Why Developing Capital Market is so urgent?

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1. I wish to start by thanking the Institute for allowing me the opportunity to share some thoughts with you today.

2. Actually, I registered to attend this conference to learn about derivatives. The reason is that Thailand has just started our futures exchanges two months ago, and I need to learn more how to best regulate this part of the capital market. But when Peter McCarthy saw my name in the booking, he suggested that I also made a short presentation about Thailand's experience on capital market development. You may recall that in 1997 Thailand pioneered the Asian crisis that had repercussion around the globe. I think Peter has the good intention that by people listening to Thailand's mistakes, other emerging countries may avoid entering into economic crisis in the future.

3. It so happened that Thailand and Turkey both now share something similar in that there is the problem of macro stability as well as the problem of political stability. However, as an emerging market, Turkey is somewhat more advanced than Thailand. I really don't think I have anything to prescribe for Turkey as such. But I guess there might be some generalization that may apply to all emerging markets as a group.

4. But if you think, should I succeed in spreading any message, that it may lead to the emerging markets no longer encounter a crisis, I am afraid you are going to be disappointed. Emerging countries will continue to suffer the occasional crisis. And I will tell you why.

Imbalances and Crisis

5. The reason is that emerging countries are invariably the ones entering the process of globalization, some are more advanced along the path than others. They want to rush to enter the world of trade liberalization and free competition. They want to rapidly improve education and absorb foreign technology. They want to speed up on development of the welfare of their people. To do so, they have to attract foreign capital. It can be in the form of foreign direct investment, or portfolio investment or foreign borrowings.

6. Unfortunately, they also have to link their domestic financial markets to the international market. They are therefore subject to the volatility and the precariousness of international capital flows. Emerging markets therefore have the ever-present danger of either too much capital inflow that may come in to speculate on one's currency, or to speculate on one's asset markets, or too much sudden capital flight. I can tell you that despite their best intentions, emerging market countries will often run into temporary imbalances.

7. These imbalances may be caused by their domestic events, which can be political, economic or even a natural disaster. They can also be caused from outside, a shock from one's close neighbor that may be a large trading partner, or sudden changes in the price of their main commodity export, for example. Imbalances that occur in emerging markets often need some time to straighten things out. They often need time for intra-agency debates, time for rallying political support to introduce the necessary changes, and time for private sector preparation.

8. However, time and time again we have seen some emerging markets robbed of this precious time by the hedged funds. They often attack your currency, or your stock market at the most awkward time, causing jittery. The jittery caused can lead to a loss of confidence in the international market very quickly indeed.

9. And here lies the difference between the developed countries and the emerging countries. The developed countries will have cultivated institutions, regulations, infrastructure, disclosure culture, compliance culture and other cultures that build resilience into their financial systems.

10. They would have done all these over many decades, the long evolution process mentioned earlier by one of the speakers, while the emerging countries either have not yet done this, or they have to learn to create all this from zero based within the short time span of only a few years. My message is therefore - - for emerging market countries in the middle of the globalization process, the risk of a temporary imbalance leading to a potential crisis is always present.

11. In the case of Thailand, when it happened, it was very disruptive. For 15 years before the crisis, Thailand grew by the average of 8 per cent per year. The year immediately after the crisis, our GDP contracted by over 10 per cent. Before the crisis, we had 16 local banks. Through the crisis we lost three from consolidation, and of the 13 that remain, two are now owned by foreign banks. The amount of bank capital increases to take care of non performing loans in the ensuing 5 years after the crisis was over US$ 18 billion, amounting to 15 per cent of yearly GDP. In fact, at the height of the crisis, our NPL ration was as high as 45%.

12. Previously we had over a hundred finance companies and mortgage lenders. More than half of them had to be closed down and liquidated. The stock market index dropped to only one fifth of its pre crisis peak level. Market capitalization contracted from over US$ 150 billion to its lowest point of only US$ 20 billion. All the figures that I quoted were large and scary. However, they seem insignificant compared to the disruption to our social fabric and human suffering. Official unemployment went up from 1.5 per cent to 4.4 per cent. Disguised unemployment in the rural area was even higher. People were selling used clothes out of the back of their cars. The feeling of despair and helplessness was pervasive, and took a good few years to heal.

13. So if the risk is always present, then it must be managed. What is the best way to manage this risk? In Thailand, we give high importance to capital market development.

Capital Market Development

14. Thailand, like most emerging markets, was previously a bank based economy. Before the crisis, banks command almost 80 per cent share in the process of mobilizing savings for lending into investments. This was high and risky. Too much of the bank loans were also concentrated in big corporate borrowers. Only 13 of their balance sheets were dedicated to consumer finance.

