APEC and Specialized Financial Institutions:

The Influence of 'Thaksinomics'

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Abstract

Leaders of member economies chair APEC in rotation, and some allow domestic politics to influence its agenda. Recent examples demonstrate positive and negative outcomes of such influence. Mexico introduced microenterprise development and 'microbanking' to the APEC agenda in 2002. This produced useful outcomes consistent with APEC liberalization principles. Thailand placed 'specialised financial institutions' (SFIs) on the agenda for 2003, but used APEC to promote financially-repressive policies associated with 'Thaksinomics' (a set of economic principles espoused by Prime Minister Thaksin Shinawatra). A Thai study of SFIs published by APEC endorsed their engagement in 'industry policy', endorsed SFIs that prop up protected industries on grounds of 'multi-functionality' and endorsed SFIs providing subsidized credit. Domestically, Thaksinomic policies of 'easy money' may have damaged Thai government banks and eroded the rural credit culture. Internationally, APEC'S Economic Committee may have been diminished by this episode while Mexico's useful initiatives of 2002 have probably been denied reinforcement.

Keywords

APEC, Thailand, Thaksinomics, Thaksin, Microfinance, Specialised Financial institutions

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1. Introduction: the nature and culture of APEC

Asia-Pacific Economic Cooperation, or APEC, is an intergovernmental grouping established in 1989 to facilitate economic growth, trade and investment, and capacity- and community-building, in the Asia-Pacific region. The paper draws attention to the influence upon APEC of domestic political agendas, and in particular the domestic politics of the incumbent APEC Chair. It provides an example of both positive and negative outcomes of APEC's work, in cases where strong domestic agendas were in play. Positive results occurred in 2002 in the related sectoral areas of 'microbanking' and microenterprise development (MED). These were placed on the APEC agenda by Mexico, as the then chair of the APEC process. The relevance of these activities to APEC lay in their capacity to advance its goal of facilitating Asia-Pacific economic growth in a framework of 'shared prosperity'.

In the case of Thailand discussed in this paper, negative outcomes arose in 2003 due to a particular feature of the APEC process. That feature is the difficulty of securing policy continuity and relevance in an institutional culture based on consensus decision-making and voluntary participation. The paper contends that, under Thailand as Chair of the process in 2003, APEC missed an important opportunity to advance the constructive work of Mexico. Thailand could have reinforced APEC's concern for sharing prosperity in the face of globalisation, through the further promotion of microbanking and MED. Instead the Thaksin government was permitted to capture an important APEC forum for the purpose of validating and promoting its financially-repressive domestic policies. That this was possible is due to the nature and culture of APEC as an institution.

The APEC process operates on a basis of open dialogue, with decisions made by consensus and with members making commitments on a voluntary basis. APEC has 21 'member economies' located on and within the Pacific Rim. These account for more than a third of the world's population, over 50% of world GDP and some 41% of world trade. Central to achieving APEC's vision are the so-called 'Bogor Goals' of free and open trade and investment in the Asia-Pacific region. However APEC is a multi-faceted process. The member economies engage in policy coordination and cooperative activities at the official and ministerial levels in a wide range of sectors, from environment to telecommunications and from fisheries to financial systems.

These wide-ranging APEC activities are conducted in many fora, including working groups and committees composed of officials and representatives of industry, academia and civil society. The outcomes of these sectoral fora are reported to one or another of the APEC ministerial meetings conducted towards the end of each calendar year. In turn, the deliberations of these sectoral ministerial meetings are reported to the primary APEC deliberative body. This is the annual APEC Ministerial Meeting, attended by Foreign and Economic or Trade Ministers. The cycle culminates in an annual 'headline' event, the 'Leaders' Meeting', which is a quasi-summit of the APEC membership[1].

This paper draws upon recent work by a number of APEC sectoral working groups and committees. In particular it is based on the deliberations of the APEC Economic Committee (EC) and the APEC Small and Medium Enterprise (SME) Working Group[2]. The EC reports directly to the annual APEC Ministerial Meeting, while the SME Working group reports to the APEC SME Ministerial (with its outcomes filtered through to the APEC Ministerial by the SME ministers).

The reason for APEC's adoption of a culture of consensus and voluntarism, with the working processes which inevitably flow from such a culture, lies in its history. APEC's processes derive to quite a large extent from the organisational culture of ASEAN, the Association of South East Asian Nations. In 1989, the members of ASEAN were geographically and politically central to the nascent APEC's credibility as a bridge across the region and between developed and developed economies. Recruitment of the ASEAN economies to membership of APEC was thus crucial to its early success, and securing their participation required agreement on a set of procedures congenial to them. A culture of consensual decision-making and mutual respect has its considerable strengths and virtues, but also some drawbacks, as this paper is intended to show.

2. Some difficulties of leadership by rotation

The Chair of APEC rotates among member economies on an annual basis and each incoming Chair is subject to certain expectations and pressures. For example, on the international stage, the Chair of APEC Leaders must be seen to have advanced the APEC enterprise in terms of its fundamental goals and objectives. On the home front, each successive Chair is likely to seek some political advantage in the form of international endorsement for particular domestic policies. Moreover, the incoming APEC Chair may harbour ambitions for some form of regional or subregional leadership which might be advanced by a successful term at the helm of APEC. These considerations are relevant in considering the APEC Economic Committee process, which adopted the themes of 'microbanking' (under Mexico in 2002) and 'specialized financial institutions' (under Thailand in 2003). In each case domestic considerations appear to have persuaded the respective APEC Chairs, President Fox of Mexico and Prime Minister Thaksin of Thailand, to have these items placed on the EC's agenda.

The organizational culture of APEC implies that the incoming APEC Chair should be extended a fair degree of latitude by the member economies in regard to choice of agenda and themes for the coming year. However, while the desire of each chairing economy to put its distinctive stamp on proceedings is conceded, it is necessary for the Chair to demonstrate its proposals are both consistent with APEC's primary goals and logically related to its ongoing agenda. Getting this right can be tricky in an assembly whose culture is one of mutual respect and consensual decision-making. Should a new Chair be permitted to lead APEC down a policy *cul-de-sac* there are penalties to be paid, including loss of credibility, failure to engage some or even most members, and a consequent loss of momentum for the APEC process as a whole.

