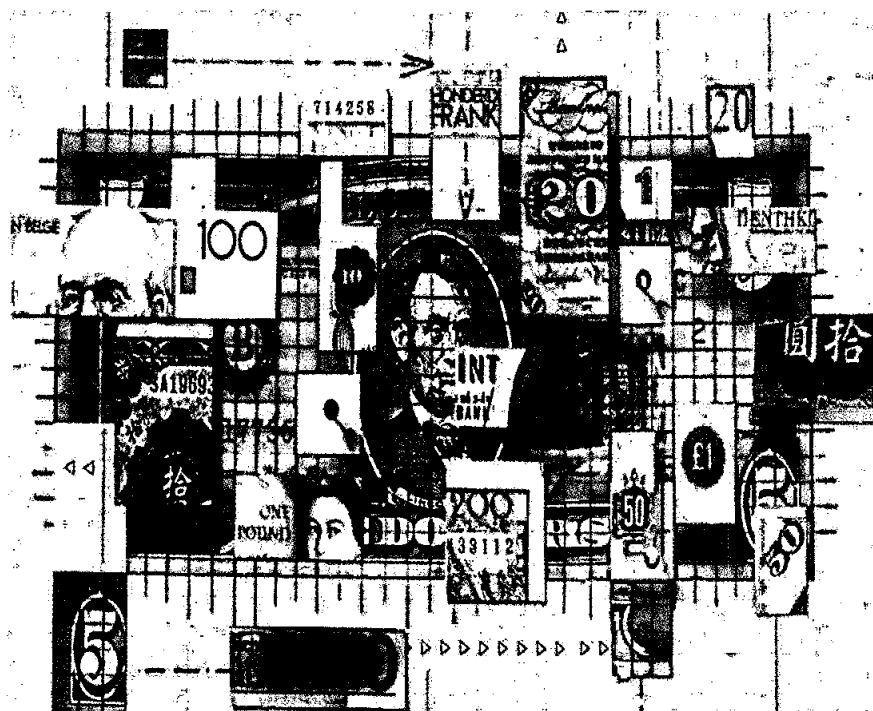


THE EFFECTS OF FOREIGN PARTICIPATION IN THE FINANCIAL SECTOR OF THE SEACEN COUNTRIES

by
Dai Hyun Kim



THE SEACEN CENTRE

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The South East Asian Central Banks(SEACEN)
Research and Training Centre
Kuala Lumpur, Malaysia

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FOREWORD

One of the significant features in world economic development in the 1990s is the globalization or the internationalization of financial markets. In an economically interdependent world, it would not be possible to isolate a country from the effects of external developments. The globalization process that is sweeping across the world does not leave the SEACEN region untouched either. In the past decade, many SEACEN countries have taken great strides in liberalizing their economies. Government and central banks in the SEACEN countries have been introducing financial reforms in order to adapt their respective financial systems to the changing environments and to mobilize savings more effectively. Among the reforms, restrictions on new entry and establishment of more branches and operations of foreign banks have been increasingly eased in the SEACEN countries.

This study attempts to review recent developments in the operations of foreign financial institutions in the SEACEN countries; examine the current policy on the participation of foreign financial institutions and their access to domestic business opportunities; assess the effects of evolving structural changes on financial markets and monetary policy; and, analyze the implications for the future direction of monetary policy.

This in-house research project was carried out by Dai Hyun Kim, Senior Economist seconded from The Bank of Korea to The SEACEN Centre. At various stages of the project, Mr. Kim was assisted by Mr. Koay Keng Teik, Research Associate, who took charge of the data collection, compilation and provided the necessary research support. The SEACEN Centre takes this opportunity to express its sincere gratitude to the departments of economic research of the member central banks for their valuable and useful comments and suggestions at various stages as well as prompt and detailed response to the questionnaire sent to The SEACEN Centre.

The views expressed in this volume, however, are those of the author and should not in any manner be ascribed to the institutions or individuals whose assistance is duly acknowledged herein.

Dr. Vicente B. Valdepeñas, Jr.
Director
The SEACEN Centre

October 1995
Kuala Lumpur

EXECUTIVE SUMMARY

The dominant characteristic of the international financial markets today is the unprecedented level of competition facing many of the major financial institutions. Market and product interpenetration in this sector is proceeding at a highly competitive rate, driven by rapid financial innovations, securitization of international capital flows, and continued evolution of offshore capital markets. Growing domestic market penetration by foreign-based institutions is becoming a focus of attention in an increasingly competitive world economic environment characterized by the globalization of financial markets.

This study attempts to shed light on the development and current status of the foreign participation in the financial sector with the related policy change in each SEACEN country against the objectives of monetary policy in a period of liberalized financial system. Review of structural changes in the international financial markets with emphasis on the financial deregulations in the SEACEN countries was also made because the opening of financial markets in the SEACEN countries occurred together with financial liberalization, the deregulation of interest rates, the promotion of capital markets, and the relaxation of foreign exchange controls.

A brief review of some issues associated with financial opening, such as preconditions for financial opening, speed and sequencing shed light on what factors the SEACEN countries should identify for the successful financial opening. As preconditions for the financial opening, such factors as macroeconomic stability, improved prudential regulations, sound fiscal discipline, and well-established domestic financial markets were examined and discussed in detail. Regarding the speed of financial opening, the discussion concerning "big-bang" versus "gradualism" was made. Even though the big-bang approach would be preferable from a theoretical point of view, empirical literature argue towards following a gradual approach. In most SEACEN countries, the process of financial opening has been a continuous and gradual one, even though the degree and the domestic financial conditions varied substantially. Indonesia and Malaysia substantially deregulated their domestic financial system against the background of very open exchange systems, whereas most other SEACEN countries implemented financial

liberalization policies that were more gradual. On the sequencing strategy, a fairly wide consensus of opinion is that the capital account of the balance of payments should be liberalized last.

With a view to protecting and promoting domestic loans, SEACEN countries have imposed restrictions on the entry of foreign banks. However, by around 1985, a noticeable easing of restrictions on new entry, establishment of branches and operations of foreign banks, was observed in the SEACEN region. This change in the policy was in response to the need of improving efficiency in financial services by stimulating competition, a desire to increase foreign direct investment as well as in response to the pressure to open up the financial system and the implications of the current Uruguay Round. On the other hand, it should also be noted that policymakers in this region are concerned that unrestricted competition from foreign banks will adversely affect the position of domestic banks. This creates the pressure to limit the entry and the operation of foreign banks.

Financial opening entails the risk of increased financial fragility and overvalued currencies. One of the dramatic changes in the world financial markets since the 1980s might be due to the apparent decline in the share of commercial banks and the rapid growth in the use of derivative financial instruments, and the increased cross-border equity holdings. The frequent movement of short-term speculative funds cause the large fluctuations in the equity prices in these countries, which undermine economic policy efficiency in those countries. An inflow of foreign capital could produce such an upward pressure on the exchange rate that monetary authorities are faced with the choice of a trade-off target between the monetary stabilization and the exchange rate stabilization. Increased financial integration also implies that developments in foreign financial markets are transmitted more rapidly and with greater impact on domestic financial markets. Hence, the conduct of an independent monetary policy is weakened.

The policymakers in the SEACEN countries devise every measure to counter those adverse effects. Sterilized intervention in varying degrees has been the common policy response. Three main channels to carry out sterilization policies are: open market operations, changes in reserve requirements, and management of government deposits. In order to discourage certain type of capital inflows or seek to influence their character, prudential controls on the banking system have also been

applied. For example, one of the most effective measures was the prohibition for domestic residents to sell short-term money-market instruments to foreigners in Malaysia. Finally, the globalization process reinforces the need for efficient prudential supervision. So, the policymakers' efforts to strengthen prudential regulation and supervision, and accounting system to cope with systematic risks of financial systems as well as the derivation of adequate policy measures become essential for successful financial opening. The prevention and the containment of systemic problems also require the cooperation and coordination of supervisory and regulatory authorities across national boundaries.

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Chapter 1

INTRODUCTION

I. Significance of the Study

One of the significant features in world economic development in the 1990s is the globalization or the internationalization of financial markets. In an economically interdependent world, it would not be possible to isolate a country from the effects of external developments. The globalization process that is sweeping across the world does not leave the SEACEN region untouched either. In the past decade, many SEACEN countries have taken great strides in liberalizing their economies. Government and central banks in the SEACEN countries have been introducing financial reform efforts in order to adapt their respective financial systems to the changing environments and to mobilize savings for investment in the private sector more effectively. Among the other reforms, restrictions on new entry and establishment of more branches and operations of foreign banks have been increasingly eased in the SEACEN countries.

Such growing domestic market penetration by foreign-based financial institutions is becoming a focus of attention in the host countries. It is recognized that financial market openings must be synchronized with changes in the general market environment, such as financial liberalization, the deregulation of interest rates and the relaxation of foreign exchange control, if the domestic financial market is to function efficiently and monetary policy is to remain effective. In view of the foregoing, it can be fairly stated that the role, especially the future role, of foreign financial institutions in the economic development of the SEACEN countries represents an important element in international capital movements.

II. Objectives of the Research Project

The primary objectives of this in-house project as approved by the SEACEN Board of Governors include the following:

- (1) to review recent developments in the operations of foreign financial institutions in the SEACEN countries as in the types and number of foreign financial institutions by country, and the extent of participation;

- (2) to examine the current policy on the participation of foreign financial institutions in the market and their access to business opportunities, including the local treatment afforded to foreign financial institutions;
- (3) to assess the effects of evolving structural changes on financial markets and monetary policy; and,
- (4) to analyze the implication for the future direction of monetary policy.

III. Scope and Organization of the Study

The study, as approved, is an in-house research project and is basically informative in nature. A questionnaire soliciting for the pertinent data and information in connection with foreign participation in the financial sector was sent to the member banks and monetary authorities. Responses were received from Bank Indonesia, The Bank of Korea, Bank Negara Malaysia, Nepal Rastra Bank, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, Central Bank of Sri Lanka, The Central Bank of China, Taipei, and the Bank of Thailand. The Central Bank of Myanmar did not respond to the questionnaire and was therefore omitted from this study. The scope of the study is therefore confined to the nine member countries.

To have a better understanding and a clearer picture of financial opening in the SEACEN countries, recent developments in the international financial market and the globalization of financial markets in the SEACEN countries are presented in Chapter II. Issues and problems associated with financial opening, such as preconditions for financial opening, speed and sequencing of financial opening, and finally merits and demerits of financial opening are dealt with in Chapter III. In Chapter IV, recent developments in the financial sector focusing on the developments of the operation of foreign financial institutions together with the regulation and policy change are dealt with on a country by country basis. Chapter V highlights the major findings on the effects of financial opening on the financial markets and the policy responses.

This study, being an in-house project, used extensively information available from in-house sources and also from responses to the questionnaire sent to the member banks and monetary authorities. As the nature of the project is mostly related with the recent developments in financial opening and the related policy responses, the scope for a quantitative approach is limited.

Chapter 2

REVIEW OF STRUCTURAL CHANGES IN THE INTERNATIONAL FINANCIAL MARKETS

I. Recent Developments in the International Financial Market

Financial opening entails the risk of increased financial fragility and overvalued currencies. Among the dramatic changes in the world financial markets since the 1980s are the apparent decline in the share of commercial banks and the rapid growth in the use of derivative financial instruments, and the increased cross-border equity holdings. With these developments, foreign giant institutional investors increased their investment in the emerging equity markets of fast growing countries with a view to maximizing their return. The frequent movement of short-term speculative funds caused large fluctuations in the equity prices in these countries, which undermined economic policy efficiency.

1.1 Decline of Traditional Banking

Dramatic changes in financial markets have occurred worldwide since the 1980s. Two developments are particularly noteworthy. First, there has been an apparent decline in the share of commercial banks and other depository intermediaries in the intermediation process. Bank deposits have declined as a share of household assets, and businesses have turned from banks to capital markets to finance their investment spending. Second, non-bank intermediaries, such as pension and mutual funds, insurance companies, and finance companies, have played an increasingly important role in the financial system.

The growing institutionalization of savings has been associated with a number of important trends, such as increased trading activity in financial markets, rapid growth in the use of financial derivatives, and increased cross-border equity holdings. Behind these developments are a variety of causes, including greater inflation and interest rate volatility, improvements in information and communications technologies, the relaxation of capital controls and the advent of flexible exchange rate systems.

The dominant characteristic of the international financial markets today is the unprecedented level of competition facing many of the

major financial institutions. Market and product interpenetration in this sector is proceeding at a highly competitive rate, driven by rapid financial innovations, securitization of international capital flows, and continued evolution of offshore capital markets.

Among financial intermediaries, the relaxation of constraints favored a trend towards despecialization, as institutions embraced a growing range of activities. Complex conglomerate structures, often straddling national borders, became increasingly common. These companies typically combined traditional banking services with various types of securities business and, more recently, the provision of insurance.

Against this background, the nature of banking activities changed in many respects. Although deposit-taking and lending generally remained the core of banks' business, a higher portion of their income tended to come from sources other than net interest (Table 2.1). Among the seven major U.S. money-center banks, non-interest income increased as a share of total revenue from nearly 30 percent at the end of 1987 to more than 50 percent at the end of 1993. These include trading, brokerage, underwriting, advisory services and the provision of backup liquidity and credit enhancement. Through these backup facilities and their key role in the payments mechanism, banks supported the growth of the markets for securities and derivatives even in those countries where they were prevented from engaging in certain types of securities business. They also became increasingly active users of derivatives themselves, notably as a substitute for operations in the traditional interbank deposit market. As a result of these developments a greater proportion of their credit and liquidity exposures was incurred off-balance-sheet.

1.2 Growth in Financial Derivatives Markets

Another recent significant development of the international financial market is the significant growth in the financial derivatives market. In fact, there was an explosion of growth in their volume in the late 1980s and early 1990s, and derivative markets have assumed an important role in transforming the management and allocation of risk.

As their name suggests, derivatives are instruments that are linked to or derived from an underlying security and commodity. The oldest

Table 2.1

BANKS' NON-INTEREST INCOME¹ IN MAJOR COUNTRIES

(Unit: Ratio, %)

Countries	1980- 1982	1984- 1986	1989- 1990	1990
United States ²	30.0	31.4	37.4	38.0
Japan ²	20.4	24.6	36.6	35.9
Germany ²	30.6	28.6	34.3	34.9
France ²	14.6	15.3	24.4	24.9
Italy	26.0	30.3	26.3	26.8
United Kingdom ²	28.5	36.9	39.7	41.1
Canada	21.6	23.7	30.1	31.0
Australia	32.1	33.5	33.9	34.0

Note: 1 Share of non-interest income in the gross income of commercial banks; the data are not fully comparable across countries.

2 Large commercial banks.

Source: Bank for International Settlement, June 1992.

and most common of these instruments are options and futures contracts.¹ A futures contract specifies a delivery date and price of a security, or its cash value, effectively locking in a price. As the spot price for immediate delivery diverges from the future price, the value of the futures contract fluctuates. This fluctuation provides a basis for both hedging and speculative strategies. Options are characterized by payoffs that depend on the difference between a security price in the future and a fixed strike price. The latter may be thought of as a threshold price that determines whether the option is in the money or not.

The banking system itself is being transformed by its involvement in the derivatives markets. In recent years as their traditional lending function has languished, banks and other depository institutions have

1. For further details, see *Financial Derivatives*, Federal Reserve Bank of Atlanta, 1993.

enjoyed strong earnings from derivatives activities, ranging from their long-standing participation in forward foreign exchange markets to trading in newer markets like those for swaps and exotic options. Many of the large money-center and regional banks are the chief market makers, acting as intermediaries between end-users of derivatives, which frequently are other financial institutions out to lay off the risk of imbalances in their own positions.

Derivative markets have continued to grow in recent years. The notional principal of all outstanding exchange-traded and over-the-counter derivative contracts increased from less than US\$ 2 trillion at the end of 1986 to more than US\$ 20 trillion at the end of 1994, an average annual growth rate of 140 percent.² The replacement value of these product is estimated to have remained at around 2.5 percent of notional value. Hence, at the end of 1994, approximately US\$ 500 billion of replacement value was outstanding, compared with the capital base of less than US\$ 200 billion of the 12 largest dealers, who together are responsible for the vast majority of the over-the-counter transactions in derivatives.

The development of derivative markets has been accompanied by a dramatic change in the activities of many of the major international money-center banks, which together are responsible for more than three fourths of all derivative activities. The financial activities of these banks have moved considerably away from their traditional lending role toward fee-based financial services and proprietary position taking. One of the main activities of banks now is the management of market risk, liquidity risk, and the credit risk associated with derivatives activities. These changes, which have occurred in all major countries, are seen most clearly in the behavior of U.S. banks.

Among the seven major U.S. money-center banks, interest income declined as a share of total revenue from nearly 70 percent at the end of 1987 to less than 50 percent at the end of 1993. In addition, during the same period, trading income doubled to 14 percent of total revenue. Finally, the volume of over-the-counter transactions in derivatives has also become large relative to total assets. At year-end 1992, the notional

2. For more details, see *International Capital Markets, Developments, Prospects, and Policy Issues*, IMF, August 1995, pp. 135-149.

principal value of interest rate and currency swaps held off balance by the seven major U.S. money-center banks was 2.3 times the value of their balance sheet assets; the replacement value of the derivatives book of the seven major U.S. money center banks was well in excess of their paid-in equity.

Table 2.2

MARKETS FOR SELECTED FINANCIAL DERIVATIVE INSTRUMENTS
(Notional Principal Amount Outstanding)
(in US\$ billion)

Instruments	1989	1990	1991	1992	1993	1994
Exchange-Traded Instruments	1,766.6	2,290.2	3,518.8	4,632.5	7,760.8	8,837.8
Interest rate futures	1,200.8	1,454.5	2,156.7	2,913.0	4,942.6	5,757.4
Interest rate options ¹	387.9	599.5	1,072.6	1,385.4	2,362.4	2,622.8
Currency futures	15.9	16.9	17.9	24.9	32.2	33.0
Currency options ¹	50.2	56.5	62.8	70.9	75.4	54.5
Stock market index futures	41.3	69.1	76.0	79.7	109.9	127.7
Stock market index options ¹	70.6	93.7	132.8	158.6	238.3	242.4
Over-the-Counter Instruments	..	3,450.3	4,449.4	5,345.7	8,474.6	..
Interest rate swaps	1,502.6	2,311.5	3,065.1	3,850.8	6,177.3	..
Currency swaps ²	449.1	577.5	807.2	860.4	899.6	..
Other swap-related derivatives ³	..	561.3	577.2	634.5	1,397.6	..

Note: 1 Calls and puts.

2 Adjusted for reporting of both currencies; including cross-currency interest rate swaps.

3 Caps, collars, floors and swaptions.

Source: Bank for International Settlements, June 1995.

1.3 Integration of World Financial Markets

The growing integration of financial markets located in the industrial countries and major offshore centers represents a fundamental structural change in the world economy during the past two decades.

This increased integration has been fostered by the relaxation of capital controls and broader financial liberalization in the industrial countries as well as by new telecommunications and computer technologies that have facilitated the cross-border transfer of funds. The liberalization of restrictions on external and domestic financial transactions was motivated in part by the desire to improve financial efficiency by increasing competition in the domestic financial systems and to reduce financial risks by allowing domestic residents to hold internationally diversified portfolios. Prior to the second half of the 1980s, it was the offshore markets and the banks that led the way, but since then it has been the reformed domestic markets and the securities markets that have provided much of the momentum.

Beyond liberalization, international financial markets have responded to the same fundamental forces that have been shaping the entire financial services industry. Dramatic decreases in the costs of telecommunications and of information gathering and processing, the need to finance larger government deficits and external imbalances, the desire and opportunity to hedge against the high variability of asset prices and inflation rates, the ascent of both "securitization" and the "institutionalization" of saving and investment, and improvements in payments and settlement systems, have all played a role.

By now, liquid markets in central and local government securities, equity, corporate debt, commercial paper, bank certificates of deposit, asset-backed securities, and both exchange-traded and over-the-counter derivative investments have become prominent features in the financial landscape of most major industrial countries. The restructured bank debt of many developing countries has now been securitized and is regularly priced and traded in the secondary market. "Global" bonds and equities too are gaining a strong foothold. Improved liquidity permits investors to move quickly in and out of domestic and international investment positions. Advances in the technology of financial transactions have reduced transactions costs to the point where they have become less and less an impediment to rearranging portfolios when expectations change. It is increasingly common, for example, to see investors switch between bond and equity funds when expected yields diverge. When transaction costs in the spot market are too expensive, the investor has the opportunity to take equivalent positions in the derivatives markets, where the daily trading volume has tripled since

1986. The increasing concentration of savings in institutional funds also means that individual investors are increasingly turning to professional fund managers when choosing among the extensive menu of liquid securities on offer.

All this has induced an impressive growth in international portfolio investments among the major industrial countries. Total cross-border equity holdings in the United States, Europe, and Japan increased from US\$ 800 billion in 1986 to US\$ 1.3 trillion in 1991, while total cross-border ownership of tradable securities is estimated to have risen to US\$ 2.5 trillion. A significant share of the government debt of all OECD countries is now held by non-residents. Close to 50 percent of all trading in the equity of firms located in the European Community (EC) takes place outside the home country. One out of every seven equity trade worldwide involves a foreigner as a counterpart. More generally, the last two decades have witnessed an enormous expansion in the volume and range of international financial transactions. No matter which relevant yardstick is taken - be it the average daily net turnover in the foreign exchange market, the scale of gross capital flows in the major industrial countries, the stock of Eurocurrency bank loans and bonds, or the share of foreign direct investment in total gross investment, there is little doubt that the international component of financial market activity has grown faster than either the domestic component or the value of world trade.

II. Globalization of Financial Markets in SEACEN Countries

2.1 Introduction

During the early 1980s, the world economy went into a recession and the SEACEN economies have not been spared the adverse repercussions of these external shocks which were compounded by alarmingly large external debt burdens. This period represents the most challenging and difficult period for economic and financial management in the SEACEN countries. The authorities in all the SEACEN countries have had to introduce various economic adjustment policies following the exposure of structural weakness and problems accumulated over the years. The most notable adjustment programs witnessed in the 1980s among the SEACEN countries were the waves of financial liberalization. It is interesting to note that the sequencing of the financial reforms and

their implementation were carried out by the SEACEN countries during the period of macroeconomic stability.

In the last two decades, a number of SEACEN countries have pursued, in different degrees, policies for financial opening as part of a broader liberalization strategy. There are several reasons prompting the liberalization of financial markets. First, in many countries, the inflationary shock of the 1970s and the early 1980s underscored the limitations of regulations on interest and credit. Second, rapid transformations in information processing and telecommunications have prompted greater financial integration both domestically and internationally, and have made it harder for government to control financial markets.

Such liberalization has involved giving the private sector a greater role in promoting economic development and growth. In a number of SEACEN countries, liberalization of the economy has been accompanied by financial liberalization for more effective mobilization of savings for investment in the private sector. This has included the deregulation of interest rate, the promotion of capital markets, the relaxation of foreign exchange rate controls in order to encourage capital inflow, and the easing of restrictions on entrance of foreign financial institutions and other barriers.

