

Why did the prudential policy in Thailand during 1985-1997 lead to the financial destabilization?

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A landmark reform of the prudential policy in Thailand started in 1985. However, the new policy led to the financial destabilization in 1997. This paper aims to reveal the mechanism of how the policy resulted in unexpected outcomes and thereby to demonstrate the role and features of the prudential policy in Thailand.

According to this paper, the prudential policy in Thailand is considered characteristic in the following respects. Firstly, the Bank of Thailand (BOT) is the major enforcing agency of prudential policy in Thailand. After three laws (Bank of Thailand Act, Commercial Banking Act, Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business) were revised in 1985, BOT became the supervisor and de facto regulator for private financial institutions. Secondly, while pursuing prudential policy, BOT had to take commercial banks into consideration in order to obtain their cooperation in implementing monetary policy for national economic growth. This is one of the reasons why BOT did not enforce strict rules against the financial companies related to commercial banks. Thirdly, the prudential policy had been pursued to maintain the credibility of the domestic financial market, especially in the eyes of foreign investors. Prior to the economic bubble bursting in 1996, the purpose was to attract international funds to underpin national economic growth. After 1996 BOT attempted to stop the outflow of international short-term funds. For instance, BOT did not order capital reductions for insolvent banks.

The first feature of the prudential policy is peculiar to Thailand. The second and third ones are unique to developing countries where financial authorities tend to pursue economic growth rather than financial stability. These features prevented BOT from enforcing strict rules against financial institutions, and thereby led to the severe destabilization of the financial system in Thailand in 1997.