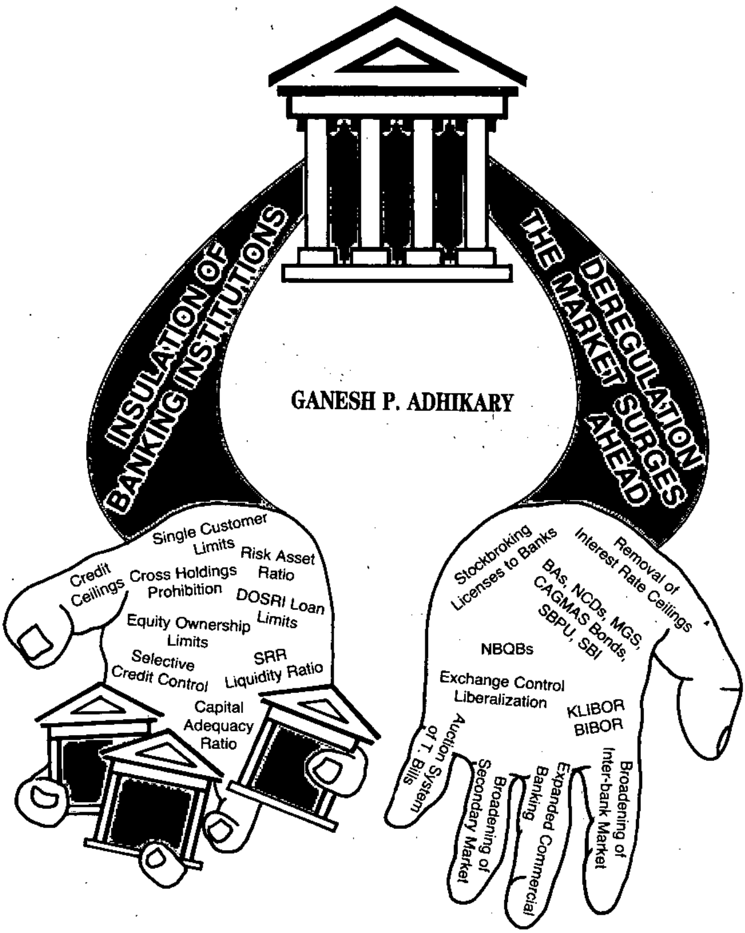
DEREGULATION IN THE FINANCIAL SYSTEM OF THE SEACEN COUNTRIES



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FOREWORD

Financial deregulation is changing the shape of the financial services industry in all the major industrialized countries. The process of deregulation was prompted partly by market competition and partly by a desire to add to the already wide services rendered by the financial system. Accordingly, price and product restrictions on financial activities are gradually being removed in favour of a new regime of competitive freedom. The emergence of a global financial services industry largely liberated from geographic, product and pricing constraints has enabled the users of financial services to benefit from greater efficiency, lower costs and a wider choice of financing and investment possibilities. However, this process of deregulation is also being accompanied by intensified regulatory activity. Several financial crises in many industrialized countries have prompted regulatory authorities to review their prudential financial arrangements for regulating the financial services industry.

On the other hand, the circumstances that led the SEACEN countries towards deregulatory path varied from country to country. Financial deregulation proceeded in various degrees and forms. Deregulation was particularly noticed in the relaxation of price and product constraints. However, there still exist regulated and non-regulated financial sectors in the SEACEN countries. The deregulatory moves, therefore, did not necessarily manifest themselves in the same way in all the countries in the SEACEN region. The desirability of the current deregulatory trend has also stressed the increased potential for conflict of interest and market volatility. Concern over a heavy reliance on market discipline reflects fears of a further volatility in the financial system. The increasing fraud, incompetence, abuses of lending authorities and anti-competitive practices are already becoming some of the targets of regulatory actions.

Accordingly, the present study on "Deregulation in the Financial System of the SEACEN Countries" is timely, particularly so when the trend towards financial deregulation has also prompted the regulatory authorities of some SEACEN countries to review the adequacy of their regulatory and prudential framework. The purpose of this research study is to discuss the rationale and objectives of deregulation, the methods and areas of deregulation, the conditions and circumstances of deregulation, and some of the issues associated with deregulation and its implications.

The study provides a comprehensive account of the chronological development of deregulation in the financial system of the SEACEN countries by capturing most of the pertinent issues on financial deregulation. It also pays due emphasis to the comparable experiences of some developed countries. The study, therefore, forms a basis for further extensive analytical research in this field.

This in-house research study was conducted by Mr. Ganesh P. Adhikary, Research Economist, seconded from Nepal Rastra Bank to The SEACEN Centre. At various stages of the project, Mr. Adhikary was provided research assistance by Miss Sally Ho, who took care of data collection, compilation and did most of the proof-reading work. The manuscript was entirely typed by Miss Karen How.

The SEACEN Centre wishes to express its sincere gratitude to the participating member central banks for their timely provision of valuable and useful information in response to the questionnaire issued by The SEACEN Centre, and also wishes to thank them for their useful comments and suggestions at various stages in the preparation of this project.

The views expressed in this volume, however, are those of the author and do not necessarily reflect the views of the member central banks or that of The SEACEN Centre.

Dr. Vicente B. Valdepeñas, Jr.
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Kuala Lumpur
December 1989

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PART I

DEREGULATION IN THE FINANCIAL SYSTEM OF THE SEACEN COUNTRIES: AN OVERVIEW

by
Ganesh P. Adhikary

Introduction

Financial deregulation is sweeping through the world's financial markets and revolutionizing the financial services industry in most of the industrialized countries. Although the basic concepts and indicators of deregulation of the financial system might be the same for all the countries, the actual practice of deregulation undertaken by different countries in various areas of their financial system has made it difficult to have a uniform definition or interpretation of the concept of deregulation.

However, financial deregulation is usually defined to encompass deregulation of deposit rate ceilings, the authorization of deposit accounts, the authorization of new entities of foreign banks and relaxation of regulations on financial activities and instruments. The centre piece of financial deregulation has been the dismantling of Regulation Q interest rate ceilings and minimum balance requirements on bank deposit accounts in the United States of America. The two major pieces of U.S. legislation that have influenced most of the countries in liberalizing and deregulating their respective financial systems are the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Garn-St. Germain Depository Institutions Act of 1982.

Despite financial deregulation being a common phenomenon to many countries, it did not necessarily manifest itself in the same way everywhere. In some countries, it was accompanied by disturbances, such as bank insolvencies and bank runs; while in some other countries, there was intense pressure to change the permitted fields of business for financial institutions. Thus, it is difficult to describe uniformly the degree of financial deregulation in a country. There are countries which have experienced sudden deregulatory reforms; countries which have experienced gradual deregulatory reforms; and, countries which have experienced only limited reforms. Some countries have also undergone two periods of deregulation, separated by a period of re-regulation. However, the rationale and objectives of deregulation in most of the developed countries seem to depend on specific circumstances, i.e., the competitive market forces or the need for financial development for the economic growth of these countries.

Similarly, in the SEACEN region, the deregulatory move proceeds in various degrees and forms. The regulations on the specialized function of financial institutions have been lifted partially or gradually, and some countries in this region are even moving towards the universal banking concept. However, the pace of deregulatory moves in these countries has been moving gradually in terms of product and pricing. Most of the deregulatory moves in these countries are generally reflected in a gradual and continuous series of discretionary mandatory policy measures. At the moment, there are both regulated and non-regulated financial sectors in most of the SEACEN countries. The existence of selective credit policies and its prominent role in the wake of deregulatory moves in these countries has created the conflicting problem of coordinating the competitive spirit of deregulation and the social aspect of priority sector lending. This has further complicated the interpretation of the rationale of deregulation.

The circumstances that led some countries toward deregulation do not give a clear picture of the rationale of deregulation and there is no certainty on the direction to take concerning some areas that have not yet been deregulated. However, the case for the developed countries is quite different. Rapid financial innovations and market pressures are demanding a quicker pace in deregulation, and as a result, the rapid regulatory changes have blurred the distinction between banks and non-bank financial institutions. Price restriction, geographic limitations and legal constraints separating banks from other financial activities are progressively being removed in favour of a new regime of competitive freedom. Yet, paradoxically, this process of deregulation is being accompanied by intensified regulatory activity, particularly to prevent the excessive risk-taking by the new financial conglomerates.

The emergence of several crises in the recent years in the developed countries as well as in the SEACEN countries have even led to proposals for re-regulation. The trend towards financial deregulation and greater competitive freedom has, therefore, prompted regulatory and supervisory authorities to review their arrangements for regulating the financial services industry. This review has been far reaching in the United Kingdom where the transformation of financial markets is occurring most rapidly, but a parallel reassessment of regulatory needs is taking place in most of the countries including countries in the SEACEN region. The most widely accepted aims of financial regulation in these countries are to limit abuses arising from conflicts of interest and to protect investors and depositors against losses due to insolvency of financial institutions. In addition, fraud, incompetence, anti-competitive practices, abuses of lending authorities and exploitation of investors' ignorance seem to be the common targets of regulatory action.

I. Objectives of the Research Project

The financial services industry has been changing quite rapidly in the SEACEN countries. The actual practice of deregulation undertaken by these countries is also accompanied by intensified regulatory activity, induced by disturbances, incidences such as bank insolvencies, bank runs, frauds and increasing amount of bad debts.

In this context, the purpose of this research project is, therefore, to look at the various aspects and issues relating to the deregulation of financial systems in the SEACEN countries which is currently being undertaken at varying forms and degrees. Among others, the aim of the study is to deal with the rationale and objectives of deregulation, the methods and areas of deregulation, prerequisite conditions for successful deregulation, problems associated with deregulation in terms of selective credit aspects, and implications of deregulation on regulation and supervision of financial institutions.

II. Scope and Organization of the Study

This study is an in-house informative research project. Therefore, a questionnaire asking for pertinent information regarding financial deregulation moves was sent to the member central banks and monetary authorities, and responses were received from Bank Indonesia, Bank Negara Malaysia, Nepal Rastra Bank, Central Bank of the Philippines, Central Bank of Sri Lanka and Bank of Thailand. The data and information prior to deregulation moves being rather scanty, and the scope of study being rather limited, The Monetary Authority of Singapore suggested that Singapore be excluded from this study. Taking into account the suggestion of the Monetary Authority of Singapore and non-participation of Myanmar, the scope of the study is, therefore, confined to six countries.

In the light of the discussion during the Meeting of the Directors of Research and Training of member central banks and monetary authorities, the scope of the project has been narrowed to examine rationale, objectives, methods, process and some of the issues arising from deregulatory moves undertaken by the SEACEN countries; and also to incorporate additional two aspects, namely, circumstances and conditions necessary for deregulation, and problems associated with deregulation, particularly the problem of coordinating selective credit policy with deregulation.

Although the project looks at deregulation of the financial system in the SEACEN countries in a broader perspective, its scope of enquiry is restricted almost entirely to the deregulatory moves and its implications on the deposit-taking banking institutions. In other words, the primary focus of attention has been on the deposit-taking banking institutions. Examples of relevant experiences of more developed countries have been drawn at times to illustrate the issues associated with the deregulatory moves, but the main task has been to examine the experiences of the SEACEN countries.

Further, due to the informative and descriptive nature of the project, the analysis and basic information are based on the replies to the survey questionnaire from member central banks. As the nature of the project is mostly related to the historical aspects of deregulation, the scope for quantitative approach is limited. Hence, an informative approach has been adopted.

The study is divided into two parts. Part I is an overview of deregulation in the financial system of the SEACEN countries, including a brief account of deregulatory moves undertaken by a few developed countries. Part II contains the analysis of deregulatory moves undertaken by the six member countries in their respective financial systems.

Part I consists of three chapters. Chapter 1 provides a brief account of the background of financial deregulatory moves which are revolutionizing the financial services industry in some of the major industrialized countries, and the problems and issues associated with it. A review of the various circumstances that led some of the developed countries towards the deregulatory path was incorporated to explore their deregulation experiences, which is expected to shed some light for the SEACEN member countries to take on a proper course in their own deregulatory schemes. The review of deregulatory moves undertaken by some of the industrialized countries is based on the information and analysis conducted as a preliminary groundwork by the author on the project of the SEACEN Staff Paper No. 18: Deregulation of the Financial Sector in Developed Countries: Some Lessons for the SEACEN Countries, December 1986, which was basically a background chapter for this project.

The deregulatory moves that are continuing in varying degrees and forms in the SEACEN countries have complicated the problem of identifying a uniform 'definition' or interpretation of the concept of 'deregulation'. In this context, Chapter 2 examines the development of the deregulatory moves undertaken by the SEACEN countries through legislative or other means, its methods or nature (full, partial or gradual), and the various areas of deregulation. This chapter also discusses the various circumstances that led to deregulatory moves in order to interpret the rationale and objectives of deregulation. In other words, the purpose of this chapter is to provide a review of the rapid changes in the regulatory policy of SEACEN countries towards deregulatory path, focusing on common elements and trends, while leaving the details and unique experiences to the individual country studies in Part II.

The final chapter of Part I attempts to study some of the issues and problems associated with the deregulatory moves and thereby into the implications of deregulation on supervision of financial institutions.

Part II contains the analysis of deregulatory moves undertaken by six member banks in their respective financial systems. It is difficult to define a homogeneous and consistent comparative analysis in view of the significant difference in the extent, degree and timing of the deregulatory moves undertaken by the SEACEN countries. Hence, the country studies are incorporated separately for the purpose of giving a brief account of the deregulatory moves and some of the issues and problems associated with deregulation in each country.

III. Limitations of the Study

As mentioned earlier, the deregulatory moves undertaken in the SEACEN countries are in different degrees and forms. Formal studies along this area are, however, relatively scarce. Further, data and information prior to each aspect of deregulatory moves being rather scanty, it was difficult to determine a uniform cut-off point between pre-deregulation and post-deregulation for all the countries for the purpose of analyzing the issues for comparative purposes. Therefore, it would also be difficult to conduct an in-depth analysis of the effects of such moves.

The time frame of the study generally covers a period of ten years, from 1977 to 1986 (both years inclusive). However, in the case of a country where deregulatory moves were initiated in the early 1970s and late 1980s, exceptional treatment has been given. As the countries in the SEACEN region have started deregulation in various periods (countrywise), starting from early 1970s, mid-1980s and late 1980s, the analysis of data may not be consistent (yearwise) from the comparative point of view.

It was also very difficult to obtain data on off-balance-sheet activities, profitability of the depository institutions, lending to priority sectors and the extent of default or bad loans. Consequently, this study was constrained since some of these data were crucial in analyzing the deregulatory impact on banks' profitability. Similarly, comprehensive data on priority sector lending for the purposes of analyzing the problems of inconsistency of selective credit policy with deregulation was also difficult to obtain. Therefore, the studies of some countries in the SEACEN region were constrained and, wherever possible, the experiences of developed countries have to be cited for the purpose of logical reasoning, particularly to analyze the effects of deregulation on profitability in the overview chapter.

In view of the separate study on Non-Bank Financial Institutions being undertaken by The SEACEN Centre, and the predominant role of the banking institutions in the financial sector in all the SEACEN countries, this study anchors on the deposit-taking banking institutions.

The deregulation policy in some of the SEACEN member countries is still in its infant stage. Therefore, it is quite impossible to evaluate whether the conditions for deregulation are sufficient to generate market competitiveness. However, the deregulatory moves of some other countries are expected to shed some light in this respect.

Chapter 1

A Brief Account of the Background of Deregulatory Moves: Experiences of Some Developed Countries

I. Background of Deregulatory Moves

The financial services industry has been changing quite rapidly and there has been a growing move towards liberalizing regulations of financial institutions and instruments in all the major industrialized countries. These changes have been reflected in the introduction of new financial instruments, new intermediation techniques, and new technologies in business and consumer finance. The timing of these financial developments has varied from nation to nation. Nevertheless, by the late 1970s virtually all the industrialized countries had experienced accelerating changes in their financial markets. Despite the wide diversity in the degree of financial market complexity, the deregulatory measures taken by the regulatory authorities have frequently followed a similar pattern in some aspects. However, deregulation did not necessarily proceed itself in the same way in all aspects. Financial deregulation in the United States of America (United States) took at least six years to liberalize their financial system. The Australian financial system, on the other hand, was deregulated over a period of three to four years, whereas the financial system in New Zealand was almost completely deregulated over a period of a few months. Japan is still moving towards the path of deregulation. Both New Zealand and United Kingdom have experienced two periods of deregulation, separated by a period of re-regulation.

These differences may be attributed to two factors; the degree of regulation in the old financial system and the means by which the new conditions express themselves. [1] For example, the financial system of the United States was, until very recently, under strict interest rate regulations administered under Regulation Q and the regulations under the Glass-Steagall Act, separating commercial banking from investment banking. In addition, it was forbidden to carry out banking business across states lines according to the McFadden Act, a regulation not seen in other countries. In Japan, there also existed not only interest rate regulations and business activity regulations as in the United States, but also, until very recently, regulations that separate domestic and foreign markets. The new conditions in Japan, however, were primarily the large scale flotation of government bonds and the growth in the movement of international capital flows. In Germany and Switzerland, interest rate decontrol had already been achieved in the 1960s, and regulations on the business activities of banks did not exist, in principle, because of the approach of universal banking. Even with new conditions, the fluctuations of interest rates and prices were rather small so that deregulation proceeded only to a limited extent.

Nevertheless, although financial deregulation is sweeping through the world's financial system, this process of liberalization is being accompanied by intensified regulatory activity. However, the extent of deregulation differs from country to country. Among the major developed countries, the financial system in the United States is closest to that of Japan, but even then there are some differences, with Japan freer in some cases and stricter in others. [2] For example, the distinction between banking and securities business, such as the acquisition of securities and equities with investment intent by banks, is not controlled in Japan through regulations but the United States is much stricter and forbids such acquisitions. But the recent vote on 30 March 1988 against the Glass-Steagall Act to discard most of the restrictions it imposed on America's banks 55 years ago, may pave the way for the commercial banks to penetrate the securities business too. The regulations on separation of businesses in Japan have, however, eased considerably in recent years.

Japan also differed from other countries in its attitude towards entry and exit in banking. With the exception of the entry of foreign

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1. Akhtar, M.A. "Financial Innovation and Monetary Policy: A Framework for Analysis", *Financial Innovation and Monetary Policy*, BIS, March 1984.

2. Suzuki, Yoshio, *Money, Finance, and Macroeconomic Performance in Japan*, Yale University Press, 1986.

banks, neither establishment of new banks nor dissolution of existing ones is permitted. This contrasts with the practice in the United States where more than 300 banks were established and more than 180 liquidated last year. Entry and exit practices in Japan is based on a number of factors, including historical experiences and the efficiency criteria. Similarly, there are unique differences between countries in the element of bank supervision. For example, Bank of Japan is permitted to open current transaction accounts with securities companies and may also conclude lending transaction contracts, but, as a result of these relationships, the securities companies are subject to the same supervision as banks. In contrast, the central banks in other major developed countries, in principle, have no transactions with securities companies, and the regulation and supervision functions are undertaken by other government institutions.

Therefore, there are still some basic distinctions of business activity in most of the financial system of industrialized countries. For instance, there are three basic distinctions of business activity in the financial market of Japan; those between banking and securities business, between banking and trust business, and between long- and short-term finance. Among the advanced countries, Japan has a clear division of activities. The driving forces for financial deregulation seem to be the emergence of contradictions between the old financial system and the new technological or economic conditions. Therefore, the regulatory framework has been restructured in most countries so that the momentum of financial deregulation is heading in the right direction. Accordingly, the indicators of deregulation or financial reform in the industrialized countries differ in terms of treatment of barriers to entry, product line restrictions, interest rate ceilings, innovation of new financial instruments and also in the treatment of banks and non-bank financial institutions. The financial reform process in the United States is usually referred to as 'deregulation', whereas the Japanese process is referred to as 'liberalization'. On the other hand, the financial reforms in Australia and New Zealand represent relatively pure examples of deregulation.

The rationale and objectives of deregulation in most of the developed countries seemed to depend on specific circumstances, on competitive market forces or on the need for financial development for economic growth. However, several crises in the past few years in some of the developed countries have even led to proposals for re-regulation. Thus, the review of the various circumstances that led some of the developed countries toward the deregulatory path may shed some light for the SEACEN member countries to undertake a proper course in their own deregulatory schemes. However, any review of deregulation must begin with an appreciation of the philosophies of financial regulation.

II. Regulatory Philosophy

The importance of the financial institutions in the economy lies in their key role in the payments mechanism and the transmission of monetary policy. Hence, the regulatory philosophy for financial institutions is based on the premise that, as the financial institutions represent the channels through which national monetary or credit policies are implemented, some prudential regulations have to be specified in order to ensure the safety and soundness of the financial system.

The present-day justification for public regulation of the financial institutions appears to be two fold: [3]

- The banking industry serves as a conduit through which stabilization policy is transmitted to the economy at large. Thus, regulation promotes stabilization and assures the continued usefulness of the banking system as a conduit; and,

- Regulation seeks to promote an ordering of the banking system that will foster allocative, distributive and technological ends sought by the community, thus promoting a social optimal banking.

In other words, the major benefits of regulation are said to be the prevention of over or under expansion of money and bank credit through a system of wide monopoly or through exces sive competition, and the protection of depositors against the consequences of bank failures. Many of the arguments that are used to justify the regulation of non-bank financial institutions are also used to justify bank regulation. [4] All these arguments are usually based on 'over expansion' or 'excessive risk taking' activities of the banking system. In this context, the principal purpose of regulation on banking and

3.Greenbaum, Stuart I., "Competition and Efficiency in the Banking System : Empirical Research and its Policy Implications", *Journal of Political Economy*, vol. 75 (February/December 1967), p. 461.

4. Meltzer, Allan H., "Major Issues in the Regulation of Financial Institutions", *Journal of Political Economy*, vol. 75 (February/December 1967), pp. 482-501.

financial institutions is to protect the interests of the public. Hence, the financial system is one of the most closely regulated sectors all over the world.

Similarly, the majority of the countries in the SEACEN region have tightly regulated and administratively controlled financial systems prior to financial reform. Such common characteristics were manifested by interest rate restrictions, segmented financial markets and institutions, underdeveloped money and capital markets, credit allocation and control mechanisms, and a variety of international capital and exchange controls. Nearly all countries have some forms of interest rate restrictions on bank deposits and loans. Interest rate restrictions were extended primarily to the borrowing and lending activities of deposit-taking financial institutions such as banking institution. Other types of financial institutions, such as finance companies, merchant banks, development banks, were usually subject to interest rate controls or were subject to generally less restrictive controls. Aside from some forms of interbank market, the majority of the countries in the SEACEN region do not have extensive money markets and, even less so, capital markets. However, in those few countries like Malaysia and Thailand, where money and capital markets existed, market forces were allowed to determine open market interest rates. While in the Philippines, the authorities played a hand in setting money market rates on deposit substitutes. The discriminatory application of interest rate controls on banking institution reflects the traditional concern on regulations to protect depositors.

Secondly, interest rate ceilings on deposits at banks and other types of deposit-taking institutions were the important features of interest rate restrictions. An important aspect of restricting interest rates on deposits was the concern about bank failures and the prevention of excessive bank competition and the consequent incentive for banks to make high return, but high-risk loans. More frequently, however, deposit rate ceilings in the SEACEN countries were designed to ensure the profitability and, hence, the stability of banks and other regulated depository institutions. The pervasive use of interest rate restrictions on bank lending is the third characteristic of interest rate regulation. Most nations — for example, Indonesia, Malaysia, the Philippines and Thailand — had lending rate ceilings set at the discretion of the central bank or maximum rates set by usury laws or a mixture of the two. In a few cases, such as Malaysia, minimum lending rates rather than ceilings were established for non-priority sectors. Many of the nations with general lending rate ceilings also used a multi-layered rate structure, whereby a variety of sectors enjoyed different preferential rates in accordance with their ranking in terms of 'social priority'. Thus, preferential rates were typically accorded to agriculture, exports, small businesses and housing sectors.

The imposition of lending rate ceilings in many countries in the SEACEN region was motivated by a desire for low-cost capital in order to stimulate domestic capital formation. It was generally held that market-determined interest rates were often too high to generate a sound optimal level of investment; hence, interest rates should be administratively set at sufficiently low levels in order to correct this market failure. Low lending rates necessitated low deposit rates. Another characteristic of financial systems in the SEACEN countries was the high degree of segmentations. The various types of financial institutions and markets are regulated within its explicitly prescribed scope. Almost all countries prohibited savings institutions from issuing transaction deposits that competed with bank deposits. Restric tion of foreign bank activities is an exceptional case of entry restrictions and market segmentations.

Beyond fiduciary concerns, segmentation was often justified by the need for monetary control because of the large extent of reliance on direct credit controls in these countries. Further segmentation in the form of specialized credit institutions was justified on the basis of market imperfections and deemed necessary to provide relief to credit starved priority sectors. Credit controls in many countries in the SEACEN region also maintained an adequate supply of financial assistance often at concessionary terms. The prerogatives enjoyed by the commercial banks and other financial institutions, in the form of limited excessive competition, is one major area which the government intervenes in regulating the prices that could be paid to depositors for their funds, and the prices that could be charged to borrowers. The rationale of this regulation is based on the fact that, if the conditions for the existence of a competitive financial market do not exist or cannot be readily established, the operation of market-determined interest rates cannot be envisaged. In a situation like this, the market would not establish an appropriate interest rate structure and interest rate deregulation in these circumstances could potentially destabilize the financial markets. The earlier experiences of some Latin American countries, as analyzed by Vicente Galbis, [5] showed that most of these countries have regulated interest rate structures on a more or less comprehensive basis between 1967 and 1976. Due to a lack of competitive financial markets, some of these countries found it difficult to deregulate the interest rate ceilings. Therefore, it is worthwhile to review or explore the rationale of the regulatory philosophy in the light of the experiences of some developed countries.

II.1 Experiences of Some Developed Countries

A review of the historical development of the financial regulation in the United States through the enactment of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 and the Depository Institutions (Garn-St. Germain) Act of 1982 clearly reveals that the reasons for the regulations varied according to the problems of the day. These included the prevention of centralized power; concern over institution solvency; provision of financial services as a social goal; attempts to allocate credit socially, particularly to housing; and, prevention of discrimination and unfair practices in the provision of these services. The United States stands out as an example of a nation that restricted deposit rates extensively but allowed market forces to determine open market interest rates.

The prohibition of interest on demand deposits and the ceilings on interest rates on time and savings deposits established by the Federal Reserve Regulation Q in the United States, date from the passage of the Banking Act of 1933. The restoration of confidence in the banking system and the protection of the depositors were the primary aspects of the regulatory philosophy at that time. In other words, an important aspect of restricting interest rates on deposits was the concern with bank failure. Deposit ceilings were rationalized on the basis of preventing 'excessive' bank competition, and the consequent incentive for banks to have higher return by securing high-risk loans. The Banking Act of 1933, therefore, established the Federal Deposit Insurance Corporation (FDIC) to insure demand, savings and time deposits at commercial banks and at mutual savings banks. The Act separated the banking business from the brokerage business, and banks were prohibited from acquiring or underwriting corporate stocks in order to eliminate 'risky assets' from bank portfolios.

The prohibition of interest on interbank demand deposits was to prevent recurring liquidity crises from temporary withdrawal of surplus funds that rural banks had deposited at large money centre

5. Vicente Galbis, "Interest Rate Management: The Latin America Experience", *Savings and Development (FINAFRICA), Quarterly*

banks to take advantage of interest yields. Similarly, the Regulation Q interest rate ceilings, that were extended in 1966 to cover the thrift institutions too, were set slightly higher than for commercial banks. The rationale behind this regulation was to give the 'thrifts' a little more power to attract deposits and thereby channel more money into home mortgage loans.

In short, the regulatory philosophy of Regulation Q was to prevent the banks from competing with each other by offering higher interest rates, to give the banks a source of low-cost funds and thereby assist the banks out of the risky loan business. The rationale of the regulatory framework at that time was justified in the light of a depressed born system of financial sector and 'financial panics' were rampant in the history of American financial markets. Therefore, the regulatory philosophy had to be directed towards restoring confidence in the banking system with the enactment of a number of legislations.

The financial regulations in Australia and New Zealand, however, emphasized more on direct control, and the control of the financial system was in large part a macroeconomic tool. Segmentation, that is, distinction among institutions, restrictive entry conditions for new banking institutions and banking concentration were the main features of financial regulations in these countries. Safety and soundness regulation through minimizing the extent of competition, through segmentation and entry restrictions were the major aspects of the regulatory philosophy.

The Canadian regulatory philosophy, on the other hand, was based on five principles: i) the federal and the provincial governments split up of regulatory responsibilities; ii) the force of nationalism; iii) the separation of the financial sector from the real sector; iv) the separation of financial activities, e.g., banking, trust activities, insurance and investment trading; and, v) the threat of failure of major financial institutions.

The rμationale in segregating the financial activities was the fear of excessive concentration of power if banks or other non-bank financial intermediaries were permitted to carry on undesirable activities.

The regulatory philosophy of the British financial system was to influence the composition of lending during the early period of the 1960s. The period of the 1960s was characterized by direct controls on bank lending and an administered bank rate. Various forms of quantitative controls were used. Some of the controls were applied either on the asset side or on the liability side of the financial institutions. The main purpose of introducing such controls had been to reduce the need to raise interest rates, at least in the short run, by inducing banks to ration their lending.

The second wave of regulation during the 'fringe banking crisis' period (1973-1974) occurred because of the deposit run and the collapse of the secondary banks, threatening the insurer clearing banks. During the first year of the deregulatory moves, new lending institutions expanded in the secondary sector, tapped the wholesale funds markets and moved into even more speculative property lending and share dealings. But with the downturn in the property market, the fringe banks were badly hit as deposits were withdrawn and the 'fringe banking crisis' emerged, ultimately leading to the enactment of the Banking Act in 1979. Under this Act, any institution wishing to take deposits from the public cannot do so unless authorized by the Bank of England either as a 'bank' or as a 'licensed deposit taker'. This second wave of re-regulation created supplementary Special Deposit Scheme in December 1973 — known as the 'corset' [6] and lending controls were re-imposed along with interest rate ceilings on retail deposits. The immediate objective of this 'corset' was to affect the relative interest rates to discourage 'round tripping'.[7]

The regulatory philosophy in Japan, on the other hand, was based on three basic distinctions of business activity in financial markets; those between banking and securities business, between banking and trust business, and between long- and short-term finance. Among the advanced countries, only Japan has such a clear division of activities. Such a distinction is due to several reasons. The first was the recognition of financial panics — that banks should specialize in short-term finance both to protect depositors and to avoid conflicts of interest. The second was the need in the high-growth period for financial institutions that specialized in long-term finance, such as long-term credit banks and trust banks. The third, which applied particularly to the distinction between banks and securities companies, was the rather abrupt introduction in the post-war occupation period of the American system as a whole. There was also, however, a policy of utilizing the unique features of securities companies to develop securities markets,

6. 'Corset': It is a scheme requiring each bank to lodge non-interest earning supplementary special deposits with the Bank of England if its interest bearing eligible liabilities exceed a prescribed ceilings.
7. 'Round tripping': It involves borrowing funds from a bank which, due to relative interest rates make it profitable, are then re-deposited with the same or another bank.

which was somewhat under-developed at that point in time.

The reasons for the post and present regulatory situation is, therefore, influenced by the following two considerations:

- Firstly, there were good reasons for regulating financial intermediaries as compared with other industry. Should some regulations be removed, the adverse conditions that gave rise to financial instability might re-occur which would be detrimental to the public interests. It would be best to learn from past experiences and to avoid history repeating itself.

- Secondly, the present situation in most of the developed countries is irrelevant and no long applicable or useful to the previous regulations that were imposed. These vestigial regulations tend to impose additional burdens on the society without any compensating benefits.

Most of the historical reasons for regulating financial institutions include taxation of banks as monopoly suppliers of money, the prevention of centralized power, bank solvency and the effects of failures on the economy, the provision of banking services as a social goal and avoidance of excessive competition. Since banking is a regulated industry, the power of government has been exploited by the banks' competitors to constrain competition by banks (such as, America's Glass-Steagall Act which prohibits banks from offering securities underwriting services). This prohibition is also supported by reference to the fears of banks controlling loans and equity sources of funds. Another frequently expressed fear concerns the possibility of banks abusing their fiduciary responsibilities. In particular, the banks might use information gathered in the course of lending to trade in a corporation's equity or might even attempt to 'bail out' bad loans by selling equities to the public. The argument for all the constraints were covered in terms of concern for the safety and soundness of the banks or fear of centralized power by the banks.

The experiences of these countries showed that the regulatory philosophy that developed during the 1960s and 1970s, was to maintain the soundness of banks and financial institutions and to protect the depositors. But over the past decade, there has been a growing move towards liberalizing various regulations on financial institutions, instruments and product lines. The rationale of deregulation at the moment centres on creating an optimal financial structure which would be characterized by a high degree of maximum responsiveness to technological and demand oriented financial changes. In this regard, it is worthwhile to review the circumstances that led some of the developed countries towards the deregulatory path, and the exploration of their experiences may shed some light for the SEACEN member countries to undertake a proper course in their deregulation efforts. This study will also facilitate the analysis of the necessary conditions for deregulation to succeed in the SEACEN region.

II.2 Deregulatory Moves: Experiences of Some Developed Countries

The principal purpose of regulation on banking and financial institutions is said to be the protection of the public interests. However, a major issue against regulation is whether it achieves a desirable social purpose when both the costs and benefits of the restrictions are considered. In this context, the analysis of Allan H. Meltzer [8] suggests that "the present system of financial controls protects some inefficient banks against competition, protects bankers against the consequences of poor judgment, and is an inefficient means of protecting the public against the errors (or in rare cases, moral failure) of individual bankers". Hence, if banking regulations are to serve a useful purpose, the benefits to the public must exceed the costs. If most of the controls imposed on banking are ineffective, it would be desirable to eliminate the said controls and replace them with a new set of institutional arrangements.

The regulatory philosophy is valid as long as the regulations that have supported the former financial system could still safeguard the soundness of the financial system. But when these regulations failed to cope with new financial and economic developments, financial innovation set forth in the form of evasion of regulations by the private sector. The review of the rationale for restricting banking activities suggests that the traditional concern for economic efficiency, safety, soundness, concentration of power and conflict of interests continued to be valid. However, public policies implemented to balance these concerns against economic efficiency objectives have at times resulted in distortions and have also created pressure incentives as a result of differential activity restrictions

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8. Meltzer, Allan H., "Major Issues in the Regulation of Financial Institutions", *Journal of Political Economy*, vol. 75 (February/December 1967), p. 497.

imposed. In this regard, Allan H. Meltzer has rightly argued that regulators have not always acted effectively to prevent bank crises. The inconsistency in implementing policies have generated uncertainty in the industry. The regulators have also tended to confuse individual bank failures with the failure of the banking system. Moreover, they have increased individual bank risk by not pricing deposit insurance on the basis of risk and have not punished management and shareholders of larger banks that have failed in economic terms. [9]

In the process, rapid financial innovation even in the old financial system, existing regulations will be circumvented and the regulatory authorities have no choice but to ratify these private sector innovations through liberalization of financial regulations or restructuring of the regulatory framework. Otherwise, the coherence between the old financial system and the new conditions breaks down. However, individual countries' experiences vary widely. At one end of the spectrum, deregulatory moves in the United States, which began in the 1970s with relatively free financial environment and well-developed financial markets, have been rather modest by international comparison. At the other end of the spectrum are Australia, Japan and New Zealand with heavily regulated financial structures by tradition. A large variety of national experiences are in between these two spectrums.

In this respect, the experiences of the United States,Japan, Australia and New Zealand, Canada, and United Kingdom would be useful in tracing the various circumstances that led these countries towards the deregulatory path.

United States

Much of the legislation that influences and controls the U.S. banking and financial system currently dates from 1930s. Since the 1930s, financial institutions have been under Regulation Q, and the regulations under the Glass-Steagall Act separating commercial banking from investment banking. In addition, there was the prohibition on carrying out banking business across state lines according to the McFadden Act. The main features of which are the prohibition of interest on demand deposits. Throughout the period of the

9. Meltzer, Allan H., "Financial Failures and Financial Policies", in Deregulating Financial Services: Public Policy Influx, edited by George G. Kaufman and Roger C. Kormendi, pp. 79-96, Ballinger Publishing Company, Cambridge, Massachusetts, August 1986.

1940s to the early 1960s, Regulation Q had little effect on the banking industry, and the financial system functioned well enough under its depression-born regulatory framework. Market interest rates remained approximately equal to or below the Regulation Q ceilings. Regulation Q worked well as long as market rates were low, and it did not have any effect until the mid-1960s. However, in 1965, the inflation rate accelerated and the interest rates rose rapidly. Market-determined interest rates in 1966 increased significantly above the Regulation Q ceiling rates, the consequences of which included the following:

- Interest rates on unregulated financial instruments inreased rapidly and funds flowed out of time, savings and demand deposits accounts into higher interest-earning alternatives;

- Disintermediation occurred whenever the market rates of interest significantly exceeded Regulation Q ceiling rates; and,

- As disintermediation occurred, many more non-regulated intermediaries and non-regulated financial instruments like Money Market Mutual Funds (MMMFs) began to appear. As these instruments were highly liquid and earned market rates of interest, there was a heavy drain of funds from the depository institutions to MMMFs funds.

- During this period of financial disintermediation, the 'thrifts' suffered even more, a result of rising cost of funds;

- The situation worsen for the banks and 'thrifts' in the late 1970s because of high and rising inflation rate, and the market interest rates were also rising very fast;

- The banks had to compete with the rapidly expanding non-bank intermediaries, while the growth of demand deposit substitutes and the thrifts suffered due to restrictions on sources and uses of funds (because of their limited kinds of deposits); and,

- As interest rates increased rapidly in the late 1970s, it became increasingly costly for member banks to hold their reserves in the non-interest bearing deposits with the Federal Reserve. A number of banks withdrew from the system and the continuing erosion of membership was a matter of serious concern to the monetary authorities as this reduces the power to control money supply.

In short, the regulatory philosophy of Regulation Q promulgated after the depression was implemented for a certain period of time. But during the years, many aspects of the old restrictions were more detrimental than beneficial. Under this regulatory system, the sudden, concentrated and simultaneous changes in technological and economic conditions caused large fluctuations of both interest rates and prices in short periods of time, and this calls for rapid deregulatory reforms. The foregoing circumstances clearly led the United States to the path of deregulation. All these circumstances, ultimately led to the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Garn-St. Germain Bill of 1982. The DIDMCA called for the complete deregulation of interest rates paid by banks and thrifts within six years and the Garn-St. Germain Act propelled deregulation further in the same direction, and it allowed the depository institutions to compete with the Money Market Mutual Funds.

Japan

The Japanese deregulation process, referred to as 'liberalization', started in 1974-1975 and has continued and accelerated through the years. Japan's financial liberalization was undertaken because the highly restricted, financial system no longer meet the needs of the economy. The Japanese banking system has only started the transition to a more competitive financial environment. Japanese banks have not experienced an intense degree of disintermediation like the U.S. banks. But it is argued that disintermediation could intensify in the future, if the regulatory authorities followed a gradual and uneven liberalization strategy. The circumstances that call for more liberalization seemed to emerge from the following factors:

- The relative decline of the banking system as a result of the decline in financial intermediation. This aspect is crucial because of the dominant role of banks in the intermediation process;

- The relative increase of government's financing to private sector resulting in the decline of the share of deposit bank funds to final borrowers;

- Decline in bank profit rates;

- Rigid interest rate ceilings on bank deposits resulting in a wider spread between market and regulated interest rates;

- The low ratio of unregulated liabilities to regulated liabilities;

- Foreign banks are not given equal access to the domestic market in the use and sources of funds;

- Japanese banks are kept out of the domestic securities business but foreign banks are allowed to deal in securities in Tokyo by granting licences to subsidiaries whereby the parent bank has no more than a 50 per cent stake; and,

- The authorities also set numerous interest rate ceilings. However, interest rates on certificates of deposits and time deposits are being gradually deregulated, starting with large time deposits.

It may be recalled that, in Japan, there also existed not only interest rate regulations and business activity regulations as in the United States, but also until very recently, regulations that separated domestic and foreign markets. The new deregulatory reform was the large-scale flotation of government bonds and the consequent expansion of free-rate, broad and open financial markets in both long- and short-maturity assets. A second major change was the new sensitivity of corporations and individuals to free interest rates. The third major change was the integration of domestic and foreign capital markets. The fourth major change was the active introduction of new telecommunication technology and computers by financial institutions. Deregulatory reform began with these four major changes, but soon conflicted with the financial regulations of the post-war recovery period and the high growth rate during the period. The most important conflicts were in the areas of interest rate regulation. This is because a very small portion of lending rates and bond rates in Japan are market-determined, the core of interest rate regulation is that on deposit rates.

The activities in the private sector, however, sought to circumvent the interest rate controls. There was a shift of funds from regulated fixed-term deposits into the 'Gensaki' market and medium-term bond fund developed by the securities companies. [10] Similarly, an attractive asset known as the fixed amount of postal savings account was developed. Because of the high interest rates, there was a rapid shift of deposits into these accounts. As a result of these innovations, the share of funds held by the deposit-taking institutions dropped from the level of 60-70 per cent in earlier years to about 40 per cent. The banks had to counter these movements by the introduction of free-rate Certificates of Deposits (CDs) in 1979 and Money Market Certificates (MMCs) in 1985, whose interest rates were tied to CDs rates. In these contexts, the regulatory authorities not only approved the new financial instruments outside the frame- work of the old regulation but also liberalized regulated interest rates that still existed. For example, in 1985, the interest on large scale fixed-term deposits of more than 1 billion yen were liberalized, and thereafter the minimum size for a free rate deposit was gradually reduced to 500 million yen, subsequently to 300 million yen, and then to 100 million yen.

Australia and New Zealand

The financial reforms in Australia and New Zealand represent relatively clear examples of deregulation. New Zealand has gone into two periods of reforms, separated by a period of re-regulation. The highly controlled financial system, which hindered economic growth, was the main rationale behind the deregulation of the financial systems of Australia and New Zealand. The previous regulatory policies in these countries created various undesirable effects. For instance, high variable and largely unpredictable inflation rates had made regulated interest rates increasingly inoperative. New Zealand tried to resist the upward pressure on interest rates by extending control over all financial activities during 1972-1976 but had to abandon the attempt when it became evident that it has a crippling effect on the financial system.

Disintermediation occurred in a secular way and funds did not flow out on a cyclical basis. The institutions which were relatively more regulated grew more slowly. As the non-bank intermediaries were highly controlled in New Zealand, most of these regulated institutions set up subsidiaries to escape regulation. Foreign banks, which were not permitted to get banking licences, established merchant banks and finance companies. The extent of off-balance-sheet lending and deposit taking was critical. Further, non-price rationing

10. 'Gensaki' transactions are generally of the same form as Repurchase Agreements (RPs) in the United States and transformed long-term (10 years) national bonds into a short-term (3-6 months) free rate securities. The medium-term bond fund is a type of investment trust for small unit transactions.

created inefficiencies and discrimination as a result of interest rate controls on both loans and deposits.

The success of some non-bank financial services firms hinged on the restrictions placed on banks and when these restrictions were lifted, 're-intermediation' occurred. There was a growing difficulty in controlling monetary expansion because the regulated structure caused disintermediation and funds flowed out of the intermediaries, through which the monetary authorities were using their monetary control mechanism. Further, the growth was occurring in the less regulated subsidiaries and there was difficulty in monitoring the safety and soundness of these institutions. As the banks had limits on growth and such limits were tied to market share, the banks did everything possible to boost service competition, with increasing overhead costs. All these circumstances set the stage for deregulation. The report of the Campbell Committee of 1982 formed the main basis of deregulation in Australia. New Zealand began deregulating in 1976 and 1977, taking off the interest rate controls and restrictions. But in 1981, New Zealand reactivated the control systems. In 1984 and 1985, the problems of regulations reappeared, prompting the New Zealand Government to free virtually all controls on the financial sector.

Canada and United Kingdom

The deregulation of the financial system in Canada and United Kingdom was market driven. The main circumstances which led Canada towards deregulating its financial system were as follows:

- Prospect of bank failure was becoming a reality and product line restrictions were becoming blurred, as holding companies also engaged in commercial lending, trust securities and insurance activities as well. The substantial interests in non-financing activities of these holding companies created a major threat to the principles of separation of real financial activities;

- The provincial regulations began to conflict with the federal regulations as the province of Quebec undertook its own financial deregulation; and,

- Much of the innovation that occurred in the Canadian financial system involved financial institutions which can undertake other activities — banking, trust activities, insurance and investment trading. The validity of the product line restrictions in a situation like this was meaningless.

The United Kingdom, on the other hand, has gone through two periods of financial reform, separated by a period of re-regulation during the 'fringe banking crisis' period of 1973-1974. The first phase of deregulation began in 1971 when 'Competition Credit Control, 1971' was introduced. It was introduced with the following aims:

- To move away from reliance on direct restrictive controls and to move towards a system in which market forces could play a predominant role.

- To boost re-intermediation process, through which banks can recapture the share of business, that was undertaken through non-banking channels.

The circumstances which led to this first phase of deregulation in 1971 were as follows:

- Most of the regulations were evaded by undertaking unregulated transactions and such transactions were taking place outside the clearing banks;

- Rapid disintermediation occurred;

- Control of actual lending as required by the quantitative ceilings became more difficult to achieve because the prevailing overdraft system allowed the customer to draw at will the agreed but unutilized overdraft facilities;

- The lending ceilings distorted the credit distribution pattern because it involved allocation of credit by rationing which stifled competition rather than through the price mechanism; and,

- The discriminatory character of many regulatory measures made it impracticable for the banks to participate in their own names in the growing wholesale money markets. This contributed greatly to the loss of a large part of the clearing banks' share in total lending. The clearing banks could participate through their subsidiaries only.

The above circumstances ultimately introduced 'Competition and Credit Control', as deregulation was called. After the first phase of deregulation, quantitative ceilings were abolished, 'cartel' was abandoned, statutory ratios were introduced and applied uniformly to all banks. However, the first phase of deregulation was interrupted by a period of re-regulation, due to the 'fringe banking crisis' of 1973-1974. The deregulatory moves were swiftly aborted. Lending controls were reimposed with interest rate ceilings on retail deposits. Further, Supplementary Special Deposit Scheme — 'corset' was introduced. However, the effects of these controls were clearly felt in the market. It had the effect of inhibiting bank from developing new types of business. Its major effect has been to divert flows into uncontrolled channels, leading again to disintermediation.

The circumstances that led to the second phase of deregulation entirely revolved around the 'corset', which was first introduced in December 1973. The immediate objective of this 'corset' was to cause a change in relative interest rates because monetary policy between 1973 and 1980 relied heavily upon this 'corset'. This led the banks to find ingenious ways of evading 'corset' imposition by shifting towards liability management because it was unprofitable for a bank to expand its business once the ceiling is reached. There was also a massive diversion of domestic intermediation to off-shore markets due to relaxation of official restrictions upon overseas investments. This made direct domestic credit control evasive by off-shore operations and the 'corset' became largely ineffective. Ultimately, the 'corset' was abolished during the second wave of deregulation. Official regulations of consumer instalment credit was again abandoned and all the direct controls were removed. Hence, each time the forces of competitive market pressure demanded a change, deregulation occurred in the United Kingdom.

Chapter 2

An Overview of Deregulatory Moves Undertaken by the SEACEN Countries

I. Circumstances Leading to Deregulation

The rigid financial regulations in most of the countries made their financial systems unresponsive to the needs of their national economies as market conditions changed rapidly after the early 1970s. Technological developments in communications, fund transfers and electronic banking and also the growth of Eurocurrency markets have exerted pressure for a more liberal financial system. High, variable and largely unpredictable inflation rates made regulated interest rates increasingly ineffective. Most of the countries responded by more frequent adjustment of interest rate ceilings. In addition, deposit rate ceilings reduced the interest income of depositors and discouraged savings. Lending rate ceilings resulted in credit rationing that often favoured low risk borrowers. Low interest policies were also relatively ineffective in maintaining a low cost of capital to business. Another typical consequence of the low interest rate policy was added pressure on the authorities for more expansionary monetary policy. Segmentation of financial institutions often resulted in a high degree of concentration of the regulated financial institutions portfolio in either specific sectors of the economy or in a particular maturity spectrum.

The review of the various circumstances that led some of the developed countries towards deregulatory path, therefore, showed that deregulation depended on the specific circumstances and competitive market forces. Under this combined pressures arising from market forces and change in regulatory philosophy most of the developed countries have to undergo fundamental changes to deregulate their financial systems. Deregulation in these countries generally included relaxation or elimination of interest rate ceilings and product line restrictions. In other words, specific circumstances and the failure of many of the controls imposed on banking to achieve their purpose and intense competition among the financial institutions were the major causes of deregulation. An important aspect in the deregulation process in these countries showed that the market was very competitive and indicative too. Their financial market is a perfect indicator in reflecting the regulatory forces that disrupted the functioning of the financial system, thus facilitating the timelyderegulatory moves. Similarly, every time deregulation occurred, competitive financial markets which exists in most of these countries also worked as an indicator.

But in a number of SEACEN countries, the aforementioned type of financial markets may not exist and complete deregulation may not be possible unless certain conditions are fulfilled. Most of the deregulatory moves were mainly reflected in the revision and removal of interest rate ceilings, removal of entry restrictions to the foreign or joint-venture banks, relaxation of credit ceilings and statutory reserve requirements. There still exist regulated and non-regulated financial sectors in most of the SEACEN countries. The circumstances that led some countries in the SEACEN region towards deregulation do not, therefore, give a clear picture of the rationale of deregulation, and there seems to be no certainty on the direction to take concerning some areas that have not yet been deregulated. On the other hand, the relatively short period in which deregulation was completed in some countries (e.g., Philippines) indicates that monetary authorities have also been resolute in pursuing the path of deregulation. Thus, the nature of circumstances leading to deregulation in the financial system of the SEACEN countries varies from country to country.

Indonesia had to undergo fundamental changes under the deregulation policy of 1 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 of which the central bank granted rediscount credits (liquidity credits) at subsidized rates. The national private banks mainly provided short-term working capital to 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 syndicated with private national banks. In other words, from 1974 to 1 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 reserves and produced some undesirable side effects, such as excessive 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 liquidities in the banking system induced capital flight and put pressure on the balance of payments. In addition, the dependency of state banks on central bank liquidity credits, whose volume was largely demand-determined, complicated the task of controlling domestic credit. All these circumstances prompted ultimately to the financial deregulation of 1 June 1983.

In the case of Nepal, a system of controlled interest rates for commercial banks and other financial institutions has been in operation for a long time. The interest rates have not changed much over time, although a significant revision took place in 1975. The reasons for maintaining a few mandatory interest rates can be attributed to the fact that competitive conditions were not sufficient to introduce a fully liberalized system of interest rates, and other instruments of monetary policy have yet to be further developed. Further, the direct control of lending rates also provided an easy mechanism for credit allocation by differentiating between priority and non-priority sectors in which the former receives concessionary interest rates. The direct control of deposit rates before 26 May 1986 deregulatory moves was also considered a potentially effective instrument for mobilizing domestic savings.

However, some anomalies, visualized in the financial system for the last few years before deregulation, induced the central bank to move towards partial deregulation of the financial system. The abundance of resources in some institutions, while others facing scarcity of the same resources and the non- flexibility of interest rate on deposits, are some of the aspects of circumstances leading to deregulation. The non-flexibility of interest rates restricted the institutions (needing more resources) in mobilizing more savings by offering higher rates. The wide margin between deposit and lending rates, the introduction of commercial banks with foreign banks' collaboration and the subsequent need to create a competitive atmosphere for commercial banking activities are some of the main reasons motivating the regulatory authority towards financial deregulation. It may be recalled that before the deregulation of 26 May

1986, there were about 20 controlled lending rates differentiated between sectors, use of funds and types of collaterals. Therefore, it was also cumbersome to manage the interest rate structure which changes frequently in line with the competitive environment. Further, the interest rate structure was also not rationale. Instead of the central bank determining the deposit rates and instruments, it seems logical in allowing the banks concerned to handle that. Nevertheless, it has been a couple of years since the move towards deregulation with the decision of 29 May 1986 granting commercial banks and financial institutions the authority to fix interest rates at their own discretion at any level above the minimum prescribed levels.

Further, the overall impact of controlled interest rates and other regulations was that the asset and liability structure of the commercial banks was tightly controlled, and changes in the structure were only possible to a limited extent. The direct control of deposit and lending rates in this situation, therefore, becomes redundant. During the post decade after deregulation, banking activities developed rapidly as is evidenced by the growth of assets, the expansion of bank branches in rural areas and a gradual decline of currency-deposit ratio over the years.

The circumstances leading to interest rate deregulation in the Philippines were triggered by the observation that a rigid and low interest rate policy tends to lead to inefficiencies and misallocation of resources in the financial system. The high inflationary pressures during the seventies also called for a more flexible interest rate policy. It may be recalled that before the three stages of financial deregulation of 1980, 1981 and 1983, when interest rates were administratively set at very low levels, there was an observed decline in financial intermediation. The gap between deposit and loan rates was aggravated by the inflation rate, resulting in negative real deposit rate, which seemed to discourage savings. As real interest rates turned negative, disintermediation again occurred with the decline of M2/GNP and M3/GNP ratios. The administrative mechanism of adjusting interest rate structure had to be applied very frequently. Further, the need for increasing the flow of savings to medium- and long-term investments was greatly felt as the bulk of the outstanding credit of the financial system remained short-term oriented. In other words, until 1980, interest rate policy was constrained not only by ceilings established by usury law but also by prohibition against changing rates more than once in any 12-month period.

The rationale behind loan rate ceilings in the Philippines was to inhibit unscrupulous lending practices of banks, build up the public confidence in the financial system and promote the growth of new industries. It was also prompted by the strong anti-usury position. [11] As a result, it was reflected in the Anti-Usury Law of 1916 which imposed limits of 12.0 and 14.0 per cent on secured and 'unsecured' bank loans, respectively. The loan rate ceilings deterred lending to small- scale enterprises and to agriculture. The ceilings also have been blamed for the shortage of medium- and long-term finances. All these circumstances ultimately led toward a gradual process of deregulation which started in 1980 and completed in 1983. The lifting of the interest rate ceilings on short-term loans was the last phase of the gradual deregulation of interest rates in the Philippines which started with the amendment of the Anti-Usury Law of 1916 in 1973.

On the other hand, prior to the 1977 deregulation policy in Sri Lanka, a restrictive monetary policy had been introduced. Foreign banks were not encouraged to commence businesses and credit ceilings were normally imposed. In other words, a low interest regime was prevailing, and even the changes made in interest rates were of a very marginal nature and occurred at very infrequent intervals, and also were not reflecting market conditions. The consequence was that the demand for bank credit increased and the central bank had to provide a large volume of funds to commercial banks at the prevailing bank rate for their liquidity requirements. With a view to rectifying this situation, the central bank imposed a ceiling on commercial bank credit on 24 May 1974. [12] Quantitative credit restriction, thus, became the norm of regulatory policy prior to 1977 deregulatory moves. The consequence of which was a movement of interest rates to a considerably higher level against a background of widespread inflationary pressures. The interest rates failed to reflect market conditions. The positive rate of interest on deposits was not maintained to promote domestic savings. In other words, there was financial suppression in the banking system and the low interest rate policy that existed during the period before deregulation did not induce the financial institutions to function competitively in mobilizing deposits. The interest rates were also kept at a lower level, mainly with a view to enhance investments and to control the

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11. Viksnins, George J., *Financial Deepening in ASEAN Countries*. Pacific Forum, University of Hawaii Press, Honolulu, 1980.

12. In addition, with effect from 4 October 1976, a ceiling was imposed on bank credits on non-essential activities such as consumption and financial purposes.

rising costs of domestic public debt which had been growing over the years. Further, the rapid monetary expansion, especially prior to 1977, posed formidable problems in demand management. In 1976, for instance, narrow money supply rose by 35.0 per cent while the broad money supply grew by 32.0 per cent. This excessive money growth was not accompanied by a parallel growth in domestic production and, therefore, the pressure on prices was severe. Therefore, a liberal financial package had to be introduced.

Ceilings on deposits and loan rates have been a standard instrument of financial policy in Thailand. The inflexibility of the administered interest rate system resulted in substan tial capital outflow after 1975 when interest rates abroad rose above the regulated interest rates in Thailand. In the absence of an upward adjustment in interest rate ceilings, real interest rates became negative by substantial margins. Negative real interest rates in turn affect the soundness of financial institutions. Commercial banks and other deposit-taking institutions, whose deposit rates were limited by ceilings or official intervention, suffered from a slowdown in deposit mobilization. On the other hand, non-bank financial institutions, such as finance companies whose deposit rates were not subject to control, prospered.

In other words, financial disintermediation was apparent in the period of high inflation, and tight liquidity conditions was created by unfavourable differentials by foreign rates and rigid domestic rates. Therefore, in 1980, the authorities attempted to move towards a more market-based interest rate structure by keeping the ceilings high so as not to be binding. At the same time, the deposit rate ceilings for maturities of three months to two years was unified.

The flexibility towards interest rate policy in Thailand has, however, been apparent since 1979. Prior to this flexibility, the ceiling on lending rates of financial institutions was 15.0 per cent imposed by the Civil and Commercial Code since 1924. After the second oil shock, the interest rate policy was not linked closely to the market sentiments. Financial institutions could not make more use of market mechanism in competing for new financial savings. However, the relative importance of the market intervention swing back and forth during 1970 till 1972. Although market-oriented policies have become the norm, government interventions remained an important feature. The authorities imposed interest rate ceilings, but these ceilings could not be set so low as to push the domestic deposit rates or the lending rate to prime borrowers much below the corresponding international rates. During 1979-1981, tight money situation that prevailed at various intervals necessitated the adoption of a more flexible interest rate management which was evidenced by frequent and substantial upward adjustments in ceilings on loans and deposit rates of financial institutions. Further, during the period 1970-1982, two waves of moderately high inflation swept through the Thai economy: one in 1972-1974 and the other in 1977-1981. The impact of these inflationary episodes was readily apparent in the ex-post real rates.

The circumstances that led most of the countries towardderegulation in the SEACEN region depended on specific situations and competitive market forces. Deregulation in these countries generally included relaxation or elimination of interest rate ceilings. But as compared to other developed countries, financial market was not perfectly indicative, thus facilitating the timely deregulatory moves. Interest rate is still regulated in some of the countries in this region, although some of the countries like the Philippines are even moving towards the universal banking concept. Even if interest rate is deregulated, it is still determined either with the consent of the central bank or with the understanding of major banks. Further, credit ceilings exist side by side with interest rate deregulation. There still exists regulated and non-regulated financial sectors. The priority sector is still a regulated financial sector in almost all the countries in the SEACEN region.

Nevertheless, deregulation in the SEACEN countries has meant, above all, greater reliance on prices and on market.forces. It has been driven by competition, especially competition from abroad. Although deregulation has occurred in many dimensions in the developed countries, the most important aspect in the case of SEACEN countries has been the various forms of price deregulation. The move towards deregulation in most of the countries in the SEACEN region was, however, basically due to interest rate policy and expansion of financial activities. Despite the wide diversity in the degree of financial structure in the SEACEN countries, the regulatory authorities in this region have frequently followed a similar pattern. Countries like the Philippines have gone a step further towards universal banking concept. But the timing of the has varied from nation to nation. Nevertheless, by the late 1970s, most of the countries in the SEACEN region have experienced accelerating changes in their financial markets. Confronted with these developments, the regulatory policies have to be reassessed, although the differences of circumstances among the SEACEN countries before deregulation were perhaps more apparent than real.

In this context, most of the financial systems were tightly regulated and administratively controlled, making them largely inflexible and unresponsive to the growing competitive market environment. Financial markets were segmented with a wide array of financial regulations and controls were perceived as essential financial policy objectives. Interest rate restrictions were pervasive throughout the SEACEN region prior to deregulatory reforms of the late 1970s and early 1980s. The pervasive use of interest rate restrictions on bank lending along with the use of multi-layered rate structure and interest rate ceilings on deposits at banks and other types of depository institution was motivated by low cost capital. It was generally held that market-determined interest rates were often too high to generate a socially optimal level of investment; hence, interest rates should be administratively set at sufficiently low levels in order to remedy this market failure. Low lending rates necessi tated low deposit rates. In order to ensure that low deposit rates did not result in serious financial disintermediation, some of the countries frequently resorted to restricting the type of available financial assets that might compete with bank deposits, as in the case of Japan. Further, each type of financial institution was restricted to conduct business within its explicitly prescribed scope. Almost all countries prohibited savings institutions from issuing transaction deposits that competed with bank deposits and commercial banks were prohibited from securities business. Restrictions on foreign banks' activities are a special case of entry restrictions and market segmentation. However, the policy regulating foreign banks varied widely among SEACEN countries before financial reforms. Beyond fiduciary concerns, segmentation was often justified by the need for monetary control.

Therefore, financial regulation was designed to restrain market forces in the allocation of credit to encourage economic growth and ensure financial stability. However, the rigid financial regulations in most of the SEACEN countries made their financial systems unresponsive to the needs of their national economies. These regulations frequently generated unintended outcomes. Deposit rate ceilings reduced interest income to depositors and discouraged savings. Lending rate ceilings resulted in credit rationing that often favoured low risk borrowers, typically the large established business and public enterprises. The result was often the promotion of economic concentration and the rigidity of the industrial sector. Low interest policies were also relatively ineffective in maintaining a low cost of capital to business since banks would often adjust the non-market rate to reflect market condition.

Another typical consequence of the low interest rate policy was the added pressure on the authorities for more expansionary monetary policy. The chronic excess demand for funds led to the general impression that credit was perpetually in short supply. Under these circumstances, there was a risk of a built- in bias for inflationary monetary policy. Finally, a low interest rate policy provided a rationale for government dominance of the banking business. The chronic excess demand for funds meant increased concentration of economic power in the hands of the lending institutions that rationed credit. Under these circumstances, in order to prevent banks from abusing the power for private gains and to ensure the achievement of credit allocation according to national priorities, some countries in the SEACEN region (Indonesia, Nepal, Philippines, and Sri Lanka) opted for partial government ownership or for government banks having a dominant, or a major role in the financial system. Hence, under the combined pressures arising from market forces and changes in regulatory philosophy, a trend towards financial deregulation has been established in the SEACEN countries.

II. Rationale and Objectives of Deregulation in the SEACEN Countries

Most of the financial systems in the SEACEN countries were tightly regulated and administratively controlled, making them largely inflexible and unresponsive to the needs of their national economies in the 1970s and early 1980s. The circumstances in the SEACEN countries before financial reforms were towards a tight regulatory approach. Bank deposit and loan rates as well as exchange rates were often fixed by the authorities. Regulation has been frequently justified as a means of maintaining financial stability and the safety factor has always been a good reason for regulation. But frequently, consequences of regulation have been less positive and a great deal of regulations became anti-competitive. Regulations frequently generated unintentional outcome and the market conditions made the regulations increasingly untenable. Consequently, a growing belief around the world in the price system with greater reliance on market forces took momentum. In this sense, deregulation means better allocation of resources, more competition and as a result more output and faster growth.

In other words, to move towards less restrictive financial regulation partly reflects fundamental revisions in national regulatory thinking and partly, a response to the rapidly changing economic and market environment of the 1970s and 1980s. The decision to initiate deregulatory reforms in most of the SEACEN countries was the result of inconsistencies generated by the rigid regulatory regime. The rationale and objectives of the 1 June 1983 deregulatory moves in Indonesia was to encourage banks to maximize their funds mobilization and thereby reduce their dependence on the central bank for low cost funds for their lending activities. In other words, the essence of the reform was to abandon the system of credit ceiling, to leave the determination of interest rate to individual bank's discretion, and to limit the use of refinancing facilities only for very restricted purposes.

The extensive deregulatory policy of 27 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 operations of banks and other financial institutions; effectiveness in the implementation of monetary policy; and, developmen of the capital market. Further, 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 indirect control of credit through reserve money management were meant to foster efficient growth of individual institutions.

The system adopted in Malaysia prior to 23 October 1978 involved the imposition of a minimum lending rate for bank loans and a ceiling on interest rates that may be offered by the banks for deposits with them. This arrangement was based on the assumption that both bank lending and private savings would be sensitive to changes in bank interest rates. However, in order to foster greater competition in the financial industry to the advantage of both savers and borrowers, the commercial banks were allowed in October 1978 to determine their own interest rates for deposits as well as for prime lending. The rationale of the successive deregulatory moves in the early and late eighties was also to allow greater flexibility and efficiency in the determination of interest rates based on the market forces. For instance, a new system of interest rate determination for the commercial banks came into effect in November 1983 under which all borrowing rates (except those for loans extended to the priority sectors) were anchored to a bank's declared base lending rate (BLR).

The automatic mechanism that was introduced into the system was intended to remove much of commercial banks' discretion as to who should benefit or be penalized and to what extent when interest rate changed. The rationale of unpegging interest rates on deposits of 12 months or less in maturities from 1 February 1987 to the rates quoted by the two leading banks is, therefore, to allow greater flexibility and efficiency in the determination of interest rates, thus breaking new grounds in the history of banking in Malaysia. The rationale of the decision to grant share dealing licences to approved commercial banks is to expand the product lines of commercial banks to improve competition. The establishment of an official index of interbank rates known as Kuala Lumpur Interbank Offer Rate (KLIBOR) and the permission of approved finance companies to participate in the interbank market also motivated the financial institutions to become more competitive. Similarly, the objectives of the financial reforms of 1 January 1989 was to enhance competition, provide depth to the money market and further develop the capital market, particularly the Malaysian Government Securities (MGS).

The objectives of the deregulatory moves undertaken in Nepal on 29 May 1986 were to equip the commercial banks with plenty of latitude to attract more deposits and to charge appropriate interest rates on loans. In other words, the rationale of allowing banks and financial institutions to freely set key deposit rates above minimum rates and also the flexibility of determining the lending rates was to generate a sense of keen competition among the banks.

The objectives of the 1980 financial deregulatory moves in the Philippines were aimed at enhancing banks' efficiency and to improve the financial intermediation process, particularly to increase the availability of and access to longer-term funds. The rationale of the removal of interest rate ceilings on all types of deposits and loans (except short-term loans) in July 1981 and a complete deregulation of interest rate in 1983 was basically intended to enhance efficiency in financial intermediation; to generate a higher growth rate in domestic savings and, to encourage the allocation of credit to viable investment. The freeing of interest rate ceilings, initiated in 1981 and completed by January 1983, was also aimed at complementing the move towards universal banking.

