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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	Claims on the	M1	M2	Gross fixed capital

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