The costs of short-sighted leadership are likely to be greatest in the core APEC areas of trade and investment liberalization and facilitation (TILF) and economic and technical cooperation (ECOTECH). However, there are also potential losses due to failure in any of the many sectoral strands of APEC's complex agenda. This paper contends that, in one such sectoral area, Thailand did indeed lead APEC down a dead-end street in 2003. This occurred in regard to Thailand's sponsorship and conduct of the study of 'specialized financial institutions' (SFIs) within the Economic Committee process during that year. In doing so Thailand diminished the relevance of the Economic Committee to the broader APEC process, as well as detracting from the important microbanking and MED initiatives taken by its predecessor, Mexico.

3. Domestic Agendas: Mexico (2002) and Thailand (2003)

In 2002, President Fox of Mexico was struggling to deal with domestic economic dislocations, principally in smallholder agriculture. These were caused, *inter alia*, by Mexico's accession to NAFTA. His government saw MED as a policy measure to ameliorate the domestic costs of adjustment, and sought endorsement of this goal through the Small and Medium Enterprise (SME) Ministerial process. MED was acceptable to the broader APEC membership as a means towards 'shared prosperity' (a goal expressed in the APEC Leaders' *Shanghai Declaration* of 2001). In addition, Mexico saw 'microbanking' as a necessary complement to MED, and pursued this topic through the APEC Economic Committee.

In August 2002, the annual meeting of APEC Ministers responsible for SMEs received the report of a Mexican-sponsored 'High Level Meeting on Microenterprises' (APEC 2002a) and endorsed microfinance as 'a sustainable development tool'. The ministerial communique (APEC 2002b) endorsed principles for microbanking institutions that eschew operating subsidies and place emphasis on commercial viability in a rigorous supervisory and regulatory environment. It reads, in part,

> 'Ministers recognized the importance of micro-finance as a sustainable development tool for micro-enterprises. Ministers took note of the performance of Bank Rakyat Indonesia's micro-financing system, which provides an extraordinary example of a commercially viable approach that succeeded during an exceptionally severe economic crisis.
>
> 'Ministers welcomed the recommendations to (1) develop an appropriate risk based regulatory framework for the commercial microfinance industry; (2) incentivize banks and financial institutions to enter the business of microfinance; (3) provide incentives, training and rewards to commercial institutions that demonstrate excellent performance; (4) limit microfinance subsidies to activities that disseminate information, develop financial tools, and train managers and staff; (5) provide capacity-building initiatives for the most promising institutions entering the micro-financing market; (6) and share lessons across APEC regarding the transformation of non-governmental organizations to commercial microfinance institutions'.

Similarly, the Economic Committee's report on *Microbanking Regulation and Supervision,* endorsed at the 2002 APEC Ministerial Meeting, set out principles for financial sector development designed to increase the outreach of financial services to microentrepreneurs (APEC 2002c). It is significant that consideration of 'microfinance' by the SME Ministerial process and of 'microbanking' by the EC process both produced policy recommendations wholly consistent with APEC trade and investment liberalization, of which financial sector liberalization is an intrinsic element[3]. Under Mexican leadership, APEC's work on microbanking and microfinance was inspired by a body of internationally-agreed best practice principles for these activities. These principles are defined by practitioners and donors under the aegis of CGAP, the World Bank's Consultative Group to Assist the Poorest[4].

In the case of Thailand, the Thaksin government was elected early in 2001 on a populist platform promising to reduce poverty levels and to accelerate recovery from the Asian economic crisis. The new government was pledged to implement a one million baht (about $24,000) revolving credit fund for each of Thailand's 77,000 villages, to create a 'People's Bank' for grassroots lending and to declare a three-year debt moratorium for farmers. As well, it was about to commence the broader program of pump-priming and consumption-led growth stimulated by cheap credit which has come to be known as 'Thaksinomics'[5].

The Thai initiative for a study of SFIs was represented to the APEC Ministerial meeting at Los Cabos in October 2002 as an extension of the microbanking study piloted by Mexico. In fact, the Thai proposal appears to have been designed primarily to validate and promote Thaksinomic policies of subsidized credit and state-directed 'policy lending'. Thus, on his departure from Thailand for the Leaders' Meeting in Mexico late in 2002, Mr Thaksin was quoted as saying, perhaps with a degree of exaggeration, that

> Every APEC member country now wants to hold talks with us since they are interested in Thailand's method of problem-solving, especially through micro credit, village funds, the people's bank, grassroot-level solutions and internal economic support (Bangkok Post 2002).

The Mexican initiatives on MED and microbanking were consistent with APEC's agenda and objectivess. This paper contends that, by contrast, the Thai-sponsored study of 'Specialized Financial Institutions (APEC 2003a) was far from being an 'extension' of Mexico's microbanking study. Instead, it advocated an abrogation of the principles of sustainability and commerciality in microbanking endorsed by the 2002 APEC Ministerial Meeting. Further, the study's premises were contrary to APEC's liberalization principles, and especially to the commitment to progressive liberalization of domestic financial systems. Ultimately it failed for that reason.

Evidence of failure is found in limited support for and participation in the study by APEC member economies and faint praise given it by the Chair of the EC (APEC 2003b). The flawed and contradictory logic of the report itself, and the nature and extent of qualifications edited into it, provide further proof**.** These matters are discussed below, in section 9. Unfortunately, the study's failure, or at best irrelevance, may prove to have diminished the significance of the Economic Committee and its annual *APEC Economic Outlook* publication, which has been regarded as a flagship document of the APEC progress. These negative outcomes will occur insofar as the EC process is seen to have been compromised. Further, the conduct and dissemination of this flawed study by APEC may have contributed to undermining the constructive Mexican initiatives of 2002 in the fields of microbanking and MED.