The objective of Sri Lanka's deregulation policy to wards interest rate reforms was to maintain interest rates which can reflect market conditions, thus providing an incentive to increase financial savings. It was also aimed at moving away from quantitative credit restriction situation, whereby, the central bank was providing a large source of fund to commercial banks at the prevailing bank rate for their liquidity requirement. The purpose of this radical change in interest rate policy against a background of widespread inflationary pressure in 1977 was to maintain interest rate which can reflect market conditions, thus providing incentives to increase financial savings. In other words, the objectives of the interest rate reform were two fold. First, the interest rate was used as an effective instrument of monetary policy in arresting the growing inflationary pressures, second, it was aimed at ensuring the positive rate of return on deposits thereby promoting domestic savings. The rationale for this deregulatory measure was also to raise the cost of credit and discourage non-essential borrowings. The objective of the second stage of deregulation, allowing National Savings Bank (NSB) the freedom to fix its deposit rates in June 1984 was to enable the NSB to increase the level of domestic savings. Consequently, one of the main objectives of deregulation policy in Sri Lanka was to emphasize the maintenance of a positive real interest rate structure by officially manipulating the deposit rates of the NSB. However, after 1984, the influencing role of interest rate is largely controlled by two leading state banks rather than NSB. Similarly, the new policy stance with regard to open market operations was to allow the rate of return on Treasury bills to move in line with market conditions.

Likewise, the main objective of interest rate deregulation in Thailand has been the gradual liberalization of the interest rate structure, keeping in mind the requirement for a positive real return on deposit and lending rates in line with market sentiments. Accordingly, central bank interventions have been minimal in the setting-up of ceiling rates.

The review of the various circumstances that led some of the developed countries and also the countries in the SEACEN region clearly shows that deregulation has been driven by competition and technological innovation, which has made information simultaneously available around the world and has permitted instantaneous responses of lenders and borrowers through frequent interest and exchange rate changes. Although deregulation has occurred in many dimensions in the industrialized countries, interest rate deregulation on the aspect of price has been the most important move in the SEACEN countries.

III. Major Features of Deregulation

During the past decade, the majority of countries in the SEACEN region had undergone major changes in the deregulation of their financial system. These changes are reflected in the relaxation of interest rate ceilings, introduction of new financial instruments, authorization of new financial activities and also introduction of expanded commercial banking activities in some countries. The timing of these deregulatory moves has varied from country to country. Nevertheless, by the late 1970s and early 1980s, virtually all the countries in the SEACEN region have undergone deregulation of their financial system in one form or another. Despite the wide diversity in the growth of the financial system and the degree of development of the financial market, the deregulatory measures taken by the regulatory authorities in the SEACEN countries have frequently followed a similar pattern: increasing movement toward a financial framework that allows market forces a greater role in fund mobilization and its allocation.

Deregulation in the industrialized countries has occurred in many dimensions, including price product and geographical deregulation which also include functions, powers and others. However, in the SEACEN countries, by far the most important aspects have been the various forms of price deregulation which include interest rates and exchange rates. The majority of the countries in the SEACEN region had undergone interest rate deregulation. Deregulation of interest rate was initiated by removing usury ceilings in countries like the Philippines and Thailand whereas, in other countries in the SEACEN region, the deregulatory moves focused on the removal of interest rate ceilings on loans and deposit rates in line with market sentiment. However, the various phases of deregulation were also accompanied by rigorous legislative regulatory features and also with aspects of detailed supervision. The different circumstances in the SEACEN countries before deregulatory moves were perhaps more apparent than real. Nevertheless, beneath the diverse financial system in the SEACEN countries, the financial systems were tightly regulated and administratively controlled, making them largely inflexible before the deregulatory policy adopted by the countries in the SEACEN region. Interest rate restrictions were pervasive in the SEACEN countries prior to the financial reforms.

An overview of the interest rate regulation throughout the countries in the SEACEN region portrays, therefore, three main characteristics:

- Interest rate restrictions (interest rate ceilings) were extended primarily to the borrowing and lending activities of the banking institutions, and other non- bank depository institutions were usually not subject to interest rate controls. But market forces were allowed to determine open market rates. Malaysia and Thailand come into this category, while the Philippines, in contrast, played a hand in setting money market rates on deposit substitutes.

- Interest rate restrictions were most commonly manifested by interest rate ceilings on deposits at banking institutions.

- The pervasive use of interest rate restrictions on bank lendings was the third characteristic of interest rate regulations. Most countries, for example Malaysia, Nepal, the Philippines and Thailand, had lending rate ceilings set at the discretion of central bank or maximum rates set by usury laws or a mixture of the two.

The general lending rate ceilings also used a multi- layered rate structure, wherein a variety of sectors enjoyed different preferential rates in accordance with their ranking in 'social priority'. Priority sector is regulated even after the deregulatory moves are undertaken by most of the countries in the SEACEN region. In other words, direct credit control for regulating the aggregate supply and sectoral allocation of credit through administrative measures were pervasive in many countries in the SEACEN region. General credit control, that is, ceilings on either the level or growth rate of outstanding loans, has been widely employed. Nepal, Sri Lanka and Thailand have traditionaly relied on direct control on aggregate bank lendings for curbing money growth. Along with general credit control, most of the countries in the SEACEN region also maintained a complex web of selective credit controls prior to deregulation, in order to ensure priority sectors' access to an adequate supply of finance, often at concessionary terms. This feature is still prevailing in almost all the SEACEN countries.

But as the competitive market forces compelled the regulatory authorities in the SEACEN countries to put greater reliance on prices and market forces, deregulation of the financial system was inevitable. Under the combined pressures arising from market forces, technological developments in communications (fund transfers and electronic banking) and changes in regulatory philosophy, a clear trend towards financial deregulation has been established. However, individual country experiences vary widely. Despite the traditionally heavily regulated financial systems, the majority of the countries in the SEACEN region has undergone major financial reforms in the last eight years.

The experiences of interest rate deregulation of the SEACEN countries have been quite varied. Countries like Malaysia and the Philippines explicitly adopted a gradual move towards deregulation. The move towards deregulation in the financial system of Nepal has a more recent history, and the degree and forms of deregulation are also limited. The gradual approach is also manifested, in the case of Malaysia and the Philippines, in the common practice of removing interest rate ceilings on deposits and loans of longer maturity as a first step which is followed by relaxation of deposit and loan rate ceilings on short-term deposits and loans. In Indonesia, however, state banks' interest rates on most categories of deposits and on all loans (except remaining priority loans) were completely deregulated in 1983. In other words, the deregulatory moves entailed the removal of ceilings on credit and on interest rates of state commercial banks, a change in the funding role of the central bank and the introduction of new instruments of monetary control. In Malaysia, after gradual stages of deregulation, starting in 1978, the interest rate was completely liberalized on 1 February 1987 by unpegging the interest rates on deposits of 12-month or less maturities to rates quoted by its two leading banks. Priority sector lending rates are also liberalized to the tune of market forces in Malaysia by pegging the rates of 1.75 per cent above the average of the base lending rate (BLR), with a view to allow the rate to move with BLR. Further, several financial reforms have been undertaken effective from 1 January 1989 to enhance competition, provide depth to the money market and further develop the capital market. Among the major changes are the appointment of 18 principal dealers for Government securities and revisions of the statutory reserves and liquidity requirements for financial institutions. Some countries in the SEACEN region, however, adopted a more discrete and dramatic form of interest rate liberalization. Indonesia, for instance, introduced extensive interest rate deregulation and other financial liberalization very quickly. However, a comprehensive deregulatory policy measures in the financial, monetary and banking fields was adopted on 27 October 1988 (see Appendix I) after five years of fundamental deregulation policy of 1 June 1983.

However, some of the countries in the SEACEN region have not experienced extensive interest rate deregulation as the others. The Philippines officially abolished all ceilings on bank deposit rates in 1981 and all bank loan rates in 1983. As a result, bank lending and deposit rates have gradually followed movements in market rates as reflected in the rates for money market instruments. Similarly, although the major thrust of Malaysia's deregulatory policy over the past few years has been towards the evolution of a market-oriented financial system, in practice, the base lending rate remained basically 'sticky downwards' because of high degree of discretion which now exists in determining BLR and the asymmetric adjustment in interest rates (whereby falls in lending rates tend to lag far behind falls in deposit rates, and increase in deposit rates are reflected in high lending rates automatically) could not be avoided. The complete flexibility of interest rates adopted in this context since 1 February 1987 was by unpegging deposit rates to the rates quoted by two leading banks, however, followed by the restriction in the margin by which lending rates might not exceed the BLR by certain percentage points, depending on the credit standing of their client. Indirectly, it can be regarded as a ceiling range despite the gradual flexibility in interest rate determination in Malaysia.

Finally, there have also been a few cases of reversals in the general trend of interest rate regulation. For instance, Malaysia issued guidelines to the commercial banks in 1987 to adjust the margin of their lending rates for all loans (except priority sector loans with prescribed ceiling rates and other loans whose rates were legally or administratively fixed) to not more than 4 percentage points above their BLR.

As to the deregulation of financial markets, initial conditions varied considerably among the countries in the SEACEN region. The Philippines had active open money markets even prior to mid-1970s. By the late 1970s, money market were being developed in Indonesia, Malaysia and Thailand. Although countries in the SEACEN region differed in their respective financial development, most of them are moving towards an open market framework. However, most countries in the SEACEN region have kept intact their selective-credit policy measures of the early 1970s. Nevertheless, financial deregulation has altered the segmented nature of financial markets. Market forces have blurred the functional differentiation in the financial sector. Universal banking has been adopted as a principle in the Philippines, permitting approved commercial banks to engage in securities transactions. Finance companies in Malaysia, Thailand and Sri Lanka have also developed rapidly and now compete directly with the traditional banking sector. Stockbroking licences have been granted to the three largest commercial banks in Malaysia and approved finance companies are allowed to participate in the interbank market.

The countries in the SEACEN region have also made a few changes in their policies regarding foreign financial institutions. In Indonesia, foreign banks are still excluded from domestic markets outside the Jakarta region, except in joint financial ventures with domestic banks. But the deregulatory measures of 27 October 1988 has enlarged the scope of establishing foreign banks. Joint-venture banks can be established (under certain requirements) by one or several domestic banks in association with one or several banks. The requirement to establish a foreign exchange bank has been eased. A foreign bank that is classified as 'sound', including its capital, is allowed to open one sub-branch office in designated cities. Similarly, the entry of foreign banks in Nepal is based on joint-venture principle and joint-venture foreign banks have been encouraged since 1984. Foreign banks in Malaysia traditionally have access to domestic markets on more or less equal footing with domestic banks. After the deregulation of 1977, foreign banks were encouraged to commence business in Sri Lanka, while the activities of the already existing foreign banks were restricted to Colombo. The foreign banks' presence in Thailand has traditionally been large but stagnant. New foreign bank entries are prohibited, and foreign banks have only limited access to local currency deposits.

Therefore, significant changes have occurred in the financial systems of the SEACEN countries in their move towards deregulation. Beginning with small adjustments in financial regulation in the early 1970s, financial deregulation began to spread; slowly at first and the pace picked up after the late 1970s, and it took momentum in early 1980s. The degree of financial deregulation, however, varied widely from country to country. In this context, Appendix 1 presents a chronology of the deregulatory moves undertaken by the countries in the SEACEN region over the 1970-1989 period. The chronology shows that most major deregulatory moves took place in the late 1970s and early 1980s. The chronology also reveals that financial deregulation in some countries has been followed by either counter-reform or partial re-regulation. Nevertheless, the general pattern clearly indicates a trend towards financial liberalization.

Chapter 3

Issues and Problems Associated with Deregulation

I. Excess Liquidity and Interest Rate Rigidity

Deregulation in most of the developed countries depended on the specific circumstances in each country. In the United Kingdom and Canada, deregulation has been market driven. Japan's financial liberalization occurred because its former system (which was highly restrictive) no longer met the needs of economic growth. Similarly, deregulation occurred in New Zealand and Australia because the highly controlled financial system hindered economic growth. However, the deregulation in the United States can be attributed to unique circumstances and rationale — a large scale of financial disintermediation, the question of survival of the thrift institutions and the declining Federal Reserve membership issue. The review also showed that deregulation in these countries was undertaken in varying degrees and forms. The timing also varies to a greater extent.

The earlier experiences of some Latin American countries (for example, El Salvador) and SEACEN countries (Nepal), showed that even after deregulation of interest rates, the banks fixed rates by an understanding among themselves, and consequently the rates were practically constant, while the rate of inflation fluctuated markedly. In a financial environment, where there are a few financial institutions which are mostly state-owned and the tradition of granting substantial volume of credit at a preferential rate to the priority sector activities, the financial institutions, particularly the banks, might tend to preserve the old structure and the level of interest rates (rather with low deposit rates) even after deregulation. This rate might be sub-optimal in the wake of rising inflation and it may not indicate the relative scarcity of financial resources and of real investible resources. Some discretionary measures would still be required. The concept of direct control of lending rates on the priority sector remains valid (even though this type of portfolio regulations are generally inconsistent with the deregulation of interest rates), because it is a convenient vehicle for establishing concessionary rates to these sectors.

Another issue is whether the piecemeal deregulation can work without creating imbalances elsewhere. Further, if financial disintermediation is the main reason behind deregulation in most of these countries, the impact on non-bank financial intermediaries, as a result of re-intermediation of funds to the banking sector in turn has to be taken into consideration in view of the spirit or objectives under which they were established. In this case, some adjustment period is necessary.

Nevertheless, deregulation has also encouraged the emergence of more self-reliance financial institutions and greater competition in the banking system of the SEACEN countries. The effect was dramatic during the initial period of deregulation in some countries. Resource mobilization after deregulation was very encouraging. The impressive growth in the amount of bank deposits in Indonesia was achieved through high interest rates. The costly time deposits in turn are the primary rupiah fund source for bank lending. An average 42.0 per cent of these time deposits are for maturity of less than six months of any one time, making fund management difficult and forcing banks to operate on a wide margin having a 7.0 per cent spread between deposit and lending rates. The competition among banks and other deposit-taking institutions (Table 3.1) was intense. As a result, the cost of funds rose significantly due to the rise in deposit rates. The initial effects of deregulation of state banks' interest rates in Indonesia have been a narrowing of the differential between these rates and the unregulated rates prevailing at private banks, a substantial change in the term structure of state bank deposit rate, an increase in time and savings deposits of the banking system, and the shortening of the average maturity of these deposits. Given these changes, the cost of funds and lending rates of state banks have also increased sharply. For instance, nominal lending rates of state banks on non-priority (general) loans have risen from a range of 13.0-13.5 per cent prior pre-deregulation period to 18.0 per cent for term loan and 21.0-24.0 per cent for working capital, representing real lending rates of around 9.0-15.0 per cent. Real lending rates of private banks are even higher, ranging from 15.0-19.0 per cent per annum. An active interbank money market had

Table 3.1

COMPETITION FOR DEPOSITS IN THE SEACEN COUNTRIES: 1977-1986
(as a Percentage of Total Deposits)

Countries	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Indonesia [1]										
State Banks	90.6	83.9	80.0	74.3	67.2	61.5	66.1	61.0	62.3	65.9
Nat. Private Banks	4.7	8.7	12.0	14.6	19.3	23.1	22.8	27.1	29.2	27.9
Local Dev. Banks	0.5	1.0	1.1	1.3	1.6	2.0	1.6	1.7	1.7	1.9
Foreign Banks	4.2	6.4	7.0	9.9	12.0	13.4	9.5	10.3	6.8	4.2
Total:	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Malaysia										
Commercial Banks	80.7	80.2	80.5	79.4	77.7	77.3	74.9	71.8	70.5	70.3
Finance Companies	14.7	15.4	15.2	16.6	17.8	17.7	18.8	21.3	22.4	23.3
Merchant Banks	4.5	4.4	4.3	4.0	4.5	4.9	6.3	6.9	7.1	6.4
Total:	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Nepal										
Commercial Banks	97.7	98.1	98.6	98.9	99.2	99.3	99.4	99.5	98.8	98.2
Agric. Dev. Banks	2.3	1.9	1.4	1.1	0.8	0.7	0.6	0.5	1.2	1.8
Total:	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Philippines										
Commercial Banks	78.8	79.4	79.8	80.3	79.1	79.9	82.9	88.3	85.3	82.9
Thrift Banks	7.6	8.3	8.9	8.7	7.2	8.0	8.0	4.6	6.3	7.8
Special. Govt. Banks	10.4	9.3	8.5	8.7	11.2	9.5	6.5	4.8	6.5	6.9
Rural Banks	3.0	2.9	2.7	2.3	2.4	2.6	2.6	2.2	1.9	2.3
Non-Stock Savings & Loan Associations	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total:	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Sri Lanka										
Commercial Banks	56.7	54.3	67.0	53.7	48.2	46.1	44.0	46.4	46.7	n/a
Finance Companies	1.5	1.2	8.0	1.3	1.3	1.7	1.9	3.1	4.0	n/a
Other Deposit-Taking Institution	41.8	44.5	25.0	45.0	50.5	52.2	54.1	50.5	49.3	n/a
Total:	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	n/a
Thailand										
Commercial Banks	76.2	74.4	74.5	75.2	74.6	75.3	77.5	80.0	78.8	79.4
Fin. & Securities Cos.	13.4	16.4	15.4	15.2	16.3	16.3	14.0	11.1	11.4	10.6
BAAC [2]	1.1	1.0	0.9	0.8	0.9	0.8	0.9	0.7	0.7	0.8
Govt. Savings Bank	8.8	7.8	8.7	8.3	7.7	7.2	7.2	7.1	7.8	8.0
Other Deposit-Taking Institution [3]	0.5	0.4	0.4	0.6	0.5	0.4	0.5	1.0	1.3	1.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. Refers to time and savings deposits only.
2. Refers to Bank for Agriculture and Agricultural Cooperatives.
3.Refers to Government Housing Bank and Industrial Finance Corporation of Thailand.

Source: Annual Reports and Bulletins of the SEACEN Member Central Banks, various issues.

also emerged. Further, the maturity structure of the time deposits revealed the concentration of deposits in long-term maturities (Table 3.2). The competition for funds remained keen, particularly in the mobilization of fixed deposits of 12-month or over 12-month maturities where rates remained fully negotiable but savings mobilized by thrift institutions continued to decline.

The deregulatory moves were expected to enhance competition among banks which may eventually lead to lower interest rates. After financial deregulation, the nominal interest rates on deposits at state-owned banks in Indonesia increased considerably. It jumped to the level of 15.0 to 16.0 per cent and the real interest rates at private banks have also increased considerably in the period after deregulation. The gross interest margins of the commercial banks and other deposit-taking institutions have tended to be too high against the very spirit of deregulatory moves undertaken in 1978 and 1979 in Malaysia. In Malaysia, the objective of interest rate policy was to encourage lower cost of funds for investment. Though deposit rates declined markedly throughout 1980s and remained at low levels in 1987 and 1988, the average lending rates remained comparatively high. The margin between the average lending rates and average deposit rates continued to be about 6.0 percentage points for commercial banks in Malaysia. Contrary to what was expected from interest rate deregulation, the deposit and lending rates only inched up a little in 1987 and 1982 in the Philippines. The interest rate structure after deregulation in Nepal too, does not give an optimistic picture of the effects of interest rate deregulation undertaken in 1986. Due to market imperfections, the financial institutions, particularly joint-venture foreign banks, were successful to some extent in increasing the interest rates spread between loans and deposit rates with rather low deposit rates. The banks' margins in most countries in the SEACEN region are also too high (Table 3.3).

The earlier experiences of some Latin American countries also suggested that in a situation of market imperfection, complete deregulation might not be feasible. Another issue associated with deregulation in Malaysia is the reluctance on the part of banks to lend as well as of customers to borrow. Part of the reason is that interest rates, although low in nominal terms remain high in real terms. The banks' margins, for instance in Malaysia, are increasing gradually, and interest rates continued to remain sticky. The loan-deposit ratios also did not improve in the latter period of deregulation. The outstanding issue in Thailand, for instance, still centered

Table 3.2

MATURITY STRUCTURE OF FIXED DEPOSITS IN SELECTED SEACEN COUNTRIES: 1977-1986

(as a Percentage of Total Fixed Deposits)

Countries	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Indonesia										
Less than 1 year	22.8	23.5	26.3	35.3	37.1	37.7	53.6	51.0	47.7	42.7
1 year	9.2	10.4	10.0	10.0	13.2	14.6	28.5	39.1	44.2	49.7
More than 1 year	68.0	66.1	63.7	54.7	49.8	47.7	17.9	9.9	8.2	7.6
Malaysia										
Less than 1 year	23.0	24.1	22.7	32.4	57.6	50.8	48.1	52.9	50.4	36.8
1 year	64.4	56.6	53.4	43.1	27.4	32.3	28.2	21.8	18.9	8.1
More than 1 year	12.6	19.3	23.9	24.5	15.0	16.8	23.8	25.3	30.6	55.1
Nepal [1]										
Less than 1 year	3.5	7.3	2.0	2.9	3.1	2.1	2.5	1.6	2.6	1.7
1 year	25.6	25.0	21.0	18.8	18.2	18.6	18.2	19.0	17.5	17.2
More than 1 year	70.9	67.7	77.0	78.2	78.7	79.2	79.3	79.5	79.9	81.2

1.Refers to commercial banks only.

Source: Annual Reports and Bulletins of the SEACEN Member Central Banks, various issues.

Table 3.3

AVERAGE LENDING RATES AND MARGIN IN SELECTED SEACEN COUNTRIES: 1977-1987

(in Percentages)

Countries	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Malaysia											
Lending Rate	7.92	7.50	7.50	7.75	8.50	8.79	11.08	11.35	11.54	10.80	8.19
Margin	2.71	2.37	2.00	1.52	-1.17	-0.96	3.06	1.81	2.73	3.63	...
Nepal											
Lending Rate	14.00	14.00	14.00	14.00	14.00	15.50	17.00	17.00	17.00	15.67	15.00
Margin	10.00	10.00	10.00	10.00	10.00	11.21	12.50	12.50	12.50	8.50	6.50
Philippines											
Lending Rate	12.00	12.00	14.00	14.00	15.34	18.12	19.24	28.20	28.61	17.53	13.34
Margin	3.50	3.50	5.33	1.75	1.62	4.38	5.66	7.02	9.70	6.28	5.14
Sri Lanka											
Lending Rate	...	18.00	18.00	19.00	19.00	17.75	13.25	13.15	13.40	11.57	9.80
Margin	...	9.50	9.50	4.50	1.12	0.25	-5.00	-6.64	-3.93	-0.64	-1.70
Thailand											
Lending Rate	15.00	15.00	15.00	18.00	19.00	19.00	17.63	18.75	19.00	...	...
Margin	7.00	7.00	6.75	6.00	6.50	6.00	4.63	5.75	6.00	...	...

... Indicates a lack of statistical data that can be reported.

Note: The lending rates are related to short- and medium-term financing needs of the private sector and are normally differentiated according to credit worthiness of borrowers and objectives of financing.

Source: IMF, International Financial Statistics, Yearbook 1988.

on interest rates. The loan-deposit ratio of commercial banks also decreased gradually after deregulation in some of the countries in the SEACEN region (Table 3.4). The financial institutions were slow in adapting to the flexible interest rate policy stance; this prevented the market forces from immediately exerting their full impact on interest rates as experienced by the downward rigidities of deposit and loan rates and a large spread between interest on deposits and credits at an early stage of market-oriented interest rate policy. The interest rate adjustments have been asymmetrical. The other reasons for the slow downward adjustment of interest rate structure is the substantial overhang of high cost of funds because of the competition for funds being most evident in fixed deposits with maturity, exceeding one year and in negotiable certificates of deposits (NCDs). For instance, one of the biggest obstacles to lower interest rates in Malaysia can be attributed to the failure to treat uniformly the interest earned on bank deposits of varying maturity.

The other issue associated with deregulation, which is emerging in some of the SEACEN countries, is the persistent situation of excess liquidity prevailing in the banking system. For instance, before deregulation of 1983, Bank Indonesia used to provide "liquidity credits" to deposit money banks to fund loans to development projects undertaken by government agencies and government-owned corporations and to refinance the general credit operations of deposit-money banks. Following the June 1983 reform, there was further build-up of surplus funds in the banking system in excess of reserve requirements. This is because the large growth in deposits following the reform was not initially matched by a similar increase in demand for credit arising from considerable uncertainties on the variable loan rates. In addition, the increased share of time deposits in total deposits reduced the growth in required reserves, because time deposits are subject to lower reserve requirements.

On the contrary, the tight liquidity condition which prevailed in the banking system just after the deregulation for the greater part of 1980 in Malaysia had led to increased competition among financial institutions for private sector deposits. There was a significant downward adjustment in statutory and liquidity requirements for the commercial banks in 1985 and 1986. Despite the downward adjustment in statutory and liquidity requirements for the commercial banks, there was no improvement in the sticky nature of lending rates leading to a decline in the loan deposit ratio. The tight liquidity situation which prevailed in the banking system in the early years of deregulation period stemmed mainly from the more

Table 3.4

LOAN-DEPOSIT RATIOS OF COMMERCIAL BANKS IN THE SEACEN COUNTRIES: 1977-1987

(in Percentages)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Indonesia	94.8	99.0	83.8	74.6	82.9	98.3	88.3	94.7	85.3	91.2	n/a
Malaysia [1]	78.2	83.6	80.4	90.2	90.8	89.8	91.0	92.7	96.0	95.5	90.6
Nepal	53.7	68.1	74.9	79.7	86.0	63.6	53.6	49.7	52.9	57.9	n/a
Philippines	108.0	124.0	142.0	134.0	129.0	119.0	120.0	118.0	81.0	60.0	n/a
Sri Lanka	93.4	99.8	96.8	98.3	98.9	92.0	92.4	89.7	87.0	89.7	n/a
Thailand	92.9	100.1	111.1	100.8	97.8	92.4	98.7	94.8	93.1	86.2	86.4

1.The loan-deposit ratio from 1983 onwards as stated in the Annual Reports, however, showed a low loan-deposit figure compared to figures derived from Quarterly Bulletins.

Source: Annual Reports and Bulletins of the SEACEN Member Central Banks, various issues.

rapid expansion in credit relative to growth in deposits. But the consecutive reduction of liquidity ratios and statutory reserve requirements has again enhanced the build-up of liquidity. The excess liquidity situation, which again emerged during 1987, forced the central bank to issue more treasury bills. In other words, the financial system was flushed with funds, with overnight interbank rate stuck at around 0.5 per cent. The excess liquidity situation also emerged during the first half of 1989. The central bank has to direct the commercial banks, finance companies and merchant banks to increase their statutory reserve requirements to mop up excess liquidity from the financial system. New problems, therefore, emerged as a result of a series of deregulatory moves.

However, excess liquidity situation could not be totally attributed to deregulation. It might be the result of a number of other factors that were in operation during the same deregulation period. For instance, in the Philippines, the excess liquidity was caused mainly by the liquidity overhang resulting from the moratorium on the payment of maturing foreign debts.

The situation after the deregulation of interest rates in the Philippines in 1983 continued to call for tight credit because the scheme was also one of the causes of excess liquidity. Sri Lanka was facing excess liquidity problem from the beginning of 1972. The commercial banks experienced an excess liquidity position in 1984 and 1985. The excess liquidity during certain years can also be attributed to the heavy borrowings of the Government from the banking system and favourable export prices. The inability of banks to lend to non-priority sectors because of the credit ceilings is also one of the causes of excess liquidity. The excess liquidity situation was reflected in the reduced level of transactions and a drop in interest rates in the interbank call money market in some of the SEACEN countries. Therefore, various steps have to be taken to mop up the excess liquidity in these countries which is contrary to the very spirit of deregulation moves.

In Sri Lanka and Nepal, the regulatory policy instruments, particularly the imposition of credit ceilings, became the basic tool in curtailing excess liquidity and (undue) expansion of credit. The persistent over liquidity of the financial systems is also evidenced in Thailand. Funds have been flooding into Thailand because of exports, tourists boom and substantial overseas borrowings by local investors. Banks assets have grown from some 25.0 per cent of GDP in the mid-1970s to just under 80 per cent in 1987. But that rise has not been matched by growth in domestic instruments. The excess liquidity of the financial system and an increase in competition meant that business remained tough and profits low. The repercussion led to several banks violating the deposit rate cartel (set up by the Thai Banker's Association) by offering higher rates. This intense competition also adversely affected many of the smaller, struggling banks. The competitive pressures are, therefore, forcing banks to move, albeit slowly, into new areas of business.

Further, the review of the various circumstances that led some of the developed countries towards deregulatory path showed that deregulation depended on the specific circumstances and competitive market forces. Deregulation in these countries generally included relaxation or elimination of interest rate ceilings and product line restrictions. In other words, specific circumstances and the failure of most controls imposed on banking and fierce competition among the financial institutions were the major causes for deregulation. The important aspect in the deregulation process in these countries revealed that the market was very competitive and indicative too. Each time regulatory forces disrupted the functioning of the financial system, financial market was perfectly indicative, thus facilitating the timely deregulatory moves. Similarly, each time deregulation occurred, competitive financial markets worked as an indicator, because in most of these countries the element of competitiveness prevails. But in a number of developing countries, such type of competitive financial markets may not exist and complete deregulation may not be possible unless certain conditions are fulfilled. Therefore, it is worthwhile to analyze some of the basic conditions which are necessary for complete deregulation, particularly the deregulation of interest rates.

II. Conditions for Deregulation

It is generally argued that competition in financial markets would substantially increase if regulations and legal restrictions that distinguish the arbitrary differences between types of institutions were eliminated and all the financial institutions were permitted to offer a wider range of services. But if the financial structure is not well developed so as to enhance this competitive financial environment, complete deregulation may not be possible.

One of the major aspects of deregulation in this regard is the deregulation of interest rate ceilings imposed on loans and deposits. The argument in favour of regulation is to ensure that the stabilization policy is transmitted to the economy at large. Although interest rate is one of the major tools of financial pricing policy, most of the developing countries use to keep rates below the market clearing level. In this context, it is argued that a system which regulates interest rates would lead to distortions in the financial system and would not promote economic growth because it leads to negative real rates, which work against mobilization of domestic savings. Thus, the rationale of deregulation too emerges from the fact that interest rate deregulation can further stabilize the financial markets through which the stabilization policy is transmitted to the economy. But in a number of developing countries, the conditions for complete deregulation may not exist. The prevailing market may not be in a position to indicate or establish an appropriate interest rate, which can work as a reliable indicator to signal the relative scarcity of financial resources and real investible resources. Looking at the various circumstances that were responsible for deregulation in some of the developed countries, one can see that whenever any aspect of financial regulation was creating an undesirable effect, the market gave the signal to rectify it. But in the absence of competitive financial markets, the impact of deregulation may not be as effective.

The earlier experiences of some Latin American countries suggest that in a highly concentrated and protected financial system, the complete deregulation of interest rates may be tantamount to allowing the financial institutions to exploit the public by effectively increasing the spread between assets and liabilities rates, while reducing the volume of financial operations and services to a sub-optimal level.

The experiences of these countries also confirmed the view that a financial system, which is concentrated and protected from foreign competition, may not establish an efficient market rate. Even if they are given full freedom to fix the interest rates by the central bank throughout the 1967-1976 period, the banks fixed rates by an understanding among themselves and, as a result of this, rates were practically constant, whereas the rates fluctuated very rapidly. Therefore, the impact of deregulation of interest rates was not effective at all. Further, it would make little sense to deregulate interest rates in a largely or partially state-owned or state-controlled financial system with a few banks and a few non-bank financial institutions, and having a tradition of granting substantial volume of credit at preferential interest rates to the priority sector activities. "In a situation where market competition is weak or virtually absent, a much more reasonable policy would be to establish floor deposit rates instead of ceiling rates on either the assets and liabilities of financial institutions".[13]

This floor deposit rates policy was recently adopted in one of the member countries in the SEACEN region too. With effect from 29 May 1986, the commercial banks and the financial institutions in Nepal were given the authority to fix interest rates at their own discretion at any level above the minimum prescribed levels. Accordingly, banks and financial institutions were allowed to fix their annual interest rates on deposits anywhere above 8.5 per cent on saving deposits. However, the interest rate structure does not give an optimistic picture of the effects of such interest rate deregulation.

It seems that the banks in Nepal fixed rates by themselves, with an understanding among themselves to preserve the old structure and level of interest rates. Due to market imperfections, these financial institutions, particularly joint-venture foreign banks, were successful to some extent in increasing the interest rates spread between loan and deposit rates with rather low deposit rates. It was earlier suggested that in a situation like this, complete deregulation might not be feasible. Therefore, in order to allow the interest rates to be determined by the free market forces in the process of complete deregulation, it assumes the existence of a competitive and unfettered financial system comprising the following aspects:

- Large size of the financial market, which can provide a reasonable chance for effective market competition;

- Favourable economies of scale in banking; and,

- Absence of traditional policies of protecting domestic banks from foreign competition, non-regulating of specialized financial intermediaries and no barriers to entry.

"In the absence of these conditions, complete deregulation of interest rates could potentially destabilize financial markets, increase the power of oligopolistic financial firms to exploit market imperfections by increasing the interest spread between loan and deposit rates, and simply perpetuate the existence of a financial environment with rather low deposit rates of interest".[14]

13. Vicente Galbis, "Interest Rate Management: The Latin America Experience", *Savings and Development (FINAFRICA), Quarterly Review,* no. 1, 1981, p. 7.

14. Vicente Galbis, "Interest Rate Management: The Latin America Experience", *Savings and Development (FINAFRICA),* Quarterly Review, no. 1, 1981, pp. 5-44

Similarly, intervention by the central bank amidst deregulation of interest rates was apparent in Malaysia. With its average lending rates of the commercial banks and finance companies declining less rapidly than the decline in the average cost of deposits, the gross interest margin of the commercial banks and finance companies widened to 6.10 per cent and 6.87 per cent, respectively, as of end-1987. As the market could not adjust and narrow the widening spread, the central bank had to introduce a series of measures to bring about a narrowing of the margin between deposit and lending rates during the year 1987. These included guidelines to the commercial banks (effective from 1 September 1987) and the finance companies (effective from 1 October 1987) stipulating the maximum margins between their lending rates and the base lending rate (BLR), including a ceiling on the penalty rate for delinquent loans. The interest rate on deposits is completely deregulated by unpegging the interest rates on deposits of 12-months or less maturities to the rate quoted by the two lead banks (effective from 1 February 1987), in order to allow greater flexibility and efficiency in the determination of interest rates. However, the central bank has to issue guidelines to the commercial banks to adjust the margin of their lending rate to not more than 4.0 percentage points above their BLR. In addition, the penalty rate was reduced to a maximum of 1.0 percentage point. Therefore, as the market was not sufficient enough to adjust or stop the assignment behaviour of the interest rate, regulatory intervention was inevitable.

In Thailand too, government intervention remained an important feature of the financial markets, and imposition of interest rate ceilings was one of the important aspects of the flexible interest rate policy. Although in principal, the movement of interest rates should be determined by market mechanism and not as a result of intervention from the authorities, the movement practically depended upon the readiness of both the public and financial institutions to accept a fully flexible interest rate system. Therefore, liquidity conditions in the financial system and the differential between foreign and domestic interest rates are the two decisive factors for a fully flexible interest rate system in Thailand. Although deregulation calls for the freeing of interest rate ceilings as a means to fully mobilize domestic financial resources and also rationalize their users, the experience of Thailand, in this regard, has been a gradual liberalization of interest rate structure. The present situation clearly indicates that the financial system is not yet flexible in adjusting interest rates. The rigidity in interest rates is clearly apparent and the banks enjoy a large spread between interest rates on deposits and credits. Therefore, the possibility of complete deregulation may not be feasible in view of the rigidities in interest rate movement, particularly in deposit rates. Although the authorities have been conducting its domestic interest rate policy more flexibly since the end of the 1970s, the financial institutions have been very slow in adapting themselves to work within the new flexible interest rate framework. Further, during periods of high liquidity in the financial system, the central bank is forced to adapt low interest rate policy in order to be in line with the interest rate trends in both domestic and foriegn markets. Further, lending to priority sectors is considered risky and commercial banks are generally reluctant to extend credit to these sectors. Therefore, to stimulate the growth of priority sectors, funds allocated to these sectors should not be sub-optimal, which might emerge if market mechanism were allowed to operate fully.

Therefore, if the financial structure is not well-developed and not flexible enough in adjusting interest rates (accompanied by excess liquidity and declining loan-deposit ratio) so as to enhance this competitive financial environment, complete interest rate deregulation may not be possible and the monetary authority would have to intervene to assist the market in determining the appropriate interest rate.

III. Deregulation and Profitablity of Banks

An important issue in examining the potential short- and long-term consequences of the deregulatory moves is the effect on bank profitability. In the absence of relevant and comparative data, in the case of the SEACEN countries, some logical reasonings put forward by some authors have been analyzed in this respect.

There are sharp differences of opinions regarding the effects of deregulation and related changes on bank profitability. It is usually expected that the greater competition that accompanies deregulation would, on average, reduce sharply the operating profitability of commercial banks. The reduction in profitability, at least in the real terms, would be principally due to the increased cost of funds as, with the elimination of ceilings, banks are forced to pay market rates of interest for their funds.

While the effects of rising costs of funds would extend to all banking organizations, it was argued that it would be most pronounced for the smaller banks as a greater share of their deposits are paid below market rates. As an example of the potential effects of deposit rate deregulation of the profitability of smaller banks, a recent study for the Texas Bankers Association of Community Banks proposed a very substantial decline in income, with many community banks becoming unprofitable. [15]

In contrast to the view that removing deposit rate ceilings and other aspects of deregulation will sharply reduce bank profits, it was argued that bank management will learn to cope with these changes in the environment just as they have with other changes in recent years. Banks may seek to offset the rising cost of funds by reducing the number of branches, curtailing operating hours and vigorously pricing their services on a full cost basis for each service. While it is difficult to know how much of the increase in explicit interest rates could be offset by a reduction in implicit interest, Flannery has estimated that a figure of 45.0 per cent of the increase in explicit interest rate could be offset by a reduction in implicit interest. [16]

Moreover, the ability of banking organizations to pay market rates for their deposits should allow them to grow more quickly so that the profits resulting from more rapid growth may partially or toally offset the shrinkage in margin caused by the rising cost of bank funds.

Additional evidence on the potential effects on bank profits of deregulation is provided by examining the time series of bank accounting profits during the 1970s and early 1980s, a period during which a substantial volume of bank deposits shifted from below-market to market-rate levels. For example, it has been estimated that the percentage of liabilities of commercial banks paying regulated interest rates increased from 1.0 per cent in 1965 to 37.0 per cent in 1979 and 50.0 per cent in 1981. Even banks with total assets of $100 million or less were estimated to have almost 40.0 per cent of their liabilities paying market rates by June 1981. Yet, as Flannery pointed out, despite the growth of liabilities not subject to deposit rate ceilings, commercial banks have been able to maintain their return on assets quite well.

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15. Management Analysts Centre, Inc., The Impact of Deregulation on Small- and Medium-Sized Texas Banks: A Report Prepared for the Texan Bankers Association, Austin, Texas, 1983.

16 Mark Flannery, "Removing Deposit Rate Ceilings: How Will Bank Profits Fare?", Federal Reserve Bank of Philadelphia, *Business Review*, March/April 1983, pp. 13-27.

In some SEACEN countries, the widening of the interest margins has helped to some extent to maintain the profitability of the banks, despite the growing overhead costs. The impact of deregulatory moves on bank profitability in Indonesia showed that the operating profits of the different groups of banks (except for foreign banks) were lower during the post-deregulation period (Table 3.6). When operating profits in real terms are considered only private and foreign banks showed increased profits in 1983 as compared to the pre-deregulation period of 1982. Higher funding cost was probably the reason for this pattern. In some countries, the average lending rate was much slower in responding to the rapid decline in deposit rates. For instance, in Malaysia, the result was a widening of the interest rate margins to the range of 5.0 to 6.0 percentage points in the late 1980s. The profits of the banking system after the first phase of deregulatory moves in Malaysia was, therefore, maintained at the lower level as seen from the income of commercial banks per employee in 1982 and 1983. It was maintained at a higher level during 1984 and 1985 when the deposit rates were brought down rapidly (Table 3.5). The low interest rates appeared to have favoured foreign banks, which can also borrow cheap funds from the interbank market. Low interest rates had not really favoured the local banks and most of the banks are not pushing loans in an atmosphere of low demand for loans. For instance, deposit rates in Malaysia have pummelled to 3.0 or 4.0 per cent level with the overnight interbank market rate at 0.5 per cent and, on an average, they are charging their customers anything from 12.0 to 13.0 per cent upwards. Therefore, it was the huge spread that was sustaining, the profitability of commercial banks in the SEACEN countries although at lower levels. The benefit of the high interest margin is being utilized to maintain the high staff costs and overheads and the rising costs of provisions for bad and doubtful debts in the SEACEN countries. In other words, despite the rising interest margins, the banking community in the SEACEN countries was not able to generate profits expected from such margins (Table 3.6). Therefore, even if the commercial banks are paying market rates for deposits, it may reduce the margin, but still can adjust to the deregulation of interest rate ceilings on deposits by reducing their overhead costs. Therefore, the fundamental issue is not the deregulation of interest rates but the question of imprudent management of the banking systems.

In this respect, on a more comprehensive analysis of the effects of interest rate deregulation on bank profits, Kolari and Fraser examined the reforms on assets and equity for a sample of over 1,000

Table 3.5

INCOME OF COMMERCIAL BANKS PER EMPLOYEE IN MALAYSIA: 1980-1986

	1980	1981	1982	1983	1984	1985	1986
Assets/employee (M$m)							
Domestic banks	1.73	1.89	1.94	1.88	1.90	2.01	1.98
Foreign banks	1.35	1.45	1.54	1.72	1.82	1.95	2.04
All banks	1.59	1.74	1.82	1.83	1.88	2.00	2.00
Staff cost/employee (M$ '000)							
Domestic banks	14.20	16.20	16.64	17.60	17.97	20.59	20.90
Foreign banks	15.60	18.50	21.13	20.98	21.57	23.42	24.72
All banks	14.70	16.90	18.01	18.55	18.92	21.32	21.85
Income/employee (M$ '000)[1]							
Domestic banks	16.50	17.00	184.76	174.15	182.69	191.65	184.17
Foreign banks	25.90	28.10	181.12	184.51	204.88	222.44	229.28
All banks	20.10	20.80	183.65	177.06	188.56	199.60	195.45

[1] Refers to net profits/employee (M$'000) for the years 1980 and 1981.

Source: Bank Negara Malaysia, Annual Report, various issues.

Table 3.6

PROFITS BEFORE TAX AND OVERHEAD COSTS OF COMMERCIAL BANKS IN SELECTED SEACEN COUNTRIES
(in Million U.S. Dollars)

Countries	1975	1980	1981	1982	1983	1984	1985
Indonesia							
Profits Before Tax (P)	n/a	404.6	546.4	645.1	501.1	575.3	486.6
Overhead Costs (OC)	n/a	464.9	627.9	955.2	810.0	850.7	849.3
P as a % of OC	n/a	87.0	87.0	67.5	61.9	67.6	57.3
Nepal							
Profits Before Tax (P)	n/a	2.5	2.5	3.8	2.1	1.9	n/a
Overhead Costs (OC)	n/a	8.6	9.1	11.5	10.6	11.6	n/a
P as a % of OC	n/a	29.1	27.5	33.0	19.8	16.4	n/a
Philippines							
Profits Before Tax (P)	146.1	213.4	209.9	198.7	208.8	81.6	-234.5
Overhead Costs (OC)	506.0	1697.7	2385.1	2662.8	2390.2	2235.6	2170.1
P as a % of OC	28.9	12.6	8.8	7.5	8.7	3.7	-10.8
Sri Lanka							
Profits Before Tax (P)	16.4	53.6	42.2	36.8	38.4	22.4	17.3
Overhead Costs (OC)	20.8	46.1	56.1	67.3	77.2	84.8	94.0
P as a % of OC	78.8	116.3	75.2	54.7	49.7	26.4	18.4

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Member Central Banks, 1987.

banks over the period from 1964 to 1982. [17] They found no evidence that either small or large banks were unable to adjust to the gradual deregulation of interest rate ceilings on deposits. Even in the period from 1978 to 1982, during which interest rate deregulation occurred at a more rapid rate and during which interest rate volatility was great, banks were able to maintain their profitability, measured either in terms of return on assets or return on equity. In fact, smaller banks which might be most affected by the deposit rate deregulation, maintained higher return on asset ratios than larger banks throughout the entire period being studied.

The argument that deposit rate deregulation will substantially reduce the profitability of small banks is based on the premise that deregulation will increase the cost of funds of small banks to such an extent that neither portfolio adjustments nor the streamlining of bank services will be able to offset the effects on banks profits. it also depends on the extent in which the ceiling rate has been effective in reducing the cost of deposits.

Similarly, two studies of Wall [18] revealed that interest rate deregulation has narrowed interest rate margins but has not affected banks profitability in general. Whereas in the SEACEN countries, deregulation has widened the interest rate margins with low deposit rates and sticky and rigid high lending rates. Therefore, recent changes in the banking environment have not altered the importance of key factors that affect banks' profitability. Those key factors that received most attention are asset composition, liability composition and expense control. By consensus opinion, numerous studies have concluded the 'expense control aspect' to be the most important factor. Those banks that economize on expenses, earn higher profits and changes in the mix of assets and liabilities, did not contribute much to improving profitability in the event of deregulatory moves.

Nevertheless, most of the commercial banks in the SEACEN countries have traditionally been deposit driven as clearly indicated by the sources and uses of funds in these countries. That is, prior to deposit rate regulation, the major problem was to acquire a sufficient share of local deposit base to maintain a reasonable level of credit flow. The new interest rate environment has changed the scenario, pushing the banks closer to a loan-driven strategy. Despite the fact that deposits may be charges make it more difficult to find

17. Fraser, Donald R. and James W. Kolari, Size and Financial Performance in Banking: A Report. Washington, D.C.: Small Business Administration.
18. Wall, Larry D., "Commercial Bank Profits: South-eastern Banks Farewell", Federal Reserve Bank of Atlanta, *Economic Review*, vol. 69, June 1984, pp. 18-29.

profitable outlets for the purchased funds. Without high quality credits with good earnings potential, competitive deposit rates and services cannot be maintained. Therefore, it is not the deregulation of deposit interest rate ceilings that is affecting the profitability of the banking institution but the widespread, high and sticky lending rates, and increasing provisions for bad and doubtful debts that is affecting the profitability of banks in the SEACEN countries. However, these are only preliminary conclusions. A better understanding of the impact of deregulation on bank profitability in the SEACEN countries is not possible as data availability is scarce and insufficient to make an inference..

IV. Problem of Inconsistency of Selective Credit Policy with Deregulation

There still exists a tradition of granting a substantial volume of credit at preferential interest rates in almost all the countries in the SEACEN region. The fast growing developing countries have placed themselves at the centre of economic stage by controlling the financial system. [19] The countries have allocated savings to those priority sectors earmarked for growth according to coordinated investment plans. In this respect, selective credit policies channel credit to priority sectors, groups and regions of the country at subsidized rates of interest. The objectives are to stimulate investment in priority activities and in many cases, to redistribute income and wealth. The typical selective credit technique utilized in most of the countries in the SEACEN region is differential discount rates and quota systems of loan portfolio. Financial institutions are compensated for lending at subsidized rates of interest to priority borrowers by rediscounting priority loans at the central bank on concessionary terms. All or most of the credit for priority sectors are actually provided by the central bank under this system.

Further, some countries in the SEACEN region also use special financial institutions for implementing its selective credit policy. In a majority of the countries in the SEACEN region, these institutions are established to meet the particular credit needs of specific sectors or groups as perceived by the government.

This type of portfolio regulation is generally inconsistent with the deregulation of interest rates. The elimination of interest rate controls and the reduction of liquidity credits effective 1 June 1983 in

19. "Now for the Next Miracle ...... Finance in the Far EAST: A Survey", The Economist, 13 November 1982, p. 6.

Indonesia were aimed at encouraging competition and making the financial system more reliant on the market sentiment. However, the central bank in Indonesia still makes available discount facilities on a 'more restricted' basis and only credits with high priority could enjoy such facility.

The maximum interest rates to be charged by the commercial banks on loans to all priority sectors in Malaysia, for instance, have been pegged at 1.75 per cent above the average of the base lending rates (BLR) of the two leading domestic banks. This rate compares with a base plus 4.0 percentage points lending rates to the non-priority sectors. These lending rates, however, apply only to the free portion of a bank's lending portfolio. But a substantial portion of the portfolio is tied. Because of these restrictions, the banks in most of the SEACEN countries went full-steam ahead to lend to the property sector. Property loans in Malaysia, for instance, still account for almost 46.0 per cent of the total new bank credit and more than 30.0 per cent of loan outstanding. The overbuilding of the construction sector inevitably lead to a property slump and, hence, the rationale of providing concessionary interest rate is questionable. The indirect repercussions of this preferential treatment is reflected in the growing bad debt provisions and outstanding interest-in-suspense. This policy of preferential lending has, therefore, segmented the credit market into two; with lower interest rate in the market for priority sectors and the higher rates catering to the non-priority sector. This has created a situation of over-extension of credit to the non-priority sector (Table 3.7). On normal commercial criteria, the banks would not lend or would lend only at 'loaded' rates. For instance, during 1986, nearly 46.0 per cent of bank assets were lent to property companies or were property related as compared to 32.2 per cent in 1980. But in the wake of the sharp fall in share and property prices since 1985, the banking system has had to make substantial provisions for interest-in-suspense and bad and doubtful debts.

The policy of preferential lendings also led to market distortions. The government has been taking a lion's share of the total savings generated by the economy at cheap rates. In this respect, an extensive selective credit policy implemented through the rediscount mechanism is likely to be accompanied by high reserve requirements designed to restrict the commercial banks' own funds available for discretionary, non-priority lendings. Also, this method can and often does jeopardize control over the monetary base. The receivers of the priority loans, therefore, must be made more conscious

Table 3.7

SECTORWISE CLASSIFICATION OF COMMERCIAL BANKS LOANS: AVERAGE 1980-1987

(as a Percentage of Total Outstanding Loans)

	INDO 1	MSIA 2	NEPL 3	PHIL 4	SLNK 5	THAI 6
Agriculture	9.0	6.6	2.2	12.7	11.2	6.9
Mining & Quarrying	1.0	1.2	-	10.3	0.9	0.6
Manufacturing	37.4	19.0	17.1	30.8	17.3	21.9
Electricity	-	0.3	-	-	-	-
General Commerce	33.8[a]	20.1	51.1	15.9	49.6	40.3
Construction	7.0[b]	7.1	-	4.9	21.9	5.2
Real Estate & Housing	-	24.8	-	-	-	-
Transport, Storage & Communication	-	1.9	-	-	-	-
Private Individuals	27.9[c]	-	-	-	8.4	8.5
Financial Institutions	-	-	1.1	12.2	16.8	6.4
Miscellaneous	4.4	19.2	28.6	13.2	5.4	10.2

- Denotes category of sector excluded from total.

1. Since April 1984, includes direct credit from Bank Indonesia for food stock placed in commercial banks. Private individual includes private institutions and refers to service rendering industry.

2. Construction includes building. As from December 1980, general commerce bills have been classified according to group of borrowers and included in the data for the appropriate group.

3.Manufacturing refers to industrial sector only, general commerce includes services sector, while miscellaneous includes general use and social purposes.

4.Private individuals are treated separately. Miscellaneous also includes transport, storage and communication; and, electricity, gas and water sectors.

5. Mining and quarrying include loans for mining and fishing. Manufacturing includes loans to all industries except mining and fishing and construction. Private individuals include loans for housing and consumption.

6. Private individuals refer to personal consumption.

a. Refers to average figures of 1984-1987.

b. Refers to average figures of 1980-1983.

c. Refers to service rendering industry from 1984 onwards.

Source: SEACEN Economic Survey Questionnaire Replies, various years.

of how much they borrow and how to utilize these borrowings. With a view to break even on funding cost (or likely to be incurring losses) in the priority sector lendings, the banks are forced to push up the lending rates, to cross-subsidize the losses the banks are incurring in their own lendings. Therefore, despite the significant fall in the base lending rate (BLR) in Malaysia, the lending rates are still sticky downwards. Therefore, some of the SEACEN countries have to gradually adapt a policy of upward revision of interest rates on priority sector lendings. For instance, the pegging of maximum interest rates to be charged by the commercial banks in Malaysia above the average of BLR of two leading domestic banks, was intended to align the ceiling rates more closely to the cost of funds.

Similarly, the upward revision of interest rate on priority sectors credits in Nepal is also aimed at reducing refinancing and to discontinue direct interest subsidy. The reduction of liquidity credits and the restricted use of discount facilities in Indonesia also reflects a desire to push the priority sectors lending rates towards market level. Similarly, the rediscount facilities with preferential rates were rationalized in the Philippines with the application of a unitary interest rate on all rediscountable loan papers based on market rates. The maintenance of subsidized rediscount rates amidst a deregulated interest rate policy between 1983 and 1985 resulted in increased loan application such that greater selectivity in allocating the rediscount budget was resorted to. Sir Lanka also has introduced special credit schemes at concessionary rates of interest. Some inconsistencies have been prevailing regarding the coordination between selective credit policy and deregulation against the background of excess liquidity situation in Sri Lanka. The distinctive measures to counteract the excess liquidity situation were seen to be confined to non-priority sector only and certain concessions were granted to priority areas. This very policy of preferential treatment was one of the reasons for the low credit demand, which in turn aggravated the situation of excess liquidity.

Government intervention in the priority sectors remained a vital aspect in Thailand. The directed credit programmes accounted as much as a third of total credit extended by the banks plus a number of specialized lending institutions. However, the need to maintain domestically mobilized savings in the commercial banking system limited the amount of subsidization the authorities could impose. Therefore, in early 1984 and 1985, interest rates ceilings for credit extended to priority sectors are one-and-a-half or two percentage points lower than that for non-priority sectors. However, the differential ceilings have been abolished since March 1986. The differential ceilings still exist in some countries in the SEACEN region. Nevertheless, bank credit should not be mistaken for charity in the name of priority sectors lendings. The banks should be allowed to develop their own strategy on how best to extend credits and financial services to priority economic sectors. Simply, meeting the numerical target of credit extension is no longer sufficient and it only brings inconsistencies between deregulation and selective credit policies. Nevertheless, in a financial environment where there are only a few financial institutions and are mostly state-owned, the tradition of granting a substantial volume of credits at a preferential rate to the priority sectors activities cannot be eliminated completely. The concept of direct control of lending rates for the priority sectors still remains valid (even though the type of portfolio regulations are generally inconsistent with the deregulations of interest rates), because it is a convenient vehicle for establishing concessionary rates to these sectors. Nevertheless, some of the countries in the SEACEN region are already aware of the problems of coordination between the policies of deregulation and priority sector lendings. The policy of maintaining higher interest rate ceilings on the priority sector lendings is directed towards maintaining the interest rates at a level, which can reflect market conditions and, thus, minimizing the chances of credits flowing to those who are unable and unwilling to repay. However, once the market becomes completely indicative, deregulation of the entire spectrum, therefore, is a must if the banking sector is to maintain its profitability in an environment of generally low demand.

In this regard, an important consideration for the direct control of lending rates in the priority sector is that it serves as a convenient vehicle for establishing concessionary rates for lending to sectors identified by the authorities as deserving special attention. Further, the direct control of lending rates has been expected to provide an easy mechanism for credit allocation by differentiating between priority and non- priority sectors, in which the first receives concessionary interest rates. It is thought that the concessionary rates combined with a refinancing facility are effective instruments to stimulate the supply and demand for priority sector credit.

However, if a system of concessionary rates is maintained, then these rates should be rationalized. In particular, it will be viewed as the differentiation in the basis of use of funds (working capital, fixed capital, etc.), and to replace it with a classification on the basis of maturity. The reason for abolishing the sectoral differentiation is that there is no quantitative evidence that rates of return in different industries differ, so that the differentiation of rates seems arbitrary.

Therefore, with respect to priority sector lending, two alternatives may be adopted. As a first best solution, it is useful to abolish concessionary lending rates altogether; while maintaining the quantitative requirement that at least certain percentage of credit is allocated to the priority sector. This alternative could be combined with or without a refinancing facility. The refinancing facility would merely function as a positive incentive, but strictly speaking, there is no need for it. As a second best solution, a margin between concessionary rates and a representative market rate may be established. In that case, the refinancing facility should compensate banks for the lost margin. The quantitative target could be maintained, provided that the banks have automatic access to refinancing, as is now normally the case. This alternative is less desirable because it: (i) involves the central bank in priority sector lending via the refinancing facility; (ii) there is a prior reason to subsidize priority sector activities; and, (iii) makes the availability of credit a more important bottleneck than the price of credit. A quantitative target is consistent with freedom of the banks to determine the proper lending rates and it serves as a constraint on the level of lending rates because banks have to meet these targets. Therefore, inconsistencies of selective credit policy with deregulation can be minimized, if a system of channelling fund out of the net profit of the relevant bank to the priority sector activities is being adopted. But refinancing facility from the central bank will be inconsistent with this policy.

V. Deregulation, Crisis of Confidence and Its Implications on Supervision

Financial deregulation is sweeping throughout the world's financial markets. Price restrictions, product restrictions and legal constraints, separating banks and other financial activities, are progressively being removed in favour of a new regime of competitive freedom. Yet, paradoxically, the process of liberalization is being accompanied by intensified regulatory and supervisory activities in order to protect investors against conflict of interest, abuses and excessive risk taking.

Although price and product deregulation would bring substantial increases in price and product offerings, there is some evidence to indicate that the diversification that accompanied product deregulation would be more limited. Entry on these areas depends upon risk and return consideration as well as the extent of bank activities. The expansion of commercial banks into investment banking, for instance, is less general than many have expected and this expansion is limited to a very few large banks. For instance, three commercial banks are granted new stockbroking licences in Malaysia. However, they are forbidden to engage in grey market trading in order to avoid the conflict of interest. Similarly, expanded commercial banks are allowed to conduct investment banking functions. But the expanded banking activities are allowed only to authorized banks provided the capital base is raised.

Therefore, all changes induced from deregulatory moves should not be presumed for the better simply because it is consistent with the general policy of 'deregulation' and with the belief in the benefits of 'increase competition'. There are good reasons that some activities of depository institutions should be regulated and supervised and should not be allowed to compete on an unrestricted basis. [20] Even in the developed financial system, there still remains a demarcation between commercial banking and investment banking. The Glass-Steagle Act provisions still prohibit commercial banks from underwriting and dealing in corporate bonds and equity securities and from investing in equities in the United States (U.S.). Similarly, underwriters are forbidden from offering depository services. These prohibitions are presently supported by reference to fears of banks controlling loans and equity sources of funds. Another frequently expressed fear concerns the possibility of banks abusing their fiduciary responsibilities.

The recent increase in the number of failures of the commercial institutions in developed as well as in the SEACEN region has renewed interest in the fragility of institutions in the financial sector of the countries in the region. Any financial failure is an evil to be avoided — a flaw, as it was, in the regulation or deregulation of the financial system. The history of the U.S. financial system provides ample evidence of associations between financial panics, bank failures and recession. The association, however, did not show that bank failures caused recession. Further, there are many examples of bank failures that did not culminate in panic or financial crisis. U.S. and British monetary history provides a record of intermittent fi-

20. Musa, Michael, "Competition, Efficiency and Failures in the Financial Services Industry" in *Deregulating Financial Services: Public Policy in Flux*, edited by George G. Kaufman and Roger C. Kormendi. Cambridge, Mass.: Balinger, 1986, pp. 121-144.

nancial failures that has been studied many times. Further, regulations too have not always acted effectively to prevent bank crisis and tended to confuse individual bank failure with the failure of the banking system. There are many examples of bank failures that were not followed by financial panic and the occurrence of financial panic always involved a failure by the central bank to discharge its duty as lender of last resort to the financial system. [21] It may be recalled that four thousand banks had collapsed in 1933, the year before the Federal Deposit Insurance Corporation was created in the United States. Recent efforts by regulations to save the insolvent or ailing banks suggest that a strong policy measure is needed to distinguish between the risk of an individual financial institution failing and aggregate financial risk. At times, regulators in most of the countries acted promptly and effectively, but there is no evidence of a policy — a reliable set of procedures based on established principles for dealing with financial failures. The fundamental issue is whether insolvent financial institutions should be sold at the market price or liquidated and whether failure should be regarded as a form of market discipline. Although the Continental Illinois experience suggests a failure by the regulatory authorities in the United States, to agree on a banking policy, the market discipline policy cannot be adopted in most of the countries in the SEACEN region. The central bank has to prevent insolvency rather than preventing only financial panics. This is due to the various social objectives that have to be fulfilled by the banks in the SEACEN region.

Therefore, a series of bank restructuring measures had to be introduced in the Malaysian financial system in the early 1980s because the crisis of confidence had triggered several small runs on banks and finance companies. Although financial institutions should be controlled by the market discipline, without much regulations by the central bank, the social obligation of the banking institutions towards the community cannot be ignored in the SEACEN countries. For instance, beginning with the capital adequacy requirements of 1982, a new provision and amendments to the banking legislation during the period 1984-1986 had to be introduced. It focused on a wide range of matters involving amongst others, the role of the central bank in bank rescues and rehabilitation, bank equity ownership and distribution, credit to single customers, suspension of interest on non- performing loans, and making it a crimi-

21. Schwartz, Anna J., 1985, "Real and Pseudo Financial Crisis" in *Financial Crisis and the World Banking System*, edited by F. Capie and G. Wood. London: Macmillan, 1985.

nal offence to exceed lending limits for bank officers.

The promulgation of the Essential (Protection of Depositors) Regulation 1986, and the ensuing need to 'freeze' 24 deposit-taking cooperatives (DTCs) broadened the central bank's responsibilities to cover fringe deposit-taking institutions. The central bank had to freeze 24 ailing DTCs which had together a huge amount of money through mismanagement or fraud. Further, the central bank was forced to acquire controlling interests in two commercial banks where mismanagement has caused enormous loan losses. The amendment to Section 3a(1) of the Finance Companies Act 1969, which came into force on 1 January 1987, is a further move towards regulation. Therefore, although deregulation is gradually taking momentum in some countries in the SEACEN region, the process of liberalization is also accompanied by intensified re-regulation. The role of Bank Negara Malaysia, therefore, has been to strike a balance between the benefits of and the objectives of regulation. In this regard, the Governor of Bank Negara Malaysia has rightly remarked, "... Bank Negara will continue to re-regulate on prudential grounds to strengthen the 'safety-net' of the system, and promote structural deregulation in order to sharpen competition and improve efficiency with the ultimate goal of ensuring an efficient but safe financial system". [22]

The Indonesian financial system has undergone fundamental changes under the deregulation policy of 1 June 1983 followed by a series of extensive deregulatory policy measures of 27 October in financial, monetary and banking fields. Nevertheless, Indonesia too continue to re-regulate on prudential ground to strengthen the financial system. In order to open a bank branch office, a bank is required to have operated as a 'sound' bank, including its capital adequacy, for at least 20 months and as a 'fairly sound' bank during four months. This criteria also applies to non-bank financial institutions (NBFIs) while opening their branch office. A strong capital requirement has been imposed for the establishment and operation of private banks and rural credit banks. The permit to become a foreign exchange bank is also based on 'sound' and 'fairly sound' including its capital adequacy criteria. Also, the participating domestic banks in joint-venture banks have to follow this criteria. Moreover, foreign banks have been subjected to various requirements in order to participate in joint-venture banks. Although the placement of deposits of non-bank state enterprises (BUMN) and

22. Business Times, Malaysia, 7 November 1988, p. 6.

non-bank local government enterprises (BUMD) with private banks has been allowed, the amount may not exceed 50.0 per cent of the state enterprises' total funds in deposits. The funds deposited in a single private bank by a BUMN/BUMD may not exceed 20.0 per cent of their total funds in deposits. Similarly, legal lending limits have been imposed on banks and NBFIs in extending bank credits to individual borrowers, groups of borrowers and executive staff. Therefore, even in the wave of two stages of deregulatory measures of June 1983 and October 1988, some form of re-regulation has to be maintained by the prudential authority.

Similarly, the Philippines experienced a financial crisis after the deregulation of the financial systems in the 1980s. The closure of Banco Filipino (the Philippines' largest saving bank) in 1985 and the latest closure of Manila Banking Corporation (MBC), one of the Philippines' nine largest banks clearly highlight the weakness still plaguing the banking institutions. Therefore, new central bank rules for wider investigative powers and record-keeping of any large loans have been introduced. Among others, a limit was set on the total outstanding liabilities or borrowings of a commercial paper issuer to not more than 300 per cent of its networth. A credit information system and a credit rating bureau were also set up. Limits are also imposed on loans that may be availed of by directors, officers, stockholders and related interests (DOSRI). In the wake of recent bank failures which had been caused mainly by the non-collection of loans, the definition of DOSRI has been expanded. The history of the Philippine financial system also indicates that bank failures have almost always been associated with mismanagement. In the long-run, problems associated with mismanagement can only be avoided if central bank effectively carries out its role in supervising banks.

With the rapid growth of the finance companies and many fraud cases, the Central Bank of Sri Lanka has to exercise a measure of control over such companies by the enactment of the Control of Finance Companies Act, No. 27 of 1979, and extend its supervisory role over these companies by extending credit restrictions imposed on commercial banks in 1984 in the operations of finance companies. The central bank now has a new Banking Act (which came into operation on 16 September 1988) with far reaching powers which will enable it to have a better supervision and control over commercial banks.

In the midst of flexible interest rate reform of 1980, the failures and bankruptcies of many banks and finance companies, some of which ceased their operations, have eroded public confidence in Thailand. Therefore, the Commercial Banking Act and the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business were amended to enable the Bank of Thailand to supervise and control financial institutions. The Central Bank has to force the commercial banks to boost their capital base to cover bad debts. During 1983-1986, these banks were taken over by the Bank of Thailand and three more were bailed out.

A deregulated environment, therefore, will certainly make the supervisory authorities more conscious of quality rather than an indiscriminated expansion of assets. The strengthening of supervision was also necessary in view of the commercial banks hit by 'bad' loan problems in some SEACEN countries (Table 3.8). For instance, commercial banks and other financial institutions in Malaysia and the Philippines were confronted with the growing problems of non-performing loans for the last few years. However, there must be a trade-off between market forces generated by deregulation.

Deregulation by itself is, therefore, not a permanent panacea to promote the financial competitiveness without considering some of the prudential concerns. Though the term 'deregulation' has been derived from the enactment of the Depository Institutions Deregulation and Monetary Control Act 1980 of the United States, the record number of bank failures too occurred in that country, creating a serious confusion about the rationale of deregulation. Bank failures have been escalating throughout this decade, in the wake of interest rate deregulation. In 1981, ten banks failed, but by 1984, closings hit 79, the highest total since 1937. Bank failures in 1987 hit 184 compared with 138 in 1986, 120 in 1985, 79 in 1984, 48 in 1983, and 42 in 1982. The prudential concern associated with fierce financial competition is that the deregulatory developments now underway may facilitate the growth of new financial institutions into deposit-taking activities, thus making banking a more risky and uncertain activity because of the inadequate regulatory and supervisory provisions for these types of institutions.

