M R Pridiyathorn Devakula: Thailand's emergence from the crisis - new paradigm for sustainable growth

Speech by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the International Conference on "Economic Recovery and Reforms", Bangkok, 28 October 2002.

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Distinguished Guests

Ladies and Gentlemen,

It is my great pleasure to be here with you tonight. I would like to begin by welcoming you all once again to Bangkok and to this important international conference on Economic Recovery and Reforms. I would also like to express our appreciation to the Faculty of Economics, Thammasat University, the main organizer of the conference, in allowing the Bank of Thailand to co-host the event. Our appreciation also goes to the distinguished scholars who came from all over the world to share with us their perspectives on this important topic.

To many of us here, especially those in the Asian region, the 1997 financial crisis has completely changed our lives. It was, in a way, a sharp reversal of fortune when suddenly things that were thought to be good before the crisis became no longer good enough. And terms like 'restructuring' and 'reforms' have then become something of a norm. This long and tiresome journey has now lasted for more than five years, and naturally begs a question, "when are we going to get out of this abyss?" This question is particularly pertinent to Thailand. After all, the Asian crisis started here.

To provide a starting point in answering this question, I would like to share with you tonight some of our views on the current state of the Thai economy, where we are, where are we heading, and most importantly, what we see as the key ingredients for sustaining Thailand's economic growth.

Ladies and Gentlemen,

At the height of the Thai crisis, Thailand's nominal per capita GDP in dollar term fell by more than 30% according to a World Bank estimate while financial restructuring costs have exceeded 30% of GDP, and capital flows reversals surpassed the 60% of GDP mark. Given such a depth and breadth of the crisis, the current momentum of recovery does suggest that Thailand has indeed come a long way. This view is increasingly shared by the market, including major credit rating agencies, with some analysts concluding that perhaps Thailand has more or less turned the corner. The extent to which Thailand has elevated from the crisis of 1997 is probably best illustrated by the latest macroeconomic performance and data.

Thailand's GDP growth in the first half of this year is a testament to the strength in the current recovery. The economy expanded by 5.1% in the second quarter after a robust 3.9% in the first quarter. In level terms, real GDP has now exceeded its pre-crisis level. And according to the latest incoming data, the economy in the third quarter looks to remain quite robust as well.

Thailand's better performance this year, notwithstanding a lackluster global economy, has been supported by the strong momentum in both domestic demand and exports. Front-loaded fiscal measure sparked up the initial momentum in domestic demand, while private consumption and investment are now adding firmly to the growth process. As the regional economies began to recover in the last five months, export growth has also provided an additional impetus to the recovery.

Along with this recovery, inflation remains subdued, credit growth has turned positive, and business profits are improving, encouraging firms to expand their capacities through new investment. These broad movements are indicative of a positive dynamic linked to the current recovery.

The most significant improvement since the crisis, however, has been the strengthening of external stability. Continued current account surpluses have allowed external debt to run down in concomitant with a build-up of international reserves. The coverage ratio of reserve to short-term debt has risen to 290% in July 2002, four times the ratio at the end of 1997.

Ladies and Gentlemen,

Although I share the view that the worst may now be behind us, I believe Thailand still has some way to go. The key question is how can we make it last, especially now that the global economic recovery may be somewhat slower than earlier anticipated? The answer to this question probably lies in the answers to yet another important question: what have we learnt from the recent crisis?

For Thailand to prosper in the future, we can no longer rely on the old way of doing business or, for policymakers, the old way of running the economy. We need a different and more effective paradigm that will not only sustain the current growth momentum but also helped the country meets future challenges.

Putting the crisis under microscope reveals critical flaws that beg for new approaches and strategies in all of the four major areas: (1) the real sector, (2) the financial sector, (3) the issue of governance, and (4) the macroeconomic framework.

In many respects, these lessons are neither limited to Thailand nor unique to the recent crisis. The challenge is perhaps how to put them into the context of rapidly evolving global and regional economies.

Let me start with the real sector.

For a brief period in the early 1990s, it seemed that everything was going well. Everywhere one turned, businesses were booming. Demand seemed to always outpace supply. And on top of all that, Thailand was just named Asia's fifth economic tiger. Little did everyone know, however, that the spectacular economic performance masked certain structural weaknesses in some part of the real sector. As it now becomes all too clear, parts of Thailand's real sector prior to the crisis were characterized by low productivity and high leverage.

