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Banking and Financial System in GMS Countries

Its Relationship to Economic Development

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Introduction

In any economy, banks play an important and sensitive role. Their performance directly affects the growth, efficiency and the stability of the economy. A country needs sound monetary and banking policies, transparent fiscal and financial regimes, and functioning capital and insurance markets to efficiently participate in international trade. To increase its physical capacity, a country also needs a legal and regulatory framework to encourage domestic and foreign investment.

Developing economies have been heavily involved in international trade, and a sound financial and banking system is essential for promoting trade. An efficient system helps in managing cash flows, providing loans, mitigating risks etc.

In the banking sector, international integration has brought an opportunity for exchange and cooperation by facilitating banks to access global funding sources and technical assistance, thereby providing them to better meet capital needs (in particular long term capital) of the economy and serve as a stimulus for reform and modernisation of the banking sector and for the enhancement of banking management capability in accordance with international standards. A well-functioning financial system is likely to contribute to economic growth by mobilising financial resources and allocating them to the most efficient uses.

The Greater Mekong Sub-region (GMS)[1] countries have been making efforts to revamp their financial system but still have a long way to go. The historical baggage of these transitional economies has slowed their process of integrating with the rest of the world. But most of the countries in the region are now conscious of their drawbacks and are working to improve their banking and financial sector.

Most of these countries successfully established the so-called two-tier banking systems (separation of central banking from commercial banking functions) from former mono-banking systems in the early 1990s. However, their banking sectors still face certain bottlenecks such as non-performing loans (NPLs), government intervention, lack of management capability and weak implementation of monitoring and supervision activities.

It is evident from table 1 that except Thailand, most other GMS countries are ranked quite low in terms of economic freedom. As far as financial freedom is concerned, only Thailand and Myanmar come half way. This table provides a better understanding of the financial climate in the GMS countries.

Vietnam

Vietnam continues to reform its economy while maintaining a single-party state. The most significant development during 2006 was an agreement in principle with the US on a bilateral market access agreement, which cleared the way for Vietnam to join the World Trade Organisation (WTO). As mentioned earlier, in 1988-1989 the Government initiated the banking reforms that transformed the then mono-bank system into a two-tier banking system, which meant that the State Bank of Vietnam (SBV) restricted itself

Table 1: Index of Economic Freedom[2]

Country/Indicators	Ranking	Fiscal Freedom	Monetary Freedom	Financial Freedom	Freedom from Government
Vietnam	138	82.9	67.5	30	80.8
Laos	140	80.6	71.3	20	83.6
Cambodia	102	94.2	81.1	50	85.1
Myanmar	153	87.9	88.3	10	65.4
Thailand	50	83.2	77.6	50	91.2

Source: http://www.heritage.org/research/features/index/countries.cfm (accessed on August 15, 2007)

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SDC Swiss Agency for Development and Cooperation

to acting as the central bank, and its commercial banking activities were taken over by four sector-specialised state-owned commercial banks.

According to the Index of Economic Freedom, Vietnam has high levels of fiscal freedom and freedom from the Government. During the 1990s, the Government encouraged the entry of new players into the financial sector. This policy led to a substantial increase in the number of representative offices and branches of foreign banks and the so-called joint-stock commercial banks as well. Joint ventures between foreign banks and state-owned commercial banks were also established, but the services offered by them were strictly circumscribed.

About 24 non-bank financial institutions, such as finance and insurance companies, have come to exist as well, but they are unimportant in terms of financing firms. The stock market, established in July 2001, is still in its infancy.

However, Vietnam suffers from weak trade, investment, financial, property rights, and freedom from corruption. Foreign investment is subject to an array of opaque regulations and cannot be guaranteed legally.

Despite reform efforts, the Government remains involved in the financial sector. Regulations, supervision, and transparency fall short of international standards. The central bank is not independent. Of the 63 commercial banks, five are state-run, and four of them provide about 70 percent of all lending. A Governmental decree issued in March 2006 permits fully foreign-owned banks to open in Vietnam, subject to some restrictions and conditions. Lending from state banks is still used as an arm of Government policy in some cases, particularly with subsidised interest rates and debt relief to farmers and large state-owned enterprises (SoEs). NPLs are a problem. The insurance sector is small, and the largest insurer is state-owned. Capital markets are very small. Trading on Vietnam's first stock market, founded in 2000, has been light.