The recent inability of one of the deposit-taking cooperatives in Malaysia to meet withdrawals of its deposits led the Government to promulgate the Essential (Protection of Depositors) Regulations 1983 on 23 July 1986. The inadequate regulatory provisions led most of the deposit-taking cooperatives towards imprudent behaviour, neglecting the minimum basic rules and discipline of the competitive market force. Therefore, the safety factor has always been a good reason for regulating bank failures, particularly the large

Table 3.8

BAD LOANS, BAD DEBT PROVISIONS AND INTEREST-IN-SUSPENSE IN SELECTED SEACEN COUNTRIES: 1982-1987

(as a Percentage of Total Loans)

	Malaysia		Philippines		
	Banking System		Commercial Banks		OFI
	Outstanding Bad Debt Provisions	Outstanding Interest-in-Suspense	Bad/Default Loans	Bad/Default[1] Loans in Priority Sector	Bad/Default Loans
1982	n/a	n/a	14.1	1.1 (7.9)	9.7
1983	n/a	n/a	12.3	0.9 (7.5)	7.4
1984	2.3	1.1	19.3	1.0 (9.5)	8.9
1985	3.5	2.1	17.7	1.9 (15.6)	9.6
1986	5.4	4.0	20.5	3.0 (23.6)	9.1
1987 p	6.8	5.9	n/a	n/a	n/a

1. Figures in parenthesis denote percentage of bad/default loans out of the total priority sector loans.

p. Preliminary

OFI Other Financial Institutions.

Source: Bank Negara Malaysia Annual Report, 1987.
Replies to the SEACEN Deregulation Project Survey Questionnaire, Central Bank of the Philippines, 1987.

banks can have a much broader effect on the economy than failures of commercial enterprises. Regulation also has been introduced for the avowed purpose of avoiding excessive competition. Deregulations, therefore, almost inevitably will lead to additional risks, although it is intended to establish a stronger foundation for a healthier development of the banking sector in the years to come. Although banks have not suffered seriously from deregulations in the SEACEN countries, the experiences of other countries showed that they create serious adjustment problems for the banking sector. Greater risks from deregulation should, therefore, be countered by appropriate supervisory action.

VI. Concluding Remarks

The SEACEN countries are fully aware of the need of establishing interest rates in accordance with the market conditions. In recent years, however, there is a movement towards a market-determined interest rate system. But those countries, which are still suspicious of the indicative capacity of the prevailing market, are proposing to establish 'market-oriented interest rate systems' by administrative means (e.g., by frequent revision of interest rates according to the market conditions). In this context, the institutional arrangement, in which specialized financial institutions play an important role in providing credits to the priority sectors, however, kept interest rates lower than market level (e.g., in Thailand). This has been one of the main deterrents to the effort to move towards a flexible interest rate system. Eventually, there is a clash between deregulatory moves designed to increase the role of market forces and the continued and, in some cases, increasing role of government financial intermediation. The policy of preferential lending, adopted in the SEACEN countries, has segmented the credit market into two: with interest rate lower in the market catering for priority sector and higher in the market catering for the so-called non-priority sectors; and, with an over-extension of credit to the priority sector and an under-provision of credit to non-priority sectors. The repercussion of this preferential treatment is reflected in the growing tendencies of the banks to cross-subsidize the losses, that are incurring in their own lending operations by pushing up the lending rates on non-priority sector loans. This tendency in turn created the growing bad debt provisions and outstanding interest-in-suspense.

Great success has been achieved in the mobilization of savings by the banking system in some SEACEN countries after the deregulatory moves. The demand, time and savings deposits in the banking system have grown at an increased rate since the deregulatory reforms (e.g., in Indonesia). The derégulatory moves have also induced greater deposit mobilization in the Philippines. There was also a tendency for the concentration of deposits towards long-term maturities after the deregulation of interest rates in most of the countries in the SEACEN region.

After deregulation, the interest rate adjustments have also been asymmetrical, such that, when deposit rates increase, there is a corresponding adjustment in the lending rates within a short-time period. However, when deposit rates decline, lending rates only adjust downwards with a long-time lag (e.g., in Malaysia). One reason for the slow downward adjustment of the lending rate has been the substantial overhang of high-cost funds. The banks are still saddled with non-performing loans and had to shoulder the burden of substantial portion of previously held high-cost deposits of longer maturities. The banks also have performing loans with a low rate of return by any comparable standards because they were loaned out in a period when interest rates were controlled. Consequently, the banks have to charge for higher rates for loans than otherwise would be the case. In other words, the financial system is not fully developed in most of the countries in the SEACEN region to offer different types of financial services or instruments other than interest rate as a means of competition. High interest rates in the aftermath of financial deregulation are not something that only occur in the SEACEN countries. This experience has also been registered in Latin American countries although under slightly different conditions. But, if the increasing trend of non-performing loans continues, the high interest rates that emerged after deregulation should not be viewed as a transitional problem. Although a certain degree of success has been achieved in deposit mobilization, the increase in both nominal and real interest rates has been a problem accompanying the deregulatory reforms.

However, in some SEACEN countries (e.g., in the Philippines), just after the deregulatory moves, interest rates and spreads did not drastically increase, contrary to what had been expected from interest rate deregulation. But, as the economy deteriorated after 1983, nominal interest rates rose and remained high in 1984 and 1985, resulting in a wider nominal spreads for banks. The high interest rate is also a reflection of the actual market situation, and there is also a close link between the domestic interest rates and the interest rates abroad. The high interest rate is also closely related to the expectation of domestic currency depreciation (e.g., in Indonesia).

The imbalance between deposit expansion and credit expansion has resulted in increased liquidity in most of the countries in the SEACEN region after deregulation. Even if some of the countries were in the process of reducing excess liquidity in their financial system, the gap between deposit and credit extensions narrowed slightly. There was no major improvement in the declining loan-deposit ratios. The excess liquidity in the financial system, therefore, compelled central banks to attempt to absorb some of the liquidity by selling bonds in the repurchase market (e.g., in Thailand) and to make the bond repurchase more responsive to the highly liquid conditions of the banking system. An excess liquidity situation emerged during 1987 in Malaysia, forcing the Central bank to issue more treasury bills to mop up its excess liquidity. The new reserve requirement for banks and finance companies was also intended to mop up the excess bank liquidity in the system that prevailed during the first half of 1989. Credit extension was at a very low level and banks also had to grapple with the problem of bad loans or low quality loans carried over from the previous recessionary years. In addition, banks had to reduce interest rates on both deposits and loans when excess liquidity prevailed in the banking system. In other words, the significant increase in liquidity in the banking system of some countries in the SEACEN region has pushed down short-term market interest rates almost continuously (e.g., in Malaysia). The interest rates in the market, such as those for short-term instruments in the repurchase market and those for interbank loans (e.g., in Malaysia and Thailand), has fallen considerably. However, given the situation that the banking system is over liquid, the lending rates have, in fact, been high in some SEACEN countries in real terms after deregulation.

It may be recalled that the commercial banks in some countries (e.g., in Malaysia) have been required to anchor all their lending rates (except for loans to the priority sectors or where the rates are prescribed by law) to their declared base lending rates (BLR). The rationale behind this was to prevent the asymmetrical adjustment in interest rates, whereby falls in lending rates tend to lag far behind falls in deposit rates, and increase in deposit rates are reflected in high lending rates almost automatically. However, in practice, the BLR remained basically 'sticky' downwards because of the high degree of discretion which largely determine the BLR. Therefore, a new mechanism that clearly states the relationship among bank deposit rates, money market rates and BLR of banks has to be formulated, although the mechanism of Kuala Lumpur Interbank Offer Rate (KLIBOR) has been initiated. Therefore, if the financial system is not well developed and not flexible enough in adjusting interest rates (accompanied by excess liquidity and declining loan-deposit ratio) so as to enhance the competitive environment, a complete interest rates deregulation may not be possible and intervention by the monetary authority would be necessary to assist the market in determining the appropriate interest rates.

The large overhang of non-performing loans is exerting a heavy strain on the profits of the banking system. For instance, in Thailand, the ability of the commercial banking system to generate profits during the past couple of years after flexible interest rate policy has been severely curtailed. While the effect of deregulation movement on the average returns on bank assets is perhaps debatable (although it appears likely that the average return will decline), the effect of deregulation on the variability of bank profits is less difficult to predict. It appears highly likely that the variability from high to low profit banks will be larger and probably much more than in the past years, as the ability to compete and offer new products produces major winners or major losers. Nevertheless, any decline in average profits or increases in the variability of profits from high to low profit will contribute to an increased incidence of bank failure.

The present system of interest rate structure in some countries in the SEACEN region (e.g., in Thailand) has little flexibility and much rigidity, particularly in the downward movement of deposit rates. However, low interest rates on deposits that are prevailing in other SEACEN countries (e.g., in Malaysia), have not really favoured the local banks, there is a need to set a minimum level for interbank rates. Low money market rates have enabled the single branch foreign banks to borrow cheap funds. Local banks with extensive branch networks are better placed to tap deposits from the non-bank sector and are therefore often net lenders in the interbank market. In other words, they are compelled to lend to the interbank market a larger amount of deposits they collected at a higher operating cost at a loss. The opposite holds in the case of banks with few or no branches, as in the case of foreign banks and merchant banks. The central bank's implicit view, in this regard, has been that deposits are less volatile than interbank borrowings, and it has directed banks to place less reliance on interbank borrowings. In such a situation, if the banks are not allowed to trade funds with each other through the interbank market to achieve an optimal usage of funds, it can result in unnecessary inefficiencies. Also, the view that deposits are less volatile than interbank funds does not necessarily apply to corporate deposits. Therefore, banks should be given the freedom to tap and rely on both types of funds in keeping with their individual circumstances.

The large overhang of non-performing loans is also exerting a heavy strain on the capital structure of a few banks in some countries in the SEACEN region. The capital of these banks has been seriously affected and a crisis of confidence has emerged and various actions were necessary to facilitate the restructuring of banks' capital (e.g., in Malaysia). In other words, the deregulatory environment has made the supervisory authorities more conscious of quality rather than of an indiscriminating expansion of assets.

There is also a need to broaden the interbank market, by including finance companies and other financial institutions in order to increase the breadth and depth of the market, and also to reduce the wide interest rate fluctuation and remove the multi-tiered rate structures which presently characterize the interbank market in some countries in the SEACEN region. In this context, some countries in the SEACEN region have already allowed authorized finance companies to transact in the interbank market (e.g., in Malaysia).

The money markets in most of the countries in the SEACEN region are not truly reflecting the demand and supply situation. Therefore, some countries in this region have to follow another tranche of financial reforms, particularly, in the area of transactions of government securities, adjustment in liquidity of the financial institutions, and flexible fund management in calculating statutory reserve ratios. The recent financial reform in Malaysia is expecting the money market to reflect demand and supply and to boost market volumes. The new policy of maintaining liquidity in the system as a whole and not to respond to the needs of each individual institution can be regarded as a major step towards maintaining flexibility in fund management.

From the foregoing analysis, it is observed that the idea of deregulation may be welcomed but not at the cost of quality of assets. The central banks in some SEACEN countries have been emphasizing, for quite some time, on the subject of quality of assets. Appropriate measures are necessary to facilitate the restructuring of the banks' capital which has been significantly eroded by losses and crises of confidence stemmed from having too many non-performing loans, which put a heavy strain on the profits of many banks. The central banks had to initiate action to rescue ailing banks by injecting capital, and to amend capital adequacy requirements. Although financial institutions should stand on their own feet without much regulation by the central banks, the social obligations of the banking institutions toward the community cannot be ignored. Therefore, a deregulated environment will certainly make the supervisory authorities more conscious of quality of assets. The strengthening of supervision is also a necessity in view of the banking institutions being hit by 'bad' loans problem. Deregulation, therefore, cannot be equated with an environment of less supervision. In fact, proper supervision does not in any way disturb the process of deregulation.

Appendix I

A Chronology of Financial Deregulation and Policy Measures in the SEACEN Countries (1970 - 1989) *

1970

Indonesia
The system of subsidy by paying one-third of all interest costs for 6- and 12-month time deposits at state banks abolished.

Malaysia
Wholesale banking introduced with the establishment of merchant banks and merchant banks given flexibility in determining the deposit and lending rates, and also allowed to operate under a system of operational informal guidelines**

Sri Lanka
Medium- and long-term loans to industry and agriculture sectors exempted from credit ceilings.

1971

Malaysia
Commercial banks allowed to accept deposits with maturities exceeding one year; interest rates payable on fixed deposits by finance companies re-regulated (prior to 1971 free from regulations); and, deposits with maturity of more than one year introduced.

1972

Sri Lanka
The credit ceilings in force in the past years lifted.

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*. Note: (1) The purpose of this chronology is to illustrate the general trend instead of providing a complete listing of deregulatory changes. Therefore, no claim is made on its completeness. The general pattern, however, indicates a trend towards financial deregulation.
(2) Financial deregulation in some countries has also been followed by other policy measures during the period under review.

**. Major deregulatory reforms

1973

Malaysia

Interest rate ceilings placed on deposits exceeding one-year maturity with banks and finance companies completely lifted; and, ceilings on deposit rates payable by the finance companies lifted completely (both the deposit rates and the lending rates of the merchant banks already being determined by market forces).

In other words, finance companies allowed to quote interest rates payable on deposits; discount rates on treasury bills allowed to be determined by open tender in the money market; and, exchange controls abolished. **

Philippines

Anti-Usury Act of 1916 amended and Monetary Board given authority to prescribe the maximum deposit and lending rates.

1974

Indonesia

The system of subsidy by paying one-third of all interest costs for 6- and 12-month time deposits reduced.

Malaysia

Interest rate restrictions abolished on finance companies. **

Sri Lanka

Ceilings on commercial banks credit imposed once again.

1975

Nepal

Significant revision undertaken in deposit and lending rates to reflect market rates of interest; longer-term deposit rates substantially raised and positive real interest rates maintained; and, re-classification of lending rate structure introduced.

**. Major deregulatory reforms.

1976

Sri Lanka
Proportion of reserve requirement that commercial banks permitted to hold in cash gradually reduced; and, a ceiling on bank credits for non-essential activities imposed.

1977

Indonesia
Reserve ratio and percentage of reserve to be deposited at the central bank reduced significantly; and, the system of subsidy by paying a certain portion of all interest cost for 18-month time deposits at the state banks eliminated and for 24 months reduced.

Nepal
Establishment of a secondary market initiated by the establishment of securities exchange centre.

Sri Lanka
Interest rates underwent a radical change with a high interest rate policy being adopted; interest rates revised upwards and a policy of less reliance on quantitative credit restrictions adopted; foreign banks encouraged to open branches in the country; exchange rate unified by floating the currency in the market vis-a-vis the other foreign currencies; freedom granted to commercial banks in determining the buying and selling rates of various foreign currency instruments; and, certain exchange control approvals delegated to the commercial banks. **

1978

Indonesia
State banks allowed freedom to set interest rates on time deposits with maturities not exceeding three months, i.e., state banks allowed to set their own rates on time deposits shorter than six-month maturities as they were already doing for the interest rate paid on demand deposits; and,

**. Major deregulatory reforms.

private and foreign banks allowed to set their own interest rates (the government, however, does not provide guarantees to deposits held at non- state banks). **

Malaysia
Commercial banks allowed to determine the rates of interest which they would offer for deposits, and the prime lending and preferential lending rates chargeable on their loans and advances (maximum interest rates to be charged by the commercial banks and finance companies for loans); priority sector lendings continued to be subject to ceilings and informal restrictions on prime lending rates retained; and, structure of liquidity requirements (including the composition of liquid assets) for the commercial banks and the finance companies reformed. **

Philippines
Interest rate ceilings on time deposits and deposit substitutes with maturities of over 730 days lifted. **

Sri Lanka
Certain functions of the exchange control department in respect of approving remittances abroad relaxed and delegated to commercial banks.

1979

Malaysia
Merchant banks brought within the ambit of the Banking Act, 1973; two new monetary instruments, namely, bankers acceptances (BAs) and negotiable certificates of deposits (NCDs) introduced into the money market; and, merchant banks allowed to accept fixed deposits from the corporate sector (subject to minimum amount limitation).

Sri Lanka
National Savings Bank allowed to introduce two new savings schemes; premium savings bonds introduced; security house established to serve as a market maker in money market instruments; foreign currency banking units

**. Major deregulatory reforms.

(FCBUs) established under the foreign currency banking scheme; FCBUs permitted to engage in certain foreign currency transactions with non-residents and designated residents; and, commercial banks authorized to provide banking facilities to the free trade zone enterprises.

Thailand
A security repurchase market established to help develop the money market; and, finance companies (credit foncier companies) allowed to lower the minimum amount of borrowing from the public by issuing promissory notes.

1980

Philippines
Interest rate ceilings on long-term loans floated; interest rate structure among banks and non-bank financial intermediaries aligned; functional distinctions among thrift banks eliminated; and, rediscount facilities and terms and other features of government securities rationalized. **

Thailand
Interest rate ceilings on lending rates of financial institutions freed from 15 per cent limit imposed by the civil and commercial code since 1929; ceilings on deposit rates also raised by the same magnitude (adjustments in rate ceilings being subsequently frequent); the maximum rates of interest or discount chargeable adjusted in line with market conditions; the ceilings on deposit and loan rates adjusted upwards frequently in line with developments in the financial markets; and, the interventions of the central bank in the setting of ceiling rates kept to a minimum. **

1981

Malaysia
Commercial banks and finance companies moved from prime lending rate (administered by the central bank) to the cost-determined base lending rate (BLR); the merchant banks allowed to extend loans in foreign currency to resi-

**. Major deregulatory reforms.

dents for the financing of ventures and also to accept foreign currency deposits from non- residents (subject to limitations in the minimum amount of such deposits). **

Philippines
All interest rate restrictions on bank deposits abolished; approved banks permitted to engage in security transactions; interest rate ceilings on all types of deposits and loans (except short-term loans) lifted; ceilings on deposit rates (two years and below), and long-term loans (over one year) freed gradually. **

Sri Lanka
Commercial banks and finance companies authorized to issue certificates of deposits (CDs) on a case by case basis subject to certain limits and secondary treasury bill market introduced; restrictive policies again reinforced; and, short-term credit ceilings on the private sector imposed but priority sector continued to be exempt from credit ceilings.

1982

Malaysia
Informal restrictions on the prime lending rate abolished. **

Nepal
Simplification in interest rate structure; lending rates of the commercial banks and development banks unified.

Sri Lanka
Merchant banks allowed to commence its commercial operations in pioneering the activities of discounting trade bills; general credit restrictions (bank credit ceiling) abolished; scope of selective credit controls removed; access of wide range of loan categories to central bank liquidity credits removed phasewise (i.e., subsidized liquidity credits to state banks eliminated); commercial banks and development banks to issue certificates of deposits (CDs); and, banks and non-bank financial institutions to trade money market securities. **

**. Major deregulatory reforms.

1983

Indonesia
Interest rate restrictions on state banks eliminated (no restrictions or ceilings imposed on interest rates paid or charged by national private banks, foreign banks and other financial institutions prior to 1 June 1983 reforms and interest rates on six-month deposits of state banks removed just before the 1 June 1983 deregulation). **

Malaysia
An automacity introduced in interest rate determination for the commercial banks for anchoring interest rates on loans and advances (except those for loans extended to the priority sector) to a bank's declared base lending rate (BLR), which in turn is linked to the BLR of two leading banks. **

Philippines
Exchange control re-imposed, interest rate ceilings on short-term bank loans completely removed; the reserve requirement ratio and the networth of risk-asset ratio of banks reduced; a prime rate monitoring system introduced and Manila Reference Rate (MRR) improved; functional differentiation among financial institutions reduced and authorized banks allowed to engage in expanded banking activities (universal banking activities) subject to their capital base; and, government securities rationalized with the gradual phase-out of premium savings bonds and eligible reserves against deposit liabilities of commercial banks. **

Sri Lanka
High interest rate policy abandoned and short-term interest rates revised downwards.

1984

Indonesia
New monetary instruments introduced; central bank certificates — Sertificate Bank Indonesia (SBI) — issued through auctions; and, new Bank Indonesia discount windows established to provide rediscount facilities. **

**. Major deregulatory reforms.

Malaysia
National Savings Bank (NSB) allowed to accept fixed deposits with maturities of six months and twelve months.

Nepal
Authorized branches of the Agricultural Development Bank to conduct specified commercial banking activities; entry of joint-venture foreign banks encouraged; and, deposit-taking institutions granted freedom to manage their deposit rates within a narrow range of one to one-and-a-half percentage points after maintaining the minimum rates as prescribed by the central bank. **

Philippines
Sectoral differential rediscount rates abolished.

Sri Lanka
Second stage of deregulation occurred; intervention in the determination of interest rates reduced; the National Savings Bank allowed the freedom to fix its deposit and lending rates; central bank securities introduced; ** credit ceilings for commercial banks re-introduced in two stages and a reserve tranche system introduced; interest rebate scheme introduced as an incentive to exporters; and, a certain degree of flexibility with respect to statutory reserve ratios introduced.

Thailand
Restrictions on bank lending rates re-imposed (a ceiling of 18 per cent on domestic credit expansion and additional restrictions on credit); ceilings for loans to priority sectors lowered and ceilings for non-priority sectors raised; limits established on net foreign liability position for banks; general credit restrictions abolished (overall ceiling on domestic credit expansion abandoned); the interest rate ceilings on short-term commercial bank deposits raised to same level as that on one- year deposits; and, a flexible exchange rate regime re-introduced, being aligned with a basket of currencies of Thailand's major trading partners. **

**. Major deregulatory reforms.

Malaysia
Liquidity requirement and statutory reserve ratio of commercial banks further reduced; secondary mortgage market established by incorporating CAGAMAS Berhad, the national mortgage corporations, as a further step to develop and deepen the money and capital market; and, one merchant bank acquired share in a stockbroking form. **

Nepal
A flexible exchange rate regime introduced, the exchange rate being aligned with a basket of currencies of Nepal's major trading partners; commercial banks and financial institutions given freedom to determine the lending rates (except for selected priority sectors lendings on which maximum lending rate is prescribed by the central bank); commercial banks granted the authority to determine the interest rates as well as the maturity period of fixed deposits after maintaining the minimum rate as prescribed by the central bank; direct interest subsidies to the priority sectors discontinued and refinancing too reduced by the upward revision of interest rate on priority sectors credits; liquidity requirement ratio completely relaxed; and, the provision of Finance Company Act came into effect, thus paving the way for the establishment of finance companies. **

Philippines
Low yielding reserve-eligible government securities (Premyo Savings Bond) gradually phased out; auction system of marketing treasury bills re-introduced to replace the negotiated system; and, authorized activities of various financial institutions expanded. **

Sri Lanka
Automated teller machines introduced; prime rate for commercial banks published and interest rate on refinance reduced; interest rate on additional refinancing facility reduced; nominal rate on commercial banks securities reduced; statutory reserve ratios (substantially reduced); requirements to maintain special reserves under special

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**. Major deregulatory reforms.

tranche system (introduced in 1984) withdrawn; credit ceilings on industrial credits to private sectors withdrawn; limits on certificates of deposits (CDs) issued and outstanding with commercial banks withdrawn; and, refinance period for certain categories of the export refinance scheme of the central bank extended. **

Thailand

Credit foncier companies allowed to reduce maturity period of promissory notes; commercial banks allowed to purchase or hold certain percentage of the total shares issued by companies in certain activities; the bank rates for first-tier and second-tier loans reduced; two-tier bank rate consolidated into a single rate; refinancing rate on promissory notes lowered; interest rate ceilings for financial institutions lowered; commercial banks permitted to exchange high-interest government bonds for low interest ones to give them greater flexibility in adjusting their financial position. **

1987

Malaysia

Exchange control system further liberalized — permission no longer required for external borrowings by residents in foreign currency up to a certain limit, while non-residents controlled companies allowed to borrow without permission, however, with some restrictions in loan amount; approved finance companies allowed to participate in interbank market to add depth to market; six merchant banks with a minimum capital as prescribed by the central bank, allowed to issue negotiable certificates of deposits (NCDs); three largest domestic banks granted stockbroking licences; one commercial bank and one merchant bank each allowed to acquire share in stockbroking firm; merchant banks ventured deeper into unit trust management; merchant banks allowed to take part in foreign exchange dealing along with commercial banks; greater flexibility introduced by allowing the banking institutions to average their holdings of eligible liquid assets in the computation of liquidity requirements;

**. Major deregulatory reforms.

the arrangement of pegging the interest rates on fixed deposits (up to twelve-month or less maturity) within a fixed margin above those quoted by two largest commercial banks abolished; priority ceiling rates allowed to move with the base lending rate (BLR), the ceiling band of maximum interest rates widened by pegging it significant percentage above the average of the BLR of the two largest commercial banks; an official index of interbank rate known as Kuala Lumpur Interbank Offer Rate (KLIBOR) established to bring about a truly market-oriented financial system (KLIBOR expected to become anchor rate for credits and other interest sensitive instruments). **

Sri Lanka
Commercial banks and other participants induced to engage more in the primary Treasury bill market; market forces allowed to play greater role in determination of yield on primary Treasury bills; statutory reserve ratios on all types of deposits lowered and unified. **

Thailand
Finance companies incorporated to undertake commercial finance activities permitted to enter the guarantee business; regulations on the financial facility extended to exporters relaxed; commercial banks allowed to participate in low interest joint credit extension programmes for traders of agricultural products; and, regulations regarding off-premise operations of commercial banks relaxed. **

1988

Indonesia
A series of policy measures in the financial, monetary and banking fields introduced; facilities for opening new branch offices granted; facilities in opening branch offices of non-bank financial institutions (NBFIs) granted; establishment of new private banks and operations of rural credit banks in districts outside the capitals allowed; non-bank financial institutions now authorized to issue certificates of deposit (CDs); all banks now authorized to execute the Tabanas and

**. Major deregulatory reforms.

other savings schemes; the requirements to become a foreign exchange bank eased; branch offices of foreign exchange banks allowed to function automatically as foreign exchange banks; establishment of joint-venture banks (under certain requirements) allowed; the opening of foreign bank sub-branch offices (under certain conditions) allowed; the BWAPs arrangements improved; licensing to money changers liberalized and also non-foreign exchange banks allowed to operate as money changers; non-bank state enterprises (BUMN) and non-bank local government enterprises (BUMD) allowed to deposit their funds in private banks (commercial, development and savings banks) as well as in non-bank financial institutions (NBFIs); facilities to open branch offices granted to all banks; the establishment of new banks, either national banks or joint-venture banks now made possible; minimum liquidity requirements for banks lowered drastically; Bank Indonesia certificates (SBI) and money market securities (SBPU) diversified and its auction techniques reformed; limit on interbank loans terminated; tax treatment of income from deposits with that of income from other securities equalized; background and origin of funds placed in time and savings deposits continued to be free from investigation; and, banks and NBFIs allowed to raise capital through issuance of new shares on capital market. **

Nepal
A new system of policy of selling Treasury bills at monthly auctions adopted. **

Sri Lanka
A repurchase market for Treasury bills established, interest rates and the maturity periods of government securities revised (taking into account the changes in market conditions); upper ceilings of interest rates fixed for deposits accepted by finance companies relaxed. **

**. Major deregulatory reforms.

1989

Malaysia

A series of financial reforms introduced to enhance competition, provide depth to the money market and further develop the capital market, especially in Malaysian Government Securities (MGS); principal dealers for government securities appointed; all government securities with longer maturity period to be issued by way of auction through the principal dealers; discount houses appointed as principal dealers for treasury bills; discount houses allowed to participate in the weekly treasury bills tender; discount houses obliged to make a two-way price for the bills in secondary market; discount houses allowed to hold and trade in money market instruments — MGS, treasury bills, CAGAMAS bonds, bankers acceptances and negotiable certificates of deposit; discounting facilities for bankers acceptances (BAs), currently provided to all financial institutions to be continued; statutory reserves and liquidity requirements for financial institutions revised; statutory reserve ratio (SRR) to be computed based on the average amount of reserves over the fortnightly reserve period; primary liquidity ratio of commercial banks reduced; primary liquidity ratio for finance companies abolished; and, variation of certain percentage point above or below the prescribed statutory reserve ratio (SRR) permitted in order to make fund management more flexible. **

Nepal

Interest rate completely liberalized and commercial banks as well as non-bank financial institutions allowed to fix their own deposit and lending rates. **

Thailand

Interest rate ceilings on long-term fixed deposits of maturity over one year lifted. **

**. Major deregulatory reforms.

PART II

COUNTRIES STUDIES*
INDONESIA
MALAYSIA
NEPAL
PHILIPPINES
SRI LANKA
THAILAND

* Based on the Questionnaire Replies to the SEACEN Research Project on "Deregulation in the Financial Systems of the SEACEN Countries", 1986-1987.

Chapter 4

Financial Deregulation in Indonesia

I. Rationale and Objectives of Deregulation

The Indonesian financial system has undergone fundamental changes under the deregulation policy of 1 June 1983. This policy was adopted to establish a stronger foundation towards a healthier development of the banking sector. The principal objectives of the 1 June 1983 reforms included reducing the reliance of banks, particularly state banks on liquidity credits from the central bank in the lending activities, improving the incentives for the mobilization of financial savings, and improving the allocation of resources. This new policy is intended to make the banking system more responsive to a more sophisticated economy and to allow the monetary authorities to undertake monetary management with greater flexibility through indirect monetary instruments, namely reserve requirements, discount policy, open market operations and moral suasion. In other words, the changes introduced in the liquidity credit system were designed to provide greater autonomy to commercial banks in their credit management to develop a sharply focused definition of priority sectors, and to achieve a better control over reserve money expansion.

Elimination of interest rate controls and the reduction of liquidity credits were aimed at encouraging competition making the financial system more reliant on the market signal, and increasing the autonomy of banks in allocating credits. In other words, it was thought that only an efficient financial sector could mobilize and utilize financial resources most efficiently for the purpose of development. Therefore, one of the objectives of the 1 June 1983 Deregulation Policy was to encourage banks to maximize their fund mobilization and thereby reduce their dependence on the central bank for low cost of funds. For instance, the dependence of state banks on Bank Indonesia's refinancing facility (liquidity credits) in their lending activities would lessen if the state banks were permitted to establish their own credit policies and by removing credit ceilings.

Before 1 June 1983, the dominant role of state banks was fostered by regulation and rediscount policies. In view of their functions as agent of developments, each state bank is responsible for financing a particular sector. State banks lend both working capital and investment funds (in rupiah and foreign exchange). Before 1 June 1983, they lent mainly to priority sectors of which the central bank granted rediscount credits (liquidity credits) at subsidized rates. State banks also obtained substantial deposits from public enterprises and government agencies which, by regulation, should hold their deposit accounts with these banks.

The national private banks mainly provided short-term working capital to the non-priority sector and access to rediscount credits from the central bank was governed by special regulations. Therefore, only selected private national banks obtained resources from central bank for lending to priority sector. The resources of funds of private banks were derived primarily from deposits of private enterprises and individuals. Foreign banks could lend only to enterprises based in the Jakarta area, unless they syndicated with the private national banks. To make the financial system more efficient and self-reliant, the authority, therefore, implemented the 1 June 1983 measures.

In order to achieve the objectives of deregulation, state banks were free to determine their own deposit and lending rates. The liquidity credit mechanism was simplified by eliminating a wide range of loan categories from access to liquidity credits. The rationale and objectives of the second phase of comprehensive deregulatory policy measures of 28 October 1988 were to promote mobilization of funds; the non-oil exports; efficiency in the operations of banks and other financial institutions; effectiveness in the implementation of monetary policy; and, development of the capital market.

II. Circumstances and Conditions for Deregulation

Prior to 1 June 1983, bank credit was regulated by numerous requirements. In an effort to lower the inflation rate, a series of anti-inflationary measures, namely imposing ceilings on credit expansion and increasing the levels of interest rates, were launched. The main elements of credit policy before the 1 June 1983 reforms were detailed credit ceilings and a complex system of long-term liquidity credits (i.e., low-cost refinancing credits) from the central bank, designed to influence the allocation of credit as well as to subsidize many categories of loans and also to effectively fix the final interest rates of banks. The credit ceiling system and liquidity credit extension were able to support a relatively high economic growth and to lessen the inflationary impact of liquidity credit. However, the combination of substantial liquidity credits and credit ceilings as major monetary instruments resulted in some side effects to the economy.

It is worthy to note that in the past, due to the substantial increase in production and prices of oil as well as favourable non-oil exports had enabled the authority to achieve growth with equity. That goal was implemented through the Bank Indonesia's low interest rate refinancing facility (liquidity credits) provided for banks, mostly state banks, to extend priority and non-priority credits. The priority credit among others was provided for small-scale businesses. To the extent that the allocation of credits could be directed towards the goal of growth and equity and at the same time to manage the inflation rate, the authority imposed a ceiling on bank credits used as a direct monetary instrument. The availability of liquidity credits and the fixing of credit ceilings had been successfully used to achieve stability, growth and equity. However, this policy also produced adverse impacts, such as the lack of initiative of banks to mobilize funds from public and excess liquidity in the banking system (Table 4.1 and Table 4.2) which in turn induced capital flight, and exerted pressure on the balance of payments.This pressure was hardly sustainable by the balance of payments due to the worsening Indonesian economy as a result of the deterioration of oil prices and the world economy recession.

Prior to 1 June 1983, both national private banks and foreign banks were free to set their own deposit and loan rates except for loans which were eligible to be financed in part by the provision of liquidity credits. However, as the share of state commercial banks' assets to total assets of the banking system was more than 70.0 per cent and given the limited role of private national and foreign banks the concept of deregulation would be strictly limited, unless the state banks were free to quote the interest rates.

The dominant role of state banks was monitored by regulation and rediscount policies. They lent mainly to priority sectors for which the central bank granted rediscount credits (liquidity credits) at subsidized rates. The national private banks, on the other hand, mainly provided short-term working capital to non-priority sectors. Their access to rediscount credits from the central bank was governed by special regulations. Therefore, only selected private national banks obtained resources from central bank for lending to

Table 4.1

MONTHLY AVERAGE LIQUIDITY POSITION OF DEPOSIT MONEY BANKS: 1977-1987

(in Billions Rp.)

Items	1977/78	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87
Reserves	602	514	593	1053	1232	1109	1354	1602	1877	2066
Current Liabilities	1721	2090	2504	4130	5507	6396	7295	9062	11542	13246
Reserves as Percentage of Current Liabilities	35	25	24	25	22	17	19	18	16	16
Minimum Reserve Requirement	516	314	375	620	826	960	1095	1359	1732	1987
Excess/Deficiency	86	200	218	433	406	149	259	243	145	79
Required Reserve with Bank Indonesia	172	104	125	207	275	320	365	453	577	662
Reserves with Bank Indonesia	506	407	456	865	996	838	1056	1255	1400	1732
Excess/Deficiency	334	302	330	658	721	518	691	802	823	870
Excess/Deficiency as a Percentage of Current Liabilities	19	15	13	16	13	8	10	9	7	7

1. April-December 1977.

Source: Bank Indonesia: Report for the Financial Year, various issues.

Table 4.2

CHANGE IN LIQUIDITY, BANK CREDITS AND DEPOSIT MOBILIZATION

(in Billions Rp.)

Year	Net Claims on Government	**Bank Credits**			**Held in the form of Changes in**		
		Public Entp. & Entities	Private Sector	Others	Total Liquidity (M2)	Change in in Savings Deposits (T)	Narrow Money (M1)
1973/74	-25.0	107.2	362.8	-165.0	434.0	180.0	254.0
1974/75	25.0	309.2	238.6	-193.0	381.0	138.0	243.0
1975/76	25.1	928.4	337.0	142.4	678.0	277.0	401.0
1976/77	-340.4	350.1	322.0	-194.4	582.0	195.0	387.0
1977/78	-232.8	-87.6	359.5	-191.7	442.0	135.0	307.0
1978/79	-291.0	974.0	632.0	-1243.0	880.0	191.0	689.0
1979/80	-1180.0	250.0	559.0	-560.0	1648.0	651.0	997.0
1980/81	-1871.0	540.0	1297.0	-71.0	2103.0	686.0	1417.0
1981/82	-164.0	683.0	1921.0	-217.0	2245.0	684.0	1561.0
1982/83	486.0	382.0	2657.0	-1658.0	2096.0	1452.0	604.0
1983/84	-2335.0	278.0	2358.0	-88.0	3512.0	2836.0	676.0
1984/85	-3004.0	138.0	3327.0	292.0	3688.0	2755.0	933.0
1985/86	1142.0	177.0	3657.0	-1326.0	4721.0	3234.0	1487.0
1986/87	-1475.0	641.0	4927.0	-2114.0	4323.0	3298.0	1025.0

Source: Bank Indonesia Annual Report, various issues.

priority sector. The resources of funds of private banks were derived primarily from deposits of private enterprises and individuals. Whereas, state banks also obtained substantial deposits from public enterprises and government agencies which, by regulation, should hold their deposit accounts with these banks. Foreign banks could lend only to enterprises based in the Jakarta area, unless they syndicated with private national banks.

Further, several imbalances were seen from the kind of system that prevailed before the deregulatory moves of 1 June 1983. These were as follows:

- Deposit rates of state banks were maintained at levels below those of private banks. The differential between private and state bank deposit rates was 12.0 percentage points for six-month deposits, 10.0 percentage points for one-year deposits and 6.0 percentage points for two-year deposits. For instance, the weighted average deposit rates for state banks was 6.0 per cent and 9.0 per cent for 6-month and 12-month deposits compared to 18.5 per cent and 19.3 per cent for private banks (Table 4.3).

- Despite lower rates, state banks had been attractive to some depositors because deposits of state banks were government guaranteed.

- The weighted average interest rate on loans from state banks was lower than those in private national banks and foreign banks mainly because state banks mostly extended lending to priority sectors which were subsidized.

In response to the interest rate differentials, time deposits in private banks grew more sharply than that of state banks. In order to enable the state banks to offer higher rates on long-term deposits, the central bank had to subsidize those deposits. Therefore, as against market competitiveness, subsidy became the basic norm. Because state banks subsidized lending to priority sectors, the weighted average interest rates on loans from state banks was much lower compared to the interest rate of private national banks. The private national banks became the residual supplier of funds to indigenous non-priority borrowers who were crowded out of state bank credits by credit ceilings, and the primary sources of funds to these borrowers were not eligible for state bank investment credits. The financial sector had, therefore, several 'specific concerns'. The

Table 4.3

AVERAGE INTEREST RATES PAID ON OUTSTANDING DEPOSITS: 1979-1986

(in Pecentages)

	Demand Deposits[3]	Tabanas Savings Deposits[4]	Taska Savings Deposits	Certificates of Deposits[5]	State Banks[1] Time Deposits[2]					Private National Banks[1] Time Deposits					Foreign Banks[1] Time Deposits			
					Less than 3 mths	3 mths	6 mths	12 mths	24 mths	Less than 3 mths	3 mths	6 mths	12 mths	24 mths	Less than 3 mths	3 mths	6 mths	12 mths
1979	3.0/1.8	15.0/ 6.0	9.0	9.8	10.6	5.1	6.0	9.0	15/12	16.2	16.7	18.3	19.6	19.6	13.8	13.7	6.6	7.7
1980	3.0/1.8	15.0/ 6.0	9.0	10.2	7.2	8.2	6.0	9.0	15/12	14.2	16.1	17.8	20.1	19.3	14.6	12.9	9.4	12.9
1981	3.0/1.8	15.0/ 6.0	9.0	10.9	12.1	10.2	6.0	9.0	15/12	15.4	17.4	17.9	19.4	19.0	16.0	16.5	11.5	12.8
1982	3.0/1.8	15.0/ 6.0	9.0	12.5	7.7	8.6	6.0	9.0	15/12	16.9	19.1	18.5	19.3	18.8	17.6	17.8	10.3	14.7
1983	3.0/1.8	15.0/12.0	9.0	15.4	14.4	14.8	13.1	17.5	12.5	18.7	17.4	18.8	19.7	19.3	16.3	16.0	17.0	17.0
1984	3.0/1.8	15.0/12.0	9.0	16.5	15.1	17.1	17.2	18.7	17.2	19.8	20.7	20.7	20.4	21.0	20.3	21.7	21.4	19.1
1985	3.0/1.8	15.0/12.0	9.0	14.5	13.4	14.6	16.0	17.8	18.3	14.6	15.9	17.8	19.8	21.3	14.3	14.9	16.5	18.1
1986	3.0/1.8	15.0/12.0	9.0	14.0	13.0-13.5	13.5-14.2	14.5	15.0	14.0-15.0	13.0-15.0	13.5-16.0	14.0-17.0	14.0-18.0	15.5-17.0	9.5-14.0	9.5-14.75	10.0-15.5	10.2-16.0

1. Weighted average.
2. State banks have been free since January 1978 to set interest rates on time deposits with maturities not exceeding three months. Rates on deposits with maturities longer than three months but not exceeding six months were deregulated in May 1983. In June 1983 all remaining time deposit rates were freed, except that a minimum rate of 12.0 per cent was maintained for 24-month deposits. From June 1983, the rates shown are the highest offered for new deposits. Between January 1978 and June 1983, 24-month deposits earned 13.0 per cent on amounts up to Rp. 2.5 million and 12.0 per cent on amounts above Rp. 2.5 million.
3. Until February 1978, 4.5 per cent for demand deposits exceeding Rp. 50 million, 3.0 per cent for smaller amounts. From March 1978, 3.0 per cent for amounts above Rp. 50 million, 1.8 per cent for Rp. 1.50 million, and individually determined for amounts below Rp. 1 million.
4. Before 1 June 1983, 15.0 per cent up to Rp. 200,000 and 6.0 per cent above Rp. 200,000. Therefore, 15.0 per cent up to Rp. 1 million and 12.0 per cent above Rp. 1 million.
5. Mid-point of range for six-month rate.

Note: For time deposits, the figures represent the lowest and the highest rate.

Source: Bank Indonesia, Country Chapter of SEACEN Collaborative Research Project on Capital Markets, 1989.

ceilings on state banks' interest rates hampered their ability to attract private sector deposits and fostered a dependence on captive customers such as state agencies and enterprises. As a result, deposits with private banks grew more rapidly than those in state banks. In addition, the dependency of state banks on central bank liquidity credits, whose volume was largely demand-determined, complicated the task of controlling domestic credit. All these circumstances prompted ultimately towards financial deregulation in June 1983.

III. Major Features and Nature of Deregulation Policy

The major feature of the policy was deregulation in the banking sector involving both credit activities and mobilization of funds. On the credit side, the policy stressed on reducing the dependence of banks on the central bank's low-cost refinancing facility (liquidity credits), freed the state banks to establish their own credit policies and removed credit ceilings. The deregulation policy also allowed Indonesian state banks greater freedom to determine their own interest rates both for lendings and borrowings. To mobilize domestic resources and attract capital at home, the central bank removed limits on the interest rates the state banks could offer on time deposits and continually exempted from taxation. In the mobilization of funds, the state banks were, therefore, free to set their own interest rates on time deposits, which in the past were regulated by Bank Indonesia.

In short, the reforms were implemented in two stages:

The first stage that became effective on 1 June 1983 comprised the following reforms:

- The elimination of credit ceilings which had been the primary tool of monetary and credit control. That is, credit ceilings were abolished and state banks were free to set their deposits and lending rates.
- Phased removal of a wide range of loan categories from access to the central bank refinancing facility (liquidity credits). Under that reform, liquidity credits were still provided for commercial banks to extend priority loans, such as those extended to finance small-scale business and export credits.
- Deregulation of state banks' interest rates on most categories of deposits and on all loans except for high priority loans.

The second stage that became effective after 1 June 1983 was the introduction of indirect monetary instruments. Prior to 1 June 1983, the Government controlled money supply utilizing credit ceilings as a direct instrument. After 1 June 1983, the use of indirect instruments, such as reserve requirements, open market operations, discount facilities and moral suasion, were stressed. The introduction of these indirect monetary instruments was a follow-up of the first stage of reform. These indirect instruments comprised the following:

- SBI (Sertificat Bank Indonesia or certificates of indebtedness) was created to provide an attractive rupiah asset suitable for cash position management by banks, especially in the case of excess liquidity. Only banks and non-bank financial institutions (NBFIs) are authorized to buy SBI directly from Bank Indonesia, but these institutions as well as the public are also allowed to trade in SBI in the secondary market.
- In order to complement the new systems of reserve money management through sales and redemptions of SBI, Bank Indonesia established two types of discount facilities in February 1984. The Discount Window I was created to assist banks in overcoming liquidity shortage in their day-to-day operation. Discount Window II was designed to support banks dealing with shortage of funds because of maturing mismatch of fund. Banks categorized as 'sound' and 'sufficiently sound' are eligible for access to these facilities.
- In order to stabilize the money market, the authorities, on 1 October 1984, imposed a limit on each bank's borrowings from the interbank market. At the same time, the authorities introduced a special credit facility as a substitute for inter-bank borrowing by a bank that had exceeded this limit.
- In 1985, the central bank created new market instruments and allowed banks and NBFIs to trade in these instruments among themselves or with Bank Indonesia. The newly created money market instruments are known as SBPU (Surat Berharga Pasar Uang).
- To streamline the process of open market operations and to enhance the secondary market, the Government appointed one non-bank financial institution (NBFI) to act as a security house in trading SBI and SBPU.

It can be noted that both SBI and SBPU are effectively used as instruments of open market operations. The SBI can be utilized by banks as a temporary outlet for excess funds before being extended as loans to their customers. Later on, through the secondary market, the SBI could be utilized more effectively to influence monetary development according to the economic policies. The SBPU is intended to manage the liquidity requirements of banks and enhance the activities of the money market. The type of SBPU which may be traded at present are, however, restricted to certain acceptances, promissory notes and trade bills. The discount windows, which is a financial facility from the central bank as a lender of last resort, are rendered to banks encountering temporary shortage of liquidity.

Therefore, to increase the share of domestic funds as one of the important sources to finance development, the Government continued to encourage efforts to mobilize funds from the public through banks, the money market and the stock market. In addition, the Government still provided tax exemption in the form of suspending the application of income tax on interest earned from time deposits and other savings. Furthermore, efforts to increase savings mobilized from the public were also pursued through institutional developments, namely by expanding the number of banks handling Tabanas/Taska and banks issuing certificate of deposits (CDs).

To develop the money market, in July 1985, the frequency of issuance of SBI was increased from once a week to every work-day. To expand the utilization of SBI, banks or non-bank financial institutions (NBFIs) could at any time discount the SBI to the securities house before maturity. Meanwhile, the maximum maturity of the SBPU was extended. Similarly, the maximum amount of the SBPU allowed to be rediscounted by banks to the securities house as a percentage of the total rupiah funds mobilized from third parties was also increased by 50.0 per cent. Furthermore, to enlarge the opportunity to utilize interbank funds, the interbank credit ceiling was raised from 7.5 per cent to 15.0 per cent of the rupiah funds mobilized. With regard to the stockmarket, the Government improved the regulations on the issuance of securities, securities trading and the activities of institutions supporting the stockmarket.

A series of policy measures introduced on 27 October 1988 has further enhanced the efforts towards deregulating the financial system. The facilities for opening new branch offices of banks and non-bank financial institutions; permission for establishing rural credit banks in districts outside the capital; authorization to issue certificates of deposits (CDs) to non-bank financial institutions (NBFIs); authorization to execute the Tabanas and other savings schemes to all banks; the liberalization of requirements to become a foreign exchange bank; enlargement of the scope of the establishment of joint-venture banks by allowing foreign banks to participate in it; permission to open sub-branch offices of the foreign bank; the drastic reduction of minimum liquidity requirements for banks from 15.0 per cent to 2.0 per cent of liabilities; diversification and maturity extension of Bank Indonesia certificates (SBI) and money market securities (SBPU) from 7 days to 6 months; the auction of SBI on daily and weekly basis; the trading of SBPU continually conducted through auction; the termination of the limit of 15.0 per cent ceilings on interbank loans; and, the enlargement of the capital market through participation of banks and NBFIs and through imposition of income tax on interest earned from time and other deposits, are some of the major reforms towards the process of further deregulating the financial system in Indonesia.

IV. Effects of Deregulation

The deregulatory moves have encouraged the emergence of more self-reliant financial institutions and greater competition in the banking system dominated by Indonesia's five state-owned banks. These five state-owned banks were originally established to provide services to specific sectors of the economy — small-holder agriculture, estate agriculture, industry, mining and export. These banks lent mainly to priority sectors for which the central bank granted liquidity credits (rediscount credits) at subsidized rates. The level and structure of deposit and lending rates of state banks were also controlled by the central bank before the deregulatory reform.

However, after the June 1983 deregulatory moves, the effect was dramatic. After the abolition of credit ceilings, the state banks were free to set their deposits and non-priority lending rates. Since the state banks play a dominant role in the banking system, the competition among banks consequently became less stiff, especially in fund accumulation areas.

The cost of funds rose significantly due to the rise in deposit rates, and the banks were forced to operate more efficiently. Nevertheless, the major problem associated with the deregulatory moves is the continuing high rates of interest. However, remarkable growth in time deposit was noticed. It must be noted that the deregulatory moves have taken place against a background which is unusual by developing country standards: the absence of foreign exchange controls. This means that the banks could freely decide whether to hold rupiah or, typically, U.S. dollars on the basis of prevailing and prospective interest rates and rates of inflation at home and abroad.

However, while the measures succeeded in mobilizing resources, they also raised the cost of borrowings during the recession, and the question of what would happen to the funds soon arose. The elimination of credit ceilings and the reduction of the scope of liquidity credits in June 1983, therefore, required the central bank to introduce new instruments for monetary control. To regulate liquidity, Bank Indonesia had to unveil on 1 February 1984 its Sertifikat Bank Indonesia (SBI) or certificates of indebtedness; and, discount instruments with varying maturities and of different denominations. These certificates are auctioned to financial institutions which can trade or resell them back to the central bank at maturity through new discount facilities. The new discount facilities consisted of two discount windows.

Further, to regulate liquidity in the economy through open market operations and to foster the development of a healthy money market, Bank Indonesia introduced new Money Market Securities (MMS), known by the Indonesian acronym SBPU, which could also be used for the development of the securities market. As a reflection of the higher capacity of banks in their management of funds, the average percentage of the rupiah liquidity maintained by the deposit money banks decreased from 25.0 per cent before the deregulation period to 16.0 per cent from total current liabilities during the period after deregulation (see Table 4.1). Similarly, the ratio of excess reserves (as a percentage of current liabilities) also decreased significantly.

However, some of the Government's policies on banking activities are contradictory to the banking deregulation introduced in June 1983. The prohibition of foreign bank operations outside Jakarta is one aspect of this contradictory policy. It must be realized that if foreign banks were permitted to operate outside the capital, private national banks would surely be encouraged to further increase their professionalism.

IV.1. Effects on Mobilization of Resources

One of the main objectives of the 1 June 1983 deregulation policy was to encourage banks to maximize their funds mobilization. The deregulatory moves have, no doubt, encouraged greater competition in the banking system. From the point of view of funds mobilization, the reform has been extremely successful. Time deposits have grown at a much higher rate than during the period prior to the deregulation policy. Bank deposits have been very attractive to the public and helped in reversing the previous pattern of private capital outflows. With the new competition for funds, 3-month, 6-month and 12-month time deposits showed an explosive growth. At the same time, offshore dollar accounts were also brought home as domestic dollar accounts.

Total time deposits at both state banks and domestic and foreign private banks rose from Rp. 2,198 billion before the deregulation period (i.e., March 1983) to Rp. 4,441 billion by the end of 1983, and to Rp. 6,022 billion by the end of 1984 (Table 4.4). However, the proportion lodged with state banks rose slightly from just under 56.0 per cent before the deregulatory changes to 58.0 per cent at the end of 1984. The deregulatory policy has motivated the banks and other deposit-taking institutions to become more self-sufficient in the financial system.

One of the main objectives of the policy to liberalize banks to set their own interest rates on deposit accounts and loans is to encourage banks to be more self-reliant, so that instead of depending on subsidized funds (liquidity credits) from Bank Indonesia, they financed their credit operations with funds mobilized from the public. The result of the policy is encouraging, in the sense that banks have improved their efficiency and professionalism in order to improve their ability to compete in funds mobilization and credit extension by offering more attractive interest rates and better services.

Classified by maturity, the share of the 24-month maturity time deposits (TDs) declined continuously while that of other TDs increased after the deregulatory moves of June 1983. The share of 24-month maturity TDs declined from 33.0 per cent at the end of May 1983 to 5.8 per cent at the end of March 1985. Declines were registered by all groups of banks. By maturity, a relatively rapid increase occurred in the 12-month TDs. This was a relatively high level of 50.5 per cent of all rupiah time deposits compared with 47.5 per cent in the preceding year.

The increase in the share of other TDs mainly occurred in the maturities of 12-month, 6-month and 3-month TDs after 1983 deregulation (Table 4.5).

Similarly, after deregulation, the amount of certificates of deposits (CDs) issued by handling banks increased markedly. The certificates of deposits (CDs) increased from Rp. 72 billion at the end of 1982 to Rp. 374 billion at the end of 1983. Following a decline of around 50.0 per cent during the financial year 1986-1987, CDs jumped further by more than 80.0 per cent to reach Rp. 222 billion at the end of March 1988 (Table 4.6). This increase was, among

Table 4.4

**RUPIAH TIME DEPOSITS
BY GROUP OF BANKS: 1973-1987**

(in Billion Rp.)

End of Period		State Banks	Private National Banks	Regional Development Bank	Foreign Banks	Total
1973		163	17	2	32	214
	1973/74[a]	199	21	2	40	262
1974		290	25	3	41	359
	1974/75	334	28	3	43	408
1975		454	38	3	44	539
	1975/76	533	44	4	48	629
1976		652	56	4	50	762
	1976/77	664	58	4	54	780
1977		737	77	5	76	895
	1977/78	747	78	5	77	907
1978		765	87	6	73	931
	1978/79	770	88	6	74	938
1979		775	123	7	86	991
	1979/80	797	129	8	104	1038
1980		903	209	10	157	1279
	1980/81	971	243	11	164	1389
1981		1093	382	19	260	1754
	1981/82	1110	404	21	283	1818
1982		1231	572	35	360	2198
	1982/83	1347	579	40	442	2408
1983		2831	1078	56	476	4441
	1983/84	3049	1216	61	591	4912
1984		3497	1750	79	696	6022
	1984/85	3925	1805	82	733	6545
1985		5337	2755	120	676	8888
	1985/86	5569	2741	131	648	9089
1986		6729	3131	165	500	10525
	1986/87	7207	3462	178	600	11448
1987		9385	5212	206	665	15366

a. Financial year.

Source: Bank Indonesia Annual Report, various issues.

Table 4.5

RUPIAH TIME DEPOSITS BY MATURITY AT ALL BANKS: 1973-1987

(in Billions Rp.)

End of Period		24 mths	12 mths	6 mths	3 mths	1 mth [1]	Others	Total
1973		122	30	18	19	10	15	214
	1973/74[a]	149	37	22	23	12	19	262
1974		204	51	30	32	16	26	359
	1974/75	232	58	34	36	18	30	408
1975		306	76	46	48	24	39	539
	1975/76	374	89	53	47	26	40	629
1976		523	112	53	42	28	4	762
	1976/77	536	114	54	43	29	4	780
1977		605	82	92	49	64	3	892
	1977/78	610	83	94	49	68	3	907
1978		612	97	104	42	73	3	931
	1978/79	614	98	105	43	74	4	938
1979		612	99	126	32	103	19	991
	1979/80	618	103	139	54	109	15	1038
1980		679	128	183	100	168	21	1279
	1980/81	721	163	199	106	180	20	1389
1981		834	231	237	161	252	39	1754
	1981/82	855	250	229	160	236	98	1818
1982		966	322	275	195	358	82	2198
	1982/83	950	335	283	256	483	102	2408
1983		683	1265	843	605	934	111	4441
	1983/84	591	1620	891	632	1010	168	4912
1984		396	2352	1132	877	1062	203	6022
	1984/85	379	2778	1181	955	1101	161	6545
1985		536	3927	1504	1403	1329	189	8888
	1985/86	631	4319	1579	1340	1094	136	9089
1986		671	5227	1767	1448	1280	132	10525
	1986/87	640	5786	1583	1767	1459	213	11448
1987		910	6061	1543	3331	3314	207	15366

1. Includes matured time deposits.
a. Financial year.

Source: Bank Indonesia Annual Report, 1986-1987.

others, attributable to attractive rates offered on this instrument and also to the increase in the number of banks that issued CDs. By maturity, the largest portion of CDs issued by state commercial banks are the 6-month maturity followed by the 1-month maturity, while those issued by foreign banks are of 6-month and 3-month maturities. Therefore, by virtue of the deregulatory moves of 1 June 1983, funds mobilized by banks in rupiah as well as in foreign currencies rose by more than 100.0 per cent at the end of March 1986 compared to just Rp.10,190 billion at the beginning of 1983. In other words, the amount of funds mobilized by banks in 1986 experienced an increase of 22.0 per cent. However, it is lower than the figure for the preceding year 1985, i.e., 30.0 per cent. Among the fund mobilized, demand deposits experienced the lowest growth. On the other hand, the share of TDs and savings deposits increased. The higher share of TDs and savings deposits were mainly due to the attractive interest rates offered on rupiah TDs and Tabanas as well as the tax exemption.

But in the banking environment of Jakarta, the moves by some state banks to come to grips with a more unfettered role and set of expectations are putting them into a new arena of international influences. Indonesia's five state banks are to varying degrees, now grappling daily with new technology, a need to be more responsive to international price movements and the threat of more competition at home and abroad. This new environment was thrust upon in June 1983 when government limits on interest rates, restrictions on areas of business and some forms of government protection were abolished. In this regard, a study was also undertaken to investigate empirically the inter-relationship among private investment, interest rates, credit and quasi-money in Indonesia before and after the 1983 financial deregulation. The study revealed that "after the 1983 financial deregulation, real interest rates became more effective in influencing the growth of real quasi-money since there is no feedback occurring from the real quasi-money to the real interest rate. The tests also show that there is only one way causality running from real credit to real investment following the deregulation. Prior to the deregulation, direct causation from real quasi-money to real credit does not exist". [23] These evidences indicate that the 1983 financial deregulation has brought a successful impact on the funds mobilization and on the utilization of the funds to finance private investments.

It should be further noted that towards the end of March 1985, bank umum suasta nasional (BUSN) or the private deposit money

Table 4.6

CERTIFICATES OF DEPOSITS [1]

(in Billions Rp.)

End of Period	State Banks	Foreign Banks [2]	Total
1978	14	33	47
1979	14	19	33
1980	52	27	79
1981	55	26	81
1982	59	13	72
1983	352	22	374
1984	112	18	130
1985	279	42	321
1986	94	37	131
1987	69	132	201
1988 (March)	64	158	222

1. Outstanding certificates of deposits represent the amount outstanding at the end of the previous period plus the amount sold and less the amount redeemed during the concerned period.

2. Since March 1985, includes the outstanding certificates of deposits owned by private national commercial banks.

Source: Bank Indonesia Annual Report, 1987-1988.

bank also started to issue CDs. Furthermore, commercial papers of NBFIs or lembaga keuangan bukan bank (LKBB) rose by 25.4 per cent. Trade in SBPU, which just started in February 1985, already showed remarkable progress. Following the re-affirmation of the 1983 deregulatory policy; several private national commercial banks (e.g., BUSN) already started to issue CDs. Prior to the deregulatory moves, the issuance of CDs was only implemented by state commercial banks and most foreign banks.

Therefore, from the point of view of mobilizing the funds from the public, the deregulatory reforms of June 1983 has been extremely successful. Time deposits increased at a much higher rate than previously. As a vehicle for saving, bank deposits have been very attractive to the public. Secondly, funds as a whole have been more expensive and banks have been competing more vigorously for funds than previously. Therefore, the objective of attempting to install fair competition has been successful.

IV.2. Effects on Interest Rates

One consequence of the deregulation policy was also the change in the behaviour of interest rates. The effect on interest rates was, therefore, dramatic. State banks reacted rapidly to deregulation, raising the time deposit rates more or less up to the same rates as private banks in order to compete more effectively. Private national banks initially kept their rates at the pre-deregulatory reform level but later gradually adjusted their deposit rates up slightly (see Table 4.3). Following the deregulation, interest rates, both in real and nominal terms, remained high by international standards. The high level of interest rate is the logical result of the climate of competition that came about following deregulation of the banking system.

The relatively stable growth of interest rates, even though it occurred in a situation in which banks have the freedom to set their own interest rates, is hard to prove to be the result of agreement among banks, since in mobilizing funds from the public and channelling them as credits, banks have to compete intensely by offering attractive interest rates and better services. The stable growth of

23. For details see, Sihotang, Kilian, Bambang S. Wahyudi and Widharto, "*The Interrelationship Among Private Investment, Interest Rate Credit and Quasi-Money in Indonesia Before and After The 1983 Financial Deregulation*". A paper presented at the Eighth Pacific Basin Central Bank Conference on Economic Modelling, 11-15 November 1988, Kuala Lumpur, pp. 18-19.

interest rates was, consequently, much more affected by the government (Bank Indonesia) policy to influence interest rates in order to maintain monetary stability, which are implemented through indirect monetary policy instruments, i.e., open market operations (SBI, SBPU), discount facilities and moral suasion.

The financial deregulation would have given more freedom of manoeveur to banks in their funds management and the implication of this freedom would be to enable banks to reduce the margin between the deposit and the lending rate. However, the system of simplification of the liquidity credit or the refinancing facilities extended by the central bank created less funds available by the central bank for banks to finance their lendings to the non-priority sectors. Consequently, the banks have to compete tightly by offering attractive interest rates on deposits. However, nominal interest rates on deposits of private banks have not really increased since the period before deregulation. For instance, in 1979, the interest rate was about 15.0 per cent or more, or about the same level as it is now. But what has increased considerably is the deposit rates of state-ownedbanks. In 1979, interest rate was still very low and then it fluctuated a little bit. After the financial deregulation it jumped up to the level of 15.0 to 16.0 per cent (see Table 4.3). However, the real interest rate, even at the private banks, has increased considerably after deregulation.

The introduction of deregulation, therefore, brought about a keen competition among banks in mobilizing funds from the public leading to an increase in the interest rates offered by banks on deposits. These high deposit rates raised the cost of funds of banks, which in turn raised the lending rates. The high interest rate is also a reflection of the actual market situation. However, there is a close link between domestic interest rate and the interest rates abroad. The high interest rate is also closely related to the expectation of domestic currency depreciation. As regards the market situation, the domestic financial system is not large enough to offer different financial services other than interest rate as a means of competition. Therefore, the interest rate has, in fact, been high in Indonesia in real terms after deregulation. This indicates that "interest rate is largely uncontrollable by the monetary authorities due to the link between domestic and foreign interest rates plus the expectation of domestic currency depreciation. On the other hand, monetary aggregates, particularly M1, appear to have a stronger relationship with economic activity than does interest rate. Therefore, as a preliminary conclusion, it would be more appropriate to choose monetary aggregate as an intermediate target for monetary policy instead of interest rate". [24]

Therefore, Bank Indonesia has to take steps to encourage a reduction in interest rates. Accordingly, measures to reduce interest rate levels were undertaken by lowering the discount rates of both the Sertifikat Bank Indonesia or SBI (Bank Indonesia certificate), discount facilities and the rediscount rate of the Surat Berharga Pasar Uang or SBPU (money market securities). The 30-day SBI discount rate was reduced from 16.0 per cent to 14.0 per cent per annum in August 1985 and the 90-day SBI from 17.0 per cent to 15.0 per cent per annum in October 1985. The rate of the discount facilities was reduced from 21.0 per cent to 19.5 per cent per annum in July 1985 and to 18.5 per cent per annum in August 1985. In the meantime, the SBPU rediscount rate, which had been fixed at 20.5 per cent since February 1985, was consecutively reduced to 19.5 per cent per annum in May to 18.0 per cent in July, and finally to 17.0 per cent per annum in August 1985. The gradual reduction of the discount rates of those monetary instruments have also brought about a reduction in the interest rates of rupiah deposits by 4.0 percentage points to an average of 16.0 per cent per annum at the end of March 1986.

However, since some old deposits with high interest rates still existed and could only be replaced gradually by new deposits with lower interest rates, the lending rates could only be expected to decline gradually. The average lending rate declined from 23.4 per cent per annum in March 1985 to 21.3 per cent per annum in October 1986. The impact of June 1983 deregulatory moves has, therefore, been heightened by their almost simultaneous nature. This is apparent in the decision of a number of private banks to reduce their interest rates on certain kinds of time deposits. Reduction of interest rates on credit, however, especially credit of longer time period, will be more difficult. The main problem is, generally, the uncertainty of the longer-term deposits.

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24. Syahril Sabirin, "Interest Rate After the Financial Deregulation in 1983: Some Key Policy Issues", in Selected Key Policy Issues in the Indonesian Economy: Proceedings and Papers of Bank Indonesia — IMF Institute Seminar on Financial Programming and Policy, Jakarta, 17-28 November 1986, pp. 92-96.

IV.3. Effects on Profitability of Banks

It may be recalled that in June 1983 the central bank initiated financial reforms. Credit ceilings were abolished and state banks were free to set their deposit and lending rates. Since the state banks play dominant roles in the financial systems of Indonesia, the competition among banks consequently became stiffer, especially in fund accumulation areas. The cost of funds rose significantly due to the rise in deposit rates, and banks were forced to operate more efficiently. To do so, banks have to optimize the use of their funds by increasing their off-balance-sheet (OBS) activities, or in other words fee-based activities, and also engaging in other types of OBS activities such as sale of assets with repurchase agreement and money market securities.

In line with these developments, the value of OBS items increased significantly. The figures reported by banks show that during the period 1982-1986 the outstanding amount of those items of all banks increased by 290.0 per cent, especially in the form of forward sales of foreign exchange which rose by 540.0 per cent. Most of these transactions were done by state banks and foreign banks which shared 43.0 per cent and 40.0 per cent, respectively, of total outstanding OBS items by the end of 1986.

After the June 1983 deregulatory moves, the tendency of banks to engage in assets sales with repurchase agreement, mainly intended to avoid capital adequacy requirement, has increased significantly. Accordingly, banks sell their buildings and equipment and lease them back. These activities are done through banks' own leasing companies and are covered by repurchase agreements. According to capital adequacy requirements, 75.0 per cent of investment in fixed assets must be financed by bank's own capital. By using these transactions, banks could reduce substantial amounts of the capital required, while the risk assumed by banks remain negligible. Similarly, the outstanding balance of forward foreign exchange transactions, mainly currency swaps, increased almost by three times compared to the balance at the end of 1982.

V. Deregulation and Competitive Financial Environment

In the banking sector, banking business demonstrated a satisfactory performance. This could be seen from the increase in the amount of assets of deposit money banks (DMBs). Based on assets, the share of private national banks increased significantly after the 1983 deregulation, whereas that of other groups decreased. With respect to loans, the share of private national banks rose, whereas that of foreign banks declined. With regard to the fund mobilization, the share of both state banks and private national banks increased, whereas those of other groups decreased. The overall bank loans also increased as compared to the pre-deregulation period. Of that amount, more than 90.0 per cent originated from DMBs loans. The most significant increase was registered by private national banks (Table 4.7) while state banks, which accounted for more than 70.0 per cent of overall DMBs loans, experienced a slow growth of banking business.