4. Thailand's proposal for a study of SFIs: background and rationale

Thailand's proposal for a study of Specialized Financial Institutions (SFIs) was presented to the Economic Committee at its meeting at Acapulco in August 2002. The study was represented as deriving its rationale from the experience of the economic crisis from 1997. Its adoption by the EC meant the study would appear subsequently as the 'structural' chapter in the *2003 APEC Economic Outlook (APEC 2003a)*. The proposal (Thailand, 2002a) asserted that in Thailand, during the crisis,

> '…. state-owned commercial banks together with specialized banks played major roles in supporting the development of real sector and grass-root economy when normal lending seemed to be [nonexistent].
>
> 'This situation has occurred in several APEC economies, especially the developing economies during the crisis period. History has proven that the current market situation, especially in developing economies, is not the perfect competition [sic]. Private sector could not be in charge of all activities required by the society. In many cases, *specialized financial institutions, which are underwritten by government*, are required to fill in those gaps [emphasis added].

> 'We strongly believe that the APEC Economic Committee should place more emphasis on the linkage between the banking sector and social sector which has proven to be an important aspect of economic infrastructure…..'

The underlying assumption of the Thai proposal appeared to be that private sector financial institutions would be unable to provide services, especially credit, under circumstances such as those of the financial crisis and the subsequent economic recovery. Since market forces could not be relied upon, it was presumed necessary for the state to create and/or underwrite SFIs in order to achieve the necessary 'linkage between the banking sector and social sector'[6].

The Thai proposal represented SFIs as a necessary element in the domestic financial architectures of APEC economies and put the case for exploring the various institutional models and regulatory regimes to be found within APEC. Indeed, since the onset of the Asian crisis in 1997, APEC has given considerable attention to both domestic and international financial architectures and to the need for compatibility between them. APEC's overriding objective is the reduction of barriers to international transactions, including financial transactions. A corollary of this is the need to increase the capacity of the financial systems of member economies to withstand external shocks and domestic financial disturbances. An important issue which arose, therefore, from Thailand's exploration of SFIs in the APEC context was whether their operation is consistent with the liberalization of APEC financial systems. No such ambiguity arose in the case of 'microbanking', championed by Mexico the previous year. However, as argued in this paper, the 'APEC-consistency' of Thailand's treatment of SFIs is open to serious question.

A revised version of the Thai proposal was circulated in October 2002 (Thailand, 2002b) and clarified the scope and intent of the study. From this it was apparent that Thailand proposed an extension of the SFI concept well beyond the simple 'linkage between the banking sector and social sector'. SFIs were described as aiming to provide 'various forms of financial assistance to certain sectors of the economy', and in particular 'a source of funds for specific potential customers'. The sectors involved could range from agriculture and the microenterprise sector to SMEs, real estate and housing, exports, water supply, asset management, savings and public sector project finance. More generally, the concept of the SFI was to include financial services to 'help alleviate social problems'. In principle, SFIs might be government-owned or sponsored, or they could be 'independent' and 'self-sufficient' institutions. They could have a specific legislative and regulatory framework, separate from that of the commercial banking system, and could be subject to their own supervisory agencies and prudential standards. The study would be intended to set out principles for the establishment, support, operation and supervision of SFIs.

As models, the document described eight SFIs operating in Thailand. Some of these (the government savings bank, GSB, and the rural development bank, BAAC) were engaged in 'microbanking', which provided a degree of continuity with the Mexican-inspired study of 2002. But others were far along the financial spectrum away from the 'micro' end (for instance, the export-import bank, EXIM, the industrial finance corporation, IFCT and a mortgage securitisation entity, the SMC). In between there was a group of institutions catering to small industry and low- or middle-income mortgage borrowers, none of which could be described as microbanking institutions or as catering to microenterprise. In this grouping of institutions it is difficult to discern any common purpose of 'linking the banking sector and social sector'. Instead we see the revised proposal's rather vapid characterisation of them as 'help[ing to] alleviate social problems'. Since this formulation could be applied properly to almost *any* institution constituted for a legal purpose, it has no analytical content.

The eight SFIs listed were (as the Thai proposal described them) 'government-sponsored financial institutions *that make loans in the interest of public policy'* [emphasis added] and were set up under special legislation or royal decree. All were subsidized by government and were said to target the underprivileged and 'grass roots' people. All were under the regulation and supervision of the Ministry of Finance rather than the Thai central bank. All shared the objective of addressing particular gaps in the financial services market in Thailand, on the assumption that the market itself would not provide the particular services required, or at least not in sufficient quantity and on 'reasonable' terms. In regard to these Thai institutions the question must be asked: how relevant were they as models for other APEC economies? And how consistent were their operations with the liberalization principles underpinning APEC itself?

5. Categorising APEC financial systems: Are SFIs relevant and appropriate?

The main problem in attempting to conduct the SFI study across the full range of APEC economies was how to generalize the issues to show relevance to all. This was because of the diversity of the financial sectors concerned, and their differing levels of development. For the purposes of this paper one might distinguish three broad categories of financial systems within APEC. These are the developed, the developing and the transitional.

The 'transitional' category, which includes China and Vietnam, is where SFIs remain most significant. There financial repression and policy lending are still important elements in financial systems. Briefly, financial repression is the imposition of policies, laws and regulations on financial markets which distort financial prices and inhibit the operation of financial intermediaries, while policy lending is the allocation of capital according to political rather than economic criteria. In China, for example, as recently as 1994 SFIs such as the Agricultural Development Bank of China (ADBC), were established to enable older state banks to move to a more commercial mode of operation. In that sense, SFIs might be regarded as a necessary, if temporary, element in modernising the banking system in the PRC. In Vietnam, state institutions such as the Vietnam Bank for Agriculture and Rural Development retain strong 'policy' functions. A new SFI with a social mandate for subsidized lending, the Vietnam Bank for the Poor, was established as recently as 1995.

In the 'developing' APEC economies, including Thailand, systematic elements of financial repression remain, with varying degrees of continuing activity by SFIs. In these economies, despite acknowledgment of the value of deregulation and the acceptance of financial sector liberalization as an ultimate goal, there remain vestiges of earlier approaches to financial institutions and markets. These include credit guarantees and insurance, state participation in the capital and management of financial institutions, differential interest rates and cross-subsidies, and preferential rediscount rates and facilities furnished by monetary authorities at the behest of governments. Such activities tend to be financially repressive, as also are the activities of the SFIs that support them.

Finally, the 'developed' economies might be characterized as having largely abandoned specialized financial institutions, as defined by Thailand. An important qualification is that in certain APEC economies, most notably Japan, Korea and Chinese Taipei, SFIs persist as tools of 'industry policy', or as instruments to preserve so-called 'multifunctionality' in agriculture. However these are seen as anomalies by much of the international financial community and their continued operation requires increasingly strenuous justification on the part of the governments concerned. These matters are discussed in greater detail in section 9, below.

