CHAPTER III

CONCEPTUAL FRAMEWORK

The main objective of this paper is to investigate the relationship between economic growth and foreign entry in Thai banking sector, accounted for a majority of financial sector in term of assets, deposits and credits. The efficiency of banking sector, which is responsible for channeling lenders and borrowers, will lead to higher investment and, from our classical sense, greater economic growth. Definitely, transmission channels between entry of foreign banks and banking sector efficiency as well as increasing in investment are the core concept of this study. Besides, that foreign participation improves efficiency of domestic banking sector depends critically on our basis assumption that foreign banks are more efficient than domestic banks. Therefore, this chapter dedicates to these main concepts: (1) the transmission mechanism between an entry of foreign banks and economic growth and; (2) efficiency of domestic versus foreign banks in Thailand.

3.1. Transmission Channels

Foreign entry could be beneficial for economic growth in several ways, either indirectly or directly. An indirect channel is that foreign banks strengthen domestic banking sector efficiency and hence encourage domestic investment as well as economic growth thereafter while a direct one is that entry of foreign banks spurs domestic investment and the effect further propagates to economic growth. A summary of transmission channels is depicted in Figure 5.

Competitive structure of domestic banking sector is one of indirect effects usually pointed out by many literatures. New entrants would increase the competition, or reduce a level of concentration, in the domestic market and hence serves as a motivation for domestic banks to reform, diversify and strengthen operations in preparation for higher competition (Francois and Eschenbach, 2002 and Bank of Thailand, 2004a). As a consequence, the quality of financial services with which financial resources is channeled from depositors and investors to borrowers and issuers will improve along with the domestic financial system.

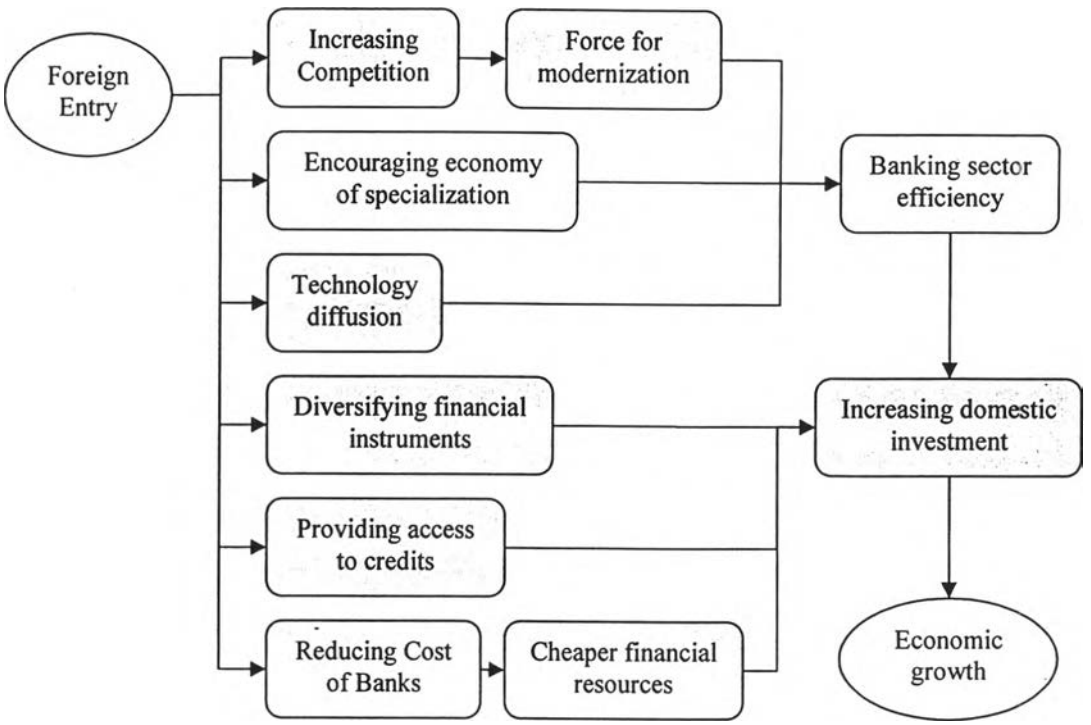

Figure 5 Trasmission channels between foreign bank entry and economic growth

Also, increasing in competition would induce economies of specialization that implies higher efficiency in the domestic banking sector (Deidda and Fattouh, 2002). Not only does specialization result in better quality of services, but the cost structure of each service would also reduce so that its price might decrease as a result.