It must be remembered that, among all the commercial banks currently in operations, the five state-owned commercial banks play a dominant role and accounted for more than 70.0 per cent of total assets of the banking system. Nevertheless, the private national foreign exchange banks and other private national banks were the only banks to experience the highest growth in the volume of business. Therefore, the interest rate deregulation was more favourable to the private national banks.

The bank lending amounted to Rp. 19,336 billion in March 1985 as compared to Rp. 10,735 billion in March 1982, i.e., before the period of deregulation (Table 4.8). The amount of bank lending, however, was up by only 16.0 per cent in March 1986 compared to around 20.0 per cent in 1985. Credit extended by the deposit money banks rose significantly as evidenced by their share in total loans outstanding (see Table 4.7), whereas credit extended by state commercial banks increased by a marginal amount after the deregulatory moves. At the end of the year 1987, bank lendings amounted to Rp. 27,852 billion, having increased by 24.2 per cent compared with 16.0 per cent in 1986. This increase was the highest since the 1 June 1983 deregulatory reform. However, funds mobilized by the banks after the deregulatory reforms (which rose by more than 30.0 per cent in 1985) increased by only 16.5 per cent in 1986 (Table 4.8). Nevertheless, improved economic activities after the June 1983 deregulatory moves has been reflected till 1985 from the growth of the offices, increases of assets, funds mobilized and credit extended by the deposit money banks (DMBs).

Over the short-term, monetary management has been complicated by the emergence of foreign exchange speculation as indicated earlier, necessitating liquidity to be tightened beyond the pro-

Table 4.7

SHARE OF GROUP OF BANKS IN TOTAL ASSETS, FUNDS AND OUTSTANDING LOANS: 1978-1987

(as a Percentage of Total)

Year (End of March)	State Banks			Private Nat. Banks			Regional Dev. Banks			Foreign Banks		
	Assets	Loans	Funds	Assets	Loans	Funds	Assets	Loans	Funds	Assets	Loans	Funds
1978	77.7	81.6	76.9	9.7	8.7	9.5	3.1	2.0	3.6	9.5	7.7	10.0
1979	78.7	81.4	75.7	9.3	8.7	10.0	3.3	1.9	4.3	8.7	8.0	10.0
1980	79.0	80.1	76.6	8.9	9.9	9.6	3.5	2.1	4.3	8.6	7.9	9.5
1981	79.8	78.9	77.8	9.4	19.7	9.6	3.9	2.8	4.6	6.9	7.6	8.0
1982	79.6	78.5	76.1	9.9	11.0	11.0	3.6	3.2	3.8	6.9	7.3	9.1
1983	77.0	78.4	70.7	11.2	11.9	13.2	3.2	3.2	3.5	8.6	6.5	12.6
1984	74.8	74.4	69.5	13.9	15.5	16.3	3.5	3.1	3.6	7.8	7.0	10.6
1985	73.4	73.9	66.6	15.3	17.5	18.5	3.5	2.9	3.0	7.8	5.7	11.0
1986	72.1	71.7	65.3	17.6	20.5	21.8	3.4	2.9	3.5	6.9	4.9	9.4
1987	71.3	71.7	66.0	19.5	21.0	22.8	3.0	2.9	2.9	6.2	4.4	8.3

Source: Bank Indonesia, Report for the Financial Year, various issues.

Table 4.8

BANKING FUNDS AND CREDIT DEVELOPMENTS: 1978-1987[1]

(in Billions Rp.)

Year	Deposits			Total Deposits	Total Bank Credits[2]	Annual Growth Rate (in Percentage)	
	Demand	Time	Savings			Total Deposits	Total Credits
1978	1536	1287	201	3024	3945	-	-
1979	2560	1458	226	4244	5490	40.0	39.2
1980	4446	1651	314	6411	6327	51.1	15.2
1981	5380	2210	420	8010	8154	25.0	28.9
1982	5396	2982	490	8868	10735	10.7	31.7
1983	6031	5782	584	12397	13705	39.8	27.7
1984	6965	7779	754	15498	16135	25.0	17.7
1985	7427	11727	1020	20174	19336	30.2	19.8
1986	8157	13967	1387	23511	22430	16.5	16.0
1987	8796	18907	1628	29331	27852	24.8	24.2

1. Banking funds and credits in foreign currency, and certificates of deposits are also included.
2. End of March figure.

Source: Bank Indonesia, Report for the Financial Year, various issues.

gramme targets. However, the monetary instruments introduced in line with a more indirect control since the 1983 policy seem to be sufficient to curtail speculative action in the bourse, while maintaining some control on total liquidity. The high rates of interest, which may be harmful to productive activities in the long-run, have recently declined. In the long-run, financial stability will support investment activities such that a sustainable development is facilitated.

Despite the successful mobilization of resources, as a result of the June 1983 deregulation policy, the volume of activities of the banking sector, however, did not experience a significant increase during 1986 compared with the increase in the preceding year 1985. The slower growth in the total volume of business of the banking sector is also the reflection of the slower growth of the economy. It may be added that among the various categories of banks, the private national foreign exchange banks and other private national banks experienced the highest growth in the volume of business.

VI. Problems and Issues Associated with Deregulation

There are two main issues in the field of monetary policy that followed the June 1983 deregulatory reform. One was the issue of how to develop an arsenal of effective policy instruments for the purpose of monetary control. With the liberalization of the banking sector, the monetary control by the central bank could not be anything else but an indirect control. It became imperative, therefore, for the central bank to develop such indirect policy instruments. The second issue was the follow-up steps that needed to be taken to guide the development of the financial sector toward an efficient sector capable of serving better the development needs of the country.

The follow-up measures of the June 1983 reform is an on-going process. Several major steps have so far been taken. In the direction of developing new instruments, the central bank has of late experimented (with notable success) with new financial instruments (the SBI and SBPU) which are hoped to be a basis for developing a money market for an effective open market operation. In the direction of raising efficiency of the financial sector, there have been steps to improve internal efficiency of the banks, particularly the state banks which still dominate the banking sector.

VI.1. Deregulation and Selective Credit Policy

Even in the environment of deregulation, there still exists a tradition of granting a substantial volume of credit at preferential interest rates (as a subsidy to borrowers), i.e., rates below, the market rates that are determined by market forces to the priority sector activities. This type of portfolio regulation is generally inconsistent with the deregulation of interest rates. It might affect the deregulatory moves in creating a competitive financial environment. In this regard, it is true that the provision of liquidity credits from Bank Indonesia with low interest rates for economic sectors/activities classified as high priority seems to be inconsistent with the deregulation policy. The policy is, however, closely related to the banks' role as agent of development, which have to support development by financing activities/economic sectors classified as high priority, which might not be attractive to the banks unless supported with subsidized funds from Bank Indonesia. Such economic sectors/activities classified as high priority cover, among others, efforts to develop the economically weak group, to boost export, and to create new employment opportunity. In addition, it should also be noted that the decision to classify certain activities/economic sectors as high priority as well as the credit extension to those sectors are implemented in a quite selective way and are supplemented by necessary security measures, including the determination of the executing banks, credit maximums and the implementation procedures.

Before 1 June 1983, the central bank controlled the level and structure of deposit and lending rates of state banks, while both national private banks and foreign banks were free to set their own deposit and loan rates except for loans which were eligible to be financed in part by the provision of liquidity credit. The state banks lent mainly to priority sectors of which the central bank granted rediscount credits (liquidity credits) at subsidized rates. This kind of system gave some imbalances. Deposit rates of state banks were maintained at levels below those of private banks so that in the period before 1 June 1983 time deposits in private banks grew more sharply. The weighed average interest rate on loans from the state banks was lower than those in private national banks and foreign banks mainly because state banks lendings to priority sectors were subsidized. Therefore, elimination of interest rate controls and the reduction of liquidity credits were aimed at encouraging competition, making the financial system more reliant on the market signal and increasing the autonomy of banks in allocating credits.

The changes introduced in the liquidity credits system were designed to provide greater autonomy to commercial banks in their credit management to develop a sharply focused definition of priority sectors. Nevertheless, with the policy introduced since 1 June 1983, the central bank still makes available discount facilities on a 'more restricted' basis and only credits with high priority could enjoy such facility. In other words, the priority sector is still a regulated sector. However, the total amount of such priority credits only constitute a relatively small portion in the total credits extended by banks. Consequently, the negative impact of the extension of subsidized credits with low interest rates can be expected to be limited.

VII. Move Towards Re-regulation

While the deregulatory measures mobilized resources successfully enough, they also raised the cost of borrowings at the time of recession. With banks being forced to the discount window, the central bank unveiled a 'special credit facility' offering funds at a 'penal rate' to be repaid in two parts, i.e., in six months and one year. It also imposed on all banks a fixed limit on interbank borrowing. The interbank credit ceiling was raised from 7.5 per cent to 15.0 per cent of the rupiah funds mobilized. However, this limit has been terminated by the second phase of deregulation initiated in October 1988.

The rationale for interbank borrowing restriction can be attributed to the disruption in the interbank call money market that occurred in August and September 1984. Interestingly due to the rise in deposit rates, the banks were forced to operate in fee-based activities. To do so, banks had to optimize the use of their funds by increasing their off-balance-sheet (OBS) activities but with greater risk exposures. The outstanding amount of OBS items increased markedly, especially in the form of forward foreign exchange transactions. Recently, there is a tendency among banks to engage in interest swap transactions with foreign banks but the figures have not been covered by the existing reports.

Therefore, re-regulatory moves is also taking place to some extent. In October 1986, the central bank had to issue new regulations concerning currency swap transactions. The main features are as follows:

- Although foreign exchange banks are allowed to engage in forward foreign exchange transactions, only those banks classified as sound or fairly sound are allowed to engage in currency swaps.

- Currency swaps provided by banks are eligible only for offshore loans received by bank's customers, but banks are free to set the premium and the maximum amount of swaps. In this regard, banks can make swap arrangements with the central bank for offshore loans received by banks.

Further, to reduce risk, the central bank had to impose the following limits on guaranteed activities:

- Banks were not allowed to guarantee loans granted or funds received by other banks or non-bank financial institutions.

- Banks were allowed only to endorse marketable securities.

- Banks were not allowed to issue guarantees in foreign exchange, except for certain activities.

- The maximum amount of total outstanding guarantees issued by a bank is 40.0 per cent of its deposits or twice its equity, whichever is larger.

- The face value of a letter of guarantee issued for each project financed or face value of each paper endorsed must not exceed 50.0 per cent of bank's equity.

Therefore, some of the government policies on banking activities are contradictory to banking deregulation introduced in June 1983. An example is the prohibition of foreign bank operations outside Jakarta, although some relaxation has been initiated in this area after the second stage of deregulation initiated in October 1988. Debate on whether foreign banks should be allowed to operate outside Jakarta has ramifications beyond mere commercial interests of foreign banks themselves. If foreign banks were permitted to operate outside the capital, private national banks would surely be encouraged to further increase their professionalism. [25] Another example of the Government's ambivalence is the set of remaining restrictions on private commercial banks in developing certain industrial sectors. There is a general feeling that more time is needed

25. The second phase of deregulatory measures undertaken in October 1988 has allowed foreign banks (that are classified as 'sound', including their capital) to open sub-branch offices outside Jakarta, however, in selected places only.

for private national banks to increase their professionalism before they can beexposed to the rigours of international competition. But given the experience of the last two or three years, work on deregulation cannot be done on a piecemeal basis. Change should be comprehensive and thoroughly explained. Otherwise, deregulation will be hindered by the policies of re-regulation instituted by others. There is a tendency to stay away from regulation, but it causes many dilemmas. For instance, the major problem is the continuing high rates of interest. Control of risk and uncertainty through a range of economic instruments is inadequate, so that the Government instead tends to provide subsidies and to create institutional distortions. Further, it must be realized that the deregulatory moves of June 1983 have encouraged the emergence of more self-reliant financial institutions and greater competition in Indonesia's financial markets, no small achievement for such a large and under-banked country. But competition with prudence should be the basic norm.

Appendix 4

Some Major Regulatory and Prudential Measures (1976-1986)

1. Prohibition to open new banking institutions in Indonesia. [a]

2. New guidelines on capital adequacy: credit with higher risk are applied with higher margin compared with lower risk credit; according to the degree of risk, credit is being classified by its collectibility, i.e., insured, uninsured credit with balance under 15.0 per cent by bank's owned capital and uninsured credit with balance above 15.0 per cent of bank's owned capital.

3. All banks are required to hold minimum liquid assets of not less than 15.0 per cent of their liabilities base, of which minimum cash balance with the Central Bank to be not less than 5.0 per cent of the liabilities base. [b]

4. Mergers among private national banks are encouraged in orderto strengthen their management, capital and improve the efficiency of their activities.

5. A limit is imposed on each bank's borrowing in the inter- bank market equivalent to 15.0 per cent of the bank's third party liabilities. [c]

6. Foreign banks are not allowed to receive savings deposits.

7. Foreign banks are not allowed to operate outside Jakarta without joint financing with local banks with the exception for export credit.

8. Bank are not allowed to guarantee other bank's loans and non-bank financial institution's loans.

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a. State banks, regional development banks, private national banks and cooperative banks guaranteed facilities to open bank branch offices throughout Indonesia effective 27 October 1988.

b. The minimum liquidity requirement for banks has been lowered from 15.0 per cent to 2.0 per cent of liabilities to third parties (demand, time and savings deposits) effective 27 October 1988.

c. This limit has been terminated effective 27 October 1988.

9. State-owned banks are prohibited to lend working capital and investment loan in foreign currency to foreign and joint venture company except loan extended to support export non oil-commodity.

10. Banks are not allowed to lend to non resident.

11. Non-bank financial institutions are not permitted to accept demand deposits, time deposits, and savings deposits.

12. Joint-venture banks can be established by one or several domestic banks only in association with one or several foreign banks.

13. To establish a joint-venture bank, the participating domestic bank should have operated as a "sound" bank for at least 20 months, including its capital adequacy, and as a "fairly sound" bank during the remainder of that period.

14. To participate in a joint venture bank, a foreign bank must be established as a bank of high ranking in the country of origin and the paid-up capital must be not less than Rp. 50 billion of which domestic ownership must be at least 15.0 per cent and foreign ownership no more than 85.0 per cent; and after 12 months of operations, outstanding export credits extended by the joint venture bank must reach at least 50.0 per cent of its total credits outstanding.

15. In order to open a bank branch office or to become a foreign exchange bank during the preceding 24-month period a bank is required to have operated as a "sound" bank, including its capital adequacy, for at least 20 months and as a "fairly sound" during the remainder of that period.

16. After 12 months of operation, outstanding export credits of a sub-branch office of a foreign bank (that is classified as "sound" including its capital) should reach at least 50.0 per cent of their total credits outstanding.

17. In order to strengthen the soundness of banks and non-bank financial institutions (NBFIs), they are subject to various legal lending limits in extending bank credits to individual borrow-

ers, groups of borrowers, shareholders and executive staff. The legal lending limits are — 20.0 per cent of the bank's/NBFI's own capital for credit facilities to any single borrower; 50.0 per cent of the bank's/NBFI's own capital for credit facilities to any group of borrowers; 5.0 per cent of the bank's/NBFI's capital for credit facilities extended to the members or businesses of the Board of Commissioners who are not shareholders; 15.0 per cent of bank's/NBFI's capital for credit facilities extended to the members of the Board of Commissioners who are not shareholders and their business group; 10.0 per cent of the share of equity participation in a bank/NBFI for credit to shareholders or two owners of the business; 25.0 per cent of the share of equity participation in a bank/NBFI; and credit to be linked to the repayment capacity of the borrowing board-members and employees and the repayment capacity to be based upon income earned from the respective banks/NBFIs.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Bank Indonesia, 1987.

Chapter 5

Financial Deregulation in Malaysia

I. Rationale and Objectives of Deregulation

The main objective of the deregulatory policy of 1978 interest rate reforms was to create a healthy and open competition environment in the banking industry. The rationale of reforming the liquidity requirements of banks and finance companies was to have an accurate picture of the liquidity position of the commercial banks and the finance companies. It may be recalled that the gradual process of deregulation had already started during the early 1970s. Wholesale banking was introduced with the approval of the first merchant bank in 1970. The main objective of allowing merchant banks to operate in wholesale banking in the 1970s was, therefore, to complement and supplement the operations and services already offered by the commercial banks and the finance companies. Further, the objective of allowing the merchant banks to extend loans in foreign currency to residents for the financing of ventures was to raise domestic productive capacity and to support the purchase of assets owned by non-residents.

With the growth of merchant banks in the early 1970s, their deposit-taking and lending activities were exempted from the central bank's interest rate administration so as to allow flexibility in determining deposit and lending rates. On 1 August 1973, the ceilings on deposit rates payable by the finance companies were lifted completely and their rates were allowed to be determined by market forces. A new system of weekly tenders for treasury bills was implemented in place of the tap system and the discount rate on treasury bills was being determined by open tender in the money market since 20 August 1973. The rationale of this system was to allow the discounts on treasury bills to be determined in the market place.

Ultimately, in order to foster greater competition in the financial industry to the advantages of both savers and borrowers, a new interest rate regime was launched on 23 October 1978. Accordingly, commercial banks were free to quote the interest rates payable on deposits and the prime and preferential rate chargeable on loans and advances. However, with effect from 1 November 1983, all interest rates on loans and advances, other than those prescribed by maximum ceiling rates and law, have been tied to the base lending rates of the respective largest commercial banks. Further, the deposit rates of the banks and finance companies became linked to the deposit rates of the two leading domestic banks with effect from 21 October 1985.

The objective of the new system of interest rate determination which came into effect on 1 November 1983 was, therefore, to ensure that borrowers would benefit when interest rates fell. Under this new regime, all borrowing rates, except those for loans extended to the priority sectors, were anchored to a bank's declared base lending rate (BLR). Only the interest margin would be fixed depending on the borrower's credit standing, and the lending rate charged would move in line with a bank's BLR. The main rationale of this system was the introduction of automaticity, which was "intended to remove much of the commercial bank's discretion as to who should benefit or be penalized and to what extent, when interest rate changes". The second rationale of this mechanism was to prevent the asymmetric adjustment in interest rates, whereby fall in the lending rates tend to lag far behind a fall in deposit rates, and an increase in deposit rates are reflected in high lending rates almost automatically.

The central bank, also, had to initiate a series of measures in 1985 by way of reducing and adjusting the statutory reserve ratio of the commercial banks; merchant banks and finance companies. The rationale of these measures was aimed at deregulating the operations of the banking system in an orderly manner and also preparing the groundwork for more equal and effective competition. In other words, the objective of deregulation was to improve liquidity in the banking system, and equalize the competitive differential in the cost of funds by reducing liquidity ratio and statutory reserve requirements for commercial banks, whereas raising the statutory reserve requirements for the merchant banks and finance companies. Similarly, the base lending rate has been reduced several times, the rationale of which was the need to reduce interest rates generally in order to counter the deflationary impact of falling commodity prices.

The decision of allowing commercial banks and finance companies to set their own interest rates even for fixed deposits up to 12-month maturity instead of keeping with fixed levels effective from 26 January 1987, was a part of measures to improve efficiency in the financial system and stimulate business by lowering the cost of funds. The decision to 'unpeg' the deposit interest rates means banks and finance companies can now compete freely for deposits offering attractive interest rates. [26] The rationale of unpegging the deposit rates completely can be attributed to the ample liquidity generated in the banking system. The objective of this greater flexibility in setting interest rates is again aimed at improving efficiency in the mobilization of funds in the economy. The measures were aimed at developing the domestic financial market, improve the efficiency of the financial system and stimulate private sector activities.

Another decision to allow the financial institutions to 'average' when meeting their liquidity requirements was aimed at reducing the cost of bank funding. This measure was designed to introduce greater flexibility for these institutions in meeting their liquidity requirements, reduce interest rate volatility in the interbank market, where banks borrow from one another, and reduce cost of bank operations.

Further, the rationale of pegging the maximum interest rates to be charged by the commercial banks on loans to all priority sectors at 1.75 per cent above the average of the base lending rate (BLR) of two leading domestic banks or 9.0 per cent per annum, whichever is lower, is aimed mainly to align the ceiling rates closely to the cost of funds. Therefore, in line with the decline in interest rates and in order to provide some degree of automaticity in the adjustment of rates, the interest rate on loans to the priority sectors has been pegged to the BLR, subject to a maximum level.

The unpegging of deposit rates with effect from 1 February 1987 and the averaging of liquidity requirements on the basis of a specified liquidity period (instead of maintaining the ratios on a daily basis) were aimed at improving the management of funds and to allow greater flexibility and efficiency in the determination of interest rates. When the pegged interest rate system was introduced, it was viewed as a temporary response to special circumstances in an environment of tight liquidity of the early 1980s. In general, the arrangement had served its purpose in preventing deposit rates from rising higher than was desirable. Following the emergence of ample liquidity in the markets, declining interest rates and pick-up in deposits of the private sector in the late 1980s, the central bank had to dismantle the pegged interest arrangement.

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26. Previously, banks and finance companies used to set their rates for fixed deposits up to 12 months within a fixed margin above the rate (i.e., not more than 1.5 per cent) quoted by the two leading banks (Bank Bumiputra Berhad and Malayan Banking Berhad).

Therefore, freeing of interest rates had been indeed one of the major concerns of deregulation. The rationale behind this deregulation, is that, it is the key to the entire reform so as to let the market forces dictate interest rates. The rationale is also based on the fact that it is timely for financial institutions to be independent without much regulation by the central bank. These measures were also aimed to narrow the spread between the lending and deposit rates so that the lending rates should lower without additional adjustment in deposit rates.

The removal of the fundamental barrier demarcating traditional commercial banking from investment banking in 1987, by allowing three largest domestic banks in stockbroking business, while allowing others (which met specific eligibility criteria) to participate in the equity of existing stockbroking firms, was aimed to expedite the corporatization process and to expand further the capability of the stronger financial institutions in order to offer a wide range of financial services to the public. In other words, this measure was intended to promote urgent corporatization of the stock-broking industry. However, this system may raise "potential areas of conflict of interests where the banks act not only as adviser and underwriter but also as agent (stockbroker) and principal". [27]

The rationale of the mechanism of an official index of interbank rates in the Kuala Lumpur money market, known as KLIBOR (Kuala Lumpur Interbank Offer Rate) with effect from 1 June 1987, was to bring about a truly market-oriented financial system. Initially, KLIBOR was expected to perform the role of an indicator of conditions in the interbank money market. In due course, KLIBOR is expected to become the anchor rate for credit and other interest sensitive instruments, such as the floating rate NCDs.

The operation of CAGAMAS Berhad in October 1987 and the investment guidelines of the discount houses were basically aimed at deepening the money and capital market, and also to play an active role in the secondary market. The lending and funding rates of the New Investment Fund (NIF) were unpegged to the average BLR of the two leading banks since October 1986, assuming the responsibility for determining the rates by the central bank itself. The rationale of this move was to widen the scope of NIF and relax its operational guidelines to encourage its usage in order to further stimulate new fixed investments, especially in the manufacturing, agriculture and tourism sectors.

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27. Bank Negara Malaysia, Annual Report 1987, p. 43.

The main objective of permitting seven finance companies to participate in the interbank market was to increase the breadth and depth of the interbank market and to improve the management of liquidity by the finance companies. The rationale for this reform is to reduce the wide interest rate fluctuation and remove the multi-tiered rate structure which presently characterize the interbank market. The primary aim of the central bank to allow participation of finance companies is to help increase the vibrancy of the interbank market. Similarly, the aim to allow merchant banks to issue Negotiable Certificates of Deposits (NCDs) was a measure to promote a more active secondary market for NCDs.

Similarly, the reduction in the liquidity requirement of the commercial banks was intended to ease liquidity conditions among the commercial banks, thus narrowing the cost of liquid funds maintained by the commercial banks and the other financial institutions. However, the objective of raising the statutory reserve ratios of the merchant banks and finance companies by 0.5 per cent to 3.0 per cent of eligible liabilities was to neutralize the competitive differential in the cost of funds. [28]

Further, the objective of several financial reforms undertaken by Bank Negara on 1 January 1989 has been to enhance competition, provide depth to the money market, and further develop the capital market.

II. Circumstances and Conditions for Deregulation

The circumstances before the deregulation of 23 October 1978 are characterized by the rising trend of the general level of interest rates and the declining trend of the liquidity of the banking system. Bank liquidity had shown a fairly persistent decline since the beginning of the year. The short-term interest rate in the money market also rose to significantly higher levels during 1978 and at times exceeding the prime lending rate of the commercial banks of 7.5 per cent per annum. The regulated rate did not tally with the market indicated rate at that time.

It was apparent that if these market conditions were allowed to persist for an extended period of time, not only would bank lending operations be limited by the shortage of funds but a general rise in bank lending rates becomes inevitable. The fund constraint was also hampered by the provision of minimum requirement of 20.0 per cent and 30.0 per cent of the total increase in credits of commercial banks

28. Bank Negara Malaysia, Annual Report 1985, pp. 28-33.

and finance companies to priority sectors and the 'Bumiputera' community. Therefore, a major thrust of the deregulatory policy has to be diverted towards the evolution of a market-oriented financing system, one which can respond more flexibly and efficiently to changing market conditions. Accordingly, the deregulatory measures involved changing the system of determining bank interest rates to a regime that is market-oriented; reform of liquidity requirements to be maintained by the financial institutions, bringing the merchant banks within the ambit of a legal framework, and the introduction of two new money market instruments.

Prior to October 1978, deposits and lending rates of commercial banks were fixed by the central bank in consultation with the Association of Banks. The central bank, however, had been committed to its policy of allowing interest rates to be determined by market forces and healthy competition between the commercial banks and among all financial institutions in the country, based on the belief that a market-oriented banking industry will ultimately work to benefit the public and the nation at large. Moreover, a system of freely competing rates would help to encourage the savings habit and promote the more effective mobilization of savings as well as an optimum allocation of funds among competing users. In the final analysis, the nation's economic interests must lie in having an efficient intermediation between lenders and borrowers. The more efficient the intermediation process, the lower the spread between lending and borrowing rates.

In a market-oriented system, it is the competition among financial institutions that provides the incentive for efficiency. In such an environment, these institutions are expected to be under constant pressure to minimize their costs in order to be able to maintain a narrow spread, and thus attract borrowers as well as savers. The determination of interest rates is, therefore, a market process that reflects the borrowing and lending activities of all participants. The central bank also participates in the market and influences the interest rate by expanding or contracting reserve money, subject to certain limitations, of course. Basically, that is how the free market system should work. The reality, however, is something else.

The hard fact remains that because of imperfect competition and institutional rigidities in the market, bank interest rates in Malaysia have not responded adequately during the years to changes in the financial conditions in the economy. Indeed, the behaviour of interest rates had become asymmetrical. As deposit rates rise, lending rates tend to rise in unison with little time lag. However, when deposit rates fall, lending rates become sticky downwards and fall only after a long time lag. Of particular concern is the fact that, in the course of the years, some banks have even taken advantage of the situation by not only increasing their lending rates (or maintaining them) in the face of falling cost of funds, but also by raising margins in an attempt to increase profits. These banks have been able to do so mainly because of the inability (due to administrative inconvenience and the high transfer cost) of their borrowers to effectively switch bankers to take advantage of lower rates elsewhere.

Although the weighted average cost of funds of the commercial banks as a whole fell, the weighted average lending rate of the banks rose from around 12.0 per cent at the end of 1981 to 12.3 per cent at the end of 1982, even though the mode base lending rate (BLR) of the industry fell to 12.0 per cent at the end of the year, as against 12.5 per cent at the end of 1981 (Table 5.1). In the interbank market, the weighted average rate for 3-month money declined from 10 per cent in December 1981 to 8.3 per cent in December 1982.

The freeing of lending and deposit rates, therefore, did not promote the desired competition during the initial period of deregulation. Interest rates tended to be rigid downwards. There were banks which, after reducing their deposit rates, did not adjust their lending rates. Therefore, in November 1983, the central bank had to ask the banks to peg their lending rates to their declared base lending rates (BLRs), which in turn were based on their cost of funds. It was expected from this policy that the lending rates of the banks should move in consonance with the deposit rates. But interest rates tended again to be rigid because even after the reduction in deposit rates, lending rates were not being adjusted.

As the market was not a perfect indicator, the commercial banks have, since November 1983, been required to anchor all their lending rates (except for loans to the priority sectors or where the rates are prescribed by law) to their declared base lending rate (BLR). Further, in order to maintain parity between different banks and finance companies, such that intense bidding for deposits would not reverse the effects of any interest rate cut, the members of the Association of Banks agreed that their fixed rates would not be more than 0.5 percentage point higher than those of the leading banks. At the same time, the members of the Association of the Finance Companies agreed that their deposit rates would not be more than 1.25 percentage points higher than those of the two leading banks.

Nevertheless, the impact of measures to liberalize the interest rate structure, which began in 1978, was generally beneficial, with posi-

Table 5.1

ASYMMETRICAL TREND OF INTEREST RATES OF COMMERCIAL BANKS: 1977-1987

(in Percentages)

	InterBank Rates [1]				Fixed Deposit Rates					Savings Average Deposit Rates	BLR (Model)	Lending Rate
	Overnight Money	Seven-day Call Money [2]	1 month	3 months	1-m	3-m	6-m	9-m	12-m			
1977	4.8	5.7	-	-	3.0	5.0	5.5	5.75	6.5	5.0	-	9.6
1978	2.470	4.116	-	-	5.0	5.5	5.75	6.0	6.5	5.0	-	9.47
1979	4.372	5.258	-	-	5.25	5.5	5.75	6.0	7.0	5.0	-	9.53
1980	3.308	5.946	-	-	8.5	8.5	8.5	9.0	9.0	6.0	-	10.59
1981	3.467	6.297	-	-	9.0	10.0	10.5	10.5	11.0	7.0	12.5	11.98
1982	5.237	7.947	8.208	8.628	8.0	9.0	9.25	9.5	10.0	6.5	12.0	12.34
1983	8.354	9.412	8.168	9.256	8.25	8.5	8.5	8.75	9.0	6.0	10.75	11.64
1984	5.931	9.087	9.292	9.210	10.0	10.5	10.5	10.5	10.75	7.5	12.25	13.14
1985	4.973	6.594	6.738	7.785	7.25	7.25	7.5	7.5	7.5	6.0	10.75	12.11
1986	1.653	3.038	4.432	6.350	6.0	6.25	6.75	7.0	7.0	6.0	10.0	12.02
1987	3.199	2.980	3.354	4.611	2.0	2.25/ 2.5	3.0/ 3.5	3.5	4.25	3.5	7.5	n/a

1. Daily averge of the week. The rates refer to the inter-bank lending rates of ten banks (interbank rates refer to end-December figures).
2. Data prior to March 1979 refer to those for eight-day money.

Sources: Bank Negara Malaysia, Quarterly Bulletin, various issues.
SEACEN Economic Survey Questionnaire Replies, various years.

tive real interest rates promoting the process of savings and improved competition in the banking industry leading to a gradual reduction in concentration and higher efficiency. Up to the end of 1980, the market was an indicator and the rates of interest in the money market also eased significantly, while interest rates for bank deposits and loans remained relatively stable, rising at a maximum of 1.25 per cent per annum, if at all. However, segmentation in the financial system still remained, with a relatively small bond and capital market. Consequently, the central bank had to initiate a series of measures in the course of 1985, aimed at deregulating in an orderly manner the operations of the banking system and preparing the groundwork for more equal and effective competition, and also to equalize the competitive differentials in the cost of funds, particularly in reducing the statutory reserve requirements and the liquidity ratio.

In other words, the conditions for complete deregulation was favourable only during the late 1980s. With the easing of interest rates and the statutory and liquidity requirements for commercial banks and finance companies, conditions were favourable for 'unpegging' the deposit rates of banks and finance companies completely. Given such current financial environment of ample liquidity, lower interbank rates, declining deposit rates, the decision to allow the banking institution greater flexibility to set their own interest rate in such competitive environment can be regarded as a right step towards complete deregulation. Therefore, the condition was favourable to dismantle the pegged interest rate arrangement with effect from 1 February 1987. But banks were still enjoying interest margins of around 5.75 per cent in 1986 and 5.40 per cent in 1987, which were high compared to 4.0 per cent in 1980. The interest margins of banks have been increasing progressively while they have reduced interest rates on deposits and savings, and lending rates became sticky. Therefore, in the wave of rapid cuts in the base lending rate (BLR), the central bank again had to issue guide-lines effective 1 September 1987 to specify the maximum margin which the banks and finance companies were allowed to charge over their BLR, at 4.0 percentage points per annum.

Hence, deregulation is again associated with some aspects of re-regulation. The bankers may regard this aspect of re-regulation as the central bank's over-enthusiasm in interfering with market forces. At one time, the central bank adopted many features of deregulation, but the market conditions did not generate a competitive environment, with demand for loan increasing and reduction in interest margin. Therefore, the margin restriction had to be implemented. The conditions for complete deregulation did not seem to be feasible at this moment.

The automatic market mechanism failed to work in an environment of market imperfections to the detrimental interests of businesses and consumers, and the well-being of the economy in general. For instance, in the first quarter of 1983, bank liquidity eased significantly. The mode interbank market rate for 3-month money had declined progressively. Deposit rates have also eased. Following only after repeated exhortation from the central bank, the mode base lending rate was also reduced together with reductions across the board in deposit rates. Since then, money market conditions as well as bank liquidity had eased further. Prospects appear excellent for the downtrend in the underlying interest rate to continue in the near term. However, continuing high interest rates undeniably place a heavy burden on industries and consumers dependent on credit, especially housing. Therefore, unless the market-oriented interest rate regime reacts more effectively to changes in the underlying financial conditions, the central bank may have to exert greater influence on the interest rate structure through measures that best promote national economic interest.

Further, the computation of the liquidity ratio prior to the 1978 deregulatory move was deficient because it tended to overstate the real liquidity position of commercial banks. Apart from the necessity of providing a more accurate picture of bank liquidity, there were other compelling reasons to change the liquidity structure.

The old system of computing the liquidity ratio relieved the 'user' of a deposit from the burden of complying with the liquidity requirement, which rested entirely on the bank which accepted the deposit from the public. This situation was obviously undesirable, and created a competitive situation which was unfair to the bank which mobilized deposits from the public. At the same time, the previous arrangements gave rise to a situation where primary deposits mobilized by one segment of the financial community (say, the commercial banks) were subject to a 'second round' of liquidity requirements in the event that such deposits were placed with another segment of the industry (say, the merchant banks).

This situation had tended to discourage intermediation to promote the optimal use of idle funds. Finally, the composition of liquid assets, as defined previously, also encouraged the growth of an artificial market fund for up to 7 days and 8 days, as a result of the incorporation of a time element in the definition of bank balances as liquid assets (that is, only balances of up to 7 days maturity were regarded as liquid fo̊r the purpose of computing liquidity requirements). To institute a more realistic measure of bank liquidity, the central bank, therefore, had to introduce certain changes, namely, limiting the amount of trade bills which were eligible for inclusion as liquid assets; including savings deposits as part of the total deposit liabilities against which liquid assets must be held; and, including inter-bank borrowing in the calculation of each individual bank's liabilities.

III. Major Features and Nature of Deregulation Policy

A major thrust of Malaysia's financial deregulation policy over the past few years has been towards the gradual evolution of a market-oriented system to ensure that financial deepening proceeds in a stable environment. The system adopted in Malaysia prior to 23 October 1978 involved the setting up of minimum lending rates for bank loans (rates for 'prime' and 'preferential' customers) and of ceilings on interest rates that may be offered by the banks for deposits with them. In other words, deposit and lending rates were fixed by the central bank in consultation with the Association of Banks. The flexible 'administered' interest rate regime from 1959 to 1978 dominated the financial operations with the changes of interest rates averaging once a year. This arrangement was based on the assumption that both bank lendings and private savings would be sensitive to changes in bank interest rates, and it was also motivated by two considerations: to influence the level of savings and maturity structure of these savings. [29]

By the early 1970s, the development of a market-oriented system of interest rate determination was initiated. Deposits with maturity of more than one year was introduced and ceiling rates that may be offered by the banks for these deposits were completely lifted by April 1973. With the introduction of the concept of wholesale banking in the early 1970s, the deposit taking and lending activities of the merchant banks were exempted from central banks interest rate administration. Deposits exceeding 4-year maturity were introduced in 1972 to encourage competition for bank deposits as well as those with finance companies. By January 1973, the ceiling rates placed on all deposits exceeding one year with banks and finance companies were lifted and the ceilings on deposit rates payable by the finance

29. Money and Banking in Malaysia, Bank Negara Malaysia, Silver Anniversary Edition, 1959-1984, Kuala Lumpur, 1984, pp. 143-146.

companies were lifted completely in August 1973. Since then, their rates were allowed to be determined by market forces. The deposit and lending rates of the merchant banks were already deregulated prior to this move. Further, a new system of weekly tenders for treasury bills was implemented in place of the tap system to allow the discounts on treasury bills to be also determined in the market.

A significant development in deregulatory policy, however, occurred in 1978. A new interest rate regime was introduced on 23 October 1978. The commercial banks were allowed to determine their own interest rates for deposits as well as the prime lending rate, but ceilings on priority lending was continued, with the ceiling rates being maintained at 9.0 per cent per annum. Although the commercial banks were free to determine their own interest rates for loans in the early period of deregulation, they began to shift away from the prime lending rate (floor) which was administered by the central bank, to the cost-determined base lending rate (BLR) from 1981 onwards.

Accordingly, the commercial banks started to peg their lending rates on their own BLR, the rate quoted based on their cost of funds. However, with effect from 1 November 1983, all interest rates on loans and advances, other than those prescribed by maximum ceiling rates and the law, was tied to the BLR of the respective two leading banks. Further, the deposit rates of banks and finance companies were linked to the deposit rates of the two leading domestic banks with effect from 21 October 1985.

It may be recalled that, before 1 February 1987, banks and finance companies had agreed to maintain their interest rates for fixed deposits (up to 12-month maturity) within a fixed margin above those quoted by the two leading banks. But this arrangement was removed with effect from 1 February 1987, thus introducing a greater flexibility in the process of deregulation of the interest rate regime. In other words, the interest rates for fixed deposits (up to 12 months) were unpegged to the rates quoted by the two leading banks, and thus to be determined by the market forces.

The maximum interest rates to be charged by the commercial banks on loans to priority sectors have been pegged at 1.75 per cent above the average of the base lending rate (BLR) of the two leading domestic banks (instead of the present requirement of prescribed rates), or 9.0 per cent per annum, whichever is lower. To align the ceiling rates closely to the cost of funds, the priority sector's loan rates were standardized with effect from 30 March 1985. The upward revision of various ceiling rates on loans to the priority sector in line with the levels that reflected more closely to the cost of funds, has added further dimension in the deregulatory moves. The ceiling will thus move with the BLR. Similarly, there will be only one level of interest rate on housing loans for all categories of houses costing M$100,000 and less.

Merchant banks have commenced issuing Negotiable Certificates of Deposits (NCDs) and they are also allowed to accept term deposits from financial institutions. The merchant banks were also allowed to accept fixed deposits from the corporate sector with effect from 1 March 1979 and they have also been allowed in October 1981 to extend loans in foreign currency by accepting foreign currency deposits from non-residents.

In view of the active involvement of the commercial banks and merchant banks in the corporatization of industry, a National Mortgage Corporation, CAGAMAS, was launched by the end of 1986. CAGAMAS became operational in October 1987, followed by the establishment of a secondary mortgage market. In addition, the investment guidelines of the discount houses were revised to enable them to play a more active role in the secondary mortgage market. From 1 June 1987, there is an official index of inter-bank rates in the Kuala Lumpur money market. The mechanism of official index known as KLIBOR (Kuala Lumpur Interbank Offer Rate) is an important step in the process of bringing about a truly market-oriented financial system and also performing the role of an indicator of conditions in the interbank money market and to become the anchor rate for credits and other interest sensitive instruments.

The other front of deregulation is widening the scope of the New Investment Fund (NIF). With NIF rates no longer pegged to the average BLR of the two leading banks since October 1986, the central bank assumed the responsibility for determining both the NIF lending and funding rates, and the scope and size of the NIF were expanded. The central bank reduced the NIF lending and funding rates several times in line with the reduction in BLR of the commercial banks and finance companies.

With effect from 1 January 1987, the commercial banks, the finance companies and the merchant banks were allowed to average their holdings of eligible liquid assets in the computation of their liquidity requirements. To comply with this requirement, these financial institutions were required to observe the minimum liquidity ratio by holding, on the average, sufficient liquid assets, equivalent to the prescribed minimum holdings over the entire stretch of each liquidity period (i.e., from the 1st to the 15th, and from the 16th to the end of each month), instead of observing minimum requirement daily. The procedure for averaging involved both the primary and total liquid asset holdings and, for the purpose of compliance, a variance of up to 2.0 percentage points below and above the minimum requirements only would be taken into account. [30]

As part of the gradual deregulation programme, with effect from 1 October 1987, finance companies with shareholders' funds (unimpaired by losses) of not less than $50 million each at all times, and which did not have serious inspection findings, were allowed to participate in the domestic interbank money market. Thus, ten eligible finance companies gained access to the interbank market. In addition, six merchant banks, with minimum capital of $30 million each, were allowed to issue negotiable certificates of deposits (NCDs). With effect from 1 February 1987, the amount of NCDs that may be issued by each merchant bank is, however, determined by the size of its capital fund. Accordingly, those merchant banks which have been allowed to issue NCDs were required to observe a higher liquidity ratio of 12.5 per cent of total eligible liabilities, compared with 10.0 per cent for other merchant banks. Similarly, three commercial banks were granted new stockbroking licences, while others (which met specific eligibility criteria) were allowed to participate in the equity of existing stockbroking firms. Thus, one of the fundamental barriers demarcating traditional commercial banking from investment banking was removed in order to expedite the corporatization process.

In the process of deregulatory moves, the base lending rate (BLR) has been reduced several times and the last reduction was done in 1 June 1987, according to which BLR of two leading banks viz Bank Bumiputra and Malayan Banking was further reduced by 0.75 percentage point to 7.0 per cent. The other banks, which pegged their BLR to Bank Bumiputra and Malayan Banking, have also reduced their respective BLRs by up to 0.7 percentage point with effect from the same date. At this level, the BLR is at the lowest in the last 20 years. The reduction of BLR, in other words, reflected current liquidity conditions, and it was expected to ease the financial burden of borrowers and also enable potential investors to have ready access to funds at a lower cost. With the interbank interest rates hovering at 2.5 to 3.5 per cent for terms of 3 to 6 months, the tenure which is normally taken to reflect the cost of funds for the banking system, there is obviously a lot of room for the rates to go down further.

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30. Bank Negara Malaysia, Annual Report 1987, p. 31.

Similarly, banks' statutory reserve requirements and liquidity ratios were reduced several times as part of deregulatory moves during mid-1980s. Accordingly, the statutory reserve requirements were reduced from 5.0 to 4.0 per cent, releasing sufficient funds in the banking system, and the liquidity ratio of commercial banks was reduced to 17.0 per cent.

Another remarkable stage of deregulatory reforms occurred in 1 January 1989. Among the main features of these deregulatory moves are the appointment of 18 principal dealers for government securities and revisions of statutory reserves and liquidity requirements for financial institutions. Accordingly, all Malaysian Government Securities (MGS) with maturity period of up to ten years will be issued by way of an auction through the principal dealers. To promote an active market in the trading of Malaysian Treasury bills, seven discount houses have been appointed as principal dealers for Treasury bills. However, only discount houses have been allowed to participate in the weekly Treasury bills tender. The discount houses were also allowed to hold and trade in money market instruments — MGS, Treasury bills, CAGAMAS bonds, bankers acceptances (BAs) and negotiable certificates of deposits (NCDs) — of up to five years of remaining maturity, compared to the present limit of three years.

The discounting facilities for BAs, currently provided to all financial institutions, has been continued to promote a viable secondary market in BAs. As for the statutory reserve ratio (SRR), it has been computed based on the average amount of reserves held over the fortnightly reserve period. A variation of a 0.5 percentage point above or below the prescribed SRR has been allowed. In the case of commercial banks, reserves of up to 4 per cent of eligible liabilities, and for the finance companies and merchant banks, up to 3.5 per cent of eligible liabilities have been taken into account for computing the SRR period. It may be recalled that, since 1 February 1987, financial institutions were already allowed to observe their respective prescribed liquidity ratios based on the average liquid assets holdings over the fortnightly liquidity period, instead of daily, and the variation was confined to a 2.0 percentage point band above and below the prescribed liquidity ratios. Also, the primary liquidity ratio of the commercial banks has been reduced from 8.0 per cent to 5.0 per cent. Finance companies are no longer required to observe the primary liquidity ratio. Nevertheless, the total liquidity ratio of the commercial banks remains unchanged at 17.0 per cent and finance companies and merchant banks at 10.0 per cent.

All these moves are expected to enhance competition providing depth to the money market and developing the capital market, especially in Malaysia Government Securities (MGS). Financial institutions with a surplus or a shortage of liquidity are now forced to square their position in the market instead of relying on the Central Bank's rediscount window, thus reflecting demand and supply more truthfully.

IV. Effects of Deregulation

IV.1. Effects on Mobilization of Resources

The major source of funds for the banking system continued to be derived from the various forms of deposits and these accounted for about one-third of total new resources, while contractural savings represented one-fifth of the total new resources as at the end of 1987. After the deregulatory moves of 1978 and the latter part of 1980s, the competition for funds was most evident in fixed deposits with maturities exceeding one year and negotiable certificates of deposits (NCDs), where the rates were negotiable. Much of the funds mobilized by the commercial banks and finance companies are tied up in longer-term deposits. At present, nearly 40.0 per cent of total fixed deposits consists of fixed deposits of more than one-year maturity. The growth rate of deposits of more than one-year maturity was remarkable, particularly, after 1982 (Tables 5.2 and 5.3).

In order to maintain a parity between different banks and finance companies, such that intense bidding for deposits would not reverse the effect of an interest rate cut, the provision that the fixed rates would be more than 0.5 percentage point higher than those of the leading banks was to be observed. Similarly, the deposit rates of the finance companies should not be more than 1.25 percentage points higher than those of the two leading banks. The impact of this agreement was a distinct shift in funds to fixed deposits of 15-month maturity, which recorded a sharp increase of more than 90.0 per cent during the year 1986. By the end of 1986, 15-month deposits accounted for the largest proportion of more than 35.0 per cent of total deposits outstanding compared with 20.0 per cent at the end of 1985. This proportion was even more pronounced in the case of deposits with finance companies. Therefore, the competition for funds remained keen, particularly in the mobilization of fixed deposits of over 12-month maturity, where rates offered remained fully negotiable and income derived is tax exempted.

The success of the deregulatory policy to grant tax exemption on interest earned on fixed deposits exceeding 12 months in maturity

Table 5.2

DEPOSITS AT COMMERCIAL BANKS BY TYPES AND MATURITIES: 1977-1987

(as a Percentage of Total Deposits)

	Total Deposits	Demand Deposits	Savings Deposits	Fixed Deposits: Less than 1 year (1-9 mths)	Fixed Deposits: 1 year (12 mths)	Fixed Deposits: More than 1 year (15-60 mths)
1977	100.0	21.6	20.0	9.1	37.6	7.2
	(16.3)	(16.9)	(28.3)	(-27.4)	(21.9)	(53.3)
1978	100.0	25.9	20.2	10.8	31.1	12.0
	(20.3)	(19.2)	(21.6)	(43.4)	(-0.6)	(101.0)
1979	100.0	23.8	18.6	11.2	30.7	15.7
	(30.2)	(19.6)	(20.0)	(34.4)	(28.5)	(70.8)
1980	100.0	22.8	17.9	17.0	25.1	17.1
	(21.9)	(17.1)	(17.3)	(85.6)	(-0.3)	(32.3)
1981	100.0	22.2	15.0	36.2	16.1	10.5
	(20.5)	(17.1)	(0.7)	(156.4)	(-22.9)	(-25.8)
1982	100.0	21.9	14.1	32.6	20.8	10.6
	(17.6)	(15.9)	(10.9)	(5.9)	(52.2)	(17.9)
1983	100.0	21.7	15.2	29.2	19.2	14.7
	(12.4)	(11.6)	(20.5)	(0.6)	(3.9)	(56.1)
1984	100.0	19.0	13.0	34.3	16.3	17.4
	(14.7)	(0.3)	(-1.7)	(34.5)	(-2.6)	(36.1)
1985	100.0	17.3	13.6	33.8	14.4	20.8
	(7.7)	(-1.7)	(12.9)	(6.4)	(-4.9)	(28.6)
1986	100.0	15.7	14.8	24.7	6.5	38.3
	(5.7)	(-4.4)	(14.7)	(-22.7)	(-52.5)	(95.0)
1987	100.0	18.2	20.6	19.4	10.1	31.8
	(2.5)	(18.7)	(42.8)	(-19.7)	(59.4)	(-15.1)

Figures in parentheses refer to growth rates.

Source: Bank Negara Malaysia, Quarterly Bulletin, various issues.

Table 5.3

DEPOSITS AT FINANCE COMPANIES BY TYPES AND MATURITIES: 1977-1987

(as a Percentage of Total Deposits)

	Total Deposits	Savings Deposits	Fixed Deposits: Less than 1 year (1-9 mths)	Fixed Deposits: 1 year (12 mths)	Fixed Deposits: More than 1 year (15-60 mths)
1977	100.0 (23.3)	8.8 (56.9)	17.6 (9.5)	6.10 (21.8)	12.6 (34.6)
1978	100.0 (26.7)	9.4 (36.1)	14.2 (1.9)	62.7 (30.2)	13.7 (37.6)
1979	100.0 (28.1)	9.6 (30.8)	10.9 (-1.5)	62.4 (27.5)	17.1 (59.2)
1980	100.0 (34.5)	7.6 (5.8)	25.6 (216.2)	51.0 (10.0)	15.8 (24.4)
1981	100.0 (31.8)	6.3 (8.7)	44.6 (129.5)	36.9 (-4.8)	12.3 (3.0)
1982	100.0 (18.0)	6.7 (26.9)	35.2 (-6.6)	37.3 (19.5)	20.7 (98.6)
1983	100.0 (23.1)	7.4 (35.6)	32.7 (14.3)	28.9 (-4.5)	30.9 (83.6)
1984	100.0 (35.5)	5.8 (5.4)	41.3 (71.0)	21.6 (1.3)	31.3 (37.1)
1985	100.0 (15.0)	6.9 (38.7)	35.6 (-0.8)	18.4 (-2.1)	39.0 (43.3)
1986	100.0 (10.2)	6.8 (7.7)	21.9 (-32.2)	5.3 (-68.3)	66.0 (86.5)
1987	100.0 (4.0)	14.1 (116.2)	22.6 (7.5)	5.2 (2.1)	58.1 (-8.5)

Figures in parentheses refer to growth rates.

Source: Bank Negara Malaysia, Quarterly Bulletin, various issues.

has also helped to increase the deposits in 1983. Similarly, due to higher rates offered, the volume of NCDs issued by the commercial banks increased sharply by around 250.0 per cent at the end of 1983. Since its introduction on 2 May 1979, NCDs have become an increasingly important instrument for the commercial banks to mobilize savings. The domestic banks as a group dominated in the issue of NCDs during 1980s, about more than 70.0 per cent of the NCDs outstanding.

However, the thrift institutions suffered. Savings mobilized by the National Savings Bank (NSB) continued to decline after the first phase of deregulatory moves of 1978. The bank faced net deposit withdrawals continuously due mainly to the intensive interest rate competition from the higher deposit rates of the commercial banks and the finance companies as compared with the 6.5 per cent per annum for savings deposits with the NSB, which has been unchanged since 1974. In order to arrest the declining trend in deposits after the deregulatory moves, the NSB had to launch, on 16 November 1984, a Fixed Deposit Scheme under which the rates offered on fixed deposits with maturity periods of 6 months and 12 months were at 9.5 per cent and 9.75 per cent per annum, respectively, with all interests earned on such deposits being exempted from tax. This feature of deregulatory moves created a positive impact in resource mobilization. After four consecutive years of decline, total deposits (including premium savings certificates) placed with the bank also increased to some extent by the end of 1985. [31]

After the introduction of wholesale banking in 1970s, the competition for funds in the secondary or interbank money market was clearly evident. The average monthly borrowings in this market increased to a great extent. As deposits are less volatile than interbank borrowings, the central bank has directed banks to place less reliance on interbank borrowings. However, this bias has hampered the growth of interbank money market in mobilizing funds. Accordingly, banks with only extensive branch networks are better placed to tap deposits from the non-bank sector and are, therefore, often net lenders in the interbank market. But the local banks with vast network of branches has to bear the burden of high cost of deposits and they lent out the large amount of deposits thus collected — at a loss in the interbank money market. There are no other places where these local banks could lend out their money. The demand for loans was not really there. The opposite holds in the case of banks with few

31. The Premium Savings Certificate Scheme was introduced in January 1978 to mobilize funds from small savers.

or no branches, as in the case of foreign banks and merchant banks. Therefore, low interest rates appear to have favoured foreign banks and low money market rates enabled the single-branch foreign bank to borrow cheap funds. The foreign banks are discouraged from borrowing more than 20.0 per cent of their total resources from the interbank market. But if these banks can expand their resource base, they may still have an advantage over their domestic counterparts in terms of cost of funds.

In such a situation, if the banks are not allowed to trade in funds with each other, through the interbank market in an optimal manner, this can result in inefficiency. Also, the view that deposits are less volatile than interbank funds does not necessarily apply to corporate deposits. Hence, no artificial distinction should be made. Therefore, in the interest of developing the money market, including the interbank money market, banks should be given the freedom to tap and rely on both types of funds in keeping with their individual circumstances with respect to such factors as branch networks.

IV.2. Effects on Interest Rates

Payment of attractive interest rates to depositors, without necessarily entailing an increase in the lending rates, is an important aspect of banks' drive to mobilize savings. However, the recent experience of the deregulatory moves of the early 1980s has been that the gross interest margins of the commercial banks and the finance companies have tended to be too high as against the very spirit of deregulatory moves undertaken in 1978 and 1979. The continuing high profitability of the banking industry, even in times of generally poor economic conditions, is a clear indication of this. In 1983, for example, the gross margin, that is, the difference between the average lending rate and the average cost of deposit funds, exceeded 5.0 per cent in the case of commercial banks as against 4.8 per cent in 1982. [32] Even after allowing for the 'cost' in meeting the statutory reserves and liquidity requirements, this margin remained too high as a national average.

One consequence has been that the deposit rates are lower than they should have been to encourage the public to save, leading to an outflow of funds and encouraging foreign borrowings as well. It was in such an environment of 'stickiness' with downward movement of lending rates when deposit rates decline, the central bank in 1983 had to remove some of the discretion of the commercial banks in

32. Bank Negara Malaysia, Annual Report 1983, p. 59.

adjusting their lending rates, requiring the banks to anchor all their lending rates (except those for loans to the priority sectors or where the rates are prescribed by law) to a declared base lending rate (BLR), thereby, ensuring that the rates charged to borrowers would move automatically in line with changes in the cost of funds. The interest margin, thus, depended on the borrower's credit outstanding.

However, with the freeing of interest rate offered on deposits of the commercial banks on 23 October 1978, there was increased competition among the commercial banks and the finance companies, leading to a gradual rise in the interest rates offered on deposits (see Table 5.1). For instance, interest rates offered by commercial banks ranged from 7.5 to 10.0 per cent per annum at the end of 1982, compared with a range of 3.0 to 6.5 per cent per annum prior to 23 October 1978 deregulation while the interest offered on savings deposits with the National Saving Bank (NSB) had remained at 6.5 per cent per annum since 1 May 1974. But before 1980 and just after the deregulation in 1978, the freeing of lending and deposit rates did not promote the desired competition as interest rates tended to be rigid downwards. There were banks which after reducing their deposit rates did not adjust their lending rates.

The rising trend in the money market interest rates from 1980 onwards was soon reflected in an increase in interest rates for bank deposits and loans and advances (see Table 5.1). Interest rates on fixed and savings deposits were also raised across the board. In other words, up to the end of 1980, the market was moving towards the deregulatory path. Up to this period, the rate of interest in the money market also eased significantly, while interest rates for bank deposits and loans remained relatively stable and the commercial banks have, since November 1983, been required to anchor all their lending rates (except for loans to the priority sectors or where the rates are prescribed by the law) to their declared base lending rate (BLR).

From October 1985, however, the deregulatory effect on interest rates reversed sharply. With further reductions in reserve and bank liquidity requirements from 4.0 to 3.5 per cent and 18.5 to 17.0 per cent, respectively, combined with capital inflows to transform the deficit in the banking system to a large surplus, interest rates began to fall. The banks were further aided by the central bank's decision to allow them to honour their liquidity requirements on an average basis, rather than adhering to a strict daily observation. By mid-June 1987, the banks' base lending rate (BLR) had dropped in five stages to 7 per cent, from its peak of 12.25 per cent in 1986. However, although interest rates are now at their lowest level for two decades, bank lending remained sluggish. This reflects both a reluctance on the part of banks to lend as well as customers to borrow. Part of the reason is that interest rates, although low in nominal terms, remain high in real terms.

The consecutive reduction of the BLR during the latter part of 1980s in the Malaysian banking system, for instance, gave an indication that the money market was flushed with funds, with overnight interbank rates hovering around 0.5 per cent.[33] Therefore, with the money market currently flush with funds, although a further lowering of the BLR appears inevitable, it can be envisaged that even with the BLR at the current level (the lowest in the last 20 years), most of the commercial banks' interest margin has in fact widened considerably from 4.0 per cent for commercial banks and 3.0 per cent for finance companies in 1980 to as high as 5.75 per cent for commercial banks and 4.8 per cent for finance companies in 1986. The lending rates of the banking institutions were still sticky. The BLR, which is 7.0 per cent for the two leading banks (Bank Bumiputra and Malayan Banking) and 9.0 per cent for all banks in 1987, is still high compared with the rates in other countries.[34] The slow downward adjustment in the BLR (despite significant decline in both the deposit and the interbank rates) can be attributed to the following two factors:

- Mounting administrative costs; and,

- The high cost of funds mobilized previously.

One of the reasons for the BLR's slow downward adjustment is the substantial overhang of high cost funds. In mobilizing funds, the competition was most evident in fixed deposits with maturity exceeding one year and in negotiable certificates of deposits (NCDs) where rates were negotiable. In other words, the policy of pegging deposit rates is also one of the reasons for this slow downward adjustment. This was aimed primarily at two goals; firstly, to avoid further bidding up of interest rates due to tightening of liquidity; and sec-

33. The BLR of the two leading banks has been reduced by 0.75 per cent to 7.0 per cent effective from 1 June 1987. The BLR of the commercial banks was reduced on four occasions by a total of 25.0 percentage points, while the BLR of the finance companies was reduced in three stages by an aggregate of 2.25 percentage points.
34. Singapore banks, for instance, are quoting a prime lending rate of 6.29 to 7.29 per cent per annum.

ondly, to encourage the mobilization of longer-term funds for proper matching of long-term assets and liabilities.

However, one of the biggest obstacles to lower interest rates can be attributed to the failure to treat interest earned on bank deposits of varying maturity uniformly and instead exempt from taxation only interest earned from deposits in excess of 12 months. This has resulted in a heavy build-up in bank liabilities in excess of this maturity. In its Annual Report, Bank Negara Malaysia reported that between the end of 1985 and 1986, the outstanding values of fixed deposits with a maturity of 15 and 24 months increased by 96.0 per cent and 258.0 per cent, respectively. As most were made when interest rates were 7.5 per cent against 4.0 per cent, currently, a large portion of banks' deposit base is still funded at very expensive rates. Consequently, what started as an attempt to provide the banking sector with a stable source of funds to mobilize for productive employment, has actually ended up doing the opposite by inhibiting private sector's capital formation. However, the decline in interest rates offered during the year 1987 as a result of easier liquidity, created a positive impact to a sharp increase in deposits with maturity periods of 9 months and 12 months.

There is one line of thought that lending rates are high because of the excessive profit made by banks. Therefore, a wide margin of around 5.0 per cent or so exists between lending and deposit rates. The second line of thought is somewhat different. According to this thought, there are other factors which explain at least a part, if not a significant portion, of the divergence in lending and deposit rates. Part of this divergence has been caused by the losses sustained by banks in their funding of government operations and by the low profits or even losses incurred on priority sectors' loans. Therefore, the lending rates charged by banks on the so-called non-priority sector loans have to be increased to compensate the banks for the losses or lower profits earned on the government and priority sector loans.

The deregulatory measures were further expected to narrow the spread between the lending and deposit rates, and thus the lending rates to come down without additional adjustment in deposit rates. It did not happen despite several stages of deregulatory moves. There was a general fear that deregulation will necessarily mean higher interest rates, depending of course on the prevailing liquidity situation. However, over the past few years, interest rates offered by banks and finance companies have plunged to less than half of their previous figure. In other words, the people who get squeezed are not the big-timers who know where to put their money overseas so as to earn higher returns, but the small-timers, such as hawkers, small traders, and wage earners with small hard-earned savings.

IV.3. Effects on Interest Margin and Cost of Funds

The reduction of costs is necessary so that the banking institutions can reduce the difference between their lending and deposit rates (interest margin) without affecting their profits. Indeed, mounting administrative costs is one of the reasons why the decline in the base lending rate (BLR) has been slow even though deposit and interbank rates have fallen significantly. The result was that average cost of funds rose to approximately 7.0 per cent per annum at the end of June 1986. Reflecting the higher cost of funds, the average lending rates of the commercial banks increased to 12.27 per cent per annum at the end of June 1986. Consequently, the gross lending margin of the commercial banks widened by 0.12 percentage point to 5.42 per cent per annum.

Further, the margin differs significantly between various financial institutions. Merchant banks have the lowest margin. The interest margins for commercial banks and finance companies were at 5.4 per cent and 5.1 per cent, respectively. The cost of funds also vary significantly. Therefore, one of the crucial features prevailing in the banking system after the deregulatory moves is the existence of high interest margins. Although there is no empirical evidence to suggest that liberalization of interest rates had led to high lending margins, it can be safely observed that margins for commercial banks have widened considerably. The margin has increased from 4.0 per cent at the end of 1980 to 5.6 per cent at the end of 1985 and 5.4 per cent at the end of 1986.

Several factors accounted for this high spread between lending and deposit rates. It should be noted that the spread covers the cost of funds from non-deposit sources: the cost of maintaining reserves, the cost of administration and overheads; the provision for potential losses; the relatively lower earnings from loans to priority sectors; and, the rate of return on bank equity. The high cost of deposits combined with certain statutory and regulatory requirements imposed on financial institutions have also resulted in high lending rates. About 25.0 per cent of all deposits taken by commercial banks are invested in government papers either directly or indirectly. In other words, it is used in funding government operations. As the yield obtained is below its cost of funds, the banks are incurring funding losses. Hence, the margin is not narrowing.

Further, banks have to commit another 10.0 to 20.0 per cent of their deposits on priority sector loans on which they are just breaking even or making a small return on funding costs. In fact, the actual size of the loans to the priority sector can be safely estimated at 30.0 per cent of the total. However, the adverse consequences of priority sector loans on lending rates will be most pronounced when there are interest rate ceilings. This has, therefore, meant that the lending rates on non-priority sector loans have had to be pushed up in relation to deposit rates. The maintenance of a wide lending margin by the commercial banks may be attributed to their effort to cross-subsidize the funding losses that the banks are incurring in their priority sector lending.

The margin also had to be pushed up to absorb the high overheads incurred on administration, to charge-off for actual loan losses and uncollectable interest as well as to ensure an adequate return on capital for which there is little or no contributions from the government and priority sector loans. Therefore, it can be generally expected that the lending margins and, hence, the lending rates will be higher in an environment of high interest rates than of low rates. This is because the funding losses on government and priority sector loans will be higher when the general interest rates are higher, given that the yields on those loans are fixed.

In the Malaysian banking system, the interest cost (that is, the amount a bank has to pay to attract depositors) accounts for nearly 70.0 per cent of total costs. Further, on average, staff costs or wages take up another 9.6 per cent, provision for bad debts another 10.0 per cent and overheads another 10.4 per cent (Table 5.4). Similarly, wages and overheads have risen faster than revenue. Banks also have to make a bigger provision for bad debts. For instance, provisions for outstandng bad debts for the banking industry accounted for 6.8 per cent of total loans in 1987 compared with 2.3 per cent in 1984. Another reason is the expansion in the branch network.

Even though all commercial banks and finance companies may reduce their base lending rates (BLRs), there may be a time lag before lending rates come down. In this context, the Governor of Bank Negara Malaysia has remarked: "If the banks are unduly slow in passing on the benefits of a lower BLR to borrowers, the central bank would also be slow in responding to a future request to raise the BLR because of a rise in their cost of funds. We are realistic about their costs but they have to take a cut in profits. They cannot expect

Table 5.4

INCOME AND EXPENDITURE COMPONENTS OF THE BANKING SYSTEM: 1984-1987

(as a Percentage of Total)

Income/ Expenditure	1984	1985	1986	1987
Interest Income	n/a	88.5	87.7	83.8
Other Income	n/a	11.5	12.3	16.2
Total Income:	n/a	100.0	100.0	100.0
Interest Expenses	72.4	69.3	65.1	64.4
Staff Costs	10.1	9.4	9.8	11.5
Bad Debt Provisions	7.2	10.7	14.2	13.0
Overheads	10.3	10.6	10.9	11.1
Total Expenditure:	100.0	100.0	100.0	100.0
Pre-Tax Profit/(Loss) (in million Ringgit)	n/a	(64)	(224)	565

Source: Bank Negara Malaysia, Annual Report, selected years.

to work 15 months before lowering lending rates". [35] But the huge overhang of money locked in long-term high-cost deposits makes an immediate lowering of lending rates for all borrowers very unlikely.

At present, more than 40 per cent of the total fixed deposits consists of 15-month fixed deposits with another 7.8 per cent in 24-month fixed deposits. In other words, both 15- and 24-month fixed deposits together account for more than half of total fixed deposits with the banking system. However, 60.0 to 70.0 per cent of these high-cost fixed deposits has been expected to mature by the end of 1987. Therefore, banks will have little or no excuse for not passing on to borrowers the benefits of lower base lending rates. Another factor to consider is that margins can only improve if the loan demand drives up interest rates, not the other way round. But demand for loan is weak. Further, interest rates do not depend merely on loan demand or deposit supply. Other factors include the loan-deposit ratio, the deposit portfolio, competitors' rates, interbank rates and reserve and administrative costs.

IV.4. Effects on Profitability of Banks

A fundamental condition of any sound banking system is a profitable and efficient system of financial intermediation. However, the findings of a series of research projects undertaken in interest margins in the banking system clearly reflects the widening of the interest margins. [36] With the improvement of general liquidity, deposit rates were brought down rapidly. Although the cost of deposits of the commercial banks had declined by 2.8 percentage points to 3.6 per cent per annum by the end of 1987, the average lending rates of the banks was much slower in responding to the rapid decline in the deposit rates. The result was a widening of the interest rate margins of commercial banks to 6.1 percentage points by the end of 1987 as compared to 5.4 percentage points in 1986 (Table 5.5). This was the highest recorded in the 1980s. Similarly, the gross interest margins of the finance companies also increased.

