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Banking and insurance services liberalization and development in Bangladesh, Nepal and Malaysia: A comparative analysis

By

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Abbreviations

AFAS	ASEAN Framework Agreement on Services
ARDL	Auto-Regressive Distributed Lagged (Model)
ASEAN	Association of South East Asian Nations
BAFIA	Banking and Financial Institutions Act
BCHB	Bhumiputra Commercial Holding Berhard Bank
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Co-operation
BLR	base lending rate
BNM	Central Bank of Malaysia
DFI	Domestic Financial Institution
ECT	error correction term
FTA	Free Trade Arrangement
GATS	General Agreement on Trade in Services
GDP	gross domestic product
NGOs	non-governmental organizations
NIM	net interest margin
NPL	non-performing loan
NRB	Nepal Rastra Bank
SAP	structural adjustment programme
SMEs	Small and medium-sized enterprises
WTO	World Trade Organization

Executive summary

This paper draws from three country case studies of the liberalization and development of the banking and insurance service sectors in Bangladesh, Nepal and Malaysia, which were undertaken as part of an ARTNeT regional study on trade in services led by the author. The paper first explores the relationship between financial and economic development, and the causality between service sector liberalization and financial deepening. An overview of the growth and importance of the banking and insurance sectors as well as of the regulatory frameworks in place in the three economies is then presented, followed by comparative case studies of bank performance according to ownership structure. The case studies reveal that private banks (including joint-venture banks) tend to outperform state-owned banks in the two least developed countries. The following three main challenges are identified for financial sector development in the three economies: (a) non-performing loans in government banks; (b) the failure of insurance companies to undertake long-term investments; and (c) the continued limited access by the poor and small businesses to credit. The paper concludes with policy implications.

I. Relationship between financial and economic development

The literature on economic growth since the 1980s has generated great interest in understanding why global growth in per capita income has been persistent. Two major schools of thought provided different explanations. One suggested that sustained growth was possible through human capital accumulation (Lucas, 1988; Rebelo, 1991; Stokey, 1991). Another school of thought suggested that growth was perpetuated through the accumulation of knowledge through either learning by doing (Romer, 1986; Young 1991) or research and development (Romer, 1990; Gross and Helpman, 1991; Aghion and Howit, 1992). The empirical literature has suggested that a number of variables could explain the differences in per capita income growth including factor accumulation, institutional development, educational attainment, the effectiveness of the legal system, international trade, ethnic and religious diversity, and corporate governance.

One important factor that received considerable attention was the role of financial markets in the growth process. The theoretical underpinnings of the relationship began with the work of Schumpeter (1911), and were extended by McKinnon (1973) and Shaw (1973). The empirical studies also suggested that financial intermediation had a positive effect on steady-state growth rate (Greenwood and Jovanovic, 1990; Bencivenga and Smith, 1991). The models also received considerable empirical support from cross-section studies (World Bank, 1989; Roubini and Sala-i-Martin, 1992; King and Levine, 1993a).

Extensive empirical work has been carried out on the relationship between financial development[1] and growth, which was surveyed extensively by Levine (1999 and 1997). One of the most influential studies was the work of King and Levine (1993b), which showed a strong positive link between financial liberalization[2] and growth.

Financial liberalization may affect growth through three main channels. First, it may affect the development of the domestic financial system in terms of size and efficiency. Second, it may affect the access of domestic firms to funds, and finally it may reduce the agency problem by improving corporate governance.

King and Levine (1993b) showed a strong causal relationship between financial development and growth, implying that financial development had predictive power for the future growth of an economy. Some studies have used the microeconomic approach (Rajan and Zingales, 1996) to analyse the relationship between industry-level growth performance across countries and financial development. The emphasis was on whether availability of external finance was crucial to financial development, which, in turn, would have an impact on economic growth. They found that the more developed a financial system, the more it could reduce the cost of loanable funds and thereby allow firms depending on external finance to grow without restrictions.

What role does the liberalization of trade and services play in the nexus of financial liberalization and economic growth? It is not difficult to understand that an efficient and well-

[1] Financial development is a process of accumulation of financial assets, which, by facilitating resource mobilization, enables the transfer of savings into productive investment (Shaw 1973, McKinnon 1973 and Pischke 1991). At the same time, it leads to improved efficiency in allocating financial resources and thus lifts the returns to financial resources that raise productivity (King and Levine, 1993a).

[2] That is, financial liberalization as a process involving a much broader set of measures geared toward the elimination of various restrictions on the financial sector, such as the removal of portfolio restrictions on the banking sector, the reform of the external sector as well as changes in the institutional framework of the monetary policy (see Ucer, www.econ.chula.ac.th/about/member/sothitorn/liberalization_1.pdf).

regulated financial sector can lead to an efficient transformation of savings to investment, thus ensuring resources are deployed where they can provide the highest returns.

Liberalization of the goods sector and services sector has different impacts on economic growth. A number of cross-country studies, such as those by Dollar (1992), Ben-David (1993) and Edwards (1998), suggested that trade liberalization had a long-term impact on growth. However, this conclusion was questioned by Rodriguez and Rodrik (1999); while implying that the results are not sufficiently robust, they stated that trade liberalization could have positive or negative impact depending on whether resource allocation effects of trade policy promoted sectors that generated long-term growth.

If greater technology transfer accompanies services liberalization, the growth effect will be stronger. Coe and others (1999) presented empirical evidence demonstrating the impact of technology diffusion (via trade in goods) on total factor productivity growth. Theoretically, the same applies to trade in services. The empirical studies show that trade openness, financial development and economic growth are highly correlated. Beck (2002) demonstrated that financial development resulted in a higher level of exports and a trade balance of manufactured goods, which, in turn, generated economic growth. Research by Beck (2002) was based on Kletzer and Bardhan (1987), who showed that countries with a relatively well-developed financial system had a comparative advantage in economic sectors that depended on external finance. The empirical results indicated that countries with a higher level of financial development experienced a larger export share and an improved trade balance in manufactured goods. Using the legal origin as an instrument for a financial ratio (private credit), the results also indicated that private credit had a significant impact on the share of manufactured exports in gross domestic product (GDP) as well as on trade balance. It would appear, then, that causality runs from financial deepening to trade in manufactured goods.

Using an entirely different approach to estimate causality, Mattoo et. al. (2001) constructed indices of openness in services trade. They drew a conclusion that openness in services trade influenced long-term growth. They contended that three key elements contributed to the dynamic benefits derived from services liberalization: (a) the degree of competition; (b) the extent of foreign ownership; and (c) the nature of regulation. For the financial sector, Mattoo et. al. (2001) used commitments under the General Agreement on Trade in Services (GATS) to represent national policies related to competition and foreign ownership of financial services. They used an index of capital controls compiled by Dailami (2000) to represent openness of a country's current and capital accounts. Both these measures were combined to form an index of openness of the financial services trade.

In the face of globalization, Bangladesh, Malaysia and Nepal have implemented several financial and capital market measures to deregulate their overall financial systems. Apart from financial and trade liberalization, these three countries have committed to liberalizing their services sectors under GATT obligations.

