ECONOMIC AND SOCIAL
COMMISSION FOR ASIA
AND THE PACIFIC

ASIAN DEVELOPMENT BANK

REJUVENATING BANK FINANCE FOR DEVELOPMENT IN ASIA AND THE PACIFIC

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ESCAP WORKS TOWARDS REDUCING POVERTY AND MANAGING GLOBALIZATION

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On 1 July 1997, Hong Kong became Hong Kong, China. Mention of "Hong Kong" in the text refers to a date prior to 1 July 1997.

"China" in the text refers to "the People's Republic of China".

All monetary amounts preceded by the dollar symbol ($) refer to the United States dollars.

PREFACE

The heads of Governments at the United Nations Millennium Summit in September 2000 adopted the United Nations Millennium Declaration, urging nations to work towards detailed development goals that include poverty eradication and human development. The International Conference on Financing for Development at Monterrey, Mexico, in March 2002 underscored in order to achieve these goals the need for mobilizing domestic financial resources in addition to international resources. In the Asian and Pacific region the banking sector remains the primary source of domestic resource mobilization for development. However, the operations of the banking system in many countries in the region are fragile due to a variety of factors such as low capital base, excessive government intervention, poor regulations, ineffective supervision and insufficient risk management skills. Fragile banking systems not only misallocate resources, but are also prone to crisis, putting the savers' funds at risk and causing serious consequences for economic growth. In several countries in the region, even long after the Asian financial crisis, banks are still suffering from an overhang of non-performing loans. Even though there has been considerable progress region-wide with regard to banking sector restructuring, there still remain a number of outstanding issues to be tackled to rejuvenate banking activity as one of the main instruments in economic development.

In the above context this volume provides an overview of domestic resource mobilization for development in Asia and the Pacific, as well as that for microfinance. It reviews country cases in the banking sector and microfinance in order to disseminate country experiences and to draw lessons for guiding policy. Country studies on the banking sector include China, India and Thailand, while those on microfinance cover Bangladesh, the Philippines and the Republic of Korea.

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ABBREVIATIONS

ADB	Asian Development Bank
AMCs	asset management corporations
ASA	Association for Social Advancement (Bangladesh)
ASEAN	Association of South East Asian Nations
BIS	Bank for International Settlements
BRAC	Bangladesh Rural Advancement Committee
CITIC	China International Trust Corporation
CPI	consumer price index
CRR	cash reserve requirement
ESCAP	Economic and Social Commission for Asia and the Pacific
GDP	gross domestic product
GNP	gross national product
IMF	International Monetary Fund
MicSMEs	micro, small and medium-sized enterprises
NGO	non-governmental organization
NPLs	non-performing loans
NPA	non-performing assets
OECD	Organisation for Economic Co-operation and Development
PBC	People's Bank of China
SOEs	state-owned enterprises
SMEs	small and medium-sized enterprises
VAT	value added tax
WSCBs	wholly state-owned commercial banks
WTO	World Trade Organization
SLR	Statutory liquidity requirement

INDICATORS AND VARIABLES USED FOR REGRESSION

ASSET	log of a bank's asset value
CITY	dummy variable (= 1 if a bank is a city commercial bank; = 0 otherwise)
COST	operating cost divided by operating income
DEPOSIT	log of a bank's deposit value
GBOND	investment in government securities/assets
EQUITY	equity divided by assets
DIVERSE	net trading and commission income plus net other operating income divided by assets
$INCOME_1$	income divided by average assets
$INCOME_2$	implicit interest rate spread

INVDEBT	equity divided by liabilities
OTHER	dummy variable (= 1 if a bank is characterized not as a wholly state-owned commercial bank; = 0 otherwise)
$LIQUID_1$	deposits with PBC divided by customer deposits
$LIQUID_2$	cash plus bank deposits divided by assets
LISTED	dummy variable (= 1 if a bank is publicly listed; = 0 otherwise)
MARGIN	net interest income divided as average assets
PRIORITY	lending to priority sectors
PROV	loan loss provisions divided by loans
PUBLIC	lending to the public sector
ROAA	profits after tax divided by average assets
ROAE	after-tax profits divided by return on average equity
SBOND	investment in securities divided by assets

I. MOBILIZING DOMESTIC RESOURCES FOR DEVELOPMENT IN ASIA AND THE PACIFIC: AN OVERVIEW*

Introduction

Financing for development has engaged the attention of policy makers and development economists for several decades. The subject is extremely vast, effectively covering all strategies, policies and instruments in the financial sphere that bear on both public and private sector development. Two broad considerations stand out. First, the underlying premise that development is still essentially measured by gross domestic product (GDP) growth rates is now subject to qualification. Development is widely accepted to be a much broader concept, including progress in the alleviation of poverty within the overall rubric of 'human development'. Issues of development finance need therefore to pass the test, as it were, of their role in reducing poverty, for instance, by the ease of access for the poor to sources of finance. It is conventional wisdom that overall growth and poverty reduction depend upon effective financial systems. As a result, policy needs to create and sustain the right institutional infrastructure, such as special arrangements for small and medium-sized enterprises (SMEs) and microfinance schemes with the proviso that these arrangements/schemes encourage the graduation of the enterprises concerned into the formal financial system and are not props to merely sustain dependency.

Second, in a globalized world economy where ever fewer countries practise exchange control in the traditional sense of the word and where, until 1997 at least, the abolition of capital controls was an avowed objective of policy, an analytical distinction between domestic and international financial resources for development is, at best, fuzzy. While resources for development can be either domestic or foreign in origin, the same factors are likely to influence their volume, composition and cost. Fiscal/monetary prudence, financial market depth, the regulatory regime, standards of governance, property rights etc., are equally relevant for both sources of finance.

In this chapter, the focus of discussion is, however, on financial resources for development that are domestic in origin. For the overwhelming majority of economies in the ESCAP region, domestic resources constitute the bulk of investment expenditures. It is true, however, that even those economies in East and South-East Asia with high savings rates, investment rates have been even higher, necessitating external private capital inflows. The saving/investment gap has been reflected in current account deficits that for many of these economies ranged between 1 and 13 per cent of GDP in the 1990s (see table 1). In South Asia, on the other hand, the situation has been both quantitatively and qualitatively different. While domestic savings have been insufficient

* Prepared by the ESCAP Development Research and Policy Analysis Division.

Table 1. Resources gap of selected developing economies in the ESCAP region, 1995 and 2000

(percentage)

	Savings/GDP		*Investment/GDP*		*Resources gap*	
	1995	*2000*	*1995*	*2000*	*1995*	*2000*
South and South-West Asia						
Bangladesh	16.7	21.4	19.1	22.4	-2.4	-1.0
India	25.1	22.7	26.8	23.5	-1.7	-0.8
Pakistan	14.2	14.0	18.3	15.0	-4.1	-1.0
Sri Lanka	15.3	19.0	25.7	29.0	-10.4	-10.0
South-East Asia						
Indonesia	30.6	22.0	31.9	17.9	-1.3	4.1
Malaysia	39.7	46.9	43.6	27.0	-3.9	19.9
Philippines	14.5	17.0	22.5	17.6	-8.0	-0.6
Singapore	50.2	49.8	34.6	31.3	15.6	18.5
Thailand	33.8	30.0	41.8	22.0	-8.0	8.0
Viet Nam	13.6	25.0	27.1	23.0	-13.5	2.0
East and North-East Asia						
People's Republic of China	42.5	38.0	40.8	37.1	1.7	0.9
Hong Kong, China	30.5	32.2	34.8	27.5	-4.3	4.7
Republic of Korea	35.4	30.9	37.2	28.7	-1.8	2.2
Pacific island economies						
Fiji	12.9	12.0	13.1	12.0	-0.2	0.0
Papua New Guinea	28.9	34.4	19.4	42.0	9.5	-7.6

Sources: Asian Development Bank, *Asian Development Outlook 2001* (Oxford University Press, 2001); and national sources.

to finance domestic investment, both savings and investment, measured as ratios of GDP, have been lower than in East and South-East Asia. The resulting current account deficits have been financed by official development assistance rather than private capital inflows. This holds true also in the least developed economies. However, taking the ESCAP region as a whole and looking at domestic savings and investment as broad aggregates, domestic resources have constituted around four fifths of domestic investment in the region over the 1990s. Thus, while external resources have been important as an additional element in financing development, such development has been primarily based upon domestically raised resources.

For most of the 1980s and early 1990s, the approach of the international community to development was dominated by an emphasis on domestic resource mobilization primarily involving tax reform. The content of tax reform was to be influenced by the move towards creating a market-friendly policy regime. The reform of income, corporate and trade-related taxes and a greater reliance on domestic value added taxes were the major planks of this strategy. Another element in this approach was the liberalization of the domestic financial sector involving the deregulation of interest rates, the elimination of directed credit and freedom of entry into the financial sector for both domestic and foreign private investors.

The above approach to development financing has come under serious questioning in the late 1990s. Many developing countries have found it very difficult to deal simultaneously with the deregulation of domestic financial markets and challenges associated with globalization. This was starkly demonstrated by a series of financial crises during the 1990s in Asia and elsewhere. Concomitantly, official aid flows have been on a declining trend for some time. As a result, the subject of domestic resource mobilization has once again taken centre stage.

The mobilization of domestic resources is the foundation for self-sustaining development. Domestic resources play the main role in financing gross domestic investment and social programmes. A dual challenge lies in generating an increasing stream of domestic resources, and efficiently channelling them to development ends and to increased productive capacity. This requires an environment conducive to private savings, the consolidation of public finances, efficient and effective mechanisms for the allocation of public expenditure and adequate room for private initiative – in short, sound macroeconomic policies.

Macroeconomic policies play a major role in promoting domestic resource mobilization and development. Proper macroeconomic policy-making depends heavily on the initial conditions that were extant, and how economic and social priorities have evolved, in particular countries. Decisions on particular objectives and choice of policy instruments are thus best left to individual countries. Nevertheless, a general principle is that sound policy requires as a foundation medium-term objectives that provide a relatively predictable framework for short-term policy decisions. Sound macroeconomic policies, as a bonus, also encourage capital inflows and discourage capital outflow, especially in the form of capital flight. A key measure for ensuring long-run stability is to manage macroeconomic policy in boom periods in such a way as to avoid deep recurring cycles in economic activity. While individual countries cannot wholly insulate themselves from what happens in the global economy, as we have witnessed in recent months, they should aim at achieving sustainable fiscal and current account balances and low or decelerating inflation. This, in turn, implies an exchange rate regime consistent with the other elements of the overall macroeconomic package.

Different groups of countries face different challenges in macroeconomic management. One important factor, other than the level of development itself, is macroeconomic capacity. This refers to the level of human skills and the efficacy of instruments and institutions necessary for making and implementing policies. Countries should assess their capacity in this area realistically and avoid taking on tasks for which they may not be fully prepared. Hence, all countries need to emphasize the strengthening of their public institutions so that policy-making can be securely placed in the public domain and provide a credible anchor to private-sector households and corporate bodies to plan ahead for the future. The strengthening of institutions is, however, a demanding and complex process and robust institutions tend, on the whole, to evolve rather than be created by administrative fiat.

Mobilizing domestic public resources through fiscal measures, while not stifling private initiative, is the key in achieving sustained long-term growth. In this regard, the domestic financial sector has played, and will continue to play, a critical role in generating resources for development for both the public and private sectors. The purpose of this overview, however, is to focus on the role of the domestic financial sector in mobilizing resources for development and the issues germane to it rather than on issues of fiscal policy, important as the latter undoubtedly are. A financial system that facilitates an efficient allocation of financing for productive purposes, widespread facilities for savings, and access to credit is essential for domestic resource mobilization and equitable development. When financial systems function well they mobilize resources and savings and allocate them at low transaction costs to their most productive uses. Well-functioning financial markets also facilitate the trading, hedging, diversifying and pooling of risk and the efficient intermediation of external financial resources.

A. SAVINGS AND INVESTMENT

Data on savings and investment in the ESCAP region since 1985 show that overall the ratio of savings to GDP has been on a gentle upward trend from around 21 per cent in 1985 to 29 per cent in 1999. This is, on the face of it, a very positive sign for the region. However, when the overall picture is disaggregated, it is clear that this relatively high level of the overall savings rate is mainly accounted for by the high-growth countries in East Asia and South-East Asia. Four Association of Southeast Asian Nations (ASEAN) members (Indonesia, Malaysia, Singapore and Thailand) as well as China; Hong Kong, China; and the Republic of Korea have all had savings rates greater than 30 per cent since 1990 (except Indonesia in the last three years). Savings rates in South and South-West Asia and the new members of ASEAN have historically been and remain, with a few exceptions, below 20 per cent. Most of the Central Asian republics also have quite low savings rates, two (Armenia and Kyrgyzstan) even having negative rates.

For the ESCAP region as a whole there is a relatively close correspondence between the savings rate and the investment rate. This implies that the region is generating almost enough resources itself for its development purposes. However, this is not true across subregions or countries. All South and South-West Asian countries, except the Islamic Republic of Iran, have had investment rates higher than their savings rates, implying a significant inflow of external resources. Much of this has come in the form of official development assistance, rather than foreign direct investment. This is also true overall for many of the Central Asian republics in recent years, where the domestic savings rate is about one half of the investment rate. (As exceptions, the Russian Federation has an increasing excess of savings over investment, whereas in Kazakhstan and Uzbekistan, the two have been almost in balance.) In South-East Asia and the Republic of Korea there has generally been a close balance between the savings and investment rates, except in the heydays of high growth in the early 1990s when FDI and other private flows surged in, and in the aftermath of the recent crisis when savings considerably exceeded investment. In most of these countries, except Indonesia, savings rates have been more or less maintained whereas investment rates have fallen considerably. Among these countries Singapore appears similar to China and Hong Kong, China where the savings rate has usually been larger than the investment rate and there has been a net outflow of funds.

B. INSTRUMENTS AND INSTITUTIONS

The principal instruments in the ESCAP region to attract private-sector (both households and enterprises) savings have been bank deposits of various sorts (see table 2). There has been very limited diversification in most developing economies into the holding of stocks, bonds and related financial instruments, and some development of pension and insurance funds as well as postal savings or unit trust systems, provident funds and other institutional forms for holding deposits. In a large and medium-sized economy there should be a more diverse financial system with not only banks (and equity markets) but also markets for longer-term instruments such as public and private bonds and mortgage markets, as well as institutional investment groups such as pension funds, life insurance and mutual funds and various non-bank financial institutions. There is also a need for some securitization modalities, particularly for infrastructure

Table 2. Size of the financial sector in selected ESCAP economies (average 1998-1999)

	Deposit money banks/GDP (1)	*Stock market capitalization/GDP (2)*	*(1) + (2)*
Indonesia	0.36	0.35	0.71
Malaysia	0.99	1.65	2.64
Philippines	0.45	0.59	1.04
Thailand	1.11	0.39	1.50
Republic of Korea	0.76	0.56	1.32
Hong Kong, China	1.66	2.11	3.77
Singapore	1.08	1.12	2.20
Bangladesh	0.30	0.02	0.32
India	0.26	0.33	0.59
Nepal	0.28	0.06	0.34
Pakistan	0.25	0.10	0.35
Sri Lanka	0.24	0.11	0.35
World average	0.43	0.44	0.87
Average of non-Asian developing countries	0.30	0.19	0.49

Sources: World Bank, *World Development Indicators* (Washington, D.C.), various issues; International Monetary Fund, *International Financial Statistics* CD-ROM, November 2000; and World Bank web site <http://www.worldbank.org/data/databytopic/GDP.pdf> (28 November 2000).

development and real estate markets. For smaller economies, the banking structure might be better complemented with access to capital markets of larger neighbours or regional capital markets, as domestic ones would be too small, too shallow and too thin to be viable. Nevertheless, the development of a professional and modern banking system remains crucial for all countries.

The sound functioning of a financial system requires both the internal discipline provided by market forces and the external governance provided by regulation and supervision. The regulations that impinge on transactions in financial markets relate to governance arrangements, transparency requirements, financial accounting and auditing rules, debt covenants, and bankruptcy procedures. A well-functioning financial sector is one that has a transparent and efficient overall legal framework and administration, complemented by efficient and independent regulatory and supervisory institutions to reduce excessive risk-taking and moral hazard as well as an effective insolvency regime that properly balances the rights and obligations of debtors and creditors. The system should foster good corporate governance, transparency by both financial institutions and enterprises, and high standards of accounting and auditing practices in private and public entities; it should also foster a competitive environment to facilitate efficiency and innovation in financial services, including the encouragement of in-country operations of foreign financial institutions. It is not obvious that these conditions are being adequately met in the majority of ESCAP member countries.

1. The banking sector

The banking sector continues to dominate as the major savings/investment conduit in all financial markets in the ESCAP region. Except for Hong Kong, China; and Singapore, equity markets in the more advanced economies are no more than one quarter of the size of the banking sector and the bond markets in all these countries are no more than 10 to 15 per cent, except in the Republic of Korea. In other economies, capital markets are even smaller. Therefore, the health of the banking sector is central to the ability of countries to mobilize their domestic resources for development. However, it should be noted that heavy reliance on bank financing can lead to a significant mismatch between the maturity structure of assets and liabilities of corporate entities and that of banks. Since a significant number of corporations, both public and private, require funding for long-term investments (such as infrastructure and construction or capital goods projects), a dependence on bank loans, which are short term by definition, makes the financial viability of these corporations highly susceptible to short-term swings in the economic environment.

The banking sector in the region has undergone considerable change over the last 10 years, and even more so after the recent financial crisis. The sector has been modernized in the use of information technology, liberalized in ownership and deregulated in terms of being less a direct instrument of government economic and investment policy. There have also been regulatory and supervisory reforms and approaches to solving the non-performing loan (NPL) problems. There has been considerable progress regionwide, but there are still a number of outstanding issues to be tackled. These are described below.

The structure of the banking sector varies considerably among countries. In some, including Malaysia and Thailand, there is a relatively small number of major banks, mainly private ones; in other countries, such as India and Pakistan, with a relatively small number of banks, the major ones are in the public sector. In yet others, including Indonesia and the Philippines, there is a much larger number of relatively small banks, usually private ones. The reasons for these varying structures are often historical and are directly influenced by the bank licensing policies of the government. Recent post-crisis reforms have included more stringent rules on starting up and operating banks. Thus, in several countries there have been bank closures or mergers leading to a decline in the number of banks. In theory this should increase confidence in the banking sector and leave it with a set of more financially viable banks.

The 1997 financial crisis in the region exposed considerable operational weaknesses in the banking sectors of countries in East and South-East Asia, including problems with cash-flow management; risk identification and management; maturity management; project evaluation; and transparency. While these areas are being addressed, much remains to be done as large segments of the banking industry remain undercapitalized and loan growth is minimal. Without further progress, the domestic mobilization of resources and the capacity of banks and the corporate sector to raise funds for investment of various sorts will remain weak.

The financial sectors of most other Asian and Pacific countries are considerably more underdeveloped and weaker than those of the crisis countries. For instance, South Asian countries are, in general, less financially developed in terms of selected quantitative indicators in comparison to both the crisis economies and to world norms. In qualitative terms, a recent study on the financial markets of selected countries concludes that transparency and bank supervision in a large number of non-crisis countries are not in any better shape than in the crisis countries. Financial weaknesses in these non-crisis countries are due, in part, to distortions arising from the need to finance large government budget deficits (South Asia) or directed lending to state-owned enterprises (such as in China and Viet Nam). State banks in these countries are usually afforded preferential treatment, often in terms of tax concessions and access to public-sector deposits. This can thwart competition and reduce efficient bank intermediation. The poor quality of bank supervision has also led to NPLs being understated and banks being insufficiently capitalized. Reform and liberalization of the financial systems of these countries is under way, with considerable progress noted in India, but enforcement of key legislation remains weak in many countries.

As evident from the high level of NPLs prevalent in the banking systems of almost all developing countries in the ESCAP region, most commercial banks have not followed market signals in their lending policies. Instead they have been primarily using relation-based lending practices and have been non-transparent about their financial performance. Thus, there is an urgent need to find ways of inducing banks to move towards data-based lending practices, such as credit scoring. One proposal worth considering is to increase the transparency of operations in both the banking and corporate sectors by putting pressure on the banks to improve their disclosure practices. They, in turn, would then have to demand enhanced disclosure (in terms of quantity, quality and timeliness of reports) from their clients, particularly enterprises, in order to meet their own reporting obligations. Pressure on the banks could be through domestic regulatory agencies and could, in addition, be backed up by good practices recommended by the Bank for International Settlements (BIS) or the International Monetary Fund (IMF). This would add weight to the regulatory authority's demands and compliance with it could form part of the BIS or IMF country reports which are available worldwide.

Most banks have used rudimentary credit assessment methodologies, when these have been applied at all. A significant improvement in their credit assessment capabilities is urgently required. The bank regulatory authorities need to verify use of these assessments for the granting of loans and impose appropriate penalties in the event of any breach. While this can be done with concerted in-house training in larger banks, it is difficult and expensive for smaller ones. It is necessary to devise some modalities for coping with this problem: BIS standards for data-based credit rating and assessment of risks could be a useful reference. Banks need to reduce their high percentage of NPLs before implementing improved credit assessment methods.

One of the problems facing banks is how to conduct credit assessments of SMEs, which usually have no track record and no proper financial recordkeeping. One initiative which has proved somewhat successful in Hong Kong, China is to establish an independent credit bureau, supported by an adequate legal and institutional framework, whose job it is to check the credit standing of SMEs and other firms not listed on any equity market. Such a bureau could provide a useful service for banks until they can undertake such functions themselves or until firms of all sizes develop track records on loans. However, the large number and variety of SMEs make such a proposition very difficult to implement in an economy of any size.

The ownership structure of banks in some of the crisis countries has changed dramatically in the last few years. This has been due to liberalization, allowing the ownership of banks, finance and security firms by foreigners, and the consequent inflow of foreign direct investment to buy significant equity stakes in such firms. There has been a similar but slower liberalization of ownership of banks in the other economies of the region. There are arguments for and against an increase in foreign participation in the banking sector. While foreign competition can increase pressure for consolidation and modernization and for the introduction of new products and services, there can also be a flight to quality as domestic clients might prefer to deal with banks having foreign participation, leaving domestically owned banks to service less attractive and more risky segments of the market. This could negatively influence the financial viability of the latter institutions.

In many countries the number of finance companies, which had soared in the East Asian and South-East Asian high-growth economies in the early 1990s, has declined substantially and only the more viable firms are left in the market. Nevertheless, the importance of banks in providing commercial lending in the medium-sized to large economies of the region is slowly declining, and capital (stock and bond) markets are of increasing importance as a modality for mobilizing domestic funds. This is partly the result of a deliberate government response, and it is expected over time to increase the stability of the economy through the diversification of modalities to finance investment. In the longer run, banks should assume a less dominant role in the financial structure and learn how to cope with competition from a more diversified set of institutions.

While banks have been the traditional modality for savings and loans for both individuals and enterprises, they have not catered well to the needs of the poor, the remote, the landless, the asset-less, or the dispersed population, nor of SMEs and the informal sector. In many countries both public and private banks have extended their geographic coverage within national borders over the past decade, thus making bank savings available to a wider proportion of the population. The increased use of information technology in the banking sector, particularly the use of ATMs (automatic teller machines), has assisted this development. However, there is still a need to expand bank networks, including taking advantage of new technologies for electronic banking, in several countries where such services are mainly urban-based. The unmet demands for service from the disadvantaged groups could then be met through the banks as well as through other means (see the next section).

In most countries, irrespective of their level of development, there are public-sector specialized banks with a distinct focus on a specific sector, such as agriculture or housing. These banks often have an important role to play in mobilizing savings (and intermediating these into investment) in sectors which are of little or no interest to commercial banks, either private or public. The promotion of these specialized banks needs to be undertaken with care so that they operate as closely as possible on commercial terms and yet are able to service their particular clients. Sometimes they play an important anti-cyclical role in the economy, encouraging savings and making loans when other banks are reluctant to do so. This has been the experience, for example, in Thailand in the last couple of years with the Government Savings Bank and the Bank for Agriculture and Agricultural Cooperatives.

Policy issues

The reform of the banking sector in almost all ESCAP member countries, developed and developing alike, has been an ongoing process over many years. Much has been written about the reforms needed. IMF and the World Bank as well as the Asian Development Bank (ADB) have been promoting reform packages and governments have taken selected reforms on board. However, much remains to be done if the banking sectors of the developing countries are to be ready and able to face the challenges of continuing to be the main conduit for the mobilization and use of domestic resources for development in an open, competitive and globalized financial system. The reforms required have several components. These include:

(1) Increasing the ***clarity of objectives*** for the operation of the central bank and the lines of its reporting (accountability) to the government. Usually the central bank is responsible for the operation of the exchange rate regime and for the money supply and related monetary variables, such as inflation. It is generally accepted that, given the inherent conflict of interest between the objectives of the central bank to keep inflation low and the exchange rate reasonably stable and those of the government in its fiscal operations, the

more independent the central bank, the better it performs in relation to its objectives. However, there are limits to this independence as it is the government which is ultimately responsible for the development policy of the country;

(2) Clarifying the division of responsibility between various ***supervisory and regulatory*** agencies on the supervision and regulation of the banking sector and their relationship with supervision and regulation of other financial firms, some of which are owned at least in part by banks. Several countries have or are considering making the supervisory agencies independent of the central bank to avoid any conflict of interest between the modalities used to achieve macroeconomic policy objectives and those for the effective supervision of banks. However, there may be problems of duplicating information and reporting functions, with each agency wishing to collect its own data, as well as of coordination;

(3) Implementing the ***Core Principles for Effective Banking Supervision*** developed by the Basle Committee on Banking Supervision, including a capital adequacy ratio and standards for credit/risk assessment and auditing of banks. The Core Principles are now becoming part of IMF conditionality and training on them is increasingly available from BIS, IMF and the World Bank. Being able to state that banks are supervised according to these standards would certainly increase both domestic and foreign confidence in the soundness of a country's banking sector. However, the capital adequacy ratio was constructed for more mature banking sectors and many developing countries should consider developing their own responses in the light of their individual circumstances to the BIS standards, especially those embodied in the new Basle Capital Accord;

(4) Demanding an increase in the ***levels, quality and timeliness of disclosure*** by banks and using BIS or IMF to back up standards of bank reporting and disclosure as discussed earlier;

(5) Dealing with ***NPL problems*** in an orderly and definitive manner and implementing a legal process for intervening in, rehabilitating or liquidating banks in financial straits. Recent exchanges of experience among the crisis countries on the treatment of NPLs reveal that the responsible authorities are aware of the need to improve their handling of this problem. However, the large volume of NPLs poses a problem for financing development in many countries in the region, not just the ones affected by the crisis;

(6) Promoting ***information-based professional credit and risk assessment procedures*** in banks, including through the flexible and phased application of BIS standards and enhanced disclosure by banks of their operating procedures;

(7) Promoting the ***use of information technology*** and new ways of conducting business to improve efficiency in the banking sector for the benefit of

depositors, including the spread of ATMs and ATM pools, e-banking and new products of interest to savers supported by professional investment counselling services;

(8) Promoting ***human resources development*** in the central bank and in other banking institutions in a wide variety of areas, including all those mentioned above;

(9) Reducing the ***direct use of banks*** by the government as a source of funds or as a modality for directing credits, and putting public-sector and government-specialized banks progressively on the same footing as commercial banks;

(10) Ensuring ***competition*** within the banking sector, including further cautious liberalization of entry by foreign banks or financial firms.

The above list should not be seen as exhaustive. Given the continuing need to rely on the banking sector as a primary engine for intermediating domestic resources, it requires ongoing attention to enable it to serve a country well; no country can afford to let its banking system fail as this would severely disrupt the flow of funds and development. The reform process is thus not static and its contents have to be specific to the country context and to the evolution of banking standards worldwide.

2. Other institutional arrangements

Mandatory provident funds, state-sponsored unit trust schemes or fully-funded pension schemes have been employed very effectively in Japan, Malaysia and Singapore, among others. They have the potential to raise the savings rate by 3 to 4 per cent of GDP, and also to provide an ideal source of institutional finance, mainly for the public sector. However, the impact of such schemes on aggregate savings depends on the extent to which they substitute for other voluntary savings. Evidence on the fully-funded Central Provident Fund in Singapore shows that it has stimulated aggregate saving. Nevertheless, such schemes so far have been successfully organized in countries that have a significant proportion of the labour force in the formal sector.

Pension funds add to the modalities for savings. But more importantly they provide a valuable addition to the institutional investor pool for domestic capital markets, as well as a source of social security and a safety net for the retired. In most Asian and Pacific countries, there is no universal retirement system beyond the public sector that fosters the regular contribution of funds from both employers and employees. With the increasing age of the population in many countries, pension funds could potentially be quite large. However, starting new schemes is a long-term proposition as they take years to build up a sufficient financial base; many smaller pension funds in the region have inadequate capital and high operating costs. In addition, it does not seem currently feasible to organize pension funds on a sustainable basis for the informal or unregistered sector.

Insurance schemes offer another form of savings with the funds collected being invested in various financial instruments. Life insurance, unemployment insurance and other forms of insurance in the ESCAP region exist mainly in the government sector and in the formal sectors of the economy. The coverage varies from country to country; 11 per cent of the population of Thailand have life insurance compared with 80 per cent in Japan and 70 per cent in Hong Kong, China. In India, premium payments for all forms of insurance are a tiny proportion of financial savings. However, the liberalization of this sector is under way and a number of firms have applied to offer life and general insurance. In the aftermath of the recent crisis and in line with World Trade Organization (WTO) agreements on services, this sector is being opened up to foreign investment. For example, in Thailand in 2000, foreign companies had stakes in 13 out of 25 life insurance companies. One of the constraints facing expansion in this area is that many insurance schemes lack credibility because of unscrupulous brokers who deal with the individuals buying and claiming under the schemes. It appears difficult to supervise all brokers even through a viable national association of dealers which undertakes self-regulation and stresses ethical behaviour.

Using the postal system as a vehicle for collecting household savings has been a modality in a number of countries for quite some time. As post offices tend to have a wide geographic distribution, they are often accessible by rural households in areas where there are no banking outlets. They have been a natural vehicle for uses beyond postal services. In addition, governments have given incentives to households to save through post offices and, with governments being the holder of the deposits, they have used the funds to invest in more projects, including social infrastructure, than they could have without access to these funds. However, as private banks and other financial institutions have improved their outreach, postal savings systems have tended to die out. There have also been problems with the viability of some of the government investments made with postal savings deposits, affecting the financial sustainability of the system. Nevertheless, there is some renewed interest in postal savings systems, especially for remote rural areas, as a modality for encouraging households to save in forms available for intermediation to government investment.

Microfinance schemes provide savings and credit mechanisms for those beyond the reach of the formal banking system, often the poor who lack collateral. Many have been successful in inculcating the habit of savings and so provide a way to intermediate resources at a micro level. It is likely, though, that the effect on the overall savings rates in an economy is rather small. According to the World Bank, there are at least 120 microfinance institutions in East Asia and South-East Asia, and about 100 in South Asia. In East Asia and South-East Asia, about 44 per cent of the funding for microfinance comes from donors; this figure is larger, about 54 per cent, in South Asia. About 32 per cent of the funding in East Asia and South-East Asia is from deposits (savings) and only 4 per cent from governments. In South Asia, deposits contribute about 30 per cent. It is interesting that for the microfinance schemes run by banks or credit unions, around 70 per cent or more of the funding comes from savings deposits, whereas for non-governmental organizations (NGO) schemes, over 50 per cent comes from donor contributions. However, in South Asia, NGO schemes obtain about 22 per cent of funding from deposits, the highest percentage in any region.

The proliferation of microfinance institutions has led to the need to reassess their role as a tool for resource mobilization and as a poverty alleviation mechanism. The question is whether users (savers and borrowers) can "graduate", that is, if people go on saving or borrowing small amounts, has their situation really changed? Evidence on this is very mixed as it is difficult to conduct counterfactual studies. It would appear desirable to graduate some of the users with good savings and loans track records to regular savings accounts and larger loans.

Some microfinance institutions themselves have graduated into the regular financial system. Some, including Grameen Bank of Bangladesh, are registered banks and so follow rules on capital adequacy etc. This means that users have reduced risks in saving with and borrowing from the institution. Another option under consideration in countries with a history of microfinance is to use an apex-type organization as an intermediary between local NGO microfinance schemes and formal financial institutions. Such an organization can, as one of its functions, borrow funds from the formal institutions and lend them on to the microfinance institutions, presumably at a better rate of interest than the individual NGOs could. Palli Karma Sahayak Foundation plays this role in Bangladesh and recently has provided as much as 17 per cent of the funds for NGO microfinance. Such an arrangement should increase the willingness of individuals to save with NGO institutions. However, when microfinance schemes are sustained by injections of funds from governments or donors, both of which may be unpredictable sources of funds, their future is quite uncertain. There is, thus, a need to increase the number of savers and the percentage of loans covered by saving deposits. All schemes should work towards being more self-supporting as a way of encouraging more micro-level domestic resource mobilization.

Policy issues

The main issues for government policy in the area of mobilizing domestic resources for development through non-bank institutions include:

(1) Whether to create or strengthen ***mandatory savings schemes***. The benefits of mobilizing funds for government investments through these modalities need to be weighed against the efficiency of the investment decisions and a judgement as to whether the savings generated are additional or a diversion from the other modes;

(2) How to encourage ***pension and insurance schemes***. The decision on whether to legislate such schemes nationwide or to leave this area to private initiatives under better developed regulation and supervision is a country-specific one. However, with an increase in the older-age population in many countries of the region, pension and life insurance schemes are most likely to be on the agenda. The regulatory legislation for these schemes and their effective enforcement are crucial to their being viewed as an attractive form of savings for households;

(3) How to make ***microfinance schemes*** an attractive and secure modality for small-scale savings and how to provide ways and means for users to graduate to formal-sector financial institutions. The following options need to be considered: registering microfinance institutions under banking legislation;

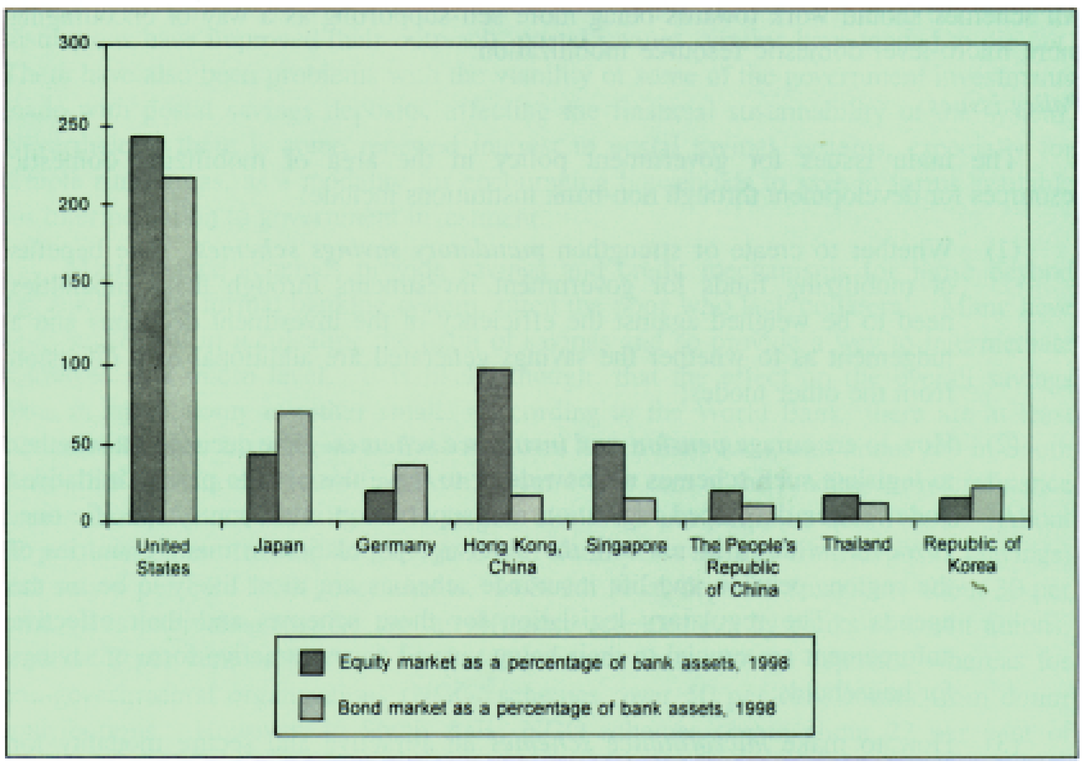
using an apex organization to provide intermediary services between the microfinance institutions and the banking sector; and increasing the security of funding of microfinance schemes, inter alia, through increased reliance on deposits as a source of loan finance.

3. Capital markets

Stock markets

Stock markets have assumed, as yet a small, but increasing, role as a means of mobilizing domestic resources and providing a wider range of financial services (see figure 1). This has been facilitated by deregulation and liberalization measures, as well as by specific policies to foster their development. Until recently, domestic capital markets have had a rather restricted clientele, mainly urban and relatively well-off groups, and sometimes foreign investors. The robustness of these markets is thus positively associated with a widening of their participants, including through the emergence of mutual funds and provident funds which collect individual savings into funds for investment by professional managers.

Figure 1. Diversification of financial markets



Source: Standard & Poor's, Emerging Stock Markets Factbook 2000 (June 2000).

The market capitalization of stock exchanges fluctuates on a day-to-day basis. More recently, following greater international integration of stock markets, markets in the region have become strongly correlated with stock markets in the United States of America. However, taking a broad view of the last few years, the following trends are evident. Except for Malaysia, all developing countries that are not financial centres have markets less than 100 per cent of GDP. The ASEAN members Indonesia, Philippines and Thailand, as well as China and India, have shown considerable growth over the last decade in both the number of companies listed and the capitalization relative to GDP; for the other countries the stock market remains small, less than 20 per cent of GDP. Consequently, their stock markets are too thin and too shallow to be a viable place for investing or raising funds. They are rather vulnerable to corners, speculative runs and other forms of manipulation. There are doubts about the future of these markets unless ways can be found to increase their robustness. Another issue that needs intensive examination is whether countries without stock markets should be encouraged to develop small ones or other more viable ways of diversifying their financial sectors.

In general, almost all the major stock markets in the region, including those that were most severely affected by the Asian currency crisis, suffered dramatic drops in size and turnover during the crisis, but recovered by the end of 1999 to levels that exceeded their respective levels in 1990. They then experienced another drop in 2000 that has, by and large, persisted into 2001. Most of these markets had opened trading to participation by foreign investors during the 1990s. A few markets that were not so affected by the crisis, including China, have continued to grow. The turnover ratios in developing country markets tend to be quite variable and generally reflect efforts to widen the investor base and investor sentiment (including sentiment by foreign investors) about the strength of the economy. A higher turnover reflects more confidence, but this is almost impossible to achieve in small, thin or narrow markets.

Despite signs of stability and continued positive private savings behaviour, most corporations in the region are experiencing difficulties in raising funds. This is caused by three factors: (a) banks and other financial institutions have become more reluctant to approve new loans or to roll over existing credit lines; (b) alternative means of financing (for example, structured financing and syndicated loans) have become almost unavailable; and (c) the weak performance of individually listed companies on stock markets makes it difficult for them to raise funds through this market. The difficulties in the financing process appear to be a manifestation of an information asymmetry problem for these corporations. As a result of the recent financial crisis, there is a general decline in the credit standing of borrowers. Given a general lack of credible information from the stock-issuing companies to investors and lenders, investors tend to focus on the larger better-known corporations with a perceived higher level of credit performance. Corporations that are unable or unwilling to demonstrate their creditworthiness, as exhibited through company financial reports, suffer from a deterioration in access to funding sources. The most seriously affected firms are those listed on stock markets with small capitalization (which suffer from a lack of investor interest) and SMEs (which suffer from the reluctance of banks to provide financing and which have limited or no access to other forms of finance).

An illustration of this phenomenon is found in Hong Kong, China, where blue chip companies have enjoyed significantly better performance than the broad market index. The Hang Seng Stock Index comprises 33 blue chip stocks whereas the All Ordinaries Index is an aggregation of all listed companies (approximately 700 as of 1999). In terms of market capitalization, the 33 Hang Seng Stock Index constituent companies represent approximately 70 per cent of the total market size. For the period January 1997 through June 2000, the Hang Seng Stock Index increased by 52 per cent whereas the All Ordinaries Index rose by merely 22 per cent. Among the constituent stocks of the Hang Seng Stock Index, China Mobile (previously China Telecom) and Hutchison Whampoa are among the largest and highest rated companies. From 1997 through June 2000, the value of the stocks of the two companies increased by 500 and 200 per cent, respectively. The discrepancy in stock price performance illustrates the fact that only a handful of good name companies are regarded by investors as worthy of investment; the rest of the corporations are still very constrained in their ability to raise funds on the stock market. Some governments, such as that of Thailand, have encouraged their stock market regulators to improve rules on disclosure and accounting/auditing. However, much remains to be done and it would be beneficial to Asian stock markets to promote best practices in shareholder communication and in related corporate governance.

The financial infrastructure for stock markets refers to the environment in which financial transactions are carried out; it includes the legal and regulatory framework, the financial institutions involved and the trading mechanisms. An important component of the financial infrastructure is the trading, clearing and settlement system. An efficient and effective trading environment can enhance investor (saver) participation and reduce systemic risk, such as the inability to complete a trade. These benefits are translated into a higher liquidity and a reduced cost of capital for listed companies. Improvements in the infrastructure of local stock markets can stimulate local investors (savers) to hold domestic stocks, thereby enhancing the robustness of the market. In India, for example, much progress has been made recently in three areas, trading modalities, depositories and settlements. Most trading is now automated and investors should soon be reaping benefits in terms of cheaper transaction costs and better service.

Bond markets

Countries in the ESCAP region are generally characterized by underdeveloped longer-term investment (bond) markets. With the exception of the Republic of Korea, bond markets are very small compared with bank loan and equity markets. The lack of a functioning bond market means that a domestic economy is vulnerable to sudden and short-term changes in investor confidence. When confidence dissipates, investors (local and foreign) do not have a more secure and stable investment alternative on which to hold. The ensuing flight to quality leads to withdrawal of funds from the country. The presence of a (high-quality) bond market with sufficient market depth would thus enhance long-term economic development prospects. However, the current state of capital markets in the region is not favourable to the development of such markets. Factors accounting for the slow development include poor financial infrastructure, the lack of benchmark bonds, fragmented capital markets, the lack of competitive credit markets, a general low credit standing for Asian corporations, the lack of pertinent financial information of the borrowers, and the inadequacy of investor protection. In most of the countries, in fact, the financial sector itself is the dominant holder of government debt instruments because secondary markets are not fully developed. Without secondary markets for debt instruments it is difficult to conceive that a large number of investors would be attracted.

Japan has the most active bond market with a size that accounts for some 85 per cent of the entire Asian bond market. The Republic of Korea is the second largest market, approximately 6 per cent of that of Japan. Singapore is the only other major Asian debt market; all other markets in publicly listed bonds are very small. For example, in India and Pakistan, the government dominates the issuing of bonds but only a very small proportion of the stock of bonds is traded daily, most bonds being held to maturity, mainly by banks and other financial institutions to meet their statutory liquidity requirement. It should be noted, however, that in several economies (for example, Hong Kong, China; Indonesia; and the Philippines) bonds are only or mainly traded over-the-counter among investors (mainly banks and financial institutions) and as a result it is difficult to obtain reliable information on the actual size of the bond market.

In the aftermath of the 1997 crisis, bond trading and bond issuance declined significantly in the second half of 1997 and in 1998. In particular, investors typically bought bonds with a high credit standing and refrained from investing in ones with a low credit standing, thus creating a polar development in the bond market similar to that in the stock market. Secondary market activity picked up in 1999 and the bond turnover appears to have recovered to pre-crisis levels in most developing countries, but not in Japan. Bond issuance began to pick up in 1999, but in many markets it has still not recovered to the pre-crisis levels. In addition, the bonds issued in 1997 and 1998 are of significantly shorter maturity. In other words, Asian bond markets are still unable to provide a stable source of long-term funds for corporations.

Domestic investors in the developing countries of the ESCAP region have generally exhibited a weak demand for long-term fixed income securities. This phenomenon is associated with the underdeveloped systems of institutional investors. In fact, it is often claimed that without the participation of a significant number of institutional investors, such as mutual funds, pension funds or insurance schemes which are independent of the banking sector, bond markets are not viable and their pricing is suspect. In turn, a lack of investor demand leads to illiquid markets and high transaction costs, and weakens the incentive for issuing bonds. In the case of Hong Kong, China, for example, high-quality private bond issuers typically raise debt financing in Luxembourg where the institutional demand for fixed-income securities is comparatively high.

Thus one measure for enhancing bond market development is to adopt a nationwide retirement benefit system. For example, Hong Kong, China is launching a mandatory provident fund scheme for all employees. Under this defined benefit scheme, employees need to contribute 5 per cent of their monthly income (subject to a certain ceiling) and the employer contributes another 5 per cent. The funds will be invested in qualified programmes organized by approved mandatory provident fund providers. There are investment guidelines for these providers, including the portion that is to be invested locally and the portion that should be invested in fixed income securities. In the long run, the funds from mandatory provident fund programmes will likely increase the demand for bonds and promote bond market development. However, the mandatory provident fund scheme is unlikely to show immediate results since it will take time for contributions to grow to any significant size.

Many governments of the crisis countries have recognized that their long-term debt markets are underdeveloped, their corporations over-leveraged, and a vicious circle of NPLs had developed. For many governments the development of a corporate bond market is a priority. For example, measures taken in Thailand have included the removal of the tax bias against bond holding and the development of a benchmark curve based on government issues. Starting from September 1999, the Bank of Thailand has been holding auctions of baht-denominated treasury bills so that yields for debt instruments of the same or lower maturities can be determined. More auctions are planned, but the secondary market liquidity is still very small. In the Republic of Korea, measures include reform of the bond-issuing procedure, introduction of new debt products (such as repurchase agreements), and reorganization of the secondary bond market. There have also been efforts to promote participation from a wider range of retail investors. The case of the Philippine treasury securities is an example of the promotion of a local bond market with sufficient market depth. In South Asia, there is quite a lengthy, but not very positive, experience with retail bonds which are not traded (there is hardly a secondary market). This experience indicates that unless the investment of the small savers is adequately protected, it is difficult to sell them bonds. Accordingly, financial intermediaries need to be registered, regulated and provided with adequate training in order for them to be able to generate investor confidence.

The development of a risk-free benchmark yield curve as the reference for the estimated rate of return on bonds is usually done by promoting a government treasury securities market. Its risk-free yield curve facilitates private issuance as investors normally price non-government securities based on a spread over the equivalent risk-free or government security with the same maturity. Several governments have used this technique (for example, Australia; Hong Kong, China; and Singapore) and maintain benchmark curves using treasury securities even when there is no need for the government to raise funds. Except for these economies, mid- and long-term benchmark government bonds do not exist, rather there are short-term benchmark government securities (such as the central bank issues in Thailand) or quasi-benchmark bonds such as guaranteed corporate bonds in the Republic of Korea. These are not a good substitute for longer-term government bonds which have very low risk. Hong Kong, China provides an interesting example of the process of developing longer-term bond benchmarks.

Bond markets would clearly benefit from reforms in corporate governance, as good corporate governance enhances the protection of the legitimate interests of the holders of corporate bonds. The elements of governance requiring attention include corruption, lack of transparency in financial transactions, use of accounting methods which do not meet international standards, and unclear ownership structures. While the crisis countries have tackled some of these practices, the adoption of best practices should be expanded. Investor perceptions of intangibles such as corporate integrity, prevention of asymmetric availability of corporate information, and enforcement capabilities of securities market regulators are key determinants of an investor's interest in corporate bonds.

Policy issues: approaches to further capital market development

Despite the myriad difficulties outlined above, establishing capital markets with sufficient depth should be achievable in several economies in the region for a variety of reasons. First, the savings rate in much of East Asia and South-East Asia has been high, at over 30 per cent. This high rate should provide sufficient funding sources to support the development of capital markets. Second, economic growth is likely to continue to be significant in the region. The last two years have seen many Asian and Pacific economies demonstrating a remarkable recovery. As the regional economies continue to grow at a respectable rate, successful firms will emerge and asset quality in general will improve. Third, many governments in the region are paying serious attention to the potential contribution of domestic capital markets in the economic development process. Such enhanced awareness provides a good foundation for governments to work towards identifying and implementing means to enhance capital market development. Outlined below are issues that are pertinent to the basic framework needed for healthy markets to thrive.

(1) ***Coping with fragmented markets.*** The economies in the region each have their own language, culture, customs and legal framework. Hence, the market structure and its mode of functioning in one country cannot automatically be translated into that of a second country. This contributes to the existence of fragmented capital markets, making regional investment difficult and sometimes more risky than necessary. As few of the economies (notable exceptions being China, India and Japan) are large enough to provide economies of scale in information processing, capital market development will be difficult. Given this situation, it would appear more rational to work towards a common set of basic structures and standards so that the regional development of equity markets becomes possible and each economy can see the benefits from contributing to this process. However, the predominance of national interests and a view that markets in the region are competitive rather than complementary mean that this is, at best, a long-term proposition.

(2) ***Dealing with the lack of disclosure.*** Both the quantity and quality of information disclosed to investors are limited in most countries of the region. The consequence is that savers inherently assume that investments are risky and demand a steep risk premium. It would be beneficial to all if sufficient relevant information were accessible to investors, either through a mandatory or a voluntary process. The proposal made above to enhance corporate disclosure through enforcing disclosure by banks would certainly benefit the capital markets as well. The standards for such disclosure could also be

harmonized among countries. As information technologies continue to improve, regulatory bodies have to constantly review the disclosure guidelines to make sure that corporate managers utilize the most efficient and effective means of communication with investors.

(3) ***Varying accounting standards*** from place to place with some exceptions, such as Hong Kong, China; Malaysia; and Singapore which use British standards. It would be a very positive step if regional or subregional accounting and regulatory bodies could agree on a common set of accounting standards. Furthermore, efforts are needed to ensure that all investors have access to the same set of sensitive information at the same time.

(4) ***Reducing government intervention.*** Traditionally, governments in the region tend to offer subsidies to activities that fit their policy thrust. An example is the provision of low-cost housing finance which exists in many countries. By pursuing this course, the return on the relevant capital market instrument, for example, mortgage products in the case of housing, becomes distorted and can substantially deviate from the market rate of return. When the instruments involved are suitable to be part of the development of a viable capital market, such as securitization of home mortgages, the existence of a significant distortion in the rate of return makes this difficult. The reduction and ultimately elimination of such government intervention could contribute to the smoother development of viable capital markets.

(5) ***Developing benchmark securities.*** As discussed earlier, typically the fixed income securities issued in the region are short term in nature. Therefore, it is impossible to construct a good benchmark yield curve from which efficient bond pricing can be done. It would be desirable if high-quality bonds with longer maturities were available.

(6) ***Enhancing the role of credit-rating agencies.*** One solution to the information asymmetry problem affecting capital markets is to have the issuers of securities (stocks or bonds) analysed and rated by a credible credit-rating agency. The role of such an agency is to provide an objective analysis of the borrowing firm. Potential lenders can then derive valuable pricing information and assess the risk of holding the security issued by the firm. Since the early 1980s, many countries have set up their national credit-rating institutions. In some countries it is required by law that debt issuers be rated by a designated credit agency. However, the existing set-ups do not seem to provide sufficient information for lenders or to promote the bond and stock markets effectively. Most of the credit agencies are either government departments or affiliated to the government. Thus, when a state-owned enterprise issues a bond, the credit agency may be reluctant to give the enterprise a negative rating. In addition, the quantity and quality of financial and non-financial information may be inadequate for the credit-rating agency to provide a comprehensive and timely analysis of the borrower's situation.

In some countries borrowers tend to get around the mandatory credit-rating procedure by issuing alternative types of debt. For example, the majority of bonds issued in the Republic of Korea are guaranteed bonds backed by a holding company. In this way, the issuing (subsidiary) company need not obtain a credit rating and hence is not required to disclose the relevant pricing information. In addition, national credit-rating agencies do not appear to provide the information on borrower quality required by international investors. In the more developed capital markets of Hong Kong, China; and Singapore, there is no local credit-rating agency and issuing firms tend to use the service of international agencies, such as Moody's or Standard and Poor's. International credit agencies actually play a significant role in the capital markets of the Asian and Pacific economies as their analyses of the risk profiles of the country, industries and specific firms are often taken by international investors as an authoritative measure of a particular local market. In fact, a few countries have set up their domestic credit-rating agencies in collaboration with an international agency. For instance, in Indonesia, PEFINDO was established in 1994 on the initiative of the Ministry of Finance and the Bank of Indonesia under a partnership agreement with Standard & Poor's. PEFINDO has rated some 200 companies involving about 250 debt securities. This partnership has contributed to PEFINDO gaining international credibility.

The options for future action in this area include establishing a regional credit-rating agency or, at least, coordination among national ones to work towards common credit assessment standards pertinent to the region and performance of unbiased analysis and disclosure. In general, rating agencies should operate according to a professional code of conduct and should be financially independent from both government and corporations. It may be desirable to invite the international credit agencies as founding members so they can participate in the process of setting up the criteria and assessment standards.

(7) ***Improving the regulatory framework.*** A prerequisite for both equity and debt market development is a good regulatory framework. The general framework should aim at legislating relevant laws, setting reporting and trading requirements for relevant financial institutions, and developing enforcement measures to implement the laws. Usually, a good regulatory framework should promote self-regulation and self-monitoring by financial institutions themselves; it should leave sufficient room for the market participants to act in a flexible manner. At the same time, the system should have measures to encourage good practices and punish offences. The underlying principles include increased transparency and disclosure, enhanced corporate governance and recognition of the accountability of regulators. The outcome of good regulation is a market infrastructure that promotes investor (especially creditor) protection, has an effective judicial system, and

facilitates high-quality economic information. Other than Hong Kong, China; and Singapore, there is evidence of considerable room for improvement. As regulatory requirements vary widely in the region, closer cooperation among regional regulators is needed to work towards a common understanding on these. Such cooperative efforts will also enhance enforcement by filling the information gap, especially for cross-border transactions. It may also be possible over the longer term to explore the establishment of a common trading platform to allow investors to trade securities on a regional basis. This could especially help smaller, thinner and shallower markets to become part of a more viable market system or to allow firms from countries without markets to issue securities on the markets of neighbours rather than develop unviable markets of their own.

(8) ***Educating investors.*** The percentage of savers (investors) holding equity is low in the Asian and Pacific region. The percentage of investors holding other types of securities is even lower. Educating potential investors is critical for increasing the general investor base and empowering investors to perform the analysis of risk and return in the investment process. Investor education is especially important for the promotion of bond markets since Asian investors exhibit a general reluctance to hold fixed-income securities. It should aim at building positive attitudes towards investing as an integral component of managing one's finances and as an important tool for planning retirement and other major consumption purchases, such as houses. It is hoped that the mutual funds being established will provide a good conduit for this exercise, and not be seen as a vehicle for cheating investors. Appropriate regulation and monitoring of mutual funds could go a long way in increasing investor confidence. In fact, various forms of mutual funds, provident funds, insurance schemes and retirement schemes (institutional investors) can be the backbone of capital market revival or development.

(9) ***Developing venture capital funds.*** These are sometimes used to stimulate new and riskier investments in SMEs, and sometimes for investment in a country that does not have a stock market (such as Viet Nam until very recently). Venture capital funds are viewed by investors as viable instruments as the monies are not invested in one firm but spread out over many. They can be national or they can also involve external investors. However, they are inherently risky and buyers can be misled about the returns possible, seeing only the upside. Therefore, the tradeability of venture capital shares, say on a stock market, is important in order to get a market valuation of the risk and return. An issue which arises with venture funds is the choice of regulator and the type of regulation and transparency rules to which they should be subject without stifling them.

(10) ***Increasing cooperation among stock exchanges.*** There is plenty of room for cooperation among both exchanges in the region and with those of the developed countries. Alliances with exchanges in the United States and

Europe can form a market place for 24-hour trading. Furthermore, such alliances can promote technology innovation. For example, in 2000, seven NASDAQ listed stocks were to be listed and traded on the Stock Exchange of Hong Kong. The listing of these stocks is part of a pilot programme that will potentially develop into the linkage of the exchange with NASDAQ and other major international stock exchanges. Another notable joint venture is the alliance between Singapore International Monetary Exchange, Chicago Mercantile Exchange and the Marché à Terme Internationale de France. This alliance allows the development of joint trading and clearing systems. However, linkages among the exchanges in the region have always been weak. This may be due to differences in the cultural background. Another reason is that individual stock exchanges consider the other exchanges as competitors. One form of cooperation is to encourage the cross-listing of Asian stocks in the region. This development would probably be a long-term goal as most Asian corporations are relatively less known to investors outside their home countries. In addition, investors have to face different disclosure and regulatory standards across countries. Nevertheless, there are already some high-quality firms from ASEAN countries which are listed on the Singaporean stock market.

(11) ***Developing internet trading.*** The recent explosion of Internet stock trading offers opportunities for the development of and cooperation among stock markets in the region. In the United States, Internet trading has been established as an efficient and reliable means of securities trading. The emergence of Internet brokerage companies puts significant downward pressure on the commissions charged by securities brokers. The result is that more investors have the accessibility to trade and can trade at a lower cost. Such pressure can be especially intense for markets with regulated commission rates such as Malaysia or Thailand. It is expected that commission rates will ultimately be deregulated in most markets. Such a change, coupled with the increasing ease of trading using the Internet, will likely be associated with more investor participation. In most countries, personal computer ownership and Internet penetration are still at an early stage, but it is expected that the growth in Internet usage will be substantial in the next few years. The Republic of Korea is the most active Internet stock trading market, with over 50 per cent of stock transactions done over the Internet. It is plausible that Hong Kong, China; and Singapore will also pick up the trend of Internet trading in the next two or three years. The Internet can provide a good basis on which national stock exchanges can cooperate, as investors can conveniently access pricing information in other markets. When a common trading platform across different markets is available, it can be expected that the integration of investor activities will speed up.