Accordingly, the profits of the banking system after the first phase of deregulatory moves had remained strong in 1983 and in 1984 as well, even after the write-off of M$1 billion in bad loans by one domestic bank. However, the banking system recorded a complete loss during 1985 and 1986. It recovered only in 1987 with the pre-tax

35. The Sunday Star, 29 March 1987.

36.Bank Negara Malaysia, Annual Report, 1987, pp. 36-37.

Table 5.5

AVERAGE INTEREST MARGINS OF THE BANKING SYSTEM: 1986

(in Percentages)

	Commercial Banks[1]	Finance Compnaies	Merchant Banks
Average Lending Rate	12.2	14.2	11.9
Cost of Funds	6.8	9.2	9.5
Interest Margin:	5.4	5.0	2.4
Less:			
Overheads	2.8	2.3	1.1
Bad Debt Provisions & Interest-in-Suspense	2.8	4.5	1.7
Loan Margin:	-0.2	-1.8	-0.4
Add:			
Non-Loan Margin	1.2	1.1	1.9
TOTAL MARGIN:	1.0	-0.7	1.5

1. Excluding four banks.

Source: Bank Negara Malaysia, Annual Report, 1987.

profit being maintained at M$565 million in 1987 (see Table 5.4). But low interest rates have not really favoured the local banks. Rather low money market rates have enabled the single branch foreign bank to borrow cheap funds. The net assets per employee of domestic commercial banks is lower as compared to the net assets per employee of foreign commercial banks. Foreign banks have higher ratios reflecting their efficiency in acquiring assets than their local counterparts although staff cost per employee was higher than that for local banks. The income at foreign banks per employee also is higher than that for local banks. Despite paying higher wages, foreign banks still managed to earn more money.

The problem with the local banks is that they assume that opening more branches would bring in more profits, but what they do not realize is that their overheads will also increase in the process. It should be realized that more profitable banks are not necessarily those aggressive in their lending or income generation but those which are able to hold down their costs effectively.

It may be recalled that "the banking community attributed their reluctance to reduce lending rates at a faster pace to the overhang effects of non-performing loans, which led to penalty rates being charged on such loans", and on the continued 'locked-in' effects of high-cost long-term deposits mobilized in mid-1986. The interest margin study showed that the underlying reasons were really high staff costs and overheads and the rising costs of provisions for bad and doubtful debts". [37]

Further, even if a certain portion of their funding is for high-cost long-term deposits of 15-month maturities at the higher rate, the banks should be able to find cheaper funds now at the new rate in the interbank market (which is lowest as compared to past few years) and come up with an average rate that is lower. Thus, despite the rising interest margin, the banking community was not able to generate profits expected from such margins after the second phase of deregulatory moves in the late 1980s. This may be attributed to the substantial provision for non-performing loans and continued high overheads.

In discussing the profitability of the banking institutions, it is important to take into consideration the risks associated with banking business. As should be readily evident, banking institutions are taking deposits for the purpose of on-lending to prospective borrowers. Their income is the interest margin or spread they earn on their

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37. Bank Negara Malaysia, Annual Report, 1987, pp. 36-37.

assets. From this income, they have to cover their overhead expenses, make adequate provisions for potential loan losses and earn a reasonable return on shareholders' funds. In this case, the non-fund based activities are independent profit centres with their own overheads and risks. There is also an active competition. Therefore, even if such activities are highly profitable, given the economies of allocative efficiency, one should not look upon the earnings from these activities to cross-subsidize losses in other areas of activities, such as loans to the government and the priority sector.

However, one should remember that interest rates on loans are generally set at a margin above the base lending rate (BLR). This margin or spread varies with cost of funds, borrowers' credit standing and loan size. In the context of profitability, one of the views is that banks are squeezing borrowers and savers to maintain high profits. It is because they are maintaining a large spread by keeping actual lending rates high when returns on savings have fallen, funds are cheaper in the interbank market and the BLR is lower.

The second line of argument is that banking has become a relatively unprofitable activity due to the recession of low returns on priority sector lending, high operating costs and over-regulation. This argument is based on the perception that deposit rates have gone down too much and too fast compared with lending rates, thus increasing bank margins. For instance, during 1986, interest rates for savings and fixed deposits fell about 4.0 per cent, while the BLR fell by only 2.25 per cent. In other words, Malaysian banks' spreads are very high by international standards. In 1986, for example, the average lending rate of commercial banks was 12.25 per cent and the average cost of funds was 6.8 per cent, giving banks an interest margin of 5.4 percentage points (see Table 5.5). This is a relatively high figure compared with the U.S., for example, where spreads are normally 2.0 to 2.5 per cent.

The implications of this scenario is that banks are discouraging businessmen from investing by charging high rates and by paying low deposit rates, encouraging their potential savers to save abroad. Banks are squeezing both consumers and investors, particularly the small borrowers, by charging high interest rates. It is estimated that the Malaysian banks are working on a hefty 150.0 per cent mark-up on their cost of funds, compared with only 34.0 per cent in Australia, 59.0 per cent in Hong Kong, 38.0 per cent in Japan, and 69.0 per cent in Singapore. [38]

38. Malaysian Business, 16 June 1987, pp. 12-13.

However, it must be realized that the interest margin does not by itself constitute profit. Profits are derived from this margin after discounting operating costs and setting aside a certain percentage of deposits for statutory reserves (on which no interest is earned), and liquidity reserves and priority lendings, which bear low returns. On top of that, bankers have to set aside a certain portion of the profits derived from this margin to cover losses from bad loans. Nevertheless, the profits were shrinking till the end of the year 1986 due to the narrowing of interest margins, low returns on priority lending, higher operating costs and increased provisions for bad loans. It was only in 1987 that the banking system had recovered to register pre-tax profits of M$565 million after two successive years of losses (see Table 5.4). This is mainly attributed to the improved margins and some successes in holding down costs. Overall pre-tax profits of the banking system, however, were still below the peak of close to M$1 billion achieved in 1984, although the average interest margin in 1984 was lower. For instance, it was 4.92 percentage points in 1984 as compared to 5.03 percentage points in 1983 (Table 5.6).

The main reason for the profits moving down in 1984 and continuing into 1986, is that the authorities have lowered the interest margin of banks by reducing the base lending rate (BLR) substantially more than the rate of the cost of funds which went down. The unprecedented lowering of the BLR several times has far outpaced the lowering of the cost of funds to banks. Therefore, margins can only improve if loan demand drives up interest rates. In other words, deposit and BLR rates, which affect margins directly, can be adjusted either through the market mechanism or by the central bank. But margins alone are not indicators of profitability. More important is the banks' control over their credit provisions and overheads. The profitable banks are those which have prudent lending policies and low overheads. The profits in some years are still high even though margins have dropped. Rather, a greater part of bank profits is being eroded by rising bad debts which are caused by imprudent lending policies.

V. Deregulation and Competitive Financial Environment

The gradual process of deregulation, which started during the early 1970s and took momentum after 1978 onwards, was launched in order to foster greater competition in the financial industry to the advantages of both savers and borrowers. With the freeing of interest rates offered on deposits of the commercial banks on 23 October 1978,

Table 5.6

AVERAGE INTEREST MARGINS OF COMMERCIAL BANKS: 1980-1987

(in Percentages)

Year	Average Lending Rate	Average Deposit Rate	Average Interest Rate
1980	10.59	6.59	4.00
1981	11.98	7.68	4.30
1982	12.34	7.54	4.80
1983	11.64	6.61	5.03
1984	13.04	8.12	4.92
1985	12.10	6.81	5.29
1986	12.25	6.50	5.75
1987	12.20	6.80	5.40

Source: Bank Negara Malaysia, Annual Report and Quarterly Bulletin, various issues.

there was increased competition among the commercial banks and the finance companies for private sector funds.

The agreement to align interest rates of the banking industry to not more than 1.5 per cent above the deposit rates of the two leading domestic banks in October 1985, and the imposition of a 5 per cent withholding tax on interest earnings on all fixed deposits with maturities not exceeding 12 months, led to a distinct shift of funds to fixed deposits of 15-month maturity, which recorded a sharp increase during 1985. Sensitivity of interest rate changes was also reflected in the growth of savings deposits in 1985, which is partly attributed to a narrowing of interest rate differentials for fixed and savings deposits.

Accordingly, to increase the competitive edge, more commercial banks sought approval to install Automatic Teller Machines (ATMs). Since the first ATM was installed in 1981, more than 80.0 per cent of the financial institutions have embarked on computerization by end-1987. Within the banking system, the commercial banks moved towards rapid computer installations. Similarly, more than 80.0 per cent of the finance companies and more than 65.0 per cent of the merchant banks have computer systems. Out of the total commercial banks, more than 45.0 per cent offered ATM services. Out of the total ATM services offered by the commercial banks and finance companies, more than 95.0 per cent belonged to commercial banks, and of which more than 90.0 per cent were on-branch and the rest were installed in off-branch sites. This rapid expansion of computerization in the banking industry after the deregulatory moves has helped to improve the speed and efficiency of processing banking transactions. However, the competitive environment is still dominated by the 38 commercial banks in electronic banking system. [39]

The competitive environment was also enhanced when the National Savings Bank (NSB) was also allowed to accept fixed deposits with maturities of 6 months and 12 months and the merchant banks were allowed to accept fixed deposits from the corporate sector with certain conditions regarding the minimum size of the deposits they would be allowed to accept. The merchant banks have also commenced issuing negotiable certificates of deposits (NCDs). To enable the merchant banks to extend loans in foreign currency, they are also allowed to accept foreign currency deposits from non-residents

39. A detailed analysis of the Development of Computerization in the Banking Industry is given in Bank Negara Malaysia, Annual Report, 1987.

with certain limitations. Similarly, with a new system of weekly tenders for Treasury bills, the free quotation of interest rates payable on deposits by the finance companies and the new interest rate regime allowing commercial banks to determine their own interest rates ultimately was implemented in order to foster greater competition in the financial industry to the advantage of both savers and borrowers.

The introduction of Negotiable Certificates of Deposits (NCDs) in May 1979 has become an increasingly important instrument for the commercial banks to mobilize savings, particularly for the corporate sector. Although the gross NCDs issued grew markedly, the domestic banks accounted for the bulk of the gross NCDs. The introduction of Bankers Acceptances (BAs) and NCDs are becoming practically useful for the financial institutions that lack a large deposit base in relation to their lending operations. These instruments also provided more attractive returns for short-term funds and greater flexibility in the money market.

In other words, these instruments have offered more sophisticated avenues for the investment of short-term funds as well as to promote the more efficient financing of trade at the lowest cost. On the other hand, market for trade bills had not become more active because of inherent credit risk involved.

The foreign banks continued to lead in the issue of BAs which accounted for more than 60.0 per cent of the outstanding amount. In line with the market for TBs and short-dated government securities, which is not active because of the low yield in these papers, the secondary market in these new instruments (BAs and NCDs) is indeed very active. The turnover in these instruments through rediscounting and 'repos' (i.e., repurchase transaction) also became very active. The development of an active repo market (where, repo stands for repurchase transactions) for negotiable instruments has broadened the range and sophistication of the money market.

The securitization of commercial banks activity with the launching of the secondary market for house mortgages on 16 October 1987 and the incorporation of the National Mortgage Corporation - CAGAMAS - on December 1986 were further steps towards a competitive environment. The issuance of four stock broking licences to the commercial banks and two licences to the merchant banks, have added a further new dimension in the area of corporatization of the stockbroking industry.

The introduction of the new system of automated cheque clearing through the Kuala Lumpur Automated Clearing House (KLACH) in

January 1984, the use of ATM cards for promoting Electronic Funds Transfer at Point of Sale (EFTPOS) by two financial institutions in December 1986; the establishment of a Joint Council on Interbank Computer Standard with the commercial banks, finance companies and merchant banks in 1986; and, a plan of facilitating linkages with global banking centres, particularly to the International Interbank Funds Transfer Network (SWIFT) by 1989; have further enhanced the competitive environment. These moves have introduced the electronic technology to speed up and increase the efficiency of payments and information transfer; promote electronic fund transfer at point of sale, facilitate the linkages with the international interbank fund transfer network; and, to ensure orderly development and wider use of electronic banking at minimum costs.

The competitive environment was also generated in the secondary or interbank money market for the trading of funds after the deregulatory moves. The broadening of the interbank market was further enhanced by giving access to the finance companies and approved financial institutions.

After two stages of deregulatory moves, the Malaysian banking system has, therefore, undergone dramatic changes since the 1980s. They have grown in numbers and their volume of business has also expanded quite substantially. Some of the banks' major activities have changed as characterized by shifts to borrowed funds, decline in core deposits for some, expanded use of leverages, and increased interest rates. Therefore, efficiency in the banking system can be better ensured by deregulation which fosters greater competition rather than by the creation of more rules; because, it is competition which keeps the market in check. However, deregulation should not mean lack of supervision.

VI. Problems and Issues Associated with Deregulation

VI.1. Deregulation and Selective Credit Policy

One of the most prominent regulatory policy in the wake of deregulation is the system of annual lending guidelines to commercial banks and finance companies. These guidelines provided that at least a certain percentage of their outstanding loans have to be extended to priority sectors to ensure that they have ready access to credit at reasonable cost. The first set of guidelines was issued in 1974, and these guidelines are still in continuation — giving preference to the sectors and activities identified in 1974, namely the indigenous community, low cost housing, agricultural food productions and small-scale enterprises.

Of even greater concern to the banking sector are the problems caused by enforced lending to 'priority sectors'. Current central bank guidelines stipulated that; 6 per cent of the value of total loans outstanding as at December 1985 must go to food production; banks must finance the purchase of a certain number of low cost houses; a certain portion of new loans must be made to small enterprises under the special loan scheme (50.0 per cent of which must go to Malays and other indigenous people — together they are often referred to as the "Bumiputera" community). There is also a general guideline that loans to the Bumiputera community must amount to 20 per cent of total bank loans outstanding (also based on loans outstanding on 31 December 1985). Altogether, this means that about 20.0 to 25.0 per cent of the new bank assets have to go to priority sectors, even after the general guidelines on lending to "Bumiputeras" are excluded. Failure to comply with these guidelines results in a requirement to make a deposit with the central bank which earns only a token rate of interest, an option which in the current market many bankers are tempted to avoid.

Therefore, a substantial portion of the portfolio of the banking system is tied to priority sector lending. It was partly because of these restrictions that the banks went full-steam ahead to lend to the property sector. Property loans still accounted for more than 40.0 per cent of the total new bank credit and more than 30.0 per cent of loans outstanding. So any slowdown in that sector is likely to affect adversely on the banks' profit. Further, if there is no alternative sector that can compensate for the property slowdown and if the cash flow also remains erratic, the rationale of concessionary interest rate is meaningless.

The indirect repercussion of this preferential treatment is reflected in the growing bad debt provisions and outstanding interest-in-suspense (Table 5.7). While the interest rate stickiness induced by the differential tax treatment of the maturities of the deposit base is ephemeral, the other causes seem more permanent. At the forefront of concern is the level of bad and doubtful debts. Some estimates suggested that non-performing loans amount to between 20.0 per cent and 25.0 per cent of bank assets. The causes of the high level of bad debts are many. However, two seem to dominate: firstly, the fact that the banks have in the past concentrated on the security offered rather than the soundness of the underlying business transaction; and secondly, the fact that under the laws banks are re-

Table 5.7

OUTSTANDING BAD DEBT PROVISIONS AND INTEREST-IN-SUSPENSE: 1984-1987

(as a Percentage of Total Loans)

	Outstanding Bad Debt Provisions				Outstanding Interest-in-Suspense			
	Commercial Banks	Finance Companies	Merchant Banks	Total	Commercial Banks	Finance Companies	Merchant Banks	Total
1984	2.6	1.3	1.7	2.3	1.4	0.5	0.2	1.1
1985	3.8	2.7	1.9	3.5	2.2	2.1	0.7	2.1
1986	5.7	5.1	2.8	5.4	4.3	3.4	1.5	4.0
1987	7.0	7.2	3.5	6.8	6.1	6.2	3.4	5.9

Source: Bank Negara Malaysia, Annual Report, various issues.

quired to extend loans to priority sectors at concessional interest rates, when on normal commercial criteria they would not lend, or would lend only at 'loaded' rates.

The criticism that banks look too much at security rather than the underlying business transaction is particularly apposite in the current circumstances. The major form of collateral has been property — particularly commercial property. Because of over-capacity fuelled by the loan-based property boom between 1980 and 1986, there has been a virtual collapse in the commercial property market. Around 45.0 per cent of bank assets were lent to property companies or were property related. This occurred despite the central bank's warnings from as early as 1982 about over-extension to any one sector. As a result, the banks, which have been badly hurt financially by the downturn in the property market, have become reluctant to lend.

In the wake of this sharp fall in share and property prices (in the order of 40.0 to 60.0 per cent) since 1985, the banking system has had to make substantial provisions for interest-in-suspense and bad and doubtful debts (see Table 5.7). Such provisions outstanding rose by approximately 70.0 per cent between 1985 and 1986, and a further 33.0 per cent in 1987. On the average, the Malaysian banking system had total provisions (including interest-in-suspense) equivalent to more than 50.0 per cent of their non-performing loans.

The policy of preferential lending, however, has segmented the credit market and the distortion in the capital market has further led to the payment of higher deposit rates by private-sector financial institutions as a result of the limited supply of funds to this sector. The Government has been taking a lion's share of the total savings generated by the economy, in particular in medium- and long-term funds, and at lower rates. It has been able to carve out for itself a 'captive market' for funds at lower rates as a result of regulatory requirements. This has undoubtedly led to a distortion in the capital market with a sizeable misallocation of scarce investment resources between the public and private sectors, and a significant differential on the interest rates they set up.

Therefore, reducing this distortion in the banking sector poses a delicate and enormous task for the authorities. It may be recalled that out of every Ringgit of a bank's deposits, about 25.00 per cent is set aside for funding government operations. On this, the bank incurs funding losses. Another 10.0 to 25.0 per cent is likely to be used up in providing priority sector loans. On this, the bank may just break even on funding cost or likely to be incurring losses.

Hence, only 50.0 to 55.0 per cent of the deposit is available to the bank for lending to the so-called non-priority sectors. It may be rememered that, under the law, banks are required to extend loans to priority sectors at concessional interest rates, when on normal commercial criteria they would not lend. Only in non-priority sectors, the bank is free to charge whatever interest rate it chooses and what ever rate the market will bear. This has meant that the lending rates on non-priority sector loans have had to be pushed up. As mentioned earlier this is to cross-subsidize the losses the banks are incurring in their own lending operations.

The bank, therefore, will try to levy a rate which is more than adequate to cover the deposit rate for funds. It would also try to cover the processing and administering cost of that loan. In other words, the lending rates will be maintained at high enough level to compensate its losses on the government and priority sector loans in order to secure an adequate return on the bank's equity capital. It is clear that if the funding losses on government and priority lending operations are reduced, if not eliminated, then the extent of cross-subsidies required will be reduced. This can be done either through an increase in interest rates on priority sector loans or through a decrease in the amounts of funds that the banking institutions have to commit on such loans, or both. This will in fact mean that the average interest rate and interest margins charged on non-priority sector loans may come down. This aspect was realized, to some extent, when the maximum interest rates to be charged by the commercial banks on loans to all priority sectors were pegged at 1.75 per cent above the average of the base lending rates (BLRs) of two leading domestic banks. The ceiling rate will thus move with the BLR.

Considering the above factors, it is clear that the lending rate on non-priority sector loans tends to be higher than the bank's deposit rate. The divergence between the two rates, caused by the various factors and elements enumerated above, is the main aspect to be considered in determining the strategy of coordination of selective credit policies and non-priority credit policies.

The policy of continued preferential lending to priority sectors may have its merits. It may promote the extension of credits and loans to the priority sector which otherwise would never get the attention of private institutions. But it has drawbacks too, especially in the context of the existence of a tight liquidity situation. Generally, the imposition of lending quotas to priority sectors will create two credit markets for funds; with interest rates lower in the market catering for priority sectors, and higher in the market catering for so-called non-priority sectors. Further, the interest differential between the markets could be wider if interest rate ceilings are imposed on priority sector lendings.

The imposition of lending quotas combined with interest rate ceilings can further result in inefficiencies in the allocation of resources in the following ways:

- Firstly, the volume of total lending activities will be lower, especially those channelled through financial institutions subject to lending quotas.

- Secondly, the lending quotas and interest differential between the two markets will result in the over-extension of credit to the priority sectors and under-provision of credit to the non-priority sectors.

- Thirdly, the non-priority sector will be subsidizing the priority sectors. And, if the former happens to be the more profitable and productive sector, it will also result in the misallocation of resources.

- Fourthly, the existence of such guidelines could induce individuals and institutions to search for ways and means of benefiting from or circumventing the lending guidelines.

If priority sector lendings are to continue and be less harmful, then the lending quotas should be imposed without the additional constraint of an interest rate ceiling. This is the same as saying that ensuring access to credit is more important than providing it at a subsidized rate. This is because a substantial portion of the portfolio is already tied and the banks are obliged to channel loans to the priority sectors. It was partly because of this restriction that the banks went full-steam ahead to lend to the property sector, where demand was high, in order to build up income and keep up the profitability and subsidize the loss in the priority sector lending. But the property market itself has been over-built to such an extent that it was caught in a slump and banking institutions faced severe problems. Deregulation of the entire spectrum, therefore, is seen as a must if the banking sector is to maintain its profitability in an environment of generally low demand.

VI.2. Deregulation and Excess Liquidity

The financial response towards the deregulatory moves undertaken in October 1978 was encouraging up to the end of 1980. The market was indicative in stabilizing money market interest rates and also interest rates for deposits and loans. But the tight liquidity position of the banking system also prevailed. This tight liquidity condition which prevailed in the banking system, just after the deregulation for the greater part of 1980, led to increased competition among the deposit-taking financial institutions.

In the quest for maximized profits in a competitive environment, several banks placed on occasions, substantial amounts of funds, mobilized in the form of deposits, in the money markets of financial centres abroad in view of more attractive rate of returns available in these markets; thereby, tightening bank liquidity to the detriment of the domestic economy. These activities exerted undue pressure on the domestic money market and forced interest rates to rise at a time of rising inflation In order to relieve the tight liquidity situation and to enable the commercial banks to sustain their lending activities, the central bank had to intervene actively in the money market by reducing Statutory Reserve Ratio (SRR) and liquidity ratios. The decline in deposit rates and the mode base lending rate (BLR) of the commercial banks, however, was not conducive enough to bring down the average lending rate of the banking industry. The rate was still sticky and decreased only marginally despite the downward adjustment in statutory and liquidity requirements for the commercial banks, thus releasing significant funds into the banking system. However, the lowering of the statutory and liquidity requirements was expected to help to even out the present differentials between various financial institutions, and thus foster greater competition among the financial institutions. The liquidity position which prevailed in the banking system just after the deregulation, for the greater part of 1980, is given in Table 5.8.

A second stage of change was effected in February 1986 when the liquidity requirement of commercial banks was lowered, but statutory reserve ratios of other banking institutions were again raised in order to put all the banking institutions to compete effectively for deposit funds on an equal footing. With effect from 1 February 1987, the liquidity requirement to be manifested by the commercial banks was again reduced along with the facility of averaging of liquidity requirements. This modification allowed for the averaging of liquidity requirements by the banking institutions helped to remove spo-

Table 5.8

LIQUIDITY POSITIONS OF THE BANKING SYSTEM: 1983-1987 [1]

(in Percentages)

	Growth of Total Loans	Growth of Total Deposits	Loan Deposit Ratio	Excess Liquidity Ratio		
				Commercial Banks	Finance Companies	Merchant Banks
1983	25.6	18.4	90.6	3.2	1.2	3.6
1984	20.9	20.3	91.0	4.2	0.9	2.2
1985	14.0	10.3	94.0	2.5	1.0	2.7
1986	6.0	7.2	92.9	3.4	1.7	2.4
1987	0.2	4.4	89.2	7.2	2.6	4.5

1. Refer to commercial banks, finance companies and merchant banks.

Source: Bank Negara Malaysia, Annual Report, various issues.

radic pressures on short-term interest rates and enabled banks to better manage their liquidity.

But the improved liquidity during 1987 affected loan growth, leading to a decline in the loan-deposit ratio of 89.2 per cent by the end of 1987 compared with a peak of 98.1 per cent in 1986. The tight liquidity situation which prevailed in the banking system in the early years of deregulation period stemmed mainly from the more rapid expansion in credit relative to growth in deposits. However, the market forces generated from the deregulatory moves further enhanced the build-up of liquidity. Consequently, interbank and deposit interest rates declined across the board. The consecutive reduction of liquidity ratios and statutory reserve requirements has increased the capacity of the banks to create more money. The excess liquidity situation that emerged during 1987 forced the central bank to issue more Treasury bills to mop up its excess liquidity or funds in the market.

However, the issue of Treasury bills have been rising very fast. The limit to the volume of Treasury bills outstanding has also been increased, from $3 billion to $5 billion. The market is thus flushed with funds, with overnight interbank rate stuck at around 0.5 per cent. Therefore, a new problem emerged as a result of a series of deregulatory moves. In this case, the banks have to look for new ways to step up their lending.

VII. Move Towards Re-regulation

After the second phase of deregulation in the late 1980s, things have been pretty gloomy on the Malaysian banking scene for the past few years. Profits plunged and several financial institutions lost money, while others, on the verge of collapsing, had to be rescued. Initially, the main problem was over-exposure in the plummeting property sector. This problem can also be attributed to the inconsistency that emerged from the priority sectors, where cheap credit at concessional rates of interest prevailed as compared to the so-called non-priority sectors. This policy has segmented the credit market into two, with substantial portion of loan portfolio tied to the priority sectors without a remunerative return on assets. It was partly because of this restriction that the banks went full-steam ahead to lend to the property sector, where demand was high, in order to minimize the loss in priority sector lending. The lending rates on non-priority sector loans have had to be pushed up and, therefore, increasing considerable amount in interest suspense or in non-performing loans.

The crisis of confidence has already triggered several small runs on banks and finance companies in the late 1980s. The quality of bank assets was severely affected, forcing the central bank to amend capital adequacy requirements. A ceiling had to be imposed on equity in banks restricting the largest stake to no more than 20.0 per cent. Also restricted was credit to a single customer after Bank Bumiputra's subsidiary, Bumiputra Malaysia Finance in Hong Kong advanced more than 80.0 per cent of its total loans to companies related to the now-defunct Carrian and other groups. Banks are now no longer allowed to calculate interest charges on non-performing loans to show paper profits and bank officials who exceed lending limits can now be jailed. All these actions were necessary to maintain depositors' confidence while the central bank attempts to get injection of new capital to save the banks.

Although financial institutions should stand on their own feet without much regulation by the central bank, the social obligation of the banking institutions towards the community cannot be ignored. Therefore, Bank Negara has been emphasizing for quite some time on the subject of quality. Effective September 1984, the banks were told that they cannot give to any individual or a single corporate borrower more than 30.0 per cent of their paid-up capital and reserves. At the same time, it limits large loans to 50.0 per cent of the banks' entire loan portfolio. A further guideline issued in 1985, made Bank Negara's concern for quality even clearer. It states that if a loan has been non-performing for more than a year, accrued interest on such a loan cannot be included in the income statement of the balance sheet. The commercial banks were also asked to devote greater attention not only to better credit evaluation but also to the basic matching of maturities in their funding operations.

The promulgation of the Essential (Protection of Depositors) Regulation, 1986, and the ensueing need to 'freeze' 24 deposit-taking cooperatives (DTCs), broadened the central bank's responsibilities (for the first time) to cover fringe deposit-taking institutions. Accordingly, in July and August 1986, the central bank had to freeze, for investigations under the Essenial (Protection of Depositors) Regulations, 1986, 24 ailing DTCs involving 522,000 depositors and approximately M$1.5 billion in deposits. By November 1986, the White Paper on the DTCs had indicated that the 24 DTCs had together lost approximately M$673 million through mismanagement or fraud. Thereby, reflecting the harsh impact of these developments on the quality of bank assets, the central bank has moved to instituting reforms to strengthen the basic structure of the banking system. Recently, Bank Negara was forced to acquire controlling interest in two commercial banks where mismanagement has caused enormous loan losses. They were the United Asian Bank and the Perwira Habib Bank, respectively; Malaysia's sixth and seventh largest locally incorporated banks. More recently, Bank Negara had to take over the control of the Oriental Bank, the thirtheenth largest commercial bank in terms of shareholders' funds. This action was necessary to facilitate the restructuring of the bank's capital which has been significantly eroded by losses during 1986 and 1987. This is the fifth bank to be reserved in recent years. In the wake of these scandals, the central bank's scrutiny of the industry has to be intensified, particularly to the appointment of chief executives. The bank managers who exceeded their authority are liable to face prison sentences.

The amendment to Section 3a(1) of the Finance Companies Act 1969, which came into force on 1 January 1987, prohibits any persons, other than licensed finance companies and those exempted from the Act, from using the words 'finance companies' or any derivative thereof in their names in the national language or in English, or in any other language.

In the context of indiscriminated expansion of assets, Bank Negara Malaysia reiterated in its 1984 Annual Report that "the commercial banks must, as a matter of priority, devote greater attention not only to better credit evaluation but also to the basic matching of maturities in their funding operations, since the growth of loans to the property sector, including housing, had lengthened the maturity structure of their assets without any corresponding lengthening of their maturities". [40]

It may be recalled in this regard that financial institutions reported a total of 202 fraud cases involving M$146.1 million during 1986 — a four-fold increase over the previous year (i.e., 1985). Fifty-two cases involving M$6.4 million were reported in 1985, while in 1984, there were 36 cases involving M$1.7 million. In this regard, the central bank noted insufficient follow-up investigations to weed out misdeeds in white collar jobs.

Further, commercial banks in Malaysia were confronted with the growing problem of non-performing loans during 1986 and 1987. There was also a problem of poor credit evaluation and loan documentation. "The bad debt provisions for the commercial banks deteriorated from 2.6 per cent to 5.7 per cent of total loans (in 1986), due mainly to the problem loans faced by four domestic banks". If these

40. Bank Negara Malaysia, Annual Report, 1984.

four were excluded, the bad debt provisions for commercial banks would average 1.7 per cent, comparable to the average of 1.5 per cent for the 100 largest banks in the U.S. The bad debt provisions and outstanding interest-in-suspense for the commercial banks were to the extent of 7.0 per cent and 6.1 per cent of total loans, respectively, in 1987 (see Table 5.7).

Accordingly, the central bank had to force the pace in rapid cuts in the base lending rates (BLRs) and also issue guidelines, effective 1 September 1987, by specifying the maximum spread which the banks and finance companies were allowed to charge over their BLR at 4.0 percentage points per annum, and the maximum penalty rate on non-performing loans was just 1.0 percentage point as against rates as high as 4 percentage points imposed previously. Therefore, unpegging of deposit rates for fixed deposits, effective from 26 January 1987, is again associated with a few aspects of interest rate re-regulation because of the growing volume of non-performing loans. Therefore, how to reduce the distortions in the banking sector amidst the rapid process of deregulation along with some aspects of re-regulation poses a delicate and enormous task for the regulatory authorities. The priority sector lending is one of the aspects in this distortion.

But, as a second best solution, more effective competition between banking institutions is clearly necessary. The central bank has recently piloted legislation to place different financial institutions on an equal footing — an example being the steps taken to create uniform reserve requirements for commercial banks, finance companies, and merchant banks. There are also plans to expand a secondary market in government debt, which at present is primarily taken up by the Employees' Provident Fund. The two leading banks, Malayan Banking and Bank Bumiputra, which are also under heavy government influence, have an almost captive market for government business. Their base lending rate (BLR) also provides guideline for the lending rates of other banks, who normally add about 0.75 percentage points. The remaining banks are therefore able to use the two leading banks as a shield for their own inefficiencies.

One solution would be to restructure the shareholdings of the two leading banks in a way that reduces government influence. Another would be to allow foreign banks greater penetration of the Malaysian market. However, against the background of suspension of the 24 deposit-taking cooperatives and the rescue packages for some major banking institutions, the authorities have to proceed cautiously. They will need to carefully balance the need for a further tightening of their supervision of the banking system which has already been strengthened since 1982, against regard for increased competition. Steps have already been taken to curtail the types of deposits the cooperatives can offer. However, it is debatable as to whether a more deregulated banking system would actually have prevented the debacle of the cooperatives from occurring. Nevertheless, even in the developed countries where market condition was a perfect indicator, the shock of de-regulation was absorbed by strengthening the supervision law. For instance, the collapse of Johnson Matthey Bankers in 1984 and its rescue by the Bank of England showed an urgent need for a new framework of supervision. Therefore, proper supervision should not be regarded as a hinderance to deregulation.

Appendix 5

Some Major Regulatory and Prudential Measures (1976-1986)

1. Bank Entry

The policy has been to restrict the issue of licenses for new commercial banks, finance companies and merchant banks.

2. Capital Adequacy Ratios [a]

On January 1, 1982, capital adequacy ratios were imposed on the commercial banks - 4.0 per cent for domestic banks and 6.0 per cent for foreign banks. Gearing ratios for merchant banks were introduced in 1979. These were:

- Borrowings to shareholders' funds - maximum of 15 times; and,
- Borrowings and contingent liabilities to shareholders' funds - maximum of 20 times.

3. Statutory Reserves and Minimum Liquid Asset Ratios

Statutory reserves and minimum liquid asset ratios for commercial banks and finance companies were already the requirements prior to 1975. These were introduced in 1979 for merchant banks. As per the recent requirement, the primary liquidity ratio for commercial banks is 5.0 per cent, with the overall liquidity ratio - which remains at 17.0 per cent for commercial banks and 10.0 per cent for merchant banks and finance companies. As per the statutory reserve ratio (SRR), it is to be maintained at 4.0 per cent of eligible liabilities for the commercial banks and 3.5 per cent of eligible liabilities for the finance companies. The statutory reserve requirements were further increased with effect from May 1989. Accordingly, statutory reserve ratio for commercial banks is increased by 1.0 per cent to 4.5 per cent of total eligible liabilities, while merchant banks and finance companies are required to raise their ratios by 1.5 per cent to 4.5 per cent.

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a. A risk-weighted capital adequacy ratio (CAR) has been imposed on commercial banks with effect from 1 September 1989. The CAR, which is to ensure that banks have adequate working capital and will be fully complied with only in 1992, is 8.0 per cent for domestic banks and 10.0 per cent for foreign banks. The CAR requirement is based on the proposal of the Basle Committee.

4. Using the Words 'Finance Companies'
The amendment to Section 3a (1) of the Finance Companies Act, 1969 (effective 1 January 1987), prohibits any persons other than licensed finance companies and those exempted from the Act, from using the words 'finance companies' or any derivative thereof in their names in the national language or in English or in any other language.

5. Limits placed on Equity Ownership
The new Section 23B of the Banking Act, 1973 (Section 28B of the Finance Companies Act) limits the proportions of total equity that any corporation or cooperative society may held in a bank or finance company. The new provisions would prohibit individuals and family holding companies from holding more than 10.0 per cent of equity of any bank or finance company while any company or cooperative may not hold more than 20.0 per cent.

6. Prohibition of Cross Holdings of Financial Institutions
Section 23C of the Banking Act (and Section 29C of the Finance Companies Act) prohibits commercial banks from holding shares in another bank. Similarly, finance companies and merchant banks are prohibited from holding shares in another finance company and merchant bank, respectively. Commercial banks are also prohibited from holding shares in the subsidiaries of other banks, finance companies and merchant banks. Similarly, finance companies are prohibited from holding shares in the subsidiaries of other finance companies, banks and merchant banks; and merchant banks in the subsidiaries of other merchant banks, banks and finance companies.

7. Suspension of Interest on Non-Performing Loans
Interest income to be suspended on all non-performing loans where such accounts had been in arrears for 12 months or more. For hire purchase loans, interest to be suspended if this accounts were in arrears for 6 months or more. The banks are required to make retro-active adjustments on all non-performing loan accounts.

8. Single Customer Limit
Section 27A of the Banking Act prohibits a bank from granting facilities to a single customer exceeding 30.0 per cent of the capital funds of a bank (net working funds for a foreign bank). In addition,

banks are required to observe an overall limit for "large" loans [b], set at 50.0 per cent of total credit facilities in order to prevent undue concentration of bank lend ing to only a few borrowers.

9. Prohibition of Lending to Directors and Employees

Section 26A of the Banking Act, prohibits the banks from lending to their directors, officers or employees or director related companies to prevent conflict of interest in their lending decisions. Finance companies are also expected to adhere to the spirit of these guidelines, pending amendments to legislations.

10. Interest Rate Regulation

Prior to 1978, interest rates for deposits were subject to ceilings and lending rates to floors. After 1978, financial institutions were free to quote deposit and lending rates except such lending rates for priority sectors. Since October 1976, ceiling rates have been imposed on loans to priority sectors.

Before 1981, commercial banks required to observe prime lending rate (floor) which was administered by Bank Negara. With effect from 1 November 1983, all interest rates on loans and advances, other than those prescribed by maximum ceiling rates and law, had been tied to base lending rates (BLR) of therespective largest commercial banks.

The deposit rates of the banks and finance companies became further linked to the deposit rates of the two leading domestic banks with effect from 21 October 1985. The fixed deposit rates of the commercial banks was arranged not to exceed 0.5 percentage point higher than those of the two leading banks and the deposit rate of the finance companies not to exceed 1.25 percentage points than those of the two lead banks. Before 1 February 1987, banks and finance companies used to set their rates for fixed deposits up to 12 months within a fixed margin above the rate (i.e., not more than 1.5 per cent quoted by the two leading banks, namely Bank Bumiputra Berhad and Malayan Banking Berhad). The maximum interest rate to be charged by the commercial banks on loans to all priority sectors has been pegged at 1.75 per cent above the average of the base lending rate (BLR) of two lending domestic banks or 9.0 per cent per annum whichever is lower. Guidelines were issued to the commer-

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b. A "large" loan means any credit facility granted by a bank to any customer which in the aggregate exceeds 15.0 per cent of the bank's capital funds or net working funds.

cial banks to adjust the margin of their lending rates to not more than 4.0 percentage points above their base lending rate (BLR). [c]

11. Credit Restriction Policies

Since 1976, Bank Negara has imposed formal lending guidelines on the commercial banks and finance companies to channel funds into priority sectors and the Bumiputra Community. For instance, the lending guidelines for 1986 were as follows:

Lending Sector	Commercial Banks	Finance Companies
Loans to Bumiputra Community	Minimum 20.0 per cent of total loan base as at 31/12/85	Minimum 20.0 per cent of total loan base as at 31/12/85
Loans to Small-Scale Enterprises	Minimum M$150 million of which M$75 million to Bumiputras	Minimum 15.0 per cent of total loan base as at 31/12/85
Loans to Agricultural Food Production	6.0 per cent of total loan base as at 31/12/85	Nil
Loans to Housing	Minimum 80,000 units of new firm commitments of newly-constructed houses costing M$100,000 and less, of which at least 48,000 units should be low-cost houses costing M$25,000 and less and least 24,000 units should be for Bumiputras. These are for 1986-87.	Minimum 20,000 units of new firm commitments of of newly-constructed houses costing M$100,000 and less, of which at least 12,000 units should be low-cost houses costing M$25,000 and less and at least 6,000 units should be for Bumiputras. These are for 1986-87.

12. Penalty on Liquidity and Risk Asset Requirements

An amendment to Section 18 of the Banking Act provides for a specific monetary penalty for non-compliance with liquidity requirements to be computed on a daily basis. The penalty is expressed as

c. Before February 1987, banks and finance companies had agreed to maintain their interest rates for fixed deposits (up to 12 months maturity) within a fixed margin above those quoted by the two leading banks. This arrangement was removed with effect from 1 February 1987 by unpegging the deposit rates to the rates quoted by the two leading banks, and thus to be determined by the market. Interest rates on fixed deposits of more than 12 months maturity were unpegged even before October 1985.

not more than one-tenth of 1.0 per cent of the amount of deficiency in liquid assets for everyday during which the deficiency continues.

A similar amendment under Section 19 imposes an express monetary penalty to be computed on a daily basis for non-compliance with the risk assets ratio. The penalty is expressed as not more than one-tenth of 1.0 per cent of the amount of risk assets held in excess of the maximum holdings prescribed by the Minister of Finance.

13. Prevention of Abuses of Lending Authorities

The new section 27AA of the Banking Act (Section 21A of the Finance Companies Act) subjects the directors, managers and employees of all banks and finance companies to express penalties (of not more than three years' imprisonment or a fine of M$20,000), should they exceed their authorized lending limits.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Bank Negara Malaysia, 1987.

Chapter 6

Financial Deregulation in Nepal

I. Rationale and Objectives of Deregulation

For a long time Nepal had operated a system of controlled interest rates for commercial banks and other financial institutions. The decision of 29 May 1986 granting the commercial banks and financial institutions the authority to fix interest rates at their own discrétion at any level above the minimum prescribed levels can be regarded as a major step towards deregulatory moves. The encouragement of the entry of joint-venture foreign banks since 1984 and some amendments made in the Commercial Bank Act enabling the banks to extend credit for a long-term period, and also allowing the Agricultural Development Bank (ADB/N) to conduct commercial banking activities are the aspects of the deregulation policy.

The main objective of the interest rate deregulation measures was to allow the commercial banks plenty of latitude to attract more deposits, and charge effective and attractive interest on loans at appropriate rates. The interest rate decision has also complemented the special emphasis laid by His Majesty's Government on fostering competition and excellence in the financial sector.

It may be recalled that before the deregulation of May 1986, there were about twenty controlled lending rates, differentiated between sectors, use of funds, and types of collateral. Further, interest rate structure was not very rational. Instead of the central bank determining the whole set of deposit rates and instruments, there seems more logic in leaving it to the banks themselves to do that. It is a matter of logic that whenever the central bank established some key mandatory deposit rates the banks will choose their portfolio of deposit instruments in such a way that it reflects the differences in liquidity and other demanded properties. By controlling a few key rates,the central bank is assured of sufficient control on interest rates to safeguard an accepted level of interest rates. It is with these objectives and rationale that banks and financial institutions were allowed to freely set key deposit rates above certain minimum rates, and the former complex structure of concessional refinancing rates applied to certain sectors was replaced by a higher, uniform maximum rate; all other lending rates were freed. Further, the reason to adopt a more flexible policy with respect to maturity of deposits is to enable the commercial banks to match their liability structure with their investment portfolio.

II. Circumstances and Conditions for Deregulation

Interest rate structure has been the major aspect of deregulatory policy in Nepal. The overall impact of controlled interest rate and other regulations resulted in a tightly controlled asset and liability structure of the commercial banks and hence, changes were only possible to a limited extent. The main reasons for controlling lending rates previously was to prevent excessive profits in a non-competitive banking system and to influence credit allocation. Further, it was noted that the competitive conditions are not fully developed and the emergence of more commercial banks may not alter the present situation of the competitive environment. In this situation, a liberalization of interest rates may be utilized by the banks only to increase their profit margin. This was the basic philosophy before the period of deregulation of interest rates in Nepal.

However, it must be realized that there is an important constraining factor, namely the requirements for priority and productive sector lending. The banks cannot freely increase their lending rates without running the risks of not attaining their lending targets. If the rates are too high, the demand for credit will be insufficient and this backfires on their profitability, particularly if other investment opportunities, such as in foreign assets, are limited. Further, even in the absence of direct controls, the central bank can promote an orderly development in consultation with the commercial banks.

During the past decade, banking activities developed rapidly as is evidenced by the growth of assets, the expansion of bank branches in rural areas and the gradual decline of the currency-deposit ratio over the years. Assets of the combined commercial banks grew on average by 21.0 per cent during the period 1977-1987. Similarly, the expansion of bank branches was stimulated under a general policy of expanding bank branches in rural areas for expanding economic activities and increased monetization. However, the currency-deposit ratio declined steadily between 1977 and 1987, from 55.9 per cent in 1977 to 48.6 per cent in 1987 (Table 6.1). Therefore, the

Table 6.1

TOTAL ASSETS AND CURRENCY-DEPOSIT RATIO

(in Percentages)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Growth of Total Assets of Commercial Banks	33.1	20.0	22.6	16.0	31.8	4.5	23.6	10.7	24.7	20.6	18.7
Currency-Deposit Ratio	55.9	53.7	55.7	54.0	49.9	49.7	43.8	46.3	43.8	47.1	48.6

Source: Nepal Rastra Bank, Quarterly Economic Bulletin, various issues.

interest rate deregulation decision of 29 May 1986 complemented the special emphasis laid by the Government on fostering competition and excellence in the financial sector.

Further, an ironic situation existed in the country before deregulation, where the commercial banks have plenty of idle money, and many farmers and potential entrepreneurs may have had to shelve their plans because of the shortage of funds. An atmosphere of competition among the banks along with the new autonomy in fixing interest rates should positively contribute to achieving the intended objectives of the present deregulatory measure.

Non-flexibility in the interest rate on deposits restricting the financial institutions to mobilize more sources, and the wide margin between the deposit and lending rates were not good indicators of competitive financial markets. Therefore, these were some of the circumstances leading to deregulatory moves in Nepal.

Very few financial instruments have emerged within the financial system during the decade under review. Among them are the issuance of traveller's cheques by one of the commercial banks and debentures by the Agricultural Development Bank (ADB/N) and the Nepal Industrial Development Corporation (NIDC) within the financial system and National Saving Certificates by the Government outside the financial system. However, the establishment of the Security Exchange in April 1977 has created a secondary market not only for financial instruments but also for shares, stocks and other forms of capital in the non-financial system. Therefore, a congenial atmosphere is being created to make the financial instruments more liquid. It should be noted that the financial instruments which already existed before 1975, such as the treasury bills and development bonds issued by the Government and mostly held by the financial system, are more intensively transacted within the financial system (Table 6.2). Agricultural saving bonds issued by the ADB/N in 1985 amounting to Rs. 50 million has emerged as a new instrument in the financial market though its sales has so far been only equal to Rs.16.9 million.

The move to allow the commercial banks to open foreign currency accounts after the deregulatory moves, however, has added a new instrument in the sources of funds. But the issuance of negotiable certificates of deposits, credit cards and other financial instruments has not been introduced.

The interest rate policy has been the major aspect of deregulation policy in Nepal. However, it has not changed much over time, although a significant revision took place in 1975 when deposit and

Table 6.2

ISSUANCE OF BILLS AND SECURITIES BY THE GOVERNMENT [1]

(in Million Rs.)

As at Mid-July	Treasury Bills			Development Bonds			National Savings Certs.		
	Total	Held by FIs	Held by Others	Total	Held by FIs	Held by Others	Total	Held by FIs	Held by Others
1975	50.0	50.0	-	327.5	265.3	62.2	-		
1976	150.0	150.0	-	370.0	297.9	72.1	-		
1977	350.0	349.0	1.0	450.0	362.1	87.9	-		
1978	490.0	489.7	0.3	530.0	438.4	91.6	-		
1979	590.0	589.8	0.2	600.0	503.0	97.0	-		
1980	670.0	664.0	6.0	650.0	558.2	91.8	-		
1981	420.0	412.9	7.1	850.0	758.2	91.8	-		
1982	620.0	614.1	5.9	1100.0	994.2	105.8	-		
1983	1000.0	987.1	12.9	1670.0	1552.1	117.0	-		
1984	1830.0	1775.0	55.0	1810.0	1728.1	81.9	500.0	377.1	122.0
1985	2830.0	2806.2	23.8	2010.0	1947.6	62.4	1000.0	778.7	221.0
1986	3080.0	3073.2	6.8	2290.0	2185.5	104.5	1500.0	1186.0	314.0

1. Outstanding.
FIs = Financial Institutions.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Nepal Rastra Bank, 1987.

lending rates were raised and a reclassification of the lending rate structure was introduced. The reasons for maintaining a few mandatory rates can be attributed to three main factors, namely: (1) insufficient competitive conditions for the introduction of a fully liberalized system of interest rates; (2) the necessity to gain experience with a partly liberalized system; and, (3) the need for further development of other instruments of monetary policy.

Therefore, the interest rate policy in Nepal was characterized by an elaborate system of mandatory deposit and lending rates for commercial banks and other financial institutions before deregulatory moves of May 1986. The direct control of interest rates was motivated by the following reasons:

- First, competition in the banking sector is very limited. There are only five commercial banks, of which the two largest ones are dominating the market, while the countervailing power of the recently opened three joint-venture foreign commercial banks is insufficient at this moment, considering their limited size and operation. The two larger commercial banks are controlled by the Government as the only or major share-holder, and effective competition has not been encouraged.

- The direct control of lending rates provides an easy mechanism for credit allocation by differentiating between priority and non-priority sectors, in which the first receive concessionary interest rates. It is thought that concessionary rates combined with a refinancing facility are effective instruments to stimulate the supply and demand for priority sector credit.

- The direct control of deposit rates is viewed as an effective instrument for mobilizing domestic savings because it allows sufficient interest rate differential to prevent capital overflow to India and also stimulate further development of the financial system.

Although, there is no definite conclusion with respect to the expected level of interest rates, the Nepal Rastra Bank (NRB, the Central Bank) was still able to promote an orderely development in consultation with the commercial banks. In this respect, it is important that banks have a general reporting requirement on their lending policy and lending rates so that NRB is able to monitor developments closely. Therefore, there is no reason to increase structurally the margin between deposit and lending rates.

The policy issue, therefore, is whether the previous system of interest rate controls was the most effective vehicle in realizing the objectives of increasing savings and investments, and if not, what alternatives are available to improve the efficiency and flexibility of interest rates management. In particular, the question arises, whether the conditions for deregulation is sufficient or whether more reliance can be placed on an indirect system of controls, and what are the policy requirements. It may be argued that a direct control of deposit and lending rates is redundant, and that fixing one or two important deposit rates is sufficient to indirectly control the structure and level of other deposit and lending rates.

Apart from this, some anomalies observed in the financial system during the past few years prompted Nepal Rastra Bank towards deregulating the financial system. The first reason was the abundance of resources in some institutions, while others face scarcity of the same resources. Non-flexibility in the interest rate on deposits restricted the institutions (needing more resources) to mobilize more resources by offering higher rates. With the removal of ceilings on maximum deposit rates, the financial institutions have now been free to attract more resources towards them by offering higher rates. The second reason was the wide margin between deposit and lending rates. Such a wide profit margin is not an indicator of a healthy financial market. The deregulation move was thus expected to reduce the margin between lending and deposit rates of the financial institutions with the creation of financial competitiveness. And, the third reason was the introduction of commercial banks with foreign banks' collaboration in the financial system and the subsequent need to create a competitive atmosphere for the commercial banking activities. However, the interest rate structure as shown in Table 6.3 does not give an optimistic picture of the effects of this interest rate deregulation. The banks were eager to preserve the old structure and level of interest rates. The joint-venture banks seem to be successful in exploiting the market imperfections by increasing the interest rate spread between the lending and deposit rates with rather low deposit rates.

III. Major Features and Nature of Deregulation Policy

The move towards deregulation in the financial system of Nepal has been very recent and the degree and forms of deregulation are also limited in Nepal as compared to other SEACEN countries in the

Table 6.3

COMMERCIAL BANK'S DEPOSIT RATES
(in Percentages)

(A) Before Deregulation

Deposits	Before 28 Apr. 1975	Effective 28 Apr. 1975	Effective 16 Jul. 1976	Effective 12 Feb. 1977	Effective 15 Jun. 1982	Effective 16 Nov. 1984
Saving Deposits	6.50	8.00	8.00	8.00	8.50	8.00-10.00
Fixed Deposits:						
3 to < 6 mths	3.50	4.00	4.00	4.00	4.50	4.50- 5.50
6 to < 1 yr	9.50	10.00	10.00	9.00	9.50	9.50-10.50
1 to < 2 yrs	9.75	15.00	14.00	12.00	12.50	12.50-13.50
2 yrs & more	10.00	16.00	15.00	13.00	13.50	13.50-14.50

(B) After Deregulation [1]

Deposits	NBL	RBB	NABL	ISUEZ
Saving Deposits	8.50 and 9.00 [a]	8.50 and 9.00 [a]	8.50	8.50
Fixed Deposits:				
3 mths to < 6 mths	8.50	8.50	8.50	8.50
6 mths to < 1 yr	8.75- 9.00	8.75- 9.00	8.75- 9.00	8.75- 9.00
1 yr to < 2 yrs	12.50	12.50	12.50	12.50
2 yrs & more	13.50-14.00	13.50-14.00	13.50 [b]	13.50 [b]

1. Effective 19 May 1986.
a. For up to Rs 50000 deposits, if kept from one financial closing to another.
b. 2 years only.
NBL = Nepal Bank Limited (commercial bank, semi-government-owned).
RBB = Rastriya Banijya Bank (commercial bank, fully government-owned).
NABL = Nepal Arab Bank Limited (joint-venture foreign bank).
ISUEZ= Indo-Suez Bank (joint-venture foreign bank).

Source: Nepal Rastra Bank, Quarterly Economic Bulletin, and Commercial Banking Statistics, various issues.

region. The history of deregulation in Nepal covers hardly a couple of years with limited deregulatory steps on assets control and deposit and lending rates but almost none towards capital and other liability control aspects. As such, most of the liabilities of the financial institutions were hardly regulated in the earlier years, and the question of deregulation on such liabilities does not exist either.

The provision regarding the entry of commercial banks which includes approval of His Majesty's Government on the recommendation of the NRB has not undergone any change throughout the review decade. However, the entry of joint-venture banks has been encouraged since 1984. As a result, three commercial banks established with the joint investment of Nepalese individuals as well as institutions and foreign banks have commenced their operations. Moreover, some amendments have been made to the Commercial Bank Act so that the banks could extend credit for a long-term period. Accordingly, the new Commercial Bank Act of 1974 has also allowed commercial banks to forward longer-term credit on agricultural and industrial sectors with the maximum period of long-term credit being fixed at 12 years. This has widened the scope of the commercial banks' lending activities.

The amendment made to the Agricultural Development Bank Act, which allowed ADB/N to conduct commercial banking activities, has encouraged it to mobilize higher financial resources, and it has created a competitive environment for deposit collection.

The amendment of the Employees' Provident Fund Act has allowed the institution to diversify its funds in various investment activities rather than concentrating on time deposits in commercial banks. The establishment of the Security Exchange Centre and the introduction of Stock Exchange Act have encouraged capital market activities in the country. The provisions of the Finance Company Act, which came into effect in 1986, have paved the way for the establishment of finance companies. Though the establishment of finance companies has not been observed yet, the Act has provided a legal base for such ventures.

However, the chronology of deregulation details does not go very far back. It was only in November 1984 that the deposit-taking institutions were granted freedom to manage their deposit rates within a narrow range of one to one and a half percentage points after maintaining the minimum rate as prescribed by the NRB. The first step towards this move was made effective on 29 May 1986, whereby the deposit-taking institutions were granted the freedom to offer higher rates than the minimum rate as prescribed by the

NRB. In other words, commercial banks have been granted the authority to determine the interest rates as well as the maturity period of fixed deposits after maintaining the minimum one-year fixed deposit interest rate as prescribed by the NRB. Accordingly, commercial banks and financial institutions have been authorized to fix their own interest rates on both deposits and loans subject to a minimum rate of 8.5 per cent on savings deposits and a rate of not more than 15.0 per cent on priority sector lending. Similarly, the commercial banks are now allowed to mobilize additional financial resources to expand their sources of funds and maintaining the minimum interest rate level as prescribed on time deposits.

With regard to deregulation on lending rates, only a few lending rates were at the discretion of the financial institutions till 19 May 1986. After the introduction of the deregulation system only the maximum lending rates on priority sector credits are enforced by the NRB, and other rates are left free at the discretion of the respective financial institutions. Effective July 1989, interest rates were completely liberalized and commercial banks and other financial institutions were allowed to fix their own deposit and lending rates.

On loans relating to security of government bonds and against fixed deposit receipts, the rate has been fixed 2.0 per cent higher than the rates against such securities and fixed deposits. The interbank lending rates are also left to the discretion of respective dealing institutions. More encouraging is the autonomy granted to the commercial banks to fix rates of interest for deposits consisting of more than two years. This should not, however, be less than the rate for two-year deposits. Further, at the deposit front, commercial banks are now authorized to take deposits on convertible foreign currencies effective July 1985. Thereafter, the banks were allowed to accept deposits (current and fixed) on two currencies (U.S. dollar and pound sterling).

The next deregulatory step is the relaxation of liquidity requirement ratio. Effective 29 May 1986, the commercial banks were granted freedom from maintaining liquidity requirement. Prior to this, the liquidity requirement was to be maintained at 25.0 per cent with the obligation of the commercial banks to invest at least 5.0 per cent of their total deposits in government securities. But still they have to comply with the statutory reserve ratio.

In the case of lending rates, except for exports and a few productive sectors, commercial banks and financial institutions have been given the freedom to determine the rates. In the case of priority sector lending the provision of interest subsidy provided by the central bank has been discontinued, and refinance facility is restricted to a few activities only.

With regard to loan limit and priority sector loans, the commercial banks are still regulated by the NRB from time to time (Table 6.4). Nevertheless, banks are now allowed to freely set key deposit rates above certain minimum rates, and the former complex structure of concessional refinancing rates applied to certain sectors was replaced by a higher uniform maximum rate; all other lending rates were freed. The minimum deposit and maximum lending rates have been kept under review and are being adjusted as needed to reflect price developments and ensure positive real interest rates. In addition, the maturity structure of government securities has been improved so as to make them more attractive to potential buyers. Furthermore, the development of short-term government securities has been explored, including measures to promote a more active secondary market in government securities, with a view to placing greater reliance on open market operations in the management of bank liquidity. Accordingly, a new policy of selling Treasury bills at monthly auctions has been adopted in a bid to mobilize the capital market and help finance the budget deficit. Although a credit ceiling was imposed on commercial banks, there was no quantitative restriction on refinance facilities to the commercial banks. However, access to concessional refinancing facilities has been planned to be regulated within the overall monetary programme.

IV. Effects of Deregulation

IV.1 Effects on Mobilization of Resources

Before deregulation, the non-flexibility of interest rates on deposits had restricted the financial institutions (needing more resources) to mobilize more resources by offering higher rates. With the removal of ceilings on maximum deposit rates, the financial institutions have now been free to attract more resources towards them by offering higher rates. Even the non-bank financial institutions were competing with the commercial banks in deposit mobilization. Although the magnitude of deposit collection by the non-bank financial institutions is quite low as compared to that of commercial banks, deregulation has paved the way for more deposit mobilization. The share of commercial banks' total deposit collection in the financial system has increased (Table 6.5). However, after a rapid increase from 45.0 per cent in 1970 to 71.0 per cent in 1980 during

Table 6.4

REGULATION OF COMMERCIAL BANKS BY TYPES OF INSTRUMENTS

Mid-July	Liquidity Ratio (%)	Statutory Reserves (%)	Loan Rates (%)	Deposit Rates (%)		Long-term Lending Deposit Ratio (%)	Priority Loan Limit (in Million Rs.)	Loans to Sector Credit Requirement	Capital Fund Requirement
				Fixed [1]	Savings				
1976	25	5	8-16	14	8	-	1509.9	5% of total deposits	
1977	-	5	8-16	12	8	5	-	7% of total deposits	
1978	-	7	8-16	12	8	15	-	7% of total deposits	
1979	-	7	8-16	12	8	15	1927.0	7% of total deposits	
1980	-	7	8-16	12	8	15	2633.2	7% of total deposits	
1981	-	7	8-16	12	8	15	-	10% of total deposits	
1982	25	9	11-17	12.5	8.5	15	-	10% of total deposits	3:1
1983	25	9	11-17	12.5	8.5	15	-	10% of total deposits	3:1
1984	25	9	11-17	12.5	8.5	15	-	10% of total deposits	3:1
1985	25	9	8-19	12.5-13.5	8.5-10.0	15	-	10% of total deposits	3:1
1986	-	9	15 [a]	12.5 [b]	8.5 [b]	15	8341.0	8% of total deposits	3:1

1. One year fixed deposit rates.
a. Maximum lending rates for priority sector credits only.
b. Maximum rates only fixed by the NRB.
Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Nepal Rastra Bank, 1987.

Table 6.5

SHARE OF FINANCIAL INTERMEDIATION CONDUCTED THROUGH THE COMMERCIAL BANKS AND NON-BANK FINANCIAL INSTITUTIONS TO TOTAL FINANCIAL INTERMEDIATION

(in Million Rs.)

Mid-July	Credits Extended by the FIs to Non-FIs [1]						Deposits Collected by the FIs from Non-FIs					
	(1) NRB	(2) CBs	(3) Other FIs	(4) Total	(5) (2) as per cent of (4)	(6) (3) as per cent of (4)	(1) NRB	(2) CBs	(3) Other FIs [2]	(4) Total	(5) (2) as per cent of (4)	(6) (3) as per cent of (4)
1970	143.5	367.7	46.0	557.2	66.0	8.2	367.1	364.2	71.6	802.9	45.4	8.9
1975	489.3	1319.6	300.4	2109.3	63.9	14.2	370.4	1054.9	264.9	1690.2	62.4	15.7
1980	1158.5	3106.9	882.4	5147.8	60.4	17.1	484.9	2954.1	731.5	4170.5	70.8	17.5
1981	1155.1	3867.5	976.3	5998.9	64.5	16.3	343.4	3584.2	935.2	4862.8	73.7	19.2
1982	1571.5	4164.5	1144.6	6880.6	60.5	16.6	275.4	4123.3	1173.8	5572.5	74.0	21.1
1983	3086.0	5071.2	1361.8	9519.0	53.3	14.3	403.3	5319.0	1437.2	7159.5	74.3	20.1
1984	3739.5	5673.5	1733.2	11146.2	50.9	15.5	390.4	6045.2	1728.3	8163.9	74.0	21.2
1985	4741.6	7351.4	2168.2	14261.2	51.5	15.2	393.4	7377.4	2247.3	10018.1	73.6	22.4
1986p	5805.0	8853.2	2924.1	17582.3	50.4	16.6	541.3	8926.6	2756.5	12224.4	73.0	22.5

1. As reflected in balance sheets of financial institutions.
2. Premiums collected by National Insurance Corporation (NIC), provident funds collected by Provident Fund Corporation (PFC) and deposits of Agricultural Development Bank of Nepal (ADB/N); including debenture and compulsory savings).

p. Provisional.
NRB = Nepal Rastra Bank.
CBs = Commercial Banks.
FIs = Financial Institutions.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Nepal Rastra Bank, 1987.

the regime of regulated interest rates, the share of commercial banks deposit liabilities to total deposit liability remained within a narrow range of 73.0-79.0 per cent up to 1986. Similarly, the share of other financial institutions also increased from less than 16.0 per cent in 1975 to more than 22.0 per cent in 1986.

It may be recalled that the NRB, on November 1984, gave a directive to the commercial banks and other deposit-taking institutions to permit an increase in deposit rates by up to 1.5 percentage points on the minimum rates of 8.5 per cent on savings deposits and 1.0 percentage point on the minimum rates of fixed deposits (12.0 per cent on one-year deposit). With such a liberalization policy, financial institutions with resource scarcity offered up to 10.0 per cent interest rate on savings deposits and 13.0 per cent on one-year fixed deposits. As a result, deposit collection speeded up. The deposit collection of the ADB/N which stood at Rs. 37.9 million at mid-July 1984 went up to Rs. 104.5 million at mid-July 1985, and further to Rs. 189.3 million at mid-July 1986. Such a growth is in part attributed to the commercial banking activities resumed by the Bank in urban areas since 1984. The deposit collection of commercial banks increased slightly by the end of the financial year 1986/1987 with the deregulation of interest rates (Table 6.6). The growth of deposits on savings accounts is most pronounced. However, it is too early to assess the impact of partial deregulation on deposit mobilization.

As a step ahead in the deregulatory moves, freedom granted by the NRB to interest rates on deposits to float in the market by prescribing only the minimum rates on various kinds of deposits showed that financial institutions needing more resources are offering to some extent higher interest rates on deposits, and they have become more self-sufficient than earlier. But the growth of deposit collection of the financial institutions has not been sufficient to reduce the use of refinancing facilities from the NRB as most of the activities of the commercial banks are still under the NRB regulations (Table 6.6). The autonomy granted for the fixation of higher deposit and lending rates, except for priority sector lendings, is expected to promote competitiveness among the financial institutions. Deregulation policy in Nepal is very recent and its effects are, therefore, yet to be visualized.

IV.2 Effects on Interest Rates

It is generally accepted that the thrust behind deregulation moves is to promote competitiveness among the financial institutions so that they would offer higher interest rates for deposits and charge lower

Table 6.6

DEPOSIT COLLECTION AND BORROWINGS FROM NEPAL RASTRA BANK: 1975-1986

(in Million Rs.)

Year (Mid-July)	Commercial Banks		Agricultural Dev. Bank	
	Deposit Collection	Borrowings from NRB	Deposit Collection	Borrowings from NRB
1974/75	1174.0	368.9	7.4	98.2
1975/76	1605.2	24.0	9.3	50.8
1976/77	2146.8	55.4	51.4	89.4
1977/78	2528.5	174.1	49.1	127.2
1978/79	2920.9	168.9	40.7	180.3
1979/80	3351.6	264.4	37.0	193.9
1980/81	4160.2	468.1	33.0	198.9
1981/82	4935.4	137.8	37.0	222.0
1982/83	6308.4	74.0	35.2	236.1
1983/84	7091.2	152.1	37.9	332.2
1984/85	8560.1	388.0	104.5	414.2
1985/86	10315.4	533.9	199.3 p	487.9 p
1986/87	11900.5	520.3	323.0 p	493.0 p

p. Provisional.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Nepal Rastra Bank, 1987.

interest rates for their lendings. Larger movements of interest rates in the financial market are expected to occur in such a situation. However, Nepal's financial system is yet to visualize such an interest rate movement. It is observed that some of the financial institutions are offering higher interest rates on some time deposit accounts meeting specific conditionalities. But competitiveness in the lending activities and subsequent lowering of the lending rates is yet to be observed.

Further, at the very initial phase of deregulation moves, the gap between lending and deposit rates of the financial institutions is not expected to narrow down abruptly. As mentioned earlier the deregulation exercise in Nepal's financial system is very recent and hence, the deposit and lending rates of various commercial banks revealed that they are not so much varying from one another. But with the entry of foreign banks into the commercial banking system and the overlapping functions among various financial institutions, it is expected that competitiveness among these institutions would prevail to capture a larger share in the financial market in the foreseeable future. This will, in turn, result in varieties of lending and deposit rates, and the apparent understanding among the financial institutions will give way to competition in the financial market. One consequence of a more liberalized interest rate policy is the reliance on other instruments of monetary control. It is, therefore, argued that the central bank should develop effective instruments of liquidity control.