With the benefits of hindsight, Thailand's past rapid growth could be attributed primarily to quantity, that is, the mobilization of capital, labor, and natural resources, rather than quality. During decades of spectacular growth, total factor productivity or TFP rose only modestly. Overtime, Thailand's inability to further move up the quality ladder, after it graduated from a low-labor-cost production- base status, gradually led to the erosion of our export competitiveness.

In relation to the attitude towards risk, Thailand's use of leverage, being among the highest in Asia, put the country in a vulnerable position to potential adverse shocks. When the crisis hit in 1997, many companies thus found themselves in desperate straits to service their debt, eventually leading up to a major collapse of the real economy.

While these weaknesses have been and are being addressed since the crisis, these measures take time to become fully effective. In the meantime, these shortcomings have been accentuated by the recent change in global competitive landscape brought about by China's WTO accession. Thailand, like many other countries, will need to reposition itself quickly to meet this new global challenge.

Stepping beyond the realm of the real sector, another expensive lesson learnt during the crisis is that the world financial markets have become extremely slippery. As today's financial world becomes increasingly interconnected, disturbances in one market can quickly spread to others with devastating results. These merciless and indiscriminating financial storms therefore need to be guarded against around the clock, with an early warning system developed to help protect all those involved.

Looking back over the past ten years, the Thai financial sector has changed considerably. The financial liberalization trend prodded along by the Bank of Thailand not only expanded the size and the scope of the sector, but also made it become more open.

The government's ultimate purpose of the liberalization was to provide domestic investors access to foreign funds so that Thailand could transform itself into a true industrialized economy. Unfortunately, the opening up of the financial sector left the country in an uncharted territory.

Confidence in the Thai economy back then meant easy offshore money for everybody with foreign market access. Encouraged by the fixed exchange rate, Thai financial institutions, like many other Thai corporates, borrowed freely and imprudently from abroad. And in pursuit of quick profit, many of these foreign borrowings were converted into baht loans without proper currency hedging.

Exacerbating the problem was the fact that many of the domestic loans went into real estate deals, rather than into productive investments. A property price bubble ensued, and the Thai financial institutions, lacking the necessary credit skills, accepted inflated property values as the basis for new loans. These pyramid-like financing schemes placed a serious strain on the system, and their eventual collapse resulted in a flood of non-performing loans for the unwary lenders.

Admittedly, the Bank of Thailand also shares the blame of what went wrong in the financial sector. Although the liberalization policy was probably correct given the circumstances, its potential benefits were undermined by the lack of strong institutional underpinnings. The existing regulatory framework was simply inadequate to detect and prevent the brewing problems. At one level, inadequate follow-up framework made it difficult to track where the funds were going. But the heart of the problem lay in the loose supervision and examination system in place. Regulatory waivers were common. And the culture evolved to one that encouraged or condoned excessive risk-taking behavior.

Compounding the problem were Thailand's underdeveloped capital markets. The absence of what Alan Greenspan termed a "spare tire" of finance made bank lending the dominant source of corporate financing. Consequently, viable businesses were trapped in the breaking down of the banking sector's intermediary role with no way out, and the crisis spiraled into a devastating credit crunch.

The most significant implication drawn from this lesson is thus a strong financial sector is essential for a country to sail through financial storms. It is perhaps not a coincidence that Singapore and Hong Kong fared better than many other Asian countries during the 1997 crisis, for their financial systems were, and still are, relatively deeper than the rest. A strong financial sector serves as an absorber for external shocks while a weak and inefficient financial sector aggravates the depth of the problem and prolongs the recovery process.

Beyond the "hardware" of the physical and financial infrastructure, the "software" of the ethical issues governing the running of the system is also critical. Tales of businesses being endowed with extraordinary treatments from bankers through their cross-holding relationship are probably still fresh in everyone's mind. Like in most other crisis-affected Asian countries, these relationships played a critical role in the evolution of the crisis in Thailand.

The problem of weak governance is not limited to the private sector, however. Regarding monetary policy, a post-crisis survey of stakeholders, consisting of domestic and foreign institutions, government agencies, as well as the general public, revealed that the BOT was also perceived to be plagued with several weaknesses: lack of good leaders, lack of experiences, and lack of transparency.