C. CONCLUSION

Taking the situation in the ESCAP region as a whole, the subject of domestic resource mobilization poses three central issues from both an immediate, short-term perspective as well from the standpoint of the next few years: one, how do countries cope with the situation of ample liquidity in the financial system and low and declining interest rates, on the one hand, with a virtual absence of creditworthy borrowers, on the other. The so-called 'credit crunch' problem has been much discussed in the region over the last few years with little, or no, indication as to what monetary authorities might do to overcome it. Two, the contribution of microfinance schemes in providing access to the poor who lack collateral to relatively assured sources of finance is now generally accepted as having been positive. The real question, however, is the efficacy of such schemes in enabling their users to graduate to the formal financial system, i.e., how effective the schemes have been in nursing their users to grow to a size where they can access and utilize the banking system and financial markets. Three, a well-developed financial system, one with appropriate institutional depth in the capital markets, is clearly an essential prerequisite for sustained development. This leaves, however, a considerable problem for the smaller economies to overcome. The issue that arises, therefore, is what could small economies, such as in the Pacific, do to either access or, over the long term, develop viable capital markets for themselves.

II. MOBILIZING DOMESTIC FINANCE FOR DEVELOPMENT AND CREDIT CRUNCH CAUSES AND CURES: SOME EVIDENCE FROM THAILAND AND OTHER EAST ASIAN COUNTRIES

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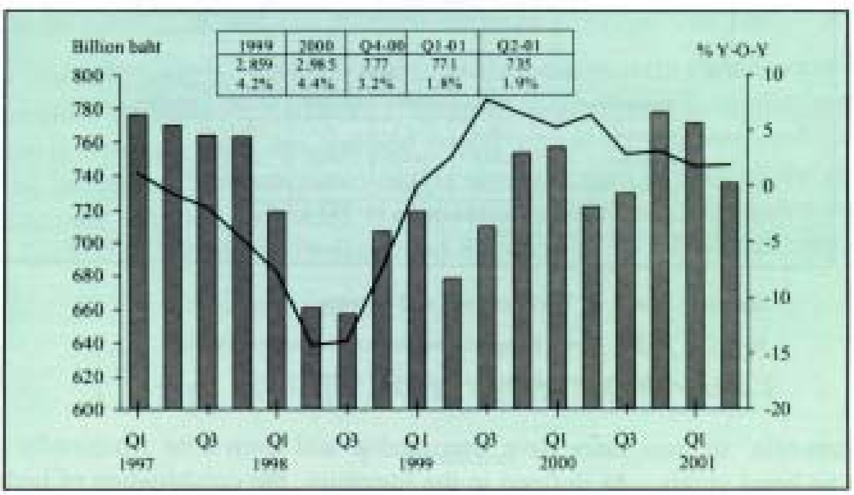
Pichit Patrawimolpon[1]

Introduction

In spite of all the reform efforts that have been implemented since the crisis in 1997, the unfavourable world economic environment still poses a major obstacle in the recovery path of the Thai economy.

A sharp slowdown that began from the third quarter of 2000 continued, with GDP registering a 1.8 per cent year-on-year growth rate, compared with 5.3 per cent of the same period of the preceding year. The buoyant private domestic consumption was more or less offset by the decline in public expenditures, particularly public investments owing to the change in government. Meanwhile, exports were weighed down by the slow global economy, depressing the overall economic activities in the first half of 2001.

Table 1. Quarterly gross domestic product at 1988 prices



Source: National Economic and Social Development Board of Thailand.

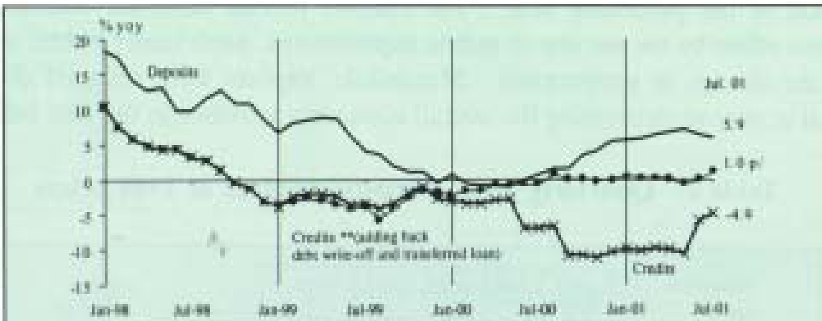
[1] The authors would like to thank Khun Donna Tris, Theerapol Rattanalankar, and Pornswan Kongkapetch for their assistance in compiling micro evidence on Thailand and other countries' experiences in addressing credit crunch problems.

As the slowdown crept in on the goods side, the services sector, particularly hotels, restaurants, education, health, public and other services continued to show strong potential. The tourist industry, for example, remained a strong pillar of the trade in services account as well as in domestic employment in related industries, at least until the attack on the United States on 11 September.

The slowdown in production and domestic demand also led to a slowdown in imports (in US dollar terms) to 7.2 per cent year-on-year during the first half of 2001. This slowdown was registered across the board, particularly raw materials and consumer goods. In volume terms, imports fell by 5.6 per cent while import prices rose as much as 17.2 per cent year on year. As a consequence, current account surpluses narrowed significantly to 2.5 billion dollars during the first half of 2001 compared with 5 billion dollars of the same period in 2000.

The unfavourable external environment and change of government have led to a loss of momentum in financial reforms. Re-entry NPLs and difficulties in debt and corporate restructuring under the existing legal framework have not helped to bolster confidence and lending activities have yet to recover.

Figure 1. Growth rate of banks' deposits and private credits



(Billion baht)	1999	2000	Q1:2001	Q2:2001	July 2001
▲ credits**	-98.5	-8.3	-0.4	-20.5	35
▲ deposits	-20.9	241.0	88.7	24.4	15
credits **/deposits	1.12	1.07	1.05	1.04	1.04

NB – BIBF converted to THB at an exchange rate on 30 June 1997 (25.97 B:USD).
– ** Excluding credits extended to AMCs.

Last Update : 24 Aug. 2001

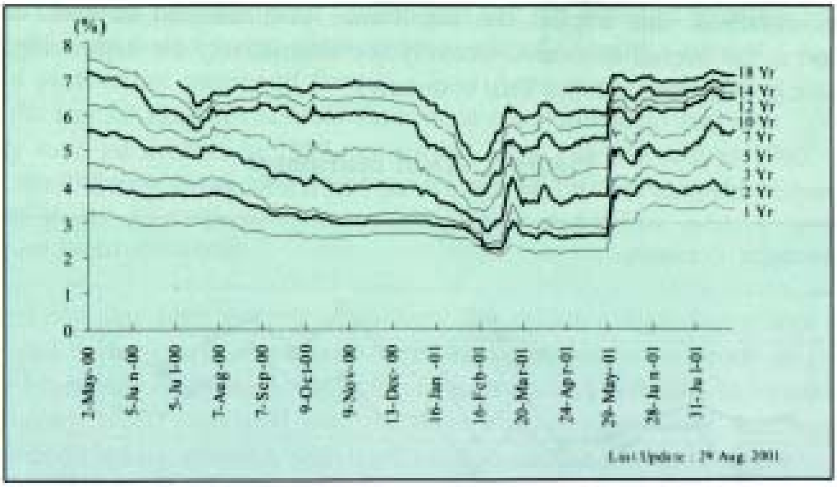
Source: Board of Trade reports and surveys.

Note: BIBF = Bangkok International Banking Facility.
AMCs = asset management corporations.

Meanwhile, interest rates have been stable and even rose marginally in 2001 as reflected by bond yields. As defined in the literature, the combination of higher interest rates and lower credit extension seem to indicate the possibility of a credit crunch. (For a more rigorous attempt to prove the existence of a credit crunch, see the annex)

Meanwhile, volatility in regional currencies as well as slow recovery in the Thai economy could not help to retard, let alone stop, the capital outflows of both the private

Figure 2. Movements of bond yield curve (2 May 2000 – 28 August 2001)



Source: The Bank of Thailand.

and public sectors. Yet, capital account deficits continued to narrow from the same period of 2000. Despite the positive impacts of capital outflows on lowering external debts, they occasionally put some pressure on the balance of payments and the baht value. The baht consequently weakened 2.8 per cent during the first half of 2001 and particularly in the second quarter in line with regional currencies from the end of 2000. In response, at the end of June, the Bank of Thailand raised the short-term interest rate (RP 14 days) by 1 per cent to stabilize the foreign exchange market and correct distortions in the domestic money market as a means to foster further economic recovery at the same time.

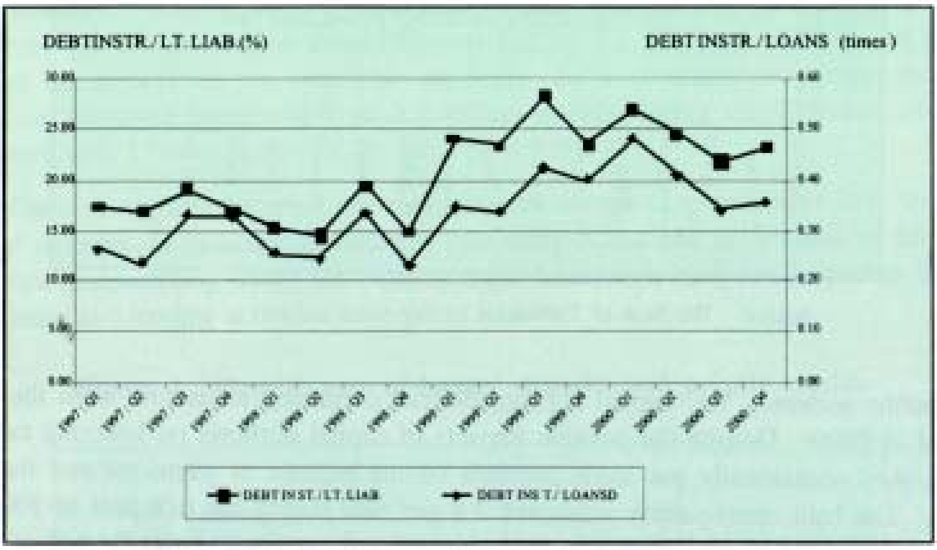
This strategy, however, involves not only these short-term stabilization measures, but also includes medium-term measures aimed of rationalizing economic and financial structures and repairing both the real and psychological damage inflicted on the Thai economy by the crisis. The latter part of this strategy aims to address the problems of the credit crunch. As a background to this strategy, however, recent developments in corporate financing structure in Thailand and a few other countries in the region will be examined.

A. THE IMPORTANCE OF BANK FINANCE

1. Thailand

The graph below is constructed based on an aggregate balance sheet of 270 corporations listed on the Stock Exchange of Thailand as of 2001 (Q1). In the graph, the ratio between debt instruments issued to borrowings from commercial banks was calculated and plotted from the period 1997(Q1). The graph shows that the ratio has been rising slowly but steadies from one quarter to almost one half at the peak during the period of analysis. With the corporate sector still relying substantially on bank finance, nevertheless, this implies the importance of a rebound in bank credit as a precondition to the overall economic recovery (or alternatively the depressing impact of a credit crunch, if it exists, on the Thai economy).

Figure 3. Debt instrument



Nevertheless, it may be noted that in flow terms, the hundreds of billions of baht of new issuances of both debt and equity instruments over the past few years have at least alleviated, if not eliminated, the impacts of the decline in bank credit during this period.

Table 2. Financing sources of the non-FI private sector from the financial markets

Billions of baht		1999	2000	Q1:01	Q2:01	July 01
1.	Credit from FIs	–156.6	–12.6	4.6	8.7	22.2
	1.1 CBs	–141.1	–49.5	–10.5	–6.2	18.7
	1.2 FCs + SFIs	–15.5	36.8	15.1	14.8	3.5
2.	Equity	46.1	59.0	2.6	3.1	3.0
3.	Domestic debentures	121.0	96.9	28.6	14.0	0
	Total	10.6	143.3	35.8	25.7	25.2

NB. 1. Credit from FIs = Claims on Bus. and Household – Investment in securities + Loan write-off and Transfer out – Transfer in.

2. Dued debentures were subtracted from issuances in each quarter.

Source: Board of Trade reports and surveys.

2. Other countries in East Asia

From a broader perspective, it can be seen that the financial structure in East Asia is still largely bank-based owing to an underdeveloped securities market. According to a 'revealed preference' pattern of finance,[2] East Asian firms were highly geared. For example, the top 30 Korean *chaebols* (industrial conglomerates) had over 500 per cent debt-equity ratio on average in 1997, increasing from 286 per cent in 1995, compared with the United States firms which had an average of 159 per cent debt-equity ratio in 1995. This made these firms more vulnerable to shocks, as evident in the recent financial crisis.

Underlying this high gearing ratio were the region's high investment rates that were financed by bank credit, particularly in the countries at the centre of the crisis – Indonesia, Malaysia, Philippines, Republic of Korea and Thailand. In terms of stocks, Asian countries when compared with the other emerging countries, had some of the most developed banking systems, with bank credit amounting on average to about 100 per cent of GDP in 1991-96, against 40 per cent for the main emerging countries outside Asia and a mere 35 per cent on average in Latin America. On top of these relatively high debt ratios, credit growth continued at very fast rates in most of these countries in the region until the crisis, 13 per cent in real terms on average in this period, against 4 per cent in the main emerging countries and 7 per cent in Latin America. Reflecting this pattern of behaviour, the bond markets remained embryonic in most countries of the region. Equity financing, on the other hand, remained restricted by the speculative nature of this market despite robust growth leaving bank credit at the centre stage of long-term development financing. On the whole,[3] bank credit accounted for three quarters of investment in the region in 1996 compared with more or less half this level in Australia and the United States.

B. SO WHAT IS THE BOTTLENECK?

With respect to the experiences specific to just Thailand, the causes of the sharp fall in domestic credit may be attributed to five major factors as follows:

1. Liquidity spiral

First, partly as a result of the depressed economic development, the level of NPLs began to rise again. On the one hand, the weaker corporate sector made banks more reluctant to provide additional loans, fearing that they would be drawn into an endless cycle of NPL-loan loss provisioning. On the other hand, the cutback in loans also

[2] Since firms seem to have a system of preferences of retained earnings over debt and debt over equity as a means of finance (Singh 1997).

[3] Calculations are based on data presented by Richard J. Herring and Nathporn Chatusripitak in "The case of the missing market: the bond market and why it matters for financial development", Asian Development Bank Institute Working Paper No. 11, July 2000.

impaired the corporate sector's debt-servicing capacity as they found it hard to raise or expand their working capital, blocking their chances of resuming normal operations and utilizing their full capacities.

2. Impaired debt-servicing capacity, especially SMEs

Traditionally, SMEs tend to encounter difficulties in obtaining loans from financial institutions because size is also a major consideration in credit analysis. This is in spite of the fact that SMEs account for over 90 per cent of the corporate sector, representing an important engine of the Thai economy.[4] As most of the liquidity remains bogged in the relatively safe, short-term money market, SMEs, being less than prime clients, tend to get caught in the debt-restructuring process as banks tighten up. Many of these SMEs were not directly involved in the substantial buildups of US dollar debts and thus may not have suffered the exchange losses to the same extent as their larger counterparts. Yet owing to asymmetry of information (in particular the unavailability of institutions such as a credit bureau, which was only established after the crisis) banks were unable to distinguish these potential clients from those suffering real losses from the crisis. As the process of reform became protracted because of an inadequacy legal framework, the liquidity problems of SMEs turned into solvency problems and a large number of them were swept into the NPL category (even if their fundamentals might have warranted stronger support and a better chance of survival at the beginning of the crisis).

3. Stalling reforms

This is not to say, however, that all SMEs are the unlucky victims of the crisis. A large number, large and small, did suffer real exchange losses and did not or could not reach restructuring agreements with banks. At the macro level, the aggregate level of NPLs that could not be restructured, rescheduled or foreclosed stood at some 1.5 trillion baht or 30 per cent of GDP in the middle of 2001. Moreover, of the 1.3 trillion baht loans already restructured, a significant proportion continued to come back as re-entry NPLs at the rate 15-20 billion baht per month, totalling some 300 billion baht as of the end of the second quarter of 2001. This development eroded the confidence of banks as well as foreign creditors/investors even further, undermining any positive impacts that reform efforts might have achieved so far and inhibiting the chance of further recovery.

4. Risks of a further fall in collateral values

One of the root causes of the financial crisis that began in 1997 was bank loans being extended on collaterals rather than economic (or cash flow) prospects of the investment projects. As the bubble burst, the gaps between collateral values and the gross amounts of loans extended became a provisioning burden and drained away banks' capital, forcing banks to reclassify these loans to 'substandard', 'doubtful' and eventu-

[4] According to a survey by the Ministry of Industry in 1998, some 124,000 SMEs, defined as firms with less that 200 employees, accounted for some 97 per cent of the corporate sector.

ally 'loan losses' categories. Fears of a repeat of these experiences made banks even more nervous in granting additional loans after the crisis, particularly when the direction of asset prices remains uncertain.

5. Commodity prices slump

Apart from the social and political concerns arising from commodity price depressed agriculture, one of the largest employers in the Thai economy, the prolonged falls in commodity prices also have a direct bearing on domestic private consumption which is probably the only growth engine left. For the other engines, investments have been limited by some 50 per cent of capacity still unutilized while government expenditures have been constrained by fear of a public debt burden over the medium-term policies, and net exports by the depressed world economy.

Corresponding to the problems experienced in Thailand, the policies and measures introduced to address these issues are discussed in the next section. These issues are in fact not unlike those (with varying degrees and emphasis) faced in the other East Asian countries that were also affected by the financial crisis. Nevertheless, the situations in these countries, may be made more complex by the political and institutional frameworks (social conflicts, exchange control, government and public sector involvement in financial restructuring etc). This, nevertheless, does not overshadow the practical aspects of the lessons that may be learnt from the case of Thailand. For completeness, however, some of these issues will be discussed from the perspectives of some East Asian countries in section E. Prior to this, attention is now turned to the policies and measures undertaken in Thailand to address the problems.

C. SOME WAY OUT?

Corresponding to the five categories of problems above, the measures undertaken by the Thai Government to resolve liquidity problems and facilitate economic recovery are also arbitrarily classified into five subsections as follows:

1. Export credit/liquidity support

To prevent export potential being inhibited by liquidity problems (for example, from the burden of bank credit cutbacks, value added tax (VAT) and tax payment procedures) of the private sector, the cabinet approved on 29 May 2001 the proposal of the Ministry of Commerce to enhance the competitiveness of Thai exports through three groups of measures. First, two state banks, the Export-Import Bank of Thailand (Exim Bank) and Bangkok Metropolitan Bank Plc. were appointed the main creditors extending credits to exporters based on exporters' business plans, including bank documents, confirmation of orders such as order sheet, contract, or letters of credit. After submitting all the relevant documents to the banks, legitimate applicants will be awarded credits in full as requested.

At the same time, the Revenue Department will attempt to resolve delays in VAT return, which has caused a drain on scarce corporate liquidity pools. At the maximum level, purchases of domestic raw materials and some imported raw materials used for export production will be completely exempted from VAT. For other transactions not exempted, the use of bank guarantees instead of VAT payments will be permitted. Further, to rationalize the VAT collection/return system in a more permanent fashion, an accounting system or a special VAT fund will be established where VAT payment can be made (paid from and returned to) through accounting procedures instead of cash payments.

2. SME credits

To provide liquidity support more directly to the SMEs, the government has issued target loan levels to be granted by state banks to SMEs, starting from the second half of 2001. In addition to the earlier arrangements under which the Small Industrial Finance Corporation guarantees a proportion of the loans extended to these SMEs, the government has also paved a way to the establishment of a 'People's Bank' by setting up a target of 3 billion baht loans to be extended initially through the Government Savings Bank. From its establishment on 25 June through 28 September, 465,029 individuals have become members depositing (as an initial requirement) some 1,252 million baht. In return, the Government Savings Bank has extended 2,720 million baht to 205,943 individuals.

At the village level, 79,754 revolving village funds (with 1 million baht initial endowment each) have been established for village members at low interest costs as a means to stimulate the economy from the grass roots. This approximately 80 billion baht fund will also be mobilized through the Government Savings Bank with some 30 billion baht already allocated to selected villages judged to have met all the preconditions at the end of August.

Related to commercial lending, the Bank of Thailand has also required Thai commercial banks to submit reports specifying their credit targets of 2001, particularly for SMEs before 15 March 2001. The report of actual lending in the first half of 2001 is to be submitted no later than 21 July 2001, while that of the latter half is to be no later than 21 January 2002. As an additional incentive also relating to earlier flood assistance, the Bank of Thailand from 12 January 2001 had also reduced the interest rates charged in rediscounting SMEs' promissory notes through financial institutions from 3 to 2 per cent for a period of one year.

3. Thai Asset Management Corporation and enforcement of BIS rules

In order to speed up and enhance the effectiveness of debt restructurings, the government has also established the Thai Asset Management Corporation starting from June 2001 to conduct bond-for-discounted-NPLs swaps based on the underlying collateral values to be evaluated independently. This measure is aimed at reducing NPLs (targeting at some 1.3 trillion baht face value) more decisively and permanently as a means to restore confidence and enhance banks' lending capability. At the same time, the law governing the establishment of credit bureaus has also been submitted to the Parliament and subsequently to the Senate by the Cabinet to increase transparency and reduce risks in the lending process. By allowing lenders, not just banks, to access more information pertaining to the risks regarding potential borrowers, the establishment of credit bureaus should allow banks and other financial institutions to better distinguish between customers facing solvency problems from those with mere liquidity problems.

Meanwhile, effective from 7 February 2001, the Bank of Thailand has issued a circular requiring privately established asset management corporations to submit reports in relation to non-performing loans, debt restructuring, loans undergoing court procedures, and detailed information on the related entrepreneurs. Furthermore, to streamline commercial lending procedure as well as to clarify loan classifications, the Bank of Thailand also issued a circular, dated 17 May 2001, amending the clients clarification criteria to which financial institutions have to comply, for example, distinguishing classification by individual merits from those classified by quality of the guarantors or by groups of businesses.

4. Property market support

To support the property market that continued to contract right after the start of the crisis, the government has introduced measures in three areas. First, from 3 April 2001, corporations or juristic persons have been allowed to deduct from their incomes the expenses arising from obtaining land or condominiums along with an earlier deduction schedule for depreciation allowances. Second, starting from 9 April the Government Housing Agency along with the Government Housing Bank as well as the Krung Thai Bank will provide long-term financial support at low cost to government and state enterprise officials (below certain ages), and low-income individuals to obtain/expand/redeem mortgages on their houses up to 100 per cent of the appraisal or purchase prices. By focusing on real-estate projects that were almost completed prior to the crisis, the project aims to boost demand for housing and lower excess supply at the same time. Third, in relation to public construction projects, from 11 July 2001, additional assistance would be provided to private contractors to speed up budget disbursements as well as to accelerate project completion in line with the schedules.

Further, to lower the cost of transactions and to provide incentives for property market developments, the cabinet approved on 15 May 2001 the property income tax decree exempting three groups of tax items, effective from 22 July 2000. These items include: (1) exempting property developers from paying income tax, VAT, specific business tax and stamp duty for income or receipt incurred from transferring property which is a public facility and services to a juristic entity set up by purchasers to take charge of the management of the property they purchase as required by the Property Development Act B.E. 2543; (2) exempting the juristic entity set up by purchasers to take charge of the public facilities and services management of the property they purchase from VAT for the management and maintenance fees collected from buyers of such property; (3) exempting the juristic entity set up by purchasers from income tax for the earnings arising from property transferred from property developers and maintenance fees collected from members of such property.

In addition, in terms of the registered right and juristic act, the cabinet also approved on 15 May 2001 the reduction of a number of fees arising from debt restructuring and bankruptcy undertakings, particularly:

(1) Reducing registration fees for the transferred property and the property used as collateral to 0.01 per cent in (a) transferring debtors' property to repay creditors, (b) transferring the property obtained from debtors or guarantors, (c) pledging of the property used as collateral between debtors and creditors, (d) transferring of the debtors' property to repay financial institutions. However, only the part transferred for debt repayment is entitled for the reduced registration fees;

(2) The fees for property transferring and/or pledging between debtors and creditors were also reduced to 0.01 per cent to be in line with the debt relief and debt settlement ruled by court according to the bankruptcy law.

5. Agricultural debt moratorium

To assist the agricultural sector, the largest employment sector faced with a slump in commodity prices, the government granted debt moratoriums to alleviate the financial burden for small farmers through the Bank of Agriculture and Agricultural Cooperatives on 20 March 2001. To limit the scope of this operation, however, farmers joining this debt relief project are required to be clients of the Bank of Agriculture and Agricultural Cooperatives or members of agricultural cooperatives who have borrowed directly from the bank or the credit guarantors or heirs of such clients prior to 1 April 2001. Farmers wishing to join the project had to apply before 30 June 2001. Moreover, to prevent moral hazard, those farmers must never have undergone any legal proceedings taken by the bank over borrowings issues, or have borrowed from the bank more than 100,000 baht, excluding other government loans and lending interest. (Farmers whose borrowing exceeded 100,000 baht and thereby not eligible for the project will be overseen by the Bank of Agriculture and Agricultural Cooperatives to undergo-debt restructuring programme). The government has earmarked a budget including the bank's additional expenses incurred from this project, for 7,700 million baht per year.

In line with the government's policy, during the debt suspension period in which these farmers can gain some savings, they will also be given career development support through government career rehabilitation programmes. Therefore, the benefits to farmers include: (1) after the 3-year debt suspension period, these farmers may, at the fourth year pay interest at the same rate prior to entering this debt relief project; (2) these farmers will be granted an additional 1 per cent of the deposit interest rate for the deposit not exceeding 50,000 baht, for a period of 3 years (as an incentive to save up and repay debt); (3) farmers completing their debt repayment before the 3-year schedule will be upgraded to a higher credit rating status by the Bank of Agriculture and Agricultural Cooperatives.

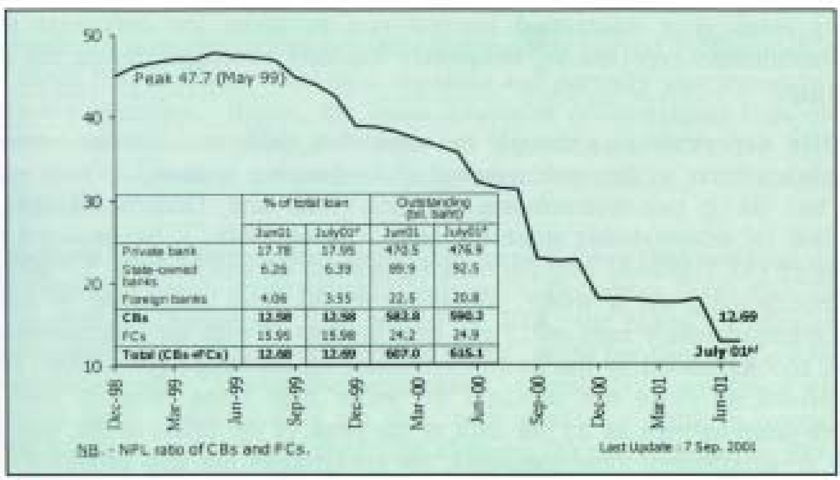
Another financial assistance along this line came with the cabinet's decision to approve the Ministry of Industry's proposal on 23 January 2001 to assist sugarcane planters in 2001/2002 crop years with a budget of 10,000 million baht. Through this project, the Bank of Agriculture and Agricultural Cooperatives was authorized as the only institution to buy discounted cheques of 46 sugar factories paid to sugarcane planters at the bank's minimum lending rate (currently at 9 per cent per annum) or lower depending on the costs of funds.

D. PRELIMINARY RESULTS

From the measures described above, particularly with the establishment of the Thai Asset Management Corporation, NPLs as of the end of June 2001 stood at 609.9 billion baht, falling from 864.5 billion baht at the end of May. As a proportion to total loans, NPLs fell to 13.13 per cent from 17.88 per cent during the same period. The decline may be considered a major improvement after the sharp slowdown in December 2000, particularly with significant amounts of NPLs being transferred from state banks to their respective asset management companies (in preparation for transferring to the Thai Asset Management Corporation) as well as successful debt restructuring and write-offs of fully provisioned debts.

As for the future trend, Thailand's economic prospects continued to be assailed by the depressed world economy, particularly after the terrorist acts in the United States on 11 September, as well as by the impacts of regional exchange rates volatility.

Figure 4. NPL ratio (per cent of total loans)



Source: Board of Trade reports.

Nevertheless, policies and measures introduced so far and described above should begin to show some positive impacts soon, countering some of these negative external effects, allowing the Thai economy to grow at a reasonable rate in 2001 and 2002.

E. OTHER APPROACHES IN EAST ASIA

1. Direct financial assistance

In addition to the Thai case, experiences in the Republic of Korea are also quite interesting and should prove useful as a policy lesson for other countries undergoing a similar situation, including the Thai Asset Management Corporation. Looking back from September 1998, the government allocated 64 trillion won of public funds ($46.1

billion at the time) to purchase NPLs and recapitalize banks, mainly through the Korea Asset Management Corporation, or Kamco, and the Korea Deposit Insurance Corporation.[5] By October 2000, Kamco had bought more than 75 trillion won of bad loans and re-sold some of these assets worth more than 40 trillion won. In total, approximately \$58.1 billion[6] of public funds have been used for financial restructuring, with \$18.6 billion used for buying negative equity of insolvent banks and \$39.5 billion for recapitalizing them and repaying customers' deposits. To finance these transactions, the funds were mobilized by the issuance of government bonds through the Korea Deposit Insurance Corporation and the Korea Asset Management Corporation in 1998. Of the total \$58.1 billion, \$10.9 billion has been re-injected after being recovered from sales of repossessed assets. In total \$69 billion has been injected into the financial restructuring process by the government.

In addition, the central bank of the Republic of Korea has introduced credit adjustment loans at a discounted interest rate to assist the corporate sector and financial institutions experiencing temporary liquidity shortages during the process of restructuring.

Similar experiences, although in somewhat different settings, were evident in Malaysia's efforts in the restructuring of its banking system.[7] From early 1998, Malaysia had set up two restructuring agencies. The first, Danamodal, was entrusted with the task of recapitalizing troubled banks. Since 1998, it has injected over eight billion ringgit (\$2.1 billion) into the banking system, of which about 3.7 billion ringgit remains outstanding. As a result, Malaysian banks have succeeded in raising their average capital-adequacy ratio to 13 per cent compared with the international norm of 8 per cent recommended by the Basle Committee on Banking Supervision. Meanwhile, NPLs, defined as those not serviced for more than three months, have fallen to 10 per cent from as high as 25 per cent at the peak of the crisis in the second quarter of 1998. To supplement these measures, the government has also provided a guideline for fifty-eight Malaysian financial institutions to consolidate, by the middle of this year, into some 10 "superbanks".

Along with Danamodal, Danaharta, another agency was given a mandate by parliament to manage assets pledged to banks by debt-plagued companies. These assets account for about four fifths of the 47 billion ringgit it now manages. Yet Danaharta has had much less success than Danamodal. Though Danaharta claims to have sold or restructured 75 per cent, or about 35 billion ringgit, of the assets it controls, this money is yet to be recycled back to the banking system.

[5] Korean Economic Briefing, July 2000, *Korea Herald*.

[6] *Dow Jones International News,* 8 August 2000.

[7] Korean Economic Briefing, July 2000, *Korea Herald*.

2. Government guarantee

Despite the substantial amount of public funds injected into the restructuring process, the recent wave of turmoil in the Korean financial sector was caused by corporate restructurings, including the Daewoo crisis, which was not anticipated at the early stage.[8] The credit crunch that followed prompted the government of the Republic of Korea to mount a massive financial-rescue package, which included pressing banks and other institutions to buy corporate bonds they otherwise would not have touched. To do this, the authorities would offer credit guarantees and grant incentives to banks in a bid to promote issuances of collateralized loan obligations and to diversify the maturity structure at the same time to prevent such obligations with a one-year maturity from expiring all at once.[9] The government introduced this new investment tool late in 2000 in a bid to ease a corporate credit crunch as some 65 trillion won in corporate bonds are set to mature in 2001.

Collateralized loan obligations are debt instruments backed by loans of 31 companies with ratings BB- to BBB+ held by companies and partially guaranteed by state-run credit guarantee agencies. Banks, the main issuers of collateralized loan obligations, would be allowed to set commission fees for the issuance (effective yields 15-50 basis points over AAA-rated corporate bonds) after discussions with state-run credit guarantee agencies.[10]

As the Korea Development Bank is the only bank underwriter and lead manager in the Korean market, it began underwriting bonds on 26 December 2000 with initial issue of 25 trillion won.[11] During the first quarter of 2001, the Korea Development Bank further underwrote 1,612 billion won worth of bonds, or 80 per cent of the 2,016 billion won in maturing bonds. Under the programme, beneficiary companies must repay 20 per cent of their maturing debt on their own while the bank is responsible for underwriting the remaining 80 per cent. In addition, 70 per cent (some 525.8 billion won) of the bonds underwritten by the Korea Development Bank also go into an asset pool for primary collateralized bond obligations that are partially guaranteed by the Korea Credit Guarantee Fund. The programme has contributed to a gradual reduction of credit risk in the bond market and revived the interest of institutional investors in Korean corporate credit.

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[8] *Dow Jones International News*, 8 August 2000.

[9] *Reuters*, 28 February 2001.

[10] *Reuters News Service*, 28 February 2001.

[11] *Korea Times*, 9 May 2001.

ANNEX

CREDIT CRUNCH: SOME MACRO EVIDENCE?

Despite its potentially important implication on policy, the term credit crunch has appeared to be identified differently among different studies and different researchers. As a starting point, the distinction between credit crunch and credit slowdown must be clarified. While credit slowdown can be caused by both the supply and demand side of the credit market, only the reduction in credit growth that is induced by supply-side constraints and yielding a disequilibrium condition is regarded as a credit crunch. According to the United States Council of Economic Advisors (1991), credit crunch is 'a situation in which the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects'.

The idea of credit crunch in recent literature arose when the traditional view of the International Monetary Fund (IMF) view failed to satisfactorily explain the observed state of the economy during and after the financial crisis 1997 of those infected countries. Under the traditional fund view, the link between the interest rate change and the real economic activity occurs through investment and consumer durable expenditure. Following the hike in the interest rate in response to the currency crisis in the 1997, it was strongly believed by IMF that this hike would help stabilize the foreign currency market and eventually induce banking reform by crowding out those projects with lower profitability. Only in the worst-case scenario was a temporary contraction of growth in the real economic activity allowed to exist. However, continuous downward adjustment of growth projection cast doubts on the true benefits of the policy and the representative version of the transmission mechanism. Together with the unique importance of the financial intermediation of the East Asian countries, the idea supporting the transmission mechanism through the credit market became a possible explanation.

The credit view of the monetary policy originated from Ben Bernanke and Mark Gertler (1995). Having examined Taylor's findings of substantial interest-rate effects on the real economy, they argued that these interest-rate effects were transmitted through other transmission mechanisms of monetary policy, apart from through the cost of capital. Alternatives included mechanisms via asset prices and via asymmetric information effects on credit markets. Only the latter is regarded as the credit view.

Based on the credit view of the monetary policy as well as the definition stated earlier, credit crunch is a disequilibrium phenomenon, accompanied by a change in the relationship between the availability of the credit supply and the interest rate. This could appear in the form of equal change across the board or change irrespective of the interest rate (flight to quality or asymmetric information problems).

Regardless of the characteristics of the change in bank lending behaviour, the presence of a credit crunch suggests that there should exist excess demand for credit and hence credit rationing, where loans are allocated via non-price mechanisms. Effectively, this imposes additional pressure on the performance of the monetary policy. The tightening of the monetary policy, adopted by IMF for instance, caused higher-than-expected adverse effects on the real economy. Assuming a prevalent credit crunch, despite the low interest-rate policy later adopted which was aimed to boost the economy, banks would still be reluctant to lend, rendering monetary policy virtually useless.

Yet, it is difficult to ascertain the prevalence of the credit crunch or, equally, to pinpoint which side of the market caused the credit slowdown. Not only are determinants of both supply of and demand for credit not known with certainty, but changes in both sides could also be induced by one common economic factor. Effectively the possibility of correctly disentangling the supply effect from the demand effect is relatively low.

This difficulty has shown itself in a number of attempts by many well-known researchers to settle this ongoing controversial issue as to whether there was a credit crunch during the 1997 crisis in East Asian countries.

A. Theoretical framework

The credit market is governed by interactions between demand for and supply of credit. In equilibrium, this interaction determines the level of interest rates for the credit market as well as the quantity of credit released. In relation to monetary policy, tighter monetary policy imposed greater cost of funds upon banks, which may or may not be passed on to borrowers. Provided that banks keep a constant profit margin, the supply of credit in the credit market decreased (a leftward shift in credit supply). The equilibrium interest rate will be pushed up and the quantity of credit released in equilibrium is then reduced. Nevertheless, in practice, the credit market may not be so flexible. Interest rates do not adjust quickly enough. The market may well end up in disequilibrium, where the supply of credit does not equate demand.

As a credit crunch represents disequilibrium under supply constraint, the essential task is to be able to identify whether a reduction in credit released is due to constraints on supply, demand or in a plausible case both reduction in supply and demand. In this last case, the credit market may well be in equilibrium.

So a careful examination to understand how credit supply and demand interplay is crucial. To do this an attempt is first made to explore how a reduction in credit supply, exogenous to interest rate, could come about.

The bank balance sheet is an essential ingredient in the bank operations recipe. Bank balance sheets comprise two equated counterparts: assets and liabilities. Liabilities are sources of funds issued by banks. Normally, liabilities include deposits, borrowings for example, from the central bank, other banks and corporations. On the other hand, bank assets comprise reserves (both required and excess), cash items in process of collection, deposits at other banks, securities and most focused upon here, loans (credit). By holding excess reserves, banks are able to pay its depositors in case of withdrawals or demand payment. Nevertheless, the greater the proportion of reserves held, the less credit could be issued, thus less profit could be made. Banks have to strike an optimal balance between profitability and liquidity.

Investigating a bank's balance sheet might shed light on the root of credit rationing. Generally, on the asset side, banks could normally select both the quantity and quality of assets with the exception of loans where pre-judgement on quality was disastrously incorrect. Especially in the light of the economic crisis of East Asia, economic downturn impairs profit prospects – what could have been a good project turns out to be ineffective. If the lending rate is pushed high, this may well aggravate the financial situation. Hence, in the event of tight monetary policy, increases in interest rates will not be passed on to bank customers. Therefore, the credit supply is restricted (see Ito and Ueda 1981 for partial adjustment of interest rate). In addition to partial adjustment, Stiglitz and Weiss (1981) proposed a model of adverse selection. Their model is based on the assumption that the quality of borrowers is private information, and hence cannot be perceived by banks. This asymmetry in information may induce banks to restrict lending. Nevertheless, the existence of asymmetric information remains difficult to prove.

On the liability side, fearing bank runs and bankrupt financial institutions, depositors may rush in to withdraw their deposits. Banks may have to call in loans to meet demand for deposit withdrawals. This fear becomes self-inflicted. (See Diamond and Dybvig, 1983 for a model of a bank run). Withdrawals further exacerbate the situation by impairing the bank's ability to lend. Hence, the credit supply is constrained.

Several factors could come into determining the demand for credit. Funding of a firm's project depends on expected profitability, alternative sources of funds, the level of economic activity etc. The credit demand function will be examined in detail at a later stage.

B. Literature review

Assuming a simultaneous adjustment to equilibrium at any point in time, a reduction in both demand and supply leads to a contraction in credit growth, but only that of the supply side raises the interest rate. The proof of a credit crunch, which has a disequilibrium condition, then requires more than the observed credit slowdown and the hike in the lending rate. Further attempts on this issue emerge in the form of both survey and econometric studies.

Looking at bank lending and firm borrowing behaviour, survey is one of the often-used methods exploited by several writers such as Domac and Ferri (1999), Dollar and Hallward-Driemeier (1998), Dwor-Frecaut, Hallward-Driemeier, and Colaco (1999), and Ito and Pereira de Silva (1999a). While that produced by Dollar and Hallward-Driemeier (1998) looked at the demand side of the Thai credit market (firm's demand for borrowing), Ito and Silva (1999a) examined the supply side (Thai banks' ability and willingness to lend). Unsurprisingly, there was a contradiction between the two.

While the former survey on the demand side concluded that the degree of credit crunch among corporations was insignificant in Thailand, the latter found the opposite. Ito and Silva proposed two necessary conditions and a choice of three sufficient conditions, supporting the existence of a credit crunch phenomenon, and found strong indications for the two necessary and 'partial evidence' for the three sufficient. He concluded "… Thailand was "most likely" under a situation of credit crunch by banks immediately after the 1997 currency crisis" and went on to criticize the interpretation of Dollar and Hallward-Driemeier as being "highly dubious". He commented that, after all, there was a report regarding the bottleneck in access to finance and that the finding on credit to the export sector satisfied one of his sufficient conditions (the loss of interest rate market-clearing role). Nonetheless, it must be noted that only the paper produced by Ito and Silva found evidence for a credit crunch. Dollar and Hallward-Driemeier, who on the contrary looked at the demand side, noticed that the firms in Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand did not regard supply constraint as problematic and concluded that the credit slowdown had stemmed from the demand side of the economy.

However, as argued in Agenor, Aizenman and Hoffmaister (2000), 'survey evidence can be seriously biased'. Firms, for example, having acknowledged or anticipated tight credit supply, tend to reduce their demand for loans. The observed reduction in credit growth would as a result appear to the respondents as a demand-induced case. Subsequent studies using econometric approaches were called for partly owing to this problem of bias.

Domac and Ferri (1999), for instance, attempted to investigate the existence of a credit view by looking at the spread between the lending rate and the rate on risk-free assets. They claimed that evidence of a widening of the referred spread together with a drop in real bank credit confirmed an extensive credit crunch, whose adverse effects on SMEs were noticeably larger. Sadly, their shortfalls lie in the determinants of the spreads used. Changes in the prudential regulations or an expected associated cost of lending can also lead to a rise in the spread.

Alternatively, a switching regression framework was employed by Ghosh and Ghosh (1999). Here, both supply and demand functions for credit were calculated. By comparing this finding to the actual amount of credit, the source of credit slowdown was determined. The evidence suggested effects from both supply and demand, where supply constraints were seen in the beginning of the crisis while the demand-induced contraction was more apparent in the later stage.

In contrast, Agenor, Aizenman and Hoffmaister (2000) exploited the two-step econometric approach, looking especially at the credit supply function. Bank demand function for excess liquidity assets was calculated and then used to project data following the crisis period, on the assumption of no structural break. Once these obtained results were compared to the actual series, significant divergence of the two should suggest involuntary accumulation of excess reserve and hence a demand-induced cause of credit slowdown. Consistent with the findings of Ito and Pereira da Silva (1999) and those of Domac and Ferri (1999), Agenor and others concluded that the credit crunch phenomenon was widespread among the East Asian countries under study.

Common features found in the literature

As agreed by several authors, there are certain common features shared by East Asian economies. First of all, it was found that depositors shifted away from banks lending more to SMEs to larger domestic banks and subsequently, to foreign banks. Bank lending is also biased towards the sector which has better access to alternative external funds. Those who could get funds, had access to excessive funds. Those who could not, starved! At the same time, the gap between the lending rate and risk-free rate and the gap between the lending rate and overnight rate has widened. In the case of the Republic of Korea, big corporations are not badly affected by supply constraints on funds, as they are able to raise external funds from corporate bonds as is clear from decreasing loan outstandings while corporate bonds outstanding increased. The consequence of corporate bond issues began to hit the Republic of Korea as a huge wave of corporate debts matured in the second half of 2001. Roughly 28 per cent of all corporate debts will come due around the same time which could prompt liquidity dry-up.

Furthermore, banks reallocate their portfolios towards larger purchase of securities. These phenomena were seen by many authors, for example, Domac and Ferri (1999), and Ito and Silva (1999) as indicating supply constraints on the system. Some authors believe constraint derived mainly from the demand side, such as Ghosh and Ghosh (1999), and Agenor and others employing distinctive methods based on econometric tests. Here, we found elements of both.

C. Methodology

In this study, we have constructed models based on the theoretical framework stated earlier in an attempt to identify the separating effects of credit demand and credit supply.[1] The earlier literature did not stand well in pinpointing exactly the effects of demand or supply in confrontation with a reduction in credit. Most of them presumed several features, namely slowdown in credit growth, increase in spread between lending rate and risk-free rate and flight to quality by banks as indicating supply constrained phenomena. Nevertheless, the analysis may appear one-sided as a credit crunch could equally well be induced by credit demand. On top of this, as seen from the definition of credit crunch, the lending rate may not be adjusted fully; therefore, a hike in interest rates may not represent a credit crunch. We offer here an alternative method. The following regressions are investigated for each individual country:

[1] We acknowledge the problem of identification as addressed in the literature. However, this exercise is aimed as another plausible alternative.

Credit supply

$$C^s_t = a + b\,(\text{deposit})_{t-l} + c\,(\text{investment})_{t-l} + d\,(\text{capital flows})_{t-l} + e\,(\text{lending rate})_{t-l} + f\,(\text{mmr})_{t-l} + g\,(\text{inflation})_{t-l} + h\,(\text{bond rate})_{t-l} + u_t$$

Credit demand

$$C^d_t = i + j\,(\text{consumption})_{t-l} + k\,(\text{capital flows})_{t-l} + m\,(\text{real GDPgrowth})_{t-l} + n\,(\text{lending rate})_{t-l} + o\,(\text{United States stockmarket indices})_{t-l} + u_t$$

where $l = 0, 1, 2, ..$ as seen appropriate and u refers to disturbances

Credit supply

As seen above from the theoretical framework, credit supply depends primarily on the factors which constitute the banks' balance sheets. Deposit is among the most prominent. Normally we would expect that the greater amount of deposit on the liability side allows banks to create more credit. On the asset side, as opposed to the credit view,[2] securities are taken as substitutes for loans as found in several papers on flight to quality by banks. Nevertheless, information on securities holdings by banks are rather limited, hence, they will not be included. Provided that securities are classified as substitutes for loans, returns on loans and securities (as represented by lending and bond rates respectively) may have a significant impact on credit supply. In addition, the costs of funds to banks as represented by the money market rate can be considered as another determinant of credit supply. By looking at the level of investment, banks may be able to deduce the state of the economy from this piece of information – presumably, investment is an indicator of market sentiments. Additional factors included in this equation are capital inflows and inflation. Capital inflows can be classified as an alternative source of funds to deposits, hence should be included.

Credit demand

Determinants of credit demand are more business-instinct oriented. It will not be too far off to assume that profit maximization is the principle objective of business. As seen earlier, the financial system in East Asia is primarily bank-based, there are close interactions between banks and corporations. Alternative sources of funds are important only in some cases such as corporate bond issues in the Republic of Korea. In other countries, the bond and stock markets are not highly developed. As a consequence, businesses, especially SMEs, have to rely on banks, the shareholders' funds or, in a few cases, direct funds from abroad. The lending rate should play a rather important role in determining credit demand as it would be classified as costs. Several economic indicators are also included, namely consumption, growth in the real GDP, and economic conditions in the major export market as could be seen from their stock market indices. These indicators should provide a rough guide for demand or purchasing power and influence the decision to invest and obtain credit. Capital

[2] Bernanke and Blinder (1992).

inflows are included as well to allow for those corporates which could have external sources of funds in place of domestic credit.

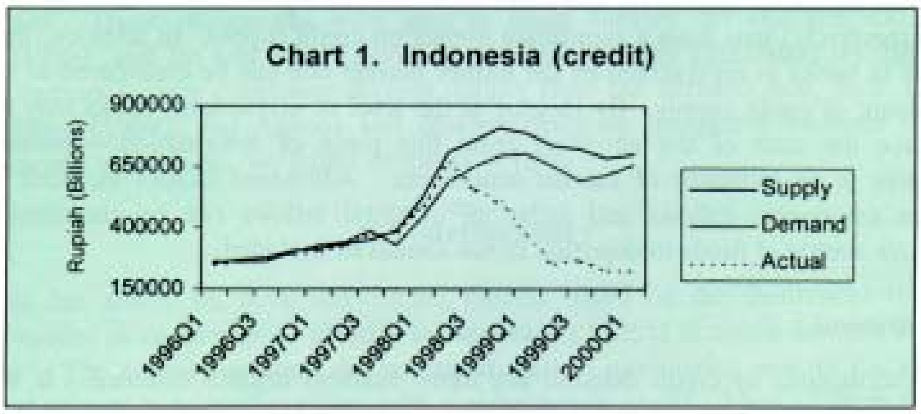
Based on a simple but strong assumption that the credit market was in equilibrium before the crisis broke out, and there have been no structural breaks in credit supply and demand models, we are able to forecast how credit demand and supply should be from the latter part of 1997 onwards. Henceforth, actual credit, credit supply and demand are compared to seek out the constraining factor.

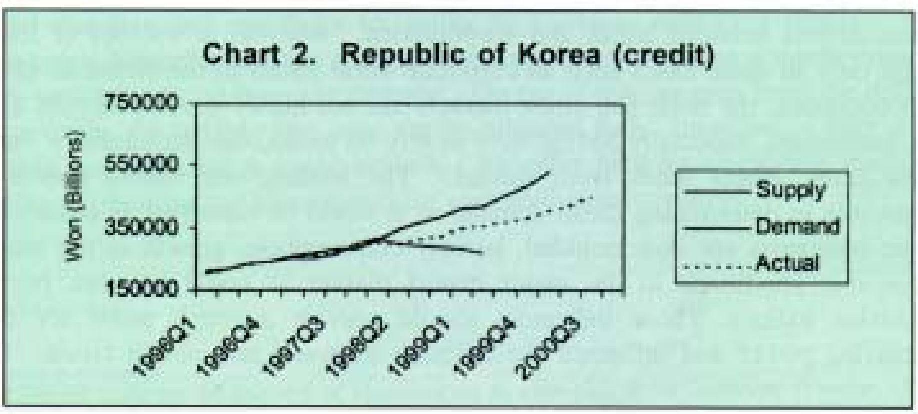
Shortfalls of the model

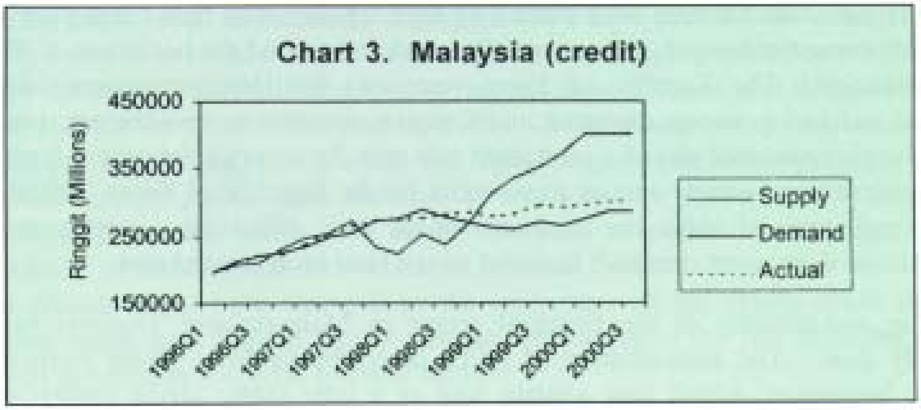
The assumption of a credit market in equilibrium before the crisis may not be viable. At the same time, parameter changes after the crisis broke out in the function of credit demand and supply are not taken into account. Nevertheless, the results obtained could be partially explained and seemed to fit in with the actual events. This study is meant for suggestive purposes and offers an alternative approach.

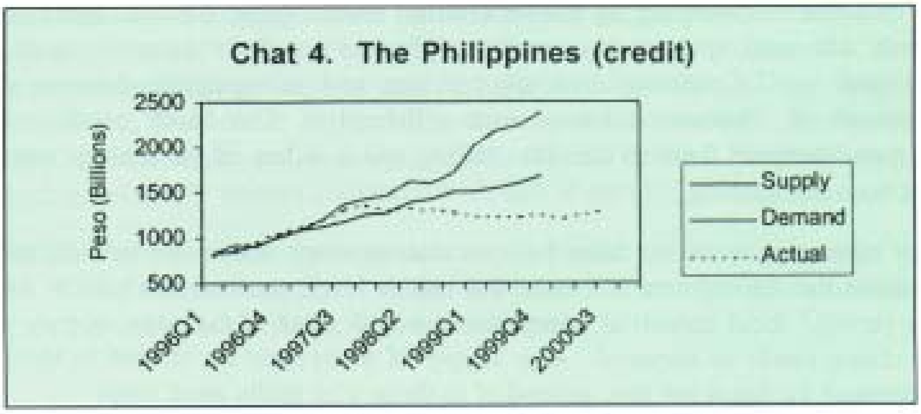
Results

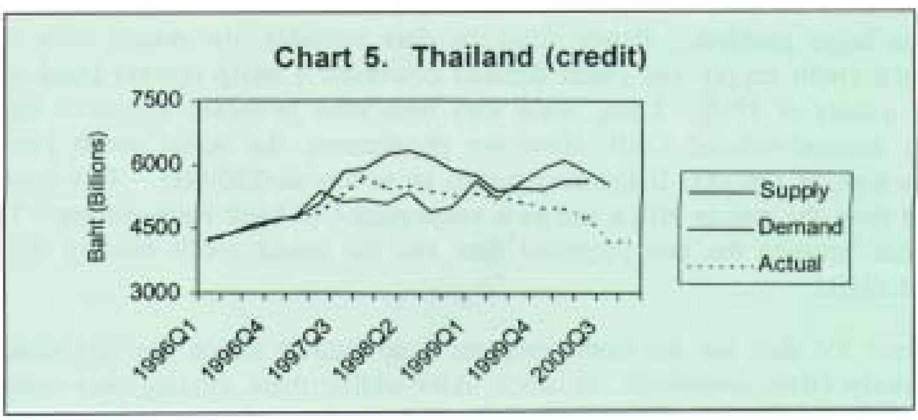
(see charts 1-5)











The forecasts for credit demand and supply revealed a few interesting features. Concerning the Republic of Korea, Thailand and Malaysia, credit demand and supply takes turn in dictating overall credit. But in Malaysia and Thailand at the beginning, the credit supply constraint overrules, hence the existence of a credit crunch. After Thailand adopted the first-stance IMF remedies, Malaysia also adopted policies along the same lines with the imposition of capital control even though Malaysia did not give in to IMF aid. Interest rates were pushed up high together with tight fiscal policy. This weeds off domestic demand, hence credit demand fell around the beginning of 1998 for both countries. The Republic of Korea went into the IMF programme later than Thailand and had to accept the same initial austere conditions, nevertheless, not for so long. Supply constraint played a prominent role only for a very brief period, apart from that, credit demand mainly acts as a constraint for the Republic of Korea. Notably, the actual credit may lie above the minimum of the two, indicating a certain degree of roll-over and drawing of overdraft facilities which have been carried over.

The restructuring of the financial sector in Malaysia and Thailand has been relatively slow. The accumulation of NPLs deters banks from giving further credit lines to businesses, which may explain why at a later stage, credit supply was not keeping up well with credit demand. On the other hand, the Repubic of Korea was in a better position. Having set up KAMCO in an earlier stage, the bad assets of banks were dealt with relatively quickly, credit supply was not distorted while demand still did not pick up. Corporate debt restructuring and renegotiation between debtors and creditors in Thailand did not work efficiently. The harsh conditions good debtors faced tempted them to turn into NPLs, which is one of the reasons why NPLs have not been diminishing.

An interesting issue to raise here is that although the credit crunch seems to disappear in the Republic of Korea at the macro level, sectoral analysis is required. From a survey,[3] local industrial companies are still short of liquidity as they are not able to obtain credit as required. The supply of loans may be offered to those areas where demand for loans are low, instead of to those who really need them.

As far as the result analysis for Indonesia is concerned, an excessive lack of data poses an acute problem. Purely from the data available, the results show that the forecasted credit supply and credit demand continued a sharp upward trend until the second quarter of 1998. Then, while they both were projected to remain high with existing demand-induced credit slowdown phenomena, the actual credit plummeted from as high as 660,000 Indonesian rupiah to as low as 230,000. This could have resulted from the rise in NPLs and as a consequence of bank restructuring. This big difference between the two projected data and the actual credit renders the results rather doubtful.

Since the data are far from complete – no data at all on the real sector such as quarterly GDP, investment, or stock index-adding these missing data would have improved the results significantly. From the author's point of view, had these data been incorporated into the model, the results would have shown a mixture of demand and supply shortage over a different period of time, just like those projected under other countries in East Asia.

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[3] The *Korea Herald*, 5 October 2000.

At the micro level, in Indonesia during the 1997-2000 period,[4] the average growth of lending capacity reached 31.2 per cent, while average credit growth was only 5.9 per cent after the crisis. Similarly, the loan to deposit ratio of banks also dropped to 35.5 per cent in 2000 from 49.5 per cent in 1999. A tightening policy regime, tougher prudential provision, bank restructuring, and flight for quality in both deposit and banks' portfolio collectively put an upper limit on the credit supply. At the same time, appalling economic prospects, which were further damaged by political complexity, eroded any possibility of stability, the main damaged of credit demand. Nevertheless, although a credit crunch might have emerged in the early state of the crisis, credit demand contraction might later impose higher adverse impacts upon the real economy, stemming from Indonesian domestic political turmoil.

Results for the Philippines were in line with what could have been expected. The Philippines has not so long ago come out of the IMF programme. It seems to be the least affected country. However, problems arose not merely from the economic structure per se but from political turmoil and climatic conditions. These factors could play an important role as far as market sentiments are concerned. Banks may well be reluctant to lend under political uncertainty. Credit demand has been on a rising trend which is relatively steeper compared with that of supply.

Overall, there seems to exist evidence of a credit crunch at a certain stage of the crisis. Credit demand constraint is also important. Hence, policy to fix distortions in credit supply and to boost credit demand is relevant.

[4] Hartadi A. Sarwono, Bank Indonesia Director of Economic Research and Monetary Policy in BISNIS Indonesia, 11 May 2001.

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III. BANKING SECTOR REFORMS IN THE PEOPLE'S REPUBLIC OF CHINA[1] - PROGRESS AND CONSTRAINTS -

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Introduction

The People's Republic of China (hereafter China) has undertaken comprehensive reforms since opening up its economy to the world in 1978. The government has removed price controls, eased investment restrictions, increased tax neutrality across different types of enterprises, exposed the domestic market to international competition, and lowered entry and exit barriers with the promulgation of the 1995 Corporation Law, which allowed firms to merge, switch production lines and close down (Bajpai, Jian, and Sachs 1997; and Broadman 1999). Moreover, the government has improved intersectoral labour mobility by permitting rural residents to set up new businesses and work in factories or firms freely, workers to resign/retire at an early age, and firms to hire workers and set wages flexibly; and has also boosted interregional labour mobility by encouraging local governments to establish human capital exchange centres. Meanwhile, the introduction of special economic zones has contributed to high economic growth and trade expansion. These reforms have given rise to township and village enterprises, urban collectives, individually-owned firms, and foreign-funded ventures, all of which have rapidly increased production and their market shares.

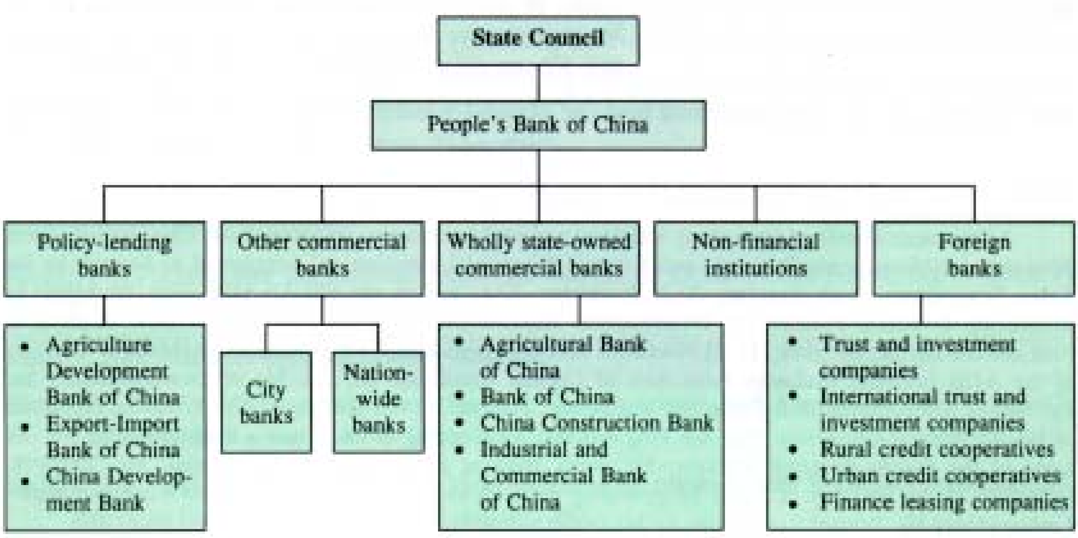
With respect to the banking system, the government has also embarked on a series of financial reform programmes since 1979. The programmes initially focused on institutional reforms to the banking system in the 1980s, especially the establishment of a two-tier banking system that comprised primarily a central bank and four specialized banks that are owned fully by the central government. Once the two-tier banking system was formed, the government launched the second wave of financial reforms, consisting

[1] This paper benefited from many insightful and useful comments received at the First Brainstorming Workshop on "Sequencing Domestic and External Financial Liberalization", organized in Beijing, by the Asian Development Bank Institute, 20-21 November 2001; and at the ESCAP-ADB Joint Workshop on Mobilizing Domestic Finance for Development: Reassessment of Bank Finance and Debt Markets in Asia and the Pacific, Bangkok, 22-23 November 2001. In particular, I am grateful to Dr. Masaru Yoshitomi of the ADB Institute; Professor Iwan Azis of Cornell University, Dr. Jun Ma of Deutsche Bank, and Dr. Suthad Setboonsarng of the Ministry of Finance, Thailand. I am also grateful to Professor Liping He of Beijing Normal University; Mr. Xie Ping and Mr. Xu Guoping of the People's Bank of China; Mr. Ke Long of the Fujitsu Research Institute; Mr. Yuan Yuedong of the Bank of China; and, Mr. Tomoyuki Fukumoto of the Embassy of Japan for providing me with useful information on China's banking sector. I acknowledge Mr. Pritipal Rajasekaran for his excellent research assistance.

of two major parts: further institutional-building and the management of NPLs. Institutional-building focused on the commercialization of specialized banks and a separation between policy and commercial lending activities. Other reform measures included an attempt to reduce local government intervention, the removal of credit allocation, a narrowing of the scope of business, interest rate and entry deregulation (albeit to a limited extent), and a gradual tightening of accounting and prudential regulations. The management of NPLs included the recapitalization of wholly state-owned commercial banks (WSCBs), the disposal of NPLs held by WSCBs, and the merger and closure of problematic banks, the transformation of urban credit cooperatives into city banks, and the promotion of debt-equity swaps. In spite of these reforms, however, the financial sector has remained dominated by the four WSCBs that were transformed from specialized banks to commercial banks in 1995.

As of 2001, China's banking system consists of the four WSCBs, three policy-lending banks, more than 100 commercial banks (most of which are city commercial banks and the rest nationwide commercial banks), about 3,000 urban credit cooperatives, some 42,000 rural credit cooperatives, and about 190 foreign banks with branches or representative offices (figure 1). The four WSCBs – the Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China – together account for about 70 per cent of loans and deposits, respectively. Further, these WSCBs dominate the banking sector in terms of branches (108,507 as of the end of 1998) and employment (1.67 million staff). Prior to their commercialization, their lending was largely restricted to designated sectors based on the government's industrial policy. Since then, however, all WSCBs have been allowed to lend to any sectors freely, although their business has in practice remained concentrated in the traditionally prescribed areas. Three policy-lending banks (the Agricultural Development Bank of China, China Development Bank, and Export-Import Bank of China) were established in

Figure 1. Structure of the financial sector



1994 to take over long-term development finance and policy-lending business previously performed by the specialized banks. Most of the other commercial banks, except the privately-owned China Minsheng Bank, are owned by local governments and/or State-owned enterprises (SOEs).

This chapter examines whether the second wave of financial reforms launched since 1994 has had any noticeable impact on the performance of the banking sector overall – and the WSCBs in particular since their transformation into commercial banks. It first assesses the extent of concentration in the banking sector. It then evaluates how the performance of the WSCBs has changed during the reform period and whether it is comparable to that of other commercial banks. Some may argue that this kind of classification is meaningless in China since most of the banks are owned by the government or state enterprises and the difference depends only on whether the sole or major owner is the central government or local government. However, this distinction is significant since it reflects a difference in payment systems. The payrolls for the staff of other commercial banks, for example, are more flexibly determined at province or city levels and, therefore, tend to be relatively more competitive, whereas those of WSCBs are set centrally in line with the payrolls of other central government officials and thus tend to be more rigid. Such differences are seen as among the major factors influencing whether other commercial banks will have the incentive to become more profit-oriented and performance-conscious. Thus, this chapter examines whether there are any significant differences in performance by this type of classification. In addition, it tests whether performance differs between nationwide or city commercial banks and between listed and unlisted commercial banks, as well as other factors affecting banking sector performance.

The following results have emerged. First, the banking sector has remained dominated by the four WSCBs in the reform period since 1994. Competition has emerged, but only at the lower end. Second, the impact of the financial reforms has not had a noticeable impact so far on the performance of WSCBs. Their profitability and cost-efficiency (measured by the ratio of operating cost to operating income) have remained poor and more or less constant throughout the reform period, and earnings-efficiency (measured by total income as a percentage of assets) has steadily deteriorated. Third, and more worrying, is that the performance of the other commercial banks (i.e., profitability and cost efficiency) has deteriorated in recent years regardless of whether these banks are city or nationwide, and whether listed or nonlisted. The deterioration reflects an increase in operating costs driven by rises in personnel expenditure in addition to a decline in operating income caused by a falloff in net interest income. Fourth, the decline in their profitability is closely associated with the slowdown of real GDP growth and a shift in depositors' preference from these banks to WSCBs in 1997-1999. Fifth, the poor performance of the banking sector is attributable partially to their holding of excess reserves and substantial investments in government bonds. This may reflect a cautious lending attitude driven by tighter prudential regulations as well as the high cost involved in extending credit to SMEs and new borrowers (i.e., information gathering and monitoring costs). In addition, payment of interest by the People's Bank of China (PBC) on excess reserves increases banks' incentives to hold such excess reserves. Sixth, the narrow scope for diversification granted to banks tends to raise operating costs, mostly likely owing to their limited ability to exploit economies of scale. And seventh, the performance of the policy-lending banks has been as poor as that of the WSCBs.

These outcomes suggest there is an urgent need for the government to undertake more comprehensive and drastic steps to restructure the WSCBs. Since most of their funds are extended to SOEs (of which about 40 per cent are loss making), this suggests that WSCBs have continued to function as a major financier of SOEs. Thus, so-called "direct (policy) lending" still occurs even though these banks became commercialized in 1995. Therefore, there can be no drastic improvement in the NPLs of WSCBs unless the problems of loss-making SOEs are tackled. Since publicly available detailed data on banks' major borrowers classified by ownership, sector, and size are scarce, detailed policy recommendations on NPL disposal and risk management cannot be prescribed. Therefore, the purposes of this chapter are to clarify recent developments affecting banking sector performance and provide some broad policy implications.

This chapter relies on data reported in the Bankscope database. It should be noted, however, that the quality of data in China is often questioned and, thus, the quantitative analysis should take into account this shortage. In addition, this analysis does not cover foreign joint-venture banks and branches since their scope and location of business are highly restricted, meaning these banks do not operate on a level playing field. Even though data on some of these banks are available, the coverage is small. An analysis of other important financial institutions, such as trust and investment companies, both local and foreign, rural credit cooperatives and urban credit cooperatives has been exchanged because of a lack of data. However, the major banks in terms of asset size (accounting for a little more than 80 per cent of total assets held by all financial institutions) are covered.

The chapter consists of five sections. Section A takes a brief overview of the financial reforms of the 1990s. Section B analyses the extent of concentration in the banking sector and trend patterns of its performance since the relatively comprehensive financial reforms of 1994-2000. It also examines whether differences in the performance between WSCBs and other commercial banks as well as between nationwide and selected city commercial banks (about six large banks) are statistically significant. Section C performs a regression estimation to examine factors affecting banking sector performance. Section D focuses on the performance of policy-lending banks. Section E sums up with some concluding remarks.

A. THE FINANCIAL REFORMS OF THE 1990s

Background: 1979-1993

Prior to 1979, China's banking system was not modern and played only a limited role in promoting economic growth. This reflects the limited role of banks in a highly centralized planning system whose primary functions were collecting revenue from

SOEs and allocating investment through budgetary grants (Ma 1997). In this circumstance, banks simply provided credit needed by the SOEs for their production plans and provided/monitored cash used principally to cover labour costs and purchases of agricultural products.

In the process of establishing the banking system, the government first removed the monopolistic position of PBC in 1979 by establishing three specialized banks. The Agricultural Bank of China was established to take over PBC's rural banking business and supervisory authority of a network of 60,000 rural credit cooperatives that had been providing small-scale rural banking (IMF 1996). The Bank of China was delegated to take over foreign currency transactions, while the China Construction Bank focused on the construction sector. The China Investment Bank was set up under the control of the China Construction Bank. In 1994, the government completed the two-tier banking system by removing commercial banking activities from PBC and transferring them to the Industrial and Commercial Bank of China, the fourth specialized bank, established in 1984. In addition, other banks were established in the 1980s, including the state-owned China Investment Bank (1981), the joint-stock Bank of Communications (1986), and CITIC Industrial Bank (1987) owned by China Investment and Trust Corporation.

Further, the reforms replaced direct grants with interest-bearing loans in an attempt to solve the soft-budget problems of the SOEs. From 1986, PBC was explicitly made responsible for monetary policy and the supervision of the financial system, including the money and capital markets (Schueller 2001). With the objective of containing inflation, moreover, PBC took responsibility for formulating a credit plan that set an aggregate credit ceiling on each PBC branch according to the national economic plan and authorized each branch to allocate credit under the ceiling. Thus, autonomy was given to every PBC branch, leaving room for them to collude with local governments, which intervened with respect to credit allocation. Moreover, PBC was not an independent regulatory body, functioning as a line ministry under the State Council and thus its monetary policy decisions were subject to the approval of the Council.

In addition, PBC lost control over monetary policy as new regional banks and non-bank financial institutions that operate outside the credit plan emerged. For example, urban credit cooperatives were established in urban areas in the 1980s as a main financier for newly emerging non-state enterprises. Together with the rural credit cooperatives, these cooperatives willingly extended credit to SMEs and new firms, since it was understood that the government would pay for any ultimate losses. Moreover, the China International Trust Corporation (CITIC) was set up as the first non-bank financial institution and a window for overseas borrowing in the 1980s (Kumar and others, 1996). Other international trust and investment companies were set up by provincial and municipal governments, allowing them to raise funds from foreign sources, for example, through overseas bond issues.

Moreover, trust and investment companies were established – mostly by the four specialized banks, Ministry of Finance, and local governments. The proliferation of trust and investment companies reflected two sources of demand for a new form of financial intermediation (Kumar and others, 1996). First, specialized banks could no longer meet market demand for credit given the rapid economic growth of the 1980s and, thus, banks and bank branches were encouraged to set up trust departments, which were able to conduct forms of business prohibited to the formal banks. These trust departments were gradually spun off as separate trust and investment subsidiaries or affiliates of the banks. Second, a movement toward economic decentralization encouraged local governments to establish trust and investment companies to raise funds directly in order to finance local priority projects and at the same time obtain higher returns on their investment than available through bank deposits. While trust and investment companies are allowed to issue bonds or stocks with permission from PBC, their major sources of funding were government and enterprise trust deposits (deposits that can be invested at the discretion and risk of trust and investment companies) and/or entrusted deposits (deposits that are invested at the specific instruction and risk of depositors).

Financial reforms of the 1990s

The major financial reforms from 1994 were centred on separating commercial lending and policy lending by transforming the four specialized banks and the urban credit cooperatives into commercial banks, and establishing three policy-lending banks and new commercial banks. Other reforms included the removal of credit plans, reduced government intervention in credit allocation, (limited) entry deregulation, a narrowing of the scope of business, (limited) interest rate deregulation, tightened accounting and prudential norms, and financial sector restructuring.

The financial reforms were motivated by the central government’s recognition that an organizational restructuring of PBC was necessary along with increased autonomy to contain the economic overheating experienced in 1992-1993 (Schueller 2001). The lack of control by PBC over credit allocation and non-bank financial institutions led to a shift of funds from the banking system to unregulated sectors, giving rise to bubbles in the real estate and stock market and causing a decline in bank deposits and a liquidity squeeze. The financial reforms came in two major parts: (a) institutional-building and financial liberalization, and (b) management of NPLs.

1. Institutional-building and liberalization

Separation between commercial and policy-lending activities

The separation between commercial and policy-lending activities aimed to promote liquidity management by PBC at the banking system level, rather than at the level of individual banks (IMF 1996). This reflects the view that it is difficult to monitor the performance of bank managements and require them to take responsibility for losses unless policy-lending activities are removed from commercial banks. The Commercial Bank Law of 1995 gave rise to a de facto two-tier commercial banking system that consists of (a) commercial banks that are subject to prudential regulations and are supervised by PBC, and (b) three policy-lending banks, which are not subject to this law and whose operations are guided by individual charters (IMF 1996).

Removal of the credit plan and reduction of direct lending

As a part of the comprehensive monetary reforms launched since 1994,[2] the WSCBs have become gradually more prudent in terms of credit allocation in the face of deteriorating performance by SOEs. By 1997, only 80 per cent of the credit quota was fulfilled. PBC removed the credit plan for both working capital loans and fixed investment loans in 1998, replacing it with an indicative non-binding target. Under this, the target serves only as a reference for commercial banks to plan their business and the aim is for a shift to indirect or market-based monetary policy.

Local governments intervened heavily in allocating WSCB credit to support the operations of loss-making SOEs. However, such interference has recently declined since the WSCBs are now required to appoint bank managers of branches at a provincial level according to their autonomous decisions at their headquarters. This means that local governments, which used to appoint managers of WSCB branches jointly with the headquarters, can no longer exert a major influence on such appointments.

On the other hand, central government intervention in allocating credit has continued even to this day, although explicit interference has declined. This practice can be justified, nevertheless, because a provision of Article 41 of the Commercial Bank Law stipulates that WSCBs will provide loans for projects approved by the State Council. In recent years, however, WSCBs have gradually become more prudent and are given the freedom to determine their lending allocations according to commercial considerations (provided that their total lending is in line with asset/liability ratios and the monetary policy target set by PBC). In 1998, WSCBs introduced a "lifetime responsibility system", which penalizes bank managers responsible for bad lending practices even after their retirement. Since banks are now to extend loans based on the repayment ability of borrowers, some loss-making SOEs have found it more difficult to obtain bank credit. However, WSCBs continue to extend credit to many SOEs. This is in part because of the latter's high demand for credit owing to their heavy involvement in a large number of infrastructure-related projects and in part under central government direction. Together with a tightening of accounting standards, some banks have reduced lending – particularly to SMEs and new borrowers – causing a credit crunch.

[2] Other monetary reforms included (1) PBC reforms (clarifying its primary objective as maintaining price stability, enforcing strict supervision over financial institutions, conducting clearance and issuing bank notes, increasing the authority of PBC headquarters in issuing effective monetary policy, rationalizing regional branches of PBC etc.); (2) a gradual shift to indirect monetary policy using open market operations, reserve requirements, and the foreign exchange market; (3) a termination of automatic monetization of fiscal deficits by PBC through the issue of bonds; and (4) a shortening of the maximum length of maturity allowed for interbank loans from three months to three days. Many of these reforms were formalized by the passage of a law governing PBC in 1995. In 1995-1996, PBC issued a number of short-term bonds to promote open market operations. Moreover, PBC lending to commercial and policy-lending banks has increasingly played an important role in liquidity management.

Limited approval with respect to the entry of new banks

Following the establishment of three banks in the 1980s, the government allowed the entry of more banks in the 1990s. The China Merchant Bank, Hua Xia Bank, and Everbright Bank were set up in the first half of the 1990s. In 1995, Minsheng Bank was established by a tycoon, Mr. Yonghao Liu, and other wealthy businesspeople as the first domestic private bank. Other banks established include the Guangdong Development Bank, Shanghai Development Bank, Shenzhen Development Bank, Fujian Industrial Bank, Yantai Housing Saving Bank, and Bengbu Housing Saving Bank. Local governments played an active role in establishing these local banks, since the move to centralize WSCB credit allocation decisions from branch level to headquarters made it difficult for local governments to raise funds for local projects from the WSCBs.

Narrowing of the scope of business

Foreign exchange business, which used to be monopolized by the Bank of China, has been granted to other banks and financial institutions since the 1980s. But the Commercial Bank Law prohibited banks from engaging in securities and related business activities. In 1992, the government allowed banks to transact some non-traditional banking business. This encouraged all of the specialized banks and most of their major branches to establish finance companies, which engaged in imprudent or fraudulent operations and led to financial chaos in 1992-1993. Furthermore, many of these banks divested funds earmarked for agriculture and other key projects into stock market and real estate market speculation. When monetary policy was tightened in late 1993, many banks and branches lost money from these securities activities, causing instability in the banking system (Ma 1997). Since then, the government has required all banks to divest themselves of investment banking affiliates and prohibited commercial banks from engaging in securities trading and underwriting, investment in non-bank financial enterprises and productive enterprises, and investment trust business under the Commercial Bank Law.[3]

Since 1998, the Bank of China, the Industrial and Commercial Bank of China, and the Bank of Communications have begun to provide money-managing services, including foreign exchange transactions and personal investment to individual clients. These banks have since established money-management offices in major cities in the face of growing demand for such services. The Agricultural Bank of China has also recently opened an asset-management centre in Shanghai.

In July 2001, PBC issued a provisional regulation on commercial banks' intermediate business to promote business innovation, improve bank services and competitiveness, and reduce financial risks. PBC has defined intermediate businesses as those that do not constitute scheduled assets and liabilities, and produce non-interest income

[3] This regulation prevents banks from lending to insiders or related parties. However, increasing debt-equity swaps as a way to clean up banks' NPLs may create such problems by allowing lending to insiders.

for banks – including settlement, warranty, acceptance, and trading. Thus, with PBC ratification, commercial banks can engage in financial derivatives business, agency security business, investment bank business, information consultation, and financial advisory services. In September 2001, the Agricultural Bank of China opened 100 "financial supermarkets" that offer a full range of financial services (i.e., granting individual loans within 24 hours, providing safe deposit boxes, conducting foreign currency transactions) in 100 cities. Financial legal affairs offices, insurance companies, and notarization administrations will also conduct business in these supermarkets.

Interest rate deregulation

Banks in the late 1980s were allowed to adjust lending interest rates within a certain margin below and above the administered rate, although such flexibility on deposit interest rates was not granted. However, the austerity programme of 1989 reversed this liberalization process. In 1993, PBC reimposed a lending rate ceiling at 20 per cent of the basic rate and floor at 10 per cent on commercial banks, a ceiling at 30 per cent and floor at 10 per cent on urban credit cooperatives, and a ceiling at 60 per cent and floor at 10 per cent on rural credit cooperatives. In 1996, PBC set the ceiling and floor both at 10 per cent with respect to commercial banks, and the ceiling at 40 per cent and floor at 10 per cent with respect to rural credit cooperatives. In 1998, the ceiling was set at 20 per cent for loans to SMEs and at 50 per cent for urban credit cooperatives. In 1999, the ceiling for SMEs was raised to 30 per cent. PBC fully liberalized interest rates on foreign currency loans and interest rates on foreign currency deposits of $3 million or more – a major step forward in the liberalization of its tight interest rate system. Interest rates on deposits of less than $3 million are now fixed by the China Association of Banks, a national-level non-government organization launched in May 2000 to promote self-discipline and cooperation in the domestic banking sector.

The interbank markets were unified into a national market through a computer network system in January 1996, contributing to a modest reduction in the excess reserves of banks, which were held partly because of inefficiencies in liquidity management. Prior to 1996, the interbank market had emerged on an experimental basis among branches and sub-branches of the Agricultural Bank of China in the 1980s in Wenzhou and then spread to Beijing, Shanghai, and Guangzhou in the mid-decade (Schueller 2001). Since interest rates were fixed and financial markets were segmented, these markets could not balance the interregional liquidity flow. With most of the transactions unsecured, the maturity mismatch (borrowing short and lending long) caused serious problems. As a result, PBC began to set a reference rate for the interbank market and introduced provisional regulations. In June 1996, the ceiling on interbank rates (China Interbank Offer Rate) was lifted. The next year, the interbank bond market mainly based on repo arrangements was introduced in addition to the already existing call markets (that do not take any collateral). The main purpose of this policy was to promote indirect monetary policy while developing liquid secondary bond markets through the active use of open market operations.[4] Further, in 1993 the government introduced a policy to subsidize the difference between the inflation rate and an administered deposit rate to protect depositors. However, this "indexation" policy was terminated since inflation declined sharply in 1997.

Strengthening of accounting and prudential norms

PBC introduced capital adequacy requirements first in Shenzhen, later applying them to all commercial banks in line with the Commercial Bank Law promulgated in 1995. Other prudential norms, such as a loan-deposit ratio, liquid asset-liquid liability ratio, followed. The loan classification system was reformed in 1998 by introducing an internationally accepted five-tier classification of loans based on recognition that poor management by banks was the fundamental cause of the East Asian crisis.[5] Nevertheless, few banks have adopted the new classification system, since many continue to use conventional practices in which loans are classified based on the length of arrears. In addition, prudential norms were rarely taken up, despite guidelines announced by PBC. In 2001, however, prudential regulations and accounting standards were tightened in the face of the increasing challenges from globalization and China's accession to the World Trade Organization (WTO). As a result, the China Construction Bank has introduced a credit risk reporting system.

Other measures

In November 2001, PBC allowed borrowers to repay loans in foreign currency to the Agricultural Bank of China, the Bank of China, the Industrial and Commercial Bank of China and the China Construction Bank, provided that the amount did not exceed \$1 million (\$4 million in the case of the Bank of China) in foreign currency.

Impact on banking sector performance

In spite of the government's efforts, these financial reforms appear not to have led to a noticeable improvement in the performance of WSCBs. Their profitability, capital

[4] The government restarted issuing Treasury bonds. Outstanding Treasury bonds amount to 1.4 trillion yuan renminbi or 15 per cent of GDP as of the end of 2000. About 40 per cent of these bonds are non-transferable and sold to individuals as savings instruments. The demand by individuals for these bonds is high thanks to an exemption of interest income taxes (compared with a 20 per cent tax rate imposed on interest incomes from bank deposits) and transactions taxes (compared with a 0.03 per cent tax imposed on shares). The volumes of issuance, maturity, and interest rates on these bonds are determined by central government and sold to individuals through syndicate banks. About 51 per cent of the bonds are sold to syndicate banks in the interbank markets through a competitive and non-competitive Dutch auction system, while 10 per cent are sold at the stock exchanges through a competitive Dutch auction system.

[5] The system before 1998 had the following problems (Lardy 1999). First, the loan classification system was based on payment status, rather than risk. Thus, in the case of multiple loans extended to a single borrower, individual loans were classified as NPLs only when the contractual terms of each loan were violated. Second, classifying loans as NPLs was often delayed since they were tied only to repayment of principal and many loans were bullet loans (such that no repayment of principal was required until the end of the loan term). Third, the most impaired category of NPLs was dead loans.

adequacy, and loan loss provisions have remained low.[6] Paid-in capital (comparable to Tier-1) of the WSCBs declined relative to bank assets from 12.1 per cent at the end of 1985 to 2.2 per cent at the end of 1997 (Lardy 1999).

Nevertheless, WSCBs are not illiquid and they are able to operate in practice because households have increasingly deposited their savings at these banks believing that they are protected by the central government, which retains full ownership. In addition, the underdeveloped state of the financial markets has left households no other choice but to save in banks or government bonds. Moreover, WSCBs continue to be agents of the central government. Although explicit policy-lending practices have been reduced, lending to SOEs still constitutes a large share of the total credit of WSCBs. Credit decisions by WSCBs are often influenced by central government guidance.

A further recent phenomenon has been an upsurge in illegal lending and corruption scandals involving the WSCBs. In some cases, borrowers find it difficult to obtain loans from WSCBs in the face of lending practices based on personal connections, bribery, and pressure from local governments. PBC continues to control official lending and deposit rates, preventing WSCBs from operating according to market principles. While the low lending interest rate policy aims at subsidizing SOEs, it has given rise to collusive behaviour among financial institutions despite the penalties faced. For example, WSCBs may legally circumvent interest rate controls by lending to non-bank financial institutions that are subject to looser interest rate controls, which in turn lend the funds at higher rates and share the profits with the banks. The fact that black markets exist and their prevailing lending interest rates are in the range of 100 per cent – 200 per cent of regulated lending rates indicates that banks have strong incentives to lend at higher lending rates. Moreover, tight entry regulations continue to prevail. Engagement in local currency-denominated transactions by foreign banks is largely limited to only Shanghai and Shenzhen and is allowed only against foreign capital enterprises. Foreign banks are not allowed to become wholly owned.[7]

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[6] PRC banks tend to overstate their profits because of the practice of (a) capitalized interest payments and accrued interest on NPLs; (b) inadequate provisioning; (c) no deposit insurance schemes; (d) lack of universal consolidated financial reporting, and (e) support by the Ministry of Finance for injection of funds to compensate for an increase in interest rate expenditure caused by an indexation scheme applied during the period 1993-1997 (Lardy 1999). As an example of (a), while loans are classified as past due as soon as any scheduled interest payment or repayment of principal has been missed, the largest WSCBs have been required to accrue interest for two years after a loan is classified as past due. Loans are also rolled over and the interest due is capitalized and recorded by the banks as income. Some of the newer, smaller institutions have more stringent accounting practices. For example, the Bank of Communications only accrued interest on loans overdue to less than one year. This practice appears to have been taken up by some WSCBs since 1998.

[7] Foreign banks will be allowed to engage in local currency-denominated transactions with resident firms within two years, and retail banking business with Chinese citizens will be allowed within five years. So far, specific rules such as eligibility criteria are not yet available for foreign banks.

2. Management of NPLs and financial sector restructuring

The following methods have been adopted in an attempt to manage NPLs and bring about financial sector restructuring: (a) recapitalization and foreign ownership, (b) conversion of debt into equity, (c) mergers, (d) disposal of NPLs, and (e) closure and bankruptcy of insolvent financial institutions.

To promote the first measure, the government in 1998 injected Y270 billion in capital to the WSCBs through the issuance of bonds.[8] In 1999, the International Finance Corporation made an equity investment in the Bank of Shanghai. In November 2001, it signed a subscription agreement with Nanjing City Commercial Bank to invest $27 billion and became the third largest shareholder, with 15 per cent of the bank's stock. The International Finance Corporation has also been making efforts to support the development of non-state small and medium-sized banks in the country's western area. China Minsheng Bank is now negotiating the sale of its stake to Bank of East Asia in Hong Kong, China. Bank of East Asia, aiming to expand its branches and business in the mainland, has also been talking with other banks. The Bank of Communications is, meanwhile, preparing to allow two foreign institutional investors to take control of 15 per cent of its stock.

For the second measure, PBC arranged a debt-equity swap of about Y5 billion in 1996 for Everbright Trust and Investment Company, since it could not meet its maturing debts. PBC intervended to prevent the latter's bankruptcy, in part to protect its biggest creditors including a state oil firm and two WSCBs.

As a third measure, more than 2,000 urban credit cooperatives were merged into 88 city commercial banks during the period 1995-1998 in accordance with the assessment of assets and capital, write-off of some bad debts, and encouragement of new shareholders. Such a merger reflected the incentives of local governments to bundle problematic urban credit cooperatives into regional banks hoping that their bad loan problems would go away, or that these problems would be concealed for a while and have time to be gradually resolved; or that PBC might intervene so that some responsibility might be transferred to central government (Gao 2001). Recognizing these incentives, PBC allowed local governments to merge urban credit cooperatives into regional banks in the face of heavy pressure from local governments.

In 1995 and 1997, Hainan Development Bank purchased some trust and investment companies and urban credit cooperatives. In 1998, the China Development Bank purchased China Investment Bank. In 2001, the Industrial and Commercial Bank of China reached an agreement with the China Merchants Group in Hong Kong, China on

[8] In 1998, PBC lowered the reserve requirement imposed on customer deposits from 13 per cent to 8 per cent and removed an excess reserve requirement of 7 per cent introduced in 1992. This reduction has enabled WSCBs to invest in government bonds issued for recapitalization. This recapitalization procedure is equivalent to two swap transactions resulting in doubling the capital of the WSCBs: (a) asset swap of bonds for reserve deposits between the WSCBs and the Ministry of Finance, and (b) a liability swap of equity for PBC borrowing between the WSCBs and PBC (Mo 1999).

the purchase of Youlian Bank established by the latter in Hong Kong in 1994. The government also intends to merge the trust and investment companies in order to reduce the number from the current 240 to about 60. In November 2001, PBC approved the merger of 1,658 rural credit cooperatives into 81 joint stock rural commercial banks in Zhangjiagang, Changshu, Jiangyin, and Jiangsu provinces, as part of a pilot reform of the rural financial system. The Zhangjiagang Rural Commercial Bank and Changshu Rural Commercial Bank have now opened for business.

For the fourth measure, the central government established four asset management companies (AMCs) in 1999 capitalized at Y10 billion each in order to acquire WSCB NPLs: Cinda with the China Construction Bank, Great Wall with the Agricultural Bank of China, Oriental with the Bank of China, and Huarong with the Industrial and Commercial Bank of China. In addition, a further six licences have been issued to other companies to allow them to become involved in asset management business. These AMCs remain under the supervision of PBC, with guidance from the State Securities Supervisory Committee of China and the Ministry of Finance. So far, their major activities have been restricted primarily to transferring debts contracted before 1995, when the current Commercial Bank Law was passed, at face value. This suggests that Y1.4 trillion of assets (about 20 per cent of combined outstanding loans) has been transferred from the four WSCBs to the AMCs, which financed this transfer by issuing bonds of Y850 billion and borrowing Y550 billion from PBC. This operation, however, did not increase reserves, since the WSCB total borrowings of Y550 billion from PBC were deducted from their liability (and the total amount of Y850 billion in bonds issued by the AMCs appeared on the asset side of the WSCBs in exchange for a reduction of transferred NPLs of Y1.4 trillion). This enabled the four WSCBs to reduce NPLs by 10 percentage points from 35 per cent. Of the Y1.4 trillion, the AMCs plan to conduct a debt-equity swap of Y460 billion with respect to 601 SOEs that are relatively better performing and thus can be regarded as candidates for becoming public companies. These SOEs, however, have been selected by the State Economic and Trade Commission, not by the AMCs themselves.

So far, only Y87.5 billion or 6 per cent of the transferred NPLs have been dealt with and the recovery rate has reached only 30-40 per cent. The AMCs plan to complete NPL disposal within 10 years. The ultimate loss incurred by the AMCs is expected to be covered by the central government and is likely to reach nearly Y1 trillion. In February 2001, Huarong Asset Management Corporation, signed a contract for advice and trading services with Ernest & Young with respect to the bidding process. In November 2001, Huarong then announced that it had agreed to sell NPLs with a book value of Y10.8 billion to an international bidding team (consisting of seven overseas investors and domestic enterprises) headed by Morgan Stanley – the first case of any of the four AMCs offering NPLs to international investors through the public bidding system. In November 2001, further, Cinda Asset Management Company signed an agreement with Goldman Sachs on the establishment of a joint venture to dispose of bad assets. In the same month, Great Wall Asset Management Company announced a plan to organize in December the largest auction of NPLs, to be conducted in different places. The items covered debtor's assets, stockholders' assets, real estate, machinery and equipment, vehicles, and durable consumer goods. So far, Great Wall has run 334 auctions involving 835 items with an estimated value of Y445 million.

For the fifth measure, Hainan Development Bank and three trust and investment companies that had become highly insolvent were closed in 1997-1998.[9] In 1998, PBC closed Guandong International Trust and Investment Company, which incurred heavy losses and could not meet maturing debts. Subsequently, the liquidation led by an international accounting firm recognized that the company was seriously insolvent, which induced the latter to apply for bankruptcy in 1999-making it the first Chinese financial institution to go bankrupt.

Improvement of NPL problems

Even though Y1.4 trillion in NPLs was transferred to the AMCs, the four WSCBs still held Y1.8 trillion or 26.6 per cent of NPLs as of the end of September 2001, according to official estimates. The average risk-weighted capital adequacy ratio of the WSCBs is estimated to reach only 5.7 per cent as of the end of 2000. If proper accounting methods were applied, however, it is believed all WSCBs would have a negative net worth and thus would have been categorized as insolvent.

Moreover, Everbright Trust and Investment Company has hardly earned any profits, even after the debt-equity swap deal was orchestrated. Thus, creditors suffered great losses from this conversion in 1996. Hainan Development Bank – which was formally established in 1995 after the merger of five trust and investment companies and the introduction of new shareholders – has not performed well owing to poor asset quality. In 1997, moreover, Hainan Development Bank took over another 28 local urban credit cooperatives faced by liquidity problems, resulting in a further deterioration of its performance. Although PBC has provided more than Y3 billion in liquidity assistance to this bank, it was not able to prevent runs on deposits and thus finally decided to close it in 1998. In addition, the new 88 city commercial banks face high NPLs and payment crises because of poor asset quality inherited at the time of merger.

Nevertheless, some banks have succeeded in reducing NPLs in recent years. The China Construction Bank has begun to control the overall loan volume, improve its loan structure, and increase credit extended to key industries and clients in order to reduce NPLs. As of the end of September 2001, the bank had granted 49.4 per cent of total outstanding loans of Y1.1 trillion to 12 key industries such as telecommunications, road construction, and electricity. Meanwhile, the bank hastened the withdrawal of loans already extended from firms with low performance and in low priory sectors. The

[9] In China, closure of financial institutions differs from bankruptcy, since closure uses the following procedures (Pining 1999). First, PBC announces a closure and designates a commercial bank to take care of its claims and debts. The commercial bank or an external accounting firm liquidates the assets of the closed institution, calculates its losses and realizable net assets, and registers/confirms debts. Second, the principles for the repayment of debts are decided. The principal and legal interests of foreign debtors and individual depositors will be repaid as a priority. Third, in cases where the institution incurs a heavy loss, it can apply to the court for bankruptcy. Once the bankruptcy procedure is initiated, the procedure of closure and liquidation terminates.

Industrial and Commercial Bank of China also recovered NPLs amounting to Y100 billion in 2001, lowering its NPL ratio by 2.8 percentage points. The Agricultural Bank of China also lowered its NPLs in 2001, while Everbright Bank reported a 13.7 per cent drop in NPLs in 2000 and a 4.48 per cent drop so far in 2001. City commercial banks also showed lower NPLs. The improvement in NPL problems can be attributed to better management of loans by banks.

3. Factors deterring successful financial reforms

The biggest constraint holding back drastic financial reforms arises clearly from the problems of borrowers – namely, the poor and deteriorating performance of SOEs. Growing numbers of SOEs have experienced a substantial decline in profits in the 1990s in spite of overall economic growth. This has not only caused a rapid deterioration of WSCB loan assets, but has also limited credit available to non-state firms by absorbing more than 75 per cent of bank loans. This has deterred investment and output growth of non-state firms. About half of the SOEs incur net losses nowadays, compared with only 30 per cent just a few years ago. Factory capacity utilization rates for major industrial products of SOEs have been at a level below 60 per cent.

The poor performance of SOEs is attributable to a number of factors. First, SOEs have suffered from growing competition, slackening efficiency owing to the slow adoption of technological advancement, and large accumulated debt. Second, SOEs are obliged to provide social services to workers and maintain their employment and, in some cases, continue to pay salary to retirees. These practices make it difficult for the SOEs to become commercially oriented (Broadman 1999). Third, in practice, few managers of SOEs are able to exert "14 autonomous management rights" (for example, the right to set prices, the right to hire and fire workers) granted under the 1992 regulations. Fourth, the absence of clear identification of owners of the SOEs and inadequate property rights undermine corporate governance since it is not clear who should monitor managers. The introduction of non-state shareholders through public listings has not resulted in a clear separation of ownership and management, since few outsider shareholders exercise discipline on the management of the SOEs. Last, most mergers of large SOEs are orchestrated by the government, not driven by market initiatives. This undermines the role of mergers as effective disciplining devices against poor management.

In response to the rapidly deteriorating performance of SOEs, the government attempted various experiments in the 1990s, including management contracting, greater autonomy to managers, corporatization, and ownership diversification. Moreover, the supervisory capacity over most industrial SOEs (about 110,000 firms) has been transferred from the central government to local governments (Broadman 1999). A multilayered organizational network has also emerged by including state asset management bureaus, state asset operating companies, and state asset supervisory committees.

Nevertheless, only a few SOEs have been divested to the non-state sector and almost all of such firms have been small. Thus, the government remains an owner of key businesses and a main driver of the industrial sector, notwithstanding that SOEs account for only 30 per cent of national production. Truly private companies (majority owned by individuals) still account for less than 20 per cent of GDP and employ only about 50 million of the jobs. It has also become increasingly apparent that the SOE reform strategy has produced problems unanticipated by the reform's framers, including asset stripping, decapitalization, wage manipulation, and tax evasion (Broadman 1999). These problems have severely undermined banking sector performance.

The second constraint acting against a smooth implementation of financial reforms is the lack of a deposit insurance system and thus no mechanism of guaranteeing repayment to individual depositors and creditors. Since many deposit-taking financial institutions do not have sufficient realizable assets, their closure or bankruptcy would imply that either the government or PBC has to provide funds to subsidize repayment, which may be costly. Moreover, the absence of a specific closure and bankruptcy law for financial institutions makes it difficult to promote their bankruptcy.[10]

The difficulty of establishing a deposit insurance system reflects the following trade-off. If a deposit insurance scheme is applied to all deposit-taking financial institutions except the four WSCBs, their contributions will be too small for it to operate. Thus, the resultant increase in premiums would generate a sense of unfairness among these financial institutions compared with the WSCBs. On the other hand, if the scheme were also applied to WSCBs, they would have to make large contributions for possible rescues of small and medium-sized financial institutions because of their disproportionately large deposit base. Thus, WSCBs would oppose this idea.

4. Banking sector reform issues

Aware that privatization of the WSCBs (as well as SOEs) is a key to successful financial reforms, the government recently announced that they would gradually be restructured by allowing them to become joint-stock companies listed on domestic and foreign stock exchanges. Immediately after the announcement, however, the stock prices of listed banks (and SOEs) plunged in the expectation that a massive disposal of stocks would lead to a decline in prices and thus investors would experience a capital loss. In response, the government reversed its decision by suspending state share sales. Nevertheless, the PBC Governor, Mr. Die Xianglong, announced in November 2001 that WSCB NPLs would be reduced by 2-3 per cent a year in the next few years and there would be no more transfers of NPLs to the AMCs in order to avoid moral hazard problems. He also said that WSCB restructuring would be carried out in several steps: (a) improving management skills with a rationalization of staff and organizations; (b) allowing WSCBs to become joint-stock companies with central government holding more than 50 per cent of stock; and (c) encouraging them to list on the stock exchange. In addition, the Governor said that WSCBs would be allowed to sell shares to foreign investors.

[10] The case of the bankruptcy of Guandong International Trust and Investment Company was based on the bankruptcy law for general enterprises.

In the meantime, other commercial banks also need to be restructured. So far, there are only four listed commercial banks: Shenzhen Development Bank (listed in 1991); Shanghai Pudong Development Bank (1999); and Hua Xia Bank and Minsheng Bank (2000). China Minsheng Bank plans to list abroad in order to raise funds and attract strategic investors, and will open a branch in Hong Kong, China. China Merchants Bank has so far completed the required paperwork for an initial public offering and plans to list publicly in the near future. While most other commercial banks are already joint-stock companies, PBC intends to improve corporate governance by allowing banks to merge with each other; promoting foreign participation; introducing a system of external directors; and clarifying the responsibilities of the board of directors, auditors, and superintendents. If these policies are to be successful, it is essential for the government to adopt the following comprehensive measures.

First, it has to clean up and restructure the balance sheets of WSCBs more drastically before they become public. Once NPL problems are resolved, the government must consider how to strengthen the capital base of these banks. However, the absence of secondary markets for credit and collateral and inadequate property rights makes it difficult to transfer, sell or securitize the assets of WSCBs, since the market price of the assets can hardly be realized and the ratio of realized asset values to book values is low. Improving the legal and institutional environment is essential to fulfilling this goal. Moreover, the government should ensure that AMCs are granted the authority to restructure SOEs and formulate asset resolution procedures. This might include a revision of the bankruptcy law that would provide AMCs with the skills and incentives to discharge their responsibilities and would ensure that their financial positions are sound (IMF 2000). Similarly, the balance sheets of other commercial banks should be cleaned up and restructured.

Second, as a related measure, the government needs to adopt global standards on accounting, auditing, and disclosure requirements, particularly with respect to potential listed banks. The government had already tightened prudential regulations in 1998 and 2000. However, existing accounting principles appear to be problematic, especially as to the calculation of maturities of interest receivable and the principle of provisioning for NPLs. Reliable, transparent business records of financial institutions are scarce, making mergers, restructuring or closure of any financial institutions difficult. Thus, promoting standardization of information regarding financial institutions as well as enterprises is a prerequisite not only for successful restructuring of WSCBs and other financial institutions, but also to foster sound capital markets.

Third, WSCBs should become more commercially-oriented and risk-conscious through corporate governance structure reforms, in accordance with the provisions of corporate law and the law governing commercial banks. This policy is essential not only to limit a further accumulation of NPLs, but also to prepare for the fuller-scale entry of foreign banks that will take place within the next five years. A further liberalization of interest rates is another crucial step to improve banks' risk management skills.

Fourth, the government needs to introduce measures to develop the investor and issuer bases that are a prerequisite for building sound capital markets. Until 2000, the state authorities decided which firm could list stock on the Shanghai and Shenzhen stock exchanges and rarely granted the privilege to private companies over the SOEs. However, in 2001, this policy was slightly modified. Moreover, the government allowed local individual and institutional investors to invest in the B-share market, where the shares of Chinese enterprises are denominated in foreign currency and only foreign investors and domestic securities companies used to be allowed to invest.[11] The policy attracted an inflow of $2.5 billion to the B-share market. Further, the government cut the stamp duty on transactions of the A-share market from 0.4 per cent to 0.2 per cent and B-share market from 0.3 per cent to 0.2 per cent in November 2001 – the lowest tax rate since its introduction 10 years ago. In December 2001, it also eased restrictions on capital expansions by securities firms in order to boost stock prices. The government needs to improve the information, legal and judiciary infrastructure to promote a sound equity market. In spite of securities regulations, the many cases of listed companies falsifying accounts and inflating profits indicates that investors have suffered great losses and the disclosure system is still at a nascent stage. The Auditor-General of the National Audit Office has stated that more enterprises and accountants have been providing false financial information of late, and 68 per cent of the 1,290 state-controlled enterprises issued false accounting reports in 2000.

Last, and most important, more drastic and comprehensive SOE reforms must be undertaken with a further emphasis on ownership diversification, liquidation, mergers and closure. Without a fundamental resolution of the SOEs, the likelihood that WSCBs will become viable, solvent financial institutions is small. The prolonged maintenance of problematic WSCBs would eventually undermine China's economic growth by limiting a further expansion of non-state enterprises.

B. PERFORMANCE OF THE COMMERCIAL BANKING SECTOR

China has taken a gradual approach to reforms, with economic reforms being launched in 1979, followed by financial restructuring reforms in the 1990s. This approach can be justified if adjustment costs are lower than that of a "big bang" approach, if credibility can be enhanced further, if the cost of adjustment can be spread out so that there will be more political support, if it is not practical to try to introduce

[11] The B-share market was established in December 1991. But the market remained marginal, reflecting (a) the attractiveness of the Hong Kong stock exchange as a place to list high-quality SOEs, (b) divestment by foreign companies that became disenchanted with the quality of the companies listed there, and (c) the poor liquidity of the market (World Bank 2001). By the end of 2000, therefore, B-share market tradable capitalization was no more than $5 billion, while A-share market tradable capitalization reached $192 billion. The Bank of China and the Industrial and Commercial Bank of China began to engage in B-share commission trade at their sub-branches in Singapore with customers consisting of Chinese working there and a few Singaporeans in 1994 and 1995, respectively. In November 2001, Singapore approved the setting up of a sub-branch of the Bank of Communications to engage in B-share commission trade.

many reforms at once, and if it takes considerable time to implement them (Feltenstein and Nsouli 1998). On the other hand, a "big bang" approach may be desirable if rapid reforms increase the incentive to relocate resources, thus lowering adjustment costs, full-scale reforms help enhance credibility, and political resistance to prolonged reforms can be overcome.

1. Financial deepening, role of bank loans and concentration

Given that China's macroeconomic performance has been remarkably favourable, the gradual approach appears to have been successful on the surface. There are few countries in the world that have been able to achieve high real GDP growth averaging 10 per cent in the past two decades and rapid financial deepening, as shown by the ratio of savings to GDP from 26 per cent in 1985 to 120 per cent in 1999 and the ratio of M2/GDP from 33 per cent in 1980 to 148 per cent in 1999 (table 1). The financial

Table 1. Selected macroeconomic indicators, 1979-1999

(per cent)

Year	*Real GDP growth*	*CPI based inflation rate*	*Deposits/ GDP*	*M1/ GDP*	*M2/ GDP*	*Gross fixed capital formation/ GDP*	*Domestic credit/ GDP*	*Corporate bonds/ GDP*	*Gov. bonds/ GDP*
1979	–	–	–	22.6	32.6	28.3	48.6	–	–
1980	7.8	–	–	25.2	36.7	29.0	53.2	–	–
1981	4.5	–	–	27.5	40.4	25.6	55.9	–	1.0
1982	8.3	–	–	27.1	41.3	27.2	55.5	–	1.8
1983	10.4	–	–	28.8	44.7	28.1	56.6	–	2.3
1984	14.6	–	–	34.2	50.2	29.7	63.0	–	2.5
1985	16.2	–	26.3	34.3	55.5	30.0	67.4	–	2.7
1986	8.9	–	29.9	38.1	62.7	30.6	78.4	–	2.9
1987	11.6	7.22	32.1	38.8	67.5	31.8	82.4	–	3.3
1988	11.3	18.74	30.6	37.3	65.3	31.5	78.5	–	3.7
1989	4.1	18.33	27.7	35.4	69.2	26.4	82.0	–	4.6
1990	3.8	3.06	30.9	38.3	80.1	25.8	91.1	–	4.8
1991	9.2	3.54	35.4	42.2	87.4	27.9	94.1	–	4.9
1992	14.2	6.34	40.1	45.3	94.1	32.2	94.7	–	4.8
1993	13.5	14.58	76.7	44.8	103.4	37.6	100.9	0.7	4.5
1994	12.7	24.24	74.6	42.1	100.5	36.1	92.3	0.5	4.9
1995	10.5	16.9	79.6	39.5	103.8	34.7	91.2	0.7	5.6
1996	9.6	8.32	88.1	40.3	111.4	34.2	97.2	0.4	6.4
1997	8.8	2.81	99.1	46.5	122.7	33.6	106.2	4.9	7.4
1998	7.8	–0.84	106.4	48.5	132.2	35.3	119.5	6.7	9.9
1999	7.1	–1.41	119.0	57.3	147.5	36.1	130.4	7.9	12.9

Source: International Monetary Fund, International Financial Statistics Database.

deepening was driven mainly by the increase in bank deposits by households, as seen by the continuous positive financial gaps in the household sector (table 2). The banking sector plays a crucial role in China because it functions as a major financier for non-financial firms. Based on the flow of funds database, for example, an increase in bank loans as a share of total sources of newly raised funds accounted for more than 70 per cent throughout the period 1992-1998, while the share of bonds and equity finance has remained small (table 2).

Table 2. Sources of newly raised funds for non-financial corporations, 1992-1998

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Loans (100 millions of yuan renminbi)	5 364	7 063	8 803	9 696	15 041	11 298	10 148
(% of total sources of funds)	78.0	77.4	70.9	74.8	76.4	74.5	74.9
Short term loans/Total loans (%)	58.6	65.6	62.4	66.6	69.7	66.4	54.0
Medium and long term loans/Total loans (%)	32.5	21.7	28.2	25.5	22.3	25.9	53.8
Foreign exchange loans/Total loans (%)	8.9	12.7	9.4	7.9	3.6	6.1	–3.6
Securities (100 millions of yuan renminbi)	807	283	95	–2.0	381	1 508	877
(% of total sources of funds)	11.7	3.1	0.8	0.0	1.9	9.9	6.5
Bonds/Securities (%)	69.1	30.0	47.6	1 222.8	19.6	2.3	4.7
Shares/Securities (%)	30.9	70.0	52.4	–1 122.8	80.4	97.7	95.3
Memorandum:							
I-S Gap (% of GDP)							
Non-financial corporations	–12.9	–16.4	–14.3	–13.8	–17.5	–11.5	–10.6
Household	16.6	14.2	16.1	14.5	16.0	14.7	14.6
Of which: Deposits	10.4	9.8	13.2	13.2	12.5	10.0	11.6
Bonds	2.6	0.9	0.9	1.0	1.8	1.8	1.8
Shares	0.7	0.6	0.1	0.0	0.4	1.1	1.0
General government	–2.5	–0.7	–0.1	–0.2	–0.6	–1.0	–1.4
Financial institutions	0.2	1.0	–0.2	–0.4	3.0	1.1	0.3
Foreign sector	–1.4	1.9	–1.4	–0.2	-0.9	–3.3	–3.0

Source: Almanac of China's Finance and Banking.

In spite of this favourable macroeconomic performance and financial deepening, however, a closer look at this giant economy reveals deep-rooted structural problems – namely, a poor and deteriorating performance from SOEs has coexisted with an equally unfavorable performance from the banking sector. Table 3 indicates that banks' major assets are bank loans extended to non-financial sectors, which increased rapidly from 83 per cent of GDP in 1994 to 111 per cent in 1999. The next major assets are in the form of deposits with PBC, accounting for 16-20 per cent of GDP during the period 1994-1999. Claims on central government have increased rapidly in recent years from 1 per cent of GDP in 1994 to 7.4 per cent in 1999, reflecting the introduction of the interbank bond market. A similar pattern on the asset portfolio has been observed both for WSCBs and other commercial banks (tables 4 and 5).

Table 3. Consolidated balance sheet of deposit money bank, 1994-1999[1]

(100 million yuan renminbi)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*
Net foreign assets	613	–300	–40	991	2 010	3 028
Reserves	7 601	9 899	13 695	16 275	15 006	15 919
Claims on central government	460	1 041	1 804	1 496	4 970	6 062
Claims on other sectors	38 640	48 086	58 232	70 691	81 493	91 160
Claims on non-monetary financial institutions	645	776	776	2 224	2 874	3 657
Deposits of non-financial sectors	35 674	47 850	61 716	75 310	86 628	100 340
Liabilities to the People's Bank of China	10 317	11 174	14 210	14 003	12 033	8 053
Liabilities to non-monetary financial institutions	354	437	579	1 501	1 134	1 641
Bonds	196	170	288	287	501	482
Equity	2 919	2 970	3 298	3 311	5 471	5 063
Others (net)	–1 500	–2 902	–5 624	–2 638	646	4 292
						(percentage of GDP)[2]
Net foreign assets	1.3	–0.5	–0.1	1.3	2.5	3.7
Reserves	16.3	16.9	20.2	21.9	18.9	19.4
Claims on central government	1.0	1.8	2.7	2.0	6.3	7.4
Claims on other sectors	82.6	82.2	85.8	94.9	102.6	111.3
Claims on non-monetary financial institutions	1.4	1.3	1.1	3.0	3.6	4.5
Deposits of non-financial sectors	76.3	81.8	90.9	101.1	109.1	122.5
Liabilities to the People's Bank of China	22.1	19.1	20.9	18.8	15.2	9.8
Liabilities to non-monetary financial institutions	0.8	0.7	0.9	2.0	1.4	2.0
Bonds[3]	0.4	0.3	0.4	0.4	0.6	0.6
Equity	6.2	5.1	4.9	4.4	6.9	6.2
Others (net)	–3.2	–5.0	–8.3	–3.5	0.8	5.2

Source: Almanac of China's Finance and Banking.

Note: [1] Deposit money banks include wholly state-owned commercial banks, other commercial banks, city commercial banks, rural credit cooperatives, urban credit cooperatives, finance companies and the Agricultural Development Bank.

[2] GDP was used instead of total assets (equal to total liabilities plus equity) since the precise data on total assets were not available owing to the netting of others and foreign assets and liabilities.

[3] Bonds are issued abroad.

Further, the dominance of WSCBs in the banking sector is one of the most important financial reform issues that should be taken into account. Their dominance is evident from tables 3-4, which report that WSCBs' share has accounted for more than 75 per cent of total claims on non-financial sectors by all deposit money banks and about 70 per cent of total deposits held by these deposit money banks in 1994-1999. The WSCBs are also major recipients of loans from PBC, accounting for more than 90 per cent of total borrowing from it.

Concentration in the banking sector

Even after the financial reforms began in 1994, tables 3-5 show that the dominance of the WSCBs has been overwhelming. To examine to what extent the degree of

Table 4. Consolidated balance sheet of wholly state-owned commercial banks, 1994-1999

(100 million yuan renminbi)

	1994	1995	1996	1997	1998	1999
Net foreign assets	336	–537	–341	620	1 316	2 095
Reserves	6 056	7 795	10 196	10 916	9 723	10 159
Claims on central government	380	486	967	762	3 691	4 357
Claims on other sectors	30 995	37 564	44 477	54 375	62 314	69 573
Claims on non-monetary financial institutions	430	456	332	1 494	1 820	2 343
Deposits of non-financial sectors	25 029	33 089	42 402	51 905	59 478	69 770
Liabilities to the People's Bank of China	10 182	11 095	14 089	13 885	11 867	7 560
Liabilities to non-monetary financial institutions	181	177	145	1 011	644	1 244
Bonds	189	170	281	278	483	476
Equity	1 848	1 789	2 010	2 028	4 369	4 097
Others (net)	767	–380	–3 295	–879	2 046	5 401
						(percentage of GDP)
Net foreign assets	0.7	–0.9	–0.5	0.8	1.7	2.6
Reserves	13.0	13.3	15.0	14.7	12.2	12.4
Claims on central government	0.8	0.8	1.4	1.0	4.6	5.3
Claims on other sectors	66.3	64.2	65.5	73.0	78.5	84.9
Claims on non-monetary financial institutions	0.9	0.8	0.5	2.0	2.3	2.9
Deposits of non-financial sectors	53.5	56.6	62.5	69.7	74.9	85.2
Liabilities to the People's Bank of China	21.8	19.0	20.8	18.6	14.9	9.2
Liabilities to non-monetary financial institutions	0.4	0.3	0.2	1.4	0.8	1.5
Bonds	0.4	0.3	0.4	0.4	0.6	0.6
Equity	4.0	3.1	3.0	2.7	5.5	5.0
Others (net)	1.6	–0.6	–4.9	–1.2	2.6	6.6

Source: Almanac of China's Finance and Banking.

concentration has changed in the reform period, the following two approaches have been adopted: (1) the m-bank concentration ratio adopted by Sarkar, Sarkar and Bhaumik (1998); and (2) the Herfindahl Index adopted by Juan-Ramon and others (2001).

The m-bank concentration measures the market share of the four largest banks or WSCBs. Deposits have been used to estimate the m-bank concentration indicator. The Herfindahl Index is defined as 100 x $\Sigma_{i=1}^{i=N} k_i^2$ where $k_i = K_i/\Sigma_{i=1}^{i=N} K_i$ and N = number of banks during the period under consideration and K_i is bank i's deposits or assets. This indicator can be calculated for the whole commercial banking sector and other commercial banks. The higher the indicator, the greater the concentration of the banking sector. The lower limit of this indicator is obtained as 100 divided by N and the upper limit is 100. All indicators are calculated from 1996 onward, since data on two WSCBs (Bank of China and China Construction Bank) are available only from 1996.

Table 5. Consolidated balance sheet of other commercial banks, 1994-1999

(100 million yuan renminbi)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*
Net foreign assets	277	237	301	418	702	939
Reserves	820	1 046	1 427	2 009	1 995	2 509
Claims on central government	12	115	301	252	460	623
Claims on other sectors	1 789	2 814	4 090	4 304	5 314	6 190
Claims on non-monetary financial institutions	59	96	153	461	781	974
Deposits of non-financial sectors	2 428	3 780	5 704	6 376	7 583	8 968
Liabilities to the People's Bank of China	93	44	81	60	78	129
Liabilities to non-monetary financial institutions	91	149	167	313	356	226
Bonds	7	0.2	7	5	16	4
Equity	242	282	429	531	538	667
Others (net)	95	62	–115	193	714	1 265
						(percentage of GDP)
Net foreign assets	0.6	0.4	0.4	0.6	0.9	1.1
Reserves	1.8	1.8	2.1	2.7	2.5	3.1
Claims on central government	0.0	0.2	0.4	0.3	0.6	0.8
Claims on other sectors	3.8	4.8	6.0	5.8	6.7	7.6
Claims on non-monetary financial institutions	0.1	0.2	0.2	0.6	1.0	1.2
Deposits of non-financial sectors	5.2	6.5	8.4	8.6	9.6	10.9
Liabilities to the People's Bank of China	0.2	0.1	0.1	0.1	0.1	0.2
Liabilities to non-monetary financial institutions	0.2	0.3	0.2	0.4	0.4	0.3
Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Equity	0.5	0.5	0.6	0.7	0.7	0.8
Others (net)	0.2	0.1	–0.2	0.3	0.9	1.5

Source: Almanac of China's Finance and Banking.

The 4-bank concentration indicator based on deposits for 1996-1999 reports that the degree of concentration in the banking sector has barely changed, accounting for about 70 per cent of total deposits held by the deposit money banks (table 6). This indicates that the dominance of the WSCBs is overwhelming. Since these banks are disproportionately large with an extensive branch network, new banks find it difficult to penetrate into the banking sector.

On the other hand, the Herfindahl Index reports that the degree of concentration based on deposits has declined slightly in the commercial banking sector, from 22.8 in 1996 to 20.4 in 2000. The degree of concentration among other commercial banks is much smaller and has declined more sharply from 29.4 in 1996 to 12 in 2000. A similar pattern is observed in terms of bank assets. Since the lower limit (100/N) has also declined throughout the sample period (except 2000 when the number of reported banks was smaller), it can be inferred that the entry of new banks, namely that of other banks, has exerted some competition at the lower end.

Table 6. Concentration indicators, 1996-1999

	1996	*1997*	*1998*	*1999*	*2000*
Concentration ratio (deposits)					
4 Bank concentration ratio (%)	68.7	68.9	68.7	69.5	–
Herfindahl Index (deposits)					
All commercial banks	22.8	21.3	21.0	21.1	20.4
100/N	7.1	6.3	5.3	5.0	5.9
Other commercial banks	29.4	23.9	19.0	11.1	12.1
100/N	10.0	8.3	6.7	6.3	7.7
Herfindahl Index (assets)					
All commercial banks	24.2	21.0	20.5	19.6	19.4
100/N	7.1	6.3	5.3	5.0	5.9
Other commercial banks	26.9	20.2	17.8	14.6	14.7
100/N	10.0	8.3	6.7	6.3	7.7

Source: Fitch IBCA, Bankscope.

Note: The indicators were estimated from 1996 onward because of the lack of data on two wholly state-owned banks. In addition, the m-bank concentration ratio was not calculated based on assets since there are some discrepancies between each bank's balance sheet and the consolidated balance sheet.

Overall financial strength of commercial banks

In spite of the government's efforts at financial reforms, the overall performance of the banking sector is perceived to be significantly low. According to the rating of the overall financial strength of a bank prepared by Moody's, table 7 shows that current ratings of selected banks are largely low and no single bank has a rating of above D^+.

Table 7. Moody's financial strength ratings of banks

	Current rating	*Previous rating*	*Change date*
Wholly state-owned commercial banks			
Agricultural Bank of China	E	E+	Jan-99
Bank of China	D–	E+	Mar-01
China Construction Bank	E+	E	Mar-01
Industrial and Commercial Bank of China	E+	E	Mar-01
Other commercial banks			
Bank of Communications	D	D+	Jan-99
China Everbright Bank	D–	E+	Mar-01
China Merchants Bank	D–	E+	Mar-01
CITIC Industrial Bank	D	–	Jan-97
Guangdong Development Bank	E+	E	Oct-01
Shanghai Pudong Development Bank	D–	E+	Mar-01
Shenzhen Development Bank Co., Ltd.	E+	E	Mar-01

Source: Fitch IBCA, Bankscope.

Note: Only banks with ratings are listed in this table.

These ratings reflect Moody's evaluation of the intrinsic financial strength of each bank on a scale of A-E, with A being the highest rating. In general, the ratings of WSCBs are lower than those of other commercial banks.

2. Performance of the wholly state-owned and other commercial banks

This section examines the performance of the commercial banks by distinguishing between WSCBs and other commercial banks, which reflects differences in wage-setting mechanisms. Based on this classification, it has been found that the performance of WSCBs has been unimpressive compared with other commercial banks (although only a selected number of other commercial banks have been covered). A more worrying sign, on the other hand, is the rapidly deteriorating performance of the other commercial banks. The results derived from the comparison during the period 1994-2000 are shown in table 8 and can be summarized as follows:

Table 8. Selected indicators for the performance of commercial banks, 1994-2000

(percentage)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Return on average assets (ROAA)							
Wholly state-owned commercial banks	0.1	0.2	0.1	0.1	0.1	0.1	0.2
Other commercial banks	1.8***	1.7***	1.6***	1.4***	1.2***	0.8***	0.6***
Of which: Nationwide banks	1.8***	1.6***	1.5***	1.2***	0.9***	0.6***	0.5***
City banks	n.a.	2.4	2.5	2.2**	1.7**	1.1**	0.9**
Return on average equity (ROAE)							
Wholly state-owned commercial banks	1.8	4.5	4.4	2.6	1.2	2.2	3.1
Other commercial banks	20.5***	25.3***	24.8***	21.1***	15.7***	11.1***	11.3***
Of which: Nationwide banks	20.5***	22.0***	22.8***	17.3***	13.7***	10.2***	9.2***
City banks	n.a.	51.7	42.9	39.9**	19.7**	12.6**	15.8**
Net interest income/average assets (MARGIN)							
Wholly state-owned commercial banks	3.1	1.7	1.9	2.2	2.3	1.9	1.8
Other commercial banks	2.5	3.4***	3.3***	3.4**	3.1*	2.3	2.2*
Of which: Nationwide banks	2.5	3.2***	3.2***	3.4**	3.2*	2.5*	2.3**
City banks	n.a.	4.7	4.1	3.4	2.9	2.0	1.7
Return from other business/asset (DIVERSE)							
Wholly state-owned commercial banks	1.5	0.1	0.1	-0.2	-0.2	-0.1	0.0
Other commercial banks	1.9	0.6***	0.6*	0.5***	0.2	0.3*	0.3*
Of which: Nationwide banks	1.9	0.5**	0.4	0.5***	0.1	0.2	0.1
City banks	n.a.	1.4	2.0	0.5	0.4	0.6**	0.8**
Investment in securities/asset (SBOND)							
Wholly state-owned commercial banks	2.9	3.3	3.7	3.4	8.4	7.9	10.9
Other commercial banks	10.4**	8.9**	14.5***	9.1	15.7	15.7	17.1
Of which: Nationwide banks	10.4**	7.6**	13.6***	9.1	13.1	13.6	15.2
City banks	n.a.	18.6	22.0	9.2	24.3	20.8	22.4
Deposit with the PBC/deposits ($LIQUID_1$)							
Wholly state-owned commercial banks	11.3	25.3	23.9	17.6	12.9	11.6	10.1
Other commercial banks	24.2	20.0	21.8	25.2**	19.5**	21.9***	22.5***
Of which: Nationwide banks	24.2	23.4	22.5	26.1**	23.8***	28.8***	27.0***
City banks	n.a.	3.1	16.5	18.0	12.6	12.7	14.5

Table 8. *(continued)*

(percentage)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Cash and bank deposits/assets (LIQUID₂)							
Wholly state-owned commercial banks	6.3	4.6	3.6	1.6	1.3	1.8	1.0
Other commercial banks	0.8	2.2	1.4	1.0	2.1	3.5	2.0
Of which: Nationwide banks	0.8	1.0	1.2	0.6	1.1	2.5	2.3
City banks	n.a.	12.1	2.8	2.7	4.3	4.9	1.4
Operating expenses/operating income (COST)							
Wholly state-owned commercial banks	85.9	70.2	69.3	67.5	79.9	78.7	77.0
Other commercial banks	45.1**	43.8**	59.9	49.9**	56.9***	63.6**	66.1**
Of which: Nationwide banks	45.1**	44.0**	61.50	50.7**	56.3***	62.6**	65.4**
City banks	n.a.	42.1	45.3	46.1**	58.2*	65.3	67.6
Total income/Total assets (INCOME)							
Wholly state-owned commercial banks	16.0	12.6	11.2	12.4	6.2	5.0	4.4
Other commercial banks	6.8	8.3	8.1	8.3	6.3	4.9	3.9**
Of which: Nationwide banks	6.8	8.1	7.8	7.9	6.2	4.7	4.0**
City banks	n.a.	10.0	10.1	10.6	6.7	5.2	3.8
Equity/assets (EQUITY)							
Wholly state-owned commercial banks	3.5	3.3	3.0	3.2	5.8	5.4	5.3
Other commercial banks	8.8***	6.4***	8.2***	6.8***	9.5	8.7	5.3
Of which: Nationwide banks	8.8***	6.6***	8.4***	7.0***	6.3	5.4	4.9
City banks	n.a.	4.6	6.5	5.8	15.8	14.2	6.1*
Equity/liabilities (INVDEBT)							
Wholly state-owned commercial banks	3.6	3.4	3.1	3.3	6.2	5.7	5.6
Other commercial banks	9.8***	6.9***	9.2***	7.4***	13.5	12.9	5.6
Of which: Nationwide banks	9.8***	7.1***	9.4***	7.7***	6.8	5.7	5.2
City banks	n.a.	4.9	7.0	6.1	26.8	24.9	6.5*
Loan loss reserves/loans (PROV)							
Wholly state-owned commercial banks	0.5	1.1	0.9	0.7	0.8	1.2	1.0
Other commercial banks	0.6	0.7	0.9	1.3	1.6	1.7	1.4
Of which: Nationwide banks	0.6	0.7	0.9	1.4	1.8	2.0	1.7
City banks	n.a.	0.4	0.5	0.5	1.3	1.3	0.6

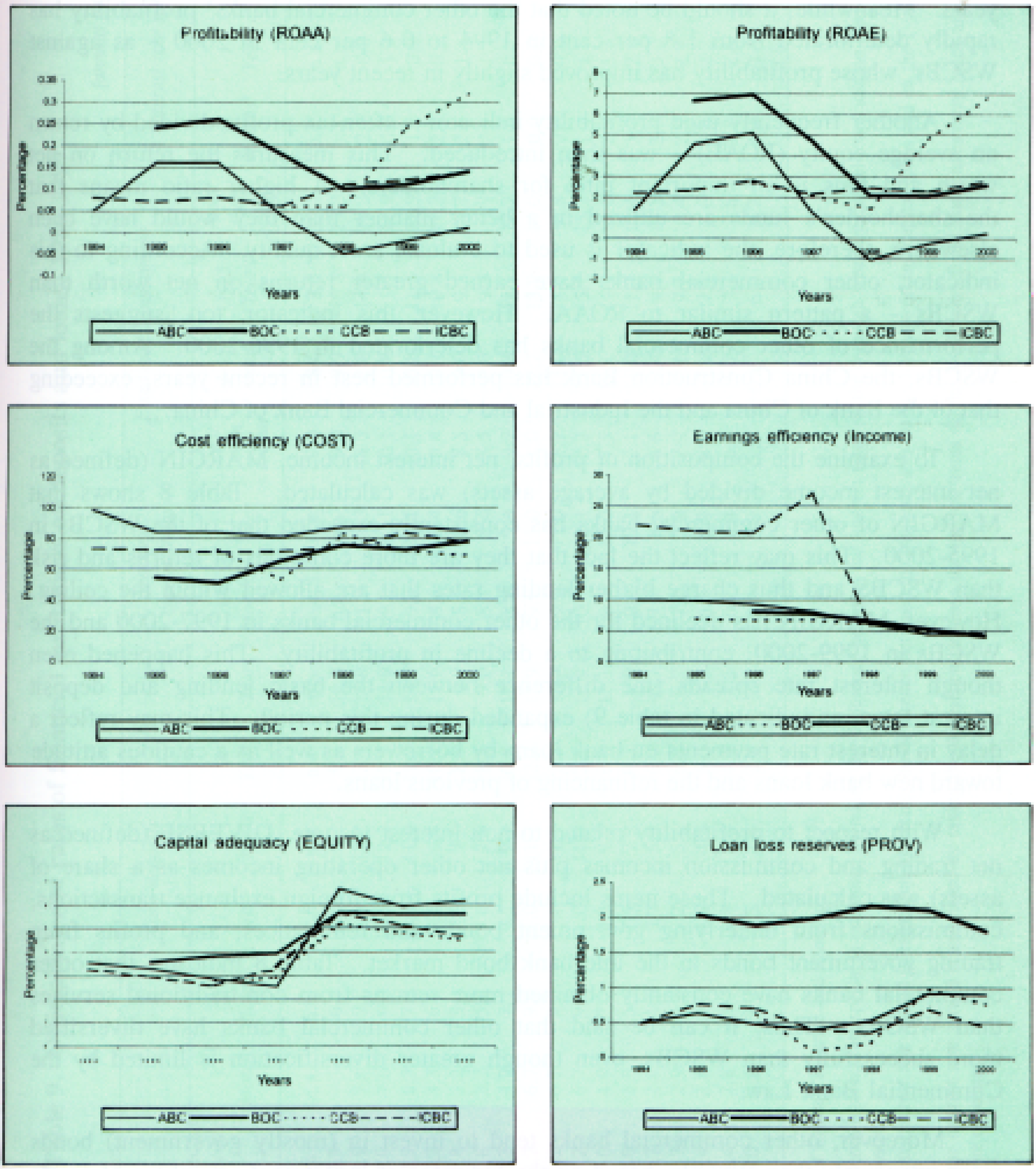
Source: Fitch IBCA, Bankscope.

Note: ***, **, * indicate that other commercial banks, national banks and regional banks are significantly different from the wholly state-owned banks with respect to the indicator under examination at significance levels of 1 per cent, 5 per cent and 10 per cent, respectively. However, the absence of * does not necessarily mean that the statistical difference is absent. In some cases it could be attributed to lack of enough samples to perform the statistical t-test.

Trend patterns of the performance of the commercial banking sector

WSCBs have maintained profitability (defined as after-tax profits divided by return on average assets [ROAA]) at a level below 0.2 per cent throughout 1994-2000. This level of profitability is remarkably small, especially when compared with other commercial banks, which achieved nearly 2 per cent profitability in 1994-1995. The Agricultural Bank of China was the worst performer among the WSCBs (figure 2). By contrast, the China Construction Bank – which has invested in product innovation and

Figure 2. Performance of the wholly state-owned commercial banks, 1994-2000



Source: Fitch IBCA, Bankscope.

ABC	Agricultural Bank of China.
BOC	Bank of China.
CCB	China Construction Bank.
ICBC	Industrial and Commercial Bank of China.

service improvement in the areas of settlement, bank cards, policy housing finance, trust loans, guarantees, and consultation-has rapidly improved profitability in recent years. Meanwhile, it should be noted that the other commercial banks' profitability has rapidly deteriorated from 1.8 per cent in 1994 to 0.6 per cent in 2000 – as against WSCBs, whose profitability has improved slightly in recent years.

Another frequently used profitability indicator – after-tax profits divided by return on average equity (ROAE) – was then introduced. This measures the return on net worth and thus is an important ratio for shareholders. A higher ratio means that the shareholder's funds are utilized in a better manner than they would have been elsewhere, therefore, the indicator is used to evaluate asset quality. According to this indicator, other commercial banks have earned greater returns on net worth than WSCBs – a pattern similar to ROAA. However, this indicator, too, suggests the performance of other commercial banks has deteriorated in 1996-2000. Among the WSCBs, the China Construction Bank has performed best in recent years, exceeding that of the Bank of China and the Industrial and Commercial Bank of China.

To examine the composition of profits, net interest income, MARGIN (defined as net interest income divided by average assets) was calculated. Table 8 shows that MARGIN of other commercial banks has consistently exceeded that of the WSCBs in 1995-2000. This may reflect the fact that they are more conscious of returns and risk than WSCBS and thus charge higher lending rates that are allowed within the ceiling. However, MARGIN has declined for the other commercial banks in 1997-2000 and the WSCBs in 1999-2000, contributing to a decline in profitability. This happened even though interest rate spreads (the difference between the basic lending and deposit interest rates, as indicated in table 9) expanded during this period. This may reflect a delay in interest rate payments on bank loans by borrowers as well as a cautious attitude toward new bank loans and the refinancing of previous loans.

With respect to profitability related to non-interest income, DIVERSE (defined as net trading and commission incomes plus net other operating incomes as a share of assets) was calculated. These items include profits from foreign exchange transactions, commissions from underlying government bonds and remittances, and profits from trading government bonds in the interbank bond market. Table 8 indicates that other commercial banks have constantly obtained more returns from non-traditional services than WSCBs. Thus, it can be said that other commercial banks have diversified more successfully than WSCBs, even though greater diversification is limited by the Commercial Bank Law.

Moreover, other commercial banks tend to invest in (mostly government) bonds more intensively than WSCBs, based on the indicator of investment as a share of assets (SBOND). All banks increased holdings of bonds in 1998 when the interbank bond market was established. Nevertheless, the other commercial banks' larger amount of bond holdings compared with WSCBs should be noted. This may reflect other commercial banks' preference for investing in safer, liquid assets since it is costly for them to establish branch networks and thus penetrate into retail markets, and at the same time find high quality customers and monitor performance. However, the

Table 9. Official interest rates of financial institutions on deposits and loans, 1986-1999

(annual percentage)

	Demand deposits	Time deposits						Working capital loans		Fixed assets investment loans				Interest rate spread		
		3 Months	6 Months	1 Year	2 Years	3 Years	5 Years	6 Months	1 Year	Less than 1 Year	1~3 Years	3~5 Years	More than 5 Years	6 Months[1]	1 Year[2]	5 Years[3]
21 September 1986	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7.9	8.6	9.4	10.1	n.a.	n.a.	n.a.
1 September 1988	2.9		6.5	8.6	9.2	9.7	10.8	n.a.	n.a.	9.0	9.9	10.8	13.3	n.a.	n.a.	0.0
1 February 1989	2.9	7.6	9.0	11.3	12.2	13.1	14.9	11.3	11.3	11.3	12.8	14.4	19.3	2.3	0.0	–0.5
21 March 1990	2.9	7.6	9.0	11.3	12.2	13.1	14.9	9.0	10.1	10.1	10.8	11.5	11.9	0.0	–1.3	–3.4
15 April 1990	2.9	6.3	7.7	10.1	11.0	11.9	13.7	9.0	10.1	10.1	10.8	11.5	11.9	1.3	0.0	–2.2
21 August 1990	2.2	4.3	6.5	8.6	9.4	10.1	11.5	8.6	9.4	9.4	10.1	10.8	11.2	2.2	0.7	–0.7
21 April 1991	1.8	3.2	5.4	7.6	7.9	8.3	9.0	8.1	8.6	8.5	9.0	9.5	9.7	2.7	1.1	0.5
31 December 1992	1.8	3.2	5.4	7.6	7.9	8.3	9.0	8.1	8.6	8.5	9.0	9.5	9.7	2.7	1.1	0.5
15 May 1993	2.2	4.9	7.2	9.2	9.9	10.8	12.1	8.8	9.4	9.2	10.8	12.1	12.2	1.6	0.2	0.0
11 July 1993	3.2	6.7	9.0	11.0	11.7	12.2	13.9	9.0	11.0	11.0	12.2	13.9	14.0	0.0	0.0	0.0
1 January 1995	3.2	6.7	9.0	11.0	11.7	12.2	13.9	9.0	11.0	11.7	13.0	14.6	14.8	0.0	0.0	0.7
1 July 1995	3.2	6.7	9.0	11.0	11.7	12.2	13.9	10.1	12.1	12.2	13.5	15.1	15.3	1.1	1.1	1.3
1 May 1996	3.0	4.9	7.2	9.2	9.9	10.8	12.1	9.7	11.0	11.5	13.1	14.9	15.1	2.5	1.8	2.9
23 October 1996	2.0	3.3	5.4	7.5	7.9	8.3	9.0	9.2	10.1	10.1	11.0	11.7	12.4	3.8	2.6	2.7
23 October 1997	1.7	2.9	4.1	5.7	5.9	6.2	6.7	7.7	8.6	8.6	9.4	9.9	10.5	3.5	3.0	3.2
25 March 1998	1.7	2.9	4.1	5.2	5.6	6.2	6.7	7.0	7.9	7.9	9.0	9.7	10.4	2.9	2.7	3.1
1 July 1998	1.4	2.8	4.0	4.8	4.9	5.0	5.2	6.6	6.9	6.9	7.1	7.7	8.0	2.6	2.2	2.4
7 December 1998	1.4	2.8	3.3	3.8	4.0	4.1	4.5	6.1	6.4	6.4	6.7	7.2	7.6	2.8	2.6	2.7
6 October 1999	1.0	2.0	2.2	2.3	2.4	2.7	2.9	5.6	5.9	n.a.	n.a.	6.0	6.2	3.4	3.6	3.2

Source: Almanac of China's Finance and Banking.

Note: [1] The 6-month interest rate spread is estimated by taking the difference between the interest rates on the 6-month working capital loans and on the 6-month time deposits.

[2] The 1-year interest rate spread is estimated by taking the difference between the interest rates on the 1-year working capital loans and on the 1-year time deposits.

[3] The 5-year interest rate spread is estimated by taking the difference between the interest rates on the 3 ~ 5 years fixed asset investment loans and on the 5-year time deposits.

increased holdings of government bonds suggests that banks are unable to exploit economies of scale from traditional banking activities and thus may not be able to reduce the costs of collecting and evaluating information regarding the creditworthiness of their borrowers. Economies of scale arise from the fixed cost of hiring professional staff with special expertise in loan evaluation. Commercial banks also provide settlement and checking accounts and other financial services to their borrowers, which give them an opportunity to grasp the economic activities and cash flow movements of their borrowers (Chemmanur and Fulgheri 1994). The limited amount of lending suggests that the information obtained in this way is not being utilized to its fullest extent.

Other commercial banks also held more liquid assets (proxied as deposits with PBC divided by customer deposits [$LIQUID_1$]) than WSCBs in 1997-2000. In particular, other commercial banks tended to hold excess reserves in 1998-2000, even after the reserve requirement sharply dropped from 20 per cent in 1993 to 8 per cent in 1998 and to 6 per cent in 1999. This result may reflect (a) the interest rate paid by PBC as reported in table 10, (b) cushions needed for settlement and clearing

Table 10. Basic interest rates on deposits and loans of the People's Bank of China, 1986-1999

(annual percentage)

	Deposits		*Loans to financial institutions*				
	Reserve require-ments	*Excess reserve*	*1 year*	*3 months or less*	*6 months or less*	*20 days or less*	*Redis-count*
1 August 1986	4.32	5.76	4.68	6.84	6.84	6.84	
1 January 1987	4.32	5.76	6.48	6.84	6.84	6.48	
21 September 1987	4.32	5.76	7.20	7.20	7.20	7.20	
21 December 1987	5.04	5.76	7.20	6.84	6.84	6.48	
1 September 1988	5.04	6.48	8.28	7.56	7.56	6.84	
1 February 1989	7.20	8.64	10.44	9.00	9.00	9.00	
21 March 1990	7.92	7.92	9.00	9.00	9.00	9.00	
21 August 1990	6.84	6.84	7.92	7.92	7.92	7.92	
21 April 1991	6.12	6.12	7.20	7.20	7.20	7.20	
15 May 1993	7.56	7.56	9.00	8.64	8.82	8.46	
11 July 1993	9.18	9.18	10.62	10.26	10.44	10.08	
1 January 1995	9.18	9.18	10.89	10.44	10.71	10.26	
1 July 1995	9.18	9.18	11.16	10.62	10.98	10.44	
1 May 1996	8.82	8.82	10.98	10.08	10.17	9.00	
23 August 1996	8.28	7.92	10.62	9.72	10.17	9.00	
23 October 1997	7.56	7.02	9.36	8.82	9.09	8.55	
23 March 1998	5.22	5.22	7.92	6.84	7.02	6.39	6.03
1 July 1998	3.51	3.51	5.67	5.49	5.58	5.22	4.32
7 December 1998	3.24	3.24	5.13	4.86	5.04	4.59	3.96
10 June 1999	2.07	2.07	3.78	3.51	3.69	3.24	2.16

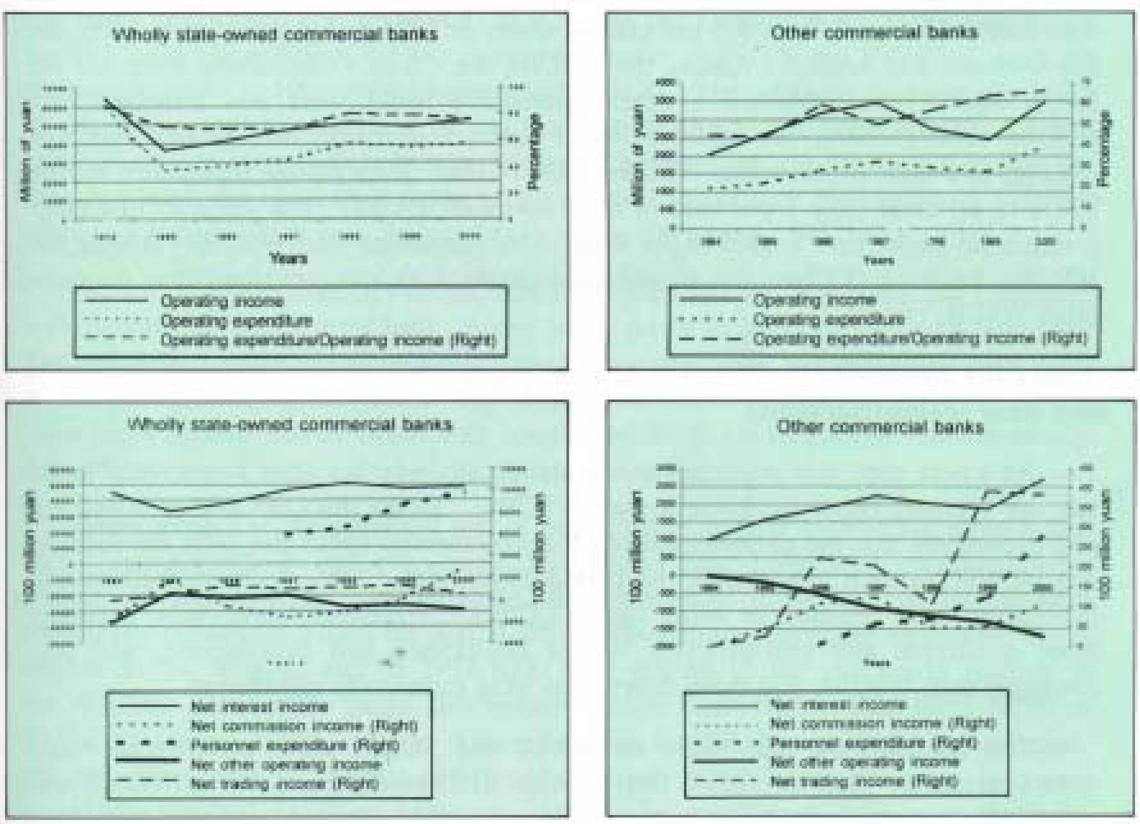
Source: Almanac of China's Finance and Banking.

Note: Prior to 1998, rediscount rates were determined within a band of ±5 – 10 per cent of respective basic lending rate.

accounts, (c) the WSCBs' preference for more liquid safe assets rather than longer-term illiquid bank loans, and (d) a cautious attitude toward lending activities given a recent tightening of accounting and provisioning requirements. Another liquidity indicator (the sum of cash and bank deposits divided by assets [$LIQUID_2$]) also shows that other commercial banks held slightly more liquid assets than WSCBs during the period 1998-2000.

With respect to the indicator of cost-efficiency, COST (defined as operating expenses divided by operating income) was used. The lower the indicator, the more cost-efficient a bank. According to this indicator, other commercial banks have been more cost-efficient than WSCBs throughout the reform period. However, their cost-efficiency deteriorated in 1998-2000, while that of the WSCBs improved slightly in 1998-2000. Among the WSCBs, the cost-efficiency of the Bank of China deteriorated in 1996-2000, while the Agricultural Bank of China was the worst performer throughout the period (figure 2). On the other hand, the China Construction Bank increased its cost efficiency in 1999-2000. The increase in COST by the other commercial banks in 1998-2000 reflects a decline in operating income in 1998-1999 and an increase in operating expenditure in 2000 (figure 3). A further decomposition of net operating

Figure 3. Decomposition of operating income and expenditure, 1994-2000



Source: Fitch IBCA, Bankscope.

income shows that a decline in net interest income and other operating income contributed to a decline in operating income in 1998-1999, while an increase in net trading income and net commission income contributed to an increase in operating income in 1998-1999 and in 1998-2000, respectively. On the other hand, a sharp and steady increase in personnel expenditure led to a rise in operating income. The increase in personnel expenditure may be attributable to staff wage rises and an expansion of employment as the numbers of branches and offices rose. This may have been caused by an expansion of business at the initial stage of establishment, increasing the costs of personnel and equipment related to traditional lending and banking business.

As for the indicator of earnings efficiency, INCOME (defined as income divided by assets) was introduced. Based on this indicator, WSCBs have performed better than other commercial banks during the period 1994-1997. However, the difference was small in 1998-2000. It should be recognized that earnings-efficiency of both kinds of banks has deteriorated in recent years. Among the WSCBs, the earnings efficiency of the Industrial and Commercial Bank of China, which used to maintain greater earnings capacity, has rapidly deteriorated in recent years (figure 2).

As measures of soundness, three indicators were adopted: (a) equity divided by assets (EQUITY), (b) equity as a share of liabilities (an inverse of leverage [INVDEBT]), and (c) loan loss reserves as a share of loans (PROV). With respect to EQUITY, other commercial banks were more capitalized than WSCBs in 1994-1999. Although WSCBs have increased capital from 3.5 per cent of assets in 1994 to 5.3 per cent in 2000, the improvement was modest. Among the WSCBs, the China Construction Bank has the lowest equity ratio. Moreover, other commercial banks were less leveraged than WSCBs in 1994-1999. In addition, other commercial banks had greater loan loss reserves as a share of loans than WSCBs in 1997-2000. Even though regulations require banks to set aside only 1 per cent of their outstanding credit, this suggests that other commercial banks have tended to put aside more provisions than WSCBs. Among the WSCBs, the Bank of China has accumulated greater loan loss provisions than the three other WSCBs (figure 2).

Testing the differential performance between the WSCBs and other commercial banks

As a next step, it is important to test statistically whether other commercial banks are, on average, better performers than WSCBs. To do this, the author tested the null hypotheses that the performance of other commercial banks has been the same as that of WSCBs each year during the period 1994-2000. Table 8 shows that the null hypotheses were rejected in many cases. Other commercial banks were generally more profitable and cost-efficient, better capitalized and provisioned, and less leveraged than WSCBs, and these differences were statistically significant.

The results show that based on ROAA and ROAE, other commercial banks were consistently more profitable than WSCBs in 1994-2000 and this difference was statistically significant at 1 per cent. Moreover, other commercial banks have been consistently more cost-efficient than WSCBs, based on COST, and this difference was statistically significant at 5 per cent in 1994-2000, except 1996. Further, their balance sheets are more structurally sound than those of WSCBs, since the former were better capitalized and less leveraged at a significance level of 1 per cent throughout the period 1994-1997.

3. Performance of other commercial banks: nationwide versus city and listed versus unlisted

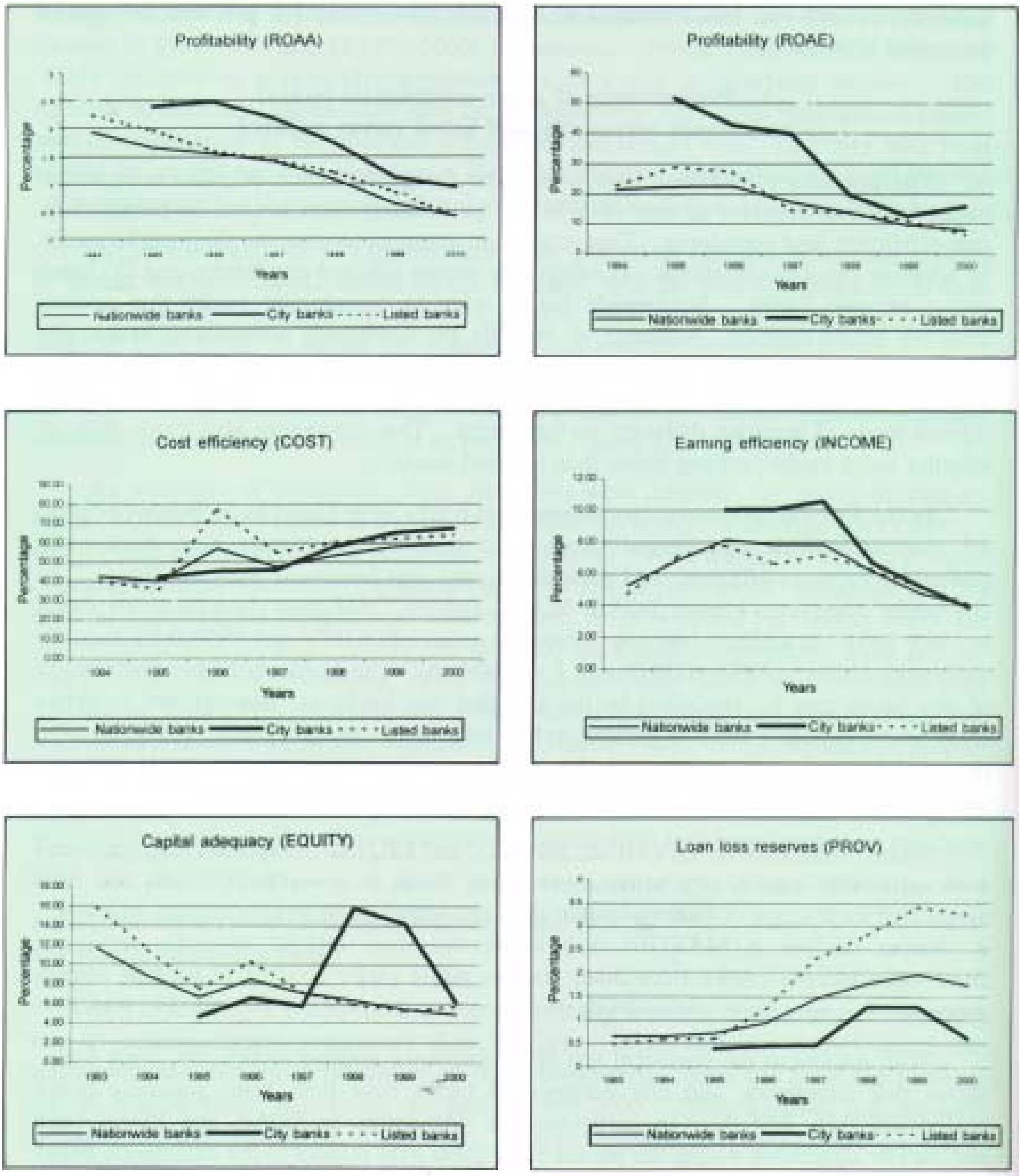
The previous subsections have found that the performance of other commercial banks has been superior to that of WSCBs, particularly with respect to profitability, cost-efficiency, and soundness. This subsection attempts to examine their performance by adopting two classifications: (a) nationwide versus selected city banks, and (b) listed versus unlisted banks. Nationwide banks refer to commercial banks that operate branches across regions. Although all WSCBs are nationwide commercial banks, this subsection focuses only on the performance of other commercial banks by considering whether the concentration of business in specific city areas or spreading to various regions tends to generate different performances. This subsection also sheds light on whether listed banks perform better than unlisted banks.

In the first classification, city commercial banks were found to be better performers than nationwide commercial banks. In general, the former have been more profitable, earnings-efficient, and capitalized, and less leveraged than the latter. The city banks maintained greater ROAA, ROAE, and INCOME than the nationwide banks in 1995-2000. In addition, the city banks had greater EQUITY and INVDEBT than the nationwide banks in 1998-2000 (figure 4 and table 8). The relatively higher profitability of city banks may be explained by the fact that city banks are concentrated in urban areas where deposit growth is greater, in line with higher income growth (table 11). On the other hand, the nationwide banks have had lower COST than the city banks in recent years and greater PROV than the city banks during the period 1995-2000.

Based on MARGIN, DIVERSE, SBOND, and LIQUID, it appears that compared with nationwide banks, city banks invest more funds in government bonds and have diversified their scope of business rather than extending credit and depositing with PBC. A sharper decline in MARGIN may imply that their interest revenues are lower since more income comes from other sources while major sources of funding remain deposits.

With respect to the statistical test of performance relative to WSCBs, table 8 also shows that nationwide and city commercial banks have both been generally better performers than WSCBs. In particular, the differences in ROAA and ROAE were statistically significant during the period 1994-2000 with respect to the nationwide banks relative to the WSCBs and in 1997-2000 with respect to the city banks relative to the WSCBs. Nationwide banks also remained more cost-efficient than the WSCBs in 1994-2000 (except 1996), with the difference being statistically significant at 5 per cent. On the other hand, a sharper deterioration in city banks' cost-efficiency in recent years has resulted in there being no statistically significant differences between city banks and WSCBs in this regard. However, there were statistically significant

Figure 4. Performance of other commercial banks, 1994-2000



Source: Fitch IBCA, Bankscope.

Table 11. Savings deposits per capita, 1956-1999

(yuan renminbi)

Year	*Total*	*Urban*	*Rural*
1956-1960	8	32	2
1961-1965	8	33	2
1966-1970	10	44	2
1971-1975	14	62	4
1976-1980	25	101	8
1981-1985	95	227	47
1986-1990	387	569	216
1991-1995	1 466	4 007	462
1996	3 147	6 519	888
1997	3 744	10 040	1 054
1998	4 279	11 337	1 202
1999	4 736	12 447	1 289

Source: Almanac of China's Finance and Banking.

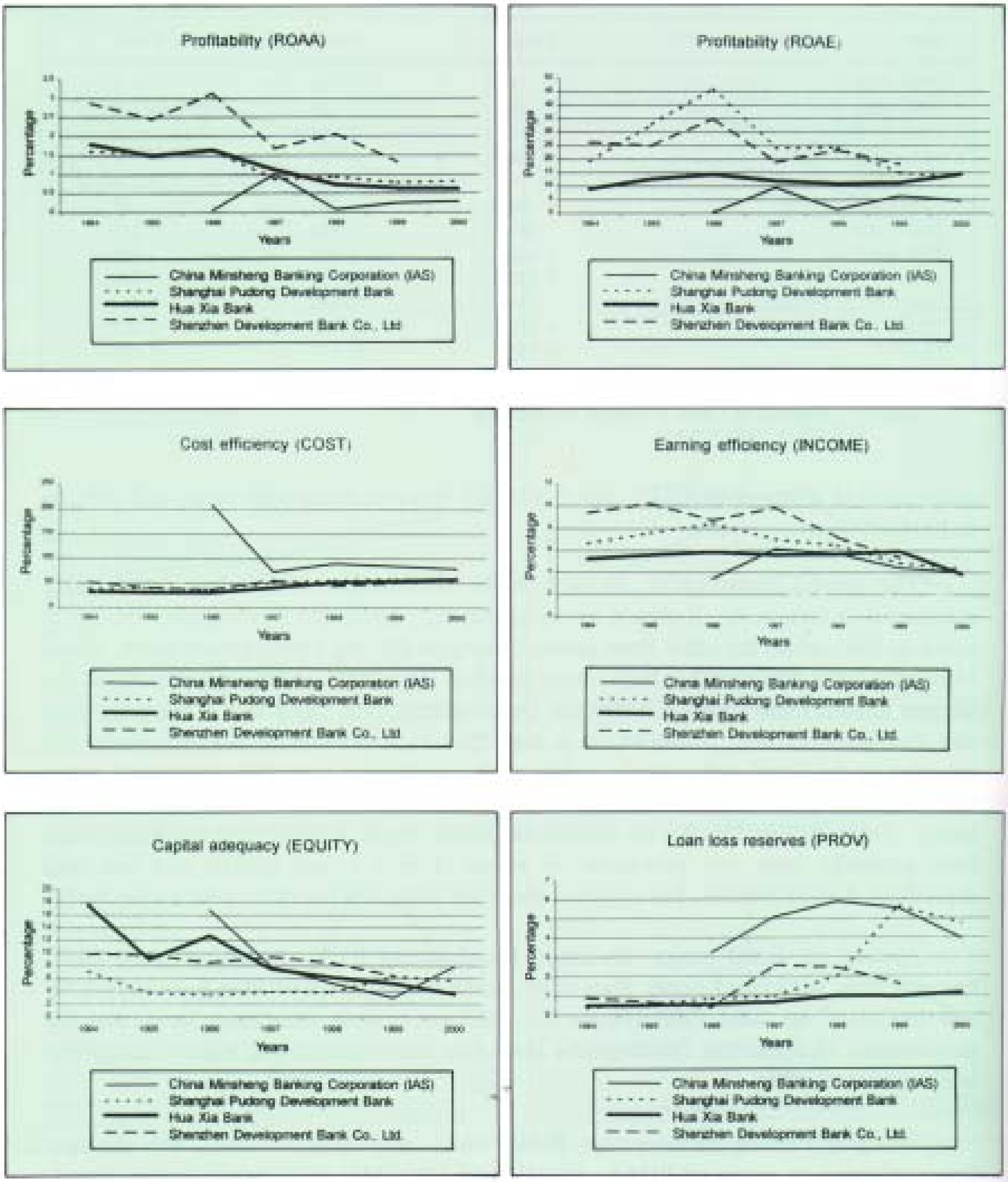
differences in terms of EQUITY and INVDEBT between nationwide banks and WSCBs in 1994-1997.

The second classification focuses on the performance of the four listed banks mentioned in section A. It should be noted that only Shenzhen Development Bank was listed in 1991 while the other three banks (Shanghai Pudong Development Bank, China Minsheng Bank and Hua Xia Bank) were listed in 1999-2000. Some may argue that the chapter should focus only on Shenzhen Development Bank since this is the only bank that was listed earlier. However, it is important to also examine whether banks that intended to be listed and actually achieved this goal have generally performed better than unlisted banks. Figure 4 indicates that listed banks have not necessarily performed better. Since all listed banks are nationwide banks, figure 4 shows that the listed banks have generally been less profitable (in terms of ROAA and ROAE) and less well capitalized than city banks, but achieved about the same level as other nationwide banks.

Among the listed banks, Shenzhen Development Bank, the oldest listed bank, has generally performed better than other banks with respect to ROAA in 1994-1999 and INCOME in 1994-1998 (figure 5). However, these indicators show that the performance of Shenzhen Development Bank has deteriorated more sharply than other banks in recent years.

Shanghai Pudong Development Bank, which was listed in 1999, was the next best performer in terms of ROAA, ROAE, and INCOME immediately before listing. China Minsheng Bank and Hua Xia Bank, both listed in 2000, have been the poorest performers. While China Minsheng Bank is said to generally lend to high-quality private companies, including joint ventures such as Ericsson AB, its performance has been unimpressive. Since other banks have performed better, this suggests that the

Figure 5. Performance of the listed commercial banks, 1994-2000



Source: Fitch IBCA, Bankscope.

government policy of approving listings is not necessary based on the performance of the bank.

C. MAIN ISSUES AND THE TESTING OF HYPOTHESES ON THE PERFORMANCE OF COMMERCIAL BANKS

This section assesses the performance of domestic commercial banks by finding out the main factors that have contributed to these results. The major issues that appear to be closely related to performance are discussed below.

1. Entry deregulation and various types of banks

Imposing entry barriers in the banking sector often give rise to an inefficient resource allocation across sectors and projects and, at the same time, collusive behaviour among creditor banks and between banks and borrowers. On the other hand, such a policy can be justified theoretically if it improves banking sector efficiency, provided that commercial banks perform a unique role that cannot be taken by non-bank financial institutions and capital markets. Commercial banks collect, analyse, and process inside information about borrowers by forming long-term relationships with them. This role is important, especially when disclosure, auditing, and accounting requirements are loosely or inadequately implemented against borrowers in the absence of sophisticated legal and institutional infrastructure. Since information about borrowers, especially SMEs sized, is largely idiosyncratic, banks do not have to attract depositors by providing them with such inside information on the creditworthiness of borrowers (Yoshitomi and Shirai 2001).

This suggests that bank loans are largely idiosyncratic and non-transferable, but cannot and/or need not be standardized, whereas standardization is necessary for corporate bonds and stocks. This may explain partly why the banking system is likely to dominate at the early stage of economic development. Further, Rajan and Zingales (1998) have pointed out that in countries where corporate governance is inadequate and bankruptcy laws virtually non-existent, the specific expertise of commercial banks – which know how to exercise power over borrowers even when explicit protections for the banks are inadequate – is necessary when extending loans to firms. They have also demonstrated the existence of a negative correlation between the degree of sophistication of accounting standards and the size of the banking sector. Such illustrations appear too simplistic, since bankruptcy laws, for example, are necessary to rotect commercial banks even in the banking system. Nonetheless, they highlight the essential points raised above.

When bank regulators determine entry criteria, therefore, they need to ensure that commercial banks have an incentive to perform their information-collecting and monitoring functions. To do so, bank regulators need a balance between allowing banks to maintain profitability (or earn economic rents that offset risks borne by banks in the process of providing various financial services) and preventing them from extracting excessive rents. Without sufficient rents, banks may have no choice but to engage in risky activities because they need to fight for their market shares or profit margins. As a result, such risk-taking behaviour would reduce the value of banks' future earnings and associated incentives to avoid bankruptcy (Allen and Gale 2000). To maintain sufficient profitability in the banking process, therefore, excessive competition among banks needs to be avoided through granting a relatively small number of them the privilege of offering demand deposits and payment services (Rajan 1997).[12]

While attempting to maintain adequate rents for banks, nevertheless, regulators need to introduce measures to prevent banks from engaging in excessive risk-taking behaviour and extracting rents from their borrowers that are more than is justified by the risks that they bear. This discourages borrowers from undertaking innovative, profitable ventures, thereby resulting in slower economic growth (Rajan 1992). Thus, regulators need to carefully consider the extent of competition in the banking sector by taking account of the trade-off and supplement this policy with others, such as capital adequacy requirements that contribute to limiting excessive risk-taking by banks.

Given this background, whether tight entry barriers can be justified or not should be assessed by examining the performance of existing commercial banks – or the WSCBs in the case of China. The analysis indicates that WSCBs have performed poorly throughout the observation period as well as relative to other commercial banks (both nationwide and city banks). In addition, the degree of concentration has remained largely unchanged, suggesting that entry barriers have not improved banks' performances. This implies that the current level of entry barriers is too tight to generate a noticeable impact on competition and thus incentives for WSCBs to manage themselves better. Such a difference in performance reflects more flexible wage-setting mechanisms and a lesser degree of central government intervention in the case of city banks as compared with nationwide banks. In line with this argument, it is important to examine whether this classification of banks is one of the important explanatory variables for the performance of banks in regression estimation. If it is found to be so, it indicates that a greater degree of entry deregulation would improve banking sector performance. Similarly, whether a bank is a nationwide (or city) bank and whether a bank is publicly listed (or unlisted) are important explanatory variables.

[12] The study by Petersen and Rajan (1994) supports this view. They have demonstrated in their model that credit market competition imposes constraints on the ability of borrowers and commercial banks to intertemporally share firms' surplus when uncertainty about firms' prospects is high. When the banking sector is competitive and banks cannot hold equity claims, they cannot expect to share the future surplus of their borrowers. In this case, banks are constrained to break even on a period-by-period basis since they would be driven away from the competitive market if they charged interest rates above the competitive level. Such high interest rates may distort firms' incentives and at the same time lower credit availability. Thus, competition makes lending relationships less valuable to borrowers because they cannot expect financial support from commercial banks when most needed. On the other hand, a monopolistic bank is able to share borrowers' future surplus through extracting future rents. This enables the bank to receive delayed interest payments from borrowers over time and encourages it to provide more credit than the amount available in a competitive credit market.

2. Reserve requirement and investment in government bonds

The reserve requirement obliges banks to hold a minimum percentage of their customers' deposits with PBC. As one of its monetary policy instruments, PBC uses the requirement to influence the banks' willingness and ability to extend or call in loans, and thus to influence the size of the money stock. Lowering the reserve requirement increases the availability of bank funds to issue more loans or allocate money for other business, thus tending to expand the money stock and increase the profitability and cost- and earnings-efficiency of the banking sector. On the other hand, raising the requirement may possibly restrict banks' ability to extend more loans to non-financial sectors and diversify their business, thereby lowering profitability and cost- and earnings-efficiency.

The government increased the reserve requirement from 13 per cent in 1988 to 20 per cent by adding an excess reserve requirement of 7 per cent in 1992, but then reduced it to 8 per cent in 1998. Table 8 indicates that other commercial banks, particularly nationwide banks, have maintained their ratio of deposits with PBC to total customers' deposits ($LIQUID_1$) at around 20 per cent even after the requirement was substantially lowered in 1998. This behaviour is contrasted with that of the WSCBs, who lowered the ratio in 1998-2000 in line with a decline in the requirement. Although PBC pays interest rates for required and excess reserves, such holdings are likely to reduce banks' opportunities to exploit economies of scale with respect to lending and related businesses as well as diversify their portfolios by engaging in non-traditional activities. This, in turn, will curb any improvement in their performance.

A similar argument may be applied when banks invest in government bonds. In some countries, the liquidity requirement imposes on banks an obligation to purchase a certain amount of government bonds. While there is no such regulation in China, section B has shown that other commercial banks, particularly city banks, invest in government bonds more intensively than other banks.

3. Scope of business

Financial conglomeration gives banks an opportunity to gain non-interest income, thereby sustaining profitability. This enables banks to maintain long-term relationships with clients throughout their life cycles and thus gives them an incentive to collect and produce inside information and monitor them. Such a practice lowers banks' incentives to take excessive risks. Banks can also benefit by diversifying the activities whose returns are imperfectly correlated, thereby reducing costs of funds to banks and maintaining their profitability. Since incomes from different financial services are not perfectly correlated, diversification can reduce the banks' costs of funds, which in turn cuts the costs banks charge their lending and underwriting customers. Close multidimensional relationships between banks and firms can reduce the costs of obtaining funds for firms, improve their performance, make investment decisions less dependent on retained earnings, and make it easier for firms to resolve financial distress (Yoshitomi and Shirai 2001).

Financial conglomeration also promotes efficiency by allowing banks to utilize inside information. Through long-term lending relationships, banks already possess "inside" information about the creditworthiness of borrowers and features of their investment projects that are not readily available to outsiders. Thus, banks do not need to spend a great deal of resources in collecting information about their clients that is necessary for underwriting securities issued by them. So banks may be able to underwrite securities at lower costs than non-bank underwriters. For example, firms issuing junior and more information-sensitive securities may receive higher prices when banks underwrite them than when independent investment firms do so because of perceived monitoring advantages of the banks that are a by-product of their lending activities.

Thanks to reputation, moreover, investors may be willing to purchase securities underwritten by bank underwriters rather than independent underwriters. To the extent that it is easier to gain a reputation in some businesses than in others and to the extent that there are spillovers in reputation, banks can use the reputation gained in offering one service to recommend their other services (Rajan 1996).

Banks also enjoy economies of scope from the production of financial services. They can spread the fixed costs in terms of physical and human capital needed for managing a client relationship over a wider set of products (Steinherr and Huveneers 1990). Economies of scope can be exploited by using their branch networks and all their other existing delivery channels to distribute additional products at low marginal cost (Llewellyn 1996). In addition, banks can better handle the shifts in demand for the products they offer by quickly transferring resources within organizations (Santos 1998).

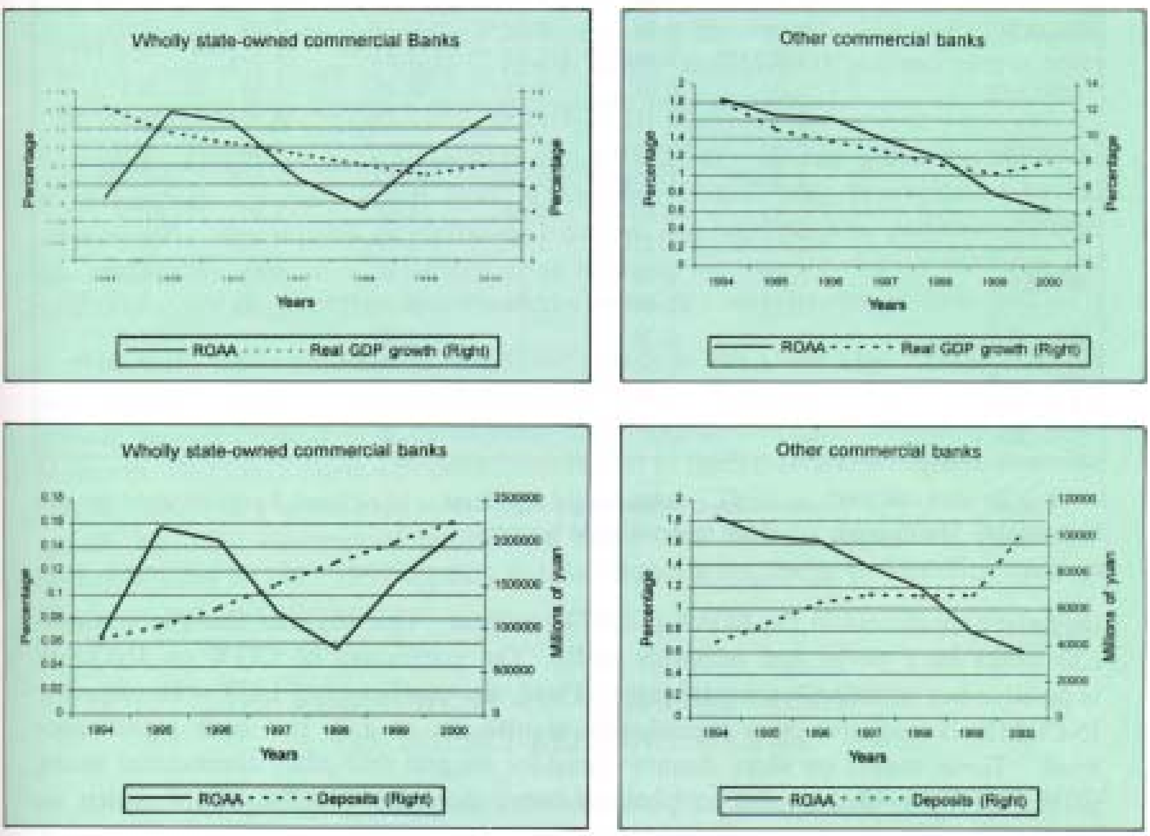
Given this background, this analysis tests whether an increase in diversification would improve profitability and earnings-efficiency. However, the impact of diversification on cost-efficiency is not clear. If diversification enables banks to exert economies of scope on a large scale, it is likely that cost-efficiency would be improved. However, limited opportunities to diversify bank business are likely to exert a minimum or even a negative impact on cost-efficiency.

4. Estimation results

Based on the hypotheses formulated above, this section investigates the performance of the Chinese banking sector. It assesses the overall impact of the financial reforms on commercial banks by using panel data for 1994-2000 compiled by Bankscope, which covers about 90 per cent of total deposit money banks in terms of deposits. The performance measures adopted are ROAA, INCOME and COST.

As discussed above, three kinds of dummy variables are used for the classification of banks: (a) OTHER (which is equal to zero if a bank under examination is one of the other commercial banks and zero otherwise); (b) CITY (which is equal to 1 if a bank under examination is one of the city banks and zero otherwise); and (c) LISTED (which is equal to zero if a bank under examination is one of the four listed banks and zero otherwise). Other variables include SBOND, DIVERSE, and LIQUID_1. Control variables that capture banks' specific features and behaviour are introduced, including the size of bank asset (proxied by the log of each bank's asset size [ASSET]). This analysis also uses real GDP growth. Figure 6 shows that a declining trend in ROAA for other commercial banks is closely associated with a decline in the rate of real GDP growth. Last, the paper examines whether the size of bank deposits (proxied by the log of each bank's deposit size [DEPOSIT]) is an important explanatory variable. According to figure 6, depositors showed an increased preference for WSCBs rather than other commercial banks in 1997-1998, in line with the view expressed earlier. Thus, it is important to examine whether a deposit-related indicator is an important explanatory variable.

Figure 6. Real GDP growth, deposit growth and profitability, 1994-2000



Source: Fitch IBCA, Bankscope.