The Vietnamese Government has adopted a framework to reform the banking sector from 2010 to 2020. Consolidation will take place, enabling the banking sector to operate more effectively. From April 2007 onwards, foreign banks will be able to open 100 percent foreign-owned subsidiaries in Vietnam.

Thailand

Thailand has a strong and business-friendly economy. This is the only Southeast Asian State which has never been colonised, and has been independent for over 600 years with a constitutional monarchy since 1932. The consistent annual growth rates of four to six percent in recent decades and relatively high gross domestic product (GDP) per capita are largely the result of free-market economic policies, manufacturing and agricultural exports, and tourism.

Thailand enjoys high levels of business freedom, fiscal freedom, freedom from government, monetary freedom, and labour freedom.

Thai laws permit 100 percent foreign ownership except in 32 restricted service occupations. Foreign exchange transactions, repatriation, some outward direct investments, and transactions involving capital market securities, bonds, debt securities, money market instruments, real estate, and short-term money securities are regulated and require the approval of Government in most cases.

Following the 1997 Asian financial crisis, Thailand pursued reform of its financial system. Financial regulation and supervision are largely transparent and have improved, although they remain short of international standards. The Government holds 56 percent of Krung Thai Bank, 48 percent of Siam City Bank, and 49 percent of BankThai, all of which are among the top 10 domestic banks. Foreign ownership of Thai financial institutions is restricted in some cases.

Cambodia

Cambodia has experienced solid economic growth over the last decade with significant macro-economic as well as political stability. The financial sector of the country is highly liberalised. Capital market development in Cambodia is guided by a financial sector blueprint (2001-2010), approved by the Royal Government of Cambodia in August 2001.

Cambodia does not have an equity and securities market. The foreign exchange market is active because of 'dollarisation' as 90 percent of the transactions take place in US$. The country scores well in fiscal freedom and freedom from the Government and moderately well in monetary freedom.

Cambodia is still shaking off the legacy of a disastrous communist history and therefore, has significant areas of economic freedom that could be improved. Weak rule of law in many areas leads to unreliable resolution of commercial disputes.

The foreign investment regime is generally liberal, although certain sectors face restriction, including legal, accountancy, and certain areas of transport, construction, and foreign trade, as well as publishing, printing, broadcasting, gemstone exploitation, brick making, rice mills, wood and stone carving manufacture, and silk weaving. There are no restrictions or controls on the holding of foreign exchange accounts by either residents or non-residents. Non-residents may not own land, but they can form joint venture with majority of partners as Cambodian citizens and access land concession up to 99 years and long-term lease up to 70 years. The Government still must approve foreign direct investment (FDI).

Financial reform in Cambodia was put in place with the ten-year blueprint from 2001 to 2010 framed by an Asian Development Bank (ADB) expert in consultation with the National Bank of Cambodia (NBC). A new Law on Banking and Financial Institutions was adopted in 1999, stipulating re-licensing for existing viable commercial banks with adequate capital and asset quality. Currently, Cambodia's banking system comprises the NBC as the central bank, with 20 provincial branches; 13 commercial banks (one state-owned, three foreign bank branches, and nine locally incorporated banks); four specialised banks (one state-owned, and three privately owned banks); and one representative office of a foreign bank.[3] Specialised banks have mainly rural and micro-credit functions under the NBC's supervision. Since those re-licensed banks are guaranteed their viability by the NBC, deposit collection has been expanding smoothly lately. Bank supervision by the NBC seems to have been strengthened by the introduction of modern inspection and auditing methods. The problem is real enforcement of strict regulations and rules. Exploring for domestic loan opportunities seems another difficulty for Cambodian commercial banks.

Laos

Laos scores well in freedom from the Government and fiscal freedom. Income and corporate tax rates are high, but overall tax revenue is relatively small as a percentage of GDP. Government spending is also fairly low, and the Government does not receive a large amount of its income from state-owned businesses.

