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A STUDY ON THE DEVELOPMENT OF BANKING SECTOR IN CLMV COUNTRIES WITH SPECIAL REFERENCE TO MYANMAR (1991-2004)

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CERTIFICATION

I hereby certify that the content of this thesis is wholly my own work unless otherwise referenced or acknowledged. Information from sources is referenced with original comments and ideas from the writer him/herself.

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A STUDY ON THE DEVELOPMENT OF BANKING SECTOR IN CLMV COUNTRIES WITH SPECIAL REFERENCE TO MYANMAR (1991-2004)

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ABSTRACT

As domestic banking industry plays a major role in financial sector development, efficient financial intermediation can contribute to the deepening of the financial sector. The efficient domestic banking institutions and financial markets are important in supporting economic development. For these reasons, this study focuses on the development of domestic banking sector in CLMV countries with special reference to Myanmar.

One of the major financial reforms in CLV is interest rate deregulation together with controlling inflation. This results in a positive real interest rate that contributes to financial deepening especially in Cambodia, Laos, and Viet Nam. All of the CLMV countries, without exception, were formerly command economies with Soviet style mono-bank system. Therefore, it is a great achievement that they were able to transform their banking system to one which is more suited to a market-oriented economy in such a short time. However, this study explores not only the pattern of relationship between banking sector development and economic development in CLMV countries but also the major issues of Myanmar banking sector. Moreover, this study proposes a design of financial market structure in Myanmar.

When Cambodia, Laos, and Viet Nam liberalized their financial sectors, they became dollarized countries due to the weaknesses of domestic financial sector and macroeconomic and political instability. Financial liberalization together with inflationary finance causes dollarization and misallocation of resources in Laos. In a situation where a country has underdeveloped financial market, inflationary financing and financial liberalization could lead to capital outflow, dollarization, and financial disintermediation.

In Myanmar on the other hand negative real interest rates hinder the development of the financial sector that decreases savings and investments. Myanmar's savings flow through informal financial intermediation and self-financing rather than through the formal channel. Most small and medium scale enterprises (SMEs) have to rely heavily not only on self-financing but also on informal sources of financing.

This study found many factors that hinder financial intermediation in Myanmar. In particular, this study points out some major factors that weaken the banking system: interest rate ceilings, fiscal imbalances, high reserve requirements, fixed exchange rate, collateral-based lending, weak lending practices, and lending to related firms. These factors restrict the financial intermediation function that limits the size of the banking system. Banking sector cannot meet the financial requirements of SMEs. In addition, low level of per capita income also reduces the level of savings that limits the size of formal banking system. It implies that the smaller the formal banking sector, the larger the informal financial sector.

Although informal financial sector contributes to economic development to some extent, high cost of capital and low grade technology cannot contribute to the economy efficiently. Low savings and low investments cannot contribute to the application of capital intensive technology. One possible way is to improve domestic savings mobilization through the banking system and to develop money and capital markets to channel funds for investment efficiently.

Finally, efficient financial system reduces information and transaction costs which in turn could promote high saving rates, good investment decisions, technological innovation, and long-run growth rates. Thus, financial reforms should be introduced to strengthen the domestic banking system and to improve the supervision of the whole financial system. It is essential to provide a more relaxed regulatory framework to strengthen the banking sector and to develop new financial instruments by introducing financial markets.

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
ASEAN	Association of South East Asian Nations
ATM	Automatic Teller Machine
BOL	Bank of Laos
BSC	Bank Supervision Committee
CAMEL	Capital, Asset Quality, Management, Earning level, Liquidity
CBM	Central Bank of Myanmar
CLMV	Cambodia, Lao PDR, Myanmar, Viet Nam
CSO	Central Statistical Organization
CST	Commodity and Service Tax
DC	Domestic Credit
DIR	Daiwa Institute of Research Ltd.,
ESAF	Enhanced Structural Adjustment Facilities
FCD	Foreign Currency Deposits
FDI	Foreign Direct Investment
FEC	Foreign Exchange Certificate
GDI	Gross Domestic Investment
GDS	Gross Domestic Saving
IMF	International Monetary Fund
LCD	Local Currency Deposits
NBC	National Bank of Cambodia
NDA	Net Domestic Assets
NEM	New Economic Mechanism
NFA	Net Foreign Assets
NPL	Non-Performing Loan
MADB	Myanma Agricultural Development Bank
MEB	Myanma Economic Bank
MFTB	Myanma Foreign Trade Bank
MICB	Myanma Investment and Commercial Bank
MSEC	Myanmar Security Exchange Centre
OTC	Over The Counter
PRGF	Poverty Reduction Growth Facilities

RER	Real Exchange Rate
SAOs	State Administrative Organizations
SBV	State Bank of Viet Nam
SDR	Special Drawing Right
SEE	State Economic Enterprise
SFA	State Fund Account
SOCB	State-Owned Commercial Banks
SIBOR	Singapore Inter-Bank Offered Rate
SOE	State-Owned Enterprise
SME	Small and Medium Enterprise
SWIFT	Society for Worldwide Inter-bank Financial Telecommunication
TB	Treasury Bond
UN	United Nations
UNDP	United Nations Development Program
UNTAC	United Nations Transitional Authority in Cambodia
VAT	Value Added Tax
WB	World Bank
WDI	World Development Indicator

CHAPTER I

INTRODUCTION

The role of the financial sector is more crucial in developing countries as the financial sector provides financial services to the rest of the economy. The important role of the financial sector in all economies is to channel resources from primary savers to investors. Therefore, efficient financial systems facilitate better mobilization and use of resources and thus, accelerate the process of capital accumulation and economic growth.

As the financial sector plays a crucial role in economic development, most governments in developing countries intervene in the financial sector to achieve macroeconomic and financial stability. Common types of government intervention in the domestic financial sector are interest rate regulations, selective credit allocation, market-entry regulation, government ownership, and capital flows. Restrictions and controls on bank behavior imposed by governments often result in negative real interest rates, high inflation, and less supply of loanable funds and excess demand for credit.

Many studies show that governmental control and intervention in the financial system limits the operation of market mechanism, lead to financial repression, and slow economic development. For these reasons, governments became increasingly aware that governmental intervention in the financial system had failed. As a result, restrictions had been relaxed in developing countries during the 1970s and 1980s. In other words, governments have introduced different financial reform packages to relax restrictions gradually to develop the banking sector.

Cambodia, Lao PDR, Myanmar, and Viet Nam (CLMV) are the late movers in the process of financial reform. They started to liberalize their financial sector in the late 1980s and early 1990s, along with economic reforms. Prior to this, in the planned economies, the banking systems were under the control of the governments and mono banking system took the leading role in the development of the financial sector.

The first stage of reform package split the mono-banking system into a two-tier banking system, thus separating the central bank's functions from commercial bank functions. Therefore, the state-owned banks were transformed into state-owned

commercial banks (SOCBs). Then, private owned domestic commercial banks, foreign bank representative offices, foreign banks, and other financial institutions were allowed to participate in the financial sector. Gradually, state ownership has been replaced by private ownership.

1.1 Problem Statement

The development of banking sector is initiated with reform packages. The most important reform mechanism is interest rate deregulation. McKinnon and Shaw point out that positive real interest rates on deposits may encourage the growth of broad money[1]. The World Development Report states that there is strong evidence that real interest rates and inflation have a significant effect on broad money because of the linkage between inflation and real interest rates. Macroeconomic stability is vital for financial sector development (World Bank, 1989: 63)[2].

In CLMV, inflation was in the double or triple digit level and real interest rates had tended to be negative before the period of financial reform. The liberalization of interest rates, together with the reduction of inflation, resulted in positive real deposit rates in Viet Nam and Cambodia. However, the inflation rate remains high in Laos and Myanmar, with Myanmar still having double digit inflation as well as high negative real interest rates since the early 1990s.

Broad money M_2 to GDP (M_2/GDP) in Cambodia, Laos and Viet Nam has grown rapidly, with positive real deposit rates. By contrast, M_2/GDP in Myanmar has declined due to high inflation and negative real deposit rates. The first problem faced by some of the CLMV countries is high and erratic inflation that leads to negative real interest rates and thus, lowering the M_2/GDP. This high inflation and negative interest rate could weaken the financial system, thereby discouraging financial sector development.

In Myanmar, there exist interest rate ceilings, high inflation, high reserve requirements, and exchange rate overvaluation. These factors usually affect the banking sector and the economy as a whole. As these factors are important for the development of the banking sector, they can become the major factors that hinder the

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[1] McKinnon, R. I., Case against Financial Repression, New York, 1986: 204-210

[2] *Broad money* (M_2) includes currency in circulation plus demand, time, and savings deposits at banks.

[3] World Bank , World Development Report, Oxford University Press, 1989: 63

development of banking sector. Among these, low interest rates tend to discourage savings, while low bank deposits can reduce loanable funds. Low lending rates usually results in excess demand for credit. However, in Myanmar, most banks are faced with excess liquidity. It means that they hold idle funds even though lending rates are lower than market determined rates. Hence, insufficient utilization of loanable funds and holding idle funds would limit the banks' profitability and intermediation function which in turn could depress investment and the growth of a country's economy. At the same time, bank financing of SMEs is very limited. They are forced to rely heavily on self-financing and informal sources of financing, such as, money lenders, friends, and relatives. The second problem is, based upon current situations, banks cannot channel idle funds efficiently although lending rates are ceiling rates. On the other hand, bank financing have not met one of the important sources of SMEs' financing requirement, that is investment and working capital requirements. This shows that the banking sector alone is not sufficient to meet the needs of investment and working capital requirements of SMEs.

In Myanmar, financial repression together with inflationary finance further accelerates inflation, forcing a downward pressure on exchange rate depreciation. High inflation and high negative real interest rates under a fixed exchange rate regime discourages deposits that weaken the banking sector development. Limited amount of deposits could reduce the size of the banking sector that could encourage informal sector. The third problem is how to attract the financial resources from informal to formal sector that leads to deepen the banking sector.

1.2 Objectives of the Study

To develop the banking sector, almost all countries introduce financial reform package. According to the different stages of economic development, different financial reform packages would be initiated to develop the banking sector. Hence, this paper provides an overview of major financial reforms in CLMV countries and their impact on the development of banking sectors in these countries. The objectives of this study are as follows:

1) To study the pattern of relationship between banking sector development and economic development in CLMV countries;

2) To identify the issues that hinder the banking sector development in Myanmar in general and find out why Myanmar banking sector alone cannot meet the investment and working capital requirements of SMEs: and

3) To identify the crucial factors in designing financial infrastructure and to design a financial market structure in Myanmar that is a bridge from informal to formal sector.

1.3 Research Questions

When the CLV countries liberalized the financial sector especially interest rate deregulation, bank deposits, and hence broad money grew rapidly in these countries. The growth of broad money increases the stock of money within the country that deepens the financial sector. By using inflation targeting, the Central Bank of Viet Nam and Cambodia tried to maintain positive interest rates in order to attract the financial resources from informal to formal sector which could in turn lead to deepening of the financial sector. Furthermore, the Central Bank of Viet Nam has used expansionary policy to increase lending to the private sector by using monetary policy tools such as reduced reserve requirements and reduced lending rates, resulting in efficient channeling of funds that leads to economic development. One research question that can be raised is that "Is there a positive relationship between banking sector development and economic development in CLMV countries after liberalizing the financial sector particularly interest rates?" Another question is that "What are the major factors that hinder the development of banking sector in CLMV countries?"

Although Cambodia, Laos, and Viet Nam have introduced interest rate deregulation, Myanmar has not done so. That could be a factor hindering the development of its banking sector. Moreover, Myanmar does not seem to have graduated from financial repression that weakens banking sector development. Interest rate ceilings results in less supply of loanable funds which cannot meet the existing demand for loans. According to authorities from the Central Bank of Myanmar (CBM), nearly 50 percent of total loans in the whole banking system goes to trading whereas only a little more than 20 percent goes to manufacturing[3]. It means

[3]As reported in IMF, Myanmar: 2006 Article IV Consultation-Staff Report, IMF, Washington, D.C. IMF Country Report, 2006

that most small and medium scale enterprises (SMEs) had to rely much on own capital and loans from the informal sector. Then again, SMEs do not want to disclose their performance which in turn makes it difficult for them to take bank loans. One research question is that "Why Myanmar banking sector alone cannot meet the investment and working capital requirements of SMEs?"

Interest rate ceilings set by the Central Bank of Myanmar (CBM) are artificially lower than market determined rates. The negative real interest rates push the savers and depositors to informal financial sector which has become quite sizeable. As a result, banking system could not attract deposits from the informal sector. The main issue that Myanmar's banking system is facing is how to attract funds from the informal sector. It is difficult to measure the magnitude of informal financial sector, but the growth of informal financial sector leads to weaken banking sector development. One important research question is that "How should Myanmar develop a financial market structure to attract deposits from informal to formal sector?"

1.4 Design of the Study

This study is based on a comparative study of four ASEAN countries, i.e., Cambodia, Lao PDR, Myanmar, and Viet Nam (CLMV). The following are reasons why this study chooses these four countries from ASEAN. First, these countries transformed from centrally planned to market based economies at about the same time. Second, in all four countries, the mono-banking system was replaced by a two-tier banking system in the late 1980s and 1990s. Third, the state-owned banks still play an important role in the financial sector.

Strenuous attempt is made in this study to obtain primary data from official sources as much as possible. Because data from primary sources is not easily available, the analysis is made by using data published by Central Statistical Organization (CSO), Central Bank of Myanmar (CBM), and Myanma Agricultural Development Bank (MADB).

As the first part of this study is a comparative study of CLMV countries, the data to be used have to be of the same source in analyzing the economic and financial conditions of these countries; the same data sources available from Asian Development Bank (ADB), International Monetary Fund (IMF), and World Bank (WB) were tapped.

Furthermore, this study conducted a survey in Meiktila and Mandalay situated in Upper Myanmar to analyze the general picture of informal money lending practices in these cities. It is based on a survey of 120 private business owners from these cities. A structured questionnaire was developed for the conduct of the survey.

The field study of 120 samples chosen from the above mentioned cities was made during October, 2006. In this endeavor, interviews with structured questionnaires were made in each city. Sixty small and medium scale enterprises in each city was chosen for the field study which is to analyze the nature of informal lending practices and the importance of informal money lending process in those cities.

In analyzing the development of banking sector, the customer relation management is critical to banking business. However, this study only tries to analyze the development of banking sector in CLMV countries from the point of view of the banking sector alone.

1.5 Organization of the Study

With Chapter (1) as the introductory part, the rest of this paper is organized as follows. Chapter (2) describes the role of financial sector in economic development and its conceptual and analytical framework. Chapter (3) presents an overview of the development of banking sector in Cambodia, Lao PDR, Myanmar, and Viet Nam. Chapter (4) provides the impact of financial reforms on banking sector development. Chapter (5) analyses the role and impact of fiscal and monetary policies on inflation and dollarization. Chapter (6) discusses the existing banking system in Myanmar. Chapter (7) proposes a financial market structure in Myanmar. Chapter (8) concludes the whole paper with findings and suggestions.

CHAPTER II

THE ROLE OF FINANCIAL SECTOR IN ECONOMIC DEVELOPMENT

This chapter discusses the relationship between financial sector development and economic development. Section 2.1 explores the role of the financial sector in economic development and the relationship between financial intermediation and economic development. Section 2.2 describes the financial repression paradigm. Section 2.3 focuses on financial restraints and the difference between financial repression and financial restraints. Section 2.4 presents financial liberalization and financial sector development. Section 2.5 considers the financial sector reforms and its impact on financial deepening and economic growth. Section 2.6 describes the financial system and economic growth and section 2.7 presents the conceptual and analytical framework of this study.

2.1 Financial Sector and Economic Development

The role of financial sector in all economies is to channel resources from primary savers to investment opportunities. The important role of financial sector has gained much attention in recent literature on economic growth.

Economists have long believed that financial markets and institutions are important factors in supporting economic development. Economists like Goldsmith (1969), McKinnon (1973), and Fry (1995)[4] established a strong positive empirical relation between the degree of financial market development and the rate of economic growth, and a negative relation between financial repression and growth. However, these early literature failed to give theoretical linkage between financial development and economic growth[5].

Recently, many economists have developed a model that shows a formal link between financial intermediation and growth [6]. This literature considers two interrelated issues: it analyses how financial intermediation affects economic growth

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[4]Goldsmith, R., Financial Structure and Development, New Haven, Conn.: Yale University Press, 1969
McKinnon, R. I., Money and Capital Market in Economic Development, Brookings Institution, Washington, D.C, 1973
Fry, Maxwell J., Money, Interest, and Banking in Economic Development, Baltimore, Johns Hopkins University Press, 1995

[5] King and Levine, Financial Intermediation and Economic Development, London 1993: 156-195

[6] Greenwald and Stiglitz (1991), and King and Levine (1993)

and it studies how economic growth might itself affect the evolution and growth of financial intermediation. It can be interpreted that high financial development increases growth or high growth leads to more developed financial systems.

King and Levine (1993) found out that countries with superior financial systems will, ceteris paribus, allocate savings to more efficient and productive endeavors than will countries with less effective financial systems. In their model, more efficient resource allocation translates into increased productivity and growth through physical capital accumulation and human capital development. They conclude that financial development may well be an important determinant of economic development. Their theoretical and empirical analyses suggest that financial sector reform can importantly promote economic growth by improving the efficient allocation of resources and the effectiveness of other public policies[7].

From the above literature review, it can be noted that financial development is a predictor of economic development. Many economists point out that not only financial development fosters for economic growth but economic growth increases the incentive for financial development. Efficient financial systems help countries to grow, partly by mobilizing additional financial resources and partly by allocating those resources to the best uses. As economies develop, so must the financial systems that serve them. As the financial system grows, efficient channeling of funds lower both the transaction cost and risk-taking from savers to borrowers.

To improve the best allocation of financial resources through an efficient financial system, many developing countries launched financial repression in the belief that it would lead to financial sector development.

2.2 Financial Repression and Financial Sector Development

Since 1970, the McKinnon-Shaw financial repression paradigm has exerted considerable influence on macroeconomic policy in developing countries, particularly through the recommendations of the IMF and the World Bank (Fry, 1995: 38)[8]. This is the reason why many developing countries adopted financial repression as a strategy for financial sector development.

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[7] King and Levine, Financial Intermediation and Economic Development, London , 1993: 160

[8] Fry, Maxwell J. , Money, Interest, and Banking in Economic Development, Johns Hopkins University Press, 1995: 38

Before and during the 1970s, many development economists favored such a policy of financial repression on several grounds but the traditional explanations in the literature are not fully satisfactory. There are four reasons, why the developing countries adopted a policy of financial repression as a strategy for financial sector development. First, the governments needed to impose anti usury laws, thereby intervening in the free determination of interest rates. Second, a strict control and regulation of the banking system would give the monetary authorities a better control over the money supply. Third, governments knew better than market or private banks what the optimal resource allocations were. Fourth, financial repression reduced the costs of servicing government debts[9].

McKinnon (1986) defines financial repression that when governments tax and otherwise distort their domestic capital market, the economy is said to be financially repressed[10]. According to McKinnon-Shaw framework, financial repression refers to a set of policies imposed by governments on the financial sector that distort financial prices and inhibit the operation of financial intermediaries at their full potential. Masuyama (1999) mentions financial repression that includes limits on interest rates and entry and obligatory lending to policy-preferred sectors and projects[11]. The main instruments of financial repression are high reserve requirements, interest rate ceilings, and directed credit to priority sectors. Successful financial repression increases the demand for credit, and at the same time, creates disincentives to save.

Financial repression paradigm permits governments to intervene in the financial market in three ways. First, the imposition of large reserve or liquidity requirements on commercial banks creates an artificial demand for a government's own securities (Agenor and Montiel, 1996: 152)[12]. Second, because of the excess demand for credit, the government invariably begins to ration credit among competing users. Third, because of the disincentive to save, savers begin to switch from holding claims on the banking sector to holding claims in foreign markets. Thus, sectoral and

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[9] See Roubini and Sala-i-Martin (1991), and Fry (1995)

[10] McKinnon, R. I, Case against Financial Repression, New York, 1986: 204-210; Terminology is introduced by Edward Shaw (1973) and McKinnon (1973)

[11] Masuyama, S, The Evolution of Financial Systems in East Asia and their Responses to Financial and Economic Crisis, Institute of Southeast Asian Studies, Singapore, 1999: 3

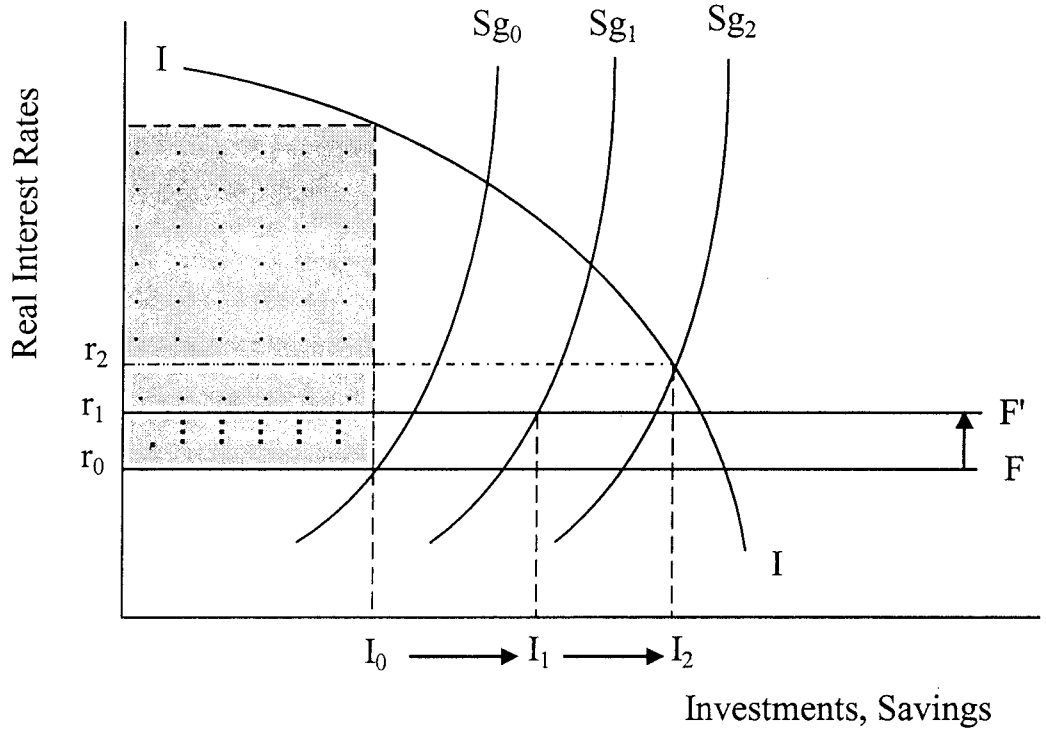
[12] Agenor, P-R., & Montiel, P.J , Development Macroeconomics, Princeton, N.J.: Princeton University Press, 1996: 152

credit schemes as well as capital controls on foreign exchange are typical components of financial repression (World Bank, 1989: 3)[13].

Many studies show that policies of repression of the financial sector lead to a reduction in the growth rate of the economy[14]. McKinnon-Shaw framework points out that the distortions from financial repression crowd out high-yielding investments which is capital-intensive projects, discourage future savings, and thereby reduce both the quality and quantity of investment in an economy.

According to Fry (1995), the essential common elements of the McKinnon-Shaw model are illustrated in Figure 2.1. Savings Sg_0 at a rate of economic growth g_0 is a function of the real interest rates.

Figure 2.1 Savings and Investments under Interest Rate Ceilings



Source: Money, Interest, and Banking in Economic Development (Fry, 1995: 25)

The line "F" represents financial repression taken here to consist of an administratively determined nominal interest rate, which holds the real rate below its

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[13] World Bank , World Development Report, Oxford University Press, 1989: 3

[14] See McKinnon (1973), Edward Shaw (1973),Fry (1995), Demirguc-Kunt & Levine (1996),and World Bank (1989)

equilibrium level. Actual investment is limited to I_0, the amount of savings forthcoming at the real interest rate r_0.

Loan rate ceilings discourage financial institutions from taking any risk. They may ration out a large proportion of potentially high-yielding investments. Raising the interest rate ceiling from "F" to "F´" increases savings and investments. It may also ration out the low-yielding investments, illustrated by the dots in the shaded area which were financed before. Hence, the average efficiency of investment increases. The rate of economic growth rises in this process and shifts the saving function to Sg_1.

The policy prescription is to raise institutional interest rates and/or reduce the rate of inflation. Abolishing interest rate ceilings altogether produces the optimal result of maximizing investment and raising still further investment's average efficiency. This is shown by the equilibrium I_2, r_2, and the higher rate of economic growth g_2 (Fry, 1995: 22-27).

In this framework, money and capital are complements rather than substitutes: the more attractive it is to hold real money balances, the greater the incentive to invest. Productive investment, and therefore capital accumulation, occurs because a large real money stock makes greater amount of loanable funds available to borrowers (McKinnon, 1973: 59-61; Shaw, 1973: 81; Fry, 1995: 38). Hence, Fry concludes that expanded financial intermediation between savers and investors, in this view, increases the incentive to save and invest, and improves the efficiency of investment (Fry, 1982: 734).

In a financially repressed economy, a low or negative real deposit rate of interest shrinks the liabilities of the banking system because savers move away from claims on banks. It reduces the supply of loanable funds that lessens the efficiency of investment. Hence, McKinnon-Shaw framework has generally suggested that raising interest rates to equilibrium levels will increase the rate of economic growth (see Figure 2.1). Financial liberalization of interest rates can increase economic growth by increasing investments and its productivity (McKinnon, 1975; Fry, 1995).

In financial repression paradigm, the low or negative interest rates, high reserve requirements, and high inflation lower the financial intermediation function that discourage savings and thereby reduce capital accumulation. The financial disintermediation leads to lower the development of the financial sector that hinders economic growth. Hence, McKinnon, Shaw and Fry view that financial liberalization

increases saving, improves the efficiency with which resources are allocated among alternative investment projects, and therefore raises the rate of economic growth.

2.3 Financial Restraints

Fry (1995: 20) pointed out that many developing countries appeared to have slipped into financial repression inadvertently. The original policy was aimed not at indiscriminate repression but rather a financial restriction. Development economists point out that financial repression has a negative relationship with economic growth. Hellmann, Murdock, and Stiglitz (1997) explain that financial repression has not been successful in developing countries[15]. It does not mean that modest government intervention cannot be healthy. They pointed out that Japan and other Asian countries had experienced enviable economic growth, helped by government intervention in the banking system. Therefore, Hellmann, Murdock, and Stiglitz (1996 & 1997) proposed some elements of financial policy for a government strategy to promote financial deepening. A new paradigm for financial development that they proposed was called financial restraint[16].

Financial restraint is fundamentally different from financial repression. While financial restraint is to create rent opportunities in the private sector, financial repression is based on the government extracting rents from the private sector[17].

The basic philosophy of financial restraint is that the government can create policies that enhance the efficiency of the private sector especially in the banking sector. Hence, Hellmann, et al., (1997) stated that a number of preconditions must be met for financial restraint to operate effectively. First, the economy needs to have a stable macroeconomic environment. Second, the interest rate ceilings must be positive in real terms. They also pointed out that financial restraint is not a static policy instrument. It should be adjusted as the economy matures[18].

By using financial restraint policy, financial depth will increase and the capital base of the financial sector will strengthen. When the economy matures, the interventions may be relaxed and the economy may make the transition to free market

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[15] Hellmann, T., Murdock. K., and Stiglitz, J. , Financial Restraint: Towards a New Paradigm, Oxford University Press1997: 200
[16] ibid: 163
[17] ibid: 164
[18] ibid: 164

paradigm. From financial restraint paradigm, it can be noted that financial restraint could strengthen the financial sector which could lead in turn to economic growth.

2.4 Financial Liberalization

Financial liberalization can lead to the development of the financial sector, enhancing the provision of funds for productive investment opportunities. Kaminsky and Schmukler (2003) pointed out two main channels through financial liberalization that promote financial development. First, it implies that new types of capital and more capital are available to developing countries. Second, it leads to a better financial infrastructure that mitigates information asymmetries, and reduces adverse selection and moral hazard[19].

Kaminsky and Schmukler, (2003) defined financial liberalization as a process in which different types of restrictions are removed over time[20]. According to their definition, financial liberalization is the removal of controls to allow market determination of interest rate and competition. It can be divided into two parts: internal financial liberalization, and external financial liberalization. Internal liberalization assumes the relaxation of restrictions in the domestic financial system, including liberalization of interest rates and elimination of credit controls, while external liberalization allows free inflows and outflows of capital. Based on this definition, the process of financial liberalization can be divided into three compartments: liberalization of the domestic financial system, liberalization of stock market, and liberalization of capital account.

Domestic and international financial liberalization can be accomplished simultaneously or in different sequences. Some authors argue that the domestic financial system should be liberalized first, and that the international liberalization can be delayed. Hanson reviews the literature in this area and questions both the optimality and practicality of delay in capital account opening, and notes that it is a process that must be managed (Capiro, 1996: 424-425)[21]. Financial liberalization is not a panacea for financial sector development. It is important to recognize that the

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[19] Kaminsky, Graciela L. and Schmukler, S. L. Short-run Pain, Long-run Gain: The Effects of Financial Liberalization, NBER Working Paper No. 9787, 2003: 1-4

[20] ibid: 24

[21] Caprio, Jr. G., Atiyas, I., & Hanson, J. A. , Policy Issues in Reforming Finance: Lessons and Strategies, Cambridge University Press, 1996: 424-425

success or failure of financial liberalization depends on the sequencing and pace of reform.

From the above literature review about the three paradigms, a few questions arise that "Does financial liberalization, particularly interest rate deregulation, improve the efficient allocation of financial resources that lead to economic growth?", and "Which paradigm will be most suitable for a certain country's growth?"

Depending on the macroeconomic stability, and the stage of financial sector development, the governments may choose one paradigm that is appropriate for their countries. Moreover, they may change from one paradigm to another according to the stage of economic development and changing environment. In brief, it may be noted that the paradigm change or the selection of paradigms is the choice of the government. Therefore, McKinnon (1973) said that the success or failure depends mainly on the choice of the policy made by the authority of a country[22].

2.5 Financial Reforms and Financial Sector Development

As the financial sector plays a crucial role in economic development, most governments in developing countries intervene in the financial sector to achieve economic objectives; for instance, China is trying to restrain lending by commercial banks because the economy is overheated due to high levels of growth rate of the economy. Common types of government intervention in the domestic financial sector are interest rate ceilings, selective credit allocation, market-entry regulation, government ownership, and capital flows. Restrictions and controls on bank behavior imposed by governments often result in negative real interest rates, high inflation, and less supply of loanable funds and excess demand for credit. Many studies show that governmental control and intervention in the financial system limit the operation of market mechanisms, lead to financial repression, and lower economic development. For these reasons, governments became increasingly aware that governmental intervention in the financial system had failed. As a result, the restrictions had been relaxed in developing countries during the 1970s and 1980s.

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[22]McKinnon, R. I., Money and Capital Market in Economic Development, Brookings Institution, Washington, D.C, 1973: i

Schmukler (2003) noticed the gradual lifting of restrictions in developed and emerging countries during the last 30 years. The author also identified the main reasons to explain the new wave of liberalization and deregulation by governments of different countries. First, governments found capital controls increase the transaction costs and so such controls are difficult to maintain capital effectively. Second, policy makers have become increasingly aware that government-led financial systems and non-market approach have failed. Third, foreign capital can finance government budget deficits. Fourth, privatization to foreign investors has helped to increase their receipts. Fifth, governments have become increasingly convinced of the benefits of a more efficient and robust domestic financial system for growth and stability of the economy.

Different countries have used different strategies and policies for the development of the financial sector. However, most transitional countries[23] have followed the same broad paradigm, which is the transformation from a mono-banking system to a two-tier banking system in the early stage of financial reform. Blommestein and Spencer (1993) stated that the highest priority must be given to banking reform to provide the basis for ensuring an efficient allocation of financial resources[24]. The issue is which kind of financial system model is the best for each transitional country. Different countries introduced different banking reform approaches. For instance, most Central and East European Countries (CEE) have launched the rehabilitation approach[25] whereas the Former Soviet Union (FSU) countries have established the new entry approach.[26]

Based on those two reform approaches, Askar Alimkulov (1999: 11) proposed an alternative model for the banking system in a transitional economy (Chart 2.1).

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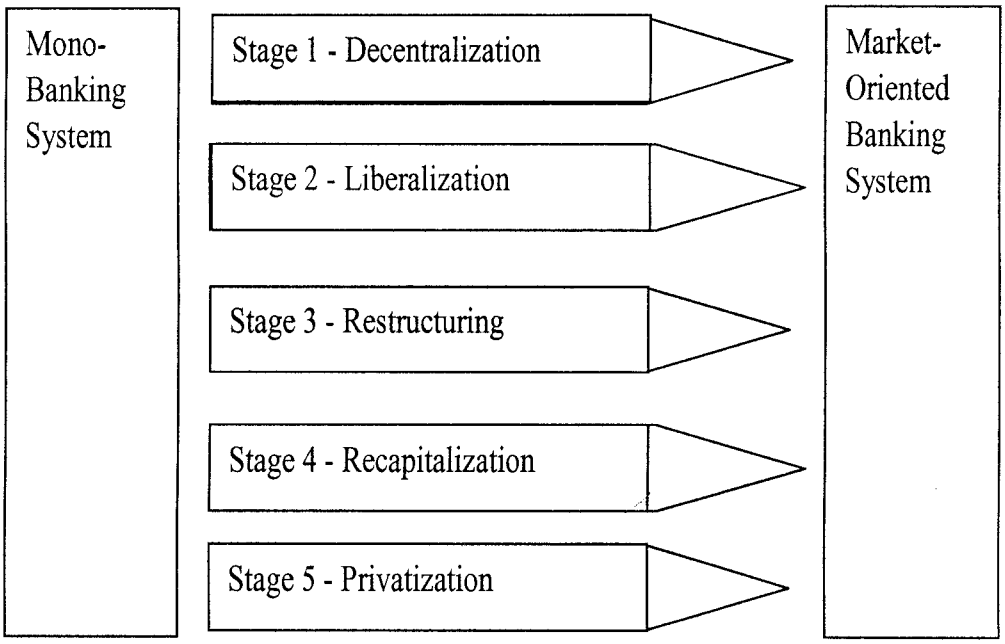
[23] Transitional countries means that those countries which are in the process of transforming from planned to market oriented economy.
[24] Alimkulov, A., A Transformation Model for Banking Systems in Transition Economies, 1999: 6
[25] The main sequences of the rehabilitation approach consists of following stages: decentralization, recapitalization, and privatization (Askar Alimkulov , 1999: 8)
[26] The main sequences of the new entry approach consists of following stages: decentralization, liberalization, and privatization (Askar Alimkulov , 1999: 9)

Chart 2.1 Transformation for Banking Systems in Transition Economies



Source: A Transformation Model for Banking Systems in Transition Economies (Askar Alimkulov, 1999: 11)

As shown in Chart 2.1, a transformation model for banking systems in transitional economies proposed by Askar Alimkulov (1999: 11) consists of five stages: decentralization, liberalization, restructuring, recapitalization, and privatization.

2.6 Financial System and Economic Growth

A financial system is composed of a network of financial markets, institutions, businesses, households, and governments. The primary function of a financial system is to perform the essential function of channeling funds to those individuals or firms that have productive investment opportunities.

Financial markets have such an important function in the economy because they allow funds to move from people who lack productive investment opportunities to people who have such opportunities. Thus financial markets are critical for producing an efficient allocation of capital which contributes to higher productivity and efficiency for the overall economy (Mishkin, 2004: 25)[27].