A. Impact of liberalization policies on financial deepening [3]

The overall impact of financial liberalization on the financial sector has been significant in Malaysia (table 1). The measures for financial sector improvement include the ratios of M3/GDP, M2/GDP, claims on government and claims on the private sector as a share of GDP. Despite the

[3] Financial deepening is a process in which the share of financial assets in an economy increases at a faster rate, as a result of a higher level of intermediation (Agenor and Montiel, 1996).

central bank's role in controlling inflation, which required that monetary growth to be stable throughout the period, the M2 ratio increased more than two-fold between 1975 and 2004. Similarly, the M3 ratio also recorded an almost three-fold increase, reflecting the fact that Malaysia is on a high economic growth path accompanied by financial deepening.

Table 1. Malaysia – indicators of financial liberalization (as a ratio of GDP)

Year	M3	M2	Claims on government	Claims on the private sector	Gross fixed capital formation	Foreign direct investment
1975-1980	54.04	46.88	21.96	46.94	25.42	4.12
1981-1988	81.3	66.55	33.23	78.96	30.40	5.71
1991-2000	124.22	91.74	-2.02	30.87	35.56	4.75
2000	133.0	103.35	-7.06	140.19	25.56	-6.95
2001	140.4	108.36	-2.84	149.24	24.92	-4.42
2002	138.4	105.95	-0.51	145.56	23.14	-3.30
2003	139.2	107.96	-1.94	140.91	22.05	-3.07
2004	137.4	118.81		130.1	20.42	
2005	134.9	124.60			20.00	

Source: International financial statistics (various years).

Financial intermediation for the public sector shows negative ratios in the 1990s and early 2000, largely due to the restructuring of government finances as the economy began to show signs of weakness beginning in the year following the Asian financial crisis. After the financial crisis, government spending became more disciplined and, as a result, lending to the government was much less than government deposits in the banks. The negative ratios shown in table 1indicate the decline in the government spending.

The financial intermediation ratio (banks' claims on the private sector) increased by more than three times, reflecting the public's willingness to hold assets. It also reflected the development of institutions that facilitate lending activities. This level of intermediation is a reflection of the commercialization of economic activities over the years and the liberal policies that promoted competition.

While public sector financial intermediation was slowing down, the private sector debt was building up, particularly when lending to the property sector increased substantially prior to the Asian financial crisis. The build-up of the private sector debt is also apparent in the growth of foreign direct investment. The 1990s witnessed large inflows, which showed up in the gross fixed capital formation ratio. This ratio increased to an average of about 36 per cent of GDP in the 1990s. These figures support the view that growth in the 1990s was generated by greater private sector participation, supported by the banking system. The financial ratios show that there was financial deepening from 1975 to 2004, with the exception of the period during the Asian financial crisis. The lessons learnt from the crisis enabled the banks to consolidate further into highly capitalized units. Overall, the effects of financial liberalization on the financial sector have been significant.

The financial intermediation of the public sector in Bangladesh remained fairly sluggish, recording 6 per cent (claims on government as a ratio of GDP) in the latter part of 2000 (table 2). Unlike Malaysia, Bangladesh did not resort to deficit financing of public expenditures. The Asian financial crisis did not have any impact on the financial sector of Bangladesh. The private sector's financial intermediation ratio increased steadily from around 11 per cent (claims on the private sector as a ration of GDP) in the early 1980s to 29 per cent in 2000. This reflected slow progress in the intermediation process, where the development of financial institutions to facilitate lending

activities appears to have been hindered by the existing regulatory framework. Overall, progress has been slow in the liberalization of the intermediation process to provide competition to the financial institutions.

Table 2. Bangladesh – indicators of financial liberalization (as a ratio of GDP)

Year	M1	M2	Claims on government	Claims on the private sector	Gross fixed capital formation
1975	6.59	5.14	5.68	2.63	5.48
1980	10.19	10.21	7.17	8.18	9.48
1985	11.34	16.85	4.63	18.63	10.28
1990	6.55	16.83	1.98	16.66	17.05
1995	8.87	20.06	3.18	20.88	19.12
2000	9.24	25.47	6.93	24.67	23.02
2001	9.56	27.66	8.12	26.71	23.09
2002	9.32	29.80	7.52	28.93	23.15
2003	9.12	31.11	6.14	28.75	23.41

Source: International Financial Statistics (various years).

Nepal experienced faster growth in the financial intermediation process where the ratio of M2 to GDP grew by seven times more than the ratio in the mid-1970s (table 3). Private sector lending has also improved ten-fold, suggesting that financial development had been responsive to the economic growth of the country. Claims on government were kept at moderate levels so that private investment could be maintained around the average of 20 per cent of GDP.

Claims on government were very high in 1985 at 15.11 per cent of GDP. Thereafter, the share went down considerably. This was a result of the ongoing liberalization policy, which gave highest priority to expanding the private sector role in the economy and to maintaining fiscal balance. The manifestation of claims on the private sector by the banking system additionally corroborates this fact. These claims as a ratio of GDP reached 36.3 per cent in 2004, up from 12.5 per cent in 1990. As table 3 shows, the expansion in broad money (M2) has been faster than the growth in narrow money (M1), indicating that time deposits rose at a faster rate. Although the share of gross fixed capital formation expanded steadily, the growth was slower than the growth in monetary variables. This clearly indicates that augmentation of financial deepening was faster than the expansion in economic activities.

Table 3. Nepal – indicators of financial liberalization (as a ratio of GDP)

Year	Claims on government	Claims on the private sector	M1	M2	Gross fixed capital formation
1975	4.37	4.29	8.05	5.11	13.42
1980	8.12	8.40	12.27	11.40	15.76
1985	15.11	9.31	12.05	15.88	20.15
1990	13.63	12.47	13.74	18.47	16.44
1995	10.95	22.58	15.31	23.04	22.07
2000	9.06	30.28	16.61	34.93	19.32
2001	7.94	32.17	17.91	35.53	18.99
2002	8.96	32.83	19.00	36.00	19.33
2003	6.60	34.50	19.14	37.73	19.12
2004	8.19	36.33	19.79	39.06	18.72

Sources: International financial statistics (various years) and the Economic Survey (2007) by the Government of Nepal.

B. Financial and economic development: An empirical analysis

1. Methodology and data sources

In this study, the Auto-Regressive Distributed Lagged (ARDL) Model was used to examine the relationship between financial deepening (with *Credit* representing domestic credit by banks to private sector) and the liberalization of trade and services (*OPEN*). A new co-integration test was also used, called the Bounds Test, which was developed by Pesaran and others (2001) to establish whether the variables were co-moving. This empirical framework has two major advantages over the traditional error correction framework proposed by Engle and Granger (1987), Johansen (1988), and Johansen and Juselius (1992). First, the ARDL approach used in this study allows the explanatory variables to be a mixture of stationary and non-stationary series. Second, the Bounds Test is robust against small sample bias. Hence, it gives reliable estimates for small sample studies.