All these measures have served to make financial markets in SEACEN countries more closely linked with international financial markets, or in short, more globalized. Such globalization of financial markets has reaped considerable benefits for the countries involved. Globalization has not only facilitated greater foreign portfolio and direct investment in the domestic economy but also has been beneficial because it has helped to make the financial sector an independent growth sector in its own right, and imposed certain market discipline upon domestic markets and financial institutions. This gives rise to greater efficiency in the domestic markets. Countries would also have to raise their financial and regulatory standards as investors shun markets that are substandard, inefficient, distorted or do not have adequate rules for customer protection.

Where markets are globalized, domestic financial institutions also tend to become more efficient as they are subject to international competition. Should the domestic institutions fail to provide a service

which meets the expectation of their clients, they could turn to other financial institutions, including foreign institutions operating locally or in some cases, even to institutions located abroad. Such is the case as financial service providers so readily reach customers across borders facilitated by the advances in telecommunication and electronic technology.

The degree to which financial liberalization and innovative measures has taken place varies in the SEACEN countries. Most of the SEACEN countries began to deregulate in the 1970s. This was followed by the easing of regulations relating to financial services. This section attempts to review the recent developments in the liberalization and innovations in the financial markets of the SEACEN countries.

2.2 Financial Deregulation in SEACEN Countries

2.2.1 Indonesia

Indonesia had to undergo fundamental changes under the deregulation policy of June 1983. Before this, the level and structure of deposit and lending rates of state banks were controlled by the central bank. The state banks extended loans mainly to priority sectors whereby the central bank granted rediscount credits (liquidity credits) at subsidized rates. The national private banks mainly provided short-term working capital to the non-priority sector, and their access to rediscount credits from the central bank was governed by special regulations. Similarly, foreign banks could lend only to enterprises based in the Jakarta area unless they are syndicated with private national banks. In other words, from 1974 to June 1983, the major instruments of monetary policy were the system of credit ceilings for individual banks (with sub-ceilings for various categories of loans); a complex discount mechanism designed to reallocate credit and provide subsidies; and controls on interest rates of state banks, with private banks remaining free to set their own rates. These policies led to a build-up of excess bank liquidity and the lack of initiative on the part of banks to mobilize funds from the public.

This created a situation whereby banks, especially state banks, were heavily dependent on liquidity credits from the central bank. The excessive liquidity in the banking system induced capital flight and put pressure on the balance of payments. In addition, the dependency of

Table 2.3

INDONESIA
Key Economic Indicators

Year	GDP Growth Rate(%)	Consumer Price (%, annum)	Current Account (bil. US\$)	Exchange Rate (Rp/US\$)	M2 Growth Rate	^a Interest Rate Deposit 1/ (%)	Lending 2 (%)
1980	9.9	17.9	3.01	627.00	47.8	9.4	10.5
1981	7.9	12.1	-0.57	631.80	25.9	9.4	10.5
1982	2.2	9.5	-5.32	661.40	14.1	9.4	10.5
1983	4.2	11.8	-6.34	909.30	32.5	9.4	11.3
1984	7.0	10.4	-1.86	1025.9	22.3	9.4	12.0
1985	2.5	4.9	-1.92	1110.6	29.2	9.4	12.0
1986	5.9	5.8	-3.91	1282.6	19.1	15.2	18.5
1987	4.9	9.2	-2.10	1643.8	22.8	17.0	20.0
1988	5.8	8.0	-1.30	1685.7	24.1	17.8	20.2
1989	7.5	6.5	-1.11	1770.1	39.1	18.1	19.7
1990	7.2	12.5	-2.99	1842.8	44.6	18.1	21.2
1991	6.9	9.4	-4.08	1950.3	17.5	21.0	23.3
1992	6.3	7.5	-3.68	2029.9	19.8	20.9	22.2
1993	^A 6.7	9.7	-2.02	2087.1	^A 21.2	15.7	19.4
1994	7.3	8.6	^A -3.5	2160.8	^A 21.5	12.1	16.8

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: **International Financial Statistics**, Yearbook 1994, International Monetary Fund.

International Financial Statistics, August 1995, International Monetary Fund.

^A **Report for the Financial Year 1994/95**, Bank Indonesia.

^B **Indonesian Financial Statistics**, Bank Indonesia.

state banks on central bank liquidity credits, whose volume was largely demand-determined, complicated the task of controlling domestic credit. All these circumstances led ultimately to the financial deregulation of June 1983. The rationales and objectives of the June 1983 deregulatory package of Indonesia were to encourage banks maximize their funds mobilization and thereby reduce their dependency on the central bank for low cost funds for their lending activities.

The extensive deregulatory policy of October 1988 has further enhanced the competitive environment in the financial system of Indonesia. Under this policy, a series of deregulatory measures were undertaken in the financial, monetary and banking fields. The objectives of these measures have been designed to promote mobilization of funds; non-oil exports; efficiency in the operation of banks and other financial institutions; effectiveness in the implementation of monetary policy; and, development of the capital market. Furthermore, it was also designed to provide greater autonomy to commercial banks in their credit management. Elimination of interest rate controls and the reduction in available liquidity credits were aimed at encouraging competition among banks, both private and state-owned, making the financial system more reliant on the market for its funding and increasing the autonomy of banks in allocating credit. The removal of credit ceilings on individual banks and the switch to interest control of credit through reserve money management were meant to foster efficient growth of individual institutions.

Under the reforms, opportunities were provided for the establishment of new banks, bank branches and to broaden the range of deposit instruments. Foreign banks were also allowed to operate on a joint-venture basis with local banks as long as the foreign banks' share did not exceed 85 percent. Foreign banks already present in Jakarta were allowed to open new branches in six major provincial cities. Reserve requirements of commercial banks were brought down from 15 percent to 2 percent with a view to increasing the liquidity positions of banks and reducing intermediation costs.

In March 1989, Bank Indonesia (BI) removed existing ceilings on foreign borrowings by banks. Banks were allowed to hold overnight foreign exchange positions equivalent to a maximum of 25 percent of banks' capital. In January 1990, the government decided to phase out the liquidity credit system with a reduction in the amount eligible for subsidized rediscount and the adoption of market-related interest rates to the end-borrower.

Since the 1970s till the present, Indonesia has adopted two regimes of exchange rate system, i.e. from 1970 to November 1978, it adopted a fixed single exchange rate system in which the rupiah rate was pegged to the U.S. dollar. Since then, a managed floating exchange rate system has been in operation. Under this system, Bank Indonesia manages the

rupiah movements without keeping the exchange rate rigidly fixed. In order to stabilize the rupiah exchange rate and at the same time, keep inflation rate at the desired level, BI is pursuing a realistic rupiah rate by maintaining real effective exchange rate at a proper level. In its daily operation, Bank Indonesia sets the rupiah rate based on a basket of trading partners' and competitors' currencies taking into account, among others, the domestic market development. In 1994, Bank Indonesia widened its bid-offer spread in the foreign exchange market. This is intended to give more flexibility in the exchange rate changes to absorb the impact of the strong inflows of foreign capital.

2.2.2 Korea³

In *Korea*, the major effort to liberalize the financial sector was initiated by the government to denationalize the five leading commercial banks in 1983. At the same time, a large number of the regulations governing the internal management and operations of banks were abolished or simplified. There was a notable increase in the number of non-bank financial institutions and two new nationwide commercial banks have been opened to provide a more competitive environment in the financial market.

From 1980, banking institutions have moved into a number of new business areas and developed a variety of innovative products to raise their competitiveness against non-bank financial institutions and to meet the growing and diversified demand for financial services. Factoring and negotiable certificates of deposit (CD) business were introduced in 1983 and 1984 respectively. In July 1989, banks were permitted to engage in the acceptance, discount and sales of trade bills to provide assistance to export firms. In August 1990, the securities business of deposit money banks, which had been previously confined to the handling of underwriting of government and public bonds under repurchase agreements, was expanded to include sales of corporate bonds under repurchase agreements. Furthermore, commercial banks which have hitherto only underwritten bonds for sale by public offerings were also permitted to handle the sales of bonds by private placement.

3. For more details, see ***Financial Liberalization and Internationalization in Korea***, Research Department, The Bank of Korea. pp. 3-5, pp. 9-14, and pp. 26-33, May 1994.

Table 2.4

KOREA
Key Economic Indicators

Year	GDP Growth Rate(%)	Consumer Price (%annum)	Current Account (bil. US\$)	Exchange Rate (Won/US\$)	M2 Growth Rate	Interest Rate Deposit 1/ Lending 2 (%)
1980	-2.7	28.8	-5.32	607.43	25.8	19.5 20.0
1981	6.2	21.5	-4.65	681.03	27.4	16.2 17.0
1982	7.6	7.1	-2.65	731.08	28.1	8.0 10.0
1983	11.5	3.4	-1.61	775.75	19.5	8.0 10.0
1984	8.7	2.3	-1.37	805.98	10.7	10.0 10.0 - 11.5
1985	6.5	2.4	-0.89	870.02	11.8	10.0 10.0 - 11.5
1986	11.6	2.7	4.62	881.45	16.8	10.0 10.0 - 11.5
1987	11.5	3.0	9.85	822.57	18.8	10.0 10.0 - 11.5
1988	11.3	7.1	14.16	731.47	18.8	10.0 11.0 - 13.0
1989	6.4	5.7	5.05	671.46	18.4	10.0 10.0 - 12.5
1990	9.5	8.6	-2.18	707.76	21.2	10.0 10.0 - 12.5
1991	9.1	9.3	-8.73	733.35	18.6	10.0 10.0 - 12.5
1992	5.1	6.2	-4.53	780.65	18.4	10.0 10.0 - 12.5
1993	5.8	4.8	0.38	802.67	18.6	8.5 8.5 - 12.0
1994	8.4	6.2	-4.78	803.45	15.6	9.5 8.5 - 12.5

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: *International Financial Statistics*, Yearbook 1994, International Monetary Fund.
International Financial Statistics, August 1995, International Monetary.
Principal Economic Indicators, The Bank of Korea, April 1995.

A major deregulation of the interest rates of banks and non-banks took place in December 1988 with the lifting of controls on a wide range of loans and deposits. Unfortunately, however, the timing of this move proved somewhat inopportune - economic conditions deteriorated from early 1989 which led to the reintroduction of de-facto controls on liberalized interest rates through the back door, such as window guidance and moral suasion. The adverse impact of the reforms sparked a debate on how interest rate deregulation should proceed. The authority finally announced a new four-stage deregulation plan in

August 1991, the first of which was put into effect on 21 November 1991.

In the first stage, most of the short-term lending rates, such as overdraft loans, commercial bill discounts and trade bill discounts were liberalized. Banks were free to set interest on deposits with maturities of more than three years. At the same time, interest rates on various money and capital market instruments including corporate bonds with maturities of over two years were also freed. The successful completion of the first phase of interest rate deregulation laid a firm basis for the more extensive second stage of the deregulation on 1 November 1993 which freed all lending rates of banks and non-bank institutions excluding loans financed by the Government or by The Bank of Korea's rediscounts, rates on long-term deposits with maturities of two years or more, and issue rates of all bonds including financial debentures.

Since Korea made a statement of policy on foreign exchange liberalization by accepting the obligations of Article VIII of the IMF Agreement in November 1988, there has been considerable relaxation of foreign exchange controls in line with the spirit of the IMF Agreement. Notably, the introduction of a market-average foreign exchange rate system in March 1990 and the adoption in September 1992 of a negative-list system for the management of foreign exchange, under which all transactions are allowed unless specifically prohibited, acted as crucial stepping stones in the progress toward an advanced foreign exchange management system in Korea. The exchange position management of foreign exchange banks, which was initially introduced in April 1981 to prevent exchange speculation and to control domestic liquidity, has been remarkably relaxed since the latter half of the 1980s.

Under the new system, the daily exchange rate of the Korean won against the US dollar, the market-average exchange rate, is determined by the weighted average of won-dollar transactions conducted on the previous business day among foreign exchange banks. The daily fluctuation band of the market-average exchange rate was widened from the previous 0.4 percent above or below the prevailing rate to 0.6 percent in September 1991 in order to allow the exchange rate to reflect market forces and to boost market transactions. This band was further enlarged to 0.8 percent in July 1982 and 1.0 percent in October 1993.

The foreign exchange position requirement of foreign exchange banks, which was introduced in April 1981 to prevent speculation and to control domestic liquidity, has been significantly relaxed since the latter half of the 1980s. In September 1989, the composite overbought position ceiling of foreign exchange banks was raised and unified to the greater of \$20 million or 200 percent of the average outstanding of bills bought in the previous month. The compulsory overbought position in spot transactions was set at two percent of the average outstanding of bills bought in the previous month. In addition, foreign exchange banks were allowed to take oversold positions in forward transactions within a \$5 million limit.

The compulsory overbought position in spot transactions was lowered in July 1991, from the previous two percent to one percent of the average outstanding of bills bought in the previous month, before eventually being abolished in January 1992. This modification was primarily aimed at reducing the liquidity burden of foreign exchange banks as well as increasing the efficiency of foreign exchange operations. The overbought position ceiling was effectively raised in September 1992 because amounts used for hedging the foreign exchange risks on operating funds or the capital of foreign exchange banks were no longer regarded as the constraining part of the overbought position.

In September 1992, the composite oversold position ceiling of foreign exchange banks was raised from \$5 million to the greater of \$10 million or 20 percent of the average outstanding of bills bought in the previous month. In addition, they were initially permitted to take oversold spot positions at the greater of \$2 million or 2 percent of the average outstanding of bills bought in the previous month. In July 1993, the ceiling on the composite oversold position was raised to the greater of \$20 million or 30 percent of bills bought, whereas the limit on the oversold position in spot transactions remained unaltered.

In October 1993, the foreign exchange position management was shifted by taking into account either net worth or the volume of bills bought. Accordingly, the ceiling on the overbought position was set at either 10 percent of a foreign exchange bank's net worth or 200 percent of the average outstanding of bills bought. The ceiling on the oversold position was determined at either ten percent of net worth or

30 percent of the average outstanding of bills bought, while the over-sold position in spot transactions was limited to the greater of one percent of net worth or, alternatively, either \$2 million or 2 percent of the average outstanding of bills bought in the previous month.

To reduce foreign exchange risk and to foster the development of the foreign exchange market, the Government has eased the requirement that foreign exchange transactions be supported by underlying real demand. In July 1991, residents whose preceding year's current transactions exceeded \$10 million were allowed to purchase and deposit foreign currencies without documentary proof with foreign exchange banks up to the lesser of \$100 million or an amount equivalent to 10 percent of their current transactions record on an annual basis. Previously, residents with a current transaction record of more than \$100 million had been allowed to deposit foreign currencies freely up to \$10 million on an annual accumulation basis.

In July 1991, foreign exchange banks were also allowed to confirm real demand for foreign currencies by accepting an application form for foreign currency funds transfer without the original documents in the case of spot transactions between the won and foreign currencies. And for spot transactions linked with forward transactions between foreign currencies, the requirement of underlying real demand was waived.

In September 1992, the category of documentary proof exemption to purchase and deposit foreign currencies with foreign exchange banks was widened to cover all residents having a record of external transactions. In addition, the standard for appraisal of the foreign currency ceiling was shifted from an accumulation basis to an outstanding basis. The maximum amount for which documentary proof of foreign exchange transactions could be provided after conclusion of the contract was also enlarged from \$1 million to \$3 million. For forward transactions involving less than \$3 million, banks were allowed to review the underlying real demand by obtaining the required documents after the contract had been entered into.

At the turn of 1993, the documentary proof requirements were further relaxed. The ceiling for purchase and deposit of foreign currency without presentation of documentary proof was raised to the larger of \$200 dollars or 20 percent of the exchange transaction recorded in April 1993, and it was again raised to the larger of \$300

million or 30 percent of the transaction recorded in July 1993, before finally being abolished in October 1993. In the case of all forward transactions based on underlying exchange transactions, foreign exchange banks were allowed, from April 1993, to review the supporting documentation after the contract had been entered into. In October 1993, the requirement of documentary proof in forward transactions between the Korean won and foreign currencies was relaxed. Besides this, the limit for turning in the underlying document was extended in July 1993 from the previous 30 days to 45 days.

In addition, in March 1990, the Government loosened the foreign exchange concentration system, permitting the overseas holding of foreign currencies by general trading companies within a limit of \$5 million and the purchase of foreign exchange within a limit of \$10 million on a yearly basis by enterprises with a record performance of external transactions in excess of \$100 million. Foreign-invested firms engaged in high-tech manufacturing have been allowed to borrow from abroad on a short-term basis since January 1993 and those in high-tech services industries since July 1993. The period for deferred payment for imports was also lengthened from 90 days to 120 days in April 1993.

2.2.3 Malaysia

In *Malaysia*, financial liberalization based on market principles was started at a relatively early stage, notably in the early 1970s with the introduction of a bidding system for government securities in 1973. In August 1973, the interest rates of finance companies were deregulated. In October 1978, interest rate on deposits and non-priority loans of commercial banks were formally freed, but remained significantly influenced by the behavior of a few banks. An inter-bank rate mechanism was introduced in late 1981, under which each individual bank announced its own Base Lending Rate (BLR) in line with its cost of funds.

Following the introduction of a prime-rate-oriented interest regime in October 1978, a new interest rate mechanism based on the base lending rate was introduced late in 1981. Under this regime, commercial bank pegged their lending rates to their base lending rate, which was based on the cost of funds after provisions for the cost of holding cash, statutory reserves, liquid assets requirements, and overhead costs. The margin charged on each loan was based on the customer's credit standing, the nature of the project to be financed, the repayment sched-

Table 2.5

MALAYSIA
Key Economic Indicators

Year	GDP Growth Rate(%)	Consumer Price (%, annum)	Current Account (bil. US\$)	Exchange Rate (RM/US\$)	M2 Growth Rate	^A Interest Rate Deposit 1/ (%)	Lending 2/ (%)
1980	7.4	6.7	-0.29	2.1769	26.2	9.0	10.2
1981	6.9	9.7	-2.49	2.3041	17.9	11.0	12.0
1982	5.9	5.8	-3.60	2.3354	16.3	10.5	12.3
1983	6.3	3.7	-3.50	2.3213	9.4	9.0	11.6
1984	7.8	4.0	-1.67	2.3436	11.4	10.8	12.8
1985	-1.0	0.3	-0.61	2.4830	6.7	7.5	12.1
1986	1.0	0.8	-0.12	2.5814	11.0	7.0	12.0
1987	5.4	0.2	2.54	2.5196	3.8	4.3	9.7
1988	8.9	2.6	1.81	2.6188	6.7	4.3	9.0
1989	9.2	2.7	0.26	2.7088	15.2	5.5	8.7
1990	9.7	2.7	-0.92	2.7049	10.6	7.3	9.0
1991	8.7	4.4	-4.18	2.7501	16.9	8.0	9.7
1992	8.5	4.7	-1.65	2.5474	29.2	7.8	10.3
1993	8.0	3.4	-2.10	2.5741	26.6	6.8	10.0
1994	8.7	3.7	^B -4.42	2.6243	12.7	5.5	8.7

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: *International Financial Statistics*, Yearbook 1994, International Monetary Fund.
International Financial Statistics, August 1995, International Monetary Fund.

^A *SFS Series No. 5 - July 1995, SEACEN Financial Statistics*
Money and Banking, SFS Series No. 3 - July 1993, SEACEN Financial Statistics

^B *Annual Report 1994*, Bank Negara Malaysia.

ule, and the security offered. The rate was however, under constant supervision by the Central Bank. From November 1983, all lending rates of commercial banks were pegged to the BLR which applied to the banks' prime customers. The free market interest rate determination was suspended during the tight liquidity period from October 1985 to January 1987.

On September 1987, guidelines on lending rates were introduced by Bank Negara Malaysia whereby the margin by which lending rates might not exceed the BLR should not be more than 4 percentage point, depending on the credit standing of their customers. Also, the maximum spread between the BLR of the other commercial banks and the two lead banks was set at 0.5 percentage point. To further deregulate the financial system, the BLR was completely freed from administrative control of Bank Negara Malaysia effective from 1 February 1991. Each commercial bank or finance company was free to fix its own BLR on the basis of its own cost of funds, including the cost of holding statutory reserves and liquid assets requirement, and administrative costs. Both the deposit and lending rates of the merchant banks have been determined by market forces while interest rates for deposits with the finance companies were freed from regulation since August 1973.

The capital market in Malaysia has witnessed significant developments in the 1980s and early 1990s. The equity market, the Government securities market and the corporate bond market have been undergoing dynamic changes in recent years. The development of the capital market was greatly activated by the legal and administrative measures such as the incorporation of Rating Agency Malaysia Berhad (RAM) in November 1990 and the setting up of the Securities Commission (SC) on March 1993.

In the Malaysian Government Securities (MGS) market, coupon rates of new issues of MGS were traditionally fixed by the Central Bank. In accordance with the January 1989 reforms, coupon rates were not regulated but market related instead, based on the average yields of the successful bids for the auctions of the MGS submitted by the principle dealers. To further improve operational efficiency of funds and securities transfer, a scripless book-entry securities trading and funds transfer system, call SPEEDS, was implemented by Bank Negara Malaysia in January 1990.

In the equities market, in order to enhance operational efficiency, permit effective surveillance of the exchange, and to improve the professional conduct of its members, several reform measures were taken. These included the installation of a real time share price reporting and corporate announcement system (MASA) in 1987, the launching of the Second Board in 1988, the implementation of a semi-automated trading system, SCORE (System of Computerized Order Routing and Execu-

tion), in 1989. To further improve the settlement system MASA system was further enhanced with MASA II in 1990, and a scripless trading system called the Central Depository System (CDS) was introduced in November 1992.

A major development currently underway in the capital market is the establishment of the Kuala Lumpur Futures market (KLFM) and the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE). The introduction of the financial futures and options in Malaysia is imminent following the promulgation of the Futures Industry Act, 1992 and the introduction of guidelines on call warrants, which served as a prelude to competitive participation in the financial options and future market.

Malaysia shifted her exchange rate system from fixed to flexible in 1973. Prior to 1973, Malaysia and Singapore were part of the Sterling Area countries. Malaysia maintains a liberal system of exchange control which applies uniformly to transactions with all countries, except Israel and the Federal Republic of Yugoslavia. Even before 1973, exchange control regulations had been liberal in respect of the countries outside the Sterling Area. The exchange control measures that were implemented were aimed not so much at controlling the inflow and outflow of funds, but rather as a means of collecting data for balance of payments compilation.

