The Financial Crisis: An Emerging Market's View

Speech by Mr. Thirachai Phuvanatnaranubala
Secretary-General, Securities & Exchange Commission, Thailand
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Foreign Banks' Association Board and members

Ladies and gentlemen

It is my pleasure to accept the invitation to give a talk to you this evening. Foreign banks have long had an important role in developing Thailand, and I am honored to be given the opportunity to present to you my views and my opinions.

I am going to talk about the ongoing financial crisis.

But this topic is in a way like the US election. The outbreak had already happened, like the election result. Therefore there is a risk of over exposure to the news.

Nowadays people talk about Obama connected to just about everything, Obamania. Similar to Obama, on this particular financial crisis, a lot has already been said and heard.

Well, for someone who has not yet lived through any major financial crisis, this may be the case. But for those who have ever lived through one, there cannot be **too much** talk on this subject. Because the suffering is so great!

I still remember the situation in Thailand a decade ago. People lined up outside banks. Companies refused to deliver goods to each other without cash up front. The sense of fear gripped the stock market which plunged every other day.

The sight of people selling possessions out of the trunk of their cars! News about factory closing and people losing job! The atmosphere was all gloomy.

In Thailand, even after the IMF program was in place, after confidence had been restored to the financial system, improvement took a long time to materialize.

Whoever has lived through a major financial crisis will therefore realize the importance of talking about it. Finding quick ways to crisis resolution, ways to lessen its impact and, more importantly, ways to prevent a future crisis from happening!

On financial crisis, there cannot be over exposure of public discussions until we have the right measures of prevention.

The causes of the crisis

Today, I wish to share some thoughts with you as to how the system could be better improved to prevent a crisis. But picking the right remedies requires one to be precise in the first place as to the causes of the crisis.

The causes of the crisis were at two levels.

At the **macroeconomic level**, many people have already pointed to the failures in both the fiscal policy and the monetary policy used in the United States.

Quite a few people have criticized the thinking that the US government can cut taxes and go into a fiscal deficit today with safety, because it would stimulate the economy and generate more tax revenue tomorrow.

This line of thinking had only resulted in the budget deficits getting bigger and bigger.

Quite a few people have also criticized the US Federal Reserve for keeping the interest rate too low for too long, perhaps mixing the low inflation that was caused by cheap goods and services from China and India - with that caused by structural productivity growth.

I shall not go into these issues because too many comments have already been made.

However, what I wish to point out is that an economy can and are often affected by macroeconomic shocks, whether home grown or imported. The shocks can be man-made as well as caused by the act of god. No country can expect the ride to always be smooth.

But we should normally expect the financial system to be able to withstand these occasional macroeconomic shocks, especially the system in the US and Europe which are supposed to be the most developed and the most resilient in the world.

So when it turned out that their financial institutions had to be rescued one after another, this raises the question as to what caused the system to have such major inherent weaknesses.

I believe the causes to be at the **microeconomic level**. And it is important to identify the right causes, or else one will not prescribe the right cure.

One wrong cause, in my opinion, is to put the blame on pay incentive. People say the pay structure that linked bonuses to yearly profits was the main culprit that pushed bankers into taking on too much risk.

I believe this is simply being too emotional. Linking pay to performance is the key to all capital markets. How else can one incentivize employees to produce superior returns for the shareholders? No, pay incentive was not the cause.

Another wrong cause is to blame the mark to market accounting rule. This is like shooting the messenger, in this case the accountant, for bringing to us the bad news. The US SEC suspended this rule.

Banks stopped lending to each other because they did not trust the financial health of one another. How fudging the accounts will in any way help to restore confidence among banks and public investors I shall never know? Therefore, Mark to Market accounting was also not the cause.

So what are the right causes? In my opinion, they lie in weak supervision and regulations.

First is the poor supervision of the companies that originated retail residential mortgages in the first place.

There were insufficient controls on credit information checking, the level of leverage compared to homeowners' earnings and the financing of excessive speculative house purchases.

The authorities simply failed to properly supervise the originate-to-distribute model.

Second is the poor due process done by the investment banks that bundled the mortgages in to securities. They failed to uncover the weaknesses built into the mortgages by the originators.

Therefore it was not only the authorities, but also the private sector that failed to properly supervise the originate-to-distribute model.

Third is the wrong use of credit rating symbols. By using the same symbols for structured products as those used for straight bonds, the rating agencies fooled everybody, including themselves, into believing that the credit decay behavior would be the same for both.