V. Deregulation and Competitive Financial Environment

With the provision of long-term investment on agriculture and industry by the commercial banks, the functions of commercial banks and development banks are somewhat overlapped. The Commercial Bank Act has a provision that the banks may advance loans for agriculture, industry, irrigation and power generation for a period of two years of working capital and for up to twelve years for fixed capital. And, these functions are generally competitive to that of the Agricultural Development Bank (ADB/N) and the Nepal Industrial Development Corporation (NIDC) which are involved in long-term investments in agriculture and industry, respectively. But such competitive investments are low as seen from the investment portfolio of the financial institutions. Of the total outstanding credit of financial institutions in the agriculture sector in July 1986, the share of commercial banks stood at only 9.2 per cent. Though the shares of commercial banks in total outstanding credit of the financial institutions in the industrial sector is quite high, most of such credit has been channelled to small and cottage industries and for working capital of large industries, and hence, does not overlap with the functions of NIDC.

Another competitive function of the financial institution is in the area of deposit collection. Since the ADB/N is also authorized to collect savings through its general branches in the rural areas and through its commercial banking branches in the urban areas, commercial banks have to compete with the ADB/N in deposit collection. But the magnitude of deposit collection by the ADB/N is quite low as compared with that of the commercial banks.

Further, the uses side of the balance sheet of the financial institutions show that the non-bank financial institutions share of credit to total credit outstanding in the financial sector is within the narrow range of 14.0 to 17.0 per cent after 1975. During the same time, the share of credit extended by the commercial banks to total credit extended has declined from 66.0 per cent in 1970 to 50.4 per cent in 1986. This is mainly attributable to the increasing share of NRB in total credit expansion in the non-financial sectors (mostly the government sector). However, the commercial banks maintained the highest share in total financial intermediation (see Table 6.5).

Similarly, the sources side of the balance sheet of the financial institutions show that the share of commercial banks in total deposit collection by the financial system is the highest. A rapid increase in deposits was particularly noticed in 1980. The deposits increased from a 45.0 per cent growth in 1970 to 71.0 per cent in 1980. Accordingly, the share of commercial banks deposit liabilities to total deposit liability remained within a range of 73.0-74.0 per cent up to 1986. Similarly, the share of other financial institutions also increased (see Table 6.5). However, the competitive environment has been affected by the small number of financial institutions and their limited scope of product lines (Table 6.7).

VI. Problems and Issues Associated with Deregulation

VI.1 Deregulation and Selective Credit Policy

With a view to create competitive financial environment, the Nepal Rastra Bank (NRB) on the eve of deregulation moves has freed the interest rates on lending except for the priority sector credit. In the

Table 6.7

COMPARATIVE INFORMATION OF THE PRODUCT LINES OF COMMERCIAL BANKS AND OTHER FINANCIAL INSTITUTIONS

	Product	Commercial Banks	Other Financial Institutions			
			PFC	ADB/N	NIDC	NIC
1.	Transaction Account	/	/	/	/	/
2.	Demand/Savings Account	/		/		
3.	Fixed Account	/	/			/
4.	NCDs					
5.	Deposit Substitutes					
6.	Credit Cards					
7.	ATM					
8.	Travellers Cheque	/				
9.	Home Mortgage					
10.	Personal Loans	/				
11.	Consumer Loans	/	/	/	/	/
12.	Underwriting			/		
13.	Brokerage	/			/	
14.	Equity Participation or	/				/
	Investment		/	/	/	/
15.	Other Securities Activities	/	/	/	/	/
16.	Promissory Notes					
17.	Treasury					
18.	Factoring					
19.	Money Market Involvement	/				
20.	Capital Market Involvement	/		/		
21.	Real Estate Lending		/	/	/	/
22.	Commercial Lending	/		/	/	
23.	Merchant Banking					
24.	Mortgage Lending	/				
25.	Consumer Lending	/		/		
26.	General Insurance Broker	/		/	/	
27.	Life Insurance Broker					/
28.	Pension Fund Management		/			/
29.	Discount Broking	/				
30.	Investment Management	/	/			
31.	Off-Shore Services	/				
32.	Unit Trust Managers	/				
33.	Insurance Underwriting	/				/
34.	Others	/				

PFC : Provident Fund Corporation.
ADB/N: Agricultural Development Bank of Nepal.
NIDC : Nepal Industrial Development Corporation.
NIC : National Insurance Corporation.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Nepal Rastra Bank, 1987.

case of priority sector lending also, the provision of interest rate subsidy by the NRB has been discontinued and the refinance facility which bears a general interest rate of 4.0 per cent below the commercial lending rate is restricted to a few activities. The objective of the NRB in this regard is to mop up excess liquidity in the system without having adverse impact on the price and balance of payments. The raising of interest rates on priority sector lending was to make the cost of credit in line with the market sentiment. The overall objective was to lessen excessive dependence on the NRB for resources and try to mobilize resources through interbank borrowing.

The upward revision of interest rates on priority sector credit from a maximum of 11.0 per cent per annum before 29 May 1986 to a maximum of 15.0 per cent per annum, thereafter, is a step towards reducing refinancing and discontinue direct interest rate subsidies. It is apparent that the present maximum lending rates in the priority sector credit are high enough to attract commercial banks to channel their resources towards this sector. At present, commercial banks are provisioned to invest at least 25.0 per cent of their total loans and advances in the productive sector (including 8.0 per cent in priority sector), and such a regulation seems contrary to the deregulation moves. However, it would not be wise to lift such regulation at this moment when commercial banks are more inclined to invest in profitable business, but maintaining regulation in a few activities would not really affect the deregulation moves either.

In this context, one must realize the consequences of liberalizing interest rates in priority sector lending. This aspect merits attention in itself, because even if controlled interest rates would be largely maintained, there is a considerable scope for simplification and rationalization.

It may be recalled that before deregulation, there were many controlled lending rates differentiated between sectors, use of funds and types of collateral. Within the sectoral differentiation, a distinction was made between priority and non-priority sectors. The priority sector covered agriculture, small-scale industries and some part of the services sector. The priority sector enjoys concessionary lending rates which differ between sectors, ranging between 10.0 and 17.0 per cent per annum. Concessionary lending rates also apply to loans against export bills, pre-export credit, development bonds and fixed deposits, irrespective of the use of the funds. Since 1974, quantitative targets with respect to priority sector lending have been imposed on the banks, while since December 1984, a quantitative lending target for so-called productive sector lending has been formulated.

The productive sector comprises the priority sector plus non-priority industrial loans, pre-export credit, export bill credit, and other specified loans and advances. The non-priority sector consists of commercial activities, some part of the services sector and part of the industrial sector not included in the priority sector. The minimum lending rate for non-priority lending was, at that time, at 17.0 per cent per annum. Before June 1982, the picture was even more complex because separate lending rates prevailed for the commercial banks and the specialized financial institutions. Since June 1982, lending rates have been unified between these institutions although there are still minor differences with respect to the refinancing rates of priority sector lending. Therefore, if a system of concessional rates is maintained, then these rates should be rationalized. In other words, the sectoral differentiation of lending rates as well as the differentiation on the basis of use of funds have to be abolished and be replaced by a classification on the basis of maturity, because there is no quantitative evidence that rates of return in different industries differ.

In this regard, one of the solutions is to abolish concessionary lending rates altogether, while maintaining the quantitative requirement. The quantitative target could be maintained provided that the banks have automatic access to refinancing. But priority sector lending via the refinance facilities is a wrong mechanism to subsidize the priority sector activities, which in turn may distort the very principal of the price of credit. A quantitative target is consistent with freedom of the banks to determine the proper lending rates and it serves as a constraint on the level of lending rates because banks have to meet these targets.

VI.2 Deregulation and Excess Liquidity

The other issue associated with the deregulatory moves is the persistent situation of excess liquidity prevailing in the banking system. The cash reserves and liquid assets after the interest rate reform in 1984 have not diminished and the loan-deposit ratio has also declined from 63.5 per cent in 1983 to 60.7 per cent in 1984. However, after the introduction of the deregulation system in May 1986, the loan-deposit ratio has slightly improved from 69.9 per cent in 1986 to 71.1 per cent in 1987 (Table 6.8). However, the excess liquid assets of the banking system have not diminished. Further,

Table 6.8

CASH RESERVES AND LIQUIDITY ASSETS: 1980-1987

(in Million Rs.)

Mid-July	Cash Reserves [1]		Liquidity Assets [2]		Loan-Deposit Ratio
	Amount	As a % of Total Deposits	Amount	As a % of Total Deposits	
1980	361.1	10.8	997.4	30.0	84.0
1981	717.5	17.3	1443.6	34.8	87.0
1982	633.7	12.9	1864.5	38.0	73.0
1983	814.7	13.0	2551.7	40.6	63.5
1984	834.4	11.8	3124.2	44.2	60.7
1985	1146.9	12.3	3510.6	41.1	63.2
1986	1378.7	13.4	3839.9	37.4	69.9
1987	1455.1	12.3	4607.6	39.0	71.7

1. Include cash on hand, balance with Nepal Rastra Bank (Central Bank) and foreign currency on hand.
2. Include cash on hand, balance with Nepal Rastra Bank (Central Bank), foreign currency on hand, balances held at banks abroad and government securities other than those pledged with Nepal Rastra Bank.

Source: Nepal Rastra Bank, Quarterly Economic Bulletin, mid-January to mid-April 1988.

there has been no restriction on commercial banks borrowing against government securities. The commercial banks are already over-liquid and can maintain such liquidity any time of the year with the existence of such facilities. Therefore, access to concessional refinancing facilities has to be contained within limits, consistent with the overall credit programme.

The liquid assets as a percentage of total deposits increased from 37.4 per cent in 1986 to 39.0 per cent in 1987 despite the relaxation of the liquidity requirement ratio for the commercial banks in May 1986. Despite the downward adjustment in statutory reserve ratio and the removal of the liquidity ratio, the excess liquidity situation and loan-deposit ratio did not improve as per the spirit of the deregulatory moves. Therefore, the creation of a basic window, selective window, and lender of last resort window, depending on the period of refinance and interest rate charged, might be some of the options to mop up excess liquidity in the system.

VII. Move Towards Re-regulation

Although the main features of the liberalization measures was to permit the commercial banks the freedom of changing their own lending rates for all types of credits as well as paying deposit rates higher than fixed by the central bank on savings and time deposits, the underdeveloped nature of the financial system and the excess liquidity of the banking system, led the regulatory authorities to initiate some regulatory moves, which are as follows:

1. Credit ceilings

Effective 25 February 1986, the Nepal Rastra Bank (NRB) has fixed loan ceilings for all commercial banks. Similar ceilings have been fixed in respect of credit to the private sector, including claims on government financial enterprises through the NRB. Credit ceilings were further continued for fiscal year 1986/1987 with a view to curb aggregate domestic credit. Accordingly, total internal loans from the banking sector is not allowed to expand at a rate higher than 13.5 per cent. The rate of growth of credit to His Majesty's Government, non-financial government enterprises and the private sectors have also been fixed at 11.8, 11.3 and 17.2 per cent, respectively.

After the devaluation of the Nepalese rupee in November 1986, the balance of payments position improved considerably and as a result, net foreign assets of the banking system went up significantly. The demand for credit for commercial purposes and industrial use showed a buoyant recovery along with positive trend in deposit growth. Consequently, the need for revising credit allocation to the private sector was felt for the fiscal year 1986/87. In the light of these developments, the ceiling for domestic credit expansion was revised at 17.0 per cent with the share of increase in public sector, public enterprises and the private sector revised at 12.4 per cent, 14.4 per cent and 25.6 per cent, respectively. In line with these developments, separate ceilings on outstanding credit by the commercial banks were also fixed.

Ceilings have also been fixed on loans to be disbursed by commercial banks to His Majesty's Government, financial and government non-financial enterprises and the private sector by mid-April and mid-July 1987. This provision also applies to both components of the principal and interest outstanding.

2. Bank entry

The establishment of any commercial bank (domestic or foreign) in accordance with the Company Act is allowed only with the recommendation of the NRB. In order to secure such a recommendation, commercial banks seeking entry have to fulfil certain requirements sought by the NRB.

3. Liquidity requirements

Before May 1986, the liquidity requirement was to be maintained at a certain percentage of deposit liabilities. This provision was, however, completely withdrawn after May 1986.

4. Statutory reserve requirements

The earlier provision of statutory reserve requirements (SRR) of 7.0 per cent remained effective till 1982 when statutory reserve requirement was increased to 9.0 per cent; 5.0 per cent to be held as balances at the NRB and 4.0 per cent as cash in vault.

5. Credit limit

As regard the credit limit which a bank or financial institution can lend to any one customer, it is to be determined as prescribed by the NRB in the Commercial Bank Act.

6. Foreign currency balance payment

The commercial banks were directed, effective January 1985, not to hold foreign currency balances abroad at more than 30.0 per cent of their total letters of credit liabilities.

7. Interest rate

Regarding interest rate regulations, the sole authority of fixing the deposit and lending rates rests on the NRB. The financial institution has to follow the prescribed rate (with effect from July 1989, the interest rates were completely liberalized).

8. Credit restriction

The commercial banks are not allowed to lend for a period of more than twelve years. Similarly, credit to the member of Board of Directors and that against the collateral of its own shares is also restricted.

9. Capital adequacy

Increase in authorized capital of the bank requires pre-approval of the NRB. The commercial banks have to increase their share capital as per the direction of the NRB. With effect from 1989, the commercial banks were also required to increase gradually the capital adequacy ratio.

Appendix 6

Some Major Regulatory and Prudential Measures (1976-1986)

1. Commercial banks seeking entry in the financial system are required to get operating licenses from the Nepal Rastra Bank and the location of the central office of such commercial banks and opening of their branches also need prior approval of the central bank.

2. The opening of finance companies as subsidiaries of domestic or foreign banks are generally restricted except for those designed for managing trust property and safe deposit vault and being auxiliary to promote banking business and industrial development as approved by the central bank.

3. Up to May 1986, the liquidity ratio was to be maintained at least at 25.0 per cent. [a]

4. Until 1977/1978 commercial banks were obliged to maintain at least 5.0 per cent of their total deposit liabilities with the central bank, which was increased to 7.0 per cent and this provision remained effective until 1981/82 when statutory reserves requirement was increased to 9.0 per cent, 5.0 per cent to be held as balances at the central bank and 4.0 per cent as cash in vault. This provision is effective till now.

5. The commercial banks are required to increase their share capital as per the direction of the central bank and maintain capital fund at a certain ratio of total deposits as prescribed by the central bank. If the capital fund at the end of any fiscal year falls short of the prescribed amount, such a commercial bank has to maintain it up either by transferring the net profit amount or by issuing new shares.[b]

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a. The liquidity requirement and the obligation of commercial banks to invest at least 5.0 per cent of their total deposits in government securities was lifted after May 1986.
b. Recently, Nepal Rastra Bank has directed the commercial banks to gradually increase the ratio of their capital funds to total deposits. Accordingly, the commercial banks are required to maintain capital adequacy ratio of at least 2.5 per cent by mid-July 1989, 3.5 per cent by mid-July 1990, and 5.5 per cent by mid-July 1991 and 1992, and the percentage is in relation to total deposits at the end of the previous year.

6. The limit applied with regard to the extent to which a bank or financial institutions can lend to any one customer, is to be prescribed by the central bank, which is mentioned in the Commercial Bank Act. Accordingly, single borrower limits are 50.0 per cent of capital funds for direct loans and 100.0 per cent of capital funds for letters of credit, guarantee, acceptance and commitment, etc..

7. Effective January 1985, commercial banks have been directed not to hold foreign currency balances abroad at more than 30.0 per cent of their total letters of credit liabilities.

8. Regarding interest rate regulations, the Act of each financial institution gives the sole authority of fixing its deposit and lending rates.

9. The commercial banks are not allowed to lend for a period of more than 12 years and credit to the members of board of directors and that against the collateral of its own shares is also restricted. The central bank also notifies from time to time restricting commercial banks from lending in certain areas and lending against the collateral of certain assets. Regarding the area of restrictive activities, the commercial banks are prohibited to extend credit on certain commercial sector (mainly the imports) from time to time, taking into consideration the external balance as well as credit expansion situation in the country.

10. Commercial banks were not authorized to take deposits on convertible foreign currencies till July 1985. [c]

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c. After July 1985, the banks were allowed to accept deposits (current and fixed) of two currencies - U.S. dollar and pound sterling.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Nepal Rastra Bank, 1987.

Chapter 7

Financial Deregulation In The Philippines

I. The Rationale and Objectives of Deregulation

The fundamental deregulatory reforms which started in 1980 were aimed at enhancing banks' efficiency and improve the financial intermediation process. Even before these reforms, four interest rate reforms were introduced between 1974 and 1980. The purpose of these reforms were to mobilize long-term funds for investment and to develop the capital market. In other words, to reduce uncertainty over long-term finance and promote greater financial intermediation, the interest rate ceilings on longer-term loans were floated in 1980. The decision to float interest rates on deposits and loans was intended to give financial institutions greater flexibility in their fund intermediation, especially long-term funds, and to allow the system to respond more promptly to domestic and external developments.

The objectives of the 1980 financial reforms, therefore, were two fold:

- To promote greater efficiency by means of more competitive conditions; and,

- To increase the availability of and access to longer-term funds.

Three major techniques have been utilized to achieve these objectives:

- Floating of the interest rates;

- Restructuring of the financial system; and,

- Strengthening the effectiveness of central bank policy instruments.

Similarly, the freeing of interest rate ceilings initiated in 1981 and completed by January 1983 was basically intended to enhance efficiency in financial intermediation, generate a higher growth rate in domestic savings and encourage the allocation of credit to viable areas of investment. In other words, there are multiple goals behind the reforms in interest rates. The primary purpose is to encourage savings, particularly long-term placements needed in economic development programmes, and secondary, to give a fair return to savers, especially in periods of rising prices.

Together with the lifting of the interest rate ceilings was the reduction of both the reserve-requirement ratio against deposit liabilities and the net-worth-to-risk-assets ratio of banks. The objective of deregulation in this front was intended to release large amount of bank resources to be made available to borrowers, thereby preventing an excessive increase in lending rates. With the lifting of the interest rate ceilings, a prime rate monitoring system was also introduced and the Manila Reference Rate (MRR) was improved in order to provide up-to-date information on the lending rates charged by banks. These moves were expected to enhance competition among banks which may eventually lead to lower interest rates. However, the central bank will monitor interest rate movements to detect extreme variations in short-term prime rates as well as divergence in the direction of the short-term prime rate and the MRR.

The deferment of the scheduled lowering of the required reserves against short-term deposits and deposit substitutes from 18.0 to 17.0 per cent in the deregulatory package of January 1983 was basically intended to prevent the build-up of excess liquidiy which could lead to a rise in the rate of inflation and a further deterioration in the balance of payments. The deferment was intended to arrest a possible immediate reduction in the reserve requirements.

The shift of the Philippine financial system towards the universal banking concept at the start of the 1980s in modified form was adopted mainly to achieve two objectives. Firstly, to attain greater efficiency in the financial system through increased competition and economies of scale, and secondly, to increase availability of and access to long-term funds. The need for increasing the flow of savings to medium- and long-term investments was greatly felt during the 1980s, because the bulk of outstanding credits of the financial system remained short-term oriented. The preference for short-term credits was mainly ascribed to the legislated specialization of financial institutions which prevented them from responding to the needs of the different clients and from operating efficiently on the basis of comparative advantage.

However, the shift with orientation of the financial system towards universal banking required financial institutions to increase their capitalization. It may be recalled that the commercial banks, which accounted for about two-thirds of total resources of the financial system, had their operations largely directed to short-term lending. Although there existed a large and continuing permanent core of short-term deposits that could be lent as long-term credit, the flow of long-term funds was impeded by the rigidities imposed by the legal regulations. Hence, the rationale of the deregulatory move towards universal banking system was also to move this rigidities towards the flow of funds in line with the growing long-term investment requirements.

Similarly, the rationalization of government securities and the market competitive rates of these securities was intended to provide the banking system with an outlet for their investible funds, and to move away from the negotiated system where rates on government securities were unilaterally determined by the monetary authorities. As part of the deregulatory measures, the floating of interest rates was expected to encourage more funds to flow into the longer-term deposits, thereby easing the availability of funds for longer-term lending. To increase further the availability of longer-term funds, banks have also been encouraged to engage in term transformation. Since it has been found that the banking system possess short-term deposit liabilities with a more or less stable core, there is some potential for such term transformation. The rationalization programme for government securities, was, therefore, intended for the change in the posture of the central bank from a development to a stabilization orientation.

The opening of the "medium- and long-term rediscounting window" was to allow banks to rediscount papers evidencing medium- and long-term loans extended by them for the acquisition of fixed assets, working capital in connection with a proposed or on-going expansion development programme, investment in affiliates and other institutions, or for investment in high grade securities. A "lender of last resort" facility was another aspect of deregulatory moves in order to encourage banks and non-banks to engage in term transformation encountering temporary liquidity problems. It can be summarized that the main rationale for deregulation in the Philippines was to improve efficiency in financial intermediation through greater competition and to enhance the maturity transformation of financial instruments as a complementary move in the adoption of a modified universal bankng concept in the early 1980s.

II. Circumstances and Conditions for Deregulation

Interest rate deregulation moves were triggered by the observations that a rigid and low interest rate policy leads to inefficiencies in the financial system, a misallocation of resources, lack of long-term funds and a slow growth of the capital market. The high inflationary pressures (due to the oil crisis) during the seventies also called for a more flexible interest rate policy that would yield a fair return to savers.

It may be recalled that during the early 1970s (1970-1974), when interest rates were administratively set at very low levels, there was an observed decline in the financial intermediation. The gap between deposit and loan rates was aggravated by the inflation rate, resulting in negative real deposit rates, which served to discourage savings (Table 7.1). As real interest rates turned negative, disintermediation again occurred with the decline of M2/GNP and M3/GNP ratios. In 1974-1977, interest rate ceilings on savings and time deposits were adjusted upward, the ceiling on time deposits of over two years maturity was lifted and interest rate ceilings were imposed on deposit substitutes. In 1975-1978, when inflation rates narrowed to single-digit levels, real interest rates turned positive (except on savings deposits) and led to an increase in financial intermediation, by the steady rise in M2/GNP. The second oil shock in 1979 reverted inflation to double-digit rates. As real interest rates turned negative, disintermediation again occurred and M2/GNP, and M3/GNP declined. Financial savings initially responded positively to the lifting of interest rate ceilings beginning in 1981 leading to a steady rise in M2/GNP. However, the positive impact of interest rate deregulation on financial intermediation was short-lived leading to a decrease in financial intermediation. The deterioration in real incomes in 1984 and 1985 led to a drop in demand for financial assets.

The overall reduction in aggregate demand resulted in financial difficulty for many firms and a weaker demand for loans. Thus, there was again a drop in M2/GNP (Table 7.2). Further, the administrative mechanism of adjusting the interest rate structure had to apply very frequently, and the need for increasing the flow of savings to medium- and long-term investments was greatly felt as the bulk of the outstanding credit of the financial system remained short-term oriented. This preference for short-term credits was

Table 7.1

DEPOSIT/LENDING RATES OF COMMERCIAL BANKS & THE ANNUAL INFLATION RATE
(in Percentages)

Period	Savings Deposit	Time Deposit (730 days &below)	Secured Loans (1 year) &below)	Inflation Rate [1]
A. **Regulated Interest Rates**				
1975	6.000	9.500	12.000	6.90
1976	7.000	10.000	12.000	9.68
1977	7.000	10.000	12.000	9.88
1978	7.000	10.000	12.000	7.07
B. **Partially Deregulated Interest Rates**				
1979	9.000	11.000 [2]	14.000	17.5
1980	9.000	14.000	14.000	18.2
1981				13.1
Mar.	9.000	14.000	14.000	
Jun.	9.000	14.000 [3]	14.000 [4]	
Sep.	n.a.	n.a.	14.000	
Dec.	9.790	15.597	15.925	
1982				10.2
Mar.	9.837	14.043	16.594	
Jun.	9.885	14.298	16.751	
Sep.	9.839	14.794	17.166	
Dec.	9.775	14.209	17.128	
C. **Fully Deregulated Interest Rates**				
1983				10.0
Mar.	9.740	13.937	18.255 [5]	
Jun.	9.721	13.273	18.143	
Sep.	9.713	13.607	17.796	
Dec.	9.687	14.341	21.278	
1984				50.3
Mar.	9.784	15.521	21.838	
Jun.	9.660	19.052	25.632	
Sep.	9.604	22.486	30.241	
Dec.	11.559	32.481	39.103	
1985				23.1
Mar.	11.062	24.312	33.169	
Jun.	11.498	23.293	31.647	
Sep.	10.084	14.094	24.195	
Dec.	9.564	12.434	17.672	
1986				0.8
Mar.	8.775	16.019	24.521	
Jun.	8.509	13.170	16.747	
Sep.	7.131	10.169	16.259	
Dec.	6.352	8.364	13.879	
1987	-	-	-	3.8

1. Inflation rate was computed with 1978 as the base year.
2. Interest rate ceilings lifted against time deposits with maturity of over 730 days since December 1979.
3. Interest rate ceilings lifted since 1/7/81 against time deposits with less than 730-day maturity.
4. Interest rate ceilings lifted since 1/7/81 against long-term secured loans.
5. Interest rate ceilings lifted since 1/1/83 against short-term loans.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Central Bank of the Philippines, 1987.

Table 7.2

SELECTED ECONOMIC INDICATORS: 1970-1987
(in Percentages)

Year	M2/M1	M3/M2	M2/GNP	M3/GNP	Nominal Interest Rates (KBs)					Real Interest Rates (KBs)				
					Savings Deposit	Time Deposit (360 days)	WAIR on Money Mkt. Transactn.	Secured Loans		Savings Deposit	Time Deposit (360 days)	WAIR on Money Mkt. Transactn.	Secured Loans	
								Short-Term	Long-term				Short-Term	Long-term
1970	2.00	1.00	0.23	0.23	6.000	7.000		12.000	12.000	-8.000	-7.000		-2.000	-2.000
1971	2.03	1.00	0.21	0.21	6.000	7.000		12.000	12.000	-16.200	-15.200		-10.000	-10.000
1972	1.83	1.00	0.21	0.21	6.000	7.000		12.000	12.000	-2.100	-1.100		3.900	3.900
1973	1.93	1.29	0.19	0.25	6.000	7.000		12.000	12.000	-10.600	-9.600		-4.600	-4.600
1974	1.86	1.44	0.17	0.24	6.000	9.500		12.000	12.000	-28.100	-24.600		-22.100	-22.100
1975	1.87	1.50	0.17	0.25	6.000	9.500	13.624	12.000	12.000	-0.700	2.800	6.924	5.300	5.300
1976	2.07	1.43	0.19	0.27	7.000	10.000	12.985	12.000	19.000	-0.240	0.600	3.585	2.600	9.600
1977	2.18	1.35	0.21	0.29	7.000	10.000	12.590	12.000	19.000	-2.800	0.200	2.790	2.200	9.200
1978	2.38	1.28	0.23	0.29	7.000	10.000	10.755	12.000	19.000	-0.300	2.700	3.455	4.700	11.700
1979	2.41	1.26	0.21	0.26	9.000	12.000	12.874	14.000	21.000	-8.500	-5.500	-4.626	-3.500	3.500
1980	2.46	1.22	0.21	0.26	9.000	14.000	13.246	14.000	21.000	-9.200	-4.200	-4.954	-4.200	2.800
1981	2.79	1.25	0.22	0.27	9.812	13.001	15.602	16.150	21.590	-3.288	-0.099	2.502	3.050	8.490
1982	3.35	1.21	0.23	0.28	9.811	13.919	14.136	16.838	21.559	-0.389	3.719	3.938	6.638	11.359
1983	2.95	1.18	0.25	0.30	9.729	14.162	16.886	18.794	21.487	-0.271	4.162	6.886	8.794	11.487
1984	3.27	1.10	0.21	0.23	9.855	17.380	27.246	26.737	26.994	-40.445	-32.920	-23.054	-23.563	-23.306
1985	3.47	1.07	0.21	0.22	10.842	19.818	20.568	28.346	23.854	-12.258	-3.282	-2.532	5.246	0.754
1986	3.20	1.04	0.22	0.23	7.993	11.490	13.347	17.142	18.933	7.193	10.690	12.547	16.342	18.133
1987	2.99	1.02	0.22	0.23	4.530	9.767[a]	11.079	13.295	13.295[b]	0.730	5.967[a]	7.279	9.360	9.495[b]

a. Refer to all maturities.
b. Refer to all maturities.
Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

mainly ascribed to the legislated specialization of financial institutions which prevented them from responding to the needs of the different clients. Therefore, the conditions for deregulation of the financial system were already sufficient to introduce some deregulatory reforms in the financial system.

Although the financial savings initially responded positively as a result of deregulation of interest rates undertaken in 1981, the positive impact of interest rate deregulation on financial intermediation was short-lived and there was not much improvement in term transformation and short-term loans continued to dominate the loan portfolio of the banking system. However, this situation cannot be totally attributed to the failure of deregulatory moves initiated in 1980 and completed in 1983. The deterioration in real income in 1984 and 1986 led to a drop in demand for financial assets, leading to an overall reduction in aggregate demand for loans.

III. Major Features and Nature of Deregulation

The major deregulatory moves, that were encouraging to financial institutions and were part of the thrust towards deregulation, included interest rate deregulation as a complementary measure to the universal banking reforms, the rationalization of the rediscount facility, and the rationalization of the terms and other features of government securities. Some of the features incorporated in the 1980 financial reforms were as follows:

- The introduction of expanded commercial banks which, in addition to their commercial banking functions, were allowed the powers of an investment house;

- The elimination of all functional distinctions among thrift banks;

- Reduction in differentiation among categories of banks and non-bank financial intermediaries authorized to perform quasi-banking functions; and,

- An increase in the powers and functions for non-bank financial intermediaries authorized to perform quasi banking functions.

To reduce uncertainty over long-term finance and promote greater financial intermediation, the interest rate ceiling on long-term loans was floated in 1980. Additionally, the interest rate structure among banks and non-bank financial intermediaries was aligned. In 1981, ceilings on deposit rates (two years and below) and long-term loan rates (over one year) were freed gradually. The 1980 banking reforms, therefore, reduced the functional differentiation among financial institutions and authorized banks to engage in expanded banking activities with the condition of an increased capital base.

The second move towards deregulation was the freeing of interest rate ceilings in July 1981 on all types of deposits and loans, except short-terms loans. Subsequently, in October 1981, the ceilings on rates of loan transactions with maturities of over one to two years were lifted. The lifting of the interest rate ceilings on short-term loans was the remaining last phase of the gradual deregulation of interest rates. The reason why the interest rate ceiling on short-term loans (loans over two-year maturities) was not lifted was to allay fears that the interest rate on short-term loans would overshoot once deregulated and also to influence banks to lend long at rates relatively more attractive than for short-term loans. The retention of ceilings on short-term loans was intended to serve as an interim measure to effect a smooth transition to the new policy and also to serve as a benchmark for other interest rates. Ultimately, the interest rate ceiling on short-term loans was finally lifted in January 1983. The lifting of this remaining interest rate ceiling on short-term loans is the last phase of the gradual deregulation of interest rates in the Philippines which started with the amendment of the Anti-Usury Law of 1906, in 1973.

The rationalization of the rediscount window included the reformulation of the basis for the determination of the rediscount rate to reflect the marginal cost of funds of banks, the lifting of the ceilings on bank lending rates, and the simplification of the rediscount structure from six to two categories.

The rationalization of government securities included the gradual phase-out of Premyo Savings Bonds as eligible reserves against deposit liabilities of commercial banks starting 1983 and the phase-out of other low-yeilding reserve-eligible government securities starting March 1986. Towards the close of 1986, the auction system of marketing Treasury bills was reintroduced to replace the negotiated system. The market competitive rates of these securities provided the banking system with an outlet for their investible funds and represented a move away from the negotiated system where rates on government securities are unilaterally determined by the monetary authorities.

Expanded commercial banking functions are allowed to be carried out by banks authorized to perform commercial banking functions and banks authorized to do full domestic banking either by conversion, merger, or consolidation, or sheer expansion to meet the minimum capital requirement of P 500 million, and in the case of investment houses, either by conversion, or merger/consolidation with any of the foregoing entities. Expanded commercial banks are authorized to exercise the powers of commercial banks as well as those of investment houses (underwriting, securities dealership and equity investment), to invest in the equity of non-allied undertakings and to own up to 100.0 per cent of the equity of a financial intermediary other than a commercial bank or a bank authorized to provide commercial banking services.

Thrift banks, upon meeting the prescribed minimum capital requirement, may likewise qualify for the full range of "full domestic banking" powers which would include the operation of demand deposit accounts, among other additional functions which a thrift bank may perform. There is now no distinction among the three types of thrift banks (private development banks, savings and mortgage banks, and stock savings and loan associations), insofar as inherent powers and functions are concerned. Accordingly, the uniform expanded powers of thrift banks are referred to as "full domestic banking", defined as commercial banking without international banking operations. There is thus now very little distinction between the powers of thrift banks and those of commercial banks.

Rural banks are also given broader domestic banking powers than before, but nevertheless without such activities as opening of domestic letters of credit, undertaking trust services and others deemed not considered essential to a rural bank's countryside operations. Provisions which have restricted rural banks to lend only to small farmers and small merchants were deleted and the previous unit banking scheme was liberalized by allowing: chain banking or group banking; or, branch banking. Non-bank financial institutions authorized to perform quasi-banking functions (NBQBs) were given access to central bank credit facilities in order to enhance their ability to generate longer-term funds and hence, to become more competitive.

These financial reforms were complemented by further deregulation of interest rates. Hence, the freeing of interest rate ceilings initiated in 1981 and completed by January 1983 further complemented the move towards a modified universal banking, and the increase in the required minimum capitalization of banks for increasing the availability of longer-term funds.

IV. Effects of Deregulation

It is indeed difficult to analyse the effects of deregulation without making some qualifications. After being weakened by the second oil shock, the economy suffered a liquidity crisis in the early part of 1981. The biggest investment house, which had played the lead role in introducing financial innovations, collapsed. Many banks found themselves in trouble. The Government's effort to bail out distressed banks resulted in the transfer of some private commercial banks into the hands of government corporations (Table 7.3). This has substantially changed the landscape of the financial system, a development contrary to the spirit of the 1980 financial reforms. The government-acquired commercial banks have undue advantages over privately-owned banks. Aside from enjoying the backing of the government, they have captive institutional deposits which do not flee at the slightest sign of trouble. It is even possible for these banks to arrange a relatively cheaper deposit rate with their captive depositors if only to show a commendable income statement. There is no doubt that these banks have been in a better position to deal with the adverse effects of the 1983 balance of payments crisis.

IV.1 Effects on Mobilization of Resources

The initial effect of deregulation on resource mobilization was positive. The total resources of the financial system at the end of 1983 amounted to P 467.2 billion. This indicated around 11.0 per cent growth from the level before deregulation. Of the total resources, more than 40.0 per cent was accounted for by commercial banks. Specialized government banks accounted for around 13.0 per cent of the entire system's resources and the non-bank financial institutions contributed around 16.0 per cent. The combined resources of thrift and rural banks accounted for the remaining 5.0 per cent.

Efforts towards resource mobilization after deregulation was very encouraging, which marked an upturn of more than 25.0 per cent in 1983 over the year before deregulation. The continued uptrend in bank deposits can be ascribed some extent to the growing consciousness of the public to save as a result of higher real returns on financial savings after the deregulation of interest rate structure. More than 60.0 per cent of the additional amount in total deposits was accounted for by savings and time deposits which posted an annual increase of 38.0 per cent (Table 7.4). But there are also several factors that may affect bank deposits aside from real

Table 7.3

PRIVATE COMMERCIAL BANKS RECENTLY ACQUIRED/CONTROLLED BY GOVERNMENT CORPORATIONS

	Private Bank	Controlling Government Corporation
1.	Associated Bank	Development Bank of the Philippines (DBP)
2.	Commercial Bank of Manila	Government Social Insurance System (GSIS)
3.	International Corporate Bank	National Development Corporation (NDC)
4.	Philipinas Bank	Philippine National Bank (PNB)
5.	Union Bank	Social Security System (SSS) and Land Bank

Source: Annual Reports of Controlling Government Corporations.

interest rates. The general level of real income and confidence in the financial system positively affect bank deposits. However, the rise in savings and time deposits can be attributed to a greater extent to an increase in real interest rates because of the declining and constant ratio of real deposits to real income evidenced after the deregulation of interest rates in 1983 (Table 7.5). Therefore, an interesting area for further research would thus be to attempt to quantify the impact of deregulation on deposit mobilization isolating the effect of real income on deposits.

The shift of funds to time deposits was due mainly to the more attractive yields on long-term deposits and the declining preference of investors to hold riskier financial assets in the form of deposit substitutes following the financial dislocations in 1981 and the alleged dampening impact of the new money market rules. In other words there was a perceptible change with regard to the maturity structure of bank deposits and loans (Table 7.6). The combined share of savings and time deposits increased in 1981 and 1982 at the expense of demand deposits and deposit substitutes. Similarly, the share of long-term loans increased in the same years at the expense of demand and short-term loans.

Further, the maturity structure of time deposits in banks, revealed the concentration of deposits in long-term maturities, i.e., above two years. Such deposits accounted about 60.0 per cent of the total, while short-term deposits (one year and below) accounted for 25.0 per cent, and medium-term deposits (above one year to two years) for the balance of 15.0 per cent.

However, total deposit liabilities (demand, savings and time deposits) of commercial banks grew at an average of 14.7 per cent during the period after deregulation (1980-1985) compared to the average of 24.9 per cent growth rate during the period before deregulation (1970-1979). Table 7.6 shows a general decline in growth rates for various deposit liabilities of commercial banks, the biggest decrease being for time deposits followed by demand deposits.

In 1980-1986 (the period after deregulation), the biggest growth was posted by savings deposits of 19.6 per cent in contrast to the earlier decade's biggest growth registered by time deposits of 36.6 per cent. The smallest growth rate at 6.4 per cent was noted for demand deposits as against the average of 19.0 per cent growth rate in 1970-1979 (before the deregulation period). However, savings deposits maintained the relatively same growth rate at 19.6 per cent compared to 21.5 per cent in the past decade.

Table 7.4

STRUCTURE OF DEPOSITS AND LOANS OF COMMERCIAL BANKS: 1977-1986

(in Million Pesos)

	Outstanding Deposits [1]				Outstanding Loans			
Year	Demand	Savings and Time Deposits	Deposit Substitutes	Total	Demand	Short-Term [2]	Long-Term [3]	Total
1977	8,966	19,025	11,400	39,391	7,490	26,767	5,917	40,173
	(22.8)	(47.3)	(28.9)	(100.0)	(18.6)	(66.6)	(14.8)	(100.0)
1978	9,535	25,034	11,494	46,063	9,164	35,227	9,688	54,078
	(20.7)	(54.3)	(25.0)	(100.0)	(16.9)	(65.1)	(17.9)	(100.0)
1979	11,275	29,268	11,951	52,494	10,637	37,601	20,026	68,264
	(21.5)	(55.7)	(22.8)	(100.00)	(15.6)	(55.1)	(29.3)	(100.0)
1980	12,447	36,146	12,371	60,964	10,458	49,844	16,895	77,198
	(20.4)	(59.3)	(20.3)	(100.0)	(13.5)	(64.6)	(21.8)	(100.0)
1981	12,198	55,368	16,452	84,018	10,667	52,823	23,014	86,505
	(14.5)	(65.9)	(19.6)	(100.0)	(12.3)	(61.1)	(26.6)	(100.0)
1982	10,756	58,415	16,566	85,737	9,308	58,478	30,454	98,240
	(12.6)	(68.1)	(19.3)	(100.0)	(9.5)	(59.5)	(31.0)	(100.0)
1983	12,883	70,211	17,106	100,200	10,434	66,792	34,162	111,388
	(12.8)	(70.1)	(17.1)	(100.0)	(9.4)	(60.0)	(30.6)	(100.0)
1984	11,871	83,944	11,276	107,091	8,322	62,652	45,408	116,382
	(11.1)	(78.4)	(10.5)	(100.0)	(17.2)	(53.8)	(39.0)	(100.0)
1985	11,565	95,680	8,609	115,854	8,061	50,038	29,474	87,573
	(10.0)	(82.6)	(7.4)	(100.0)	(9.2)	(57.1)	(33.7)	(100.0)
1986	19,038	96,859	4,874	120,771	10,529	46,869	25,689	83,087
	(15.8)	(80.2)	(4.0)	(100.0)	(12.6)	(56.4)	(31.0)	(100.0)

1. Consists of peso deposits of national government, local governments, semi-government and private entities.
2. Loans with maturities of one year or less.
3. Loans with maturities of more than one year.

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

Table 7.5

RATIO OF REAL DEPOSIT TO REAL INCOME

Year	Real Deposits [1] (in Million Pesos)	Real GNP [1] (in Million Pesos)	Ratio of Real Deposits to Real Income (%)
1977	380.5	2253.2	16.9
1978	441.8	2437.2	18.1
1979	428.3	2611.8	16.4
1980	452.5	2650.8	17.1
1981	477.5	2684.7	17.8
1982	529.9	2699.2	19.6
1983	556.2	2762.6	20.1
1984	427.9	2557.5	16.7
1985	394.5	2355.2	16.8
1986	419.3	2393.4	17.5
1987	453.8	2633.3	17.2
1988	529.2	2827.8	18.7

1. Deposits and GNP have been deflated by the Consumer Price Index (1980 = 100).

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

Table 7.6[1]

AVERAGE GROWTH AND SHARE OF DEPOSITS BY TYPE OF COMMERCIAL BANKS: 1970-1986

Type of Deposits	Average Share (%)		Average Growth (%)	
	1980-86	1970-79	1980-86	1970-79
Demand	14.4	29.5	6.4	19.0
Savings	35.2	43.1	19.6	21.5
Time	50.3	27.3	14.9	36.6
Total	100.0	100.0	14.7	24.9

1. Refer to Table 7.4 to reflect corresponding changes.

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

Nevertheless, the preference for time deposits over demand and savings deposits in 1980-1986 (post deregulation period) was partly induced by higher interest rates during this period and shifts of deposits from distressed financial institutions to the more stable commercial banks. During the pre-deregulation period (1970-1979), savings deposits averaged 43.1 per cent share of total deposits of commercial banks compared to 27.3 per cent for time deposits and 25.5 per cent for demand deposits. In the post deregulation period (1980-1986), the pattern changed, resulting in a higher share of time deposits (50.3 per cent) compared to 35.2 per cent of savings and 14.4 per cent of demand deposits. It may be recalled that banks have been encouraged to engage in term transformation in order to increase further the availability of longer-term funds. For this purpose, the central bank had initiated a rationalization programme for government securities in 1981 and opened the "medium- and long-term rediscounting window". In this regard, the pattern established from 1980-1986 (post deregulation period), seems to be indicative of the interest of surplus units to commit their financial resources for long-term use.

Further, the actual use of the medium-term resources induced by the term transformation process encouraged by the central bank, however, indicates a greater preference by commercial banks for loans and discounts which are mostly of short-term maturities (Table 7.7). In 1980-1986 (post deregulation period), loans and discounts were, on average, more than half (51.5 per cent) of commercial banks' total assets which is only slightly lower than the average of 53.2 per cent recorded in 1975-1979 (pre-deregulation period). The preference for short-term loans could be due to the relative profitability of this type of loans compared to longer-term investments like investments in bonds and securities. Keeping the funds on highly profitable short-term loans and discounts enabled these banks to avoid locking up financial resources in longer-term placements whose viability (and profitability) might be impaired with the depressed economic conditions in 1980-1985 (post deregulation period).

Outstanding loans of commercial banks classified by maturity showed a consistent tendency to favour short-term loans during the period 1977-1985, despite their lower average share at 59.3 per cent of total commercial bank loans in 1980-1985 compared with the average of 62.3 per cent in 1977-1973. Both intermediate loans and long-term loans experienced relatively minor increases in their respective shares of total commercial bank loans which indicate a

Table 7.7

STRUCTURE OF ASSETS AND LIABILITIES OF COMMERCIAL BANKS: 1975-1986

(as a Percentage of Total)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Assets	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Cash & Other Cash Items	3.8	3.7	3.1	2.6	2.8	2.4	1.9	1.6	1.6	1.4	1.5	2.4
Due from CB & Other Banks	13.6	10.6	9.0	9.5	12.1	13.3	12.9	13.1	11.2	17.7	20.0	22.8
Loans & Discounts	49.0	53.5	53.8	54.4	55.2	55.9	55.0	54.7	56.2	46.4	43.9	37.7
Investments in Bonds/ Securities & Customer's Liability Acceptance	23.9	23.0	24.4	23.0	21.1	17.8	17.4	16.9	14.9	15.0	13.3	15.7
Other Assets 1/	9.6	9.2	9.6	10.4	8.8	10.6	12.7	13.8	16.1	19.5	21.3	21.4
Liabilities	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Demand Deposits	12.5	12.7	13.2	10.7	10.0	9.2	8.7	6.2	7.7	5.3	5.2	7.9
Savings Deposits	16.8	18.8	19.3	19.3	18.3	16.6	16.4	17.5	16.5	16.3	19.9	28.5
Time Deposits	9.6	12.9	16.7	18.6	20.8	26.6	23.0	25.0	22.6	24.9	25.4	19.1
Bills Payable [2]	34.2	30.4	23.8	24.2	24.6	23.7	27.2	24.9	26.7	22.5	24.2	11.8
Other Liabilities [3/]	17.0	15.4	16.8	18.2	18.2	16.1	16.1	17.6	18.4	22.4	17.7	21.3
Capital & Reserves	9.7	9.8	10.2	8.9	8.0	7.7	8.5	8.8	8.1	8.5	7,6	11.4

1. Includes bank premises, furniture and other real property.
2. Includes deposit substitutes.
3. Includes dues to banks and treasurers'/managers' cheques.

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

preference by commercial banks for shorter-term credits (Table 7.8). This preference could be partly explained by the desire of commercial banks to minimize both liquidity and interest rate risks.

In other words, the deregulatory moves which started in 1980 were quite successful in mobilizing savings before the economic crises started. The volume of savings mobilized by the financial system rapidly increased during 1980-1983. Similarly, the share of time and savings deposits in total deposits, and share of medium- and long-term loans have been improved (Table 7.9). There was also a significant lengthening of loan maturities during initial post-deregulatory periods. However, after 1983, the economy has also undergone a period of considerable financial shallowing. The ratio of M2 to GNP dropped considerably, and saving mobilization was at an all time low.

Financial savings, although, initially responded positively to the lifting of interest rate ceilings, the positive impact of interest rate deregulation on financial intermediation was short-lived. The deregulation could have induced greater deposit mobilization in the succeeding years but the financial liberalization efforts were thwarted by the huge fiscal deficits at the beginning of 1980s and later on by the 1983 balance of payments crisis, and the political developments in 1980-1985.

IV.2 Effects on Interest Rates

In 1973, the Monetary Board was authorized to prescirbe maximum rates of interest on loans as warranted by the prevailing socio-economic conditions. Prior to deregulatory moves initiated in 1980, several revisions in interest rate ceilings were made and interest rate policy began to be used as an instrument to improve the mobilization of domestic savings. Interest rate ceilings on savings and time deposits were adjusted upward, and ceilings on over two-year time deposits were removed. Similarly, loans were categorized into short-term and long-term, with a higher ceiling imposed on long-term loans. Interest rate ceilings were imposed on deposit substitutes and in 1980, the Monetary Board also allowed the floating of interest rates on loans with maturities of over four years. The ceilings on all deposit and loan rates (except that for short-term loans) were, however lifted in 1981.

One of the most important indicators of the financial system's response to the 1980 financial reforms was the upward adjustment of both the deposit and lending rates and the change in the maturity

Table 7.8

LOANS OUTSTANDING OF COMMERCIAL BANKS BY MATURITY: 1977-1986

(as a Percentage of Total)

Year	Total	Demand	Short-Term	Inter-mediate Term	Long-Term
1977	100.0	18.6	66.6	10.5	4.2
1978	100.0	16.9	65.1	10.3	7.6
1979	100.0	15.6	55.1	13.8	15.6
1980	100.0	13.5	64.5	10.0	11.9
1981	100.0	12.3	61.1	17.3	9.3
1982	100.0	9.5	59.5	18.1	12.9
1983	100.0	9.4	60.0	15.1	15.5
1984	100.0	7.1	53.8	24.2	14.8
1985	100.0	9.2	57.1	16.7	16.9
1986 1/	100.0	12.7	56.4	18.1	12.8
Average 1977-79		17.0	62.3	11.5	9.1
Average 1980-86		11.0	58.7	16.6	13.7

1. Revised to reflect final figures.

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

Table 7.9

SHARE OF VARIOUS DEPOSITS AND LOANS OF THE COMMERCIAL BANKS: 1980-1986

(as a Percentage of Total)

Deposits/ Loans	1980	1981	1982	1983	1984	1985	1986
Total Deposits [1]	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Demand	29	22	16	17	13	12	12
Time and Savings	71	78	84	83	87	88	88
Total Loans Outstanding	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Short-Term	78	73	69	70	61	61	71
Medium- and Long-Term	22	27	31	30	39	39	29

1. Including deposit substitutes.

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

structure of deposits and loans. High interest rates are generally associated with a tight monetary policy, while low interest rates are associated with a liberal monetary policy. However, this might not always be the case. It depends to a large extent on whether the economy is in an inflationary or stable price period. Nevertheless, in the beginning of the eighties, when both deposit and loan rates were fully deregulated, interest rates became more responsive to changes in the inflation rate and monetary policy, and to the changes in the supply and demand for credit or indirectly to business activity. Table 7.10 shows the movements of nominal interest rates from 1977-1986. Contrary to what was expected from interest rate deregulation, the deposit and lending rates only inched up a little in 1981 and 1982 (see also Table 7.1).

Changes in interest rates were relatively higher and more frequent when the interest rate ceilings on deposits and on loans were deregulated gradually from 1981 to 1983, unlike in the previous years when interest rates were fixed. However, rates were relatively stable in 1982 to June 1983 but began to increase thereafter following the foreign exchange crisis to reach peak levels during the fourth quarter of 1984. Starting in 1985, real interest rates have been so high that they seriously threaten economic recovery. However, with the deceleration in inflation rates and the concomitant ease in monetary policy, interest rates began to drop in 1985 and continued to be on a downtrend in 1986.

On the whole, the interest rate deregulation supported the thrust of deregulatory moves in the first half of the eighties. However, a conflict of goals among the generation of domestic savings, the achievement of real GNP growth and the containment of inflationary pressures, often ensued in a period of tight monetary policy.

IV.3 Effects of Deregulation on Spreads

Compared with the prevailing rates prior to the deregulation moves, interest rates and spreads in 1981 and 1982 did not increase drastically. However, as the economy deteriorated in 1983 and with the tightening of monetary policy and the implementation of other external adjustment measures, nominal interest rates rose and remained high in 1984 and 1985, resulting in wider nominal spreads for banks. Even as average borrowing rates and the cost of reserves declined in 1986, spreads continued to be relatively wider compared with the spreads during the period of regulated interest rates (sixties and seventies), possibly due to the need for banks to minimize

Table 7.10

NOMINAL INTEREST RATES: 1977-1986

(in Percentages)

Year	Deposits			Loans (Secured)	
	Savings	Time (360 days)	WAIR [1]	Short-Term	Long-Term
1977	7.00	10.00	12.59	12.00	19.00
1978	7.00	10.00	10.76	12.00	19.00
1979	9.00	12.00	12.87	14.00	21.00
1980	9.00	14.00	13.25	14.00	21.00
1981	9.81	13.00	15.60	16.00	21.08
1982	9.81	13.92	14.14	16.84	21.56
1983	9.73	14.16	16.89	18.79	21.49
1984	9.86	17.38	27.25	26.74	26.99
1985	10.84	19.82	20.67	28.35	23.85
1986	7.99	11.49	13.35	17.14	18.93

1. Weighted average interest rate on money market transactions.

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

the losses incurred in times of slack credit demand and sluggish economic activity. Moreover, developments in the economy since 1983 limited the normal growth of the financial system and the financial market so as to deter the rise of a conducive and competitive atmosphere wherein banks would be capable of reducing spreads between deposit and lending rates.

Two factors seem to have been at least partially responsible for the higher spread. First, the government has been increasingly forced to source its financing domestically. The direct government intervention, through reserve money expansion and higher reserve requirements was also one of the causes for widening of the spread. Second, the increase in taxes on intermediation, which is translated into a higher spread, has lead to a further increase in lending rates. The large spreads between commercial deposit and lending rates became one of the most disturbing features of the Philippine financial sector. Accordingly, spreads in the Philippines remained in the range of 15.0 to 16.0 per cent while in most countries spreads are much lower, around 3.0 to 4.0 per cent. These large spreads stem from high intermediation costs, mainly in the form of taxes and probably do not contain a significant rent element. Reserve money expanded by nearly 50.0 per cent during the second half of 1983 alone, and reserve requirements increased from 18.0 to 24.0 per cent. As a result of this increased implicit taxation, bank spreads doubled, thus contributing to the increase in real lending rates. Therefore, with a view to increasing the liquidity of the banking system and reducing bank intermediation costs, reserve requirements on short-term deposit liabilities were reduced from 24.0 per cent to 21.0 per cent in September 1985. The intermediation index of banks dropped from an average of 2.7 per cent in 1986 to 1.1 per cent in 1987 which helped reduce bank lending rates and encourage private sector credits. [41]

In addition, the government led the increase in real interest rates through increased domestic borrowing. Since 1985, real interest rates have been very high as a result of falling inflation, high intermediation costs and the high level of government borrowing. As inflation started to fall, nominal rates did not adjust fast enough, so real rates were high in part because of this lagged adjustment (Table 7.11).

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41. Economic and Monetary Developments in the Philippines in 1987, Central Bank of the Philippines, Country Paper presented at the Twenty-Third SEACEN Governors' Conference, Singapore, 20-22 January 1988.

Table 7.11

REAL INTEREST RATES DEVELOPMENTS: 1983-1987 [1]

(in Percentages)

Year (End of Period)	Lending Rate Secured Loans (All Maturities)	Savings Rate	Time Deposit (All Maturities)
1983	(4.36)	(16.41)	(8.97)
1984	-11.07	-39.24	-18.11
1985	12.12	3.86	9.76
1986	14.22	6.65	9.79
1987	8.81	-3.43	3.65

1. Real interest rates correspond to the difference between nominal interest rates (weighted average interest rates) and annual inflation rates. Figures before 1984 refer to weighted average interest rate of all maturities.

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

In the Philippines, there are implicit and explicit taxes on intermediation. The implicit taxes are high reserve requirements, forced investment in agrarian reform bonds and inflation. There is also an explicit tax of 5.0 per cent on gross receipts and a tax on profits. With no taxes on intermediation, real lending rates would have been low. Taxation on financial intermediation, which has been historically high in the Philippines, has further increased in the 1983-1985 period. Since these taxes increase the cost of intermediation, they are reflected in higher bank spreads. These high spreads would ultimately be passed on by the commercial banks to their borrowers in the form of higher interest rates. Therefore, the lowering of implicit and explicit taxes on intermediation may serve to bring down the intermediation cost.

IV.4 Other Effects

The expansion of bank capital and operations is another indicator of the response of financial system to the 1980 deregulatory moves. To date, ten commercial banks have been given licences to operate as universal banks. They have expanded the number of their affiliates/subsidiaries through merger/acquisition to position themselves in the new competitive environment. The 1980 banking reforms has already reduced the functional differentiation among financial institutions and authorized banks to engage in expanded banking activities provided that the capital base is increased.

Further, towards the close of 1986, the auction system of marketing Treasury bills was reintroduced to replace the negotiated system. The market competitive rates of these securities provided the banking system with an outlet for their investible funds and represented a move away from the negotiated system where rates on government securities are unilaterally determined by the monetary authorities.

One of the objectives of the 1980 financial deregulation was to encourage term transformation among financial institutions, i.e., the rechannelling of short-term liabilities to long-term assets. A study of the trend in the composition of assets and liabilities of commercial banks would show that little term transformation has occurred. Although there was a significant lengthening of loan maturities just after the deregulatory moves, short-term loans continue to account for more than half of loan outstanding of commercial banks, averaging 58.7 per cent in 1980-1986 compared with 62.3 per cent in 1977-1979 (see Table 7.8). Commercial banks prefer to extend short-term loans to clients, rolling them over when due, because this allows them to earn more from fees and other charges while minimizing liquidity and interest rate risks.

V. Deregulation and Competitive Financial Environment

The 1980 deregulatory moves was successful to reduce the functional differentiation among financial institutions and to authorizing banks to engage in expanded banking activities provided that they turn up a bigger capital base. The competitive financial environment could also be seen in the emergence of new bank product lines, increased efficiency and quality of service and increased automation and computerization among banks and financial institutions. The authorized activities of various financial institutions have also been expanded (Table 7.12).

The central bank's policy of merging and consolidating banks may have some beneficial short-run effects. However, the risk of encouraging further consolidation of commercial banks is that it might lead to an uncompetitive financial system in the long run.

VI. Problems and Issues Associated With Deregulation

VI.1 Deregulation and Selective Credit Policy

In the Philippines, deregulation was done in stages not based on institutional differentiation but towards the uniform treatment of all banks. However, partial deregulation may not be fully effective without causing imbalances or problems elsewhere in the system particularly as a result of policy consideration on credit allocation.

When a deregulated interest rate policy was adopted in 1983, loans under the rediscount facility continued to carry preferential rates until November 1985, when this facility was rationalized with the application of a unitary interest rate on all rediscountable loan papers based on market rates and the lifting of prescribed bank lending rates and spreads on rediscounted loans. The maintenance of subsidized rediscount rates amidst a deregulated interest rate policy between 1983 and 1985 resulted in increased loan applications such that greater selectivity in allocating the rediscount budget was resorted to.

At present, credit subsidies in the form of preferential rates for reserve eligible government securities against bank deposit liabilities, outstanding issues of certain low yielding-government securi-

Table 7.12

AUTHORIZED ACTIVITIES OF VARIOUS FINANCIAL INSTITUTIONS

Activity	Commercial Banks	Thrift Banks (incl. PDBs &SLAs)	Rural Banks	Investment Houses	Expanded Commercial Banks	Thrift Banks	Rural Banks	Investment Houses
Accept Deposits	/	/	/	/	/	/	/	*
Issue Letters of Credit and Accept Drafts	/	*	*	*	/	a/	*	*
Discounting of Promissory Notes	/	a/		*	/	//	//	/
Foreign Exchange Transactions	/	*	*	*	/	*	*	/
Equity Investment in Allied Undertakings	/	/	/	/	/	/	/	/
Equity Investment in Non-Allied Undertakings	*	*	*	/	*	*	*	/
Trust Operations	/	//	*	*	//	//	a/	/
Issue Real Estate and Chattel Mortgage, buy & sell them for its own account, accept/receive in payment or as an amortization of loan	/	/	/	/	/	/	/	/
Securities Underwriting	*	*	*	/	/	*	*	/
Syndication Activities	a/	*	*	/	a/	*	*	/
Business Development and Project Implementation	/	*		/	/	/	/	/
Money Market Operations	/	*	*	/	/	//	*	/

Legend: / = Authorized; // = Authorized but with prior M.B. approval;
⋆ = Not authorized; a/ = Limited authority.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Central Bank of the Philippines, 1987.

ties still exist although the reserve eligibility feature of government securities is already being phased out, pursuant to the policy of deregulation.

Certainly, credit should not be mistaken for charity and should not be given to those unable and unwilling to repay even though it is in the priority sector. This approach is particularly important in view of the gradual growth in bad or default loans in the priority sector after 1984 (Table 7.13).

Agricultural Credit Quota Policy

To encourage urban-oriented institutions to undertake rural lending and to mobilize the resources of urban-based institutions for agricultural development, all banking institutions, whether government or private, were required since 1975, to set aside at least 25.0 per cent of their loanable funds for agricultural credit in general. Of this quota, a minimum of 40.0 per cent (10.0 per cent of total loanable funds) shall be made available for agrarian reform credit. Banking institutions were, however, allowed to invest in eligible government securities any portion of the amount set aside for agrarian reform credit not actually loaned out.

Studies have shown that banks have consistently exceeded the minimum agricultural credit requirement (15.0 per cent) and agrarian reform credit subquota (10.0 per cent) during the period 1975-1986. Banks' compliance with the agrarian reform subquota was, however, largely in the form of eligible government securities. It has also been observed that the requirement did not substantially increase the share of agricultural loans to total loans outstanding of banks.

Subsidized Credit

Credit subsidy to agriculture came in the form of preferred interest rates on loans obtained for the central bank and other government financial institutions. The different schemes for the availment of agricultural credit subsidy comprised — special time deposit availed of through the Special Financing Programme administered by the central bank; the regular discounting window of the central bank; and, other special credit programmes of government agencies.

The provision of relatively cheap loanable funds to agriculture through the various central bank and national government-managed credit programmes resulted in several negative, unintended

Table 7.13

TOTAL LOANS, PRIORITY LOANS AND BAD OR DEFAULT LOANS: 1980-1986

(in Percentages)

Year	Commercial Banks				Other Financial Institutions [1]			
	Total Loans and Advances	Bad or Default Loans	Total Priority Sector Loans and Advances [2]	Total Bad or Default Loans in the Priority Sector [3]	Total Loans and Advances	Bad or Default Loans	Total Priority Sector Loans and Advances	Total Bad or Default Loans in the Priority Sector
1980	100.0	13.0	12.0	1.1 (9.3)	100.0	16.0 [a]	45.1	25.4
1981	100.0	13.0	13.1	1.1 (8.5)	100.0	19.2	36.6	23.9
1982	100.0	14.1	13.6	1.1 (7.9)	100.0	25.0	37.1	24.7
1983	100.0	12.3 [b]	12.4	0.9 (7.5) [b]	100.0	15.5	34.8	22.2
1984	100.0	19.3	10.2	1.0 (9.5)	100.0	26.5	34.5	32.8
1985	100.0	17.7	12.0	1.9 (15.6)	100.0	16.9	23.1	36.3
1986	100.0	20.5	12.7	3.0 (23.6)	100.0	31.4	48.3	29.2
1987	–	n/a	n/a	n/a	100.0	22.7	48.1	24.9
1988	–	n/a	n/a	n/a	100.0	20.7	40.8	26.8

1. Consist of thrift banks, specialized Government banks, rural banks and non-bank financial institutions.
2. Total priority sector loans is agricultural (agrarian loans).
3. Figures in parenthesis denote percentages of bad/default loans out of the total priority sector loans.

a. Rural banks only.
b. Figures at November 1983.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Central Bank of the Philippines, 1987.

effects on savings mobilization and the development of rural financial markets. Subsidized rates, which make credit artificially cheap, encourage uneconomic and inefficient use, non-payment or arrears, and cause price distortions which lead to the wrong choice or use of factor combinations. Arrears of payments and wasted credit resources not only add to the liquidity overhang, which the central bank has to mop up at a great cost, but also deprive others who could have used the credit more productively. For instance, there was very little attempt on the part of rural banks to build up internal resources and mobilize savings because subsidized loanable funds were available.

The rural banks in effect became mere channels of government credits, serving almost half of their loanable funds from special time deposits and rediscounts with the Central Bank of the Philippines. Because rural banks were heavily dependent on government for their supply of loanable funds and for management assistance, they could not diversify their portfolios and spread their risks. Thus, many rural banks found themselves saddled with high arrears. On the part of farmer-borrowers, subsidized credit resulted in an excess demand for cheap institutional credit, prompting banks to resort to credit rationing. Thus, only the large farmers who had assets eligible for collateral had access to cheap institutional credit, driving small farmers to informal credit markets, their only other alternative source of credit.

It may be recalled that one of the causes of high intermediation cost is the system of forced investment in agrarian reform bonds. As an agrarian reform requirement, banks have had to allocate 25.0 per cent of their net loanable funds to 'agri-agra' securities or to direct lending to agriculture. However, the programme has had no effect on agricultural credit and the share of loan to agriculture actually fell after 1975. The 'agri-agra' programme has simply been an additional tax on intermediation. The yield on 'agri-agra' securities has been consistently lower than alternative loans, sometimes it was even lower than the banks' cost of funds. The 'agri-agra' requirement is also not consistent with the deregulatory policy.

In other words, the 'agri-agra' requirement has distorted the market forces hampering the capability of banks to adequately respond to the demands of the market. This requirement unnecessarily raises the gross spread between bank lending and borrowing rates, and therefore, prevent banks from bringing down lending rates to a more reasonable and realistic level. The differentiation in the reserve requirements among different types of banks has also pushed the intermediation cost of the commercial banks towards a higher range than that of thrift banks. This also runs counter to the principle of market-oriented policy of deregulatory moves. Therefore, this differentiation has to be eliminated.

Similarly, government banks should be financially viable without the need for continuing government financial support and special privileges, including special tax treatment and access to government deposits above the working balance. They should not also support directed and subsidized credit programmes without explicitly off-balance-sheet funding from the government. In this regard, the performance of the two largest public financial institutions, the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP) raises questions about the rationality of subsidized credit to the priority sector. For instance, the government assistance to these institutions in 1986 alone is expected to be around P 15 billion and these two institutions together represent around one-third of the Philippine financial system, excluding the central bank.

The economic rationale for the existence of government financial institutions in the Philippines is that they provide services which, due to market imperfections, the private sector is unable to provide. Specially because of uncertainty and the private banks' excessive risk aversion, the amount of credit provided to the priority sector is lower than what is deemed to be economically desirable. But in practice, priority loans to agriculture from these institutions account for not more than 7.0 to 8.0 per cent of their total portfolio. Instead they provided maximum loans to support investment in real estate and towards trade-related loans. The ratio of agricultural credit to total credit in these two institutions' (PNB and DBP) portfolio was lower than the average for the commercial banking sector as a whole. In addition, these institutions have been lending large amounts to a few big enterprises.

In order to rectify the deteriorating condition of the financial system, a package of financial reforms was introduced recently. As part of the deregulation exercise of the financial system, a uniform and market-oriented rediscount rate has been adopted in 1986, in place of the selective and subsidized credit policy. In early 1987, a circular was passed providing for a rehabilitation package for rural banks. A Comprehensive Agricultural Loan Fund (CALF) was also created which consolidates the different special credit programmes of the Department of Agriculture into a single fund, which was converted into a guarantee fund. Under the guarantee scheme, the

CALF assumes a maximum of 85.0 per cent of the default risks of banks lending to agricultural projects. This type of risk-sharing strategy was expected to attract private banks to lend to agricultural projects.

The Agricultural Loan Fund (ALF) was also established in 1985 to increase loanable funds to agriculture, albeit at market interest rates. Funding for the ALF came mainly from a loan from the World Bank. Nevertheless, some features of the subsidized credit facilities were still creating price distortions, making credit artificially cheap and also affecting the payment of credit.