Exchange control is administered by the Central Bank in accordance with the provisions of the Exchange Control Act, 1953. No permission is required from the Controller of Foreign Exchange for non-resident to undertake direct or portfolio investment in Malaysia. All payments to non-residents, including repatriation of capital and profits, are freely permitted through authorized dealers in foreign currency and may be made in any foreign currency other than the currencies of Israel, Serbia and Montenegro. Payments by a resident to a non-resident for any purpose are freely permitted, subject only to the completion of a simple statistical form for remittances of more than RM 10,000 or its equivalent in foreign currency in each case.⁴

The most recent liberalization on exchange control rules were made in December 1994. The objectives of the liberalization were: to reduce

4. For details, see *Money and Banking in Malaysia*, 35th Anniversary Edition 1959-1994, Bank Negara Malaysia, pp. 365-367.

operational costs for business, allow the small- and medium-scale industries greater access to credit facilities, increase the efficiency of cross-border transactions and encourage multinational corporations to set up their operational headquarters in Malaysia.

2.2.4 Nepal

In *Nepal*, financial reform measures have been more frequent and substantive towards the middle of the 1980s and has concentrated on broadening the range of financial instruments. An important measure adopted in March 1984 was the sale of the National Savings Certificates (NSC) to the non-bank sector. Its purpose was to absorb excess liquidity in the non-banking sector and to reduce bank financing of the budget deficit.

In order to promote the private sector's participation in the development of the financial sector, the "Finance Company Act 1985" was enacted in 1985. This generated strong enthusiasm and a large number of applications were made to Nepal Rastra Bank seeking the approval for the opening finance companies. As of October 1994, 11 of them have been approved and seven of them have already come into operation while the remaining four are going to be operational soon.

Another reform measure taken during this period included the revamping of the Securities Exchange Centre (SEC) to widen its functions. These included mandatory listing by all public companies of their shares and debentures in order to promote its role in establishing a secondary market in securities. In addition, permission was granted to commercial banks to accept foreign currency deposits (August 1985). Furthermore, interest rates on Treasury bills and overdrafts of the central banks were increased to market levels and the maturity structure of Treasury bills was widened to make them more attractive to potential buyers. Nepal Rastra Bank also began phasing out automatic lending to commercial banks against government bonds. During the fiscal year 1988/1989, financial reforms focussed on establishing an auctioning system for Treasury bills, improving the institutional framework of the financial sector and strengthening bank supervision and regulation. Monthly auctioning of 91-days Treasury bills was introduced in November 1988 and extended to 182-day bills in 1989.

Table 2.6

NEPAL

Key Economic Indicators

Year	GDP Growth Rate(%)	Consumer Price (%,annum)	Current Account (bil. US\$)	Exchange Rate (Rup./US\$)	M2 Growth Rate	Interest Rate Deposit 1/ (%)	Lending 2/ (%)
1980	-2.3	14.8	-0.04	12.000	17.3	4.0	14.0
1981	8.3	11.3	-0.02	12.336	19.1	4.0	14.0
1982	3.8	11.6	-0.09	13.244	21.4	4.3	15.5
1983	-3.0	12.5	-0.15	14.545	20.1	4.5	17.0
1984	9.7	2.8	-0.10	16.459	13.0	4.5	17.0
1985	6.1	8.0	-0.12	18.246	20.0	4.5	17.0
1986	4.3	19.0	-0.12	21.230	19.4	7.2	15.7
1987	3.9	10.8	-0.12	21.819	22.4	8.5	15.0
1988	7.4	9.0	-0.27	23.289	22.1	8.5	15.0
1989	4.5	8.8	-0.24	27.189	21.0	8.5	15.0
1990	7.9	8.2	-0.29	29.369	18.5	N.A.	14.4
1991	4.6	15.6	-0.30	37.255	22.7	N.A.	N.A.
1992	2.1	17.1	-0.18	42.718	20.7	N.A.	N.A.
1993	^A 3.1	7.5	-0.38	48.607	24.8	N.A.	N.A.
1994	^A 6.9	^A 8.7	^A -0.18	49.398	^A 18.1	N.A.	N.A.

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: *International Financial Statistics*, Yearbook 1994, International Monetary Fund.
International Financial Statistics, August 1995, International Monetary Fund.

^A *Quarterly Economic Bulletin, Mid-July/Mid-October 1994*, Nepal Rastra Bank.

In August 1989, Nepal Rastra Bank generalized rediscounting with three separate windows: a basic, a selective, and a lender-of-last resort window. The basic window provides loans against the collateral of development bonds and Treasury bills. In December 1991, Nepal Rastra Bank, for the first time, issued its bonds parallel to Treasury bills as an important input for open market operations. In January 1992, in order

to mop up excess liquidity in the economy, the authorities mandated the commercial banks to retain 24 percent of its total deposit liabilities in the form of government bonds and NRB bonds in addition to the 12 percent statutory reserve requirement.

In November 1984, the authorities relaxed controls on interest rates with a view to maintaining interest rates in real terms and fostering lending to priority sectors. Controls were relaxed further in May 1986, when authorities allowed commercial banks to freely set deposits rates equal to or above minimum rates and freed all lending rates, except for those applied to priority sector loans. In response, the commercial banks raised interest rates on three-month time deposits by 4 percentage points to 8.5 percent, thus correcting a long standing distortion in the interest rate structure, which had been maintained to encourage the sale of Treasury bills at below-market rates.

The process of interest rate liberalization was completed in August 1989, when the Nepal Rastra Bank completely deregulated the interest rate structure of the financial institutions. Accordingly, commercial banks and term lending institutions became free to determine deposit and lending rates fully on their own discretion. The statutory liquidity requirement was also waived so as to enable the commercial banks to optimize their investment portfolio which could in turn narrow the spread between deposit and lending rates without jeopardizing their profitability. Since 1989, Nepal Rastra Bank stopped setting credit ceilings and then veered from direct intervention in the commercial banking industry. It started instead to develop indirect policy tools of monetary control. Steps were taken to intensify open market operations by increasing the transactions of government securities in the secondary market. As treasury bills alone were not sufficient enough for mopping up excess liquidity, Nepal Rastra Bank bonds were issued for the first time in 1992 to intensify open market operations.

Nepal had a regulated exchange rate regime until June 1983 when the currency basket system was introduced. The exchange rate system in Nepal is characterized by a fixed exchange rate regime with the Indian currency and a flexible (market-determined) exchange rate with convertible currencies. The Nepalese rupee is officially pegged to a basket of currencies of its major trading partners. In effect, the exchange rate vis-à-vis the Indian rupee has been almost constant since May 1986. The exchange rate of the Nepalese rupee and the Indian

rupee is unique in its free convertibility to make possible the trade between Nepal and the 800-km open border with India. These characteristics make the Nepalese economy highly sensitive to any change in the Indian economy either in the domestic or in the external sector. The maintenance of a fixed exchange rate with the Indian currency has resulted in a de facto peg of the Nepalese rupee with convertible currencies as well. In this respect, exchange rate in Nepal is still highly influenced by the exchange rate of Indian currency vis-à-vis convertible currencies.

The lifting of foreign exchange control can be said to be one of the most important aspects of financial liberalization in Nepal. There has been a great deal of liberalization in the foreign exchange regime in Nepal since early 1990s. In March 1992, the Nepalese rupee was made partially convertible in the current account. In July 1992, the proportion of convertibility was raised to 75 percent from the early ratio of 65 percent. In February 1993, full convertibility in the current account was implemented followed by various measures to liberalize the capital account as well. The noteworthy ones were entitlement to the exporters to retain their export earnings in convertible currency, freedom to open bank accounts in convertible currencies, provision of usance credit in certain areas, freedom for the commercial banks to extend credit in convertible currencies, and freedom for the foreign investors to repatriate their profit and equity capital in convertible currency. As a result, Nepal has, in May 1994, attained the Article VIII status of the IMF Charter.

2.2.5 Philippines

In the *Philippines*, the fundamental deregulatory reforms were pursued beginning in 1980. Among new measures, the introduction of the universal banking system and the deregulation of interest rates beginning in 1981 were considered most important. In July 1981, the ceilings on all deposit rates were lifted while those on medium- and long-term lending were lifted on October 1981. The remaining ceilings on short-term lending rates were eliminated at the end of 1992.

The reform package of 1980 included specific measures to enhance the efficiency of financial institutions by increasing the scope for more competition and allowing the expansion of the scale of operations.

Table 2.7

PHILIPPINES
Key Economic Indicators

Year	GDP Growth Rate (%)	Consumer Price (%, annum)	Current Account (bil. US\$)	Exchange Rate (Pesos/US\$)	M2 Growth Rate	Interest Rate Deposit 1/ (%)	Lending 2/ (%)
1980	5.2	17.9	-1.92	7.511	22.1	12.3	14.0
1981	2.8	13.3	-2.10	7.900	18.4	13.7	15.3
1982	3.6	10.1	-3.21	8.540	21.2	13.7	18.1
1983	1.9	10.1	-2.77	11.113	56.5	13.6	19.2
1984	-7.3	50.4	-1.29	16.699	17.3	21.2	28.2
1985	-7.3	23.1	-0.04	18.607	9.7	18.9	28.6
1986	3.4	0.7	0.95	20.386	1.8	11.3	17.5
1987	4.3	3.8	-0.44	20.568	13.3	8.2	13.3
1988	6.8	8.8	-0.39	21.095	24.6	11.3	15.9
1989	6.2	12.2	-1.46	21.737	30.1	14.1	19.3
1990	2.7	14.2	-2.70	24.311	22.5	19.5	24.1
1991	-0.5	18.7	-1.03	27.479	17.3	18.8	23.1
1992	0.1	8.9	-1.00	25.512	13.6	14.3	19.5
1993	1.7	7.6	-3.29	27.120	27.1	9.6	14.7
1994	4.3	9.1	^A -3.00	26.417	24.4	10.5	15.1

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: *International Financial Statistics*, Yearbook 1994, International Monetary Fund.
International Financial Statistics, August 1995, International Monetary Fund.

^A *Second Annual Report 1994, Table 17*, Bangko Sentral ng Pilipinas.

Further, banks and other financial institutions were encouraged to merge or consolidate in order to become strong and stable. The government also raised the minimum capital requirements and gave 100 percent approvals for investments by commercial banks in savings and private development banks.

The financial reform process of the Philippines was temporarily interrupted during 1983-1985 as a result of the deterioration in the financial crises and management problems faced by some financial institutions. The reforms were resumed in 1987 with some structural adjustment loans from the World Bank. They basically focused on the improvement of the legal and supervisory framework of the financial system, strengthening of the banking system, reducing the intermediate costs and improvement in the mobilization of long-term credit. In effect, they consisted of a follow-up on the financial reforms undertaken in the early 1980s.

A privatization program intended to reduce the scope and the size of government presence in the banking system was initiated in 1986. Bank branching policies both for urban-situated and rural banks were liberalized in 1991. Bank's capitalization requirements were increased to enable them to expand their capability to serve the growing needs of the public. And with the establishment of a new independent Central Bank, *Bangko Sentral ng Pilipinas* (BSP), with strengthened supervisory and regulatory powers over the operations of banks and quasi-banks, financial deregulation moves could be continuously undertaken.

The exchange rate policy of the Philippines has been guided by the 1970 policy of letting the exchange rate of the peso reflect basic market forces. A free floating exchange rate policy was started in October 1984, with the abolition of some exchange regulations imposed during the crisis of 1983 and 1984. In 1985, the restrictions on foreign exchange positions of commercial banks were lifted. In the same year, authorized agent banks were allowed to sell foreign exchange to cover importation of a substantial number of non-essential and unclassified customer goods, dispensing with prior approval of Central Bank.

The onset of the 1990s witnessed a definitive shift towards a more liberal environment. Partial liberalization was initially implemented

in December 1991, followed by sweeping foreign exchange reforms in September 1992. These resulted in the virtual convertibility of the current account, including repatriation of profits, dividends, and capital in registered foreign investments. Most restrictions on capital accounts have been lifted, and investment abroad by domestic residents have been allowed within prescribed limits.

2.2.6 Singapore

In *Singapore*, financial markets may be categorized as (i) The Asian Dollar Market (ADM), (ii) domestic money market, (iii) foreign exchange market, (iv) securities market, and (v) financial futures market.

The ADM is mainly a market in foreign currencies involving non-resident borrowers and depositors. Transactions in the ADM are predominantly interbank, though transactions with non-bank customers are also significant. Asian dollar credits carry floating rates pegged either to the Singapore Interbank Offered Rate (SIBOR) or to the London Interbank Offered Rate (LIBOR) which are essentially of short-term maturities. Borrowers may also raise medium- and long-term capital by raising funds through bond issues. Reflecting the worldwide trend towards securitization, there has been a shift towards fee-based and capital market activities in the ADM, and financial institutions have increasingly undertaken the managing and underwriting of debt securities.

In the domestic money market, banks with surplus funds usually place them on an over-night, one week or longer term basis. MAS monitors money market rates closely and helps smooth out large fluctuations. With the liberalization of domestic interest rates since July 1975, MAS has relied on market operations to implement its policies and to influence liquidity in the system.

The Stock Exchange of Singapore has a main board and a second tier board, called the SES Dealing and Automated Market (SESDAQ). The main board is an avenue for domestic companies to raise long-term capital through the flotation of securities on the SES. Listed companies may also raise additional capital through right issues, private placement of shares or debt securities. The flotation of corporate securities is undertaken by commercial banks, merchant banks and

Table 2.8

SINGAPORE
Key Economic Indicators

Year	GDP Growth Rate (%)	Consumer Price (%, annum)	Current Account (bil. US\$)	Exchange Rate (S\$/US\$)	M2 Growth Rate	Interest Rate Deposit 1/ (%)	Lending 2/ (%)
1980	9.7	8.4	-1.56	2.1412	24.5	9.4	11.7
1981	9.6	8.3	-1.47	2.1127	22.4	10.7	13.7
1982	6.7	3.9	-1.30	2.1400	15.9	7.2	10.2
1983	8.2	1.1	-0.61	2.1131	11.9	6.3	9.1
1984	8.3	2.6	-0.39	2.1331	6.2	7.0	9.7
1985	-1.6	0.0	0.00	2.2002	3.8	5.0	7.9
1986	1.8	-1.3	0.32	2.1774	10.0	3.9	6.8
1987	9.4	0.0	-0.16	2.1060	19.8	2.9	6.1
1988	11.1	1.5	0.89	2.0124	13.5	2.7	6.0
1989	9.2	2.4	2.79	1.9503	22.5	3.2	6.2
1990	8.3	3.4	2.09	1.8125	20.0	4.7	7.4
1991	7.0	3.4	3.99	1.7276	12.4	4.6	7.6
1992	6.1	2.3	3.75	1.6290	8.9	2.9	6.0
1993	9.9	2.4	2.04	1.6158	8.5	2.3	5.4
1994	^A 10.1	3.1	^A 12.0	1.5274	14.4	3.0	5.9

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: *International Financial Statistics*, Yearbook 1994, International Monetary Fund.
International Financial Statistics, August 1995, International Monetary Fund.

^A *Annual Report 1994/95*, Monetary Authority of Singapore.

stockbroking companies. Private placements are usually done through stockbrokers. SESDAQ was opened in February 1987 to enable younger, medium-sized companies with sound growth potential to tap long-term funds to finance their business expansion. There is also an active over-the-counter market in foreign securities, comprising mainly Japanese, U.S. and U.K. stocks.

A number of measures were undertaken in recent years to further encourage the development of the securities market. In 1990, a fully computerized trading system called the Central Limit Order Book (CLOB) was installed to cater for an expansion in trading capacity of the exchange. From 1991, all new securities listed on the exchange are settled under a scripless trading system called the Central Depository Limited (CDP). Currently, SES is converting all securities listed on the exchange to the scripless trading system. Finally, in response to strong interest from reputable international securities houses, the SES created a new category of membership, called "International Membership" in October 1990. Such memberships can be wholly-owned by foreign securities houses.

From the mid-1980s, efforts were undertaken to diversify the financial sector and promote the development of fee-based services such as risk management and fund management. The financial futures market in Singapore, under the Singapore International Monetary Exchange (SIMEX), was established in 1984 to foster the development of Singapore as a risk management centre in the region. SIMEX has a mutual offset link with the Chicago Mercantile Exchange (CME), which enables a position opened in one exchange to be offset in the other without having to pay additional margins to the other exchange.

The Singapore foreign exchange market was given impetus to grow in the 1970s by the admission of foreign banks and international money brokers, as well as the abolition of cartel exchange rate quotations in 1973. The main currencies transacted involve the US\$/DM (32 percent), US\$/Yen (27 percent) and US\$/Pound Sterling (12 percent). The international nature of the foreign exchange market is indicated by the small proportion of transactions involving the Singapore dollar, which is 5 percent. Foreign exchange trade in the market include spot transactions, swaps and outright forwards. Several banks in Singapore has also developed 24-hour trading capability to monitor the prices of currencies in other centers after the domestic market closes.

2.2.7 Sri Lanka

In *Sri Lanka*, a number of liberalization and deregulation policy packages have been introduced since 1979. Steps have been taken to rationalize the interest rate structure in the country. Interest rates have been deregulated with the view to bringing them closer to market determined rates. The rates on Treasury bills have been aligned to make them more competitive in the financial market. Steps have also been taken to increase the refinance rate by 4 percent points and this will further bring the refinance rate closer to market rates.

In 1990, a major financial liberalization measure was introduced to facilitate capital market development. The liberalization measures to encourage capital inflows have concentrated on the Colombo Stock Exchange and the Greater Colombo Economic Commission. With the measure, approved country and Regional Funds and individual residents outside Sri Lanka are permitted to invest up to 40 percent of the issued equity of listed public companies without having to pay the previously imposed 100 percent transfer tax. All flows and repatriations and dividends relating to these investments are channeled through the Share Investment External Rupee Accounts (SIERA) in commercial banks with automatic exchange control. These SIERA facilities are extended to companies incorporated abroad. The control on the transfer of foreign exchange was relaxed by the introduction of the Resident Non-National Foreign Currency (RNNFC) Accounts, Non-Resident Foreign Currency (NRFC) Accounts and the Resident Foreign Currency (RFC) Accounts. FCBUs are allowed to grant foreign currency loans to exports.

Some important developments with respect to foreign exchange controls have taken place in the recent past. It has become a necessity to liberalize and deregulate interest rates and foreign exchange rate controls to achieve the government objective of developing Colombo as an international financial market. In 1993, the repatriation and surrender requirement with respect to export proceeds were abolished. And with the acceptance of the obligation under Article VIII of the IMF charter from March 1994, all current account transactions were fully liberalized.

However, capital account transactions are still controlled to some degree. Private foreign capital for direct investment, except in some strategic sectors, is allowed. Investment in share in listed companies up

Table 2.9

SRI LANKA
Key Economic Indicators

Year	GDP Growth Rate(%)	Consumer Price (%annum)	Current Account (bil. US\$)	Exchange Rate (Rup./US\$)	M2 Growth Rate	Interest Rate Deposit 1/ (%)	Lending 2/ (%)
1980	5.7	26.4	-0.66	16.534	28.7	14.5	19.0
1981	5.5	17.7	-0.45	19.246	19.9	17.9	19.0
1982	-15.7	10.8	-0.55	20.812	25.4	17.5	17.8
1983	5.0	14.1	-0.47	23.529	20.9	18.3	13.3
1984	5.1	16.6	0.00	25.438	16.0	19.8	13.2
1985	5.0	1.5	-0.42	27.163	12.8	17.3	13.4
1986	4.3	8.1	-0.42	28.017	4.2	12.2	11.6
1987	1.5	7.7	-0.33	29.445	15.4	11.5	9.8
1988	2.7	14.1	-0.39	31.807	14.9	13.2	12.4
1989	2.3	11.5	-0.41	36.047	8.4	16.4	13.2
1990	6.2	21.5	-0.30	40.063	21.0	19.4	13.0
1991	4.8	12.2	-0.59	41.372	22.4	18.5	13.8
1992	^A 4.3	11.4	-0.45	43.830	16.4	18.3	13.0
1993	^A 6.9	11.7	-0.38	48.322	23.1	18.4	16.4
1994	^A 5.6	8.5	^A -0.76	49.415	19.2	15.3	13.0

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: *International Financial Statistics*, Yearbook 1994, International Monetary Fund.

International Financial Statistics, August 1995, International Monetary Fund.

^A *Annual Report 1993*, Central Bank of Sri Lanka.

Annual Report 1994, Central Bank of Sri Lanka.

to 100 percent of the issued share capital, by approved country funds, regional funds, non-resident individuals and corporate bodies incorporated outside Sri Lanka has been allowed from 1992 subject to exclusions, limitations and conditions set out by the Controller of Exchange. Investment in government securities and Treasury bills by non-residents is still restricted.

Until 1977, there have been restrictions on the entrance of foreign financial institutions. With the liberalization of the Sri Lankan economy, establishment of branches of well reputed foreign banks is encouraged with the view to developing the financial system. Restrictions on entrance of established international banks are now almost non-existent.

2.2.8 Taiwan

In *Taiwan*, several measures were taken in recent years to liberalize the financial market. Until 1989, Taiwan's interest rates were strictly controlled by the Central Bank. Upper limits had been set for deposits of different types and terms while upper and lower limits for loans of different terms had been fixed. Actual interest rates were usually close to the upper limits owing to the chronic shortage of funds. However, following the G-5 meeting in 1985, there was a surge in the inflow of foreign funds which created an oversupply of capital. This led to a decline in interest rates even below the minimum level set by the Central Bank; and for a period, banks even rejected large time deposits.

As a response to these developments, a system of posting standard loan interest rates was implemented in 1985. Since September 1985, all banks are required to display publicly their loan interest rates. In addition, the gap between the highest and lowest rates with respect to medium- and long-term loans was increased to 3.25 percentage points, and that of short-term loan interest rates to 3 percentage points. In 1986, deposit rates were partially deregulated.

With the revisions to the Banking Law in July 1989, the Central Bank abolished the regulations controlling interest rates on deposits and loans. Under the new system, deposit rates are to be posted at the counter and are applicable to all customers equally. On the loan side, the standard loan interest rates are to be posted and actual rates are determined based on the standard rates.

Table 2.10

TAIWAN
Key Economic Indicators

Year	^A GDP Growth Rate(%)	^B Consumer Price (%, annum)	^B Current Account (bil. US\$)	Exchange Rate (RM/US\$)	^B M2 Growth Rate	Interest Rate Deposit 1/ (%)	Lending 2/ (%)
1980	7.3	19.0	-0.91	36.02	21.9	12.5	13.5
1981	6.2	16.3	0.52	37.83	18.6	13.0	13.0
1982	3.6	3.0	2.25	40.17	24.3	9.0	9.0
1983	8.4	1.4	4.41	40.19	26.4	8.5	8.5
1984	8.0	0.0	6.98	39.33	20.1	8.0	8.0
1985	7.5	-0.2	9.20	39.98	23.4	6.3	7.5
1986	11.6	0.7	16.28	36.31	25.3	6.3	6.8
1987	12.3	0.5	18.00	29.55	26.6	6.3	6.8
1988	7.3	1.3	10.18	28.36	17.9	6.3	7.0
1989	7.6	4.4	11.38	25.97	15.3	9.5	10.4
1990	4.9	4.1	10.77	26.893	9.9	9.5	10.0
1991	7.2	3.6	12.02	26.815	19.3	8.3	8.6
1992	6.8	4.5	8.15	25.164	19.3	7.8	8.3
1993	6.3	2.9	6.71	26.387	15.1	7.7	8.2
1994	6.5	4.1	6.02	26.457	14.0	7.2	7.9

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: **SFS Series No. 5 - July 1995, SEACEN Financial Statistics**
Money and Banking, SFS Series No. 3 - July 1993, SEACEN Financial
Statistics

^A **Statistical Yearbook of the Republic of China, 1992.**

^B **Taiwan Statistical Data Book, 1993.** Council for Economic Planning and
Development, Republic of China.

