Staff Papers No. 8

SEACEN CENTRE

SOME OBSERVATIONS ON RECENT DEVELOPMENTS IN THE FINANCIAL SECTOR IN SOUTH-EAST ASIA

Vinyu Vichit-Vadakan

The SEACEN Research and Training Centre
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Staff Papers No.	Title	Author
1	THE SEACEN COUNTRIES AND THEIR RESPONSE TO THE ENERGY CRISIS	Zeti Akhtar Aziz
2	INTEREST RATE DEVELOPMENTS IN THE SEACEN COUNTRIES: 1980 - 1982	Zeti Akhtar Aziz
3	DEVELOPMENTS IN THE FINANCIAL SYSTEM OF THE SEACEN COUNTRIES: 1976 - 1983	Zeti Akhtar Aziz
4	CREDIT PLANNING IN THE SEACEN COUNTRIES	Gerardo.S. Tison
5	THE ROLE OF SOUTH-EAST ASIAN CENTRAL BANKS IN DEVELOPMENT FINANCE	Bimal Nath Rimall
6	EXPORT PERFORMANCE OF THE SEACEN COUNTRIES: 1970 - 1984	Zeti Akhtar Aziz
7	DEVELOPMENTS IN GOVERNMENT EXTERNAL DEBT IN THE SEACEN COUNTRIES	Zeti Akhtar Aziz

Vinyu Vichit-Vadakan

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The South-East Asian Central Banks (SEACEN)
Research and Training Centre

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FOREWORD

One of the major activities of the SEACEN Research and Training Centre in the pursuance of its objective of promoting closer collaboration and understanding among the South-East Asian central banks is undertaking research. The research activities of the SEACEN Centre covers a wide range of subjects, in particular, monetary, foreign exchange, fiscal and other current issues faced by central banks and monetary authorities in the region.

The publication of the Staff Papers reflects the continuing efforts of the SEACEN Centre to achieve the above-cited objective. These papers were prepared by the professional staff of the Centre and were done mostly in connection with its other activities. More specifically, they were undertaken to serve as background papers for the seminars and meetings conducted by the Centre, as special papers on current issues in the annual Economic Survey on SEACEN Countries, and as materials for the speaking engagements of the staff members. Hence, these studies are not the regular research projects of the Ce~tre which are more in-depth and usually cover a longer time perspective.

The views presented in these papers are those of the authors and do not necessarily reflect those of the SEACEN Centre or the member central banks and monetary authorities. It is hoped that the publication of the Staff Papers would contribute to a better understanding of the developments and issues currently confronting central banks and monetary authorities in the region.

This paper was presented at the training course organised by the Development and Commercial Bank in Petaling Jaya, Malaysia on April 26, 1985. The author acknowledges the substantial contribution of Dr. Zeti Akthar Aziz of the Economics Department of Bank Negara Malaysia in the preparation of this paper. She provided the author with suggestions and ideas which were most useful and were incorporated in the paper.

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SOME OBSERVATIONS ON RECENT DEVELOPMENTS IN THE FINANCIAL SECTOR IN SOUTH-EAST ASIA

by
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Introduction

During the previous two decades, the financial system in South-East Asia has experienced radical changes to a large extent in response to changing domestic and external conditions. In many of the countries in the region, it has also been the deliberate effort on the part of the monetary authorities to strengthen the financial structure not only to meet the changing requirements of the economy, but also, to improve the means by which monetary policy affects the economy.

This paper will attempt to discuss some of these evolutionary changes and the underlying factors that have led to these changes. For many countries in the region, these changes have significantly altered not only the character of the financial system but also its role in the economy. These financial developments include innovations in the form of new instruments, institutions and markets, and changes in financial arrangements and operations. These developments are not necessarily recent, but they have become a new feature in the sense that the momentum and strength of these developments have increased considerably over the previous decade.

The development of the financial structure is considered essential from the point of view of increasing the flow of savings intermediated through the financial system and increasing the amount of funds available for borrowers. In other words, the financial sector provides an efficient means by which savings can be used to achieve an efficient allocation of capital. A well developed financial system is also essential in providing a more efficient payments mechanism in the economy.

