10 Years after the Crisis: Thailand's Financial System Reform

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Discussion Paper 356
January 2007
ISSN: 0949-9962

Abstract

This paper uses the framework of long-term financial system development to describe and assess the reform process in Thailand after 1997. The present financial reforms are well in line with the pattern of financial development found in the academic literature. A detailed analysis of capital markets, specialized financial institutions and supervisory regulation shows recent advancements and open issues. The rapid rise of non-banks financial institutions can serve as a paradigmatic example of market driven dynamism requiring appropriate policy action. Overall, the building of modern and sophisticated financial institutions is an ongoing process which should consider human resource constraints.

JEL-Classification: O 1 (economic development), G 2 (financial institutions)
Keywords: Financial institutions, financial development, Thailand

October 26, 2006

* We would like to thank participants at the Hitotsubashi-Nomura JAE Conference on Financial System Reform and Monetary Policies in Asia and in particular our discussant Hidenobu Okuda for helpful comments.

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I. Introduction

Thailand is back on its long-term growth path. Annual growth rates during the last five years, i.e. 2002 to 2006, average more than 4.5 percent and are thus somewhat above acceleration of the world economy with about three to four percent during the same period (calculated in real per capita terms). So Thailand has managed to overcome the depression caused by the Asian financial crisis and has regained its earlier position as a rapidly growing economy.

This ambitious development process includes a continuing reform of Thailand's financial sector. We can, indeed, show that the phase where financial reforms were dictated by the needs of crisis resolution has gone and that the country is back to a "normal" situation. Normal, however, does not mean "no change" as Thailand's economy is evolving with high speed. High growth implies continuous severe structural changes and one of the important areas of change is the financial system. This paper addresses this financial system change with an emphasis on the policy viewpoint, neglecting the dynamics within single institutions. Accordingly, we use the macroeconomic literature on long-term financial system development as a framework to describe and assess the reform process in Thailand after 1997.

It turns out that this perspective is well suited to understand major steps in Thailand's present reform process. Reforms are largely in line with the pattern of financial development found in the academic literature. The quite general pattern needs, however, many supplements to generate a consistent and detailed reform perspective. We discuss major issues in this respect.

Due to the present development stage of the Thai economy, the role of non-bank financial institutions has become a most important issue. That is why we focus on this aspect which will receive even increased attention during the next decade. This focus serves a second purpose as it illustrates the race between dynamic market forces pushing forward and authorities aiming for a consistent regulation of the financial sector. An efficient balancing of these forces will decide about the financial system's long-run success (Rajan and Zingales, 2003).

The rest of the paper is structured from general to the specific and unfolds as follows: Section II contains the long-term perspective structuring our discussion. Section III describes measures of financial crisis resolution in short, whereas we put more emphasis on Section IV which presents the measures taken thereafter, i.e. roughly during the last five years. Section V turns to recent developments of non-banks financial institutions which are heavily engaged in the market for personal, i.e. mainly consumer, loans. Finally, Section VI concludes.

II. Long-term financial system development

The available long-term as well as cross-sectional evidence documents well that the financial system develops in line with the overall economy. Stylized facts include overwhelming evidence that the financial system develops even faster than the rest of the economy over large periods as early shown by Goldsmith (1969). Most of this evidence is provided in terms of nominal assets of the financial sector put in relation to nominal GDP. However, the story holds when financial sector growth is rather measured in real terms, such as income generated or simply the number of branches etc. (Levine, 1997). So, high financial sector growth is evident and Thailand is—as an emerging economy—in the middle of dynamism in this process.

In some contrast to the undisputed relation between financial and overall economic growth, the issue of causality created long-standing controversy. At present, it seems fair to conclude that the basic thrust is from financial development to economic growth and less so the other way round (see Fase and Abma, 2003, for Asian countries). There are some caveats although, because there is still lots of reverse and two-way causality as first shown by Demetriades and Hussein (1996). Moreover, the experience of countries (De Gregorio and Guidotti, 1995) and episodes (Graff and Karmann, 2006) demonstrates that financial growth can be even harmful or at least useless for overall development. So, policy makers are well advised to put the right dose of reform to the economy and neither being too cautious—thus giving growth opportunities away—nor being too ambitious—thus wasting resources and possibly risking crises.

The heterogeneous experiences with financial market reforms indicate that it is not just the "amount" of development that matters but probably also the "step" of development. Again, there is evidence providing a useful starting point for designing appropriate policy measures. A first approximation is gained from Levine (1997) who classifies countries into three income levels and describes the average financial sector structure at these income levels. Figure 1 reproduces main insights, and shows that the central banks become more unimportant over time, commercial banks gain somewhat, stock markets gain too and non-bank institutions grow fastest.

The question arises where a middle-income economy such as Thailand should be placed in this classification more precisely. If one takes just Thailand's mean income, its place is closer to the low income countries. One can argue, however, that this is misleading for many emerging economies which show aspects of a dualistic development. Large sectors of the Thai economy compete with higher level foreign firms or institutions than indicated by Thailand's average income. Considering for example the quite industrialized Greater Bangkok Area alone, this "economy" would match the lower bound countries of the European Union.[1] Accordingly, this consideration justifies placing Thailand (in parts) at the edge towards the high income countries. This implies that we expect a reform process which develops commercial banks but puts more emphasis on stock market development—reflecting rather lower middle income economies—as well as on the development of non-bank institutions—being an issue more for higher middle income economies.

A last insight from the financial development literature—adding to "amount" and "steps"—is the "institutions" of development, i.e. the central role of institutional quality. What applies to the growth process in general, i.e. the decisive importance of functioning institutions to explain total factor productivity improvements (Easterly and Levine, 2001), also holds for the financial sector (Krahnen and Schmidt, 1994). In the long transition process towards functioning financial markets, the necessary institutions have to be built, including the core financial institutions, such as commercial banks, capital markets etc., as well as "corollary institutions", such as supervisory authority, reliable accounting standards or insolvency regulations.

We will see that, indeed, all three elements—capital markets, non-banks and further institution development—are important in Thailand's recent reform process. Before we discuss these issues in later sections, we first recapitulate in short some reforms kicked off by the Asian financial crisis.

III. Financial crisis resolution in Thailand

This section provides evidence that measures taken to resolve Thailand's financial crisis of 1997 were successful and provide a solid basis for more ambitious reforms thereafter.