In the ‘developed’ economies, where financial liberalisation has proceeded furthest, the tendency has been for governments to discard those of their specialized financial institutions that were established primarily to achieve social goals. These governments have tended to reduce their own commercial activities in financial systems where these were judged to distort markets. They have concentrated instead on improving competition policy and consumer protection, refocussing the attention of regulatory agencies on prudential issues and seeking better coordination among agencies. And where SFIs had been designed to secure specific social benefits, such as for example, greater affordability of home-ownership for low income families, governments now tend to attempt to secure such objectives through direct budgetary expenditures[7].

Thus, in Australia, prior to financial sector deregulation and the process of internationalization which commenced in 1983 when the Australian dollar was floated, federal and state governments held substantial ownership stakes in a range of financial institutions[8]. These stakes were justified in terms of social, including competition, objectives. The operations of these institutions involved various degrees of subsidy, including cross-subsidy, and generally some form of direct government guarantee. Today, however, direct guarantees and support are much less significant. Cross-subsidies have been largely eliminated, due to the emergence of new and smaller financial institutions which have taken advantage of deregulation to invade profitable market niches which had enabled the older institutions to finance cross-subsidies in the past. Direct expenditures by government to achieve social ends have largely taken the place of credit subsidies and guarantees. Matching trends observable in other developed APEC economies, governments in Australia have largely withdrawn from ownership of financial service institutions.

6. Specialized Financial Institutions in the ‘Thaksineconomy’

We turn now to consider financial sector implications of certain Thaksinomic policies involving Thailand’s SFIs and state banks. These involve substantial subsidized credit initiatives which are ‘quasi-fiscal’, having been kept off-budget to avoid high ‘headline’ levels of deficit financing. Thaksinomics is concerned primarily with macroeconomic issues of recovery and growth, with poverty alleviation as an important subtheme. However, this paper is not concerned to evaluate its success in these fields. Rather its purpose is to examine the implications of Thaksinomics for financial sector development and to consider whether its use of SFIs and state banks is consistent with the APEC financial liberalization agenda. In particular, it examines the implications of Thaksinomics for neglected ‘bottom-end’ financial sector operations which are the province of microbanking, and to which APEC devoted constructive attention under Mexican leadership during 2002 (as described above in section 3).

Among the stimulus measures to which the Thaksin government was pledged on election in 2001 were, as previously mentioned, a wholesale moratorium on farm debt and a massive injection of spending power across the rural sector through a ‘village development fund’. These and other pump-priming measures are credited with contributing to the boom in consumer spending that supported economic growth in Thailand over the period 2001-2004. The debt moratorium involved either a three year suspension of repayments of principal and interest on smaller farm loans by BAAC (the state agricultural bank, the Bank for Agriculture and Agricultural Cooperatives) or interest rate concessions on loans that continued to be serviced. Take-up by farm debtors is said to have been almost universal. The three year grace period for borrowers will expire during 2004 and BAAC is said to have reservations about the likely repayment rate and to be preparing to reschedule loans as necessary[9]. The potentially damaging impact of the moratorium on BAAC’s balance sheet is discussed below, in section 8.

The village fund initiative involved grants of a million baht (about $24,000) to each of more than 70,000 communities, to be employed to set up revolving credit funds to finance micro-scale economic activities by lending to individuals. According to the World Bank, 'the individual credit limit is set at Baht 20,000 ($460) and the average loan size is about half of that. According to a [central bank] survey most of the loans (60 percent) are funding the purchase of intermediate inputs (such as fertilizer) and the rest are equally split between investment in small scale projects and refinancing of high-cost debt' (World Bank 2002). This money, equivalent to some $1.6 billion, was borrowed from an SFI, the Government Savings Bank, with principal and interest costs kept off-budget initially, to be brought into the budget over an eight year period.

The scope for politicization of such lending is obvious where decisions are decentralised to local authorities in more than 70,000 locations. A former Director-General of the Government Savings Bank was quoted in 2001 as warning that '[t]he Village Fund Programme must not be used to build up a political base for any politician but to empower communities…' (News in Perspective, 2001). There is much anecdotal evidence to suggest that the funds have gone as much to pay off other forms of rural debt or to purchase consumer durables as for investment purposes. The fungibility of the cash distributed prevents definitive tracking of its use.

The World Bank has commented on the difficulty of assessing the contribution of village fund lending to poverty alleviation, noting that 'take-up was larger in the Northeast' [Thailand's poorest region]… and '[p]overty rates among participating households are lower than non-participating households. However, from this evidence 'it is … impossible to tell the actual contribution of the Fund to poverty-reduction; it could reflect the fact that better-off households took out more village-fund loans' (World Bank 2003). Nor is much known about the repayment rate of loans received from the Village Fund; No report seen by the writer presents any conventional measure of loan portfolio performance for the village funds. Repayment is routinely reported as being around 97% or 98%, but the information available does not inspire confidence[10].

The Government has also employed the resources of the Government Savings Bank to create a new SFI, Peoples' Bank, which specialises in small lending in the range of Bt 30,000 ($680). These and other initiatives, to be discussed below, were intermediated through SFIs and the state banks at a cost equivalent to some 2.7% of GDP in fiscal 2001-2002, but not taken directly into the budget (IMF 2002). A more recent estimate of the scope and cost of these measures is provided by the IMF (2004). They include

- Credit for Small and Medium Enterprises from SFIs and state banks (about half from SFIs) totalling Bt 95 billion by February 2003, and equivalent to 1.9% of GDP
- Subsidised mortgages for public sector employees. Equivalent to 0.5% of GDP by 2/03
- Civil service retirees given the option to take lump sum advances on their retirement benefits
- Housing for the poor, with SFIs to finance the construction and purchase (at subsidised prices) of 0.6million houses. Another 0.4 million house purchases also to be financed by SFIs.
- Establishment of the Village Fund, costing 1.5% of GDP with the Government Savings Bank to be reimbursed over 8 years.