Relative Importance of the Financial Sector

In South-East Asia, the relative importance of the financial sector varies considerably. In terms of the ratio of the financial system's assets to GDP, it ranged from 2.2 per cent for Indonesia to 21 per cent for Singapore based on 1983 figures. In Malaysia, the ratio was 7.7 per cent; in the Philippines, 5.3 per cent; and in Thailand, 6.9 per cent. All the countries have shown an increasing trend in the ratio of the financial sector's assets to GDP.

Common to all the countries, moreover, is the rapid growth of this sector. For all the countries, over the period 1978-1983 the growth of the financial sector has exceeded the increase in GDP.

Links with the Rest of the World

A major development in the face of the growing importance of the external sector in most of the economies of South-East Asia and the increased interdependence with the rest of the world is the internationalisation and globalisation of the financial industry. This has made the individual domestic financial systems to contribute in the generation of funds across countries.

Among the major underlying factors that have contributed to the internationalisation of finance is the growth in world trade. Over the decade, world trade has increased more rapidly than world output. There has also been a widespread use both by the private and the government sectors within the region of foreign financial markets. Private investors have increasingly extended their portfolio and have invested in foreign financial instruments.

The increased openness of the economies of South-East Asian countries is reflected in the growing ratios of exports and imports to Gross Domestic Product. In the recent years, there is also an increase in the ratio of the balance of payments deficit to Gross Domestic Product. There has also been an increased share of this deficit being financed by funds raised through international financial markets as opposed to inter-governmental and other official sources of fund. For many developing countries, the 1970s and the early 1980s showed a rapid increase in their external debt position resulting in a number of countries experiencing external debt difficulties. A major factor which led to an expansion in their external indebtedness has been the easy access to international funds at relatively low costs during the 1970s. This situation, of course, changed radically in the 1980s as international lending has become more cautious. The debt crisis has been an issue not only for the borrowing countries but has also posed serious problems for the international financial system as a whole.

Evolution of the Financial System

It can be observed that the financial structures of the South-East Asian countries vary widely in terms of size and degree of development. The development of financial institutions in the region has proceeded in a number of directions. For many countries, the monetary authorities have played an important role in developing the financial infrastructure.

One of the notable trends in the evolution of the financial system is the expansion and consolidation of existing financial institutions. In many countries, mergers, particularly among banks, have been encouraged. This is in line with the objective of allowing for increased operational efficiency and permitting economies of scale. Economies of scale would enhance portfolio diversification and management and thereby reduce costs. In many South-East Asian countries, historical reasons explain the existence of a large number of small banks. Many of these banks were family controlled enterprises and the practice of employing professional management has only emerged recently.

Despite the trend towards consolidation and expansion of existing institutions, new institutions have also emerged. They include highly specialised financial institutions which perform distinct functions on the one hand and institutions which perform a wide range of functions and operations on the other. In the case of the former, such specialised institutions include development financial institutions generally established by the authorities to perform a specific function. An example of the latter are universal banks whose activities range not only from traditional banking but also equity investments and underwriting of securities. The move towards universal banking in the Philippines was made with the objective of improving the efficiency of the system through increased competition and economies of scale.

For most developing countries, specialised financial institutions have generally been established to provide services that are not yet provided by existing financial institutions. Since their introduction, specialised financial institutions have grown not only in size but also in their range of activities. They have contributed significantly to the economic growth of the country. It has been argued, however, that while these institutions may aim to complement existing ones, they have generally been too small in size to become fully effective and to take full advantage of economies of scale. For countries in which the number of highly specialised financial institutions have increased significantly, there has been a tendency towards what can be described as a fragmented financial system.

Other new financial institutions that have emerged in the region include merchant banks in Malaysia and Singapore; offshore banks in Singapore, the Philippines and Sri Lanka; Islamic banks in Malaysia , Indonesia, and the Philippines ; and Export Credit Insurance in Malaysia, Sri Lanka and Indonesia.

A wide range of instruments have also been introduced to develop fiancial markets in the region. Among the significant ones include negotiable certificates of deposit and bankers acceptances.

