CHAPTER I

INTRODUCTION

1.1. Preface

The fact that financial sector is crucial in economic development by primarily accumulating and reallocating financial resources in the economy for the most productive uses has brought us great efforts to improve its efficiency. In hope to strengthen their financial systems, countries around the world, especially developing economies including Thailand, constantly pursue several forms of financial liberalization.

Though Thailand has proactively liberalized its capital account and interest rates in the past decade, foreign entry to Thai financial sector[1] which contributes mostly to commercial banks has been highly restricted by the limitation of which only one foreign bank branch is allowed in Bangkok and foreigners cannot hold more than 24.99 percent shares. However, after the crisis, the Bank of Thailand (BOT) has permitted foreigner to hold a majority of shares in Thai commercial banks under administration of the new guidelines for equity holding in financial institutions. The recapitalization policy is expected to foster competition and efficiency of the banking sector as well as encourage economic growth. According to the Financial Sector Master Plan, the BOT plan to lower the impediments to foreign entry further in subsequent phases even though costs and benefits of this approach are still controversial in both theory and practice.

This study therefore analyzes the relationship between entry of foreign banks and aggregate growth effect with an emphasis on Thailand. The study is organized as follows. The next section provides some background in Thai banking sectors and financial liberalization. The objective and scope of this paper are discussed in subsequent sections. Previous relevant literatures are reviewed in the second chapter. In third chapter the conceptual framework of the research question which involves primarily on transmission mechanisms is discussed and some evidence regarding costs of domestic versus foreign banks that are served as a basis of the study is also

[1] The WTO term is *market opening* (Dobson, 2002).

presented. The theoretical model is implemented and analyzed in the forth chapter. We also conduct empirical study to verify results of our model in the fifth chapter. The conclusion including policy implication and suggestion for future works are located in the sixth chapter.

1.2. Background

1.2.1. Financial Liberalization in Thailand

Since 1989, Thailand has pursued the financial liberalization under the main purpose of fostering competition in the domestic financial system and giving more resilience to financial institutions as preparation for the impending global liberalization of trade and services. The BOT began by liberalizing interest rates and removing the ceilings on time deposit rates followed by decontrolling saving deposit rates and lending rates in 1992. In 1989 foreign exchange control is also liberalized by allowing non-resident baht accounts to accommodate foreign borrowing settlements, stock transaction and foreign investment. Also, current and capital account transactions are deregulated in 1990 and 1991 respectively. In addition, the BOT, aiming to develop Thailand as a regional financial center, has permitted financial institutions to hold the Bangkok International Banking Facilities (BIBF) and Provincial International Banking Facilities (PIBF) licenses in 1993 and 1994 respectively. Financial institutions which hold the license can provide several foreign transactions such as accepting deposits in foreign currencies, lend foreign currencies to domestic residents (out-in) and to non-residents (out-out), and provide foreign exchange service.

Between 1989 and 1997, by financial liberalization policies, Thailand enjoyed tremendous economic growth with two-digit GDP growth along with credit growth as shown in Figure 1. The liberalization policies allowed both money and capital market mechanisms to be more flexible and efficient spurring substantially domestic consumption and investment. Undoubtedly, this process drove Thailand toward one of the most rapidly growing economies.