The crisis starting with a heavy devaluation of the Thai Baht in July 1997 turned into a fully fledged financial crisis within a few months. The exchange rate and the stock market collapsed, most financial institutions were closed, virtually all financial institutions had to be recapitalized, it came to a credit crunch and the economy shrank by almost 10 percent in 1998 (e.g. Warr, 1999). The core of immediate measures taken aimed at keeping the financial sector existent: first, the state stabilized the sector by guarantying most deposits and thus the existence of banks. This emergency measure was the basis for the later plan to work out the cumulating non-performing loans (NPL) with the help of bad-debt resolution mechanisms (so-called asset management corporation) and a recapitalization of financial institutions. Figure 2 shows the result of these measures, i.e. the return of the ratio of NPLs to an almost conventional level to about 10 percent at the end of 2001 and less thereafter.

A second measure i.e. the closure of bankrupt financial institutions (and often the merger with others) helped to drastically reduce the number of financial institutions. Whereas the number of the most important branch of financial institutions, the commercial banks, did not change much, the number of the formerly second most important group (in terms of assets), the finance companies, decreased significantly from 91 to 7. Thus, there are nowadays less but bigger financial institutions than before the crisis.

Third, the government explicitly encouraged foreign banks to participate more actively in the Thai financial sector in order to stabilize it and to promote technological upgrading (Okuda and Rungsomboon, 2006). Before the crisis, the bank licenses for foreigners were strictly limited as well as their range of activities which in effect limited the share of foreign banks at financial assets to five percent. Whereas this figure was almost unchanged over decades, foreign banks are now allowed to purchase some major stakes of local banks, to increase portfolio holdings in the financial sector (up from 25 to 49 percent) and to operate somewhat more unrestricted with their own entities.[2] Accordingly, foreign institutions have gained a market share of more than 15 percent and their influence on the Thai financial system is stronger than ever before.[3]

There are of course many more measures that could be reported here but the focus is not on crisis management (a more fully account is provided by Mullineux et al., 2003). Thus, we directly present the conclusion that the apparent way out of the crisis can be recognized from the new era of increasing credit volume which started in 2002 (see Figure 3). We take this as starting point to come to the longer lasting reform steps that have been taken since then.

IV. Recent financial system reforms

This section describes and assesses financial system reforms which have taken place during the last five years, i.e. since normalization after the crisis, and which are going to occur in the near future.[4] Most elements of these changes have been outlined in the financial sector master plan (FSMP) which was developed in 2002/03 and approved in early 2004. However, we organize our discussion according to the three elements of structural change introduced in Section II, i.e. Sub-sections IV.1 to IV.3, and add a Sub-section IV.4 on improved broad access to financial services as laid out in the financial sector master plan of 2004.

IV.1 Capital markets

The motivation for Thai authorities to promote the development of capital markets in the country was twofold during the last decade. First, it follows from the logic of long-term financial development as argued before (Levine, 1997); it is known in particular that the development of capital markets yields advantages in addition to that of banks (Levine and Zervos, 1998). Second, diversified financial systems are more stable in the presence of shocks. Accordingly, two “capital market development master plans” were set up, the first in 2002, spanning the period 2002-2005, and the second in 2006 to reach until 2010.

Shortcomings identified in plan I referred to the small size of Thailand’s equity market, the limited number of listed firms and thin trading volume. Several measures were taken to upgrade institutions and to make capital markets more attractive to issuers and investors. Seen from the outcome, the first plan’s initiatives seem to have been successful to some degree as respective quantitative indicators show. Figure 4 compares such indicators for the year 2000, i.e. the basis when the plan was set up, and the year 2005, i.e. when the plan was fully implemented. Despite this obvious success, much of the change was more or less a return to the situation before the crisis when equity markets had a similar importance for firms finance. Consequently, it is plan II, presently under implementation, which aims for a more comprehensive progress.

A major thrust of this plan is to reach beyond equity market development. Although the Thai bond market has gained some volume after the crisis, this reflects a rather involuntary development as public budget deficits had to be financed (whereas there was rather a surplus before the crisis). Consequently, the focus is on the development of a corporate bond market whose size is less than 15 percent of the equity market. A second focus aims for increasing the share of individual investors in the bond market which is seen as a cause of low liquidity (institutionals hold more than 70 percent). This is mirrored by a third focus, i.e. to increase the low share of institutional trading in the equity market and thus to reduce the relative importance of individual investors. Presently, institutional trading is 10 percent whereas individuals dominate with 60 percent (foreigners make up for the rest). Empirical studies show that individual investors tend to behave as noise trades (Brown and Cliff, 2005, and Schmeling, 2006, for the US and Germany, respectively). Finally, a fourth focus is to improve presently insufficient risk mitigation instruments.

Thai authorities have started training programs, have set tax incentives and have introduced further regulatory measures to realize these goals. To give a flavor about the decisiveness of policy measures, we note that—with respect to the above mentioned second focus of the capital market development master plan II—individual investors who trade on the newly created bond electronic exchange (BEX) will be exempted from the capital gain tax.

Whatever the outcome may be over the next years, we conclude that already now Thailand's financial system has become more diversified than ever during its recent history (Figure 5). The more balanced financial structure should positively contribute towards a more stable financial system which is able to better withstand shocks.

IV.2 Specialized financial institutions

The emergence of financial institutions beyond banks and capital markets is very typical for a country being at Thailand's stage of development. These institutions typically consist of specialized financial institutions (SFIs), which we address here, of non-banks, which are addressed later in the paper and of insurance companies which are beyond the focus here.

The recently increasing importance of state-owned SFIs in Thailand may be surprising given the fact that financial development goes along with a declining role of the state. The answer to this puzzle is simply that state interference tends to become more specific over time. So, the central bank does not directly lend to firms anymore and the role of state-owned commercial banks is decreasing. However, it is well accepted that there is a productive role of the state to provide certain services that are in the social interest but which are not automatically provided by the private sector. One possibility to provide such services is to run public SFIs which complement private financial institutions.[5]

Accordingly, Thailand's SFIs serve as a government's arm for the economic and social development as well as certain policy implementation agencies in order to provide financial assistance to specific sectors of the economy. With a wide range of services provided such as housing credits, credits to small and medium sized enterprises (SMEs), export-import credits or micro-credits, SFIs are able to reach various types of customers, particularly low-income groups who are unable to access the service of commercial financial institutions.[6] Further-more, SFIs also play a major role in helping the people being affected by all kinds of natural disaster.