Most recently, total outlays on these credit-based fiscal initiatives are estimated to have cost between 5.5% and 6.1% of annual GDP over fiscal years 2002 and 2003, with SME lending accounting for around 2.7% (World Bank 2003).

As previously mentioned, much of this cost is in the form of interest rate subsidies which SFIs and state banks have been obliged to cover 'off-budget' as a matter of government policy. 'At the root of Thaksinomics is cheap money', as a journalistic commentary put it at the beginning of 2004 (Wang 2004). Thus farm borrowers from BAAC benefited from either an outright moratorium on their repayments, or a 3% concession, if they chose to continue servicing their debts. Similarly, borrowers from the village funds received loans at a 4% annual interest rate, compared with the 'commercial' rate available to borrowers of this class from BAAC of 5% to 8%[11]. And as mentioned above, substantial elements of subsidy exist in the housing, mortgage and SME financing schemes introduced since 2001.

7. 'Capital Creation': the Next Phase of Thaksinomics?

By the end of 2002, with the village fund fully disbursed and other stimulus measures underway, it appears the Thaksinomic project was preparing to enter a new phase of pump-priming. According to its most supportive foreign observer, (Lian 2003a), the government had exploited the consumption potential of the 'underleveraged' rural household sector, had raised rural incomes by stimulating SME activities and had begun to mobilize the unsatisfied housing demand of middle- and lower-income families. This had an undoubted benefit both in stimulating expenditure and in switching spending patterns. As he noted, '[t]he experience of Mr. Thaksin's initial fiscal pump-priming in 2001 indicates that rural and poorer households are likely to demonstrate a substantially higher propensity to consume, as well as a higher propensity for locally made goods and services'.

In an effort to maintain the momentum of recovery, and to continue the domestic consumption bias of pump-priming initiatives, Thaksinomics appears to have adopted ideas popularized by the Peruvian economist Hernando de Soto (de Soto 2003). Briefly, de Soto posits the existence of substantial capital assets owned and operated by the poor, who are unable for a variety of reasons (lack of adequate documentation or legal title, bureaucratic constraints, absence of a facilitative regulatory environment, etc) to deploy them as collateral for formal credit. Overcoming these obstacles would free up the assets of the poor and convert them into a 'pledgible' capital stock. Examples of such inert capital include 'land assets, intellectual property, machinery assets, public sidewalks and stalls, and rental rights'. (Lian 2003a, see also Looney 2003).

By activating these assets, Prime Minister Thaksin has promised to 'turn paper into gold' (Thanong, 2003). According to another enthusiast, plans for the scope of 'capital creation' are ambitious: 'the Capital Creation Scheme in the next 6-7 years could convert at least US$10 billion of dead capital into pledgible capital and transfer US$10-15 billion worth of underground economy activities into the real economy'. In addition, 'the government aims to have the state-owned banks make available some 200 billion baht to support the next wave of loans arising from this asset-reclassification scheme' (Looney 2003).

Whatever about the political context in which these ideas have emerged in Thailand, there is obvious merit in the 'capital creation' concept, at least insofar it means that the assets of the poor should be recognised as underpinning their essential 'bankability'. There is much in the arguments of de Soto and others who urge the need for radical changes in the mindsets of bureaucrats and bankers, to permit microentrepreneurs to capitalise on their hardwon assets. Legislation or regulation that impedes this without good reason should be re-examined and bureaucratic or banking practices that discriminate against the working poor should be scrutinised.

The assets of the poor, of which agricultural land is the most obvious and important example, are often held in a customary or *de facto* (rather than *de jure*) fashion which prevents their being accepted as collateral by formal lenders. Also, land titling arrangements are said to have lagged behind official land redistribution efforts in Thailand, leaving many beneficiaries without adequate documents. The proposal is that bankers should be persuaded to apply less stringent criteria in collateralising inadequately- or un-documented land. However the difficulty of making satisfactory arrangements to protect either financial institutions or landholders in such transactions is formidable. Accordingly the scheme has been slow to commence. Presumably state banks and SFIs could be directed to lend according to criteria that recognise *de facto* land ownership and would be required to incur the balance sheet risk associated with such policy lending. And large numbers of landholders, many of them inexperienced in managing credit, might be persuaded to pledge their means of livelihood in a politically-charged environment.

The ‘intellectual property’ suggested as ‘pledgible’ includes, according to Robert Looney, ‘plant varieties, trade secrets and local wisdom’ to which the customary owners have no enforceable rights. It appears here that the barriers to collateralisation are even more formidable than in the case of land. That any such ‘collateral’ could have a recovery-value for lenders is not obvious. The risk to borrowers would be less than in the case of land, as it is hard to see how they could be dispossessed of their ‘intellectual property’ in the event of default.

‘Capital-creation’ as conceived by Thaksinomics extends to recognising the value of small items of machinery or equipment owned by the microentrepreneur. It can even encompass such informal arrangements as the regular occupation of a market stall or sidewalk position by a vendor, providing a valuable position for trading. In this latter case, the ‘asset’, access to public space, is always likely to be at risk from the arbitrary action of officials. Regular informal payments may be required to maintain access. The increased vulnerability of vendors who have incurred debt on the ‘collateral’ of such assets should be obvious.

The value of an environment facilitating access of the poor to sustainable financial services, and which encourages initiatives to that end, including innovative approaches to collateral, can be seen from the successes of microfinance in a variety of settings. These successes are based upon painstaking institution-building, on human capacity-building and on the creation and maintenance of a sound credit culture. They are facilitated by an appropriate policy and regulatory environment. All of these things take time to put in place and growth is typically slow[12]. They are not likely to be created by crash programs such as the Thai village funds, in which well over a billion dollars was disbursed in more than 70,000 communities in a year or so. Nor does it appear likely that an initiative as bold as Thaksinomic ‘capital creation’ could be expanded rapidly without great risk of politicisation and moral hazard. Using orthodox banking or SFI channels for the purpose, without careful preliminary ‘piloting’ and substantial staff retraining, would appear to invite failure.

