Capital market Development in Emerging Markets

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Ladies and gentlemen

1. Capital market development, as a subject, can be very dry. The workload involved takes a long time. You have to make the foundation layer by layer. What appears adequate today can become inadequate tomorrow. The subject is so dry that - - if someone tells you that emerging countries should speed up on capital market development, you may not pay much attention. It will sound just like plain commonsense advice. But if I tell you that capital market development can help prevent **your** economic crisis, it starts to feel personal. People start to pay attention.

Impact of Economic Crisis

2. Thailand went into a major crisis in 1997. It started in Thailand, then it extended to Indonesia and then Korea. In the year after the crisis, our GDP did not grow at all. Instead, it contracted by over 10 %. We took us 6 years to climb back to the same GDP level before the crisis. We lost 6 years of growth. Our stock market capitalization before the crisis was US $ 150 billion. At the low ebb in the crisis, it was less than one fifth of that peak. Today we are only back to US 120 billion, still quite a bit less than before the crisis.

3. Thailand was the first into the crisis, so no one helped us to negotiate our foreign loans. In the past, we have never defaulted on a foreign loan taken by our government or our bank. But despite this high reputation, in the crisis, many foreign banks refused to roll over the loans. As a result, the capital outflow dragged down our currency. The currency lost almost 60 % of its value before stabilizing. Many Thai private companies borrowed denominated in foreign currencies. When the currency weakened, the banks panic and forced many of their customers to convert their loans into local currency, often right at the bottom of the curve. This, among other factors, caused non-performing loan to balloon to 47%. Business failure was common. Half built condominiums were everywhere. You could see people gathered in car parks to sell old clothes and belongings out of the trunk of their cars. After a while, they had to sell out of cardboard boxes instead, because the cars were repossessed due to non-payment.

Reasons for Economic Crisis

4. It is important therefore to ask why emerging markets are so prone to crisis? I think it comes about because they try to embrace the process of globalization. They join in the free flow of world trade. They open their markets to foreign capital. They allow the private sector to tap international funds to speed up on investment. They dream to leap frog the industrial development process. But joining the globalization process does involve risks. Despite your best intention, temporary imbalances do occur. Imbalances

inevitably lead to subsequent corrections. And corrections are often painful and disruptive.

5. In order to safeguard against these risks, emerging markets have to put into place systems that add resilience to the financial market. Systems that allow the private sector to better manage their risks. Systems that allow the authority to closely monitor events. Unfortunately, the systems take time to build. The problem is that emerging markets have to put into place these systems in a matter of a few years, what the developed markets have taken many decades. This is why emerging markets that look absolutely sound one day can suddenly become vulnerable tomorrow. In the case of Thailand, for fifteen years before the crisis, we grew by average 8 % per year. Eight per cent per year for fifteen years certainly made us look very sound. But as emerging countries continue pass each stage of development, they will find that the systems that were adequate before can no longer serve them well. The systems need to be upgraded. However, this also takes time. Because changes adversely affect profits for some, so additional time is often needed for debating and convincing. Unfortunately, it is often during these times that a crisis starts.

Benefits of Capital Market Development

6. Ladies and gentlemen, I have told you that crisis is bad, imbalances take time to correct, and in the meantime it can lead to a crisis. But what does it have to do with capital market development? Capital market development can help prevent crisis, well not all type of crisis, but some.

7. If the cause of your crisis is over spending by the government, especially on building welfare state or grand wasteful projects, whether financed by printing your own money or by foreign borrowing, then you have to cut down on the spending. No other measure will do. However, the type of crisis in Asia was not caused by over consumption. It was caused instead by over investment. The private sector was trying to do good. The long period of high GDP growth before the crisis led them into a sense of false confidence. Hence, many manufacturers expanded capacity all at the same time. Companies that previously did well in exports, suddenly had the urge to diversify. Everybody thought they could make a fortune in real estate development. For this type of mistake, capital markets can help prevent.