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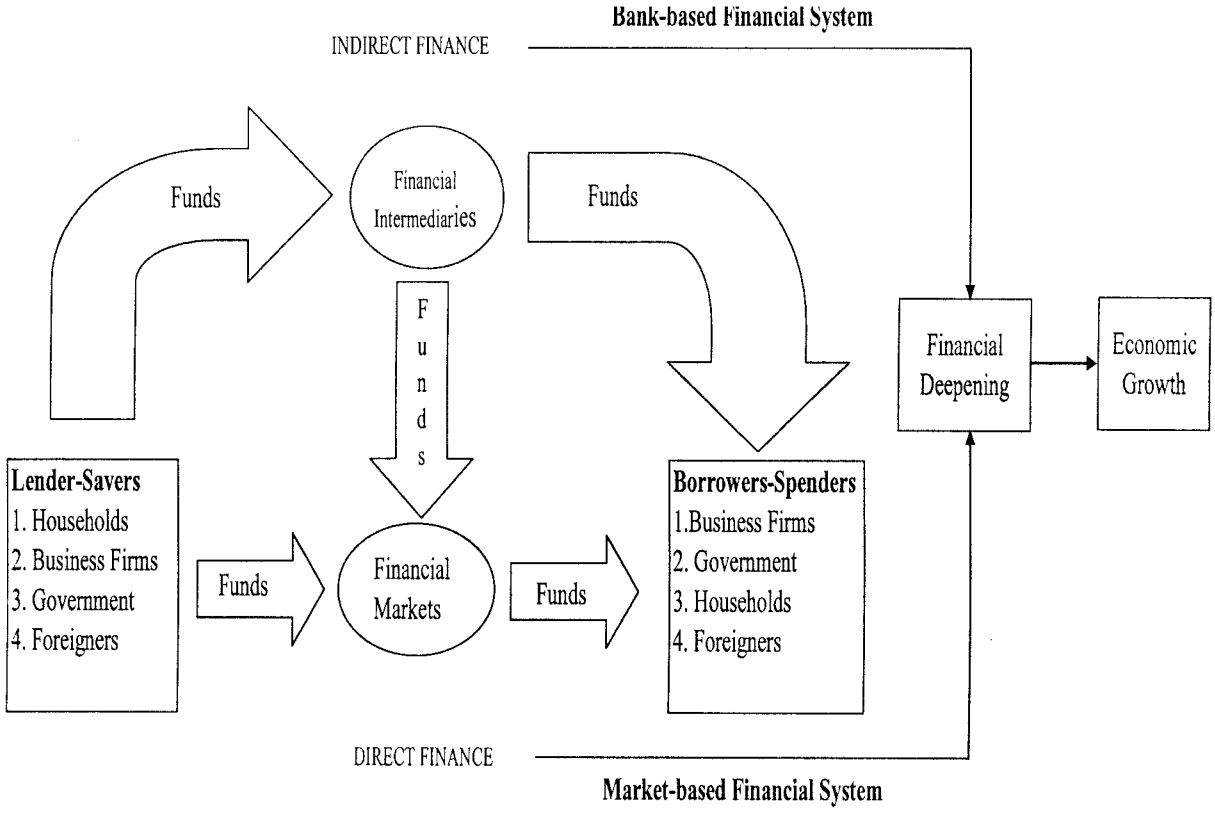
[27] Mishkin, Frederic S., The Economics of Money, Banking, and Financial Markets, New York: Addison Wesley, 2004: 25

Financial intermediaries play an important role in the financial system because they reduce transaction costs, allow risk sharing, and mitigate information problems. Financial intermediaries defined by Mishkin (2004) are financial institutions that acquire funds by issuing liabilities and in turn use those funds to acquire assets by purchasing securities or making loans through the financial system[28].

The major players in the financial system are households, business firms, governments, and foreigners. They play in the system as lender-savers and borrower-spenders. The efficient channeling of funds from lender-savers to borrower-spenders is very important to the economy. Two main routes of channeling funds through the financial system described by Mishkin (2004) are direct finance and indirect finance (Chart 2.2)[29].

Chart 2.2 Flows of Funds through the Financial System



Source: The Economics of Money, Banking, and Financial Markets (Mishkin, 2004: 24)

As illustrated in Chart 2.2, funds can move from lenders-savers to borrowers-spenders by a first route (the route at the top of the chart) is called indirect finance.

[28] op. cit: 41
[29] ibid: 24

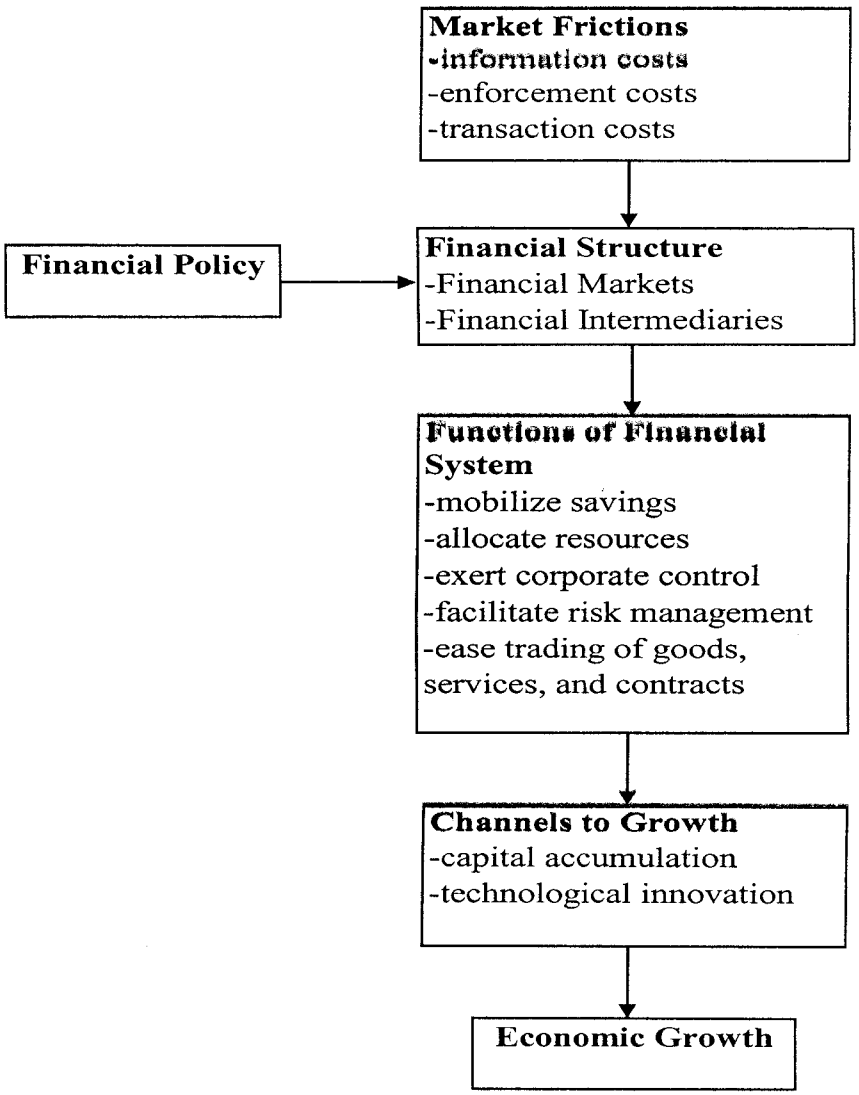
The process of indirect finance using financial intermediaries can be defined as financial intermediation. This process is the primary route for moving funds from lenders to borrowers. An efficient flow of funds from lenders to borrowers through financial intermediaries called bank-based financial system contributes financial deepening.

A second route, at the bottom of the chart, is called direct finance in which borrowers borrow funds directly from lenders in financial markets by selling securities to them. This direct finance way of channeling funds described as market-based financial system contributes financial deepening also. The efficient flows of funds from lender-savers to borrower-spenders through both direct finance and indirect finance are important in the financial system that promotes economic growth.

Levine (1996) pointed out that a well functioning financial system promotes long-run economic growth, so that implementing sound financial sector policies should be a high priority on policy-makers' agendas. He also explained the links between financial sector policies and the structure and functioning of the financial system which can lead to an overall economic growth (Chart 2.3).

As shown in Chart 2.3, a country's regulatory framework will influence the structure and function of the financial system. Financial functions may affect long-run economic growth through two channels: by influencing the savings rate and by affecting capital allocation. In addition, a well-functioning financial system mitigates information costs, transaction costs, and enforcement costs.

Chart 2.3 A Theoretical Approach to Finance and Growth



Source: Financial Development and Growth (Levine, 1996: 688-726)

As the financial system plays a crucial role in economic development, the positive contribution of the financial system is crucial to the process of economic growth which depends, among other things, on how this system is designed (Hermes & Lensink, 2000: 509)[30]. They also pointed out that the design of financial system can be chosen between two dominant systems: the market-oriented financial system which can be found in countries like the United States and the United Kingdom and on the other hand, the bank-dominated system which can be found in Germany and Japan. However, in reality, these two systems overlap.

[30] Hermes, N., & Lensink, R., Financial System Development in Transition Economies, Journal of Banking and Finance, 24, 2000: 509

In bank-based systems, banks play a leading role in mobilizing savings, allocating capital, overseeing the investment decisions of corporate managers, and providing risk management vehicles. In market-based systems, on the other hand, securities markets share center stage with banks in getting society's savings to firms, exerting corporate control, and easing risk management (Demirguc-Kunt & Levine, 1999: 1-4)[31].

As mentioned earlier, most developing countries rely heavily on bank-based financial system. According to Levine, he found a pattern for financial development, that is, poor countries might thus be encouraged to focus on developing their banking systems first, while middle-income countries might adopt a policy that facilitates stock market development (Levine, 1996)[32]. It can be concluded that low-income level countries should develop, firstly, a sound banking system, and then try to adopt securities markets or they should develop an efficient banking system and securities markets at the same time.

The financial systems can generally be divided into formal, semiformal, and informal sectors as shown in Table 2.1. Formal financial institutions are chartered by the government and are subject to banking laws, rules, regulations, and supervision. They include public and private banks, insurance firms, and finance companies. Semiformal institutions are not regulated by banking authorities but are usually licensed and supervised by other government agencies. Informal financial intermediaries operate outside the structure of government regulation and supervision (Ledgerwood, 1998: 12-13)[33].

In developing countries, the role of informal financial intermediaries in the financial system is crucial for economic development because a sizeable informal financial market exists there. Such informal financial intermediaries include local money lenders, pawnbrokers, self-help groups, and NGOs, as well as the savings of family members who contribute to the micro-enterprises as shown in Table 2.1.

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[31] Demirguc-Kunt, A., & Levine, R., Bank-Based and Market-Based Financial Systems, The World Bank Development Research Group, Policy Research Working Paper, 2143, 1999: 1-4
[32] Levine, R., Financial Development and Economic Growth, 1996: 22
[33] Ledgerwood, Joanna, Microfinance Handbook in Sustainable Banking with the Poor, The World Bank, Working Paper No. 18771, 1998: 12-13

Table 2.1 Financial Intermediation Services

Formal Sector	Semiformal Sector	Informal Sector
Central bank	Savings and credit cooperatives	Savings associations
Banks		
Commercial banks	Multipurpose cooperatives	Combined savings and credit associations-Rotating Savings and Credit Associations (ROSCA) and variants
Merchant banks		
Savings banks	Credit unions	Informal financial firms
Rural banks		Indigenous bankers
Postal savings banks	Banques populaires	Finance companies
Labour banks		Investment companies
Cooperative banks	Cooperative quasi-banks	
		Nonregistered self-help groups
Development banks	Employee savings funds	
State-owned		Individual moneylenders
Private	Village banks	Commercial
		Noncommercial (friends, neighbors, relatives)
Other nonbank institutions	Development projects	
Finance companies		Traders and shopkeepers
Term-lending institutions	Registered self-help groups and savings clubs	
		NGOs
Building societies and credit unions	Nongovernmental organizations (NGOs)	
Contractual savings institutions		
Pension funds		
Insurance companies		
Markets		
Stocks		
Bonds		

Source: Food and Agriculture Organization 1995,5

Source: Microfinance Handbook (Ledgerwood, 1998: 13)

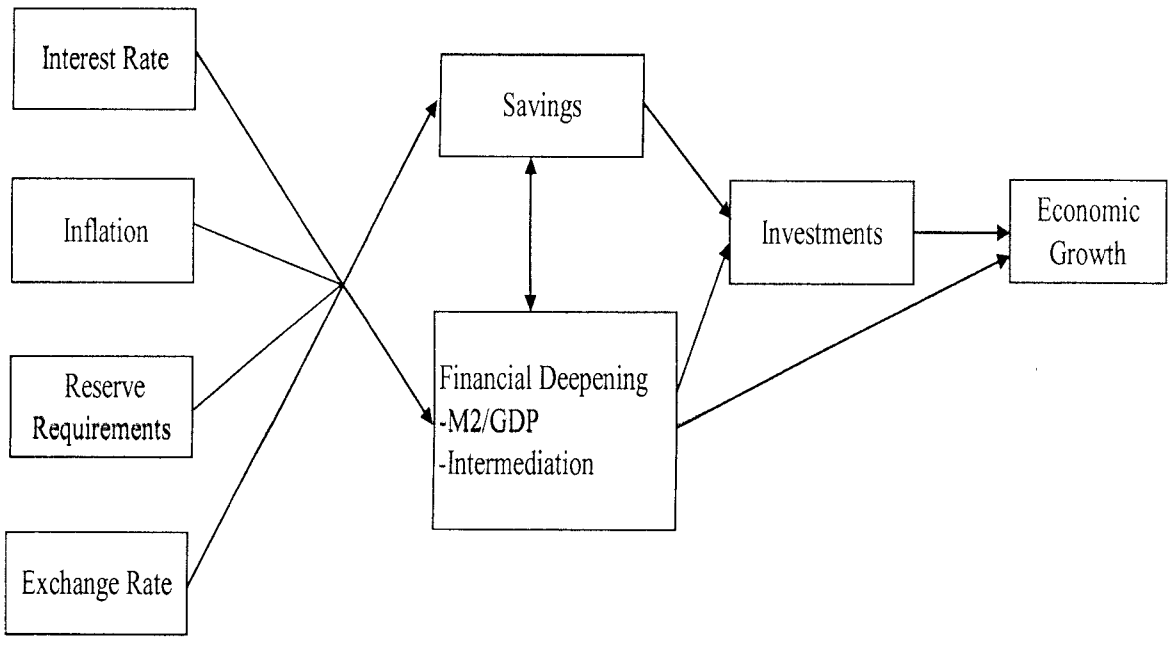
The existence of informal market complements the banking system. The effective way to provide the financial resources to the poor is to adopt Micro Finance Institutions (MFIs) not only for urban poor but also for rural poor. Micro Finance Institutions (MFIs) have evolved as an innovative approach intended to benefit low-income groups. As the contribution of microfinance is to strengthen and expand existing formal financial systems, MFIs are the important bridge from informal to formal financial system that encourages financial deepening.

It can be noted that the development of banking sector depends on the efficiency of both saving mobilization and resource allocation. The more developed the banking sector, the more efficient the resource allocations. If the banking sector is sound and efficient, the financial resources can be transferred from informal financial sector by deregulating interest rates. For instance, financial resources flow from informal sector to formal sector when interest rates were raised up to market rates in Korea. One way to attract financial resources from informal sector efficiently is the resource mobilization through MFIs. MFIs can mobilize the financial resources particularly from rural areas where financial services of banks rarely reach them in developing countries. In developed countries, the efficient banks extend their services to meet the customers' satisfaction. Hence, establishment of MFIs can contribute to the development of banking sector.

2.7 Conceptual and Analytical Framework

As presented in Chart 2.4, interest rate deregulation with reducing inflation, low reserve requirements, and a managed floating exchange rate regime deepen the financial sector development. These factors increase savings and investments. By increasing savings and capital accumulation, the financial sector may contribute to economic growth.

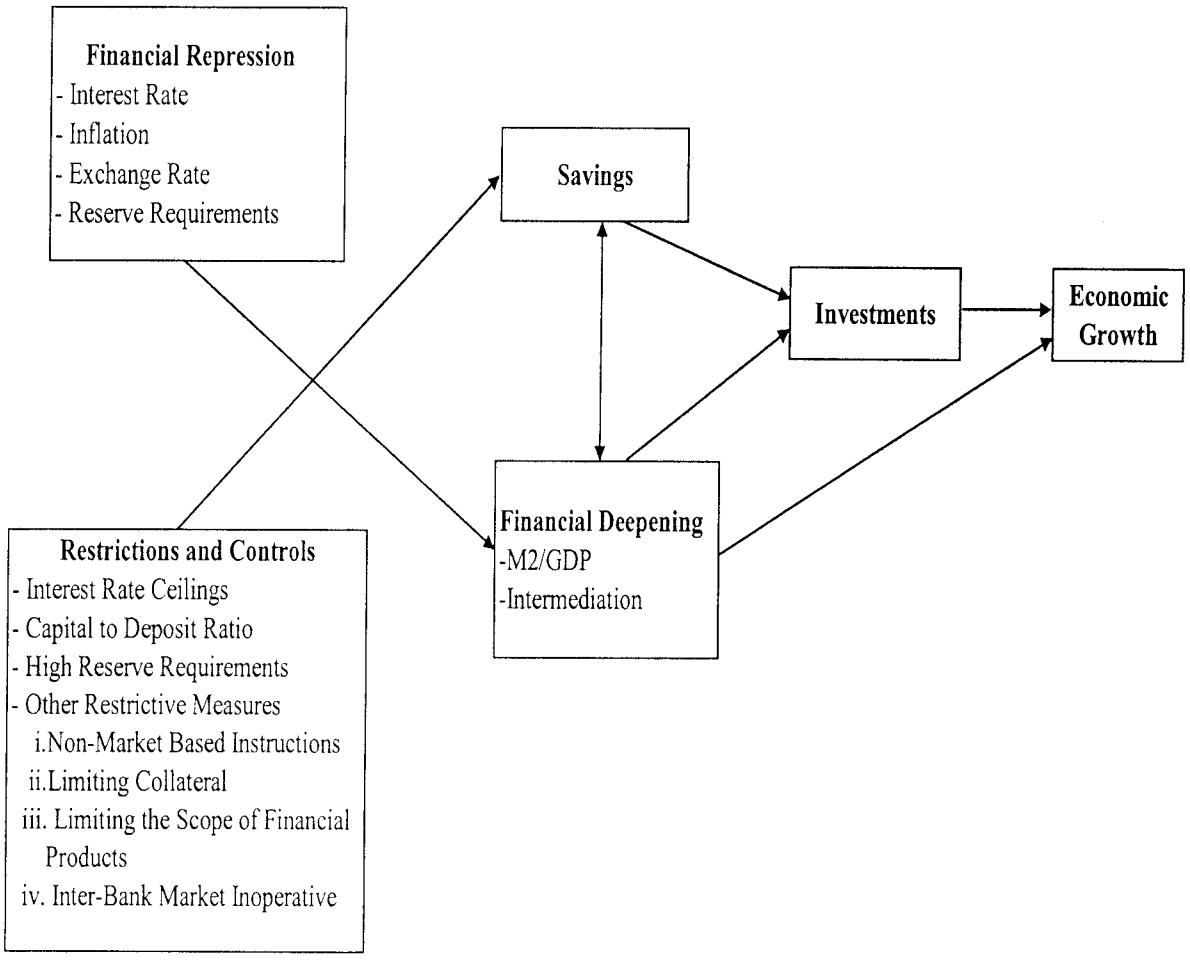
Chart 2.4 General Conceptual Framework in CLMV Countries



On the other hand, interest rate ceilings with high inflation, high reserve requirements, and fixed exchange rate regime decreases savings and investments that weaken the development of the financial sector. Low savings and investments may hinder the development of financial sector that may discourage growth.

Chart 2.5 describes the key factors which could affect savings and investments in Myanmar. The Central Bank imposes direct control tools such as interest rate ceilings, capital to deposit ratio, and high reserve requirements and other restrictive measures and controls on the commercial banks. Then again, under a fixed exchange rate regime with highly overvalued exchange rate and direct control tools could weaken the financial deepening that hinders growth. Moreover, these control mechanisms could reduce the savings in the banking sector and thus pushes depositors to the informal market with high transaction costs. As a consequence, low bank savings reduce the capital accumulation and can hinder economic growth.

Chart 2.5 Key Factors Affecting Savings and Investments in Myanmar



CHAPTER III

THE DEVELOPMENT OF BANKING SECTOR IN CLMV COUNTRIES

As mentioned in Chapter 2, many economists point out that not only financial development allows for economic growth but economic growth increases the incentive for financial development. Since macroeconomic condition influences the development stage of the financial sector, the first part of this chapter introduces an overview of macroeconomic performance in CLMV. The second part of this chapter then describes the financial sector reforms and banking sector development in CLMV.

3.1 Economic Performance in CLMV Countries

The CLMV countries transformed their planned economies to market based economies in late 1980s and early 1990s. However, they have different economic backgrounds and different stages of economic development. For that reason, an overview of the economic development of each country could better enhance the understanding of the CLMV economic conditions in general, before describing the development of banking sector in CLMV countries.

3.1.1 Cambodia

Cambodia introduced economic reform in 1985 under the Enhanced Structural Adjustment Facility (ESAF) of IMF. In addition, the first Socio-Economic Development Plan for 1996-2000 was adopted in 1997 (IMF, 1998: 4)[34]. As shown in Table 3.1, Cambodia's economy had an average growth rate of 5.7 percent during 1991-2004. However, the economy slowed down to 4.1 percent in 1993 and to 4 percent in 1994 due to political instability. The economy slowed down again to 1 percent in 1997 and to 1.8 percent in 1998 due to an impact of regional financial crisis and political uncertainty (IMF, 2000: 5)[35]. Due to the political instability, the inflation rate also grew to 14.8 percent in 1998. However, inflation declined sharply from 14.8 percent in 1998 to -0.6 percent in 2001. As Cambodia is one of the highly dollarized countries, the Central Bank is able to reduce inflation. The result is that Cambodian's economy hit by Asian financial crisis has recovered within three years. After 1999, Cambodia began to have high growth rates together with reduced inflation. This

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[34] IMF, Cambodia: Recent Economic Developments, IMF, Washington, D.C. IMF Staff Country Report No. 98/54, 1998: 4

[35] Cambodia: Selected Issues, IMF, Washington, D.C. IMF Staff Country Report No. 00/135, 2000: 5

shows that both political stability and macroeconomic stability support higher growth rates during 2000-2004. One important factor is that Cambodia has also benefited from large aid inflows which have boosted economic activity (IMF, 2004: 65)[36].

Table 3.1 Economic Performance in CLMV

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Mean
GDP growth (annual %)															
Cambodia	7.6	7.0	4.1	4.0	7.6	7.0	1.0	1.8	5.0	7.7	6.3	5.5	7.1	7.7	5.7
Lao PDR	4.1	6.9	5.9	8.2	7.0	6.8	7.0	4.0	7.3	5.8	5.7	5.8	5.8	6.1	6.2
Myanmar	-0.7	9.7	6.0	7.5	6.9	6.4	5.7	5.9	10.9	13.7	9.7	12.0	13.8	3.0	7.9
Vietnam	6.0	8.6	8.1	8.8	9.5	9.3	8.1	5.8	4.8	6.8	6.8	7.1	7.3	7.7	7.5
Inflation, consumer prices (annual %)															
Cambodia	n.a.	n.a.	n.a.	n.a.	1.1	10.1	3.2	14.8	4.0	-0.8	-0.6	3.3	1.2	3.9	4.0
Lao PDR	13.4	9.9	6.3	6.8	19.6	13.0	27.5	91.0	128.4	25.1	7.8	10.6	15.5	10.5	27.5
Myanmar	32.3	21.9	31.8	24.1	25.2	16.3	29.7	51.5	18.4	-0.1	21.1	58.1	24.9	4.2	25.7
Vietnam	n.a.	n.a.	n.a.	n.a.	n.a.	5.7	3.2	7.3	4.1	-1.7	-0.4	4.0	3.2	7.7	3.7

Source: World Development Indicators (WDI, 2003 & 2006); and World Economic Outlook (2006) (Note: Same data source is used for comparative study)

3.1.2 Lao PDR

After initiating an economic reform in Laos under the New Economic Mechanism (NEM) in 1989, the annual GDP growth rate grew from 4 percent in 1991 to 7 percent in 1997. As Asian financial crisis affected the economy, the annual growth rate then declined to 4 percent in 1998. The slowdown in economic growth was largely caused by a reduction in foreign investment and construction spending. Heavy borrowing from the Central Bank resulted in a rapid expansion of liquidity that caused a collapse of the local currency (Kip) and triple digit inflation that is from 91 percent in 1998 to 128.4 percent in 1999 (Table 3.1).

3.1.3 Myanmar

In Myanmar, the major economic reforms were initiated in late 1988, leading to higher growth rates during the period of 1992-1996[37]. The Asian financial crisis has had an unexpectedly limited impact on Myanmar. However, the Foreign Exchange

[36] Cambodia: Selected Issues, IMF, Washington, D.C. IMF Country Report No. 04/331, 2004: 65

[37] See Myat Thein (2004: 128) for the reasons for high growth rates during that period

Certificate (FEC) rate depreciated against US dollar, accelerating the inflation rate in 1998. Inflation remained at an average rate of 25.7 percent during 1991-2004. However, the average growth rate was 7.9 percent during 1991-2004 which was higher than CLV countries. It is however difficult to reconcile high inflation and high economic growth in Myanmar. For instance, inflation decreased sharply from 58.1 percent in 2002 to 24.9 percent in 2003 and the growth rate increased from 12 percent in 2002 to 13.8 percent in 2003.However, inflation decreased remarkably to 4.2 percent in 2004 again[38], but the growth rate declined noticeably to 3 percent. As a result, macroeconomic instability causes fluctuations in the growth rate in Myanmar.

3.1.4 Viet Nam

Viet Nam was one of the fastest growing economies in CLMV countries. The annual growth rate of GDP grew to 8 percent in 1997, up from 6 percent in 1991 with reduced inflation after initiating Doi Moi or Renovation (1988-1992). However, the growth rate decelerated to 5.8 percent in 1998 and 4.8 percent in 1999, as a result of the Asian financial crisis (ADB, 2000). Inflation has remained low and manageable, despite rapid economic growth.

In conclusion, all the CLMV countries achieved economic growth after introducing economic reforms. Although these countries were hit by the Asian financial crisis indirectly, their economies recovered within a short period of time. Among these countries, Viet Nam's economy had grown impressively together with reduced inflation. It can be noted that economic reforms together with macro economic stability and political stability can lead to growth with price stability.

3.2 The Development of Banking Sector in CLMV Countries

This part introduces an overview of the banking sector reform in Cambodia, Lao PDR, Myanmar, and Viet Nam particularly the ownership structure, fiscal and monetary policy and exchange rate policy. The CLMV countries transformed their economies from planned economies to market oriented economies in late 1980s and early 1990s followed by financial sector reform. Before transforming the financial

[38] However, inflation decreased remarkably to 3.8 percent in 2005, but increased again to 16.4 percent in September, 2006. The New Light of Myanmar, Monday, 18 December, 2006. Figures are cited by Minister for National Planning and Economic Development, U Soe Tha, at the Press Conference held on 17 December at Nay Pyi Taw

sector, the banking systems of these countries were based on the mono banking system. The financial sector was dominated by the state-owned banks and the Central Bank.

The procedures of financial reform in CLMV countries were the same with the other transitional countries, as mentioned in the previous chapter. The first step was that banking systems in CLMV countries were transformed from mono banking systems to two-tier banking systems in late 1980s (Unteroberdoerster,2004: 2 and Appendix 1). In the two-tier banking system, the Central Banks' functions were separated from the commercial banks.

In the second stage, the banking systems allowed the participation of local private banks, and foreign banks in CLV countries. As entry into the banking system was liberalized, the ownership structure of banking institutions has gradually shifted from state sector to private sector since early 1990s. Nevertheless, in Laos, and Viet Nam; the market shares of State-Owned Banks or State-Owned Commercial Banks (SOCBs) have remained larger than the shares of both domestic and foreign private banks in 2004. The market share of State-Owned Commercial Banks (SOCBs) was 74 percent in Viet Nam, 73.6 percent in Lao PDR [39], and 51 percent in Myanmar[40](Appendix 1). It shows that banking system in these countries is still under the control of SOCBs. In Cambodia, on the other hand, the market share of SOCBs was only 19.3 percent. But as Cambodia liberalized the entry mode, many foreign and local private banks entered rapidly into the banking system that resulted in a larger share of private sector participation.

3.2.1 Cambodia

Cambodia's reforms gathered momentum in 1990s. After establishing a joint venture between National Bank of Cambodia (NBC) and a foreign bank in 1991, the number of banks increased rapidly reaching 30 at the end of 1994 (IMF, 1998 & 2003[41]). With the small size of Cambodian's economy and a large number of small

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[39] See Banking Reform in the Lower Mekong Countries (Olaf Unteroberdoerster, 2004: 2)
[40] Calculation is based on state own banks' total assets as a percent of whole banking system' total assets(2001) [Source: International Financial Statistics (IMF, 2004)]
[41] Cambodia: Selected Issues and Statistical Appendix, IMF, Washington, D.C. IMF Country Report No. 03/59, 2003: 35

banks, has resulted in limited lending opportunities, thus making most banks to become engaged in trade sector.

In 1996, a new central bank law was promulgated to establish NBC as the central bank. Cambodia's banking system consisted of NBC, with 20 provincial branches, 22 local incorporated banks, 7 foreign bank branches, and 1 state-owned bank, and also a decentralized system of NGOs engaging in rural financing in 1997 (IMF,1998: 12).

Too many small banks entering into the relatively small local market weakened the financial system. To strengthen the financial system, Banking and Financial Institutions Law was enacted in 1999. This law promotes a sound financial structure and orderly financial markets by providing appropriate legal framework for the licensing, organization, operation, and supervision of a broad range of financial services companies. During this process, non-viable banks were closed and the size of the banking system was down-sized to a level in line with the size of Cambodian economy and the supervisory capacity of the NBC (IMF, 2003: 35).

As a result of restructuring process in 2002, the banking system of Cambodia remained with 17 banks, comprising 1 state owned bank, 3 foreign bank branches, 9 locally incorporated commercial banks and 4 specialized banks [42]. The bank restructuring program has improved the financial soundness of the banking sector. After completing that restructuring program, the Cambodian banking system is well capitalized and highly liquid. Due to the fact that a large portion of bank assets is held in low-yielding liquid assets, the profitability of the banking sector is low. Moreover, lending activities of the banking sector are quite limited relative to the size of economy, as well as to the size of the deposits[43].

Monetary Policy

The indirect tools of monetary policy namely reserve requirements and refinancing facilities were introduced. Reserve requirements of 8 percent are levied on deposits in both foreign and domestic currencies. The indirect monetary policy tools, particularly open market operations do not exist yet, but the authorities find out to

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[42] ibid: 36
[43] ibid: 39

issue Treasury bills during 1997 (IMF, 1998; & Kuyly, 2002[44]). The lending and deposit rates were completely liberalized in 1995 and restrictions on bank lending were abolished. Interest rates have been set somewhere higher than the inflation rate (ADB, 2000[45]; and IMF, 1998: 14).

Exchange Rate Policy

Cambodia has introduced a managed floating exchange rate regime since 1993. Recent monetary policy actions continue to intervene in the exchange market to stabilize the excessive fluctuation of the exchange rate. The gap between official and parallel market exchange rates has been kept below one or two percent (ADB, 2000).

Fiscal Policy

In the 1980s, modern taxation did not exist under socialist regime and levels of revenue collection were extremely low. In those years, budget deficit was financed by central bank borrowing with limited external financing that caused hyperinflation into triple digit level. Fiscal policy was undermined by government intervention which resulted in a weakening position to collect revenue, exemption of custom duties, smuggling, accumulation of arrears on tax and non tax revenue, and significant loss in forestry revenue (IMF, 2003: 15-24).

In the early 1990s, a major fiscal reform was initiated in 1992 with assistance from the IMF and UNDP to mobilize revenue. According to the Organic Budget Law promulgated in 1993, domestically financed expenditure was contained within budget estimates, and central bank financing was eliminated. The reform program covered all aspects of Cambodia's revenue system in tax policy and tax and custom administration.

The main effective policy measures were: (a) a consumption tax on imports, which was introduced in 1993; and (b) a higher ad valorem duty rate on petroleum products which increased gradually from 3-5 percent in 1992 to about 50 percent in 1994[46].

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[44] Kuyly, Keo, The Challenge of the Cambodian Economy, Center for ASEAN Studies. CAS Discussion Paper No. 38, 2002

[45] ADB, Country Economic Review: Cambodia, Asian Development Bank, CER: CAM 2000-14, 2000

[46] ibid: 15-16

Nevertheless, the government faced serious difficulty in managing fiscal policy between mid 1997 and late 1998. The fact is that government use central bank financing strategy in 1998, resulting in increased inflation to double digit level (IMF 2000: 11-25).

Fiscal policy management was improved by eliminating ad-hoc tax and custom duty exemptions. Moreover, the value-added tax (VAT) was introduced in 1999. The VAT enhanced revenue and improved the efficiency of tax system. The fiscal reform that started in early 1999 was strengthened during 2000-02 under the Poverty Reduction Growth Facilities (PRGF) arrangement. Achieving the government's revenue target will be a key to maintaining fiscal sustainability[47]. Cambodia's fiscal position appears to be only marginally sustainable over the year due to an eventual rescheduling of external debt management.

On the other hand, the expenditure program has been implemented with the government's financing targets to maintain a sustainable fiscal framework that require a restructuring of public expenditures[48].

In conclusion, the Cambodian government introduced a reform package to broaden the tax base that can collect revenue systematically in collaboration with World Bank, IMF, and UNDP. At the same time, the government introduced a restructuring of public expenditures to maintain sustainable fiscal framework. Moreover, the government limits central bank financing that can control inflation.

3.2.2 Lao PDR

The Lao's banking system consisted of the Central Bank, the Bank of Laos (BOL), with 7 State-owned Commercial Banks (SOCBs), 2 small private banks, and 7 branches of foreign banks (IMF, 1998: 15)[49]. In early 1990s, all the state commercial banks became deeply insolvent because of the huge amount of inefficient SOEs' loans that became non-performing loans (NPLs). One important reason to become financially distressed was weak lending practices. The directed lending and excessive exposure to the SOEs weakened the financial system.

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[47] ibid: 12
[48] ibid: 17
[49] Lao People's Democratic Republic: Recent Economic Developments, IMF, Washington, D.C. IMF Staff Country Report No.98/77, 1998: 15

Hence, the government recapitalized all state-owned commercial banks in 1994 to eliminate NPLs originating from the mono banking system. At the end of 2004, the banking system of Laos comprised of the Central Bank, 2 State Commercial Banks, 3 joint venture banks, 6 branches of foreign banks, and 1 representative office (Koyama, 2005: 5)[50].

Monetary Policy

A standard mechanism on interest rate determination is formulated by the Central Bank of Laos. Commercial banks are allowed to set their own rates. However, interest rates for saving accounts had been fixed in a wide range of 6 percent to 22 percent in 2000 (ADB, 2001)[51].

According to Socio-Economic Plan, the Bank of Laos conducted a relaxed monetary policy by reducing bank interest rates from 35 percent to 20 percent. After that, the Bank of Laos (BOL) relaxed interest rate ceilings gradually. In addition, reserve requirements on local currency were reduced, from 12 percent to 6 percent in 2002 to expand private sector lending. However, at the end of 2002, BOL had to conduct tight monetary policy as a response to local currency depreciation. The tight monetary policy certainly increases reserve requirements from 6 percent to 8 percent for local currency and from 12 percent to 15 percent for foreign currency (World Bank & ADB, 2002: 14[52]).

Exchange Rate Policy

In Lao PDR, the exchange rate system has moved to a managed floating exchange rate system. The Bank of Laos (BOL) has continued to manage exchange rate flexibility, permitting 2 percent spread between banks' exchange rate and the parallel market rate (IMF, 1998: 18).

Fiscal Policy

Under the World Bank Structural Adjustment Credit, government monitored its current and capital expenditure more closely. The package of revenue enhancing

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[50] Koyama, M., Financial System Development and a Study on DFIs in Lao PDR, Unpublished Paper, Development Bank of Japan, 2005: 5

[51] Country Economic Review: Lao PDR, Asian Development Bank. CER: LAO 2001-11, 2001

[52] World Bank and ADB, The Banking and Financial Sector of Lao PDR, Bank of the Lao PDR, 2002: 14

measures was proposed by the government to National Assembly which emphasized particularly on the revenue side. The revenue enhancing measures are: rationalizing income tax rates; reducing turnover tax rates; increasing excise duties on petroleum products; introducing a stamp duty; and increasing land tax on commercial and residential land in urban areas. In 2000-01, low revenue without expenditure adjustment in the first year of fiscal decentralization led to excessive bank financing of the budget deficit that increased inflation into double digit level. Ineffective provincial expenditure control gave rise to excessive commitments and an accumulation of domestic arrears that resulted in exchange rate depreciation (IMF, 2002: 6)[53]. Under the PRGF program, a VAT system was introduced in 2003 to strengthen the tax base. However, the revenue collection is below its potential because of weaknesses in structural reforms.

The Laos budget system has many weaknesses for modern fiscal management. However, in 2004, limiting exemption and other tax incentives is to broaden the tax base. At the same time, public expenditure reform was introduced. The weaknesses of fiscal management worsen fiscal imbalances. The widened budget deficit financed by central bank borrowing causes inflation acceleration.