8. The View from Washington: IMF and World Bank commentary on the SFIs

International financial institutions do not yet appear to have addressed the ‘capital creation’ initiative in their periodic reviews of the Thai economy. They have, however, expressed reservations about the impact of Thaksinomic expenditure initiatives on the SFIs employed to intermediate them, and about their implications for the broader financial system and credit culture in Thailand. Thus in August 2001, at the annual IMF Article IV consultation, and referring to the debt suspension program for farmers, the Fund noted that ‘…a number of Directors cautioned that the new fiscal initiatives should be assessed both in light of their lasting economic effectiveness *and their impact on an already weak credit culture*’ (emphasis added) (IMF 2001).In regard to these same initiatives, the World Bank observed that '[t]he challenge is to ensure that these policy actions are consistent with ….developing a well balanced financial sector with a strong credit culture….' (World Bank 2001).

Further, with regard to the solvency of financial institutions used by Government to channel lending initiatives, the Fund noted that 'any attempt to increase lending through state banks and specialized financial institutions without due regard to the viability of borrowers could set the stage for future losses at those institutions (IMF 2001). Two years later, at the Article IV Consultation in 2003, the Fund noted again (IMF 2003)

> '…the potential impact of quasi-fiscal activities, including those of the specialized financial institutions (SFIs), on medium-term fiscal consolidation objectives. Some Directors acknowledged the value of the SFIs' objectives; a few Directors also noted the role of the SFIs in stimulating domestic demand. Nevertheless, Directors in general welcomed the authorities' intention to better record policy-related activities of SFIs through improved accounting procedures, and stressed the importance of keeping the SFIs' operations in accordance with their narrowly defined mandates. Directors also recommended that the SFIs' policy-related activities be brought within the official budget to improve transparency and accountability, and that plans to enhance the supervisory and regulatory oversight of the commercially-oriented operations of the SFIs be implemented speedily, to contain risks to the financial sector'.

The dangers can be illustrated by reference to one important SFI, the Bank for Agriculture and Agricultural Cooperatives (BAAC). BAAC's importance is as a source of financial services for middle- and lower-income families in rural Thailand; its outreach, both direct and indirect, was to some 92% of rural families in 2001. This is unique in Asia, and perhaps in the developing world. It was cited as a best practice institution during APEC's discussions of microbanking in Mexico during 2002.

An internal study of BAAC (Haberberger *et al* 2003) notes that '[i]n the past…BAAC ha[d] managed to sustain pressures from political interest groups and to resist pressure from local government in borrower selection and lending decisions'. However as a result of the 1997 financial crisis and international debt exposure, about half of the bank's equity was lost. With the advent of the Thaksin government in 2001, the study judges that the government-directed farm debt suspension was '…affecting the autonomy of the BAAC's operations'. Further, 'the outcome of the debt suspension program is uncertain. It certainly interrupted BAAC's struggle for viability and presents a potential threat to its long-term sustainability….and [seems likely to] support the spread of moral hazard of BAAC borrowers. Therefore, BAAC should be well prepared for a very challenging time ahead from 2004 onwards' [when the debt suspension was due to expire].

Subsequently, IMF Directors commented on a separate but related issue. This has to do with imbalances arising from the expansion of lending by state financial institutions at a time when private bank lending was constrained. The IMF suggested that state institutions could be taking advantage of their official status and implicit government guarantees to expand lending rashly. For example, SFIs are exempt from profit and other taxes, hold more than a third of government deposits, and receive government guarantees on their debt instruments and customer deposits. Thus, according to the IMF (2003),

> 'the recent rapid growth in lending by state-owned banks could reflect the need for a more level playing field between state-owned and private banks, or unwarranted risk-taking. [Directors] urged the authorities to remain vigilant in monitoring state banks closely to ensure that they are run on a commercial basis, with appropriate risk-management practices. Privatization of state banks would be welcome, as it would help to ensure the competitiveness of the financial sector'.

The World Bank (2003) enlarged on the same theme:

> 'Intervention by the government in the financial markets continues to increase. State financial institutions have been increasing their loan market share since the crisis. This was initially driven by steady growth of lending by specialized financial institutions, continued nationalization of undercapitalized banks and [non-performing loans], and the slow pace of re-privatization of these institutions and assets. The government-owned institutions now provide half the loans in the system….' [compared with around 15% before the crisis].
> 'Government intervention in the market can be most effective if tempered by a level playing field among state and private institutions, promotion of prudent risk management and minimal distortion of pricing and competition'.

In summary, since the election of the Thaksin government, the World Bank and the IMF have expressed concerns about the impact of Thaksinomic lending initiatives on the national credit culture, on the longer-run viability of the SFIs involved, and on the balance between state and private sector institutions in Thai financial markets (the 'level playing field').

A more recent discussion of these issues (IMF 2004) took as a backdrop Thailand's 'moderately high' public debt to GDP ratio, which rose from about 15% before the crisis to about 55% in 1998/99, and stood at just over 57% in 2000/01. It discusses 'increasing concern that the government is using state-owned specialized financial institutions (SFIs) outside the budgetary process to pump-prime the economy'.

In the event, the Fund did not conclude that SFI lending was contributing to an unmanageable level of public debt. Indeed it found that 'public debt dynamics are expected to remain manageable…. and contingent liabilities from public enterprises [including SFIs] are not that large'. However, the Fund put an important qualification on these findings. It warned that 'if the recent pickup in lending activities by state-owned financial institutions is inconsistent with prudent risk-management practices, it raises concerns about the level playing field and fiscal implications'.

Further, in the case of SFIs, the Fund was unable to evaluate their risk-management, due to 'lack of clear separations between policy and commercial operations and less stringent regulatory requirements than for commercial banks [which] make it difficult to assess the SFIs' financial conditions'. Thus cause for legitimate concern remained in regard to SFIs. These concerned their viability, their impact on credit culture and their inhibition of private commercial bank activity. As an earlier Fund review (IMF 2003) had concluded, '[t]he extension of SFIs' operations in areas beyond well-defined mandates raises concerns about contingent liabilities and fairness of competition'.

9. A Critique of the Economic Committee study of SFIs

The SFI study (APEC 2003a) attracted quite limited support from the member economies, considering it was conducted by a key APEC committee (the EC) and was designed for publication in a flagship annual document to be presented to the APEC Ministerial (the *2003 APEC Economic Outlook*). In the event only ten economies participated[13], fewer than half the membership, while material from only eight of these was included in the report.

