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Financial Deepening in ASEAN Countries

George J. Viksnins

PACIFIC FORUM

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Preface

This work examines the relationship between financial institutions and economic development in Southeast Asia. After the Communist takeover in Indochina, the ASEAN organization (Association of Southeast Asian Nations) has assumed increasing political importance. Its five member countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) are strategically located astride air and sea lanes linking the Far East to the Middle East and Europe, and their governments have emphasized repeatedly that they wish to make the region into a zone of peace, freedom, and neutrality. As it enters into its second decade, the ASEAN organization has become more active in the economic sphere as well: regional trade preference schemes are being negotiated and discussions are under way to make the economies of the ASEAN less competitive and more complementary. While trade among the ASEAN countries presently accounts for only about 15 percent of their total trade, a viable network of financial and commercial contacts is being developed.

The term "financial deepening," as used by Professor Edward S. Shaw in his well-known *Financial Deepening in Economic Development* (Oxford University Press, 1973), refers to increased utilization of money and other financial instruments in the modernization process. It can be contrasted to "shallow finance," where financial repression—runaway inflation, government ceilings on interest rates, and extensive regulations on financial institutions—makes money and other financial assets "perilous to hold." Such repressive measures force spending units to hoard stocks of commodities and to resort to barter which has obvious negative consequences for economic growth and development. This study finds that considerable financial deepening has in fact taken place in the ASEAN region during the past several decades. The Indonesian hyperinflation in the 1960's, culminating in Sukarno's overthrow, is a good case study within the region. To put it very simply, the populace was trying to get rid of money about as quickly as the government was printing it.

The other four ASEAN countries have been spared from the ravages of hyper-inflation and considerable financial deepening has taken place. Even in Indonesia, to a certain extent, the financial markets have recovered and money holdings have increased. By and large, the ASEAN group has followed a capitalistic approach to growth and development; while the free market and private enterprise are not exactly flourishing in all of these countries, they do exist. Unlike those of many other "third world" countries, foreign banks have not been nationalized and foreign investment continues to be welcomed, though on increasingly circumscribed terms. In Singapore and Malaysia, foreign banks continue to perform a quantitatively significant commercial banking function, though their share of total banking system assets is declining—quite sharply in the case of Malaysia. The Asian dollar market in Singapore has begun to provide a significant allocative function for the region as a whole.

It can generally be argued that further liberalization and greater competition in the financial markets would yield positive economic benefits to most ASEAN countries. Private domestic saving provides the bulk of investment funds in comparison to government saving or foreign investment. However, the crucial question is whether the ASEAN governments will have the political will to maintain an atmosphere conducive to private saving and investment.

My involvement and scholarly interest in Asian economic development began more than a dozen years ago, when I participated in a project on private foreign investment carried out by the Stanford Research Institute and worked in Thailand for two years for the U.S. economic assistance mission (1968–1970). As a U.S. AID economist, I worked closely with the National Economic Development Board and the Bank of Thailand. In subsequent trips to the ASEAN region in 1976 and 1979, I have benefitted from meetings and discussions with professional colleagues in all five countries. Specifically, I wish to thank the SGV company of multinational accountants for making available data on ASEAN commercial banks, as well as the staffs of Bancom Development Corporation of the Philippines and the Bank of Thailand for bibliographical assistance.

My sponsors and friends at the Pacific Forum provided outstanding support and editorial guidance from the outset of this study; but I assume sole responsibility for errors of fact and interpretation.

George J. Viksnins

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CHAPTER I

Development and Financial Institutions

The role of financial institutions in the development process has been investigated quite extensively, both from a theoretical and an empirical–historical point of view. The importance of money and finance in a modern exchange economy cannot be exaggerated; indeed, the extent of monetization in a country appears to be one of the best indications of its growth and development. Goldsmith's pioneering work on financial development observes that the "monetization ratio" in practice ranges from 0.2–0.3 in the "Bantu areas of South Africa" to 0.88 in Japan and 0.93 in the U.S.[1] From a purely theoretical point of view, the use of money lowers the cost of each transaction by eliminating the high search and information costs associated with barter. In a non-monetized economy there must be a "double coincidence of wants": a person wishing to sell a chicken and buy rice must find a mirror image—someone wishing to sell rice and buy a chicken. A second problem arises in arranging intertemporal transactions: if you borrow a chicken from the neighbor for a month, what should be the repayment (a fatter chicken, a herd of chickens, or several omelettes)? In the absence of a standardized unit of account, it is also very difficult to compare alternative courses of action: should one follow strategy A, yield three chickens, or strategy B, produce two pigs? Finally, the use of money enables a surplus-producing spending unit to "store value" efficiently. It is undoubtedly this