The percentage of loans outstanding of the five major SFIs to total loans during the past five years (2001 – Q1 2006) has been growing from 17.5 percent to 20.3 percent. However, this increase is due to one-time effects and possibly marks an all time high. The one time effects are due to the Asian crisis which first damaged credibility of private institutions, second, the crisis caused a credit crunch which did not apply to the SFIs and, third, the late Thaksin administration implemented a series of new credit programs between 2002 and 2004. Consequently, there was some cooling off in SFIs loan growth during the years 2005 and 2006. Regarding SFIs role in saving mobilization, during the past five years, the ratio of deposit in five SFIs to total financial institution deposit increased from 16.0 percent to 17.5 percent. However, also here the rate stayed steady during the last 3 years.

After this phase of expansion, policy now aims to direct SFIs into a position where these institutions by and large follow the same general regulations as commercial banks do. The responsible ministry has set up a so-called "SFIs monitoring and reporting system" which requires SFIs to provide information in a similar manner and frequency as commercial banks (which are regulated by the central bank). As a last step of consolidation, SFIs are requested to further solve their NPL problem. Even though the overall NPL ratio of SFIs stood at 7.6 percent at the end of 2005 and thus rather below the average of financial institutions, some SFIs are well above 10 percent, signalling a need of action.

IV.3 Corollary institutions

At Thailand's stage of financial development, the introduction and refinement of corollary institutions can be expected and does, indeed, take place. We mention core institutions in this respect and discuss changes in the capital adequacy regulation in more details.

With regards to the creation and refinement of such institutions the Asian crisis served as a catalyst which has increased the speed of Thailand's financial upgrading (see more details in Table 1). Thus, the lack of information about credit granting to one borrower by several institutions has motivated the implementation of a *national credit bureau* in 2005. Regarding *deposit insurance* the full blanket guarantee of the government, that was necessary to stabilize the system in 1997, is going to be replaced by a partial deposit insurance in 2007. Another major step would be the introduction of the replacement of the commercial bank act of 1962 by the modernized and extended *financial institutions business act* (FIBA), whose implementation is still pending at the point of writing. The FIBA unifies the supervision of commercial banks, finance companies and credit foncier companies. It also covers the supervision of consumer loans of non-bank financial institutions. Moreover, it introduces rules of *corporate governance*, a field where international comparisons indicate a particular weakness of Thai financial institutions (Caprio and Levine, 2002).[7]

Finally, canonical banking regulation—in accordance with the Basle I and II framework—was implemented in several steps. It may be worthwhile to remember that Thailand had formally adopted the *Basle I regulations* already in 1993, i.e. before the outbreak of the Asian crisis. A positive consequence of this adoption was for example—in contrast to public perception—that Thai banks did not take high currency risks. However, the adoption was to some extent rather perverse as the less diversified finance companies were allowed to operate with a lower capital adequacy ratio than regular banks. Most importantly, implementation was weak as loan classification did not fulfill international standards. In consequence, too few loans were recognized (and classified) as non-performing which was no problem as long as banks and their customers could "grow out" of their problems. When, however, effectively non-performing loans could not be easily extended and expanded in the less advantageous macroeconomic environment of the years 1996/97, the effective mis-classification turned into a massive problem. It follows from this experience that the authorities already started in 1997 to correct the overly generous classification of problematic loans. It took until 2002, however, to bring classification rules in Thailand to the international level.

Another aspect is the required and effective level of regulatory capital. When the Basle framework was introduced, Thai authorities first set their required minimum capital ratio below the international level of 8 percent reflecting the obviously problematic situation of many Thai banks. However, it was made clear from the beginning that the aspired level would be 8.5 percent, signaling the objective of strongly capitalized institutions. The aspired level has been realized years ago; more surprising, commercial banks in the country reached a capital adequacy ratio of about 13 percent in the year 2006.

One reason for this capital buffer may be the introduction of the *Basle II regulations* in 2008/09 which is expected to increase required capital for Thai banks. In 2006 the central bank is expected to release appropriate guidelines for the banking sector to prepare. However, prudential regulation is only one among the seven areas of *Basle core principles*. There is still room for improvement with respect to consolidated supervision, to international financial reporting standards, to a general regulation of more complex derivatives and with respect to management and regulation of market risks in general. Authorities and practitioners are aware that the implementation may require years to become effective.[8]

IV.4 Access to financial services

As a final issue of financial system development, which cannot be directly related to stylized facts of structural change in development as outlined above, Thai authorities have emphasized "measures to broaden general access to financial services".

The motivation for this policy goal is twofold, to improve allocation efficiency and to address equity concerns. As mentioned above, Thailand—as many emerging countries did—has taken a somewhat dualistic path of development with a flourishing Greater Bangkok Area and other regions which are economically lagging behind. The resulting per capita income difference between Bangkok and remote areas is easily 1 to 10, whereas the income difference between rich and the poor areas in developed economies is much less.[9] This regional disparity is closely related to a gap between urban and rural areas and is also linked to distributional concerns in general, because rural regions tend to have lower incomes. Concerns have been fuelled by the fact that Thailand's income distribution has become more unequal (Krongkaew and Kakwani, 2003), although it is still far away from Latin-American levels of inequality (World Bank, 1993).

Beyond this equity concern, there is also a standard allocation efficiency argument in the sense that financial infrastructure is necessary to bring about best investment alternatives. Interestingly, Paulson and Townsend (2004) provide evidence for Thailand that financial constraints are stricter limitations to entrepreneurial activities in the less developed, rural North-East of the country than in the more developed Central region, where Bangkok is located. This means improving access to financial services could provide a double dividend.

The financial sector master plan suggests to improve financial infrastructure in three directions: first, to inform and support commercial banks in addressing low income households, second, to upgrade the Bank for Agriculture and Agricultural Co-Operatives (BAAC) into a fully-fledged rural development bank and, third, to support community financial organization, i.e. micro-finance institutions. These policies have been started but are not fully implemented yet. As another step towards broadening the access to financial intermediaries by supporting competition and to reduce the importance of informal moneylenders, one can see the operation of certain non-bank financial institutions as discussed in the next sections (which focus, however, more on urban areas).