3.2.3 Myanmar

Myanmar has introduced a significant program of economic reforms since 1988. Following the adoption of a market oriented economy, the financial system in Myanmar has been restructured since 1989. A new financial system relieved the debt burden of the SEEs by converting the debts into state equity. According to World Bank sources, liabilities of SEEs towards Myanma Economic Bank (MEB) amounting to 49 million kyats were converted into state equity. The Central Bank has relieved MEB of part of the SEEs' loans while the rest may be written off (Myat Thein & Mya Than, 1995: 227)[54].

According to the new banking system laws enacted in July 1990, Myanmar's financial structure includes the Central Bank of Myanmar (CBM), 4 specialized state

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[53] Lao People's Democratic Republic: Selected Issues and Statistical Appendix, IMF, Washington, D.C. IMF Country Report No.02/207, 2002: 6

[54] Myat Thein & Mya Than, Transitional Economy of Myanmar: Performance, Issues, and Problems, Institute of Southeast Asian Studies, Singapore, 1995: 227

owned banks, 20 private commercial banks, and 34 foreign representative offices. After banking crisis, 3 private banks were closed and 3 cooperative banks were merged to 1 cooperative bank. Thus, 15 private banks remain in operation.

The new financial system is different from Laos and Viet Nam. SOCBs in both Laos and Viet Nam have suffered from the increasing amount of SOEs' lending that weakened the financial system. In Myanmar, the government has prohibited the SEEs' lending to prevent the accumulation of NPLs after financial restructuring in 1989. The SEEs are to deposit their receipts to the State Fund Account (SFA) and their expenditures are to be incurred from the fund (Statistical Year Book; CSO, 2001). The State Fund Accounts (SFAs) administered by the Myanma Economic Bank (MEB) was introduced to make up the deficits of SEEs using the national budget allotment. This means that the deficit of SEEs is financed by national budget through SFA account, instead of borrowing directly from MEB which is one of the largest SOCBs.

Although all countries tighten prudential regulations, especially strengthening of banks' equity capital, the equity to deposit ratio regulation in Myanmar is to restrict the amount of deposits within 10 times of the paid-up capital. Moreover, loans cannot account for more than 80 percent of total deposits[55]. The result is a contractionary effect on the banks' deposits and balance sheets.

Monetary Policy

Interest rates being set by the Central Bank of Myanmar are that minimum interest rates payable on saving certificates and time deposits shall not be more than 12 per cent; maximum interest rate chargeable on loans and overdrafts shall not be more than 17 per cent. Hence, private commercial banks are not free to set the interest rates. However, the saving rates are still below the inflation rate.

According to the prudential regulation, the reserve requirements are 5 percent and 10 percent on time and demand deposits respectively. At least 75 percent of reserves must be held as a non-remunerated deposit at the Central Bank of Myanmar

[55] The Myanmar Times, July 19-25, 2004

(CBM) and the rest 25 percent in cash. Holding of Treasury bonds can be counted against the reserve requirement (IMF, 1999: 21).

Exchange Rate Policy

In Myanmar, the official exchange rate is pegged with Special Drawing Rights (SDRs) at Kyat 8.5087 = SDR 1, or at around Kyat 6 per US dollar since 1997. As is well known, this rate is highly overvalued and irrelevant for most practical purposes. As a result, external trade by the private sector is conducted at the market-determined parallel exchange rates. The parallel exchange rate or market-determined rate is determined by unofficial foreign exchange market. Moreover, there exists imported goods valuation rate for the purpose of custom duty valuation i.e., Kyats 100 in 1996, Kyats 450 in 2004, and Kyats 850 for border trade in 2006.

Cent percent retention of foreign exchange is allowed to foreign investors who bring their foreign exchange into Myanmar, and who generate foreign exchange income in Myanmar. In addition, Myanmar citizens who earn foreign exchange earnings are also allowed to open foreign exchange accounts in state-owned banks.

In addition, in 1993, the Central Bank of Myanmar has introduced Foreign Exchange Certificates (FECs) to be allowed to exchange for kyat at a market determined rate, representing a de facto devaluation and one Foreign Exchange Certificate is equal to one US dollar (Mya Than 2006: 14-15). People in Myanmar can accept, use, and hold FECs freely within the country. However, according to a number of economists the highly overvalued exchange rate is one of the factors inhibiting a sizeable inflow of FDIs into Myanmar.

Fiscal Policy

The government budget in Myanmar consists of the budget of state administrative organizations (SAOs), state-owned economic enterprises (SEEs), and development committees. Since the lunching of the third 5 year Short-Term Plan (2001/2002- 2005/2006) one of the important policy goals of the government is to reduce fiscal deficit [56]. The main objectives of fiscal policy are to promote infrastructure development which is essential for socio-economic development as a

[56] Ministry of National Planning and Economic Development

short-and medium-term objective, and to achieve sustainable higher economic growth as a long-term objective.

The SEEs deficit increases government expenditure that widens budget deficits. The financing of these deficits is mainly through an expansion in central bank borrowing that increases the money supply which in turn leads to inflation.

Myanmar's tax structure is heavily dependent on indirect tax. Three types of measures had been carried out to reform the tax structure and administration: broadening the base of indirect taxation by replacing commodity and service tax (CST) with commercial tax; improving tax administration; and streamlining and simplifying procedures in the collection of tax.

3.2.4 Viet Nam

Viet Nam has implemented a wide range of economic reforms when transforming from a centrally planned economy to a market oriented economy since introducing Doi Moi or Renovation during 1988-1992. Before introducing the economic reform, the banking sector was dominated by State Owned Commercial Banks (SOCBs) and its credit by State Owned Enterprises (SOEs).

Viet Nam's banking system consisted of the State Bank of Viet Nam (SBV) and 4 State Owned Commercial Banks (SOCBs). Two more new specialized SOCBs were established and 54 Joint Stock Banks (JSBs) were allowed in 1990. At the end of 1999, Viet Nam's banking sector comprised of 4 SOCBs, 48 JSBs, 26 foreign bank branches, 5 financial companies, and 8 leasing companies (IMF, 2003: 48-51)[57].

The SOCBs carry the role as a supplier of credit to SOEs, and they constitute the core of the banking sector. Because of inadequate credit risk management, the financial distress of the SOCBs is a more serious problem in terms of its size and difficulty. With a comprehensive scheme for reconstruction in 1999, a number of banks underwent recapitalization, mergers, and liquidation.

Although the financial system is becoming more market-based, SOCBs continue to play a dominant role (Appendix 1). As a result, key money markets are quite thin and underdeveloped, complicating the task of monetary management through indirect instruments; banks still closely follow SBV reference rates; and the

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[57] Vietnam: Selected Issues, IMF, Washington, D.C. IMF Country Report No. 03/381, 2003: 48-51

SBV continues to play an important role in smoothing movements of the Dong (IMF, 2003; 8)[58]. A priority now would be to develop money markets and reduce segmentation of the banking system, through the issuance on a regular basis of short-term treasury bills or the more active use of SBV as a liquidity management tool[59].

Monetary Policy

The monetary instruments namely credit ceilings, reserve requirements, refinancing facilities, Treasury bill auctions, and interest rates have been used to meet the objective of low single digit inflation. Interest rate policies are gradually being liberalized. The real interest rates on deposits have been positive since 1995. Banks have been permitted to determine the local currency (Dong) deposit rates individually since 1996. On the other hand, the lending rate ceiling was gradually reduced in 1999 to stimulate credit growth and demand[60].

Although the government of Viet Nam has gradually liberalized interest rates since 1996, the State Bank of Viet Nam (SBV) maintained an interest rate ceiling mechanism until 2000. The State Bank of Viet Nam (SBV) replaced the ceiling mechanism with the base interest rate mechanism regarding domestic currency-based lending in 2000. Under this mechanism, the State Bank of Viet Nam (SBV) sets a base lending rate and margins above this rate to serve as limits for the lending interest rates charged by banks. This new mechanism provides adequate flexibility to credit institutions and helps to enhance firms' access to credit.

At the same time, the government also adopted a market interest rate mechanism for foreign currency-based lending activities. The interest on dollar deposits is now based on the SIBOR, i.e., Singapore Inter-bank Offered Rate. The SBV maintained a formal reserve requirement ratio of 10 percent of all deposits until 1994. The reserve requirement ratio was further reduced to 3 percent to relax credit supply in order to encourage firm investment[61].

Exchange Rate Policy

Viet Nam has adopted a flexible exchange rate regime. The State Bank of Viet

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[58] Article IV Consultation-Staff Report (Viet Nam), IMF, Washington, D.C. IMF Country Report No. 03/380, 2003

[59] ibid: 17-18

[60] ibid

[61] http://www.ub.rug.nl/eldoc/dis/eco/l.khuong.ninh/c3.pdf. "The Financial System in Vietnam":45-46

Nam (SBV) intervenes in the exchange market to stabilize the exchange rate and reduce inflation. The Dong continues to depreciate slowly against the U.S. dollar, with the SBV intervening to prevent appreciation and build up reserves (IMF, 2003: 10). The crawling peg system, introduced in 1999, allowed the inter bank exchange rate to depreciate by a maximum of 0.1 percent per day. It means that the daily trading band within which the rate is allowed to fluctuate was 0.1 percent. The exchange rate moves with the daily trading band set by the SBV, and policy-based lending is being shifted to specialized institutions[62]. Although there has been some liberalization, foreign currency denominated earnings remains tightly controlled (ADB, 2000)[63].

Fiscal Policy

Viet Nam started to modernize the tax system in the late 1980s. The present composition of budgetary revenue is indirect taxes, direct taxes, and non tax revenue. Overall revenue performance depends crucially on contributions from the state enterprise sector. The most significant changes in Viet Nam's revenue performance since 1996 have been a gradual decline in tax revenue, an increased dependence on oil revenue, and a further decline in revenue from the state sector. The major source of revenue is from oil revenue.

Although value added tax (VAT) was introduced in 1999, ad hoc exemptions currently granted on the VAT resulting in poor efficiency of VAT and custom administration.

In conclusion, after all four CLMV countries transformed their economies from planned economies to market oriented economies in late 1980s and early 1990s, Cambodia, Laos, and Viet Nam have relaxed their interest rates gradually with reduced inflation rate. Fiscal policy of all CLMV countries is to balance the budget, that is, broadening the tax base and cutting expenditure. They (CLV) also have adopted the managed floating exchange rate system. However, on the other hand, Myanmar remained with unchanged interest rate ceilings set by the Central Bank of Myanmar and foreign exchange rate is still pegged officially to SDRs. CBM has not realigned the exchange rate yet and has used multiple exchange rates (Appendix 2).

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[62] ibid: 8

[63] Country Economic Review: Socialist Republic of Vietnam, Asian Development Bank, 2000

CHAPTER IV
THE IMPACT OF FINANCIAL REFORMS ON BANKING SECTOR DEVELOPMENT

The first part of this chapter describes the impact of financial reforms on banking sector development after deregulating interest rates. As the financial sector is based on the banking sector in these countries, an efficient financial intermediation particularly in the banking sector plays an important role for financial sector development. A well functioning financial intermediation will better enhance savings mobilization, and then the efficient allocation of those funds will further increase financial depth. The second part finds out the relationship between savings, investments, and economic growth.

4.1 Financial Sector Development

The main discussion in this part is the impact of financial reform on financial sector development. The most important part of financial reform is interest rate deregulation which raises broad money and the main impact of financial reform is the widening and deepening of the financial sector. Many empirical studies show that financial reform has a greater chance not only to mobilize resources but also to allocate them more efficiently[64].

All CLMV countries except Myanmar had suffered from double and triple digit inflation before deregulating their interest rates. When the interest rates were liberalized in Cambodia, Lao PDR, and Viet Nam, broad money grew rapidly. The question is whether the growth of broad money really deepens the financial sector particularly in these dollarized economies[65].For this, focus will be given on the deepening of the banking sector in CLMV and then the extent of financial intermediation by mobilizing financial resources and by channeling them effectively and efficiently.

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[64] See McKinnon and Shaw, 1973; Fry, 1995; Levine, 1996

[65] When those countries lifted the high negative interest rates, they become the highly dollarized economies i.e., Cambodia and Lao PDR and a moderately dollarized economy i.e., Viet Nam.

4.1.1 Financial Deepening

McKinnon (1973), Shaw (1973), Fry (1995), and many scholars found that liberalization of interest rates can deepen and widen the financial sector. The term financial deepening, as defined by Shaw refers to the increased utilization of money and other financial instruments in the modernization process (Shaw, 1973)[66]. The concepts of financial development and deepening refer to the growth and diversification of financial services, markets, and instruments. Cole (1995) pointed out that the measurement of financial deepening is the ratio of broad money to GDP (M_2/GDP), the standardized statistics compiled by IMF (Cole, 1995: 223-257)[67].

The traditional quantitative measures for financial deepening are M_2/GDP as mentioned above and allocation of credit in the economies. M_2/GDP ratio expresses the real money stock in the economy and the credit allocation shows the efficient allocation of funds in the economy.

The measurement of M_2/GDP can be compared with the currency to GDP ratio (C/GDP) and narrow money to GDP ratio (M_1/GDP). The ratio of currency to GDP (C/GDP) expresses the degree of monetization in the economy. Narrow money (M_1) consists of money in circulation and demand deposits whereas broad money (M_2) includes narrow money (M_1) and time and saving deposits.

As shown in Figure 4.1, currency ratio and narrow money ratio in Cambodia were nearly on the same trend. This can be explained by the very low demand deposits in local currency mostly held in the form of non-interest bearing vault cash and reserves with National Bank of Cambodia (NBC). A number of institutions do not accept local currency (Riel) deposits, and bank intermediation in local currency is minimal (Viseth, 2001: 15)[68].

From the observation of IMF staff report, foreign currency deposits have started to become an important component of the bank deposit base since 1992 as a result of lack of confidence in local currency and political uncertainty. Figure 4.1 also

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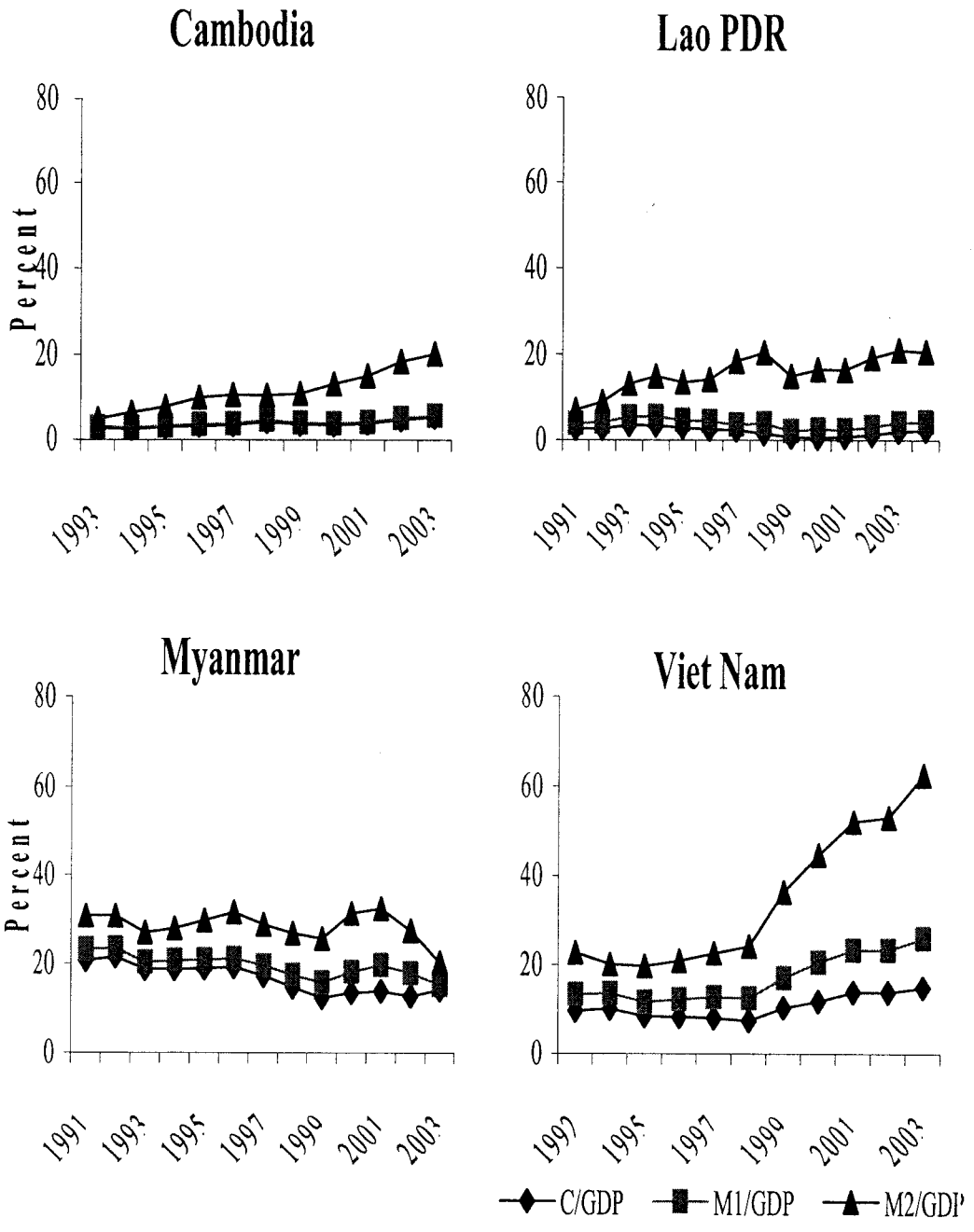
[66] Shaw, E. S., Financial Deepening in Economic Development, Oxford University Press, New York, 1973: 3-16

[67] Cole, David. C., Financial Sector Development in South East Asia, Oxford University Press, Oxford, New York, 1995: 223-257

[68] Viseth, K. R., Currency Substitution and Financial Sector Developments in Cambodia, Working Papers: International and Development Economics, Australian National University (ANU), 2001: 15

showed that broad money to GDP ratio increased gradually from approximately 5 percent in 1993 to approximately 20 percent in 2003 but it was still low, comparing with the other countries. However, this ratio became stagnate during 1996-1998 that may be due to the negative real deposit rates.

Figure 4.1 Financial Deepening in CLMV



Source: International Financial Statistics (IMF, 2005)
(Note: Same data source is used for comparative study)

In Laos, the currency ratio has decreased gradually since 1993, meaning that Laos proceeds the demonetization process. However, this ratio increased slightly from 0.7 percent in 2001 to 2.2 percent in 2004. The growth pattern of narrow money to GDP was similar to currency ratio. Broad money to GDP increased from 7 percent in 1991 to 20 percent in 1998 and then decreased to 16 percent in 2001. The decrease in broad money ratio was mainly due to high inflation and negative real interest rates.

For the case of Myanmar, the currency ratio declined sharply from 1996 to 1999 but it was still high comparing with the other countries. This means that the degree of monetization is still high in Myanmar. Broad money to GDP ratio increased from approximately 27 percent in 1993 to approximately 32 percent in 1996 percent due to the growth of private banks. However, this ratio declined to approximately 20 percent in 2003, which was very low in comparison with the other countries. A main factor that influenced the broad money ratio was negative real interest rates. Myanmar remained with unchanged ceiling rates, which was lower than the market clearing rates, resulting in negative interest rates. Moreover, the inflation rate in Myanmar has also remained high since 1991.

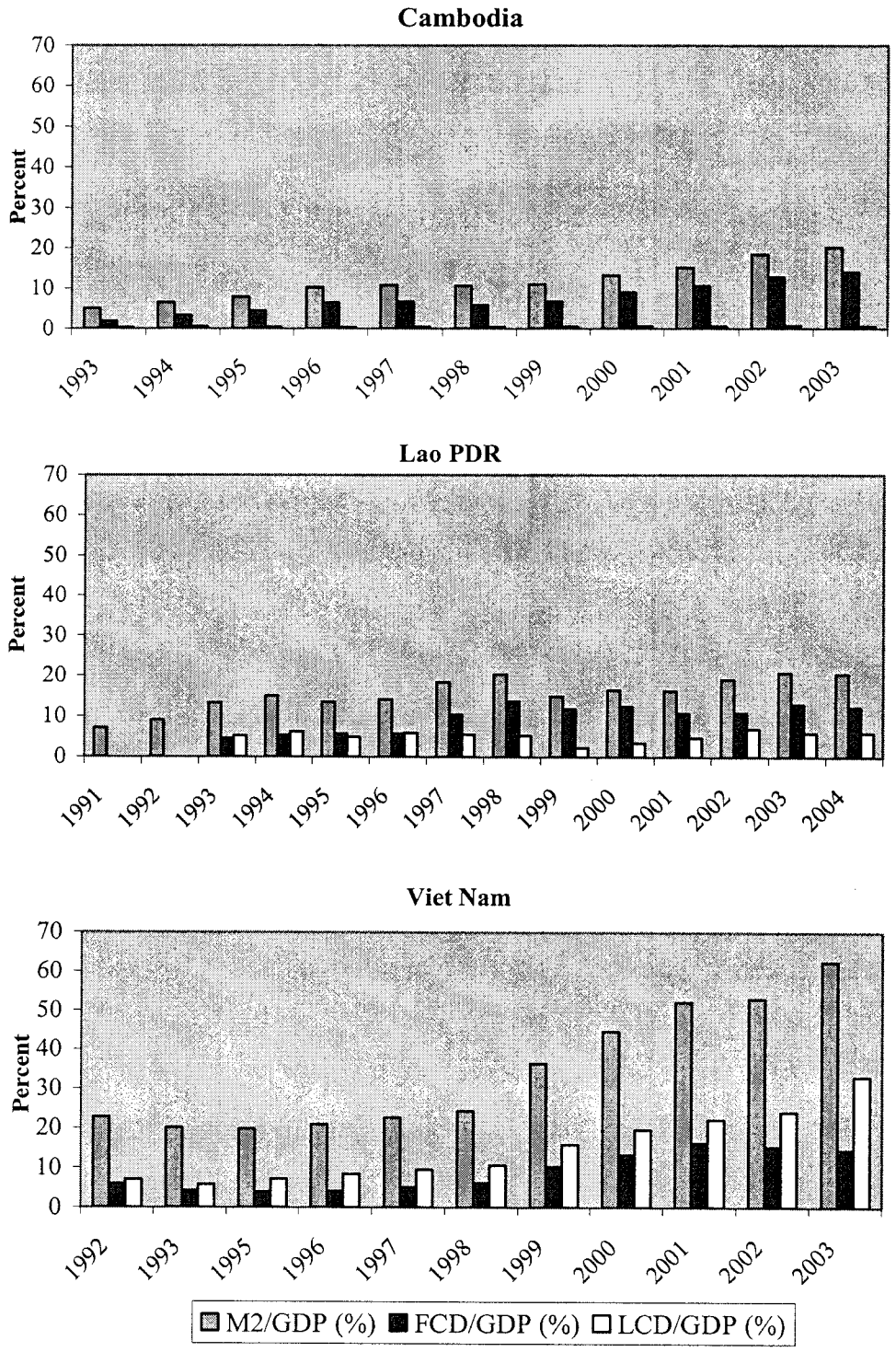
Broad money to GDP in Viet Nam grew faster than in the other countries. This ratio increased sharply from 24.2 percent in1998 to 62.4 percent in 2003. It was mainly due to the positive real interest rates. Currency ratio and narrow money ratio have increased slightly since 1998 in line with the growth of broad money.

From the above observation, broad money to GDP in both Cambodia and Viet Nam increased with positive real interest rates. However, broad money ratio in Myanmar started to decline because of negative real interest rates. It cannot be said that an increase in broad money ratio deepens the financial sector particularly in dollarized countries, i.e., Cambodia, Laos, and Viet Nam. As most of the contribution to broad money is foreign currency deposits in these countries, it cannot explain the real level of financial depth. Therefore, the degree and the extent of dollarization have to be analyzed. The degree of dollarization can be measured by (1) comparing foreign currency deposits to GDP with local currency deposits to GDP, (2) foreign currency deposits to broad money, and (3) foreign currency deposits to total deposits.

As shown in Figure 4.2, in the case of Cambodia and Laos, foreign currency deposits to GDP ratios were larger than the local currency deposit ratios throughout the years. It shows that people prefer to deposit in foreign currency because of lack of

confidence in local currency. In fact, an increase in broad money is mainly contributed by foreign currency deposits.

Figure 4.2 Foreign Currency Deposits to GDP and Local Currency Deposits to GDP

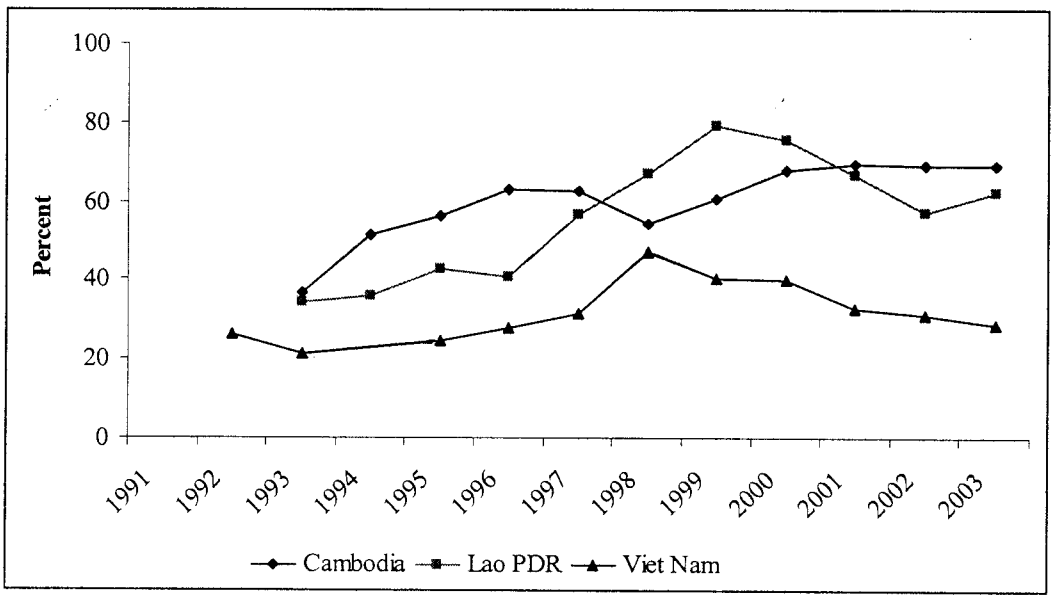


Source: International Financial Statistics (IMF, 2005)

In Viet Nam, on the other hand, the local currency deposit ratio was larger than the foreign currency deposit ratio throughout the years. It can be explained that an increase in broad money is mainly contributed by local currency.

The implication is that the financial reform particularly interest rate deregulation has a chance to mobilize not only local currency but also foreign currency. In other words, the deregulation is a great opportunity for restoring the financial resources outside the banking system.

Figure 4.3 Foreign Currency Deposits to Broad Money

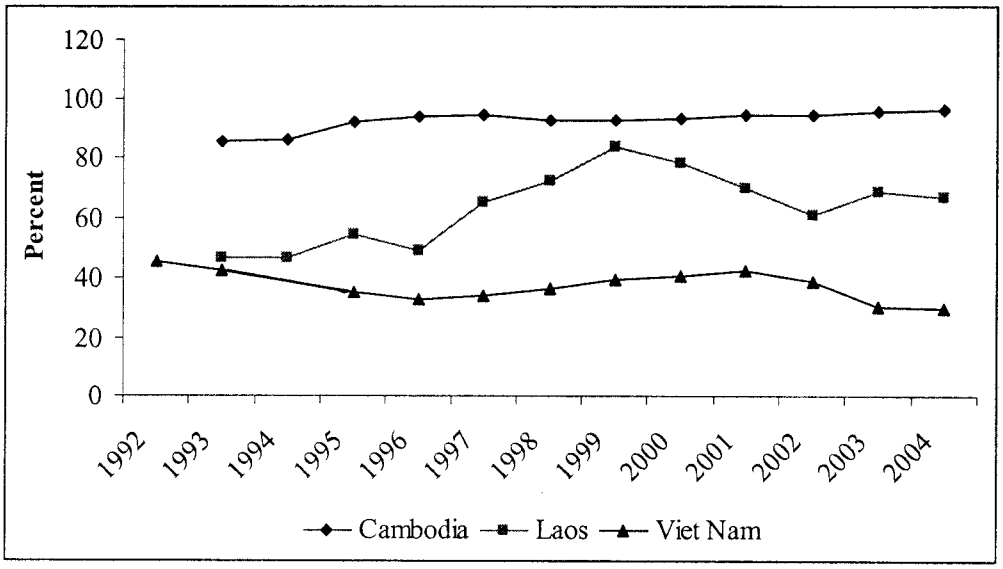


Source: International Financial Statistics (IMF, 2005)

Figure 4.3 explains the trend of foreign currency deposit contribution to broad money in Cambodia, Lao PDR, and Viet Nam. This ratio reflects the degree of dollarization. Figure 4.3 illustrated that the degree of dollarization in Cambodia and Laos was higher than that of Viet Nam.

Figure 4.4 explains the contribution of foreign currency deposits to total deposits. The contribution of foreign currency in both Cambodia and Laos was larger than that of in Viet Nam. It can be noted that nearly all deposits in Cambodia were foreign currency. In Laos, two thirds of deposits were foreign currency, and one third remained local currency deposits. This means that banks are still channeling local currency but the share of foreign currency is larger than that of local currency. The currency composition of Viet Nam was one third in foreign currency and two thirds in local currency.

Figure 4.4 Foreign Currency Deposits to Total Deposits



Source: International Financial Statistics (IMF, 2005)

From the above analysis, the growth of broad money in Cambodia and Laos was mainly contributed by foreign currency deposits. In Viet Nam, on the other hand, domestic currency deposits contributed mainly to broad money growth. Broad money growth in Viet Nam was the highest among the CLMV countries but comparing with other developing countries, it was still low, for example, the broad money ratio of Thailand was 90.4 percent in 2004[69].

4.1.2 Financial Intermediation[70]

As mentioned earlier, one of the quantitative indicators based on credit allocation is the traditional measure of financial development and deepening. Before proceeding to credit allocation, the movement of interest rate structures that influence the allocation of credit is to be introduced.

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[69] Data source is based on International Financial Statistics (IMF, 2004 & 2005)

[70] *Financial intermediation* is the process of indirect finance whereby financial intermediaries link lender-savers and borrower-spenders (Mishkin, 2004: 34 & G-5). Yarbrough & Yarbrough define that financial intermediation refers to channeling saving to investor (Yarbrough & Yarbrough, 2003: 445)

Financial disintermediation is a reduction in the flow of funds into the banking system that causes the amount of financial intermediation to decline (Mishkin, 2004: 259 & G-3)

Interest Rates

Tables 4.1 and 4.2 compare the nominal and real loan and deposit rates across countries. Although one country's deposit and loan rates may be based on a different type of category, the data shows some movement of the interest rate structure.

Table 4.1 Bank Loan and Deposit Interest Rates and Inflation Rate (%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Mean
Cambodia															
Lending Rate	n.a.	n.a.	n.a.	n.a.	18.7	18.8	18.4	18.3	17.6	17.3	16.5	16.2	18.5	17.6	17.8
Deposit Rate	n.a.	n.a.	n.a.	n.a.	8.7	8.8	8.0	7.8	7.3	6.8	4.4	2.5	2.0	1.8	5.8
Spread	n.a.	n.a.	n.a.	n.a.	10.0	10.0	10.4	10.5	10.2	10.5	12.1	13.7	16.5	15.8	12.0
Inflation	n.a.	n.a.	n.a.	n.a.	1.1	10.1	3.2	14.8	4.0	-0.8	-0.6	3.3	1.2	3.9	4.0
Lao PDR															
Lending Rate	26.0	26.0	25.3	24.0	25.7	27.0	n.a.	29.3	32.0	32.0	26.2	29.3	30.5	30.0	27.9
Deposit Rate	23.5	15.0	13.3	12.0	14.0	16.0	n.a.	17.8	13.4	12.0	6.5	6.0	6.6	6.3	12.5
Spread	2.5	11.0	12.0	12.0	11.7	11.0	n.a.	11.5	18.6	20.0	19.7	23.3	23.9	23.8	15.5
Inflation	13.4	9.9	6.3	6.8	19.6	13.0	27.5	91.0	128.4	25.1	7.8	10.6	15.5	10.5	27.5
Myanmar															
Lending Rate	n.a.	8.0	n.a.	16.5	16.5	16.5	16.5	16.5	16.1	15.3	15.0	15.0	15.0	15.0	15.2
Deposit Rate	9.0	9.0	9.0	9.0	9.8	12.5	12.5	12.5	11.0	9.8	9.5	9.5	9.5	9.5	10.1
Spread	n.a.	-1.0	n.a.	7.5	6.8	4.0	4.0	4.0	5.1	5.5	5.5	5.5	5.5	5.5	4.8
Inflation	32.3	21.9	31.8	24.1	25.2	16.3	29.7	51.5	18.4	-0.1	34.5	58.1	24.9	4.2	26.6
Viet Nam															
Lending Rate	n.a.	n.a.	32.2	n.a.	n.a.	20.1	14.4	14.4	12.7	10.6	9.4	9.1	9.5	10.0	14.2
Deposit Rate	n.a.	n.a.	22.0	n.a.	n.a.	n.a.	8.5	9.2	7.4	3.7	5.3	6.5	6.6	6.5	8.4
Spread	n.a.	n.a.	10.1	n.a.	n.a.	n.a.	5.9	5.2	5.3	6.9	4.1	2.6	2.9	3.5	5.2
Inflation	n.a.	n.a.	n.a.	n.a.	n.a.	5.7	3.2	7.3	4.1	-1.7	-0.4	4.0	3.2	7.7	3.7

Source: Financial Sector Development in Asia (1995, 226); World Development Indicators (WDI, 2003); International Financial Statistics (IMF, 2005); and World Economic Outlook (2006)

(Note: Same data source is used for comparative study)

The spread in Viet Nam was remarkably low among all other countries. In the early phase of Doi Moi, however, deposit interest rates were higher than lending rates. The spread rate was minus 3.3 percent at the end of 1989. The spread has become positive since 1992[71].

[71] The Financial System in Viet Nam: 45

Table 4.2 Real Loan and Deposit Interest Rates and Inflation Rate (%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Mean
Cambodia															
Real Lending Rate	n.a.	n.a.	n.a.	n.a.	17.6	8.7	15.2	3.5	13.6	18.1	17.1	12.9	17.3	13.7	13.8
Real Deposit Rate	n.a.	n.a.	n.a.	n.a.	7.6	-1.3	4.8	-7.0	3.3	7.6	5.0	-0.8	0.8	-2.1	1.8
Spread	n.a.	n.a.	n.a.	n.a.	10.0	10.0	10.4	10.5	10.2	10.5	12.1	13.7	16.5	15.8	12.0
Inflation	n.a.	n.a.	n.a.	n.a.	1.1	10.1	3.2	14.8	4.0	-0.8	-0.6	3.3	1.2	3.9	4.0
Lao PDR															
Real Lending Rate	12.6	16.1	19.0	17.2	6.1	14.0	n.a.	-61.7	-96.4	6.9	18.4	18.7	15.0	19.5	0.4
Real Deposit Rate	10.1	5.1	7.0	5.2	-5.6	3.0	n.a.	-73.2	-115.0	-13.1	-1.3	-4.6	-8.9	-4.3	-15.0
Spread	2.5	11.0	12.0	12.0	11.7	11.0	n.a.	11.5	18.6	20.0	19.7	23.3	23.9	23.8	15.5
Inflation	13.4	9.9	6.3	6.8	19.6	13.0	27.5	91.0	128.4	25.1	7.8	10.6	15.5	10.5	27.5
Myanmar															
Real Lending Rate	n.a.	-13.9	n.a.	-7.6	-8.7	0.2	-13.2	-35.0	-2.3	15.4	-6.1	-43.1	-9.9	10.8	-9.5
Real Deposit Rate	-23.3	-12.9	-22.8	-15.1	-15.5	-3.8	-17.2	-39.0	-7.4	9.9	-11.6	-48.6	-15.4	5.3	-15.5
Spread	n.a.	-1	n.a.	7.5	6.8	4.0	4.0	4.0	5.1	5.5	5.5	5.5	5.5	5.5	4.8
Inflation	32.3	21.9	31.8	24.1	25.2	16.3	29.7	51.5	18.4	-0.1	21.1	58.1	24.9	4.2	25.7
Viet Nam															
Real Lending Rate	n.a.	n.a.	n.a.	n.a.	n.a.	14.4	11.2	7.1	8.6	12.3	9.8	5.1	6.3	2.3	8.6
Real Deposit Rate	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5.3	1.9	3.3	5.4	5.7	2.5	3.4	-1.2	3.3
Spread	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5.9	5.2	5.3	6.9	4.1	2.6	2.9	3.5	4.6
Inflation	n.a.	n.a.	n.a.	n.a.	n.a.	5.7	3.2	7.3	4.1	-1.7	-0.4	4.0	3.2	7.7	3.7

Note: Real interest rates are calculated as nominal interest rates less consumer price inflation

Source: World Development Indicators (WDI, 2004 & 2006); International Financial Statistics (IMF, 2005); and World Economic Outlook (2006)
(Note: Same data source is used for comparative study)

In 1993, both lending and deposit rates were very high that is 32.2 percent and 22 percent respectively (Table 4.1). The State Bank of Viet Nam (SBV) became concerned and thus, reduced both lending and deposit rates in 1995. Hence, both real lending and deposit rates declined throughout the years (Table 4.2). It can be noted that Viet Nam tried to maintain positive real interest rates by reducing inflation rate.

