

Managing Financial Crisis:
Key Lessons and Future Regulatory Challenge
Speech by Dr. Tarisa Watanagase
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Distinguished members of the faculty, ladies and gentlemen,

It is an honour to be invited to give today's lecture on this distinguished occasion at the prestigious Oxford University. Most importantly, I am privileged to join a long list of eminent speakers who have spoken at this lecture series. My topic today is on financial crisis, I hope that our experience in Thailand in the late 1990's during the Asian financial crisis will prove useful in providing lessons and insight for the current challenge.

First and foremost, there have been many economic and financial crises throughout history. The forces unleashed by these crises have profound and far-reaching impact. Particularly, in the case of the Great Depression, they shaped not just economic and financial landscape, but also ideological and geographical landscape, as the international society had to face the challenge of how to create a better world order in their aftermath, many of which arose from the very corridors and courtyard here in Oxford.

The current crisis is having a deep impact on the major economies at the epicentre, and the impact looks set to spread rapidly to other countries which have been less affected by the first wave, despite the strong response from authorities worldwide. As cost of the crisis rises, we are once again debating the age-old question of the merit of free market, the role of regulation, nationalisation and state ownership. We are also confronted with the challenge of reshaping the domestic, and indeed, the global financial system and its regulation.

My talk will be structured into three parts. First, I will quickly summarise what we know about financial crises in general. Then, I will share with you our experience in dealing with a crisis of our own, stressing in particular the aspect of crisis resolution and regulatory reform. Finally, I will touch on the current crisis and the future regulatory challenge. By the end of my talk, I hope the lecture will prove to be useful for the understanding of the current situation.

Let me begin by drawing on the most recent studies on financial crises by Reinhart and Rogoff in 2008 and 2009. After reviewing a broad set of crises, covering developed and developing countries, dating back to England's 14th century crisis, the authors concluded that all crises share many common features, and the current crisis being no different from the past. Let me share with you some of these key findings.

First, the warning signs, for example, large capital inflows, sharp house price and equity price increases, strong GDP growth and rising indebtedness, were all too familiar. Second, global crises frequently emanated from financial centres, with the macroeconomic variables such as interest rate and commodity price as the transmission channels. Third, banking crises were normally associated with sovereign

default, accompanied by inflation, and currency crises. In this regard, repeated sovereign defaults on external debt were often the norm, where each period of calm would often be followed by a new wave of defaults.

In terms of the effects of severe crises, the authors found that the impact on house price and equity price were similar for emerging and advanced economies, with GDP contracting more for emerging economies and unemployment rising higher in advanced economies. The average real house price and equity price during severe crises fell by 36 and 56 percent, on a cumulative basis over a period of five and three and a half years, respectively. Unemployment was found to rise by 7 percent over a period of almost five years while real per capita GDP contracted by a little more than 9 percent over a period of just two years – the lag in unemployment recovery, of course, implied significant and prolonged hardship and social cost.

I need not remind you that the numbers we are seeing today, for example, house price and equity price declines, are already similar to these historical records. Although major central banks have acted very quickly and in a concerted manner in terms of damage control, the impact continues to spread worldwide. Moreover, we have already begun to feel the second round impact on the real sector, through falling exports and GDP of countries not immediately hit by the financial implications of the crisis, and of course, declining prices. Longer-term adjustment also remains a source of concern. I am referring to the fact that the US dollar remains the safe haven – a contradiction to the underlying fundamentals.

As I said earlier, crises share many common characteristics; therefore, a thorough analysis of the 1997 crisis in Thailand which I will now discuss could offer some lessons and insights to the current one.

The crisis we faced in 1997 was, both in its origin, and the dynamic of the crisis, not dissimilar to other previous crises, and indeed the current global one. At the time, we were faced with both economic and financial crises, with the vicious cycle starting from the vulnerability caused by macroeconomic imbalance. Such imbalance was encouraged by the fixed exchange rate regime that had been in place at the time. Weakness in prudential supervision, which allowed risks to be under-priced was the other key driver.

