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Speech by M.R. Pridiyathorn Devakula, Governor of the Bank of Thailand, to the APFA 2001 Conference held in Bangkok, 24 July 2001.

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President of APFA, Distinguished Guests, Ladies and Gentlemen,

It is an honour to address the 8th Asia Pacific Financial Association Annual Conference, and to welcome the distinguished members of the Asia Pacific financial community. Judging by the attendance I trust that this three-day event will prove most fruitful and rewarding for all participants.

I would like to discuss today the current challenges facing monetary policy in Thailand and what we, at the Bank of Thailand, have set out to do to meet those challenges.

In so doing, I will briefly review the progress of the past few years, and look forward to some key emphases of our current policies.

The current situation

On July 2nd this year newspapers in Thailand ran headline stories to remind us of the four-year ordeal since the floating of the baht and the ensuing economic and financial crisis. These have been difficult years as the economy fought hard to regain macroeconomic and financial stability, and the confidence of financial markets.

Economic growth shrank by more than 10 percent in 1998. Underlying this was a sharp correction in the current account in response to the depreciation of the exchange rate. The correction was substantial. The investment-saving gap moved to surpluses averaging 10 percent of GDP in the first three years after the crisis, from the pre-crisis deficits average of 7 percent of GDP before 1997.

Such magnitude of change is indicative of the depth of the adjustment Thailand had to go through. Although the initial imbalance in the lead up to the crisis was not small, the adjustment was amplified partly by the wave of contagion effect in the early years of the crisis which brought pressure on the capital account, the exchange rate, and growth.

Now, while we can look back to the last two years of growth of around 4 percent, signs of fragility still abound, with important issues remaining to be resolved. This includes the continued reform of the banking sector and the resolution of the costs of financial sector restructuring. The main fragility in the recovery process at this time is the weakness in domestic demand. The problem is compounded by the slow growth in bank credit and the weak corporate balance sheets, particularly the non-export sector.

Unfortunately, the current external environment does not bode well for the recovery, going forward. The global slowdown is posing strains on Thailand’s export, and is adding pressure to the current account and external stability. Official GDP forecast this year is around 2.0-2.5 percent. Given the change in external environment, this year will be more a time for consolidation than for expansion. A key challenge confronting macroeconomic policy in Thailand is to safeguard the pace of recovery while maintaining macroeconomic stability and financial discipline, and at the same time continuing with the essential reforms.

Past records

Before moving on to discuss the challenges facing Thai monetary policy, I would like to review some of the notable progress of the last few years. There have been gains that should further be expanded.

Macroeconomic and financial stability has been restored. Inflation remains low and stable. Thailand’s international reserve position is healthy.

Surpluses in the external current account of these few years have been matched almost entirely by falls in external debt, especially short-term debt. Such reversed flows have been instrumental in avoiding a real currency appreciation and loss of competitiveness.

The surplus on the external current account is expected to continue this year, although at a somewhat lower level. This would allow the debt stock to fall further as scheduled repayments are made. About 50 percent of the existing non-bank private debt stock represents debt contracted after the crisis, including some rollovers which were done under new contract. This means that private sector in Thailand currently has no difficulties in gaining access to the international financial markets. Reflecting this, the spreads of Thai Government bond yields over US Treasuries have narrowed while Thailand's sovereignty credit ratings remain stable.

The financial system has now stabilized, but much work still lies ahead.

To restore stability to the financial system, the most immediate step taken was to ensure that financial institutions have adequate capital to withstand future risks. The sources of capital were to come from the private sector including the original shareholders and new partners, both Thai and foreign.

As it turns out, in some cases, the authorities did eventually provide a recapitalisation scheme. Nevertheless, this scheme was not much utilized by banks. In fact, only 74 billion baht of the scheme was actually used.

Another important step taken to stabilize the financial system was to raise the prudential and supervision standards such as the rules on loan classification, provisioning, asset valuation, just to name a few examples, to be in line with international standards.

As a result, commercial banks in Thailand have gradually recovered from the crisis. Here are some facts and numbers.