In this section, the empirical model and the data used in this study are outlined. First, a unit root test is conducted, using the Phillips Perron (PP) test. The PP test will determine the order of integration of each of the series. Once the order of integration is determined, we test whether there is a long-term relationship between the variables. Here, the ARDL method proposed by Pesaran et. al. (2001) is used. This involves the following models (UECM):

$$\begin{aligned}\Delta LnCredit = \alpha_{om} + \sum_{i=1}^{k1} \beta im \Delta LnCredit_{t-i} + \sum_{i=1}^{k2} \xi im \Delta LnOPEN + \\ + \theta_{1m} LnCredit_{t-1} + \theta_{2m} LnOPEN_{t-1} + \varepsilon_{Mt}\end{aligned} \qquad (1)$$

where *LnCredit*, and *LnOPEN* are the logarithm value of domestic credit/gdpn and trade/gdpn. The variables in (1) are in logarithms so the coefficients are the elasticities.

In order to test for the absence of a long-term relationship in equation (1), a Wald-type (F-test) coefficient restriction test is conducted, which entails testing the following null hypothesis, respectively:

$$H_0: \theta_{1m} = \theta_{2m} = 0 \qquad (2)$$

In the Bounds Test, the computed F-statistics under the null hypothesis in equation (2) is F (*LnCredit*/*LnOpen*). The asymptotic distribution of the test statistic is non-standard regardless of whether the variables are I(0) or I(1). For this purpose, Pesaran et. al. (2001) computed two sets of asymptotic critical values where the first set assumed variables to be I(0) and the other as I(1), which are known as lower bounds (LCB) and upper bounds critical values (UCB), respectively. A decision on whether co-integration exists between the dependent variables and its regressors is made based on the criterion given in table 4, which provides example of how the hypothesis is accepted or rejected in the co-integration test.

Table 4. Wald-type (F-Test) Coefficient Restriction Test

F statistics	Decision	Meaning
F statistic > UCB	Reject H0	LnCredit and its regressors are co-integrated
F statistic < LCB	Fail to reject H0	LnCredit is not co-integrated with regressors
LCB < F statistic<UCB	Results inconclusive	

Once both (order of integration and co-integration) are established, the standard Granger causality tests are used to confirm the direction of causality. In this case, when the series are of order I (1) and co-integrated, the Granger causality is conducted with the inclusion of the lagged error correction term (ECT).

Table 5. Phillip-Perron Unit Root Test

	Log levels with trend	Log differences with trend
LnCredit	-2.4194	-11.8875*
LnM3	-2.8002	-10.6093*
LnOPEN	-3.2946	-6.6160*

Notes:

Credit – Domestic credit to private sector refers to financial resources made available to the private sector as a ratio of nominal GDP of the respective country.

OPEN – Openness is the sum of exports and imports of goods and services as a share of nominal GDP.

M3 – M3 is the sum of currency in circulation and deposits in the central bank, plus demand, time and savings deposits at commercial banks, and time and savings deposits at other financial institutions as a ratio of nominal GDP.

* Level of significance.

All variables are non-stationary. The PP test shows that all the series are integrated of order 1. This implies that using ordinary least squares may lead to spurious estimates. All the variables are significant at 1 per cent critical value. In many of the empirical studies, both variables were used to denote either financial liberation or financial deepening. Here, for the purposes of testing causality and the long-term relationship, reliance was placed on domestic credit rather than M3 because funds allocated for trade related activities are more relevant than an increase in money supply.

Major data sources used for the regression analysis were the international financial statistics of the International Monetary Fund as well as the Ministry of Finance and central bank of the respective countries.

2. Empirical findings

Annex table 1 reports the results of the Bounds Test for the co-integration analysis. Annex table 2 presents the long-term elasticities. Table 6 reports the direction of causality. The estimation period was divided into two stages: 1970-2004, and 1986-2004. The period of analysis was divided into two sub-periods based on the assumption that significant liberalization of the financial system, trade and trade in services was carried out after the minimum commitments on the financial services sector liberalization were made to WTO when GATS was implemented.

The results indicate that there is a link between financial development and exports and imports of trade and non-factor services. The long-term impact is captured by ECT. When ECT is significant, the coefficient shows the magnitude of deviation from the equilibrium level that is corrected within the period of analysis.

The Bounds Test indicates that a long-term relationship exists between domestic credit and openness of the economy during 1970-2004 and 1986-2004. The variable “trade openness” can be treated as the long-term forcing variable for the changes (growth) in domestic credit during both periods of analysis. In other words, trade liberalization generates credit growth to finance the growth of trade and, in the process, improves the efficiency of the financial system (financial deepening). The one-way causality therefore runs from trade openness to growth of domestic credit. Estimates

by the Bounds Test were not significant for 1970-1985, and there was no evidence of any causality between trade openness and growth of domestic credit.

Table 6. Direction of causality

Malaysia	
1970-2004	Causality from openness to domestic credit
1986-2004	Causality from openness to domestic credit
Nepal	
1975-2004	Causality from openness to domestic credit
1985-2004	Causality from openness to domestic credit
Bangladesh	
1974-2003	No causality
1986-2003	Causality in both directions

3. Other evidence from the Nepal, Malaysia and Bangladesh studies

In Nepal, faster growth in the economy occurred especially after the initiation of intensive reforms in the early 1990s. The growth rate increased from 5.1 per cent during 1985-1990 to 6.4 per cent during 1995-2000. Moderate growth in the financial sector value-added took place even at a time when there was a big downturn in sectors such as trade and industry. The financial sector also contributed to bringing about some structural changes in the economy. The share of finance and real estate value-added in total GDP was 9 per cent in 1985. That share rose to 11.5 per cent in 2005. Similarly, the contribution of that sector in total employment reached 0.8 per cent in 2001, up from 0.1 per cent in 1981. The growth performance of the financial sector, and consequently its increased contribution to the economy, show that considerable scope exists for enhancing its role in the Nepalese economy. A regression analysis carried out to examine the linkage between financial deepening (represented by private sector credit) and economic growth indicates a strong positive relationship between the two and, therefore, the positive effect of financial deepening on Nepal's economic growth.

Likewise, a big structural shift in the Malaysian economy took place from 1970. The increased contribution of the service sector, which includes banking and financial services, occurred after the development of the manufacturing sector was accelerated. The services sector has now been identified as another source of growth for accelerating the transformation of the Malaysian economy. Value-added in the services sector has increased at a faster pace than the overall growth of the economy. The share of the services sector in GDP increased from 46.8 per cent in 1990 to 52 per cent in 2005. This partly reflects the success of policies that were directed towards liberalization of the services sector. Among the subsectors, the share of finance, insurance and business services increased from 17 per cent in 1987 to 26.4 per cent in 2005. This enabled the augmentation of the level of employment in that sector, from 557,900 jobs in 2004 to 593,500 jobs I 2005. On average, the recorded growth of employment in this subsector was 5.3 per cent per annum from 2000 to 2005. The finance, insurance, real estate and business services sector recorded the fastest growth in employment, compared with all other sectors, since 2000. This shows the growing importance of banking and insurance in the Malaysian economy.