This, of course, was an all too familiar story of unsustainability turns crisis. For Thailand, the fixed exchange rate induced large short-term capital inflows, which together with weak prudential supervision led to market under-pricing of risks, especially exchange rate risk and credit risk. In the case of credit risk, a large part was due to links to the real estate bubble, causing the value of collateral to rise. The collateral-based lending practices caused over-lending, which in turn fuelled the real estate bubble even further. This bubble cycle was magnified by excess liquidity, financed by short-term capital inflows. Sounds familiar? Of course, abstracting from exotic products like CDOs, the dynamics was not dissimilar to the current crisis.

Such vicious cycle led to excess leverage, over-spending, a large current account deficit of 8 percent of GDP, and high external debt of 110 billion US dollars. Eventually, the collapse in confidence from the combination of decline in export and suspension of weak financial institutions triggered a sudden reversal of capital flows, collapses in currency and asset prices, and widespread corporate insolvencies that

were exacerbated by the impact of currency depreciation on foreign debt. These events subsequently created a huge non-performing loan (NPL) problem for the whole banking system.

On the macroeconomic front, the collapse of businesses and banks together with the IMF-mandated fiscal tightening led to a sharp economic contraction, GDP growth fell from an average of 8 percent to a contraction of 10.5 percent in 1998. Meanwhile, inflation rose to 8 percent, due to its imported components, before plummeting the next year due to a stagnant economy. At the same time, external debt continued to be high and the unemployment rate doubled.

On the financial side, the abrupt reversal of capital flows coupled with the sharp increase in interest rate required to stem currency depreciations as part of the IMF's Adjustment Program, led to a serious liquidity shortage in the financial sector that quickly translated into a credit crunch in the real sector.

The credit crunch problem was partly due to the system's inability to promptly take care of good borrowers of the closed institutions who were left stranded without credits to keep their businesses running, reflected by a continued contraction in private credit growth. As a result, these hitherto viable borrowers fell victims to the crisis, and collapsed as a consequence, propagating yet another round of crisis, triggered partly and endogenously by the very policy aimed to stabilise the currency leg of the crisis.

The depth of the banking sector damage was extensive. Huge losses were recorded during 1997 to 1999. At the same time, non-performing loans in the banking system reached almost half of the total loans at 43 percent in 1998, and remained at over 10 percent for almost 7 years. The uncomfortably low level of Capital Adequacy ratio eventually rose as crisis resolution measures kicked in. These included recapitalisation and bank nationalisation.

The effects of the 1997 crisis persisted for almost a decade. The major turns of events can be grouped into three phases.

The initial phase, covering the latter part of 1997, involved a run on deposit-taking finance companies. The damage was so large that 56 out of 91 finance companies were closed down, directly impacting 10 percent of total assets in financial institutions system. A blanket guarantee was also introduced during this period.

Unfortunately, such closures did not stop the run, as lack of confidence remained at the core of our problem. As a result, during the second phase between 1998 to 2000, the effect of the crisis became widespread, where we had to intervene in several weaker banks, and subsequently closed them down. Also as mentioned earlier, both banks and the real sector suffered from a prolonged period of credit crunch. There was also a rundown on bank capital, which had to be replenished by the Bank of Thailand, with some banks sold to foreigners. The total cost of intervention was later estimated to be around 26 percent of GDP in 2002.

The last leg of the crisis that covered the period from 2000 onwards, mainly dealt with debt restructuring and NPL resolution. In an attempt to clean-up banks' balance sheets and resuscitate borrowers, the government set up the Thai Asset

Management Corporation or the “bad bank” to buy up NPL from banks and manage the bad assets.