- The banking sector now has a capital adequacy ratio of 11.9%.
- The Thai banks recorded a better result in the first quarter of this year. They turned in a profit of 1.9 billion compared to a loss of 39 billion baht in the same period last year, as loan provision expenses declined significantly. This is partly due to the large provisioning and loss recognition, which were already taken last year. In addition, there has been substantial progress in debt restructuring the Thai banks recorded.
- Debt restructuring as well as some positive environment in the economy, especially buoyant export growth in 1998 until the first half of 1999, together with the transfer of NPL to AMC and write-off alter full provisioning, helped NPL to decline from the peak of 48% of credit in mid 1999 to around 18% presently.

The current challenges

Against this background of achievements, I would now like to turn to the current challenges.

The first is the challenge facing monetary policy.

Key concern of macroeconomic policy in Thailand at this time is the weak domestic economy. This concern has been met by an accommodative stance of fiscal and monetary policies. But the external environment in which the Thai economic policy operates has changed considerably since the end of last year. The global economy is now slowing with possible substantial impact on the growth performance of the regional economies and on financial markets.

Because of the strong dependency on exports, Asia will be one region most affected by the slowdown. Many countries have revised downward their export and growth estimates. Some have seen increased pressure on the external current account and the exchange rate. A key risk to the current environment is the global slowdown coinciding with a period of increased market volatility. This increase in market volatility could come about following possible further repricing of financial assets in the key markets abroad.

Because excessive market volatility is not supportive of businesses, monetary policy will have to be watchful of financial developments abroad and to take account of the impacts that the global slowdown might have on external stability.

Under the managed float, Thailand's monetary policy is operating under an inflation-targeting framework. As the economy slows, the current domestic inflation rates remain low. Going forward, our analysis shows that inflation will not pose a policy concern in the immediate future.

But with considerable uncertainty in the economic situations abroad, I believe monetary policy will need to take heed of both internal and external stability. This balance of emphasis will provide Thailand with some flexibility in dealing with the pressure that could stem from the external front. In essence, I see the need for monetary policy in the period ahead to be vigilant and give due safeguards to both internal and external stability.

One question often asked is, “Does the continued emphasis on stability mean that monetary policy is abandoning growth?”

The current policy preference for now is clear – stability ahead of growth. And to qualify this, I would like to make three points.

First, an important pre-condition for growth on a sustained basis is a stable macroeconomic environment. To this end, the best contribution that monetary policy can make to promote growth is to ensure continuity of macroeconomic and financial stability. I remarked earlier that macroeconomic and financial stability are the gains we have made in the last few years. They are the gains that we must continue to preserve.

Second, the increased emphasis of monetary policy towards external stability so far has not put undue pressure on key domestic interest rates. They remain broadly accommodating. This is because of the large liquidity overhang in the banking system. I believe interest rates at the current levels are appropriate and consistent with the need to support the recovery of domestic demand, provide incentives for corporate debt restructuring, and maintain the economy’s cost competitiveness.

And third, in addressing the issues of growth with stability, we must look for a proper coordination of fiscal and monetary policies. At this time, fiscal policies will have a dominant role in reviving the weaknesses in domestic demand. The Government has been cautious to balance fiscal stimulus measures within the context of longer-term fiscal sustainability. The role of monetary policy is to ensure the continuity of macroeconomic and financial stability.

Ladies and gentlemen,

One of the key concerns over Thailand’s long-term fiscal sustainability has been the issue of how the Government will find solutions to the remaining cost of financial restructuring. The cost, which includes the remaining uncovered losses up to now plus the contingent losses for the next three years, is currently estimated at 774 billion baht or about 17.2 billion US Dollar.

On this issue, yesterday, the Thai authorities announced a plan which would constitute a comprehensive solution to this problem. The solution centres on a programme of Government guaranteed bond issue that would provide for the full financing of the estimated cost. This programme of bond issuance will run for a maximum period of twenty years, and the financings will be provided for in the Government budget. This incorporation is projected to keep the share of the debt-service ratio to an average of 13.6% of the Government budget in the first decade and 11.5% in the second decade. This means that there will be little crowding-out effects on the Government’s investment expenditure in the period ahead, while the public debt stock-to-GDP is projected to trend down in the long term.

With this programme, Thailand’s long-term fiscal sustainability is now assured.

With monetary stability in place and fiscal stability enshrined in the Government’s long-term fiscal sustainability framework, I believe the operating environment in Thailand in the period ahead will be more assured and remain conducive to growth. But to really put the growth engine back on its feet, notably the recovery of the domestic demand, more works will have to be done at the micro level to remove the bottlenecks that inhibits the real economy.