VI.2 Deregulation and Excess Liquidity

After the deregulation in 1983, the central bank faced two major constraints in the allocation of credit — the need to restraint credit and liquidity growth and the limitations of the instruments of monetary control. However, the emergence of excess liquidity can also be attributed to the liquidity overhang resulting from the moratorium on the payment of maturing foreign debts. This phenomenon was evidenced during the same deregulatory period. The situation after the deregulatory moves in 1983 continued to call for tight credit because the country needed to mop up excess liquidity and discourage overspending. The priority sector credit scheme also was one of the causes of excess liquidity overhang which the central bank had to mop up.

It may be recalled that during the second-half of the seventies, interest rates and the level of prices generally moved together in times when rate ceilings were adjusted upwards. The rise in inflation rates served as a guide to the upward revision of interest rates. December to December growth rates in domestic liquidity averaged 19.0 per cent in the mid-seventies as the share of time deposits rose to a substantial share of about one- fifth of domestic liquidity or 36.0 per cent of total savings and time deposits by end-1979 (Table 7.14).

From 1982 onwards to 1984, however, a marked slowdown in the growth of domestic liquidity to an average of 13.7 per cent was noted. On account of difficulties in the country's external payments positions, the lack of foreign exchange to cover current account deficit and to serve maturing foreign debt, the monetary policy, especially toward the last quarter of 1983, was tightened. Reserve requirements were gradually raised from 18.0 per cent in 1982 to 23.0 per cent in 1983, and eventually to 24.0 per cent in 1984. Open market operations to mop up excess liquidity became more active

Table 7.14

ANNUAL DOMESTIC LIQUIDITY GROWTH: 1978-1986

(in Percentages)

End of Period	Annual Domestic Liquidity Growth
1978	7.99
1979	10.65
1980	18.21
1981	21.07
1982	16.05
1983	18.50
1984	7.31
1985	9.62
1986	6.21

Sources: Central Bank of the Philippines, Statistical Bulletin, and Annual Reports, various issues.

with the introduction of high-yielding Central Bank bills in the same year and an unprecedented increase in 91-day Treasury bill rates to as high as 41.0 per cent. Even as rediscount rates were tied to the Manila Reference Rates (MRR), the rediscount window was eventually closed to new availments except for non-traditional exports and food production, to control growth in reserve money and domestic liquidity.

The ratio of excess reserves to deposit liabilities was likewise lower to 0.2 per cent from 0.7 per cent as the demand for credits grew at a faster rate than the increase in deposits (Table 7.15).

VII. Move Towards Re-regulation

The Philippines experienced a financial crisis after the deregulation of the financial system in the eighties but the crisis occurred at a time when there were adverse external and domestic developments. Hence, no conclusive evaluation could be made as to the role of deregulation in the financial crisis. However, it may be said that deregulation, particularly the lifting of interest rate ceilings, facilitated such adjustment efforts as the mopping up of excess liquidity.

But in 1981, when holders of hundreds of millions of pesos worth of commercial paper refused to roll over and demanded cash instead and the stock market was hit by sellers needing to repay loans, the central bank had to tighten up reporting requirements on certain financial institutions. Several banks and investment houses were hit by above-average withdrawals, with the latter suffering from many non-paper liabilities. In this context, the central bank reforms included a 4.0 per cent drop in required reserve levels, higher interest rates (up from 15.0 to 18.0 per cent), and the taking over of the issue of commercial paper from the Securities and Exchange Commission by the central bank. New central bank rules also allowed for wider investigative powers and record-keeping of any large loans. The Government also had to establish also a reserve fund of P 1.5 billion to help private companies that were particularly hard hit by the wave of financial uncertainty.

The closure of Banco Filipino in 1985 and the latest closure of the Manila Banking Corporation (MBC), one of the Philippines' nine largest banks, clearly highlights the weakness still plaguing the banking institutions and a move towards re-regulation rather than deregulation seems to be the logical answer.

Further to prevent a recurrence of the crisis of 1981, the central bank, in coordination with the Securities and Exchange Commis-

Table 7.15

LIQUIDITY POSITION AND LOAN DEPOSIT RATIO OF THE COMMERCIAL BANKS: 1977-1986

(in Percentages)

	Before Deregulation			After Deregulation						
	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
1. Liquidity Ratios (in per cent of deposit liability)										
Available Reserves	20.7	19.6	20.1	21.6	18.9	13.8	13.8	17.1	15.8	n/a
Required Reserves	20.0	20.0	20.0	20.0	19.9	13.6	19.1	19.1	18.9	n/a
Excess (Deficiency)	0.7	(0.4)	0.1	1.6	(1.0)	0.2	(4.1)	(2.0)	(3.1)	n/a
2. Loan/Deposit Ratio [1]	108.0	124.0	142.0	134.0	129.0	119.0	120.0	118.0	81.0	60.0
3. Inter-Bank Rate [2]	14.44	13.22	16.25	15.70	14.70	16.12	31.18	15.22	15.03	9.92

1. Refers to ratio of outstanding loans and deposits.
2. Refers to interbank call loans.

Sources: Various statements of commercial banks,
Central Bank of the Philippines, Philippine Financial Statistics, and Annual Reports, various issues.

sion, drew up new rules and regulations so that only prime borrowers could avail themselves of funds and suppliers of funds would be protected in the money market. Among others, a limit was set on the total outstanding liabilities or borrowings of a commercial paper issuer to not more than 300.0 per cent of its net worth. Any proposed issue was also required to be supported by a committed credit line agreement with a qualified bank. A credit information system and a credit rating bureau were set up in 1981 in order to provide lending institutions with more information on total borrowings and credit standing of their borrowers.

To determine the true financial condition of banks and quasi-banks, the Supervision and Examination Sector (SES) of the central bank conducts periodic examination of these institutions. There are, however, factors which serve as deterrents to a thorough examination of banks. For instance, the Secrecy of Deposits Act (Republic Act 1405) hampers the ability of the central bank examiners to check the disposition of proceeds of loans lodged in deposit accounts. Thus, a review of the legal constraints and other related factors may be undertaken to further improve the examinations of financial institutions.

In order for bank management to establish sound banking policies and maintain confidence of its clients, limits are imposed on loans that may be availed of by directors, officers, stockholders and related interests (DOSRI). In the wake of recent bank failures which were caused mainly by the non-collection of loans, especially those made to linked borrowers, it has been recommended that the definition of DOSRI be expanded to include borrowers with special linkages to DOSRI which do not fall under the coverage of the present DOSRI definition or to adopt separate regulations to limit loans to said borrowers with special linkages to DOSRI to limit insider loans granted on terms which are disadvantageous to the bank. It has also been recognized that the early warning system of SES has to be continuously improved to take into account lessons learned from past bank closures.

Despite all these measures, several government-acquired banks are currently facing liquidity and/or solvency problems. The loan-to-deposit ratio depicts that they have overstaked their resources to provide loans thus facing stability problems (Table 7.16). The two other ratios in the table indicated the bank's ability to adjust its portfolio in response to shocks. In general, private banks, although affected by the crisis which started in 1983, were able to reduce the size of their loan portfolio. Instead of lending, many banks preferred

Table 7.16

REPRESENTATIVE FINANCIAL RATIOS OF COMMERCIAL BANKS: DECEMBER 1986

(in Percentages)

Banks	Loan/ Deposit Ratio	Liquid Assets/Liabilities Ratio	Liquid Assets/All Assets Ratio
Foreign Banks	190.79	23.92	23.72
Government-Acquired Banks	164.98	38.48	37.52
Private Domestic Banks	50.63	52.68	46.11

Sources: Central Bank of the Philippines, Philippine Financial Statistics, and Statistical Bulletin, various issues.

to hold government securities and this group of banks seems to be fairly liquid (Table 7.16).

Further, merging a failing bank with a money institution may avoid some of the problems associated with the bankruptcy of the weaker bank. However, this approach will have no long-run effects on the soundness of the banking system. Bigger banks are not necessarily more stable than smaller ones. The various empirical evidence conducted in the developed countries showed no significant relationship between size and stability.

Therefore, the history of the Philippine financial system indicates that bank failures have almost always been associated with mismanagement. Increasing bank size will not necessarily improve the quality of management. In the long-run, problems associated with mismanagement can only be avoided if the central bank effectively carries out its role in supervising the banks. Hence, re-regulation rather than deregulation that ensures the soundness of the banking system need to be introduced. The early-warning system, introduced to monitor the soundness of the financial institutions and the central bank's ability to enforce prudential regulations, has to be strengthened. Although the central bank has played an important role in maintaining financial stability during the recent crisis, it would be better if interventions by the central bank could occur before an institution is on the brink of bankruptcy and requires emergency assistance. A set of guidelines, plays a vital role in determining the exposure of banks to risks in the form of various ratios reflecting, its liquidity, its solvency and the adequacy of the capital base. But it depends on the ability of the central bank to enforce such regulations in penalizing the management of the violating bank and forcing it to take prompt corrective actions. Therefore, there must be a trade off between market forces to be generated by the deregulatory moves and the effective supervision of the central bank.

Appendix 7

Some Major Regulatory and Prudential Measures (1976-1986)

Regulation	Effective Date	Description/Remarks
1. Bank Entry		
Cir. 476	14 Jul. 1975	* Prescribed guidelines for the establishment of new banking offices. Applications would be evaluated based on criteria relating to capital adequacy, solvency, profitability and capacity to absorb losses, reserve and liquidity position, paid-in capital and other related factors. It likewise limited applications for additional offices.
Cir. 501	2 Feb. 1976	* Prescribed guidelines for the establishment of branches of pawnshops by defining their operations and functions, establishment, documentary require ments and location.
Cir. 546	26 Nov. 1976	* Provided the implementing rules for PD 1034 authorizing the establishment of an offshore banking unit; issuance by the Monetary Board of certificates of authority to operate an offshore bank unit should consider the applicant's liquidity and solvency position, networth and resources, management, international banking expertise, contribution to the Philippine

Regulation	Effective Date	Description/Remarks
		economy, and other relevant factors such as participation in equity of local commercial banks and appropriate geographic representation.
Cir. 551	1 Jan. 1977	* Prescribed guidelines governing the establishment and operations of money shops by domestic commercial banks (KBs), savings and mortgage banks, private development banks, stock savings and loan association and rural banks. At least 70.0 per cent of the voting stock must be owned by Filipinos.
Cir. 567	4 May 1977	* Set the minimum capital required for every additional banking unit to be established in the Greater Manila Area (GMA) as follows: commercial banks (KBs) P5 million; savings banks (SBs) P1 million; stock savings and loan associa tions (SSLAs) P250 thousand and in places outside GMA: KBs P2 million; SBs P0.5 million.
Cir. 739 Batas Pambansa Blg. 61	10 Jul. 1980 1 Apr. 1980	* Provided that the establishment of banking offices for commercial banks, including expanded commercial banks, as well as branches nation-wide or overseas would require prior Monetary Board approval and compliance with other requirements on capitalization,

Regulation	Effective Date	Description/Remarks
		profitability and capacity to absorb losses, qualification of officers, reserve and liquidity position, citizenship, etc..
Cir. 740 Batas Pambansa Blg. 61, 62 & 63	10 Jul. 1980	* Provided that establishment of banking offices and branches of thrift banks (TBs) nation-wide would require prior Monetary Board approval, ownership by Filipinos of 70.0 per cent of voting stock; compliance with capital requirements; and other factors, e.g., that the proposed banking area is not over banked.
Cir 741 Batas Pambansa Blg. 65	10 Jul. 1980 1 Apr. 1980	* Provided that the establishment of rural banks would require prior Monetary Board approval, full compliance with minimum capital requirement, and other requirements/factors as in other types of banks.
Cir. 742 Batas Pambansa Blg. 61 & 66	10 Jul. 1980 1 Apr. 1980	* Provided that the applica tions for license as an investment house be referred to the Central Bank of the Philippines (CB) which would evaluate the application in accordance with prescribed guide lines.

Regulation	Effective Date	Description/Remarks
Cir. 934	3 Jun. 1983	* Required KBs and TBs applying for authority to establish or transfer a branch or banking unit or to purchase only existing branch/banking unit from another bank, to purchase from the CB five-year special series T-notes or Central Bank Certificates of Indebtness (CBCI) in graduated amounts depending on the locality where the branch would be established. Rural banks applying for authority to establish or the purchase from another bank, or to transfer from one service area to another, within its region any branch or other banking units are similarly required to purchase from the CB a minimum of P500,000 worth of the said securities. This measure was aimed at avoiding overbranching and improve the quality of the local banking industry.
Cir. 1033	23 Nov. 1984	* Suspended the establishment of banking offices in heavily branched, overbranched and ideally branched areas (Categories I, II and III) and encourages the purchase of closed banks in the area.
1985-1987		No new circulars issued.

Regulation	Effective Date	Description/Remarks
2. Limits Placed on Equity Ownership of Financial Institutions, and Securities Brokerage Activities:		
Cir. 462	2 Apr. 1975	* Amended guidelines in the Rural Banks Act (Republic Act No. 720, as amended) regarding investment of rural banks in allied/related undertakings.
Cir. 467	2 Jun. 1975	* Prescribed procedure for acquisition by small farmers of equity in rural banks.
Cir. 480	24 Sep. 1975	* Prescribed guidelines for granting authority to all thrift banks to invest in equities of allied undertakings.
Cir. 449	3 Feb. 1975	* Prescribed rules governing equity investments by financial intermediaries both banks and non-banks, authorized to engage in quasi-banking functions, their stockholders, their wholly or majority-owned subsidiaries and/or its minority-owned affiliates in which their stockholdings exceed 40.0 per cent of the voting stock and/or holding companies, as well as by foreign financial aggrupations in other financial intermediaries authorized to engage in quasi-banking functions.
Cir. 532	2 Jul. 1976	* Prescribed regulations governing the extent of equity investments of corporations in rural banks. The equity

Regulation	Effective Date	Description/Remarks
		investments in any particular rural bank of a holding corporation which is wholly-owned, or the majority of the voting stock of which is owned by one person or persons related to each other within the third degree of consanguinity, or affinity was limited to 20.0 per cent of the voting stock. The equity investment of a holding corporation, otherwise owned, including of qualified corporate investors, i.e., 100.0 per cent Filipino-owned corporation shall not exceed 30.0 per cent of the voting stock of any particular rural bank.
Cir. 739	10 Jul. 1980	* Amended Republic Act No. 337 which includes a chapter on equity investments for all financial institutions.
Cir. 1026	10 Oct. 1984	* Amended Book III of the Manual of Regulations for Banks and Other Financial Intermediaries such that in the case of credit cooperatives registering as rural banks, no member or group of members related to one another by consanguinity or affinity within the third degree shall own more than 20.0 per cent of the voting stock of the rural banks, except as provided for in Subsection 3131.3b of the Manual.

Regulation	Effective Date	Description/Remarks
3. Capital Adequacy Requirements		
Cir. 678	28 May 1979	* Approved amendment, consolidation and re-issuance of guidelines governing establishment of banking office of thrift banks in regard to capitalization as follows: (a) Savings banks and mortgage banks (with head offices located within): (i) Greater Manila area and fringes thereof - P10.00 million (ii) Other places - P5.00 million (b) Private development banks & stock savings and loan associations (SSLAs) located within: (i) Greater Manila area & First Class A cities - P4.00 million (ii) First Class B & C, Second & Third Class Cities - P3.00 million (iii) Fourth & Fifth Class Cities & Others - P2.00 million
Cir. 720	22 Feb. 1980	* Approved the minimum capitalization for new rural banks and capital build-up program of existing rural banks. The paid-up capital requirement was raised from P100 thousand to P500 thousand.

Regulation	Effective Date	Description/Remarks
Cir. 739	10 Jul. 1980	* Approved rules and regulations governing commercial banks and banks with expanded commercial banking authority, defining among other things the minimum capital requirements: (a) Expanded Commercial Banks - P500 million (b) Commercial Banks - P100 million
Cir. 740	10 Jul. 1980	* Among others, raised the minimum capital requirement for existing thrift banks located within Metro Manila (MM) to P10 million and to P5 million for those located outside MM. For new thrift banks, minimum capitalization was raised to P21million and P10 million for banks in MM and outside MM, respectively.
Cir. 757	22 Aug. 1980	* Approved the regulations governing the capitalization requirement of financial intermediaries applying for authority to perform quasi-banking functions at P50 million.

4. Statutory Reserve Requirements (see the following page)

4. Statutory Reserve Requirements (in Per Cent)

Circ. No.	Effective Date	Commercial Banks [1] Demand Deposits	Commercial Banks [1] Savings Deposits	Commercial Banks [1] "Now" Accounts[2]	Time Deposits 730 days & below	Time Deposits More than 730 days [3]	Development Bank of the Philippines Savings Deposits	Development Bank of the Philippines Time Deposits	Thrift Institutions Demand Deposits	Thrift Institutions "Now" Accounts	Thrift Institutions Savings & Time Deposits	Rural Banks Demand Deposits	Rural Banks Savings Deposits	Rural Banks "Now" Accounts	Rural Banks Time Deposits	All Financial Institutions Deposits Substitutes 730 days & below	All Financial Institutions Deposits Substitutes More than 730 days
Prior to 30 Jun'75		20.0	20.0	-	20.0	-	10.0	10.0	-	-	10.0	14.0	12.0	-	10.0	n/a	n/a
169	30 Jun'75	20.0	20.0	-	20.0	-	8.0	8.0	-	-	8.0	14.0	8.0	-	8.0	5.0	b
496	1 Apr'76	20.0	20.0	-	20.0	-	8.0	8.0	-	-	8.0	14.0	8.0	-	8.0	9.5[a]	b
628	21 Aug'78	20.0	20.0	-	20.0	-	8.0	8.0	20.0	-	8.0	14.0	8.0	-	8.0	20.0	b
752	22 Aug'80	20.0	20.0	-	20.0	-	8.0	8.0	20.0	-	8.0	15.5	8.0	-	8.0	20.0	b
782	27 Feb'81	20.0	20.0	-	20.0	-	8.0	8.0	20.0	-	8.0	16.0	8.0	-	8.0	18.0	1.0[c]
908	1 Jan'82	18.0	18.0	18.0	18.0	2.0	8.0	7.0	18.0	12.0	8.0	18.0	8.0	-	8.0	19.0	4.0[c]
945	Sep-Oct'83	23.0	23.0	23.0	23.0	4.0	13.0	13.0	23.0	17.0	13.0	21.0	13.0	17.0	13.0	23.0	6.0
1002	17 Oct'84	24.0	24.0	24.0	24.0	6.0	14.0	14.0	24.0	18.0	14.0	22.0	14.0	18.0	14.0	24.0	6.0
1079	3 Oct'85	23.0	23.0	23.0	23.0	6.0	14.0	14.0	23.0	18.0	14.0	22.0	14.0	18.0	14.0	23.0	6.0
1104	26 May'86	22.0	22.0	22.0	22.0	6.0	14.0	14.0	22.0	18.0	14.0	22.0	14.0	18.0	14.0	22.0	6.0
1111	4 Aug'86	21.0	21.0	21.0	21.0	6.0	14.0	14.0	21.0	18.0	14.0	21.0	14.0	18.0	14.0	21.0	6.0
1112	28 Nov'86	21.0	21.0	21.0	21.0	6.0	14.0	14.0	21.0	18.0	14.0	21.0	14.0	18.0	14.0	21.0	5.0

1. Effective 17 January 1977, the Land Bank and Amanah Bank were considered commercial banks for reserve requirements. Prior to that date, they had the same reserve requirements as the Development Bank of the Philippines.
2. This is a special form of account from which funds may be drawn by means of 'negotiable order of withdrawal' (NOW).
3. Time deposits with maturities of more than 730 days were exempted from reserve requirements until 1982.

a. Effective 1 April 1976, reserve requirements shall be 5.5 per cent and shall be increased at the rate of 0.5 percentage point every month. Thereafter, until the 20 per cent requirement shall have been reached.
b. Exempt from reserve requirements.
c. For commercial banks, rural banks and thrift banks, 5.0 per cent for non-bank institutions with quasi-banking functions.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Central Bank of the Philippines, 1987.

Regulation	Effective Date	Description/Remarks

5. Liquidity Requirements (Asset Control):

Subsections 1239.3, 2239.2, 3239.3 of Books I, II, III of the Manual of Regulations for Banks and Other Financial Institutions	1 Aug. 1982	* Liquidity Flow: Unless otherwise provided by the Monetary Board, private banks and non-bank financial intermediaries shall, in addition to the required reserves against deposits and/or deposit substitutes, maintain a 30.0 per cent liquidity floor with respect to deposits of and/or borrowings from, the government, and government entities in the form of Central Bank-supported securities, separate and distinct from those used by them for other specific purposes required by law, rules and regulations. There are some transactions howevever, which are exempted from the liquidity flow requirements.

6. Limit Applied with Regard to the Extent to which a Bank, Other Deposit-Taking Institutions and Non-bank Financial Institutions Can Lend to any One Customer:

Cir. 600	27 March 1978	* Amended Sec. 7 of Circular No. 575 on credit accommodations of non-bank financial institutions with quasi-banking functions to its directors and stockholders such that these accommodations do not exceed 100.0 per cent of the combined capital accounts of the lending entity, following certain provisions.

Regulation	Effective Date	Description/Remarks
Cir. 729	18 Apr. 1980	* Provided amendment of Sec. 116 of the Revised Rules and Regulations Governing Rural Banks re: loan limits for medium-term loans will be up to 80.0 per cent of the amount necessary to finance the expenditures and shall be secured by a first mortgage on the land, machinery, equipment or real estate purchased without prejudice to the right of the rural bank to require additional collaterals acceptable to it.
Cir. 1084	20 Nov. 1985	* Reduced the single borrower's limit of non- bank financial intermediaries performing quasi-banking functions (NBQBs) to any person, corporation or firm from 80.0 per cent to 15.0 per cent of the combined capital accounts, net of unbooked valuation reserves.

7. Monitoring of Asset Quality and Provisioning Policy:

Regulation	Effective Date	Description/Remarks
PD 717	29 May 1975	* Provided for an Agrarian Reform fund for agrarian reform beneficiaries through banking institutions. Mandated all banking institutions, whether government or private to set aside at least 25.0 per cent of their loanable funds for agricultural credit in general, of which at least 10.0 per cent of the loanable funds shall be

Regulation	Effective Date	Description/Remarks
		made available for agrarian reform credit.
Cir. 473	30 Jun. 1975	* Provided guidelines for the grant of agrarian reform credit and agricultural credit by banking institutions under PD 717. Defined loanable funds, agrarian reform credit, agrarian reform beneficiaries, and agricultural credit in general.
Cir. 560	21 Mar. 1977	* Amended Item C.2 of Circular No. 473 and set guidelines for temporary investments in government securities in the absence of qualified borrowers.
Cir. 619	17 Jul. 1978	* Prescribed amendments to guidelines on agrarian reform credit, particularly in investments in eligible government securities. Only the buying/lending bank in a resale/repurchase agreement between private entities covering eligible government securities may use such securities under the conditions that the resale/ repurchase should be for terms not less than 30 days and that the buying/lending bank shall register with the CB its holdings of CBCIs under repurchase/resale agreement.

Regulation	Effective Date	Description/Remarks
Cir. 651	2 Feb. 1979	* Prescribed incentives for investments in agricultural enterprises. Expanded the definition of agrarian reform beneficiaries to include agricultural enterprises registered under PD 1159.
Cir. 687	20 Jul. 1979	* Superseded Circular No. 473, 619 and 651 and reissued guidelines to govern the grant of agrarian reform credit and agricultural credit by banks, government or private. Redefined loanable funds, agrarian reform and agricultural credit in general and agrarian reform beneficiaries. In the absence of qualified borrowers, provided for alternative investment of funds set aside for agrarian reform credit not actually loaned out in the form of government securities.
Cir. 795	4 May 1981	* Provided for additional qualified borrowers under the mandatory agrarian reform credit allocation. For purposes of determining compliance with the 10.0 per cent agra-requirement, marketing credits to six qualified borrowers under the Grains Quedan Financing Program shall be considered as agrarian reform credits.
Cir. 867	2 Apr. 1982	* Amended Circular 867 by adding to the list of qualified

Regulation	Effective Date	Description/Remarks
		borrowers under the Grains Quedan Financing Program, the National Food Authority, provided that the palay procurement operations thereof are certified by the Ministry of Agrarian Reform as having been obtained through direct/ indirect linkage arrangements with agrarian reform beneficiaries.
Cir. 1058	23 Apr. 1986	* Rationalized the base for determining the loanable funds of banks to exclude interbank loans with maturities not exceeding 15 days, proceeds from CB rediscounting (except STDs), proceeds from special programs like the Apex, and special CB credit accommodations in the form of emergency advances, overnight RPs, and availments of overdraft facilities.

8. Deposit Insurance Scheme:

R.A. No. 3591, amended by P.D. 1094	1963 18 Feb. 1977	* The insurance limit on insured deposits of financial institutions was raised from P15,000 to P40,000 in 1977. The financial institutions covered were: commercial banks, savings banks, mortgage banks, rural banks, development banks, cooperative banks, trust companies, branches and

Regulation	Effective Date	Description/Remarks
		agencies in the Philippines of foreign banks and other companies with banking functions.

9. Credit Control and Restrictions:

Cir. 568	4 May 1977	* Limited loans to directors, stockholders and related interests to an amount not exceeding outstanding deposits, and book value of the paid-in capital contribution.
Cir. 575	28 Jul. 1977	* Prescribed guidelines on credit accommodations by non-bank financial intermediaries performing quasi-banking functions to directors, officers and stockholders (DOSRI) and to subsidiaries and affiliates. In the case of DOSRI loans, it should not exceed an amount equivalent to the book value of the paid-in capital contributed plus the outstanding balance of loans to and placements with the lending entity. For subsidiaries and affiliates, it should not exceed an amount equal to 50.0 per cent of the combined capital accounts of the lending entity.
Cir. 587	24 Dec. 1977	* Set at 5.0 per cent the maximum ratio of a bank's past due direct and indirect loans to its stockholders, directors, officers and related interest to

Regulation	Effective Date	Description/Remarks
		the bank's aggregate past due loans.
Cir. 958	17 Oct. 1983	* Announced that loans and advances that have been past due for 6 months and are justified to be incollectible may be written off. Also, the aggregate amount of loans and advances which may be written off during the year should not exceed 3.0 per cent of total loans and investments and that charge-offs are made against allowance for probable loss of earnings during the year and/or retained earnings. Loan limit to a single borrower - total liabilities of any person, company, corporation or firm, to a commercial banking corporation for money borrowed shall at no time exceed 15.0 per cent of the unimpaired capital and surplus of such bank.
Cir. 993	7 Mar. 1984	* Limited the maximum total bank equity investment in and outstanding loans to any single enterprise (whether allied or non- allied) to 15.0 per cent of the networth of the investing bank.
Cir. 1019	16 Jul. 1984	* Limited the maximum total credit exposure of banking institutions to affiliates/ subsidiaries or corporate stock holders.

Regulation	Effective Date	Description/Remarks
Cir. 1084	20 Nov. 1985	* Reduced the single borrower's limit of NBQBs to any person, corporation or firm from 80.0 per cent to 15.0 per cent of the combined capital accounts, net of unbooked valuation reserves.
Cir. 1123	5 Dec. 1986	* Expanded the concept of single borrower's loan limit to include in its determination foreign as well as domestic standby and deferred letters of credit net of marginal deposits. Likewise clarifies and makes explicit that guarantees mentioned refer to those the nature of which requires the guarantor to assume liabilities/ obligation of third parties in case of their inability to pay and rephrases exceptions to include those fully secured by cash, holdouts on deposits/deposit substitutes or government securities.

10. Interest Rates Regulation: [a]

A. Loan Rates

Cir. 494	1 Jul. 1976	* Increased the interest rate ceilings on loans with maturity of more than 730 days granted by banks and NBQBs to 19.0 per cent per annum, including

a. Prior to 2 Jan. 1976, all loans were subject to the interest rate ceilings prescribed by the provisions of the Usury Law, i.e., 12.0 per cent and 14.0 per cent per annum, respectively, for secured and unsecured loans, regardless of Maturity.

Regulation	Effective Date	Description/Remarks
		commissions, premiums, fees and other charges. Loans with maturity of 730 days or less remained subject to the interest rate ceilings of 12.0 per cent and 14.0 per cent per annum secured and unsecured loans, respectively.
Cir. 586	1 Jan. 1978	* Prescribed maximum effective rate of interest of 14.0 per cent and 12.0 per cent (excluding charges) per annum, respectively, for unsecured loans granted by banks and NBQBs with maturities of 730 days or less, and 19.0 per cent (including charges) per annum, for loans, whether secured or unsecured, maturities of over 730 days.
Cir. 705	1 Dec. 1979	* Increased the maximum effective rates of interest on loans granted by banks and NBQBs with maturities of 730 days or less to 16.0 per cent and 4.0 per cent (excluding charges) per annum, respectively, for unsecured and secured loans, and 21.0 per cent per annum (including charges) in case of loans with maturities of over 730 days, whether secured or unsecured.
Cir. 721	22 Feb. 1980	* Prescribed among others an interest rate ceiling of 14.0 per cent and 16.0 per cent,

Regulation	Effective Date	Description/Remarks
		respectively, for secured and unsecured loans with maturity not exceeding 730 days, and 21.0 per cent for both secured and unsecured loans with over 730 days maturity. Other additional charges, which may be collected in addition to the interest rate are prescribed a ceiling of not more than 2.0 per cent per annum.
Cir. 783	1 Jul. 1981	* Superseded Circulars 705 and 721, among others, increased the effective rate on loans with maturities of 730 days or less to 16.0 per cent and 10.0 per cent (including charges) per annum for secured and unsecured loans, respectively, and lifted the ceilings on the interest rate on or forbearances of money, goods or credits with maturity of more than 730 days. Lifted the ceilings on bank charges effective 1 July 1981 in view of the lifting of interest rate ceilings on loans, with maturities of more than 730 days and the inclusion of charges in the ceilings on interest rates for loans with maturities of 730 days or less.
Cir. 917	1 Oct. 1981	* Amended Circulars 780, 783 and 784, among others, prescribing the effective rate of interest, granted by banks and NBQBs on a loan or forbearance

Regulation	Effective Date	Description/Remarks
		of any money, goods or credits with maturity of 365 days or less to 16.0 per cent and 18.0 per cent (including charges) per annum for secured and unsecured loans, respectively, and lifted the ceilings on the interest rates on loans or forbearances of money, goods or credits with maturity of more than 365 days.
Cir. 905	1 Jan. 1983	* Among others, lifted all ceilings on interest rates granted by banks and NBQBs, including other charges, on a loan or forbearance of any money, goods or credits, regardless of maturity and whether secured or unsecured.

B. Bank Charges

Cir. 504	6 Feb. 1976	* Limited ceilings on charges only to loans with maturities of 730 days or less.
Cir. 783	27 Feb. 1981	* Lifted the ceilings on back charges.

C. Deposit Rates

Cir. 578	9 Sep. 1977	* Prescribed the maximum interest rate of 7.5 per cent for savings deposit; 9.0 per cent for 90-day time deposit; 9.5 per cent for 180-day time deposits; 10.5 per cent for 360-day time deposits; 11.5 per cent for 540-day time deposits; and, 12.5 per

Regulation	Effective Date	Description/Remarks
		cent for 730 day time deposits of non-stock savings and loan associations (NSSLA).
Cir. 585	1 Jan. 1978	* Lifted the interest rate ceilings on the deposits and deposit substitutes with maturities of over 730 days.
Cir. 706	1 Dec. 1979	* Provided that the interest rate ceiling on savings and time deposits on various maturities of banks authorized to accept demand deposits shall be 0.5 percentage point higher than those prescribed against deposits of banks not authorized to accept demand deposits.
Cir. 739/742	10 Jul. 1980	* Prescribed rules and regulations to govern banks with expanded commercial banking authority as well as non-banking institutions performing quasi-banking functions.
Cir. 777	1 Jul. 1981	* Prescribed among others the lifting of maximum ceilings on interest rate on savings deposits and "NOW" accounts.
Cir. 813	26 Jun. 1981	* Amended the minimum maturity on time deposits of banks to 30 days.
Cir. 905	10 Dec. 1982	* Lifted the remaining interest rate ceilings on borrowing and lending instruments of banks.

Regulation	Effective Date	Description/Remarks
		Prescribed guidelines for the prime rate monitoring system.
Cir. 1021	20 Jul. 1984	* Provided for the discontinuation of the prime rate monitoring system.

D. Manila Reference Rate

Cir. 866	2 Apr. 1982	* Prescribed the monitoring scheme for reference rates for various interest periods and the weekly announcement of said rates by the central bank.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Central Bank of the Philippines, 1987.

Chapter 8

Financial Deregulation in Sri Lanka

I. Rationale and Objectives of Deregulation

The year 1977 marked a watershed in Sri Lanka's deregulation policy towards interest rate reforms and the encouragement of reputed foreign banks to set up branches in the country. Prior to 1977, the country has been committed to maintaining a low interest regime and, quantitative credit restrictions, thus, became the norm of regulatory policy.

However, in 1977, there was a departure from this policy and the interest rates underwent a radical change, resulting in a move towards a considerably higher level of rates against a background of widespread inflationary pressures in the economy. The interest rate changes that occurred in 1977, therefore, represented a landmark in the history of Sri Lanka's deregulation policy. For the first time, interest rates which hitheto had failed to reflect market conditions were permitted to move in step with the general economic conditions in the country. Therefore, the main objective and rationale of 1977 deregulation policy was to maintain interest rates which can reflect market conditions, thus providing an incentive to increase financial savings. In other words, the interest rate policy has been used as an effective instrument and the objective of the interest rate reforms was two fold. First, the interest rate was used as an instrument of monetary policy in arresting the growing inflationary pressures. Second, it was aimed at ensuring the positive rate of return on deposits, thereby promoting domestic savings. Therefore, the rationale for deregulatory measures was also to raise the costs of credit and discourage non-essential borrowings.

Prior to the liberalization policy in 1977/1978, interest rates were kept at a lower level mainly with a view to enhance investments and control the rising costs of domestic public debt which had been growing over the years. When the liberalized policies were introduced in 1977 it was a conscious decision towards introducing a higher interest rate policy. This policy change was also considered as a correction of nominal interest rates in line with the higher inflation rate and to mobilize additional funds for economic development.

The second stage of deregulation in the financial system of Sri Lanka occurred in 1984, when the National Savings Bank (NSB) was allowed the freedom to fix its deposit and lending rates in June 1984. Prior to this, the usual practice in fixing its deposit rates was to obtain the approval of the Ministry of Finance and Planning. The rationale behind these deregulatory moves was to enable the NSB to determine its interest rates according to their liquidity requirements and the costs of funds, and thus allowing the NSB to diversify its asset portfolio according to the profitability of investment.

II. Circumstances and Conditions for Deregulation

The period before 1977 was marked by financial suppression in the banking system. Foreign banks were not encouraged to commence business in the country, while the activities of the existing foreign banks were restricted to Colombo. Similarly, for a long time, the country has been committed to maintaining a low interest rate regime or a "cheap money" policy dictated by the exigencies of the Government's borrowings operations, a tacit acceptance of a well known hypothesis that savings are generally not very sensitive to changes in interest rates. The changes made in interest rates before the deregulatory moves of 1977 were of very marginal nature and occurred at very infrequent intervals, and also were not reflecting market conditions (Table 8.1).

Further, prior to the imposition of deregulatory policy in 1977, restrictive monetary measures had become the norm of the regulatory policy. The low interest rate policy that existed during the period before deregulation did not induce the financial institutions to function competitively in regard to deposit mobilization (Table 8.2). The interest rates were also kept at a lower level, mainly with a view to enhance investments and control the rising costs of domestic public debt which had been growing over the years. Despite the administrative controls on credit, the demand for bank credit increased and the central bank was compelled to provide a large volume of funds to commercial banks at the prevailing bank rate for their liquidity requirements (Table 8.3). In view of all these circumstances, some regulations affecting the financial sector were either removed or relaxed. In other words, the financial sector was allowed more freedom in their activities.

Table 8.1

INTEREST RATE STRUCTURE BEFORE DEREGULATORY MOVES: 1970-1976

(in Percentages)

Year	Savings Deposits		Fixed Deposits				Inter-Bank Call Loan Rates	Lending Rates		
	Commercial Banks	National Savings Bank	Commercial Banks			National Savings Bank		Commercial Banks		National Savings Bank
			3-6 mths	1 year	More than 1 year			Secured Loans	Insecured Loans	
1970	4.50	4.00 [a]	4.50-4.75	4.50-4.75	4.75-5.50	4.50	4.50	6.50-12.00	8.50-12.00	10.00-12.00
1971	4.50	7.00 [a]	4.50-4.75	4.50-4.75	4.75-5.50	4.50	5.00	6.50-12.00	8.50-12.00	10.00-12.00
1972	4.50	7.20	4.50-4.75	4.50-4.75	4.75-5.50	7.50	5.00	6.50-12.00	8.50-12.00	10.00-12.00
1973	4.50	7.20	4.50-4.75	4.50-4.75	4.75-5.50	7.50	5.00	6.50-12.00	8.50-12.00	10.00-12.00
1974	5.50	7.20	4.50-4.75	4.50-4.75	4.75-5.50	7.50	5.00	6.50-12.50	8.50-13.50	10.00-12.00
1975	5.50	7.20	6.00-7.00	7.00-7.50	7.00-7.50	7.50	5.00-8.00	6.50-13.00	9.50-14.00	10.00-12.00
1976	5.50	7.20	6.00-7.00	7.00-7.50	7.00-7.50	7.50	5.00-8.00	6.50-14.00	9.50-14.00	9.00-12.00

a. Interest rates shown before 1972 are those of the Ceylon Savings Bank and the Savings Certificates Fund.

Source: Central Bank of Ceylon Bulletin, March 1977.

Table 8.2

DEPOSIT MOBILIZATION BEFORE DEREGULATION

(in Million Rs.)

End of Period	Savings Deposits		Fixed Deposits		Annual Growth Rate of Savings and Fixed Deposits			
					National Savings Bank		Commercial Banks	
	National Savings Bank	Commercial Banks	National Savings Bank	Commercial Banks	Savings Deposits	Fixed Deposits	Savings Deposits	Fixed Deposits
1970	707.2 [a]	534.8	0.5 [a]	633.7	19.4	n/a	42.4	3.9
1971	831.7 [a]	615.0	25.0 [a]	702.3	17.6	n/a	15.0	10.8
1972	913.0	610.6	55.6	914.4	9.8	122.4	-0.7	30.2
1973	1043.2	749.6	103.7	662.2	14.3	86.5	22.8	-27.6
1974	1244.1	857.4	172.4	803.4	19.3	66.2	14.4	21.3
1975	1413.7	947.4	249.7	780.8	13.6	44.8	10.5	-2.8
1976	1580.3	1216.1	307.6	975.3	11.8	23.2	28.4	24.9

a/ Savings Deposits shown before 1972 are those of the Post Office Savings Bank and the Ceylon Savings Bank.

Source: Central Bank of Ceylon Bulletin, March 1977.

Table 8.3

DEMAND FOR BANK CREDIT AND CENTRAL BANK REFINANCING CREDITS BEFORE DEREGULATION: 1970-1976

(in Million Rs.)

Item	1970	1971	1972	1973	1974	1975	1976
Central Bank Refinancing Credits to Commercial Banks	-	168.5	95.5	208.0	654.5	526.9	333.5
Loan/Deposit Ratio (%)	64.6	70.2	65.9	71.1	92.7	97.8	86.0
Bank Rates (%)	6.50	6.50	6.50	6.50	6.50	6.50	6.50
Loans and Advances	1547.7	1765.5	2159.4	2252.1	3296.7	3533.0	4250.8

Source: Central Bank of Sri Lanka, Annual Report, various issues.

III. Major Features and Nature of Deregulation

Prior to 1977, policy measures (e.g., in the sixties) were aimed at tightening monetary and credit conditions. Accordingly, direct controls on commercial bank credit became one of the important instruments used along with the introduction of quantitative restrictions on imports. On the whole, during the period 1960-1977, administrative types of monetary and credit policy measures were pursued to remedy balance of payments difficulties and to eliminate domestic price instability due to excessive credit expansion. However, following the economic reforms of 1977, some regulations affecting the financial sector were either removed or relaxed. Consequent to the liberalization, commercial banks were given a greater degree of freedom in foreign exchange transactions. Effective November 1977, Sri Lanka departed from the practice of adopting a multiple exchange rate system through the unification of the exchange rate. Since then, the Sri Lankan rupee was allowed to float in the exchange market vis-a-vis the other foreign currencies. With the introduction of the unified exchange rate, the commercial banks were allowed to square their foreign exchange position among themselves or with the central bank. They were allowed to carry out most of these transactions without the prior approval of the Exchange Control Department. Moreover, since 1977, they were given an increasing degree of freedom in determining their buying and selling rates on various foreign currency instruments. At present, the central bank announces the buying and selling rates in respect of U.S. dollars, applicable to transactions with the commercial banks. Commercial banks can determine on their own the buying and selling rates for foreign currency instruments including telegraphic transfers.

The other salient feature with respect to commercial banking after deregulation was the departure from the hitherto accepted policy of not encouraging foreign banks to open branches in the country. Under the new economic policies, foreign banks were invited to commence business in Sri Lanka. Accordingly, three new foreign banks opened branch offices in Sri Lanka during 1979. They were allowed to open only two branches with the approval from the Ministry of Finance and Planning; one in Colombo and one in the Free Trade Zone. In 1982, two foreign banks were allowed to open branches in outstations. This enabled them to enter the field of rural banking. Another innovation in commercial banking in Sri Lanka was the launching of the Foreign Currency Banking Scheme (FCBS) which enabled the establishment of Foreign Currency Banking Units (FCBUs) in the country.

These units were permitted to deal in foreign currency only with non-residents, approved residents and Greater Colombo Economic Commission (GCEC) enterprises only. However, on-shore operations of these units were restricted by the central bank to transactions carried out with the approved residents and GCEC enterprises. The FCBUs are subject to periodic supervision of the central bank.

Commercial banks and finance companies were also allowed to mobilize more deposits by issuing Certificates of Deposits (CDs), a novel instrument to the money market. However, limits on the amount of CDs issued and outstanding were imposed by the central bank since the introduction of the CDs in 1981. But effective August 1986, the limits applicable on the commercial banks were also withdrawn.

In early 1984, the NSB was given the freedom to fix their own deposit and lending rates, and there was less intervention by the authorities in the determination of interest rates since 1984. Its lending business is rather limited and the bulk of funds is invested in government securities.

Another most important deregulatory move adopted by Sri Lanka is the less reliance place by the monetary authorities on quantitative credit restrictions and the shift towards more market-oriented measures. In this respect, intensification of the open market operations, particularly in the Treasury bill market, was noteworthy. The new regulatory policy stance with regard to open market operations (OMO) was to allow the rate of return on Treasury bills to move in line with market conditions. An additional measure initiated to make Treasury bills more attractive to the public was the opening of the repurchase window at the central bank for the purpose of discounting Treasury bills prior to maturity. Similarly, taking into account the changes in market conditions, interest rates and maturity periods of government securities were revised during the year 1988.

Nevertheless, commercial banks are still subject to certain regulations. The regulatory measures adopted in respect of commercial banks are more intensive than those imposed on other financial institutions. For instance, reserve requirements and other intensive regulatory measures are not imposed on other financial institutions. Although the foreign banks were allowed to enter other areas of banking activities, rural banking continued to be in the hands of domestic banks. However, in 1982, two foreign banks were allowed to open branches in two provincial towns enabling them to engage in rural banking activities. Further, the regulatory policy instruments had also to be directed towards curtailing excess liquidity and expansion of credit to the private sector. Several restrictive measures had to be introduced to absorb the excess liquidity by imposing credit ceilings on commercial bank lending and also imposing a Reserve Tranche System on incremental deposits, thus, strengthening the increase in reserve ratios.

However, in February 1986, commercial bank credit for industrial purposes was again exempted from credit restrictions imposed in 1984. In other words, with effect from 28 February 1986, commercial banks were not required to maintain marginal reserves under the Reserve Tranche System on incremental deposits (special reserves), which were required to be maintained as from 23 November 1984. Further, the introduction of a Secondary Treasury Bill (STB) market by the central bank in April 1981 was a significant move towards the development of a sub-market on Treasury bills. The movement of funds to and from this market has been corollary to the transactions in the interbank call money market. Therefore, these different levels of regulatory and deregulatory measures clearly indicated that the financial system is partially deregulated.

IV. Effects of Deregulation

IV.1 Effects on Mobilization on Resources

The low interest rate policy that existed during the period before 1977 did not induce the financial institutions to function competitively in regard to deposit mobilization. In view of this situation, the higher interest rate policy was introduced. It may be recalled that one of the major objectives of the deregulatory moves undertaken in 1977, particularly the interest rate reform, was to provide an incentive to increase financial savings. Since the suppression in the financial system was eased following the deregulatory moves, deposit mobilization efforts of the banking sector gained momentum. Competition for deposits between commercial banks and finance companies was also remarkable. Finance companies competed with commercial banks for short-term lending. Considerable growth in deposits mobilized by commercial banks, savings banks and finance companies was also noted. To a certain extent, market forces were allowed to determine interest rates.

During the period ending December 1978, total time and savings deposits of the non-bank private sector with commercial banks and the National Savings Bank (NSB) rose significantly as compared to the amount during the pre-deregulation period (Table 8.4). The average monthly rate of accumulation of time and savings deposits with the commercial banks very nearly doubled from Rs. 77 million during the pre-interest reform period to Rs. 146 million in the post-interest reform period. Although deposit mobilization has been successful as a result of the provision of incentives to increase the financial savings, as anticipated, the upward revision of short-term interest rates triggered off an increase in the deposit and lending rates of commercial banks, which was followed by an upward movement in the rate on interbank call loans.

Further, since the formation of NSB, a steady increase in savings deposits as well as in fixed deposits was observed. Savings deposits with the NSB doubled from Rs. 913 million in 1972 to about Rs. 2030 million by the end of 1979 (that is just after the deregulatory moves of 1977). Fixed deposits rose from Rs. 55 million in 1972 to about Rs. 2194 million in 1979 (see Tables 8.2 and 8.4). This dramatic increase was mainly due to the attractive rates of interest offered for fixed deposits since 1977, which rose sharply from 7.5 per cent in 1976 to a range of 12.0 to 18.0 per cent in 1977 (Table 8.5). In Sri Lanka, however, savings deposits rates of the NSB did not follow closely with the rates of the commercial banks. The savings deposits rates of the NSB far exceeded the rate of the commercial banks over the period 1971 to 1977 (see Table 8.1). Similarly, finance companies provided the most attractive rate of return on deposits. These are the main factors which have induced the growth of deposit mobilization. By the end of December 1987, the NSB had Rs. 5172 million in savings deposits and Rs. 11182 million in fixed deposits. The total deposits of the finance companies too rose from Rs. 410 million in 1980 to Rs. 4772 million in 1986 (see Table 8.4). Therefore, the impact of deregulatory moves in the mobilization of deposits was remarkable. For the first time, the interest rates succeeded in reflecting the market conditions.

A remarkable increase in time deposits was also oberved particularly in reflecting the responsiveness of deposits to interest rate deregulation. Despite the successful mobilization of deposits during the initial few years of the period of deregulation, the rate of growth of time and savings deposits (quasi-money) of the private sector held with the commercial banks, however, decelerated to 11.0 per cent in 1985 from 18.0 per cent in 1984. Moreover, the downward revision

Table 8.4

MOBILIZATION OF DEPOSITS
AFTER THE DEREGULATORY MOVE: 1977-1987

(in Million Rs.)

Year	Savings Deposits			Fixed Deposits			Deposits with the Finance Companies
	National Savings Bank	Commercial Banks	Total	National Savings Bank	Commercial Banks	Total	
1977	1727.3	1645.1	3372.4	771.5	1796.4	2567.9	181.1
1978	1825.0	1846.0	3671.0	1265.4	3179.5	4444.9	146.6
1979	2029.5	2308.6	4338.1	2193.8	5200.4	7394.2	178.5[a]
1980	2146.0	2509.6	4655.6	2758.8	8093.9	10852.7	410.6
1981	2250.9	3202.8	5453.7	3146.3	11689.6	14835.9	709.3
1982	2494.2	5087.7	7581.9	5137.2	15195.7	20332.9	1024.0
1983	2887.1	7038.6	9925.7	6546.5	17821.0	24367.5	1403.7
1984	3216.9	8984.8	12201.7	8322.6	20606.5	28929.1	2593.2
1985	3701.4	11155.2	14856.6	9479.9	22838.0	32317.9	3883.1
1986	4326.5	12211.3	16537.8	9827.9	22854.7	32682.6	4772.1
1987	5172.3	14504.4	19676.7	11181.6	25377.3	36558.9	n/a

a. Includes the operations of 27 finance companies which furnished information for 1979.

Sources: Central Bank of Sri Lanka Bulletin, various issues.
Central Bank of Sri Lanka, Review of the Economy, various issues.

Table 8.5

INTERBANK RATES AND DEPOSIT AND LENDING RATES OF COMMERCIAL BANKS AND NATIONAL SAVINGS BANK: 1977-1987

(in Percentages)

Deposit/Lending Rates	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
1. **Deposit Rates**												
a) Commercial Banks:												
Fixed Deposit Rate												
3-month	6.00- 6.75	8.50- 8.50	8.50- 8.50	8.50- 8.50	12.00-16.00	12.00-20.00	10.00-17.00	10.00-22.00	10.00-19.00	9.00-17.00	8.00-11.50	8.00-11.50
6-month	6.50- 7.00	11.00-12.00	11.00-12.00	11.00-12.00	15.00-18.00	15.00-21.50	13.00-18.50	13.00-25.00	13.00-19.00	9.00-19.00	7.50-13.00	7.00-13.00
12-month	7.00- 7.50	14.00-15.00	14.00-15.00	14.00-15.00	20.00-20.00	20.00-22.00	15.00-22.00	16.00-25.00	14.00-22.00	12.00-18.00	8.50-14.00	8.50-14.00
over 12-month	7.00- 7.50	7.00- 7.50	-	-	22.00-22.00	22.00-23.00	20.00-23.00	18.00-20.00	16.00-22.00	16.00-18.00	13.00-14.00	13.00-14.00
Savings Deposit Rate	5.50- 5.50	7.20- 7.20	7.50- 7.50	5.00- 9.00	10.00-14.00	10.00-14.00	10.00-14.50	10.00-15.00	10.00-15.00	10.00-13.50	6.00-12.00	6.00-11.00
b) Savings Institution:												
Fixed Deposit Rate	7.50	12.00-18.00	12.80	12.00-18.00	15.00-20.00	15.00-22.00	15.00-22.00	14.00-18.00	14.00-18.00	13.00-15.00	12.00-13.00	12.00-13.00
Savings Deposit Rate	7.20	8.40	8.40	8.40	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00
2. **Lending Rates**												
a) Commercial Banks:												
Secured Loans	6.50-14.00	12.50-20.00	10.00-20.00	10.00-20.00	11.00-28.00	11.00-30.00	11.00-30.00	11.00-30.00	12.00-30.00	12.00-30.00	12.00-30.00	11.50-30.00
Unsecured Loans	9.50-14.00	9.00-12.00	18.00-20.00	18.00-21.00	19.00-30.00	19.00-32.00	14.00-30.00	11.00-30.00	13.80-33.00	13.00-30.00	9.80-30.00	9.80-33.00
b) Nat. Savings Bank:												
Lending Rate	9.00-12.00	9.00-12.00	9.00-13.00	9.00-13.00	9.00-17.00	12.17	12.00-17.00	12.00-17.00	12.00-17.00	12.00-21.00	12.00-20.00	13.00-20.00
3. **Rates on Inter-Bank Call Loans**:	7.00- 9.50	9.00-11.00	21.50-25.00	15.00-18.00	15.75-18.50	20.00-37.00	14.00-15.50	11.00-14.00	12.00-12.75	11.00-14.00	-	-

Source: Central Bank of Sri Lanka Bulletin, various issues.

of deposit rates by the commercial banks on several occasions and the lower growth in income associated with the drop in external earnings during 1985 also aggravated the situation. The time and savings deposits of the other private sector constituents also decelerated from 15.0 per cent in 1984 to 13.0 per cent in 1985. Further, during the post liberalization period, the behaviour of deposits and advances was influenced by several factors and have also undergone certain changes in their pattern. This was mainly due to the liberalization of trade and payments, and permission granted to foreign banks to open branches in Sri Lanka and to carry on offshore banking facilities.

IV.2 Effects on Interest Rates

The major thrust of the in 1977 was directed at the short end of the interest rate spectrum, and the upward revisions in the bank rate provided the lead in the drive towards higher rates. The upward revision of the bank rate on the latter occasion was also combined with some restrictions on the commercial banks, so as to make the bank rate more effective in influencing the deposit and lending rates of the commercial banks. Immediately, thereafter the NSB was induced to raise its deposit rates very sharply. The rate on savings deposits of the NSB was raised by 1.2 percentage points to 8.4 per cent on 7 September 1977. Simultaneously, the rate on fixed deposits was raised sharply from 7.5 per cent to 12.0 per cent per annum for 6-month deposits, 15.0 per cent per annum for 12-month deposits, and 18.0 per cent per annum for 18-month deposits. These reforms in turn led to upward revision in the deposit and lending rates of the commercial banks. As anticipated, this upward revision of short-term interest rates triggered off an increase in the deposit and lending rates of the commercial banks. This was followed by an upward movement in the rates of interbank call loans (Table 8.6). However, the high deposit rates of the commercial banks soon percolated into their lending rates.

Deregulatory moves, such as permitting the NSB to act independently in investing and mobilizing the funds as from June 1984, resulted in a reduction in the deposit rates of the NSB itself and the other financial institutions. Such moves have helped to reduce the lending rates of commercial banks and some of the financial institutions. These moves had an impact on the change in the interbank call money market rates too. After the second stage of deregulatory moves in June 1984, the NSB was given the freedom to fix its de-

Table 8.6

THE INTEREST RATES ON SECONDARY TREASURY BILL MARKET AND CALL MONEY MARKET RATES: 1977-1987

(in Percentages)

	Interest Rates on Interbank Call Money Market (Per Annum)		Interest Rates on Secondary Treasury Bill Market (Per Annum)	
	Minimum	Maximum	Minimum	Maximum
1978	7.00	9.50	-	-
1979	9.00	11.00	-	-
1980	21.50	25.00	-	-
1981	15.00	18.00	15.00	15.25
1982	15.75	18.50	12.25	13.25
1983	20.00	37.00	12.00	12.50
1984	14.00	15.50	14.00	14.20
1985	11.00	14.00	11.30	11.50
1986	12.00	12.75	10.00	11.00
1987	11.00	14.00	7.26	11.26

Source: Central Bank of Sri Lanka Bulletin, various issues.

posit rates. Although the NSB reduced its deposit rates in several occasions commencing from July 1984, the interest rate determination adopted by the commercial banks were not influenced by the central bank (except in the case of refinance facilities extended by the bank). Commercial banks were compelled to make the necessary adjustments in their lending and deposit rates along with the developments observed in competitiveness of deposit mobilization with the NSB, excess liquidity situation with the banking system, reduced inflation rate (especially in 1985), and limited central bank accommodation at the bank rate.

It must be remembered that the increase in deposit rates of the NSB would compel the commercial banks to increase their deposit rates to compete with the NSB and attract deposits. Interest rates on lending were also reduced by the commercial banks but not by the same amount as the deposit rates were reduced. In other words, the interest rate adjustments have been asymmetrical, in that when deposit rates increased there is a corresponding adjustment in the lending rates within a negligible time period. However, when deposit rates decline, as has been experienced recently, lending rates only adjust downwards with a long time lag. Therefore, for the first time, interest rates which hitherto had failed to reflect market conditions were permitted to move in step with the general economic conditions in the country.

However, the other adverse effect of this high interest rate policy was reflected in the high lending rates, thus, affecting the loan-deposit ratios. An excess liquidity situation emerged, leading to a second round of changes in the interest rate structure in 1985. The changes in the interest rate structure in 1985 included a considerable drop in deposit rates of the NSB and the commercial banks, and a marginal reduction in selective lending rates. Due to the substantial liquidity situation and the reduction in the inflation rate, the NSB reduced its deposit rates on 1-year deposits from 18.0 to 15.0 per cent per annum and set the pace for a reduction in deposit rates. Meanwhile, the Central Bank of Sri Lanka too had to signal its interest rate policy to the money market by reducing the bank rate and lending rates of the export refinancing scheme, thereby inducing the commercial banks to bring down the level of interest rates to take into account of the decline in the rate of inflation.

Another significant feature in the monetary scenario was the continuation of the decline in the market interest rates observed since 1985. The reduction in deposit rates of the NSB, the excess liquidity situation and the decline in the inflation rate induced the commercial banks to reduce their deposit rates by a range of 1.0 to 3.0 percentage points. The decline in deposit rates together with the withdrawal, in February 1986, of the Special Reserve Tranche System (which was in force since November 1984), lowered the cost of funds to commercial banks enabling them to reduce their lending rates on advances to priority sectors.

Further, the introduction of a Secondary Treasury Bill (STB) market by the central bank in April 1981 was a significant move towards the development of a sub-market on Treasury bills. At the beginning, the impact of deregulation was positive. The interest rates of the STB followed the call money rates (see Table 8.6). However, since 1982, the central bank had to intervene in fixing the secondary bill market rates in view of the excess liquidity situation experienced by most commercial banks.

Thus, following the liberalization policies adopted in 1977, a steady increase in the rates of interest paid on deposits as well as that charged on loans and advances extended was observed. Accordingly, the rates paid on deposits rose from 8.5 to 15.0 per cent per annum in 1977 to a range of 10.0 to 25.0 per cent per annum in 1983, while rates charged on loans and advances rose from 7.0 to 20.0 per cent per annum in 1977 to a range of 11.0 to 30.0 per cent per annum in 1983 (see Table 8.5).

The adverse effect of this high interest rate policy and consequently high cost of credit were reflected in the low level of activities in the private sector. Therefore, it was considered desirable to revise the short-term interest rate downwards with a view to introducing a certain degree of flexibility in the interest rate structure, thereby enabling it to change according to economic conditions since 1983. [42] In other words, certain marginal changes were introduced to the interest rate policy since 1983. A certain degree of flexibility was also introduced with respect to the statutory reserve ratios. However, quantitative credit ceilings were reimposed from mid-1984 and statutory reserve ratios were again raised in order to absorb excess liquidity.

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42. In March 1983, the bank rate was brought down to 13.0 per cent, and the penal rate was fixed at 20.0 per cent. With effect from 23 November 1983, the practice of granting penal rate advances to commercial banks was discontinued. With effect from 30 December 1985, the central bank reduced the lending rates on its advances to 11.0 per cent. With effect from 7 August 1987, the central bank reduced the lending rates on its advances to 10.0 per cent.

V. Deregulation and Competitive Financial Environment

The year 1977 marked a new era for the banking industry in Sri Lanka. Since 1977, the banking industry has undergone rapid changes. The banks expanded their activities catering to the changing needs of the economy. The competition among banks led to a general improvement in banking services. More complex and sophisticated services were made available to customers. The commercial banks established Foreign Currency Banking Units (FCBUs) which are engaged in the provision of offshore banking services to non-residents and approved residents. The banks in competition with each other provided numerous incentives to savers, thereby attracting more deposits. Novel instruments, such as certificates of deposits (CDs), were introduced.

The FCBUs were introduced with a view to developing offshore banking activities in Sri Lanka and to cater to borrowing requirements of the entrepreneurs in the Free Trade Zone (FTZ) which was created in 1979. The number of FCBUs established with the commercial banks totalled more than 25 at the end of 1987. The major part of the operation of these units included the financing of projects in the FTZ, and Euro-currency loan syndicates. The total assets and liabilities of these FCBUs increased from Rs. 7516 million at end-December 1981 to Rs. 20405 million at end-December 1987.

Further, deregulatory moves have created a competitive environment to the NSB. The NSB has been effectively engaged in mobilizing domestic savings and channelling such savings towards economic development. The bank provided incentives, such as tax exemptions and higher interest rates to savers, thereby competing with other deposit mobilizing institutions. The savings schemes of the bank included savings accounts, fixed deposit schemes, savings certificates, gift tokens and special long-term savings schemes. The total amount of savings mobilized by the NSB amounted to more than Rs. 16000 million as at the end of 1987. Similarly, the total deposits of the finance companies too rose from Rs. 140 million in 1980 to more than Rs. 4000 million in 1987 (see Table 8.4). These finance companies are generally engaged in the business of accepting term deposits and provision of hire purchase finance. The finance companies competed with commercial banks in deposit mobilization as well as short-term lending by offering high deposit rates to customers. This has resulted in maintaining high lending rates by the companies, thereby raising the cost of funds. Similarly, the market share of deposits of deposit taking institutions, particularly the commercial banks and financial companies increased after 1983 (Table 8.7).

Prior to 1977, the accepted policy was not to encourage foreign banks to open branches in the country. A salient development in commercial banking in Sri Lanka during the late 1970s, however, was the departure from this policy in pursuance of the objective of attracting foreign investment, and the establishment of Free Trade Zone. Accordingly, there were 14 foreign banks, which established branches in Sri Lanka since 1979, raising the total number of banks to 25. The central bank played a key role in this development by designing a scheme under which the application of foreign banks to open branches were considered and processed. The removal of the limitations imposed on the foreign banks was used as a leverage to re-orientate the structure and policies of foreign banks. The intention of the central bank was, therefore, to encourage such banks to participate in financing economic development.

However, the competitive environment, by virtue of deregulation policy, is still in the initial phase. The state sector still predominates the financial system. In 1961, one of the biggest bank, the Bank of Ceylon (BOC), was nationalized. People's Bank was also established by the Government as a public sector bank. The growth and expansion of these two state sector banking institutions, together with the imposition of certain restrictions on the operations of foreign banking institutions, marked a period of rapid expansion of banking facilities during the decade of the 1960s. By the end of the decade, these two banks accounted for more than 70.0 per cent of total bank deposits and total bank advances.

The total nominal value of financial instruments reached a higher level in 1987 and the relative share of interest-bearing instruments increased from less than 80.0 per cent level before deregulation to more than 90.0 per cent in 1987. Similarly, the number of financial institutions and branches increased rapidly. Total assets too increased from just Rs. 15000 million before the deregulation to about more than Rs. 40000 million. Increased deposit rates and improved facilities relating to availability and transferability of interest-bearing assets were the major reasons for this increase. In 1985, the central bank also initiated a scheme of Regional Rural Development Banks (RRDB), which are self-contained banks.

However, in terms of competitive environment, the interbank call money market transactions are normally dominated by commercial banks. The central bank has been the major buyer in the Treasury

Table 8.7

MARKET SHARE OF DEPOSIT OF THE DEPOSIT-TAKING INSTITUTIONS: 1977-1987

(in Percentages)

Year	Commercial Banks	Finance Companies	Other Deposit-Taking Institutions
1977	56.7	1.5	41.8
1978	54.3	1.2	44.5
1979	67.0	5.0	25.0
1980	53.7	1.3	45.0
1981	48.2	1.3	50.5
1982	46.1	1.7	52.2
1983	44.0	1.9	54.1
1984	46.4	3.1	50.5
1985	46.7	4.0	49.3
1986	n/a	n/a	n/a

Source: Central Bank of Sri Lanka, Country Chapter of SEACEN Collaborative Research Project on Capital Market, 1987.

bills market as the participation of commercial banks and non-bank public has been marginal. Nevertheless, with the introduction of a secondary market in April 1981, the Treasury bills market was activated by letting the Treasury bill yield be determined by the market forces and continuing with the weekly issue of Treasury bills in the primary market. As a result, there has been significant changes in the Treasury bills market particularly since 1987. The commercial banks and other participants were induced to engage more in the primary Treasury bill market. The attractiveness of primary Treasury bills can also be attributed to the fall in the yield on secondary Treasury bills during the year 1987. The weekly issue of Treasury bills also provided a regular short-term investment outlet to investors. As a result, the non-central bank holdings of Treasury bills increased significantly. For instance, the Treasury bill holdings of the non-central bank sector expanded from 14.0 per cent at the end of 1985 to 21.0 per cent by the end of 1986 and further to around 28.0 per cent at the end of 1987.

The post liberalization period also created a favourable atmosphere increasing new instruments. The freely negotiable certificates of deposits (CDs) introduced in 1981, became the most attractive money market instruments due to their anonymity, especially for non-institutionalized and hoarded money. However, the minimum maturity period of CDs was limited to six months and the interest rates on CDs fluctuated on a large range between 13.0 to 22.7 per cent per annum. By the end of 1985, out of 20 commercial banks and 10 finance companies 19 banks and 5 finance companies had issued CDs. The total outstanding value of CDs at the end of 1985 amounted to Rs. 1168 million; consisting of Rs. 1068 million issued by commercial banks (as against Rs. 908 million in 1984) and Rs. 100 million issued by the finance companies. This indicated an increase in the value of CDs issued by the commercial banks. However, the product lines of financial instruments are still limited to some areas (Table 8.8).

VI. Problems and Issues Associated with Deregulation

VI.1 Deregulation and Selective Credit Policy

In order to ensure sufficient credit flows to the priority sector, such as agriculture, industry and exports, the authorities have introduced special credit scheme at concession ary rates of interest. Under these credit schemes, the banks and other credit institutions are provided with refinance facilities at relatively lower rates of

Table 8.8

COMPARATIVE INFORMATION OF THE PRODUCT LINES OF COMMERCIAL BANKS AND OTHER FINANCIAL INSTITUTIONS

	Product	Commer. Banks	Expanded Commer. Banks	Finance Cos.	Savings/ Thrift Insts.
1.	Transaction Account	/			
2.	Demand/Savings Account	/			
3.	Fixed Account	/		/	/
4.	NCDs				
5.	Deposit Substitutes				
6.	Credit Cards				
7.	ATM				
8.	Travellers Cheque	/			
9.	Home Mortgage	/			/
10.	Personal Loans	/			
11.	Consumer Loans	/			
12.	Underwriting				
13.	Brokerage				
14.	Equity Participation or Investment				
15.	Other Securities Activities	/		/	
16.	Promissory Notes				
17.	Treasury				
18.	Factoring				
19.	Money Market Involvement				
20.	Capital Market Involvement				
21.	Real Estate Lending	/			
22.	Commercial Lending	/		/	
23.	Merchant Banking				
24.	Mortgage Lending	/			
25.	Consumer Lending	/		/	
26.	General Insurance Broker				
27.	Life Insurance Broker			/	
28.	Pension Fund Management				
29.	Discount Broking				
30.	Investment Management				
31.	Off-Shore Services				
32.	Unit Trust Managers				
33.	Insurance Underwriting				
34.	Others				

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Central Bank of Sri Lanka, 1987.

interest but subject to certain conditions. Loans to the priority sectors are treated as conditional credit and the on-lending rates are pre-decided by the institutions which provide refinance. Therefore, interest rates on those credit schemes have no significant influence on the deregulatory moves. Nevertheless, some inconsistencies have been prevailing regarding the coordination between selective credit policy and deregulation.