Laos' foreign investment law guarantees foreign investors that their investments will be protected, that their property will not be confiscated without compensation, that their operations will be free from government interference, and that they have the right to lease land and repatriate earnings. However, foreign investment is threatened by the country's macroeconomic instability, particularly the tendency for the currency to weaken, and the potential for deterioration in security. All capital transactions require central bank approval.

The Laotian financial system is small and subject to heavy government involvement. Supervision and regulation of financial services are weak. The banking sector is the most important part of the financial system. Three state-owned banks dominate the banking sector, accounting for about 70 percent of assets. There are 10 private and foreign banks, but their activities are limited. The Government extensively directs credit. The banking sector is hindered by NPLs, predominantly from state-owned banks to SoEs. Microfinance has a small presence.

The dominating state-owned banks are still struggling to solve heavy accumulations of NPLs caused by the steep depreciation of the local currency (kip) in US$ denominated loans after the 1997 Asian financial crisis and the directed finance inherited. These accumulations are the result of loans to loss making SoEs and loans directed by provincial governments to local contractors. A huge budget is needed in order for state-owned commercial banks (SOCBs) to solve their NPL problems and achieve the necessary capital adequacy. However, another difficulty is the shortage of national budget. Recently, SOCBs' loan assets have been flush with loss provisions, which have caused deterioration of equity in their balance sheets. Without restructuring of SOCBs, further financial system development cannot be achieved.

Myanmar

As an autocratic state, Myanmar imposes severe restrictions on many areas of its economy. Investment freedom, financial freedom and property rights are weak and corruption prevails. The almost complete lack of a judicial system means that domestic and foreign companies must negotiate directly with the Government to resolve disputes. Foreign investment is adjudicated in each instance, with no clear guidelines for investors. Heavy restrictions in the financial sector and labour market inflexibility are serious economic problems.

Foreign investment is approved by the Cabinet on a case-by-case basis. Once permission is granted, the foreign investor needs to get a business license to trade. The Government restricts foreign exchange accounts and current transfers and controls all capital transactions. Multiple exchange rates make conversion and repatriation of foreign exchange very complex and a source for corruption. Foreign firms are prohibited from owning land, but it may be leased from the Government.

Myanmar's financial sector is subject to very heavy Government intervention, and forced loans to Government projects have almost frozen new deposits and smaller loans by private banks. The private banking sector crashed in February 2003. The Government claimed that no banks were closed. Some private banks resumed full operation in 2004. There were five state-owned banks in 2005. Foreign banks are permitted to enter into joint ventures with domestic private banks, although none have done so. Only 16 of the original 49 authorised foreign banks remain. The state-owned insurer retains a near monopoly of that sector. Though Myanmar Securities Exchange Centre (MSEC) was formed 1996, efficient shares and bonds market have not been established. Private company are reluctant to go public.

But the banking system has a long way to go. The major state banks may be protected by the Government, but their non-performing loans are believed to be closer to 20 percent than the official five percent. As for the 35 or so other banks, many are undercapitalised and prone to using their own capital for stock-market speculation. Bank stocks themselves are among the mostly heavily traded. Entry of foreign banks, as happened elsewhere in Asia, will help the sector's long-term development, but in the short-term may cause increased competition to lend and hence lower standards for borrowers.

China

In China, traditionally banks met Government policy goals by financing the SoEs regardless of their profitability or risk.

In the past three decades, the Chinese authorities have taken a number of steps to ensure that the financial sector will be able to support the rapid rate of growth. In China, the reform of the financial system has been carried out cautiously and gradually; however, much progress has been made to date, particularly considering the fact that banking system reforms based on market mechanisms began less than 15 years ago. In particular, the structural reform of major Chinese commercial banks progressed significantly in the four years following 2002.

The reform of the Chinese banking system has progressed favourably since 2002, supported by infusion of capital, tax exemptions, the introduction of foreign funds, the enhancement of disclosure rules, and other key Government policy changes. Based on confidence about the country's financial stability, the Chinese Government opened much of the banking sector to foreign banks in December 2006 (in accordance with its accession commitments to the WTO) by eliminating the then prevalent strict restrictions on foreign banks' local currency business.