There are also indirect benefits of the financial liberalization by technology diffusion and transfers of financial innovation and know-how which could raise domestic financial institutions' productivity and hence increase economic growth. Also, foreign financial institutions might introduce new financial instruments and techniques that would increase incentives for improving the financial sector regulations as well as financial institution supervisory framework (Prasad et al, 2003).

On the other side, foreign banks which are more efficient might have lower operational costs than domestic banks. The entry of lower cost firms would drive overall cost of domestic banking markets and also the price of financial resources, say cost of capital for firms. As a result, domestic firms would gain assess to cheaper financial resources and thereby increase their production. The operational costs of domestic and foreign banks are discussed in the next chapter.

In addition, domestic households could also benefit from better financial institutions. They could access to cheaper financing selected from broader sources, diversify their risks and yield higher rate of return (Prasad et al, 2003). In other words, the cost of capital decrease while benefit from saving increase raising domestic supply and demand for capital. That banking competition affects the availability of credit for entrepreneurs is also endorsed by the work of Cetorelli and Peretto (2000).

After the crisis, the BOT announced the new guidelines of equity holding for commercial banks which allows foreign to hold more than 50 percent of share in Thai commercial banks for 10 years. As a result, 4 of 13 domestic banks were bought by foreign commercial banks. These acquisitions increase foreign participation that result in higher competition in banking sector.

Since the authorization for commercial banks to obtain the BIBF license in 1993, commercial banks can engage in the foreign transaction: execute foreign exchange services, deposit foreign currencies, lend foreign currencies to residents (out-in) and nonresidents (out-out). That is, commercial banks which hold BIBF license can improve their profitability from the broader scope and economy of scale. Furthermore, this license also facilitates capital accumulation from outside that would encourage domestic growth. In previous theoretical paper, less restricted capital control will reduce costs of capital faced by domestic and foreign firms in a higher proportion for the smaller domestic firms, says Thai commercial banks. In other words, the reduction in costs to avoid capital controls would increase the FDI (Desai, Foley and Hines Jr., 2004). Therefore, the BIBF license can reduce cost of capital of domestic and foreign firms and foster competition by encouraging FDI.

Currently, according to One Presence Policy in the Financial Sector Master Plan, Thai authorities tend to extend the foreign bank license removing the distinction on intra-sectoral activities so that, for example, a bank can also offer insurance. Not only can foreign financial institutions enjoy the economy of scale by sharing duplicate operations of each business type, but the financial sector competition as well as cost structure is also enhanced.

Foreign financial institutions would provide better access to credit for the domestic residents. If they establish new branches in locations where there are still excess

demands for, or even absence of, financial services, the residents in that region will have opportunities to access the financial services so that the regional and overall financial resource accumulation and allocation would be more efficient. Together with PIBF license and the Financial Sector Master Plan[4] which also includes the measures to broaden access to financial services by promoting and encouraging financial services to low-income households. Promoting grass-root financial services would therefore improve the distributional consequence in the economy as well.

In GATS framework, there are two types of impediments of the service trade which include financial sectors: restriction to market access and national treatment. However, WTO refers the financial liberalization as market opening. Capital account liberalization, freedom with which capital inflows and outflows of varying maturities are allowed to move across borders, is the responsibility of International Monetary Fund (IMF). This paper assess only the liberalization in case of WTO whose barriers are relatively high compared to the capital account liberalization in Thailand, and that the domestic government lower the barrier to access the market for foreign financial institutions implies increasing in a number of financial institutions in the domestic market.

