Thai market ready for strong medicine

During the past 10 years, Thai governments have implemented a successful policy balance for progressive industrialisation and liberalisation of international trade and finance. This had helped to fuel economic development and almost double-digit growth in gross domestic product. Thai export industries have benefited tremendously from cheap and skilled labour and also from growth in demand from the world market with relatively little competition.

The pegged exchange regime was a benefit when the US dollar was in a relatively weak position in the international currency market. However, the onslaught of short-term foreign funds flooding the world's emerging economies has induced excessive behaviour and contributed to the misallocation of investments and credits. Buoyed by bullish sentiment about the growth in the economy, Thailand bore the brunt of this excessive funds flow.

Excessive credit expansion, financed by short-term capital inflows at low exchange rates, fuelled increases in asset prices, especially of property and real estate, and distorted investment toward these high-risk and less productive activities. This contributed to a persistent high current account deficit and a rapid increase in foreign debt and weakened the country's credit rating. The authorities warned the private sector against excessive lending to unproductive sectors, imposed measures to curb short-term inflow, strengthened prudential supervision and initiated structural measures to reduce the current account. Yet these measures and warnings were not enough to slow down these undesirable developments.

The strengthening of the US dollar against other major currencies and growing competition from fast-developing neighbouring countries led to unexpected stagnation of export performance in 1996 and, after 10 years of rapid expansion, caused a decline in corporate profits, a turnaround in investors' sentiment, and a severe correction in the asset markets, including stocks and property. The loan quality of financial institutions worsened as the ability of customers to service debt deteriorated. The overall economic decline led to weaker revenue performance and introduced the risk of a deficit. The pegged exchange rate became inconsistent with economic weakness and currency speculation.

The present predicament is a consequence of a combination of the economic downturn, mismanagement, asset and liability mismatch and the
crisis of confidence in both the financial system and the regulators. The problem of weak asset quality is deep-rooted. Many unproductive sectors of the economy received a huge transfusion of cheap short-term funding driven by highly speculative sentiment. Many financial institutions failed to recognise that the collateral in their loan portfolio was overvalued and could not be liquidated easily should marketplace liquidity dry up. Many investors failed to diversify into less speculative sectors such as manufacturing and agricultural commodities.

Against this backdrop emerged the Bangkok Bank of Commerce’s difficulties, asset quality problems in some financial institutions and the failed merger attempt of Finance One. Depositors’ confidence in financial institutions was badly shaken. At the same time, alarmed by what they perceived as a potentially dire situation, the creditors began to call in their outstanding loans. These actions exacerbated liquidity problems in the system and the authorities were forced to suspend the operations of 16 finance firms that were at the blunt end of this crisis. As the confidence problem increased, the authorities had to suspend the operations of 42 more finance firms whose operations had become financially unviable.

Since then, series of strong measures have continued to be adopted by the authorities. The baht has been allowed to float. Thailand has entered the IMF comprehensive adjustment program, a 34-month standby arrangement in conjunction with regional central banks, the World Bank, the Bank for International Settlements, and the Asian Development Bank. The adjustment strategy is centred on the reduction of the current account deficit and the comprehensive restructuring of the financial sector. These are to be reinforced by a stringent stance on inflation control, the progressive restoration of reserves, and upgrading of infrastructure and human resources. A recovery will naturally follow, once the economic and financial situation improves and structural reforms are progressively implemented.

The fiscal stance formulated in the IMF program is aimed at ensuring the overall balance of public-sector revenue and expenditure. The government is prepared, if necessary, to increase selective tax rates and broaden the tax base. To reduce expenditure, the budget has now been reduced from 982 billion baht to 800 billion baht. On the financial institutions front, parliament passed emergency decrees to allow the authorities to merge troubled financial institutions or adopt purchase and acquisition programs for them. Limits on foreign equity in these institutions can now be waived by the authorities if foreign investors are prepared to inject new capital. The Bank of Thailand’s power to intervene in firms showing signs of financial troubles has been beefed up. A Financial Restructuring Agency has been set up with extensive authority to deal with the operations of the 58 suspended finance firms. Finally, a legal framework has been finalised for an Asset Management Corporation to deal with the bad assets of these firms. These structural reforms will greatly contribute to the speedy recovery of confidence in the financial system.

The crises in the economy have had direct implications for the capital market: the floating of the baht and the general slowdown in the economy have meant that many listed companies have become financially distressed. Serious efforts must be made to help these companies to restructure loans and expenditures or to recapitalise. Many will have to consider allowing foreign investors with fresh funds to provide a helping hand. These are companies which have strong prospects for future growth; however, those that are unviable must be delisted and allowed to die.