This leads to our **second challenge**: to put the banking system back to normal lending.

Our banking system is returning to health and profitability with strengthened capital base, and a much lower level of non-performing loans. Yet, the growth in credit has been very minimal with deposit growth rising and liquidity remaining ample. Finding solutions to this problem is not going to be easy. But this is where efforts to revive the domestic economy will need to focus on.

New lending is perceived as risky given the current negative factors on the macro fronts and external factors, while NPL overhang preoccupied bankers’ attention and kept them from renewing their client relationship.

To address this problem, the authorities have chosen to approach the problem in three ways:

- First, to further accelerate corporate debt restructuring by improving the legal frameworks and by setting up a national asset management corporation to deal with the remaining unresolved problem loans. Progress on this front is most visible. The law establishing the Thai Asset Management Corporation, or TAMC, was passed and operations set to begin soon with all asset transfer to be completed by September. A key benefit of TAMC is the advantage of being a single creditor of the transferred asset. This would allow TAMC to deal effectively and speedily with the unresolved debts that involve multiple creditors. Also, the vast executive powers given to TAMC by law would make it easier for TAMC to take a comprehensive approach to debt restructuring, and have the ability to deal with cases that might warrant corporate restructuring and change of management.
- Second, to introduce a scheme of credit guarantees which would provide a facility of risk-sharing between corporate borrowers, the Government, and banks based on market mechanism.
- Third, to work with the management of the state banks and commercial banks to facilitate their resumption of lending without compromising the banks' own risk management and the Bank of Thailand's own supervisory standards.

On our part, the Bank of Thailand has improved the credit information system through fostering the establishment of credit bureaus, which provide the much-needed infrastructure for the resumption of new credit. Meanwhile, we will continue to adhere to the best practices in prudential standards, and look to further improving the standards.

Let me now turn to the **third challenge: Rebuilding our financial architecture.**

This is an area that the Bank of Thailand takes leadership role to strengthen the soundness and efficiency of the financial institutions. Our leadership must lead to outcome which makes practical sense, measures up to international best practices, and must be market-oriented and suitable to Thailand.

So far, we have laid down necessary groundwork to tackle short-term difficulties, such as the persisting non-performing loan problems, the lack of credit growth, or the restoration of financial sector soundness. Long-term prosperity however requires more. It requires a new financial architecture and corresponding market infrastructures to foster competition and efficiency while ensuring a non-recurrence of past problems.

Specifically, in the world where financial innovations, economic integration, and technological advancements bring nations and markets closer and define a new paradigm for competition for financial service industries, the rebuilding of our financial architecture becomes vital for our long-term successes, if not survival.

Given such a challenge, which direction are we heading?

- Going forward, we must improve our financial architecture to raise efficiency and ensure nationwide access to financial services.
- In term of *market competition*, the opening up of our banking system has accelerated the transfer of technical knowledge and ensured competition for our domestic financial institutions.
- In term of *market structure*, the new Financial Institutions Bill – currently at the Senate and is expected to be passed in the course of this year – will provide a legal and formal framework that accommodates the establishment of financial conglomerates. Financial institutions will be allowed to offer varieties of financial services such as insurance or securities through their subsidiaries. Though this is still a step away from universal banking model where all financial services will be offered under one entity but the draft law is flexible enough to make room for such eventuality, and in the meantime boost competition.
- Among the major milestone in the law are: consolidated supervision of financial conglomerates, unified legal framework for both banks and finance companies, and prompt corrective actions for weak financial institutions.
- As for ***the availability of our financial services and product qualities***, our recent survey of financial product availability within Thailand indicated that market participants are keen to expand product range, thus structural impediments obstructing them need to be dealt with.

The Bank of Thailand has announced new rules for the Internet banking – simply what can be done over the counter, will be allowed over the Internet. This should facilitate development of financial products in this area.