The first difficulty with the study that a reader encounters is one of definition, and is the key to its conceptual weaknesses. As the study states, '[t]he definition of specialized financial institutions (SFIs) is very broad and vague since there are a number of entities which have been established to operate certain services not offered by traditional financial institutions….'. Striving for more precision, it continues:

> 'In the context of this study, SFIs are institutions established to provide various financial services to certain sectors of the economy. They usually work in markets that have not been adequately served by traditional financial institutions. In particular, they aim to be a source of funds for a specific group of potential customers, including those involved in agriculture, small and medium enterprises (SMEs), real estate and housing, exports, and offer a repository for savings, as well as help alleviate social problems'.

However, the more closely the study examines the diverse set of institutions nominated as SFIs, the less rigorous its analysis appears. Thus, in a further effort at clarification, we are told that: 'The focus [of the study] is on regulated institutions whose services have driven economic growth. These institutions are recognized by the member economy governments and related authorities'[14]. This appears to mean that a government can use or create a financial institution in *ad hoc* fashion to serve its political ends, and then justify its actions by reference to an amorphous definition of SFIs and the set of 'principles' for their conduct set out in the EC study.

After examining SFIs in participating economies the study develops a threefold classification of them, which may be categorised as follows (APEC 2003a, 80):

- SFIs claiming legitimacy on the basis of national 'industry policy' in 'high-tech' sectors (mostly in industrial countries)
- SFIs deriving their rationale from supposed 'multifunctionality'[15] in the agriculture, livestock and forestry sectors (again, mostly in industrial countries)
- SFIs mandated to conduct microenterprise and SME financing (primarily in the developing member economies)[16].

Stripped down to these essentials it is possible to see how far Thailand has taken the EC from the relatively modest microbanking and microenterprise initiatives of Mexico in 2002, and from the principles of free and open trade and investment upon which APEC was founded in 1989. Instead the SFI study opens the door to special pleading by member governments in contradiction of their APEC liberalisation commitments. And while purporting to advance the Mexican microbanking agenda it does so without reference to the principle of unsubsidised financial service provision stressed by the SME Ministers in 2002. In that, and other, respects it marks a retreat from liberal (let alone sound and sustainable) financial sector policy.

The study endorses SFIs that are engaged in 'industry policy' in the face of commitments to trade liberalisation. It endorses SFIs that prop up uneconomic primary industries on the pretext of their 'multifunctionality'. And it endorses SFIs that provide subsidised credit for SMEs and the poor whatever the negative implications for financial sector development.

Given these positions taken by the study, it scarcely seems to matter that it also lists a set of caveats that are at war with its main conclusions. These include assertions very damaging to the overall thrust of the study, namely (APEC 2003a, 64-65) that

- '….government intervention through SFIs causes an uncompetitive financial market'.
- '….government efforts to direct the flow of capital to favoured industries, firms, or individuals frequently steer it away from a value-maximizing use toward a lower-value or a "value-destroying" use'.
- 'the use of government-owned financial institutions to dispense political patronage or to implement social welfare programmes may rapidly lead to insolvency'.
- '….SFIs lead to serious fragmentation and segmentation of the credit market. Little competition among financial institutions together with poor allocation of funds leads to high intermediation costs'.
- 'Moreover, SFIs created to solve a perceived market imperfection may cause a suppression of financial development', and finally that
- '…..political interference in management decisions limits the rate of financial innovation'.

The internal inconsistencies of the study are crippling. It is an embarrassment to the Economic Committee and was only published because of the particular character of APEC as an organisation, described in section 1 above. The primary 'character defect' is that, since APEC places such great emphasis on consensus and mutual respect, it is correspondingly unable to deal with abuses of the 'gentlemen's agreement' implicit in its institutional culture.

10. Conclusion

This paper has not been concerned to criticise the pump-priming and consumption-stimulating aspects of Thaksinomics directly, even though these are controversial. Rather, it has been concerned to examine the 'quasi-fiscal' activities of the Thaksin government and their impact on the health of the Thai financial sector and on the possibility of their developing sustainable financial institutions catering to the needs of low-income people. As well the paper has been concerned to examine the relevance of Thaksinomics, in particular its promotion of SFIs, to the agenda of APEC's Economic Committee.

While the Thaksin government has employed SFIs ostensibly for the purpose of meeting the financial needs of people who are not served by conventional financial institutions, it has neither developed credible models for such service provision nor encouraged a credit culture supportive of their sustainability. Instead it has attempted to secure APEC validation of its own policies of subsidised credit and pump-priming. In the process Thailand has licensed a number of other member economies to claim endorsement for their domestic financial sector policies, despite these being at odds with fundamental APEC goals and principles.

In general, deliberate government action to create and support SFIs in the manner championed by Thaksinomics appears likely to be financially repressive. However the circumstances of particular developing member economies may justify establishing SFIs at some stage of their development. It is unlikely that the experience of the more developed member economies will define any unique or unilinear path to financial sector development. Nor is it likely that their experience with SFIs (which all developed economies have had at one time or another) will suggest any uniform or unique role for such institutions. The current roles of SFIs in transitional economies and how these should be modified over time is a particularly important issue.

This analysis suggests the need for a study of SFIs in all economies in which the time dimension should be given particular emphasis. Understanding the historical development of financial systems in the diverse circumstances of APEC would be a useful guide to the potential of SFIs. It might further assist in identifying which of the various SFI models could contribute positively to financial sector development, and when. And those economies which no longer have any great use for SFIs might still make valuable contributions to such a study, by tracing the evolution of their financial systems and the roles which SFIs have played in them, historically.

Unfortunately the 2003 study of SFIs did not follow such a course, instead opting for an ahistorical and tendentious approach. Had the EC been used as a forum for the useful sharing of current and historical experience, rather than simply providing an opportunity for the validation of a particular national policy stance and for the advancement of regional leadership ambitions, the 2003 study of SFIs could have led to useful policy exchanges between APEC member economies. As it was, the EC may prove to have been diminished by its association with, and lukewarm endorsement of, the SFI study. Meanwhile, constructive Mexican initiatives from the previous year have suffered from a lack of the reinforcement they deserved from the ongoing work program of the Economic Committee.