In brief, the financial liberalization in the form of entry of foreign banks could encourage economic growth through several transmission channels: (1) fostering competition among the banking sectors; (2) reducing average cost of banks; (3) diversifying financial instruments available for household and hence encouraging domestic investment; (4) encouraging economies of specialization which improve banking efficiency; (5) providing better access to credit for domestic residents and; (6) transferring technology and financial innovation to domestic banking sector. However, these transmission channels are based primarily on the assumption that foreign banks have higher efficiency than domestic banks. This issue is discussed in the next section.

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[4] In the Financial Sector Master Plan, foreign financial institutions are subjected to one of the two types of bank licenses: (1) subsidiaries can undertake the same scope of business as commercial bank and are allowed to open 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 are to have single office operation.

3.2. Operational Cost of Domestic versus Foreign Banks

This analysis depends mostly on the assumption that foreign bank efficiency is higher compared to that of domestic banks. Efficiency of each bank varies across countries depending on several external factors rather than an individual bank itself. For example, a multinational bank which directly invests in highly restricted country may not have a competitive advantage over domestic banks maybe because it could not fully enjoy an economy of scale and might be suffered from informational disadvantage.

In order to compare efficiency between foreign and domestic banks, we must find a proper quantitative measurement. Demirgüç-Kunt et al. (1999) suggested indicators for bank efficiency such as overhead, net interest margin, non-interest income and profits. To fit this assumption into the theoretical model where net interest margin and profits are endogenous, the overhead cost ratio is therefore used as a proxy for efficiency.

Generally, in developing countries where financial institutions are relatively less efficient, foreign banks have lower costs than that of domestic ones. Unfortunately, this may not be the case. Demirgüç-Kunt et al. (1999) stated that foreign banks can be expected to face high overhead costs if they have to overcome large informational disadvantages, but they may have low overhead expenses if they engage mostly in wholesale transactions and that in many developing countries foreign banks tend to have higher overhead than the case of developed economies. Alternatively, foreign banks in a highly restricted country might not be able to fully optimize their cost and enjoy an economy of scale. As a result, the overhead costs of domestic and foreign banks should be calculated country-by-country and cannot be compare cross-country.

Bayraktar and Wang (2004) also compiled and calculated domestic and foreign bank performance indicators including a ratio of overhead to total assets from BANKSCOPE database of IBCA and found that in general foreign banks' revenue indicators which include net interest margin, non-interest income and profits are higher, but their overhead costs are lower. As shown in Table 2, foreign banks have a lower ratio of overhead to total assets than that of domestic banks in Thailand. It should be noted that a bank in one country could face a different overhead cost from that bank in another country depending on several external factors.

Table 2 Ratio of overhead cost to total assets of domestic versus foreign banks classified by country

All ratios are in percent average. Data are acquired from BANKSCOPE database of the IBCA.

	Ratio of overhead to total assets	
	Domestic	Foreign
Argentina	4.7	4.6
Brazil	10.5	6.9
Canada	2.6	2.4
Chile	1.9	3.1
China	1.0	0.7
Colombia	6.1	8.9
Denmark	1.0	1.5
Finland	1.9	5.6
France	1.5	1.4
Germany	1.0	1.2
Hong Kong	0.3	0.3
Indonesia	3.8	2.1
Ireland	0.7	0.2
Italy	2.4	1.7
Japan	1.0	0.8
Korea,	1.5	1.6
Malaysia	1.0	1.5
Mexico	2.5	5.3
Norway	1.4	2.0
Peru	2.9	5.7
Philippines	2.6	4.7
Portugal	1.6	1.6
Spain	1.8	2.4
Sweden	1.1	5.3
Taiwan, China	1.1	1.9
Thailand	3.4	2.3
Turkey	7.4	8.2
UK	0.8	0.8
US	3.3	2.1
Venezuela	5.5	8.6

Source: Bayraktar and Wang (2004)

In this chapter we provide comprehensive review on several transmission channels between entry of foreign banks and economic growth. Most of channels depend primarily on the assumption that foreign banks are more efficient than domestic banks. To validate this assumption, based on Demirgüç-Kunt et al. (1999), we use overhead cost as a proxy for efficiency and find that in Thailand cost of foreign banks is higher than that of domestic banks (Bayraktar and Wang, 2004).