Thirachai Phuvanat naranubala: How to create a stable financial environment in emerging market economies

Remarks by Mr Thirachai Phuvanat naranubala, Deputy Governor of the Bank of Thailand, at the International Conference of Banking Supervisors, Cape Town, 19 September 2002.

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The title of " How to create a stable financial environment in emerging market economies " is almost a contradiction. The events in the past few decades will bear me out. It has been difficult for emerging market economies to maintain stable financial environment over a long period of time. Crises and disturbances have erupted every now and then, resulting in losses of output, employment and livelihood.

The problem is -- emerging market economies and stable financial environment do not always go hand in hand. Some of the reasons are obvious. Emerging market economies are the countries in the process of integrating themselves into the new environment of globalization. They are invariably at some points in their journeys in enhancing free trade, attracting foreign direct investments and capital inflows, adopting rule based supervision and control, and introducing market discipline.

The risks to stability occur because they have to learn and put into place the framework and the machinery to regulate, supervise and monitor their financial markets in the tight time span of years what developed countries had taken decades to do.

For the emerging markets, globalization is like sailing out of the inland waterway where the environment is safe and calm into the international ocean with its more choppy water. The risks multiply.

What can one do about this?

You can, of course, opt for the easy approach. You can continue to maintain tight controls and resist liberalization. But this will hinder the development of your domestic financial markets, and also the skill of the people involved, both the regulators and the commercial banks themselves.

In my opinion, the right approach is for the emerging market to create, or improve and maintain the right fundamentals. In a way, instead of trying to extend your breakwater further and further, it is better to change from the less stable rowing boat to a more sturdy and seaworthy ship, one that can handle the rough ocean better.

In this respect, there are three things that I wish to highlight.

The first is the need to ensure that the country conducts proper macroeconomic policy. I mention this even though it is not directly the job of supervisors because it can overwhelm everything. To take the example of Thailand, we used the fixed exchange regime for too long, but without the domestic flexibility to adjust wages and prices to correct lack of competitiveness. We therefore could not maintain the parity for long. It also led to distortion in risk perception that led to excessive foreign exchange risk mismatch, over investment in the non-traded sector and damaging speculation, especially in real estate.

When we had to change to the flexible exchange regime, the exchange rate depreciated to a low point of less than 50% of its pre-crisis value before backing up to above 60. The exchange losses that occurred was, among other things, one of the major factors causing the level of non-performing loans to go up to the peak of 45%. This was almost one out of every two dollars lent out. What stress test can really prepare us for such an event?

The second is to have the right infrastructure for the domestic financial markets. This topic includes many things like

(a) having the proper market rules,

(b) having the legal framework that facilitates the enforcement of creditors' rights,

(c) having the laws and procedures to deal with bankruptcy,

(d) having proper accounting and auditing standards as well as a reliable system of credit information on individual borrowers.

I can still recall that during the 1997 crisis, the inter bank market in Thailand ceased up for fear of counter party failure. But the problem also extended to the system of commercial trade credit between ordinary companies, the sellers and buyers of goods.

Today, five years after the event, the system of trade credit still has not regained its full recovery. This problem can be mitigated with the function of credit bureau that reports regularly on payment behavior of commercial firms.

Third is to ensure that there exists proper supervision of financial institutions. The country has to ensure that the agency entrusted with this task has sufficient power to act. I can still remember that in Thailand long ago, when government successions often did not come from elections but through military actions, it was very common for commercial banks to have army generals sitting on their boards. Banking supervision under such an environment was a challenge.

But the biggest challenge is what to do when banks suffer such losses that they are unable to continue. This happened when Thailand went into the crisis in 1997. We closed down two-thirds of our finance companies. As for the commercial banks, we had 15 local banks then. Six banks had to be taken over by the authority.

The private shareholders were forced to take full losses, and new capital provided by the authority. Management was totally revamped. We have merged four of these banks into the others, and have carved out non-performing loans to a national asset management company. Two government-owned banks are now ready to be privatized to the general public.

The banks that remained were forced to recapitalize. Three of them were unable to find domestic capital, and decided to invite foreign strategic partners. We allowed the foreign banks to own majority shares and control management.

Now for the bad news! Despite your effort in trying to strengthen your ship, it may not always be smooth sailing. I wish to point out two dangers that may crop up.

The first danger is that there are sharks lurking under water-- in the form of highly leveraged institutions and hedged funds. No matter how well you try to manage your economy, no matter how good your intentions, there will often be some things out of synchronization. This will cause your currency or your stock market to be temporarily out of balance, or even wrongly perceived to be so. This is exactly when you need some time to work out the problems. But the attack by sharks can rob you of this precious time.

I asked myself -- how can these sharks create so much trouble for the emerging markets? The problem is that these sharks are often able to command oversize resources financed by large international banks. I strongly believe that these financing should be curbed.

Leveraging beyond a certain threshold is particularly risky. I propose that the international banks that give credits to such institutions should be required to weigh these risks, in their capital requirement calculations, at a much higher rate than the 150 per cent currently being considered in the new Basle Accord.

The second danger is that during good weather you tend to get assistance from many international banks. They will give you tow lines hitched to their catamarans that help increase your speed. However, when your ship starts to leak, they tend to cut the lines just when you need them most.

On this issue, therefore, I strongly support the idea of private sector involvement that the IMF is proposing. There should be ways for countries to cope with bank runs on the international scale. There should be opportunity for countries to renegotiate their debts with the foreign creditors, without imposing an insurmountable handicap that will prevent them from returning to the market in future.

In the case of Thailand, had such mechanism existed during the Asian crisis, our non-performing loan ratio would have been less. Actually we paid back all foreign debts owed by the government and by the banks in full, with interests. We never needed any hair cut, we just needed time. But many foreign banks did not roll over the debts that fell due, despite the fact that the authority guaranteed all foreign debts of the banks.

The continuous repayment caused the currency to weaken more than it should. The exchange loss was therefore greater than should have been, and hence the non-performing loan ratio. At the same time, our weak currency also created pressure on the exchange rates of our neighbors, causing the interest rate to be kept high for longer than necessary, which in turn also fed into the non-performing loan ratio.

I am therefore attaching a lot of hope to the Sovereign Debt Restructuring Mechanism now being deliberated by the IMF members. I do hope that it will offer better solutions for this kind of problems in the future.

I will close by saying this. Globalization is a two way street. Relationship in the international financial market benefits both ways. Funds flow to emerging economies because they are able to generate better return for savers in the developed economies.

On the one hand, the emerging markets have to do their homework and preparation. But on the other hand, when things get temporarily out of balance, shouldn't there be tools and safeguards to help them deal with situations better?

The good news is there could, if all the countries here want to!