Observations on Trends in Monetary Policy and Strategy

Over the period of 25 years, it can be observed that the objectives and strategies of monetary policy within the region have changed in response to the economic situation and economic thinking over the different periods.

During the early period of the establishment of central banks in most of the developing countries, including those of the South-East Asian region, monetary policy was basically without any well conceived objectives. Monetary policy was formulated largely to accommodate the needs of the business sector. In certain countries, the central banks also accommodated the needs of the government either directly or through loans to the commercial banks which in turn extended loans to the government.

Subsequently, with a number of countries experiencing inflation, monetary policy was directed to the stabilisation of the price level. Central bank policy was generally geared towards controlling bank reserves which was assumed to be closely related to the expansion in money and credit supply which, in turn, was thought to be a major source of inflation.

During the late 1960s and early 1970s, a major strategy taken by the central banks not only placed emphasis on economic stability but also moved towards a development-oriented one. To achieve economic growth, most central banks pursued a policy of low interest rates. The main economic thinking during this period was generated by Keynes.

The development strategy of the central banks, on the other hand, was generally directed to affect the allocation of credit to certain specific sectors whose funding needs were not met by the existing financial institutions or alternatively to curb lending in areas that were regarded as not useful to the economy. This policy was approached in two major directions. One was the adoption of selective credit policy to affect the allocation of credit. Such selective credit policy has been applied, for example, to limit the expansion of bank credit to undesirable purposes, for instance to prevent speculation in the stock market, real estate and commodities, to discourage consumption of luxuries and to curb imports.

Selective credit policy was also applied to encourage credit for financing certain activities. Some of the objectives of such policy are to achieve a more equitable distribution of income, to encourage activities desirable from the point of view of national interest, to affect the balance of payments position, to quicken the pace of industrialisation and to generate employment by encouraging credit to labour intensive activities. It was felt that the central bank should not be indifferent to the composition of bank credit. In the developing countries in particular, it is viewed that markets are more imperfect than in the industrialised countries. These conditions, it was felt, justify more intervention to guide investments and production into the right or desirable direction.

These credit policies have to be implemented through various means including preferential interest rates, portfolio regulation, refinancing facilities and interest rate subsidies.

An alternative to selective credit policy to affect the composition of credit is the setting up of specialised development finance institutions. These institutions, introduced in many of the South-East Asian countries during the 1970s, were designed to complement the existing financial arrangements. More specifically, these corporations have been established in developing countries where commercial banks are not able to provide long term financing for development projects or short term loans to unproven entities that nevertheless have potentials to contribute to economic growth. Commercial banks in these countries traditionally finance trade and industry. Their loans were generally short term and the recipients of the funds typically have an established financial record because banks have usually been risk adverse and in many cases do not have the capacity to evaluate longer term or rural projects submitted by unproven borrowers. Commercial banks neglect the investment opportunities that is beyond the short term.

In the 1980s, however, in view of the increasing difficulties confronted by several countries, there has been increasing reliance on the use of monetary policies to achieve macro-economic objectives. Most countries during this period were faced simultaneously with the problems of inflation, balance of payments disequilibrium, and recession. Thus, policy formulation becomes a far more complex task in view of the conflicting objectives of stimulating growth on the one hand and curbing inflation and reducing the external imbalance on the other.

Impact of Technological Advancement

One of the major developments in the financial sector is the introduction of technological advancement in its operations. The advantage of technological advances in the sector has been manifested in the reduction of cost of operations. It has also facilitated the improvement of existing services as well as resulted in the introduction of new services. The application of information technology in banking has radically altered the relative costs of providing different services as well as allowing for easy entry into certain areas of banking. Such advances have also provided access to new customers, extended the size of the market and increased the responsiveness of the transactors to changes and events in the financial sector.

While the extent of these technological advances have been fairly widespread in the financial sector, there is a tendency, however, for these developments to affect larger units. However, it is expected that with further innovations in electronic facilities and the reduction in the cost of electronic hardware and standardized softwares, advantages of such developments would be more widespread and extend to small and medium sized units in the financial system.