Overall, recent reforms have brought Thailand's financial system into much better shape: the development of capital markets is under way, specialized financial institutions serve their role and will be "normalized" to some extent (integrated into "normal" supervision and reduced in relative importance), necessary corollary institutions have been implemented and broad access to financial services has been addressed. Nevertheless, due to the increasing international integration, further rapid growth and economic upgrading, requirements on the financial system are steadily increasing too. One of the particularly interesting fields is the role of non-bank financial institutions which we will discuss in the next section.

V. The role of non-bank financial institutions

Seen from the long-run development perspective, an increasing role for non-bank financial institutions (NBFIs) is a normal process reflecting the broadening and specialization of financial institutions. The fascinating aspect of Thailand's—but also of other countries'—present financial development is the dynamism by which such institutions flourish and the important policy issues that are raised. We discuss this from general to specific in three subsections.

V.1 Non-bank financial institutions

NBFIs in Thailand are defined as non-deposit taking financial intermediaries.[10] Their main purpose is the provision of loans and in this respect they have reached a considerable position in the market. At the end of 2005 the market share of all NBFIs—including finance companies, life insurance companies, the marginal credit foncier companies and as its core the biggest group of other general non-bank companies—accounts for 8.1 percent of total loans (total is 7,500 billion Baht, i.e. about 185 billion USD). Thus banks are still by far dominating with a share of 91.9 percent. However, this picture is misleading because NBFIs have much higher market shares in their fields of operation. The relative size of these fields of loan granting by non-bank businesses, each approximated by the respective suppliers of credit, is shown in Figure 6. Whereas leasing and hire-purchase companies provide loans of longer-term nature (usually 3 to 5 years), the three other kinds of companies—i.e. personal loan, credit card and factoring companies—provide rather short-term loans.

The reason for the rise of these NBFIs is threefold: first, there is a pull factor, as they operate in the gap being left by extremely risk-averse commercial banks after the Asian crisis. In this sense, they are dynamic forces competing with banks but without a licence (Rajan and

Zingales, 2003). Second, there is a push factor, as these loans tentatively overcome the strong reliance of the banking system on collateralized loans, collateral mainly provided by real estate (see Menkhoff et al., 2006). Instead, their rationale is based on other assets, such as durable consumer goods in hire-purchase, or income streams, as in their personal loan business. Third, NBFIs are tolerated to operate by authorities—despite a lack of consistent regulation—because they expand the available loan volume, in particular because they serve low income households which have less access to loans provided by banks and finally because they provide some competition to the established banking sector.

However, these reasons for the rise of NBFIs at the same time cause concerns. Due to their rapid growth NBFIs have reached a size where their failure may have severe negative external effects on the overall economy, which calls for an appropriate regulation of these financial institutions. Moreover, NBFIs compete with banks, so that there should be also from this angle a level playing field with regards to regulatory burden. It seems obvious that this unequal treatment should come to an end and, indeed, Thai authorities presently develop plans on how to regulate NBFIs. A reasonable benchmark could be the regular framework for banks, including the capital adequacy requirements, as NBFIs are financial intermediaries.

Beyond this aspect, there are further hopes and concerns linked to the rise of NBFIs which we discuss in the following with respect to personal loans.

V.2 NBFIs in the market for personal loans

In this section we describe the market for personal loans in Thailand and the role of NBFIs therein. Whereas some observers argue that NBFIs are beneficial by serving low income customers, others argue that interest rates are still very high and that these customers need protection.

Outstanding total household debt was about 2,000 billion Baht in 2004, 31 percent of this was personal loans. However, two thirds of these loans were secured and are often used for business purposes. The remaining one third of unsecured loans, which approximates typical consumer loans, was divided between banks and NBFIs at the shares of 80 to 20 percent. However, taking the number of customers instead of volume yields shares of 52 to 48 percent. Obviously, NBFIs are very important in this field, in particular for smaller customers.

Detailed information is provided in Table 2, where information is given on the distribution of income (among the so-called permanent income population) and their personal loans. The disaggregation of the loan statistics into banks versus NBFIs and in volume versus numbers provides further insights. The table shows that, indeed, NBFIs provide smaller loans than banks in all income groups and that this difference increases for the two richest groups. However, differences between banks and NBFIs are not so important up to an income level of 15,000 Baht per month. NBFIs even serve more customers in these groups. So NBFIs complement banks with respect to loan extension for lower income groups.

Another very interesting insight can be taken from the NPL figures. The last column in Table 2 shows that overall NPL rates (with respect to number of customers) are 5 percent on average. The NPL rate per volume is considerable with 8.9 percent (and slightly lower than financial sector average in 2004, see Figure 2). This figure becomes even more advantageous when the banks' largest customers are taken out and then falls to 6.3 percent. The disappointing performance of banks indicates already that NBFIs realize lower NPL rates than banks in comparable income groups (detailed figures not shown here).

However, there is also some downside to the NBFIs performance. First, one should not oversell the low income story as less than 25 percent of NBFIs customers are in the lowest income groups which represents 75 percent of the population. It would be thus interesting to compare the benefit of NBFIs not only with banks but also with SFIs which are intended to target low income groups. Second, interest rates are quite high in this business with roughly 25 to 30 percent p.a.; rates are even somewhat higher for NBFIs due to their business structure with smaller customers and loans. At the end of 2005, authorities set the maximum interest rate in this business to 28 percent p.a. Third, NBFIs contribute towards considerable loan levels. Table 2 reveals that loan volumes are in the order of two monthly incomes. This does not consider that many households borrow from several sources, such as various lenders or that households hold various forms of consumption loans (personal loans, credit card loans and hire purchase loans).

In particular high interest rates and cases of heavy borrowing have raised criticism and started a debate on consumer protection and macroeconomic consequences of possible misallocation.

V.3 The policy of personal loans

Personal loans have been by and large unregulated in the past so that the present debate has a quite fundamental character. We start our discussion with consumer protection issues.

Possibly the main public concern with regards to NBFIs' personal loans refers to the seemingly high interest rates of up to 28 percent which contrast with money market rates that only recently have risen to about 5 percent. There is no question that the interest rate margin of the personal loan business is very generous. However, this is not the same as indicating extremely high profits. Personal loans are characterized by a considerable amount of non-performing customers and—more important—operating costs are high because of low loan volumes and limited duration of loan extensions.[11] Nevertheless, the boom in this business and the entrance of banks, among them leading foreign banks, into it by means of starting non-bank businesses makes very clear that profit opportunities are very attractive.