8. The reason for resource misallocation in many emerging markets is because they rely on the banking system too much. Banks operate on private relationship with clients. Unfortunately, bad and poor judgments do happen. Sometimes bankers are not entirely honest and take bribes. Sometimes clients are not entirely honest and fudge their financial reports. Often they declare their intention to borrow for one purpose, but instead use the loans for another purpose.

9. But on the contrary, capital markets thrive on transparency. Investors demand regular disclosure. Many pairs of eye observe the process. There are the underwriters, the dealer-brokers, the stock analysts, the rating agencies, the professional fund managers as well as the financial press. The more capital market becomes developed, therefore, the less risk of resource misallocation. Unfortunately, even if emerging markets embrace this fact to heart, capital market development is a difficult task.

Benefits of Adopting International Standards

10. So, what advice can I give? For emerging countries that want to speed up their capital market development, I have just one suggestion. Go for international standards. I can highlight 3 advantages.

11. **First**. It helps build confidence among the domestic investors. Markets that comply with international standards are more resilient. It benefits not only the savers, but also the businesses. The stronger market, the more conveniently they can tap funds.

12. **Second**. It helps to attract foreign money. You may recall that a few years ago, CalPERS, the pension fund for public employees of the State of California, announced that they cut off a few countries from their list to invest. Thailand was then also taken off the list. This year CalPERS decided to put Thailand back in. They did so only because we improved on good governance to international standards.

13. **Third**. It will help when you harmonize your rules and regulations with your neighbors' when you are able to allow regional savings to go across borders.

Need for External Assessment

14. I hasten to point out though that when you adopt international standards, you must have assessment done by outside experts, not just by your own staff.

15. Thailand gives very high importance to external assessment. Last year, we assessed our compliance with IOSCO Principles. We entered the Pilot Program. We had experts to help from the Securities and Futures Commission of Hong Kong and the Australian Securities and Investment Commission. They were very helpful and I must again thank them here. But the important point is that some of the results turned out to be substantially different from our own internal assessment done before that.

16. This year added another task. We asked the World Bank to perform a ROSC, Report on Observation of Standards and Codes on Thai corporate governance. We wanted to compare our practice with the OECD standards. The result was released last month and it was quite good. But again, on many principles, when we did our own internal assessment before that, we were also too generous to ourselves.

Get Involved in Standard Setting Process

17. Finally, ladies and gentlemen, I have argued that capital market development can help to prevent crisis. And I have suggested that to develop capital markets properly, you need to go for international standards. I can stop now. But if I do, you will miss out on an important point. The point is that as an emerging market, when you apply international standards to your local conditions, you may once in a while find that some of the provisions in the international standards could **not** be readily applied to your own situation.

18. This could be an issue on accounting, disclosure or even corporate governance. This is not unusual. International standards are set by committees that are often dominated by developed markets. This is perhaps to be expected because they represent interest of the

international investors. However, it is important that these committees in their standard setting receive all information relevant to that exercise. If there are specific situations in one emerging market that could occur in many other emerging countries, the committee should be informed. I am not talking about throwing out the principles. But there may be room to allow for additional alternatives in the standards, if it is justified. The key is to ensure that emerging markets participate in the process.

19. The way for emerging markets to participate is to follow closely the work being done by IOSCO Technical Committee Standing Groups as well as by EMC Working Groups. You should follow them closely. You should make comments and contributions to chairman of the Working Groups if you have good ideas.

20. Ladies and gentlemen, I think this point is important. At the end of the day, options that are open to us as regulators of emerging markets are sometimes quite limited. We have no choice. We have to link our capital markets to the world. And we have no choice. We have to adopt international standards. But in one aspect, we do have a choice. We can participate in the process of standard setting. We can contribute our good ideas through IOSCO Working Groups. Emerging markets have a choice. They can stand up and be counted.

Thank you.