In a bid to reduce the activities of the unorganized private financial market and to attract such funds into the organized market, banking activities were expanded. With basically the same objective in mind, the revised Banking Law allowed the establishment of new private banks. It also liberalized foreign banks' operations with regard to trust business, savings deposits and long-term (over seven years) loans.

Since 1979, a flexible exchange rate system has been adopted in Taiwan. The range in which the NT dollar spot exchange rates could fluctuate against the US dollar was determined daily between the authorized banks and the Central Bank of China. From March 1980, the daily exchange rate was determined by the authorized banks themselves without the participation of the Central Bank provided that it lies between the current day's range of buying and selling US dollar spot exchange rates in the foreign exchange market. At the same time, the existing foreign exchange clearing system which required that foreign exchange income be sold to the Central Bank via authorized banks was abolished.

From March 1989, the Central Bank of China abolished the regulation which prevented fluctuations in the exchange rate from exceeding 2.25 percent in either direction of the central rate and allowed exchange rates to fluctuate more freely. And the authorized banks can set their own exchange rates and publicly display them according to their particular foreign exchange funding conditions after the liberalization measure of December 1990. As a result, exchange rates became fully deregulated. Currently, banks may engage in foreign currency transactions with foreign investors involving the following kinds of financial derivatives - foreign exchange swaps, interest rate swaps, forward rate agreements, margin trading, cross-currency interest rate swaps, over-the-counter (OTC) currency options, caps, floors and collars.

2.2.9 Thailand

Thailand has been pursuing a policy of financial deepening since the late 1970s. They ranged from interest rate deregulation to expansion of financial institutions in scope of activities and in number while improving and strengthening the regulatory framework. They also included measures to deepen the money and capital markets. For instance, in 1980, interest rate ceilings on financial institutions were freed from the 15 percent rate imposed by the Civil and Commercial Code

of 1924. Since then, the interest rate was set by the Minister of Finance on the advice of the Bank of Thailand (BOT).

The BOT encouraged the commercial banks to introduce the Bangkok Inter-Bank Offered Rate (BIBOR) as a reference for the pricing of floating rate loans to customers. The controls on the opening of Letters of Credit were also lifted in the same year. In 1986, interest rate ceilings on credit to priority sectors were lifted. In 1989, the interest rate ceilings on commercial banks' time deposits of more than 1 year maturity were removed followed by the relaxation of ceilings on other types of deposits of commercial banks as well as finance companies and credit companies. In March 1990, interest rate ceilings on time deposits with a maturity of one year and below were abolished. At the same time, the maximum interest rate for loans was raised from 15 percent to 16.5 percent, and to 19 percent in November 1990. The financial institutions now have the flexibility to adjust their interest rates in line with market conditions.

To ensure continuity of the reform process, the financial reforms plan was incorporated in the BOT's Three-Year Plan (1990-1992). During the plan period, a series of measures were taken to further deregulate interest rates and liberalize exchange controls by freeing all current account transactions and reducing restrictions in capital movements. Controls on new branch opening were relaxed and the scope of activities for financial institutions and securities companies was expanded. The banks were given concessions on the maintenance of liquidity ratios. Also, rural credit definition was broadened to include more activities. Continuation of this financial reform process is an important feature of the second Three-Year Plan (1993-1995), which also envisages the development of Thailand into a major regional financial center.

The setting up of the Bangkok International Banking Facility (BIBF) in March 1993 is a part of the overall plan to develop Bangkok into a regional financial center. BIBF is an off-shore banking facility, which must mobilize funds from abroad, but is permitted to conduct limited on-shore activities with residents. The on-shore activities comprise chiefly the lending in foreign currency to residents, with minimum floor set (currently each loan disbursement must not be less than US\$2 million). The existence of BIBF has increased the degree of capital mobility through its on-shore activities.

Table 2.11

THAILAND
Key Economic Indicators

Year	GDP Growth Rate(%)	Consumer Price (%, annum)	Current Account (bil. US\$)	Exchange Rate (Baht/US\$)	M2 Growth Rate	^A Interest Rate	
						Deposit 1/ (%)	Lending 2/ (%)
1980	4.8	19.9	-2.07	20.476	22.4	12.0	18.0
1981	6.3	12.6	-2.57	21.820	16.2	13.0	19.0
1982	4.1	5.2	-1.00	23.000	24.1	12.5	19.0
1983	7.2	3.8	-2.87	23.000	23.3	12.5	15.5 - 16.5
1984	7.1	0.9	-2.11	23.639	20.2	12.5	16.5
1985	3.5	2.5	-1.54	27.159	10.3	11.0	15.5
1986	4.9	1.8	0.25	26.299	13.2	7.3	12.0
1987	9.5	2.5	-0.37	25.723	20.4	7.0	11.5
1988	13.2	3.8	-1.66	25.294	18.2	7.8 - 9.5	12.0
1989	12.0	5.4	-2.50	25.702	26.3	9.5 - 10.3	12.5
1990	10.0	5.9	-7.28	25.585	26.7	12.0 - 15.5	16.3
1991	8.1	5.7	-7.57	25.517	19.8	10.5	14.0
1992	7.6	4.2	-6.36	25.400	15.6	8.5	11.5
1993	^A 8.2	3.5	-6.93	25.319	18.4	8.1	11.1
1994	^A 8.5	5.4	^B -8.47	25.150	12.9	7.0 - 10.3	11.1 - 11.2

1 Refers to 1 year or more time deposits.

2 Refers to loans of general funds up to 1 year.

Sources: *International Financial Statistics*, Yearbook 1994, International Monetary Fund.
International Financial Statistics, August 1995, International Monetary Fund.

^A *SFS Series No. 5 - July 1995, SEACEN Financial Statistics*
Money and Banking, SFS Series No. 3 - July 1993, SEACEN Financial Statistics

^B *Annual Economic Report 1994*, Bank of Thailand.

In 1994, additional measures were taken to allow foreign financial institutions which have participated in the BIBF to open branches outside Bangkok, especially in the border provinces. This is to help expand the role of BIBF in promoting the border trade between Thailand and its neighboring countries and to promote economic development in rural areas.

Thailand has undergone three major periods of foreign exchange liberalization, i.e., in 1990, 1991 and 1992. In 1990, the official acceptance of the obligation under Article VIII of the IMF's Articles of Agreement was announced, along with the launching of the first phase of exchange control deregulation. In 1991, the Bank of Thailand announced further deregulation measures allowing greater flexibility to private business operations and the general public in the transaction of foreign exchange. All exchange control forms were either abolished or simplified for commercial banks' reporting purpose only. In 1992, exporters were allowed to transfer foreign currency deposits for overseas debt payment and commercial banks were free to approve the withdrawal of funds for payment overseas, provided that certain conditions were met. Presently, all foreign exchange transactions by non-residents for the transfer of current or capital account are free from any restrictions.

Chapter 3

ISSUES AND PROBLEMS ASSOCIATED WITH FINANCIAL OPENING

I. Preconditions for Financial Opening

The monetary authorities in most SEACEN countries are currently opening their financial markets to foreign participation for at least three reasons. First, there has been increasing opening of the capital account as its control has been less effective due mainly to the growing integration of trade, financial innovation and financial opening by other countries. In addition, as the adverse impact of the debt crisis wears off, credit rationing by commercial banks is diminishing while capital flight reverts back to the country. Second, some countries have increasingly been subject to pressure in bilateral trade talks to open their financial market and let their currencies float. Third, the OECD Codes of Liberalization requires advanced developing countries such as Korea to liberalize their financial sectors before joining the OECD as the OECD member countries are committed to eliminating any restrictions between member countries on both the current invisible transactions and the capital movements. Once the governments opt for financial opening, their initial task would be to identify the impediments to liberalization which must be removed. The identification of such impediments helps determine the policy measures which should precede the financial reforms.

Three common characteristics of most SEACEN countries may pose as major impediments to the dismantling of capital controls on macroeconomic grounds. First, regular tax effort is often weak and replaced by the repression of the domestic financial system. Second, since poor domestic markets result in a high dependence on world demand, SEACEN countries rely on capital controls to prevent undesired appreciation in the real exchange rate. Third, domestic securities markets are too shallow for indirect monetary control to be effective while the fragile international credit standings make the countries vulnerable to external shocks.

In general, the countries have to look into the following conditions before opening up their financial markets and liberalizing their capital accounts.

1.1 Macroeconomic Stability

Macroeconomic stability is an essential condition for the success of financial opening. Financial openings carried out under an unstable macroeconomic background can worsen the instability and even set the stage for serious disturbances. In this regard, stability-oriented macroeconomic policy is also an important condition for financial opening. There are two kinds of stability to be achieved prior to financial reform: price stability as an internal condition and current account viability as an external condition. The economic crises that immediately followed the financial reforms in the Southern Cone countries were caused by the lack of these two crucial stabilities.

With low inflation, manageable external condition and small and sustainable budget deficits, the chances are good that a financial liberalization will result in the sustainable level of real interest rates being high; and under these conditions, the problems of credit risk will be significantly minimized. This makes it easier to overcome any problems that may emerge from financial reforms such as those related to prudential regulation and supervision.

Efforts should be made to keep the money supply at an appropriate level both before and during the financial opening to ensure the crucial condition of price stability. These efforts will also help to close the gap between the domestic interest rates and the international rates.

Current account viability is another essential factor to be achieved before, or at least during, the financial opening process. If both foreign exchange liberalization and capital market opening proceed simultaneously with the deregulation of interest rates while the current account is in large deficit, the monetary authorities would find it difficult to influence exchange rate and to handle capital flows. This could lead to the rapid and serious deterioration of the current account and capital flight, sparking off a foreign exchange crisis. Therefore, a surplus, or at least a sustainable level of current account deficit is necessary to absorb the initial shocks caused by the financial market opening.

There is an argument that a stable macroeconomic condition may not be absolutely necessary, although there is no question that it is desirable, before financial opening. It is argued that for countries in which inflation is still raging and, worse still, in which there is very

little hope that the authorities will have either the political will or the means of controlling the budget process and inflation in the foreseeable future, they may have to wait forever for the economy to stabilize. In fact, it is observed that a large number of developing countries have freed interest rates and eliminated other non-market controls over the financial sector without suffering a financial crisis, even though some of them have not yet managed to conquer inflation.

1.2 Prudential Regulation and Supervision

Like macroeconomic stability, prudential regulation and supervision are a *sine qua non* for successful financial opening. Stringent regulatory and supervisory policies are important to minimize moral hazard in the banking system, ensure the viability and health of the banking industry and make interest rate liberalization more effective. The ultimate objective of prudential regulation and supervision of the banking sector is to ensure the stability of the financial system, as well as being able to manage systemic risk and protect bank clients. Risks in the financial system increases as a result of more intense competition, greater market volatility and uncertainty after deregulation and liberalization. Thus, the authorities must strengthen prudential regulation and supervision, notably with respect to capital requirements and the range of banking supervision. In most SEACEN countries, financial institutions are significantly undercapitalized and the regulatory framework often lacks meaningful minimum capital adequacy guidelines. Appropriate capital adequacy requirements should be established to provide a cushion against unexpected losses for the protection of depositors and to maintain general confidence in the banking system. When the accounting and management information systems of banks are sound, it may be appropriate to adopt the risk-based capital adequacy guidelines formulated by the Basle Committee of Bank Supervisors. Concern over the stability of the banking system may induce the government to impose high capital requirements. However, this may deter new entrants and foster a rather concentrated banking structure.

Improved prudential regulations can also help prevent the problem of non-performing loans, the emergence of interlocking lending among related banks and firms as well as the concentration of loans to specific sectors and firms. In countries with such problems, full interest rate liberalization should not be implemented until they are overcome.

Successful financial reform also depends on the healthy profitability of the private sector. If the macroeconomic environment is unstable and bank supervision is ineffective, interest rate liberalization should proceed gradually to avoid the possible disruption of long-term financial contracts that might arise from sudden removal of interest rate regulations. Given the economies of scale in finance and the temptation to form economic groups based on banks, banking regulations must be devised to limit bank-ownership links, to assure a wide distribution of ownership and control of banks, and to limit loans to any single economic group or sector, especially if it is related to the bank itself.

Prudential regulation is also essential for the development of a healthy capital market. An adequate regulatory environment for securities markets should include systems of corporate disclosure, external auditing and the provision of credit ratings. Furthermore, regulations to deal with insider trading, price manipulations and other unfair transactions should already be effectively in operation.

An adequate information system is another important, but frequently neglected, ingredient for financial system efficiency. Lack of complete and accurate information, the absence of adequate accounting standards and reluctance to make balance sheets and profit-and-loss accounts available to creditors probably constitute the most severe obstacles to financial development in many SEACEN countries. To overcome these problems, however, requires institutional reforms that include a strong supporting infrastructure to provide an adequate flow of information, credit appraisal and rating, and legal and accounting systems. Accounting and auditing are fundamental tools not only for managerial decision-making but also for lenders to evaluate credit risk. Information and disclosure requirements are particularly important for effective securities markets. However, accurate, reliable and timely information are still scarce in most SEACEN countries.

With the advent of deregulation, technological advances, financial innovation and the globalization of financial markets, competition will be keener while new areas of risks, including foreign exchange risk and position risk in securities trading will emerge. In economies with a long history of financial repression, the market participants, whether banks, fund managers, borrowers, lenders or regulators, may not be trained to deal with these risks. Thus, financial opening has to be accompanied by a further strengthening of bank supervision and sur-

veillance of the financial system. At the same time, banks' capacities to assess new types of risks associated with international financial markets have to be enhanced. While the supervising body should be concerned with the integrity of the financial system as a whole, it should focus special attention on the banks as a group in view of the banks' role as a major depository of savings and a main intermediary of payments and settlements systems.

1.3 Fiscal Control

It is commonly agreed that fiscal control is the most important requirement to avoid macroeconomic complications that may arise from the dismantling of capital controls. First, the government financial position must be sufficiently strong to obviate the need for domestic financial repression. If implicit and overt taxation of financial intermediation is needed to substitute regular tax receipts, capital outflows might arise. Second, unless the government is in control of its fiscal position, it may have to depend solely on monetary policy for internal balance. However, to use monetary policy for internal balance requires a high degree of capital controls to insulate the country from international capital movements. Once the capital account is open, even imperfectly, there would be a comparative advantage in using monetary policy to deal with external balance, leaving fiscal policy to deal with internal balance (Mundell, 1962).

If the government operates high and unsustainable deficits, it may ultimately resort to money creation, inflationary financing or imposing domestic financial repression, the consequences which severely complicated the freeing of capital account. The removal of capital controls may reduce the opportunity for the central banks to print more money without excessive money supply growth. Interest-free minimum reserve requirements on demand and savings deposits are important for providing the government with direct access to bank credit. As long as the government relies on this source of finance, free entry of banks is resisted. If tax measures which result in financial repression do not give the government enough resources at a stable price level, the government may allow inflation to erode its debt stock. As high inflation tends to result in preference for shorter maturities of financial assets, reduce the information content of relative prices and stimulate capital flight, capital controls are required to stem the outflows of capital. An additional public finance aim of capital controls are accommodating

the stock of government debt. Controls serve this purpose by maintaining captive buyers, e.g., pension funds which cannot easily escape domestic controls that are forced to buy government debt at below-market interest rates.

Sound government finances are also a precondition for a more active fiscal policy for managing domestic demand. As experience in Singapore shows, channeling the government savings to the banking system helps to avoid a dependence on the interest rate for demand management purposes. This has enabled Singapore to free its capital account and focus on exchange rate as a major policy instrument.

1.4 Financial Market Deepening

To absorb speculative shocks to domestic liquidity, small open economies typically resort to control short-term capital flows. Thus, to overcome this problem, domestic money markets have to be deepened so that the monetary authorities could effectively use the market-based policy instruments. For example, to prevent excessive growth of money supply and unwarranted exchange rate appreciation when a country attracts large portfolio inflows, the central bank could sterilize the foreign exchange inflows in the domestic money markets. A sterilized purchase of foreign currency leaves the money supply unchanged, because the Central Bank sells domestic assets of equal value to the private sector. However, if domestic securities markets are shallow, a direct supply effect would be felt much quicker than in other mature economies such as the OECD countries. The sectoral distribution of the domestic credit squeeze is sharper, working capital costs for unpreferred lenders in the residual curb markets rise faster, the liquidity position of financial markets is quickly affected, and the resulting crowding-out rapidly depresses the shallow corporate bond market.

The first instrument of domestic money markets is usually the short-term government bonds. Other money market instruments - interbank deposits, bankers' acceptances, certificates of deposits, and corporate bond issues - then develop. The reluctance of finance ministries to pay market rates on their debt is usually the biggest obstacle to the development of a domestic money market. Obviously, heavy reliance of government revenues on concessional borrowing tends to create a shortage of government paper on domestic market. Lax enforcement of corporate income taxes is another impediment to foster the growth

of money markets for both private bonds and equities. As corporations attempt to evade corporate taxes by announcing very low profits, this action also represses investors' confidence to subscribe to the equity and bond issues. Setting up independent credit rating agencies may overcome these obstacles as potential investors are provided sound market judgments on private debt issues. Subsidized bank lending is another important obstacle that must be removed to develop domestic money markets. The time needed to establish and deepen money markets depends crucially on how quickly domestic financial repression is overcome.

1.5 Bank Competition and the Bad Loan Problem

Credit market segmentation, lack of competition in the domestic banking sector and insufficient prudential regulation and supervision have complicated financial opening and frustrated intended outcomes. This policy brief identifies three policy areas that may help achieve successful liberalization.

Credit market segmentation can be overcome by abolishing restrictions imposed on banks and specialized financial institutions. Financial institutions should be allowed to extend their business over a wider range of financial activities. For example, industrial banks should be allowed to lend to other sectors as well. Banks should be encouraged to be transformed from risk-averse management and cultures to become more profit-oriented. Governments should not discourage the innovation of new financial instruments that provide a wider range of financial substitutes better tailored to the needs of clients.

Measures to stimulate competition among existing financial institutions include the abolition of interest rate ceilings, the abolition of subsidized loans to, and credit floors for, priority sectors, and the privatization of government-owned financial institutions. An effective way of strengthening competition is to encourage the establishment of direct securities markets. The success of privatization is tied to the ability of privatized banks to exercise independent credit judgments. Hence, banks must be able to protect their own capital position against loan losses forced upon them by past and present government credit allocation. This cannot happen before the existing balance sheets are cleaned up by writing off bad loans and by injecting new capital.

New domestic as well as foreign bank entry should be allowed and encouraged, subject to adequate prudential requirements, new entrants should not be allowed to exacerbate the problem of interlocking ownership between financial, industrial and commercial sectors. In most SEACEN countries, powerful business interests are often in a position to finance new entrants into the domestic banking system. When competition from a domestic entity is a remote option, foreign competition on a level playing field becomes all the more important. A prerequisite for undistorted competition between domestic and foreign banks is to end domestic financial repression. For example, excessive minimum reserve requirements give a competitive edge to foreign banks which can more easily raise funds abroad that are not subject to these reserve requirements. Another obvious disadvantage for domestic banks is their obligation to buy government bonds and to make high-risk policy loans at below-market interest rates. Equal treatment also requires that the existing stock of non-performing loans can be largely consolidated before the refreshing winds of foreign competition start to blow. After the banks' balance sheets have been cleaned up, the authorities might consider the merger of some banks with the foreign entrants. This would help domestic banks obtain an international reputation as well as open opportunities for diversifying into a broader portfolio.

Even though generalizations cannot be made about the optimal approach to the bad loan problem, some basic principles can be advanced. The first step for a government committed to solving the bad loan problem is to determine the precise extent of the damage. The cost of rescue schemes is multiplied by the lack of data on non-performing loans, and the failure of the banks and regulatory authorities to recognize the size of the problem and to address it at an early stage. Auditors, who must be independent from the parties involved should identify the problem and assess its magnitude, and formulate possible rescue measures.

In the second stage, a choice has to be made whether to liquidate or to recapitalize the ailing financial institutions. The decision depends on a country's legislative framework, the size and structure of the national banking system, the amount of loss not backed by the ailing bank's equity and the weakness of government finances. A possible solution is to merge ailing domestic banks with healthy domestic or foreign banks.

A good example is the approach which was chosen by the Malaysian authorities. Shareholders of ailing banks were required to inject as much capital as possible through a right issue. The privately injected capital was supplemented by the Central Bank to meet the minimum capital adequacy requirements. The shares subscribed by the Central bank were held under a buy-back scheme in which shareholders who had participated in the rescue operation could buy back the unsubscribed shares at par plus holding costs.

Financial opening provides other avenues for solving the non-performing loan problem in the domestic banking system. Newly entering foreign banks are potential candidates for mergers with and recapitalization of ailing domestic banks. Participation in the consolidation of the domestic banking system can be incorporated in the entry conditions for foreign banks. There are essentially two options: entry of foreign bank is made conditional on merging with the ailing bank, and for foreign banks unwilling to participate in that sort of rescue operation, a limited number of new bank licenses could be auctioned. The highest bidders would be awarded licenses and the auction proceeds would be earmarked for rehabilitating the domestic banking system.

II. Speed and Sequencing of Financial Opening

2.1 Speed of Financial Opening

The discussion concerning the appropriate speed of financial opening focuses on a dichotomy that may be described as the "big bang" versus the "gradualism".⁵ Theoretically, this debate concentrates on two aspects. On the one hand, it is related to individual liberalization measures, such as trade liberalization. On the other hand, the discussion is explicitly related to the speed of the sequential implementation of different liberalization measures. In this analysis, the focus will be given on the latter.

The issue of the appropriate sequencing of financial opening arises when it is decided, for whatever reason, that a gradual rather than a

5. Funke Norbert, *Timing and Sequencing of Reforms: Competing Views*, The Kiel Institute of World Economics, 1993.

big-bang approach will be used. Thus, the first question that must be answered is that of determining the relative urgency and speed of financial opening and clarifying the reasons for preferring a big-bang or a gradual approach. It is obvious that, while the issue of sequencing is potentially relevant to the gradual approach, it is of little relevance to the big-bang approach. In principle, in a big-bang approach all the elements of the reform should be put in place at once. In practice, it is difficult to find a clear-cut case of the big-bang approach, although some actual experiences can be cited which would approximate the definition. Any delay in the implementation of some elements could potentially compromise the big-bang approach and, in fact, turn into an involuntary gradual reform, which would potentially raise the question of the appropriate sequence of measures. Even on a cursory inspection, it seems certain that, whereas financial liberalization could, if desired, be achieved by one single set of measures, most of the complementary reforms would inevitably take time.