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NOTES

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[1] APEC eschews the term 'summit' because of political sensitivities, since not all APEC members are independent states. Thus APEC is the first, and so far the only, international forum which seats Chinese Taipei and Hong Kong at the same table as the PRC. This sensitivity also explains the use of the term 'member economies' instead of 'governments' to describe participants, and 'Leaders' Meeting' rather than 'heads of government meeting' to describe the annual quasi-summit.

[2] Information on the complex set of activities in the annual APEC working cycle is available on the site of the APEC Secretariat at

www.apec.org/apec/enewsletter/march_vol2/publication.primarycontentparagraph.0001.LinkURL.Download.ver5.1.9

[3] For a discussion of this see John Conroy, 'APEC Discovers Microbanking' at http://www.microfinancegateway.org/content

[4] See the CGAP website, and especially http://www.cgap.org/strategic_priorities .

[5] Mr Thaksin himself has embraced the term and attributes it to Pres. Gloria Arroyo of the Philippines. However it seems more likely to have originated within his own circle. It is reported that at the Bangkok Leaders' Meeting the Prime Minister's Office distributed a DVD titled 'Thaksinomics'. The elements of Thaksinomics are outlined at www.thaksinomics.com. There appears to be a close correspondence between the material on this site and analysis published by a US academic. See Robert Looney, 'Thailand's Thaksinomics: a new Asian paradigm'? at www.ccc.nps.navy.mil/rsepResources/si/dec03/eastAsia . Thaksinomics does not lack foreign supporters, among whom the most enthusiastic is Morgan Stanley Southeast Asia analyst Daniel Lian. See 'Understanding Mr Thaksin's Super Cycle' Morgan Stanley Equity Research, Thailand Economics, 10 October 2003, at www.thaitopproperties.com/images/morganstanleyeconomyanalysis

[6] However this presumption is inconsistent with the APEC Ministerial statement of 2002, quoted in section 3, above: 'Ministers took note of the performance of Bank Rakyat Indonesia's micro-financing system, which provides an extraordinary example of a commercially viable approach that succeeded during an exceptionally severe economic crisis'.

[7] Australian experience of the abandonment of SFIs is documented in the *Financial System Inquiry Final Report,* (the Wallis Report), Canberra, Australian Government Publishing Service, 1997.

[8] The federal government operated the largest Australian commercial bank, while a number of state governments owned savings banks and insurance institutions. The federal government also operated a 'Housing Loans Insurance Corporation', while one state retained a specialised rural and SME lender, the Rural and Industries Bank. These have all now been privatised or otherwise restructured. The Australian study prepared as information for the purposes of the EC study of SFIs dealt with the single remaining government institution that could be considered an SFI. This was the Australian Export Finance Insurance Corporation.

[9] 'Arun Lertwilai, vice-president of the Bank for Agriculture & Agricultural Cooperatives' loan department, figures a third of farmers won't meet payments due next spring on $1.5 billion in loans. He says his bank will reschedule the payments'. Business Week Online 14 July 2003, *Will Thailand Be Hamstrung by Handouts?*

[10] Finance Minister Suchart, in an interview with The Straits Times published on 5 August 2003, was quoted as saying that '…the repayment rate had defied criticism and exceeded even his own expectations, vindicating the government. He said he had initially expected - and was prepared to accept - a default rate of about 30 per cent. The actual rate is more than 2 per cent, or 2,009 of the 70,000 villages'. Apparently a 98% repayment rate is calculated on the basis of the failure of funds in 2% of villages! This figure bears no relation to conventional repayment calculations and suggests the Government does not seriously regard the Village Funds as financial institutions. See http://straitstimes.asia1.com.sg/asia/story/0,4386,203098,00.html

[11] See the Thaksinomics website at http://www.thaksinomics.com/Elements_of_Thaksinomics.htm In fact, BAAC rates at 5% to 8% are not actually 'commercial', since low-income farm borrowers already benefited from cross-subsidies from other BAAC activities.

[12] See Marguerite Robinson, *The Microfinance Revolution* (3 vols, 2001, 2002, forthcoming). Washington DC: World Bank and Open Society Institute. For a discussion of the ASEAN region, including Thailand, see John D Conroy, 'The challenges of microfinancing in Southeast Asia', in Nick freeman (ed), *Financing Southeast Asia's Economic Development*, pp 97-161. Singapore: Institute of Southeast Asian Studies, 2003.

[13] They were Australia, Canada, Indonesia, Hong Kong, China, Japan, Mexico, Philippines and Chinese Taipei, apart from Thailand.

[14] In other words, the authors cannot define SFIs succinctly, but their governments know an SFI when they see one!

[15] According to the OECD, 'Behind multifunctionality is the idea that agriculture, in addition to producing food and fibre, produces a range of other non-commodity outputs such as environmental and rural amenities, and food security and contributes to rural viability'. See www.oecd.org/department/0,2688,en_2649_33779_1_1_1_1_1,00. Unfortunately, according to the Cairns Group, 'Discussions of multifunctionality in the international context have made one fact clear: multifunctionality is being used by some developed countries to justify their high levels of protection and other trade-distorting policies'. See www.australiaun.org/Statements/UNGA%2054/Economic,%20Environment/000426_csdcairnsstatement.

[16] In case these three categories should be thought a caricature of the study, I quote in full (p.80): 'The three leading sectors that benefit from the establishment of SFIs are:

'In most economies, it is necessary to support and promote key and/or high-growth industries in order to sustain economic development. In Chinese Taipei and Japan, electronic and technology-related industries are the major contributors to their economic development and growth. Therefore, efficient business facilitation and sufficient financial support to these particular sectors is vital to the growth of the economy as a whole.

'In addition, some industries, such as food and forestry related industries are 'preserved' industries which are linked to the well-being of the population, and to environmental issues. The government, therefore, protects and nurtures these sectors through the establishment of specialized financial institutions which provide both financing and technical assistance to these sectors particularly. A good example of this is Japan.

'Furthermore, since small and medium enterprises (SMEs) are the backbone of most economies, the SME sector inevitably gains huge support from government through both financing and capacity-building to these businesses. Likewise, microfinance is considered to be important to most developing economies where the majority of people lack access to other formal lending channels. The establishment of SFIs providing microfinance-related services to the grassroots and people in rural areas are important for their empowerment and improvement in their living standards'.