In the case of Bangladesh, changes in the sectoral distribution of GDP indicate that the country's economy has undergone important structural transformations over the past three decades. At independence in 1971, agriculture was the dominant sector, accounting for more than half of total GDP. The industrial sector was small, contributing less than 10 per cent of GDP, while services, including transportation and power, accounted for the balance. In 2004, the industrial

sector accounted for 27 per cent of GDP, while the share of agriculture dropped to 23 per cent and that of the services sector climbed to 50 per cent. About 9 per cent is contributed by the financial sector. In terms of employment, however, no major structural change has taken place. The services sector absorbed about 38 per cent of the labour force in 2003 compared with 41 per cent in 1996. After liberalization, structural changes also occurred in the economy, with the share of the non-agricultural sector including banking and insurance increasing.

4. Conclusions

The results of the above econometric analysis suggest that there is a positive link between economic growth and financial deepening. They also show that there is causality from trade liberalization to financial deepening in both Malaysia and Nepal. This is true for both the short- and long-term period. However, in case of Bangladesh, no long-term causality in any direction is found. Only in the short term is causality in both directions found. The estimated long-term elasticities thus show that greater liberalization of services trade has a significantly positive effect on financial deepening and economic growth.

II. Growth and importance of banking and insurance in the three economies

A. Banking

As of mid-July 2005, there were 181 licensed bank and non-bank financial institutions in Nepal. This total comprised 17 commercial banks, 26 development banks, 60 finance companies and 78 micro-credit development banks, saving and credit cooperatives and non-government organizations (NGOs) performing limited banking activities. The other non-deposit-taking financial institutions included 21 insurance companies, one Employee Provident Fund, one Citizen Investment Trust, one Deposit Insurance and Credit Guarantee Corporation, one Nepal Stock Exchange Limited, one Credit Information Bureau, 116 postal savings offices and one Rural Self-Reliance Fund. In terms of commercial bank ownership structure, six were joint-venture banks and 11 were fully domestic owned banks, including two that were at least partly state-owned.

The total financial assets of the financial system reached NRs 474.33 billion in mid-July 2005. In terms of financial assets to GDP ratio, this works out to be about 90 per cent. The share of financial assets in GDP was 29 per cent and 32 per cent in 1985 and 1990, respectively. Similarly, the deposit and credit ratios to GDP also showed the growing importance of the financial system to the economy. The deposit-to-GDP ratio went up from 10 per cent in 1980 to 32 per cent in 2000 and 47.7 per cent in 2005. The credit-to-GDP ratio reached 30.9 per cent in 2005 showing somewhat slow growth in comparison to deposit-to-GDP ratio.

Although, in terms of market share, commercial banks dominate the financial system, a rapid change in structure has been taking place in recent years. Expansion of the credit share of development banks and finance companies has been rapid in recent years; their combined credit share increased from only 6.5 per cent in 2000 to 19.4 per cent in 2005. The asset share of the two government-owned banks decreased from 56.6 per cent in 2000 to 38.1 per cent in 2005. Increases in asset, deposit and credit shares of private domestic banks was phenomenal during the same period, jumping from 8.2, 9.4 and 10.4 per cent respectively in 2000 to 24.4, 25.4 and 32 per cent in 2005.

The commercial banks are the main players in the financial system in Malaysia. They are the largest and significant providers of funds in the banking system, with total loans and total deposits amounting to M$ 524.7 billion and M$ 644.9 billion, respectively, at the end of 2005. These figures represent approximately 94 per cent and 93 per cent of the Malaysian banking system's total loans and deposits, respectively. As of December 2005, there were 29 commercial banks including locally incorporated foreign banks and 10 merchant banks in Malaysia. There are also a few Islamic banks with branches operating in various parts of the country. The total assets of the commercial banks had risen to M$ 885.9 billion at the end of 2005. The average growth of assets during 1995 to 1997 was 26.3 per cent, the highest since the crisis of 1985. The main contributory factor for the higher growth of the assets was the Central Bank of Malaysia's efforts to accelerate the pace of liberalization to ensure a strong and competitive banking industry. After the Asian financial crisis of 1997, asset growth was negative but began to consolidate from 2003.

In Bangladesh today there are 49 banks, with 6,318 branches, comprising 30 private banks, 4 state-owned commercial banks, 10 joint-venture commercial banks and 5 specialized banks. In addition, there are 30 registered merchant (investment) banks) under the regulation of the Securities and Exchange Commission, which invest in stocks on behalf of customers. Fund management companies that provide brokerage services have also been established recently. In 2005, the share of nationalized commercial banks, private commercial banks and joint-venture banks in total assets of the financial institutions was 40.14 per cent, 42.63 per cent and 9.46 per cent, respectively. Thus, the share of commercial banks in total financial assets stood at 92.23 per cent in 2005. In terms of deposits, the share of nationalized commercial banks reached 39.78 per cent in 2005. The total assets of commercial banks increased by 9.8 times during 1990-2005, from Tk 254.4 billion to Tk 2,487.7 billion. Similarly, deposits and loans, and advances of commercial banks increased 7.2 and 6.4 times during the same period, from Tk 233.5 billion and Tk 226.6 billion to Tk 1,690 billion and Tk 1,444.7 billion, respectively.

B. Insurance sector

The 21 insurance companies in Nepal include 14 in the private sector, 3 branches of foreign insurance companies, 3 joint-venture companies and a government-owned company. The total paid-up capital of those insurance companies, excluding the paid-up capital of branches of foreign insurance companies, stood at NRs 1.2 billion in 2005. The share of domestic insurance companies was 87.1 per cent while the remainder was with joint-venture companies. The total paid-up capital (excluding the branches of foreign insurance companies) of all insurance companies was only NRs 46 million in 1990, but by 2005 it had climbed to NRs 1.2 billion. Likewise, the total capital investment of foreign insurance companies was meagre at NRs 4 million in 1990, following which the figure decreased slightly to reach NRs 1.6 million in 2001. However, after 2001, it jumped markedly and stood at NRs 150 million in 2005, showing the growing importance of foreign insurance companies in Nepal.

The total collection of premiums, which amounted to NRs 244 million in 1990, also increased gradually to reach NRs 5.85 billion in 2005. Of the total premium income, premiums from life insurance accounted for 34.5 per cent in 1990. However, in 2005, that share went up to 48 per cent; the remaining 52 per cent was generated by non-life sectors. The investible reserve fund also surged up accordingly and stood at NRs 14.6 billion in 2005. In 1996, it was just NRs. 3.07 billion. Interestingly, more than 80 per cent is kept in the form of fixed deposits in commercial banks. There has also been a steady rise in employment in the insurance sector. In 1990, direct employment opportunities provided by the sector were 646, increasing to 1,350 opportunities in 2003.