Laos's nominal interest rates were higher than in the other countries and inflation was more erratic than in other countries (Table 4.1). Real lending rate was highly negative in 1998 and 1999 represented by -61.7 percent and -96.4 percent respectively (Table 4.2). Real deposit rate was also highly negative during 1998-2004. It shows that Bank of Laos (BOL) is reluctant to change nominal deposit and lending rates although the inflation rate is high.

Nominal loan interest rates in Cambodia remained broadly unchanged even though inflation was high in 1996 and 1998. As a result, the real lending rates were low in those years represented by 8.7 percent in 1996 and 3.5 percent in 1998 (Table 4.2). Nominal deposit rates, on the other hand, declined sharply from 8.7 percent in 1995 to 1.8 percent in 2004 (Table 4.1). The Cambodian banks wanted to maintain nominal loan rates and at the same time they attempted to reduce nominal deposit rates. Hence, the spread rates increased from 10 percent in 1995 to 15.8 percent in 2004 (Tables 4.1 & 4.2). It may be due to the limited lending opportunities that increase lending rates and decrease deposit rates.

As shown in Tables 4.1 and 4.2, interest rate ceiling remained unchanged in Myanmar even though inflation grew up to the double digit level.

Domestic Credit Provided by Banking Sector

All CLMV countries have relied heavily on the banking sector because the financial markets are not well developed yet. Therefore, bank loans are major external sources for financing business expansion. The credit expansion indicator, total credit to GDP, shows the efficient resource allocation of the financial intermediation in the economy.

From Table 4.3, the total credit to GDP ratio in Viet Nam increased noticeably from 4.7 percent in 1992 to 52.5 percent in 2003. Viet Nam's credit expansion was faster than the other countries especially in the private sector. Private sector credit to GDP increased dramatically from 2.5 percent in 1992 to 49 percent in 2003. Moreover, private sector credit to total credit increased obviously throughout the years. According to the Banking Sector Review (World Bank, 2002), an increase in credit expansion to the private sector was mainly due to the government's interest rate policy that was to encourage bank lending to the private sector. In addition, the loan portfolios have shifted from provision of short term working capital to funding medium and long term investment projects. The largest share of loan portfolios was lending to the agriculture and aqua-culture sectors (26 percent), followed by trade and services sector (22 percent), and manufacturing sector (16 percent) (World Bank, 2002).

Table 4.3 Domestic Credit (%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Credit to GDP													
Cambodia	n.a.	n.a.	5.2	5.7	5.5	6.4	7.1	7.4	7.0	7.0	6.5	6.0	7.3
Lao PDR	5.7	6.7	7.9	11.6	11.1	8.7	16.5	16.6	10.1	10.5	15.3	12.3	11.2
Myanmar	44.6	41.0	34.5	32.9	32.5	33.6	30.7	28.2	26.8	32.1	34.0	28.7	22.1
Viet Nam	n.a.	4.7	11.4	n.a.	9.7	10.4	11.4	11.5	28.9	35.1	39.7	44.8	52.5
Private Sector Credit to GDP													
Cambodia	n.a.	n.a.	2.5	3.5	3.6	4.9	6.5	5.8	6.1	6.9	7.0	6.8	8.1
Lao PDR	3.0	4.5	6.9	8.9	9.1	9.0	13.0	12.6	8.4	8.9	9.6	8.2	7.2
Myanmar	6.6	7.7	6.4	6.0	7.6	9.5	10.3	9.7	8.6	10.5	11.7	10.8	4.4
Viet Nam	n.a.	2.5	5.5	n.a.	8.0	8.8	10.0	9.7	28.2	35.3	39.3	43.1	49.0
Private Sector Credit to Total Credit													
Cambodia	n.a.	n.a.	47.1	61.4	65.7	76.6	91.4	78.0	87.1	99.3	107.9	112.4	110.6
Lao PDR	52.0	67.0	88.1	76.6	81.9	104.1	78.8	75.6	83.4	84.5	62.6	66.6	64.9
Myanmar	14.9	18.7	18.6	18.2	23.4	28.3	33.6	34.3	32.2	32.6	34.6	37.8	20.1
Viet Nam	n.a.	53.2	47.8	n.a.	81.7	84.4	87.6	83.9	97.4	100.3	98.9	96.3	93.4

Source: International Financial Statistics (IMF, 2005); and World Economic Outlook (2006)

(Note: Same data source is used for comparative study)

In Cambodia, private sector credit to GDP increased gradually but it was still low. However, private sector credit to total credit increased sharply from 47.1 percent in 1993 to 110.6 percent in 2003. The largest share of credit extended by commercial banks was for services and personal consumption (27.1 percent), followed by wholesale and retail trade (24.6 percent), and manufacturing (19.4 percent) (ADB, 2000).

The private sector credit to GDP in Laos started to decline from 13 percent in 1997 to 7.2 percent in 2003. The reason was that the supply of loans had decreased because of negative real deposit rate. Moreover, banks were reluctant to lend at negative real interest rates (Table 4.2). However, private sector credit to total credit increased till 2000 but then decreased again (Table 4.3).

For the case of Myanmar, total credit to GDP decreased from 44.6 percent in 1991 to 22.1 percent in 2003. The share of private sector credit to GDP increased

from 6.6 percent in 1991 to 10.8 percent in 2002 and then decreased noticeably to 4.4 percent in 2003. The private sector credit was remarkably low because of a bank crisis that had occurred in that year. Moreover, private sector credit to total credit increased during 1991-2002. However, this ratio declined to 20 percent in 2003.

From the comparative analysis of financial deepening and intermediation, Viet Nam has been the most successful in financial deepening among the CLMV countries. Viet Nam maintained the real stable interest rates that increased broad money. Two thirds of the savings were in local currency, showing that local currency contribution to broad money was much more than foreign currency contribution. Furthermore, private sector credit grew rapidly, showing that the efficient fund allocation contributed to the deepening and widening of the banking sector.

In Cambodia, broad money grew, though still low compared with the other countries. As Cambodia was a highly dollarized country, the high dollar deposits contributed to the broad money. Although private sector credit to total credit was high, private sector credit to GDP was still low. It showed that allocation of financial resources was still in a weak position that is the financial sector remained shallow but however it had started to develop.

For the case of Laos, the volatility growth of broad money may be due to the erratic inflation. As Laos was a highly dollarized country with 75 percent of dollar holding, the contribution of dollar deposits to broad money was high. Private sector credit was still low, meaning that the inefficient fund allocation had weakened the financial intermediation and had lowered the financial depth.

In Myanmar, broad money ratio started to decline because of the negative interest rates. Private sector credit started to decline, showing that the banking sector was inefficient in resource allocation for the economy and had lowered the financial depth.

The implication of this section is that the financial reform especially interest rate liberalization increases broad money. However, a stable real interest rate as a result of macroeconomic stability can increase the broad money that deepens the financial sector. Moreover, high private sector credit ratio shows the efficient fund allocation in the economy encouraging financial intermediation that deepens the financial sector.

As mentioned earlier, Viet Nam has been successful in financial deepening whilst other countries are still shallow. While the banking sector in Myanmar and in Laos is still underdeveloped, Cambodia starts to develop after restructuring the banking sector. One important thing is that it is still early to say about the financial sector development in CLMV countries because they are still in the early stage of development and the economies are still in transition.

4.2 Effects on Savings, Investments, and Economic Growth

Fry (1995), McKinnon (1973) and Shaw (1973), and Cole and Patrick (1986) tested the effects of financial repression on savings and investments from empirical research. Financial repression widened the gap between controlled and free-market interest rates and became negative institutional interest rates (loan as well as deposit rates) in real terms, resulting in financial disintermediation (Fry, 1995: 155). The negative real institutional interest rates (Millard Long, 1983: 22) enumerate the following effects: reduced national savings, more capital flight, worsened misallocation of resources, excessive lending to prime borrowers, resurgence of non institutional money markets, increased use of foreign financial institutions, and increased problems of monetary control[72].

Many empirical investigations found that financial deregulation moved real interest rates from negative levels to positive levels, resulted in increased saving behavior and investments. Fry (1995) explained that saving behavior is a crucial element of the process of economic growth. The reason is that domestic investment can be financed from both national and foreign savings that provides the bulk of resources for investment [73]. McKinnon-Shaw also pointed out that financial liberalization increases savings, improves the efficiency of investment, and thereby raises the rate of economic growth.

As mentioned earlier, financial reform particularly interest rate deregulation increased financial savings in CLV countries. Table 4.4 explains the relationship between financial deepening and economic growth, and the relationship between savings, investments, and growth. To find out these relationships, the study period

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[72] ibid: 155
[73] ibid: 156

(1991-2004) is divided into two periods of time, before and after the Asian financial crisis and be denoted as pre crisis (1991-1997), and post crisis (1998-2004). The following table shows the changing pattern of relationships between the period of pre Asian financial crisis and post crisis.

Table 4.4 Impact on Savings, Investments, and Growth (Annual Average)

	Inflation		GDP Growth (Annual %)		Gross Domestic Savings to GDP		Investments to GDP		M2/GDP	
	1991-1997	1998-2004	1991-1997	1998-2004	1991-1997	1998-2004	1991-1997	1998-2004	1991-1997	1998-2004
Cambodia	4.8	3.7	5.5	5.8	7.0	8.5	17.0	19.6	8.0	14.8
Lao PDR	13.8	41.3	6.6	5.8	10.8	15.2	n.a.	22.8	12.9	18.4
Myanmar	25.9	25.4	5.9	10.1	12.5	10.0	13.3	13.3	29.6	27.4
Vietnam	4.5	3.5	8.3	6.6	15.8	28.1	23.7	31.6	21.2	45.5

Source: International Financial Statistics (IMF, 2005); Asian Development Bank (ADB, 2005); and World Development Indicators (WDI, 2004 & 2006)

(Note: Same data source is used for comparative study)

In Cambodia, interest rate deregulation deepened the financial sector, which was M_2/GDP ratio increased from 8 percent in pre crisis period to 14.8 percent in post crisis period. Moreover, financial restructuring and recapitalization of the banking sector that was successfully completed in 2002 can also restore the trust of the customers. The restructured banking system maintained the viable banks that can improve financial deepening. That financial deepening contributed to economic growth by reducing inflation.

The large contribution of foreign currency deposits to financial deepening shows that Cambodian banking system can restore the scarce financial resources from capital flight. As a consequence, Gross Domestic Savings (GDS) to GDP ratio increased from 7 percent in pre crisis period to 8.5 percent in post crisis period because of macroeconomic stability. As Cambodia is a highly dollarized country, it can control the inflation rate and reduced it from 4.8 percent to 3.7 percent. Hence,

the increase in savings increased investments to GDP ratio from 17 percent to 19.6 percent and thus bettered the growth.

In Viet Nam, interest rate deregulation gives the improvement of financial deepening. M_2/GDP ratio has doubled from 21.2 percent in pre crisis period to 45.5 percent in post crisis period. A huge contribution to financial deepening is local currency although Viet Nam is one of the moderately dollarized countries. The large local currency contribution to broad money ratio (M_2/GDP) deepened the development of financial sector. The growth rate, on the other hand, decreased in post crisis period even though Viet Nam's economy has already recovered within a short period of time. Although Viet Nam has not met the growth rate of pre crisis period, the average growth rate throughout the years was 7.5 percent which is high enough comparing with other countries. By reducing inflation, positive real interest rates increased savings from 15.8 percent to 28.1 percent.

At the same time, the Central Bank reduced lending rates to encourage private sector lending. In addition, the government tried to relieve tight credit policies for resource allocation to become more efficient. As a consequence, an efficient resource allocation encourages capital formation that contributes to the growth of the economy. Hence, investments to GDP ratio increased from 23.7 percent in pre crisis period to 31.6 percent in post crisis period. Since an increase in capital accumulation contributes to growth, Viet Nam's economy is able to catch up rapidly.

Although inflation accelerated in Laos, M_2/GDP increased throughout the years. The reason is that people want to deposit foreign currency more, especially in high inflation period because of high returns through foreign currency holding. That is why the contribution of foreign currency deposits increased broad money (M_2/GDP) from 12.9 percent to 18.4 percent between the two periods. This improvement of broad money cannot contribute to the development of financial sector because of macroeconomic instability. Even though the Central Bank, Bank of Laos (BOL), launched the restructuring package under the control of the World Bank, the State owned Commercial Banks (SOCBs) still faced with a large amount of SOEs' loans that weakened the development of financial sector. Thus, the growth rate was erratic and still slow.

The instable interest rates led to volatile savings but however Gross Savings to GDP ratio increased from 10.8 percent to 15.2 percent since high inflation led to increase foreign currency deposits. Investments to GDP ratio may also increase to 22.8 percent. Nevertheless, the growth rate decreased from 6.6 percent in pre crisis period to 5.8 percent in post crisis period because of economic instability.

In Myanmar, inflation was high with double digits but stagnant in both the two periods. Interest rate ceilings with high inflation decreased M_2/GDP from 29.6 percent in pre crisis period to 27.4 percent in post crisis period. A huge gap between ceiling rates and market rates that discourages financial savings results in decreased broad money. According to the results of regressions over the period 1976/77-1990-91 by Khin Saw Oo, real interest rates and total financial savings (M_2) are found to be positive and significant (Khin Saw Oo 1993: 264-265)[74]. According to tests over the period 1976/77-1996/97 by Myat Thein, he found that the relationship between Gross Domestic Savings and total financial savings to be positive and significant. He also found out that the relationship between Gross Domestic Savings and nominal interest rates rather than real interest rates to be positive and significant (Myat Thein, 1999: 19)[75].

According to Myat Thein (1999) and Khin Saw Oo (1993), nominal and real interest rates have positive relationship with GDS and financial savings. As shown in Table 4.4, the negative real interest rates decreased both GDS and financial savings that push the investors into informal financial market and real asset market. A large deposit outflow outside the channel of the banking system discourages the development of the banking sector.

Moreover, although GDP growth rate increased 5.9 percent in pre crisis period to 10.1 percent in post crisis period, GDS ratio decelerated from 12.5 percent in pre crisis period to 10 percent in post crisis period but investment ratio remained stunted. This is contrast to the findings of Myat Thein i.e., the relationship between Gross

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[74] Khin Saw Oo, Domestic Resource Mobilization in Myanmar, YMBA, The SEACEN, 1993: 264-265

[75] Myat Thein, Improving Domestic Resource Mobilization in Myanmar, ISEAS Working Papers: Economics and Finance, Institute of Southeast Asian Studies, Singapore, 1999: 19

In conclusion, interest rate liberation in Viet Nam increases the broad money that deepens the financial sector which contributes to the growth of the economy. The stable positive real interest rates restore financial resources from the informal sector so that GDS ratio increases and thus increases investment. The increased capital accumulation contributes to the development of the country's economy. The positive real interest rates with macroeconomic stability can improve savings and investments that encourage growth. Cambodia moves according to the same pattern of Viet Nam, but the growth rate is slower than Viet Nam.

In Laos, on the other hand, interest rate deregulation increases the broad money but the increasing trend of broad money is erratic because of economic instability. As a result, low savings and investments hinder the growth.

Myanmar case is different from other countries. Macroeconomic instability leads to decrease broad money. The interest rate ceilings, leading to negative real interest rates, decrease financial savings and investments that weaken the financial sector. This shows that the financial sector of Myanmar is under financial repression. Nonetheless, Myanmar's growth rate has increased even in post crisis period. The growth in Myanmar is not based on saving-investment process because small and medium enterprises (SMEs) that contribute a substantial portion to total production, rely heavily on self-financing and informal sources of financing that contribute to growth.

The major factor that hinders the development of financial sector is inflation. Macroeconomic instability and political instability force to a relative decline in financial savings and the push to invest more in real assets. This asset inflation can be expected to further increase inflation again. Thus, inflation acceleration weakens financial sector development which discourages economic development.

CHAPTER V

ROLE AND IMPACT OF FISCAL AND MONETARY POLICIES ON INFLATION AND DOLLARIZATION

According to Milton Friedman (1980), "Inflation is a monetary phenomenon arising from a more rapid increase in the quantity of money than in output"(Friedman, 1980: 282)[77]. Many economists argue that inflation is strictly a monetary phenomenon. That inflation occurs when the growth rate of money supply is higher than the growth rate of the economy. This is the conventional monetarist linkage from the creation of base money to inflation. Fry (1997) explained the relationship between money supply, budget deficit, and inflation; if budget deficit is financed by an increase in the money supply, then inflation would be increased (Fry, 1997: 45-47)[78].

This chapter focuses on the impact of fiscal and monetary policies which lead to budget deficits, increase in money supply, inflation, leading to depreciation of exchange rate, and dollarization. Deficit financing can increase inflation, discouraging financial intermediation function that lowers financial depth. Furthermore, the first part of this chapter tries to explain impact of fiscal and monetary policies on dollarization. The second part of this chapter continues to explain the budget deficit and inflation.

5.1 Impact of Fiscal and Monetary Policies on Inflation and Dollarization

Chart 5.1 exhibits the impact of fiscal and monetary policies on inflation and dollarization. As presented in Chart 5.1, Fry (1997) stated that if budget deficit is financed by monetary growth, inflation would be increased. It means that budget deficit financed by central bank borrowing increase money supply, results in inflation acceleration.

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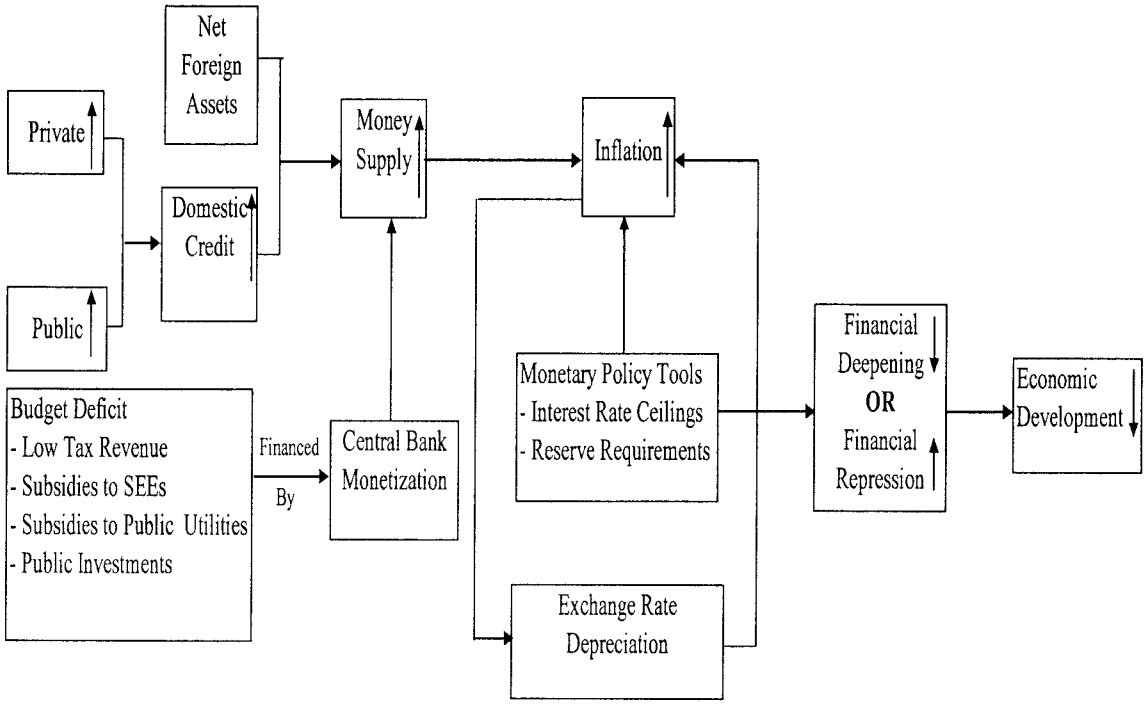
[77] Friedman, M. and Friedman, R., Freedom to Choose, Harcourt Brace Javanovich, New York, 1980

[78] Fry, Maxwell J., Emancipating the Banking System and Developing Markets for Government Debt, London; New York: Routledge, 1997: 45-47

Chart 5.1 Impact of Fiscal and Monetary Policies



Most developing countries use financial programming by the IMF. The most important identity in financial programming is the monetary identity. In Easterly (2004: 6), Barth et al., (2000: 152) stated that changes in the size of the money stock is one of the main policy instruments by the central bank that influence macroeconomic developments [79]. According to IMF financial programming, determinants of money supply are Net Foreign Assets (NFA) and Domestic Credit (DC) that can be divided into net domestic credit to government and to private sector.

Most developing countries use credit expansionary policy by monetary growth that causes inflation acceleration. Furthermore, in some countries, the central bank imposed high reserve requirements to the commercial banks as a monetary policy tool. Hence, high inflation, high reserve requirements, interest rate ceilings, and exchange rate depreciation hinder the development of financial sector that influence macroeconomic developments. In addition, financial liberalization without correcting fiscal deficit causes dollarization and misallocation of resources (Dornbusch and Reynoso, 1989).

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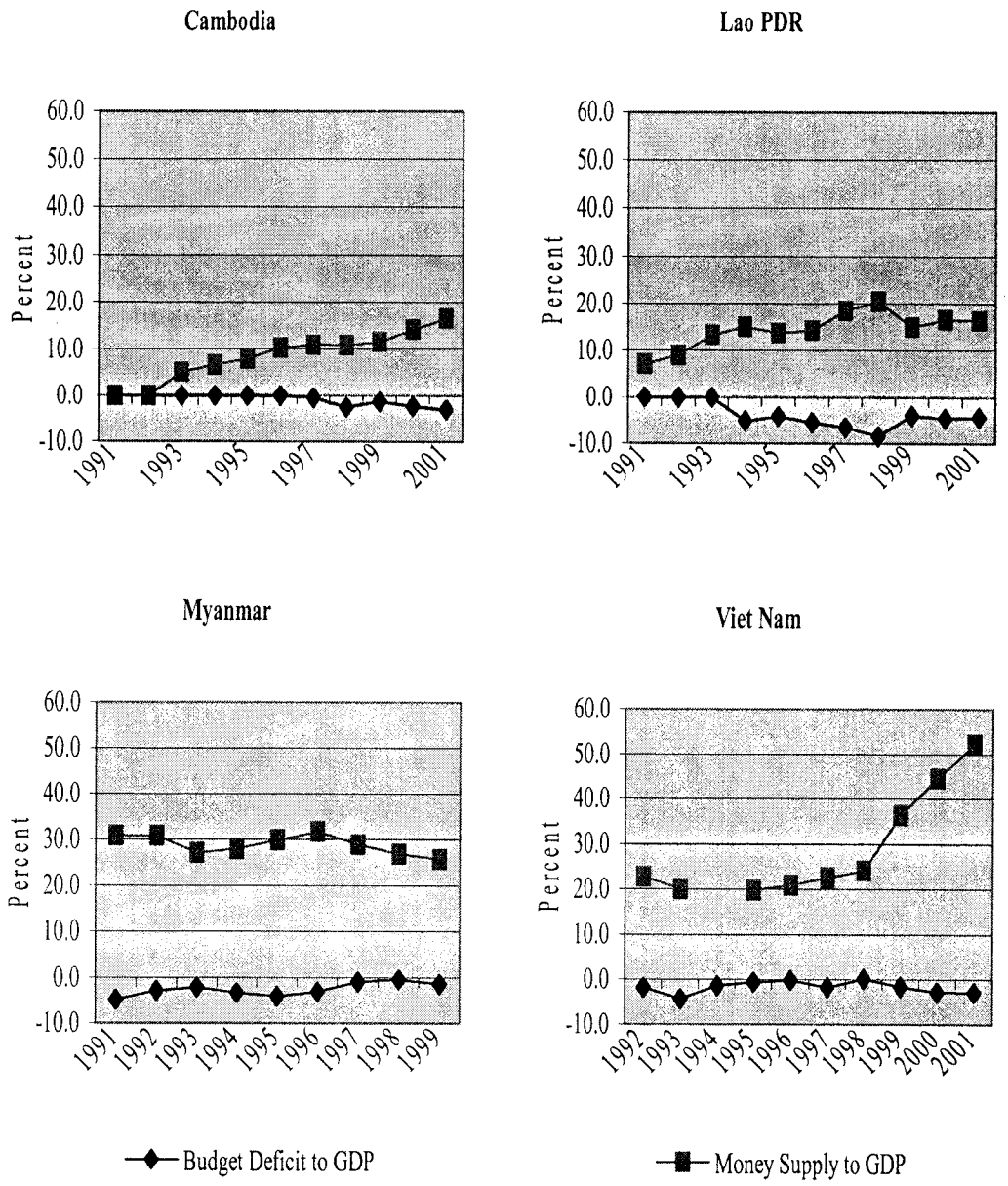
[79] Easterly, W., An Identity Crisis? Examining IMF Financial Programming, New York University, 2004: 6

5.1.1 Monetization of Budget Deficits

Figure 5.1 shows the relationship between money supply and budget deficits in all CLMV countries where the trend of growth in money supply was in line with budget deficit throughout the years. It means that, the more the budget deficit, the higher the growth of money supply.

Figure 5.1 Money Supply and Budget Deficit



Source: International Financial Statistics (IMF, 2005)

(Note: Same data source is used for comparative study)

As presented in Figure 5.1, the growth of money supply in Myanmar and Viet Nam was higher than that of in Cambodia and Laos. However, money supply growth accelerated in Viet Nam since 1998 but budget deficit was lower than the other CLM countries, because Viet Nam adopted inflation targeting that reduced the fiscal deficit. The Cambodian case is similar with Viet Nam, but, credit expansion in Cambodia is lower than that of Viet Nam.

In the case of Myanmar, however, successive budget deficits resulted in growth of money supply and credit expansion that widens the budget deficit thus fueling inflation. Successive governments had resorted to monetization of the budget deficits. Laos case is comparable to Myanmar, that is, budget deficit results in the growth of money supply. Growth of money supply and credit expansion fuelled inflation.

5.1.2 Growth of Money Supply

This section is concerned with the factors that determine the growth of money supply by analyzing monetary survey in the banking system as a whole. According to IMF monetary survey, determinants of money supply are Net Foreign Assets (NFA) and Net Domestic Assets (NDA), sometimes called Domestic Credit (DC). Net Domestic Assets can be divided into net domestic credit to government and credit to private sector.

When governments control the money supply as a monetary policy tool, it can have control upon net domestic assets. If governments use credit expansionary policy to raise domestic credit to the private sector, it will encourage economic development. If credit expansion is invested in the public sector to develop the infrastructure of the country and at the same time reduce the credit to private sector, it might not have the same impact on growth. Excessive borrowing in both the private sector and the public sector would be harmful for the financial sector, for example, East Asia and Latin America respectively.

The following analysis shows the factors that determine the growth of money supply for each country.

Cambodia

As illustrated in Table 5.1, the trend of broad money growth rate in Cambodia declined during 1993-2001. It also shows that domestic credit contribution to the

monetary aggregate was smaller than net foreign assets contribution. Moreover, domestic credit declined from 1995 to 2001. For domestic credit, credit to private sector was larger than net domestic credit to government. However, from 1996 to 1997, credit to the private sector declined sharply while net credit to government increased sharply because of uncertainty in business operations which is due to political instability in the country.

Table 5.1 Changes in Broad Money (%)

Cambodia

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Net Foreign Assets (NFA)	n.a.	n.a.	59.2	19.9	33.4	20.1	30.0	11.3	19.6	14.2	16.7
Domestic Credit	n.a.	n.a.	9.3	7.7	12.2	8.9	7.6	1.5	1.0	-1.1	1.9
Claims on govt (Net)	n.a.	n.a.	-7.0	0.5	-2.0	-5.1	6.7	-2.8	-3.7	-2.1	-1.2
Claims on private sector	n.a.	n.a.	16.4	7.2	14.2	14.0	1.0	4.2	4.7	1.1	3.1
Changes in broad money	n.a.	n.a.	68.5	27.7	45.6	29.0	37.6	12.8	20.6	13.1	18.6

Lao PDR

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Net Foreign Assets (NFA)	22.0	39.0	-9.8	10.4	33.4	22.3	46.2	63.6	11.5	-4.2	24.2
Domestic Credit	24.0	20.0	36.7	15.1	-3.3	69.5	58.3	28.4	17.2	32.5	-3.8
Claims on govt (Net)	-1.8	-10.4	14.4	-0.9	-14.7	27.1	16.2	0.1	2.2	22.8	-3.8
Claims on private sector	25.7	30.4	22.3	16.0	11.4	42.4	42.1	28.2	15.0	9.7	0.0
Changes in broad money	46.0	59.0	26.9	25.5	30.2	91.8	104.5	92.0	28.7	28.3	20.4

Myanmar

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Net Foreign Assets (NFA)	1.0	-0.8	-0.3	0.7	-0.6	0.1	0.7	-0.3	-0.1	0.0	0.1
Domestic Credit	26.2	23.6	27.7	28.3	37.5	30.4	33.1	29.7	40.5	47.6	34.2
Claims on govt (Net)	16.9	19.3	23.1	16.0	21.7	14.7	21.0	22.3	26.9	29.1	18.1
Claims on private sector	9.3	4.2	4.6	12.3	15.8	15.8	12.1	7.4	13.6	18.5	16.1
Changes in broad money	27.2	22.8	27.4	28.9	36.9	30.6	33.7	29.5	40.4	47.6	34.4

Viet Nam

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Net Foreign Assets (NFA)	n.a.	-30.9	18.9	n.a.	9.6	15.8	18.4	40.8	19.2	8.9	-0.1
Domestic Credit	n.a.	63.2	27.3	n.a.	18.3	17.0	10.5	101.6	22.4	14.4	15.8
Claims on govt (Net)	n.a.	34.6	-18.9	n.a.	1.1	-0.1	4.0	-5.1	-1.9	1.0	2.2
Claims on private sector	n.a.	28.6	46.2	n.a.	17.2	17.1	6.5	106.7	24.3	13.3	13.6
Changes in broad money	n.a.	32.4	46.3	n.a.	27.9	32.8	28.9	142.4	41.6	23.3	15.7

Source: International Financial Statistics (IMF, 2005)
(Note: Same data source is used for comparative study)

In this case, it can be seen that more than two thirds of broad money growth was contributed by net foreign assets since Cambodia was one of the dollarized countries with 95 percent of foreign currency cash holdings. Then, as for domestic credit mentioned above, Cambodia also uses credit expansionary policy particularly for the private sector.

Lao PDR

Since Laos was also a highly dollarized economy with 75 percent of foreign currency cash holding, the contribution of net foreign assets to broad money growth was more than the domestic credit contribution (Table 5.1). Broad money grew from 91.8 percent in 1996 to 104.5 percent in 1997 and then declined again to 92 percent in 1998.

The domestic credit increased sharply from -3.3 percent in 1995 to 69.5 percent in 1996 because the Bank of Laos (BOL) extended the domestic credit in 1996 not only to the private sector but also to the public sector. However, the domestic credit declined sharply from 69.5 percent in 1996 to -3.8 percent in 2001 due to the financial crisis in 1997 and also because of the recapitalization and restructuring programs for the State Owned Commercial Banks (SOCBs) (World Bank and ADB, 2002).

In the case of Laos, as one of the dollarized countries that foreign asset contributed more to monetary growth, that is, similar with Cambodia's monetary growth. In that case, Laos also uses credit expansionary policy.

Myanmar

In Myanmar, the growth of money supply (broad money) was mainly contributed by domestic credit expansion as presented in Table 5.1. Domestic credit increased from 26.2 percent in 1991 to 34.2 percent in 2001. It means that Myanmar expand domestic credit throughout the years. Moreover, more than half of domestic credit went to be public sector, which is not directly productive.

In the case of Myanmar, monetary growth had increased significantly compared with other countries (Table5.1). Most of the contribution to the growth of money supply was domestic credit which means that the government used monetary growth and credit expansionary policy. In addition, public sector borrowing was larger than that of the private sector. It shows that the growth of money supply is mainly contributed by the public sector borrowing. Noticeably, the net foreign asset

contribution was very low because capital flows are controlled as Myanmar is under a fixed exchanged rate regime and also because of low level of FDI inflows.

Viet Nam

In Viet Nam, the growth of money supply was mainly contributed by domestic credit (Table 5.1). The changes in broad money grew dramatically from 28.9 percent in 1997 to 142.4 percent in 1998. Private sector credit grew substantially from 6.5 percent in 1997 to 106.7 percent in 1998. It shows that government uses excessive domestic credit expansionary policy especially in the private sector by reducing lending rates, reducing reserve requirements, and introducing medium and long term loans.

The analysis of monetary growth explains that the movement of money supply growth for highly dollarized countries i.e., Cambodia and Laos is mainly contributed by net foreign assets whereas that movement of Myanmar and Viet Nam is mainly contributed by domestic credit. The growth of domestic credit is mainly absorbed by the public sector in Myanmar but by the private sector in Viet Nam. And this is an important difference between Myanmar and Viet Nam with a much lower rate of inflation (Tables 4.4 and 5.2).

5.1.3 Money Supply and Inflation

All CLMV, particularly Myanmar and Viet Nam expanded their money supply throughout the years as presented in Table 5.2.

In Cambodia, although money supply to GDP ratio increased from 5.1 percent in 1993 to 16.5 percent in 2001, average money supply ratio was the lowest among the CLMV countries. Average inflation rate was 4.5 percent throughout the years. However, inflation increased to double digit level in 1996 and 1998, i.e., 10.1 percent and 14.8 percent respectively partly due to Asian financial crisis and partly due to political instability.

It can be noted that the Central Bank did try to control inflation even though money supply ratio increases. When compared with other countries, this ratio is low because Cambodia is a highly dollarized country.

In the case of Laos, the expansion of money supply was volatile throughout the years. Nevertheless, inflation increased sharply from 27.5 percent in 1997 to 128.4 percent in 1999 because of Asian financial crisis and exchange rate depreciation. It shows that the budget deficit financed by the growth of money supply accelerates

inflation. The result is that failure to control the money supply and monetization of the budget deficit cause inflation acceleration.

Table 5.2 Money Supply and Inflation

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Mean
Cambodia(%)												
Money Supply to GDP	n.a.	n.a.	5.1	6.6	8.0	10.3	10.9	10.8	11.5	14.2	16.5	10.4
Inflation	n.a.	n.a.	n.a.	n.a.	1.1	10.1	3.2	14.8	4.0	-0.8	-0.6	4.5
Lao PDR(%)												
Money Supply to GDP	7.1	9.1	13.2	15.0	13.6	14.2	18.5	20.4	15.0	16.5	16.4	14.4
Inflation	13.4	9.9	6.3	6.8	19.6	13.0	27.5	91.0	128.4	25.1	7.8	31.7
Myanmar(%)												
Money Supply to GDP	30.7	30.8	27.1	28.0	29.9	31.7	28.8	26.9	25.7	n.a.	n.a.	28.8
Inflation	32.3	21.9	31.8	24.1	25.2	16.3	29.7	51.5	18.4	-0.1	21.1	24.7
Viet Nam(%)												
Money Supply to GDP	n.a.	22.7	20.1	n.a.	19.8	20.9	22.6	24.2	36.4	44.6	52.1	29.3
Inflation	n.a.	n.a.	n.a.	n.a.	n.a.	5.7	3.2	7.3	4.1	-1.7	-2.1	2.8

Source: International Financial Statistics (IMF, 2005)
(Note: Same data source is used for comparative study)

In Myanmar, average money supply to GDP ratio was 28.8 percent. Money supply to GDP ratio was high throughout the years. The average growth of money supply in Myanmar was higher than that of Cambodia and Laos but lower than that of Viet Nam. Furthermore, the average inflation was 24.7 percent. Inflation rate throughout the years was higher than Cambodia and Viet Nam. It implies that the CBM cannot fully control the growth of money supply as monetary policy is dominated by fiscal policy. Consequently, the budget deficit financed by the growth of money supply results in inflation acceleration.

In the case of Viet Nam on the other hand, although money supply ratio increased significantly from 22.7 percent in 1992 to 52.1 percent in 2002, inflation had declined from 5.7 percent in 1996 to -2.1 percent in 2002 except in 1998. Central Bank tries to reduce inflation by using inflation targeting. In 1998, inflation increased

to 7.3 percent partly because of the Asian financial crisis and credit expansion policy to provide funds for the private sector.