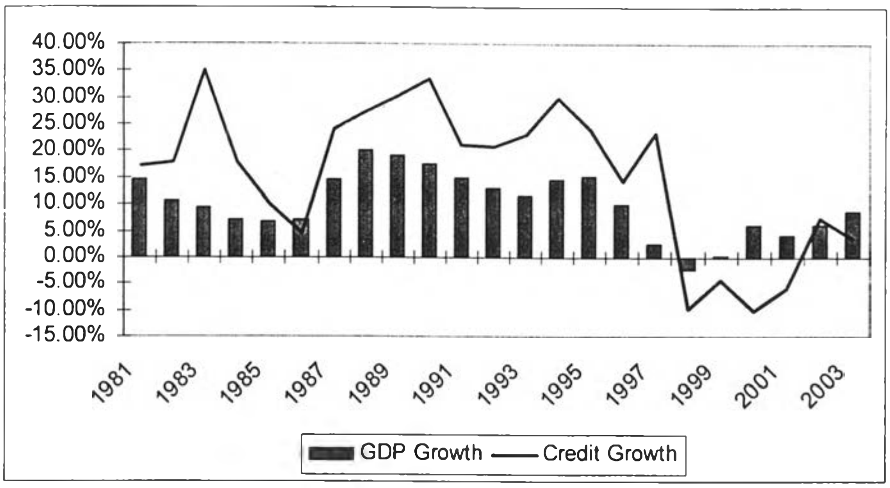

Figure 1 Thai GDP growth and credit growth between 1981 and 2003

However, in 1996 Thai economy encountered several difficulties. The fall in global demand which diluted Thai export resulting in surging account deficits and increasing domestic inflation recurrently deteriorated the problem by depressing the country' competitiveness in the world market. Foreign investors' confidence shrank due to the country's high non performing loan (NPL) causing surges of capital outflow reflecting the repayment of external debt and exchange rate speculation. The BOT could no longer defend the exchange rate and decided not to hold the basket-peg exchange rate. On July 2, 1997, Thai baht was floated and touched its peak at 53.71 baht per one US dollar in the beginning of 1998. Thailand's real GDP was contracted by 10 percent as shown in Figure 1. This evidence might reflect the sensitivity of Thai financial system to external factors despite the fact that Thailand had partially opened up. In 1997 the BOT has permitted foreign banks to hold a majority of shares in Thai commercial banks under the new guidelines for equity holding in financial institutions in order to restructuring Thai financial institutions (Montreevat, 2000). This regulation has increased foreign participation in and diversified Thai banking sector afterward

In the multilateral free trade negotiation, issues of the financial liberalization are included in the World Trade Organization (WTO) negotiation for several times. As an extension of General Agreement on Trade in Services (GATS), the standalone Financial Services Agreement (FSA) reached the conclusion on December 13, 1997. According to the agreement, the 104 WTO members bound market access commitments and assented on a legal framework for cross-border trade[2] and market access as well as a process of a dispute settlement (Dobson, 2002). Among the widespread belief that liberalization increases the chances of crises, Thailand is however one of active players in the global-level free trade negotiation. Compared to other developing countries as shown in Table 1, Thai banking sector openness is still on average.

Table 1 Indices of openness in financial services in 1997

	Banking		Securities		Insurance	
	Commitment	Practice	Commitment	Practice	Commitment	Practice
Hong Kong	4.20	4.75	4.00	4.40	4.40	4.00
Indonesia	3.15	3.20	3.50	3.00	3.10	2.60
Korea	1.10	1.70	1.70	2.10	1.20	2.60
Malaysia	2.40	2.40	2.50	2.50	2.10	2.10
Philippines	2.80	3.35	2.40	2.40	2.90	2.80
Singapore	2.25	2.50	2.70	2.70	4.10	4.10
Thailand	2.95	2.85	2.00	2.00	2.80	2.80
India	2.70	2.25	2.50	2.10	1.00	1.00
Average	2.69	2.88	2.66	2.65	2.70	2.75

Note: 1 = most closed; 2 = most opened
Source: Claessens and Glaessner (1998).

Besides, Thailand has negotiated financial sector liberalization in advanced not only with several trading partners such as Australia, but also in a regional level within ASEAN and BIMSTEC, and planed to engage further negotiation with other countries by the belief that successful negotiations in bilateral and regional forums can be beneficial in restarting multilateral negotiation (Bank of Thailand, 2004a).

1.2.2. Thai Banking Sector

The first commercial bank was established in December, 1888 when Hong Kong and Shanghai was granted a bank license in Thailand. It was followed by the Chartered Bank and Banque de L'Indochine in 1894 and 1897 respectively. The first Thai commercial bank was Siam Commercial Bank, founded in 1904, with the Book Club as its former name and follows by several banks[3]. During World War II, most foreign banks were closed bringing an opportunity for new domestic banks to enter the market. No new license for foreign banks was granted until 1993 when Thailand had to fulfill GATS obligations (Bank of Thailand, 1992).

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[2] The cross-border supply or commercial presence is one of the four modes of supply cover by GATS. For example, a company from one country sets up subsidiaries or branches to provide services in another country.

[3] For example, Wang Lee bank (1933), Tan Peng Chuan Bank (1934) and Bank of Asia (1939)

Foreign banks are allowed to hold four types of licenses: (1) Representative Offices serve as a customer relation representative main offices; (2) Full Branch can provide the same scope of services as Thai commercial bank except that only one branch and ATM on the branch are allowed; (3) Bangkok International Banking Facilities , announced in 1993, can, for example, deposit and borrow form other countries in foreign currencies and provide foreign exchange services; (4) Provincial International Banking Facilities can execute IBF activities in provincial regions and have credit limit for less than one billion baht per branch (Pootrakool et al., 2004)

The foreign bank restriction to establish new branches and hold share in Thai banks has limited the foreign participation in Thai banking sectors. Even though there are many foreign banks relative to Thai banks in the market as shown in Figure 2, foreign shares in term of assets and credits is small as shown in Figure 3, reflecting a little participation of foreign banks in the domestic market. Therefore, it may be misleading if only a number of foreign banks rather than asset share are investigated.