Again, high interest rates and even high profits are not themselves a good motivation for public intervention as long as there is functioning competition in the market. It may be useful in this respect to change the perspective of assessment: many customers in the lower income segments choose between the newly established NBFIs and money lenders in the black market.[12] Although there are of course no official statistics on the latter business it is known from many surveys that they charge interest rates for small loans that are easily as high as 50 percent p.a.—the most often mentioned figures are even about 10 percent per month. These figures have been compiled in order to assess the usefulness of microfinance institutions which often charge interest rates of about 20 percent p.a. However, because many microfinance institutions are financially supported, it is not fair to take their nominal interest rates but their cost-based interest rates which are rather at the order of 30 percent (in lower inflation environments). We conclude that interest rates of Thai NBFIs are not generally overly high.

There are, however, serious problems due to an insufficient financial education of consumers who have problems to recognize effective interest rates and to correctly anticipate intertemporal payments. Accordingly, there is the suggestion that loan suppliers should indicate the effective interest rate including all charges (and not simply flat rates). A related problem refers to hidden charges in case of repayment problems which should be made transparent and which should be limited to fair amounts. With regards to the total debt burden that is often difficult to assess appropriately for uneducated customers, a regulation has limited personal loans to a maximum of 5 times monthly income (since end of 2005). However, any such regulation can be only a very rough guide as the repayment ability of customers depends only partially on income but also on wealth, prospects and existing obligations. It would be thus better to support suppliers in this sector to advance modern technologies in calculating reasonable financial burden. Whatever measure is taken, it would be always advantageous that information about borrowers is centralized so that different loan suppliers can get information about total obligations of their customers. This requires expanding existing credit bureaus to the field of personal loans and other fields of NBFIs as well.

The policy debate on personal loans has a second component too, i.e. possible macroeconomic effects. There is a concern that lending might be too much focused on consumer loans and thus neglect financing of true entrepreneurial activities. This is a well-known theme from many developed economies, such as the US in particular, and an assessment is equally difficult to make for the Thai case. This difficulty is not at least caused by severe information deficits: first, there is no solid information on how personal loans are used by borrowers—it is known that some of these loans have investment character, either for educational purpose or for short-term small enterprise financing. Second, there is some difficulty in assessing an appropriate level of household debt, one part of which is personal loans. Seen from the perspective of Malaysia for example, the Thai level of household debt with 33 percent to GDP is low as Malaysia has 63 percent. Third, household debt can have various reasons. In Thailand, housing loans make slightly above 50 percent of total household debt which seems to be rather low in comparison to other countries, indicating that consumer loans are rising possibly too fast.

Overall, personal loans have gained a volume during the last years that calls for policy action. There is no doubt that a better consumer protection and an extension of credit bureaus into this field would be helpful. Further measures beyond that need more careful study.

VI. Outlook

The recent reform of Thailand's financial system fits well into the long-term development pattern—nevertheless, it is a huge and ongoing task. Whereas most of the population has a monthly income of a few hundred US dollars and a few years school education only, some firms of the same economy compete with advanced products on the world market. Accordingly, financial system reform at the same time has to develop efficient micro-finance tools for remote rural areas, electronic bond trading and advanced Basle II risk management techniques.

In addition to this disparity at the cross-section there is much dynamism over time, due to Thailand's high growth but also due to consequences from its international integration. Two aspects of the latter are the introduction of bank regulation in accordance with the Basle II framework and strong US financial liberalization requirements derived from the Thai-US FTA (free trade agreement). Both developments—growth and qualitative upgrading—put heavy strain on human resources. If we consider that even in the leading economies' financial regulators tend to lag behind the dynamic private sector, the precarious situation of Thai authorities should become obvious. It seems thus a natural consequence in order not to overstrain resources that complexity is reduced wherever possible. We discuss a few aspects of such a policy stance.

First, it seems highly advisable to further implement the suggestion of the financial sector master plan to "rationalize the structure of financial institutions". Whereas finance companies and credit foncier firms have to become either commercial or retail banks, there seems to be room for streamlining SFIs and for integration of NBFIs into the field of other financial intermediaries.

Second, despite much sympathy for capital market development, authorities might keep in mind that it is less so the kind of institution that matters but its quality (Levine, 2002). Moreover, developing economies rely more on—and benefit more from—banks than on capital markets, so that incentives should reflect these economic benefits (Tadesse, 2002).

Third, the rise of SFIs calls for consolidation and for better integration into conventional supervision.

Fourth, it's a standard lesson learned that regulation should precede liberalization (Villanueva and Mirakhor, 1990, Obadan, 2006). The preparatory steps to be taken before Basle II should be effectively introduced which will help provide a natural benchmark for the effective state of financial sector development.

Finally, there is no good economic reason why NBFIs are not regulated as other financial intermediaries. With presently missing appropriate consumer protection one might rather ask for tighter regulation than for effective promotion of these institutions.

Given these aspects, the many more issues discussed before and Thailand's position as an emerging economy, it is no surprise that another high ranking financial system reform committee has been set up in 2006 to steer the ongoing process of financial system reform.

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[1] Thailand's GDP per capita in 2005 of 2,600 USD puts it well in the range of middle income economies, i.e. 880 to10,700 USD. However, the Greater Bangkok Area alone has more than 10 mill. people (out of 63 mill.) and an average income that is about three-times the country average, yielding 80 bill. USD. This is comparable to the Czech Republic or Hungary, just to mention respective figures for comparison.

[2] For the first time, foreign banks were allowed to buy into existing, country-wide operating Thai commercial banks. DBS of Singapore bought into Thai Military Bank, Standard Chartered of UK bought a failed Thai bank, ABN Amro bought into Bank of Asia and sold this stake later on to UOB of Singapore and GE Capital recently bought into Ayudhaya Bank.

[3] The 15 percent only reflect the operation of foreign subsidiaries and the two "Thai" banks being wholly controlled by foreign banks. In addition, there are major stakes at two further commercial banks that go far beyond portfolio investments, there is increased foreign ownership at the other banks (which reaches the allowed maximum of 49 percent at the two largest private Thai banks) and there are four foreign retail banks being established in 2005.