It can be implied that inflation targeting results in reduced inflation. In the case of Laos and Myanmar, they cannot fully control money supply growth. Budget deficits financed by monetization results in inflation acceleration.

5.1.4 Monetary Policy Tools

Financial intermediation is inhibited by high reserve requirements, one of the monetary policy tools, which typically accompany excessive inflationary finance (Fry, 1997: 68)[80]. Inflationary finance causes capital flight, dollarization and misallocation of resources due to uncertainty (Dornbusch and Reynoso, 1989: 25)[81].

Three monetary policy tools that the Central Bank used to control money supply are the reserve requirements, the discount rate, and the open market operations (OMO). Most developed countries use open market operation whereas the developing countries use changes in reserve requirements to control money supply as one of the monetary policy tools. Although central banks in many countries around the world have been reducing or eliminating the reserve requirements in recent years, the CLMV countries have been maintaining high reserves for commercial banks. The implicit tax imposed on commercial banks from high reserve requirements leads to high cost of funds, making banks less competitive, and weakening the health of the banking system. The cross-national evidence suggests that there are negative correlations between low real interest rates, high reserve requirements, and low degrees of financial intermediation on the one hand, and investment and growth on the other.[82]

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[80] Fry, Maxwell J., Emancipating the Banking System and Developing Markets for Government Debt, London; New York: Routledge, 1997: 45-47

[81] Dornbusch, R., and Reynoso, Financial Factors in Economic Development, NBER Working Paper No.2889, 1989: 25

[82] Studies establishing this relationship are: World Bank, 1989; Fry, 1997; World Bank, 1998 for a review

As illustrated in Table 5.3, the real effective reserve ratios[83] were very high in all countries, if compared with other developing countries i.e., 3.4 percent in Thailand (1994).[84] As illustrated in Appendix 1, the Central Banks from all the countries, except Viet Nam imposed high reserve requirements on commercial banks.

In Viet Nam, the SBV (State Bank of Viet Nam) in 1999 started to reduce the required reserve ratio to stimulate credit, reduce operational costs, and improve the profitability of credit institutions. The required reserve ratio in terms of local currency (Dong) was reduced from 10 percent during 1995-1998 to 5 percent in 1999, and then it was reduced again to 3 percent in 2000[85]. Since Viet Nam reduced the required reserve ratio to 3 percent, real effective reserve ratio declined from 29 percent in 1993 to 6.8 percent in 2004. The reductions in required reserve ratios were supposed to relax credit supply in order to encourage firm investment.

Table 5.3 Real Effective Reserve Ratios on Bank Deposits

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Mean
Cambodia	n.a	n.a	26.7	39.7	16.0	24.5	26.8	40.7	46.2	49.9	48.1	57.2	51.6	48.2	39.6
Lao PDR	21.9	26.2	29.7	28.0	27.9	30.4	27.4	27.2	27.5	31.9	28.9	25.8	24.3	20.6	27.0
Myanmar	62.1	51.9	39.1	19.7	15.4	12.0	14.7	16.8	16.6	19.0	24.2	19.6	39.6	44.2	28.2
Viet Nam	n.a	25.6	29.1	n.a	26.9	26.2	23.0	19.4	16.3	14.2	10.1	10.1	10.8	6.8	18.2

Source: International Financial Statistics (IMF, 2005); World Economic Outlook (2006); The Political Economy of Financial Repression in Transition Economies (World Bank, 1998); and The Informal Credit Market and Monetary Policy in Developing Countries (Ishida, 1996)

(Note: Same data source is used for comparative study)

[83] Real effective reserve ratios are calculated as (reserve money-currency outside banks) / (money +quasi money- currency outside banks)

[84] Effective reserve ratio in Japan and United States in 1994 were 1.4 percent and 1.9 percent respectively (Ishida.1996: 17)

[85] See Thailand Development Research Institute, 2002; and the Financial System in Viet Nam

However, real effective reserve ratio remained high compared with the other developing countries as a result of imposing high reserve requirement ratio on foreign currency. The required reserve ratio on foreign currency was 8 percent in November, 2000 rose up to 12 percent in December, 2000, and 15 percent in May 2001; and then declined to 10 percent in December, 2001[86].

The real effective reserve ratio of Cambodia was the highest among the three countries. This ratio increased dramatically after 1997 which maybe due to the holding of huge excess reserves at the National Bank of Cambodia (IMF, 2003: 2). Furthermore, all these reserves are in foreign currency because Cambodia is a highly dollarized country.

In Laos, the large amount of reserves is contributed by foreign currency because Laos is also one of the highly dollarized countries. The real effective reserve ratio fluctuated throughout the years as a result of changing reserve requirement ratio (ranging from 6 percent to 12 percent) promulgated by the Bank of Laos (BOL). The fluctuating reserve requirements created more uncertainty for the commercial banks.

In Myanmar, the real effective reserve ratio was extremely low during 1994-2000 which is mainly because of the expansion of credit to the private sector. However, this ratio increased remarkably from 24.2 percent in 2001 to 44 percent in 2004. It may be due to the fact that Myanmar had faced with a banking crisis in those years as banking crisis raises the real effective reserve ratios on bank deposits by making bankers more cautious. Households responded to the banking crisis by holding more currency relative to deposits while on the other hand bankers responded by holding more reserves relative to loans. Comparing with the other countries the reserve requirement ratio is still high ranging from 5 percent to 10 percent.

Because of the high reserve requirements, the average margin was high in Cambodia and Laos represented by 12.3 percent and 15.5 percent respectively (Table 5.4). On the other hand, the average margin in Viet Nam was low i.e., 4.5 percent during 1991-2004. The average gross interest margin was very low in Myanmar represented by 4.9 percent. Gross margins remain throughout the years because

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[86] See Thailand Development Research Institute, 2002

Myanmar's interest rate ceiling remained unchanged. The present level of gross margin is well below the average negative real lending rate of -8.9 percent.

As presented in Table 5.4, the average real lending rate of Cambodia was very high i.e., 13.6 percent because of a high margin. In Myanmar and Laos, the real lending rates were negative because these countries were reluctant to increase the nominal lending rates together with increased inflation. The lending rate of Viet Nam was lower than the other countries because of a low margin.

Table 5.4 Margin and Real Interest Rates

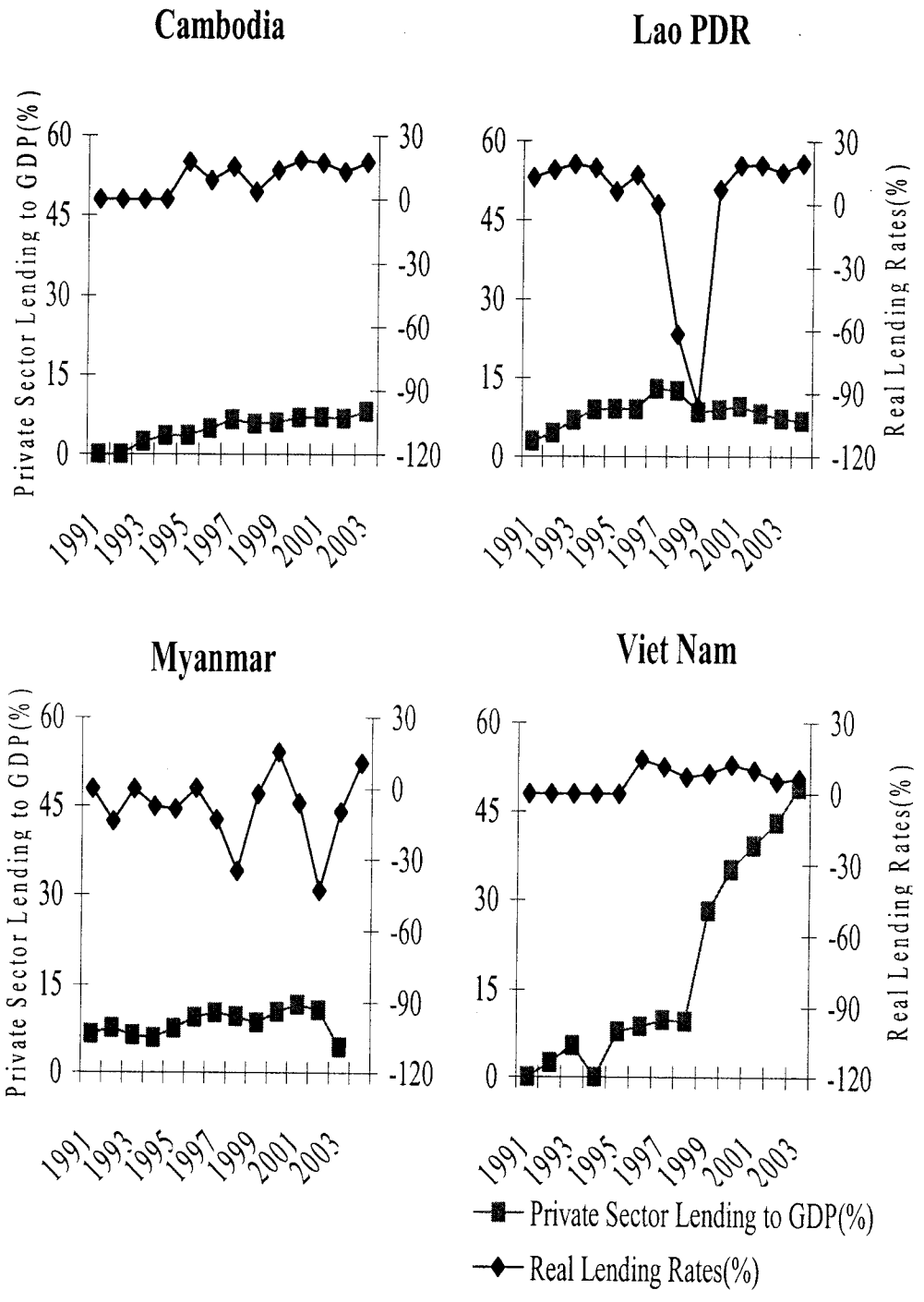
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Mean
Real Lending Rate (%)																
Cambodia	n.a.	n.a.	n.a.	n.a.	17.6	8.7	15.2	3.5	13.6	18.1	17.1	12.9	17.3	13.7	11.5	13.6
Lao PDR	12.6	16.1	19	17.2	6.1	14	n.a.	-61.7	-96.4	6.9	18.4	18.73	15	19.5	n.a.	0.4
Myanmar	n.a.	-13.9	n.a.	-7.6	-8.7	0.2	-13.2	-35	-2.3	15.4	-6.1	-43.1	-9.9	10.8	-2.7	-8.9
Vietnam	n.a.	n.a.	n.a.	n.a.	n.a.	14.4	11.2	7.1	8.6	12.3	9.8	5.1	6.3	2.3	n.a.	8.6
Gross Interest Margins(%)																
Cambodia	n.a.	n.a.	n.a.	n.a.	10	10	10.4	10.5	10.3	10.5	12.1	13.7	16.5	15.8	15.4	12.3
Lao PDR	2.5	11	12	12	11.7	11	n.a.	11.5	18.6	20	19.7	23.3	23.9	23.8	n.a.	15.5
Myanmar	n.a.	-1	n.a.	7.5	6.7	4	4	4	5.1	5.5	5.5	5.5	5.5	5.5	5.5	4.9
Vietnam	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5.9	5.2	5.3	6.9	4.1	2.6	2.9	3.5	n.a.	4.5

Source: International Financial Statistics (IMF, 2005); World Economic Outlook (2006); World Development Indicators (WDI, 2003); and Bank Soundness and Macroeconomic Policy (Lindgren, 1996)

(Note: Same data source is used for comparative study)

High reserve requirements increase the real lending rates, which results in a reduction of the private sector lending (Figure 5.2). It can be easily seen that a decrease in real lending rate increases lending to the private sector. On the contrary, an increase in lending rate decreases lending to the private sector.

Figure 5.2 Private Sector Lending and Real lending Rates



Source: International Financial Statistics (IMF, 2005); World Economic Outlook (2006); and Bank Soundness and Macroeconomic Policy (Lindgren, 1996)
(Note: Same data source is used for comparative study)

In Cambodia, private sector lending increased gradually but was still low, shown by 8 percent in 2003 because of high real lending rate. In the case of Viet Nam,

the private sector lending grew rapidly as a consequence of low lending rate, illustrated as 49 percent in 2003.

From the above analysis, it can be concluded that reducing reserve requirements can create credit expansion in Viet Nam. It means that it affects the efficient channeling of funds to private sector development, and thus, deepens the financial sector development. On the other hand, the high reserve requirements in Laos, Myanmar and Cambodia reduce the opportunities of credit creation that weakens financial intermediation and lowers the degree of financial deepening.

The implication is that low reserve requirements decrease can increase private sector lending. Furthermore, the low reserve requirements can also lead to a decrease in the cost of funds, making banks more competitive, and thus increasing the degree of financial intermediation that leads to financial deepening.

In developed countries, they use open market operations as the primary tools to control money supply. On the other hand, these countries rarely use changing reserve requirements for controlling money supply. All the CLMV countries use changing reserve requirements to expand money supply to stimulate domestic credit by creating public sector borrowing and private sector lending.

5.2 The Budget Deficit and Inflation

When governments control the money supply as a monetary policy tool, it can control net domestic assets. If governments use credit expansionary policy to raise domestic credit to the private sector, it will encourage economic development. If credit expansion is invested in the public sector to develop the infrastructure of the country and at the same time crowding out credit to private sector, the growth impact may be limited. Both excessive borrowing in private sector and in public sector would be harmful for the financial sector, for example, as the recent experiences of East Asia and Latin America indicated.

Fry (1997: 45-47) states that if budget deficit is financed by monetary growth, inflation would be increased as mentioned above. The following Table 5.5 shows the relationship between budget deficit and inflation in CLMV countries.

The average budget deficit of Laos was the highest among the CLMV countries. Budget deficit increased sharply from 5.6 percent in 1996 to 8.5 percent in 1998. This was largely because of capital spending on irrigation and also the higher

cost of foreign financed projects which is a consequence of the depreciation of the currency (Kip). The sharply increased money supply from 14.2 percent in 1996 to 20.4 percent in 1998 had resulted in the inflation rate increasing from double digits to triple digits during 1996-1999. The IMF staff report (1999) explained that government spending was expanded in 1997/1998 leading to a large fiscal deficit as mentioned above. As a consequence, the central bank financing of the budget deficit created strong inflationary pressures (IMF, 1999: 14).

Table 5.5 Money Supply, Budget Deficit, and Inflation

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Mean
Cambodia(%)												
Overall Balance to GDP	na	na	na	na	na	na	(0.4)	(2.5)	(1.3)	(2.3)	(3.1)	(1.9)
Money Supply to GDP	na	na	5.1	6.6	8.0	10.3	10.9	10.8	11.5	14.2	16.5	10.4
Inflation	na	na	na	na	1.1	10.1	3.2	14.8	4.0	(0.8)	(0.6)	4.5
Lao PDR(%)												
Overall Balance to GDP	na	na	na	(5.2)	(4.2)	(5.6)	(6.6)	(8.5)	(4.0)	(4.6)	(4.4)	(5.4)
Money Supply to GDP	7.1	9.1	13.2	15.0	13.6	14.2	18.5	20.4	15.0	16.5	16.4	14.4
Inflation	13.4	9.9	6.3	6.8	19.6	13.0	27.5	91.0	128.4	25.1	7.8	31.7
Myanmar(%)												
Overall Balance to GDP	(4.8)	(2.8)	(2.2)	(3.3)	(4.1)	(3.2)	(0.9)	(0.4)	(1.4)	na	na	(2.6)
Money Supply to GDP	30.7	30.8	27.1	28.0	29.9	31.7	28.8	26.9	25.7	na	na	28.8
Inflation	32.3	21.9	31.8	24.1	25.2	16.3	29.7	51.5	18.4	-0.1	21.1	24.7
Viet Nam(%)												
Overall Balance to GDP	na	(1.8)	(4.3)	(1.4)	(0.5)	(0.2)	(1.7)	0.1	(1.6)	(2.8)	(2.9)	(1.7)
Money Supply to GDP	na	22.7	20.1	na	19.8	20.9	22.6	24.2	36.4	44.6	52.1	29.3
Inflation	na	na	na	na	na	5.7	3.2	7.3	4.1	(1.7)	(0.4)	3.0

Note: Numbers in parentheses show budget deficit
Source: International Financial Statistics (IMF, 2005); and World Economic Outlook (2006)
(Note: Same data source is used for comparative study)

In Myanmar, the budget deficit that declined from 3.2 percent in 1996 to 0.4 percent in 1998 was primarily attributable to the lowering of the government expenditure where capital expenditure was cut sharply in those years (IMF, 1999). Average money supply growth rate was very high in Myanmar which had resulted in high inflation. The government had used expansionary fiscal and monetary policies that led to an increase in the money supply which resulted in increase in inflation rate.

In the case of Viet Nam, the government used credit expansionary policy in the private sector as mentioned before. Although the growth of money supply was the highest among the four countries, the government managed to lower the budget deficit. Together with inflation targeting pooling, it was able to lower the inflation rate.

In Cambodia, money supply to GDP ratio increased from 5.1 percent in 1993 to 16.5 percent in 2001. However, the average money supply ratio was relatively lower and then the average budget deficit was also low, resulting in low inflation.

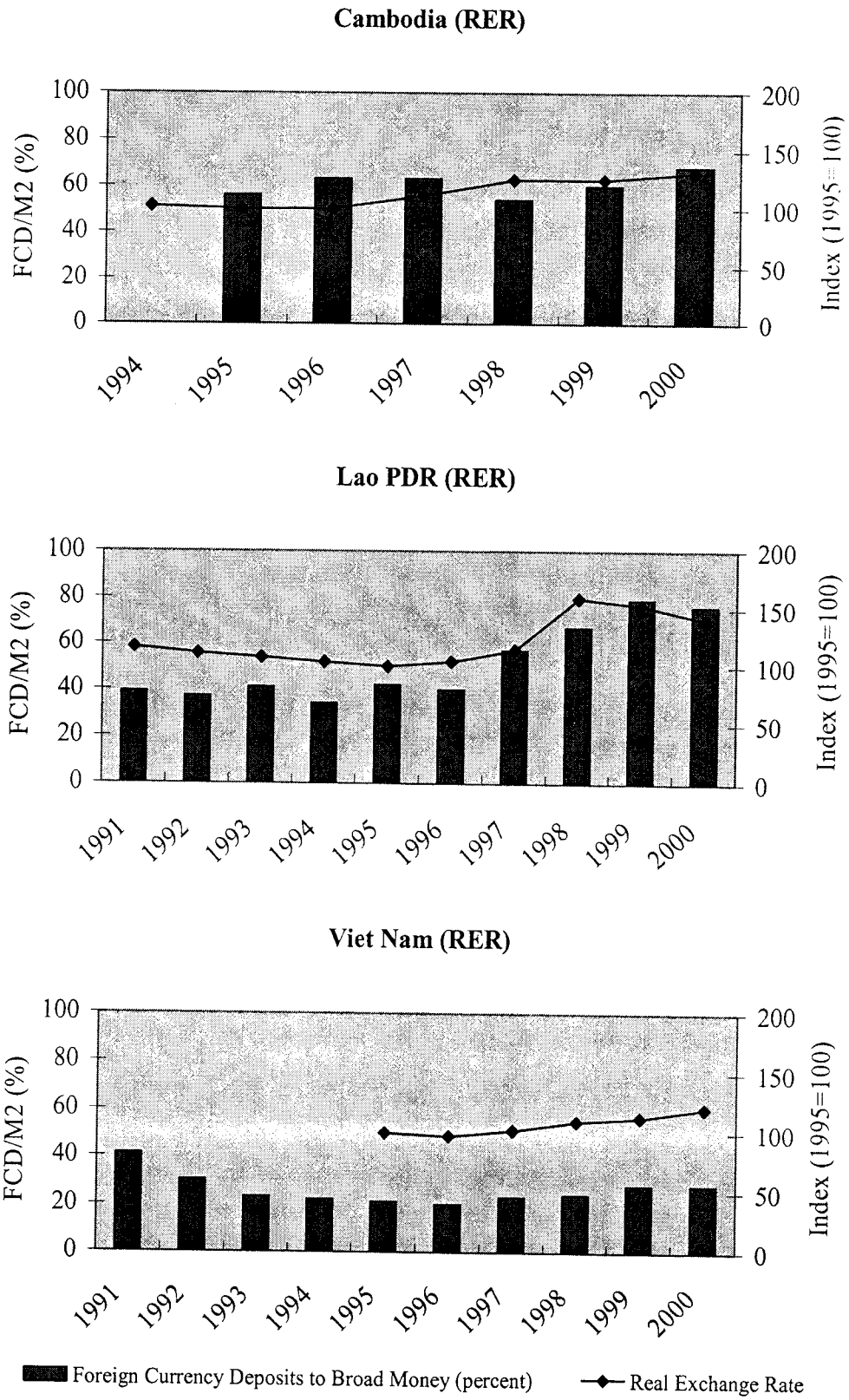
5.2.1 The Effects of Budget Deficits and Dollarization

All CLMV countries had experienced high inflation before reforming the financial sector. To reduce inflation and to perform bank intermediation efficiently, interest rates deregulation is permitted in the financial system for CLV countries. However, Dornbusch and Reynoso (1989) point out that financial liberalization raises the inflation rate unless it is accompanied by a reduction of the budget deficit. They also point out that if a country fails to liberalize the financial market, there will be a capital flight or dollarization with the same or worse consequences for inflation and intermediation.

After interest rate liberalization, the banking systems in CLV are allowed to offer foreign currency deposits, resulting in foreign currency deposits (FCD) growing rapidly. It indicates that households and firms prefer to hold foreign currency but they however want to deposit their idle funds in the banking institutions if interest rates are reasonable. This changing behavior of households and firms increase the FCD in the banking system. The increase in FCD means that banking systems in CLV are able to attract foreign currency funds, thus preventing speculation in foreign currencies and capital flight.

In the case of Laos and Viet Nam, one of the major factors that induce foreign currency deposits is partly due to exchange rate depreciation which resulted from high inflation, and partly due to realignment of exchange rates closer to market rates. High inflation usually leads to speculation of foreign exchange, i.e., US dollar (USD). Figure 5.3 shows the relationship between the movement of foreign currency deposits and real exchange rate (RER).

Figure 5.3 Foreign Currency Deposits to Broad Money and RER



Source: International Financial Statistics (IMF, 2004); and JICA (2002)

As Cambodia is a highly dollarized country, foreign currencies especially US dollar is the most effective currency. Hence, the changes in exchange rate do not affect the foreign currency deposits. As shown in Figure 5.3, local currency (Riel) depreciated against foreign currency (US dollar) shown by Real Exchange Rate (RER)[87] index, which increased from 100.1 percent in 1996 to 125.4 percent in 1998. However, foreign currency deposits to broad money ratio (FCD/M_2) declined from 63 percent in 1996 to 54 percent in 1998. This shows that the local currency (Riel) depreciation does not affect foreign currency deposits.

However, in the case of Laos and Viet Nam, the growth of FCD/M_2 ratio was in line with the movement of real exchange rate depreciation. It means that present local currency depreciation and the expected currency depreciation leads to an increase of the foreign currency deposits.

On the other hand, if the banking system is not allowed to offer foreign currency deposits, people will prefer to buy foreign currency as a store of value for speculation purposes, or as financial assets in response. As a result, the financial resources do not flow into the banking system. In other words, the domestic financial resources cannot be fully mobilized for productive investment.

Myanmar is still under a fixed exchange rate regime and had not realigned the official exchange rate to the market determined rate. The overvaluation of the exchange rate is shown in Figure 5.4, and negative returns on savings produced deposit outflow, reducing financial resources in the financial system. Thus, the degree of financial disintermediation becomes higher and that leads to weaken the domestic financial system. The estimate of resident capital outflows, according to the broad money measure of capital flight, was 378 million dollars in 1998 (Schneider, 2003: 43)[88]. A huge amount of domestic financial resources leaks outside the country. It means that the banking sector is not able to channel the funds to private sector development.

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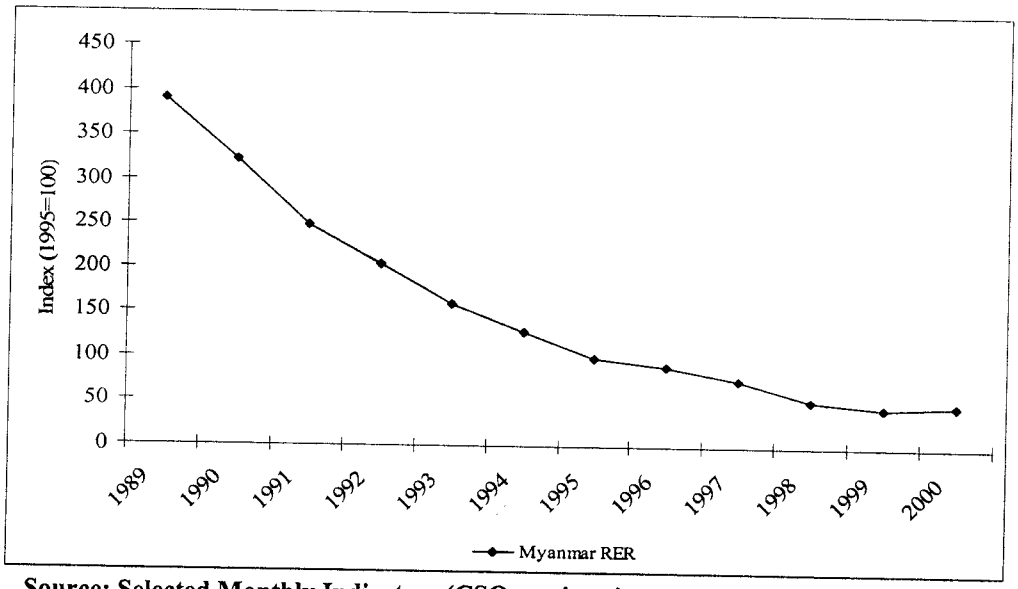
[87] Real Exchange Rate = (Nominal Exchange Rate x Price of Domestic Goods)/ Price of Foreign Goods (Mankiw, 2002: 129)

[88] Schneider, Benu, Measuring Capital Flight: Estimates and Interpretations, Overseas Development Institute, London, Working Paper No. 194, 2003: 43

Figure 5.4 The Real Exchange Rate in Myanmar



Source: Selected Monthly Indicators (CSO, various issues); International Financial Statistics (IMF, 2004)

The banking sector in CLV can mobilize the financial resources by allowing foreign currency deposits after lifting up the interest rate to a positive level. However, Myanmar has not allowed private banks to offer foreign currency deposits that lead to weaken the banking sector development.

As mentioned above, the commercial banks, households, and firms in CLV have shifted parts of their businesses to foreign currency denominated deposits and loans, as a result of high inflation and exchange rate depreciation. This currency switching depends on the traditional portfolio choice based on the relative rate of returns.

In CLV, the foreign currency deposits grew rapidly after lifting up the interest rate as mentioned in Chapter 4. The increasingly mobilized foreign currency funds have been allocated into three channels: (i) lending foreign currency denominated loans; (ii) selling foreign currency into local currency; and (iii) redepositing foreign currency at offshore banks.

The first channel of fund allocation illustrates that the commercial banks are able to channel the foreign currency funds efficiently, leading to efficient financial intermediation function that deepens the financial sector. The second and third channels express that the banks cannot channel the scarce financial resources

efficiently, reducing financial intermediation function that weakens the financial sector.

The interest rate liberalization in CLV restrains or prevents the capital outflow and increases the foreign currency deposits dramatically. However, the banks are not able to channel the foreign currency funds to productive investments because of limited lending opportunities for foreign currency loans. If the banks transform foreign currency deposits into local currency loans, the currency mismatch will occur in their balance sheets, discouraging financial intermediation function. To reduce currency risk and credit risk, the banks have to redeposit foreign currency funds at offshore banks. This shows the inefficient channeling from savers to investors within the country, weakening the degree of financial intermediation function, and discouraging financial sector development.

The following sections explain the consequences of dollarization in Cambodia, Laos, and Viet Nam.

Cambodia

The dollarization in Cambodia has increased since adopting a market oriented system. Moreover, dollarization was further facilitated by large foreign currency inflows, associated with UNTAC (United Nations Transitional Authority in Cambodia) operations in 1993 and the return of emigrant Cambodians. Hence, foreign currency deposits started to be an important component of the banking system.

The banks were not able to channel the foreign currency funds into productive investment because of the limited lending opportunities. Hence, the banks have to export between 30 percent and 50 percent of scarce financial resources to overseas banks, which is lowering the degree of the financial intermediation function (Tin Tin Htwe, 2005: 73). Furthermore, this discourages the deepening of the financial sector.

Lao PDR

The dollarization phenomenon in Laos is different from other countries. Two foreign currencies, Thai Baht and US dollar, are widely used together with local currency. After raising the interest rate to a positive level, foreign currency deposits increased during 1991-2003, while local currency deposits declined during this period. In 2003, the composition of deposits illustrated that two thirds of the share were in foreign currency and one third was in local currency.

The low foreign currency loans to deposits ratio indicates that the banks in Laos are not able to channel the foreign currency funds efficiently (JICA, 2002). Therefore, the banks export the domestic financial resources, i.e., foreign deposits to international financial markets because of limited lending opportunities in the economy. Furthermore, the banks try to expand the local currency loans with foreign currency deposits (Tin Tin Htwe, 2005: 76). Consequently, there might be currency mismatches in the banks' balance sheets. The conclusion is that dollarization lowers the degree of the financial intermediation function, which weakens the deepening of the domestic financial sector.

Viet Nam

After the war, the use of foreign currency, particularly the US dollar was continued to be held by the public as a store of value because of a lack of confidence in the local currency. When Viet Nam introduced banking reforms, particularly interest rate deregulation, a large amount of foreign currencies was attracted to the banking system in the form of foreign currency deposits. During a period of hyperinflation, individuals and households preferred to keep their savings in foreign currency or durable assets.

As Viet Nam is a moderately dollarized country, only one third of the total deposits is in foreign currency deposits. Although banks cannot channel foreign currency funds into the domestic financial sector, they can allocate the local currency resources to the private sector efficiently (Tin Tin Htwe, 2005: 79). It means that banks in Viet Nam can perform financial intermediation more efficiently, compared with other countries.

Myanmar

Unlike CLV, the dollarization phenomenon in Myanmar is different. As stated before, holding of foreign currency by the public is not legally allowed. The Central Bank does not allow private banks to offer foreign currency deposits, resulting in speculation in the unofficial foreign exchange (USD) market. Under a fixed exchange rate regime, the government had not realigned the widening gap between the official exchange rate and the parallel exchange rate. This multiple exchange rate with high inflation hinders foreign investments that reduce the capital inflow.

In Myanmar, business firms and households want to hold foreign currencies especially dollars, but however, all the businesses firms and households cannot hold

foreign currencies legally. They want to hold foreign currency as a store of value because of high inflation, high negative interest rates, and overvaluation of exchange rate. The Central Bank has introduced Foreign Exchange Certificates (FECs) in 1993, as mentioned in chapter 3. The FECs turned out to be popular, as a result of which the government eventually allowed thirty foreign-exchange dealers and ten semi-government and private banks to buy and sell FECs. However, later the government revoked the licenses of seven foreign exchange dealers and nine banks (Myat Thein, 2004: 141)[89]. This imposed more restrictions to those who want to hold foreign currencies. For this reason, the dollarization is practiced through the informal financial markets.

Hence, it gives arise to a sizeable informal exchange market which may be larger than formal exchange market because only state-owned banks are allowed to operate foreign exchange transactions. However, it is difficult to measure the magnitude of the informal foreign exchange market. It shows that the banking system cannot attract scarce financial resource that reduces savings and thereby declining capital accumulation. The reduced capital accumulation discourages the growth of Myanmar's economy.

In conclusion, when Cambodia, Laos, and Viet Nam liberalized their financial sectors, they became dollarized countries due to the weaknesses of domestic financial sector and macroeconomic and political instability. The uncertain inflation may weaken the domestic financial sector. However, if the Central Bank allows private banks to accept foreign currency deposits, foreign currency deposits will increase. This means the banking system can at least attract foreign currency deposits but if the banks cannot create foreign currency loans because of the limited lending opportunities, foreign currencies deposits would be exported to the offshore banks.

On the other hand, in the case of Myanmar, foreign currency holding is limited because private banks are not allowed to accept foreign currency deposits. As a consequence, scare foreign currencies are kept outside the country, weakening the banking sector that lowers the financial depth.

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[89] Myat Thein, Economic Development of Myanmar, Institute of Southeast Asian Studies, Singapore, 2004: 141

Tin Htwe, 2005: 80). Moreover, if the banks convert their foreign currency deposits to local currency loans, this can cause currency mismatch problem.

In Viet Nam, one third of foreign currency funds were invested outside the country, but the banks can channel the local currency funds efficiently (Tin Tin Htwe, 2005: 80). This indicates that banks can perform intermediation function efficiently. This deepens the financial sector.

5.2.2 Financing the Budget Deficit

Sundararajan & et al., (1994)[90] illustrate the linkage between budget deficit and the sources of financing which is expressed as follows:

$D_t = [B_t - B_{t-1}] - [MB_t - MB_{t-1}]$; where

D_t = budget deficit on cash basis;

$[B_t - B_{t-1}]$ = the net placement of government bonds;

$[MB_t - MB_{t-1}]$ = changes in monetary base arising from the bank credit.

The above expression shows that changes in the monetary base will be zero if budget deficit is fully financed by bond issues. In the case of bonds remaining unsold; the changes in monetary base will be positive. The model indicates that budget deficit can be financed by government bonds or by borrowing from the central bank.

Fry points out three distinct ways of government financing from the central bank as follows:

1. A central bank holds liabilities in the form of reserve money paying no interest and assets earning market interest rates; these assets might all be private sector bonds. This seigniorage revenue becomes government non tax revenue when the central bank's profit is transferred to the government.
2. The government takes interest free loans from the central bank seigniorage now reduces government interest costs rather than raising its revenue.

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[90] Ali, F. A., and Jayaraman, T.K., Monetary and Fiscal Policy Co-ordination in Fiji, Working Paper 2001/01, 2001: 7

2. The government takes interest free loans from the central bank seigniorage now reduces government interest costs rather than raising its revenue.

3. The government can reduce its recorded primary deficit by requiring its central bank to undertake various fiscal activities on its behalf (Fry, 1997: 51-52).

Government financing from the central bank increases inflation. It shows that too much dependence on the Central Bank borrowing increase money supply which results in inflation acceleration.

5.2.3 Government Borrowing from the Central Bank

The first variable in Table 5.6 constitutes the increase in central bank net credit to the government (central bank loans to the government minus government deposits at the central bank) expressed as a percentage of government deficit. The second variable expresses the central bank net credit to government as a proportion of net domestic credit to the government from the banking system as a whole (loans to the government minus government deposits at the whole banking system)[91].

As shown in Table 5.6, Myanmar met over 300 percent of its borrowing requirements from its central bank while the other countries had reduced net government borrowing from central bank either by repaying loans or increasing deposits. The second variable shows greater reliance on central bank loans. Myanmar, Laos and Cambodia had greater reliance on their central bank borrowing i.e., over 90 percent during 1991-2002. However, average government borrowing in Viet Nam was round about 30 percent. It can be said that Myanmar, Cambodia and Laos relied on central bank borrowing more than Viet Nam.

From the above analysis, it can be concluded that government authorities expand the public sector by monetizing deficits such as in Laos and Myanmar. The result is that the greater the proportion of deficits financed by borrowing from central bank, the higher the inflation rate. Hence, the inflation rate of Myanmar and Laos had double digit level throughout the years.