It may be recalled that, against the background of the excess liquidity situation, several restrictive measures had to be introduced during the year 1984. But the positive impact of these restrictive measures was seen to be confined to non-priority sector only. Thus, in order to mitigate the adverse impact of these restrictive policies on the productive sector, certain concessions were granted to priority areas. This policy of preferential treatment generated some distortions in the total credit flow to the economy. Credit demand could not take momentum which in turn further aggravated the situation of excess liquidity despite the successful savings mobilization as a result of the deregulation policy.

For instance, with the intention of bringing down lending rates for priority sector lending, the Central Bank of Sri Lanka announced, on 30 December 1985, a two percentage point reduction in the bank rate from 13.0 to 11.0 per cent and on all refinance rates available to the commercial banks and other participating institutions except those in respect of loans for cultivation and agricultural product marketing facilities. These reductions were expected to induce commercial banks to bring down lending rates. But the continuation of credit ceilings introduced in 1984 and other restrictive policy measures introduced during 1984 resulted in a decline in bank credit. Despite the exclusion of export and agricultural credit from credit ceilings, the outstanding credit granted for such purposes lagged behind the target throughout the year due to poor loan recovery rates.

VI.2 Deregulation and Excess Liquidity

One of the adverse effects of financial reforms was the excess liquidity position of the financial system. However, the excess liquidity situation may not be totally attributed to the deregulatory moves. Excess liquidity was a common feature even before and after the deregulation in 1977. There were certain years during which the excess liqudity could be attributed to favourable export prices and increased domestic expenditure. From the beginning of 1972, the financial system was facing an excess liquidity problem. Nevertheless, the commercial banks experienced an excess liquidity position to a greater extent in the eighties, particularly in 1982, 1983 and 1984 (Table 8.9). The existence of excess liquidity with the commercial banks at certain times, however, has affected the effectiveness of open market operations (OMO) as a market-oriented instrument in achieving monetary and credit targets.

The impact of excess liquidity situation experienced by most banks was also reflected in the reduced level of transactions and a drop in interest rates in the interbank call money market, particularly, since the third quarter of 1984 (Table 8.10). The transactions in the interbank call money market dropped substantially. For instance, the total outstanding amount of interbank transactions in the call money market dropped from Rs. 1405 million in 1984 to Rs. 777 million in 1986. Similarly, total lendings/borrowings decreased from Rs. 28166 million in 1984 to Rs. 20036 million in 1986. [43]

The low level of financial activities in the private sector is also reflected in the declining loan growth rate and loan/deposit ratio, particularly, after 1983 (Table 8.10). Therefore, against this background of excess liquidity situation, several restrictive measures had to be introduced during the year 1984 to contain undue credit expansion by commercial banks to the private sector and absorb the excess liquidity in the system which otherwise would have created an inflationary pressure in the economy. Accordingly, credit ceilings were imposed in two stages. Firstly, a credit ceiling on outstanding commercial bank credit to the private sector on non-essential imports was imposed on 23 March 1984. Secondly, effective 16 May 1984, an overall credit ceiling was placed on commercial bank lendings, excluding those of exports and agriculture, instructing banks not to exceed their outstanding loans and advances by more than 5.0 per cent as on 11 May 1984. Also in March 1984, a ceiling of Rs. 400 million was placed on refinance provided for marketing activities to the Paddy Marketing Board at 3.0 per cent, which was raised by Rs. 100 million at 5.0 per cent in September. Therefore, again quantitative credit ceilings had to be imposed from mid-1984 and Statutory Reserve Ratio (SRR) had to be raised in order to absorb excess liquidity (Table 8.11).

Further, two major steps to absorb excess liquidity in the economy had to be initiated. A Reserve Tranche System was introduced from 14 November 1984 on incremental deposits strengthening the increase in reserve ratios effected in December 1983. The central

43. Central Bank of Sri Lanka, Review of the Economy, 1986, p. 311.

Table 8.9

EXCESS LIQUIDITY OF COMMERCIAL BANKS: 1978-1987

(in Million Rs.)

Year	Required Reserves	Actual Reserves	Excess Reserves
1978	682.1	737.8	55.7
1979	926.0	966.0	40.0
1980	1221.3	1263.7	42.4
1981	1694.7	1846.3	151.6
1982	2067.2	2243.6	176.4
1983	3244.2	3413.2	169.0
1984	3793.1	4025.5	232.4
1985	5736.6	5823.2	86.6
1986	5380.0	5373.3	6.7
1987	4594.3	4427.3	-167.0

Source: Central Bank of Sri Lanka Bulletin, June 1988.

Table 8.10

LOAN-DEPOSIT RATIO AND INTERBANK CALL LOANS RATES: 1978-1987

(in Percentages)

Year	Loan-Deposit Ratio [1]	Interest Rates on Interbank Call Loans		Loan Growth Rate [2]
		Maximum	Minimum	
1978	99.8	9.5	7.0	49.4
1979	96.8	11.0	9.0	34.7
1980	98.3	25.0	21.5	43.8
1981	98.9	18.0	15.0	22.5
1982	92.0	18.5	15.8	20.3
1983	92.6	37.0	20.0	24.3
1984	89.7	15.5	14.0	11.1
1985	87.0	14.0	11.0	9.4
1986	89.7	12.8	12.0	7.2
1987	93.7	14.0	11.0	18.7

1. Loans and advances as a percentage of total deposits.
2. Refer to commercial banks credit.

Source: Central Bank of Sri Lanka Bulletin, June 1988.

Table 8.11

STATUTORY RESERVE RATIO (SRR) REQUIREMENT
(in Percentages)

Type of Liability	Effective Date	SRR Rate
Demand Deposits	1981-06-19	14
Time & Savings Deposits		6
Demand Deposits	1983-12-02	16
Time & Savings Deposits		8
Total Unused Balance of Overdrafts Allowed	1983-12-16	16
Demand Deposits	1985-08-09	18
Time Deposits (not exceeding 90 days)		12
Time Deposits (not exceeding 90 days)		10
Savings Deposits		10
Special Deposits		10
Total Unused Balance of Overdrafts Allowed		16
Time Deposits (not exceeding 90 days)	1985-09-13	14
Total Unused Balance of Overdrafts	1987-06-05	nil
Demand, Time and Savings Deposits	1987-08-07	10
Demand, Time and Savings Deposits	1988-02-26	13

Source: Central Bank of Sri Lanka Bulletin, June 1988.

bank also issued its own securities in terms of Section 91(1)(b) of the Monetary Law Act. Therefore, in the midst of deregulatory policy, the regulatory policy instruments had to be introduced with the aim of curtailing excess liquidity and (undue) expansion of credit, in particular, to the private sector.

Although, the central bank continually intervened in fixing the secondary bill market rates in view of the excess liquidity situation experienced by the commercial banks, the banks again experienced excess liquidity situation during 1985 and 1986. It was primarily due to the heavy domestic expenditure of the Government. Moreover, the inability of the banks to lend to non-priority sectors due to credit restriction and the sluggish demand for credit (due to high lending rates) from the private sector also augmented the excess liquidity situation. The reduced demand for credit and the restrictive credit policy measures resulted in the average loan/deposit ratio of commercial banks fluctuating between 85.0 and 89.0 per cent in 1984 as against the range of 90.0 and 93.0 observed in the previous year (see Table 8.10). The restrictive policy measures introduced in 1984 had to be continued during 1985 and 1986 in order to contain the excess liquidity situation.

VII. Move Towards Re-regulation

While the deregulatory measures were successful to boost the mobilization of resources, the rate of growth of time and savings deposits (quasi-money) of the private sector held with commercial banks decelerated after 1984. Moreover, the downward revision of deposits rates by commercial banks on several occasions during the year caused this situation. Time and savings deposits of the other private sector constituents too decelerated.

Further, in view of the increased liquidity situation, primarily resulting from an expansion in the reserve money base due to heavy reliance of the Government on central bank credit since 1985, the regulatory policy during 1986 had to be directed at mopping up excess liquidity while restraining credit expansion for non-priority sectors. The central bank had to continue to issue its own securities.

With a view to absorbing excess liquidity, the central bank had to increase the statutory reserve ratios on all deposits. In other words, the regulatory policies continued to be restrictive to cope with the excess liquidity situation. Credit ceilings imposed on private sector credit and high reserve ratios imposed on incremental deposits of commercial banks during 1984 continued to be in force in the latter years.

After 1979, the central bank had to introduce some direct controls, like liquidity ratio, restriction on credits for imports, etc., over finance companies. With the rapid growth of deposit-taking finance companies, action was taken to enable the central bank to exercise a measure of control over such companies by the enactment of the Control of Finance Companies Act, No. 27 of 1979. The Act vested the central bank with certain power to regulate the operations of these institutions, the supervision of NBFIs, especially the finance companies. Finance companies were, therefore, no longer free from central bank regulations as was the case before 1979. Since December 1979, they were subjected to the statutory liquidity ratio as specified by the central bank. In 1980, in terms of the Control of Finance Companies Act, No. 27 of 1979, the large finance companies were also required to register with the central bank. The considerable impact on the monetary and banking system, and the need to ensure liquidity and solvency of these companies were the main motives behind reregulation.

It may be recalled that in 1985, the central bank extended its supervisory role over the finance companies by stipulating credit restrictions that were similarly imposed on commercial banks in 1984. With effect from 21 January 1985, finance companies were also informed that their loans and advances granted for the import of non-essential goods should not exceed such advances granted and outstanding as on 18 January 1985. The lending capacity of the finance companies was further regulated by imposing a higher liquidity ratio. Accordingly, finance companies are required to maintain a liquidity ratio of 15.0 per cent of deposits received and outstanding on any particular day, with effect from 1 June 1985.

The central bank has also evolved a new Banking Act with far reaching powers, which will enable it to have a better supervision and control over commercial banks. Although there were legal provisions relating to banks, these were somewhat loose and piecemeal in nature. Therefore, a new Banking Act came into operation on 16 September 1988. The object of the new legislation is to ensure that prudential standards are kept high and that bank activities progress in a systematic manner.

Some of the more important features of the new Banking Act are:

- A full-fledged bank licensing system;

- Capital and liquidity requirements for banks; and,

- Full disclosure of financial information by banks.

Appendix 8

Some Major Regulatory and Prudential Measures (1976-1986)

Description of Regulations	Effective Date
1. Entry of Foreign Banks	
Before 1977, foreign banks were not permitted to open their branches in Colombo.	1975-1977
2. Interest Ceilings	
. Before 1977, low interest rate ceilings were imposed; and quantitative credit restriction became the norm of regulatory policy.	May 1974
. Interest rate ceilings on deposit rates were also imposed on finance companies.	August 1982
3. Prime Rate	
Prime rate for commercial banks was published.	January 1986
4. Credit Ceilings	
. The credit ceilings on commercial banks were introduced in two stages.	March 1984 and May 1984
. Credit ceilings to private sector were imposed prior to February 1986. [a]	1985-1986
5. Loan Limit	
A level of borrowings by the commercial banks from the central bank was set for a limit of 8.0 per cent.	1975-1977

a. The credit ceilings to private sector were withdrawn from February 1986.

Description of Regulations	Effective Date
6. Limits on Certificates of Deposits	
Limits were imposed on certificates of deposits (CDs) issued and outstanding with commercial banks. [b]	Before 25 August 1986
7. Reserve Requirements [c]	
. Reserve requirements were revised.	1981-1983
. A reserve tranche system was introduced.	November 1984
. The commercial banks were required to hold one-eighth of reserves against their time and savings deposit liabilities in the form of Development Finance Corporation of Ceylon (DFCC) bonds.	August 1985
. Ratio of Reserve requirements was again revised.	Aug./Sep. 1985
. A special tranche was imposed. [d]	1985
8. Credit Restriction on Finance Companies [e]	
Credit ceilings were imposed on finance companies.	January 1985
9. Liquidity Ratio	
. Finance companies were required to maintain a liquidity ratio of 10.0 per cent, and also required to maintain 3.0 per cent of their intended deposit liabilities in the form of treasury bills and government securities.	1984

b. The limit was withdrawn effective 29 August 1986.

c. In order to further reinforce the contractionary monetary policy, the statutory reserve requirements was raised by 3 percentage points to 13.0 per cent effective 26 Febraury 1988. This was further raised by 2 percentage points to 15.0 per cent in 16 September 1988.

d. The special tranche system was withdrawn as from February 1986.

e. The central bank was vested with certain additional powers by regulations in terms of Section 5 of the Public Security Ordinance in June 1988. Under the Provision of the Finance Companies Act No. 78 of 1988, the powers of the Monetary Board has been further enhanced.

Description of Regulations	Effective Date
. The lending capacity of the finance companies has been further restricted by imposing a higher liquidity ratio of 15.0 per cent.	June 1985
10. Priority Loans	
Finance companies were required not to exceed their loans and advances (granted for the importation of non-essential goods) from the level of such advances granted and outstanding as at 18 January 1985.	January 1985

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Central Bank of Sri Lanka, 1987.

Chapter 9

Financial Deregulation in Thailand

I. Rationale and Objectives of Deregulation

Interest rates continued to dominate the banking scene in Thailand. The main objective of interest rate deregulation in Thailand has been the gradual liberalization of the interest rate structure, keeping in mind the requirement for a positive real return on deposit and lending rates as close to the market sentiments as possible, including lending to the public sector. However, with regard to interest rate policy, the Bank of Thailand (BOT) directly sets ceilings on deposit and lending rates of commercial banks, finance companies and credit fonciers. In this context, several monetary and banking measures were introduced to promote a sound financial structure and to encourage more competitiveness among financial institutions. For instance, after the second oil shock, interest rate policy was moved towards a more liberal regime in order to achieve more flexibility in the domestic interest rate system and also to encourage financial institutions to make more use of the market mechanism in competing for new financial savings.

In 1980, the ceiling on lending rates of financial institutions was freed from 15.0 per cent per annum limit imposed by the Civil and Commercial Code Section 654, which came into effect in 1929. This adjustment was made in view of the changing financial conditions, particularly in the international market.

The rationale and objectives of deregulation of interest rates was: "to increase the financial system's ability to cushion the effects of rapid changes which occurred in both domestic and international economies in a more flexible manner." The deregulatory moves were also motivated by the following factors:

- Subsidized interest costs generally resulted in negative real rates, being far below the market-clearing levels. These in turn penalized savers and benefitted the intensive users of capital; and,

- The need for the freeing of interest rate ceilings and exchange rate fixation as a means to fully mobilize domestic financial resources, so as to rationalize their uses. But its application has to be done with caution to allow some time for initial adjustment.

II. Circumstances and Conditions for Deregulation

The move towards deregulation in the financial system of Thailand was basically anchored to the interest rate policy. The flexibility towards interest rate policy has been apparent since 1979. The tight monetary condition that prevailed at various intervals, during 1979 to 1981, necessitated the adoption of a more flexible interest rate management which was evidenced by frequent and substantial upward adjustment in ceilings on loan and deposit rates of financial institutions. While the financial systems of certain SEACEN countries were hovering on the free market end of the spectrum, government interventions remained an important feature of Thai financial markets. However, the latitude for intervention was constrained in many areas by the government's overall policy objectives of economic stability and growth.

Although the authorities imposed interest rate ceilings, these ceilings could not be set so low as to push the domestic deposit rates or the lending rates to prime borrowers much below the corresponding international rates. Due to the free convertibility of the currency, such a disparity would induce capital flows that would worsen the mobilization of financial resources and threaten the stability of the Baht. In other words, if deposit rates were set too low, savers would be induced to place their deposits overseas, reducing the pool of domestically available resources and running down foreign reserves. Low lending ceilings would either pressure banks to lower the deposit rates to maintain their spreads, sending depositors overseas or to squeeze the profitability of domestic lending operations. Such a profit squeeze would cause the banks to restrain their domestic lending, and shift towards greater net foreign lending. Moreover, borrowers who obtain credit would find it profitable simply to deposit the funds abroad. Thus, low interest rate ceilings would adversely affect the mobilization of domestic and foreign resources and would put pressure on international reserves.

It may be recalled that Thailand's financial sector is quite advanced, open and deep. Market forces, in particular, international market forces, govern the financial sector to a much greater degree than in most countries. The relative importance of the market and intervention swung back and forth during the period 1970 to 1982. Since 1970, the economy passed through episodes of relatively liberal economic policy (1970-1975) and of increasing intervention (1975-1980). Therefore, more market-oriented policies had to be implemented.

However, although interest rate policy has moved towards liberal regime so as to encourage financial institutions to make more use of market mechanism in competing for new financial savings, the present situation clearly indicates that the financial system is not yet flexible in adjusting interest rates. The rigidity in interest rates is clearly apparent (Table 9.1). The commercial banks enjoy a large spread between interest rates on deposits and loans (Table 9.2).

Institutional arrangements in which specialized financial institutions play an important role in providing credit to priority sectors kept interest rates lower than the market levels. This may affect, to some extent, the efforts to move towards a flexible interest rate system. It is not, however, certain whether institutional arrangements, whereby priority sectors are provided with concessional credit have been the main deterrents towards a more flexible interest rate system. Despite the indication of the Bank of Thailand to see a more flexible interest rate system, the fear of aggressive competition for deposits by the banks by undercutting each other, may be one of the obstacle towards complete deregulation of the interest rate system. The slowness on the part of financial institutions in adapting to the new flexible interest rate policy can also be regarded as one of the main obstacles towards a complete deregulatory policy. In other words, the excess liquidity and the in flexibility of the financial system in adjusting interest rates by making more use of the market mechanism during the initial period of flexible interest rate policy were the major factors affecting the deregulatory policy.

III. Major Features and Nature of Deregulation Policy

Interest rate structure is the major area of deregulation in Thailand. The interest rate system operates under a number of Acts. According to the Financial Institution Loan Interest Act, [44] the

44. Financial Institution Loan Interest Act, B.E. 2523, Section 4.

Table 9.1

LENDING RATES DEVELOPMENTS: 1970-1986
(in Percentages)

Year	Inter-Bank Rates	Commercial Banks				Finance Companies
		Prime Lending Rates	Loans to Industrial Enterprises [1]	Loans for Exports	Others [2]	Loan Rates
1970			12.0	9.0	14.0	
1975			12.5	15.0	15.0	
1980	16.55		18.0	18.0	18.0	20.0
1981	14.29		19.0	19.0	19.0	21.0
1982	11.99		19.0	19.0	19.0	21.0
1983	14.94		17.5	17.5	17.5	19.5
1984 [a]	10.97	16.5	17.5/19.0	17.5/19.0	17.5/19.0	21.0
1985	15.03	15.5	17.5/19.0	17.5	17.5/19.0	21.0
1986	6.35	12.0	15.0	15.0	15.0	18.5

1. For manufacturing industry the ceiling of 17.5 per cent is applied.
2. 17.5 per cent ceiling rate is applied for lending to other priority sectors comprising mining and quarrying and agriculture including wholesale trade of agricultural produce.

a. As from 5 March 1984, the interest rates and discount rates on loans and bills extended to four types of undertakings, i.e., agricultural, industrial, exports and trading of agricultural products, remained unchanged at 17.5 per cent per annum.

Sources: Bank of Thailand, Quarterly Bulletin, various issues.
SEACEN Economic Survey Questionnaire Replies, various years.

Table 9.2

INTEREST MARGIN: 1977-1986

(in Percentages)

Year	Deposit Rates [1]	Lending Rates [1]	Margin
1977	8.00	15.00	7.00
1978	8.00	15.00	7.00
1979	8.25	15.00	6.75
1980	12.00	18.00	6.00
1981	12.50	19.00	6.50
1982	13.00	19.00	6.00
1983	13.00	17.63	4.63
1984	13.00	18.75	5.75
1985	13.00	19.00	6.00
1986	9.75	n/a	n/a

1. Refers to period averages.

Source: IMF, and International Financial Statistics, Yearbook 1988.

Ministry of Finance has been empowered to prescribe maximum rates of interest [45] over and above the ceiling limit imposed by the Civil and Commercial Codes chargeable by the financial institutions, with the recommendation of the Bank of Thailand. Accordingly, the ceiling on lending rates of financial institutions was freed from 15.0 per cent per annum limit imposed by the Civil and Commercial Code, and the commercial banks were left to initiate the changes in loan rates under the new prescribed ceilings in accordance with market conditions and direction of the authorities.

Moreover, since 1979, finance companies have been allowed to lower the minimum amount of borrowing from the public by issuing promissory notes from not less than B. 50,000 in Bangkok and nearby provinces to B. 10,000 and not less than B. 5,000 for other areas. Effective 15 January 1980, the maximum rate of interest or discount rate chargeable was adjusted to not exceeding 18.0 per cent per annum, and effective 1 July 1981, it was raised further to 19.0 per cent per annum. Similarly, in 1986, the credit foncier companies were also allowed to reduce maturity period of such promissory notes from 3 years to 1 year without any premature redemption.

Freeing of ceiling loan rates was, perhaps, one of the first and most important step towards this flexibility. Adjustments in ceilings on deposit and loan rates were subsequently frequent and in line with developments in the financial markets. The adjustments were supplemented by the liberalization of interest rates applied to certain activities, e.g., import refinancing, and foreign currency deposit taking. Direct intervention, i.e., ceiling adjustment, has been kept to a minimum so as to allow interest rates to promptly change in line with market conditions. Recently, the interest rate for long-term fixed deposits with maturity of over one year has been floated with the aim of creating more flexibility in the financial market and also at mobilizing more savings. Nevertheless, with regard to the interest rate policy, the Bank of Thailand directly sets ceilings on deposit and lending rates of commercial banks, finance companies and credit fonciers, and also cooperates with other government agencies in setting the maximum lending rates for other institutions, which are normally lower than the rates charged by commercial banks, since those specialized institutions were set up to provide credit to priority sectors. However, such institutions may independently alter the rate of interest on both deposit and lending according to their

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45. Civil and Commercial Code, Section 654.

respective liquidity positions while keeping within the limit of ceiling.

Apart from the deregulation of the interest rate policy, the move towards deregulation in the Thai financial system was also anchored to the foreign exchange rate policy. As it could be seen, a flexible exchange rate regime was introduced in November 1984, since then, the exchange rate has been rendered more flexible by being aligned with a basket of currencies on a day-to-day basis.

In spite of the excess liquidity and the inflexibility of the financial system in adjusting interest rates by making more use of the market mechanism, commercial banks were also given freedom to operate seven more businesses which will earn them more revenue and expand their client services. As the current economic climate has changed dramatically from the past, the permission for commercial banks to operate more businesses was designed to enable them to adjust their operations in order to cope with the changing situation, and to make them more flexible and help them expand their client services. The permission was granted under the authority of Article 9(bi) on the amended Commercial Banking Act in November 1987.

Commercial banks are now allowed to lease, for commercial purposes, fixed assets which they possess for use in their operations, but which have not been fully utilized. These include office buildings, parking lots and warehouses which banks use for collateral storage. Although the Commercial Banking Act prohibits a bank from holding more than 10.0 per cent share in a private company, the Bank of Thailand may consider, on a case-by-case basis, where necessary, a commercial bank's request for holding more than 10.0 per cent of a private firm's stocks. The banks are also allowed to rent out property secured as collateral for loans.

For fixed assets received as loan payments, the banks must sell these within five years as stipulated by law. However, if they want to lease these fixed assets to avoid depreciation, they can do so if:

- The lease is on a temporary basis and does not affect the sale of the assets. If any commercial bank fails to sell the assets as required by the law, it will face tough legal action; and,

- The leasing period must be short. For example, one year for padi fields or three years for factories and other buildings.

The banks are allowed to sell developed working programmes, including developed computer programmes, under the following conditions:

- The sale must not be part of normal business;

- The programmes must be related to the business of rendering financial services; and,

- The sales must be carried out in a manner which help the banks maximize the use of their existing resources.

Further, to enter both activities, namely, leasing fixed assets and selling computer programmes as mentioned above, each bank must seek the Bank of Thailand's permission on which additional conditions might also be imposed on a case-by-case basis. The commercial banks can act as middlemen for the insurance of assets placed as collateral for loans borrowed from them. However, the insurance deals must be agreed upon by the clients. The commercial banks may automatically offer this service to their clients without seeking further permission from the Bank of Thailand. Commercial banks can provide feasibility study services. They are also allowed to provide syndicated loans, but only in the form of funds and not in the form of arrangements for the issuance and distribution of corporate bonds, debentures, or any other debt securities. They may act as consultants for business acquisitions, mergers or consolidations, but may not arrange for the issuance of securities for the financing of mergers, acquisitions or consolidations. Finally, banks are now allowed to provide custodian services, including receiving and delivering securities, and receiving and paying dividends and benefits. However, they are not allowed to receive purchase or sell orders from clients or purchase or sell on behalf of clients. Such activities are treated as brokerage services.

Further, during the early 1984 and early 1986, interest rate ceilings for credits extended to priority sectors were set at one and a half or two percentage points lower than that for the general sectors. These differential ceilings have been abolished since March 1986. However, recently, three major changes have taken place in Thailand's banking community, namely, the re-regulation of time deposits, increased concentration of lending to specific sectors, and technological enhancement.

IV. Effects of Deregulation

IV.1 Effects on Mobilization of Resources

The adoption of a more flexible interest rate management which was evidenced by frequent and substantial upward adjustments in ceilings on loan and deposit rates of financial institutions proved an effective means to mobilize financial savings and to ensure steady inflows of foreign funds and thus, help eliminate the tight money situation. Since 1979, substantial changes in the financial system have already been noted. The money market mechanism has been improved by the establishment of the repurchase market at the Bank of Thailand in 1979. The market has significantly helped facilitate liquidity adjustment of commercial banks and subsequently other financial institutions. These adjustments proved an effective means to mobilize financial savings.

In Table 9.3, which displays the levels of financial assets held in the commercial banks by the private sector, the effects of the 1980 reforms show up markedly. Total assets grew by 32.1 per cent in real terms, from the end of 1979 to the end of 1982, and, as a share of GNP, rose to 52.6 per cent in 1982 compared to 48.4 per cent in 1979. The increase in the ceiling rates also affected the composition of asset holdings, accelerating the on-going shift into quasi-money from M1. Further between 1980 and 1984 deposits at the commercial banks also expanded by an average annual rate of 18.9 per cent. Thus, the 1980 reforms generated a significant financial deepening.

However, the outstanding issue still remains is that of interest rates. A glance at the recent past places the issue in a better perspective. The money market was highly liquid for most of 1985. However, there were periods of tight money in the short-term due to volatile exchange rates. Commercial bank deposits grew at a lower rate of 12.0 per cent and credits grew at a lower rate of 10.0 per cent, even though lending rates were adjusted downwards by 2.0 per cent from the 1984 level. The credits to deposits ratio decreased from 95.7 per cent at the end of 1984 to 93.7 per cent at the end of 1985 and further reduced to 86.7 per cent in 1986 (Table 9.4), reflecting increased liquidity in the money market. Interest rates, therefore, continued to dominate the banking scene. A move to further reduce interest rates commenced at the beginning of 1986. On 2 January 1986, the commercial banks ceiling rate for lending had to be reduced from 19.0 to 17.0 per cent per annum and that for finance and credit foncier companies from 21.0 to 19.0 per cent per annum. The

Table 9.3

LEVELS AND COMPOSITION OF FINANCIAL ASSETS: 1979-1986

End of Period	Total Assets (as a Percentage of GNP)	M1	M2
		(Percentage Changes)	
1979	48.36	15.77	14.76
1980	45.42	13.79	22.44
1981	46.88	1.71	15.57
1982	52.63	10.50	15.28
1983	60.04	4.45	23.26
1984	67.85	14.09	21.57
1985	71.33	-3.48	10.18
1986	73.57	18.60	12.84

Sources: Bank of Thailand, Quarterly Bulletin, various issues.
SEACEN Economic Survey Questionnaire Replies, various years.

Table 9.4

GROWTH OF LOANS, DEPOSITS AND LOAN DEPOSIT RATIO OF COMMERCIAL BANKS: 1975-1986

(in Percentages)

End of Period	Total Loans	Total Deposits	Loan/Deposit Ratio
1975	20.13	17.61	93.93
1980	12.23	23.62	100.84
1981	16.22	19.84	97.80
1982	17.81	24.64	92.43
1983	33.99	25.68	98.54
1984	18.26	21.77	95.70
1985	9.69	11.93	93.79
1986	4.36	12.89	86.70

Source: Bank of Thailand, Quarterly Bulletin, various issues.

ceiling rate for fixed deposits for commercial banks was reduced from 13.0 to 11.0 per cent per annum, and for savings accounts from 9.0 to 8.5 per cent per annum.

IV.2 Effects on Interest Rates

Immediate and long-term effects of the flexible interest rate policy have been favourable, i.e., as interest rates have become more responsive to market conditions, savings at organized financial institutions have accelerated substantially at the expense of those in the informal sector, while reliance on foreign savings to finance domestic investments has declined; the effective spread between loan rates and deposit rates has become narrower, and the structure of commercial banks lending rates has been changed to pave the way for the improvement of the banks asset management (Table 9.5). However, the institutional arrangement for providing credits to priority sectors at concessional rate of interest has been one of the adverse factors since it affects the efforts to move towards a complete deregulation of the interest rate system.

It may be recalled that after a couple of years of accelerated inflation, the interest rate ceilings were moved upwards and maintained even after inflation slackened. This upward ricocheting process gave rise to positive real rates. The late 1980 reforms were clearly an example of this process. Table 9.5 shows a substantial increment of the ceiling rates for deposits and general lending. Interest rates on savings deposits shifted upward from 5.5 to 8.0 per cent per annum, six-month term deposits interest rates from 7.0 to 10.0 per cent per annum, and the general loan and overdraft interest rates rose from 15.0 to 18.0 per cent per annum. These increases were sustained, and in some cases, augmented through 1981 and 1982, while inflation declined.

Conspicuously absent in 1980 was an upward adjustment of the discount rate for export bills. Also, the discount rate charged for agricultural bills unaffected by the reforms, remaining unchanged at 10.0 per cent since 1972. Despite the authorities' intentions to pursue more market-oriented rates, apparently the reform programme had its limitations.

In other words, the regime of interest rate ceilings met with somewhat limited success in adjusting to inflationary developments and maintaining positive real rates ex-post — judging from Table 9.6 which displays a selection of nominal interest rate ceilings and the corresponding ex-post real rates, for the period 1970-1982.

Table 9.5

STRUCTURE OF INTEREST RATES OF THE COMMERCIAL BANKS
(in Percentages)

Year	Call Money Rates [1]	Loans & O/D (Ceiling)		Discount Rates On: Other Bills			Prime Rates		Savings Deposits[2]
		Priority	Others	Agri.	Redis. at BOT	Others	Min. O/D Rates	Min. Loan Rates	
1978	12.0			5.0			12.0		4.5
1979	14.76			5.0			14.5		5.5
1980	16.55			5.0			16.5		8.0
1981	14.29			5.0			17.0		9.0
1982	11.99	19.0	19.0	5.0	10.0		16.0	16.0	9.0
1983	14.94	17.5	17.5	5.0	7.00	17.5, 19.0	16.5	16.5	9.0
1984	10.97	17.5	19.0	-	8.00, 9.00	17.5, 19.0	16.5	16.5	9.0
1985	15.03	17.5	19.0	-	8.00, 9.00	17.5, 19.0	15.5	15.5	9.0
1986	6.35	15.0		-	7.00	15.0	12.25	12.00	9.0

1. It was called the interbank lending rates (weighted average) from 1982 onwards.
2. As offered by four big commercial banks (ceiling rates).

Sources: Bank of Thailand, Quarterly Bulletin, various issues.
SEACEN Economic Survey Questionnaire Replies, various years.

Table 9.6

NOMINAL AND EX-POST REAL INTEREST RATE CEILINGS: SELECTED YEARS

(in Percentages)

	1970	1975	1980	1981	1982
Deposits, domestic denom.					
Demand					
Nominal	0.0	0.0	0.0	0.0	0.0
Ex-post real	-0.6	-2.6	15.3	-3.3	-5.5
Savings					
Nominal	3.5	4.5	8.0	9.0	9.0
Ex-post real	2.8	1.8	-8.5	5.4	3.1
Term, 6 months					
Nominal	6.0	7.0	10.0	11.0	11.0
Ex-post real	5.3	4.2	-6.8	7.4	4.9
Weighted average rate of return on deposits plus currency					
Ex-post real	2.4	1.8	-9.4	4.5	2.4
Lending, domestic denom.					
General loans & overdrafts					
Nominal	14.0	15.0	18.0	18.0	18.0
Ex-post real	13.2	12.0	0.0	14.1	11.6
Export (discount rate)					
Nominal	7.0	7.0	7.0	7.0	7.0
Ex-post real	6.3	4.2	-9.3	3.5	1.2
Inflation (CPI) 6 months					
Forward from December	0.7	2.6	18.0	3.4	5.8
Devaluation 6 months					
Forward from December	0.0	0.0	3.6	0.0	0.0
Inflation (CPI) over					
Prior December	-1.3	4.4	16.4	12.3	2.6

Note: Real rates were calculated ex-post, i.e., they reflect the inflation rate six months forward from December.

Source: Bank of Thailand, Quarterly Bulletin, various issues.
IMF and International Financial Statistics (IFS), Yearbook 1984.

During this period, two waves of moderately high inflation swept through the Thai economy, in 1972-1974 and again in 1977-1981. These two surges closely corresponded to the movements of world inflation, both in timing and magnitude, with the Thai inflation running a little above the world rate in the first, and approximately around the world rate in the second wave. The impact of these inflationary episodes is readily apparent in the ex-post real rates, for they moved decidedly negative during both pre-1975 and post 1975 periods.

However, in comparison with most developing countries, the regime's performance was quite remarkable, as measured by the frequency of positive real rates. Taken as a group, the year-end figures for the ex-post real ceilings rates on savings deposits, six-month term deposits, general loans and concessional export credits, were positive in most instances, for the years 1970 to 1982.

Since 1982, a high liquidity in the financial system has provided a favourable environment for the authorities' moves towards a interest rate liberalization regime and has also encouraged financial institutions to adapt promptly to this new policy framework. For example, a new lending rate, i.e., a minimum lending rate has been introduced to induce term borrowing and to discourage the use of overdraft facilities. However, the attractiveness of the new lending rate has not been apparent for bank customers as foreign interest rates remain relatively low and as collateral is still required for term borrowing. The absence of fully developed secondary markets for money market instruments and papers through which companies could adjust their liquidity position is another obstacle for promoting term lending. In addition, the funding of long-term loans of commercial banks could also run into difficulty by the lack of genuine long-term deposits. The introduction of new instrument, i.e., CDs and new type of financial institution (discount houses), are being contemplated to overcome these obstacles. The establishment of discount houses is also seen as a means to quicken the development of secondary markets for government bonds and other bills such as bankers acceptances which also emerged during the high liquidity period.

The ceiling rates for various deposit accounts in the commercial banks at the end of 1982 are shown in Table 9.7. Some spread exists between maturities, but it is questionable whether that spread was adequate to mobilize longer-term deposits. In particular, the 3.0 per cent spread between six-month and two- year deposits was probably not sufficient to cover the risk of committing funds for an additional

Table 9.7

INTEREST RATE CEILINGS ON DEPOSITS: 1982 [1]

(in Percentages)

Category	Nominal
Demand Deposits	0.0
Savings Deposits	9.0
Time Deposits	
3 to 6 months	11.0
6 to 12 months	12.0
1 to 2 years	13.0
over 2 years	14.0

1. End of year.

Source: Bank of Thailand, Quarterly Bulletin.

year and a half, especially when the inflation rate was not moderate. The banks, however, moved to reduce this risk somewhat by offering lower early-withdrawal penalties.

In comparison with the 19.0 per cent per annum ceiling rate, which binds most borrowers, and the 15.0 to 60.0 per cent per annum rates paid in the informal credit market for up to half of all credit, the preferential lending rates displayed in Table 9.8, of 7.0 to 10.0 per cent per annum, were difficult to justify on efficiency grounds. Judging from the large volume and widespread credit transacted at rates well above the preferential rates, many investment opportunities existed at rates much higher than those offered preferentially. However, the prevalence of preferential lending rates bears testimony to the adage 'that central banks in developing countries, in addition to performing conventional central banking duties as their counterparts in the industrialized world, should also undertake developmental roles'. One of the areas in which central banks can participate in development is through selective credit policy or lending to priority sectors. Priority sectors do not necessarily offer the highest returns but support is given to them on account of their contribution to the economy by creating employment and generating income to the less privileged group, promoting the development of domestic resources, and generating foreign exchange earnings to the country. It is, therefore, uncertain whether the net effect of the preferential credit programmes help direct resources to applications with the highest return. It may, however, help mitigate capital market imperfections by channelling funds to sectors which otherwise would have been left out due to capital market imperfections.

Nevertheless, it is possible to question the credit programmes on distributional grounds. By their nature, rationing schemes at below market rates tend to favour the higher income, more creditworthy borrowers in both the target and general markets. Furthermore, the suppressed cost of funds promotes investment in overly capital intensive method of production. Both of these phenomena have been observed in Thailand.

Comparing the 11.0 per cent per annum rate paid on six-month time deposits, a good benchmark for the interest cost of commercial bank deposits to the general lending ceiling rate of 19.0 per cent per annum reveals a healthy gross spread of 8.0 per cent. In contrast, the spread for concessional lending was much smaller. Since these discount rates were offered on credits, which were, in turn, rediscounted by the Bank of Thailand, the cost of these funds to the

Table 9.8

COMMERCIAL BANK LENDING RATES: 1982 [1]

(in Percentages)

Item	Nominal
Loans and Overdrafts	19.0
Discount Rates (rediscounted from the Bank of Thailand)	
Export bills	7.0
Bills from industrial undertakings	7.0
Bills from purchases of:	
agricultural products	7.0
agricultural bills	10.0

1. End of year.

Source: The Bank of Thailand, Quarterly Bulletin.

commercial banks was the rediscount rates. Thus, on credits discounted at 7.0 per cent per annum, the spread was rather small. Such a small spread was unlikely to fully cover the cost of the lending operation, and some of the costs must have been borne by the non-preferential borrowers. This transfer, in addition to the direct cost borne by the government through the central bank, must be included in an assessment of the economic cost of the funds used in the preferential credit programme.

Although the present deposit-to-lending rate margins may appear rather wide, the actual margins are in fact much narrower. The effective lending rate is substantially lower than 15.0 per cent per annum depending to a great extent on the loan portfolio of each bank, because as a general practice, different lending rates are applied to different categories of borrowers.

Nevertheless, the fundamental impact of the flexible interest rate policy was also to allow each individual bank to offer its customers a variety of choices. Regulations on time deposit interest rates, which set a single ceiling as the minimum maturity of three months and above, have allowed each individual bank to offer its customers a wider variety of choices. Practically, interest rates on deposits of 3-month and 6-month maturities have usually been set at a quarter or half a percentage point lower than those set for deposits with the conventional maturity of one year.

Customers, therefore, may decide to save their money in the form of short-term (3- or 6-month maturity with lower interest rates) or longer-term deposits (1-year and over with higher interest rates). the level of interest rates offered for each term of maturity may vary below its ceiling according to the liquidity position of each commercial bank. In addition, the difference in interest rates for each period of maturity may also be changed to comply with expectations of future interest rates. This differs greatly from the picture in the past when different ceiling rates were fixed for each term of maturity, i.e., a certain percentage per annum for one-year maturity and another one or two percentage points lower for 12-month and 6-month maturities.

The virtue of the new regulations is that it may lead to the birth of a greater market for certificates of deposits, both non-negotiable and negotiable, like those long established in the developed money markets abroad (presently, a few banks have already issued non-negotiable certificates of deposits). In future, customers shall have to be ever alert of the changing money market so as to manage properly their portfolio savings.

IV.3 Effects on Profitability of Banks

Commercial banks' profits have dropped substantially during the past few years, after the flexible interest rate policy was pursued. There has been much debate over the magnitude of this problem, especially in the face of criticism that banks have always had easy profit. It may be recalled that substantial credits have to be channelled to priority sectors. This has to be implemented by the banking institutions in spite of the low interest rates (i.e., concessional rates) that may be charged on these sectors, considerably affecting bank's profitability as credits extended by the bank to these sectors amount to as much as 70.0 per cent of total credits. However, it should be noted that concessional loan rates are only applicable to custom-ers who satisfy Bank of Thailand's requirements, the rest are charged at market rates.

Further, the bulk of these facilities have been resorted to by middle-income earners. It is nonetheless foreseen that the portion made use of by low-income earners will grow as the bank is in the process of reviewing procedures to make it easier for low-income groups to obtain home loans or to hire purchase houses.

The easy profits notion is, in the case of commercial banks, a myth. Commercial banks have to adhere strictly to the banking acts, while the controls and supervision which the Bank of Thailand exercises on them are close, constant and thorough. Operational profits which banks show and even advertise to the public are for the purpose of emphasizing their operational efficiency. This has a strong impact, especially on present and potential shareholders. This advertisement may give the impression that profits come easy for commercial banks. If this was true, one would not hear about troubled banks.

At present, commercial banks are faced with increasingly stiff competition among themselves and between them and other institutions in the organized money market. In the meantime, businessmen are better informed and consequently possess increased bargaining power vis-a-vis the bankers. It is common nowadays for bankers to undercut each other's prices, i.e., interest rates, paring down profits to the barebone minimum. Banks, particularly those with far-flung branch systems, have witnessed operational costs rising. Banks will therefore have to increase their efforts to effect adjustments aimed at enhancing their efficiency and quality of their operations so as to be ready to serve their customers when the economy picks up.

The claim that the Thai commercial banks enjoy a large spread between interests on deposits and credits has been proven false by recent studies which show that the effective interest spread is only 3.55 per cent — not the nominal 6.0 to 7.0 or 6.5 per cent as commonly believed by the man in the street. The banks' net interest income, profits before taxes and net profits were estimated at a mere 2.58 per cent, 0.82 per cent and 0.55 per cent of total assets, respectively. Banks faced with higher costs, due to intense competition, are experiencing narrow profit margins. Therefore, in the next few years, banks have to adapt to environmental changes to prevent profits from declining too rapidly. Controlling operating costs, increasing non-asset based income, maintaining market shares are some of the short-run strategies that will be undertaken by banks.

Furthermore, one has also to understand that when a cut in interest rates is announced, a reduction of the interest rates on credits is made immediately, mainly because overdrafts and bill discounting account for more than 70.0 per cent of commercial bank credits. On the deposit side, however, the cut in interest rates can be effected only when the deposits mature, and fixed deposits make up more than 70.0 per cent of the total. This situation has considerable repercussions on bank profits.

The claim that the banking sector has wasteful overhead costs is to some extent true, mainly because the banking industry, especially in Thailand, is labour-intensive. Moreover, labour mobility is practically absent here, and life-time employment is the norm in commercial banks as well as the vast majority of other businesses. Further, the excess liquidity situation compelled the banking system to reduce interest rates several times in 1986. For instance, the return on assets for the banking system, which averaged 0.8 per cent for a decade, declined to 0.55 per cent in 1985 and 0.38 per cent in 1986.

In spite of the deposit-to-lending margins being very high, as a result of flexible high interest rate policy, a downward trend of the revenue and profits was observed which can be attributed to several factors. First and perhaps foremost, credit expansion in 1986 was at a very low level as the economy recovered only slowly and banks themselves adopted a cautious lending attitude. Second, banks have had to resolve problems of bad loans or low quality loans carried over from the previous recessionary years. Third, some banks have had to extend more financial as well as managerial assistance to businesses encountering losses in operation. Fourth, although banks reduced interest rates on both deposits and loans, they still had to carry the burden of previously high interest rate deposits. Last, but not of least importance, is the intense competition among banks to capture the market of financial innovation, resulting in their large capital outlays on new technology.

Further, as a result of the new regulations, the Thai commercial banking system, as a whole, is likely to face with the problem of smaller profits. Clear symptoms of the strain on the system emerged in mid-February 1986, when the Government Savings Bank (GSB) raised the interest rate for short-term fixed deposits to 11.0 per cent per annum to fight for its market share, following the failure of major commercial banks to jointly maintain their rate of 10.5 per cent per annum. The potential exists to mobilize savings in the market, and every bank is pushing for more deposits.

However, the ability of the commercial banking system to generate profits during the past couple of years has been severely curtailed. All 16 Thai commercial banks during the year 1985 made a total profit of 2,900 million baht, down 18.0 per cent compared to the 1984 figure. The profits have further declined by 40.0 per cent during 1986. The deterioration in the ability of the banks to generate higher profits can be attributed to the following factors:

- Firstly, there is an excess liquidity in the system and there have been several official and unofficial reductions in the interest rates during the past couple of years. Frequent reductions in the interest rates have brought lower revenue to commercial banks because of unmatching expenses paid out for deposits with time lags; and,

- Secondly, the unfavourable state of the Thai economy till 1986 has resulted in a lower credit expansion, while customers of banks have been facing operating difficulties and causing higher bad debts to their creditor banks. The banks have to step in to assist these customers by offering debt rescheduling, lower interest payments and so on. The ability to maintain the level of income has been undermined.

As the ability of the commercial banking system to generate profits has been severely curtailed due to the excess liquidity in the system, resulting in lower credit extension and the deposits of longer maturities yet to mature, there was a tendency for banks to switch towards business which were not associated with lending and borrowing and to earn more income from fee-based activities.

Presently, the income which is not interest-related is a small margin or just 5.0 per cent of total earnings. However, there are ample opportunities to expand these activities and thereby, profit. The declining profit margin and the increasing cost of intermediation tend to prompt banks to move towards off-balance-sheet banking.

Looking solely at the profit, this can be considered as a short-term problem, which will require only time to resolve. Eventually, the banking system is expected to be able to adjust and improve profitability once the previous deposits complete their maturity. This process could take up to 6 or 12 months depending on the position of each bank, based on its fundings, whether long- or short-term and/ or large or small associated costs. However, what banks need to be aware of is the temptation to rapidly extend credit facilities in order to generate higher profits in the event of excess liquidity, which could lead to problems of instability of particular institutions in the future.

V. Deregulation and Competitive Financial Environment

The early periods of the Thai banking history was dominated by foreign European and Asian banks. At the moment, there are 16 Thai banks operating approximately, 1,855 branches, including 26 overseas branches. There are 14 foreign banks operating 18 branches; in addition, there are approximately 25 offices of representatives in Bangkok. The Thai banks account for 98.0 per cent of deposits, 96.0 per cent of loans and 95.0 per cent of total assets of all commercial banks. Until recent years, the banking industry in Thailand could be classified as one of conservatism. Banks in the past seemed to be contented with living off the spread (difference between interest rates of loans and deposits) that they were enjoying under a regulated environment and limited competition. In the past four years, however, the banking industry has changed dramatically; becoming complex, uncertain and competitive at both the local and international level. The past decade has seen tremendous changes in the banking industry. To be able to keep pace with the encroaching competition from financial institutions throughout the world, Thai banks had to change and innovate their services in terms of convenience, accuracy and speed.

Regulations on time deposit interest rates, which set a single ceiling on the minimum maturity of three months and above, have allowed each individual bank to offer its customers a wider room of choices. Many efforts were made to increase efficiency, quality and stability of the domestic financial institutions in Thailand. Accordingly, commercial banks agreed to set up a system to quote interbank offer rate (BIBOR) to improve efficiency in liquidity management. Commercial banks also offered new services to customers, namely telephone banking, ATM pool and foreign exchange options.

Local banking industry in the last four to five years has, therefore seen a tremendous rise in competition in terms of new services offered to the public. The clearest example is the introduction of electronic banking. Electronic banking services developed very rapidly. The number of ATMs operating nationwide by the end of 1986 totalled 491, an increase of 245. In addition, five banks expanded the service called "office banking", first introduced in 1984, while some began offering "tele- banking", a telephone banking service. Banks have been compelledto provide a wider choice of products to keep up with competiting other services, such as foreign exchange options, interest swaps and various hedging instruments, which have been introduced in the past few years.

The reduction of the ceiling rate for lending from 19.0 to 17.0 per cent per annum for the commercial banks and that for finance and credit foncier companies from 21.0 to 19.0 per cent per annum, and the reduction of ceiling rate for fixed deposits and savings accounts with the commercial banks from 13.0 to 11.0 per cent per annum and from 9.0 to 8.5 per cent per annum, respectively, has helped the commercial banks to operate in a more orderly manner, although there had been some instances of unofficial rate-cutting by some banks over and above the normal practice. However, the commercial banks were not in a position to adjust interest rates on their own initiative because of the competition in the banking industry, particularly in deposit rates. Although the Thai Farmers Bank had tried over the past four years to initiate its own interest rates, it did not succeed.

The reason for this was that credit financing invariably exceeds savings. Although this puts pressure on lending rates, leading to self-adjustment, individual banks could not act upon deposit rates which, if reduced, would cause customers to transfer their deposits to other banks which offered higher rates. It was also difficult for the commercial banks to develop secondary financial markets on their own as the scope was very small.

VI. Problems and Issues Associated with Deregulation

VI.1 Deregulation and Selective Credit Policy

Despite a free market financial system and of the spectrum of Thailand's financial developments, government intervention in the priority sectors remained an important feature of the financial markets. Although Bank of Thailand (BOT) directly sets ceilings on deposit and lending rates of commercial banks, finance companies and credit fonciers, the BOT also cooperates with other government agencies, such as the Ministry of Finance, the Ministry of Commerce, and the Ministry of Agriculture, in setting the maximum lending interest rates for other institutions which are normally lower than the rates charged by commercial banks, since these specialized institutions were set up to provide credit to priority sectors. These directed credit programmes were quite sizeable. They accounted for as much as 43.0 to 45.0 per cent of total credits extended by commercial banks and finance companies (Table 9.9). The BOT participated in these schemes in a number of ways and is an important source of funds. It did so by providing cheap rediscounting on bills of target borrowers with the commercial banks as the specialized lending institutions, such as the Government Housing Bank and the Bank for Agriculture and Agricultural Cooperatives (BAAC).

The authorities also required the commercial banks to lend 13.0 per cent of their previous year's total deposits to agriculture, either by direct lending, by purchasing government bonds, or by depositing with BAAC. At present, commercial banks are regulated to extend 20.0 per cent of their deposits to the rural sector. However, if the target could not be met, commercial banks are required to deposit the rest of the money with the BAAC so that money could further be extended to the agricultural sector. Since the rates of return to the commercial banks on these assets were less than the market rate on bank lending, they have to bear the burden of high cost of deposits. It may be a source of subsidized funds to the directed credit schemes, but the need to maintain domestically mobilized savings in the commercial banking system may also limit the amount of subsidization the authorities could impose. Otherwise, excessive forced lending in priority sector with low interest rates would also force the monetary authority to lower the deposit rates of the commercial banks, driving away some depositors.

Table 9.9

TOTAL LOANS AND LOANS TO PRIORITY SECTOR: 1970-1985

(in Millions of Baht)

Year	Commercial Banks		Finance Companies	
	Loans & Advances	Priority Loans	Loans & Advances	Priority Loans
1970	28,234.2	9,786.2 (34.7)	n/a	n/a (-)
1975	82,898.8	33,915.5 (40.9)	n/a	n/a (-)
1980	199,387.4	87,772.6 (40.0)	54,977.6	24,238.2 (44.1)
1981	258,117.4	115,288.6 (44.7)	65,389.6	27,756.7 (42.4)
1982	306,787.8	133,992.7 (43.7)	79,517.7	33,869.6 (42.6)
1983	411,962.8	175,369.7 (42.6)	90,711.0	39,640.0 (43.7)
1984	481,851.9	212,178.4 (44.0)	95,029.4	40,737.1 (42.9)
1985	530,729.5	239,740.4 (45.2)	98,052.3	42,709.9 (43.6)

Note: (1) Prority sector consists of agriculture, mining, export and manufacturing.
(2) Figures in parenthesis are the percentages of total credit extended to the priortiy sector.

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire, Bank of Thailand, 1987.

Other forms of government intervention in the financial markets included compulsory holding of government securities by the banks and a requirement for regional bank branches to unlend 60.0 per cent of deposits mobilized in that area. In short, while the Thai financial sector could be counted among the developing world's most market-oriented, and certainly among the most open, the authorities maintained important institutional controls. However, the distortions created by these controls were limited by the overriding policy objective of maintaining a convertible currency and an open economy.

It may be recalled that, during early 1984 and 1986, interest rate ceiling for credits extended to priority sectors were set at one and a half or two percentage points lower than that for general sectors. However, the differential ceilings have been abolished since March 1986. These differential ceilings still exist in Malaysia and certain other SEACEN countries. Although the differential ceilings have been removed, the government came up with further incentives for the commercial banks to extend more credits to the priority sector. It has been decreed that only 80.0 per cent of lendings to the priority sectors would be counted as risk assets (whereas, formerly the whole 100.0 per cent was regarded as risk assets).

Institutional arrangement, in which specialized financial institutions play an important role in providing credits to priority sectors at rates kept lower than market levels, has been one of the main deterrants to the effort to move towards flexible interest rate system. Slowness on the part of financial institutions in adapting to the new policy stance also prevented market forces to immediately exert their full influence on interest rates as experienced by downward rigidity of deposit and loan rates at the early stage of market-oriented interest rate policy. Nevertheless, the above regulations governing commercial banks lendings have provided more incentives for commercial banks to extend more loans to those priority sectors.

Most of the commercial banks in Thailand are aware of the gravity of the problem of priority sector development. Substantial credits have been channelled to priority sectors (see Table 9.9), including agriculture, manufacturing, mining, wholesale trade in agricultural products and exports. This was in spite of the low interest rates that may be charged on these sectors.

Although the banks have a greater role to play in the extension of credit to priority economic sectors and the central bank is continuously emphasizing to provide low interest funds via several refinancing facilities, the facilities have to be revised in response to changes in the economic conditions. Accordingly, banks should not expand their lending activities with unlimited discretion. However, banks should also develop their own strategy on how best to extend credit and financial services to priority economic sectors. Simply meeting the numerical target of credit extension is no longer sufficient and it only brings inconsistencies between deregulation and selective credit policies.

VI.2 Deregulation and Excess Liquidity

The high liquidity which was prevailing in the financial system since 1982 has provided a favourable environment for the authorities' moves towards an interest rate liberalization regime. But this steadily growing high liquidity became a problem in the latter years, starting in 1985 and worsening in 1986. The principal cause of this situation was deposits growing much more rapidly than credit expansion. The liquidity position of the commercial banking system in 1985 was fairly high, with intermittent fluctuations stemming from the impact of the international money markets. In spite of the sharp rise in deposits, the credits dropped sharply. The loan-deposit ratio of commercial banks fell on an average to 95.0 per cent. Between 1980-1986, deposits of Thai commercial banks expanded at an average annual rate of 18.0 per cent. This growth dropped to 12.0 percent in 1986. On the lending side, the rate dropped from 18.2 per cent between 1980-1986 to around 4.0 per cent in 1986 (see Table 9.4). The sharp decline in demand for loans and increases in offshore loans, caused local excess liquidity, and thus, forcing the banking system to reduce interest rates on deposits four times beginning in 1986.

Perhaps most importantly, the ceiling of loan and deposit rates for commercial banks were reduced significantly in 1986. The ceiling rates had been adjusted twice as follows:

	1985	Jan.1986	Mar.1986
Loan and Overdrafts			
Priority sectors	17.5	15.0	15.0
Others	19.0	17.0	15.0
Deposits			
Savings deposits	9.0	8.5	7.25
Time deposits	13.0-14.0	11.0	9.5

By the end of August 1986, outstanding credit extended by all commercial banks to the private sector was lower than at the end of 1985, and was growing only at a low annual rate, thus reducing the ratio of credit to confined deposits from 98.5 per cent at the end of December 1983 to 86.2 per cent at the end of 1986 (see Table 9.4). In other words, increased liquidity was still plaguing the local financial system, although the central bank has been cautiously exploring ways and means of absorbing the excess funds. The reasons for credit expanding at a rate far slower than usual include more cautious lendings on the part of commercial banks after passing through a period of problematic loans. The adoption of a flexible interest rate policy proved an effective means to mobilize deposits but with a decreasing trend in loan portfolio, it induced excess liquidity. The striking rise in liquidity pushed down interest rates almost continuously. Some interest rates in the financial market such as those for three day short term instruments in the repurchase market, dropped from an average annual rate of 5.98 per cent in December 1986 to about 5.7 per cent per annum in the first quarter of 1987, and ranged between 5.0 to 5.6 per cent per annum for the rest of the year.

However, as the liquidity in the financial system was still buoyant, a considerable portion of the Government's budget deficit could be largely financed by domestic sources in the form of both government bonds and promissory notes. Nevertheless, deposits growing faster than credits kept the level of liquidity in the commercial banking system high throughout 1986. Although excess liquidity in general was declining throughout 1987, the commercial banking system experienced increases in baht liquidity and the central bank had to issue its own bonds with a maturity of six months for sale to the commercial banks, in order to help mop up excess liquidity in the banking system. [46]

In these circumstances, the Bank of Thailand was forced to intervene in alleviating the excess liquidity by implementing measures to bring interest rates down rapidly, for instance, by lowering the interest rate ceilings for deposits and loans of financial institutions and then inducing many further reductions in market rates. In spite of the interest rates falling significantly, the imbalance of deposit growth with credit growth persisted continuously and posed a danger to the financial system. The liquidity of the banking system in

46. On 26 May 1987, the Bank of Thailand issued bonds worth B. 2,000 million for sale to the commercial banks in order to absorb the excess liquidity in the banking system.

1986 accounted for 20.0 per cent of the total assets of the commercial banks. Contributing to the high liquidity situations was the fact that commercial bank lendings had fallen sharply. The drop in lendings was due to the fact that the private sector was borrowing directly from financial institutions abroad.

As the commercial banks were encountering difficulty in finding high quality loan customers; the Bank of Thailand attempted to absorb some of the liquidity by selling bonds in the repurchase market. At the same time, the central bank had to increase the maturity of repurchase transactions by lengthening them in response to the persistence of the excess liquidity, and by easing the requirements concerning the net foreign asset holdings of the commercial banking system, in order to allow them to pass some of the liquidity on to international money markets. Further, the central bank had to take further steps to absorb the Government Savings Bank's excess liquidity by selling bonds directly to the Government Savings Bank (GSB).

As a result, there was a gradual reduction of excess liquidity during 1987. This can also be attributed to the rigourous increase in commercial bank lendings, which was due to three major factors. Firstly, the upturn of the economy and investment activities helped to induce higher demand for credits. Secondly, large amount of excess liquidity in the banking system brought down domestic rates of interest which encouraged demand for credits. Thirdly, the commercial banks, having emerged from a period of adjustment following bad debt problems, were recovering and ready to respond to their customers' demand for loans, as their financial positions had improved in the wake of better prospects for the economy and lower domestic interest rates.

VII. Move Towards Re-regulation

The 1980 reforms generated a significant financial deepening. However, the failures and bankruptcies of many banks and finance companies; some of which ceased their operations and some reorganized under supervision of the central bank, have eroded public confidence in the financial system of the country. For instance, of the 25 ailing finance companies, 11 had to be taken over by the government and the other 14 are still in need of financial assistance.

Prudent and responsible management are essential for the success of banks. Therefore, many efforts were made to increase the efficiency, quality and stability of domestic financial institutions.

Commercial banks are now required to submit credit extension plans to the Bank of Thailand. Further, the Commercial Banking Act and the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business were amended to enable the Bank of Thailand to supervise and control financial institutions more effectively. The following measures were also taken towards re-regulation:

1. Ceiling on commercial bank overdraft loans

The Bank of Thailand prescribed the ceiling on overdrafts which commercial banks granted to each customer at not more than B. 50 million with an aim to improving the efficiency in liquidity management of commercial banks.

2. Suspension of monthly payment for deposit interest

The Bank of Thailand made a request to the commercial banks for the suspension of monthly payment for deposit interest, in order to alleviate excessive competition among banks.

3. Financial Institutions Development Fund

This Fund was officially set up in December 1985 under the Bank of Thailand Act by a special amendment. According to the special decree, each commercial bank and finance company would contribute up to 0.5 per cent of their deposits or outstanding loans at the end of the year to the Fund. At present, commercial banks and finance companies are required to contribute 1.0 per cent of total deposits, at the end of prior year, to the Fund. The main purpose of the fund was to ensure the availability of sufficient financial resource, in case a rescue mission was launched to save a financial institution. However, the fund might help to stabilize financial institutions, but might not protect depositors because the fund would not be adequate to rescue ailing institutions if the situation was very serious and depositors might get no compensation.

4. Apart from the decree setting up the rehabilitation fund, two other decrees have empowered the Ministry of Finance to take drastic action against banks and other financial institutions, including the filing of criminal charges against offending executives in the financial sec tor.

5. Commercial banks are prohibited from providing certain services to their shareholders, to business organizations in which the banks themselves, their directors, or their shareholders were involved in a substantive way. Such services included the guaranteeing of debt, the provisions of and to honor bills and the issuing of letters of credit or letters of comfort.

6. To institute consistent treatment of assets by commercial banks, the Bank of Thailand promulgated criteria specifying when to declare an asset worthless, irrevocable, or doubtful effective April 1986.

Appendix 9

Some Major Regulatory and Prudential Measures (Up to June 1986)

Description of Regulation	Statutory Power Conferred By
1. Cash Reserve Ratio and Liquidity Ratio	
(a) Commercial banks are required to maintain cash reserve ratio of 7.0 per cent of total deposits of which: - Balance at Bank of Thailand: not less than 2.0 per cent; - Cash in hand: not to exceed 2.5 per cent; and, - Government securities: the rest.	Commercial Banking Act 1962 and 1979 amended by Emergency Decree, 1985; Bank of Thailand Act; and Currency Act
(b) The Finance Companies are required to maintain liquidity ratio of 7.0 per cent of which: - Balance at Bank of Thailand: not less than 0.5 per cent; - Unobligated government securities: not less than 5.5 per cent; and, - Deposit at & call loan to domestic banks: not more than 1.0 per cent.	Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business 1979 amended by Emergency Decree, 1985
(c) Credit Foncier Companies are required to maintain liquidity ratio of not less than 5.0 per cent of total borrowings of which: - Balance at Bank of Thailand: not less than 0.5 per cent; - Unobligated government securities: not less than 3.5 per cent; and, - Deposits at & call loan to domestic banks: not more than 1.0 per cent.	Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business 1979 amended by Emergency Decree, 1985

Description of Regulation	Statutory Power Conferred By
(d) Life Insurance Companies are required to maintain liquid assets for security purpose to the tune of 2 million bahts.	Life Insurance Act 1967
2. Capital Adequacy	
(a) Commercial banks are required to maintain: . Capital to Risk Asset Ratio: 8.0 per cent; and, . Capital to the aggregated sums of its aval to bills, acceptance bills, issuing of L/C and etc.: not less than 20.0 per cent.	Commercial Banking Act 1962 and 1979 amended by Emergency Decree, 1985 and Bank of Thailand Act
(b) Finance Companies are required to maintain: . Risk asset to capital ratio: 6.0 per cent; . Ratio of capital to the aggregate sum of its aval to bills and acceptance bills: not less than 25.0 per cent; and, . Minimum Registered Capital which has been fully paid up: 60 million bahts.	Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business 1979 amended by Emergency Decree, 1985
(c) The Credit Foncier Companies are required to maintain 6.0 per cent capital to risk assets ratio.	
(d) Life Insurance Companies are required to maintain minimum capital to the tune of 5 million bahts.	Life Insurance Act, 1967

Description of Regulation	Statutory Power Conferred By
3. Single Customer Limit	
(a) Commercial banks are not allowed to extend aggregate sum of its aval to bills, accepting, issuing of L/C and etc. to any one person exceeding more than 50.0 per cent of capital funds, and to grant loans to any one borrower exceeding 25.0 per cent of capital funds.	Commercial Banking Act 1962 and 1979 amended by Emergency Decree, 1985
(b) Finance Companies are not allowed to grant loans to any person exceeding 30.0 per cent of capital funds as from 1 May 1983.	Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business 1979 amended by Emergency Decree, 1985
(c) Credit Foncier Companies are not allowed to grant unsecured call loan to any commercial bank, Government housing banks, finance companies exceeding more than 20.0 per cent of capital fund but total amount not exceeding 100.0 per cent.	
4. Other Loan Limit	
(a) The Finance Companies are to required observe: . Minimum amount for downpayment for car hire purchase finance: 30.0 per cent of car's prices; . Maximum period for term-payment: 42 months; and,	Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business 1979 amended by Emergency Decree, 1985

Description of Regulation	Statutory Power Conferred By
. Maximum amount of loans for specific purposes: no more than 5.0 per cent of capital funds for car hire purchase.	
5. Interest Rate Ceilings	
(a) Commercial Banks:	
Maximum interest on deposit and loans . Savings deposits: 7.25 per cent per annum; . Time deposit (3 months and over): 9.5 per cent; and, . Loans 15.0 per cent per annum.	Commercial Banking Act 1962 and 1979 amended by Emergency Decree, 1985 and Bank of Thailand
(b) Finance Companies:	
. Maximum interest rates on loans not to exceed 18.5 per cent per annum as from 5 March 1986; and, . Maximum interest rates on Promissory Notes (P/N) not to exceed 13.5 per cent per annum for P/N of the amount exceeding 50,000 Baht and repayable within a minimum period of 180 days, otherwise not to exceed 12.5 per cent per annum.	Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business 1979 amended by Emergency Decree, 1985
(c) Credit Foncier Companies:	
. Maximum interest rates on loans not to exceed 18.5 per cent cent per annum; and, . Maximum loans by pledging its own promissory notes not to exceed more than 90.0 per cent of their face values.	

Description of Regulation	Statutory Power Conferred By
(d) Government Savings Bank:	
. Maximum interest on loans not to exceed 19.0 per cent per annum; . Interest rates on savings deposits at 7.25 per cent per annum; . Time deposits (6 months): 9.0 per cent per annum; Time deposits (12 months and over): 9.5 per cent per annum; and, . Savings bonds: 4.0 and 6.0 per cent per annum.	Government Savings Banks Act 1947
(e) Bank for Agriculture and Agricultural Cooperatives (BAAC)	
Maximum interest rates on deposits and loans . Savings deposits: 7.25 per cent per annum; . Time deposits (3 months): 8.5 per cent per annum; Time deposits (6 months): 8.75 per cent per annum; Time deposits (1 year and over): 9.0 per cent per annum; and, . Loans: 19.0 per cent per annum.	Bank for Agriculture and Agricultural Co-operatives Act 1966
(f) Government Housing Bank	
Maximum interest rates on deposits and loans . Interest rates on deposits same as commercial banks; and, . Loans: 19.0 per cent per annum.	Government Housing BankAct 1953, Revolutionary Party Decree No. 317, 1972 Royal Decree defining the scopes and operations of the Government Housing Bank 1975

Description of Regulation	Statutory Power Conferred By
(g) Savings Cooperatives	
Interest Rate on Deposits and Loans . Savings deposits: 7.5-8.0 per cent per annum; . Time deposits (3 months): 8.0-10.0 per cent per annum; Time deposits (6 months): 9.0-11.0 per cent per annum; Time deposits (12 months-2 years): 10.0-12.0 per cent per annum; and, . Loans: 13.0-14.75 per cent per annum.	Co-operatives Act 1968

Source: Replies to the SEACEN Deregulation Project Survey Questionnaire,
Bank of Thailand, 1987.

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