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Who's afraid of banking liberalisation?

Foreign banks are a plus -not a threat - to an economy

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IN the aftermath of the East Asian crisis of 1997-98, financial sector restructuring has been an essential element in structural adjustment programmes in Indonesia, South Korea, Thailand and the Philippines.

Broadly, governments in the crisis-hit regional economies have attempted to restructure their financial systems by closing down commercial banks and finance companies; merging some existing institutions and nationalising others; injecting public funds to recapitalise viable banks; putting in place systematic asset resolution strategies; and easing regulatory impediments to foreign bank entry.

The liberalisation of entry norms for foreign banks has borne fruit. For instance, foreign bank penetration in Thailand rose from 3.6 per cent in 1996 to 11.3 per cent by 2000. Nonetheless, most of Asia continues to lag other emerging markets in Central or Eastern Europe and Latin America, where foreign banks own 50 per cent of total bank assets, on average.

What is the rationale behind this enthusiasm in Asia for the internationalisation of the banking sector?

A common view is that this was a policy imposed on the regional economies by the International Monetary Fund (IMF) and its largest shareholder (the United States) as a condition for the 1997-98 IMF-led bailouts. While this perception may be valid, it is instructive that even countries relatively unimpacted by the regional financial crisis, such as Singapore, are taking steps to promote the internationalisation of their banking sectors, as are India and China, albeit less aggressively. Why?

Apart from helping recapitalise the banking systems, it is becoming increasingly apparent that foreign competition brings with it additional benefits that domestic competition does not.

First, there is a growing body of empirical evidence of the benefits of foreign bank entry in emerging economies by way of reductions in cost structures; improvements in operational efficiency; introduction and application of new technologies and banking products; marketing skills; and management and corporate governance structures. These pro-competitive gains brought about by free trade in financial services are not dissimilar to those arising from trade in merchandise goods. The big difference between trade in goods and services is that the latter usually requires the right of establishment of foreign suppliers.

Less crisis-prone

Second, a banking system with an internationally diversified asset base is more likely to be stable and less crisis-prone. In addition, the domestic branches of foreign banks may be able to obtain financing from the foreign head office which could act as a private

lender of last resort during a period of financial stress. However, it is important to ensure that foreign investments do not largely originate from a single home country as this might increase, rather than decrease, instability.

Third, bank internationalisation may create domestic pressures for local banking authorities in the host countries to enhance and eventually harmonise regulatory and supervisory procedures and standards, and the overall financial infrastructure to international best-practice levels.

Fourth, entry of foreign banks ought to reduce the extent of non-commercial or connected lending, as these banks are not as politically connected as the homegrown institutions.

Fifth, foreign banks could enhance the quality of human capital in the domestic banking system by importing high-skilled personnel to work in the local host subsidiary as well as via knowledge spillovers to local employees.
Notwithstanding these benefits, some are strongly opposed to banking liberalisation, and have raised questions about whether foreign ownership in the banking sector is appropriate.

Broadly, the economic justifications for continued protection of the domestic banking system boil down to the usual 'infant industry' and 'strategic industry' arguments.

The first essentially argues that time is needed for domestic bank consolidation if local banks are to be able to compete effectively against multinational foreign banks which have much larger and more diversified capital bases. The second maintains that the financial sector, with its intricate linkages to the rest of the economy, is too important to be left in the hands of foreigners.

Moderate the pace

While the infant industry argument has merit in theory, the problem in practice is that most infants take too long to grow up, and many's the time they grow old rather than grow up. With regard to the strategic industry argument, one could turn it on its head and suggest that, in view of the importance of the banking and overall financial sector to the rest of the economy and society, everything possible must be done to ensure it is as efficient as possible, including welcoming foreign bank participation.

In any event, as with most other industries, the infant and strategic industry arguments appear more valid as grounds for moderating the pace and possibly even the extent of foreign bank entry, rather than opposing the policy in its entirety.

With regard to the timing of liberalisation, there is much to be said for a gradual, as opposed to cold turkey or big bang, approach to bank internationalisation. The long sheltered and coddled local banking sector usually needs some breathing space and lead time to prepare for the impending competition. This in turn necessitates a broad consolidation of many of the hitherto relatively weak and small banks and non-bank financial institutions via mergers or takeovers.

Absent this, apart from outright closures of some smaller and inefficient banks, remaining domestic banks may opt for increasingly risky and speculative investments to compensate for declining market shares, lower profit margins and eroding franchise values.

If such gambling for redemption occurs, an increase in bad loans due to risky investments will partially offset the efficiency gains associated with greater international competition. In addition, foreign banks may, in some instances, be in a position to engage in cherry-picking - that is, being able to choose clients/debtors of highest quality and leaving the domestic banks with lower-quality (default-prone) borrowers. There is some evidence that this has been happening in some Asian countries like the Philippines.

First mover advantage

If the internationalisation of the banking sector is properly managed, fears that no domestic financial institutions may survive following foreign bank entry are without basis. Indeed, cross-country evidence suggests that the first mover and informational or familiarity advantages enjoyed by domestic banks for some business like consumer lending and deposit taking limit the extent of inroads that foreign banks can make, at least in the short run.

Experience from other regions suggests that domestic financial institutions will continue to play a crucial role in the financial system. There may even be a role for a government-backed Postal Savings bank to meet the basic retail banking services such as small checking and savings accounts, mortgages or small business loans - areas that may sometimes be overlooked by larger foreign banks.

From the regulator's perspective, any form of financial services liberalisation requires that the institutional and regulatory environment be fortified before and during the process of liberalisation. Liberalisation in a weak or ineffective regulatory and supervisory environment can be calamitous.

This was made abundantly clear by the East Asian crisis of 1997-98 which was partly caused by the ill-timed and ill-sequenced liberalisation of the financial sector. This is yet another reason to favour introducing competition in a phased and nuanced manner.

That said, the danger of a gradualist approach to internationalisation is that it may eventually run out of steam as opponents of the programme will have more opportunities to block it. Lest there be any wavering of commitment by Asian policy makers to bank internationalisation, it is imperative to keep in mind that what matters for growth and welfare is the availability of high-quality products and services at internationally competitive prices - not who provides them.

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