Several authors have pointed out that a big-bang approach would be optimal from an economic point of view in the absence of market distortions and/or externalities [Edwards (1986), Mussa (1982)].⁶ In this case, all the markets should be liberalized at once since there would be immediate benefits to the liberalization and no costs. It should be added that the big-bang approach would also be preferable from an strictly economic point of view if policy-makers faced complete uncertainty about potential distortions and externalities, to the extent that they could not be identified empirically, much less measured quantitatively.

Even if there are identifiable and measurable market distortions and/or externalities that require a gradual approach from a purely economic point of view, the introduction of political economy considerations can have the effect of making a big-bang approach superior in an overall sense [Lal (1987)].⁷ This is so because the gradual ap-

6. Edwards, Sebastian, *The Order of Liberalization of the External Sector in Developing Countries*, Essays in International Finance, No. 156, December 1984. Mussa, Michael, *Government Policy and the Adjustment Process*, Import Competition and Response, 1982.

7. Lal, Deepak, *The Political Economy of Economic Liberalization*, The World Bank Economic Review, Vol. 1, No. 2, 1987.

proach may be incompatible with the full implementation of the program if at one stage of its implementation a political coalition of interests emerges with sufficient power to block the reforms to be carried out at that stage. This would cause some of the benefits of the program to be lost and the overall effect could be to reduce the value of the package to below that of the big-bang implementation. Empirical findings have indicated that the simultaneous implementation of all stages tends to increase the probability that agreement will be reached among all the various groups concerned because there will be offsetting costs and benefits to all the participants. For this reason, it has been argued, although it sounds paradoxical, that a big-bang approach may be specially suited to the needs of democratic governments with relatively weak power, which in order to succeed will have to try to form a grand coalition of opposing interests that may secure simultaneous implementation, given their inability to confront each interest group who attempts to block the individual measures of the package.

These political economy arguments for the big-bang approach are also complemented by arguments relating to the credibility of the reforms. To the extent that speed, comprehensiveness, consistency, and sustainability are perceived as being related to credibility, the big-bang approach will be superior to the gradual or phased approach. The point has also been made that democratic governments face a definite time horizon beyond which they cannot guarantee their control over the process.

Despite these abstract analytical considerations in favor of the big-bang approach, most of the literature - especially the empirical literature on developing and transition economies - argues that there are in fact economic, technical, and sometimes political reasons to follow a gradual approach. In most of the SEACEN countries, the financial liberalization program has been on a continuous and gradual path, so as to minimize adjustment difficulty on the part of financial institutions and to give enough time to the existing financial system to be restructured.

2.2 Competing Views on Sequencing Strategies

It is widely agreed that the full benefits of integration into the world economy accrue only after a country has liberalized the capital account of its balance of payments as well as the current account. Only

then can savings be deployed to best advantage for achieving full risk diversification, only then can investment be pushed to the optimal level independently of any constraint posed by domestic savings, and only then will the domestic financial system be exposed to the full rigors of international competition.

A simultaneous and instantaneous implementation of all the relevant liberalizations would be recommended within a standard textbook economy. However, administratively it is impossible to carry out all reforms immediately. Some distortions will inevitably remain in some markets for some time. Short-run rigidities in wages and prices, and immobilities in the movement of resources can result in short run falls in real income, real wages and employment and can lead to undesired and unsustainable distributional consequences. Institutional constraints and possible temporary negative side effects of comprehensive reforms contribute to the incapability and unwillingness of governments to reform all markets simultaneously. Consequently, the appropriate sequencing and timing of liberalization becomes a major issue.

While the benefits of integration into the world economy are rarely challenged, there remains concern about the dangers of premature liberalization. This is best exemplified by the literature about "sequencing", which reaches the conclusion that the capital account should be the last thing to be liberalized in a program aimed at overall economic liberalization.

The first wave of sequencing literature was entirely related to developing countries. Following the failure of the Latin American countries liberalization programs in the late 1970s, a number of economists questioned whether the failure might be traced to an inappropriate sequence in which different markets were liberalized, rather than the objective of liberalization itself being inappropriate. The focus was on specific issues, such as the sequence of stabilization programs, financial market reform and trade reform, or the optimal sequence of trade reform and the liberalization of capital flows.

With the on-going changes in the Central and Eastern Europe, a second wave of proposals emerged, related to economies in transition. Although the substance of the reform efforts in post-socialist countries overlaps with many developing countries, the task facing post-socialist countries is undoubtedly more challenging and demanding. The lack

of market institutions, the need for fundamental microeconomic reforms, the extent of domestic price liberalization and the sheer quantity of firms to be privatized are some of the major concerns and have to be taken into account in any comprehensive sequencing proposal.

It is generally agreed that all reforms should be scheduled close to each other. Fiscal and monetary stability should be accorded a top priority and measures to achieve this goal be implemented as early as possible. Next come trade reforms and financial system reforms which should be closely linked to fiscal and monetary stabilization. There is a fairly wide consensus of opinion that the capital account of the balance of payments should be liberalized last.

However, this mainstream advice is challenged by Lal (1987) and Roland (1990). Both authors base their sequencing strategy on political economy considerations, whereas most other authors rely on orthodox assumptions. But, it is suggested that the credibility of government policy plays a crucial role in both approaches and may provide a fruitful link between them.

2.3 Some Experiences of SEACEN Countries

In the last two decades, most SEACEN countries have pursued, in differing degree, policies for financial opening as part of a broader liberalization strategy. However, the sequencing path and the implementation time-frame varied substantially. Some countries achieved a significant financial deepening but at the expense of a loss of control over monetary aggregates after their financial reforms, whereas some countries like Indonesia and Korea liberalized administrative controls over bank credit more gradually and did not experience the same extent of the loss of control over money supply.

In the 1980s, Indonesia and Malaysia substantially deregulated their domestic financial systems against the background of the very open exchange systems. Malaysia has had an open capital market since the 1960s and Indonesia essentially removed all foreign capital controls in 1971. In contrast, most other SEACEN countries implemented financial liberalization policies more gradually internally while maintaining some controls over the capital accounts. In such countries as Korea, Taiwan and Thailand, positive real interest rates were achieved and maintained mainly through credible macroeconomic policies that successfully re-

duced inflation to low levels. At the same time, capital controls remained intact or were only gradually removed.

Indonesia's domestic financial reforms in 1983-1984 eliminated the ceilings on bank credits, the gradual limiting of the categories of loans having access to Bank Indonesia's liquidity credits, and deregulation of state banks' interest rate on most categories of deposits and on all loans except a few priority loans. From 1988 through early 1990, further measures were implemented to promote more fundamental structural and operational reforms of the financial system. With an early liberalization of the capital account in 1971, the opening up of the financial sector to external competition and the early introduction of capital liberalization are said to be factors contributing to the acceleration of domestic financial sector reforms, as well as liberalization of the current account.

In Malaysia, the structural reform measures along with the strengthening of prudential re-regulation has been one of the most important elements in the overall reform strategy. The liberalization effort in the early 1980s was targeted at the real sector in order to overcome the problem of a prolonged and deep recession at that time as the country suffered a sharp deterioration in the terms of trade. The reform was also necessary to address the large budget and current account deficits as well as the widespread inefficiencies in the economy. Under such difficult situation, the real sector reforms consisted of a drastic reduction in public sector spending, the launching of the privatization policy, a reduction in public sector employment, and the shift in strategy to make the private sector a main engine of growth.

It is important to note that the reform of the financial system was not pursued concurrently in the early stages of the structural adjustment in the real sector. On the contrary, greater control and supervision of the financial system was exercised as the system was beset with difficulties. Consequently, the main policy concern in the first half of the 1980s was to maintain a tight control over the financial system to prevent it from collapsing in the face of possible bank failures and the erosion of public confidence. It was during this period that financial liberalization took a step backward when in 1985 the system of lead banks were introduced. It was only in 1987, when the economy recovered from the recession and growth began to escalate, that it became possible again for the Malaysian Government to take further steps towards

financial liberalization. Since then, the controls on interest rate have been gradually dismantled.

Similarly, the liberalization of the current account of the balance of payments came well before the liberalization of the capital account. In Malaysia, international trade has been fairly free from restrictions and tariff rates have been pared down over the years. Reform of the capital account has proceeded gradually due to justifiable fears that rapid liberalization of the capital account is likely to be destabilizing. Nonetheless, the exchange control regulations have since been liberalized and few restrictions on the flow of capital remain.

In the early 1980s, the Korean government began to privatize the nationwide commercial banks, the entry barriers especially for the non-bank financial sector and for foreign banks have been relaxed, and various new financial instruments have been introduced to promote the development of short- and long-term financial markets and enhance the capacity of financial institutions to mobilize savings. Nevertheless, the remaining size of the curb market suggests that the financial system is still underdeveloped. Bond and stock markets are shallow, the range of financial instruments is limited, and the allocation of resources by the financial institutions seems to remain inefficient. No significant steps have been taken to liberalize external capital flows except for a few closed-end foreign funds such as the Korean Fund.

In Taiwan, a liberalization of interest rates in stages was the most important of all deregulation measures in the 1980s. Article 41 of the July 1989 revision of the Banking Law states that restrictions on interest rates have been eliminated with the aim of enhancing the role of market mechanism. In order to foster competition among financial institutions, the Taiwanese government has gradually liberalized banks' operational restrictions to allow them to offer more diversified services. In addition, steps were taken to relax the restrictions on new banks. However, despite privatization and greater managerial autonomy of commercial banks, the banking system is still subject to extensive government intervention. Policy loans by banks and non-bank financial institutions still account for almost one-third of domestic credit. In the late 1980s, restrictions on trade and service-related transactions on current accounts were completely lifted. With respect to capital account transactions, permission is still required for companies and individuals to purchase foreign currencies equivalent to more than US\$1 million, while

there are no restrictions on deposits in, or outward remittances from, foreign currency deposit accounts.

The financial liberalization path in Thailand during the past five years has been a continuous and gradual one, so as to minimize adjustment difficulty for the financial institutions. Given the low inflation rate in Thailand, lending and deposit real interest rates remained positive throughout the 1980s. Both of these rates have historically been subject to ceilings imposed by the Bank of Thailand. Interest rates on deposits, except for savings accounts, were freed only in March 1990. It took two and a half years (from June 1989 to January 1992) before official interest rate ceilings on all types of commercial banks' deposits were completely abolished. In addition, many kinds of regulations continued to be in place. Apart from exempting priority sector lending from capital adequacy requirements, the selective credit policy constitutes three main forms: commercial banks must lend a certain percentage of their previous year's deposit to the rural sector; second, the Bank of Thailand engages in lending for specific purposes through its rediscount windows; and finally, different tax rates are used as an incentive system. Furthermore, capital movements in and out of the country are closely regulated. Since March 1990, individual banks cannot have an open foreign exchange position in excess of US\$ 6 million or 25 percent of the bank's capital, whichever is greater.

Likewise, the Philippine financial system has followed the gradual path to financial opening. From repressive policies in the 1950s, the financial system was gradually liberalized through a series of policy reforms which paved the way for the market-orientation of interest rates starting 1982 and the adoption of a floating exchange rate policy (1970) followed by measures designed to enhance market competition and financial intermediation in the eighties. Towards the nineties, policy reforms were further advanced with the relaxation of restrictions covering foreign exchange transactions on both current and capital accounts. Simultaneously, reforms were undertaken to promote stability in the financial system. Furthermore, as macroeconomic stability was achieved, the law liberalizing the entry and scope of operation of foreign banks in the country was passed.

The process of financial reform implementation in Sri Lanka was also gradual. The main features of the financial sector reforms undertaken since 1977 were the liberalization of interest rates, the relaxation

of exchange controls, the removal of barriers to enter the Sri Lankan financial market by foreign banks and the eligible domestic private sector, the setting up of offshore banking units, the restructuring of the two state banks, the gradual removal of selective credit restrictions, the strengthening of the legal, accounting and regulatory framework of financial institutions and a greater emphasis on market-based policy instruments in conducting monetary policy. The prevailing dual exchange rate system was abolished in 1977 while foreign banks were allowed to open more branches together with an establishment of offshore banking units in 1978. Sri Lanka's current account was fully liberalized in March 1994 and there has been a gradual progress towards the liberalization of capital markets.

Chapter 4

FINANCIAL OPENINGS IN THE SEACEN COUNTRIES

I. Introduction

The dominant characteristic of the international financial markets today is the unprecedented level of competition facing many of the major financial institutions. Market and product interpenetration in this sector is proceeding at a highly competitive rate, driven by rapid financial innovations, securitization of international capital flows, and continued evolution of offshore capital markets.

The convergence of financial markets across countries results from the lifting of capital controls, financial deregulations and innovations as well as increasing competition. This trend which began in the 1980s has taken place in both the developed countries and the developing countries, including those in the SEACEN region. And with the adoption of the General Agreement on Trade in Services (GATS) in December 1993 at the Uruguay Round of multilateral trade negotiations, it is expected that the SEACEN countries will be more open to international banking.

In most SEACEN countries, the opening of financial markets occurred together with financial liberalization, including the deregulation of interest rates, the promotion of capital markets, and the relaxation of foreign exchange controls. These developments appear to indicate a conducive environment for the integration of the SEACEN region into the international financial markets.

With a view to protecting and promoting domestic financial market, SEACEN countries have imposed certain restrictions on the entry of foreign banks. However, since 1985, a noticeable easing of restrictions on new entry, establishment of branches and operations of foreign banks has been observed in the SEACEN region. This change in the policy was in response to the need to improve efficiency in financial services by stimulating competition, the desire to increase foreign direct investment, the pressure from their major trading partners and their commitment to GATS to open up the financial system. On the other hand, policymakers in this region are concerned that unrestricted

competition from foreign banks will adversely affect the development of domestic banks, especially when foreign banks have the advantage in terms of more access to funds from abroad. This creates the pressure to limit the entry and the scope of operations of foreign banks. In this section, the development and current status of the foreign participation in the financial sector particularly in relation to policy changes in each SEACEN countries will be examined.

II. Recent Developments in Financial Opening in SEACEN Countries⁸

2.1 Indonesia

2.1.1 Current Regulations and Policy Changes

The Indonesian Government implemented the most important financial opening measures which fundamentally changed the face of Indonesian banking in October 1988. To promote competition, the restriction on the entry and expansion of branch network of private banks which had been in effect since 1971 was removed. Foreign banks were also allowed to operate through a joint-venture with foreign domestic banks as long as the foreign banks' share did not exceed 85 percent. Foreign banks already present in Jakarta were allowed to open new branches in six major provincial cities.

The regulations governing the new entry and the operations of foreign financial institutions and the participation in the capital market as stipulated in the Government Regulation of the Republic of Indonesia Number 70 of 1992 are as follows: A commercial bank may only be established and conduct business pursuant to a license granted by the Minister of Finance after taking into consideration the recommendations of Bank Indonesia. A commercial bank may only be established by Indonesian citizens, and/or an Indonesian legal entity which is wholly owned by Indonesian citizens, or a commercial bank as referred to

8. *Sources:* Responses to the SEACEN Questionnaire on Research Project on *The Effects of Foreign Participation in the Financial Sector in the SEACEN Countries* from member central banks and monetary authorities, and additional references from The SEACEN Centre library.

Table 4.1**NUMBER OF JOINT/FOREIGN BANKS IN INDONESIA**

	1992	1993	1994	1995
State Commercial Banks	7 (1,434)	7 (1,455)	7 (1,488)	7 (1,577)
Local Govt-Owned Banks	27 (613)	27 (639)	27 (645)	27 (647)
Private National Banks	144 (3,385)	161 (3,801)	166 (3,776)	166 (3,866)
Joint Banks	20 (31)	29 (45)	30 (50)	30 (51)
Foreign Banks	10 (94)	10 (98)	10 (100)	10 (101)
Total	208	234	240	240

Note: Figures in parenthesis are number of bank offices.

Source: Bank Indonesia.

commercial bank whose founders are the parties referred to above mentioned together with a bank whose head office is domiciled overseas (foreign bank). The paid-up capital for the establishment of a joint bank shall be not less than one hundred billion rupiah. A foreign citizen and/or foreign legal entity may buy shares in a commercial bank sold through stock exchange in Indonesia to not more than 49 percent of the shares listed on stock exchanges in Indonesia. Under decree of the Minister of Finance number 220/KMK.017 of 1993, a commercial bank in the form of a joint bank may only be domiciled in one of the cities of Jakarta, Surabaya, Semarang, Denpasar, Ujung Pandang, Medan, Bandung and Batam Island.

2.1.2 The Operations of Foreign Financial Institutions

Commercial banking in Indonesia is dominated by seven state-owned banks, each originally established to provide banking services to a specific sector of the economy. All seven state banks are authorized to deal in foreign exchange. There are private commercial banks owned and operated by Indonesian nationals. The deregulatory measures introduced in October 1988 provided incentives for foreign banks as well as domestic banks in Indonesia as reflected in the establishment of 13 new domestic private banks and the approvals granted to eight joint-venture banks. Foreign banks are now permitted to set up sub-branches in cities other than Jakarta. There are 10 foreign banks and 30 joint-venture banks in Indonesia as of the end of 1994.

2.2 Korea

2.2.1 Current Regulations and Policy Changes

The Korean government has pursued deregulation, liberalization, and internationalization of its financial market. Since the early 1980s it has supported the privatization of the banking sector and the self-regulation of financial institutions. Foreign exchange management was converted from a positive to a negative system to encourage full-scale overseas activities in 1992. Preferential treatment and discriminatory restrictions for foreign banks in Korea have steadily abolished since the mid-1980s with a view to augmenting the competitiveness of the markets. They have progressively been placed on equal footing with domestic banks by lifting certain restrictions on their operations and, at the same time, reducing their privileges.

In April 1984, the Korean government announced its intention to put the foreign bank branches in Korea on an equal footing with domestic banks. To this end, discriminatory restrictions on their business activities have been lifted. At present, foreign banks are treated the same as domestic banks. They were allowed to join the Korean Federation of Banks in 1984 for the purpose of exchanging business information with domestic banks.

In addition, foreign bank branches were permitted to use the rediscount facilities of the Central Bank for export financing in March 1985, with the scope of rediscounts being expanded to include general commercial bills in July 1986. Foreign bank branches were also allowed to handle money-in-trust and negotiable certificates of deposit (CDs) in September 1985 and in September 1986, respectively. Citibank and Chase Manhattan Bank joined the Clearing House as special members in November 1985. Since August 1988, foreign bank branches have been given access to the Bank of Korea's rediscount window, enabling them to borrow from the central bank as a means of financing possible shortages of reserve requirements or settlement funds. The ceiling of CDs issuance has been increased several times to allow foreign banks to mobilize their domestic currency funding. In May 1991, the ceiling on foreign bank branch capital (previously 12 billion won) was removed. Discriminatory requirements for the establishment of multiple branches were abolished and the same procedures and criteria have been applied for the opening of additional branches in Korea by both domestic and foreign banks from June 1991.

The restrictions on multiple branching of foreign banks were also eased. Multiple branching was possible from the latter half of the 1980s. Under the revised "General Banking Act" of December 1991, multiple branches of foreign banks are regarded as a single entity, thereby enabling additional branches to operate in other services such as trust business without the need for each branch to apply for approval.

In May 1991 the ceiling on in-country capital was removed and foreign banks were permitted to handle the specific money-in-trust and the miscellaneous trusts from June 1991. And in August of that year, the "guidelines for approval of foreign bank branches' handling of trust business" were abolished. Therefore, all discriminatory restrictions on their operations regarding trust business have been lifted.

In July 1992, foreign banks are admitted as the regular members of the Korean Financial Telecommunications & Clearing Institute. Since July 1993, they are permitted to install ATMs outside bank premises. Citibank became the first foreign bank to join in the inter-transfer system of the joint-electronic banking network system in April 1994.

In May 1993, the guidelines for new entry by foreign banks were clarified reflecting pressure from the advanced countries. The main guidelines are as follows:

- (1) The applicant should be ranked among the top 500 banks in the world based on total assets and its overall performance should be in good standing.
- (2) The applicant maintains a good business relationship with domestic banks and enterprises.
- (3) The applicant has operated a representative office in the previous one year.
- (4) The applicant has experience in international banking business and is competent to operate the branch.
- (5) The branch, where established, would give a boost to the domestic financial market and contribute to the development of banking services.
- (6) The representative of the branch has extensive knowledge about, and experience in, banking business.
- (7) The branch has appropriate operating funds for conducting its banking business with soundness and efficiency, and adequate organization and a set of operating rules.
- (8) The establishment of branch has the consent of the home country supervisory authorities.

The measures to allow foreign banks to compete on the same footing as domestic banks are accompanied by the gradual removal of their privileges. Since 1986, the Bank of Korea has gradually reduced their swap facilities, originally introduced in 1967 to assist capital in-

ducement by the branches of foreign banks, and lowered the yield guaranteed them on swap transactions. Since March 1985, the Monetary Board has required foreign bank branches to extend at least 25 percent of the increment of their Korean won lending of banking funds to small and medium firms. For those foreign bank branches that make use of central bank's rediscount facilities for commercial bills, this mandatory ratio⁹ was increased to 35 percent in August 1986.

As part of the process to internationalize the Korean won, import or export trade settlements in Korean won of up to \$100,000 per transaction have been permitted since October 1993, permitted and non-residents were allowed to open won accounts without restriction. A foreign currency call market was established in December 1989 in order to boost the foreign exchange market. Initially dealing in US dollar only, the market was expanded to include Japanese yen call transactions in March 1991 and Deutschemark in September 1992.

Foreign exchange transactions, which usually result from international trade and capital transactions, are handled by the foreign exchange banks which act as market makers, intermediating between the demand and supply of foreign exchange. Thus, foreign exchange banks carry out the most important role in the foreign exchange market. Foreign exchange banks deal among themselves mainly to dispose of open positions resulting from transactions with non-bank customers. They also deal with foreign banks in major international exchange markets for the same purpose. Customers, mostly corporations engaging in exports and imports, participate in the market as end-users and/or suppliers of foreign exchange. They are involved in the purchase and sale of foreign exchange against domestic currencies, the management of foreign exchange risk, and the acquisition of credit facilities to be furnished through the market.

In the area of capital market, the internationalization of the Korean securities market had its beginning in the Government's announcement of a long-term blue print for capital market opening in 1981. As a first step, two open-end type investment trusts for foreigners were set up

9. Domestic commercial banks are similarly required to extend a certain proportion of the increment in their loans from banking funds to small and medium enterprises. In the case of nationwide commercial banks, this minimum ratio is 40 percent, and for local banks, it is set at 80 percent.

in December 1981. The Korea Fund, a close-end international investment vehicle primarily for Korean stocks was subsequently established in May 1984. Another similar fund, the Korea Europe Fund, was set up in March 1987.