The Malaysian life insurance industry has recorded significant growth during the past decade. Premiums grew at an average rate of 23.9 per cent from 1990 to 1995, but slowed during

1996-2000. By 2005, total premiums had reached M$ 12.3 billion. Based on growth in individual a period that included the years of the Asian financial crisis, witnessed a growth rate of 9.9 per cent in premiums. The period also witnessed the implementation of operating costs guidelines that became effective on 1 January 1996. The investment performance of life insurance funds remained relatively stable with the exception of 1993 and 1994, when high investment returns of 16.5 per cent and 15.2 per cent were achieved due to the buoyant stock market. Overall, the net yield on life insurance funds was maintained at an average rate of 7.2 per cent from 1990 to 1999, and 5.7 per cent from 2000 to 2005.

Consistent with the growth of the life insurance business, the general insurance business also recorded impressive growth during the 1980s and early 1990s, when it registered an average growth in direct premiums of between 18 per cent and 19 per cent. As a result of the economic slowdown in the late 1990s, the general insurance business suffered a slow average growth rate of 4.9 per cent from 1995 to 2000. Despite the decline in premiums, however, strong growth was evident in the expansion of total assets with an average growth of 13.1 per cent. During the five-year period of 2000-2005, the growth rate of assets was around 5.9 per cent. Most of the assets were held in the form of corporate debt securities and Malaysian government securities; almost 30 per cent of the assets were held in the form of cash and deposits.

Analysis of the underwriting performance in the general insurance sector for 1988 to 2005 shows that, beginning in 1992, the underwriting business of the general insurance sector turned profitable. In 1991, this sector experienced substantial losses to the tune of M$ 333 million. Since 1992, the general insurance sector has enjoyed good underwriting results with the highest profits registered in 1997 and 2005 (M$ 62 billion and M$ 96 billion, respectively). This was the result of an improved claims ratio and a reduction in commission payments following the implementation of cost control guidelines by the central bank in 1992. A similar trend emerged in the operating results of the general insurance sector with the exception of losses from 1988 to 1991. On the other hand, due to mergers and acquisitions of insurance companies, their number declined from 57 in 1990 to 42 in 2005.

The number of insurance companies operating in Bangladesh reached 58 in 2005. With total combined life and non-life insurance market premiums of approximately Tk 20 billion, Bangladesh ranks seventy-eighth in the world and has a world market share of 0.01 per cent. Per capita spending on insurance is only US$ 2.30. Insurance premiums as a percentage of GDP remain low at 0.57 per cent. However, the market has been steadily growing at a double-digit rate. In 1986, the total premium income of private sector insurance companies was Tk 280 million. In 2004, it rose to TK 20.31 billion, of which life insurance premiums amounted to Tk 14.09 billion and general insurance premiums, Tk 6.22 billion. Gross premium income of private and public companies reached Tk 6.22 billion in 2005, up from Tk 5.1 million in 2003. In order to ensure long-term growth and sustainability in income, insurance companies in Bangladesh are building up reserves and assets. The total reserves and assets of the insurance companies increased by 6.59 per cent and 23.46 per cent, respectively, in 2005, when compared with 2004.

III. Overview of regulatory frameworks

A. Banking

1. Nepal

In Nepal, financial sector liberalization began in the mid-1980s with the introduction of some liberal interest rate policies. Starting in 1984, interest rate control was gradually lifted. The Finance Companies Act went into effect in 1985 to meet the rising demand of small borrowers. From 1989, the Nepal Rastra Bank (NRB) also began to fix the capital adequacy ratio. Similarly, in 1990, the NRB introduced an open market operations policy as one of its monetary policy implementation tools. The Finance Companies Act, 1985 was amended to allow promoters to hold 60 per cent of the total issued capital. The Development Bank Act, 1995 and the Financial Intermediary Institutions Act, 1998 were introduced to attract the private sector and NGOs in establishing financial institutions in the rural areas. These measures were brought into effect to strengthen the regulation system as well.

However, despite all these initiatives, Nepal gradually experienced a deepening crisis in its financial system. The crisis was worsened by the increased share of non-performing assets in two state-owned commercial banks. By 2000, the ratio of NPAs of these banks climbed above 60 per cent, indicating a very poor financial regulatory system. As a result, a comprehensive financial sector reform programme was started in 2002, aimed at creating a competitive, market-friendly, well-diversified and prudently managed system capable of leading the healthy growth of the financial sector. The major components of the initial programme were three-fold: (a) the re-engineering of NRB; (b) the restructuring of state-owned banks (i.e., the Rastriya Banijaya Bank and the Nepal Bank Limited); and (c) capacity-building in the financial sector.

Initially, the focus of reform was on improving the legislation and prudential norms in the financial sector. The enactment of the New NRB Act, 2002 and the introduction of some steps to enforce better prudential regulations are the outcome of that reform effort. The Banking and Financial Act, 2006 (an umbrella Act covering all financial institutions) was enacted with the aim of bringing about more reforms in financial institutions in a more coordinated way. Under the comprehensive financial sector reform plan, a new thrust has been given to prudential regulations. The directives related to the prudential regulations include:

(a) Maintenance of capital adequacy;
(b) Loan classification and loan loss provisioning;
(c) Limiting of credit exposure and facilities to single borrowers, groups of related borrowers and single sectors of the economy;
(d) Accounting policies and formats of financial statements;
(e) Minimization of risk;
(f) Corporate governance;
(g) A time frame for the implementation of regulatory directives issued in connection with inspection and supervision of the banks;
(h) Investments in shares and securities;
(i) Statistical reporting by commercial banks to NRB;
(j) The sale and transfer of promoters' share;
(k) Provisions related to consortium financing;
(l) Provisions for blacklisting;

(m) Maintenance of the cash reserve ratio;
(n) Provisions for bank branches;
(o) Provisions related to interest rates; and
(p) Provisions related to financial resource collection.

2. Malaysia

Prior to 1973, banking legislation in Malaysia was specific to each type of financial and non-financial institution. The separate legislation did not provide the central bank with effective regulatory and supervisory powers to oversee the activities of non-financial institutions that were operating at the fringe of the regulated banking sector. Until 1972, the general policy regarding the supervision and regulation of the banking system in Malaysia was to provide only a broad legal framework for governing the activities of the commercial banks. Several amendments were introduced to the Banking Act, 1973 regarding the supervision and control of banks, equity limits on ownership of banks as well as strict controls on lending. The amendments came into effect during the early part of 1986. The regulatory and supervisory framework was put on a sound footing with the introduction of the Banking and Financial Institutions Act (BAFIA) in 1989. BAFIA empowers the central bank with wider powers for supervising all financial institutions and, under specific circumstances, regulate scheduled and non-scheduled institutions. All domestic banks were required to have new licences issued under BAFIA. Many of the banking regulations regarding the statutory reserve ratio, base lending rate (BLR) and two-tier asset ratio have been replaced with a single liquidity ratio to allow flexibility in the management by the banks of their liquid assets.

In November 1995, a new market-based BLR framework based on a weighted average of a three-month interbank rate and an administrative margin of 2.5 percentage points was introduced. The maximum margin above BLR was retained at 4 percentage points. The computation of the BLR ceiling was further improved by substituting the weighted average interbank rate with the intervention rate.