Recent Developments

Developments in the financial sector, and particularly in the banking business, have been numerous. These can be generally classified into services to customers, internal organizational development and changes in the policy measures of the government and the monetary authorities. This could be reviewed as follows:

Services to customers. Electronic banking has been a single major contributor to the services provided by the commercial banks to their customers. The following are some of the services in this category which are now used in the countries in South-East Asia:

- The use of Automated Teller Machines (ATM), which may be called differently by different banks, have gained substantial popularity in all the countries and this was made possible by the computerisation of banking services.

- A number of countries have introduced a programme called Telebank where a customer can undertake transactions using any telephone. Such transactions include checking balances, transfer of funds and basically the transactions that are performed by ATM. This has gained even more popularity because, except for withdrawing cash, everything else can be done from the comfort of one's home or office.

- Office banking, where one is connected to his bank and is instantly kept current on transactions in his account. This is very much used by companies and offices to have a current status of their financial positions.

- Telecash or Electronic Fund Transfer at Point of Sale is becoming more popular among department stores and retail outlets as it is much better than credit cards where one has to wait for the actual transfer of funds. It is sometimes even considered preferable to cash because there is no risk involved and the amount is immediately transfered to the account of the seller without having to carry cash for deposit in the bank.

- Some of the banks provide on-line trade information for their major customers. Information on prices, exchange rates, and many others are shown on the screen in the clients' offices and updates are done frequently, providing the client with the latest information.

- Different types of savings accounts are also introduced so that these accounts could be tailored to the specific situations and requirements of a particular customer.

- SWIFT which helps speed up fund transfer world wide is more and more used in the countries in South-East Asia.

Internal organisational development. Developments within the banks are also quite numerous both in the area of computerisation and automation of the various tasks on the one hand and the management techniques on the other. There is not much need to dwell on automation and computerisation of the internal administration of the banks as this is quite widespread and has been there for quite some time. These electronic processes have contributed a great deal to the increased efficiency of the internal management and reduction in the operating costs. It is very difficult for a modern bank these days to do without the help of computerisation.

Another development which is gaining in popularity in the countries in South-East Asia is in the area of management. These include:

- Marketing of Banking Services. New marketing techniques are now being used to attract customers to the services provided by the banks. It can be observed that banks devote more time, effort and budget to market their products and there are more studies made by banks on the market possibilities of their services.

- Strategic Planning and Cost Control Measures. The techniques of planning have been adopted to the banking industry and developed in such a way that a number of banks now use the most modern tools and techniques in the formulation of their policies and strategies. Careful studies are being made on the unit cost of the various services and cost control measures are being introduced.

<u>Introduction of New Government Policies</u>. The introduction of new policies by the government or authorities such as the central banks in the countries of South East Asia has also been varied. The general trend, however, is towards deregulation.

A recent phenomenon in the financial system in several parts of the world has been the process of deregulation. This primarily involves the elimination of restrictions on lending by depository financial institutions and the removal of informal and formal constraints on the range of activities performed by the financial institutions. Deregulation also involves the move to abolish exchange controls.

In the earlier periods, the banking industry in most of the countries in South-East Asia, has been subject to close supervision. Regulations, however, prevailed in different areas and in different intensity. Primarily, such regulations focus on the interest rate structure for borrowing and lending and on the institutional specialisation within the banking industry. These regulations were largely implemented with the view to protecting depositors and ensuring orderly operations of the financial institutions. The regulation of the interest rates and other prudential controls were imposed to allow banks to survive through difficult periods.

As already noted, the rationale for regulations in the financial system has also been to achieve a desired allocation of resources both to the private and the public sectors. This was to ensure the flow of funds to sectors identified as important for the development of the country. Regulation on the banking system has been considered essential on these grounds in view of their crucial role in the financial system in particular and in the economy in general.

The widespread and global phenomenon of the process of deregulation has primarily been prompted to increase competition within the financial system and to allow the financial system to be more responsive to the changing economic and financial environment. The motivation for increased competition in the financial system is to reduce cost of funds and to narrow the spread between interest charged and return on funds while at the same time increasing access of borrowers on funds. Deregulation has also aimed at allowing the financial system to be more responsive to the changing economic and financial environment, in particular, the internationalisation of national economies with increased trade liberalisation and the technological advancement of the industry already mentioned earlier.