Let me now turn to the crisis resolution measures. For our case, four major groups of policy resolutions or what I will refer to as “the four Rs” were introduced to address four respective key areas of vulnerabilities. The first R is what needs to be addressed right at the onset of the crisis – that is “Restore public confidence”. This was achieved by introducing a blanket deposit guarantee scheme to stop further runs to spread to otherwise strong banks. Then, there was a need to “Restructure the financial sector” to strengthen financial institutions’ balance sheets and ensure their viability. The measures under this R ranged from capital injection, to closures as well as sell-offs. As a result, of course some banks were nationalised. The third R is “Resolve NPL problem” to rid of lingering weaknesses through debt restructuring and the establishment of the “bad bank”. Finally, measures to “Revive credit” were instituted, including liquidity injection, raising banks’ capital, regulatory easing, for example on consumer loans.

What I would also like to stress here is that, it is of utmost importance that the four Rs are implemented simultaneously, given that the problems each R is designed to address are, in fact, interconnected. Lack of solutions in any area could derail others. In addition, it is also necessary to ensure a strong financial legal foundation, to be able to effectively carry out crisis resolution measures, for example, to expedite debt restructuring and bankruptcy processes.

In conjunction with crisis resolutions, we also tackled long-term reforms that would help ensure that all the necessary safeguards are in place to prevent any future mishaps and ensure economic and financial stability, going forward. Such reforms can be organised into three main fronts, macroeconomic policy, prudential supervision, and strengthening financial infrastructure.

On macroeconomic policy, after abandoning the fixed exchange rate regime, a managed float was adopted with the subsequent introduction of Inflation Targeting in May 2000. Furthermore, the Bank of Thailand continued to safeguard financial stability, by monitoring key vulnerabilities, including household debt, asset prices and utilises monetary and macro-prudential policies when needed.

On prudential supervision, as well as requiring banks to conform to international best practices on risk-based supervision under Basel I and now Basel II, the Bank of Thailand also moved to strengthen our supervisory function, utilising both on-site and off-site supervision as well as asking banks to carry out stress tests on a regular basis. The key here is to strengthen banks’ own risk management culture and system.

Finally, works on strengthening the financial infrastructure are on-going. In this regard, various initiatives were introduced, including the long-term effort to reshape the financial system, and address inherent structural weaknesses in the medium-term plan, or the Financial Sector Master Plan, the establishment of the National Credit Bureau to improve credit information, and improvements in financial legislations, including the new Financial Institutions Business Act, the Bank of Thailand Act and the Deposit Protection Agency Act.

Given our decade-long journey of comprehensive reforms, we can now look back to assess how we have done. First, the economy finally started to recover in mid 1999, aided by strong global trade, with the return of GDP growth, stabilising inflation, lowering external debt and declining unemployment. On the financial sector side, bank profitability resumed in 2001 and has been positive since. At the same time, NPL continued to decline and banks' Capital Adequacy ratio rose steadily, signifying a strengthening of banks' balance sheet. More importantly, banks have strengthened their risk management significantly, as reflected in the favourable assessment under the Financial Sector Assessment Program (FSAP) of the IMF and World Bank in 2007.

Lastly, the financial landscape has also changed dramatically. Given the closures of financial institutions as well as voluntary mergers and acquisitions during the post-crisis period and after the implementation of the Financial Sector Master Plan, the total number of financial institutions declined markedly. As a result, we have much fewer but significantly stronger banks at play today.

To summarise, I believe there are four key lessons that the Thais as well as the international community can learn from the 1997 crisis. First, confidence is key and the way to regain stability is through a timely and comprehensive crisis resolution scheme. As demonstrated time and again, the lack of such strong resolve could easily lead to a large downturn in sentiments and economic stability. Second, bank resolution measures need to be complemented with measures to prevent credit crunch. In other words, it is imperative that we protect good borrowers in bad times. Third, reforms are necessary but they are best carried out when fragility in the banking sector has been addressed. Finally, a blanket guarantee, though important for restoring confidence, may not be sufficient by itself, and may lead to moral hazard, thus should be lifted as soon as stability is regained.

With the lessons from the Thai experience in mind, I would now like to take you to the final part of my presentation today, that is, the current crisis and future regulatory challenge.