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value-storing function that led to the development of money commodities in pre-historic times—metallic coins and the like became a fairly efficient way to store purchasing power or invest surplus income. Basically, the use of money lowers the cost of each transaction, thus increasing a country's output and income. In most of the ASEAN countries covered in this study, the use of money is presently quite well developed; but these countries cannot be considered fully monetized by any means.

To outline further a general theoretical framework, money—defined as any generally accepted medium of exchange—is the most basic financial asset. In any given time period, say, one year, an economic system consists of surplus spending units, those with income greater than expenditure, and of deficit spending units, those wishing to spend in excess of that year's earnings. In an economy where money is the only financial asset, the development of financing is subject to essentially the same problem as with barter of commodities—the need for double coincidence of wants. In a primitive financial market, the deficit spending unit wishing to issue a "primary security," such as a mortgage or an I.O.U., must find a particular surplus spending unit who has an appropriate amount of surplus and who is also willing to acquire primary security. As Gurley and Shaw have put it:

> The rudimentary economy's capacity for growth is limited by its financial system. With no financial asset other than money, there are restraints on saving, on capital accumulation, and on efficient allocation of saving to investment that depress the rate of growth in output and income. Some of the constraints on real growth that are evident in this model are reminiscent of the financial handicaps faced by the American economy about the time of the Revolution and by some underdeveloped countries today.[2]

As the economy grows and develops a surplus of output above subsistence needs, specialized institutions are created to mobilize and allocate such funds. These "financial intermediaries" provide an indirect finance function, issuing secondary securities (bank deposits, insurance policies, and the like), which are acquired by the surplus spending units. In turn, the financial intermediaries allocate these funds to deficit spending units by acquiring their primary securities (stocks and bonds, mortgages, and so on). This process of intermediation has been succinctly summarized by Hugh Patrick:

> Financial intermediaries have an important function in providing a market mechanism for the transference of claims on real resources from savers to the most efficient investors. The more perfect are financial markets, the more nearly optimum allocation of investment is achieved. In this way, the financial system accommodates economic growth; on the other hand, to the extent that the financial system is underdeveloped and/or inefficient, it restricts growth below what optimally could be achieved. The mechanism whereby financial institutions effect this transfer is to issue their liabilities (sell indirect securities) to savers, in exchange ultimately for their real saving (assets) or monetary claims upon such assets, and to provide the assets so accumulated to investors by purchasing their primary securities. The financial system can create a wide variety of financial claims (indirect securities) to serve as assets for savers, with claims differentiated by liquidity, yield, maturity, divisibility, risk of default or change in values, and other services. In this way the financial system obtains claims to resources which it provides, under optimal market conditions, to the most efficient user.[3]

Historical experience shows that most countries accumulate financial assets more rapidly than real wealth; according to Gurley and Shaw, the ratio of financial to real wealth ranges from 10–15 percent in countries such as Afghanistan and Ethiopia to 30–60 percent in more prosperous countries, Brazil, Mexico, Korea, Venezuela, to more than 100 percent in Japan, Switzerland, and the U.S.[4] In the same vein, Goldsmith finds that his "financial interrelation ratio" rises more than proportionately with growth in GNP.[5] Monetization and the growth of financial intermediaries are very closely correlated with economic growth and development in market-oriented economies, although the direction of causation is still a matter of some dispute. Considerable discussion has taken place in the literature about whether the growth of financial institutions is "supply leading" or "demand following." While this is akin to the old "chicken–egg" issue, it is to be hoped that works of the present sort will contribute some useful information on this issue.