The results from the estimation for the commercial banking sector are shown in table 12. First, the coefficient of OTHER with respect to ROAA (and COST) is positive (negative) and statistically significant at a 5 per cent significance level. This suggests that other commercial banks have performed relatively well. However, the coefficient of OTHER in the INCOME equation is negative, but statistically insignificant. Second, the coefficient of CITY has a statistically significant positive

Table 12. Regression results for the commercial banking sector

Explanatory variables	*Dependent variables*					
	ROAA		*INCOME*		*COST*	
Constant	0.92	−1.46	7.54	−18.5	132.3	415.4
	(0.78)	(−0.42)	(1.73)*	(−1.51)	(2.98)***	(3.36)***
OTHER	0.87	0.80	−1.09	−1.98	−59.7	−50.1
	(2.51)**	(2.17)**	(−0.85)	(−1.52)	(−4.60)***	(−3.81)***
CITY	0.42	0.36	0.79	0.24	−22.4	−16.3
	(1.77)*	(1.49)	(0.92)	(0.27)	(−2.55)**	(−1.87)*
LIST	−0.26	−0.31	−1.50	−2.09	5.86	12.2
	(−1.38)	(−1.55)	(−2.19)**	(−2.93)***	(0.84)	(1.7) *
SBOND	−0.04	−0.04	−0.13	−0.11	2.25	2.07
	(−3.05)***	(−2.88)***	(−2.63)**	(−2.33)**	(4.65)***	(4.41)***
DIVERSE	0.01	0.01	−0.42	−0.40	10.14	9.93
	(0.09)	(0.11)	(−1.24)	(−1.23)	(2.94)***	(3.01)***
$LIQUID_1$	−0.02	−0.02	−0.03	0.01	0.34	−0.06
	(−2.60)**	(−1.97)*	(−0.96)	(0.13)	(1.00)	(−0.17)
ASSET	−0.23	−0.60	−0.66	−4.65	−2.65	40.8
	(−2.42)**	(−1.17)	(−1.88)**	(−2.59)**	(−0.75)	(2.25)**
RGDPG	0.17	0.19	0.69	0.84	−5.35	−6.98
	(2.54)**	(2.64)**	(2.74)***	(3.33)***	(−2.10)**	(−2.76)***
DEPOSIT		0.36		3.88		−42.2
		(0.73)		(2.26)**		(−2.44)**
R^2	0.63	0.63	0.42	0.47	0.54	0.59
F-Statistic	11.7	10.35	5.02	5.37	8.14	8.55

Note: *, **, *** indicate the coefficients are significant at 10 per cent, 5 per cent and 1 per cent respectively. The t-statistic values are reported in the brackets.

(negative) coefficient in the ROAA (COST) equation. This suggests that city commercial banks have performed relatively well. The coefficient of CITY on INCOME is positive but statistically insignificant. Third, the coefficient of LIST with respect to INCOME is negative and statistically significant at a 5 per cent significance level. These results on three dummy variables suggest that other commercial banks, particularly city banks, tend to perform better than the WSCBs, all of which are unlisted and nationwide commercial banks.

Third, SBOND exerted a negative impact on ROAA and INCOME and a positive impact on COST at a significance level of 1 per cent. This indicates that investment in government bonds does lower profitability, earnings efficiency and cost-efficiency. Thus, a tendency to hold government bonds by the other commercial banks, particularly by city banks, does not improve their performance, most likely because of the limited use of economies of scale in lending and related business and economies of scope in non-traditional banking services.

Fourth, the coefficient of DIVERSE with respect to ROAA is positive but statistically insignificant. However, the coefficient of DIVERSE in the COST equation is positive with a 1 per cent significance level, suggesting that limited diversification allowed by the government so far has made it difficult for commercial banks to exploit economies of scope. This implies that while a careful examination should be conducted as to the pros and cons of banks undertaking securities and other business, broadening the scope of business may offer banks an opportunity to improve profitability and efficiency (Shirai 2001). This is particularly so for city banks, which do not have nationwide branch networks and thus face scale disadvantages.

Fifth, the impact of $LIQUID_1$ on ROAA was negative and statistically significant. This indicates that the holding of excess reserves particularly by nationwide banks does give them interest income, but lowers banks' incentives to gain profits from other sources. It may be worthwhile for PBC to consider removing interest rates on excess reserves, since this policy is likely to distort banks' incentives to conduct proper asset management and thus achieve a more appropriate asset portfolio.

Sixth, ASSET tends to lower ROAA and INCOME, indicating that the large size of banks does adversely affect bank performance. This may be explained by the existence of a large number of inefficient branches and sub-branches, particularly in the case of WSCBs. While WSCBs have been reducing the number of their branches and staff, this result suggests that there should be a further rationalization of these banks.

Seventh, the coefficients of real GDP growth in INCOME (and COST) equation were positive (negative) and statistically significant. A recent slowdown in real GDP growth has contributed to a decline in banks' performance, as shown by table 8. Moreover, DEPOSIT made a positive contribution to INCOME and a negative contribution to COST at a significance level of 5 per cent. Thus, a deceleration of deposit growth for other commercial banks as a result of a shift in depositors' preference toward WSCBs in 1997-1999 appears to have caused a decline in profitability, earnings efficiency and cost efficiency.

D. ASSESSMENT OF THE PERFORMANCE OF POLICY-LENDING BANKS

Three policy-lending banks were established in 1994 as institutions that would focus on long-term development finance and other policy-lending activities. Among the three banks, the Agricultural Development Bank of China is supposed to finance the procurement of agricultural products and development projects determined by central government; the Export-Import Bank of China finances export and import activities by supplying loans to exporters and importers; and the China Development Bank is supposed to finance key construction and infrastructure projects and thus covers a broader scope of projects and sectors. The China Development Bank, the largest policy-lending bank, extends loans amounting to about Y170 billion per year, more than 80 per cent of which are assigned to major infrastructure projects such as electricity, railways, roads and telecommunications.

The China Development Bank signed an agreement for agent business with Everbright Bank in October 2001, suggesting that the latter will increasingly handle government policy funds. It will also launch a new policy to provide financial support to promising SMEs with good credibility in collaboration with city commercial banks. The new challenges imposed by entry to WTO will accelerate China's structural reforms and urbanization process, which might raise unemployment in the short run. Therefore, the policy of the China Development Bank aims to promote an expansion of the SMEs and thus employment. The main capital sources of these policy-lending banks are borrowings from PBC and bonds issued domestically and abroad. However, on a limited scale, the Agricultural Development Bank of China accepts deposits.

While the creation of policy-lending banks and the separation between policy-lending and commercial-lending activities is intended to have a positive impact on the performance of WSCBs, this objective has not been achieved so far. Further, some argue that the problem of policy-lending to poorly performing SOEs has simply been transferred from the former specialized banks to these policy-lending banks without any measures to contain the problems. This section provides a brief overview of the performance of the three policy-lending banks.

Since their establishment, the overall performance (in terms of ROAA, ROAE, INCOME, EQUITY) of policy-lending banks has remained poor (figure 7). Their profitability based on ROAA and ROAE has remained as low as that of the WSCBs. Among the three banks, the Export-Import Bank of China has been the most profitable owing to trade expansion that has been taking place in China. With respect to cost efficiency, there was an improvement in 1995-1996 in the bank, but this was followed by a sharp deterioration. The Agricultural Development Bank of China has improved cost efficiency throughout 1996-2000, contributing to an improvement in ROAA. On earnings efficiency, all banks have shown a decline in INCOME, affecting ROAA adversely.

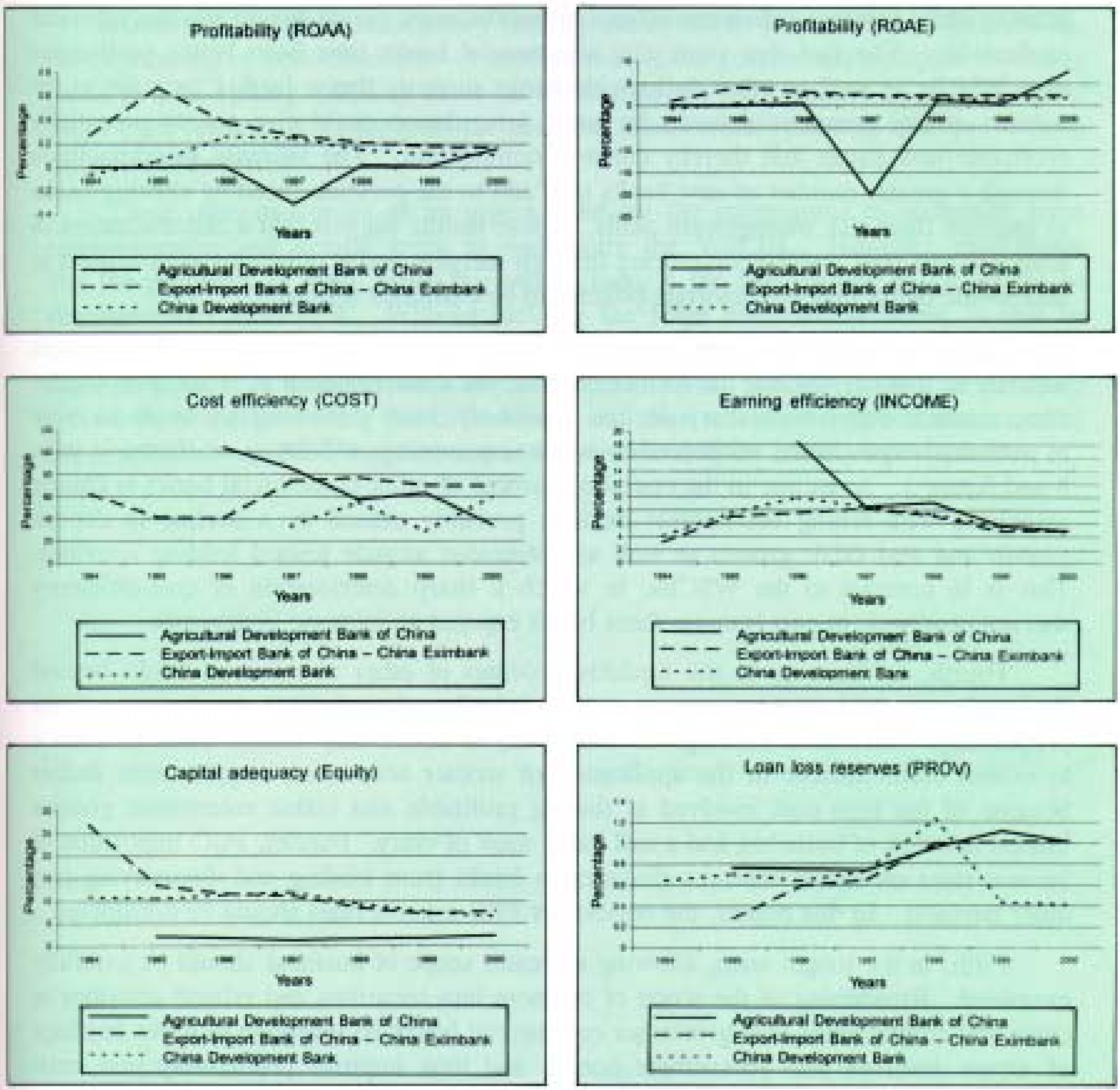
E. CONCLUSIONS

This chapter has attempted to assess the performance of the banking sector and thereby the progress of the financial reforms undertaken by the government in the 1990s. The main findings are summarized below.

First, the banking sector has remained dominated by the disproportionately large WSCBs during the period 1996-2000, accounting for about 80 per cent of total deposits. Competition took place mostly at the lower end among the other commercial banks. This suggests that the financial reforms have not yet generated a noticeable impact on demonopolization of the banking sector. The long-standing dominance of the WSCBs is worrisome since it not only discourages new entrants, but also undermines economic and financial stability.

Second, WSCBs and selected other commercial banks do exhibit strong systematic differences in profitability and cost-efficiency throughout the sample period. There

Figure 7. Performance of the policy-lending banks, 1994-2000



Source: Fitch IBCA, Bankscope.

were also systematic differences in terms of equity ratio and leverage in 1994-1997. In general, other commercial banks are more profitable, cost-efficient, capitalized, and less leveraged than WSCBs. This suggests that the balance sheets of some of other commercial banks are more structurally sound than those of WSCBs. This also reflects the fact that some of them have adopted tighter credit review standards. Thus, the further entry of new banks, provided that they are well capitalized and technologically advanced, is likely to improve the performance of the banking sector, particularly that of the WSCBs, by increasing competition.

Further, some city commercial banks have generally been more profitable than nationwide commercial banks. Although the former are less cost-efficient than the latter, greater earnings-efficiency offset cost-inefficiency, giving rise to relatively greater profitability. The fact that some city commercial banks have been better performers than WSCBs as well as other nationwide banks suggests that a further increase in the number of city commercial banks by entry deregulation could give rise to potentially profitable new banks and thereby enhance competition. The increase in competition through a greater number of new banks may add to the pressure faced by existing banks to improve their risk management skills. These results suggest that a rationalization of branches and staff and a restructuring through mergers and acquisitions with respect to nationwide banks may be important policies to be examined seriously.

Third, although the performance of some of the other commercial banks is superior to that of WSCBs, the former have shown a deterioration in recent years. The direct cause comes from a sharp decline in cost-efficiency driven mainly by an increase in personnel expenditure, reinforced by worsening earnings-efficiency, as shown in table 8 and figure 3. A decline in the operating income of other commercial banks is closely associated with falling net interest income, probably caused by a decline in deposit growth and real GDP growth as well as a cautious attitude toward lending activities. This is in contrast to the WSCBs, in which a sharp deterioration of cost-efficiency was not observed, in part because these banks enjoyed an increase in deposits.

Fourth, an increase in the liquidity holdings of other commercial banks beyond the legally required reserves appears to have contributed partially to the decline in their profitability. Increased holdings of excess liquid assets may reflect their reluctance to extend credit further in the application of stricter accounting requirements and/or because of the high cost involved in finding profitable and viable enterprises given a limited network of branches and a still early stage of entry. Further, PBC imposition of interest rates on excess reserves discourages banks from lending and diversifying into other business. In this regard, the removal of PBC interest rates should be considered.

Fifth, in the longer term, allowing a greater scope of business should be carefully examined. Broadening of the scope of business into securities and related activities in cities and coastal areas may give other commercial banks an incentive to lower holdings of excess reserves and government bonds, and thus improve profitability and cost-efficiency. However, the types of business should be selected with careful consideration of the advantages and disadvantages, as well as the proper prudential regulations needed to cope with new risks and problems that would arise from new activities (Shirai 2001). Since the prolonged presence of the excessively large WSCBs has resulted in an inefficient resource allocation and a concentration of power in the four banks, this puts newly established banks in a disadvantageous position in terms of penetration into the existing retail market. Thus, broadening the scope of business is important, particularly to new banks so that they can enter into niche markets and gain in profitability.

The recent deteriorating performance of the other commercial banks should be considered a warning signal since this may indicate a smaller positive spillover effect of their entry on the performance of the WSCBs. Given the dominance of the WSCBs, this also implies that other commercial banks may not be able to compete effectively in the domestic banking market.

Sixth, the performance of policy-lending banks was as poor as that of the WSCBs, except in terms of cost-efficiency. A continuation of the government policy of extending credit to loss-making SOEs is likely to deteriorate the performance of policy-lending banks even further. This suggests the need for fundamental measures to improve these banks' performance.

These outcomes point to an urgent need for the government to undertake more comprehensive and drastic steps to restructure the WSCBs. However, this means that the problems of their major borrowers, namely the loss-making SOEs should be simultaneously examined. Without tackling the large loss-making SOEs, it will be almost impossible to achieve a drastic resolution of NPL problems. Unfortunately, there is a lack of detailed data on banks' borrowers, making it difficult to grasp the mechanisms generating NPL problems and thus to derive more concrete policy implications as to a NPL disposal and an improvement of the banks' balance sheets.

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IV. ASSESSMENT OF INDIA'S BANKING SECTOR REFORMS FROM THE PERSPECTIVE OF THE GOVERNANCE OF THE BANKING SYSTEM

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Introduction

Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. This is because sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks (Beck, Levin and Loayza 1999; King and Levin 1993; Rajan and Zingales 1998; Demirgüç-Kunt, Asli and Maksimovic 1998; Jayaratne and Strahan 1996). Many countries adopted a series of financial sector liberalization measures in the late 1980s and early 1990s that included interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation. In many cases, the timing of financial sector liberalization coincided with that of capital account liberalization. Domestic banks were given access to cheap loans from abroad and allocated those resources to domestic production sectors.

Since the Asian financial crisis of 1997-1999, the importance of balancing financial liberalization with adequate regulation and supervision prior to full capital account liberalization has been increasingly recognized. The crisis was preceded by massive, unhedged, short-term capital inflows, which then aggravated double mismatches (a currency mismatch coupled with a maturity mismatch) and undermined the soundness of the domestic financial sector. A maturity mismatch is generally inherent in the banking sector since commercial banks accept short-term deposits and convert them into relatively longer-term, often illiquid, assets. Nevertheless, massive, predominantly short-term capital inflows – largely in the form of inter-bank loans – shortened banks' liabilities, thus expanding the maturity mismatch. Further, a currency mismatch was aggravated since massive capital inflows denominated in foreign currency were converted into domestic currency in order to finance the cyclical upturn of domestic

[1] This paper was presented at the ESCAP-ADB Joint Workshop on "Mobilizing Domestic Finance for Development: Reassessment of Bank Finance and Debt Markets in Asia and the Pacific", Bangkok, 22-23 November 2001. This paper benefited from many insightful and useful comments from the participants at this seminar. I am also grateful to Dr. Y.V. Reddy, Deputy Governor of the Reserve Bank of India; Dr. V.V. Desai of ICICI Ltd; Dr. Jayati Sarkar, Indira Gandhi Institute of Development Research; Bank, Ms. Usha Thorat of the Reserve Bank of India; and Mr. Saumitra Chaudhuri of the Investment Information and Credit Rating Agency of India for providing me useful comments and information. I also acknowledge the help of Mr. Prithipal Rajasekaran for his excellent research assistance.

investment in manufacturing equipment, real estate and stocks (Asian Policy Forum 2000 and Yoshitomi and Shirai 2000).

In other words, many share the view that the proper sequencing of financial sector and capital account liberalization is one of the most important policies in preventing another Asian-type "capital account" crisis. It is now widely accepted that capital account liberalization should follow current account and domestic financial sector liberalization (Mckinnon 1973). This sequence issue is even more important for countries such as China and India, which have not yet launched full capital account convertibility and where public-sector banks still remain dominant. In such countries, financial sector liberalization comes against more politically difficult issues than those that have already opened up their capital account to a substantial degree since they have to first restructure predominant public-sector banks.

This chapter focuses on India's banking sector, which has been attracting increasing attention since 1991 when a financial reform programme was launched. It assesses whether the reform programme has been successful so far in restructuring public-sector banks and if so, what elements of the programme have contributed. This chapter tackles the following fundamental questions. In what way has the reform programme affected the behaviour of public-sector banks? To what extent have foreign and new domestic banks contributed to the performance of the whole banking sector? Has India's gradual approach to the privatization of banks been successful? What policy implications can we derive from India's experience?

A. MAIN ISSUES AND HYPOTHESES

1. India's pre-reform period and financial reform

Since 1991, India has been engaged in banking sector reforms aimed at increasing the profitability and efficiency of the then 27 public-sector banks that controlled about 90 per cent of all deposits, assets and credit. The reforms were initiated in the middle of a "current account" crisis that occurred in early 1991. The crisis was caused by poor macroeconomic performance, characterized by a public deficit of 10 per cent of GDP, a current account deficit of 3 per cent of GDP, an inflation rate of 10 per cent, and growing domestic and foreign debt, and was triggered by a temporary oil price boom following the Iraqi invasion of Kuwait in 1990.

Prior to the reforms, India's financial sector had long been characterized as highly regulated and financially repressed. The prevalence of reserve requirements, interest rate controls, and allocation of financial resources to priority sectors increased the degree of financial repression and adversely affected the country's financial resource mobilization and allocation. After Independence in 1947, the government took the view that loans extended by colonial banks were biased toward working capital for trade and large firms (Joshi and Little 1996). Moreover, it was perceived that banks should be utilized to assist India's planned development strategy by mobilizing financial resources to strategically important sectors.

Reflecting these views, all large private banks were nationalized in two stages: the first in 1969 and the second in 1980. Subsequently, quantitative loan targets were imposed on these banks to expand their networks in rural areas and they were directed to extend credit to priority sectors. These nationalized banks were then increasingly used to finance fiscal deficits. Although non-nationalized private banks and foreign banks were allowed to coexist with public-sector banks at that time, their activities were highly restricted through entry regulations and strict branch licensing policies. Thus, their activities remained negligible.

In the period 1969-1991, the number of banks increased slightly, but savings were successfully mobilized in part because relatively low inflation kept negative real interest rates at a mild level and in part because the number of branches was encouraged to expand rapidly. Nevertheless, many banks remained unprofitable, inefficient, and unsound owing to their poor lending strategy and lack of internal risk management under government ownership. Joshi and Little (1996) have reported that the average return on assets in the second half of the 1980s was only about 0.15 per cent, while capital and reserves averaged about 1.5 per cent of assets. Given that global accounting standards were not applied, even these indicators are likely to have exaggerated the banks' true performance. Further, in 1992/93, non-performing assets (NPAs) of 27 public-sector banks amounted to 24 per cent of total credit, only 15 public-sector banks achieved a net profit, and half of the public-sector banks faced negative net worth.

The major factors that contributed to deteriorating bank performance included (a) too stringent regulatory requirements (i.e., a cash reserve requirement [CRR][2] and statutory liquidity requirement [SLR] that required banks to hold a certain amount of government and eligible securities); (b) low interest rates charged on government bonds (as compared with those on commercial advances); (c) directed and concessional lending; (d) administered interest rates; and (e) lack of competition. These factors not only reduced incentives to operate properly, but also undermined regulators' incentives to prevent banks from taking risks via incentive-compatible prudential regulations and protect depositors with a well-designed deposit insurance system. While government involvement in the financial sector can be justified at the initial stage of economic development, the prolonged presence of excessively large public-sector banks often results in inefficient resource allocation and concentration of power in a few banks. Further, once entry deregulation takes place, it will put newly established private banks as well as foreign banks in an extremely disadvantageous position.

[2] The CRR requires banks to hold a certain portion of deposits in the form of cash balances with the Reserve Bank of India. In the 1960s and 1970s, the CRR was 5 per cent, but then rose steadily to its legal upper limit of 15 per cent in early 1991. The statutory liquidity requirement requires banks to hold a certain amount of deposits in the form of government and other approved securities. It was 25 per cent in 1970 and then increased to 38.5 per cent in 1991 – nearly to the level of its legal upper limit of 40 per cent. With respect to direct lending, the priority sector target of 33 per cent of total advances was introduced in 1974, and the ratio was gradually raised to 40 per cent in 1985. There were sub-targets for agriculture, small farmers, and disadvantaged sections.

Against this background, the first wave of financial liberalization took place in the second half of the 1980s, mainly taking the form of interest rate deregulation. Prior to this period, almost all interest rates were administered and influenced by budgetary concerns and the degree of concessionality of directed loans. To preserve some profitability, interest rate margins were kept sufficiently large by keeping deposit rates low and non-concessional lending rates high. Based on the 1985 report of the Chakravarty Committee, coupon rates on government bonds were gradually increased to reflect demand and supply conditions.

Following the 1991 report of the Narasimham Committee, more comprehensive reforms took place that same year. The reforms consisted of (a) a shift of banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations and supervision; (b) a reduction of the CRR and SLR; (c) interest rate and entry deregulation; and (d) adoption of prudential norms.[3] Further, in 1992, the Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning, and also adopted the Basle Accord capital adequacy standards. The government also established the Board of Financial Supervision in the Reserve Bank of India and recapitalized public-sector banks in order to give banks sufficient financial strength and to enable them to gain access to capital markets. In 1993, the Reserve Bank of India permitted private entry into the banking sector, provided that new banks were well capitalized and technologically advanced, and at the same time prohibited cross-holding practices with industrial groups. The Reserve Bank of India also imposed some restrictions on new banks with respect to opening branches, with a view to maintaining the franchise value of existing banks.

As a result of the reforms, the number of banks increased rapidly. In 1991, there were 27 public-sector banks and 26 domestic private banks with 60,000 branches, 24 foreign banks with 140 branches, and 20 foreign banks with a representative office.[4] Between January 1993 and March 1998, 24 new private banks (nine domestic and 15 foreign) entered the market; the total number of scheduled commercial banks, excluding specialized banks such as the Regional Rural Banks rose from 75 in 1991/92 to 99 in 1997/98. Entry deregulation was accompanied by progressive deregulation of interest rates on deposits and advances. From October 1994, interest rates were deregulated in a phased manner and by October 1997, banks were allowed to set interest rates on all term deposits of maturity of more than 30 days and on all advances exceeding Rs 200,000. While the CRR and SLR, interest rate policy, and prudential norms have always been applied uniformly to all commercial banks, the Reserve Bank of India treated foreign banks differently with respect to the regulation that requires a portion of credit to be allocated to priority sectors. In 1993, foreign banks – which

[3] In 1998, the Narashimham Committee II has recommended a convergence of developing financing institutions to with commercial banks or non-bank financial institutions and an adoption of the integrated system of regulation and supervision etc.

[4] Representative offices may not be allowed to hold deposits or extend credit. Their main business is to develop business contacts between local firms and their head offices, and collect local information to for their head offices.

used to be exempt from this requirement while all other commercial banks were required to earmark 40 per cent of credit – were required to allocate 32 per cent of credit to priority sectors.

2. Drastic versus gradual privatization approaches

While India's financial reforms have been comprehensive and in line with global trends, one unique feature is that, unlike with other former planned economies such as Hungary and Poland, the Indian Government did not engage in a drastic privatization of public-sector banks. Rather, it chose a gradual approach toward restructuring these banks by enhancing competition through entry deregulation of foreign and domestic banks. This reflects the view of the Narasimham Committee that ensuring the integrity and autonomy of public-sector banks is the more relevant issue and that they could improve profitability and efficiency without changing their ownership if competition were enhanced.

Since this approach was introduced, some criticisms have been expressed (Joshi and Little 1996). First, public-sector banks continue to be dominant thanks to their better branch coverage, customer base, and knowledge of the market compared with newcomers. Second, public-sector banks would find it more difficult to reduce personnel expenditure because of the strong trade unions. Third, the government would find it difficult to accept genuine competition within public-sector banks. In response to these concerns, the government decided to gradually expand private-sector equity holdings in public-sector banks, but still avoided the transformation of their ownership. The 1994 amendment of the Banking Act allowed banks to raise private equity up to 49 per cent of paid-up capital. Consequently, public-sector banks, which used to be fully owned by the government prior to the reform, were now allowed to increase non-government ownership. So far, only eight public-sector banks out of 27 have diversified ownership.

Meanwhile, a consensus is emerging that state ownership of banks is bad for financial sector development and growth (World Bank 2001). Based on data from the 10 largest commercial and development banks in 92 countries for 1970-1995, La Porta and others (2000) have found that greater state ownership of banks in 1970 was associated with less financial sector development, lower growth, lower productivity, and that these effects were greater at lower levels of income. Barth and others (2001a, 2001b) have shown that greater state ownership of banks tends to be associated with higher interest rate spreads, less private credit, less activity on the stock exchange, and less non-bank credit, even after taking into account other factors that could influence financial development. This suggests that greater state ownership tends to be anti-competitive, reducing competition from both banks and non-banks. Barth and others have also noted that applications for bank licences are more often rejected and there are fewer foreign banks when state ownership is greater. Moreover, Caprio and Martinez-Peria (2000) have shown that greater state ownership at the start of 1980 was associated with a greater probability of a banking crisis and higher fiscal costs.

With respect to privatizing banks, moreover, the World Bank (2001) takes the view that privatization can yield real benefits to economies provided that an appropriate accounting, legal and regulatory infrastructure is in place. It should be noted that premature privatization may give rise to banking crises. Clarke and Cull (1998) have demonstrated that Argentina promoted the privatization of public-sector banks in a reasonably developed regulatory and infrastructure environment, and thus privatized banks improved productivity remarkably.

Considering the implications derived from the above studies, this chapter examines whether India's gradual approach has been successful so far by examining whether public-sector (commercial) banks have improved their performance (profitability, efficiency and soundness) in the reform period.

Two hypotheses have been adopted in this regard. The first hypothesis is that the degree of concentration in the banking sector has been declining in the reform period. The second hypothesis is that the performance of public-sector banks may have deteriorated initially during the adjustment period, but performance improved later on. Three types of performance indicators have been used: (a) profitability, (b) cost efficiency, and (c) earnings efficiency.[5] It tests this hypothesis by analysing trend patterns and empirically testing the performance of public-sector banks.

3. Diversification of banking activities

The second unique feature of India's banking sector is that the Reserve Bank of India has permitted commercial banks to engage in diverse activities such as securities-related transactions (for example, underwriting, dealing and brokerage), foreign exchange transactions and leasing activities. The 1991 reforms lowered the CRR and SLR, enabling banks to diversify their activities. Diversification of banks' activities can be justified for at least five reasons. First, entry deregulation and the resulting intensified competition may leave banks with no choice but to engage in risk-taking activities in the fight for their market share or profit margins. As a result, risk-taking would reduce the value of banks' future earnings and associated incentives to avoid bankruptcy (Allen and Gale 2000).

Second, banks need to obtain implicit rents in order to provide discretionary, repetitive and flexible loans.[6] In addition, banks attempt to reduce the extent of

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[5] Profitability is likely to be positively correlated with efficiency and soundness. The correlation is expected to be greater for public-sector banks that had long been performing poorly since the reform impact could be greater. For example, the average correlation coefficient between profitability and cost efficiency in 1993-2000 was -0.7 for public-sector banks, -0.48 for private domestic banks, and for -0.3 for foreign banks. The average correlation coefficient between profitability and soundness was 0.76 for public-sector banks, 0.59 for private banks, and 0.37 for private banks.

[6] For example, banks' clients are able to obtain refinance or to return loans earlier than maturity with relatively small fees. Furthermore, if borrowers fall into financial distress, banks often make flexible choices as to whether continuing to continue to supply loans or buying back bank loansones that turn problematic (Gilson, John, and Lang 1990; Hoshi, Kashyap, and Scharfstein 1990). Further, banks may renegotiate with firms over lowering interest rates in order to prevent risk-taking behaviour, as pointed out by Stigliz and Weiss (1981). Since most of these transactions cannot be written explicitly in loan contracts, these promises are regarded as implicit "insurance" that commercial banks provide to their borrowers.

information asymmetry by processing inside information on their clients and monitoring their performance. Such roles are unique to the banking system and important particularly for SMEs since information on them tends to be highly idiosyncratic. Without sufficient rents, however, banks are likely to cease providing these services and the implication for SMEs and economic development can be enormous. Thus, it is important for bank regulators to ensure adequate implicit rents to banks in order to encourage them to provide such unique services. Moreover, banks may lose an opportunity to collect implicit rents if their clients switch to capital markets once they become larger and profitable.[7]

Diversification of banking activities helps banks to mitigate the two problems raised above by providing them with an opportunity to gain non-interest income and thereby sustain profitability. This enables banks to maintain long-term relationships with clients throughout their life cycles and gives them an incentive to process inside information and monitor their clients.

Third, banks can stabilize their income by engaging in activities whose returns are imperfectly correlated, thereby reducing the costs of funds and thus lending and underwriting costs.

Fourth, diversification promotes efficiency by allowing banks to utilize inside information arising out of long-term lending relationships.[8] Thanks to this advantage, banks are able to underwrite securities at lower costs than non-bank underwriters. Firms may also obtain higher prices on their securities underwritten by banks because of their perceived monitoring advantages. Further, banks can exploit economies of scope from the production of various financial services since they can spread fixed physical (i.e., branches and distribution channels) and human capital costs (Steinherr and Huveneers 1990).

Fifth, diversification may improve bank performance by diluting the impact of direct lending (through requiring banks to allocate credit to priority sectors). Direct lending reduces the banks' incentives to conduct information processing and monitoring functions. As a result, this not only lowers banks' profitability by limiting financial resources available to more productive usages, but also results in a deterioration of efficiency and soundness by discouraging banks from functioning properly.

These five advantages, however, can be offset by the following disadvantages. First, public-sector banks' engagement in the securities business may promote a concentration of power in the banking sector since the asset size of banks expands. This is partly because banks have a natural tendency to promote lending over securities,

[7] Patil (2001) reports that Indian firms increasingly raise funds through commercial paper and debentures, since their the costs are much lower than for bank loans.

[8] Through long-term relationships, banks already possess inside information about the creditworthiness of borrowers and features of their investment projects that are not readily available to outsiders. Thus, banks do not need to spend use a lot of resources in collecting information about their clients that is necessary for underwriting securities issued by them.

thereby indirectly deterring the development of capital markets. Further, the reputation and informational advantages enjoyed by public-sector banks put them in an even more favourable position, preventing other banks and investment firms from competing on a level playing field.

Second, the engagement of banks in underwriting services may lead to conflicts of interest between banks and investors. Banks may decide to underwrite securities for troubled borrowers so that the proceeds of the issue of securities can be used to pay off these banks' own claims to the companies. Banks may dump into the trust accounts they manage the unsold part of the securities they underwrite. Further, banks may impose tie-in deals on customers by using their lending relationships with firms to pressure them to purchase their underwriting services (for example, using the threat of increased credit costs or non-renewal of credit lines). Banks may also use the confidential inside information that they possess when they underwrite firms' securities in a way that the firms do not contemplate, such as disclosing the information directly or indirectly to the firms' competitors.[9]

Third, diversification may expose banks to various new risks. For example, banks may end up buying the securities they underwrite. They may also face greater market risks as they increase their share of securities holdings and market-making activities. Further, derivatives involve higher speed and greater complexity, which may reduce the solvency and transparency of banking operations.

The presence of these three potential disadvantages suggests that measures are needed to balance the advantages and disadvantages. The Reserve Bank of India tries to cope with the disadvantages by encouraging banks to engage in securities business through subsidiaries, thereby putting in place firewalls between traditional banking and securities services.[10] The Reserve Bank of India also prohibits cross-holdings with industrial groups to minimize "connected lending" – one of the causes of the East Asian crisis.

To assess the overall impact of banks' activities, this chapter examines whether diversification improves bank performance. In particular, the impact of disadvantages can be assessed indirectly by examining how soundness is associated with diversification. It is also important to examine whether diversification has led to even greater dominance of public-sector banks by examining whether banks' asset portfolios differ between public-sector and private banks.

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[9] These various conflicts of interest are likely to lower the quality of services offered by banks, and thus, investors need special protection against such malpractices. Conflicts of interest can be exploited especially when (a) there is some monopoly power, as with tie-in deals; (b) there is the an asymmetry of information between the contracting parties, as in the conflict between the bank's promotional and advisory roles; or (c) one of the parties involved is naive as when securities are issued to transfer bankruptcy risks to outside investors (Santos 1998).

[10] In a restricted way, banks are permitted to engage in investment banking, leasing, credit cards etc., within the entity.

The following hypotheses have been examined with respect to diversification. The third hypothesis is that banks' engagement in foreign exchange and securities business improves their performance. The fourth hypothesis is that investment in government securities has worsened banks' performance since it limits the realization of the diversification effect. The fifth hypothesis is that lending to priority sectors and the public-sector has lowered banks' performance.

4. Impact of foreign and private domestic banks

One interesting feature of India's banking sector is that some large public-sector banks appear to have been performing reasonably well in the post-reform period. This could be attributed to (a) the import of better risk management skills from foreign and private domestic banks, (b) intensified competition, (c) the diversification effect described above, (d) reorganization (for example, mergers and acquisitions), and (e) goodwill. In India, however, given the virtual absence of an exit policy, large-scale mergers and acquisitions among problematic banks have not occurred so far.

It is generally thought that the entry of well-capitalized new banks is likely to improve the quality and variety of services, efficiency of bank management, and prudential supervisory capacity (Levine 1996; Walter and Gray 1983; Gelb and Sagari 1990). The entry of foreign banks tends to lower interest margins, profitability, and the overall expenses of domestic banks (Clarke, Cull, D'Amato, and Molinari 2000; Claessens, Demirgüç-Kunt and Huizinga 2000). Further, Claessens, Demirgüç-Kunt and Huizinga have reported that the number of entrants matters compared with their market share, indicating that foreign banks affect local bank competition upon entry rather than after they have gained a substantial market share. Moreover, these banks may be able to provide a source of new capital for enterprises and thus reduce government restructuring costs, especially when the domestic banking sector is devastated in the aftermath of a crisis. Some studies also find that foreign banks tend to go for higher interest margins and profitability than domestic banks in developing countries, while the opposite is true in developed countries (Claessens, Demirgüç-Kunt and Huizinga 2000).

On the other hand, premature deregulation and foreign entry may cause some downside effects. First, they may increase the risk of a banking crisis if there is macroeconomic or regulatory weakness, as was experienced in Argentina, Brazil and Chile in the 1970s (Demirgüç-Kunt, Asli and Detragiache 1998). Second, foreign banks may exhibit a home country bias, leading them to retreat promptly and massively at the first sign of difficulty. In the East Asian crisis, for example, it is widely believed that foreign banks, such as Citibank, played a major role in supporting the capital outflow without consideration as to the national damage caused.

This chapter assesses whether their performance shows statistically different results from that of public-sector banks through three steps: (a) analysing trend patterns, (b) testing the hypotheses that the average level of each indicator is the same between public-sector and foreign and private domestic banks, and (c) using ordinary least squares regression. The sixth hypothesis is that foreign and private domestic banks have performed better than public-sector banks, and thus have contributed to an improvement in overall banking sector performance. The seventh hypothesis is that new banks perform better.

B. APPRAISAL OF THE PERFORMANCE OF THE BANKING SECTOR

India's financial market has been gradually developing, but still remains bank-dominated in the reform period. The extent of financial deepening measured by total deposits in GDP has risen only modestly from 30 per cent in 1991 to 38 per cent in 1999. Capital market development has also been quite sluggish. Outstanding government and corporate bonds as a share of GDP rose from 14 per cent in 1991 to 18 per cent in 1999 and from only 0.7 per cent in 1996 to 2 per cent in 1998, respectively, while equity market capitalization dropped from 37 per cent in 1995 to 28 per cent in 1999.

Nevertheless, the government's commitment on restructuring the highly regulated banking sector appears strong. Since financial reforms were launched in 1991 and particularly when the entry of new banks was permitted in 1993, public-sector banks appear to have become more conscious of the need for greater profitability and efficiency, suggesting that the reform has had a favourable impact on India's financial market.

According to an analysis of the overall performance of state-owned, domestic and foreign banks based on trend patterns in 1993-2000, the overall performance of public-sector banks appears comparable with foreign and private domestic banks (table 1). In general, foreign banks performed better than domestic banks (public-sector and private domestic banks) in terms of cost, earnings efficiency and soundness. However, domestic banks overtook foreign banks in terms of profitability in 1999-2000. Moreover, all banks are comparable in terms of the scale of medium- to long-term credit and liquidity. The results are summarized below.

1. Profitability

Foreign banks' profitability (defined as the ratio of profits after tax to average assets [ROAA]) exceeded that of private domestic and public-sector banks in 1993-1997, despite a declining trend.[11] However, private domestic banks have become more profitable than foreign banks in 1999-2000. IMF (2001) has also reported that foreign and new private domestic banks maintained higher profitability (about 1-2 per cent) than public-sector and old private domestic banks (0.6-0.8 per cent) during the period 1995/96-1999/2000. Profits from securities and foreign transactions, and brokerage/commission services have also increasingly contributed to profitability for all banks, suggesting that the diversification effect is positive.

[11] For example, the average profitability of Standard Chartered Bank in 1994-2000 was 1.38 per cent, well above that of the State Bank of India at 0.7 per cent.

Table 1. Performance indicators of the banking sector, 1993-2000

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
ROAA								
All banks	–0.1	0.1	1.1	0.8	1.1	1.0	0.5	0.4
Foreign	2.0	2.0	2.0	1.6	1.6	1.1	0.4	–0.2
Private	–0.2	0.5	1.2	1.2	1.3	1.1	0.7	1.0
Public sector	–1.3	–2.3	0.1	–0.4	0.4	0.8	0.4	0.6
COST								
All banks	81.5	78.4	82.6	162.7	84.8	76.8	83.8	78.3
Foreign	67.7	60.9	80.7	81.7	87.2	68.6	81.2	72.4
Private	86.4	83.9	80.3	80.1	80.5	80.1	85.0	80.0
Public sector	93.8	92.2	87.3	88.1	86.7	84.9	86.6	85.3
INCOME$_1$								
All banks	12.4	11.5	10.4	11.6	12.0	12.1	11.4	11.2
Foreign	14.5	12.9	12.1	13.2	13.3	13.8	12.3	12.5
Private	11.2	10.1	8.7	11.0	11.4	11.4	11.0	10.4
Public sector	10.9	11.1	10.7	10.6	10.9	10.7	10.4	10.2
INCOME$_2$								
All banks	7.6	7.3	5.0	5.5	6.3	5.8	5.3	4.0
Foreign	12.9	9.1	7.1	5.1	6.3	6.8	6.9	4.3
Private	5.2	7.6	3.9	5.1	6.5	5.6	4.2	3.7
Public sector	3.5	5.1	4.1	6.4	6.3	4.7	4.2	3.6
DIVERSE								
All banks	1.3	1.2	1.2	1.2	1.4	2.1	1.4	1.6
Foreign	1.8	1.6	1.4	1.5	1.9	3.2	2.0	2.1
Private	1.0	0.9	1.0	1.1	1.1	1.5	1.0	1.3
Public sector	1.1	1.1	1.1	1.1	1.1	1.1	1.0	1.1
GBOND								
All banks	20.4	23.8	20.7	19.1	21.3	22.0	23.3	24.3
Foreign	19.5	24.4	20.5	16.3	18.0	19.4	21.6	22.4
Private	21.0	20.5	17.5	17.5	20.6	21.2	22.0	23.5
Public sector	21.1	25.8	24.6	24.6	26.9	26.6	27.4	28.0
PROV								
All banks	2.4	2.3	1.5	1.1	0.8	1.2	1.5	1.7
Foreign	3.8	3.0	2.3	0.9	0.8	1.9	2.7	3.0
Private	1.1	1.0	1.2	1.0	0.7	0.8	0.5	0.7
Public sector	1.8	2.6	1.2	1.6	0.9	0.8	0.8	0.7
EQUITY								
All banks	4.1	4.6	8.7	13.6	14.4	13.3	13.6	11.4
Foreign	6.8	7.9	17.4	25.0	28.4	25.2	25.4	20.3
Private	1.7	2.2	3.6	3.3	4.0	4.8	4.4	4.2
Public sector	3.2	3.4	5.3	10.6	6.5	6.0	5.8	5.7

Source: PROWESS Database, Centre for Monitoring Indian Economy Pvt. Ltd.

Note: All indicators are estimated from PROWESS database with the available data.

2. Cost and earnings efficiency

Foreign and private domestic banks are generally more cost-efficient than public-sector banks.[12] The ratio of operating expenditure to operating income (COST) in 2000 was 72 per cent for foreign banks, 80-85 per cent for domestic banks, and 84 per cent for public-sector banks. While foreign banks are more cost-efficient, their efficiency level has somewhat deteriorated. Instead, domestic and public-sector banks improved efficiency over the sample period.

As for earning capacity, foreign banks are generally better performers. The earning indicator proxied by the ratio of income to assets ($INCOME_1$) shows that foreign banks have consistently performed better than private domestic and public-sector banks. However, foreign banks' income-generating capacity deteriorated somewhat from 14.5 per cent in 1993 to 12.5 per cent in 2000, while the two other types of banks maintained their performance at a level of about 11 per cent. The inferior performance of domestic banks relative to foreign banks can be attributed to (a) the larger share of credit extended to the public-sector, (b) more stringent requirements imposed on direct lending, (c) a lesser degree of diversification, and (d) lower interest rate margins.

Implicit interest rate spread (defined as the difference between implicit lending and deposit rates [$INCOME_2$]) has been shrinking for all banks over the sample period. While foreign banks have received higher interest rate spreads than private domestic banks and public-sector banks, their margins have become comparable in 2000. An alternative indicator (the difference between interest income and expenditure) shows that while all types of banks reduced interest rate margins over the sample period, those of public-sector and private domestic banks have generally remained negative and recently even worsened. This suggests that domestic banks must obtain income from other activities to maintain profitability and thus extend credit to the private sector.

3. Capital, asset quality, management and liquidity

The balance sheets of foreign banks appear to be more structurally sound than those of domestic and public-sector banks based on the following criteria: capital adequacy, asset quality, management and liquidity.

First, on the capital adequacy ratio proxied by equity plus reserves over total liabilities or total assets (EQUITY), the ratio of foreign banks increased from 7 per cent in 1993 to 20 per cent in 2000. While the ratios increased moderately for domestic banks, it still remains small. This suggests that foreign banks have greater incentives to lend prudently and remain well capitalized than the two other kinds of banks. This reflects the fact that foreign banks steadily reduced their deposit dependence ratio from 67 per cent of liability in 1993 to 47 per cent in 2000, while the two other types maintained their dependence ratio at about 85 per cent throughout the sample period.

[12] For example, the average cost efficiency of Standard Chartered Bank in 1994-2000 was 80 per cent, comparable to that of the State Bank of India at 81.6. However, income divided by assets of the former was 12.6 per cent, above exceeding that of the latter at 10.6 per cent.

Nevertheless, the IMF report (2001) indicates that the risk-weighted capital ratio has been comparable among all banks and has improved from 1996/97 to 1999/2000: from 10.4 per cent to 11.9 per cent for foreign banks, from 11.7 per cent to 12.4 per cent for old private domestic banks, and from 10 per cent to 10.7 per cent for public-sector banks, while that of new private domestic banks declined from 15.3 per cent to 13.4 per cent.

Second, by contrast, the assessment on asset quality based on (a) the ratio of contingent liabilities to assets, (b) asset growth, (c) the ratio of investment in securities to assets, (d) the ratio of provisions for NPA to assets (PROV), and (e) the ratio of medium- and long-term credit to assets reveal mixed results. The first indicator reports that the ratio of foreign banks (at around 25-30 per cent) has been greater than that of domestic banks and public-sector banks. While this indicates that foreign banks are more exposed to high potential losses in cases of default, this outcome may simply show that foreign banks provide more complex and sophisticated services than the two other types of banks, given that their activities are concentrated on urban areas, wholesale markets and large clients.

The second indicator reports that foreign and private domestic banks faced rapid credit growth in 1993-1997, signalling some kind of risk-taking behaviour. However, this may be explained simply by their early stage of establishment. The third indicator shows that all three banks invested about 30-40 per cent of assets in securities in response to the SLR, indicating that all of them have a large cushion against NPAs. In particular, public-sector and private domestic banks increased their share of investment in government bonds in assets in 1993-2000 from 21 per cent to 23 per cent and from 21 per cent to 27 per cent, respectively. This may be due to their preference for more liquid, safe assets as the Basle Accord was applied.

The fourth indicator reports that foreign banks generally allocated greater provisions for NPAs. Given that more stringent accounting and auditing standards of their mother countries are applied to foreign banks, the foreign banks are more resilient to adverse shocks. IMF (2001) has reported that foreign and new private domestic banks maintained small NPA ratios (about 2-4 per cent) during the period 1995-2000 – below the level of public-sector and old domestic banks, with the former declining from 9.2 per cent in 1996/95 to 7.4 per cent in 1999/2000 and the latter remaining at around 7 per cent. The final indicator reports that foreign and private domestic banks increased medium- to long-term credit in 1993-2000 from 7.5 per cent to 17 per cent and from 10 per cent to 13 per cent, respectively, suggesting their increased confidence in India's financial market. Public-sector banks maintained the same level of exposure throughout the sample period.

Third, management performance is assessed based on two indicators: (a) the ratio of credit to deposits; and (b) the ratio of equity and reserves to debt (inverse of leverage). The first indicator reports that foreign banks attempt to improve their income by expanding their lending operations as compared with other domestic banks. The ratio of foreign banks surged from 56 per cent in 1993 to 94 per cent in 2000, while the two other types of banks maintained the ratio at about 40 per cent over the same period. Given that foreign banks' ratio of credit to assets is similar to other domestic banks (about 35 per cent of assets), however, this simply suggests that foreign banks lowered the deposit dependence ratio. Based on the second indicator, foreign banks are generally less leveraged than domestic and public-sector banks.

Fourth, all three types of banks maintain a similar liquidity position, accounting for about 15 per cent in terms of cash and balances with banks; and about 50 per cent in terms of the sum of cash, balances with banks, and investment. This reflects the CRR and SLR.

4. Testing the differential behaviour between public-sector, foreign and private domestic banks

As a second step, a statistical test was conducted to see whether the average levels of the following indicators are the same for public-sector, foreign, and private domestic banks: ROAA, COST, $INCOME_1$, $INCOME_2$, PROV, and EQUITY. The results show that foreign banks have generally performed better than public-sector banks in terms of all indicators (table 2). A similar pattern is observed for private domestic banks against public-sector banks. However, such differences were more pronounced in the earlier period compared with later periods. This may suggest that public-sector banks have made greater efforts to improve their performance as reforms have progressed.

C. TESTING HYPOTHESES

This section assesses the extent of concentration in the banking sector and conducts empirical estimation to test seven hypotheses.

1. Concentration index: testing the first hypothesis

This chapter tests this hypothesis by adopting two approaches: (a) the m-bank concentration ratio adopted by Sarkar and Bhaumik (1998) and (b) the Herfindahl Index adopted by Juan-Ramon and others (2001). The m-bank concentration measures (a) one-bank concentration ratio (market share of the largest bank or the State Bank of India, (b) five-bank ratio, and (c) 10-bank ratio. Deposits are used to estimate the m-bank concentration indicator. The Herfindahl Index is defined as 100 x $\Sigma_{i=1}^{i=N} k_i^2$ where $k_i = K_i / \Sigma_{i=1}^{i=N} K_i$ and N=number of banks during the period under consideration. This indicator can be calculated for the whole banking sector as well as for public-sector, foreign, and private domestic banks, respectively. The higher the indicator, the greater the concentration of the banking sector. The lower limit of this indicator is obtained as 100 divided by N and the upper limit is 100.

The m-bank concentration indicator reveals that the degree of concentration in the banking sector has barely changed during the period 1993-1999 (table 3). Since most of these large banks are public-sector banks, this indicates that public-sector banks continue to be dominant and enjoy scale advantages over new banks. On the other hand, the Herfindahl Index shows that the degree of concentration has declined consistently in the whole banking sector, more or less in line with the first hypothesis. In addition, the

Table 2. Testing the differential behaviour between public-sector and foreign and private banks

	Foreign banks vs. public-sector banks	*Private banks vs. public-sector banks*		*Foreign banks vs. public-sector banks*	*Private banks vs. public-sector banks*
1993			**1997**		
ROA	4.213***	0.951	ROA	3.875***	3.537***
COST	–6.435***	–1.865*	COST	0.037	–2.745***
INCOME$_1$	3.704***	0.301	INCOME$_1$	1.414*	0.245
INCOME$_2$	5.128***	1.274	INCOME$_2$	–0.066	0.455
PROV	2.487**	–1.945**	PROV	–0.288	–1.812*
EQUITY	9.688***	1.469*	EQUITY	–0.008	0.263
1994			**1998**		
ROA	4.390***	2.637***	ROA	0.295	1.270
COST	–9.475***	–2.169*	COST	–5.456***	–2.266**
INCOME$_1$	1.565*	–0.821	INCOME$_1$	4.854***	1.089
INCOME$_2$	3.957*	0.976	INCOME$_2$	2.116*	2.861***
PROV	0.674	–3.785***	PROV	1.559	–0.184
EQUITY	4.435***	2.599***	EQUITY	0.541	1.436*
1995			**1999**		
ROA	6.684***	2.852***	ROA	0.057	1.355
COST	–0.530	–2.008**	COST	–0.835	–0.853
INCOME$_1$	1.255	–1.694**	INCOME$_1$	3.087***	0.967
INCOME$_2$	4.392***	–0.395	INCOME$_2$	2.615**	0.047
PROV	3.899***	0.037	PROV	1.608*	–2.008**
EQUITY	0.639	–0.231	EQUITY	0.687	0.025
1996			**2000**		
ROA	3.704***	2.870***	ROA	–1.299	2.361**
COST	0.971	–2.950***	COST	–4.127***	–2.797***
INCOME$_1$	1.297	0.188	INCOME$_1$	3.020***	0.351
INCOME$_2$	–1.161	–1.637*	INCOME$_2$	0.630	0.557
PROV	–2.024**	–2.026**	PROV	3.159***	0.065
EQUITY	–0.225	–0.461	EQUITY	0.273	0.234

Source: PROWESS Database, Centre for Monitoring Indian Economy Pvt. Ltd.

Note: The values reported are t-test values and *, **, *** indicate significance at 10 per cent, 5 per cent and 1 per cent significance level respectively.

concentration has declined even within foreign banks, private domestic banks, and public-sector banks. Since the lower limit (100/N) has also declined, this suggests that a number of new banks have entered the market and exerted some competition at the lower end.

2. Empirical estimation

There are two studies that assess the impact of India's reform programme. Based on data from 1993/94 and 1994/95, Sarkar, Sarkar and Bhaumik (1998) have shown that

Table 3. Concentration indicators, 1993-2000

Table 3

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
M-Bank Concentration Ratio								
1 bank concentration ratio	24.7	24.3	22.0	22.2	21.9	21.7	23.7	24.2
5 banks concentration ratio	50.2	48.5	47.3	47.4	46.9	46.7	47.7	48.1
10 banks concentration ratio	65.4	63.3	63.6	65.5	64.4	63.4	64.2	65.0
Herfindahl Index								
All banks	11.2	9.9	7.9	7.2	6.6	6.5	7.1	7.0
Foreign banks	14.1	12.6	11.5	11.9	10.8	10.9	11.7	12.2
Private banks	11.3	10.8	7.8	5.8	4.8	4.6	4.8	5.2
Public-sector banks	15.1	13.4	10.7	9.8	9.4	9.4	10.1	10.1

Source: PROWESS Database, Centre for Monitoring Indian Economy Pvt. Ltd.

Note: All indicators are estimated from PROWESS database with the available data.

foreign banks are more profitable than public-sector banks, based on two indicators (profits divided by average assets and operating profits divided by average assets). The profitability of private domestic banks is similar to that of foreign banks, but private domestic banks spend more resources on provisions for NPAs. Second, foreign banks are more efficient than private domestic and public-sector banks, based on two measures (net interest rate margins and operating cost divided by average assets).

Based on data from the period 1980-1997/98, Sarkar and Bhaumik (1998) have concluded that foreign banks, despite the superior quality of services they offer, have not been a competitive threat in Delhi, West Bengal and Maharashtra, where their presence is greatest. This shows that competition has emerged only at the fringe, since the entry of new banks has been at the lower end. Domestic private banks have gained some market share in these regions, but the impact on public-sector banks was small and gained at the expense of foreign banks. In Uttar Pradesh, Madhya Pradesh, Bihar, Orissa, Gujarat and Punjab, public-sector banks have been predominant before and since the reforms, thus no apparent impact from new entries was observed. In Tamilnadu, Kerala, Andhra Pradesh, Karnataka, Jammu and Kashmir and Rajasthan, private domestic banks have been more concentrated than in other regions and have experienced an increase in market share at the expense of public-sector banks. But the presence of foreign banks was small.

The progress of India's financial reforms has been investigated via two steps. In the first step, the overall impact of the financial reforms on public-sector banks has been assessed by using pooled data. The performance measures adopted are ROAA, COST and $INCOME_1$. Some of these indicators were employed from Claessens, and others [2000]; Demirgüç-Kunt and Huizinga [1997]; Sarkar Sarkar and Bhaumik [1998]; and Sarkar and Bhaumik [1998].

The time dummy (TIME) has been introduced to capture time differences in the sample. Five control variables account for banks' specific features and behaviour: (a) diversification (proxied by the sum of profits from securities and foreign exchange transactions and brokerage and commissions/assets [DIVERSE]), (b) investment in government securities/assets (GBOND), (c) lending to priority sectors (proxied by lending to priority sectors/assets [PRIORITY]), (d) lending to the public sector (proxied by lending to the public sector/assets [PUBLIC]), and (e) size of the bank (proxied by the log of each bank's asset size [SIZE]). This analysis uses data from the Prowess database for 1993-2000 compiled by the Centre for Monitoring Indian Economy Pvt. Ltd., which includes most of the major banks in India.

The results from this estimation are reported in table 4. A significant coefficient of the time dummy variable would indicate that the particular year was different,

Table 4. Regression results of public-sector banks

Explanatory variables	*Dependent variables*		
	ROAA	*COST*	*INCOME$_t$*
Constant	-4.67 (-1.47)	119.91*** (10.15)	9.15** (2.43)
Time93	-1.87*** (-2.75)	9.65*** (4.16)	0.62 (0.84)
Time94	-2.67*** (-4.87)	5.55*** (2.68)	0.82 (1.24)
Time95	-0.38 (-0.72)	1.83 (0.91)	0.33 (0.51)
Time96	-0.85 (-1.63)	2.69 (1.37)	0.19 (0.31)
Time97	0.13 (0.27)	-0.05 (-0.02)	0.7 (1.16)
Time98	0.24 (0.51)	-0.14 (-0.07)	0.36 (0.61)
Time99	-0.04 (-0.09)	0.23 (0.13)	0.38 (0.66)
DIVERSE	1.24*** (3.12)	-10.92*** (-7.33)	2.27*** (4.77)
GBOND	-0.08*** (-3.18)	0.66*** (6.59)	0.004 (0.12)
PRIORITY	0.07** (2.48)	-0.49*** (-4.34)	-0.008 (-0.24)
PUBLIC	0.03 (1.08)	-0.15 (-1.45)	-0.03 (-0.91)
SIZE	0.32 (1.55)	-2.18*** (-2.84)	-0.09 (-0.38)
R^2	0.36	0.53	0.14

Note: *** indicates significant at 1 per cent significance level.
** indicates significant at 5 per cent significance level.
* indicates significant at 10 per cent significance level.

which could be due to numerous factors, including regulatory changes, if any, that happened during that year. First, the time effect on ROAA (and COST) given in columns 1 and 2 was negative (positive) and statistically significant initially. Since many of the regulatory changes took place during the earlier period of reforms, the significance of the time effect could reflect the initial negative impact of the reform, which has disappeared in the later period. Based on these outcomes, the financial reforms appear to have had a non-negligible impact on the overall performance of public-sector banks. While the reforms lowered their profitability and cost efficiency at the initial stage, this negative effect disappeared later on as they adjusted to a new environment, supporting the second hypothesis.

Second, DIVERSE has exerted a statistically positive (negative) contribution to ROAA and $INCOME_1$ (COST), indicating that the diversification effect on the performance of public-sector banks is favourable and thus the third hypothesis is supported. The statistically significant and negative (positive) impact of GBOND on ROAA (COST) is present. This suggests that investment in government bonds limits banks in the diversification of their asset portfolios and thus the fourth hypothesis is supported. On the other hand, PRIORITY has made a statistically significant and positive (negative) impact on ROAA (COST), contrary to the fifth hypothesis. This implies that while lending to priority sectors is generally regarded as the cause of NPAs, some lending activities have generated high income and have allowed banks to improve cost efficiency.

As a next step, the analysis examines the overall impact of the whole banking sector by using pooled data of all commercial banks for 1993-2000. In addition to the approach adopted above, ownership dummy variables ([FOREIGN] and [PRIVATE]) have been used to capture differences in ownership. FOREIGN (PRIVATE) equals 1 if the bank is foreign (domestic)-owned and equals 0 otherwise. Moreover, the age dummy (AGE) has been used to capture the differences between new and old banks. AGE is equal to 0 if the bank existed before 1991 and equals 1 otherwise.

The estimation results reported in table 5 are summarized as follows. First, if the entry of foreign and private domestic banks brings in more skilled banks, the profitability and efficiency of the banking sector is expected to be higher. The results reported in columns 1-3 indicate that the coefficients of FOREIGN and PRIVATE in the ROAA equation were statistically significant and positive, although their coefficients were not significant in the COST equation. Further, coefficients of FOREIGN are positive and statistically significant in the $INCOME_1$ equation. These results suggest particularly that foreign banks perform better than domestic banks, and that ownership matters, thus supporting the sixth hypothesis.

Second, the coefficient of TIME is negative (but statistically insignificant) initially in the ROAA equation of the whole banking sector, but is positive and statistically significant in 1995 and 1997. The TIME coefficient was also positive and statistically significant in the $INCOME_1$ equation.

Third, DIVERSE has improved profitability and the cost and earnings efficiency of the whole banking sector, in line with the third hypothesis. The coefficient of DIVERSE

Table 5. Regression results of the whole banking sector

Explanatory variables	*Dependent variables*		
	ROAA	*COST*	*INCOME₁*
Constant	0.49	273.52**	6.49***
	(0.46)	(2.28)	(3.49)
FOREIGN	0.79**	–60.36	2.65***
	[illegible]	(–1.36)	(3.87)
DOMESTIC	0.96***	–60.48	0.58
	(3.02)	(–1.63)	(1.01)
Time93	–0.62	3.22	1.69**
	(–1.24)	(0.07)	(2.29)
Time94	–0.14	–17.46	0.64
	(–0.36)	(–0.39)	(0.92)
Time95	0.72**	4.18	0.14
	(2.01)	(0.098)	(0.22)
Time96	0.25	100.99**	1.27**
	(0.74)	(2.47)	(2.01)
Time97	0.67**	13.87	1.44**
	(2.07)	(0.36)	(2.39)
Time98	0.30	15.70	0.82
	(0.97)	(0.41)	(1.37)
Time99	0.12	8.32	0.62
	(0.37)	(0.22)	(1.05)
DIVERSE	0.36***	–17.38**	0.79***
	(4.98)	(–2.09)	(6.20)
GBOND	–0.08***	7.71***	0.08***
	(–5.46)	(4.89)	(3.29)
PRIORITY	–0.003	–1.61*	–0.003
	(–0.31)	(–1.83)	(–0.21)
PUBLIC	0.014	0.199	–0.04*
	(0.99)	(0.12)	(–1.74)
AGE	–0.23	16.91	–0.77*
	(–0.93)	(0.59)	(–1.73)
SIZE	0.08	–34.83***	0.11
	(0.92)	(–3.56)	(0.71)
R^2	0.15	0.07	0.17

Note: *** indicates significant at 1 per cent significance level.
** indicates significant at 5 per cent significance level.
* indicates significant at 10 per cent significance level.

shows that the diversification impact on ROAA and $INCOME_1$ (and COST) was positive (negative) and statistically significant.

Fourth, GBOND helps banks to increase holdings of safe, liquid assets, and thus improve their liquidity position. At the same time, however, it reduces the opportunity to allocate limited financial resources toward more needed sectors and hence profitability and cost and earnings efficiency. The results indicate that the coefficients of GBOND on ROAA (and COST) were negative (positive) and statistically significant, supporting the fourth hypothesis. Contrary to our expectations, however, the impact of GBOND on $INCOME_1$ was positive and statistically significant.

Fifth, lending to priority sectors and the public sector would be expected to lower the profitability and earnings efficiency of the whole banking sector, reflecting that this type of lending is characterized by direct lending. Despite the share of credit extended to priority sectors accounting for more than 20 per cent of their total credit, the coefficients of PRIORITY and PUBLIC with respect to ROAA turn out to be insignificant, contrary to the fifth hypothesis. Moreover, the coefficient of PRIORITY on COST was negative and statistically significant, implying that some types of those credits have enhanced cost efficiency. However, the coefficient of PUBLIC on $INCOME_1$ was negative and statistically significant, suggesting that such lending lowers banks' income earnings capacity.

Sixth, the coefficient of AGE with respect to ROAA and $INCOME_1$ was negative but statistically insignificant.

D. CONCLUSIONS

Since the financial reforms of 1991, there have been significant favourable changes in India's highly regulated banking sector. This chapter has assessed the impact of the reforms by examining seven hypotheses. It concludes that the financial reforms have had a moderately positive impact on reducing the concentration of the banking sector (at the lower end) and improving performance.

The empirical estimation showed that regulation (captured by the time variable) lowered the profitability and cost efficiency of public-sector banks at the initial stage of the reforms, but such a negative impact disappeared once they adjusted to the new environment. In line with these results, tables 1 and 2 show that profitability turned positive in 1997-2000, cost efficiency steadily improved over the reform period, and the gap in performance compared with foreign banks has diminished.

Moreover, allowing banks to engage in non-traditional activities has contributed to improved profitability and cost and earnings efficiency of the whole banking sector, including public-sector banks. By contrast, investment in government securities has lowered the profitability and cost efficiency of the whole banking sector, including public-sector banks. Lending to priority sectors and the public-sector has not had a negative effect on profitability and cost efficiency, contrary to our expectations.

Further, foreign banks (and private domestic banks in some cases) have generally performed better than other banks in terms of profitability and income efficiency. This suggests that ownership matters and foreign entry has a positive impact on banking sector restructuring.

The above results suggest that the current policy of restructuring the banking sector through encouraging the entry of new banks has so far produced some positive results. However, the fact that competition has occurred only at the lower end suggests that bank regulators should conduct a more thorough restructuring of public-sector banks. Given that public-sector banks have scale advantages, the current approach of improving their performance without rationalizing them may not produce further benefits for India's banking sector. As 10 years have passed since the reforms were initiated and public-sector banks have been exposed to the new regulatory environment, it may be time for the government to take a further step by promoting mergers and acquisitions and closing unviable banks. A further reduction of SLR and more encouragement for non-traditional activities (under the bank subsidiary form) may also make the banking sector more resilient to various adverse shocks.

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V. DEVELOPING SUSTAINABLE MICROFINANCE SYSTEMS

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Introduction

While many factors contribute to poverty, its most obvious manifestation is insufficient household income. Both the extent of income-generating opportunities and ability to respond to such opportunities are determined to a great degree by access to affordable financial services. Increasing the access of poor households to microfinance[1] is therefore being actively pursued worldwide. Once almost exclusively the domain of donors and experimental projects, microfinance has evolved during the last decade with prospects for viability, offering a broader range of services and significant opportunities for expansion.

Development practitioners, policy makers, and multilateral and bilateral lenders, recognize that providing efficient microfinance services is important for a variety of reasons. Improved access to microfinance services can enable the poor to smoothout their consumption, manage their risks better, build their assets, develop their micro-enterprises, enhance their income-earning capacity, and enjoy an improved quality of life. Microfinance services have a significant positive impact on the depth (severity) of poverty and on specific socio-economic variables such as children's schooling, household nutrition status, and women's empowerment.

Despite this, about 95 per cent of some 180 million poor households in the Asian and Pacific region still have little access to affordable institutional microfinance services. Significant resources are required to meet the potential demand. This chapter argues that on the supply side there is a need to build microfinance systems that can grow and provide microfinance services on a permanent basis to an increasing number of the poor through domestic resource mobilization. On the demand side, there is a need to invest in social intermediation[2] to enable the poor to optimally utilize microfinance services. The chapter analyses the status of microfinance in Asia and the Pacific, discusses means to develop microfinance systems capable of financing

[1] Microfinance is the provision of a range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their microenterprises. Microfinance institutions (rural banks, cooperatives, NGOs etc.) are defined as institutions whose major business is the provision of microfinance services.

[2] Improving the condition for the excluded to access finance, for example, through grass-roots training in group formation and vocational and financial skills.

their growth for sustainable expansion, and provides an overview of the microfinance activities supported by the Asian Development Bank (ADB).

A. MICROFINANCE IN THE ASIAN AND PACIFIC REGION

Over 900 million people in about 180 million households in the region are poor, earning less than one dollar a day. More than 670 million poor people live in rural areas. Reliance on secondary occupations in rural areas is increasing as agriculture can no longer meet the income needs of the growing rural population. These occupations include paid employment, micro-enterprises, and services such as carpenters and weavers. The urban poor are engaged in self-employed businesses such as food stalls, tailoring and shoe repair. Women, who are a significant proportion of the poor and suffer disproportionately from poverty, operate many of these micro-enterprises. Corresponding to the higher rural poverty incidence, most of the microfinance institutions have a rural bias. However, the supply of microfinance to the urban poor has also markedly increased in recent years. In comparison with rural areas, microfinance service delivery in urban areas involves lower costs owing to higher population density as well as better infrastructure and economic opportunities.

1. Demand for microfinance services

The poor and low-income households as well as the micro-enterprises they undertake differ greatly in Asia and the Pacific. The collective demand of these groups for financial services is large and the types of services they demand vary across households and micro-enterprises. This large demand and the heterogeneity of services needed across households and micro-enterprises and over time have created scope for commercial financial intermediation.

Savings. Poor and low-income households and their micro-enterprises have a large demand for safe and convenient deposit services. The poor households have the capacity and willingness to save for emergencies, investment, consumption, social obligations, education of their children and other purposes. Savings are important for micro-enterprises and provide them with a major source of investment funds. Extensive use of informal savings arrangements by poor households is another indicator of their demand for savings facilities. The demand for deposit services is particularly strong among poor women in the Asian and Pacific region.

Microcredit. Demand for microcredit that originates both from households and micro-enterprises is also large. Poor households require microcredit to finance livelihood activities, for consumption smoothening, and to finance non-food expenses for purposes such as education, housing improvements and migration. Many countries in the region have numerous small farms and their operators also require microfinance services. The other source of demand is non-farm micro-enterprises, which cover a wide array of activities such as food preparation and processing, weaving, pottery, furniture making and petty trading.

Others. The poor are the most vulnerable to economic and physical downturns. As a result, they forego potentially viable income-generating opportunities because of risk aversion. Therefore, the demand for insurance services among the poor is vast. For instance, micro-insurance products offered by microfinance institutions in Nepal have been subscribed to by most of the clients. This shows that the supply of such services creates its own demand because the real demand remains hidden in the absence of suitable products.

2. Supply of microfinance services

The microfinance market structure varies significantly across countries depending on their stage of financial development, level of economic development and policy environment. Most commercial banks do not serve the poor because of perceived high risks, high costs involved in small transactions, perceived low relative profitability, and inability of the poor to provide physical collateral. Thus, a segment of the poor households that has viable investment opportunities persists in poverty for lack of access to credit at reasonable cost. Most of the poor households also find it difficult to accumulate financial savings without easy access to safe institutions that provide deposit services.

Informal. The supply of microfinance services is dominated by informal sources. Their collective outreach, both breadth and depth, is vast in most countries. They supply mainly short-term credit and charge higher interest rates than semi-formal and formal sources. Because of the relatively greater bargaining power enjoyed by the informal suppliers in general, the terms and conditions under which services are provided do not enable the clients to fully harness economic opportunities. The informal sources operate in highly localized areas. Therefore, their contribution to financial intermediation and improvement of resource allocation is also limited.

Semi-formal. Semi-formal sources mainly comprise the NGOs. In virtually all countries NGOs have become important microfinance providers. Their involvement is important because their clients in general are poorer than those reached by many formal institutions, their services are targeted in most countries to serve poor women and services are provided largely on the basis of social collateral. The small average loan sizes of NGOs, which usually range from about $30 to $150 per loan account, suggest that their clients include the poorest. NGOs in some countries are trying to organize themselves into coalitions to improve microfinance standards and self-regulation. Some NGOs plan to graduate into formal financial institutions, illustrating the potential value of the NGO modality for expanding the services to a large number of poor households.

Formal. Formal refers to an organized, registered and regulated system of institutions providing microfinance services. The involvement of formal sources in microfinance has increased during the last two decades. This greater involvement has stemmed from (a) the expansion of the scope of formal institutions into microfinance through downscaling (for example, Government Savings Bank, Thailand); (b) establishment of linkage programmes with semi-formal sources of different types (Self-help Group-Bank Linkage Programme, India); (c) the emergence of formal institutions focused on microfinance (for example, Grameen Bank of Bangladesh and Khushhalibank in Pakistan); (d) reforms of state-owned financial institutions (for example, unit desas of Bank Rakyat Indonesia); (e) the introduction of microfinance programmes by the governments through non-financial institutions (for example, Viet Nam Womens' Union); and (f) entry of private sector institutions (for example, Badan kredit-desas owned by Indonesian villagers). Cooperatives are also playing a significant role as financial intermediaries in the region, particularly in India, Sri Lanka, Thailand and Viet Nam. However, the formal operations concentrate mostly on providing credit facilities, and savings mobilization has yet to receive adequate attention, with few exceptions.

3. Major achievements in microfinance

The microfinance institutions and other microfinance providers have expanded their outreach from a few thousand clients in the 1970s to over 10 million in the late 1990s. The developments in microfinance in Asia and the Pacific have set in motion a process of change from an activity that was entirely subsidy dependent to one that can be a viable business.

(a) The myth that poor households cannot and do not save has been shattered. Savings can be successfully mobilized from poor households.

(b) Poor, especially poor women, have emerged as creditworthy clients, enabling microfinance service delivery at low transaction costs without relying on physical collateral.

(c) Microfinance services have strengthened the social and human capital of the poor, particularly women, at the household, enterprise and community level.

(d) Sustainable delivery of microfinance services on a large scale in some countries has generated positive developments in microfinance policies, practices and institutions.

(e) Microfinance services have triggered a process toward the broadening and deepening of rural financial markets.

4. Major challenges

The achievement in microfinance in the region has been impressive relative to the status in the 1970s. However, a number of major problems remain.

(a) Policy environment

Despite general improvement in the policy environment for financial sector programmes, the policy environment for microfinance in many countries remains unfavourable for sustainable growth in microfinance operations. For example, in countries such as Viet Nam and China, ceilings on interest rates limit the ability of microfinance institutions to expand and diversify. Governments continue to intervene in microfinance to address the perceived market failure through channelling microcredit to target groups that are considered to have been underserved by the existing institutions. Furthermore, government programmes with subsidized interest rates and poor loan collection rates undermine sustainable development of microfinance. As a result, most countries are crowded with poorly performing government microfinance programmes that distort the market, discourage private sector institutions from entering the industry, and affects the integration of microfinance into the financial sector.

(b) Inadequate financial infrastructure

Inadequate financial infrastructure (legal, information, and supervision and regulation) is another major problem. Most governments have focused on creating institutions or special programmes to disburse funds to the poor with little attention to building the financial infrastructure that supports, strengthens and ensures their sustainability. Lack of a legal framework conducive for the emergence and sustainable growth of small-scale microfinance institutions and corresponding supervisory and regulatory systems have impeded the expansion of market-based microfinance services by limiting their access to commercial sources of funding.

(c) Limited retail level institutional capacity

Most retail level institutions do not have adequate capacity to expand the scope and outreach of sustainable microfinance services. Many institutions lack the capacity to leverage funds, including public deposits, in commercial markets and are unable to provide a range of products and services compatible with client characteristics. In the absence of an adequate network and delivery mechanisms, many microfinance institutions are unable to cost-effectively reach the poorest of the poor, particularly those concentrated in resource-poor areas and areas with low population densities.

(d) Inadequate emphasis on financial viability

Inadequate emphasis on financial viability is the most serious problem of microfinance institutions in the region. This prevails among many NGOs, government-directed microcredit programmes, state-owned banks, and cooperatives providing microfinance services. As a result, only a few microfinance institutions are sustainable; most are not moving toward sustainability nor reducing subsidy dependence. Viability is important from an equity perspective because only viable institutions can leverage funds in the market to serve a significant number of clients.

(e) Inadequate investment in agriculture and rural development

Agricultural growth, which underpins much of the growth in the rural non-farm subsector, significantly influences rural financial market development. Inadequate investment in the sector is a major constraint on the development of sustainable microfinance services. The insufficient investments in physical infrastructure (especially irrigation; roads; electricity; and support services for marketing, business development and extension) continue to increase the risk and cost of microfinance and particularly discourage private investments in the provision of microfinance services on a significant scale. In addition, in the absence of economic opportunities created by growth-inducing processes, microfinance cannot be expected to play a significant role in poverty reduction.

(f) Inadequate investment in social intermediation

The low level of social development, a distinctive characteristic of the poor in Asia and the Pacific is another major constraint. This is particularly true with respect to the poorest, women in poor households, the poor in resource-poor and remote areas, and ethnic minorities. The development of sustainable microfinance to reach a large segment of the potential market requires supporting social intermediation on a large scale. Private sector investments in social intermediation are unlikely in view of the externalities associated with such investments.

5. Lessons learned

Microfinance is a critical element of the overarching poverty reduction objective of ADB. During the period 1988-2000, ADB approved 21 microfinance projects and 24 projects with microfinance components totalling $741 million (table 1). Over the same period, 60 technical assistance projects totalling $31 million were also approved for social mobilization, training of clients, and institutional strengthening (table 2). Increasing attention is being given by ADB to sector analysis and policy dialogue for establishing self-financing microfinance systems, as resources required to serve the potential market are far beyond what funding agencies and governments can provide.

In general, the early microfinance projects did not make a significant poverty reduction impact because of their limited outreach. There was no mechanism to sustain the positive impact on a small number of clients beyond the project period. Poor infrastructure, sluggish agricultural growth, and limited markets imposed serious limitations on the potential for broad-based growth in rural areas and access to credit could contribute little to permanent improvements in income for clients of microfinance projects under such conditions. Thus, to maximize their development impact, it is essential to integrate microfinance services with other critical measures aimed at reducing poverty.

Other lessons learned include:

(a) Microfinance is an effective way to assist and empower poor women, who make up a significant proportion of the poor and suffer disproportionately from poverty;

(b) Microfinance clients are more concerned about access to services that are compatible with their requirements than about the cost of the services;

(c) Social mobilization is necessary to introduce the poor to a market-oriented institutional environment. This is particularly true for poor women and the poorest of the poor. It is important, however, to distinguish between financial intermediation and social intermediation in designing support programmes;

Table 1. Asian development bank-financed microfinance projects, 1988-2000

Project no.	*Year of approval*	*Country*	*Project title*	*Loan amount (Millions of US dollars)*
I. Microfinance projects				
1L940-PHI (SF)	1988	Philippines	NGO Microcredit	8.00
2L1037-NEP (SF)	1990	Nepal	Third Small Farmers Development	30.00
4L1066-BAN(SF)	1990	Bangladesh	Rural Training	16.30
5L1067-BAN (SF)	1990	Bangladesh	Rural Women Employment	8.00
7L1137-PHI (SF)	1991	Philippines	Second NGO Microcredit	30.00
9L1213-BAN (SF)	1992	Bangladesh	Rural Poor Cooperatives	30.00
10L1237-NEP (SF)	1993	Nepal	Microcredit for Women	5.00
11L1290-MON (SF)	1993	Mongolia	Employment Generation	3.00
12L1327-INO (SF)	1994	Indonesia	Microcredit Project	25.70
13L1435-PHI (SF)	1996	Philippines	Rural Micro-enterprise Finance	18.12
14L1524-BAN (SF)	1997	Bangladesh	Participatory Livestock Development	16.58
15L1529-KGZ (SF)	1997	Kyrgyzstan	Rural Financial Institutions	11.87
16L1634-BAN(SF)	1998	Bangladesh	Rural Livelihood	42.26
17L1650-NEP(SF)	1998	Nepal	Rural Microfinance	18.66
18L1741-CAM(SF)	2000	Cambodia	Rural Credit and Savings	20.00
19L1805-PAK(SF)	2000	Pakistan	Microfinance Sector Development Programme	70.00
20L1806-PAK(SF)	2000	Pakistan	Microfinance Sector Development Project	80.00
21L1768-PNG(SF)	2000	Papua New Guinea	Microfinance and Employment	9.60
			Subtotal	**443.09**
II. Projects with microfinance components[a]				
1971/972	1989	Philippines	Fisheries Sector Programme	30.00
21128 (SF)	1991	Sri Lanka	Southern Province Rural Development	6.40
31179 (SF)	1992	Pakistan	NWFP Barani Area Development	7.90
4L1201-SRI (SF)	1992	Sri Lanka	Fisheries Sector Programme	4.00
5L1457-VIE (SF)	1996	Viet Nam	Rural Credit Project	2.00
8L1461-NEP(SF)	1996	Nepal	Third Livestock Development	4.61
9L1531-PAK (SF)	1997	Pakistan	Dera Ghazi Khan Development	2.75
10L1549-IND(SF)	1997	India	Housing Finance	45.00
11L1550-IND(SF)	1997	India	Housing Finance	30.00
12L1551-IND	1997	India	Housing Finance	20.00
13L1583-INO	1997	Indonesia	Rural Income Generation	20.40
14L1609-NEP(SF)	1998	Nepal	Community Groundwater Irrigation Sector	12.98
15L1605-INO	1998	Indonesia	C.Sulawesi Integrated Area Dev. and Conservation	1.58
16L1672-PAK(SF)	1999	Pakistan	Malakand Rural Development	5.28
17L1771-BAN(SF)	2000	Bangladesh	Chittagong Hills Tract Rural Development	1.60
18L1758-IND	2000	India	Housing Finance II	25.00
19L1760-IND	2000	India	Housing Finance II	5.00
20L1761-IND	2000	India	Housing Finance II	10.00
21L1802-VIE(SF)	2000	Viet Nam	Rural Enterprise Finance	42.00
22L1766-INO	2000	Indonesia	Community Empowerment for Rural Development	15.00
23L1822-MON	2000	Mongolia	Agriculture Sector Project	5.50
24L1786-KGZ	2000	Kyrgyzstan	Skills and Entrepreneurship Development	0.80
			Subtotal	**297.80**
			Grand Total	**740.89**

[a] Includes co-financing by other agencies.

[b] The amounts refer to the size of the microfinance component.

(d) Given the diversity of demand for financial services, a broad range of institutional types is required to expand outreach;

(e) Expansion of the outreach of savings services can have a potentially significant impact on both institutional sustainability and poverty reduction;

(f) Adoption of financial system development is the key to achieving sustainable results and to maximizing development impact. This approach emphasizes an enabling policy environment, financial infrastructure, and the development

Table 2. Asian development bank-financed technical assistance for microfinance 1988-2000

Year	*I. Project preparatory technical assistance*	*Amount (US dollars)*	*Year*	*II. Advisory technical assistance*	*Amount (US dollars)*
1989	TA 1133-NEP: Third Small Farmers	99,000	1989	TA 1092-PHI: Micro-enterprise Sector	595,000
	TA 1155-BAN: Non-Farm Employment Creation for Women	99,000			
	Subtotal	**198,000**			
1991	TA 1617-PHI: Rural Credit	640,000			
1993	TA 1849-INO: Microcredit	455,000	1993	TA 1871-NEP: Institutional Strengthening of ADBN	690,000
	TA 1840-MON: Employment Generation	100,000		TA 1903-NEP: Group Formation and Training of Women Beneficiaries	
	Subtotal	**555,000**		TA 2020-MON: Institutional Enhancement for Employment Generation	598,000
				Subtotal	**1,288,000**
			1994	TA 2232-BAN: Training of Cooperative and Field Staff	1,310,000
				TA 1807-BAN: Institutional Strengthening of Bangladesh Rural Development Board	600,000
				TA 2277-INO: Microcredit	1,000,000
				Subtotal	**2,910,000**
1995	TA 2293-BAN: Rural Livelihood	287,000	1995	TA 2449-KAZ: Study of Rural Credit and Savings	470,000
	TA 2410-BAN: Urban Poverty Alleviation	600,000			
	TA 2426-BAN: Participatory Livestock	598,000			
	TA 2453-KRY: Agriculture Credit	910,000			
	Subtotal	**2,395,000**			

Table 2. *(Continued)*

1996	TA 2700-IND: Housing Finance Facility *	100,000	1996	TA 2601-CAM: Rural Credit Review	100,000
	TA 2634-INO: Rural Income Generation	493,000		TA 2105: Country Institutional Strengthening of Agricultural Banking Services *	205,000
	TA 2604: PAK: Malakand Rural Development *	800,000		TA 2524-THA: Institutional Strengthening of Bank of Agriculture and Agricultural Cooperatives *	500,000
	TA 2624-UZB: Rural Enterprise Development	100,000		TA 2558-PHI: Strengthening Rural Micro-enterprise Finance	600,000
	Subtotal	**1,493,000**		**Subtotal**	**1,405,000**
1997	TA 2818-CAM: Rural Credit and Savings	600,000	1997	TA 2939-PRC: Reform of the Rural Credit Cooperative System *	997,000
	TA 2836-NEP: Rural Finance	500,000		TA 2851-NEP: Third Livestock Development *	750,000
	TA 2918-PAK: Balochistan Rural Development *	800,000		**Subtotal**	**1,747,000**
	TA 2937-PAK: Rural Microfinance	600,000			
	Subtotal	**2,500,000**			
1998	TA 3132-PAK: Sindh Rural Development *	800,000	1998	TA 3078-BAN: Establishment of a Framework for	800,000
	TA 2991-VIE: Second Rural Credit *	150,000		Sustainable Microfinance	
	Subtotal	**950,000**		TA 3143-PRC: International Symposium on Microfinance and Urban Unemployment in China	150,000
				Subtotal	**950,000**
1999	TA 3213-BAN: Chittagong Hill Tracts Rural Development*	500,000	1999	TA 3270-CAM: Capacity-Building for Rural Financial Services	1,450,000
	TA 3288-IND: Housing Finance II *	405,000		TA 3344-IND: Strengthening Microfinance Institutions for Urban and Environmental Finance	500,000
	TA 3315-PNG: Microfinance and Employment	150,000		TA 2558-PHI: Strengthening Rural Micro-enterprise Finance	600,000
	TA 3254-UZB: Rural Savings and Credit Union Development	600,000		TA 3227-VIE: Strengthening Corporate Governance at Viet Nam Bank for Agriculture and Rural Development *	900,000
	TA 3206-VAN: Rural Financial Services	250,000		**Subtotal**	**3,450,000**
	Subtotal	**1,905,000**			

* The scope of these TAs included microfinance, among other things.

Table 2. *(Continued)*

2000	TA 3397-MON: Rural Finance	700,000	2000	TA 3435-ETM: Microfinance	150,000
	TA 3581-NEP: Information and Communication Technology for Improved Financial Services Provision	565,000		TA 3556-ETM: Strengthening the Microfinance Policy and Legal Framework	250,000
	Subtotal	**1,265,000**		TA 3480-IND: Reducing Poverty in Urban India *	300,000
				TA 3413-LAO: TA Cluster for Rural Finance Development	2,020,000
				TA 3555-TAJ: Support to Rural Financial Systems Development	150,000
				Subtotal	**2,870,000**
	III. Regional Technical Assistance				
1992	TA 5496: Regional Workshop on Banking with the Poor	15,000			
1995	TA 5634: Review of Micro-enterprise	300,000			
1997	TA 5723: Fourth Consultative Group Forum	150,000			
	TA 5744: Economic and Policy Analyses in Pacific Developing Member Countries	600,000			
1999	TA 5836: Consultations on the Bank's Microfinance Development Strategy	400,000			
	TA 5851: Rural Financial Systems Workshop in Central Asia	360,000			
	TA 5889: Gender and Development Initiatives *	850,000			
2000	TA 5950: Financial Services for Poor Women	600,000			
	TA 5952: Commercialization of Microfinance	700,000			
2001	TA 5984: Microfinance Outreach Initiatives for the Consultative Group to Assist the Poorest				
	Total	**3,875,000**			
	Grand Total (I + II + III) 31,461,000				

* The scope of these TA included microfinance.

of viable microfinance institutions that can provide a variety of financial services, not just credit;

(g) Strong retail institutions committed to outreach and sustainability are essential for extending the permanent reach of financial services and for a significant impact on poverty reduction. Thus, building the capacity of institutions with a commitment to reach the poor is vital;

(h) Microfinance can contribute to the development of the overall financial system through the integration of financial markets.

The collective experience of ADB and other funding agencies confirms that microfinance can play an important role in poverty reduction, and the economic and social benefits can be large. The challenge is to mainstream good practice in microfinance operations and increase outreach to the poor on a sustainable basis. Experience also indicates the importance of integrating microfinance operations with the broader financial system to sustain outreach.

B. TOWARDS A SUSTAINABLE MICROFINANCE SYSTEM

To realize the poverty reduction potential of microfinance, substantial continuing resources are required to provide institutional microfinance services to the potential clients who are currently outside formal finance in the Asian and Pacific region. Efficient institutional and market mechanisms are needed whereby funds can be sourced and allocated efficiently through appropriately designed and priced services to the poor for profitable investment in agriculture and micro-enterprises. Hence, there is a need to catalyse the growth in supply of sustainable microfinance services and strengthen the capacity of the potential clients to access the services. This can be facilitated through support for the following mutually reinforcing areas:

- Creating a conducive policy environment
- Developing critical financial infrastructure
- Developing viable microfinance institutions
- Pro-poor innovations in financial technology
- Social intermediation

1. Policy environment

In many countries, the lack of an enabling policy environment for microfinance continues to be a major constraint. Relevant policy reforms include undertaking interest rate reforms for microcredit and savings, creating an environment sufficiently flexible to accommodate a wide array of microfinance service providers to meet the diverse demand, and redefining the role of the state and the central banks in microfinance development to facilitate the participation of private sector financial institutions. Given that non-financial policies such as agricultural pricing and taxation of micro-enterprises also have a critical role in the sustainable development of microfinance, the policy reforms need to be extended to address such issues where they constitute significant constraints.

2. Financial infrastructure

Microfinance institutions can develop sustainable commercial services on a permanent basis and expand their scope of operations and outreach only if they operate within an appropriate financial infrastructure, such as information systems and training facilities. The legal framework and supervision and regulation of microfinance institutions, including self-regulation and performance standards need to be established to facilitate sound growth and improve the capacity of microfinance institutions to leverage funds in the market and provide competition. However, legal and regulatory systems should not discourage financial innovations, stunt institutional growth, and prevent the emergence of a diverse set of dynamic institutions. Legal barriers preventing banks from establishing business relationships with informal or semiformal bodies, such as community-based organizations or self-help groups, will need to be removed.

3. Developing viable microfinance institutions

Viability is critical for expanding the outreach of microfinance institutions to achieve the primary objective of poverty reduction. The institutional development support for viability needs to encompass (a) ownership and governance, (b) diversified products and services, (c) management information systems and accounting policies and practices, (d) management of portfolio quality and growth, (e) systems, procedures and financial technology for reducing transaction costs, and (f) training facilities. In countries where state-owned agricultural and rural development banks continue to undermine the development of sustainable microfinance operations, reform of such banks is necessary. In some circumstances, especially in transitional economies that lack appropriate institutions to efficiently provide microfinance, new institutions may be needed.

4. Pro-poor innovations

Those in resource-poor and low-population density areas, the poorest of the poor, and ethnic minorities often tend to be excluded by financial institutions because of risk-return considerations, although the social returns to reaching these clients may be high. Therefore, it is important to support microfinance institutions and other financial institutions to expand the services to these categories through innovative programmes, the development of financial technology that contribute to breaking these barriers through pilot projects and other measures that aim at establishing linkages between formal financial institutions and informal service providers.

5. Social intermediation

Investment in social intermediation is necessary to increase the capacity of the poor to access and productively use microfinance services. Such investments, among other things, should support (a) awareness-building programmes on a broad range of microfinance services; (b) information dissemination on service providers; (c) basic literacy, numeracy and skills training for women, ethnic minorities, and other disadvantaged groups; and (d) social mobilization for the formation of community-based organizations and solidarity groups to actively participate in microfinance markets.

C. CONCLUSIONS

The landscape of microfinance is changing as a result of increasing understanding of how the poor use money and their diverse demands for financial services. Correspondingly, the microfinance industry is evolving into an increasingly commercial operation to serve a larger segment of the potential market. A number of challenges need to be overcome to facilitate and accelerate this process to realize the vast potential of microfinance. This calls for a comprehensive approach, as outlined above, that takes cognizance of the diversity of microfinance development issues across countries. ADB interventions in support of microfinance pursue this approach to catalyse the development of sustainable microfinance systems in the region. With a view to leveraging its support, ADB is coordinating with other funding agencies involved in microfinance and enhancing the involvement of its private sector operations in microfinance.

VI. FINANCING FOR MICRO-ENTERPRISES, SMALL, MEDIUM-SIZED AND COTTAGE INDUSTRIES: BANGLADESH PERSPECTIVE*

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Introduction

After a less than successful experimentation with top-down (trickle-down) development policies over the last few decades to alleviate poverty in most developing countries, financing micro-enterprises is now considered a "new paradigm" for bringing about development and alleviating absolute poverty. Although the importance of developing small, medium-sized and cottage industrial enterprises has been discussed for a long time, the innovative poverty-focused group-based financing of micro-enterprises is a relatively new concept. Pioneered by Professor Muhammad Yunus of Grameen Bank in Bangladesh, microfinance institutions providing credit to the poor have burgeoned in both developing and industrial countries. Mustak Parker has maintained in his research paper that a total of USD 7 billion has been disbursed to over 13 million people (Parker 1998). The Microcredit Summit held in Washington, D.C., in 1997 envisaged that 100 million poor would have access to microfinance by 2005.[1]

Pioneered by the Grameen Bank in Bangladesh, microfinance institutions have developed as specialized financial institutions that cater to the needs of the poor.[2] In order to understand the nature of microfinance institutions in Bangladesh, as specialized

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[1] Inspired in part by concerns raised at the 1995 Fourth World Conference on Women, held in Beijing, more than 2,900 people representing 1,500 institutions from 137 countries gathered at the Microcredit Summit in Washington, D.C., in February 1997. Delegates set the ambitious goal of reaching 100 million of the world's poorest families, especially the women with credit for self-employment and other financial and business services by the year 2005. While not a panacea, microcredit provides a powerful tool for progress in nearly all of the 12 critical areas of concern outlined at Beijing. (For details about the 12 critical areas of concern, please see "Empowering Women with Microcredit", 2000 Microcredit Summit Campaign Report).

[2] Jonathan Morduch (1999) suggests in his article that though different approaches to microfinance have evolved in Bangladesh, the dominant among these is the Grameen Bank Model.

financial institutions, we will briefly highlight their origin, operations and activities in this chapter. Accordingly, the chapter has been organized into five sections:

1. The origin and operational framework of microfinance institutions, especially Grameen Bank;
2. The impact of the microfinance institutions loan programmes including Grameen Bank;
3. Financing small, medium-sized and cottage industries – a closer look;
4. Problems and prospects of microfinance institutions in Bangladesh;
5. Suggested measures and concluding remarks.

A. THE ORIGIN AND OPERATIONAL FRAMEWORK OF MICROFINANCE INSTITUTIONS, ESPECIALLY GRAMEEN BANK

Bangladesh is the largest least developed country with the eighth largest (third in the Muslim world) population of 130.2 million in an area of 147,570 square kilometres frequently ravaged by floods and cyclones (Bangladesh Bank 2000). It has one of the highest population densities (882 persons per square kilometre) with a low per capita GDP ($369), very Limited natural resources, and great poverty. The various dimensions of this poverty are manifested in terms of declining trends in real wages in agriculture, inequality in income distribution (in favour of urban areas), wage differentials between the formal and informal sectors, dramatic increases in the cost of living, less than adequate calorie intake by the vast majority of the population, unemployment and internal migration. Despite these indicators, Bangladesh has a proven stock of natural gas and efficient and skilled human resources.

It is the Grameen Bank which has come forward to take responsibility for bringing the poor out of abject poverty. Grameen Bank of Bangladesh was the brainchild of Dr. Muhammad Yunus, a Vanderbilt-educated economics professor at Chittagong University and a social scientist. What started out as a personal anti-poverty experiment and a social revolution in 1976 became a fully fledged bank in 1983. Since then it has continued to expand.

Apart from the operation of Grameen Bank, some other microcredit institutions, such as the Association for Social Advancement (ASA), the Bangladesh Rural Advancement Committee (BRAC) and the Palli Karma Sahayak Foundation (PKSF), have also been implementing several microcredit programmes with a vision to make adequate financial services available to the poor. We will try to discuss their operations here in brief.

1. Grameen Bank

The Government of Bangladesh undertook a project on rural finance in the middle of the 1970s and appointed Nathan Associates, a United States consulting firm, to assess the loan requirements of rural Bangladesh. Subsequently, the most cost-effective was chosen among different alternative hypotheses of a rural loan delivery system under the Rural Finance Experimental Project of Bangladesh Bank. Among those alternatives, one that was pioneered by Dr. Muhammad Yunus proved to be the most viable and suitable for Bangladesh. This Grameen Bank project was finally converted into a unique bank under the Grameen Bank Ordinance 1983.

Thus, the Grameen Bank was formally set up in 1983 to organize particularly the landless and poor women through a group-based credit system. This was done with the hope that if some capital could be made available to the landless poor on reasonable terms and conditions they could engage in productive self-employment activities, thereby helping to increase their income level. The Grameen Bank provides small loans without collateral for the following broad categories of activities:

- Service
- Trading
- Peddling
- Livestock and fisheries
- Collective enterprises
- Agriculture and forestry
- Shopkeeping
- Processing and manufacturing

Grameen Bank has already covered 40,384 villages out of a total of 68,000 villages in the country. It currently serves 2.38 million borrowers, 95 per cent of whom are women. It has 1,170 branches. Unlike conventional banks, it works on the principle that people should not go to the bank, but rather the bank should go to the people. Grameen's staff, each week, go to all 40,384 villages to meet all the borrowers to do the banking at their doorsteps. Grameen's loans are paid back in weekly instalments. The poor, particularly the poor women in a Muslim majority country like Bangladesh, find it very convenient to do business with the Bank at their doorstep rather than waiting in line in a distant office located in crowded commercial place.

Conventional banks are based on the principle that the more you have, the more you can get, if you don't have anything, you don't get anything. Grameen has literally turned this principle around. The Grameen principle is that the less you have, the higher the priority you get in receiving loans from the bank. If you have nothing, you get the highest priority.

Loan procedures

When Grameen Bank enters a new district, it brings with it an economic and social development programme which has evolved over the last 18 years while continuously interacting with the landless poor. But the programme is not imposed on people. It is merely a well tried starting point for a new participatory process which is open to further modification, according to local conditions, priorities and needs. The programme involves people in a long-term learning process. Through participatory efforts and joint experiences, people gradually acquire knowledge particularly in organizational and managerial skills. In this way the programme realizes the ideas of endogenous and self-reliant development. When Grameen Bank opens a new branch, the branch manager has to prepare a socio-economic study of the locality. The study covers the geography, demography, economy and the infrastructural facilities in the area. After approval of the report by the Head Office, the general manager organizes a general public information meeting where he explains Grameen Bank's purpose, procedures and programme. Particularly he explains the procedures for forming groups and centres and encourages the landless to form five-member groups of like-minded people in similar economic conditions to become eligible for credit facilities.

The next step in disbursing loans is the compulsory participation of the group members in a group training programme which is a minimum of seven days continuous instruction. The training is conducted by the bank workers teaching the rules and regulations of the bank, including understanding the purpose of various bank procedures, knowing in detail the responsibilities of the group chairperson and the centre chief, and explaining the importance of fund-saving schemes for joint activities or children's welfare. The training also explains the different aspects of social development programmes and educates them to write at least their own signatures, which is a condition for obtaining loans. At the end of seven days' training, the branch manager, after his evaluation, gives provisional recognition to the group. The group is again examined thoroughly by the programme officer. If all group members are found suitable and well-trained in the procedures of the bank, the programme officer accords formal recognition to the group. After this recognition the group becomes a formal entity entitled to undertake transactions with Grameen Bank.

One of the remarkable features of Grameen Bank is that the groups themselves are involved directly in the decision-making processes of the loan operation. The group members are actively integrated in the decision-making process individually, as a part of a group and as a part of the centre. The first decision to be taken by the group is to decide the amount of loans and to select the loanees. Two conditions apply to these decisions: the first loan the group can sanction without higher approval should not exceed the range of Tk. 500 to Tk. 1,500 and only two members may at first receive loans. If the first two loanees can observe the bank discipline and meet their payments, the next two members become eligible for loans. Generally the chairman gets the loan last. Thus, group pressures ensure credit discipline. It is in everybody's interest that bad loans do not jeopardize the future prospects of other members. After the Loan is agreed upon by the group, the Loan can be proposed for approval. Once a Loan is approved, the branch manager issues the Loan money a1ong with a Loan passbook. At the centre meeting which takes place early in the morning on a regular day each week, the bank worker records the instalment in the loan passbook of each member. The weekly instalment begin as soon as the loan is disbursed. The innovation of the weekly instalment emerged quite early in the development of the bank's loan delivery and recovery system.

From the bank's perspective, regular centre meeting attendance and the payment of weekly instalments do not in themselves constitute adequate supervision. Immediately following a loan disbursement, it is a regulation that within seven days the loanee must utilize the loan for the specific purpose of generating income. Grameen Bank's extraordinarily high repayment from 98 to 100 per cent is largely due to the tight supervision and the participatory process at work in the groups of five and in the centres. In the event of default, there is no collateral the bank can resort to. The only recourse is social collateral, that is through group solidarity and accountability relationships the members have established among themselves. However, in the event of a member being unable to meet a loan instalment, the group usually contributes the funds to pay their instalment while making it a private matter to collect from the member. A member usually makes a great effort to avoid the public indignity of being a defaulter.

Savings schemes

One of the conditions of the loan is that the group members save five taka every week plus 5 per cent of the loan amount, which is kept aside at the time of loan disbursement. The rate of interest is 20 per cent. The borrowers pay Tk. 24 for each one thousand taka in 46 equal weekly instalments.

In September 2001, the Grameen Bank completed its eighteenth year of operation. Its progress can be appreciated from the following table:

Table 1. Progress of Grameen Bank up to September 2001

Particulars	*Amount*
1. Number of villages covered	40 384
2. Number of branches	1 170
3. Number of members (in millions)	2.38
Landless (women)	2.26
Landless (men)	0.12
4. Number of centres	68 507
Landless (women)	61 810
Landless (men)	3 697
5. Number of groups	500 223
Landless (women)	474 864
Landless (men)	25 359
6. Loans disbursed (in million taka)	150 612.10
Landless (women)	141 311.50
Landless (men)	9 300.60
7. Loans repaid (in million taka)	137 797.60
8. Percentage of loans realized	90.10
9. Area-wise disbursement (in million taka)	150 612.10
Housing loans	7 559.70
Other loans repaid	143 051.40
10. Housing loans repaid (in million taka)	5 447.10
Other loans repaid	132 350.50
11. Savings in group fund (in million taka)	11 858.90
12. Overdue amount (percentage)	9.90

Source: Annual Report of Grameen Bank.

We will give a brief account of other prominent microfinance institutions in Bangladesh, such as BRAC and ASA that function with the same objectives and credit line but with small differences in their priorities and activities.

2. Bangladesh Rural Advancement Committee

BRAC has been in existence since 1972. However, it started its rural development programme in 1986. The main aim of the programme was to assist the landless people to organize themselves into village organizations for their socio-economic development. The rural credit programme of BRAC came into operation in 1990. Both programmes cover four major activities: (a) institution-building; (b) sector programmes: (c) credit operations; and (d) support services.

All these activities aim at empowering the poor and promoting social awareness and education among the members of the voluntary organizations. The sector programmes have six components, such as (a) irrigation; (b) vegetable cultivation; (c) poultry; (d) livestock; (e) fisheries; and (f) sericulture. The main objectives of these components are to:

- Increase agricultural production through irrigation and crop diversification
- Promote the introduction of new technology
- Increase vegetable production and improve nutritional status
- Increase poultry, livestock and fish production to meet the nutrient needs of the rural poor
- Develop human skills
- Improve the socio-economic status of the rural poor
- Increase income and employment generation opportunities for the landless poor
- Reduce rural poverty

The rural development programme and the rural credit programme covered 61,879 villages/slums with 430 branches at the end of August 2001. By then BRAC had mobilized 4.21 million members of which 82 per cent were women. While the percentage of borrowers was 64 per cent of all members, women borrowers were 58 per cent of the total women members. The total outstanding loans of BRAC stood at Tk. 8.0 billion in August 2001, an increase of 624 per cent over the amount disbursed in 1993. Of the total outstanding loans, women members received 75 per cent. By the end of August 2001 BRAC had mobilized Tk. 504 million as savings and deposits from the members. Women contributed 82 per cent of these savings. Rural trading, food processing and livestock poultry accounted for more than 71 per cent of the total loans disbursed up to August 2001. The overdue amount of loans stood at Tk. 703.2 million during the period under review. Presently, BRAC's two programmes cover only about 30 per cent of the target population. Its low coverage is said to be the result of both demand and supply constraints. On the demand side, one constraint seems to be the absence of growth-oriented activities in the portfolio of the borrowers and on the supply side, the constraint is its high cost of delivering credit to the poor.

3. The Association for Social Advancement

ASA was established in 1978 as an NGO aimed at empowering the landless through awareness raising and leadership development, involving the poor in various fields of development through a participatory process, helping the poor in identifying income-generating activities at the grass-roots level, providing poor professional groups with short-term finance, and marketing their products.

About 1.4 million poor rural households spread over 26,328 villages were covered by 954 branches up to August 2001 under ASA's poverty alleviation programme. Of these, 1.2 million members were organized as borrowers, of whom 90 per cent were female. A total of Tk. 4.5 billion was disbursed up to August 2001 among the group members. The recovery rate is more than 99 per cent. The sources of fund for use as a revolving credit are from the Danish International Development Agency (DANIDA), a consortium of donors, PKSF, and ASA's own funds. Of the total loan disbursed up to August 2001, ASA's own fund comprised about 30 per cent. It has also recently started borrowing from the commercial banks.

B. THE IMPACT OF THE LOAN PROGRAMMES OF MICROFINANCE INSTITUTIONS, ESPECIALLY GRAMEEN BANK

Grameen Bank provides loans in cash to the landless poor, particularly women, to promote self-employment and make them income earners. As the repayment rate is about 90 per cent, it is indicative of the fact that the loanees are utilizing the loan for productive purposes. Thus, the bank has generated self-employment opportunities for women members who were either unemployed or underemployed earlier, increasing the labour force participation rate in the area of its operation. It is difficult to estimate the exact income effect of the programme as the income of Grameen Bank members or female members can not always be separately estimated from their household income. However, the total cumulative amount of savings in the group fund of all the members rose to Tk. 11.9 billion by the end of September 2001. This indicates a strong positive income effect of their loans. A survey conducted by Mahboob Hossain (1995) indicated that the proportion of the population living in moderate poverty was 84 per cent for target-group non-participants in a project village and 80 per cent for the target-group in a control village. But the same figure for Grameen Bank members was 61 per cent in the target village. The percentage of Grameen Bank members living in extreme poverty was 48, while it was about 78 per cent for its control group counterparts (Hossain 1995). These figures suggest that Grameen Bank has been able to alleviate poverty for its members.

Another important addition to the impact research of different microfinance programmes has been the development of 10 criteria by Grameen Bank. The 10 criteria are: (i) respectable housing, (ii) pure drinking water, (iii) children's education, (iv) 300 taka weekly instalment, (v) possession of a sanitary latrine, (vi) clothing, (vii) scope of supplementary income, (viii) loan defaults, (ix) self- sufficiency of food and (x) capability of the members to meet health hazards.

A field survey was conducted by Professor M.A. Hamid on the basis of the above 10 criteria (Hamid 2000). He found that Criterion 1 (on respectable housing) is applicable to most members of Grameen Bank (85.5 per cent), Criterion 2 (on pure drinking water) is satisfied by almost one out of every four persons. This is definitely a good sign of human development in rural Bangladesh. Criterion 3 (on children's education) is not applicable to all members. The survey shows that for only 3 per cent of Grameen Bank members, this criterion is not applicable. That means that they do not have any schoolgoing children in their families. Of those to whom it is applicable, 83.5 per cent of members satisfy this criterion. Criterion 4 (on 300 taka weekly instalment), a pure economic criterion, 35 per cent of members satisfy this criterion. Criterion 5 (on the possession of a sanitary latrine) is satisfied by about half of the members of the programmes under review. Criterion 6 (on clothing) is found to have been satisfied by more than 90 per cent of the members. Criterion 7 (on the scope of supplementary income) is satisfied by 61.5 per cent of members. This means that more than half of the poor people have some scope for supplementary sources of income. Criterion 8 (on loan defaults) is not applicable to all members. In Grameen Bank 1 per cent of members had not taken loans for less than 3 years. Leaving these members aside, it was found that 41.9 per cent of members satisfy this criterion. Criterion 9 (on self-sufficiency in food) appears to have been satisfied by around 95 per cent of the respondents of the Grameen Bank programmes. This implies that in their own opinion, most of the members do not face any serious food crisis. Criterion 10 (on the capability of the members to meet health hazards) is satisfied by 91 per cent of the members of Grameen Bank.

Ali Akkas (1998) in a study observed that by late 1995, the Grameen Bank and NGOs covered 25 per cent of the target group households with Tk. 16.6 billion in loans outstanding. Coverage varies substantially from area to area and between social groups. Areas with poor roads, a low level of economic activity and weak infrastructure have benefited little from microcredit. NGOs and Grameen Bank have performed at much higher levels than government credit schemes and their achievements compare very favourably with all other anti-poverty strategies in the county.

Ainon Nahar Mizan (1994) in a study found that a respondent's mean score on the household decision-making skill increases with the years of loan up to a certain level (three through six years) and then begins to fluctuate. The correlation between years of loan from Grameen Bank and the household decision-making skill is positive and moderately high. According to her research, Grameen Bank participation has a significant effect on women's decision-making, both in the bivariate and multivariate context. This finding indicates the significant success of Grameen Bank programmes in affecting women's status relative to men in Bangladesh. Another important dimension of women's decision-making involved their political participation, such as in voting. A test reveals that even though women's participation in politics in Bangladesh is increasing substantially, their participation is still negligible compared with that of men. However, in the recent past Jatio Sangshad Election (8th National Parliament election held on 1 October 2001 in Bangladesh), the participation of women was substantially higher as compared with anytime earlies. Women's voting participation apparently increases with their employment, income and education, for those variables raise women's consciousness about their rights and privileges in the society.

Hasnat Abdul Hye (1996) has observed that Grameen Bank has financed its activities with funds obtained at concessional rates from external and domestic sources. Reliance on external funds, either as grant or on a concessionary rate has raized questions: Would the Grameen Bank be viable without these subsidized funds? Pointing out that Grameen Bank receives both financial and economic subsidies, a study by the World Bank/Bangladesh Institute of Development Studies considers it a source of concern for its long-run viability (Khandoker and others 1995). However, in a impact study Shahidur R. Khandoker (1999) found that participation in a microcredit programme had a positive effect on per capita expenditure, although the effect was not always statistically significant for borrowing by men. Microcredit also affected socio-economic variables, including children's schooling, children's nutrition, fertility and contraception use etc. Microcredit programmes have helped reduce rural poverty in Bangladesh. But have they done so cost effectively? This is a burning question.

C. FINANCING SMALL, MEDIUM-SIZED AND COTTAGE INDUSTRIES: A CLOSER LOOK

Small and medium-sized enterprises (SMEs) have a special role to play in the achievement of equitable and broad-based economic growth in a country like Bangladesh. This is due to SMEs generally being more labour-intensive, having linkages to traditional industries, and contributing to the development of entrepreneurial skills and the spread of new technologies.

There is no standard definition of SMEs, and alternative taxonomies based on investment, ownership, value added or employment levels can be justified. We see the classification used in several reports was based on employment levels, defining SMEs as those enterprises employing up to 50 workers, excluding household enterprises (World Bank/USAID 1992). The Ministry of Industry (Government of Bangladesh 1999) made a broad-based classification of industrial enterprises, classifying them into five sectors. The sectors are: (i) large industry (100 employees or more and/or capital of more than Tk. 30 crores); (ii) medium industry (50 to 99 employees and/or fixed capital of from Tk. 10 crores to Tk. 30 crores; (iii) small industry (less than 50 employees and/or fixed capital of less then Tk. 10 crores; (iv) cottage industry (household basis where the family members are workers); and (v) reserve industry (the industries earmarked by the government for its own investment).

The key role of SMEs in employment generation is well recognized. They are also important in the training of labour and in the diffusion of technologies. Greater emphasis on developing this sector could also yield significant dividends in terms of improving the spatial distribution of enterprises, shifting the current trend towards concentration in Dhaka and a handful of major industrial centres.

Institutional finance for SMEs assumes significant importance in developing countries such as Bangladesh in view of low capital formation, ill-organized capital markets, and gaps between demand for and supply of institutional finance in this sector. Small-scale and cottage industries derive finance from institutional, semi-institutional and non-institutional sources. Small-scale enterprises remain vulnerable with regard to their requirements for working capital. These enterprises do not have continuous business hours and as such their requirements for raw materials and inventories vary depending on their order book and payments received by them.

A study (Khandoker 1998) regarding financing to small-scale and cottage Industries in Bangladesh reveals that in many cases credit is obtained from suppliers in the form of raw materials or from the buyers of the firm's output. The study demonstrated that about 70 per cent of the start-up cost in respect of small grocery stores was financed from the owner's savings and sales of other assets. Friends and relatives provided loans to the extent of 20 per cent on average and the supplier's credit financed about 10 per cent of the start-up cost.

Outstanding advances to the large and medium-scale industrial sector by the banks in Bangladesh stood at Tk. 53.4 billion or 25.39 per cent of total bank advances at the end of December 1990, rising to Tk. 93.1 billion or 26.71 per cent of total bank advances at the end of December 1995 and further to Tk. 159.1 billion or 25.18 per cent by the end of December 2000 (see table 2). Outstanding advances to small-scale and cottage industries, on the other hand, stood at Tk. 2.4 billion or 1.13 per cent of total bank advances at the end of December 1990, rising to Tk. 5.3 billion or 1.51 per cent of total bank advances at the end of December 1995 and further increasing to Tk. 8.3 billion or 1.31 per cent of total bank advances by the end of December 2000. It, thus, confirms the idea that formal lending institutions largely met the financial requirements of large and medium-scale industries at the expense of the small-scale and cottage industry sector during the last decade in Bangladesh. There were no tangible changes in the share of small-scale and cottage industries to total industrial credit during the last decade.

Medium-sized, small and cottage enterprises have played a prominent role in economy of Bangladesh which has widespread unemployment, a narrow capital base, inequality of income, poverty, and an absence of modern technology. The main government agencies set up to promote industrial growth and exports, for example, the Board of Investment and export processing zones, have come under criticism for their apparent ineffectiveness in boosting investment or encouraging the diversification of the economic base. On the other, the social and economic infrastructure remains severely inadequate. In addition, financial institutions always favoured financing large-scale manufacturing and the business sector because of the convenience of administration and creditworthiness of the borrowers of this sector. The borrowers of small-scale and cottage enterprises, on the other hand, faced many difficulties borrowing from institutional sources with their complicated and lengthy procedures. Above all, the commercial banks, burdened with a huge overhang of non-performing loans concentrated in the larger-enterprises sector, have sought to make up for earlier losses by raising lending charges and sharply tightening collateral requirements. Moreover, deficiencies in the regulatory system have added to business uncertainty and risk, and imposed additional costs on small and cottage enterprises because of delay and expensive approval procedures. Undoubtedly, a large part of the problem stems from the failure of enforcement agencies. However, if we have to improve the overall condition of the medium-sized, small and cottage industries, we must undertake special financial support closely supervised by trained personnel of the lending institution.

D. PROBLEMS AND PROSPECTS OF MICROFINANCE INSTITUTIONS IN BANGLADESH

Poverty in Bangladesh is a chronic and acute problem. Whether the situation has really improved or not is a debatable issue. The experience so far gathered from the activities of the microfinance institutions indicates several acute problems and shortcomings in the programmes.

Today there is a widespread perception that most of the laws under which the microfinance institutions are operating seem to have fallen short in dealing with their institutional and operational aspects. Microfinance institutions, which are basically NGOs providing financial services, do not fall under the government regulations that are applied to banks and other non-bank financial intermediaries. Actually, they are in need of appropriate regulatory frameworks. The absence of a single registering, monitoring and supervising organization appropriate for the microfinance institutions in Bangladesh has made it difficult to decide if they have been targeting the right people and for the right purpose.

If a microcredit institution is to maintain its capacity holdings, it must generate sufficient revenue to meet its operating costs, including the cost of administering loans, mobilizing and training groups, mobilizing funds for on-lending, and covering bad debts. Although a number of microfinance institutions are showing their financial efficiency, in most cases this is misleading since the borrowing cost of on-lending funds is highly subsidized by donors (Khandoker 1998). Performance evaluation of microcredit given by microfinance institutions is increasingly important. It is very difficult to evaluate the performance of the large number of NGOs operating in Bangladesh. In Bangladesh, the major sources of microfinance institutions revolving loan funds are the donors, the commercial banks, PKSF, members' savings etc. It has been observed that donor funds as a percentage of the total is declining over time. On the other hand, NGOs have limited access to formal financial institutions. There are complaints that the microfinance institutions in Bangladesh have been charging an exorbitant rate of interest on their loans. According to a study conducted by Bangladesh Bank (1997), it was found that the effective rate of interest charged by Grameen Bank is 22.45 per cent while the formal sector interest rate ranges from 10 per cent – 12 per cent for the small and cottage sector. Hashemi (1997) and Khandoker (1995) point out that Grameen Bank would operate at a loss without grants. As per the regular statutory rules, weekly instalments are started by the borrowers to repay the principal and interest from the subsequent week after obtaining the credit. This procedure puts serious economic and mental pressures on the borrowers. In many cases, it is found that due to the pressure of repayment, overlapping problems in microcredit have emerged. A study by the Bangladesh Institute of Development Studies revealed that 11 per cent of the participanthouseholds have two or more members from the same household in the same NGO. Among households with one male and one female membership about 80 per cent were involved in multiple NGOs (Khaled 1998).

A major shortcoming of the microfinance institutions in Bangladesh is that they do not always reach the hardcore poor – the poorest of the poor. Since the absolute poor run a higher risk for loan default, they often fall outside the coverage of the microfinance institutions. At the same time, the poor people with more than 0.50 acre of land do not fall under the programme. So, a huge number of disadvantaged people are left out from the programme. Moreover, the microfinance institutions follow the same rules/ obligations of microcredit for all regions of the country. This has created different problems, such as economic depression and underuse of potential. Not all participants are skilled enough to initiate self-employment schemes, but are in need of opportunities in wage employment.

The microfinance institutions do not have a proper coordination mechanism that would enable them to ensure effective coverage in all areas of the country. While some provide a broad range of services, most of them provide limited credit and savings options. Thus, proper representation also requires that the poor have the opportunity to receive as many services as they need. The microfinance institutions are also beset with fund constraints and there are no linkages between the financial institutions at the grass-roots level. On the other hand, owing to the absence of a national policy on microcredit and a nationwide default culture, loan repayment at the microfinance institutions is affected by the spillover effect of those big borrowers.

The bulk of the loans advanced by microfinance institutions in Bangladesh is targeted towards women. In reality, however, the male members of the household initiate taking loans and control the funds received by the female members. Furthermore, Aminur Rahman (1999) pointed out that loans taken are often used for purposes other than those the loan is sanctioned for. Rezaul Karim and Osada (1998) observed that there was a steady increase in the dropout rate from the Grameen Bank (15 per cent in 1994) and that 88 per cent of the total dropouts did not graduate to the status of non-poor. Ahmed (1998) finds that a larger association with Grameen Bank reduces the household income.

E. SUGGESTED MEASURES AND CONCLUDING REMARKS

Despite many shortcoming and criticisms raised by a group of researchers about the function, impact and sustainability of the microfinance programmes in Bangladesh, microfinance institutions, especially Grameen Bank, have made a successful breakthrough in reaching the target group mainly because of the easy availability of funds and close supervision. It is pertinent to further gear up the activities of the microfinance institutions for the sake of poverty alleviation and also to deal with socio-economic-financial issues of the rural areas. Although microcredit is not the panacea for poverty alleviation and rural upliftment in a developing country like

Bangladesh, the supportive services of microfinance institutions for primary requisites (such as health, education, and infrastructure) and financial services (such as savings schemes, consumption, investment and insurance services) are essential for the smooth operation of microcredit.

In order to improve the performance of the microfinance institutions and microcredit for targeting the poor, the following measures have been suggested:

(a) Bangladesh Bank and the commercial banks should establish separate functional relations with the microfinance institutions to provide the required guidelines, supervision and financial assistance;

(b) Close cooperation among the microfinance institutions, banks and organs of the government for social welfare activities is essential for the effective coordination of their activities. Integration can improve the efficiency of segmented rural financial markets by exploiting the comparative advantage of each sector;

(c) A regulatory body is essential to monitor the activities of microfinance institutions in Bangladesh, besides internal regulation by themselves, through governance and transparency in the disclosure of all types of their accounts and documents;

(d) Accounting systems, management information systems services, the calculation method of the recovery rate of the microfinance institutions should be streamlined and transparent;

(e) An initiative should also be considered to establish a link among the medium-sized, small and cottage industries and the corporate sector through the development of subcontracting. Banks and non-bank financial institutions could create funds for the development of subcontracting enterprises.

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VII. FINANCING FOR MICRO-ENTERPRISES, SMALL AND MEDIUM-SIZED BUSINESS AND POOR HOUSEHOLDS IN THE PHILIPPINES

*Mario B. Lamberte**

Introduction

The population in the Philippines currently stands at 76.5 million. With a population growth rate of 2.36 per cent, which is well above the 1.3 per cent world population growth rate, 1.8 million will be added each year to the country's population. Since the economy in the last 15 years has grown only modestly, the number of poor people inevitably keeps on rising. Thus, despite the fact that poverty incidence had declined from 49.3 per cent in 1985 to 40 per cent in 2000, the number of poor people has risen from 26.2 million to 31.3 million during the same period.[1] A great majority of the income earners of poor households are self-employed.

The 1998 Annual Poverty Indicators Survey showed that 70 per cent of the poorest 40 per cent of the respondents relied on entrepreneurial activities as their main source of income. However, only 25 per cent out of the 8.5 million families in business had obtained credit to finance their business.

There is no accurate information on the number of micro-enterprises, and small and medium-sized enterprises in the Philippines because many of them do not register with the concerned government agencies. The past and most recent statistics for manufacturing establishments alone suggest that some 90 per cent are those with an average total employment of less than 10 workers. This does not include those in the agriculture and service sectors.

This economic landscape has not gone unnoticed by policy makers in the country. Since the country gained its independence from the United States of America in 1946, the government has put in place policies and programmes to address the needs of small and medium-sized enterprises and to reduce poverty incidence. Financial policies and credit programmes have been used as instruments for mobilizing and moving financial resources to micro, small and medium-sized enterprises (MicSMEs for short) and poor households. This will be the main focus of the discussion below.

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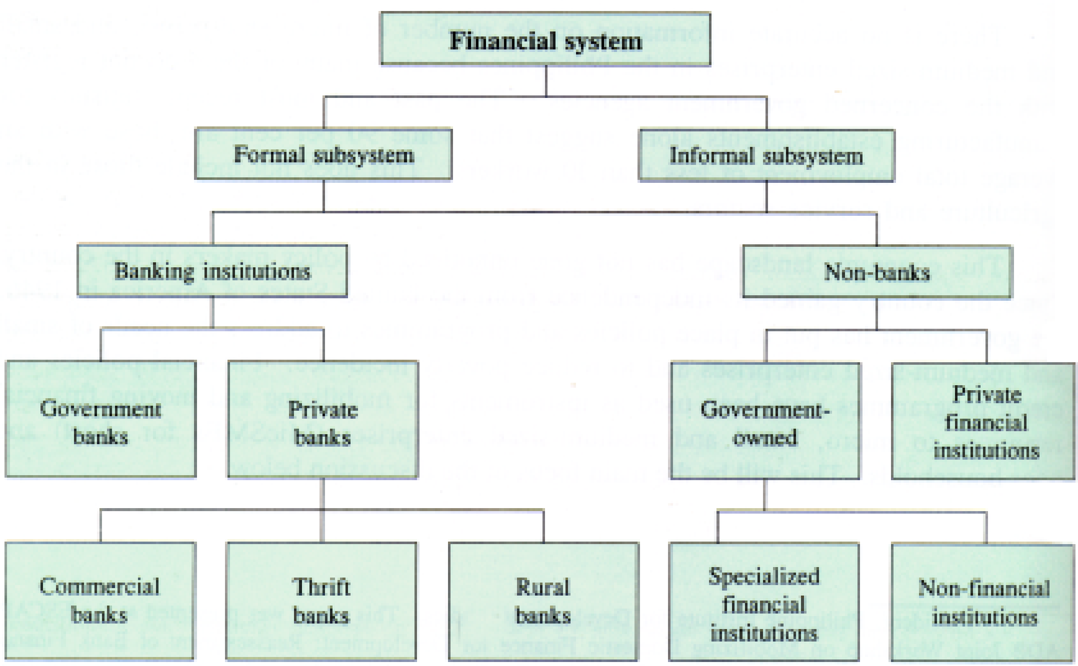
[1] In terms of number of families, poverty incidence declined from 44.2 per cent in 1985 to 34.2 per cent in 2000, but the number of poor families increased from 4.4 million to 5.2 million.

The next section gives an overview of the entire Philippine financial system. Although this chapter deals only with bank lending to MicSMEs and poor households, the overview gives a clearer picture of the role of banking institutions in lending to these sectors. Section B discusses the existing policy framework and programmes for bank lending to MicSMEs and poor households. A discussion on the current status of bank lending to MicSMEs and poor households is presented in section C. The last section analyses the constraints facing banks, especially private banks, in lending to MicSMEs and also recommends some measures to address them.

A. OVERVIEW OF THE PHILIPPINE FINANCIAL SYSTEM

The Philippine financial system consists of formal and informal financial subsystems (figure 1). The informal sector is composed of heterogeneous players, such as moneylenders, and rotating savings and credit associations. The formal financial subsystem can be broken down further into banking institutions, which are authorized to provide credit and accept deposits from the general public, and non-bank institutions, which are authorized to extend loans but are not permitted to accept deposits from the general public.

Figure 1. The Philippine financial system



Non-bank institutions include government specialized financial institutions and non-financial institutions. The two largest pension fund systems, namely the Social Security System and Government Social Insurance System, belong to the former. They provide housing and other small loans to their members. Other institutions that belong to the former are the specialized non-bank government institutions, which are created by law or administrative order for the purpose of providing credit to specific sectors. Examples are the Small Business Guarantee and Fund Corporation, which provides credit guarantees up to 100 per cent of the loan and extends credit to small and medium-sized enterprises, and the Quedan and Rural Credit Guarantee Corporation (QUEDANCOR), which provides credit-support mechanisms for the benefit of farmers, fisherfolk, rural workers, cooperatives, retailers, wholesalers and agricultural processors. It also implements a guarantee system to promote inventory financing of agri-agra commodities, to establish production and post-production facilities and to acquire farm and fishery equipment. Government non-financial agencies refer to regular government agencies, such as the Department of Agriculture, Department of Trade, and Department of Labour and Employment and their attached agencies that implement various directed credit programmes for the sectors they are mandated to serve.[2]

Both non-bank financial and non-financial government agencies obtain funds from the government and bilateral and multilateral donor agencies to finance their credit programmes.

Private non-bank financial institutions, on the other hand, include insurance companies, investment institutions, finance companies, lending investors, trust companies securities dealers, pawnshops, credit unions etc.[3]

The banking system is composed of the commercial banking system (universal and ordinary commercial banks), the thrift banking system (savings and mortgage banks, private development banks and stock saving and loans associations), the rural banking system, and government banks.[4] These different bank categories are authorized to perform different functions (table 1). Understandably, they have different minimum capital requirements commensurate to their authorized functions, i.e., those that are authorized to have more functions have higher minimum capital requirements than those that have limited functions (table 2). Among the different bank categories, the universal banks are allowed to perform the most number of functions (both commercial and investment functions). At the other end of the spectrum are the rural banks, which are authorized to perform a limited number of functions.

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[2] Lamberte and others (1998) found that 13 non-financial government agencies have implemented or managed at least 37 special or directed credit programmes that were mostly inefficient and ineffective.

[3] Although credit unions are financial intermediaries that mobilize and lend money to their members, they are not considered part of the banking system.

[4] The rural banking system includes the rural cooperative banks.

Table 1. Authorized activities of various bank categories

Authorized activities	*Commercial banks*		*Thrift banks*	*Rural banks*
	Universal	*Ordinary*		
A. Commercial banking services				
1. Accept deposits	1	1	1	1
2. Issue LCs and accept drafts	1	1	1[a]	11[a]
3. Discounting of promissory notes and commercial papers	1	1	1	1
4. Foreign exchange transactions	1	1	11	*
5. Lend money against security	1	1	1	1
B. Nationwide branching operations	1	1	1	1
C. Equity investments in allied undertakings	11	11	11	11
D. Equity investments in non-allied undertakings	1	*	*	*
E. Trust operation	11	11	11	11
F. Issue real estate and chattel mortgage, bonds buy and sell these for its own account, accept/ receive in payment or as amortization of loan	1	1	1	1
G. Direct borrowing with Central Bank	1	1	1	1
H. Activities of investment houses				
1. Securities underwriting	1	*	*	*
2. Syndication activities	1	1	1	1
3. Business development and project implementation	1	1	1	1
4. Financial consultancy and investment	1	1	1	1
5. Mergers and consolidation	1	1	1	1
6. Research and studies	1	1	1	1
7. Lease real and/or personal properties	*	*	*	*
Money market operation	1	1	*	*

Source: Lamberte, Mario B., 1992. *"Assessment of the Financial Market Reforms in the Philippines 1980-1992".*

1– Authorized activities
11– Authorized but subject to Monetary Board Approval
*– Not authorized/prohibited
[a] Limited only to domestic letters of credit and drafts.

As of December 2000, there were 16,676 offices (head offices, branches and extension offices) of the financial institutions in the country (table 3). Of these, some 45 per cent were offices of the banking institutions. Over 50 per cent of the banking offices of commercial banks are concentrated in Metro Manila, while most banking offices of thrift and rural banks are located in areas outside Metro Manila. The offices of rural banks are widely dispersed in rural areas.

In terms of assets, the banking system overwhelmingly dominates the financial system. Its total assets as of December 2000 amounted to P3.3 trillion or 82 per cent of

Table 2. Minimum level of capitalization for new entrants as of August 2000

Bank category	*Minimum capital (in millions of pesos)*
Expanded commercial banks (universal banks)	4 950.0
Non-expanded commercial banks (ordinary commercial banks)	2 400.0
Thrift banks	
With head office within Metro Manila	325.0
With head office outside Metro Manila	52.0
Rural banks	
Within Metro Manila	26.0
Cities of Cebu and Davao	13.0
1st/2nd/3rd class cities and 1st class municipalities	6.6
4th/5th/6th class cities and 2nd/3rd/4th class municipalities	3.9
5th and 6th class municipalities	2.6

Source: Circular No. 257, Bangko Sentral ng Pilipinas, 15 August 2000.

Table 3. Total resources and offices of the financial system, 2000

Type	*Resources amount (PB)*	*Per cent*	*Offices*	
			Number	*Per cent*
A. Banking institutions	3 326.80	81.83	7 553	45.29
1. Commercial banks	3 013.60	74.12	4 250	25.49
2. Thrift banks	245.80	6.05	1 391	8.34
3. Rural banks	67.40	1.66	1 912	11.47
B. Non-banks	738.80	18.17	9 123	54.71
Total	4 065.60	100.00	16 676	100.00

Source: Bangko Sentral ng Pilipinas.

the total assets of the financial system. The total assets of the commercial banking system stood at P3 trillion or 74 per cent of the total assets of the financial system.

Going back to figure 1, this chapter will focus only on the banking system, which is only a part of the Philippine financial system that provides financial services to MicSMEs and poor households.

B. EXISTING POLICY FRAMEWORK AND PROGRAMMES FOR BANK LENDING

This section discusses the government's operational definition of MicSMEs and poor households and the elements of the policy framework and programmes for bank lending to MicSMEs and poor households.

1. Operational definition

It is important for policy direction and for evaluating the effectiveness of policies and programmes to have a common definition of MicSMEs and poor households. When dealing with farm enterprises, the Comprehensive Agricultural Reform Law provides an operational definition of what constitutes small farm enterprises. Since the retention limit for agricultural lands is seven hectares, then small farm enterprises refer to those who own and farm seven hectares or less. As regards MicSMEs, Section 3 of the Magna Carta for Small Enterprises (Republic Act No. 6977 as amended by Republic Act No. 8289) provides an operational definition. It states that "small and medium enterprise" shall be defined as any business activity or enterprise engaged in industry, agribusiness and/or services, whether single proprietorship, cooperative, partnership or corporation whose total assets, inclusive of those arising from loans, but exclusive of the land on which the particular business entity's office, plant and equipment are situated, must have value falling under the following categories:

Micro:	less than	1,500,001	Philippine pesos
Small:	1,500,001	15,000,000	Philippine pesos
Medium:	15,000,001	100,000,000	Philippine pesos[5]

The same law authorizes the Small and Medium Enterprise Development Council to periodically review the above definitions and, if necessary, adjust them upon the recommendations of sectoral organizations taking into account inflation and other economic indicators.[6]

In the context of the Social Reform and Poverty Alleviation Act of 1997 (Republic Act 8425), the poor households refer to the "basic sectors", which include the disadvantaged sectors of the Philippine society, namely: farmer-peasant, artisanal fisherfolk (i.e., municipal, small-scale or subsistence fishermen who use fishing gears which do not require boats or which only require a boat of less than 3 tons), workers in the formal sector and migrant workers, workers in the informal sector, indigenous peoples and cultural communities, women, differently-abled persons, senior citizens, victims of calamities and disasters, youth and students, children, and urban poor. It also defines micro-enterprise, which is any economic enterprise with a capital of 150,000 Philippine pesos and below. This does not necessarily conflict with the definition provided under the Magna Carta for Small Enterprises because the latter defines micro-enterprise in terms of assets inclusive of those arising from loans, whereas the former defines micro-enterprise in terms of capital.

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[5] The exchange rate as of 16 November 2001 was 52 Philippine pesos to 1 US dollar.

[6] When Republic Act 6977 was passed in 1991, the definitions were as follows: micro – less than P50,000; cottage – P50,001 to P500,000; small – P500,001 to P5,000,000; and medium – P5,000,001 to P20,000,000.

2. Elements of the policy framework and programmes

(a) Banking structure

Banks have the natural tendency to be large in order to exploit economies of scale and scope. In the process, they tend to shy away from small savers and borrowers because of the high transaction costs they will incur and lack of related businesses they can generate with them. Thus, a banking system that consists of a few large banks will likely force small savers and borrowers to go to the informal financial system. Recognizing this possible consequence, the Philippine authorities have structured a banking system that includes a subsystem that will cater to the needs of small savers and borrowers. The thrift banks and rural banks are expected to perform such functions. Since most small savers and borrowers are located in areas outside Metro Manila, the Central Bank encourages thrift and rural banks to locate in those areas by requiring only low minimum capital requirements.

To improve the viability and competitiveness of thrift and rural banks that cater mainly to MicSMEs and poor households, the government has provided several incentives. One is that the reserve requirement ratio of their deposits is lower by 2 percentage points than that of commercial banks. Another is that they are exempt from the payment of all taxes, fees and charges of whatever nature and description, except the corporate income tax and local taxes, fees and charges, for a period of five years from the date of commencement of operations. These incentives enable thrift and rural banks to give higher interest rates on their deposits and lower interest rates on loans and, at the same time, to build up their capital.

(b) Microfinance-friendly policy and banking regulations

The Social Reform and Poverty Alleviation Act provides the policy framework for microfinance services for the poor. More specifically, it sets out the following thrusts:

(a) Development of a policy environment, especially in the area of savings generation, supportive of basic sector initiatives dedicated to serving the needs of the poor in terms of microfinance services;

(b) Rationalization of existing government programmes for credit and guarantees;

(c) Utilization of existing government financial entities for the provision of microfinance products and services for the poor;

(d) Promotion of mechanisms necessary for the implementation of microfinance services, including indigenous microfinance practices.

One of the lessons of the East Asian financial crisis is that banks must be well-regulated and adequately supervised. However, new prudential regulations, if applied uniformly to all types of banks, could further force banks to ration out small borrowers. Thus, the newly passed General Banking Act tries to achieve a balance between the objectives of tightening up prudential regulations and ensuring the flow of financial services to MicSMEs and poor households. This law includes three provisions that touch on microfinance, especially on issues regarding collateral-based lending, unsecured loans, interest to be paid by microfinance borrowers and amortization on loans. In view of the substantial increase in the non-performing loans in the wake of the East Asian financial crisis, a significant portion of which were unsecured, the new law encourages banks to demand from their credit applicants a statement of assets and liabilities and of income and expenditures and other information. Obviously, microfinance borrowers cannot meet such a requirement. Thus, the law exempts them from this regulation and instead encourages banks to lend to them not on the basis of a collateral they can present but on the basis of their cash flows. As regards interest rate, the Central Bank has issued a circular that clearly spells out the policy that the "interest rate shall not be lower than the prevailing market rates to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending". This runs counter to the previous policy that promoted a below-market rate of interest for loans to MicSMEs and poor households.

Banks normally require payment on their loans either on a monthly, quarterly or annual basis. In the microfinance market, however, borrowers usually borrow small amounts and are given a more flexible amortization schedule that reflects their cash flow. Thus, the Central Bank is given authority by the law to formulate more flexible guidelines in so far as loan amortization is concerned. The new guidelines issued by the Central Bank allow microfinance loans to be amortized on a daily, weekly, bi-monthly or monthly basis, depending on the cash flow conditions of borrowers. The Central Bank has issued the "Notes on Microfinance" to guide banks in implementing the new policy on microfinance (see annex).

The existence of adequate banking offices in all areas in the country can improve the access of MicSMEs and poor households to banking services. Beginning in 1989, the Central Bank relaxed the regulation on bank entry and branching. This led to the proliferation of banks and branches in the country. Many of these banks became in distress in the aftermath of the East Asian financial crisis and the El Niño weather phenomenon that struck in 1998. Thus, the Central Bank has declared a moratorium on the opening of new banks and has encouraged merger or consolidation to strengthen their financial position. However, to ensure that microfinance services will not diminish, the Central Bank recently approved a partial lifting of the general moratorium on the licensing of new thrift and rural banks to allow the entry of microfinance-oriented banks. A rural bank to be established as a microfinance bank is required to have a minimum paid-in capital of 5 million Philippine pesos while the existing capitalization requirement for thrift banks applies (see table 2).

(c) Loan portfolio regulations

Loan portfolio regulations pertain to those regulations that require banks to allocate a certain proportion of their loanable funds to specific sectors of the economy. There are three existing regulations. First is the deposit retention scheme. Under this scheme, at least 75 per cent of the total deposits, net of required reserves against deposit liabilities and total amount of cash in vault, accumulated by branches, agencies, extension officers, units and/or head offices of specialized government banks, in a particular regional grouping outside the National Capital Region, must be invested as a means to develop that region. This policy is used to deal with the problem of fund diversion, that is, banks with a nationwide branch network mobilizing deposits in rural areas where most of the MicSMEs and poor households can be found and lending them to large enterprises in urban areas, more specifically, Metro Manila. This is detrimental to the development of MicSMEs and poor households in rural areas because they are denied badly needed funds. For purposes of this regulation, the country used to be divided into 13 regions. Commercial banks were against this policy because they could hardly find borrowers in rural areas that would pass their credit criteria. As a result, they were discouraged from intensively mobilizing deposits. Borrowers and savers ultimately borne the cost of this regulation in terms of higher interest rates on loans and lower interest rates on deposits. Thus, in 1990, this regulation was relaxed by reducing the number of regional groupings from 13 to 3, which gives banks greater scope for diversifying their loan portfolio and sources of funds, at least geographically.

The second loan portfolio regulation is Presidential Decree No. 717, otherwise known as the "agri/agra law", that mandates all banking institutions to set aside 25 per cent of their net incremental loanable funds for agricultural lending, 10 per cent of which is to be lent to agrarian reform beneficiaries and 15 per cent for general agricultural lending. Commercial and thrift banks have not found difficulty in complying with the latter because there is a good number of credit-worthy agribusiness corporations, such as plantation farms, some of which are domestic corporate giants and multinational firms. In contrast, they have difficulty in complying with the former simply because their operations are not structured to provide small loans to the widely dispersed agrarian reform beneficiaries. In other words, they face severe information asymmetry problems when it comes to lending to agrarian reform beneficiaries. Worse, the number of agrarian reform beneficiaries has not grown much in recent years owing to the delay in the implementation of the comprehensive land reform programme while deposits of banks have grown tremendously. This has complicated further the problems faced by commercial and thrift banks in complying with this requirement. However, the government has provided banks with alternative instruments for complying with the law, such as investing in government securities declared eligible by the Central Bank for the compliance of the law. Examples are the Pag-IBIG Bonds, the proceeds of which will be used by the government for low-cost housing projects; investment by banks in the authorized capital stock of QUEDANCOR or loans extended by banks to farmers, fishermen, cooperatives, rural workers and rural enterprises covered by guarantees of QUEDANCOR; investment by banks in NDC Agri-Agra ERAP Bonds, the proceeds of which are going to be used exclusively for the development of the agriculture and agrarian sectors and in priority development projects to these sectors identified by the National Development Company, Department of Agrarian Reform, and the Department of Agriculture; and investment by banks in Special Purpose Treasury Bonds to finance the comprehensive agrarian reform programme-related expenditures. The Central Bank has recently increased the penalties for non-compliance/under-compliance of the law.

The third loan portfolio regulation is the mandatory credit to small enterprises as provided for under Republic Act 6977, otherwise known as the Magna Carta for

Small Entrprises. Under this law, all lending institutions were mandated to lend at least 10 per cent of their total loan portfolio to small enterprises. This requirement was tiered and was time bound: 5 per cent of the total loan portfolio by the end of 1991 to rise to 10 per cent by the end of 1992 through 1995 and to decline to 5 per cent by the end of 1996 and zero by the end of the seventh year. As expected by many, the law was amended in the seventh year (Republic Act 8289). Thus, for a period of 10 years after the introduction of the law, all lending institutions were required to set aside at least 6 per cent and at least 2 per cent for small and medium-sized enterprises, respectively, of their total loan portfolio and to make it available for small and medium-sized enterprises credit. Only instruments issued by the Small Business Guarantee and Credit Corporation which do not pay market rates and non-interest bearing deposits with the Central Bank are deemed alternative compliance to the this loan portfolio regulation.

(d) Direct participation by the government in the banking system

The government directly participates in the provision of financial services to MicSMEs and poor households through its banking institutions. It currently maintains two banks that perform special functions. These are the Development Bank of the Philippines and the Land Bank of the Philippines.[7] These banks lend to MicSMEs and poor households including farmers and land reform beneficiaries either directly through their retail lending windows or indirectly through their wholesale lending in windows. Because they have been largely used by the government as instruments for increasing the access of MicSMEs and poor households to financial services, we will describe them in length here.[8]

Development Bank of the Philippines

Charter/legal mandate. The Development Bank of the Philippines was created by Republic Act No. 85 in 1947 primarily to provide credit facilities for the rehabilitation, development and expansion of agriculture and industry, the broadening and diversification of the national economy, and to promote the establishment of private development banks in the countryside. Executive Order 81 issued on 3 December 1986 revised the bank's charter giving it a new development mandate. Under this new charter, the bank's principal objective is to provide banking services particularly to meet the medium- and long-term financing needs of small and medium-scale agricultural and industrial enterprises. The bank's orientation has similarly been changed to that of a primarily wholesale bank with a significant retail presence. Guided by its new mandate, the Development Bank's priority areas for financing include export promotion, new entrepreneurs and infrastructure, including loans for local government units.

On 20 December 1995, the Central Bank of the Philippines granted the Development Bank of the Philippines a permit to operate as an expanded commercial bank. As an expanded commercial bank, the Development Bank currently offers the following products and services to its clients: (a) deposit products and services; (b) fund transfer

[7] A third bank, the Philippine National Bank, has been privatized.

[8] This draws on Lamberte and others (1997 and 1998).

services including the provision of telegraphic transfer services and acceptance of PLDT/SSS/BIR payments; (c) fund management services including government securities dealerships and servicing of foreign currency remittances; (d) trust products and services including dealership of blue chips and trusteeship of asset-backed securities; (e) merchant banking services including underwriting and loan syndications; (f) wholesale lending services; (g) retail lending services; (h) export financing; and (i) guarantee services. At present, the Development Bank of the Philippines has five regional offices and 70 branches nationwide.

Major policies/strategies. The Development Bank of the Philippines was restructured into a predominantly wholesale bank in 1990 following the recommendations of a study conducted under the World Bank Financial Sector Adjustment Loan in 1987. Participating financial institutions were tapped as conduits of the bank's wholesale funds.

In order not to share the same market segment and avoid competition, wholesale and retail banking operations have been distinctly separated, such that wholesale resources are not employed to fund retail activities. Likewise, both operations are also administered separately by two different groups in the bank. The major functional departments of the retail banking operation are the Institutional Banking Group, the Branch Credit Group and branches, and the Window III group. Wholesale banking, on the other hand, is handled by the Wholesale Banking Group and is still considered centralized.

The Development Bank of the Philippines maintains three lending modes or windows as part of its retail lending services. Window I caters to short-term working capital needs with maturities of up to 18 months. The bank's internal funds are usually used for this purpose. Window II finances the acquisition of fixed assets and permanent working capital with repayment terms of up to five years. Lastly, Window III assists activities which have catalytic effects on the country's economic development. Loans under this window are for infrastructure, fixed asset acquisition and/or working capital with repayment periods of more than five years. This window is considered the centerpiece of the bank's retail lending operations that support the government's Social Reform Agenda. Most of the programmes under Window III are implemented in cooperation with government line agencies, such as the Department of Science and Technology, Department of Agriculture and Department of Agrarian Reform, and Congress. Eligible borrowers under Window III social programmes, in general, include cooperatives, associations, and non-government or private institutions engaged in developmental activities. The Development Bank is mandated to maintain at least 20 per cent of its loan portfolio for Window III. Thirty per cent of the net income of the bank after tax is used to fund this window. There are also domestic sources of funds, for example the Social Security System. Window III accounts comprised about 18 per cent of its outstanding loan portfolio.

Special credit programmes implemented. The Development Bank of the Philippines currently administers 19 special credit programmes that are financed by foreign or domestic borrowings and special funds. These are apart from those that they administer for government line agencies. Of the 19 programmes, 10 fall under its wholesale lending operations and use the participating financial institutions as conduits of funds. The remaining nine programmes are implemented as part of its retail operations and cater directly to end-borrowers.

Land Bank of the Philippines

Charter/mandate. The Land Bank of the Philippines was established on 8 August 1963 as a government-owned financial institution by virtue of Republic Act 3844, otherwise known as the Agricultural Land Reform Code. The Land Bank was primarily mandated to serve as the financial arm of the land reform programme that advances payments to landowners and collects amortization from farmer beneficiaries. In 1973, the Land Bank was given a comprehensive commercial or universal banking status through a presidential decree. It then established its commercial banking arm to cater to agribusiness projects and rural industries.

With the enactment of Republic Act 6657 or the Comprehensive Agrarian Reform Law in 1988, the Land Bank expanded its agrarian operations as the law covered all agricultural lands, both private and public, regardless of tenurial arrangement or commodity produced. Cooperatives emerged as the main conduit of the Land Bank's support to agrarian reform beneficiaries.

Until it was given a new charter under Republic Act 7907 on 23 February 1995, the Land Bank utilized a structure that tried to balance its universal banking and countryside development mission through a unique combination of branches and field offices that are scattered throughout the archipelago. Its branch network handled commercial banking while its field offices were in charge of its developmental or agrarian reform functions. The profits derived from its commercial banking operations finance development initiatives that benefit small farmers, fisherfolk and other countryside-based small and medium-sized entrepreneurs. However, under its new charter wherein the Land Bank was authorized to pursue a developmental approach in banking, it implemented the Unified Systems Project. While the balancing act remains, the United States Project merged the field banking and agrarian operations and placed them under one roof in order to operate as a one-stop-shop. The Project was meant to enable the Land Bank to cut down on operating expenses and ensure a more efficient delivery of services. Moreover, this was intended to provide more convenience to clients and enable the bank to undertake more ambitious projects for the development of the rural areas and ensure food security for the country.

Major programmes and lending strategies. In its bid to address all aspects of progress, the Land Bank implements the Total Development Option-Unified Land Bank Approach to Development or TODO-UNLAD programme. TODO-UNLAD links cooperatives, farmers' cooperatives, private companies, rural banks, non-government organizations and local government units in specific areas around an integrated area development project through the Land Bank's various lending programmes and support services. Each project under the programme entails linking producers to markets and processors as well as strengthening cooperatives and local government units.

TODO-UNLAD prioritizes communities covered by the Comprehensive Agrarian Reform Programme and communities belonging to the 20 priority provinces identified under the Social Reform Agenda. Qualified for financing are farm production, farm-to-market roads, rural electrification, telecommunication systems, processing and post-harvest facilities, among others.

The Land Bank has access to various bilateral and multilateral institutions for special credit facilities whose target beneficiaries belong to the priority sectors: farmers and fisherfolk cooperatives, local government units, small and medium-sized enterprises, agrarian reform beneficiaries and micro-enterprises. Through these financing programmes, the Land Bank strives to address the country's need for long-term loans, dispersal of economic activity, infrastructure and support for agrarian reform beneficiaries. The Land Bank's international partners include the World Bank, the ADB, Overseas Economic Cooperation Fund and Kreditanstalt fur Wiederaufbau of Germany.

The Land Bank of the Philippines also provides support to SMEs. In 1996 it launched six new credit programmes for SMEs, foremost of which are the "Negosyo Mo, Susuportahan Ko" and the "Todo Kaya: Isulong ang Pagsulong" even as it remained a preferred conduit of the Social Security System and the Development Bank of the Philippines in their SME financing.

The Land Bank of the Philippines continues to tap rural banks as conduits in its credit delivery. It is in fact the major institution which rehabilitated the rural banks through various capital infusion and rediscounting programmes.

The Land Bank also attempts to immediately respond to the emergency requirements of the agricultural/agrarian sector. For instance, it launched PROGRESS or its Programme for Grains Productivity Enhancement and other Support Services in response to the rice crisis that hit the country in 1995. This programme makes available appropriate financing schemes to increase rice and corn production while ensuring the profitability of farmers' cooperatives. PROGRESS integrates all aspects of farm operation from crop production, storage and milling up to marketing. Through the programme, the Land Bank finances the production of certified seeds, the provision of communal irrigation systems, the acquisition of post-harvest facilities, and the extension of marketing assistance.

Special credit programmes implemented. The Land Bank currently implements 13 special credit programmes. Nine of these are funded by foreign loans while the rest are supported by domestically-sourced special funds. This count excludes those being administered by the bank for government line agencies.

C. CURRENT STATUS OF BANK LENDING

This section presents an overview of the compliance of banks with loan portfolio regulations, specifically those that pertain to the "agri-agra" law and the Magna Carta for Small Business, and the status of lending by various types of banks to MicSMEs and poor households.

1. Overview of the banks' compliance with loan portfolio regulations

Private commercial banks usually cater to large and upper medium-sized enterprises. The loans they book under the agri-agra law include loans they extend to large agri-business corporations and plantation farms and investments in substitute instruments for complying with the law. Thus, it cannot be said that commercial banks are directly lending to small farmers.

As regards lending to MicSMEs under the Magna Carta for Small enterprises, the Central Bank is required to submit a quarterly report to the Small and Medium Enterprise Development Council with respect to the banks' compliance with the law. Table 4 shows that the banking system as a whole has greatly exceeded the minimum loan requirement for both small and medium-sized enterprises. As of June 2001, 93 per cent of the total credit allocation for SMEs was directly lent by banks to such enterprises. The bulk of the loans to MicSMEs came from commercial banks (table 5).

Table 4. Distribution of credit allocation for small and medium-sized enterprise credit (in billion of pesos)

	Small enterprise – 6 per cent				*Medium-sized enterprise – 2 per cent*			
	June 2001		*March 2001*		*June 2001*		*March 2001*	
	Amount	*Per cent to total*	*Amount*	*Per cent to total*	*Amount*	*Per cent to total*	*Amount*	*Per cent to total*
Direct compliance	137.0	93.1	117.7	92.1	84.4	93.4	95.6	94.7
Indirect compliance	4.2	2.8	4.6	3.6	3.9	4.3	3.6	3.6
Funds set aside:	6.0	4.1	5.5	4.3	2.1	2.3	1.8	1.8
Cash on hand	0.6	0.4	0.5	0.4	0.3	0.3	0.2	0.2
Due from Central Bank	5.4	3.7	5.0	3.9	1.8	2.0	1.6	1.6
Total credit allocation	147.2	100.0	127.8	100.0	90.4	100.0	101.0	100.0
Net loan portfolio	962.1		1 007.5		962.1		1 007.5	
Minimum amount required to set aside	57.7		60.4		19.2		20.1	
Excess (deficiency)	89.5		67.4		71.2		80.9	
Rate of compliance	15.3		12.7		9.4		10.0	

Source: Small and Medium Enterprises Development Council.

The data, however, hide a few things. One is that foreign banks and large domestic banks, which are predominantly wholesale banks, comply with the requirement mainly by depositing the required amount with the Central Bank, rather than by looking for small and medium-sized enterprises as borrowers. Another is that several rural banks did not submit any report to the Central Bank. A major reason is that these banks can

Table 6. People's Credit and Finance Corporation Summary of performance

	For the year 1999	*As of 31 December 1999*	*For the year 2000*	*As of 31 December 2000*
Loans granted (PM)	775 578	1 661.3	693.6	2 564.1
Loans outstanding (PM)		769.7		
Current		756.0		
Past due		12.1		
Restructured		1.6		
Repayment rate (%)		98.5		
Past due ratio (%)		1.6		
No. of borrowers/no. of loans	105 084	217 239	106 869	324 108
No. of programme partners	49	143	35	178
Non-governmental organizations	6	24	3	27
Cooperatives	17	42	14	56
Rural banks	20	51	15	66
Cooperative banks	5	23	1	24
Thrift banks		2	2	4
Lending investors	1	1		1

Source: People's Credit and Finance Corporation.

hardly find medium-sized enterprises in the small towns where they operate. Thus, they find it better to pay the fines rather than set aside non-income generating funds for lending to medium-sized enterprises.

2. Government banks

As already mentioned above, the government has utilized the Development Bank of the Philippines and the Land Bank of the Philippines as instruments for providing financial services to MicSMEs and poor households. For 2000, the Development Bank granted short- and long-term loans to SMEs amounting to almost 22 billion Philippine pesos. The outstanding exposure of the Development Bank to SMEs stood by year-end at 17 billion Philippine pesos for both wholesale and various retail lending programmes through its 77 branches across the country. Under Window III, which finances innovative and socially desirable projects with a high development impact, the total loan outstanding reached 1.72 billion Philippine pesos. All this comprises only 17 per cent of the total loan portfolio of the Development Bank because it also provides large loans to private enterprises for large projects, such as infrastructure projects, acquisition of modern technologies, transport and telecommunications.

The Land Bank of the Philippines extends financial services to its clients through its 300 branches distributed across the country. Its outstanding loans to small farmers and fisherfolk stood at 13.5 billion Philippine pesos as of the end of 2000. Loans for this sector were released through 1,797 cooperatives and 464 countryside financial institutions (rural banks, cooperative banks, thrift banks) which serve as the Land Bank's channels of credit to farmers and fisherfolk. Its outstanding loans to MicSMEs for the same period reached 12.3 billion Philippine pesos. Seventy per cent were directly lent by the Land Bank to SMEs and the remaining through some of its programmes that either use wholesale or retail lending.

The Land Bank has a subsidiary – People's Credit and Finance Corporation – that specializes in microcredit with loans ranging from 5,000 to 10,000 Philippine pesos. It works closely with NGOs and microfinance institutions to implement its programme. As of December 2000, it had already granted a total of 2.6 million Philippine pesos loans to 324,108 borrowers with a very good repayment rate (table 6).

Table 6. People's Credit and Finance Corporation
Summary of performance

	For the year 1999	*As of 31 December 1999*	*For the year 2000*	*As of 31 December 2000*
Loans granted (PM)	775 578	1 661.3	693.6	2 564.1
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Rural banks	20	51	15	66
Cooperative banks	5	23	1	24
Thrift banks		2	2	4
Lending investors	1	1		1

Source: People's Credit and Finance Corporation.

3. Thrift banking system

The thrift banking system provides production and commercial loans to SMEs, mortgage loans to households and other retail financial services to small savers and borrowers. Some large commercial banks that want their presence to be felt in the retail market have established wholly owned thrift banks. Thrift banks have a lower cost structure than commercial banks. Therefore, they can accommodate small deposits and loans more efficiently than commercial banks. Under this setting, large commercial banks indirectly provide financial services to small savers and borrowers through their subsidiary thrift banks. Presently, the country's thrift banking system consists of independent thrift banks and subsidiaries of commercial banks.

Table 7 shows that thrift bank loans granted and outstanding in both nominal and real terms had been rising up until the East Asian financial crisis. As of 1998 when the most recent published data became available, loans granted in nominal terms reached 342 billion Philippine pesos, while loans outstanding in nominal terms stood at 104 billion Philippine pesos. About half of these loans are short term for the purpose of

Table 7. Loans granted and outstanding of thrift banks (in millions of pesos)

Table 7

Year	*Loans granted*		*Loans outstanding*	
	Nominal	*Real**	*Nominal*	*Real*
1990	65 069.8	135 115.9	17 842.8	37 050.2
1991	65 585.6	114 773.4	24 646.8	43 131.4
1992	124 919.5	200 653.2	25 440.5	40 864.1
1993	180 843.5	269 942.6	36 461.5	54 425.6
1994	252 235.3	345 310.1	70 391.0	96 365.3
1995	338 479.4	428 921.7	69 590.9	88 185.7
1996	342 589.9	398 249.7	92 893.1	107 985.2
1997	467 615.3	513 089.9	110 478.3	121 222.1
1998	341 510.5	341 510.5	104 616.2	104 616.2

Source: Bangko Sentral ng Pilipinas.

Note: CPI Base Year: 1998 = 1.00.

financing the working capital of MicSMEs. There is no information on the number of borrowers; hence, it is not possible to estimate the average size of loans they grant. However, personal interviews conducted among a few thrift banks in Metro Manila indicate that their minimum loan size ranges from 20,000 to 100,000 Philippine pesos and the maximum loan sizes from 5 million to 10 million Philippine pesos. Most thrift banks have branches operating within a certain region. However, a few large thrift banks have nationwide branch networks.

4. Rural banking system

The rural banking system truly caters to small savers and borrowers. In 1998, it granted more than one million loans to farmers, fisherfolk, and small non-farm enterprises (table 8). The rural banking system's average loan size rose from 4,600 Philippine pesos in real terms in 1980 to 15,000 in 1995, and thereafter tapered off reaching 11,000 in 1998.[9] In nominal terms, the system's average loan size amounted to 28,000 Philippine pesos or $684 in 1998, which was well below the 150,000 Philippine pesos loan ceiling for micro-enterprises under the Social Reform and Poverty Alleviation Act. At present, rural banks grant loans as low as 10,000 Philippine pesos, which is approximately $200 per borrower.

Aside from increasing geographical diversification, rural banks have been increasingly diversifying their loan portfolio across major economic activities. In the 1980s, rural bank loans were mostly concentrated in the agricultural sector (table 9). This is understandable because rural banks were merely serving as conduits of government funds, most of which were directed to the agricultural sector. In addition, a large chunk of their loan portfolio was supposed to be for the agricultural sector. Over

[9] The figures for 1997 are not comparable with those of other years because they include non-supervised credits only.

Table 8. Total loans granted by rural banks

Year	No. of loans	Amount (in millions of pesos)	Average loan size (in thousands of pesos)		Exchange rate (P/US $) (Period average)
			Nominal	Real	
1980	923 229	3 775	4.09	4.63	7.51
1981	942 671	4 389	4.66	5.13	7.90
1982	947 201	5 204	5.49	6.04	8.54
1983	895 065	5 721	6.39	9.61	11.11
1984	666 001	4 429	6.65	9.17	16.70
1985	519 230	3 891	7.49	8.37	18.61
1986	498 818	4 467	8.95	10.05	20.39
1987	531 997	5 650	10.62	11.57	20.57
1988	558 807	6 516	11.66	11.66	21.09
1989	739 257	9 884	13.37	11.92	21.74
1990	684 991	9 349	13.65	10.65	24.31
1991	537 788	10 519	19.56	12.87	27.48
1992	564 939	12 708	22.50	13.58	25.51
1993	747 759	18 548	24.81	13.92	27.12
1994	505 880	15 187	30.02	15.45	26.42
1995	892 303	27 770	31.12	14.82	25.71
1996	1 138 791	35 944	31.56	13.86	26.22
1997	300 923	18 743	62.28	26.05	29.47
1998	1 368 063	38 291	27.99	10.74	40.90

Source: Bangko Sentral ng Pilipinas.

Notes: CPI Base Year: 1988 = 1.00.
1997 data consist of non-supervised credits only.

the years, however, rural banks have been able to reduce their exposure to agriculture in relative terms, and to increase the shares of other economic activities, such as commercial and industrial, in rural areas. Thus, the share of agricultural loans in the total loan portfolio of rural banks went down from 89 per cent in 1980 to 46 per cent in 1998. In contrast, the shares of commercial, industrial and other loans increased from 6.1 per cent, 2.5 per cent and 2.3 per cent, respectively, in 1980 to 16.7 per cent, 5.9 per cent and 31.3 per cent, respectively, in 1998. This suggests two things. One is that there are some people in rural areas who are engaged in viable non-farm activities needing financial services from banks. Second, if left to themselves, rural banks will find a way of diversifying their loan portfolio as ordinary banks do to manage risks in lending.

There has also been a substantial change in the way rural banks finance their lending operations over the years. In 1980, deposits comprised only 43 per cent of their total liabilities (table 10). A big chunk of their liabilities comprised borrowings from the Central Bank and other special credit programmes of the government. The radical change in rediscounting and interest rate policies in the mid-1980s has encouraged banks to mobilize deposits and to rely less on the rediscounting window of the Central

Table 9. Distribution of loans of the rural banking system by purpose (in millions of pesos)

Year	Total	Agricultural		Commercial		Industrial		Other loans	
		Amount	Per cent share	Amount	Per cent share	Amount	Per cent share	Amount	Per cent share
1980	4 762.7	4 241.2	89.05	291.2	6.11	120.5	2.53	109.8	2.31
1981	5 488.1	4 876.6	88.86	269.8	4.92	147.6	2.69	194.1	3.54
1982	6 669.0	5 770.7	86.53	383.8	5.75	208.9	3.13	305.6	4.58
1983	7 648.0	6 514.9	85.18	484.6	6.34	226.8	2.97	421.7	5.51
1984	7 022.5	6 039.7	86.00	444.0	6.32	197.1	2.81	341.7	4.87
1985	6 636.3	5 555.7	83.72	449.0	6.77	160.5	2.42	471.1	7.10
1986	6 790.5	5 471.7	80.58	566.6	8.34	187.7	2.76	564.5	8.31
1987	7 227.0	5 504.0	76.16	712.8	9.86	219.3	3.03	790.9	10.94
1988	7 970.2	5 769.6	72.39	864.0	10.84	253.4	3.18	1 083.2	13.59
1989	8 859.0	6 086.6	68.71	1 106.8	12.49	323.5	3.65	1 342.1	15.15
1990	9 735.7	6 429.1	66.04	1 274.3	13.09	358.2	3.68	1 674.1	17.20
1991	10 744.1	6 826.1	63.53	1 416.6	13.18	387.8	3.61	2 113.6	19.67
1992	12 671.1	7 855.6	62.00	1 691.9	13.35	512.2	4.04	2 611.4	20.61
1993	15 543.8	8 859.6	57.00	2 196.9	14.13	745.6	4.80	3 741.7	24.07
1994	19 135.6	10 246.0	53.54	2 805.7	14.66	978.8	5.12	5 105.1	26.68
1995	24 874.0	12 381.6	49.78	3 822.0	15.37	1 415.0	5.69	7 255.4	29.17
1996	33 403.2	15 230.2	45.60	5 530.3	16.56	1 917.4	5.74	10 725.3	32.11
1997	40 803.7	18 674.2	45.77	7 007.0	17.17	2 408.6	5.90	12 713.9	31.16
1998[1]	41 176.3	18 964.5	46.06	6 894.8	16.74	2 417.1	5.87	12 899.9	31.33

Source: Bangko Sentral ng Pilipinas.

[1] As of June 1998.

Bank. Thus, by 1998, the share of deposits in the total liabilities of rural banks rose to 74 per cent. Another way of looking at it is to take the ratio of deposits to loans, which shows the extent to which deposits have financed loans. In 1980, deposits financed 45 per cent of every peso lent by rural banks. This rose to 88 per cent in 1998.

The significant change in the structure of the sources of funds of rural banks supported loan diversification by rural banks. In this regard, it can be said that the relaxation of restrictions on the loan portfolio of rural banks and the change in the rediscounting and interest rate policies of the Central Bank were definitely a step in the right direction.

Some rural banks are now increasing their capital to strengthen their balance sheets and hence, their competitive position. Most of them can easily meet the recent increase in the minimum capital requirement. An interesting development in the last few years is the broadening in the ownership of cooperative rural banks. More specifically, cooperative rural banks are no longer exclusively owned by farmer associations, but also by other types of non-farm associations, such as market vendors. A cooperative rural bank services an average of 5,000 individual borrowers (Guanlao 1999).

Table 10. Selected balance sheet items of the rural banking system

Year	Assets		Loans		Deposits				Capital	
	Millions of pesos	*Per cent of GNP*	*Millions of pesos*	*Per cent of total assets*	*Millions of pesos*	*Per cent of total liabilities*	*Per cent of total liabilities and capital*	*Deposit to loan ratio*	*Millions of pesos*	*Total liabilities to capital accounts ratio*
1980	5 524	2.27	4 572	82.77	2 051	43.00	37.12	0.45	755	6.32
1981	6 490	2.31	5 347	82.39	2 427	43.30	37.40	0.45	884	6.34
1982	7 978	2.54	6 510	81.60	2 996	43.01	37.55	0.46	1 013	6.88
1983	9 324	2.57	7 472	80.14	3 591	44.29	38.52	0.48	1 216	6.67
1984	8 819	1.73	6 818	77.31	3 316	44.14	37.60	0.49	1 306	5.75
1985	8 822	1.59	6 636	75.22	3 019	41.69	35.10	0.45	1 360	5.32
1986	9 351	1.57	6 790	72.62	3 626	47.38	39.83	0.53	1 452	5.27
1987	9 961	1.48	7 143	71.71	4 516	55.75	46.68	0.63	1 575	5.14
1988	11 018	1.39	7 970	72.33	5 269	58.67	49.27	0.66	1 713	5.24
1989	12 522	1.37	8 659	69.15	6 254	49.94	43.25	0.72	1 939	6.46
1990	13 862	1.28	9 736	70.23	7 067	50.98	43.78	0.73	2 280	6.08
1991	15 936	1.26	10 744	67.42	8 547	53.64	45.93	0.80	2 674	5.96
1992	18 641	1.35	12 671	67.97	10 512	70.29	57.87	0.83	3 209	4.66
1993	22 667	1.51	15 544	68.58	13 422	73.49	60.57	0.86	3 893	4.69
1994	28 191	1.62	19 135	67.88	17 553	76.06	63.48	0.92	4 576	5.04
1995	36 653	1.87	24 875	67.87	23 347	76.70	64.76	0.94	5 611	5.43
1996	48 039	2.12	33 403	69.53	30 279	75.57	63.94	0.91	7 290	5.50
1997	57 635	2.28	40 804	70.80	36 667	76.08	64.51	0.90	8 644	5.58
1998	56 838	2.03	41 831	73.60	36 615	74.04	62.34	0.88	9 274	5.33
1999	61 500	1.96	–	–	–	–	–	–	–	–

Source: Bangko Sentral ng Pilipinas.

A number of rural banks have adopted variants of the Grameen Bank technology so that they can penetrate high-risk, small borrowers at very low cost. One example is CARD Rural Bank's modified Grameen Bank project. The bank's target clients are landless women rural workers who have no regular jobs and have total marketable assets of less than 50,000 Philippine pesos or a little less than $1,000. In 1997, it was able to organize 1,654 groups with a total of 9,968 members (Hossain and Diaz 1997). Access to CARD's loans, despite an effective loan rate of 44 per cent per annum, has yielded some benefits to the borrowers in terms of higher income, employment, productivity and capital accumulation. Many rural banks have also created special credit windows for salaried people in rural areas whose families are engaged in small and cottage enterprises. All this indicates that rural banks are steadily enhancing their capabilities to assess credit risks as they seek to build good relationships with their clients.

Many rural banks have shown some creativity in mobilizing deposits. For instance, they require only a minimum of 100 Philippine pesos or $2.00 to open a savings account and a modest minimum average daily balance for deposits to earn interest, which could be as low as 100 Philippine pesos.[10] They offer different types of deposits that suit the varying tastes of their clients at rates much more attractive than commercial and thrift banks. Some rural banks already offer checking accounts to their clients. Most rural banks are now aggressively campaigning for deposits through print and broadcast media by sponsoring important events in the communities or by conducting raffles, bingo etc.

Most rural banks have now automated their operations to bring down the cost of processing numerous, small transactions. The rapid decline in the cost of computer hardware and software development has become a boon to rural banks. A highly computerized rural bank can process so many small deposit and loan accounts in a very short time – a development that favour small savers and borrowers.

5. Commercial banks' credit programmes for MicSMEs

Although commercial banks mainly cater to large borrowers, they have tried to formulate innovative lending programmes to address the credit needs of small borrowers. In 1991, the commercial banks' Bankers Association of the Philippines (BAP) established the BAP Credit Guaranty Corporation funded by member contributions. Its paid-up capital is more than 100 million Philippine pesos. Legally, this corporation is considered a lending investor, not a bank. It provides loans to those who do not normally qualify for a loan under the regular loan windows of its member banks. It has greater flexibility than commercial banks because it can grant loans not on the basis of the quantity and quality of the collateral and established credit track record of borrowers, but on the basis of the viability of the projects to be funded and the potential repayment capacity of borrowers. Loans are mostly for short-term working

[10] Commercial and thrift banks usually require at least 1,000 Philippine pesos to open a savings account.

capital requirements of micro-enterprises. The minimum size of the loan is 50,000 Philippine pesos. It charges the usual commercial bank rate on its loans, which is much lower than the interest rate charged by lending investors, pawnshops and informal money lenders. Some of its borrowers have already graduated to the regular loan windows of commercial banks. To increase its outreach, the BAP Credit Guarantee Corporation has decided to go into wholesale lending by tapping existing NGOs that have a good track record in managing credit programmes.

The BAP Credit Guarantee Corporation is currently facing the problem of a lack of funds. Being classified as a lending investor, it is not allowed to mobilize deposits or to borrow from more than 19 individuals/corporations, including BAP members.

Aside from the BAP Credit Guarantee Corporation, which is a collaborative effort among commercial banks, some commercial banks came up with certain initiatives on their own to meet the credit demands of small borrowers who do not have access to their regular lending facilities. These special lending windows are funded out of their own resources, not from the special credit programmes of the government. One example is the Equitable-PCI Bank's successful lending programmes to small footwear manufacturers in Marikina, a city within Metro Manila. Another example is the Export Dragon Fund of the Rizal Commercial Banking Corporation. This facility provides loans for working capital to small exporters who have little or no hard collateral, such as real estate, to offer to banks.

D. CONSTRAINTS AND ISSUES IN BANK LENDING

The current policy environment (for example, no interest rate ceiling) is already conducive for banks to expand their services to MicSMEs and poor households. In fact, there are already signs that small banks are favourably responding to this. For instance, the number of offices of thrift and rural banks together have increased from 2,685 in 1996 to 3,285 in 2001 (June) despite the fact that many of them had failed during the same period. The recent decision of the Central Bank to exempt microfinance-oriented banks, such as thrift and rural banks, from the moratorium on the licensing of new banks supports the effort to expand financial services to MicSMEs and poor households. Recently, a microfinance-oriented bank was set up by a thrift bank jointly with foreign partners in the southern part of the Philippines. A large commercial bank followed suit by establishing a wholly-owned microfinance-oriented bank. Based on the criteria formulated by the Central Bank for giving a licence to microfinance-oriented banks, these banks are not like ordinary rural banks or thrift banks.[11]

[11] For example, Section 1.4 of the Central Bank Circular No. 273 that organizers must have the capacity to engage in microfinancing, which may be indicated by the following: (a) at least 20 per cent of the paid-in capital of the proposed bank must be owned by persons or entities with a track record in microfinancing; (b) the majority of the members of the board of directors have experience in microfinancing with at least one member having actual banking experience; and (c) the proposed bank must have, as a minimum, an adequate loan tracking system that allows daily monitoring of loan releases, collection and arrearage, and any restructuring and refinancing.

Notwithstanding this favourable policy environment, banks still face some constraints in expanding their financial services to MicSMEs and poor households. We will discuss them below and also recommend some measures to address them.

Macroeconomic instability. Lending to MicSMEs and poor households is a very risky venture, especially if lenders base their lending decisions solely on the strength of the cash flow position and character of borrowers. Instability of the economy can make those loans much riskier because cash flows can easily dry up during a sudden downturn of the economy. This can lead to the collapse of banks, especially small ones, and ultimately undermines the public's confidence in the banking system. Such confidence is not easy to restore especially if a large number of savers lose their money and otherwise good borrowers become known delinquent borrowers. The experience of the Philippines in the last 25 years clearly demonstrates this point. From 1998 to 2000 alone, 12 thrift banks and 83 rural banks were closed by the Philippine Deposit Insurance Corporation, thereby reducing the number of potential providers of financial services to MicSMEs and poor households. Indeed, a stable macroeconomic environment is conducive to the expansion of financial services to these sectors of the society.

Inadequate infrastructure. Poor infrastructure increases the cost of providing financial services to MicSMEs and poor households. In particular, some thrift and rural banks are prevented from computerizing their operations because of a lack of adequate and reliable supply of electricity in their area. They badly need to computerize their systems to be able to accurately process numerous small deposits and loans in a short time. The government, therefore, should give infrastructure improvements in rural areas high priority in its development agenda.

Regulation on deposit mobilization. The key to expanding financial services to MicSMEs and poor households is for banks to mobilize more deposits. Several studies have shown that even poor households save, and if properly compensated, they place their savings in banks. Many of them reside in areas quite far from where banks are located and transport costs are very high. Microfinance-oriented banks can mobilize more deposits at lesser cost only if they are allowed to make house-to-house visits to pick up deposits. The Central Bank, therefore, has to rethink the circular it issued in 1999 prohibiting banks from doing this (Llanto 2000).