Indeed, the root cause of this crisis is no different than the others in the past. To some, this maybe at once reassuring, and disconcerting. On the one hand, we are dealing with "the devil we know". But, on the other, it is disheartening in that, despite all our confidence in our understanding of the economy and the financial system and advancement in supervision and central bank models, we seem to inevitably fall prey to the same age old problem, again and again. Yet, we cannot deny that the usual warning signs of global imbalance, be it capital flows, soaring prices or growing indebtedness, were there and left to accumulate.

With a lot of crisis talks already concentrating on the causes, I would like to focus my remarks on the lessons learnt and future implications. The current crisis, given the events unfolded so far, is the most severe since the Great Depression. This is perhaps because the major growth engines of the world economy were struck at once, with all major economies and financial markets sinking rapidly, in a domino like manner, propagated by their common financial exposures.

The second round effect on the economic sector has already begun to take its toll, with the impact looking far greater than many expected, causing continuous

downward revisions in GDP forecasts for the next two years. With contagion spreading fast, there is increased pressure on sovereign risk of emerging markets.

Also, as global banks remain fragile to further write-down and recapitalisation, this global crisis has turned into a full-fledged dual crisis, with a risk of both the economic and financial sectors' impacts feeding on to each other in a cycle. To break this vicious cycle, I believe that policy makers must base their efforts on two important factors. First, recovery prospect depends crucially on strong, comprehensive, and timely policy actions. And second, there needs to be better coordination among nations at centre of the crisis.

With regard to immediate policy resolutions, I think this crisis, too, requires a revisit to the four Rs: Restore public confidence, Restructure the financial sector, Resolve NPL problem, and Resolve credit crunch, and reviving the normal credit mechanism. While the detailed policy actions may differ from country-to-country, the principles remain the same. And I want to stress here again that, these policies must be simultaneously undertaken, and supported by strong legal foundation and infrastructure. Also, given the global implication of the crisis, coordination among authorities concerned, both domestic and cross-border, needs to be strengthened. Otherwise, it may not be possible to completely break the loop.

In a medium- to long-term horizon, supervisory reforms also need to be carried out but only at an appropriate time, after the corrective measures have already been taken. In this regard, there are at least five key areas of regulatory framework improvements that are being discussed internationally.

First, since micro-prudential supervision alone failed to prevent systemic risk, macro-prudential measures must be incorporated into the supervisory framework. This is because micro-prudential approach focuses on risks of individual institutions, and pays inadequate attention to two key linkages which determine systemic risks:

The first linkage is between systemically important components of the financial system, the feature which can propagate systemic risk, or the externality effect. Such linkage arises from exposure to each other, or the counterparty risks, as well as from exposure to common risk drivers, such as similar asset class, or funding strategy.

The second linkage is one between the financial system and the macro economy. Its effect is seen mainly in the form of the procyclical behaviour of financial decision and regulation, which can lead to excessive risk taking. One such example is collateral-based lending, where collateral appraisal are based on market value, which varies with economic cycle.

Because of this weakness, micro-prudential regulatory framework would need to be supplemented by macro-prudential approach, which aims at monitoring and regulating such systemic aspects. This idea is not new, as financial regulators and central banks do engage in financial stability assessment and exercise, but this process needs to be further strengthened.

Second, due to the procyclical nature of the financial system, as mentioned above, measures need to be taken to counter procyclicality and prevent excessive risk-taking and asset bubbles. This, perhaps, can be thought of as "taking the punch bowl

away” – an unpopular act but perhaps, as the current crisis taught us, necessary. The reluctance in the past to act had been based on arguments such as: regulators do not have superior information to the market on whether asset prices were unsustainable or a bubble, or whether buoyancy was a result of cycles or underlying productivity growth.

My view is that, authorities do not need to have exact knowledge of the “equilibrium” asset prices, or business cycle. We can, and do, observe indicators of the build-up in vulnerability in various parts of the economy and financial markets, such as household indebtedness. If the body of evidence points to a momentum towards instability, it is our duty to act in a forward-looking manner to moderate and ward-off such momentum. Indeed, central banks are already doing so in the context of monetary policy to safeguard price stability under the Inflation Targeting framework.