On a slightly longer-term basis, there must be an injection of new products into the Stock Exchange of Thailand. Until there is optimism about the economic climate, investment in the SET will remain relatively slow and concentrated in a few carefully chosen stocks. If this situation continues, it will have a substantial effect on the securities business, which essentially relies on trading volumes. Moreover, failure of the secondary market to function properly will affect the ability of those companies, particularly financial institutions, that need to recapitalise. In this respect, the government must act urgently to privatise state enterprises that are in a position to attract long-term investors, both domestic and international.

The development of an effective debt market is another important step. Leading up to our present predicament, the bulk of available funding in the Thai financial system was short-term. In 1996, $3.12 billion of BIBF loans, or almost half of the total private foreign debt, was short-term in nature. The establishment of a liquid and deep government and corporate bond market would be an important structural contribution to the capital market. However, there must be legislation to allow the government to issue bonds on a regular basis in order to establish effective benchmarks for all other debt instruments. That would facilitate the use of related instruments such as short-term commercial paper and securitised debt instruments.

Development of long-term domestic institutional investors must also be high on the agenda of reform in the capital market. Traditionally, the Thai market has centered on the Stock Exchange of Thailand, with majority of domestic investors being small retail individuals. With receding prospects of growth in the Thai economy and the drying up of liquidity in financial system, the Thai stockmarket has suffered a substantial downturn as foreign and domestic investors continue to stand on the sideline. I believe that such market trends are cyclical and once that we have instituted the IMF program and implemented measures to solve the financial institutions problem we will see the return of investors. I believe that we have already begun our journey on the right track.

Recent governments have
aggressively encouraged long-term collective investment schemes. Substantial tax benefits were given to provident funds and mutual funds. In addition, more provident fund management licenses have now been granted to qualified market intermediaries. Every state enterprise, government agency, licensed financial institution and listed company is being requested to set up a provident fund for employees. As a result, as of 31 August 1997, there are 42 registered provident fund managers operating 951 funds with a total value of $US3.1 billion.

In addition, a bill passed by parliament has the effect of setting up a central pension fund for government officials. From now on, every civil servant in Thailand will contribute part of his or her income in a collective pool that will become due to them upon their retirement. The government has provided a substantial seed money for the establishment of the fund and will continue to add its own contributions to the pool, which currently stands at $US1.5 billion.

At the Securities and Exchange Commission, of which I was a former board member, collective investment schemes and discretionary asset management accounts have always been at the forefront of our policy objectives. Until 1992, when the SEC was established, only one mutual fund management company operated in Thailand, with assets under management of about $US1 billion. The number has increased to 14, with assets close to $US18 billion.

Apart from collective investment schemes, the SEC has begun to allow financial institutions and securities companies to provide tailored asset management services to valued customers. The potential market for this form of asset management still remains relatively unexplored.

Alongside the development of a domestic institutional investor base, there must exist effective hedging instruments. Arrangements are under way for the issue of such instruments as covered warrants, and for the facilitation of short selling and securities lending transactions. In addition, legislation for the trading of futures and options contracts is being presented to the cabinet for approval. Once implemented, these laws and regulations would allow instruments of this nature to flourish and this new class of institutional investors will have the means of protecting the value of their investment in a cheap and efficient manner.

Transaction costs are another issue that institutional investors will rank among their priorities. The liberalisation of commissions has already begun. Once institutional investors begin to enter the equities market in full force, there will be market pressure for the commission structure to be changed. A fixed commission regime will not be able to accommodate wholesale players who will demand discounts on fees based on their volume of businesses.

Prevention of systemic risk in regard to clearing and settlement is another issue that demands serious attention. Investors must be confident that the settlement system cannot fail. In this regard the SEC has decreed that there must be sufficient capital available to the stock exchange's Thailand Securities Depository Company (TSD) to cover any failed transactions. This safeguard should provide confidence to investors.

Turning to regulations for market intermediaries, more progress is needed on the issue of capital requirements for market risk. Such regulations should seek to measure various types of market risk that broker/dealer firms are exposed to, particularly in the area of derivatives positions, to enable calculation of the capital needed to cushion losses arising from such exposure. Another very important issue for listed firms is the concept of good governance. Even though listed companies raise capital from the public, many remain essentially family-owned businesses with relatively little professional management. Strong and independent internal audit must be given high priority so that any abnormality in the conduct of businesses can be quickly detected. Qualified and professional management must also be instilled in key positions. Financial institutions and corporations engaged in more risky business must have an independent risk-monitoring unit with strong compliance obligations. This would assure the investing public that companies have great degree of accountability and are operated within a proper framework.

Thailand has suffered a severe and drastic downturn in terms of recent economic growth, but once the measures I have outlined are implemented, confidence will quickly return. Many measures can be considered strong medicine and will have a devastating effect on some of the sectors involved. However, the quicker the problems are addressed and solutions implemented, the sooner the