[4] We have argued before that "normalization" may be recognized from NPL being back to the pre-crisis level and the return to credit growth.

[5] The widespread and well justified scepticism against state-owned financial institutions refers to such institutions providing general financial services in competition with private intermediaries (see La Porta et al., 2002). Beyond that argument, however, state interference in the financial sector can play a very positive role as the example from Korea shows (Demetriades and Luitel, 2001).

[6] SFIs consist of the Bank of Agriculture and Agricultural Cooperatives (BAAC), the Export-Import Bank of Thailand (EXIM), the Government Housing Bank (GHB), the Government Saving Bank (GSB), the Islamic Bank of Thailand (ISBT), the Secondary Mortgage Corporation (SMC), the Small Industry Credit Guarantee Corporation (SICGC) and the Small and Medium Enterprise Development Bank of Thailand (SME Bank).

[7] Further reforms refer to modernizing and streamlining "supportive" regulation, such as foreclosure law etc.

[8] Insufficient capabilities to manage market risks are seen as a major cause for the failure of Thai banks in the Asian crisis (Menkhoff, 2000). A credit file study shows, moreover, that also the management of credit risks could have been better (Menkhoff and Suwanaporn, 2006).

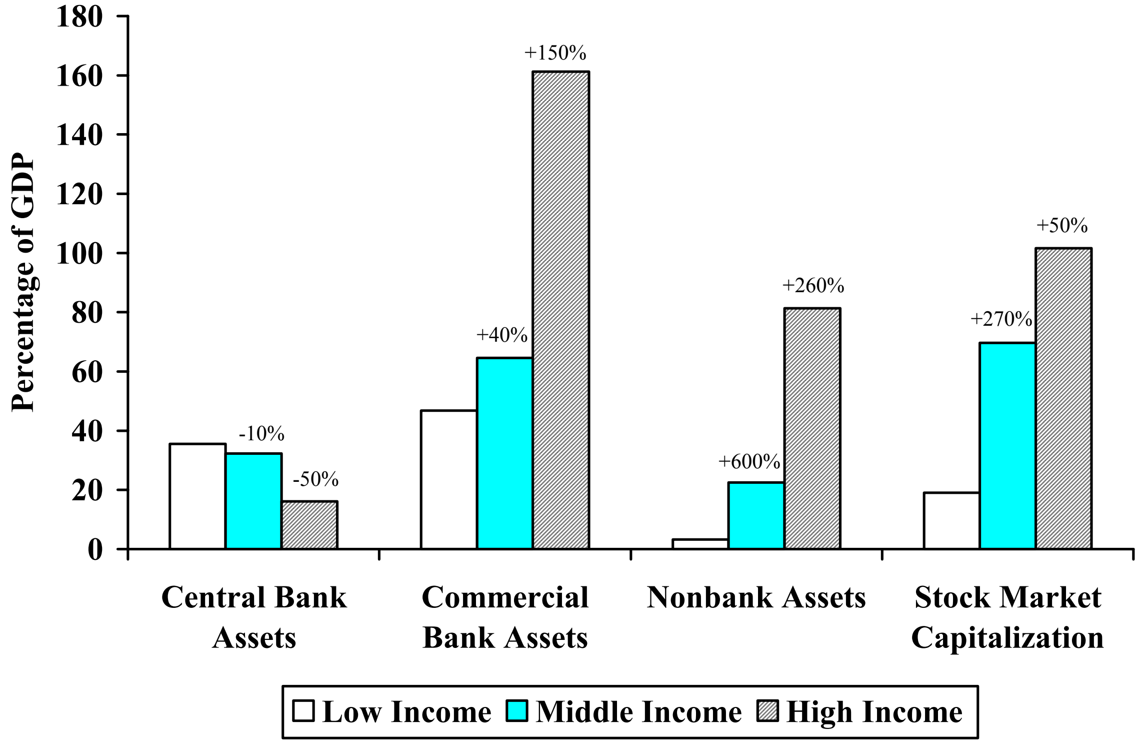
[9] For example, the per capita income difference between the richest and the poorest German state (out of 16) is less than 2.

[10] Some countries limit NBFIs to non-deposit taking institutions only for current accounts, other countries use definitions that may include institutions taking deposits but not credit services, such as postal saving institutions in the USA or Japan.

[11] It may be noteworthy in this respect that a NPL rate of 8.9 percent in this field has a different economic meaning from the same figure at commercial banks because personal loans reflect new business whereas the NPL of average loans is still a burden of the crisis.

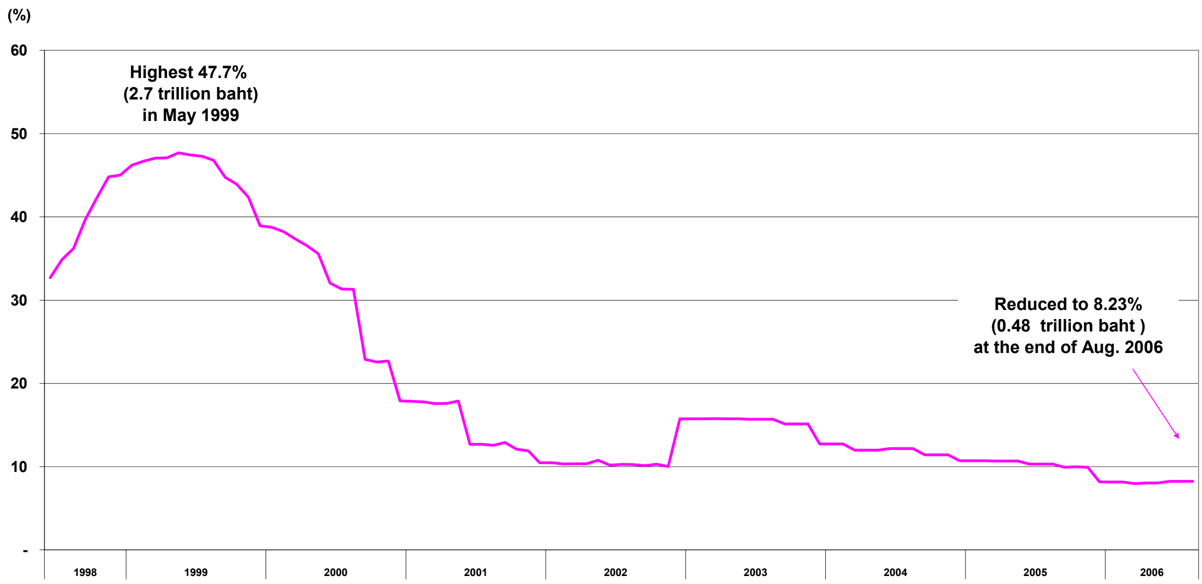
[12] The importance of money lenders in Thailand is documented e.g. in Siamwalla et al. (1990) or Kaboski and Townsend (2005).