The central bank revised its guidelines for banks to invest in any shares listed on the stock exchange subject up to certain prudential limits. Banks can also invest in corporate bonds and commercial papers approved by the central bank; such investment should not exceed 10 per cent of the banking institution's capital funds. The central bank also introduced prudential guidelines periodically to ensure that banking institutions are not overtly exposed to excessive risks as happened in 1985. Limits were imposed on financing for purchasing cars and residential properties, and for credit card holders. With the conclusion of the Uruguay Round in December 1993, and Malaysia's commitments under GATS, it was evident that the Malaysian banking and insurance sectors had to be progressively liberalized. Therefore, the central bank began to introduce several measures to consolidate the banking system, which comprised several commercial banks, finance companies, merchant banks and discount houses and which came under the regulatory framework of BAFIA in 1989. The central bank introduced a two-tier system to encourage banks to recapitalize into larger units so that they could become competitive domestically and abroad.

The recession of 1985 exposed the absence of a sound and effective credit-risk management process. In November 1985, the Guidelines on the Suspension of Interest on Non-Performing Loans and Provision for Bad and Doubtful Debts (GP3) were introduced. In January 1986, the Guidelines on the Credit Limit to a Single Customer (GP5) were issued to limit lending to a single customer and related corporations (30 per cent of total capital, which was reduced to 25 per cent from March 1998). In terms of large loans, the central bank imposed a limit of 50 per cent of total credit facilities.

The guidelines on investment in private debt securities were revised in February 1994 to allow banks to invest in all approved corporate bonds and commercial papers rated at least "BBB" or P3, respectively. Over the years, GP3 (provisions for NPLs) was modified to bring it into line with international practices. In 1989, the classification period for NPLs was reclassified from 12 months to 6 months. General provisions for bad loans remained at 1 per cent of total outstanding loans.

The central bank employs the CAMEL framework to evaluate the overall financial and general conditions of a banking institution. CAMEL is the acronym for "capital adequacy, asset quality, management quality, earnings performance and liquidity position". On the question of approach to supervision, the central bank employs off-site surveillance and on-site examinations.

Initially, the central bank introduced a merger programme for all the finance companies. In July 1999, this merger programme also included the domestic banking institutions. The central bank announced the framework for the creation of investment banks in March 2005. On completion of the merger exercise, an investment bank holds both a merchant banking licence and a dealer's licence, which are issued under BAFIA 1989 and the Securities Industry Act, 1983, respectively.

The strength of the banking system lies in the laws that regulate corporate governance. Many laws govern the Malaysian corporate sector, including: the Companies Act, 1965; Company Regulations, 1966; the Securities Industry Act, 1983; the Securities Commission Act, 1993; the Futures Industry Act, 1993; BAFIA, 1989; the Malaysian Code on Takeovers and Mergers, 1987; KLSE Guidelines on Stock Exchange Listing; and the Foreign Investment Committee guidelines. This legislation has been enacted during the process of liberalizing the banking and insurance sectors. In addition, the central bank has introduced the following measures at various stages to improve the governance of the banks:

(a) Guidelines on directorship in the banking institutions (GP1);
(b) Guidelines on the code of conduct for directors, officers and employees in the banking industry (GP 7);
(c) Guidelines on the specimen financial statements for the banking industry (GP8); and
(d) Guidelines on minimum audit standards for internal auditors of financial institutions (GP10).

3. Bangladesh

A new Banking Company Act was introduced in 1991 in Bangladesh in order to strengthen the regulation and monitoring system. Since 1994, Bangladesh has also introduced the CAMEL framework in its banking system.

In order to strengthen credit discipline and bring classification gradually into line with international standards, a new policy was introduced on 3 March 2005. Prudential guidelines for consumer and small enterprise financing were issued. In order to improve credit risk management, the central bank reduced the single borrower exposure limit from 50 per cent to 35 per cent of total capital, subject to the condition that the maximum fund-based credit facilities did not exceed 15 per cent of its total capital. The cash reserve requirement was fixed at 4 per cent in July 2004.

In order to strengthen credit discipline and bringing classification gradually into line with the international standards, credit, demand and term loans that remain overdue for 90 days or more are put under the "special mention account".

B. Insurance

1. Nepal

The Insurance Act, 1992 and Insurance Regulation, 1993 govern the insurance business in Nepal. They guarantee equal treatment for national as well as foreign insurance companies. The Act does not restrict the pattern of ownership, location of business inside the country or the legal forms (e.g., subsidiaries vs. branches vs. joint ventures). In the case of foreign joint ventures, 20 per cent of the shares have to be issued to the public. However, the insurer is not allowed to operate life insurance and non-life insurance businesses side by side through the same organization. The Insurance Act, 1992 and Insurance Regulation, 1993 have incorporated various provisions that are related to prudential regulations. The insurer has to maintain a separate insurance fund for each category of insurance business. While creating a separate fund in the case of a life insurance business, the amount should not be less than the total liability as specified by the insurance policies. Similarly, in the case of a non-life insurance business, the amount should not be less than 50 per cent of the net non-life insurance premiums.

The Insurance Board has also set investment norms. The insurance companies are required to invest at least 75 per cent of their total investment in government securities, treasury bills and fixed time bank deposits. The remaining 25 per cent can be invested in housing schemes, financial companies and debenture schemes of public limited companies apart from depositing in commercial banks.

2. Malaysia

In Malaysia, the supervision and regulatory power of the industry were vested with the central bank in 1988. The central bank manages the insurance sector, both through the regulation and supervision of insurance licensees. Central bank regulation of the industry falls into four categories: (a) policy development; (b) administration and enforcement; (c) actuarial function; and (d) consumer education and complaints handling. Policy development focuses on the continuous improvement in the regulatory framework for the insurance industry. A special actuarial unit was set up in 1992. The Insurance Act, 1996 incorporated all the changes necessary to the Insurance Act, 1963 in order to make the industry more competitive within a substantially strengthened legal framework. New rules were introduced for financial requirements that were more stringent, a higher level of disclosure and transparency in operations. The renewal of licences has been biannual since 1999 for good management of financially strong brokers and adjusters. The Insurance Act, 1996 also allows the central bank to specify the manner in which assets backing the solvency margin of an insurer are invested. The central bank introduced the admitted assets framework in 1997. Insurers are also required to maintain a minimum margin of solvency of M$ 50 million (M$ 5 million under the previous Act). Both the capital and solvency margin requirements have been fully implemented since the beginning of 2001.

3. **Bangladesh**

The Insurance Act, 1938 and Company Act, 1994 regulate the insurance business in Bangladesh. The industry is dominated by two large state-owned companies, SBC for general insurance and JBC for life insurance, which together command most of the total assets of the insurance sector. The total number of insurance company branches is around 7,500, located throughout the country. Most of the insurance companies have branches in rural areas.

