer coherent.

6 Relationship banking, liberalization and the crisis

Thailand's banking system during the 1990s can be characterized as a transition between two forms of relationship banking: from personal relations to market relations. This transition becomes necessary in the process of a further development of market institutions, although it is not necessary for social progress, as the pessimistic Polanyi (1978) stresses. To foster efficiency, ambitious governments introduced several measures to move towards a more market-oriented environment. In this process, the former fundamental importance of personal relations in banking weakened markedly, a good indicator being the declining market share of the commercial banks in providing external finance, from about 75 % to 50 % within four years (see Fig. 3). It is obvious that enterprises had found several alternative sources of finance, such as loans from finance companies or debt issues (see Menkhoff 1999). What is progress from the viewpoint of increased competition is a catastrophe for the traditional banking system.

To make market relations function smoothly certain institutional prerequisites must be fulfilled. If these prerequisites do not exist, the financial sector will run into problems, as mentioned in the last section. In the case of Thailand, it has become obvious – not least through the crisis in 1997/98 – that the environment for market-based relationship banking does not fully exist yet. This will be discussed briefly using the requirements for credit contracts laid out in Figure 1 (see also La Porta et al. 1998, Table 5 "Rule of Law").

Accounting standards in Thailand were weak and depended largely on the discretion of the management. To give an example from banking: whether a loan was classified as performing or non-performing could be "manipulated" in several ways. The easiest way to avoid a negative classification was to roll-over the loan and to enlarge the amount by the interest that should have been received in the past. In this case the loan was formally regarded as being performing and the payments not received could be handled as increasing credit business. Thus, there was no depreciation necessary and the profit was not depressed but rather lifted by interest payments which were de facto never received.

Independent auditing is something which did not fit into the world of traditional business relations. What seems to be obscure in a modern environment is easily rationalized in the old world of banking. By definition a delegated monitor, i.e. a bank, has private information about the quality of its loans. Furthermore, the collateral is not based on market evaluation but on trust in a personal relationship. Therefore it is not clear what information independent auditing should focus on. The accounting figures are largely arbitrary and are not very useful in forecasting whether a credit contract will be fulfilled.

Regarding the usefulness of formal contracts of collateral, it has often been less than clear to outsiders who the owner of a certain property is. The fact that even a formal agreement on a defined property to be used as collateral does not help the bank either, has carried great importance. In practice, the lender will not lay hands on the collateral for many years. To make things even worse, any attempt to force the borrower can backfire. These cases may lead to strategic defaults where interest is not paid although enough liquidity would be available. The delay of payment or the threat of non-payment is then an instrument to "discipline" the lender because the latter is in need of timely cash flows.

Finally, the content of a contract is by and large subordinate to the mutual benefit of the business relationship. In traditional understanding means this that the contract is more of an instrument to declare a common interest than a measure to define property rights of parties involved in the case of conflict. It is an implication of this understanding that any formal legal system does not make much sense in business. Rather, there are other forms of managing conflicts, such as established forms of consensus finding, the advice from people with authority or force by people of superior standing (coordination by hierarchy). It is a consequence of these practices that political connections can be used to promote the person's own business interests.

In sum, the reforms of financial liberalization were quite successful in breaking old business practices, such as relationship banking based on personal relations (see Fig. 3), but were dramatically less appropriate in creating new institutions.[3] From this perspective the rate of failures in the system increased. In particular, the quality of capital allocation decreased, leading among other things to overinvestment, and the assessment of risk became less appropriate, which led to higher fragility of the financial sector. Both developments taken together weaken the economy in the case of shocks. As heavy shocks came to bear in 1996 – the breakdown in exports and in asset prices – the economy faltered.

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[3] Many of the former shortcomings have been addressed after the crisis as indicated by the last column in Fig. 5.

7 Policy implications

The policy implications of the above account seem to be straightforward. As relationship banking based on market relations could be more efficient than that based on personal relations, it seems worth building up the necessary institutions to make the latter system work. This is the approach followed by the Thai government and by the international financial institutions, in particular by the World Bank (Bank of Thailand 1998). Several initiatives have been undertaken since the crisis, such as reforms of accounting practices, a reform of bank supervision and the promotion of new banking acts, bankruptcy and foreclosure laws (see Figure 5).

Figure 5: The state of necessary market institutions in banking

prerequisites for functioning market relations	de facto situation in Thailand 1996/97	reforms started since the crisis
accounting standards	no strict standards existing	much improved banking supervision
independent auditing	usefulness questionable; not enough auditors available	
land registration	some problems	
bankruptcy and foreclosure laws	not functioning	new initiative
functional legal system	does not fit to the character of "contracts"	initiatives to limit political influence
	prerequisites not fulfilled	great improvement

These reforms, addressing mainly the credit risk in banking, are accompanied by further measures whose purpose can be interpreted as the reduction of the importance of market risk for banks. They aim at improving institutional capacity in the central bank and in the other financial institutions. As far as the other institutions were concerned, the most inefficient ones, mainly finance companies, had to close down operations, others were merged and, finally, some additional foreign institutions were allowed to enter the market. As a result, there are now much fewer financial institutions operating, which is expected to lead to more professional risk management.

In sum, a major aspect of Thailand's economic crisis, possibly relevant in other Asian countries too, has been the growing discrepancy between market development and institutional development. Newly introduced markets required capabilities which were not available in the existing institutions. Unfortunately, this process of increasing imbalance had been promoted by impatient government policies supported by the international community. Although some imbalance between markets and institutions seems to be "natural" in development, it became overly stretched here. As has often been the case in the past, however, this crisis is also a chance to speed up the reform process and to bring the economy to a new stage of development (see Crafts 1998, Klump 1999). In this sense, Thailand still has the potential to be successful in the longer term.

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