Figure 1. Change in financial structure depending on income



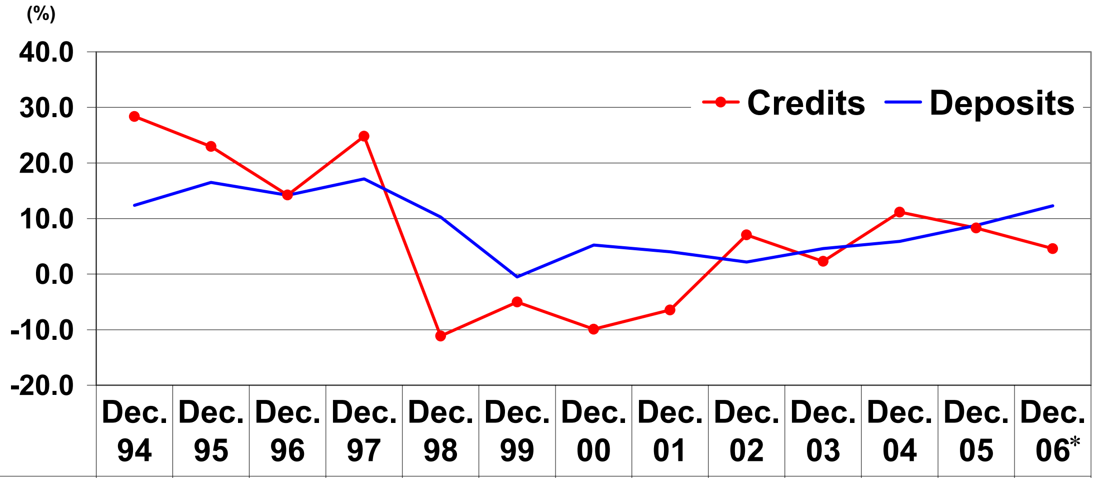
Note: Percentage figures give changes from low income to middle and high income respectively.
Source: Levine (1997).

Figure 2. NPLs to total lending ratio in the Thai financial system (1998 - 2006)



Notice: Since January 2006, "Commercial banks" are commercial banks registered in Thailand that have included the NPL of public and private commercial banks.
Source: Bank of Thailand

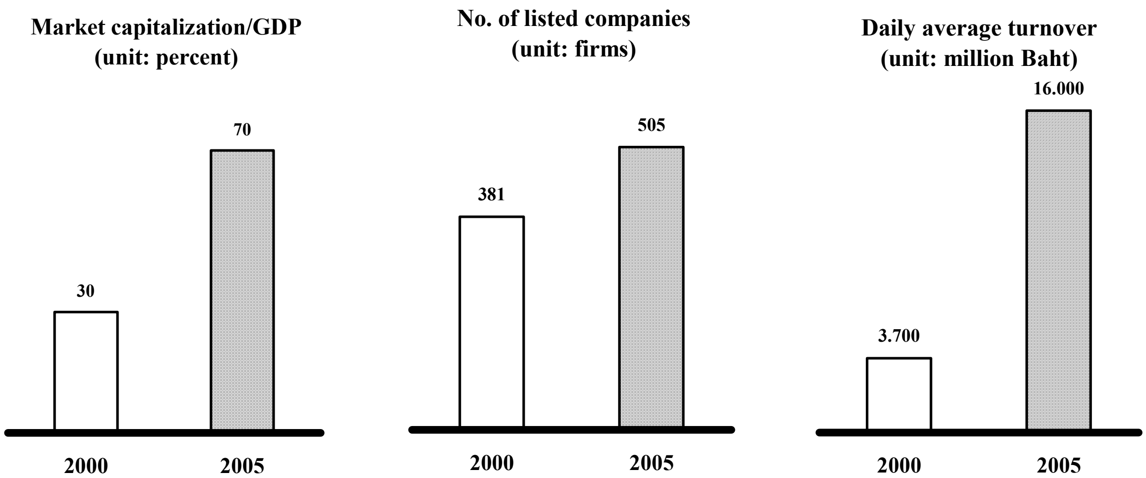
Figure 3. Changes in credits and deposits of the banking system (YoY)



	Dec. 94	Dec. 95	Dec. 96	Dec. 97	Dec. 98	Dec. 99	Dec. 00	Dec. 01	Dec. 02	Dec. 03	Dec. 04	Dec. 05	Dec. 06*
Credits	28.4	23.0	14.2	24.8	-11.2	-5.0	-9.9	-6.4	7.1	2.3	11.2	8.3	4.6
Deposits	12.4	16.5	14.2	17.1	10.3	-0.5	5.2	4.0	2.2	4.6	5.9	8.8	12.3