C. Conclusion

In Nepal, the successes of financial reforms so far indicate that the regulation system is still weak, and that further prudential rules and an effective regulatory framework are needed. In that regard, the introduction of CAMEL could be a major positive approach, especially in view of the effectiveness of CAMEL in Malaysia. Similarly, Malaysia has introduced a number of regulatory measures for the healthy development of insurance sector. As noted above, under the Insurance Act, 1996, the central bank must specify the manner in which assets backing the solvency margin of the insurer are invested. At the same time, insurers are required to maintain a certain minimum margin of solvency. Such a regulatory framework could be useful for both Nepal and Bangladesh.

IV. Banking performance in the three economies: Case studies

To examine banking system profitability and efficiency, case studies of selected banks were carried out in the three economies. In each country, three case studies were undertaken of banks with different ownership structures (private, joint-venture and state-owned banks). For comparing the profitability and efficiency of the banks, the net profit to total income, interest income to total loan and advances, and NPLs to total loans were estimated and compared.

A. Private banks

The net profit to total income of private banks in Nepal and Malaysia has increased gradually. The net profit to total income of Nepal reached 20.26 per cent in 2005, up from 13.68 per cent in 2001. In Malaysia, the ratio rose to 41.02 per cent in 2005, up from 34.37 per cent in 2001. As expected in a competitive environment, interest income to total loan decreased in these two economies. The opposite trend, however, was observed in Bangladeshi banks. The interest income to loan ratio in Bangladesh increased to 20.49 per cent in 2005, up from 17.6 per cent in 2001. This means that in Bangladesh there is less competition between private sector banks. Similarly, it appears that frequent intervention by the central bank in the banking system is still prevalent in Bangladesh. In all three economies, the NPL to total loan ratio has decreased gradually overtime. The rate of decline has been sharper in Nepal and Malaysia than in Bangladesh (table 7).

B. Joint-venture banks

The share of net profit to total income of the joint-venture banks has increased markedly in Nepal and Malaysia. In Nepal, the net profit to total income ratio reached 34.21 per cent in 2005, up from 25.92 per cent in 2001. Similarly, in Malaysia, the ratio rose to 23.98 per cent in 2005, up from 8.79 per cent in 2001. The ratio of NPLs to total loans and advances has also decreased sharply in the three economies. The decline rate was found to be higher in Nepal compared with Malaysia and Bangladesh. Interest income to total loan and advances also declined from 10.22 per cent in 2001 to 7.43 per cent in 2005 in joint-venture banks of Nepal. In Malaysia, the ratio declined to 6.33 per cent in 2005 from 8.55 per cent in 2001. Conversely, interest income to total loans and advances in Bangladesh increased to 10.12 per cent in 2005, up from 6.3 per cent in 2001.

C. Government banks

The profitability and efficiency performance of the government banks is entirely different from private and joint-venture banks. In the case of Nepal, the net profit to total income ratio was negative in 2001. After intensive financial sector reform, the net profit to total income became positive at 37.69 per cent in 2005. Similarly, interest income to total loan and advances declined from 9.98 per cent in 2001 to 7.78 per cent in 2005. In Bangladesh, too, the ratio of interest income

to total loans and advances declined marginally from 8.89 per cent in 2001 to 8.75 per cent in 2005. The ratio of NPLs to total loans in the Rastriya Banijaya Bank of Nepal increased to 52.99 per cent in 2005, up from 48.16 per cent in 2001. In Bangladesh, the NPL ratio of the government bank declined modestly from 27.46 in 2001 to 22.52 per cent in 2005 (table 7).

Table 7. Performance of the banking system in Nepal, Malaysia and Bangladesh

(Unit: %)

	2001			2005		
Country/banks	**Net profit to total income**	**Interest income to total loans**	**Non-performing loans to total loans**	**Total net profit**	**Interest on loans**	**Non-performing loans to total loans**
Nepal						
Rastriya Banijaya Bank	-226.22	9.98	48.16	37.69	7.78	52.99
Private bank (NIB)	13.68	9.43	8.29	20.26	7.36	2.69
Joint-venture bank (SCBL)	25.92	10.22	5.23	34.21	7.43	2.69
Bangladesh						
Government bank (Sonali)	-	8.89	27.46	-	8.75	22.52
Private bank (Prime)	-	17.60	12.22	-	20.49	10.98
Joint-venture bank (SCBL)	-	6.3	3.17	-	10.12	2.49
Malaysia						
Private bank (BCHB)	19.51	9.18	6.7	17.51	8.72	10.7
Public bank (Private bank)	34.37	9.07	4.41	41.02	6.38	1.37
Joint-venture bank (May bank)	8.79	8.55	15.23	23.98	6.33	8.72

Source: Case studies carried out in individual countries.

V. Main financial sector development challenges

A. Non-performing loans in government banks, and non-profitability

The performance of the government bank in Nepal is not sound, as the NPL and profitability indicators reveal. The ratio of NPLs in the government bank is very high when compared with the private and joint-venture banks. The government bank still undertakes government-directed programmes, including priority sector lending programmes, partly to cater to the needs of people living in the rural areas. Therefore, profitability and performance issues are hardly considered while lending in the priority areas. Likewise, high overhead costs, political interventions in loan sanctions and the low quality of collateral create greater burdens for the government bank, leading to continued deterioration in the financial health of state-owned banks. Therefore, without autonomy in management supplemented by changes in ownership structure, it will be very difficult to improve the performance of state banks. However, unless this is done, misallocation of savings will continue. The persistence of non-profitability will also encourage continuing misallocation of labour.

In Bangladesh, the ratio of NPLs to total loans is very high in the government bank. The government bank implemented directed credit programmes during the 1970s and 1980s. Poor appraisal, and inadequate follow-up and supervision of loan distribution eventually resulted in massive booking of poor-quality assets, the level of which remains high. The banks were reluctant to write off the historical bad loans because of the poor quality of underlying collateral as well as to avoid any possible legal complications due to a lacuna in the judicial framework. Therefore, in Bangladesh, revamping of the government bank also appears essential to ensuring a healthy development of the entire banking system in the country. Without such steps, both savings and labour misallocation will continue in Bangladesh.

In Malaysia, data indicate that much of the lending after the financial crises was directed to residential property with strict guidelines in lending. Prior to the crisis, substantial loans had been given to the construction sector, which experienced a greater burden of NPLs in domestic financial institutions. The reforms in the post-crises periods have tried to avoid both savings and labour misallocation in Malaysia.

B. Failure of insurance companies to undertake long-term investment

In Nepal, the Insurance Board has set the investment norms. The insurance companies are required to invest at least 75 per cent of their total investment in government securities, treasury bills and fixed time bank deposits. This has led to hampering of long-term investment and encouragement of misallocation of savings. This is also true in the case of Bangladesh.

In Malaysia, on the other hand, most of the assets of the insurance sector are held in the form of corporate debt and government securities. Only 30 per cent of the assets are held in cash and deposits. Encouragement to invest in corporate debt securities enabled insurance companies to divert resources towards long-term investment in Malaysia.