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[91] ibid

Table 5.6 Government Borrowing from the Central Bank in CLMV (%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Mean
Cambodia													
Increase in central bank net credit to government as percent of government deficit[1]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.33	-0.03	-0.06	-0.03	-0.02	-0.01	0.03
Central bank net credit to government as percent of net domestic credit to government[2]	n.a.	n.a.	110.5	97.1	101.1	99.1	96.7	98.9	94.4	62.6	109.6	136.7	100.7
Inflation, consumer prices (annual %)	n.a.	n.a.	n.a.	n.a.	1.1	10.1	3.2	14.8	4.0	-0.8	-0.6	3.3	4.4
Lao PDR													
Increase in central bank net credit to government as percent of government deficit[1]	n.a.	n.a.	n.a.	5.9	-96.5	67.5	78.8	19.2	-54.2	66.9	-35.5	-0.9	5.7
Central bank net credit to government as percent of net domestic credit to government[2]	37.9	61.8	13.8	1.7	13.3	818.8	15.0	73.7	108.2	-0.5	43.6	20.7	100.7
Inflation, consumer prices (annual %)	13.4	9.9	6.3	6.8	19.6	13.0	27.5	91.0	128.4	25.1	7.8	10.6	30.0
Myanmar													
Increase in central bank net credit to government as percent of government deficit[1]	153.9	236.6	318.7	164.3	162.1	127.6	647.7	720.4	381.5	262.7	n.a.	n.a.	317.6
Central bank net credit to government as percent of net domestic credit to government[2]	85.8	89.8	90.4	91.3	94.4	95.6	94.0	94.4	83.4	81.0	85.7	88.9	89.6
Inflation, consumer prices (annual %)	32.3	21.9	31.8	24.1	25.2	16.3	29.7	51.5	18.4	-0.1	21.1	58.1	27.5
Viet Nam													
Increase in central bank net credit to government as percent of government deficit[1]	n.a.	167.9	-89.8	n.a.	178.4	-230.7	42.3	-1324.4	65.1	29.9	21.9	n.a.	-126.6
Central bank net credit to government as percent of net domestic credit to government[2]	n.a.	208.9	100.8	n.a.	74.2	117.3	91.7	94.6	6.8	-892.4	382.1	125.8	31.0
Inflation, consumer prices (annual %)	n.a.	n.a.	n.a.	n.a.	n.a.	5.7	3.2	7.3	4.1	-1.7	-0.4	4.0	3.2

Note: 1. Positive sign shows an increase in government borrowing, in contrast, negative sign shows a decrease in government borrowing

2. Positive sign shows central bank loans to government is larger than government deposits at the Central Bank, in contrast, negative sign shows government deposits is larger than its loans.

Source: International Financial Statistics (IMF, 2005); World Economic Outlook (2006); and Emancipating the Banking System and Developing Markets for Government Debt (Fry, 1997)

(Note: Same data source is used for comparative study)

In Myanmar, fiscal policy becomes more dominant than monetary policy. It implies that fiscal expansion particularly expenditure on infrastructure projects is financed by expansion of money supply that causes inflation rate to be high.

The government of Viet Nam tried to reduce the borrowing from central bank either by reducing loans or by increasing deposits. In addition, Viet Nam tried to reduce inflation. This is one of the reasons for low level of inflation

Cambodia also tried to reduce reliance on central bank borrowing but still the level was high. However, Cambodia had maintained a low inflation rate.

5.2.4 Public Sector Borrowing and Financial Intermediation

As mentioned earlier, budget deficit financed by borrowing from the central bank put upward pressure on inflation that represses the banking system. When government uses the credit expansionary policy particularly in the public sector, for example, the high investment in infrastructure projects and capital and current expenditure on the State-owned Economic Enterprises (SEEs) or State Owned Enterprises (SOEs), these loans are a burden for the banking sector.

As long as Myanmar and Laos still need to develop the infrastructure, they may have to build it up with the financial resources from the banking sector. The important reason is that infrastructure development can contribute to the country's economic development. Moreover, most SEEs or SOEs are the major economic units in Laos and Myanmar. The governments assume that these economic units are engines of economic development. For that reason, governments subsidize these priority strategic economic units. Consequently, directed lending to these priority economic units becomes a burden to the banking sector.

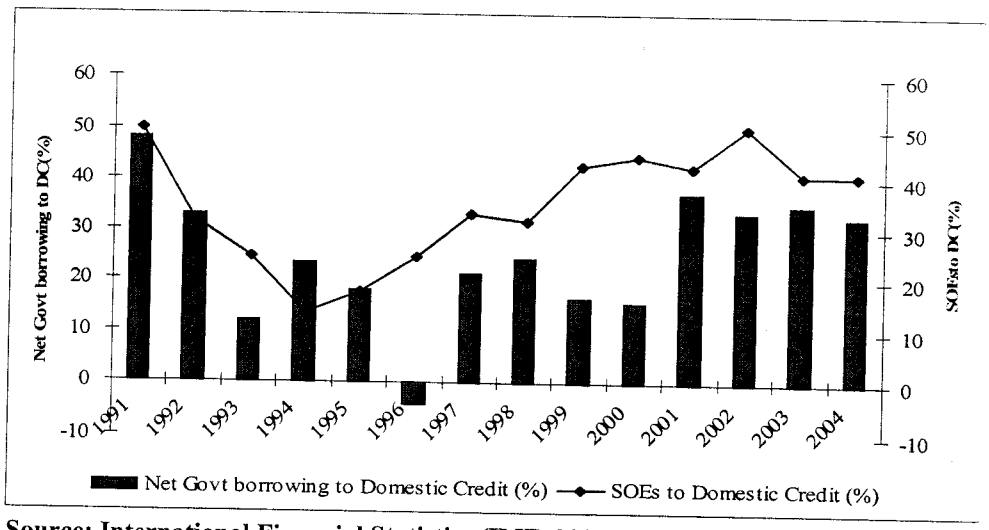
Almost all the State Commercial Banks are having problems with SEEs' or SOEs' loans. SEEs or SOEs cannot make the repayment of their loans because of their poor economic performance. As a result, SOEs' or SEEs' loans become nonperforming loans in commercial banks particularly in State Owned Commercial Banks (SOCBs). Consequently, banks that fail to intermediate efficiently become insolvent. To resolve the NPLs, the banking sector needs to restructure and recapitalize particularly the SOCBs. The costs of restructuring and recapitalization increase government expenditure that will widen the budget deficit.

The following section analyses public sector borrowing in Laos and [illegible] and its impact on the banking sector as case studies.

Lao PDR

The average of public sector borrowing to total domestic credit was [illegible] about 56 percent during 1991-2004, of which net government borrowing [illegible] percent and SOEs' borrowing was 35 percent. As illustrated in Figure 5.5 [illegible] government borrowing increased noticeably in 2001 and 2003 as a result of [illegible] expansion for the public sector. SOEs' borrowing grew sharply during 1998-2[illegible] result of import of equipments and loans to the agriculture sector i.e., loans to [illegible] authority of farmer organization (IMF, 1999).

Figure 5.5 Public Sector Borrowing to Domestic Credit in Lao PDR



Source: International Financial Statistics (IMF, 2005)

In fact, the public sector especially SOEs' loans mainly contributed to the non performing loans in the banking system. According to Furukawa's report (2004), nonperforming loans to total loans grew substantially from 35 percent in 1995 to 60 percent in 1997, and 70 percent in 2000. One result of the increasing accumulation of nonperforming loans was the rise in inflation, and rapid exchange rate depreciation after the 1997 Asian financial crisis. These accumulated bad loans were the result of loans to loss making SOEs and directed lending to local contractors requested by the local authorities (Komatsu, 2005: 1-2[92]; Koyama, 2005: 12[93]). Although the latter

NPLs did not appear in public sector borrowing, as the borrower was the government authorities it was called disguised fiscal deficit financing by the banking sector (Komatsu, 2005: 2). As a result, the banking system in Laos remains largely insolvent (IMF, 1998: 16 and Koyama, 2005: 12). Consequently, the weak lending practices and excessive exposure to the SOEs or directed lending had become key sources of vulnerability in the financial system. As a result, financial intermediation cannot function very well thus lowering financial depth.

According to Koyama's paper, total NPLs of the banking sector was more than 50 percent of the loan assets, of which the composition of public sector borrowing was more than that of private sector (Komatsu, 2005: 2). Resolution of NPLs becomes a criterion to make a sound banking system and to restore the effectiveness of bank intermediation. For that reason, a first round recapitalization of SOCBs was initiated in 1994 (IMF, 1998: 15). 77 percent of SOCBs' nonperforming loans, amounting 1 percent of GDP, were removed from their balance sheets. About 70 percent of NPLs were written off and the remaining 30 percent were transferred to the Bank of Laos (BOL). In 1999, 6 SOCBs were merged into 2 (IMF, 2002: 12). At the end of 2004, only 3 state owned banks, 3 joint venture banks, and 6 branches of foreign banks, and 1 representative office existed in Laos (Koyama, 2005: 5).

The estimated costs for recapitalization of these banks are about Kip 380 billion (i.e. US$ 50 million) for the total banking system (World Bank, 2002 and ADB, 2002: 44). These costs constitute a substantial portion in the increase of the government expenditure that leads to widen the budget deficit.

Myanmar

Figure 5.6 illustrates the contribution of net government borrowing to domestic credit and the contribution of the State-owned Economic Enterprises (SEEs)[94] borrowing to domestic credit in Myanmar. Net government borrowing declined from 85 percent in 1991 to 62 percent in 2001 and then increased to 81.3 percent in 2004. On average, two thirds of domestic credit was government borrowing.

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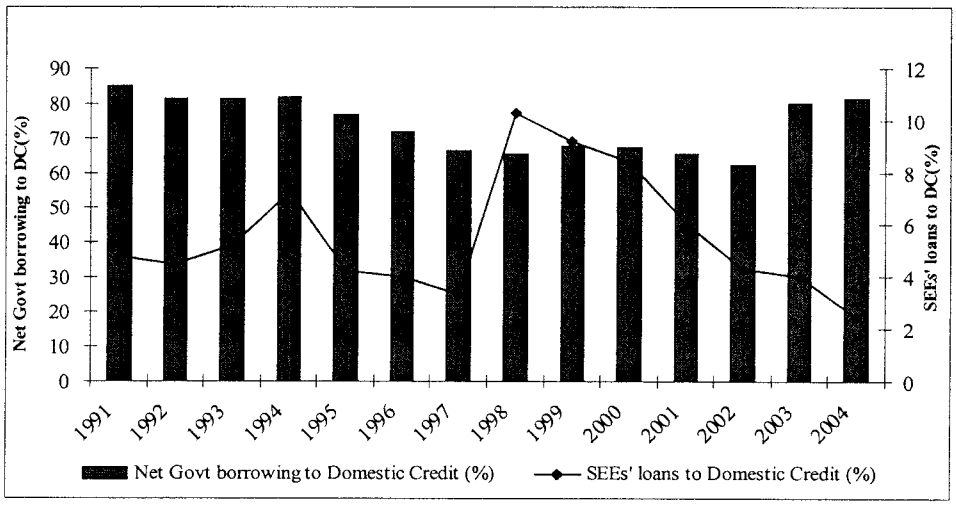
[92] Komatsu, M., Major Issues in Financial and Fiscal Sector in Lao PDR, Unpublished Paper, Hiroshima University, 2005: 1-2

[93] Koyama, M., Financial System Development and a Study on DFIs in Lao PDR, Unpublished Paper, Development Bank of Japan, 2005: 12

[94] In Myanmar, State-Owned Enterprises referred to SOEs are called State-owned Economic Enterprises and are referred to as SEEs (ADB, 2000; IMF 1999, 2000, 2001; and World Bank,1995)

It shows that public sector borrowing is much more than the private sector because Myanmar needs to invest in infrastructure projects of the public sector. The public sector has been mostly financed by issuance of Treasury Bills and Bonds (ADB, 2000).

Figure 5.6 Public Sector Borrowing to Domestic Credit in Myanmar



Source: Statistical Year Book (CSO, 2003 & 2004); International Financial Statistics (IMF, 2005)
(Note: All data is not available in Statistical Year Book (CSO, 2003 & 2004)

On the other hand, an average of SEEs' loans to domestic credit ratio was 6 percent during 1991-2004. The reason was that SEEs were not allowed to borrow from banks since 1989. The SEEs are to deposit their receipts to the State Fund Account (SFA) and their expenditures are to be incurred from the fund (CSO, 2001). The State Fund Accounts (SFAs) are administered by the Myanma Economic Bank (MEB).

Comparing with Laos, the net government borrowing in Myanmar was higher than that ratio in Laos, whereas the SEEs' borrowing in Myanmar was lower than that ratio in Laos. Nevertheless, public sector borrowing in Myanmar was the highest among CLMV countries. The main reason is that most government borrowing has been invested in infrastructural projects. As mentioned earlier, the public sector deficit has continued to be primarily financed by the Central Bank. Bank credit provided financing to the public sector of 3½ percent of the GDP in 1998/99. Issuing Treasury Bonds (TB) has become one of the significant sources of financing since 1994/95. In 1998/99, the net issue of 3-year and 5-year Treasury Bonds amounted to

Kyat 25 billion (1½ percent of GDP). Most of the Treasury Bonds were taken by private enterprises (IMF, 1999: 22) particularly private banks.

According to the IMF report (1999), NPLs which appeared at the end of 1998 were in the range of 1-18 percent of total loans; of which 6 percent of total loans were from Myanma Economic Bank (MEB), the largest state owned bank, 1 percent of total loans from Myanmar Agricultural Development Bank, one of the state owned banks, and 6 percent of total loans from major private banks[95] (IMF, 1999: 22). Between 2002 and 2004, nearly one fifth of total loans of MEB were still NPLs (Table 6.8).

An increase in NPLs decreases fresh loans to the private sector. Hence, private sector credit to GDP was low represented by 4.4 percent in 2003 (Table 4.3). In addition, only one fifth of the total credit was private sector credit in 2003 (Table 4.7). The low level of private sector lending shows the excessive public sector borrowing that leads to a decrease in private sector lending. The inefficient allocation of credit to the private sector reduces the degree of financial intermediation, weakening the financial sector development.

5.2.5 Need for Macroeconomic and Financial Stability

In developed countries governments are able to expand and contract their money supply and also to raise and lower the costs of borrowing in the private sector. In developing countries, however, the ability and the extent to undertake these functions may differ from nation to nation. The fact is that these countries have had to rely primarily on fiscal measures to stabilize the economy and to mobilize domestic resources because of absence of well-organized and locally controlled money markets.

In some CLMV countries, governments expand money supply to stimulate domestic credit worsening the fiscal deficit. These countries followed a policy of inflation-financed industrial growth. In the case of Latin America, for instance, governments resorted to deficit financing enhanced growth and, increasingly, caused high and unstable inflation which leads to poor economic performance and high levels of debt. The fact is that while the scope for inflationary finance is small, the risks are

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[95] Nonperforming Loans (NPLs) are defined as loans on which repayment of principal or interest is more than 6 months overdue

larger than commonly accepted (Dornbusch and Reynoso, 1989: 2). This [illegible] inflationary finance causes inflation acceleration that weakens the de[illegible] banking sector.

As financial systems of the countries remain an integral compo[illegible] general economic system, macroeconomic and financial stability is [illegible]. Macroeconomic stability encourages the stability of financial system that deepens the financial sector.

Macroeconomic stabilization has three objectives:

- getting inflation under control;
- restoring fiscal balance through government expenditures, raising pers[illegible] and business taxes, and reforming the financial system; and
- eliminating the current account deficit through adoptions of realis[illegible] flexible exchange rate and promotion of exports (Todaro, 2003: 135)[96]

In Viet Nam, the Central Bank uses credit expansionary policy and moneta[illegible] growth to stimulate domestic credit financing. Because of inflation targeting, alth[illegible] money supply increases sharply, inflation is under control during 1995-2004. T[illegible] increase private sector credit, the Central Bank forced the commercial banks to reduce lending rates and to relax the credit terms. Moreover, the Central Bank reduced reserve requirements to increase private sector lending.

As Cambodia is a highly dollarized country, the Central Bank cannot effectively control money supply because most payments are made in US dollars (USD). However, in 1996 and 1998, budget deficit was financed by central banking borrowing with limited external financing that caused double digit inflation. In those years, depositors withdrew Foreign Currency Deposits (FCD) because of macroeconomic and political instability. It shows that macroeconomic and political instability causes financial instability that weakens the financial sector.

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[96] Todaro, M. P. & Smith, S.C., Economic Development, Pearson Education Ltd., Edinburgh Gate, England, 2003: 135

Laos pursued credit expansionary policy particularly providing loans to public sector that often results in increased fiscal deficit. By expanding public sector borrowing, the government invested in long-term infrastructure projects that worsen fiscal imbalances. At the same time, the Central Bank used tight monetary policy tool, i.e., an increase in reserve requirements that leads to a decrease in private sector credit. This budget deficit financed by central bank borrowing causes inflation acceleration i.e., the inflation rate increased to triple digits during 1996-1999. Macroeconomic instability forced downward pressure on exchange rate depreciation that causes financial instability.

Myanmar also uses expansionary fiscal and monetary policies to finance development projects. Most of the domestic credit goes to public sector financing that widens the fiscal gap. Myanmar uses central bank financing strategy that increases inflation into double digits. Moreover, Myanmar uses interest rate ceilings and high reserve requirements that leads to the underdevelopment of the baking sector.

The implication is that there is a need to coordinate monetary policy with fiscal policy and other elements of macroeconomic strategy. Monetary policy could not counter-act the dominance of fiscal policy. Instead of market-based instruments, direct administrative tools are used leading to financial repression and disintermediation, hindering the development of the banking sector. Lack of coordinated and correct fiscal and monetary policy mix is one of the main causes of economic and financial problems. It is a policy failure, more than any other factors. They are the root causes of current problems.

In summary, when Cambodia, Laos, and Viet Nam liberalized their financial sectors, they became dollarized countries due to the weaknesses of domestic financial sector and macroeconomic and political instability. The uncertain inflation may weaken the domestic financial sector. However, the Central Bank allows the commercial banks to accept foreign currency deposits, resulting in foreign currency deposits increase. This means the banking system can at least attract foreign currency deposits but if the banks cannot create foreign currency loans because of the limited lending opportunities, foreign currencies deposits would be exported to the offshore banks.

In Viet Nam, the Central Bank uses credit expansionary policy and monetary growth to stimulate domestic credit financing. Because of inflation targeting, although money supply increases sharply, inflation is under control during 1995-2004. To increase private sector credit, the Central Bank imposes low reserve requirements to the commercial banks to reduce lending rates and to relax the credit terms. When Viet Nam introduced banking reforms, particularly interest rate deregulation, a large amount of foreign currencies was attracted to the banking system in the form of foreign currency deposits. As Viet Nam is a moderately dollarized country, only one third of the total deposits is in foreign currency deposits. Although banks cannot channel foreign currency funds into the domestic financial sector, they can allocate the local currency resources to the private sector efficiently. As a result, the banking sector of Viet Nam becomes healthy and stable that contributes to financial deepening. It can be learned that the balance between fiscal and monetary policy can stabilize financial sector.

Since Cambodia is a highly dollarized country, the Central Bank cannot effectively control money supply because most payments are made in US dollars. Cambodia tries to reduce the budget deficit financed by central bank borrowing but central bank borrowing as a whole remains high because of political instability which in turn accelerates inflation. Nevertheless, the Central Bank tries to control inflation even though money supply increases. The Central Bank imposes high reserve requirements to the commercial banks as one of the monetary policy tools. High reserve requirements increase lending rates that decrease private sector lending. However, private sector lending increases gradually but still low compared with other LMV countries. It can be said that Cambodian bank intermediation is relatively more effective.

Laos pursued credit expansionary policy particularly providing loans to public sector that often results in increased fiscal deficit. Budget deficit financed by the central bank borrowing leads to the acceleration of inflation. The directed lending to the public sector is not efficient. The higher the amount of public sector borrowing, the lower the lending to private sector. By expanding public sector borrowing, the government invested in long-term infrastructure projects that worsen fiscal imbalances. Macroeconomic instability forced downward pressure on exchange rate depreciation that increases foreign currency deposits. At the same time, the Central

Bank used tight monetary policy tool, i.e., an increase in reserve requirements ranging from 6 percent to 12 percent. The fluctuating reserve requirements created more uncertainty for the commercial banks. That also leads to a lower degree of financial intermediation, weakening the financial sector development.

In Myanmar, the growth of money supply was mainly contributed by budget deficits and domestic credit expansion. Most of the domestic credit goes to public sector financing that increases budget deficit. The budget deficit which is financed by central bank borrowing increases inflation. An increase in inflation depreciates local currency. The Central Bank did not realign the official rate with the market determined exchange rate. The exchange rate overvaluation causes the gap between official and parallel exchange rate. In addition, the private banks are not allowed to accept foreign currency deposits that causes deposit outflow from the banking system. Moreover, Myanmar uses interest rate ceilings and high reserve requirements as monetary policy tools that lead to the underdevelopment of the baking sector. Myanmar uses expansionary fiscal and monetary policies to finance development projects. However, monetary policy could not counter-act the dominance of fiscal policy. Lack of coordinated and correct fiscal and monetary policy mix is one of the main causes of economic and financial problems, hindering the development of the banking sector.

CHAPTER VI
THE EXISTING BANKING SYSTEM IN MYANMAR

From the analysis of banking sector development in CLMV countries, it can be noted that Myanmar banking system has not escaped from financial repression paradigm. Under financial repression, an interest rate ceiling which is lower than market rate creates disincentive to save and at the same time encourages the demand for credit. Because of disincentive to save, savers begin to switch from buying financial assets to holding real assets. It reduces the supply of loanable funds that lessens the investments.

The negative real interest rates, high reserve requirements, and high inflation weaken the financial intermediation function that discourages financial savings and thereby reduces capital accumulation. The financial disintermediation leads to lower financial deepening. However, though Myanmar is under financial repression, there is an increase in the growth of Myanmar economy because of other compensating factors, such as sizeable infrastructure investment by the government, increased role of private sector, both domestic and foreign, and the significant contribution of informal financial sector. This finding is contradictory with the general finding of development economists, that is, the relationship between financial repression and economic growth is negative as explained in Chapter 2. The implication is that, had there been less financial repression; there could have been more possibility for economic development.

The previous analyses show that Myanmar banking sector is shallow, comparing with the other CLV countries. Even if the weak banking system can enhance economic growth, a sound banking system will contribute more to economic growth.

Since the soundness of banking system is crucial for economic development, the first part of this chapter introduces the existing structure of the financial system in Myanmar. The second part describes the functions of banking business and third part discusses the information problem of bank-based economy in general. The fourth part

tries to find out the factors that hinder the banking system. The last part of this chapter presents the role of central bank and existing regulatory system.

6.1 The Structure of Financial System

Financial system performs the essential function of channeling funds to those individuals or firms that have productive investment opportunities. Because banking plays such a major role in channeling funds to borrowers with productive opportunities, this financial activity is important in ensuring that the financial system and the economy run smoothly and efficiently (Mishkin, 2004: 25)[97].

To run the economy smoothly and efficiently, the financial system in Myanmar has been restructured since 1989 in line with the market-oriented economy. The banking system was transformed by new laws enacted in July 1990: the Central Bank of Myanmar Law, the Financial Institutions of Myanmar Law, and the Myanmar Agricultural and Rural Development Bank Law.

The Central Bank of Myanmar Law defines the authority and responsibilities of the Central Bank, including the conduct of monetary policy. As a consequence, the banking system in Myanmar has changed from mono-banking system to two-tier banking system. The Financial Institutions of Myanmar Law provides the establishment and operations of banking institutions. The Myanma Agricultural and Rural Development Bank Law defines the activities of the state-owned Myanma Agricultural Development Bank (MADB).

As shown in Chart 6.1, the structure of financial system comprises of banking and non banking financial institutions and organizations of government finance under the Ministry of Finance and Revenue. Government finance organizations include Budget Department, Customs Department, Internal Revenue Department, Pension Department, and Revenue Appellate Tribunal.

6.1.1 Banking Institutions

The banking sector consists of the Central Bank of Myanmar (CBM) which is under the Bank Supervision Committee (BSC), 4 state-owned banks, 15 private banks,

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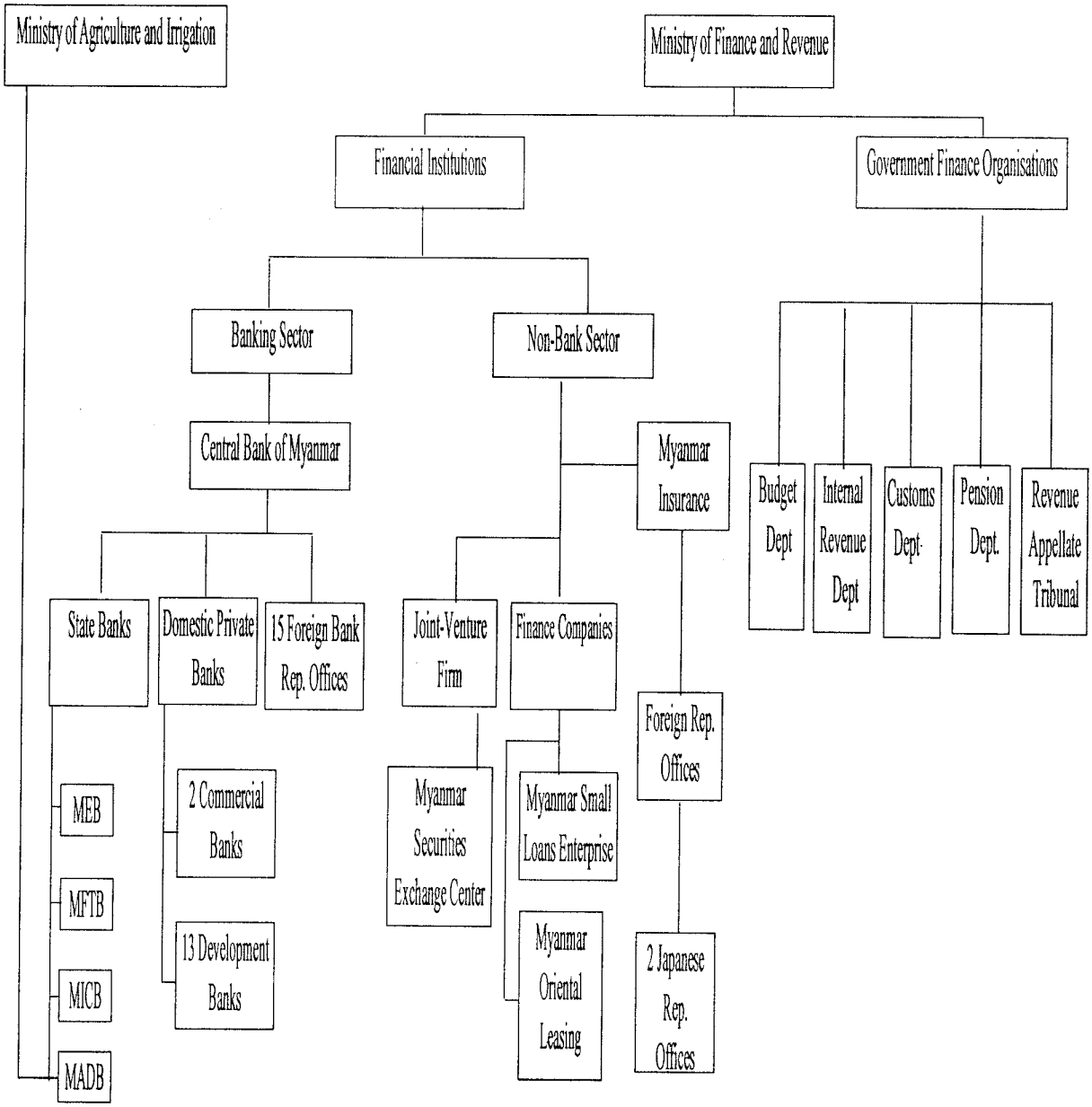
[97] Mishkin, Frederic S., The Economics of Money, Banking, and Financial Markets, New York: Addison Wesley, 2004: 25

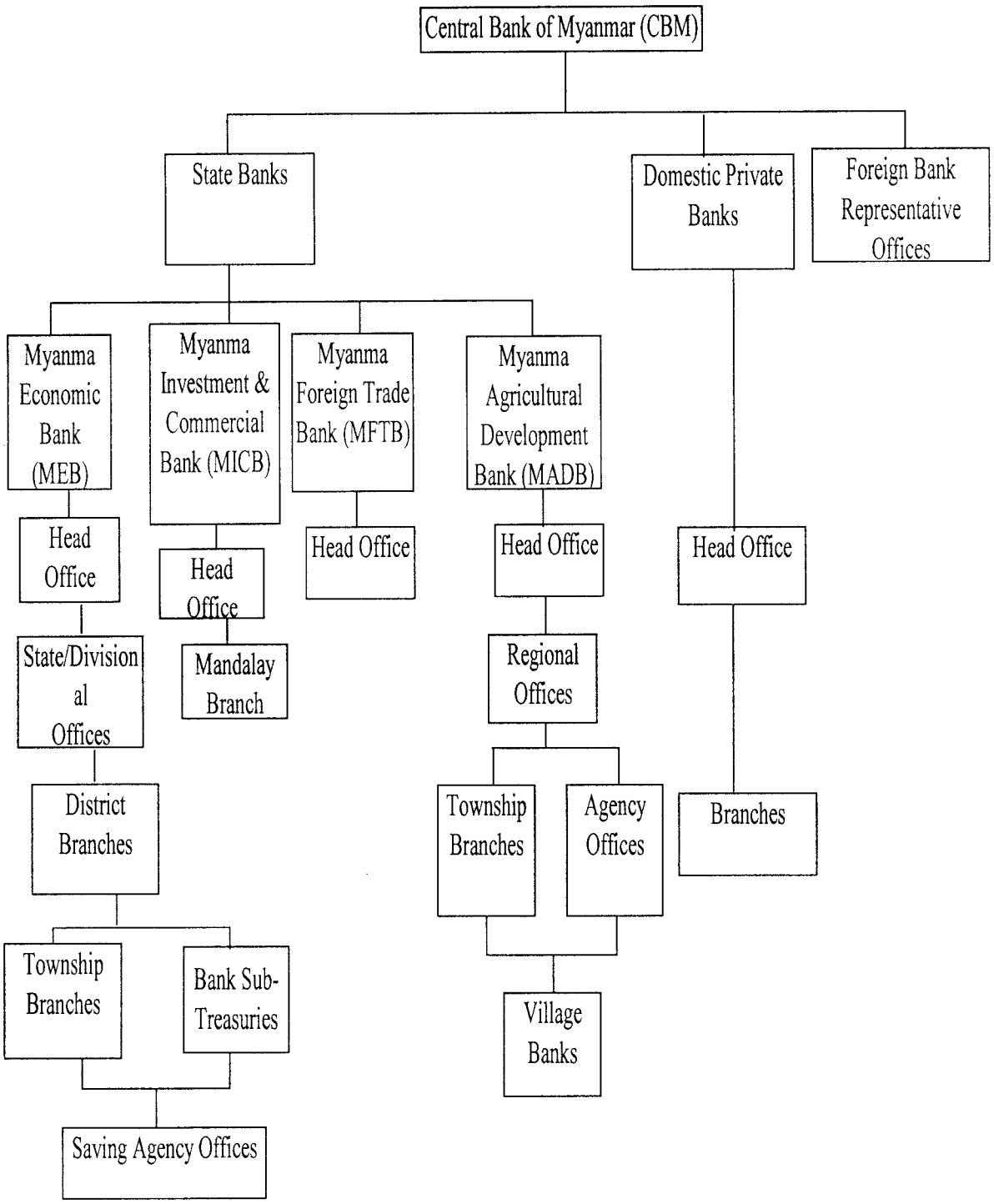
and 11 foreign representative offices (Chart 6.1). The state-owned commercial banks are the Myanma Economic Bank (MEB), the Myanma Foreign Trade Bank, the Myanma Investment and Commercial Bank (MICB), and the Myanma Agricultural Development Bank (MADB). However, the MADB was transferred to the Ministry of Agriculture & Irrigation in 1996, emphasizing more on agricultural development.

Chart 6.1 The Structure of Financial System in Myanmar



To have better supervision on all commercial banks, Bank Supervision Committee (BSC) was formed in 2003 to prevent the occurrence of banking crisis again (Chart 6.2).

Chart 6.2 The Structure of Myanmar Banking System



6.1.2 The Myama Economic Bank (MEB)

The Myanma Economic Bank (MEB) is the largest state-owned commercial bank in Myanmar having 7 head offices, 280 branches, 20 banking sub-treasuries, and 38 saving agency offices throughout the country. Thus, the MEB is the strongest bank taking the largest deposits.

The Myanma Economic Bank (MEB) provides wide domestic commercial banking services, selling saving certificates, providing various types of loans and advances, disbursing of pension, issuing remittances and payment orders, acting as fiscal agent of the government and the Central Bank of Myanmar (CBM), managing government accounts, and operating as currency agent on behalf of the CBM. The MEB has been conducting foreign exchange transactions since April, 1996. It also operates the functions of Government Employees Bank, which was established in 1996 for the welfare and benefit of the in-service and retired government employees.

Although the MEB is the largest and strongest state-owned commercial bank, the MEB cannot channel the funds efficiently and that results in making losses year by year for the following reasons:

- The amount of interest income from loans are not able to cover the operating costs;
- Directed lending to priorities like housing loans for some government personnel and earning no interest on SEEs' loans; and
- Treasuries are opened in remote areas where there are no real banking activities except treasury functions; and
- The pool of funds by taking deposits cannot be allocated to the productive projects efficiently and this results in increased non performing loans (NPLs), that is, may be one fifth of total loans (Mya Than, 2006: 16-17).

6.1.3 The Myanma Foreign Trade Bank (MFTB)

The Myanma Foreign Trade Bank (MFTB) provides international banking services for the state, cooperative, and private sectors. It concentrates in functions like international banking business i.e. exports, import bank guarantees and remittances.

The MFTB accepts foreign currency deposits of which a major portion is non-interest bearing. MFTB, unlike MEB and MICB, does not allocate foreign currency funds to the private sector, but most of the foreign currency loans go to SEEs with low or no interest rates. The main source of income is remittances.

6.1.4 The Myanma Investment and Commercial Bank (MICB)

The Myanma Investment and Commercial Bank (MICB) became a separate bank according to the Financial Institutions of Myanmar Law promulgated in 1990. The MICB has one branch in Mandalay which is a commercial and business centre in upper Myanmar to provide banking services for the customers in upper Myanmar.

The MICB provides both domestic and foreign banking services for local and foreign investors, joint ventures and private enterprises. The MICB is the only one bank which performs not only domestic banking but also foreign banking functions.

6.1.5 The Myanma Agricultural Development Bank (MADB)

The Myanma Agricultural and Rural Development Bank was transferred to the Ministry of Agriculture & Irrigation in 1996 and became Myanma Agricultural Development Bank (MADB) emphasizing more on agricultural development.

The objectives of the MADB are to provide loans for the development of agricultural, livestock and rural socio-economic enterprises in a simple procedure; to promote village banks; to encourage saving habits in order to cultivate self-reliance spirit in the local populace; to support socio-economic development in rural areas; to cultivate banking habits in the rural populace; and to build up the banks which is self-reliant and self-sufficient (MADB, CBM, & Mya Than, 2006: 29).

6.1.6 The Private Banks

Although foreign banks are not allowed to conduct banking business in Myanmar, the CBM has issued licenses for representative offices of 49 foreign banks. The representative offices are primarily engaged in gathering information for foreign customers trading with Myanmar. Because of the absence of branch offices, most representative offices have withdrawn. There remain 11 foreign representative offices by the end of 2005.

These representative offices of foreign banks cannot conduct banking operations in Myanmar as the strategy of government regarding financial development is to give domestic private banks to become more efficient and competitive before allowing foreign banks to operate. This means that strategies for financial sector development have relied on domestic financing other than external financing. McKinnon (1973: viii) pointed out that kind of strategy, a "bootstrap" strategy, aimed at securing their own economic development without having to rely on foreign aid and foreign capital investment.

The Central Bank of Myanmar grants operating licenses to domestic private banks under the Financial Institutions of Myanmar Law promulgated in 1990, with a view to promoting banking business in the private sector. Total numbers of 20 private banks operated in the banking system as of 2002. After the occurrence of banking crisis in 2003, only 15 private banks remained in the banking system as the authorities

revoked the licenses of 3 of the larger banks and 3 cooperative banks were forced to merge in 2004. Some banks are allowed to operate their normal banking functions according to the permission of Bank Supervision Committee (BSC). To prevent banking crisis, the Bank Supervision Committee has decided that one bank i.e. YOMA bank is not yet allowed to operate normal banking functions.

The organizational structure of Myanmar banking system shows that the state-owned banks compete with private banks but not a perfect competition. The state-owned banks have special privilege comparing with the private banks such as foreign currency transactions. When the state-owned banks are compared with the private banks by size, coverage, and capacity, more than a half of total savings are deposited in the Myanma Economic Bank (MEB) which is the largest state-owned bank. Moreover, the MEB operates with 85 branches, 195 township branches and 38 saving agencies throughout the country providing saving facilities, even in some remote rural areas (Myint Myint Tin, 1998: 73)[98]. On the other hand, the remaining 15 private banks operate with 15 head offices and 139 branches reduced from 224 branches in pre banking crisis period of Myanmar.

It can be concluded that Myanmar banking sector is dominated by the state-owned banks since the MEB has acquired the largest market share in post banking crisis period. In addition, the private banks are not able to compete with the state-owned banks in terms of size, scale, and scope. The question is that "Are the state-owned banks able to channel the funds efficiently?"

6.1.7 Non-Bank Financial Institutions

Direct financing channel, on the other hand, the non-bank financial sector is relatively small and major non-bank sources of financing like capital market still do not exist in Myanmar. Since non-bank financial institutions are not well developed yet, commercial banks are the most important sources of external fund providers for the development of businesses in Myanmar. The non-bank financial institutions include the Myanma Insurance Company, Myanma Small Loans Enterprise, licensed private small loans enterprises (pawn shops), the Myanma Security Exchange Center (MSEC),

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[98] Myint Myint Tin, Creating Domestic Investment via the Banking System in Myanmar, Institute of Southeast Asian Studies, Singapore, 2000: 73

and representative offices of foreign banks that do not conduct banking operations in Myanmar.

6.1.8 Informal Financial Markets

As formal banking system cannot reach the rural areas, informal financial market appears to play a significant role in financial intermediation. Additionally, negative real interest rates push the savers to informal financial market because lending rates in informal credit market is 3-10 percent per month with or without suitable collateral.

Informal credit markets seem to be most active in rural areas because of the absence of bank branches. Since two thirds of population live in rural areas, those people rely heavily on the rural money lenders.

6.2 The Functions of Banking Business

The primary function of banking business is to accept deposits from the public, and extend loans and advances for various purposes. In addition, the commercial banks provide other financial services, for example, remittance services. Although commercial banks act as financial intermediaries, private banks are allowed to operate domestic banking functions. The process of indirect finance using financial intermediaries is the primary route for moving funds from depositors to borrowers. Hence, how well functioning the channeling of funds are, can be measured by Deposits to GDP and Loans to GDP ratios. These indicators also present the progress of banking businesses. Before the analysis of deposit and loan ratios, the following currency to deposits ratio shows the magnitude of local currency usage in business operations.

6.2.1 Currency to Deposits ratio

Currency to deposits ratio shows that how much the payment mechanism relies on the currency in the economy. Table 6.1 presents the currency to deposits ratio in Myanmar, comparing with the other CLV countries.

As shown in Table 6.1, it can be clearly noted that currency to deposits ratio decreased from 232.7 percent in 1992 to 75.3 percent in 2001. As Myanmar economy has relied on domestic financing, the development of banking sector is vital for the financial sector development. Although private banking sector has grown rapidly during 1991-2002, cash to deposit ratio is still high, as compared to other CLV countries. Myanmar is still essentially a cash-based economy but people consume

bank facilities more during 1992-2001 because of the impressive participation of private banks since 1990s. Nevertheless, banking crisis raised the currency to deposits ratio noticeably in 2003 because of loosing public confidence in the banking system.

Table 6.1 Currency to Deposits Ratio (%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Cambodia	n.a.	n.a.	134.2	65.0	63.1	49.0	50.4	70.6	51.4	37.0	35.5	36.1	37.6	34.7
Lao PDR	60.7	42.8	35.9	30.3	27.7	21.3	15.1	7.9	5.3	3.1	4.6	6.9	10.4	14.9
Myanmar	207.6	232.7	226.5	206.6	174.0	156.3	151.0	120.9	94.3	75.7	75.3	86.4	235.0	183.6
Viet Nam	n.a.	74.0	102.0	n.a.	76.2	67.2	55.2	44.6	39.6	36.1	35.9	35.4	31.5	28.2

Source: International Financial Statistics (IMF, 2004 & 2005)
(Note: Same data source is used for comparative study)

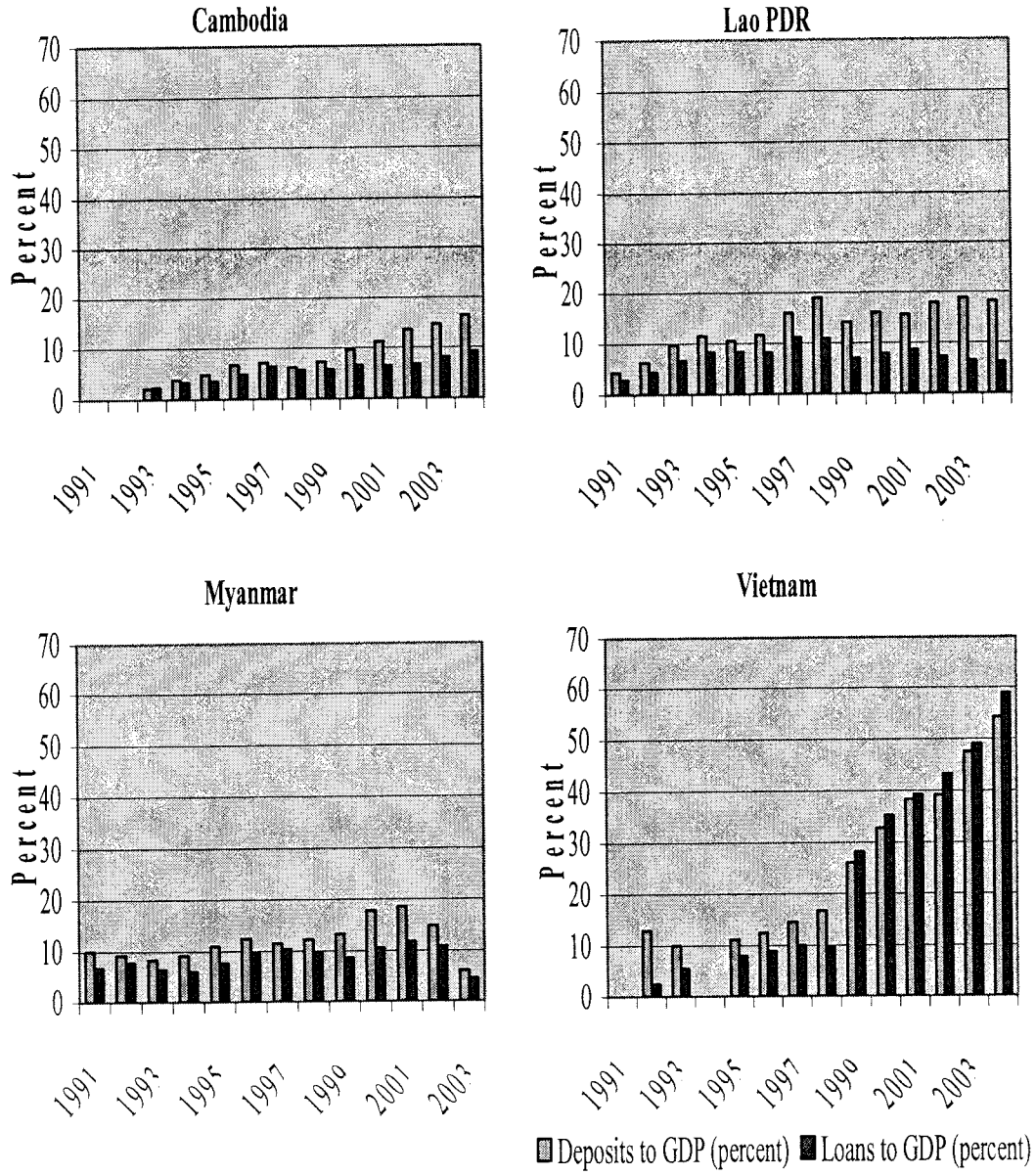
In Viet Nam, on the other hand, currency to deposits ratio decreased from 102 percent in 1993 to 28.2 percent in 2004. Thus, Viet Nam seems to have moved quickly from a cash-based economy to a financially developed economy.

6.2.2 Deposits to GDP and Loans to GDP

Figure 6.1 shows deposits to GDP ratio compared with loans to GDP ratio in Myanmar. The average deposit ratio was 11.8 percent throughout the years but this ratio is very low comparing with the other CLV countries. However, deposits to GDP ratio increased from 9.3 percent in 1992 to 18.5 percent in 2001, even though real deposit rates are negative.

Since the early 1990s, the remarkable development of private banks attracts by better services in both deposit taking and lending. The more developed the private banks, the more banking facilities people consume. As a result, private banks played a leading role during 1990-2001. However, the negative ceiling rates can no longer maintain the savers in the banking system. The deposit ratio had declined sharply from 18.5 percent in 2001 to 6.1 percent in 2003. The main reason is that the contagion effect of informal financial firms caused bank run in 2003.

Figure 6.1 Deposits to GDP and Loans to GDP Ratios



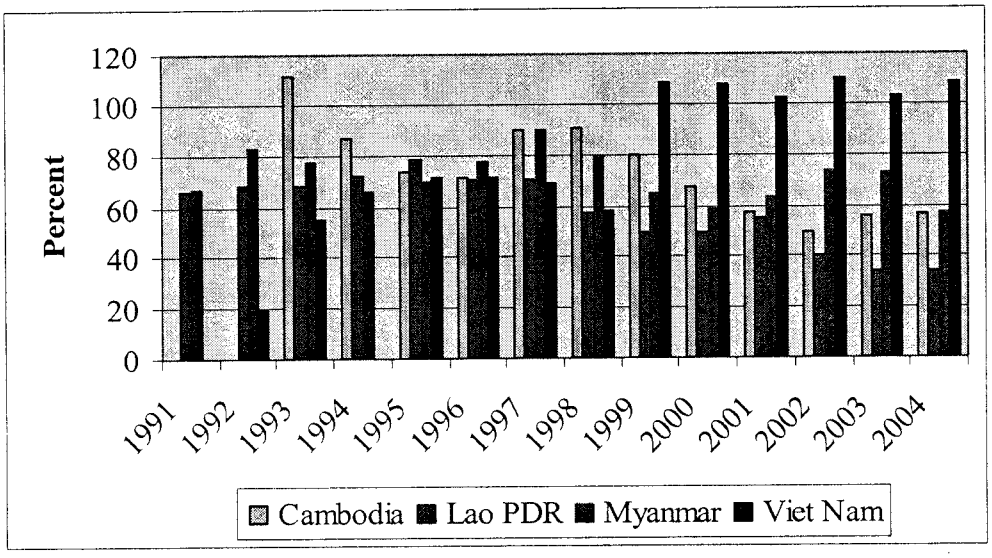
Source: International Financial Statistics (IMF, 2004& 2005)
(Note: Same data source is used for comparative study)

The informal financial firms, A Kyoe Saung firms like mutual funds, played a ponzi game. When these firms collapsed, banking crisis occurred. During the banking crisis, the declined deposits reduced the loanable funds to provide loans and advances to the private sector thus, the loan ratio declined to 4.4 percent in 2003 (Figure 6.1). As a result, both deposit and loan ratios declined remarkably. This shows that channeling of funds from depositors to borrowing firms is still limited though banking industries have been playing a major role in financial intermediation.

During the crisis period, the Bank Supervision Committee (BSC) limited the deposits with paid-up capital, that is, total deposit amount is not allowed to be more than seven times of its paid-up capital. This limitation stopped the deposit inflows into the banking system. At the same time, the reduced loanable funds had led to a decline in private sector lending that discourages the financial intermediation function, leading to hinder the banking sector development.

Consequently, the loans to deposits ratio, erratic and low, as shown in Figure 6.2, illustrates that banks cannot channel the funds efficiently. Thus, it leads to financial disintermediation hindering the development of the banking sector. Conversely, among CLV countries, the banking sector in Viet Nam seems to become more efficient in channeling of funds because of an increase in loans to deposits ratio. The increase in loans to deposits ratio is due to the interest rate liberalization and reduction of reserve ratio to 3 percent since 2000 as described in Chapter 3.

Figure 6.2 Loans to Deposits Ratio



Source: International Financial Statistics (IMF, 2004 & 2005)
(Note: Same data source is used for comparative study)

6.2.3 The Composition of Deposits

The following Table 6.2 shows the composition of deposits in Myanmar banking sector.

Table 6.2 The Composition of Deposits in Myanmar (%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Mean
Demand Deposits	25.3	21.5	19.5	21.3	17.1	15.3	19.9	22.8	25.1	26.3	31.4	34.9	17.7	18.6	22.6
Time, Saving & Foreign Currency Deposits	74.7	78.5	80.5	78.7	82.9	84.7	80.1	77.2	74.9	73.7	68.6	65.1	82.3	81.4	77.4

Source: Statistical Year Book (2003 & 2004); International Financial Statistics (IMF, 2004 & 2005)

The contribution of demand deposit to total deposits is round about 20 percent on average whereas that of time and saving deposits to total deposits is 80 percent on average. Of 80 percent, saving deposits is more than the other deposits which means that the banks cannot transform the saving deposits into mortgage loans. In other words, a bank cannot make long-term loans and funds them by issuing short-dated deposits.

Table 6.3 The Composition of loans in Myanmar (%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Mean
Claim on Central Government (Net)	24.9	12.2	8.4	-1.8	-0.6	-2.9	1.8	-17.5	4.7	9.6	7.6	5.9	7.8	15.1	5.4
Claim on Local Government	2.0	2.0	1.4	1.3	0.6	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.5
Claim on Nonfinancial Public Enterprises	17.8	16.5	19.7	28.8	15.4	12.7	8.8	27.1	21.2	18.6	13.7	9.6	15.3	9.8	16.8
Claim on Private Sector	55.2	69.3	70.5	71.8	84.6	90.0	89.3	90.4	74.1	71.8	78.7	84.5	76.9	75.1	77.3

Source: Statistical Year Book (2003 & 2004); International Financial Statistics (IMF, 2004 & 2005)

Although private sector credit to total credit is the lowest amongst the CLMV countries, the analysis of loans shows that average 77.3 percent of loans and advances goes to private sector and 16.8 percent goes to SEEs from the banking sector throughout the years as shown in Table 6.3. Even though SEEs are not allowed to borrow from the MEB which is the largest state-owned bank, average 16.8 percent of

bank loans from private banks sink to SEEs' operations which are not so efficient in Myanmar.

6.2.4 Loans by Sector

Although four-fifths of loans go to the private sector, banks lend out most to the trading sector during 1999-2004 (Table 6.4). Why do banks prefer to lend out to trading sector most? One reason is that the returns on trading are favorable- low capital with high returns, and loans for trading are short-term loans. Another reason is that the traders can submit the sufficient amount of collaterals to the bank. For these reasons, banks prefer to lend out more to the trading sector.

Table 6.4 Loans by Sector in Private Banks (%)

	1999	2000	2001	2002	2003	2004
Agriculture	n.a.	n.a.	2.51	1.23	0.80	0.76
Industry	19.4	22.4	28.3	25.3	25.5	32.4
Trading	38.4	40.1	40.0	48.4	43.2	36.0
Transport	4.5	3.5	2.7	2.1	2.1	1.4
Construction	7.5	5.9	4.7	3.1	4.0	5.6
Service	16.1	17.5	11.2	12.6	12.9	13.8
Others	6.8	5.5	8.4	5.3	7.1	4.3
Housing	7.3	5.1	2.1	2.0	4.4	5.8
Total	100	100	100	100	100	100

Source: The Central Bank of Myanmar (CBM)

However, trading loans started to decline from 43.2 percent in 2003 to 36 percent in 2004 whereas industrial loans increased from 25.5 percent in 2003 to 32.4 percent in 2004. It may be due to the fact that the Central Bank has forced to reduce the interest rate on industrial loans from 15 percent to 13 percent since 2000. Even though the CBM forced to expand industrial loans, loans on industry is still low that is 32.4 percent in 2004. The question is that how commercial capital can be transferred to industrial capital by the commercial banks.

Furthermore, low loans to deposit ratio (57.5 percent in 2004) shown in Figure 6.2 expresses that the commercial banks cannot fully utilize deposit funds because of strict money lending practices and limited acceptance of certain types of collateral.

Even though lending rates are artificially lower than market rates, these banks cannot channel the deposit funds fully and efficiently. The fact is that the banks mainly depend on commercial banking function rather than development banking although they are permitted to operate both commercial banking and development banking functions because of mismatch of funds, that is, deposits are short-term and development lending is either medium- and long-term in nature. Mismatch of funds is very risky for banks especially in an inflationary environment with negative real interest rates. However, development banking function would attract SMEs' lending that would increase loans to deposit ratio. By introducing long-term loans, the banks can meet the requirements of SMEs that would result in banks utilizing the funds more efficiently. In this way, commercial capital (short-term loans) can be converted to industrial capital (medium- and long-term loans) by introducing development banking operation by the commercial banks.

Table 6.5 shows why industrial loans are very low in Myanmar. As shown in Table 6.5, external financing of manufacturing firms is very low, comparing with the other Asian countries. According to a JICA research paper, it finds out the nature of lending behavior depends on the size of manufacturing firms in Myanmar. Medium-sized companies are the most active in borrowing from banks; and large-sized companies rely on both bank loans and self-financing, whereas small-sized firms have less access to bank financing. Moreover, the method of corporate financing in Myanmar is self-financing. Bank financing is 9.7 percent of the total average. The share of bank financing is very low in comparison with other Asian countries, resulting in a lower leverage rate (JICA, 2003: 514)[99]. In another research by Khin Naing Oo[100] finds that the financing behavior of SMEs in Monywa Industrial Zone situated in Upper Myanmar is mostly by self-financing and informal financing rather than bank financing. Bank financing of SMEs in that area is only 4 percent. This finding supports the argument that SMEs in Myanmar are relying heavily on self-financing or reinvesting out of profits and informal financing.

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[99] JICA, Myanmar-Japan Cooperation Program for Structural Adjustment of the Myanmar Economy, Fiscal and Monetary Policy Working Group, Yangon, Myanmar, 2003: 514

[100] Khin Naing Oo, The financial behavior of SMEs in Monywa Industrial Zone, Unpublished Ph.D Thesis, Yangon Institute of Economics, Yangon, 2006

Table 6.5 Capital Structure of Companies in Comparison with Asian Countries

	Myanmar	Thailand		Korea	Japan
	1998-2000	Listed 1997-99	Non-listed 1997-99	Listed 1995-96	Both 1990
No. of Companies	40	85	77	776	
L 2 Bank Borrowing	9.7%	51.0%	40.9%		42.0%
L 3 Borrowing from Affiliated Companies	2.3%	1.7%	9.4%		N/A.
Bond	0.0%	2.0%	0.0%		10%
L 1 Accounts and Notes Payable	11.9%				38.0%
L 4 Borrowing from Owners & Managers	5.0%	18.0%	28.1%		N/A.
L 5 Borrowing from Informal Lenders	0.3%				N/A.
L 6 Other Liabilities	4.0%				5.0%
L 7 Total Liabilities	34.7%	72.7%	78.4%	78.5%	74.0%
C 1 Paid-up Capital	48.3%	18.1%	21.2%		7.0%
C 2 Retained Earnings	10.0%	-10.5%	-4.6%		19.0%
C 3 Additional Paid-in Capital and Others	6.3%	14.4%	5.0%		
C 4 Total Capital Account	65.1%	22.0%	21.6%	21.5%	26.0%
L C Total Liabilities and Capital Accounts	100%	95%	100%	100%	100%

Source: JICA (2003: 517)

One question that should be raised is that "Why do Myanmar business firms rely on self-financing rather than on bank-financing?" First, the ideology of business firms in the Socialist system was that firms did not want to expand their businesses because the government discouraged the private sector whereas government encouraged the state economic enterprises (SEEs), and the co-operative sectors. Consequently, they have relied heavily on internal sources rather than external sources. As most firms have operated secretly, these firms have not kept the financial information systematically. In addition, as they also intended to evade the tax, the owners of the firms have not expanded their businesses. Although Myanmar's economy has transformed from a socialist economy to a market-oriented economy, the ideology of businessmen have not changed yet as the so called socialist attitude overhang; their financing behavior is still based on the traditional way of financing, that is, self-financing. This may be due to the fact that businessmen are afraid of being taken over by the government as the country had experienced nationalization of various businesses before.

Second, most SMEs have not kept their financial record systematically because the size of business is very small and the businesses are family-owned businesses. These businesses do not want to expand as owners are afraid of loosing control and results in these businesses wanting to sustain their businesses.

Third, because of strict lending policies, businesses are reluctant to rely on bank financing. The bank lending practices are based on collateral rather than on cash flow basis. On the other hand, most small and medium businesses (SMEs) do not have sufficient amount of collateral to submit to the banks to obtain the loans because of lack of legal documents concerning property rights which is not so clear in Myanmar. In addition, most industrial loans are short-term loans that cannot meet the long-term investment requirements of SMEs.

Fourth, banks try to minimize risks and carefully select borrowers as interest rates are ceiling rates which are lower than market rates. It means that some business firms have not obtained loans from the banks whilst some firms have, but insufficient.

Although Myanmar is an agriculture-based country, the average loans on agriculture to total loans range between 0.76 percent and 2.51 percent during 2001-2004 (Table 6.4). These agricultural loans are those obtained from the Myanma Agricultural Development Bank.

6.2.5 Rural Savings and the Myanma Agricultural Development Bank (MADB)

As two thirds of populations live in rural areas, the MADB is able to mobilize savings from rural areas and to promote banking habits of the rural population. On the other hand, the private banks are not able to open their branches in rural areas because operating cost is very high. Thus, private banks are entirely absent in rural areas, and they do not reach out to a significant portion of the population even in urban and peri (semi) urban areas. Although deposit mobilization is crucial in Myanmar, a significant savings potential in the rural areas are not intermediated through the formal sector. The MADB can only reach rural areas with its branches to attract significant rural savings through the formal banking institutions.

The agricultural loans and rural savings under the MADB are shown in Table 6.6. As presented in Table 6.6, loans to savings ratio declined year by year since rural savings increased year by year. However, low rural saving results in loans to savings ratio being very high. As the MADB cannot meet adequate loanable funds for rural areas, the MADB subsidizes the agriculture sector by borrowing from the CBM and MEB.

Table 6.6 Savings, Loans, and Borrowing from MADB (%)

Financial Year	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Rural Savings to Total Deposits (%)	1.0	0.8	0.7	0.6	0.5	0.6	1.0	0.8	0.7	0.6	0.4	0.5	1.0	0.9
Loans to Savings Ratio	913.7	974.8	1152.2	1184.2	935.6	1714.3	884.8	691.4	505.3	448.6	413.6	339.0	264.9	343.6
Borrowing from CBM, MEB/Total Loan	76.1	65.4	60.8	62.8	59.5	55.8	43.3	51.1	57.3	59.9	59.5	55.7	43.9	59.3

Source: MADB Annual Report (2003-2004)

Nevertheless, the MADB cannot provide sufficient loans to fulfill the need of the agriculture sector and socio-economic development of rural populace. Consequently, the rural people have relied heavily on money lenders who charge exorbitant interest rates. This shows that rural banks are not able to channel the funds efficiently.

6.3 Information Problems in General

Bankers and businessmen have long recognized the importance of finance, financial constraints, and financial institutions for the vitality and growth, both of their enterprises and of the economy (Greenwald and Stiglitz, 1991: 1)[101]. There are two main reasons to consider for the development of the banking industry: those businesses which want to expand their businesses require capital more than they have, and those businesses which start to invest in their new projects. Bank intermediaries have to select among alternative uses of those funds to accomplish these functions. Moreover, they have to design contracts with borrowing firms and monitor them as a control mechanism.

Asymmetric information is a common feature of market interactions. The seller of a good often knows more about its quality than the prospective buyers. The borrowing firms know more than the bankers or lenders about their creditworthiness.

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[101] Greenwald, B.C. and Stiglitz, J.E., Information, Finance, and Markets: The Architecture of Allocative Mechanisms, NBER Working Paper No. 3652, 1991: 1

Akerlof (1970)[102] showed that how information asymmetries can produce adverse selection in markets.

When there is an information asymmetry between bankers and borrowers, bankers may face difficulties such as the lack of information about borrowers, their creditworthiness, investment opportunities, and returns on investment. The presence of asymmetric information leads to adverse selection and moral hazard problems.

The first problem of asymmetric information is adverse selection that arises before transferring funds to borrowers. Bankers may select risky investment projects as returns on investment are high. As selection process is important for the bankers, ex-ante monitoring is required.

The second problem is moral hazard that is the consequences of adverse selection. As banks select the risky project, the default rate is high and immoral behavior of borrowers happens. The careful ante monitoring and supervision is required to reduce the moral hazard problems.

The third problem is financial distress of the borrowing firms. The problem is that banks are not able to distinguish between viable firms and non-viable firms when borrowing firms are facing liquidity crisis. That is why ex-post monitoring is required to distinguish the viable firms from the non-viable firms and to give a chance to temporarily illiquid firms (Yoshitomi and Shirai, 2001)[103].

Information asymmetry exists between depositors and the commercial banks, and between the commercial banks and borrowers, not between depositors and borrowers because banks are direct risk bearers of banks loans on behalf of depositors. Chart 6.3 indicates that information asymmetry arises from depositors and bankers, and bankers and borrowing firms in Myanmar. Furthermore, there exists information asymmetry between savers and General Service Companies, so called A Kyoe Saung firms.

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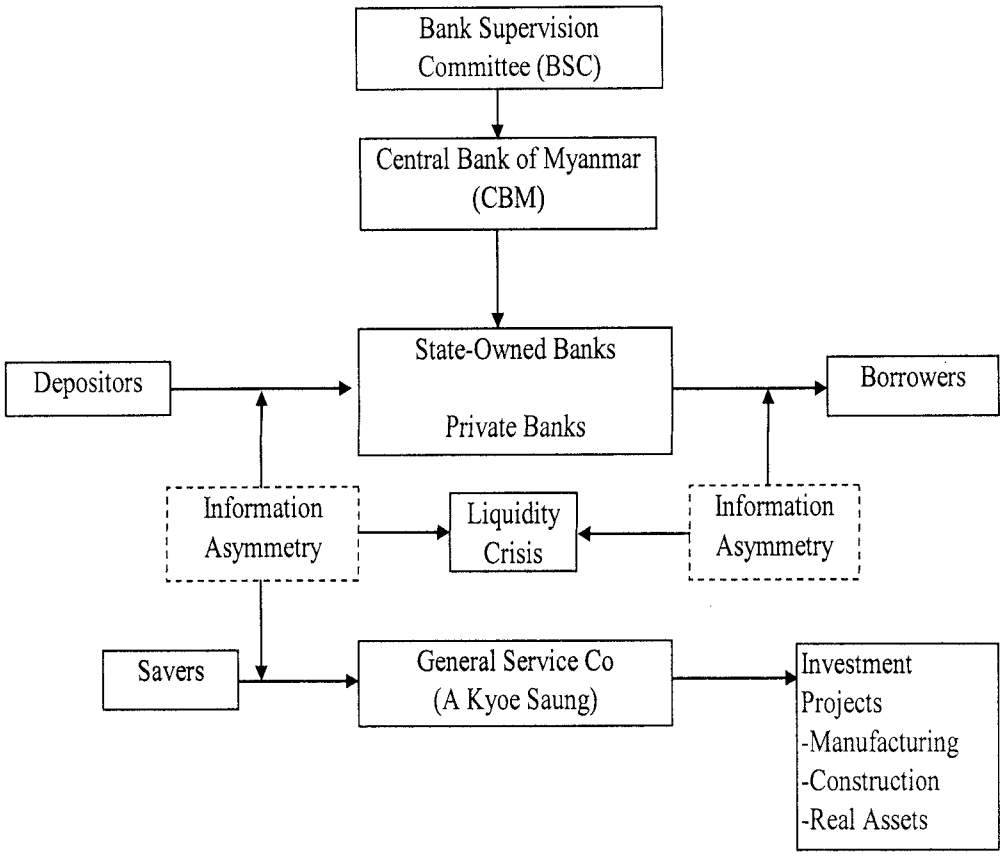
[102] Akerlof, G.,The Market for Lemons : Quality Uncertainty and the Market Mechanism, QuarterlyJournal of Economics (84), 1970 : 488-500

[103] Yoshitomi, M. Dr. and Shirai, S. Dr., Designing A Financial Market Structure in Post-Crisis Asia, ADBI Working Paper No. 15. ADBI, Tokyo, 2001: 24-25

Chart 6.3 Information Problems of Banking System in Myanmar



Some depositors are not familiar with the process of depositing their money in the banks because of lack of information. Some banks have not provided such inside information to depositors that is, how well functioning the banking business is to attract depositors. This leads to a general distrust of banks, thus, depositors and potential depositors are difficult to choose which bank has good performance and which one has bad performance.

On the other hand, information asymmetry arises between the lenders and borrowers. In other words, information asymmetry arises between bankers and borrowing firms. The main effect of information asymmetry is an increase in nonperforming loans in the banking sector. Consequently, some banks cannot channel funds efficiently and effectively as nonperforming loans have increased year by year.

When there is an information asymmetry between bankers and borrowers, bankers may face difficulties of lack of information about borrowers; their creditworthiness, investment opportunities, and returns on investment. Because of imperfect information about borrowers, bankers would make the decision, either to

reject the good project or to accept the risky project or bad project. If bankers reject the good project, borrowers have lost the opportunity to invest in the good project. On the other hand, if bankers choose risky project, although the bank may earn higher returns, but face the problem of repayment of loan. When the unsuccessful project cannot make the repayment, the moral hazard problem occurs.

In Myanmar, most of the firms are small and medium scale or family controlled businesses. They lack adequate financial, legal, and management skills. Because of lack of credible accounting practices and good disclosure, it is difficult for bankers to estimate the probability of default or an expected loss in the event of default. In fact, the firms know more about their business conditions than commercial banks.

As banks are the major sources of fund providers, they have to take the risks and provide loanable funds to borrowing firms. Before giving loans, bankers go through a selection process in spite of insufficient documents. After the screening process, banks might choose the risky projects or firms because of the need for interest income. However, some banks cannot monitor those firms or projects from time to time after providing the loans. On the other hand, borrowing firms do not want to submit their business condition. The result is that there is an information gap between borrowing firms and bankers. Consequently, the problem of information gap leads to moral hazard and then the effect is the increase in nonperforming loans.

The problems created by adverse selection and moral hazard are obstacles to the well-functioning of bank intermediation. The fact is that banking industry should try to mitigate these problems to reduce nonperforming loans.

6.3.1 A Kyoe Saung Firms and Liquidity Crisis

General Services Companies (A Kyoe Saung firms) were formed under the company law but they acted as mutual funds. General Service Companies, the informal financial institutions, collected a pool of funds from the public who have idle funds and allocated these funds in some investment projects such as manufacturing firms, trading businesses, construction businesses, and speculating real assets.

Since A Kyoe Sauung firms proposed an attractive interest rate which was much higher than bank ceiling rates to the savers, most savers who have idle funds deposited in these firms as six months or one year term. The savers enjoyed the attractive interest rate but they did not demand what A Kyoe Saung firms did.

On the other hand, the performance of the investment projects had not been disclosed although the firms invested in the very popular businesses which have good turnover in cash flow. There is information gap between savers and informal financial firms. Because of information asymmetry between savers and investment firms, the savers adversely selected to deposit in these firms other than the commercial banks.

According to the traditional portfolio choice based on the relative rate of returns, savers or depositors had switched from depositing in commercial banks or investing in real assets to informal financial firms. A huge amount of inflow of funds could not be channeled efficiently because of limited business opportunities or limited skills of portfolio management. The only way the firms can do was to redeposit in the commercial banks even though the bank rates cannot cover the rates these firms paid. Another was the mismanagement of funds such as buying own properties and using unlimited expenses. As a result, almost all A Kyoe Saung firms had collapsed within a short period of time.

The followings are the reasons why informal financial firms collapsed within two or three years. Firstly, the interest rate that the firms charged was 3 percent to 5 percent per month, i.e., 36 percent to 60 percent per annum. Comparing with bank rates, the banks' ceiling rates are unattractive rates which is 9 percent or 10 percent per annum. The result is that the earnings of informal financial firms cannot cover the interest rates the firms charged; as a consequence this service is covered with fresh funds from new deposits. These firms played a Ponzi game at the end.

Secondly, the maturity mismatch in the balance sheet of the firms, as the short term deposits are allocated into long term investment projects and fixed assets.

Thirdly, the firms invested in real assets to speculate asset prices. An increased asset price increased the net worth of the firms. However, the price decline on speculative assets shrank the firms' balance sheets, resulting in the firms facing with liquidity crisis and thus affected the insolvency.

Finally, the management team of a firm had no systematic financial plan. The channeling of funds was not so efficient because the management team cannot manage the increasing amount of funds. Moral hazard encourages firms to choose riskier projects or misreport results of their investment activities.

Savers realized this mismanagement of funds that caused loss of confidence of these savers, resulting in a failure of the General Service Companies within a short

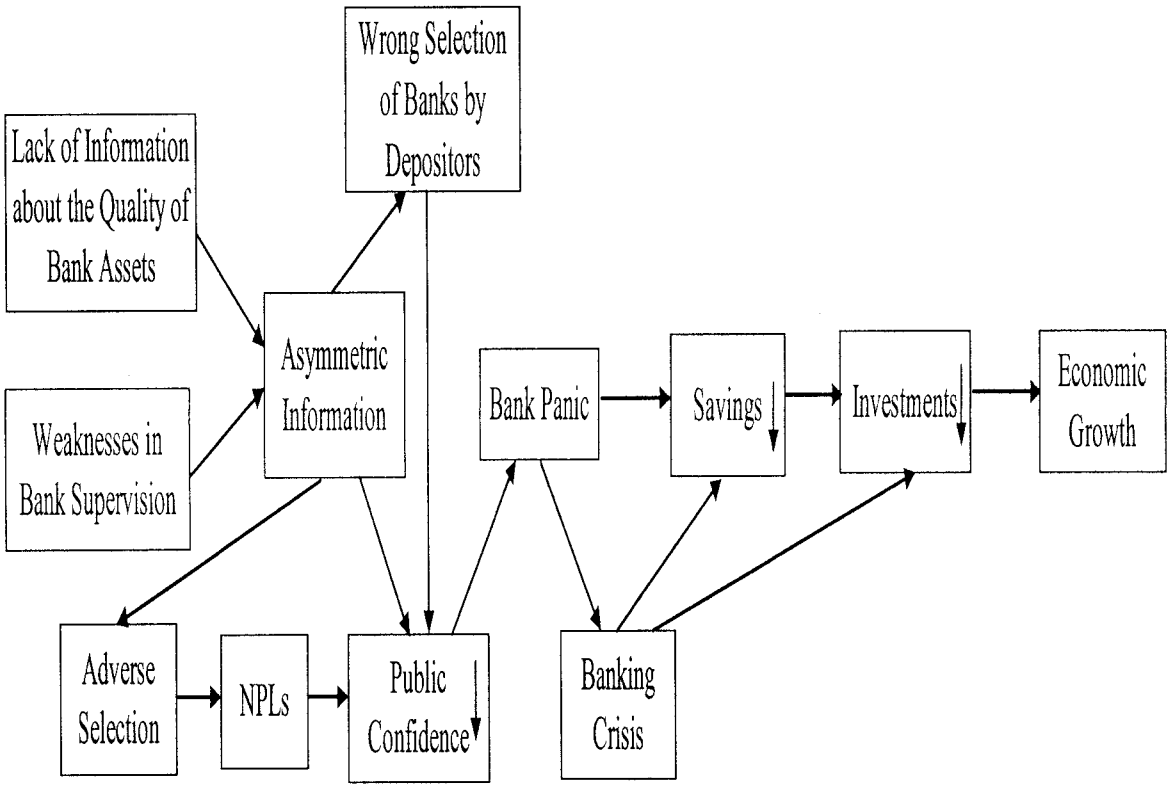
period. This failure of informal financial firms spread to other banks. When a bank's depositors had lost confidence, each and every depositor wanted to withdraw the funds from the bank.

In terms of the balance sheet, a sudden run initially causes both the bank's deposits and its reserves to fall by equal amounts. It has to curtail its loans or sell assets to cover withdrawals and bring reserves back up to the required level. When the value of bank's assets is insufficient to cover the value of its liabilities, illiquidity occurs. As short-term illiquidity fails to improve, the banks face with insolvency. 3 banks became illiquid and then insolvent. On the other hand, 3 weak co-operative banks were restructured into 1 healthy bank by merging.

6.3.2 The Consequences of Information Asymmetry in General

Asymmetric information leads to adverse selection and moral hazard problems that have an important impact on the banks. The depositors have lack of information about the quality of the commercial banks. This asymmetric information problem leads to two reasons why the banking system might not function well (Chart 6.4).

Chart 6.4 Consequences of Asymmetric Information



Firstly, in the absence of government intervention, if there is a bank failure, depositors would have to wait to withdraw their deposit funds until the bank is liquidated. Secondly, the depositors have lack of information about the quality of bank assets that can lead to bank panic. Thus, it can have serious harmful consequences for the economy.

Because of asymmetric information, depositors are unable to determine whether their bank is good or bad. When depositors face loss of confidence, depositors at good or bad banks withdraw their funds. However, they are worried about that the bank may run out of funds. The uncertainty about the health of banking system in general can lead to runs on banks both good and bad. If nothing is done to restore the public confidence, a bank panic can ensue. A bank panic reduces the amount of channeling funds and so leads to a decline in productive investments and aggregate economic activity. Thus, this leads to economic contraction.

6.4 Weaknesses of the Banking System

Most countries do, at one time or another, experience banking-sector problems. The International Monetary Fund (IMF) reported that 130 of its member countries, approximately three-quarters of all IMF members, experienced significant banking sector problems between 1980 and 1996 (Yarbrough & Yarbrough, 2003: 435)[104].

Banking crisis can impose large cost to an economy. When banks failed and become unable to pay back deposits, governments often step in, costing the governments. For instance, Argentina's crisis (1980-1982) ended up costing the Argentina government almost 60 percent of annual GDP[105]. In the case of Myanmar's liquidity crisis in 2003, the Central Bank of Myanmar (CBM) injected the required funds by pledging government treasury bonds and accepting mortgages.

The major factor that causes the liquidity crisis is the weaknesses of the commercial banks. The weaknesses cause the loss of depositors' confidence that stops the operations of some commercial banks. The following are some major factors that may limit the scope of the banking system.

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[104] Yarbrough, B. V. & R. M. Yarbrough, The World Economy: Trade and Finance, Thomson, South Western, United States 2003: 435
[105] Ibid: 435

6.4.1 Interest Rate Ceilings

According to the CLV countries' experiences, interest rate deregulation increases financial savings that contribute to national investment. An increased investment contributes to economic growth. The positive real interest rates with reducing inflation can restore the financial resources not only in local currency but also in foreign currency. This is the one way to restore the financial assets from informal to formal sector.

In Myanmar, on the other hand, interest rate ceilings are lower than market-determined rates. As the ceiling rates cannot cover the high inflation rate, Myanmar people do not want to buy financial assets, rather they want to buy real assets that cannot contribute to capital accumulation. Consequently, it leads to financial disintermediation and thus discourages the growth of the economy. Since the ceiling rates are lower than market rates, the formal banking system is not able to manage a deposit out-flow from the banking system. Furthermore, the combination of high inflation and artificially low deposit rates discourage deposits and thereby reduced the resources available for relending by the banks. Savings to GDP ratio in 2003 was only 5 percent of GDP (Table 7.1). This decline is partly due to the liquidity crisis in 2003.

It can be noted that the informal financial firms can collect financial savings when an attractive interest rate was proposed. Even though this rate was still a negative real interest rate, people had shifted their deposits from formal firms i.e., banks to these informal ones. In addition, according to portfolio returns, people had switched from real assets to these firms. This case indicates that by lifting the interest rate up to an attractive level, it can increase the flow of financial resources into the formal banking system. Hellmann, Murdock, and Stiglitz (1997) proposed that by lifting up the interest rate close to the market rate can increase financial savings. Hence, the attractive interest rates encourage financial savings, leading to improve the financial intermediation functions[106]. Furthermore, the increased financial resources increase capital accumulation that leads to growth.

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[106] Hellmann, T., Murdock, K., and Stiglitz, J., Financial Restraints and Market Enhancing View, 1997: 4

6.4.2 Fiscal Imbalances

One of the major factors that weaken the banking sector is fiscal imbalances. The government fiscal deficits are financed by issuing government bonds where most of these bonds are purchased by the commercial banks. This can weaken the bank's balance sheet and lead to a contraction in private sector lending. It means that the excessive public sector borrowing from the banking system reduces the private sector investments that lead to a contraction of economic activity.

Another way is that fiscal deficits are financed by the Central Bank borrowing. The fiscal deficits financed by the Central Bank borrowing cause high inflation. If inflation is high, people expect inflation to become higher in the future. When households expect higher inflation, they will have to spend more of their income on consumption resulting in less savings. High inflation pushes people to buy real assets rather than financial assets according to returns on investment. It weakens the banking sector that leads to financial disintermediation.

In the case of Viet Nam, the government controls inflation to obtain macro economic stability and relaxes the ceiling rate. Interest rate deregulation with reducing inflation improves financial savings. In addition, this may increase the flow of financial resources from informal sector to formal sector. Macroeconomic stability creates a favorable environment for the growth of the banking sector.

6.4.3 High Reserve Requirements

A lesson learned from the case of Viet Nam's banking sector is that the Central Bank of Viet Nam had reduced the reserve ratio down to 3 percent and at the same time reduced the lending rates to create more opportunities for private sector lending. Hence, loans to GDP ratio is the highest among the CLMV countries as explained in Chapter 4, leading to improve the financial intermediation function, contributing to growth.

In the contrary case of Myanmar, the reserve requirements are very high compared with other CLV countries. The high reserve requirements reduce the loanable funds to private sector lending. It may weaken the banking system because the probable loanable funds are in the Central Bank as idle funds. In addition, the

implicit tax imposed on financial intermediation through the reserve requirements rises with accelerating inflation.

6.4.4 Fixed Exchange Rate Regime

Myanmar is still under a fixed exchange rate regime whereas the other CLV countries have moved to a managed floating exchange rate regime. Since Myanmar has not realigned the exchange rate, the huge gap exists between official rate and parallel market rate. The combination of overvalued exchange rates and interest rate ceilings encourage deposit outflows. Furthermore, the government does not allow the private banks to accept foreign currency denominated deposits. For these reasons, the banking system cannot diversify financial products and provide financial resources in terms of foreign currency in the private banks.

These flows were illegal in Myanmar with foreign exchange controls, but such controls have rarely been effective. Although capital flight is hard to measure, the estimate of resident capital outflows, according to the broad money measure of capital flight, was 378 million dollars in 1998 as mentioned before (Schneider, 2003: 43). It seems to be financial disintermediation function that weakens the banking system.

6.4.5 Collateral-based Lending

As the commercial banks excessively depend on collateral-based lending, monitoring the borrowers is very weak. The heavy dependence particularly on real estate enhances the weakness of the banking system since banks become more vulnerable to the boom-bust cycle of asset prices. This kind of collateral-based lending may reduce incentives to adequate monitoring. Because of information imperfection in collateral-based lending, moral hazard occurs. Most of the MEB's NPLs appear as a consequence of collateral-based lending, leading to weaken the banking system.

In collateral based lending, if loans are not repaid, bankers have the right to claim for ownership of immovable assets which borrowers have mortgaged to the banks as collateral. However, the period that the banks have to claim through court takes time from 5 to 10 years because of slow and cumbersome judicial procedures and enforcement. The long period of claimant time freezes the loans that cannot become fresh loans. Those frozen loans shrink the banks' balance sheets. This

indicates that banks cannot channel the funds fully and efficiently that limit the scope of the banking sector.

6.4.6 The Weak Lending Practices and Non Performing Loans (NPLs)

If a loan officer has insufficient skills and experience to decide whether a project is good or bad, then adverse selection occurs. The screening process is an initial stage of allocating the funds from depositors to investment projects. The wrong decision to choose the risky projects leads to non performing loans (NPLs). The more NPLs, the less fresh loans banks can allocate. The MEB has been facing with a large amount of NPLs while the private commercial banks can manage the NPLs. Some private banks roll over the loans. It is not a good practice, but it is a way of hiding NPLs.

The following Table 6.7 shows amount of NPLs in the MEB. Nearly one fifth of total loans were NPLs partly because of insufficient skills and experience in lending and partly due to corruption practices. One more reason is that the loans relied heavily on the collateral particularly real estates as explained above. Lack of supervision and enforcement, and strict monitoring process seems to increase moral hazard that enlarges the amount of NPLs.

Table 6.7 The Non Performing Loans in the Myanma Economic Bank

	Sep-02	%	Sep-03	%	Sep-04	%
Performing Loans (Kyats in Million)	63236	81.5	104433	82.3	111416	83.5
Non Performing Loans (Kyats in Million)	14354	18.5	22459	17.7	22016	16.5
Total Loans	77590	100	126892	100	133432	100

Source: The MEB (Head Office, 2004), and Shin Htwe Nyan Win (2004: 61)

In the case of private commercial banks, the banks roll over the short-term loans to long-term loans. By rolling over the loans, the NPLs did not appear in the banks' balance sheet. For that reason, the private banks can manage the NPLs. However, they may face with maturity mismatch problem that leads to liquidity crisis that weakens each individual bank.

6.4.7 Lending to Related Firms

The poor lending practices are the most common form of technical mismanagement. Poor internal control, and inadequate credit analysis often lead to excessive risk concentration as a result of making a high proportion of loans to a single borrower or to trading other than industry.

An important aspect of borrower behavior has been the tendency of certain groups of firms to become highly leveraged. The availability of credit at low or negative real interest rates encourages borrowers, a strong incentive to take loans, but negative interest rates discourage the expansion of domestic deposits. Since credit is granted selectively, the privileged firms belonging to industrial-financial conglomerates have advantages of cheap credit by lending generously to themselves. This problem is particularly severe if commercial banks are part of wider industrial-financial groups. Sometimes, the banks excessively lend to the related companies and businesses. This greater concentration tends to reduce economic efficiency of resource allocation.

6.4.8 Risk Management

As risk management plays an important role in a bank's efficiency, capital requirements of a bank can be calculated based upon risk-weighted assets. It means that the more the bank holds risky assets, the more the requirement of capital. Capital requirements create pressure on the targeted financial institutions. Increasing capital requirements can result in increasing rather than reducing risk. Capital requirements can motivate banks to take greater risk by holding more risky assets rather than less risky assets. Dr Rubi Ahmad (2006) states that there is no guarantee that capital requirements will lead to greater stability and wealth for banks (Dr Rubi Ahmad, 2006: 13-17)[107]. However, lack of sufficient capital has often been cited as a major cause of a bank failure.

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[107] Ahmad, Dr. R., Capital Requirements and Financial Regulations in Banking: Are They Effective?, Bankers' Journal Malaysia, The Journal of the Institute of Bankers, Malaysia, Issued no. 130, 2006: 13-17

The Basel Accord I on capital requirements was developed to make capital requirements responsive to the amount of credit risk borne by the bank. In 1998, the Basel Accord specified a minimum ratio of total capital to weighted risk assets of 8 percent. While Basel I Accord covers credit risk and market risk, the Basel II Accord has included operational risk. Internationally active banks are required to implement risk-based capital requirements by 2007. Risk management skills are a pre-requisite for modern banking. Myanmar banks need to train their staff in risk management techniques and skills.

In Myanmar, the minimum capital adequacy or capital requirement for private banks as prescribed by CBM is 10 percent of risk-weighted assets. All private and semi-private banks in Myanmar have to submit to the CBM their capital adequacy ratio. One public banker announced that the capital adequacy ratio of his public bank was 79.97 percent. It shows that the bank hold less risky assets rather than more risky assets. The high capital adequacy ratio may increase cost of capital and reduce bank's profits.

6.4.9 Banking Technology and Skills Training

In Myanmar, most banks have been using both manual and computerized system. Although banks are using computer technology, computer skills of all the staffs need to be upgraded with advanced technology. Most developing countries have initiated on-line banking system to communicate with international financial market. Since Myanmar's telecommunication infrastructure is not fully developed yet, and so is on-line banking system. One reason is that expenditure for on-line banking system is too high. This high cost of on-line installation, i.e., nearly one billion Kyats for one bank, becomes a constraint to use on-line banking system. However, some banks try to retain reserve funds for installation of computerization and on-line banking system. By using on-line banking system, the banks can extend their scope not only to local area but also to international financial market. When banking system introduces the application for on-line banking system, computer skills development is needed to upgrade human resource in the banking system as a whole.

The Society for Worldwide Inter-bank Financial Telecommunication (SWIFT) system has recently been introduced in the MFTB, the MICB, and the MEB. The objectives of SWIFT system are as follows:

- To build messaging infrastructure in order to facilitate communications among financial institutions of the world; and
- To use technology to explore the possibilities that can be profitably utilized by member countries.

SWIFT is primarily concerned with messaging, processing services, clearing, payment and security settlement system. In order to achieve financial stability and to build financial infrastructure, it is the responsibility of the Central Banks of member countries to effectively manage and supervise SWIFT (Maung Htwe, 2004: 116)[108].

6.5 Supervisory and Regulatory Framework

The above major factors that weaken the banking sector resulted from poor prudential regulation and supervision together with inadequate legal system. One banker states that lax enforcement of legal requirements is partly responsible for the malpractices of some private banks which led to the liquidity crisis of some banks (Dr. Sein Maung, 2003: 7)[109].

One question is that "What is an efficient regulatory framework?" Another is that "Who has the authority to supervise all financial institutions?" The Central Bank of Myanmar is to exercise supervisory and regulatory authority over a wide range of financial institutions, both state and private owned. According to the Central Bank of Myanmar Law section 8 (f), (57), the Central Bank of Myanmar (CBM) is empowered to inspect, supervise, and regulate the financial system.

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[108] Maung Htwe, Banking and Financial Development in Myanmar, Unpublished Research Paper, EMPA, Yangon Institute of Economics, Yangon, 2004: 116

[109] Sein Maung, Dr., Some Thoughts on Liquidity and Confidence Crisis of Some Private Banks, Unpublished Paper, Yangon, 2003: 7

The Central Bank of Myanmar Law lays down the aims and objectives of the bank as follows:

- The aim of the Central Bank shall be to preserve the internal and external value of the Myanmar currency (section 5).

- The Central Bank shall, in accordance with its aim also endeavor to attain the following objectives (section 6) :
    a) To promote efficient payment mechanisms, and the liquidity, solvency, and proper functioning of a soundly based financial system;
    b) To foster monetary, credit and financial conditions conducive to the orderly, balanced and sustained economic development.

During the crisis period, the Central Bank did not allow opening new accounts, accounting transfers, stopped clearing windows and failed to comply with the provisions of Central Bank of Myanmar Law. In particular, the Central Bank is also empowered to set reserve requirements, maximum discount rates, maximum and minimum interest rates on loans and deposits, assets and liability ratios and minimum cash margins. As the monetary authority, the Central Bank of Myanmar (CBM) implements monetary policy. There are three main tools of monetary policy that almost all countries use: reserve requirement, discount rate, and open market operations (OMO). The imposition of high reserve requirements and interest rate ceilings are monetary policy tools that the CBM use.

Under prudential supervision, the CBM establishes regulation to reduce risk-taking. In addition, the CBM, as a supervisor monitors banks to see that they are complying with these regulations and not taking on excessive risk. For these reasons, prudential supervision is thus needed to ensure the safety and soundness of the banking system. Inadequate supervision has led to severe problems in the banking sector.

Under section 46 and 48, the Financial Institutions of Myanmar Law consists of disclosure requirements and inspection by the CBM. According to this law, the banks have to submit their weekly and monthly financial position to the CBM. Bank Supervision Department, one of the CBM's departments, is responsible to examine

and supervise the banks. Its main function is to ensue that banks comply with the provision of CBM, Financial Institution of Myanmar Laws, rules and regulations, and directions issued by CBM.

Two main approaches of the Bank Supervision Department are on-site examination and off-site examination while the CBM also monitors the banks through daily contact. The CAMEL[110] rating method is used during on-site examination conducted on bi-annually basis. The following reports must be submitted to the CBM: required reserve (weekly); liquidity ratio (weekly); balance sheet (monthly); income and expenditure statement (monthly); capital adequacy ratio (monthly); non-performing loans statement (quarterly); and annual report (annually).

The elements of the prudential and supervisory regulations (IMF, 1999: 21 and CBM, 2005) and oversight are:

i. A reserve requirement of 5 percent and 10 percent on time and demand deposits, respectively, including foreign currency-denominated deposits. At least 75 percent of reserves must be held as a non-remunerated deposit at the central bank and the rest in cash. Holding of treasury bonds can be counted against the reserve requirement. Required reserves for a bank to be maintained with the Central Bank must not exceed 35 percent of the total liabilities of the bank; however, in the event of serious inflationary development the Central Bank may increase the 35 percent ceiling requirement.

ii. Banks are required to maintain the level of their liquid assets against their eligible liabilities at not less than 20 percent.

iii. A 10 percent risk-weighted capital adequacy ratio.

iv. A lending limit to a single borrower of 20 percent of bank's capital and reserves.

v. A penalty of 0.2 percent per day is levied on the shortfall in the prescribed reserves (section 60).

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[110] C = Capital, A = Asset Quality, M = Management, E = Earning Level, and L = liquidity

There exists a strong regulatory and supervisory framework before the crisis, but however, the problem lies in loose supervision and lax enforcement. Inadequate supervision of the Central Bank as well as other factors such as money laundering are the causes of the banking crisis that occurred in 2003.

During the crisis period, the banks were closely supervised by the Bank Supervision Committee (BSC). Banks had to submit the daily, weekly, and monthly reports to the CBM. All banks' directors had to attend daily briefing at the CBM to present the daily operation. In this period, banks had conducted three functions: withdrawal function; loan collection function; and remittance function. Some new rules and regulations promulgated by BSC are as follows:

- Banks have to maintain free capital that is equivalent to 50 percent of fully paid up capital.
- Banks have to provide the appropriate provision for reserve for both bad debts and contingencies.
- Bank's deposits must not be more than 7 times, later modified to 10 times paid-up capital.
- Prohibits inter-bank borrowing among banks
- Loans to deposits ratio must be between 70 percent and 80 percent.

The implication for this chapter is that Myanmar banking system is underdeveloped because of negative interest rates in real terms. Because of negative interest rate in real terms and short term maturity, most loans go to traders as commercial capital which has quick turnover. On the other hand, as small and medium enterprises are relying less on bank loans because these enterprises rarely meet the strict collateral-based lending practices in Myanmar. As a result, the limited SMEs' loans hinder the SMEs' development. Therefore, informal sources of financing are the major external sources of financing for SMEs and as they are also small and family-owned businesses, it can be noted that they are also rather weak in keeping accounting records systematically. This in turn, will give them lesser chance to obtain bank loans, even if the banks offer those loans on cash-flow base.

Since information gap exists between depositors and banks and between banks and business firms, banks and firms should disclose their performance to build up confidence among households, banks, and firms. The major banking sector issues that hinder financial sector development in Myanmar are interest rate ceilings, fiscal imbalances, high reserve requirements, fixed exchange rate, collateral-based lending, tight lending practices, lending to related firms, and lax enforcement. Because of these weaknesses, Myanmar banking sector alone cannot meet the financial requirements of SMEs.

CHAPTER VII
DESIGNING A FINANCIAL MARKET STRUCTURE IN MYANMAR

Developing countries like Myanmar should develop the commercial banking system as fast as the other sectors of the economy. A faster development of the banking sector encourages the development of the remaining sectors which leads to growth of Myanmar's economy. An efficient and sound banking system, by collecting idle funds, is able to mobilize domestic savings and channel them into those who can utilize them effectively to increase the output of goods and services that contributes to growth.

The performance and effectiveness of financial institutions are important considerations for policy-makers concerned about economic development. Growth, after all, is heavily dependent on investments, and a significant fraction of all investments flows through financial institutions (Hellmann and Murdock, 1998)[111]

U Tun Wai (1972) mentioned that there are three major ways in which efficient financial intermediation help the development process: by the collection of additional savings, by the allocative function, and by redistributing the benefits of larger returns on capital investment (U Tun Wai, 1972: 31)[112]. Therefore, the well-functioning financial intermediation system and the development of financial markets are more necessary for those who have idle funds to earn supplementary income on interest-bearing financial claims, for instance, saving certificates, post office saving deposits, government bonds, or insurance policies.

The first part of this chapter introduces the existing savings-investments process in Myanmar. Low savings and low investments weaken economic growth. In addition, a small portion of investment flows through the banking sector limits the size of banks. The second part continues to present why the size of the banking sector is small in Myanmar. The third part expresses the important role of the informal

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[111] Hellmann, T., and Murdock, K., Financial Sector Development Policy: The Importance of Reputational Capital and Governance, Development Strategy and Management of the Market Economy. Oxford University Press, 1998

[112] U Tun Wai, Financial Intermediaries and National Savings in Developing Countries, Praeger Publisher, Inc. New York, USA, 1972: 31

sector and money-lending process that reduces the size of the formal sector. The fourth part describes mobilization of financial resources, and the current structure of financial market in Myanmar, and the final part designs a proposed financial market structure in Myanmar.

7.1 Savings and Investments in Myanmar

As savings provide the bulk of resources for investment, saving behavior is a crucial element in the process of economic growth. The higher the rate of savings, the higher the rate of investments, leads to economic growth. The following Tables 7.1 and 7.2 describe how saving-investment process creates the growth in Myanmar.

Table 7.1 Gross Domestic Savings (Percent of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Mean
Cambodia	7.8	6.9	5.5	4.4	4.3	9.9	10.3	5.5	3.9	4.3	9.8	13.3	14.5	n.a.	7.7
Lao PDR	n.a.	n.a.	n.a.	n.a.	11.9	10.6	9.8	16.4	12.8	14.0	14.0	16.0	16.8	16.3	13.9
Myanmar	14.0	12.8	11.6	11.9	13.5	12.8	11.1	9.4	9.9	13.2	12.7	9.6	5.0	n.a.	11.3
Vietnam	10.0	13.6	15.5	16.0	18.0	17.1	20.2	21.7	24.8	27.1	28.8	29.6	36.5	n.a.	21.5

Source: World Development Indicators (WDI, 2003 & 2006); World Economic Outlook (2006); Asian Development Bank (ADB, 2006)

(Note: Same data source is used for comparative study)

As shown in Table 7.1, average Gross Domestic Savings rate in Myanmar was 11.3 percent throughout the years which is lower than that of Viet Nam and Laos. The GDS rate in Viet Nam increased from 10 percent in 1991 to 36.5 percent in 2003. An increase in GDS rate contributes to investment. Therefore, Gross Domestic Investment ratio increased 15.1 percent in 1991 to 35.6 percent in 2004 (Table 7.2). In Viet Nam, savings contribute capital accumulation that leads to economic growth. Viet Nam follows McKinnon-Shaw views, that is, financial liberalization increases savings, improves the efficiency with which resources are allocated among alternative investment projects, and therefore raises economic growth.

In CLM countries, however, GDS ratio (Table 7.1) and GDI ratio (Table 7.2) were volatile throughout the years. In Myanmar, it is clear that low savings

discourage capital accumulation that hinders economic growth. However, Myanmar case is different with the other CLV countries because the channel of savings to investments is not only through formal financial intermediation but also through informal financial intermediation and self-financing. Since the financing behavior in Myanmar depends not only on bank-financing but also on other informal sources such that the banking system is still limited.

Table 7.2 Gross Domestic Investments (Percent of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Mean
Cambodia	9.4	9.8	14.3	18.5	21.8	25.9	19.0	15.0	15.8	16.9	18.7	20.2	25.2	25.8	18.3
Lao PDR	n.a.	n.a.	n.a.	n.a.	26.0	29.0	27.2	24.4	22.7	21.8	22.1	n.a.	n.a.	n.a.	24.7
Myanmar	15.3	13.5	12.4	12.4	14.3	13.4	11.7	12.4	13.4	12.4	15.0	n.a.	n.a.	n.a.	13.3
Viet Nam	15.1	17.6	24.3	25.5	27.1	28.1	28.3	29.0	27.6	29.6	30.9	33.2	35.4	35.6	27.7

Source: World Development Indicators (WDI, 2003); World Economic Outlook (2006); Asian Development Bank (ADB, 2006)

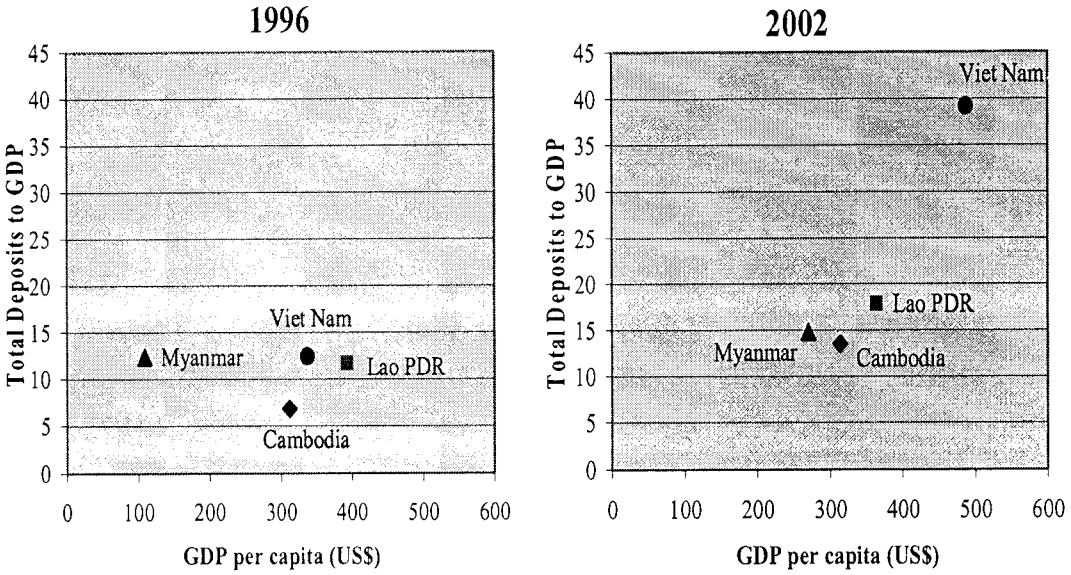
(Note: Same data source is used for comparative study)

7.2 Size of Banking Sector

The following Figure 7.1 shows the relationship between size of banking sector and GDP per capita in terms of U.S dollars. This figure explains that the higher the per capita income, the larger the size of banking sector, for instance, Viet Nam.

In 1996, the sizes of banking sector in all CLMV countries were very small. In 2002, however, Viet Nam had moved to the upper right i.e., the higher per capita income increased the size of banking sector. In contrast, Myanmar was in the lower left which means that the lowest per capita income resulted in lower GDS. From a comparative study, it can be noted that the size of Myanmar's banking sector is surprisingly smaller than Viet Nam and Laos. Moreover, per capita income in Myanmar is the lowest among the CLMV countries. It can be concluded that the size of the banking sector in Myanmar is small because of its low income, low saving rate and low deposits.

Figure 7.1 Size of Banking Sector and GDP per Capita (US$)



Source: International Financial Statistics (IMF, 2000 & 2004); World Bank (2001)
(Note: Same data source is used for comparative study)

7.2.1 Why the Banking Sector is So Small in Myanmar?

Three main factors that cause the banking sector to be of a small size (Chart 7.1) are negative real interest rates, high inflation, and exchange rate overvaluation. Because of these factors, although it is difficult to measure the magnitude of the informal financial sector, it is functioning well and contributes to the financing of SMEs. Anecdotal evidence suggests that a large number of money lenders can survive with informal banking profession from generation to generation. However, informal banking practice will not be able to finance large capital-intensive projects based on high technology. Nevertheless, it cannot be denied that the informal sector contributes to investment in Myanmar to some extent.

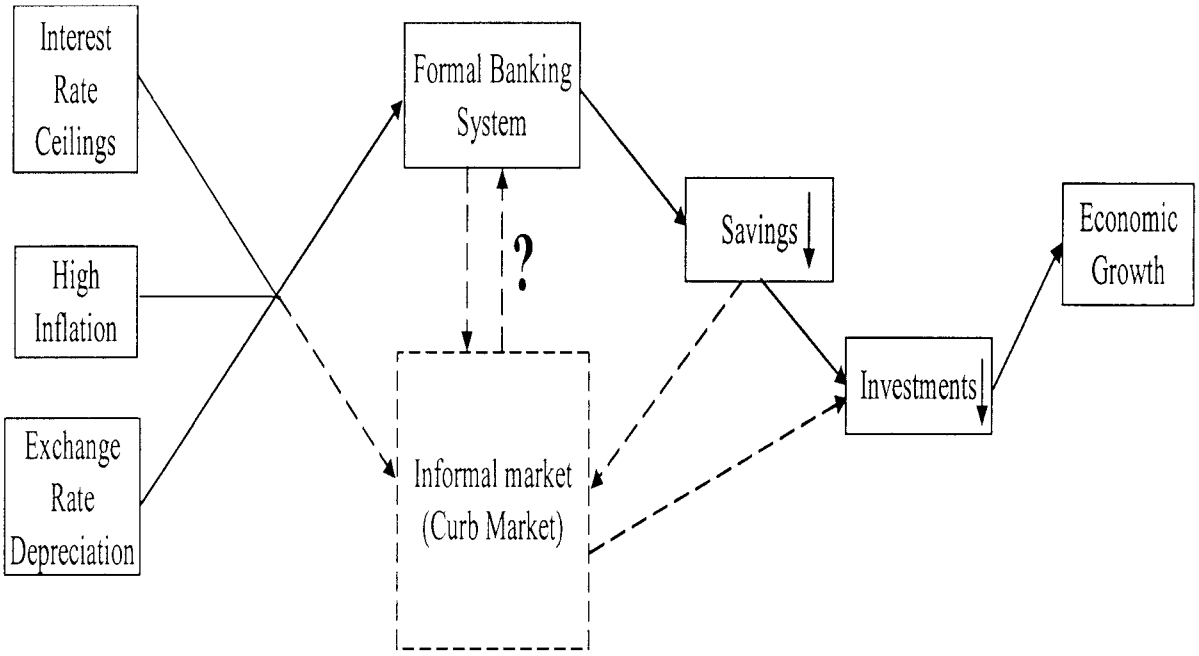
Even though income is low in Myanmar, people want to save some portion of their income according to religious precepts such as from Buddha's teaching. Since unattractive interest rates discourage savings, informal sector becomes quite sizeable.

7.3 The Role of Informal Sector and Money Lending Process

Informal sector plays an important role in Myanmar. Low savings contribute to low capital formation. The limited saving opportunities and negative real interest

rates discourage savings in the formal financial sector. In Myanmar, domestic savings flows to domestic investments through three channels: formal banking sector, informal sector, and self-finance. As mentioned earlier, a small portion of investment comes from bank-finance. A large portion of investment is predominantly self-financed by plowing back profits and finance through informal market. As shown in Chart 7.1, informal market, mostly called curb market may be comparable to the formal banking sector in size. It is difficult to measure the magnitude and importance of the informal financial market in Myanmar. Chart 7.1 explains why informal financial market is no less important than the formal banking system.

Chart 7.1 Relationship between the Banking System and Informal Market



Myanmar has yet to graduate from financial repression that leads to weaken the banking sector. High inflation, artificially low interest rates, and exchange rate overvaluation limit the scope of banking sector. These factors serve as disincentives to save and incentives to borrow. Thus, that leads to reduce savings and investments. Negative interest rates in real terms with high inflation push the savers and depositors to informal market.

Informal market supports small and medium enterprises (SMEs) development with high interest rates, low transaction costs and information costs. So it cannot be denied that a major portion of external financial resources for SMEs' development

come from informal market rather than formal banking sector. The question is that "Why is informal financial market more efficient than formal banking system?" The larger the informal financial market the more limited the size of the banking sector in the economy. The question is that "How do the commercial banks attract financial resources from informal to formal to achieve growth through saving-investment process?"

7.3.1 Informal Money Lending

This part is based on a case study covering two cities i.e., Mandalay and Meiktila situated in Upper Myanmar. It is based on the survey of 120 private business owners from these cities. A structured questionnaire was developed for the conduct of the survey.

The field study of 120 samples chosen from the above mentioned cities was made during October, 2006. Interviews with questionnaires were made in each city. Sixty small and medium scale enterprises in each city were chosen for the field study. This section presents only a descriptive study and the nature of informal lending practices, the importance of informal money lending process, and the general picture of money lending behavior of SMEs in these cities since it is difficult to make sound statistical analysis, based upon convenience samples.

Out of 120 samples, 37 percent are traders, 35 percent are manufacturers, and 28 percent are agriculturists. Most businessmen take the loans from the money lenders, merchants, and relatives with or without collateral. Eighty seven percent of business firms took the loans and this showed that small and medium enterprises used external sources of financing. Out of 87 percent, 25.9 percent relied on bank financing whereas 74.1 percent relied on informal sources of financing.

As illustrated in Table 7.3, a little more than a third of manufacturing firms used bank loans while the others obtained loans from the informal sector. The fact is that the Central Bank forced to reduce the interest rates on industrial loans to encourage the industrial sector; results in bank loans in manufacturing firms, comparatively high.

Table 7.3 Sources of Financing by Types of Business (%)

	Types of Business			Grand Total
	Trading	Manufacturing	Agriculture	
Banks	13.2	36.4	29.7	25.9
Money Lenders	28.9	9.1	32.4	24.1
Relatives	23.7	21.2	18.9	21.3
Merchants	31.6	33.3	18.9	27.8
Ethnic Groups	2.6	0.0	0.0	0.9
Grand Total	**35.2**	**30.6**	**34.3**	**100**

Source: Survey data

The purposes of borrowing showed that nearly 70 percent of firms used external financing for working capital. Nearly 25 percent were to expand their businesses. The remaining 5 percent was to make donations and to use for medical care.

Table 7.4 Sources of Financing by Collateral (%)

	With Collateral	Without Collateral
Banks	48.8	10.9 (MADB)
Money Lenders	16.3	29.7
Relatives	14.0	26.6
Merchants	20.9	32.8
Ethnic Groups	n.a	n.a
Total	100.0	100.0

Source: Survey data

Although almost all bank loans need collateral, agricultural loans do not need to submit collateral because of the directed loans. Borrowing from informal sources need collateral, but however, loans without collateral are still high. Interest rates on loans without collateral are high, ranging from 3 percent to 20 percent per month. Interest rates can vary according to the type of collateral i.e., 3 percent to 4 percent per month for mortgage loans and 3 percent to 7 percent per month for gold and jewellery. Even though borrowers have to pay high interest rates, two thirds of borrowers still think that these interest rates are not so high. That is why their

willingness to pay (WTP) is still high, that is, the average interest rate of 5 percent per month is the willingness to pay (WTP) of the borrowers for those loans.

Most borrowers do want to borrow from commercial banks if they have a chance because of low ceiling rates. Nevertheless, more than half of the firms want to expand their businesses on their own funds. This proves that the financing behavior of Myanmar business firms relies heavily on self-financing as mentioned earlier.

7.4 Mobilization of Financial Resources

Although financial savings are mainly collected by the banking sector, Myanmar's banking system is still limited. There is the question of the mechanism and the role played by financial institutions in the savings-investment process. As mentioned earlier, U Tun Wai (1972) pointed out three major ways in which efficient financial intermediation helps the development process: by the collection of additional savings, by the allocative function, and by redistributing the benefits of larger returns on capital investments (U Tun Wai, 1972: 31).

Interest-bearing financial claims are limited in Myanmar because a capital market has not yet developed in Myanmar. Many economists suggest two alternatives of financing: indirect financing through the commercial banks; and direct financing from financial markets.

7.4.1 Savings through the Commercial Banks

Since Myanmar's financial system is a bank-based financial system, existing saving structure through the commercial banks shows the important role of domestic savings through the commercial banks (Table 7.5).

Although financial intermediation has an important role to play in the saving process, banking system in Myanmar can provide only three kinds of financial assets: saving deposits, time deposits, and saving certificates. Saving deposits are the most popular form of financial assets in Myanmar that is, more than 80 percent of total deposits is saving deposits. The reason is that saving deposits is more liquid than other types of financial assets.

Table 7.5 Domestic Savings through Banking System (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Saving Deposits										
State Owned Banks	66.0	52.6	49.3	41.6	34.8	31.9	30.6	36.6	55.0	54.9
Private Banks	20.4	34.7	38.5	45.4	54.6	59.0	59.7	52.8	39.3	41.4
Total	86.4	87.3	87.9	87.1	89.5	90.9	90.3	89.4	94.3	96.3
Saving Certificates										
State Owned Banks	10.1	8.3	8.2	6.2	4.9	3.6	2.9	3.2	3.3	2.5
Total	10.1	8.3	8.2	6.2	4.9	3.6	2.9	3.2	3.3	2.5
Time Deposits										
State Owned Banks	1.9	1.4	1.0	1.2	1.0	0.5	0.3	0.3	0.5	0.5
Private Banks	1.6	3.0	3.0	5.5	4.7	5.0	6.5	7.1	1.8	0.7
Total	3.5	4.3	4.0	6.7	5.6	5.5	6.8	7.4	2.3	1.2
Grand Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Statistical Year Book (CSO, 2003); Selected Monthly Indicators (CSO, various issues)

Demand for saving certificates had declined sharply from 10 percent in 1995 to 2.5 percent in 2004 and it was very low because of increasing negative interest rates in real terms. Saving certificates are issued by the state-owned banks under the new Savings Bank Law 1992. They are issued in varied denominations of Kyat 5, Kyat 10, Kyat 50, Kyat 100, Kyat 1000, Kyat 10,000, Kyat 100,000. The maturity date is one year to twelve years. The saving certificates can be redeemed after one year with accrued interest rate.

Rural Savings

Since Myanmar is an agricultural country, 75 percent of populace lives in the rural areas. Savings mobilization in rural areas cannot be neglected. