CHAPTER II

LITERATURE REVIEW

This chapter provides review of previous literatures involving an impact of financial sector liberalization. These papers will serve as constructive elements for our conceptual and theoretical frameworks as well as comparative study. Several papers, both theoretical and empirical studies, attempted to analyze the impact of financial sector liberalization with an emphasis on banking sector and majority of them focused on effects in term of economic growth. Almost reaching a consensus, most papers agreed that financial sector liberalization improves financial sector efficiency and thereby encourages economic growth, though applying different methodologies.

Literatures which studied the impact of foreign entry to banking sector on economic growth and suggested some transmission channels

To begin with, Demirgüç-Kunt et al. (1998) conducted an empirical study whether foreign banks increase chance of banking crisis and accelerate long-run economic growth using 80 countries data between 1988 and 1995. The results indicated that foreign participation in domestic market lowers the probability of banking crisis and encourage economic growth by fostering domestic banking sector efficiency. This paper investigated this issue in general so that the result of this paper cannot be appropriately applied to any specific country.

An effect of foreign entry on a competitive condition of domestic market as one of transmission mechanisms was investigated by Francois and Schuknecht (1999). They applied econometric model to analyze the relationship between growth rates of real per capita GDP with a measure of the degree of openness in trade, key macroeconomic variables and a measure of concentration in the financial sector. As a result, they found a strong relationship between growth rate and financial sector competition which suggests a positive link between openness and trade.

Following his previous empirical work, Francois and Eschenbach (2002) developed an analytical model and explored a dynamic linkage between financial sector openness, financial sector competition and growth. This process was followed by exercising an econometric method to determine the relationship between each factor using the data of 130 countries in the 1990s. He found a strong positive relationship between financial sector competition and financial sector openness, and between economic growth and financial sector competition confirming his previous empirical work with Schuknecht.

Besides the positive impact of foreign entry on economic growth, some literatures suggested additional adverse effects on economy. Deidda and Fattouh (2002) assessed the effect of a reduction in level of concentration in banking sector and economic growth. They found two opposite effects: (1) it induces economies of specialization which enhances efficiency and then economic growth; (2) it duplicates fixed costs which is harmful for efficiency and growth. They also found that the trade off between them is ambiguous. Empirical evidence suggests that banking concentration and economic growth have a negative relationship only in low income countries.

Suggesting different transmission channels, Tornell and Westermann (2004) examined linkages between financial liberalization, growth and crises and provided several useful facts. They stated that the liberalization adds more growth because it will lead to an increase in investment in the non-tradable sectors which mostly are subjected to financing constraints. However, the cost of the liberalization in credit risks or financial fragility associates along capturing by negative skewness, not by variance, of credit growth. Also, they suggested that, even though the liberalization could leads to occasional crises though boom-bust cycle, it would encourage growth in the long run. Furthermore, FDI does not obviate the need for risky international bank flows because they are the only source of financing for most firms in non-tradable sector. So, parallel with the general view, they believed that FDI is the safest form of capital inflow.

Desai, Foley and Hines Jr. (2004) suggested that the capital controls, one type of impediments to entry, will increase the cost of capital for foreign investors and that multinational firms distort trade patterns, profitability, and dividend payment to mitigate the impact of them. Consequently, capital controls not only raise the costs of capital faced by smaller domestic firms but also are disadvantageous for them relative to larger multinational firms they compete with. Besides, the costs incurred in order to avoid capital controls significantly reduce levels of foreign direct investment.

A few theoretical papers investigated banking system and economic growth in microeconomic aspects. Cetorelli and Peretto (2000) presented a different perspective on financial sector and growth as well as suggested two transmission channels. They explored a market structure of the banking industry and growth by implementing a dynamic general equilibrium model of oligopoly competition in banking sector. Two channels of growth were identified in their model. That is, banking structure affects the amount of credit available to entrepreneurs and banks' decisions to collect costly information about borrowers which determines the efficiency of the credit market. Confirming the model result, they empirically showed the existence of multiple channels through which banking market structure affects growth.

Literatures which suggested implications related to banking sector modeling

Monti (1971) and Klein (1972) introduced an industrial organization approach to banking in which banks are considered profit-maximizing firms. Several authors extended this model to analyze various empirical study such as Neuberger and Zimmerman (1990) and Suominen (1994). Afterward, this approach was revisited by Freixas and Rochet (1997). Our theoretical model is based on this simplified version discussed in detail in the fourth chapter.

Another paper that has numerous relevant implications to our study, Demirgüç-Kunt et al. (1999) used commercial bank data for 80 countries in 1988 to 1995 to study how foreign bank presence has affected the domestic banking markets in 80 countries. They explored foreign and domestic banks' performance indicators such as profitability, net interest margin, overhead cost and non-interest income. They found that foreign banks achieve higher profits than domestic banks in developing countries and, for developed countries, vice versa. In addition, the result also suggested that an increase in the share of foreign banks leads to a lower profitability of domestic banks. Compiling data from BANKSCOPE, they also found that overhead costs of foreign and domestic banks are varied across countries. In term of effects of foreign entry, they stated that a foreign share of banks reduces profitability and overhead cost ratio of domestic banks which implies that foreign entry improves the efficiency of banking sector confirming their previous literature.

In recent study, Bayraktar and Wang (2004) examined the impact of foreign bank entry on the performance of domestic banks, and how this relationship is affected by the sequence of financial liberalization using data set constructed from the BANKSCOPE database consisting of 30 developed and developing countries from 1995 to 2002. They compiled overhead cost ratios of foreign and domestic banks which are also utilized in our conceptual framework. From their analysis, they found that foreign bank entry has significantly improved domestic banks' competitiveness in countries which liberalized their stock markets first and their profits and costs are negatively related to the share of foreign banks. Countries which liberalized their capital accounts first gain relatively less benefit from foreign bank entry.

Literatures which studied the impact of foreign entry to banking sector in Thailand

Integrating Petri (1997) framework into a computer general equilibrium model, the Productivity Commission of Australia implement FTAP, a multi-regional CGE model that incorporates FDI into GTAP to analyze trade in services. Verikios and Zhang (2000) used this model to analyze possible sectoral effects which include communication and financial sectors of multilateral liberalization of trade in services in the form of FDI. They found that Thai real GDP and real income will increase by 0.03 and 0.23 percent respectively if all countries liberalize their financial sectors. However, this general framework can rarely capture sector-specific nature. For example, in financial sector FDI can not only increase capital instruments in which domestic residents can invest, but also gain access to credit that would spur domestic investment that the model cannot take into the analysis.

There are only a few papers which concentrated specifically on Thai banking sector. One of them is a descriptive discussion of Putrakula, Rodprasert and Nakorntan (2004). They explored Thai banking services liberalization in WTO and under the Financial Sector Master Plan and suggested that the financial liberalization is unavoidable and that the Financial Sector Master Plan play a pivotal role in preparing Thai financial institutions to the liberalization in the future. They also agreed that the gradualism approach is justified but authorities should concern about the stability and benefit of consumers as the main objective.

Investigating an impact of foreign-owned banks on Thai banking sector, Montreevat (2000) analyzed how entry of foreign banks inferences Thai banking sector focusing on four hybrid banks which are Nakornthon Bank, Radanasin Bank, Bank of Asia and Thai Danu Bank. The paper suggested that the acquisitions of Thai banks have changed their structures in several aspects such as operational improvements, availability of adequate funds for capital, infusion of advance technology and expertise, financial innovation and marketing skills. Therefore, Thai banks are forced to revamp their corporate management, risk controls and technology base but the competitive advantage of foreign banks may not last for long. On the other hand, consumers would gain benefits from a wide variety of services in the long-run.

Based on the framework of Demirgüç-Kunt et al. (1999), Herberholz (2002) conducted qualitative and quantitative studies to analyze an effect of foreign bank entry to Thai banking sector. Her empirical study applied Thai data from the second quarter of 1997 to the first quarter of 2002. Similar conclusion to that of Demirgüç-Kunt et al. (1999) was reached. She found that foreign-owned banks incorporated in Thailand are more efficient than domestic-owned counterparts in terms of profitability and that foreign entry reduces the net interest margin and profitability in banking sector implying a greater efficiency. She also argued that the asset share of foreign-owned banks determines competitive conditions rather than a share of a number.

Again, almost all previous literatures agreed that foreign entry to banking sector is beneficial to economy although some stated that adverse effects may come along with. These papers also suggested transmission channels linking between entry of foreign bank and economic growth on which our conceptual and theoretical framework based. In addition, the result of our analysis will be compared with some relevant papers in the sixth chapter. Especially, our work is highly related to the work of Demirgüç-Kunt et al. (1999) in our conceptual framework as well as finding though they did not investigate an impact on economic growth.