Third, supervision of large and complex financial institutions must be strengthened due to the externality they pose to the global economy. Fourth, capital requirement alone is not adequate to cushion unexpected loss. Finally, supervision of liquidity risk and maturity mismatch should be strengthened.

Turning to what I believe are the key priority in reforms.

Much effort seems to focus on refining how to measure risks, identifying systemically important institutions, or to calibrate regulations, such as Basel II capital requirements, stress-testing, and accounting rules to alleviate such problems. Significant progress has been made which would benefit future regulations.

As a policy maker, and in keeping with this lecture series, I would also like to add another key perspective, that of governance.

While progress has been made on the technical aspects mentioned above, I believe the real difference has to come from a re-thinking of governance aspect.

The first on my priority list would be the need to deal with the issue of governance, by setting a clear mandate for the lead supervisor in charge of systemic stability.

Most central banks and regulators assume responsibility for financial stability, and indeed, that is what society expects of us. However, the legal mandates are rarely clear. This is partly because the notion of financial or systemic stability is very hard to define explicitly. The debate on this issue includes those on institutional forms—the notion of a single regulator and the integration or separation of central bank from supervision function. The points of discussion cover issues of synergy of function, efficiency, conflict of objectives, independence of mandates, and transparency.

One thing is clear from the current crisis, that is, the institutional form is not the key question, as failure to deal with systemic risk is seen in financial centres with all governance forms for regulations.

My view is that the key is to have lead regulators who must have two key features, first, being focused on risk, and second, being the supervisor of the core systemic institutions and market.

I believe that there may be a tendency towards redesigning the mandate of the central bank. While many central banks today are formally entrusted with the price stability mandate, that of financial stability is perhaps less well defined and spelled out, leaving an important accountability gap to be filled. I strongly believe that this gap should be responsibilities of central banks.

Moreover, with current regulatory gaps exposed, re-regulation would be needed in order to close regulatory gaps of banks as well as extend the reach to cover product, market or institutions that pose systemic threat.

In addition, due to the unprecedented scale of closures, bailouts, nationalisation, mergers and acquisitions of global banks, the international financial landscape would be changed dramatically from being an international, universal banking-oriented community to a traditional, local banking-oriented community. The regulatory framework would, of course, need to keep up.

Finally, the international financial architecture would need a better system to deal with the impact of globalisation. This calls for improvements in policy dialogue, coordination as well as cross-border supervisory rules and regulations.

From the perspectives of emerging market economies, although we were less affected by the first round impact of the financial crisis, the second wave that is coming through via the real economy remains a challenge for all of us. Strengthening policy and risk management could help mitigate risks, but the ultimate outcome still hinges on major economies' efforts in resolving the crisis quickly.

Before I end my presentation, I would like to share with you what the Bank of Thailand, as bank regulator, has done in terms of policy responses to the crisis.

For us, we have put emphasis on strengthening risk management and capital adequacy of banks even before the current crisis began, including the adoption of Basel II and IAS 39, which allows our banking system to remain robust at present. Thus, for us there would be no need to impose additional burden on our banks during the bad times, apart from continued vigilance on risk management.

We are also taking steps to prevent credit crunch for vulnerable sectors, such as SMEs, including improvements in the SME guarantee scheme. Finally, our fiscal stimulus package is underway and monetary policy continues to be accommodative to cushion spending and propel the domestic economy forward.

Of course, no regulators and central banks can be complacent in this environment, and we are working closely with key policy makers inside the country as well as on various international and regional forums to ensure close coordination. The global nature of this crisis demands no less.

In closing, while much of this crisis is similar to the past crises, one difference stands out, that is the enhanced role of the emerging economies has been brought to the fore, and I believe the new regulatory framework would and should reflect this, and in embracing this role, the governance of the international financial community should also evolve accordingly.

Thank you for your attention.