As one might expect, commercial banks are the most common institutions to develop early in the process of economic growth and industrialization. Banks provide a basic intermediary function between savers and investors, or surplus and deficit spending units. As Cameron has pointed out, commercial banks are unique in being able to supply liquidity to the economy by creating money (at first bank-notes and later checking accounts or demand deposits): "They are in a position not merely to serve as the custodians of the stock of money, but also to increase or decrease that stock. The consequences of this power for society at large can be considerable—and either favorable or unfavorable."[6] In addition, Cameron notes that bankers are also often in a position to assist entrepreneurs or to perform entrepreneurial functions themselves. Germany and Japan, in particular, are often cited as historical examples of close cooperation between aggressive bankers and emerging industrial firms,[7] although some, more recent research has suggested that this comparison may be simplistic.[8]

The theoretical benefits associated with monetization and the growth of financial intermediaries are seldom fully realized in practice, especially in the so-called developing countries or less developed countries (LDCs). In many LDCs, markets for financial assets simply do not exist and often the use of money is less than universally accepted. Even in most of the larger ASEAN countries—say, the Philippines, Thailand, or Indonesia—the bulk of the population will be found in rural areas and engaged primarily in subsistence farming. For the average peasant in such countries, income and consumption are usually quite closely matched. If a particularly good harvest does come along, and/or the "farm-gate" price of the product rises substantially, it is rather unlikely that the resulting surplus income will be saved or transformed into productive investment in most cases. In rural areas of Asia, as well as in most economies of the less developed world, a small surplus of saving may often be used to buy additional consumer goods (to engage in a shopping spree) or for the enhancement of ceremonial–religious activities (a larger dowry, a fancier funeral, or more gold leaf pasted on the village idol). Another very likely use for the surplus lies in the hoarding of precious metals or jewelry. If the surplus is very large, the farmer may consider buying more land, farm animals, or agricultural implements—but, if the supply is relatively fixed, prices of land and investment goods are simply bid up and real investment remains about the same. The idea of traveling to the provincial capital and depositing the funds in a financial institution, probably filling out forms and dealing with often supercilious white-collar clerks perhaps from a different social or tribal group, will not even be considered. These limitations in ASEAN countries contrast with the range of alternatives available to a surplus spending unit in a typical Western city: commercial banks, mutual savings banks, and savings and loan associations on every corner are advertising the attractions of their checking and savings accounts daily; insurance policies and pension plans are being marketed aggressively; mutual funds and brokers of various sorts are calling on the telephone; and so on. In most cases, these specialized financial institutions will mobilize even very small surpluses and, at least in theory, make these funds available to the most credit-worthy borrowers for their most productive investment projects.

In addition to the unavailability and/or inaccessibility of financial institutions, markets in less developed countries often do not allocate funds to the most credit-worthy borrowers for their most efficient projects due to what has been termed "financial repression." This phenomenon has been discussed at length elsewhere,[9] but perhaps the simplest definition of financial repression would be a situation where the average saver is consistently offered a negative real rate of return on financial assets. In other words, in such markets the expected inflation rate is on average above the interest rate paid on deposits and securities, with the latter rate being held below its market-clearing level by government fiat (e.g., usury ceilings, tax provisions, and the like). If the real rate of interest offered by financial institutions becomes negative, the demand for loanable funds shifts to the right and the supply schedule to the left—more simply, everyone wants to borrow and virtually nobody wishes to lend.

Under these conditions, the country's money and capital markets soon become *fragmented* in a number of ways. The first example of this fragmentation is a division between the market for physical capital or durable goods and the market for financial assets. Capital goods in a less developed country often are (or become) as McKinnon has put it, "lumpy, illiquid, and specific to a task."[10] In an industrial country a 1 percent or 2 percent addition to the electric power generating capacity is relatively easy, and there is considerable flexibility in responding to variations in demand. In the provincial capital of a poor country, with a single power plant, the choice may be to increase capacity by 100 percent (by building one more plant of the same size) or to do nothing at all. The owner of a rice mill in rural Sumatra may not be able to "liquidate" his real investment, either partly or as a whole. In other words, he may not be able to borrow against his equity and the market for used machinery may be very imperfect. Surplus spending units simply refuse to hold financial assets, even though the costs of hoarding inventories of commodities or having excess capacity may be, from society's point of view, very high. As U Tun Wai has put it:

> If a developing country does not have adequate financial intermediation, then farmers and others living in rural areas do not have much opportunity to choose between different forms of savings. They could either save in the form of currency or hoard gold or other consumer goods, either as a means of protection against inflation or to be certain of obtaining the consumer goods when needed. The stocking of commodities by a large section of the consuming public can be very wasteful, however, as, for example, in India, where harvested crops are eaten by rodents.[11]

A second example of market fragmentation is the familiar distinction made between the organized and the unorganized money market.[12] As noted above, real interest rates in the organized market are often negative, producing a chronic situation of excess demand for loanable funds. In the financially repressed economy the organized market typically consists of a handful of commercial banks, who have been granted quasi-monopoly status by the government, and probably also a small group of government credit institutions, whose funds come from the government (or foreign aid donors) directly. As McKinnon has put it, "even ordinary government deficits on current account frequently preempt the limited lending resources of the deposit banks. Financing of the rest of the economy must be met from the meager resources of money lenders, pawn-brokers, and cooperatives."[13] Financial repression reduces the mobilization of savings, and also affects the allocation process; low or even negative interest rates on bank assets will intensify the bank manager's risk aversion and liquidity preference. It is not really necessary for the banker to scrutinize the credit-worthiness of the borrower or the benefit–cost ratio of the proposed project, for a 20 percent inflation rate and a 10 percent usury ceiling will make every borrower a financial genius and almost every project a profitable one. Thus, bankers are likely to rely more on non-economic (or quasi-economic) considerations in allocating loanable funds in the organized market. Small amounts of short-term credit will be granted to safe, established customers (e.g., the export–import sector), whose collateral is riskless (e.g., bills of lading, import licenses), after the priority needs of government finance have been satisfied. Credit allocation on the basis of nepotism, rebates and "kick-backs," political and establishment connections will tend to supersede economic calculations of project efficiency. Finally, even if we postulate a credit allocation system completely free from all of these abuses—a system with supremely honest bureaucrats just carrying out their mandate, what would probably emerge is a form of "queuing," or a lining-up of credit applications on a first-come, first-served basis, without regard to the merit of the project at the time that the loan is actually made.[14]

A third example of financial market fragmentation is primarily a special case of the distinction made above—namely the urban–rural split. Until very recently, in most ASEAN countries the term "organized money market" in practice meant the "urban money market" or, even more narrowly, the market for loanable funds organized by commercial banks in the capital city. Newlyn points out that "almost without exception the third world countries, whether or not under colonial political domination, have historically been dependent upon financial institutions imposed upon them by the developed countries."[15] As such, early commercial banking development was closely connected with export and import trade, and the national surplus (if any) was often invested in the money markets of the developed countries. The number of commercial banks and bank branches was generally quite limited, and especially so in rural areas. As a result, agricultural finance had to be conducted almost entirely in the so-called unorganized money market. Charles Nisbet found that only about 30 percent of the population had any dealings with financial institutions, and the remainder had access only to money lenders or shopkeepers. This fragmentation produced very high rates of interest in the unorganized rural sector: "most commercial lenders emerge with positive rates ranging from 27 percent to 360 percent, with an annual mean rate of 82 percent."[16] While about half of this lending was for consumption purposes, growth in rural credit to finance expanded production has lagged behind other forms of lending as well.

In the ASEAN countries surveyed in this study, there has been quite a rapid expansion in bank branches located in rural areas—in provincial capitals at least—but these often serve to channel funds back to the capital city. In Thailand, for example, Rozental notes that commercial banks "operate branches in every province of the Kingdom except the Hac Hong Sorn, a remote northwestern area bordering on Burma. Apart from the Bangkok–Thonburi area, there is little correlation between number of persons inhabiting a province and the number of branches. . . ."[17] Despite the fact that interest

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