15. We have also learnt that managing capital inflows through the banking channel was not the best way to manage risk. International banks might have relied too much on the authorities to intervene in the event of a crisis. Therefore, they might have lent to our local banks too much -- far more than the strength of the balance sheets alone justified.

16. Furthermore, the bank channel, compared to the capital market channel, was also less efficient in disbursing the imported capital to productive uses, particularly when the speed of inflow was too fast. The yearly average rate of loan growth of Thai banks for the period 10 years before the crisis was as high as 18 per cent per year. This meant that their loan books double in size every 3 years.

17. How can their loan departments maintain vigilance with this kind of growth? They couldn't and too many loans went to undeserving projects, resulting in a lot of over capacity, over investment and over diversification. If instead we have had a more developed capital market, the risk would have been less. Capital market demands public disclosure, independent appraisals by outside experts, by outside analysts and by rating agencies. Therefore, it should lead to less risk of over investment, less risk of over diversification.

18. Today, the share of intermediation commanded by banks is still high at just under 60 per cent, but capital market has played a substantially bigger part. Market capitalization earlier this year recovered back to the pre crisis peak of US$ 150 billion, before the latest tumbling that affected all markets globally. It enabled listed companies to raise capital and reduce their debt to equity ratios that before the crisis was higher than 4 times to a much lower 1.2 times today.

19. A well-developed capital market can also strengthen the financial system in another way. When banks lose more and more of their large corporate customers to the bond market, the banks will have to concentrate more on SMEs customers and consumer finance. The more they go into consumer finance, their risks will be better diversified. Banks in Thailand today still have only 18 per cent of their balance sheets in consumer finance. I have seen balance sheets of banks in Europe that these proportions go higher than 50 per cent. So we still have a long way to go. Exposures to consumer finance can also be transferred out, through securitization, to investors who are better able to absorb these risks.

20. Overall, therefore, we think that the banking system will become more resilient the more the capital market becomes developed.

21. But developing capital market is not easy. To make international investors give complete trust to your capital market, you have to do everything right. Not a few things. Not most things, but everything must be right.

Keys to Development

22. So what are the key considerations in capital market development?

23. If you ask that question to market participants, their answers will cover a myriad of things ranging from

- the need to develop good market infrastructure
- the need for good codes of conduct for business deals, for business ethics
- the need for good regulations, effective enforcement and market integrity
- the need for tools to manage portfolio risks, such as derivatives, swaps
- etc, etc.

24. They all culminate into one thing and that is the need to adopt international standards and best practice.

25. Among securities regulators, there is the International Organization of Securities Commissions, IOSCO, that sets standards for the capital market. It has issued a set of 30 Principles that define good regulations and good regulatory structure. Thailand and Turkey are among the first batch of countries that went under the process of assessment done by outside experts, and ended up with good results. These experts are in fact not from the private sector, but were seconded from regulators of other countries.

26. Last year, we also engaged the World Bank to conduct the Report on Observance of Standards and Codes on the topic of corporate governance. The result was also satisfactory. In addition, Thailand is now beginning the process of Financial Sector Assessment Program being conducted by the IMF, as well as other modules of ROSCs by the World Bank. We give high importance to international standards and best practice because we know that it is the only way to attract and retain investors' confidence.

27. Ladies and gentlemen, I am now going to close my remarks.

28. I have emphasized strongly international standards and best practice. Unfortunately, I am afraid I have to close by pointing out that -- that alone is not enough. For the capital market to really attract international attention, in competition with other markets around the globe, it also has to be of high quality. I have of course left out the aspect of macro economy and political stability because they are so fundamental that they need to be put right anyway.

29. But quality is actually a difficult part, because it means the market participants, such as people in this room, must be of high quality. They must be knowledgeable, reliable and efficient. And it covers both the private sector and the regulators.

30. I wish to point out that, in the next few years, quality is going to be very important. Make no mistake about it.

31. In the past decade, competition from China and India has caused inflation to be exceptionally low. This low inflation was a supply-side phenomenon, and was not caused by a weakening of demand. But it had caused some central banks to become very

concerned about the prospect of deflation and hence provided too much liquidity. Some kept the interest rates too low for too long.

32. One of the results is the search for yield. You will have seen in one of the charts presented by a previous speaker that international investors now therefore receive unusually low levels of return in comparison to the level of risk. But this will not last forever. And when it happens, it will cause a reallocation of international capital from some markets to others. Only the markets with best practice, the market of high quality, will be able to compete for funds effectively.

33. It makes sense therefore to develop quality early. It makes sense therefore to strengthen the education and knowledge of participants early. Because the quality of any capital market can only be as good as the sum of the quality of its participants. No more, no less.

Thank you.