Domestic firms were permitted to issue convertible bonds (CBs) to foreigners in December 1985, bonds with warrants (BW's) in March 1987 and depository receipts (DRs) in December 1990. Since Samsung Electronics Co. first issued overseas CBs in December 1985, various firms have issued overseas CBs, BW's and DRs, raising a total of \$3,100 million as of the end of 1993. In a parallel development, the Government allowed foreign securities companies to own up to 10 percent of the paid-in capital of large Korean securities companies, subject to a proviso that the total stake of foreign securities companies in any one Korean securities company might not exceed 40 percent. Three foreign securities companies subscribed capital to two domestic securities companies in June 1985.

With the start of the Bilateral Financial Policy Talks between Korea and the U.S. in February 1990, the internationalization of the Korean securities was further deepened. In November 1990, foreign securities companies were permitted to establish branches and joint-venture securities companies. From June 1991, foreign securities companies' branches were allowed to become members of the Korea Stock Exchange. In January 1992, the green light was given for non-residents' direct investment in Korean stocks, subject to a limit of three percent of any one company's total outstanding shares to a single non-resident and ten percent on all non-residents. The ceiling on foreign portfolio investment was lifted from August 1993 for companies whose non-residents already hold more than 50 percent of the equity of a company through direct investment.

Foreign financial institutions in Korea was accorded similar treatment as domestic ones regarding their investment in Korea stocks in July 1992. Furthermore, in September 1992, foreign securities companies were allowed to engage in forward foreign exchange transactions as a means of hedging against possible foreign exchange risk to their operating funds.

The securities investment trust business was opened to foreigners in January 1993. Specifically, foreigners who handle securities invest-

ment trust business can set up representative offices in Korea and own the shares of domestic investment trust companies within a 10-percent overall limit and three percent for any individual foreigner. Foreigners are also able to invest in domestic investment advisory companies, subject to a ten percent limit and five percent on any individual foreigner. Foreign investment advisory firms are allowed to set up representative offices in Korea.

Now, the Korean branches of foreign securities companies can conduct various types of securities related activities; underwriting, own-account trading and broking. The scope of operations authorized differs according to the size of the branch's in-country operating funds, which are deemed its capital. While branches with operating funds larger than 20 billion won can do the whole business, those with operating funds of between 15 and 20 billion won can do two of the above three activities, and those with less than 15 billion won can do only one of the three activities. Foreign securities companies which want to set up branches in Korea should operate as securities companies for at least 10 years at their home country and have representative office operated for at least 2 years in Korea. They also must not have been disciplined by home country regulatory body in the past 2 years.

However, there are no differences as to the scope of operations between domestic and foreign insurance companies. The branch establishment criteria for foreign life insurance companies are as follows: First, they should operate nation-wide life insurance business in their home countries. Second, size of premiums and total assets in the past three years should be at least half of the size of domestic life insurance companies' annual average over the same period. Third, during three most recent operating years they have achieved net profits and judged satisfactory as to its financial status by the government or responsible supervisory authority of their home countries. Lastly, they must not have been subject to disciplinary action beyond a letter of warning by their home-country governments or the supervisory authorities in the past five years.

Foreign investment in domestic stock market was permitted from January 1992. An individual foreign investor may hold up to 3 percent of the total outstanding shares of a listed company and the ceiling on overall foreign investment in a listed company has been expanded from 10 percent to 12 percent in December 1994. Foreigners are also al-

lowed to invest in convertible bonds issued by small and medium firms, and government and public bonds at international rates.

The Korean government's efforts toward financial liberalization are reflected in the Uruguay Round negotiation on financial services and in Korea-U.S. financial relations. With regard to Korea-U.S. financial relations, the Korean government has held the Korea-U.S. financial policy talks since 1990, and many issues raised by the United States have been resolved through this bilateral negotiation. Participation in the trust business, the elimination of ceilings on operating funds, and restrictions on branch establishments are some of the achievements of these talks.

In early 1992, the Korean government initiated a comprehensive reform program and announced its three-stage Blueprint for Liberalization and Opening of the Financial Industry (Table 4.2). The first stage, which was already implemented, includes measures to facilitate the Korean currency funding for foreign banks, to improve transparency in bank supervisory regulation, and to widen the range for foreign exchange rate fluctuations. The second stage included plans to open the investment trust industry, relax restrictions on foreign exchange positions of banks, and internationalize the Korean currency. The third stage deals with the long-term and structural issues in the Korea's financial industry. These include deregulating interest rates, relaxing lending regulations, opening a bond market, and liberalizing capital transactions. By continuing with such measures the Korean government plans to liberalize and open up Korea's financial industry to the level of developed countries in near future. However, as the experience of some Latin America countries shows, what the Korean government worries about is the fact that hasty liberalization could invite undesirable side effects and destabilize the economy.

2.2.2 Operations of Foreign Financial Institutions

Foreign banks may open branches in Korea with the approval of the Monetary Board as recommended by the Superintendent of Banks under the provision of the General Banking Act. Foreign banks were allowed to open branches in Korea as early as 1967 when the Chase Manhattan Bank opened its Seoul branch, but it was only in the latter half of 1970s that the number of branches and volume of business expanded rapidly. In a further development of the foreign banks' participation in the domestic banking system, some foreign banks have

Table 4.2

**BLUEPRINT FOR LIBERALIZATION AND OPENING OF
THE KOREAN FINANCIAL INDUSTRY**

Implementation Schedule	Items
First Stage (1992-93)	<ol style="list-style-type: none">1. Expand CD issuance quotas, extend maturities, and lower minimum, denominations.2. Improve the transparency of regulations.3. Extend maturities on the short-term call market.4. Allow securities companies to hedge funds against exchange rate risks.5. Allow over-the-counter trading of domestic bonds.6. Liberalize over-the-counter option transactions.
Second Stage (1994-96)	<ol style="list-style-type: none">1. Allow more branches of foreign securities companies.2. Open securities investment trust businesses.3. Allow Koreans individual access in the foreign securities market. <p><i>Macroeconomic conditions:</i> Current account in balance, Korean-international interest rate differential narrowed to half that of 1992, below 7 percent.</p>
Third Stage (1997-onward)	<ol style="list-style-type: none">1. Complete the proposed liberalization of interest rates.2. Open the domestic bond market.3. Eliminate the mandatory purchase of monetary stabilization bonds by foreign banks.4. Permit foreign banks to establish subsidiaries.5. Expand limits on foreign investment in the stock market. <p><i>Macroeconomic conditions:</i> Current account in surplus, interest rate differential narrowed to 2 to 3 percent, inflation of 5 percent.</p>

been allowed to open additional branches in Korea since July 1977. As of the end of November 1994, there were 72 foreign banks' branches and 23 representative offices serving as liaison offices in Korea. As for market share as of the end of October 1994, foreign banks had 7.7 percent of the total assets of all commercial banks. Their shares of the deposit and loan market (including those in foreign currency) were 0.9 percent and 6.9 percent, respectively, showing a relatively high ratio in loans. In the early stage of Korean economic development, foreign bank branches in Korea helped facilitate foreign capital inducement through their close relationships with international financial markets. It is now hoped that they will serve as catalysts in improving domestic banks' financial services and techniques.

Foreign investors' access to the Korean capital market has been substantially increased since 1981, when the Capital Market Internationalization plan was first announced by the Government. As a first step, two open-end type investment trusts for foreigners were set up in November 1981. Since then a number of such trusts have been founded. The Korea Fund, a closed-end international investment vehicle which invests primarily in the Korean stock market, was subsequently established in 1984. Another similar fund, the Korea-Europe Fund was set up in March 1987. Foreign securities companies are allowed to open representative offices and to own up to 10 percent of the paid-in capital of large Korean securities company. The establishment of branches of foreign securities companies was authorized from March 1991 as one of the measures to stimulate the stock market. As of the end of November 1994, there were 11 branches and 35 representative offices of foreign securities companies in Korea. As for market share, foreign securities companies recorded 1.4 percent of total turnover of stocks and bonds during the first three quarters of 1994.

The Korean insurance market has been opened, with the establishment of three foreign life insurance company branches in Seoul since 1987. As of the end of November 1994, there were 2 branches and 3 local subsidiaries of foreign life insurance companies. So far, the extent of foreign participation in the Korean life insurance market has been insignificant. As of the end of September 1994, their sums insured under agreements and premiums were 0.36 percent and 0.39 percent of the respective totals. As for the non-life insurance companies, there were 3 branches, 13 representative offices and 3 agencies.

Table 4.3**ENTRIES OF FOREIGN FINANCIAL INSTITUTIONS IN KOREA**

(Unit: Number)

	1967- 1975	1976- 1980	1981- 1985	1986- 1990	1991- 1994	Total
<i>Banks</i>						
Branches	9	24	20	16	3	72
Rep. Offices	7	13	-	4	-1	23
<i>Securities Companies</i>						
Branches	-	-	-	-	11	11
Rep. Offices	-	-	6	18	11	35
Capital Participation	-	-	3	-	1	4
<i>Life Insurance Companies</i>						
Branches	-	-	-	4	-2	2
Local Subsidiaries	-	-	-	1	2	3
Joint-Ventures Cos.	-	-	-	5	2	7
<i>Non-Life Insurance Companies</i>						
Branches	2	-	-	-	1	3
Rep. Offices	-	3	-	8	2	13
Agencies	-	2	-	-	1	3
Capital Participation	-	3	-	-	-	3

Source: The Bank of Korea.

2.3 Malaysia

2.3.1 Current Regulations and Policy Changes

In Malaysia, no new banking license is granted to foreigners as well as Malaysians, and foreign banks operating in Malaysia are not allowed to set up branches (including off-premises ATMs) and networking with ATMs of local banks in Malaysia without Bank Negara's approval since the existing number of banking institutions is considered to be adequate to meet the needs of the nation. However, foreign banks are allowed to establish operations in the Labuan International Offshore Financial Center, to buy into existing banks subject to an aggregate limit of 30 percent equity participation, and to set up representative offices.

To a large extent, the regulatory treatment of foreign banks in Malaysia is the same as domestic banks, such as:

- (1) No new entry of either foreign or local banks are allowed.
- (2) Limitation of share holdings in financial institutions by any corporations or cooperative is 20 percent, and foreign banks which do not currently operate a branch in Malaysia can acquire a maximum of 20 percent equity stake in a financial institutions; and,
- (3) Capital adequacy ratio requirement is applied to all financial institutions. Prior to local incorporation foreign banks had to maintain a ratio of 10 percent compared with 8 percent of the domestic institutions. With local incorporation, the minimum risk weighted capital ratio requirements was standardized at 8 percent for the entire banking system.

A major reform which took place in the banking sector was the introduction of the Banking and Financial Institutions Act 1989 (BAFIA) to replace the existing Banking Act, 1973 and Finance Companies Act, 1969. The introduction of the BAFIA is intended to provide an integrated supervision of the Malaysian financial system and to modernize and streamline the laws relating to banking and banking institutions. When the BAFIA came into force on October 1, 1989, the foreign banks were given a time period of five years to incorporate locally. In essence, this local incorporation exercise merely changes the legal form

of the foreign banks from that of a branch of foreign banks to a wholly-owned subsidiary. In compliance with Section 4 of the BAFIA, which requires that only a public company can be licensed to conduct commercial banking business, all 16 foreign bank branches operating in Malaysia duly completed their local incorporation exercise by October 1, 1994. Of the 16 foreign bank branches operating in Malaysia, all but two (United Overseas Bank Limited and Security Pacific Asian Bank Ltd.) which sold their banking operations to local concerns, transferred their banking operations in Malaysia to their wholly-owned locally-incorporated subsidiaries.

Upon the completion of the exercise, all commercial banks in Malaysia became public companies incorporated under the Companies Act 1965 and maintained the paid-up capital in the country. This had contributed to a greater leveling of the playing field for the banking system in Malaysia. Several capital-based regulatory requirements such as the capital adequacy ratio, the limit for issuing negotiable instruments of deposit and the single customer credit limit, can now be applied uniformly to all banking institutions operating in the country. For instance, with the completion of the local incorporation of the foreign bank branches operating in Malaysia, the minimum risk-weighted capital ratio (RWCR) requirement applicable to the entire banking industry has been standardized at 8 percent.

Foreign participation in the capital market is guided by the Foreign Investment Committee (FIC) Guidelines whereby:

- (1) Foreign ownership of companies is generally restricted to 30 percent.
- (2) Any proposed acquisition of 15 percent or more of the voting power by any foreign interest or associated group or by foreign interests in the aggregate 30 percent or more of the voting power of a Malaysian company or business; any proposed acquisition of interest exceeding RM 5 million; and, any proposed acquisition of substantial assets are subject to FIC approval. The guidelines, however, do not apply to specific projects approved by the Government. In addition, foreign ownership of stockbroking firms are allowed up to 49 percent from 30 percent since July 1988, subject to the approval of the Minister of Finance.

The inclusion of 68 Malaysian stocks in the Morgan Stanley indices, namely the Europe, Australia-Asian and Far East (EAFE) Index and the World Index in May 1993, also provided further impetus for foreign funds to invest in the Kuala Lumpur Stock Exchange (KLSE). As a result, the number of major country funds investing in the KLSE has risen from 29 funds in 1988 to 87 funds in 1994.

The majority of the foreign participants in the Malaysian capital market are mainly from Singapore and Hong Kong. They represent just over 90 percent of the total foreign participation in Malaysia. This essentially reflects investment by foreign funds made by their offices based in these countries. Taken as a whole, foreign participation accounts for about 15-20 percent of total trade done in the KLSE. Although their involvement is not of great magnitude, their presence can be significant as funds are transferred in and out of the domestic market. This is because moves by foreign fund managers generally tend to trigger off trading by local investors and, in the process, cause share price to change.

Since 1987, non-resident controlled companies (NRCCs) in Malaysia are required to obtain at least 60 percent of their total domestic borrowings from locally-incorporated financial institutions.

2.3.2 Operations of Foreign Financial Institutions

Unlike in many countries where foreign banks operate mainly in the wholesale market, the foreign banks in Malaysia are authorized to engage in a full range of commercial banking activities, including retail deposit-taking. The foreign banks command a significant share of the retail banking market in Malaysia, accounting for over one-third of total deposits mobilized by the commercial banks from the household sector at the end of 1993. As at end-1994, there were 37 locally incorporated commercial banks, of which 23 were domestic banks and 14 foreign-owned.

Amount due to foreign financial institutions which accounted for 12.7 percent of total sources of funds in 1993, fell significantly by RM 13.7 billion in 1994 to account for 6.1 percent of the banking industry's total sources of funds. Capital and reserves increased its share of the industry's total sources of funds from 4.1 percent in 1993 to 6.7 percent in 1994. While the higher profits enabled the banks to increase retained

earnings, more than one-half of the increase in capital and reserves was attributed to the injection of capital by the foreign banks into their locally incorporated subsidiaries operating in Malaysia following the local incorporation exercise in 1994.

The number of licensed finance companies stands at 40 as of the end of 1994, of which 12 are wholly-owned subsidiaries of domestic commercial banks, while another four were subsidiaries of locally incorporated foreign commercial banks.

Table 4.4

COMMERCIAL BANKS AND BRANCH OFFICES IN MALAYSIA

	Banks			Branch Offices		
	Total	Domestic	Foreign	Total	Domestic	Foreign
1959	26	8	18	111	12	99
1960	28	10	18	131	29	102
1970	38	16	22	336	177	159
1980	38	21	17	546	398	148
1988	38	22	16	911	765	146
1989	38	22	16	951	805	146
1990	38	22	16	998	852	146
1991	37	21	16	1,050	904	146
1992	37	21	16	1,125	979	146
1993	37	21	16	1,220	1,074	146
1994	37	23	14	1,283	1,139	144

Sources: *Money and Banking*, Bank Negara Malaysia, 1994.
Annual Report 1994, Bank Negara Malaysia.

2.4 Nepal

2.4.1 Current Regulations and Policy Changes

With the prior approval of Nepal Rastra Bank and the Government of Nepal, the foreign financial institution may participate in the equity capital of banks and financial institutions. However, foreign commercial banks are allowed to open only their representative office in Nepal.

An important policy initiative was taken in July 1984 when entry barriers were removed for joint-venture banks and the establishment of finance companies was permitted. The private sector was allowed to open commercial banks business, with up to 50 percent partnership with foreign banks. Since then, 7 joint-venture banks have been set up and two finance companies have started operation.

Regarding the participation in the capital market, no foreign institution is allowed to participate in the capital market as the capital account is still restricted. However, the foreign institutions are encouraged to invest directly in joint-venture projects.

In 1965, Nepal introduced the restriction measures under the Foreign Investment Abroad Act (RFIAA). This Act strictly controlled the Nepalese citizens and all locally incorporated companies to move or invest capital abroad. There have been no significant revisions to the RFIAA since its inaction, and the Act continues to govern foreign investment by the Nepalese citizens outside the countries. Under the RFIAA, "investment" is defined to encompass foreign securities, partnerships in foreign firms, accounts with foreign banks in foreign countries, houses and land abroad, and all other types of investment abroad either in cash or in-kind. The Act states clearly that no Nepalese citizen or company is permitted to undertake any of the activities defined as "investment". In addition to restrictions on Nepalese foreign investment abroad, there are some restrictions on foreign investment in Nepal. Foreigners are allowed to take equity stakes in firms, but are restricted from investments in joint venture in small sectors having fixed capital up to 20 million rupees. Since May 1993, Nepalese citizens and organizations that earn income in foreign exchange have been permitted to retain the income in foreign currency accounts in Nepal. However, these resources can only be used for certain purposes, making it difficult to transfer them as capital investment. In particular, these resources may

be used for payments of current transactions such as trade, services and transfer with evidence of payment requirements. Foreign nationals are permitted to open only non-interest bearing accounts in Nepalese rupees.

2.4.2 Operations of Foreign Financial Institutions

To activate its outward-oriented strategy, Nepal adopted the structural Adjustment Program supported by a three-year SAF arrangement with the International Monetary Fund (1987/ 1988 - 1989/1990). The reforms were aided by technical assistance from the Fund, the World Bank and United Nations Development Program (UNDP).

The success of the Structural Adjustment Program in Nepal reflects a shift in its changed outlook on the strategy of the national economic management from public-led to private initiatives. Hence, the private sector increasingly dominates economic activities as a result of the deregulation in interest rate and effective exchange rate policies. Although foreign exchange is subject to regulation, the exchange rates are allowed to follow the movements of the currencies of Nepal's major trading partners. Foreign investment is also encouraged. Foreign banks incorporated under joint-venture are growing steadily while their coverage of services is increasing.

The authorities also implemented the recommendations of the Commercial Banks Problems Analysis and Strategy Study (CBPASS), which was conducted with the UNDP assistance, to eliminate the current financial weakness of the two big commercial banks. The recommendations include: recapitalization of both banks; setting up of a loan recovery agency to administer recovery of overdue loans; modifying the classification of loans in accordance with international standards; strengthening asset and liability management; improving the accounting system; and modernizing their operations. With a view to strengthening the financial position of commercial banks, the government began to repay arrears on loans which had been extended to non-financial public enterprises. A Credit Information Bureau has been established to monitor loan defaults. Consequently, the loan recovery has been improving significantly. Measures were also taken to strengthen bank supervision and regulation such as the amendments made on financial institutions acts. The Nepal Rastra Bank Act empowered the Bank to impose penalties on banks and other financial institutions for failing to comply with reserve

and portfolio requirements. In addition, the Bank's supervisory capability was enhanced by improved off-site and on-site inspection programs and improvement in periodic reportings by banks.

2.5 Philippines

2.5.1 Current Regulations and Policy Changes

The General Banking Act [Republic Act(RA) No. 337], dated July 24, 1948, prohibits the establishment of foreign banks in the Philippines with the exception of four foreign banks (Bank of America, Citibank, Hongkong and Shanghai Bank and Standard Chartered Bank) which were already operating before the General Banking Act took effect. These four foreign banks have since been the only foreign bank branches operating in the country. The R.A. No. 337 also requires that a majority or at least 70 percent of the voting equity of banks organized under the Philippine law should be owned by Filipino citizens. This restriction has, however, been gradually relaxed. In 1977, foreign banks were allowed to operate offshore banking units. In 1992, foreign banks were allowed to negotiate inward export letters of credit and to provide full foreign exchange services for all foreign currency non-trade remittance.

The passage of the R.A. 7721, also known as the "Act Liberalizing the Entry and Scope of Operations of Foreign Banks in the Philippines" on May 18, 1994, results in an increase in the number of foreign bank branches operating in the country. The new law increases the number of foreign bank branches by 10 over a period of five years. As of end-1994, 23 foreign banks have formally applied to operate in the country, 22 as branches and one as a subsidiary.

The current regulations for new entry and the operation of foreign financial institutions in the Philippines are well described under Circular No. 51 dated October 14, 1994 which formulates the rules and regulations in implementing the R.A. No. 7721. Among the significant features are:

I. Mode of Entry

- (1) By acquiring, purchasing or owning up to 60 percent of the voting stock of an existing domestic banks;

- (2) By investing in up to 60 percent of the voting stock of a new banking subsidiary incorporated under the laws of the Philippines; and,
- (3) By establishing branches with full banking authority.

II. Qualification Requirements

- (1) A foreign bank seeking to acquire, purchase or own up to 60 percent of the voting stock of an existing domestic bank needs only to meet the following selection criteria:
 - (a) Geographic representation and complementation;
 - (b) Strategic trade and investment relationships between the Philippines and the country of incorporation of the foreign bank;
 - (c) Relationship between the applicant bank and the Philippines;
 - (d) Demonstrated capacity, global reputation for financial innovations and stability in a competitive environment of the applicant;
 - (e) Reciprocity rights enjoyed by the Philippine banks in the applicant's country; and,
 - (f) Willingness to fully share technology.
- (2) A foreign bank seeking to establish a new banking subsidiary or to establish branches with full banking authority, in addition to satisfying the criteria prescribed in the above, must be widely-known and publicly-listed unless more than 50 percent of the capital stock of the foreign bank is owned by the government of its country of origin. Also, it must be among the top 150 banks in the world or the top 5 banks in its country of origin as of the date of application. Lastly, it must be in compliance with the capital requirements of its country of origin.

III. Minimum Capital Requirements

- (1) For locally incorporated subsidiaries of foreign banks : the same as that for domestic banks.
- (2) For foreign banks authorized to establish branches with full banking authority : inward remittance and conversion into the Philippine currency at prevailing exchange rate on effective day of R.A.

7721 (₱ 26.979 to US\$1), US\$ equivalent of ₱ 210 million as permanently assigned capital.

- (3) For foreign banks with existing branch or branches: the same as (2) but compliance within 1-1/2 years from the effective date of R.A. 7721 (June 5, 1994).

With respect to their participations in the capital market, subsidiaries and branches of foreign banks are allowed to perform the same functions and enjoy the same privileges of a Philippine bank of the same category. Moreover, foreign banks who would enter the domestic market and operate as expanded banks are automatically empowered by the R.A. 7721 to engage in underwriting activities.