However, these changes do not mean that the business foundation of Chinese banks has become completely stable. Compared to the world's leading banks, major Chinese commercial banks are still very fragile in terms of asset quality, business profitability, and the diversification of their services. The Chinese banking system is not yet functioning as an efficient financial intermediary due to the banks' own weaknesses and problems, such as the loose credit culture and widespread disregard for the rule of law. The problems of frauds and corruption are impediments to the further development of market mechanisms in China.

The Chinese Government is strengthening institutional mechanisms for exposing and eradicating financial crime and corruption. Commercial banks are also making efforts to thwart crime in cooperation with the China Banking Regulatory Commission (CBRC). In July 2006, 68 members of the China Banking Association signed an anti-bribery commitment and three conventions pledging to strengthen self-discipline, promote fair competition, resist illegal transactions, and establish a system to combat commercial bribery[4].

Conclusion

In the context of regional and international integration, the development of the economy requires the acceleration of restructuring and modernisation of the banking system. Strictly following governance principles and enhancing banking governance efficiency is always banking sector's utmost concern and is considered a prerequisite for the sector's stability and growth. In general, this has a positive correlation with a stable development of enterprises. This also has positive impact on the economy as a whole. The governance system should be examined from various perspectives, including objective versus strategy, organisation versus operation, and systemic risk governance in particular.

Restructuring should be in line with establishing regulations in accordance with development and integration process. Building up concrete management regulations in compliance with international standards for basic operation of banks also contributes to the development of the financial system. Besides these issues, the banking and financial system of these developing economies also need to put in place the mechanism to prevent new bad debts, accounting and financial management under international standards.

Cross-border payment systems form an integral part of the overall banking and financial system and are an essential part of the trade finance infrastructure. A payment system is a set of institutions, laws, regulations and other mechanisms needed for a buyer to make a payment and a seller to receive that payment. An effective payment system should be designed to meet the financial needs of buyers and sellers. For importers and exporters, this means that the payment system must be capable of providing for accurate, secure, efficient and affordable international payments.

Corporate governance, establishment of a reliable credit culture and information sharing among all participants is crucial in maintaining the stability of the financial system. The government authorities need prompt, accurate, and comprehensive data in order to effectively monitor and supervise the system.

Since further economic development cannot be achieved in transitional economies without efficient and productive financial intermediary functions, each country should speed up its bank restructuring in a precise manner.

Therefore, a conscious effort is being made to develop the banking and financial sector in the GMS economies. But a lot still needs to be done since countries like Vietnam are largely cash-driven. It is estimated that only 60 to 70 percent of business transactions go through the banking system. So, if these countries are to evolve to meet the challenges of the future, a developed banking and insurance system needs to be put in place. In Vietnam, for example, four SOCBs will complete the equalisation process in 2007, domestic initial public offering (IPO) at the end of 2007, IPO abroad in 2008. The new law on SBV will also be put in place by 2008.

On the other hand, there are countries like Myanmar, which have been going through a long phase of internal turmoil and the political environment hampering the functioning of an economy. The problem of NPLs and enforcement of strict rules and regulations is also a fundamental principle, something which the Mekong countries need to work on.

Endnotes

1 The Greater Mekong Sub-region (GMS) is an economic cooperation framework set up and assisted by the Asian Development Bank (ADB), consisting of five nations – Cambodia, Lao People's Democratic Republic ('Lao PDR'), Myanmar, Thailand and Vietnam – and parts of the People's Republic of China (PRC), which is the Yunnan Province and the Guangxi Autonomous Region. More about it at: http://www.adb.org/GMS/.

2 The highest form of economic freedom provides an absolute right of property ownership, fully realised freedoms of movement for labour, capital, and goods, and an absolute absence of coercion or constraint of economic liberty beyond the extent necessary for citizens to protect and maintain liberty itself. In other words, individuals are free to work, produce, consume, and invest in any way they please, and that freedom is both protected by the state and unconstrained by the state.

3 http://www.mof.go.jp/jouhou/kokkin/tyousa/0503laos_9.pdf

4 http://www.rand.org/pubs/occasional_papers/2007/RAND_OP194.pdf (accessed on November 01, 2007)

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