Shortage of capital. Although small banks can mobilize more deposits, as many of them have already demonstrated, their limited capital sets a ceiling as to how much they can mobilize. There are ways of dealing with this problem. One is to encourage large commercial banks to infuse equity into small banks, such as rural banks, by including such investment as an alternative instrument for complying with the existing loan portfolio regulation so long as they remain minority stakeholders.[12] Such arrangements could pave the way for correspondent banking relationships between small and large banks in the country. This is definitely a better option than compelling large commercial banks to lend to small enterprises or to buy eligible government securities.

[12] Commercial banks seem to prefer to have a wholly-owned thrift bank.

In the case of cooperative rural banks, the expansion of their capital is constrained by the limited number of cooperatives that have the financial capability to invest in cooperative banks.[13] The Rural Banking Act must, therefore, be amended to allow cooperative rural banks to accept individual members as preferred shareholders.

The establishment of a microfinance-oriented bank by a large commercial bank is a welcome development. The Central Bank should look into the possibilities of encouraging other commercial banks to venture into the microfinance business. Perhaps, it can organize training programmes for banks to expose them to microfinance lending technologies.

Competition with government banks. It has been the policy of the government to give private financial institutions a bigger role in the provision of financial services, especially to small farm and non-farm enterprises. The role of government financial institutions, therefore, is to fill some of the gaps left by private financial institutions and provide support to them in areas where they have a comparative advantage. However, the number of offices of government banks has increased from less than 100 before 1990 to about 400 today. Because of the policy of the government to make these banks self-sufficient, they are currently intensely competing with private banks in mobilizing deposits. Although the two government banks are engaged in wholesaling, they also do retail lending, which directly competes with private banks. Unless the orientation of government banks is changed, private banks will always find a serious constraint to the expansion of their services since they will be facing undue competition from those banks.[14]

Aside from competing with government banks, private banks also compete with non-bank financial institutions, such as the Small Business Credit and Guarantee Corporation, the People's Credit and Finance Corporation and a host of special credit programmes for MicSMEs and poor households implemented by non-financial government agencies. Many of these special credit programmes have performed badly, which, if continued, could undermine the discipline needed to promote market-based microfinance institutions.

Inadequate supervision. While the Central Bank encourages private banks to engage in microfinance, it must ensure that banks that do so remain safe and sound at all times so that financial services to MicSMEs and poor households will not be disrupted because of a massive bank failure. Indeed, some banks are hesitant to venture into microfinance because the possibility that the failure of poorly managed, ill-supervised microfinance-oriented banks can undermine otherwise soundly managed microfinance-oriented banks.[15] In this regard, the Central Bank must adopt a

[13] Under the existing law, only cooperatives can own shares in cooperative rural banks.

[14] Government banks are also designated depository banks of all government agencies and corporations. Hence, they maintain a large pool of cheap deposits. See Lamberte (2000) for a proposal to reorient the Land Bank of the Philippines.

[15] This is part of the information asymmetry problem wherein bank depositors and other creditors are not able to distinguish between good and bad banks in times of severe financial distress.

risk-based supervision approach for microfinance and upgrade the capability of its staff to effectively utilize such an approach. It must also constantly fine-tune its regulatory system to discourage banks from doing regulatory arbitrage.

Loan portfolio regulations. Most rural banks and some thrift banks are not able to meet the requirement to allocate at least 2 per cent of their total loan portfolio to medium-sized enterprises, but they can easily meet the requirement to allocate at least 6 per cent of their loan portfolio to small enterprises because of the nature and size of their operation. The government should, therefore, review this law to give small banks, such as rural banks and small thrift banks, more flexibility in selecting their own clients.

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ANNEX

NOTES ON MICROFINANCE

A. Definition of microfinance

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance products to the poor and low-income households, for their micro-enterprises and small businesses, to enable them to raise their income levels and improve their living standards.

B. Core principles for microfinance

- The poor need access to appropriate financial services
- The poor have the capability to repay loans, pay the real cost of loans and generate savings
- Microfinance is an effective tool for poverty alleviation
- Microfinance institutions must aim to provide financial services to an increasing number of disadvantaged people
- Microfinance can and should be undertaken on a sustainable basis

Characteristics and features of microfinance

Characteristics	*Distinguishing features*
Type of client	• Low Income • Employment in informal sector; low wage bracket • Lack of physical collateral • Closely interlinked household/business activities
Lending technology	• Prompt approval and disbursement of micro loans • Lack of extensive loan records • Collateral substitutes; group-based guarantees • Conditional access to further micro-credits • Information-intensive character-based lending • Linked to cash flow analysis and group-based borrower selection
Loan portfolio	• Highly volatile • Risk heavily dependent on portfolio management skills
Organizational ideology	• Remote from/non-dependent on government • Cost recovery objective vs. profit maximizing
Institutional structure	• Decentralized • Insufficient external control and regulation • Capital base is quasi-equity (grants, soft loans)

- Microfinance non-governmental organizations and programmes must develop performance standards that will help define and govern the microfinance industry toward greater reach and sustainability

C. Definition of microfinance loans

Microfinancing loans are small loans granted to the basic sectors, on the basis of the borrower's cash flow and other loans granted to the poor and the low-income households for their micro-enterprises and small businesses to enable them to raise their income levels and improve their living standards. These loans are typically unsecured, but may be secured in some cases.

D. Level of microfinance loans

The average microfinance loan of a non-governmental organization microfinance institution or of a cooperative bank or credit union in the Philippine case is about 25,000 Philippine pesos. To be realistic, the maximum principal amount of a microfinance loan can be pegged at 150,000 Philippine pesos. This is equivalent to the maximum capitalization of a micro-enterprise under Republic Act 8425.

E. Collateralization of microfinance loans

A microfinance borrower is not likely to be able to borrow from a large commercial, thrift or rural bank but from a non-governmental organization microfinance institution or perhaps from a small rural or cooperative bank. Thus, microfinance loans are typically unsecured, for relatively short periods of time (180 days) with monthly (or more frequent) amortizations of interest and principal, and often featuring a joint and several guarantee of one or more persons and, certainly, seldom with tangible collateral. But in some cases, they can also be secured, depending on the capacity of the borrower to offer collaterals acceptable to the lending institution.

F. Interest on microfinance loans

Old approach

The old (and by now highly discredited as ineffective) approach to loans for low-income borrowers emphasized subsidized interest rates. It did not recognize that subsidized below-market interest rates do not necessarily result in opening up access to financial services for low-income households and micro-enterprises.

New approach

The new approach, which has been demonstrated by global experience, is characterized by a market-based interest rate regime which permits the institution providing microfinance services to cover administrative costs, provisions for loan losses and intermediation/funding costs. This basis is consistent with financially sustainable rural finance and microfinance. Invariably, the global experience continues to validate the proposition that what matters most to the poor and underserved segments is access to financial services rather than their interest-rate cost – most especially because micro-enterprise and small business borrowers will take a microfinance loan whose repayment periods match the additional cash flows they hope to generate.

Therefore, interest on such microfinancing loans should be reasonable, but should not be lower than the prevailing market rates. This is to enable the lending institution not only to recover the financial and operational costs incidental to this type of microfinance lending, but also to realize some bottom line gains.

G. Segments of demand for microcredit

(1) The landless who are engaged in agricultural work on a seasonal basis and manual labourers in forestry, mining, household industries, construction and transport require credit for consumption needs and also for acquiring small productive assets, such as livestock.

(2) Small and marginal farmers, rural artisans, weavers and those self-employed in the urban informal sector as hawkers, vendors and workers in household micro-enterprises require credit for working capital, including a small part for consumption needs. This segment largely comprises the poor but not the poorest.

(3) Medium farmers/small entrepreneurs who have gone in for commercial crops and others engaged in dairy or poultry. Among non-farm activities this segment includes those in villages and slums engaged in processing or manufacturing activity. These persons barely live above the poverty line and also suffer from inadequate access to formal credit.

VIII. BANK LOANS TO MICRO-ENTERPRISES, SMALL AND MEDIUM-SIZED ENTERPRISES AND POOR HOUSEHOLDS IN THE REPUBLIC OF KOREA

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Introduction

The economy in the Republic of Korea has achieved unprecedented growth in the last three decades. Between 1965 and 1995 per capita GNP increased from $105 to over $10,000 while the share of agriculture in GDP decreased from 38 per cent to less than 7 per cent during this period. Exports recorded a substantial increase from $0.2 billion to $125 billion.

Small and medium-sized enterprises (SMEs), and particularly new firms, have a distinct role in economic growth and in the development of innovation. Recent studies show that SMEs are at least as important as large firms in the creation of gross and net new jobs in the Organisation for Economic Co-operation and Development (OECD) area.[1] In terms of innovation, SMEs have a greater tolerance for higher-risk initiatives and the capacity to reap substantial market rewards in niche markets.[2] SME access to the formal financial sector, however, is constrained by the high risks and transaction costs associated with commercial lending to that segment of the market. The government has provided a wide variety of programmes to assist SMEs.

The international competitiveness of the Republic of Korea began to deteriorate in the early 1990s owing to amassed structural deficiencies within the economy. A major shock to the economy occurred with the bankruptcy of the Hanbo Group in January 1997. Four more of the thirty largest *chaebols* also went bankrupt in 1997. The failure of these *chaebols* revealed problems with low profitability and excessive leverage ratios in the corporate sector and faulty corporate governance in the country.

In November 1997, less than a year after its accession to OECD, the Republic of Korea experienced a severe economic and financial crisis. The government formally requested assistance from IMF to mitigate the external liquidity shortage and regain the confidence of international investors.

Since December 1997, the nation has embarked on a comprehensive programme for economic reform and recovery, which has produced fruitful results in terms of rectifying the causes of the crisis.

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[1] OECD, *Technology, Productivity and Job Creation,* vol. 2 Analytical Report, 1996.

[2] OECD, "Regulatory reform, industrial competitiveness and innovation" (DSTI/IND/STP(96)7/REV2).

SMEs were more likely than larger firms to be denied new loans during the financial crisis. Since December 1997, the government has implemented policies to strengthen support for SMEs and to overcome the economic crisis. The government has given greater attention to the "finance gaps" in SMEs and made efforts to help them overcome the credit crunch during the financial crisis.

The economic crisis has been followed by social repercussions in many dimensions: rapidly augmenting unemployment, decreasing wages and incomes, and growing absolute poverty. In the wake of the financial crisis and subsequent economic recession, the unemployment rate has shown a steep rise, from an annual average of 2.6 per cent in 1997 to a record high 8.6 per cent in February 1999. Because of income reduction, unemployment increased the size and depth of poverty. In response to the record high rates of unemployment, the government put forth a comprehensive package to resolve unemployment, which includes job preservation, general job creation, vocational training and social care.

In this chapter, bank loans to SMEs, micro-enterprises, and poor households in the Republic of Korea will be discussed.

A. ECONOMIC DEVELOPMENT AND SMEs

1. Definition of small and medium-sized enterprises

In general, a firm is classified as an SME if the number of employees in a firm does not exceed 300. More specific standards on the classification of SMEs are stipulated in Article 2 of the Framework Act on Small and Medium-sized Enterprises as follows:

Table 1. Classification of SMEs

Industry	*Small and medium-sized enterprise*		*Small enterprise*
	Employees	*Assets*	
Manufacturing	300 or fewer employees	Less than 80 billion won	50 or fewer employees
Transportation	300 or fewer employees	No standard	50 or fewer employees
Construction	300 or fewer employees	No standard	30 or fewer employees
Commerce and other services	20 or fewer employees	No standard	10 or fewer employees

Source: Framework Act on Small and Medium-sized Enterprises.

There are certain types of businesses that are classified as SMEs even though the number of employees exceeds the above standard. Some labour-intensive businesses such as leather or fabric footwear, household or sanitary ceramic products, and parts and accessories for motor vehicles and engines belong to the exceptional category.

2. Small and medium-sized enterprises in the Republic of Korea

More than 99 per cent of all businesses in the Republic of Korea were SMEs (generally, firms having fewer than 300 employees in the manufacturing sector and fewer than 20 in the service sector) at the end of 1999. In 1999 there were more than 2.7 million small businesses with fewer than 300 employees, providing employment for 82 per cent of all Koreans working in the private sector.

Table 2. Status of SMEs, 1999

(unit : unit, person, percentage)

	Total (A)		*SMEs (B)*		*Ratio (B/A)*	
	No. of establishments	*No. of employees*	*No. of establishments*	*No. of employees*	*No. of establishments*	*No. of employees*
Total	2 777 986	10 829 961	2 769 012	8 866 001	99.7	81.9
Agriculture	2 164	23 208	2 113	19 043	97.6	82.1
Fishery	865	37 674	856	35 604	99.0	94.5
Mining	2 115	21 971	2 108	17 061	99.7	77.7
Manufacturing	297 416	3 170 029	296 548	2 356 265	99.7	74.3
Gas	320	11 809	308	6 431	96.3	54.5
Construction	64 777	652 372	64 593	472 257	99.7	72.4
Wholesale and retail trade	909 205	2 345 671	907 217	2 113 979	99.8	90.1
Hotels and restaurants	601 117	1 453 198	600 415	1 398 217	99.9	96.2
Transport, storage	238 486	728 766	238 204	617 763	99.9	84.8
Communications	3 162	37 871	3 134	25 055	99.1	66.2
Finance	3 280	31 849	3 095	14 367	94.4	45.1
Real estate, renting	97 206	315 224	96 058	248 946	98.8	79.0
Education	78 598	296 584	77 409	233 344	98.5	78.7
Health and social work	52 265	379 762	51 736	245 744	99.0	64.7
Other community, social and personal service activities	249 979	502 060	249 534	472 449	99.8	94.1

Source: Small and Medium Business Administration, SME statistics, 2000.

Notes: In this table, the standard number of employees of SMEs is between 1 and 299 employees.

Table 3. The economy of the Republic of Korea

	1965	*1975*	*1985*	*1995*	*2000*
GDP ($ billion)	3.0	21.1	93.4	489.4	457.4
Per capita GNP ($)	105	592	2 229	10 823	9 628
GDP growth (real, %)	8.5	6.7	7.7	4.0	
Employment growth (%)	3.7	2.5	3.1	0.6	
Industrial (employment) Structure (%)					
Agriculture, forestry and fishery	38.0 (59.0)	27.5 (45.9)	14.1 (25.2)	6.8 (12.4)	5.1 (10.9)
Manufacturing	18.0 (9.5)	28.4 (18.7)	32.6 (23.7)	32.2 (23.5)	34.9 (20.2)
Construction and services	41.9 (31.5)	44.1 (35.4)	53.4 (51.2)	61.0 (64.1)	59.9 (69.0)
Commodity exports ($ billion)	0.2	5.0	26.6	124.6	175.8
Total exports/GDP (%)	9.5	28.5	35.5	31.0	45.0
National savings rate (%)	13.2	19.5	31.1	35.5	32.3
Foreign savings rate (%)	0.2	9.6	–0.6	1.8	–3.5
Tax burden/GDP (%)	8.6	15.3	17.1	19.1	18.7
Consumer price inflation (%)	14.0	12.0	5.8	2.0	
Won/US$ (year-end)	273	484	890	775	1 265

(a) Development of SMEs in the manufacturing industry

In the 1960s, manufacturing SMEs accounted for 94 per cent of the increase in manufacturing establishments. However, they accounted for only 25-40 per cent of the growth in employment, gross output, value of shipments, and value added.

In the 1970s, owing to the heavy and chemical industry development policy which resulted in favouring large enterprises, the share contributed by manufacturing SMEs to the growth in employment, gross output, value of shipments, and value added remained at only 30-45 per cent.

From the early 1980s, the government started to strengthen support for SMEs in order to rectify the worsening economic distortion, which had resulted from the concentration of economic power by large business groups. Manufacturing SMEs accounted for 89.2 per cent of the increase in the number of employees in the 1980s. In addition, the share contributed by manufacturing SMEs to the growth of gross output, value of shipments, and value added increased significantly.

In the 1990s, the share contributed by the manufacturing SMEs to the growth in gross output, value of shipments, and value added continued to increase. SMEs made a great contribution to economic growth. SMEs accounted for 99.1 per cent and 74.4 per cent in the number of establishments and the number of employees in all industries, respectively. In 1997, the manufacturing SMEs accounted for 99.7 per cent and 71.6 per cent in the number of establishments and employees in the manufacturing industry, respectively.

(b) The importance of SMEs in the economy of the Republic of Korea

The growth rates of manufacturing SMEs in the 1960s were only half those of large manufacturing enterprises in number of establishments, number of employees, gross output, value of shipments, and value added.

Manufacturing SMEs did not grow as fast as large manufacturing enterprises in the 1970s because of heavy and chemical industry promotion policies, which favoured large enterprises. However, from the end of the 1970s, the manufacturing SMEs started to outperform large manufacturing enterprises in their growth rates following the increasing participation of SMEs in parts and basic materials industries.

From the 1980s, manufacturing SMEs outperformed the large manufacturing enterprises in all growth indicators as a result of the government's active SME promotion policy to rectify the structural imbalance stemming from the heavy and chemical industry promotion policy.

Table 4. Growth rates: breakdown by firm size

(percentage)

Items / *Growth rate*[1]	*1960s (1963-69)*	*1970s (1970-79)*	*1980s (1980-89)*	*1990s (1990-97)*
Number of establishments				
SMEs[2]	3.4	3.1	9.0	4.4
Large firms	11.8	5.1	1.9	–5.3
Number of employees				
SMEs	5.4	10.2	7.3	0.0
Large firms	12.8	10.8	2.0	–4.7
Gross output				
SMEs	14.5	40.4	20.7	15.0
Large firms	29.7	39.1	14.8	12.6
Value of shipments				
SMEs	14.7	40.1	20.8	15.1
Large firms	29.7	38.9	15.0	12.6
Value added				
SMEs	16.3	40.0	21.9	15.1
Large firms	29.6	35.3	16.4	13.7

Source: Korea Federation of Small Business, *Economic Development and Contribution of SMEs*, 1998.

Notes: [1] Annual average rate.

[2] 5-299 employees.

From the 1990s, manufacturing SMEs continuously had higher growth rates than large manufacturing enterprises while large manufacturing enterprises had negative growth rates in the number of establishments and employees.

Table 5. Contribution ratios to economic growth: breakdown by firm size

(percentage)

Items / *Contribution ratio*[1]	*1960s (1963-69)*	*1970s (1970-79)*	*1980s (1980-89)*	*1990s (1990-97)*
Number of establishments				
SMEs[2]	94.0	93.1	99.6	101.6
Large firms	6.0	6.9	0.4	–1.6
Number of employees				
SMEs	38.1	45.3	89.2	–3.4
Large firms	61.9	54.7	10.8	–96.6
Gross output				
SMEs	26.5	32.1	44.6	48.4
Large firms	73.5	67.9	55.4	51.6
Value of shipments				
SMEs	26.7	32.2	44.5	48.4
Large firms	73.3	67.8	55.5	51.6
Value added				
SMEs	25.7	35.5	46.9	47.1
Large firms	73.3	64.5	53.1	52.9

Source: Korea Federation of Small Business, *Economic Development and Contribution of SMEs*, 1998.

Note: [1] The contribution ratio is the percentage share of each group of enterprises to total increase.

[2] 5-299 employees.

B. FINANCING SMALL AND MEDIUM-SIZED ENTERPRISES

1. Financial supporting system for small and medium-sized enterprises

A financial system can influence the allocation of real resources between surplus and deficit units. In addition, a financial intermediating system can be used to channel financial resources to certain favoured deficit units that are expected to use the resources for specific purposes, or the terms on which the financial resources are provided can be manipulated to influence the decisions of potential users.

Access to financing can be a critical issue for SMEs, particularly in their early years. The current financial support system for SMEs aims to facilitate SME access to banks and non-bank financial institutions, and to lower the cost of borrowing from banks and such institutions. Financing for SMEs in the Republic of Korea is extended in various forms through diversified financial institutions and can be summarized in four major categories.

First, commercial banks provide loans and discount commercial bills to SMEs.

Table 6. Number of establishments in manufacturing industry: breakdown by firm size and number of employees

Size \ Year	1993	1994	1995	1996	1997	1998	1999
Total	88 864 (100.0)	91 372 (100.0)	96 202 (100.0)	97 144 (100.0)	92 138 (100.0)	79 544 (100.0)	91 156 (100.0)
SMEs	87 913 (98.9)	90 447 (99.0)	95 285 (99.0)	96 241 (99.1)	91 324 (99.1)	78 869 (99.2)	90 449 (99.2)
5–9	36 144 (40.7)	37 777 (41.3)	42 576 (44.3)	44 029 (45.3)	43 965 (47.7)	36 525 (45.9)	42 796 (46.9)
10–19	25 205 (28.4)	25 784 (28.2)	26 447 (27.5)	26 300 (27.1)	23 536 (25.5)	21 065 (26.5)	23 970 (26.3)
20–49	18 169 (20.4)	18 349 (20.1)	17 894 (18.6)	17 802 (18.3)	16 197 (17.6)	14 612 (18.4)	16 335 (17.5)
50–99	5 438 (6.1)	5 519 (6.0)	5 335 (5.5)	5 208 (5.4)	4 856 (5.3)	4 288 (5.4)	4 774 (5.2)
100–199	2 244 (2.5)	2 283 (2.5)	2 298 (2.4)	2 192 (2.3)	2 110 (2.3)	1 861 (2.3)	2 011 (2.2)
200–299	713 (0.8)	735 (0.8)	735 (0.8)	710 (0.7)	660 (0.7)	518 (0.7)	563 (0.6)
Large enterprises	951 (1.1)	925 (1.0)	917 (1.0)	903 (0.9)	814 (0.9)	675 (0.8)	707 (0.8)
300–499	422 (0.5)	411 (0.4)	420 (0.4)	432 (0.4)	377 (0.4)	309 (0.4)	356 (0.4)
500 or more	529 (0.6)	514 (0.6)	497 (0.5)	471 (0.5)	437 (0.5)	366 (0.5)	351 (0.4)

Source: Small and Medium Business Administration, SME statistics.

Note: The figure in brackets is the composition ratio.

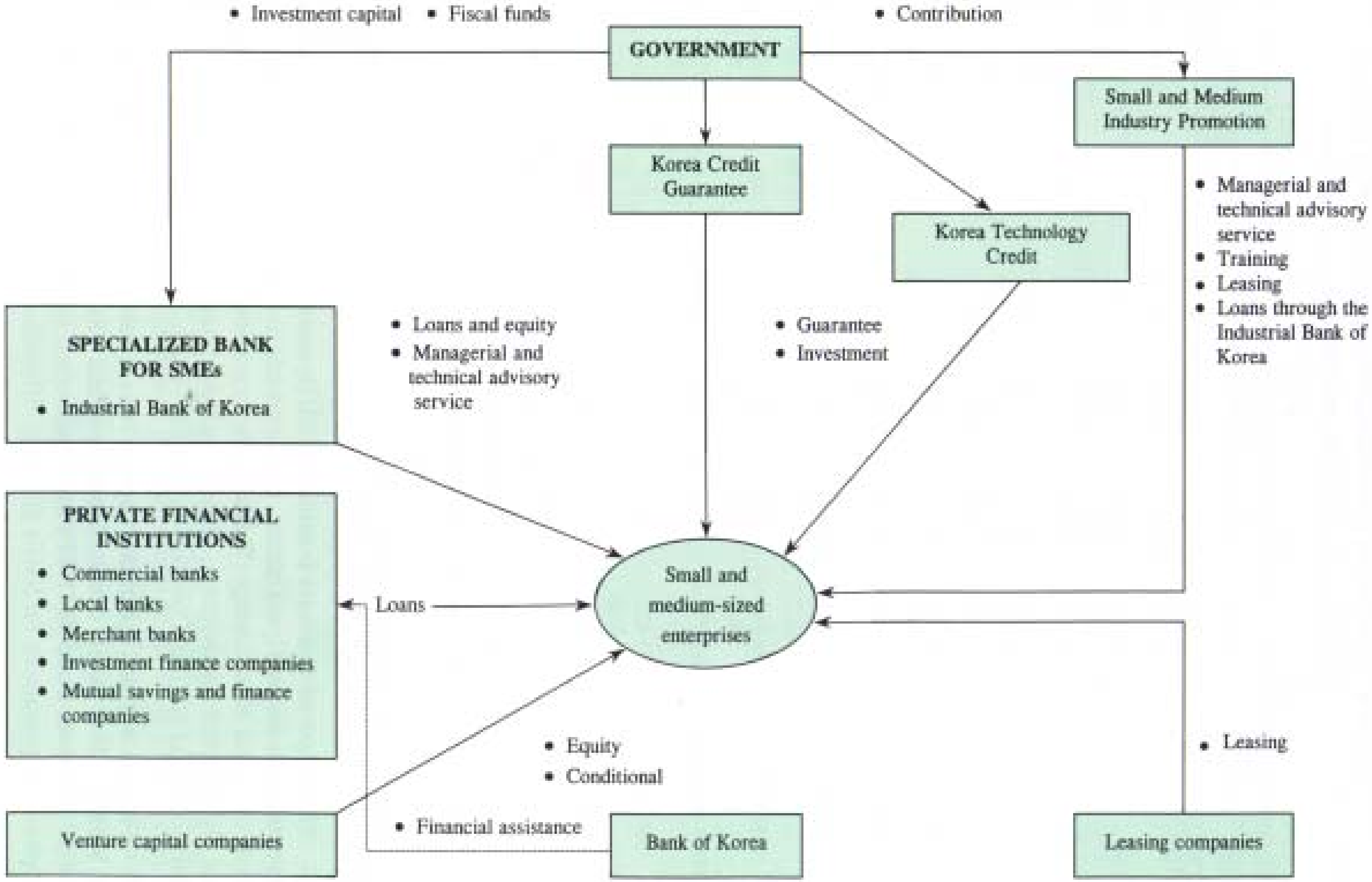
Second, the Industrial Bank of Korea, a special bank founded by the government specifically for SMEs, finances SMEs exclusively (Industrial Bank of Korea 1999).

Third, special loans are provided to SMEs under various schemes. These include government-sponsored programme loans, which are extended through the Industrial Bank of Korea to encourage SMEs in facility investment and to strengthen research and development activities. Others include Energy Consumption Rationalization Fund loans and Start-up Company Promotion Fund loans.

Finally, a credit guarantee system was established to facilitate bank lending to SMEs. The Korea Credit Guarantee Fund (KCGF) and the Korea Technology Credit Guarantee Fund (KTCGF) have undertaken guarantee businesses with a special emphasis on guarantees for SMEs that have difficulties in qualifying for bank loans.

The basic financial supporting system for SMEs in the Republic of Korea is shown in figure 1.

Figure 1. Financial assistance system for small and medium-sized enterprises



2. External financing of small and medium-sized enterprises

Most SMEs turn to debt financing at an early stage. Banks are the main lenders. Bank loans accounted for 79.7 per cent of total external financing at the end of 1999. Borrowings from non-bank financial institutions and corporate bonds recorded 7.5 per cent and 3.9 per cent, respectively, at the end of 1999. Borrowings from the private curb market declined to 0.6 per cent.

Table 7. SME borrowings: breakdown by source of funds (based on balances)

(unit : billion won, percentage)

	End-1998		*End-1999*		*Change (Ω)*	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Banks	39 914	89.2	48 971	79.7	9 057	22.7
Non-bank financial institutions	1 219	2.7	4 636	7.5	3 417	280.2
Corporate bonds	1 547	3.4	2 350	3.9	803	51.9
Curb loans	968	2.2	375	0.6	Ω592	Ω61.2
Others	1 117	2.5	5 093	8.3	3 976	355.8
Total	44 765	100.0	61 426	100.0	16 661	37.2

Source: The Kookmin Bank, Survey of Small and Medium Enterprise Financing, Annual Report 2000.

3. Bank loans to small and medium-sized enterprises

Deposit money bank loans extended to SMEs at the end of June 2001 are shown in table 8. Deposit money banks provided 41.9 per cent of total loans to SMEs at the end of June 2001. Banks have significantly expanded loans to households and tried to reduce their risk exposure to SMEs as well as large firms since the financial crisis in 1997.

Table 8. Deposit money bank loans to SMEs[1]

(unit : 100 million won)

	December 1997	*December 1998*	*December 1999*	*December 2000*	*June 2001*
Total loans (A) (%)	1 964 112 (..)	1 963 503 (–0.03)	2 453 312 (24.9)	3 046 918 (24.2)	3 209 860 (5.3)
Loans to SMEs (B) (%)	922 547 (..)	891 736 (–3.3)	1 094 936 (22.8)	1 275 979 (16.5)	1 344 321 (5.4)
B/A (%)	47.0	45.4	44.6	41.9	41.9

Source: The Bank of Korea.

Note: [1] Based on banking account loans to SMEs.

[2] Numbers in parentheses denote increase rates over previous year.

4. Mandatory minimum ratio of bank loans to SMEs

The government used credit allocation through the banking system as its most powerful means of supporting SMEs. Banks were directed to make loans to SMEs.

According to the Credit Operation Guideline of the Financial Supervisory Service, all commercial banks are required to provide more than a specified proportion of their loans to SMEs. For example, nationwide commercial banks are required to supply more than 45 per cent of the increase in loans to SMEs. This mandatory credit extension system has contributed considerably to expanding bank loans to SMEs since 1965. The mandatory credit extension system, however, has intervened in the credit allocation of banks; the financial health of borrowers was often neglected when loan decisions were made.

Table 9. Mandatory minimum ratio of bank loans to SMEs

(percentage)

	April 1965	*December 1976*	*October 1980*	*March 1985*	*April 1986*	*August 1986*	*February 1992*	*May 1994*	*July 1997*	*February 1999*
Nationwide commercial banks	30	30	35	35	35	35	45	45	45	45
Local banks	60	40	55	55	80	80	80	70	60	60
Foreign bank branches	-	-	-	25	25	35	35	35	35	35
Industrial Bank of Korea	90	90	90	90	90	90	90	90	80	80

Source: The Bank of Korea.

Note: Based on loans in domestic currency.

5. The aggregate credit ceiling system of the Bank of Korea

The Bank of Korea encourages deposit money banks to extend more funds to SMEs with its aggregate credit ceiling system. In 2000, the Bank of Korea revised the aggregate credit ceiling method of operation in order to assist business firms in the process of corporate and financial restructuring who were facing difficulties in obtaining funds, and particularly, to encourage bank lending to SMEs.

In September 2000, the Bank of Korea changed its method of appraising bank performance on lending to SMEs. It did so in such a way as to assist banks that were expanding lending to SMEs to receive a larger allocation than other banks focusing on retail credit.

To encourage an expansion of bank lending to regionally-based SMEs suffering from difficulties in the process of corporate restructuring, the Bank of Korea increased the aggregate credit ceiling for its regional branches by a total of 500 billion won (from 2.2 to 2.7 trillion won) in December 2000. The total aggregate credit ceiling stood at 7.6 trillion won at the end of August 2000.

The value of SME commercial bills discounted accounted for 84.7 per cent of total commercial bills discounted in the first half of 2000. The Bank of Korea made available refinancing under the aggregate credit ceiling to banks for up to 98.3 per cent of SME commercial bills discounted.

Table 10. Trend of SME commercial bills discounted

(unit: billion won)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*June 2000*
Total value of bills discounted (A)	14 887	18 420	21 783	24 498	23 629	16 098	22 158	21 485
SME bills discounted (B)	13 080	16 577	19 410	21 961	20 981	14 674	19 001	18 184
B/A (%)	87.9	90.0	89.1	89.6	88.8	91.2	85.8	84.7
Bank of Korea rediscount (C)	11 853	13 388	15 117	18 143	17 640	13 022	17 616	17 879
C/B (%)	90.6	80.7	77.9	82.6	84.1	88.7	92.7	98.3

Source: Small and Medium Business Administration.

6. Introduction of the corporate procurement loans scheme

In the Republic of Korea, business firms had for long made use of commercial bills for the settlement of commercial transactions. This practice, however, caused problems because SMEs, which had received commercial bills, had to wait for a considerable time before they could obtain cash settlement in full, aggravating their financial burden. The default of a company that had issued commercial bills ran the risk of causing a chain of defaults by those companies having received or accepted them.

The Bank of Korea introduced the corporate procurement loans scheme in May 2000 to gradually reduce the use of commercial bills and encourage the expansion of cash settlement. The corporate procurement loans scheme represents a new procedure for the settlement of commercial transactions under which corporations purchasing goods borrow settlement funds from banks, paying the suppliers in cash rather than commercial bills.

In order to secure the widespread adoption of the corporate procurement loans scheme, under the aggregate credit ceiling, the Bank of Korea made up to half of a bank’s total corporate procurement loans available for refinancing.

Thanks to the Bank of Korea’s supportive provision of incentives and the favourable response of enterprises and banks, the scheme was swiftly established. The outstanding balance of loans extended under the new scheme surged from 65 billion won at the end of June 2000 to 3.3 trillion won at the end of December 2000. The number of corporate beneficiaries of the scheme also soared from 135 to 5,458 during the corresponding period.

In contrast to the rapid rise in the utilization of the scheme, the value of commercial bills discounted continued to decrease. At the end of December 2000, the corporate procurement loans were equivalent to 17.2 per cent of total discounts of commercial bills.

Table 11. Trends of outstanding amounts of corporate procurement loans and commercial bills discounted

(unit: billion won)

	2000		
	June	*October*	*December*
Corporate procurement loans (A)	65.1	1 989.7	3 361.7
Commercial bills discounted (B)[1]	18 453.7	18 336.2	19 566.6
A/B (%)	0.4	10.9	17.2

Source: The Bank of Korea.

Note: [1] Based on small and medium enterprises.

7. Credit guarantee schemes

The Korea Credit Guarantee Fund (KCGF) and the Korea Technology Credit Guarantee Fund (KTCGF) were established in 1976 and in 1989, respectively, to increase the availability of loans for the establishment, expansion and improvement of SMEs. KCGF and KTCGF provide lenders with a guarantee against losses incurred on loans. This support to lenders helps SMEs that do not have the tangible collateral to obtain debt financing. They provide guarantees for bank loans, bonds, commercial bills and leasing.

The government substantially augmented its contribution to KCGF and KTCGF after the financial crisis in 1997. The government contributed $2 billion consisting of loans from ADB and the World Bank to KCGF and KTCGF in order to enlarge loan guarantees to SMEs and venture businesses. Thanks to a sharp increase in government contributions, the outstanding balance of credit guarantees extended by KCGF and KTCGF surged from 4,105.5 billion won at the end of 1989 to 31,496.7 billion won at the end of June 2000.

The sharp increase in credit guarantees helped SMEs overcome the financial difficulties during the financial crisis. On the other hand, the credit guarantee scheme has not been without cost to the state. Claims paid to lenders by KCGF and KTCGF on defaulted loans have sharply increased, recording more than 3 trillion won in 1998. The ratio of claims paid to the outstanding balance of guarantees also soared from

4.8 per cent in 1993 to 8.1 per cent in 1995, and then to 9.2 per cent in 1998. The high cost of the Credit Guarantee programme has stopped the fund properties of both KCGF and KTCGF from growing over time. The financial losses associated with defaulting businesses should be reduced. Losses can be reduced by lowering the percentage guaranteed or by raising the interest premium. KCGF, KTCGF and banks should strengthen their capacity to evaluate the creditworthiness of SMEs in a cost-effective manner, for example, through the use of credit scoring techniques.[3]

The Credit Guarantee programme has been successful in helping start-ups and other SMEs in the Republic of Korea gain access to needed capital for expansion and growth. The programme has succeeded as an economic development tool and is a good example of public sector/private sector cooperation. Its success has spawned similar guarantee programmes. However, controlling the high cost of the Credit Guarantee programme and keeping the programme responsive to users will remain a challenge in coming years.

Table 12. Credit guarantee activities of the Korea Credit Guarantee Fund and the Korea Technology Credit Guarantee Fund

(unit : 100 million won, percentage)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*June 2000*
Fund properties	7 545	8 626	8 596	11 002	10 318	33 069	38 352	38 390
Government contribution[1]	1 500	3 300	4 100	5 000	6 000	43 837	14 269	7 800
Outstanding balance of guarantees	107 208	104 496	116 977	138 074	170 521	328 035	309 264	314 967
Claims paid	5 183	6 435	9 466	7 882	11 707	30 191	18 588	5 115
B/A (%)	4.83	6.16	8.09	5.71	6.87	9.20	6.01	1.62

Source: Special Commission on Small and Medium-sized Enterprises, White Paper on Small and Medium-sized Enterprises, 2000.

Note: [1] Loans from the Asian Development Bank and the World Bank ($2 billion) are included 1998 and 1999.

8. Policy funds for SMEs

Policy-related loans for SMEs are supplied from government policy funds, primarily through the specialized bank. Total policy funds to SMEs financed by the government budget amounted to 5,152 billion won in 2000. In addition, the government contributed 1,036 billion won to credit guarantee funds in 2000. Facility funds and technology development funds accounted for 57.2 and 18.1 per cent, respectively,

[3] Kristin Hallberg, "A market-oriented strategy for small and medium-scale enterprises", Discussion Paper 40, International Finance Corporation, 2000, pp. 11-13.

in 2000. Equity investment in venture businesses increased from 20 billion won to 315 billion won in 2000.

The maturity of facility funds and technology development funds is eight years. The provision of long-term loans helped SMEs to modernize production facilities and develop a new product or process. The government budget appropriations for supporting SMEs increased in the 1990s and accounted for 4.6 per cent of the total government budget in 1999.

SMEs complain about complicated loan assessment and decision-making procedures of lenders. Banks place high priority on the creditworthiness of borrowers and their ability to repay loans. Streamlining the loan assessment and decision-making procedures will remain a challenge in coming years.

Table 13. Trend of policy funds to SMEs

(unit : billion won, percentage)

	1998		*1999*		*2000 (Budget estimate)*	
Facility fund	3 780	(78.3)	3 366	(62.4)	2 957	(57.2)
Operation fund	317	(6.6)	1 262	(23.4)	957	(18.6)
Technology development fund	713	(14.8)	648	(12.0)	933	(18.1)
Equity investment in venture businesses	20	(0.4)	118	(2.2)	315	(6.1)
Subtotal	4 830	(100.0)	5 394	(100.0)	5 152	(100.0)
Loan guarantees and others	4 620		1 661		1 036	
Total	9 450		7 055		6 188	

Source: Special Commission on Small and Medium-sized Enterprises.

Table 14. Trend of budget appropriations for SME support

(unit : 100 million won, percentage)

	Total government budget (A)	*Appropriations for SME support (B)*	*B/A (Per cent)*
1993	463 922	10 990	2.37
1994	543 366	14 537	2.68
1995	633 665	20 014	3.16
1996	711 269	20 088	2.82
1997	730 309	28 466	3.90
1998	853 618	38 088	4.58
1999	934 769	43 139	4.61

Source: Ministry of Planning and Budget.

C. THE FINANCIAL CRISIS AND SMES

1. Financial crisis

(a) Weak banking system

There was evidence of deterioration in the balance sheets of commercial banks in the Republic of Korea up to four years before the crisis. In 1997, however, this trend took a turn for the worse, as can be seen in table 15.

Table 15. Non-performing loans of commercial banks

(Ratio to total loans, percentage)

	1994	*1995*	*1996*	*1997*	*1998*	*September 1999*
NPL ratio	5.6	5.2	3.9	5.8	7.4	6.2

Source: Financial Supervision Information, vol. 99, No. 4, Financial Supervisory Service, March, 1999.

Note: 1) Figures from end-1996 include the Housing and Commercial Bank, whereas figures from end-1997 include the Long-term Credit Bank and not the five closed banks.

2) Non-performing loans (NPL) = Substandard + Estimated Loss + Doubtful.

Fifteen merchant banking corporations were suspended in December 1997, and 13 of these were closed in early 1998. Five non-viable banks were ordered to close down and transfer their assets and liabilities to relatively sound banks. Two of these five non-viable banks (Daedon Bank and Dongnam Bank) specialized in lending to SMEs. The government intervened and rescued two troubled banks (Seoul Bank and Korea First Bank) in December 1997.

Disruptions in financial markets occurred in the last quarter of 1997. The pattern of rising interest rates and a declining stock price index in the midst of an increase in the number of default incidences had already been in place as early as September 1997. Interest rates jumped to an unprecedented level in December 1997, while credit flows to the non-financial sector was abruptly interrupted. Both of these events led the ratio of dishonoured bills to reach 2.09 per cent in December 1997.

(b) Corporate failures

Firms depended heavily on external borrowings to finance investments and other expenditures. The financial crisis in the Republic of Korea originates not only from cyclical downturns, but also from structural deficiencies and delayed policy responses. As the Korean economy slid toward slower economic growth, firms had to change their business strategies from being volume-oriented to profit-oriented. Successive failures of business firms revealed, however, that many firms, including big business groups, neglected or failed to undertake restructuring efforts in the rapidly changing economic environment. Faced with slower economic growth, it was particularly important that business firms reduce excess capacity and high debt leverages.

Table 16. The current state of financial restructuring, 1998-2000

	No. of institutions as of end of 1997	*As of end of 1998*			*As of end of 1999*			*As of end of 2000*			*No. of institutions as of end of 2000*
		Licence revoked	*Closure through merger*	*Liqui-dation and other*	*Licence revoked*	*Closure through merger*	*Liqui-dation and other*	*Licence revoked*	*Closure through merger*	*Liqui-dation and other*	
Banks	33	5	3	–	–	2	–	–	1	–	22
Merchant banks	30	16	–	–	1	3	–	1	–	1	10
Securities companies	36	6	–	1	–	–	1	–	1	12	43
Investment trust companies	31	6	–	–	–	1	–	–	–	3	27
Life insurance companies	31	4	–	–	–	–	–	1	5	–	21
Non-life insurance companies	14	–	1	–	–	–	–	–	–	–	13
Mutual savings and finance companies	231	22	2	4	21	10	6	28	13	2	147
Credit unions	1 666	69	14	9	105	45	–	83	42	–	1 317
Total	2 072	128	20	14	127	61	7	113	62	18	1 600

Investors as well as lenders failed to subject investment decisions to a true market test or due diligence. Many commercial banks and merchant banks extended asset-based lending to business firms without prudent and proper credit assessment while the profitability of the corporate sector was declining.

Owing to high interest rates and the severe recession, the number of firms filing for bankruptcy surged from 11,589 in 1996 to 22,828 in 1998. As a result, the flow of bank credit came to a virtual stop. The number of bankrupt SMEs recorded 3,197 in December 1997 when the IMF bailout programme began. These increased to 3,323 in January and 3,377 in February 1998.

The dishonoured bills ratio jumped to 1.49 per cent in December 1997. It declined to around the 0.4 per cent to 0.6 per cent level during the first half of 1998, and then tapered off to 0.20 per cent in November 1998. It plunged to 0.12 per cent in December 1998.

The number of bankrupt companies was approximately 2,700 a month on average during the first half of 1998. However, as the dishonoured bill ratio declined from the second half of 1998, the number of bankrupt companies began to taper off to below 1,000 a month on average from November 1998. The number of bankrupt companies declined sharply to 599 in January 2000.

Table 17. Number of bankrupt companies and dishonoured bills ratios

(unit : million won, percentage)

	1990	*1993*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Number of bankruptcies	4 107 (–)	9 502 (6)	13 992 (5)	11 589 (7)	17 168 (58)	22 828 (39)	6 718 (..)	6 693 (..)
Dishonoured bills ratio	0.04	0.13	0.17	0.14	0.40	0.38	0.33	0.26

Source: The Bank of Korea.

Note: Figures in parentheses denote numbers of bankrupt large enterprises.

Table 18. Bankruptcies in 1997 and 1998

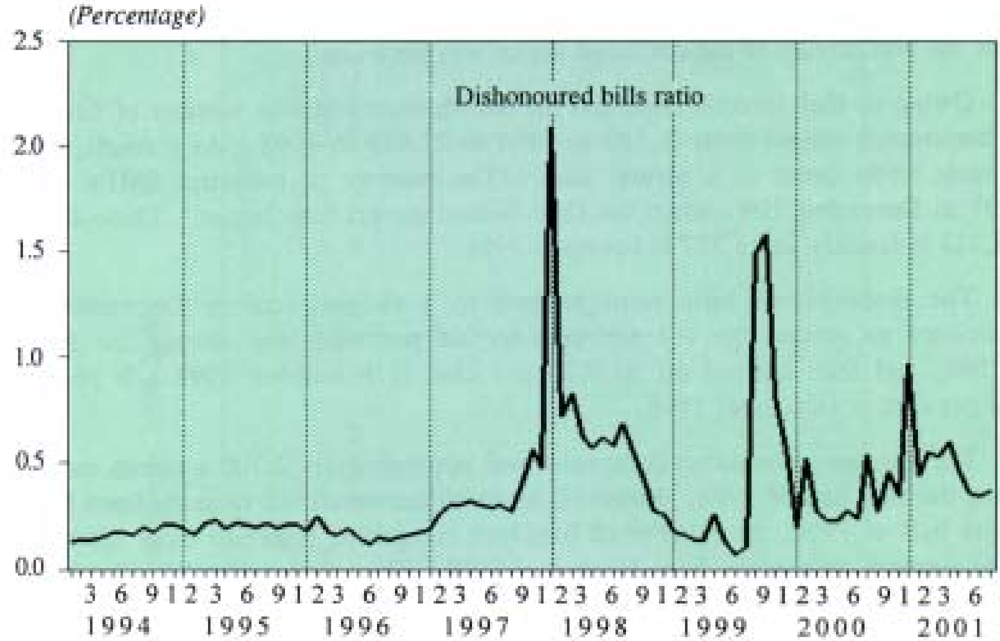
(unit: percentage each)

	January 1998	*February*	*March*	*April*	*May*	*June*	*July*	*August*	*September*	*October*	*November*	*December*	*1998 (1997)*
Dishonoured bills ratio	0.53 (0.21)	0.62 (0.24)	0.47 (0.24)	0.42 (0.25)	0.45 (0.23)	0.42 (0.22)	0.50 (0.24)	0.41 (0.21)	0.31 (0.31)	0.20 (0.43)	0.20 (0.38)	0.12 (1.49)	0.38 (0.40)
Number of bankruptcies	3 323 (1 115)	3 377 (1 060)	2 749 (1 268)	2 462 (1 318)	2 070 (1 257)	1 825 (1 215)	1 799 (1 384)	1 337 (1 215)	1 085 (1 235)	1 036 (1 435)	903 (1 469)	862 (3 197)	22 828 (17 168)

Source: The Bank of Korea.

Note: Figures in parentheses denote numbers of bankruptcies in 1997.

Figure 2. Trend of dishonoured bills ratio



Source: The Bank of Korea, Monthly Bulletin.

2. Corporate restructuring and financial structure of SMEs

The high level of corporate debt and weak governance in the Republic of Korea resulted in debt-financed expansion by business conglomerates and SMEs – raising the country's vulnerability to the financial crisis in 1997. To facilitate corporate sector reform, the government has sought to create an environment conducive for active corporate restructuring. It set up different approaches corresponding to the restructuring requirements of each of the following groups: conglomerates and SMEs. SMEs thought too weak to bear the costs of restructuring made conditional arrangements for support with their creditor financial institutions, which provided restructuring funds worth 1.4 trillion won.

The equity-to-total-assets ratio of SMEs has improved to 35.8 per cent in 2000 from 23.0 per cent in 1998. The debt ratio and current liabilities ratio of SMEs have been lowered to 179.7 and 121.3 per cent in 2000 from 334.4 and 219.7 per cent in 1998, respectively. Interest expense-to-total borrowings of SMEs has been lowered to 9.4 per cent in 2000 from 13.8 per cent in 1998.

3. Credit crunch in the financial crisis and bank loans to SMEs

The credit crunch following the outbreak of the financial crisis was mainly caused by two elements of the IMF programme: the high interest rate policy and the strengthened prudential regulation on banks. High interest rates spurred an increase in the defaults and credit risks of business firms, while the need to tighten prudential regulation induced Korean banks to reduce lending in order to maintain BIS capital adequacy ratios.

Table 19. Financial structure of firms in the manufacturing industry: breakdown by firm size

(percentage)

	1998			*1999*			*2000*		
	Total	*Large firms*	*SMEs*	*Total*	*Large firms*	*SMEs*	*Total*	*Large firms*	*SMEs*
1. Stockholders' equity to total assets	24.8	25.3	23.0	31.8	32.4	30.1	32.2	30.8	35.8
2. Debt ratio	303.0	295.4	334.4	214.7	208.9	232.4	210.6	224.6	179.7
3. Total borrowings and bonds payable to total assets	50.8	52.9	43.0	42.8	44.5	37.8	41.2	43.6	35.0
4. Current liabilities ratio	169.8	157.6	219.7	122.1	111.1	156.2	134.7	140.8	121.3
5. Interest expenses to total borrowings	13.51	13.45	13.80	11.54	11.93	10.22	10.49	10.83	9.40

Source: Bank of Korea, Financial Statement Analysis, 2001.

To overcome the credit crunch, the government implemented a comprehensive set of policies:

(a) Interest rates were lowered to reduce pressure on the financial system and the financing costs of business firms, and to promote capital market activities;

(b) A financial restructuring programme was launched to recapitalize viable banks and cover their losses. By the end of 1998, almost all commercial banks met the 8 per cent capital adequacy ratios;

(c) Loan guarantees of 33 trillion won were provided to SMEs to aid them in obtaining financing;

(d) Trade financing of $3.3 billion, consisting of World Bank loans and excess reserves from the Bank of Korea, was extended to SMEs to compensate for the shortage of commercial banks' foreign reserves.

These policies helped ease the credit crunch so that by the third quarter of 1999, bank lending to SMEs had increased by 17 trillion won, surpassing the level of 1997.

Owing to a severe credit crunch after the financial crisis in 1997, loans to SMEs by deposit money banks decreased 3.3 per cent in 1998. Deposit money banks, however, have expanded loans to promising and healthy SMEs with high growth potential since 1999 and offered them lower lending interest rates. Deposit money bank loans to SMEs have increased 22.8 per cent and 16.5 per cent in 1999 and 2000, respectively (table 8). The average lending interest rate to SMEs has declined to 7.5 per cent in June 2001 from 14.3 per cent in December 1997.

Table 20. Deposit money bank average lending interest rate to SMEs

(annual percentage)

	December 1997	*December 1998*	*December 1999*	*December 2000*	*June 2001*
Average lending interest rate	14.6	11.3	8.6	8.4	7.9
SMEs	14.3	10.9	8.0	7.8	7.5
Large firms	17.1	11.2	8.5	8.7	7.8

Source: The Bank of Korea.

D. FINANCIAL ASSISTANCE TO SMALL ENTERPRISES

1. The importance of small business

More than 97 per cent of all businesses in the Republic of Korea are small businesses. In 1998 there were more than 2.5 million small businesses with fewer than 50 employees, providing employment for more than 59 per cent of all Koreans working in the private sector. Job creation is the most important contribution made by small businesses.

Table 21. Status of small and medium-sized enterprises, 1998

(unit: person, percentage)

	No. of establishments	*No. of employees*
All industries	2 629 868 (100.0)	10 177 797 (100.0)
SMEs	2 607 710 (99.1)	7 659 010 (75.2)
Small enterprises	2 562 500 (97.4)	6 062 035 (59.6)

Source: National Statistical Office of Korea.

2. Financial assistance

The Special Act on Small Business Support came into being in April 1997. The economy suffered from the surge in unemployment and witnessed severe economic difficulties of many newly-poor households after the financial crisis in 1997.

From April 1999, the government launched the financial assistance programme for small businesses with the objective to support start-ups and improvements of small businesses. The government earmarked 300 billion won and 200 billion won in 1999 and 2000, respectively, for the programme. The maximum loan amount was increased from 30 million won to 50 million won and the maturity of loan was extended from three to four years. From April 1999 to June 2000, 21,657 loans for 1,141.6 billion won were made for start-ups and improvements of small businesses.

Table 22. Loans for small business start-ups and improvements

(unit: 100 million won)

	1999	2000		Total
		First quarter	Second quarter	
Recommendation	6 351	3 015	2 050	11 416
Loans	2 512	858	1 127	4 497

Source: Small and Medium Business Administration.

E. FINANCIAL ASSISTANCE TO POOR HOUSEHOLDS

1. Social consequences of the economic crisis

The economic crisis has been followed by social repercussions in many dimensions: rapidly increasing unemployment, decreasing wage and income, growing absolute poverty, and increasing health risk. In the wake of the financial crisis and subsequent economic recession in the Republic of Korea, a rapid increase in unemployment was inevitable as thousands of firms went bankrupt. The unemployment rate has steeply risen from an annual average of 2.6 per cent (556,000 unemployed) in 1997 to 5.9 per cent (1.23 million unemployed) in February 1998, to a record high of 8.6 per cent (1.78 million unemployed) in February 1999. In response to the record high rates of unemployment, the government has taken measures to increase employment, such as job preservation, general job creation, vocational training and social care.

2. Public loans through the Life Stabilization Fund

Since the financial crisis struck, mid- and low-income earners have suffered from deteriorating living standards. If we define the middle-income class as those earning between 50 and 150 per cent of the median income, the ratio of the middle-income class has declined to 65.7 per cent from the 68-70 per cent level before the financial crisis. Unemployment hit the poor and disadvantaged population more severely, such as unskilled labour, SME workers, and female labour.

The government put forth a comprehensive unemployment package to minimize the adverse impacts of the crisis in March 1998, including loan programmes for the unemployed and venture businesses.

Public loans through the Life Stabilization Fund were provided to the unemployed who were excluded from unemployment insurance and the livelihood protection programme, and whose assets were below a certain level. The fund was financed by sales of employment security bonds (120 billion won) and the World Bank fund (300 billion won) in 1998. The loans had a low interest rate and two-year repayment period beginning within two years of the loan disbursement.

In the early stage, restrictive eligibility requirements adopted by banks hampered the effectiveness of the programme. The gradual relaxation of loan eligibility requirements eventually increased the number of beneficiaries. The amount of loans made per day also increased from 500 million won to 3 billion won.

The Resettlement Allowance Fund provided loans in 1998 to the increasing number of people returning to the countryside for agricultural work and to the unemployed who started their own small businesses (200 billion won to 10,000 households). In addition to these loan programmes, the National Pension Fund deployed a separate loan programme (a total of 1 trillion won) for the unemployed who subscribed to the national pension.

In June 1999, the government formulated a policy aimed at stabilizing the living standards of mid- and low-income earners and allocated 1.1 trillion won for this policy.

3. Loan Guarantee Programme for Start-ups for Living

Since July 1997, the government has implemented the Loan Guarantee Programme for Start-ups for Living with the objective of increasing the availability of loans for the purpose of the establishment of small businesses for living to mid- and low-income earners and the unemployed. The maximum guarantee is 100 million won, and the guarantee fee is 0.9-1.0 per cent a year. More than ninety-four per cent of loans made were 50 million won or less.

The government allocated 200 billion won for the Programme. The outstanding balance of guarantees provided by the Korea Credit Guarantee Fund for the Programme recorded 1,900 billion won for 70,000 loans made at the end of April 2000. The benefits of the Programme can best be measured by its stimulation of job creation. According to government estimates, the Programme has resulted in the total additional employment of 215,000 persons from July 1999 to September 2000.[4] However, claims paid

[4] Special Commisssion on SMEs, White Paper on SMEs, 2000, pp. 142-143.

have soared from 0.13 per cent of loans made in 1999 to 5.57 per cent of loans made in September 2000.

F. CONCLUSION

The share of loans to SMEs of all loans of deposit money banks has steadily increased for the last forty years. Banks have, however, significantly expanded loans to households and tried to reduce their risk exposure to SMEs, as well as large firms, especially since the financial crisis in 1997.

SMEs in the Republic of Korea have been well served by credit guarantee programmes and the mandatory minimum ratio of bank loans to SMEs. The credit guarantee schemes have played an important role in inducing the banking sector to lend under circumstances in which, without the guarantee, they would be unwilling to lend. The government allocated about 40 per cent of the budget appropriations for the SME sector to credit guarantee programmes in 1999. The sharp increase in credit guarantees has lead to greater finance being provided to SMEs by banks and non-bank financial institutions since the financial crisis.

Loan guarantees and public loans through the Life Stabilization Fund stimulated start-ups by the unemployed and low-income earners.

Greater finance from banks to SMEs, mid- and low-income earners, and the unemployed has led to additional jobs and a lower unemployment rate in the Republic of Korea. SMEs provided employment for 81.9 per cent of all Koreans working in the private sector at the end of 1999, compared with 74.4 per cent at the end of 1997. The unemployment rate has declined from a record high of 8.6 per cent in February 1999 to 3.0 per cent in September 2001.

On the other hand, the credit guarantee scheme has not been without cost to the state. The ratio of claims paid to lenders by KCGF and KTCGF on defaulted loans to the outstanding balance of guarantees soared from 4.8 per cent in 1993 to 9.2 per cent in 1998. The financial losses associated with defaulting businesses should be reduced. Losses can be reduced by lowering the percentage guaranteed or by raising the interest premium. Lenders, the KCGF and the KTCGF should strengthen their capacity to evaluate the creditworthiness of micro-enterprises and SMEs in a cost-effective manner, for example, through the use of credit-scoring techniques. Controlling the high cost of the credit guarantee programme and keeping the programme responsive to users will remain a challenge in coming years.

The government may have to retrench policy funds for SMEs to reduce the budget deficit in coming years. A market-oriented strategy should be taken to improve financing to micro-enterprises and SMEs. The market-oriented strategy focuses on reducing risks and transaction costs associated with loans to them, intensifying the capacity of banks and non-bank financial institutions to serve smaller customers and augmenting competition in the financial market.[5] The government and the Financial Supervisory Service should curtail barriers against entry to the financial market by revising the BIS capital adequacy requirements and prudential regulations that may be unsuitable for regional banks and non-bank financial institutions serving micro-enterprises and SMEs.

Information on the creditworthiness of potential borrowers could be enhanced by establishing credit bureaus for micro-enterprises, SMEs, and households. The development of a model to evaluate the creditworthiness of potential borrowers would help lenders reduce the associated high risks and transaction costs. The information asymmetry problem in loan decision-making could be improved by helping SMEs prepare reliable business plans and financial projections.

Demand for working capital by SMEs will grow when the economy emerges from recession. Helping to create the environment in which SMEs can gain easy access to needed capital will be a key priority for policy makers and financial market participants with responsibility for encouraging the growth and development of SMEs on which jobs and wealth in the economy depend.

[5] Kristin Hallberg, ibid., pp. 11-13.

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