Finally, in the macroeconomic framework as a whole, it is probably obvious from the experiences leading up to the crisis that high growth cannot be reached and sustained in the absence of consistent government economic policies.

The most striking example here is the combination of the fixed exchange rate and the financial liberalization policy, which inherently led to underestimation of exchange rate risks. In the end, market stability that the fixed exchange rate regime was intended to foster was undermined by market-driven foreign borrowings.

The lesson for Thailand as well as for other emerging economies is that the authorities must regularly review their policy stances in the drive to keep up with changing financial environments. A move towards liberalization, for example, should be examined carefully in the light of the public sector's capability in stabilization and whether there is sufficient infrastructure in place to support the regime shift.

Finally, the crisis reminds us the importance of monetary and fiscal policy coordination. More conservative fiscal policy would have done what monetary policy could not accomplish; namely, to cool down the overheated economy.

Ladies and Gentlemen,

These lessons have been expensive ones. Thailand, as a nation, has spent the last five years dealing with the problem with some severe hardship and grave consequences. Although it is probably safe to say that the height of the problems is now behind us, we still face an enormous uphill battle. A new set of challenges seems to emerge everyday, some with very important repercussions on the Thai economy. Here, what spring to my mind are the delay in the global economic recovery and China's WTO entry already mentioned, as well as the current global equity slump. This is just to name a few.

To prepare Thailand for these future challenges, we need to get the fundamentals right on all of the four areas that I have just discussed. In brief, we need to raise productivity in the real sector, rebuild our financial infrastructure, instill the value of good governance in both the private and public sectors, and develop a comprehensive macroeconomic strategy.

Needless to say, comprehensive real sector reform is at the core of the new paradigm for sustainable growth. And this requires a carefully planned national agenda. In essence, Thailand needs to distinguish itself quickly in the fast-evolving global competitive landscape. As global competition intensifies, Thailand can neither simply keep growing on the back of capital accumulation nor dwell on massive production of low value-added goods. Desirable product features such as high quality and consistency are needed to sustain export competitiveness, and to maintain linkage to the global arena with clear focus on market awareness and adaptability.

Recently, there have been positive signs in some industries such as jewelry, garments, and food, where production technology has been upgraded to increase competitiveness of these industries and to move them up the value chain. Unfortunately, while such developments are encouraging, they have not been adequately spread out to other industries. By the time these adjustments are completed, it may have been too late, probably rendering losses in a number of industries.

What we need now is a national agenda that comprehensively looks at competitiveness of all parts of the real sector. Industries that can no longer compete in the world market will have to be gradually phased out. Other industries that depict competitive edge and growth potential in the global arena will warrant further plans to upgrade technology, increase added values, and develop marketing strategies. These plans will have to be implemented through a concerted national effort so as to ensure better resource allocation along with greater value creation.

Reforming the real sector would however need to be complemented by strengthening of the financial sector. A notable example of such a strategy is the establishment of the Thai Asset Management Corporation or TAMC. The TAMC was set up to reduce distressed assets in the banking system through centralization of NPLs management. TAMC's ultimate goal goes beyond the partial clean up banks' balance sheets. It is hoped that doing so would enable banks to resume their normal lending activity and get the entire economy going strongly again. Nevertheless, as great goals alone do not automatically translate into successful results, the eventual impact of TAMC on the current recovery will depend crucially on the performance of its management.

Still, the effort to nurture our banking system back to its normal health has already started to bear some fruit. Profitability of the banking system is improving and the recent credit upgrade of major banks confirms that we are proceeding on the right track.

This of course does not mean that all is well. There are still weak points in the system. But at least, we know where they are and we are working hard to tackle them.

With respect to financial institution stability, the authorities' strategy was to bring the infrastructures of the Thai financial system up to international standards. Among the measures taken are the introduction of strict provision requirements, the steps to the establishment of the Deposit Insurance Agency, and the tightening of the Bank of Thailand's supervision and examination framework.

To improve oversight, the Bank of Thailand has also adopted a policy in line with the new BIS Capital Accord, emphasizing the importance of systemic stability and efficient risk management.

In an effort to further modernize our financial system, the Bank of Thailand, in cooperation with stakeholders and representatives from the SEC and the Department of Insurance, is in the process of drafting the country's first Financial Sector Master Plan. Scheduled to be implemented in 2003-2012, the Master Plan is intended to increase competition within the Thai financial systems and at the same time to improve the soundness of the system as a whole.