- And for ***the alternate forms of financial intermediaries***, capital market, bond market, and equity market will play a greater role in the future. They will help increase the efficiency of our banks' operations by providing new instruments to help manage, mitigate and repackage risks.
- The **second agenda of the financial sector reform is enhancing *our risk management capacity***, particularly of the Thai regulatory bodies and financial institutions. On this front, our Supervision Group have moved from regulation and transaction-testing toward risk-based supervision early this year.
- From our preliminary assessment, these changes have fostered corresponding and encouraging changes in the Thai financial institutions. Several have hired foreign consultants to transfer the know-how and adopted the best international practices on risk management, while many have imported several standard off-the-shelves risk management software to help improve their current practices. Of course, there remain several impediments to change; these include scarce and expensive human resource in this particular field, and it is even more difficult to re-engineer the business process to ensure that such resources are employed productively.
- The New Accord is a major challenge and milestone in this area. The Bank of Thailand has been working closely with the banking communities in Thailand, on how to implement it in practices.
- Though we applaud the Basel Committee in their efforts to create a framework that is more sensitive to risk and incentive compatible, I believe there are many areas which would benefit from closer consultation with the academia.
- First, to apply the Internal Rating-Based approach or the IRB approach of the New Accord requires a substantial build-up of capacity: Human resource, Database, Business model re-engineering, to name but few.
- As far as the data on the default probability on credit risk is concerned, most countries that just embarked on developing the required database will be at a disadvantage with a shorter and probably less representative series. Moreover, for those just recovering from crisis such as Thailand, the implied risk from such series collected during the crisis period will be higher than average over a complete business cycle. Thus, developing countries will find a high cost before emerging from crisis.

Ladies and gentlemen,

- This pro-cyclical aspect of the default statistics may be an important issue for the global economic recovery.
- Secondly, some technical aspects remain unclear. In many cases, capital is being calculated to support both expected and unexpected losses, and overly costly.
- Thirdly, the proposed capital charge for operational risk needs to be made more refined, incentive compatible to risk management, and more practical and less cumbersome in its application.

The third aspect of our financial reform is *market discipline*.

- We recognise that sound corporate governance, both in banks and their borrowers, will provide discipline from within, while public disclosure will allow market force to discipline the financial institutions from the outside.
- We will launch a new Directors' Handbook for the financial community, which will further encourage understanding and motivation behind good governance, and we will also endeavour to improve the transparency of appointment and compensation.

Ladies and gentlemen,

The last challenge I want to share with you is the strengthening of the Bank of Thailand to meet future challenges.

The crisis of 1997 brought to light weakness in Thailand's financial management. The Bank of Thailand like most central banks in the region, have had to go through sea of changes in the wake of the crisis, and undergo intensive reform of its operation and organization. Three areas of change in particular that stands out as our major achievements are internal reorganization, strengthening the framework for monetary policy under inflation targeting, and enhancing communication and transparency of operation.

At the onset of the crisis, the Bank of Thailand underwent major restructuring in the organization structure, data management and work process. These were aimed to ensure the good foundation in our decision-making process particularly with monetary policy implementation and financial institution supervision. A risk management unit has been established to manage operational risks more effectively, by reviewing and monitoring areas of risks in central bank operations with a view to taking forward looking risk mitigation actions.

Another important area that has been strengthened is in the process of monetary policy operation. The inflation targeting framework adopted by Thailand provides sufficient flexibility to take care of the challenges facing the economy. Through regular communication with the market and through open discussions on public policy issues, the central bank has fostered and enhanced the participation of academic and market interests.

The Bank of Thailand's monetary policy-making process was reformed to ensure a balance of transparency, independence and accountability. This is with the belief that transparency of operation limits discretion and leads to accountability. The Bank quickly moved towards greater openness in the provision of data and timely economic information. It is our belief that public acceptance and understanding of monetary policy is most important. And this will come about only with greater transparency and predictability.

Conclusion

Ladies and gentlemen,

In conclusion, I hope that I have given you some updates and direction of where we are heading in this current environment. The experiences of Thailand are not significantly different from other countries emerging from a crisis and I therefore welcome any comments and suggestions which you may have.

Before leaving you today, may I thank you once again for the honour to address this distinguished forum. I would also like to congratulate the organizers, specially the Sasin Graduate School and the Faculty of Commerce and Accounting of Chulalongkorn University for successfully organizing a high profile international conference. Our thanks also go to Professor Carl Chiarella, the current President of APFA for his untiring efforts in guiding the APFA activities and a warm welcome the newly elected APFA President, Dean Professor K.C. Chan.

I wish you a successful and enjoyable term.

Thank you for your attention.