2.5.2 Operations of Foreign Financial Institutions

As of October 1994, the total resources of the four existing foreign banks amounted to ₱ 81.2 billion representing 8.4 percent of the total resources of the commercial banking system. It may be noted however, that the size of the foreign banks' resources relative to total resources of all commercial banks combined show a declining proportion. From 15.8 percent of total commercial banks resources in 1988, the ratio of foreign banks' resources to total commercial banks resources declined to 8.4 percent. Meanwhile, domestic commercial banks' aggregate resources showed an uptrend from 84.2 percent to 91.6 percent during the same period. This is due to the fact that the number of foreign banks remained at four while the local commercial banks have increasingly grown from 28 in 1993 to 32 as of end-September 1994.

2.6 Singapore

2.6.1 Current Regulations and Policy Change

As there have been no foreign exchange control since 1978, banks in Singapore are able to conduct foreign currency transactions (including foreign currency deposits and loans) with residents and non-residents. Total assets in the foreign currency market or Asian Dollar Market (ADM) amounted to US\$ 420 billion or almost 4 times the size of the domestic banking market. In other words, the domestic banking sector comprises only 20 % of the total banking market.

Some of the liberalization measures undertaken by Singapore in the last two years include:

- (1) increasing the offshore banks' S\$ lending limit progressively as follows;
 - 1978 : S\$ 15 million to S\$ 30 million
 - 1988 : S\$ 30 million to S\$ 50 million
 - 1992 : S\$ 50 million to S\$ 70 million, and
 - 1993 : S\$ 70 million to S\$ 100 million.
- (2) increasing the foreign ownership limit in local banks from 20 percent to 40 percent;
- (3) allowing foreign full banks to provide home banking services to both individual and corporate customers through telephone and personal computers;
- (4) allowing foreign stockbrokers to acquire up to 49 percent shareholding interest in members of the Stock Exchange of Singapore (SES); and
- (5) admitting 7 foreign stockbrokers as wholly-owned international members of SES.

2.6.2 Operations of Foreign Financial Institutions

There are 204 banks and merchant banks from more than 30 countries in Singapore, of which 22 are foreign full banks, 14 restricted banks and 91 offshore banks in Singapore. Foreign banks account for more than half of total banking business and profits. The high foreign content in Singapore's domestic banking sector is unmatched in the world. To ensure that Singapore's domestic banking market is not overbanked, Singapore has not issued new full banking license to either locals or foreign entities. Those who satisfy the admission criteria are, however, welcomed to establish offshore or merchant banks in Singapore.

Table 4.5

NUMBER OF FINANCIAL INSTITUTIONS IN SINGAPORE

Institutions	End-March						
	1983	1987	1991	1992	1993	1994	1995
Banks	118	133	137	131	128	132	140
Local	13	13	13	13	13	13	12
Foreign	105	120	124	118	115	119	128
Full banks	23	23	22	22	22	22	22
Restricted banks	13	14	14	14	14	14	14
Offshore banks	69	83	88	82	79	83	92
Stockbroking Companies	NA	36	63	71	72	78	81
Local	NA	24	26	26	33	33	33
Foreign	NA	12	37	45	39	45	48

Source: Annual Report 1994/95, Monetary Authority of Singapore.

Following the revamp of the SES in 1985/86, foreign brokers were allowed to acquire equity stakes of up to 49 percent in SES member firms. In October 1990, the SES introduced a new category of membership called "International Membership". To-date, 7 wholly-owned foreign stockbroking firms are international members of the SES. International members can deal freely in SES-quoted securities with non-residents and resident companies controlled by or beneficially owned by non-residents as well as with residents for transactions above S\$ 5 million each. Of the 7 primary dealers in the Singapore Government Securities (SGS) market, 2 are foreign-owned. Two other foreign-owned dealers sold their primary dealership.

Of the 58 direct insurers in Singapore, 42 are foreign-owned. They account for more than half of the total domestic insurance business. Of the 36 reinsurance companies in Singapore, 32 are foreign-owned.

2.7 Sri Lanka

2.7.1 Current Regulations and Policy Change

The selection criteria for foreign banks are as follows;

- (1) It should be a body incorporated outside Sri Lanka or formed in pursuance of any statute, royal charter or letters of patent of a foreign country.
- (2) A license should be obtained from the Monetary Board, with the approval of the Minister of Finance.
- (3) Unimpaired capital should be no less than Rs. 200 million. This sum has to be assigned to the bank by its Head Office. In addition, the Head Office of the bank should remit to Sri Lanka a sum determined by the Monetary Board.
- (4) Application has to be made to the Monetary Board. The application has to be accompanied by:
 1. The memorandum and Articles of Association.
 2. Any other document required by the Monetary Board.
 3. A report with regard to the directors of the company.
 4. A feasibility report with regard to the proposed bank.

The Finance Minister's approval must be obtained for Country Funds and Regional Funds investing in the stock market. These investments should be routed through Share Investment External Rupee Accounts (SIERA). These accounts should be operated subject to certain terms and conditions. Dividends received and proceeds from the sale of shares can be freely remitted out of the country.

2.8.2 Operations of Foreign Financial Institutions

With the liberalization of the Sri Lankan economy, the establishment of branches of well reputed foreign banks was encouraged with a view to developing the financial system in the country. In 1977, there were only 7 foreign banks in the country, but this number had increased to 17 by 1994 with a branch network of 34. In the past, the foreign banks had tended to concentrate in the metropolitan area of

Table 4.6

NUMBER OF FINANCIAL INSTITUTIONS IN SRI LANKA

Category	1985	1989	1990	1991	1992	1993	1994
Institutions	29	35	36	38	39	40	40
1. Commercial banks	25	24	24	23	23	23	23
1.1 Domestic	4	6	6	6	6	6	6
1.2 Foreign	21	18	18	17	17	17	17
2. Regional Rural Development Banks (RRDBs)	4	11	12	15	16	17	17
Branches	714	870	918	967	1051	1093	1134
1. Commercial Bank							
Branches	697	712	741	762	811	845	875
1.1 Domestic	671	691	718	737	782	812	839
1.2 Foreign	26	21	23	25	29	33	36
2. Regional Rural Development Bank (RRDB) Branches	17	89	101	124	156	163	169
3. National Savings Bank Branches	-	69	76	81	84	85	90

Source: *Annual Report 1987*, Central Bank of Sri Lanka.
Annual Report 1991, Central Bank of Sri Lanka.
Annual Report 1992, Central Bank of Sri Lanka.
Annual Report 1993, Central Bank of Sri Lanka.
Annual Report 1994, Central Bank of Sri Lanka.

Colombo, but in more recent times, these banks have shown an interest in establishing branches in other areas as well. Both foreign banks and domestic banks in Sri Lanka offer a full range of standard banking services normally expected from a commercial bank. Both types of banks have introduced a number of new facilities and financial instruments (e.g. electronic money transfer facilities, credit cards, automated teller machines etc.) in the past. Total assets of foreign banks increased from Rs. 14,294 million in 1985 to Rs. 36,167 million in 1994. However, the share of foreign banks in the total assets of commercial banks had fallen from 23 percent in 1985 to 13 percent in 1994.

The foreign Currency Banking Unit (FCBU) scheme was introduced in Sri Lanka in 1979 with a view to developing Colombo as an international financial centre and providing offshore banking facilities, particularly for investors in the Investment Promotion Zone (IPZ). Under this scheme, foreign banks were allowed to operate FCBUs as separate units of the banks to undertake foreign currency denominated transactions. FCBUs accept time and demand deposits from non-residents while granting foreign currency loans to non-resident enterprises in the Free Trade Zones and to approved domestic enterprises. Total assets of FCBUs owned by foreign banks accounted for 54 percent and 48 percent of total assets of FCBUs at the end of 1992 and 1994, respectively.

A number of new financial institutions have been established with limited foreign participation in recent years. Among these were Unit Trusts, Merchant Banks, Venture Capital Companies and Insurance Companies. In addition, in recent years, action has been taken to divert a larger share of public ownership of the two development banks to the private sector, including a number of foreign financial institutions.

2.8 Taiwan

2.8.1 Current Regulations and Policy Change

The revised Banking Law of July 1989 provides national treatment for foreign banks, enabling them, upon approval by the Ministry of Finance, to set up savings and trust departments, accept savings deposits, extend medium- and long- term loans and to apply for securities underwriting and brokerage licenses.

On August 9, 1994, the Ministry of Finance officially removed the other major restrictions imposed on foreign banks to enable them to enter the Taiwan market and compete on an equal footing with Taiwan banks. All regulations governing the establishment of new branches by foreign banks are exactly the same as those applying to domestic banks. There is also no restriction on the location of the new branches. The limit on the total N.T. dollar deposits to be accepted by foreign banks has also been lifted.

A foreign bank which applies to establish a branch should meet the following requirements;

- (1) The bank shall not have a record of major financial irregularities or bad practices in the preceding five-year period.
- (2) The bank shall rank among the top 500 in the world in terms of either capital or assets in the year prior to application, or have business transactions with the banks and major enterprises of the Republic of China amounting to not less than US\$ 1 billion in three calendar years prior to the application, of which no less than US\$ 180 million has been granted as medium- or long-term credit.
- (3) The bank is engaging in international financial activities and has a good reputation and a sound financial position. Besides, the bank's capital adequacy ratios must meet the criteria set by the Ministry of Finance.
- (4) The bank shall employ managers specializing in the financial field and having deep experience in the undertaking of international financial business.
- (5) Both the monetary authorities of the applicant's home country and the head office of the bank have the ability to supervise and administer overseas branches.

2.8.2 Operations of Foreign Financial Institutions

As of the end of 1994, there were a total of 57 foreign bank branches and 25 representative offices in Taiwan. The consolidated assets of foreign bank branches accounted for 40 percent of total assets of all financial institutions in the country.

Table 4.7

NUMBER OF FINANCIAL INSTITUTIONS IN TAIWAN

End of Year	¹Domestic General Banks	Medium Business Banks	Local Branches of Foreign Banks
1980	536	8	21
1982	598	8	25
1984	578	8	31
1986	618	8	32
1988	680	8	35
1989	709	8	38
1990	738	8	41
1991	900	8	37
1994	-	-	57

Note: 1. Includes Head Offices and Branch Offices

Source: *Statistical Yearbook of the Republic of China 1992*

The Taipei offshore market was established in June 1984, with a view to accelerating the internationalization of banking. There were 46 offshore banking units with total assets of US\$30 billion at the end of February 1995. The offshore market is restricted to transactions between non-residents. Its regulations are similar to those of the Eurodollar or the Asian Dollar market with regard to interest rate determination, exemption from reserve requirements, withholding tax, and business income corporations, government agencies, and financial institution within the territory of Taiwan.

Beginning in 1983, Taiwan's four local securities companies were permitted to raise funds overseas and indirectly invest in domestic securities. By the end of September 1992, six such securities investment funds had been established. In addition, at the end of 1990, qualified foreign institutional investors were allowed to invest in the Taiwan stock market. The amount of funds that could be inwardly remitted was as a first step limited to US\$2.5 billion before being raised to US\$5 billion. In March 1994, the limit for such funds was increased to US\$7.5 billion. In February 1995, the central bank lifted the dollar limit of total foreign investment in Taiwan's stock market. Currently, this limitation is regulated by a stock-held ratio instead of by volume, subject to the following ceilings on foreign holding of the listed stocks.

- (1) The share held by a single foreign investor of a listed stock shall not exceed six percent of its issued shares;
- (2) The shares held by all foreign investors of a listed stock shall not exceed twelve percent of its issued shares.

In February 1990, US securities investment companies, Merrill Lynch and Shearson Lehman were given permission to set up branches in Taiwan, and in May 1991, Taiwan Depositary Receipts (TDRs) started to be transacted in the Taiwan securities market. And in April 1992, a further liberalization took place whereby Global Depositary Receipts (GDRs) were issued in order to supply domestic enterprises with funds collected abroad.

2.9 Thailand

2.9.1 Current Regulations and Policy Change

The legal framework governing the operations of both Thai banks and foreign bank branches was first laid down in 1937. The "Act Regulating the Commercial Banking Business B.E. 2480(1937) was promulgated on 24 September 1937 and became effective on 1 April 1938. "The Commercial Banking Act B.E. 2505(1962), which was amended twice in 1979 and 1985, represents a milestone in the modern banking system. It regulated reserve requirements, cash reserve, credit extension, branch opening, and banks' inspection. According to this law, a foreign bank branch operating in Thailand was not allowed to open any more branch. To do so, foreign banks must apply for licenses from the Minister of Finance through the Bank of Thailand. As for Thai commercial banks, branch opening required prior authorization from the Finance Minister.

To promote technology transfer to local managers, the Bank of Thailand sets a maximum limit on the number of expatriates that foreign banks may bring in to manage their branch offices in Thailand. However, favorable consideration is given to commercial banks' request to bring in extra technicians or experts on a temporary basis.

Concerning the business of mutual fund management, the current policy to grant new licenses for the management of mutual funds sets a foreign participation ratio of 25 percent. This is to encourage foreign equity participation and transfer of new technology in mutual fund management.

An important impetus for the financial liberalization has also been the GATS which will substantially increase the presence of foreign financial institutions. The policy concerning the liberalization of the banking sector is contained in Thailand's offer list tabled at the GATS negotiation and signed in Marrakesh in April 1994, which contained 3 important points as follows;

- (1) Acceptance of the principle of progressive liberalization and is prepared to standstill by not introducing new discriminatory policies;
- (2) Acceptance of the principles of National Treatment and Most Favored Nation;

- (3) An offer to permit not more than five Bangkok International Banking Facilities (BIBFs) to operate as a full-licensed commercial bank by 1997 under the terms and conditions announced.

In line with the Thai offer list in the GATS and the progressive liberalization, foreign participation in the Thai financial system is expected to increase substantially in the next five years. The Ministry of Finance, the Bank of Thailand, and the Securities and Exchange Commission have jointly drawn up a Financial System Master Plan for the period 1995 - 2000. The Plan which received approval from the Cabinet on 28 February 1995 spells out comprehensive policy guidelines and measures for developing the Thai financial system as follows;

- (1) Expansion in the scope of operations of financial institutions;
- (2) Improvement of the financial structure;
- (3) Measures to support the Government's provincial and rural development policy;
- (4) Improvement of the efficiency of supervision of financial institutions and financial system;
- (5) Development of human resource and promotion of business ethics in the financial industry; and,
- (6) Developing Thailand into a regional financial centre.

The policy to enhance competition and financial liberalization sets forth measures which will substantially increase and expand foreign participation in the Thai financial system. These measures include:

- (1) upgrading 5 - 7 BIBFs to full-branch status by mid-1996;
- (2) granting new BIBF licenses within the year 1996;
- (3) permitting existing foreign bank branches to open additional branches. In this connection, foreign banks with full-branch status, which have been permitted to operate the Provincial International Banking Facility (PIBF), will be permitted to open up to 2 branches (with one branch being outside Bangkok and its vicinity). Foreign

banks with a full-branch status which have not applied for the PIBF licenses will be permitted to open one additional branch which must be located outside Bangkok and its vicinity; and,

- (4) granting new BIBF licenses by May 1996.

2.9.2 Operations of Foreign Financial Institutions

Foreign participation in the Thai financial system is more prominent in the area of commercial banking than any other type of financial businesses. Commercial banking first came to Thailand in 1888 with the establishment of foreign bank's branch. The branch of the Hongkong and Shanghai Banking Corporation was the first commercial bank established in Thailand. After 1932, when Thailand switched to a constitutional monarchy system, more foreign banks were opened in the country. The first Thai bank, Siam Commercial Bank which at one time was also called the Thai Commercial Bank, was set up later in 1906. For a period of time, the Thai banks had played only a minor role relative to foreign banks' branches. Later, the Thai banks have grown rapidly and Thailand has not awarded any new full branch license to foreign banks since 1978. In contrast, the Finance Ministry has indicated that another five foreign commercial and investment banks will be allowed to establish branches in Thailand by 1997.

At the end of October 1994, there were 14 branches and 38 representative offices of foreign banks operating in Thailand, compared to 15 domestic banks with 2,816 branches. The Thai Government is considering granting up to seven new branch licenses for foreign banks currently operating offshore banking business in Thailand as of September 1995. Domestic banks and foreign bank branches in Thailand can engage in the same types of banking business, although they may be subject to different prudential regulations in a few areas. Furthermore, while the Thai banks have been allowed to set up new branches throughout the country, foreign banks have not been allowed to do so.

The recent development regarding foreign entry in the Thai financial system occurred in March 1993 when the Bangkok International Banking Facilities (BIBFs) were established to perform off-shore banking businesses in Thailand. In all, 48 BIBF licenses have been granted to the 15 domestic banks, 11 of the foreign banks that have branches in Thailand, and 22 other foreign banks. The BIBF units mainly accept

deposits and borrowing from overseas for the purpose of extending credits to residents and non-residents in foreign currencies. They can also engage in certain international investment and banking businesses, for example, credit guarantees, letters of credits, loan syndication from abroad, financial consultation, feasibility study, and underwriting debt instruments to be issued overseas. Although at present all international banking businesses must be done in foreign currencies, the authorities allow the existing BIBF units to apply for approval to set up provincial offices (Provincial International Banking Facilities: PIBFs) in order to extend Baht-denominated credits. At the end of August 1994, the BIBF credits to Thai resident business (the so-called "out-in" credits) account for about 11.4 % of total credits extended by the entire banking system. As a result of BIBF businesses, the market share of the 14 foreign bank branches (in terms of assets and credit extended) had increased from 4.9% at the end of 1992 (before the BIBFs was established) to 6.5% at the end of June 1994.

Table 4.8

**THE DOMESTIC AND FOREIGN FINANCIAL
INSTITUTIONS IN THAILAND**
(End of 1994)

Foreign		Domestic	
Bank Representative Offices	46	Banks	15
Bank Branches	14	Bank Branches	2816
Bangkok International Banking Facilities (BIBFs)	32	Bangkok International Banking Facilities (BIBFs)	15
Provincial International Banking Facilities (PIBFs)	12	Provincial International Banking Facilities (PIBFs)	25

Source: Bank of Thailand

Chapter 5

EFFECTS OF FINANCIAL OPENING ON FINANCIAL MARKETS AND POLICY RESPONSES

I. Introduction

In general, financial opening helps to enhance savings mobilization and allocate financial resources more efficiently by lowering borrowing costs, providing facilities to hedge against financial risks associated with currency, interest rate and price volatility, and increasing access to new financial resources. At the same time, however, financial opening entails the risk of exposing the domestic market to external influences and overvalued currencies.

As mentioned earlier, the main objective of financial opening is to improve the efficiency of the financial sector, especially in terms of resource allocation. Ultimately, it is expected to stimulate economic growth through two effects. First, the resultant positive real interest rates will encourage savings, particularly in the form of the financial assets. An increase in the stock of financial assets (financial deepening) through higher domestic savings and increased access to foreign funds will make available more funds for financing investments. Although a simultaneous rise in lending rates might reduce demand for investment through the price effect, the overall investment can still rise because of the greater availability of funds. Second, even though the financial system intermediates only part of total investible resources, it could play a vital role in allocating savings to the most profitable projects if sufficient competition and efficiency are encouraged. Accordingly, with the increased average productivity and higher quality of investment, the overall economy will prosper.

The most important implication of financial opening is the increased degree of capital mobility which may bring about undesirable outcome. The ease of capital moving across national borders to seek maximum profits either in terms of high domestic interest rates or the low price of equity may induce a large inflow of speculative and short-term funds. This may cause large fluctuations in the equity prices, exert upward pressure on exchange rates and undermine the effectiveness of economic policy in those countries. Recently, several SEACEN countries

had to implement strong measures to counter these adverse effects as they were faced with the trade-off target between the monetary stabilization and the exchange rate stabilization.

Increased financial integration also makes the domestic market more vulnerable to developments in foreign financial markets. This weakens the autonomy to conduct an independent monetary policy. With a rapid increase in capital inflows, the exchange rate will tend to appreciate. This hurts the country's exports and deteriorates the current account deficits further. Thus, the monetary authorities may be impelled to resist the upward pressure in the exchange rate by intervention in the foreign exchange market, a move which will result in a large monetary expansion. To counter such expansion, the monetary authorities may opt to sterilize the money supply and consequently put upward pressure on interest rate, which in turn attracts more foreign capital.

Financial opening, unless carefully designed and implemented, may not yield the desired results of moving the domestic interest rate towards the world levels, strengthening competition within the banking sector, or improving allocational and operational efficiency. It may even bring about financial instability by increasing the risk of financial institution failure as the premature competition from foreign banks undermines the viability of domestic banks which are saddled with bad loans. The problem may be compounded as the inexperienced local banks are simultaneously exposed to foreign exchange risk. So the question facing the SEACEN countries is how to minimize the international disturbances on the domestic financial markets, while continuing to maintain close links with the global financial system. In this regard, the globalization process reinforces the need for stringent prudential supervision. Accordingly, the policy-makers' efforts to strengthen prudential regulation and supervision and accounting system to avert possible systemic risks to financial systems as well as the derivation of adequate policy measures become the key ingredient in successful financial opening.

II. Effects on the Financial Markets

2.1 Surge in Capital Flows

Rising capital inflows have allowed the SEACEN countries to grow faster, while maintaining external viability. However, these inflows have

also complicated macroeconomic management as they have contributed to overheating and rising inflation. Even though capital inflows help to strengthen the overall balance of payments, they can also be associated with inflationary pressure, real exchange rate appreciation and a deterioration in the current account. Massive capital inflows may contribute to speculative bubbles in stock and property markets and lead to an excessive expansions in domestic credit, thereby threatening the stability of the financial system. These problems are likely to intensify if a significant portion of inflows are short-term, as the probability of an abrupt and sudden reversal of these flows increase. The experience of several Latin American countries confirms this scenario. Nonetheless, the "right" kind of capital inflows could hasten the development process and induce economic growth. Basically, there are two factors that attract capital inflows. They may be induced by a sufficient gap between domestic and foreign interest rates due to an increase in economic activity or monetary tightening. The inflows may also occur without such a large interest rate differential if the expected rate of return on capital investment domestically is relatively higher than the returns elsewhere. This illustrates how international capital mobility could affect allocation of world resources.

Korea has experienced considerable capital inflows especially in the form of stock investment from foreigners since 1992. This is likely to lead to a build-up of pressure for expansion of money supply and exchange rate appreciation. So Korea is concerned with the consequences on the major macroeconomic variables such as economic growth, prices and current account position.

Malaysia experienced a strong surge in capital inflows during the period 1991-1993, recording the highest average net inflows for long-term and short-term capital compared with other periods. The major factors accounting for the flows were the record of strong economic growth (above 8 percent) with low inflation (below 4 percent) and sound macroeconomic policies. Equally important was the liberalization measures, including the further easing of exchange control regulations and the trade and capital accounts. Foreign investment has been promoted actively by relaxing foreign equity ownership restrictions in the manufacturing sector for exports, generous tax incentives and import tariff reductions on a wide range of goods in the early 1990s.

