Bandid Nijathaworn: Financial globalization and emerging market economies

Speech by Dr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at the Panel Discussion, Bank of Thailand's International Symposium 2008, Bangkok, 8 November 2008.

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First, let me thank the organizer for inviting me to take part in this panel. A lot has been said in the last two days about financial globalization and emerging markets. We spoke about the challenge for monetary policy, the challenge for financial regulation, and the implications for capital flows management, and on this panel, we discuss the importance of having the right international financial architecture to respond to the global challenge. But more important at this time, I think the current global financial turmoil also offers a unique and important perspective for us to look closely at financial globalization, in terms of the inherent risk, the lessons that can be learned, and how emerging markets should go about managing the process of financial globalization.

My remarks today will be on the practical challenge faced by emerging market economies like Thailand in managing the process of financial globalization. On this, I will focus on the financial sector and the implications that financial globalization has for the financial sector in emerging markets.

A good starting point to discuss the issue is to look first at the lessons that can be learned so far from the current turmoil. For all that can be said, the current turmoil is a powerful manifestation of the risk and the complexities that could come with financial globalization. For me, the turmoil points to three important observations.

<u>First</u> and foremost, it shows that financial turmoil can happen in any market regardless of whether it is large or small, or whether it is emerging or developed. Once the imbalance is allowed to occur, financial distress will likely happen and there is no exception to it.

<u>Second</u>, the turmoil highlights the central role that the financial sector plays in a boom-bust cycle. First is the role that it plays as a mechanism that can contribute to and trigger a crisis. This is because a bubble usually cannot happen without excessive credit growth. Therefore, without proper regulation, a combination of strong capital inflows, easy credit, and the procyclicality of the financial system can set the stage for a build-up of serious economic and financial imbalances.

The financial sector also plays an important second role in that its strength and resilience can significantly help cushion the real economy from the impact of external shock. The fact that a majority of emerging markets in Asia at this time have been in a better position to weather the first round impact of the turmoil, both the direct impact on banks and the impact on financial markets from de-leveraging and capital flow reversals, is a clear testimony to the importance of this second role. For emerging markets, both these roles are powerful, and they put the financial sector at the center of any efforts to ensure economic and financial stability in the long run.

The <u>third</u> observation is that the turmoil shows that the risk of systemic instability can be greater with financial globalization, and this raises an important question about the appropriate monetary policy framework for maintaining macroeconomic stability.

For central banks, price stability remains the first and foremost objective of monetary policy. But in the context of today's financial globalization when the source of systemic danger is clearly external, the idea that price stability in itself might not be enough to ensure macroeconomic stability is now gaining more acceptance. One approach to deal with this is to combine conventional monetary policy framework like inflation targeting with a macroprudential framework. The latter is aimed at addressing the risk to financial stability by implementing measures to counter excessive lending or the procyclical nature of the financial system. This is the approach that we have taken at the Bank of Thailand, and I will speak more on this later.

So, the current turmoil is a reminder of things that can go wrong with financial globalization, and the three observations I cited point to the key challenge faced by policy makers in emerging markets. In this context and in relation to the financial sector, the challenge for policy is three-fold.

The first is how to ensure that we have a strong and resilient financial sector with disciplined risk management so that it can help mitigate the risk of major imbalances in the economy. The second is how to reduce the procyclicality of the financial sector so that the risk of a credit-driven bubble can be avoided, especially at the time of strong and persistent capital inflows. And the third is how to develop a deep and liquid financial market that can help improve the ability of the economy to adjust to shocks.

In the context of financial regulation in emerging markets where the dominant part of the system is typically the banking sector, the challenge for policy is to calibrate a regulatory policy that fosters a strong and resilient banking sector with good and disciplined risk management, that makes use of the necessary macroprudential measures when needed to help reduce or counter the procyclicality in the financial system, and that provides momentum for reform to strengthen financial infrastructure and governance. Thailand, like most emerging markets, has also been struggling with this issue. And I want share with you some of the policies that we have pursued in response to the challenge. It is a long journey, and it is the journey that we are making.

On the issue of reducing risk from procyclicality of the financial sector, prevent excessive lending, and ensure adequate capital. In our view, the key issue here is to reduce a possible large swing in the availability and the price of credit stemming from the tendency of banks to underestimate risks in good times, and then to overestimate them in bad times. On this, our approach has been to ensure that banks' capital and risk-management policy is forward-looking by using a combination of three instruments.

The first is **stress testing** to ensure that bank's own internal process for assessing the adequacy of capital and overall risk management is alert to possible key risks. Thai banks have begun conducting stress tests as part of the supervisory process since early last year when we first underwent the FSAP assessment. From our experience, we find stress testing to be a useful and effective instrument for helping banks in formulating strategy for capital and risk management in a forward-looking manner. Also importantly, it provides a formal process for a two-way dialogue between banks and supervisors on risk management and on other financial stability issues.

The second instrument is the **fair value accounting rules or IAS 39**, which we have adopted for non-performing loans and for structured products. In our view, these rules can help strengthen market discipline over bank lending and investment. And because fair valuation involves marking to market, its adoption also helps make provisioning for asset impairment more forward-looking. The third instrument is **prudential policy** to limit excessive procyclicality. In the past five years, when capital inflows were strong, we have put in place prudential measures to stem the build-up of excessive credit growth on consumer spending and on speculative housing demand. These include measures on credit card approval and maximum loan-to-value ratio for luxury housing. As I noted earlier, in the context of monetary policy framework, combining inflation targeting with macroprudential measure offers a pragmatic approach to deal with concerns on financial stability and asset prices without compromising the discipline of monetary policy with respect to its primary inflation objective. So far, we have found this approach to be practical and useful.

On a final note, financial globalization is an important issue for emerging markets. It is the development that is likely to continue given the strong momentum of globalization in trade and in production that we are now seeing. But financial globalization is not without risk as the current turmoil shows. For emerging markets, this risk can be quite potent because of the smallness of the financial market and the limited abilities of economic agents to adjust to shocks. How well we manage this risk will depend critically on how well we manage the process of financial globalization.

In dealing with this, my view is that we should not resist it, but should manage it by adopting a pragmatic approach to financial globalization. Being pragmatic means having the right reservation about it, taking a careful step toward it, and be willing to take the needed action to deal with the unintended consequence. This is not going to be easy, but it is probably the best that we can do for now.

Thank you.