However, after the financial crisis in 1997, the BOT announced the new guidelines for equity holding in financial institutions which authorize foreign banks to hold more than 50 percent shares of Thai financial institutions for 10 years (the previous limit is less 25 percent of shares). After the enforcement of the new regulation, four Thai commercial banks were bought: (1) ABN Amro bought Bank of Asia in June, 1998; (2) DBS bought Thai Danu Bank in January, 1998; (3) Standard Chartered bought Nakornthon Bank in September, 1999; (4) United Oversea Bank bought Radanasin Bank in November, 1999. For other Thai banks such as Bangkok Bank, Kasikorn Bank, Siam Commercial Bank and Bank of Ayudhya, foreign investors also bought their equities significantly, almost 50 percent of shares, after the announcement of the new guidelines (Putrakula, Rodprasert and Nakorntan, 2004).

Announced in January, 1997 by the BOT, Financial Sector Master Plan was issued under objectives to increase competitiveness of financial institutions, improve access to financial services and correct the remaining weaknesses of the financial system. Also, foreign financial institutions will be allowed to play a greater role in Thai financial sector development. That is, foreign financial institutions can hold two types of bank licenses: (1) Subsidiaries can undertake the same scope of business as commercial banks and are allowed to open one branch in Bangkok and its vicinity, in addition to the head office and three branches outside; (2) Full branches can undertake the same scope of business as commercial banks but only single office operation is allowed. Furthermore, tax benefits for IBF out-in transaction will be discontinued and out-out transactions can be carried out by a financial institution encouraging stand-alone BIBFs to upgrade to full branches or subsidiaries. According to one presence policy, there will be only one form of deposit-taking institution and therefore financial institutions can enjoy the economies of scale. (Bank of Thailand, 2004)

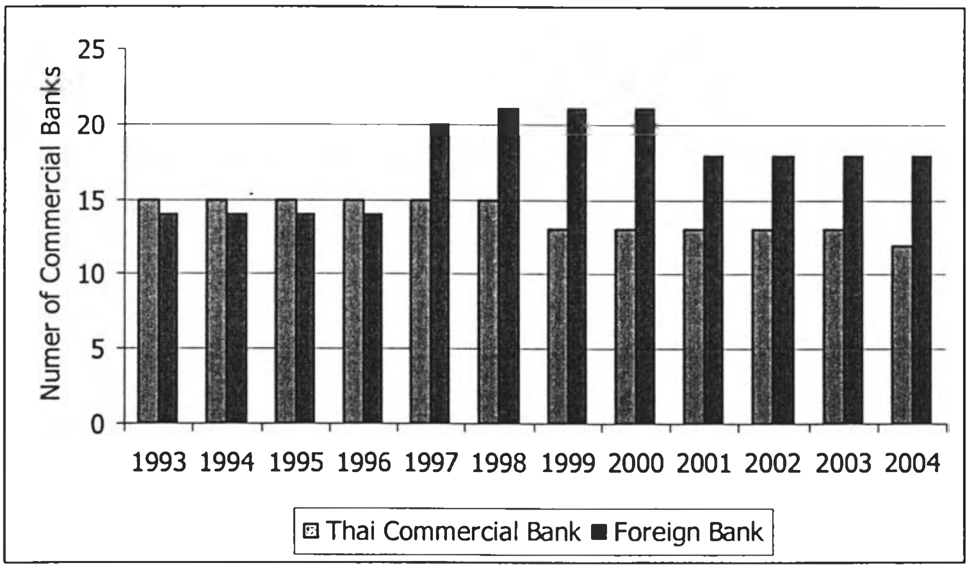

Figure 2 Numbers of Thai and foreign commercial banks between 1993 and 2004

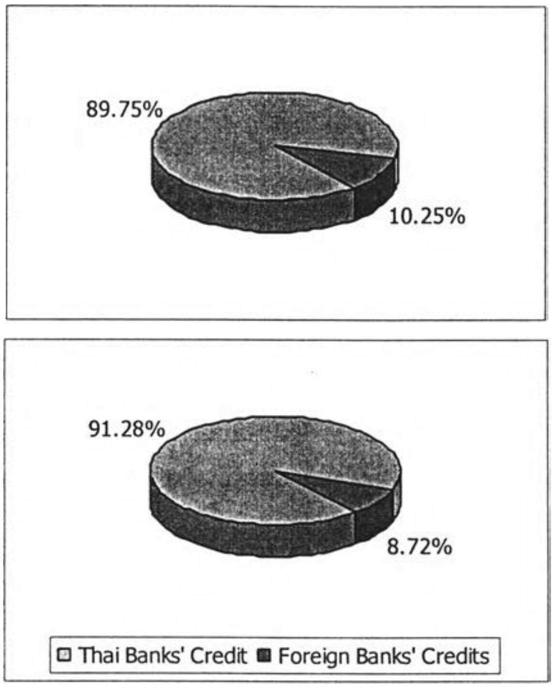

Figure 3 The shares of assets and credits of Thai and foreign commercial banks in 2003

In term of efficiency of Thai and foreign banks, NPL ratio of Thai banks is high compared to that of foreign banks as shown in Figure 4. This may reflect that risk management system of Thai banks is relatively inefficient. Learning from the past, the BOT applies the gradualism approach by gradually release the barrier to foreign financial institutions, or phased liberalization, in order for Thai financial institutions to prepare for more intensive competition in the future. Besides, the competition will encourage Thai financial institutions to reform and improve their efficiency. At last, Thai financial sector is expected to be more deepened (Bank of Thailand, 2004a).