Capital began to flow significantly to Thailand from 1988 when the inflows rose to US\$ 3.6 billion from a normal average of about US\$ 1

billion annually. It increased to US\$ 5.5 billion in 1989 and rose gradually to reach its peak of US\$ 11.4 billion in 1991 before falling slightly to US\$ 9.9 billion in 1992. The surge in the inflows was entirely due to the private sector that accompanied the sharp expansion in private sector investment. In the period of an economic boom (1989-1990), the inflows were dominated by medium- and long-term capital, led by foreign direct investment and, to a lesser extent, by portfolio investment. The relative importance of these two components peaked in 1989, accounting for 64 percent of the total medium- and long-term inflows.

During the early phase of the surge in capital inflows, there were sharp increases in the stock prices. During 1988-1989, a number of the emerging stock markets in Asia outperformed the U.S. and Japanese stock markets by considerable margins. The IFC Asia composite, which include Korea, Malaysia, Taiwan, and Thailand registered a total return (in dollars) of 83 percent and 57 percent in 1988 and 1989, respectively.

2.2 Conduct of Independent Monetary Policy

As the financial opening progresses, the relationship between the monetary aggregates and other price variables, namely, interest rates and exchange rate strengthens. The influence of overseas interest rate fluctuations, along with the volatility in total domestic liquidity caused by foreign capital flows, will make monetary control more complicated and problematic. In particular, as international capital mobility increases, speculative activities will become more prevalent, causing the real exchange rate to deviate from the level that best reflects economic fundamentals.

A raising or lowering of domestic short-term interest rates coupled with intervention by the central bank in the foreign exchange market would be effective in moderating exchange rate volatility, but this would be at the cost of a loss of freedom in the conduct of monetary policy. Under such an environment, the monetary authority needs to coordinate monetary, interest rate, and foreign exchange policies effectively while ensuring that money supply is kept at an appropriate level.

In most SEACEN countries, the exchange rate was managed in various ways, but typically with increasing flexibility over time. For instance, wider fluctuation bands were introduced in Indonesia. The

use of a basket system in Indonesia and Malaysia implied a degree of uncertainty about movements vis-à-vis individual component currencies and, as in Korea, adjustments in the exchange rate value were made periodically. Increasing the variability of the exchange rate may deter short-term inflows by making the return on them more risky.

However, between 1991 and early 1994, the monetary authorities in most SEACEN countries sought to limit the monetary effects of their intervention in the exchange market. Limited success was achieved in insulating interest rates, which generally fell in real terms. In most SEACEN countries, short-term interest rates fell in nominal terms between 1991 and early 1994 were at low levels in real terms. In Korea, Thailand and to a limited extent, Indonesia, money market or deposit interest rates generally remained above both the US interest rates and the domestic rate of inflation. In Singapore, expectations of currency appreciation pulled the domestic interest rates even lower.

In his study on the effects of financial opening on monetary policy in Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand, Fry (1988)¹⁰ found that these countries retained considerable autonomy in their conduct of monetary policy especially in the short term despite having open capital markets. Using the offset coefficient statistics, which measure the degree to which changes in domestic credit leak through the country's balance of payments, it was found that such statistics for these SEACEN countries were significantly lower than in OECD countries, and even lower than other developing countries. A low offset coefficient can be due to exchange rate flexibility, effective capital immobility, or imperfect asset substitutability. He also observed that these countries highly sterilized net capital inflows, while monetary and fiscal policies in other developing countries were much more accommodative. High sterilization of capital inflows can raise a country's risk premium, thereby reducing asset substitutability and the offset coefficient.

2.3 Financial Sector Risk

It has also been argued that financial opening together with the deregulation have increased volatility in financial markets and intro-

10. For details, *see Money, Interest, and Banking in Economic Development*, pp. 203-220, The Johns Hopkins University Press, Baltimore, 1988.

duced new elements of risk - some of them of a systemic variety - due to: (i) increased volatility in real exchange rates and hence risks of de-industrialization and inflation in the wake of real and monetary shocks; (ii) increased price volatility of financial assets due to speculation; (iii) emphasis on financial rather than productive investment due to overshooting financial returns and moral hazard of market participants; (iv) perceived loss of monetary interdependence; and, (v) bankruptcies within the domestic banking system.

Since the financial systems in many SEACEN countries have only recently been liberalized or privatized, the ability of banks to manage financial risk is still relatively limited. In addition, resilient and liquid capital markets that could absorb shocks are frequently not fully developed. The accounting and legal infrastructure may not be sufficiently developed to monitor and enforce loan contracts effectively. In many SEACEN countries, credit- and market-risk management in the banking system is still in the early stages of development. At the same time, the supervisory and regulatory agency has some way to go towards becoming independent and highly competent.

In this environment, financial opening generates a number of risks in the banking sectors of host countries. Foreign exchange market intervention that is not fully sterilized exposes the banking system to the additional credit risk generated by the expansion of banks' balance sheets. Experiences in some developing countries suggest that a rapid expansion in banks' loan is normally accompanied by decreasing credit quality, even under an effective regulatory and supervisory environment. Fast growth in credit tends to be concentrated in only a few sectors and a cyclical reversal will frequently lead to a deterioration in the credit quality of these sectors.

In addition to the increased credit risk, banks in emerging market countries frequently assume market risks due to fluctuations in exchange rate, interest rate and equity price that cannot be fully hedged. For example, there are several instances in which banks, as major borrowers of foreign loans, carry a significant foreign exchange exposure, and in which banks are exposed to volatility in equity prices as they are holding sizable equity portfolios.

If a banking system possesses an adequate risk management and is financially resilient, and if the supervisory and regulatory agencies

are well equipped to enforce prudential requirements, then the international active banking system may not be adversely affected by its enlarged intermediary role. This can be seen from the experience in Singapore, where supervisory and regulatory agencies are firmly established and where the banking system can cope with large capital inflows and outflows, as well as the large swings in asset prices. Recent experiences, however, show that these conditions are not always fully met, and the need to ensure that banking systems can safely intermediate capital inflows remains an important policy challenge.

Table 5.1

**EXCHANGE RATE VARIABILITY OF SELECTED COUNTRIES:
1988-1994¹**

	Indonesia (1990)	Malaysia (1990)	Philippines (1992)	Thailand (1988)
1988	0.07	0.65	0.21	0.40
1989	0.07	0.80	0.16	0.41
1990	0.03	0.17	6.16	0.27
1991	0.02	0.76	0.58	0.37
1992	0.03	2.69	12.38	2.43
1993	0.02	2.95	6.43	0.15
1994	0.02	2.63	2.69	0.14

Note: ¹ Variance of monthly rate change, in percent.

² The years in parentheses indicate the year in which capital flows began.

Source: **International Capital Markets**, IMF, August 1995.

III. Policy Responses to Financial Opening

3.1 Monetary and Exchange Rate Policy

3.1.1 Sterilized Intervention

Sterilized intervention in varying degrees has been the common policy response to the surge in capital inflows. This is evident in a marked accumulation of international reserves during the intense capital inflow period. The sharp build-up in international reserves suggests that the capital inflow was met with a heavy degree of intervention. Another indicator, the rise in monetaries' gross foreign assets in relation to the increase in the monetary base, suggests that sterilization operations were very large in the early 1990s in Indonesia, Malaysia, Singapore and Thailand (Table 5.2).

Table 5.2

RATIO OF INCREASE IN GROSS CENTRAL BANK FOREIGN ASSETS TO THAT IN RESERVE MONEY

	Indonesia	Korea	Malaysia	Philippines	Thailand
End-1980 to end-1984	1.64	0.35	-0.26	3.88	0.62
End-1989 to end-1993	3.81	0.61	4.07	9.02	2.89

Source: Bank for International Settlements, June 1995.

Sterilized intervention seeks to accomplish two things. First, the foreign exchange market intervention aims to reduce pressure on the nominal exchange rate. Second, sterilizing the intervention aims to avoid the excessive monetary expansion that intervention creates.

Sterilization policies affect capital flows through their impact on domestic interest rates. Domestic interest rates would likely rise if the domestic currency assets which investors want to hold are poor substitutes for short-term central bank paper or treasury bills being sup-

plied by the central bank. Another reason is through the rise in money demand owing to lower inflation or a higher level of income; the latter is often observed to accompany large capital inflows. Hence, there are two disadvantages with the sterilized intervention. First, the rise in domestic interest rates may stimulate further short-term flows. Second, the wider domestic and foreign interest rate spread entails larger quasi-fiscal costs if the interest rate paid on debt issued by the central bank exceeds earnings by the central bank on international reserve holdings. Overall, the evidence in the SEACEN countries suggest that sterilized intervention is not very effective on a sustained basis and may even create other problems.

There are three main channels to carry out sterilization policies: open market operations, changes in reserve requirements, and management of government deposits.

Sterilization through open market operations is usually done through the sale, by the central bank, of either government or central bank securities. This will remove the liquidity generated by central bank purchases of foreign currency. In many countries such as Indonesia, Korea and the Philippines, the central bank issued its own debt instruments for this purpose. In other countries such as Malaysia and Sri Lanka, instruments used at the initial stage are government securities. The central bank will issue its own bonds only after the stock of government securities is depleted.

A key advantage of sterilization via open market operations is that it limits the monetary expansion of the authorities' intervention in the foreign exchange market without distorting the price signals in the banking system. Furthermore, sterilization by open market operations may limit the domestic banks' intermediating role regulating the capital inflows. This limit can be desirable when there are concerns about the strength of the banking system or when the inflows are considered to be temporary. The main disadvantage of sterilization is that it may incur sizable central bank financial losses, even in a relatively short period of time. Sterilization efforts also might widen the domestic-international interest rate spread and thereby attract additional short-term capital. For example, the interest rate on Bank Indonesian Certificates (SBI) was raised from 11.6 percent in 1988 to 18.8 percent in 1990 and 21.5 percent in March 1991. Meanwhile, the sterilization measures left Bank Indonesia with increasing SBI position from Rp. 10.9 trillion at the

end of 1991 to Rp. 20.6 trillion at the end of 1992 with the interest burden falling entirely on the Central Bank.

The intensity of these open-market policies varies considerably across countries and across time. One can gauge the intensity of the sterilization efforts by examining the stock of central bank bills relative to the monetary base, or by analyzing the change in net domestic assets. Indonesia during 1991-1992, Malaysia from mid-1991 to early 1993 and Sri Lanka in 1991-1993, attempted to conduct open market operations on a scale that would almost fully sterilize capital inflows. Korea, the Philippines and Thailand used sterilized intervention throughout much of the inflow period to sterilize a portion of the flows.

An increase in reserve requirements can be used to reduce the money multiplier and thereby curtail the monetary expansion associated with the central bank's intervention in the foreign exchange market. Malaysia and Sri Lanka have periodically increased the statutory reserve requirement for this purpose. When inflows began to accelerate in Malaysia in 1989, the statutory reserve requirement was 3.5 percent; by early 1994, it had been increased to 11.5 percent.

Where government deposits account for a sizable part of money supply, several SEACEN countries such as Indonesia, Malaysia, Taiwan and Thailand sterilized the effects of capital inflows by shifting deposits of the public sector or of pension funds from the banking system to the central bank. For example, in Indonesia, a significant amount of state enterprises deposits were converted into claims on the central bank in February 1991 as part of the measure to reduce liquidity brought about by stray capital inflows. If government deposits are counted as part of the money stock, then their transfer to the central bank works in the same way as an increase in reserve requirements. If the deposits are not counted as part of the money stock, then the shift is more akin to a liquidity-draining, open market operation. This type of sterilization operation has several advantages. It does not act like a tax on the banking system as in the case of reserve requirements, and it may not put upward pressure on short-term interest rates as much as the open market operations. Further, if the deposits do not earn interest, then there are no quasi-fiscal costs associated with. If below-market interest rates are paid on these deposits, the cost will be below that of the open market operations.

There are some drawbacks to the shifting of public sector deposits, however. Large and unpredictable changes in the bank deposits make it difficult for banks to manage their cash positions. For example, when Indonesia forced state enterprises to move their deposits out of the state banks, these banks not only lost liquidity but they also had to shrink their loan operations. In addition, if some of the deposits do not strictly belong to the public sector (e.g., Malaysia's Employment Provident Fund or Singapore's Central Provident Fund), the cost of shifting deposits may be borne by those who contribute to the fund, depending on whether payouts from the funds are tied to the return on the funds. Finally, the shifting of deposits may be limited in scope by the availability and size of public sector's funds. For example, government deposits held at the Bank of Thailand increased from 25 percent of total government deposits at the end of 1987 to a peak of 82 percent in mid-1992. In this case, the scope for further sterilization operations via deposit shifting was clearly limited.

3.1.2 Capital Controls

As mentioned earlier, the benefits of capital inflows are often accompanied by many side effects, depending on the type and duration of the foreign capital. As such, it is necessary for many SEACEN countries to employ measures to discourage certain types of capital inflows or seek to influence their character. Such measures include prudential controls on the banking system, market-based measures and quantitative controls on inflows and outflows. In some countries like Indonesia, Malaysia and the Philippines, prudential limits are also placed on banks' offshore borrowing and foreign exchange transactions.

In Indonesia, foreign borrowing limits were imposed on state enterprises and guidelines for private sector external borrowing were adopted. Malaysia also responded to the inflow of speculative short-term capital with the imposition of several quantitative measures. One of the most effective measures was the prohibition for domestic residents to sell short-term money-market instruments to foreigners. In this case, abandoning the sterilization of foreign exchange intervention and imposing capital controls appear to have been successful in reducing domestic interest rates and short-term inflows. Many SEACEN countries have restrictions on foreign borrowings by domestic companies and some have maintained prudential restrictions on financial institutions, such as restrictions on the open foreign exchange positions of banks.

However, such measures as taxes on short-term capital flows or bans on the purchase of particular types of securities, may be justified as temporary measures until domestic financial markets and institutions become well-established and resilient. For example, the Malaysian experience reveals that, in the short run, the volume of inflows was reduced by capital controls during the period of higher exchange rate volatility and little or no sterilization in 1994. However, it is recognized that capital controls are undoubtedly less important than sound economic fundamentals and prudent macroeconomic policies in explaining the long-run success of several countries cited above in dealing with capital inflows.

In this regard, it should be noted that Singapore has successfully managed large capital inflows without recourse to capital controls. Therefore, although capital controls may be helpful at times, they are not the main contributing factor for the success of countries in dealing with capital inflows and outflows.

3.1.3 Other Policy Responses

The different approach which might be used is to remove controls on capital outflow. If existing controls are binding, this policy would likely increase outflows and therefore lower net capital inflows. Many SEACEN countries have liberalized residents' acquisition of foreign assets, usually by relaxing constraints on outward foreign direct investment or institutional investment abroad. Such reforms have the advantage of diversifying investment opportunities of domestic institutions and investors.

Increased national savings are a standard remedy for excessive capital inflows because they tend to depress domestic interest rates. Such domestic resource mobilization through compulsory pension funds or other saving schemes has been the strategy of a number of countries, including Malaysia and Singapore. Such compulsory saving schemes do not appear to seriously reduce voluntary saving, which remains high in these countries.

Fiscal consolidation is another possible response to capital inflows as the contractionary impulses will offset the expansionary impact of the unsterilized portion of foreign exchange intervention, which may result in an eventual fall of interest rates, particularly if the government

borrowing requirement is perceived to be declining. The use of contractionary fiscal policy in response to capital inflows is most clear in Thailand, which over 1988-1991 turned a modest fiscal deficit into a surplus of 5 percent of GDP. Malaysia has also implemented fiscal restraint as a means of dealing with capital inflows.

3.2 Financial Supervision and Regulation

The question facing the monetary authorities in the SEACEN countries is how to minimize the internationally induced disturbances on the domestic financial markets, while maintaining close links with the global financial system. In this regard, the financial opening reinforces the need for stringent prudential supervision. So, the policy-makers' efforts to strengthen prudential regulation and supervision, and accounting system to prevent systemic risks to the financial system as well as the derivation of adequate policy measures become essential ingredients in successful financial opening. Furthermore, the increased international integration of financial markets and advances in communications technology mean that a financial crisis is unlikely to remain isolated to one institution and one national jurisdiction. The prevention and the containment of systemic problems now require the cooperation and coordination of supervisory and regulatory authorities across national boundaries.

3.2.1 Capital Adequacy in SEACEN Countries

The importance of supervision of financial markets may be observed by the steps that have been taken over the past ten years to develop international coordination of bank supervision under the auspices of the Cooke Committee and of other regional supervisory groups. The common attention of the supervisory agencies is in the areas of capital adequacy, reserves for loan losses and liquidity. In 1988, an international agreement among industrial countries was reached regarding the risk-related capital adequacy guidelines for banks. This is known as the Basle Accord¹¹ which involves the work of the Cooke Committee. The

11. The 1988 Basle Accord establishes a capital requirement as a percentage of the credit risk exposure of a bank. However, shortly after the Basle Accord was agreed, both supervisors and bankers came to see that minimum capital adequacy standards were inadequate, in part because of changes in the nature of banking and, more generally, in the financial services industry. As a result of these perceived weaknesses, the European Union released in March 1993 a new Capital Adequacy Directive (CAD) for implementation starting January 1996. Similarly, the Basle Committee on Banking Supervision issued for comment, in April 1993, a proposal on a capital standard based on market risk.

objective of this Accord are to "strengthen the soundness and ability of the international banking system and to be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing the existing sources of competition inequality among international banks".

With the rising incidence of bank failures, proliferation of off-balance sheet activities, higher share of non-performing loans and increasing requirements for bad or doubtful debts, the SEACEN countries have paid particular attention to the Basle Accord. Many are closely examining the guidelines of the Accord, with a view to adopting the standards while some have already adopted them. It should be observed that the impact of the outgrowth of globalization in international financial markets is quite noticeable in the SEACEN countries in the sense that they had heeded the Basle Accord and responded positively by strengthening their financial systems.

The Indonesian authorities have adopted prudential regulatory measures with respect to capital adequacy guidelines. Bank Indonesia uses a similar computation method as the Basle Accord to measure capital adequacy in banks. For computing the capital requirements, a risk-weight is assigned to all assets bearing any possible risk. The asset categories in this risk-weighted computation are broadly similar to those in the Basle Accord, though they differ in scale.

In Korea, the capital adequacy standards set by Basle Accord are being progressively phased in and will be applied to Korean commercial banks in full from the end of 1995. The exchange position of foreign banks, resulting from their transactions with other foreign exchange banks or customers, is regulated by The Bank of Korea under the Foreign Exchange Management Regulations to prevent excessive foreign exchange exposures and to guide them to sound administration. Under an overall position management system, the overall position including spot and forward position is regulated and, at the same time, the spot oversold position is separately regulated because it has a great influence on the foreign exchange market. Foreign exchange banks can opt for either of the two standards, i.e.:

- (1) the average balance of export bills bought and held in the previous month, or

- (2) total equity capital at the end of the previous month.

Malaysia adopted the risk-weighted approach of the Basle Committee in assessing the capital adequacy requirements of the licensed financial institutions in 1989. Following the completion of the local incorporation exercise, 14 foreign bank branches in Malaysia now maintain permanent paid-up capital in their books instead of net working funds. Bank Negara Malaysia introduced the "Two-tier Regulatory System" in December 1994 to allow well-managed commercial banks with strong financial standing to carry out certain new activities under a more liberal regulatory environment.

In the Philippines, Bangko Sentral ng Pilipinas (BSP) prescribes a minimum standard net worth-to-risk asset ratio of 10 percent, except for expanded commercial banks which allows lower ratios of 8 to 6 percent subject to compliance with certain conditions or requirements prescribed by the Monetary Board. Recognizing the difference with Basle standard, BSP is moving towards the implementation of the Basle framework in order to align Philippine standards with international standards. Currently, the Basle standard is only informally being implemented by requiring banks to submit reports to BSP for purposes of monitoring of banks' compliance.

BSP uses the CAMEL Rating System as a post-examination tool in the analysis and evaluation of the financial health and performance of banks and non-bank financial intermediaries with quasi-banking functions (NBQBs) and as a management's quick index of soundness. The CAMEL Rating System is based on the evaluation of five critical measures of banks'/NBQB's operations, namely: Capital Adequacy (C), Asset Quality (A), Management (M), Earnings (E), and Liquidity (L). This rating system reflects in a comprehensive fashion the entity's financial condition, compliance with Central Bank rules and regulations and applicable rules, and overall operating soundness.

In Taiwan, the Bank Capital Guideline was issued in 1992 which required capital adequacy ratios of domestic banks to be in line with the Basle Accord to ensure that the banks maintain a capital base equivalent to the risks inherent in its activities. The "Financial Institutions Examination Information System" was established in 1989 to integrate all the on-site examination, off-site monitoring and supervision of financial institutions' internal auditing on a consolidated basis. The

Central Bank also sets limits on each authorized foreign exchange banks' overall foreign exchange position so as to restrict a bank's exposure to risks. The Central Bank also sets limits on each bank's foreign liabilities. These limits were frequently reviewed and adjusted so as not to hamper a bank's justified business needs.

In Thailand, the BIS capital adequacy requirement has been imposed on commercial banks and finance companies to ensure their soundness. Net foreign exposure limit (25 percent of capital on net overbought or 20 percent on net oversold) was imposed on finance companies for the first time in June 1994. In November 1994, commercial banks' net foreign exchange exposure limit (imposed since 1984) was lowered from 25 percent of capital to 20 percent on net overbought and from 20 percent of capital to 15 percent on net oversold.

3.2.2 International Cooperation in Regulation

The increased international integration of financial markets and recent developments in communications technology means that a financial crisis is unlikely to remain isolated to one institution and one national jurisdiction. The prevention and the containment of systemic problems now require the cooperation and coordination of supervisory and regulatory authorities across national boundaries.

Among several banking supervisory organizations, the Basle Committee on Banking Supervision is the most recognized one. In addition to the Basle Committee, there are several other international banking supervisory organizations such as the European Union, the Offshore Group of Banking Supervisors, the SEACEN Meeting of Directors of Supervision, the SEANZA (South East Asia, New Zealand, Australia) Forum of Banking Supervisors, and the Arab Committee on Banking Supervision. Each organization has been formed to pay special attention to the needs of its members and therefore adopts an agenda reflecting these special requirements.

Another development to improve the quality of bank supervision is international cooperation among bank supervisors through exchange of information, experience as well as training in supervisory techniques. Such cooperation effort is being organized by the South East Asian Central Banks (SEACEN), the South East Asia, New Zealand and Australia (SEANZA), and the International Conference for Banking Supervision.

There is only one multinational supervisory body to oversee the primary securities, namely the International Organization of Securities Commissions (IOSCO). The IOSCO, established in 1983, has 115 regular (voting), affiliate, and associate members, who are primarily securities regulators, self-regulatory organizations, and related international organizations. The Technical Committee, composed of members from the developed countries, and the Development Committees, composed of members from countries with emerging markets, are two principal committees through which policies or recommendations are proposed.

In between the public sector supervisory organizations and the purely private organizations are the professional accountancy bodies which regulate the profession. Through their members, these accountancy bodies could impose accounting standards on public companies within their jurisdiction. The two bodies most recognized as influencing banking and securities firm supervision through their accounting standards and practices are the International Accounting Standards Committee (IASC) and the Financial Accounting Standards Board (FASB) of the United States of America.

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