The preliminary vision for the future of commercial banking and financial services in Thailand given by a high-level steering committee comprises three pillars – accessibility and availability of financial services for all potential users nationwide; a competitive and efficient financial system; and finally fairness for all customers.

This preliminary vision of the Master Plan reflects our changing perception of the country's new financial architecture. As there are already two Asian financial centers in Hong Kong and Singapore, there is no point to try to be the third one. Instead, what Thailand needs is probably a more customer-oriented financial sector with efficient operation and minimum systemic risk.

The extent to which Thailand's financial service landscape is going to change from today will depend on the results and recommendations of an ongoing study. What I can tell you now is that whatever the final outcome will be, for Thailand, this is a change to rectify past shortcomings for the better.

As we are drafting our Financial Sector Master Plan, the SET is working tirelessly on its Capital Market Master Plan. The SET plan tackles another important problem, namely the underdevelopment of

Thailand's capital markets. If its implementation is successful, Thailand will have a balanced and diversified financial system that is more robust and stable than the one today.

The third area that needs to be addressed is good governance. We need to move fast to ensure that firms follow proper accounting standard and information disclosure, to improve the protection of minority shareholders' right, and especially to assure independence of board of directors from management. For financial institutions in particular, the Bank of Thailand, with the assistance and cooperation from the World Bank and several domestic stakeholders, has assembled a manual entitled the Directors' Handbook, which provides guidelines of practice for directors of financial institutions. Regulations on the required structure of Board of Directors would follow within "November". Most important point was the regulation announced in July 2002 which imposes strict conditions on lending to related companies, which was one of the major cause of NPLs in the past. Moreover, the Government has also set up a National Committee on Good Governance, responsible for campaigning for good corporate governance on various inspects simultaneously, with the SET as the secretariat.

Instilling the value of good governance in the public sector is as important as in the private sector. On this issue, the current government has expressed an intention to tackle the problem that has long plagued the Thai public sector. Among steps already taken are the recent overhaul of the civil service workforce, fiscal decentralization, and privatization of state-owned enterprises. If executed in a proper manner, these efforts will go a long way towards good public sector governance. However, there are still some other areas in public governance that need attention from the government. These areas are of great interest to the public and are therefore currently under public scrutiny.

On transparency, progress has also been made in terms of public data disclosure. Having adopted already the IMF's Special Data Dissemination Standard (SDDS), Thailand is considering moving up one step further to publish the more stringent Reports on the Observance of Standards and Codes (ROSCs), which disclose in more details the country's economic and financial management.

In an attempt to restore the public confidence in the financial system, the Bank of Thailand itself has undergone major reforms in its organization structure, data management, and work processes. Inflation targeting has been adopted as a framework for the conduct of monetary policy. And despite the crisis turmoil, we have been able to maintain and better define our independence.

The final area of the new growth paradigm is the urgent need for a comprehensive macroeconomic strategy. Policies must be conducted under good discipline, with the right policy mix and stance. Here, the keyword is the coordination of monetary and fiscal policies.

The Bank of Thailand's role in promoting sustainable growth is to conduct responsible monetary policy to ensure price stability. But sound fiscal policies are also needed to complement the effectiveness of our policy. It is critical that public debt does not become a problem and threaten to drag the recovery process. Fiscal responsibility and discipline are thus keys, and I am extremely glad to see that the government has taken the first step towards fiscal sustainability by consolidating its budget this fiscal year.

Underlying all these frameworks, however, efforts must also be made to ensure that domestic saving mobilization is adequate to finance our economic development in a sustainable fashion. As the Thai economy regains full strength, our current account is likely to be in deficit again and we need to ascertain that the savings-investment gap is kept at an appropriate level.

Ladies and Gentlemen,

In closing, allow me to reconfirm that Thailand has certainly come a long way since the crisis. To make it last, we do need a bit of luck on the global economic development while ensuring that we get all the fundamentals right.

Some of these reform measures are tough and social support is needed to ensure that we continue to move in the right direction.

If we manage to get all of these real, financial, governance, and macroeconomic frameworks in place, I do believe that Thailand would be well on a sustainable road to development.

With these in mind, allow me to wish this conference every success in its endeavor. As a Thammasat Economics alumnus, it is an honor and a great pleasure to be 'home' addressing the distinguished guests and participants of this prominent conference.

Thank you.