We have seen many cases of AAA rated straight bond that in the past deteriorated down to junk. But it would take some time, with a lot of tell tale signs. For a country, there would be worsening current account deficits, climbing government debts, etc. For a company, there would be accumulating losses, weakening market shares, etc.

But for tiered structured products that were backed by mortgages, the collateral turned out instead to behave more like fire burning on straws.

The speed of fire that went up the tiered structure, up all the way to the AAA tranche surprised everybody.

By using the same set of symbols, everybody was lulled into a false sense of security.

The next cause that I wish to point out is the rules used by the US SEC that allowed US investment banks to have leverage as high as 30 to 40 times. I found this to be surprising.

This high leverage, while generated exceptionally high return on equity, made it impossible for investment banks to withstand portfolio losses.

The final point may or may not be a cause. I have to make further investigation. It is the Credit Default Swap.

I am not criticizing the CDS market itself. But I am not sure whether the credit risks to the banks that wrote the swaps were adequately reflected in the current BIS capital rule.

These items are off balance sheet, and one should query whether the risk weights placed on these exposures in calculating capital ratios were sufficient.

Improvement to the system

Ladies and gentlemen

Now that I have spelled out the causes, I shall not risk boring you by going into details as to how the system can be improved to take care of the causes that I have mentioned.

These gaps and deficiencies in supervision and regulation are quite simple to put right, provided one has the will.

But I wish to take this opportunity to say a few words on the things that are much more difficult to put right – things beyond simple regulations.

First, it seems that we cannot rely on the International Monetary Fund to prevent the really big and powerful countries from pursuing the wrong policies.

Despite the fact that these policies may have strong negative external impacts on other countries, meaning that when things go wrong everybody suffers, the IMF still appeared to be powerless.

You may recall that the pursuit of both fiscal and monetary policies in the US that resulted in unsustainable current account deficits. This has been absolutely clear for many years. But did the IMF have enough clout to make the US government change its policies?

On the other side of the world, China kept its currency artificially low for many years.

If China had allowed its currency to strengthen, its citizen would have had more purchasing power for import. The Chinese public would have imported more goods and services for themselves.

They would have consumed more at home, and gone more for holidays abroad. This will go a long way towards rebalancing the global imbalances.

Instead, with a weak Chinese currency, too much foreign financial assets ended up in the hand of the government, in the form of bulging and gigantic international reserves. And they had to invest these reserves somewhere.

But they cannot invest in any currency other than the US dollar. Whichever other international currencies they buy in a big way will strengthen against the US dollar, causing their vast international reserves, which is mostly in US dollar, to lose value.

So they had no choice but to plow the money back into the US government bond market. Unfortunately, this caused the bond market to have too high demand, and the long term interest to be too low.

The low long term interest rate was indeed the major fuel driving mortgage borrowing and house prices.

You may recall Alan Greenspan talked about a conundrum. When the Federal Reserve started to tighten and raised short term interest rate, the long term interest rate still kept going lower, defying the power of the Fed.

All this was caused by China and other Asian countries plowing their reserves into the US bond market. And this went on for many years.

It is obvious that China should have allowed its currency to strengthen faster. Other Asian countries that de facto manage their currencies tied to China, because they are part of the same supply chain, would then have been able to do the same.

But did the IMF have enough clout to make China change its policies?

Second, it seems that we also cannot rely on some international bodies that set international standards to be really objective.

In the area of securities regulation, we have the International Organization of Securities Commissions (IOSCO) that set rules.

It is time therefore to raise the question as to why the IOSCO in the past did not set as international standard a capital rule for securities companies to prevent such high and damaging levels of leverage as used in the US.

In the area of accounting standards, on the US side we have the US Financial Accounting Standard Board (FASB). But why did they not fight the US SEC on the subject of doing away with the mark to market accounting rule?

In the area of accounting standards, on the international side we also have the International Accounting Standard Board. This Board is supposed to be absolutely objective and unwavering. But they also caved in to the political demand against the mark to market accounting rule.

Ladies and gentlemen

These are the two major weaknesses that worry me the most. I am worried particularly about these weaknesses, because I do not see enough of other people voicing the same concerns as I do.

I am also worried because the international institutions that I mention look set to continue to be dominated still by the same group of large countries. This can go on for many years to come.

I believe that reforms on these international institutions are urgently needed.

If not, we had better brace ourselves for the possibility of more financial head wind in the future.