C. Restricted access by the poor and small businesses to credit

Despite a more than three-fold increase in per capita credit of the commercial banks in less than a decade, access to credit among the lower income strata and poor people has not improved commensurately in Nepal. The collateral-based lending practice of the banks has been a factor in denying access by the poor to bank credit. Although non-collateral-based lending increased considerably from 12 per cent in 1996 to 28 per cent in 2004, it has yet to encompass most poor and vulnerable groups of society. In Bangladesh, the share of the agriculture sector in total lending of commercial banks declined sharply from 23.27 per cent in 1990 to 9.55 per cent in 2005. Of the total credit requirement, 8 per cent of the poor have received credit from the commercial banks. More than 80 per cent of the branches of private and joint-venture banks are located in urban areas. Thus, despite the massive increase in financial institutions, 52 per cent of poor people are dependent on the informal sector for credit in Bangladesh. On the whole, the priority sector lending in the agriculture sector has only led to misallocation of savings in Bangladesh and a review of ongoing policy in the changed liberal environment is required. In the case of Malaysia also, lending by commercial banks to the agricultural sector fell from 5.2 per cent in 1988 to 1.9 per cent in 2005, indicating the existence of some problems of access to credit in that sector.

VI. Policy implications

Institutional reforms should be an integral part of the opening-up process and liberalization policies. In particular, the institutional capacity of the central banks needs enhancing with the focus on improving the effectiveness in the prudential regulations. This will make ongoing reform effective and result-oriented. This will also reduce the need for abrupt measures or actions to address unexpected crises as those that countries such as Nepal and Malaysia have had to take in the past. In this regard, more drastic reforms in the banking and insurance sectors of Bangladesh appear essential as indicated by the weak performance, dominance of state ownership and more regulatory interest structure. One possible option could be to convert government banks into joint-venture banks. This would help to enhance employment opportunities as well as improve the allocation of labour and savings.

The changes and reforms in ownership and market structures are particularly important, as private and joint-venture bank performances indicate. In the context of countries such as Nepal, raising the capital base of the banks and introducing policies removing government control and interference in the state-owned banks would be necessary. In view of Nepal's commitment to WTO in allowing wholesale banking by 2010, such a step seems essential. The operation of wholesale banking in Nepal, together with measures to enhance financial and other capabilities of the domestic banks, will enable the size of NPAs to be reduced as well as allow considerable improvement in the allocation of labour and savings.

Country experiences suggest that the strengthening of institutions by introducing financial laws such as banking fraud control laws, asset securitization laws and a trustee law, among others, would be necessary for ensuring the sustainability of reforms. In countries such as Nepal, in the absence of such laws, central banks have been unable to control fraud; this has led to the regulatory systems being made less effective. At the same time, in the absence of specific laws, the judiciary also cooperates very little with ongoing financial sector reforms. Similarly, for security of loans, a policy of asset securitization and the formulation of a trustee law will be essential for making ongoing banking sector reforms effective.

One of the problems experienced by countries such as Nepal in the course of intensive liberalization is that despite financial deepening, access to credit among the rural population could not be increased. This is also partly true in the case of small businesses operating in urban areas. In order to overcome such problems, it will be necessary for policy to focus on the rapid expansion of micro credit institutions, community-based self-help saving credit groups and cooperatives. The success story of the Grameen Bank also indicates that in order to enhance access to credit among poor or small businesses, non-collateral group-based lending could be a better approach. This will ease pressure on the governments or central banks to force commercial banks to divert resources into non-profitable ventures. At the same time, it may prevent the crowding out of funds available to the private sector.

Empirical evidence suggests that liberalization of trade in financial services and the consolidation of the banking sector with foreign participation should proceed simultaneously. Liberalization of trade has an impact on the deepening of the financial system (opening of trade facilities improves availability of domestic credit) and vice versa; therefore, careful policy sequencing is essential to benefiting from liberalization and the strengthening of the domestic banking system.

For the enhancement of technical or institutional capacity of the banking system, including central banks, some support measures through WTO would be desirable for least developed countries such as Nepal and Bangladesh. With regard to enhancing trade capacity, in particular, technical support for institutional building will be necessary. In view of small businesses being adversely affected by ongoing reforms, some safeguard measures for them would be desirable. For this, the role of WTO in the negotiation process will be vital. WTO support for enhancing internal trade-related capacity-building will also help to provide some feedback to WTO in the negotiation process.

Annex

Annex table 1. Bounds Test for co-integration

		F-Statistic	Lag	ECM
Malaysia				
1970-2004	F_{credit} (LnCredit/LnOpen)	3.033 [0.219]	6	=-0.1055 [0.227]
	F_{open} (LnOpen/LnCredit)	1.9875 [0.370]	4	= -0.7475 [0.461]
1986-2004	F_{credit} (LnCredit/LnOpen)	5.6003 [0.061]	5	= -0.4363 [0.009]
	F_{open} (LnOpen/LnCredit)	3.1611 [0.206]	6	= -0.6876 [0.502]
Nepal				
1975-2000	F_{credit} (LnCredit/LnOpen)	18.031 [0.000]	5	= -0.3278 [0.001]
	F_{open} (LnOpen/LnCredit)	0.6495 [0.723]	5	= -0.0096 [0.934]
1982-2000	F_{credit} (LnCredit/LnOpen)	16.8577 [0.000]	1	= -0.3048 [0.005]
	F_{open} (LnOpen/LnCredit)	0.2077 [0.901]	1	= -0.0123 [0.929]
Bangladesh				
1974-2003	F_{credit} (LnCredit/LnOpen)	2.7933 [0.247]	1	= -0.2722 [0.058]
	F_{open} (LnOpen/LnCredit)	1.1238 [0.570]	1	= -0.1872 [0.141]
1986-2003	F_{credit} (LnCredit/LnOpen)	26.3085 [0.000]	1	= -0.3825 [0.005]
	F_{open} (LnOpen/LnCredit)	20.0185 [0.000]	1	=- 0.4541 [0.004]

Note: Critical values are at 1 per cent (6.84–7.84), 5 per cent (4.94–5.73) and 10 per cent (4.04–4.78).

Annex table 2. Long-term elasticities (trade in goods and services)

Country	Years	Dependant variable	Independent variables	
			Lnopen	Lncredit
Malaysia	1970-2004	LnCredit	0.7683 [c] (0.083)	
		LnOpen		0.4314 (0.3414)
	1986-2004	LnCredit	0.7224 [a] (0.000)	
		LnOpen		0.7728 [b] (0.023)

Nepal	1975-2000	LnCredit	0.6498 ^{a} (0.000)	
		LnOpen		-0.6949 (0.926)
	1982-2000	LnCredit	0.5997 ^{a} (0.000)	
		LnOpen		-1.8334 (0.961)
Bangladesh	1974-2003	LnCredit	0.6391 ^{c} (0.056)	
		LnOpen		0.7400 (0.302)
	1986-2004	LnCredit	7.5255 (0.633)	
		LnOpen		0.7458 ^{a} (0.002)

Note: ^{a}, ^{b} and ^{c} denote significance at the 1 per cent, 5 per cent and 10 per cent level, respectively. The probabilities are given in parentheses.

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