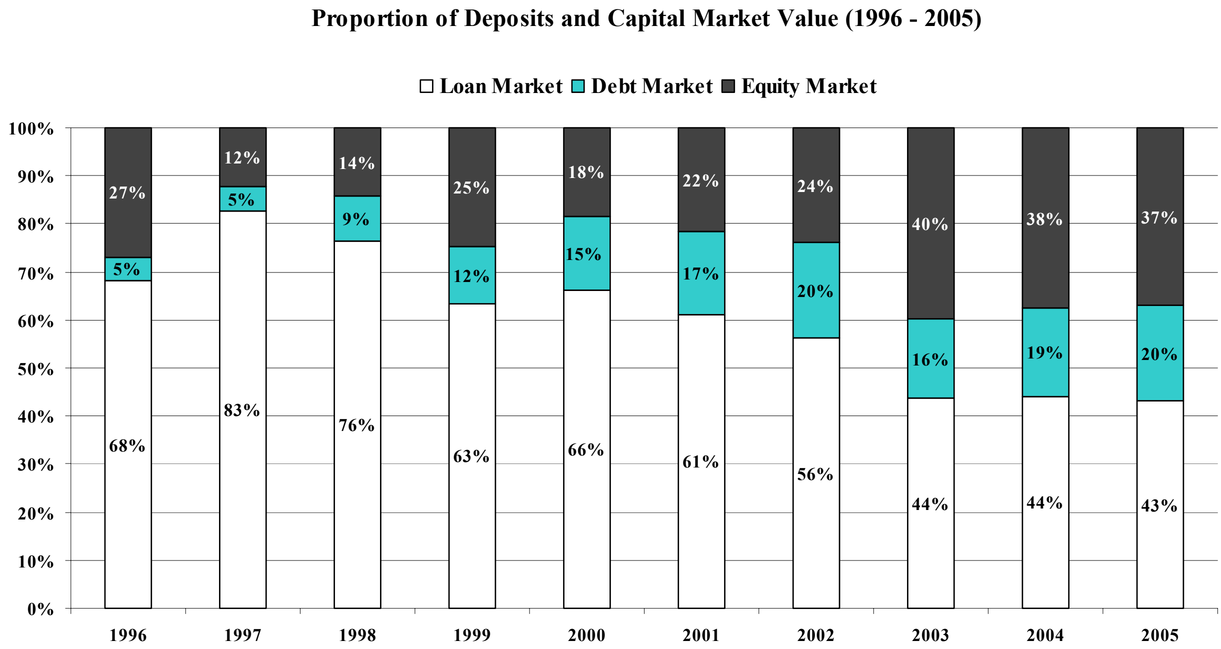
* estimated values, calculated by linear transformation
Source: Bank of Thailand

Figure 4. Comparison of Thailand´s capital market situation over time



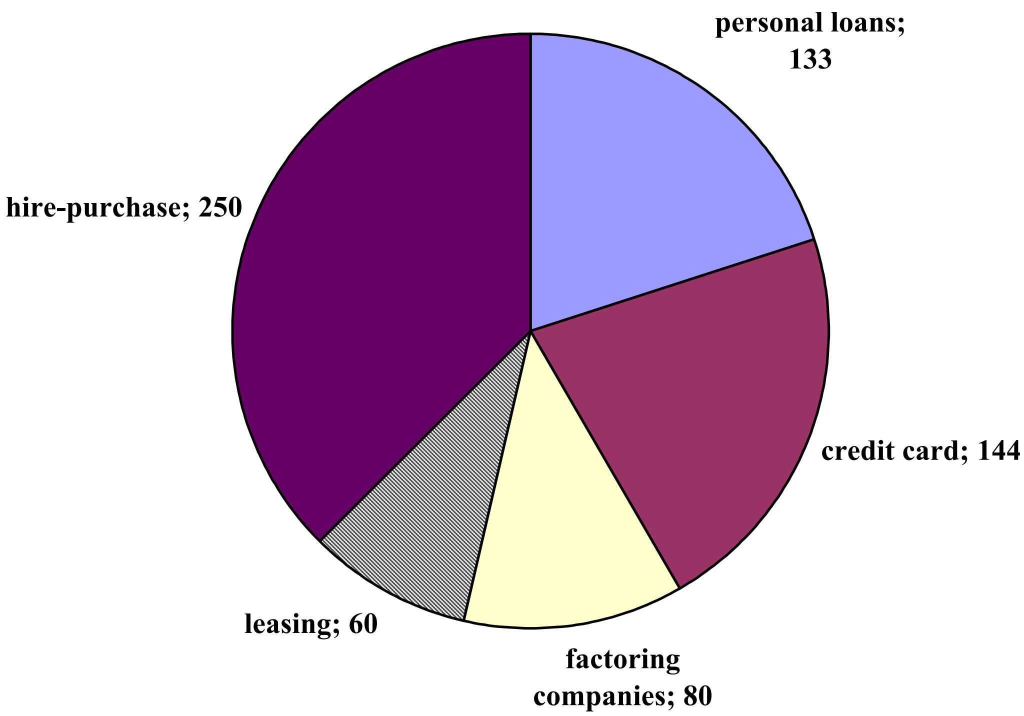
Source: Securities and Exchange Commission

Figure 5. Market shares of loans, bonds, and equities



Source: Bank of Thailand

Figure 6. Relative importance of the NBFI's fields of operation (values in bill. Baht)



Note: In the fields of personal loans and credit cards banks have a market share of roughly 50 percent.
Source: Fiscal Policy Office, Ministry of Finance

Table 1. The introduction of corollary institutions

Year	Institution	Further information
2005	National Credit Bureau	Merger of the two credit bureaus that were started in 2003 by the Thai Bankers Association (focused on firms) and by the Government Housing Bank (focused on individuals) respectively.
2004	Real Estate Information Centre	An independent unit within the Government Housing Bank to make property data (including transactions) available to the market.
2007	Deposit Insurance Agency	To be introduced in 2007
since 1998	Foreclosure law, bankruptcy law	Ongoing changes: from almost no protection of debtors and creditors to some. The foreclosure law is still regarded as debtor friendly (too time-consuming to realize collateral). The bankruptcy law is still regarded being biased in favor of debtors (creating delays).
1999	Thai Institute of Directors	To improve corporate governance practices, for example through educational programs. The government also supported the creation of the Federation of Accounting Profession (standardization and code of conduct).

Table 2. Personal loans according to income groups

Income groups	Population[1]	Personal loan volume		Personal loan customers		NPL rate
		volume bill. Bath	share of NBFIs	thsd.	share of NBFIs	total customers
<7,500 Baht[2]	75%	10.4	40%	840	49%	6.8%
7,500-10,000	15%	12.7	46%	837	59%	6.0%
10,000-15,000		17.3	43%	720	50%	5.0%
15,000-30,000	8%	26.8	33%	706	45%	3.4%
>30,000 Baht	2%	108.8	9%	632	38%	4.0%
	100%	176.0	21%	3,734	49%	5.2%

1) This distribution covers 11.7 million people in the year 2004. Self-employed make up for another 12.3 million people. Source: National Statistical Office
2) The lowest income group of loan statistics reaches to 7,000 Baht (instead of 7,500 as for the income statistics) only.

Source: Fiscal Policy Office, Ministry of Finance