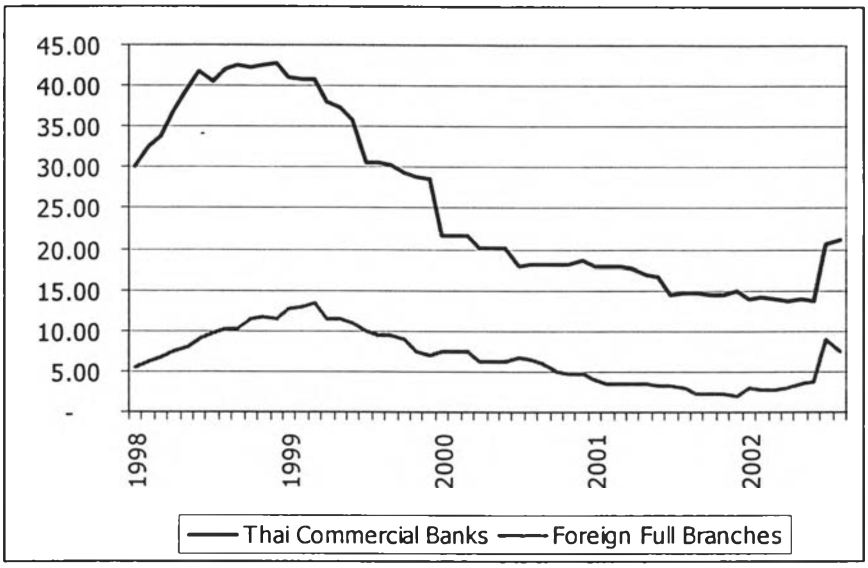

Figure 4 The ratio of NPL to total loan for Thai and foreign commercial banks

The impending Basel II would play a crucial role in banking sector around the world. In 1988 Basel Committee consisting of thirteen countries introduced a capital measurement system referred to as the Basel Capital Accord. This framework has been adopted by not only member countries but also all other countries with active international banks. In 1999 the Committee issued a proposal of capital framework that superseded the 1998 Accord and that consists of three pillars: minimum capital requirements, supervisory review and market discipline. This new framework is expected to promote practices of risk management in banks, encourage risk-based supervision and improve market discipline through enhanced disclosure (Bank for International Settlements, 2005)

Preoccupied by implementing the Financial Sector Master Plan, NPL resolution, consolidated supervision and new Banking Act, Thailand plans to commence Basel II capital charge for all banks in December, 2008 (Watanagase, 2004). For Thailand, Basel II framework which requires extensive data necessitates for a new IT system to support its risk management practices (Twivey, 2003). However, this new framework is expected to improve risk management and capital adequacy regulations as well as strengthen Thai financial system as a whole. Besides, it would sharpen Thai banks' competitiveness and enable them to compete in the international markets.

1.3. Objective

The main objective of this paper is to investigate the relationship between entry of foreign banks and economic growth in Thai banking sector. In order to analyze this issue, a theoretical model will be developed to assess the impact on the economy with the emphasis on the banking sector. Then an empirical study will be conducted by estimating econometric models derived from the theoretical model using Thai data from 1993 to 2004 to verify the results of the study.

1.4. Scope

- In the analysis, only the financial liberalization in the form of establishments as well as merger and acquisition of foreign banks in Thailand is studied. Other form such as capital account liberalization will not be considered.

- The definition of foreign bank is the commercial bank whose largest stakes are held by foreigners.

- Foreign entry refers to either foreign bank establishment or domestic bank acquisition of foreigners.

- An impact of domestic bank entry is not included in the analysis.

- Commercial banks are considered the only form of financial institutions. There are two types of commercial banks: domestic and foreign. The home countries of foreign banks are not distinguished.

- The process whereby foreign entries are determined is not explored. This analysis covers the process that starts from foreign entry and ends at economic growth.

- The growth means Thai economic growth and is not disaggregated into sectoral details.

- The external elements are not considered and assumed not to be influenced by Thailand and the distributional effect of commercial banks, such as gaining better access to credits for provincial residents, is not investigated.

- The time period used in empirical study is between 1993 and 2004.