In many of the South East-Asian countries, this process of deregulation can be seen in particular with respect to interest rate regulation. Singapore liberalised interest rates in 1975, Malaysia in 1978, the Philippines in 1981 and Indonesia in 1983. Thailand has also revised its ceilings in 1980 and has a more flexible interest rate policy.

While the process of deregulation has intensified, regulatory authorities still have the crucial role to play in ensuring the stability of the financial system. While the changing environment has rendered the existing regulatory system obsolete, with the additional risks assumed by the financial institutions and their increased international exposure, the monetary authorities need to see that it does not jeopardise the financial viability of these institutions.

There is also an indication that deposit taking institutions which are not under the supervision of the monetary authority would sooner or later come under its purview. Depending on the countries, these institutions are supervised by a government ministry or sometimes not supervised at all. Examples of these institutions include, depending on countries, cooperative associations, building societies, credit fonciers, insurance companies, merchant banks and discount houses.

Some Current Issues

It can be observed that there are quite a number of issues which are being debated by the monetary authorities and central banks both at the domestic levels and in the international forum. Examples of these are:

Electronic Banking. The main issue is up to what extent should the central banks or monetary authorities promote the use of these electronic services and how they can be or how much should they be monitored, supervised or regulated. This would include services provided to the customers and also internal management use of computerisation.

Supervision of other deposit taking institutions, as distinguished from commercial banks and finance companies which are already supervised by the central banks. The questions that can be raised along this line include which type of institutions should central banks supervise and whether they should be supervised any differently from the commercial banks and finance companies.

The unregulated credit market which is sometimes referred to as the unorganised market or the informal market. This market is quite large and has increased in magnitude very rapidly. Central banks and monetary authorities are now contemplating on both issues of understanding its operations and magnitude better and also to see how it can be regulated. The existence of such an unregulated credit market is a clear indication that there is an unsatisfied demand for financial services by the public. An alternative solution would be to develop the formal market in such a way that it would be of service to a larger clientele group.

Deregulation which is being implemented by most of the central banks is likely to continue. Deregulation could be undertaken in the various aspects of banking services.

Conclusions

The various developments in the recent decades within the financial sector and the environment in which it operates enables one to draw the following conclusions:

- the financial sector is a very rapidly expanding sector and is likely to continue to be so;

- all indicators show that there will be increased competition in the sector;

- banking operations of various nature need to be more professionally performed and technologically oriented; and

- it is very important to be competitive by being up to date on the various developments and efficient in operations. This can be done through training, seminars, research studies and updating of knowledge.

THE SEACEN CENTRE

The SEACEN Research and Training Centre was set up by the South-East Asian Central Banks (SEACEN) comprising the Union of Burma Bank, Bank Indonesia, Bank Negara Malaysia, Nepal Rastra Bank, the Central Bank of the Philippines, the Monetary Authority of Singapore, the Central Bank of Sri Lanka and the Bank of Thailand.

The basic objective of the SEACEN Centre is to promote closer collaboration and better understanding among member central banks and monetary authorities by undertaking research activities, conducting training courses and organising seminars and meetings.

Research activities of the SEACEN Centre are undertaken to have a better understanding of the monetary, foreign exchange, fiscal and other economic issues and developments affecting the member countries.

Training courses are conducted to provide an opportunity for officials of the member central banks and monetary authorities to acquire, refresh and expand their knowledge of the basic concepts and techniques necessary in the performance of their tasks as well as to widen their understanding of the issues related to policy formulation and implementation.

Seminars and meetings are organised to provide a regional forum for exchange of views and experience on selected aspects of central banking from the operational and policy standpoint.

Although the SEACEN Centre acquired its formal legal status only in 1982 when it was registered as a corporation in Malaysia and agreements to that effect were signed by the Governors and Managing Director of the member central banks and monetary authorities, collaborative efforts started as early as 1972. These undertakings initially consisted of training courses and eventually expanded to research activities and holding of seminars and meetings.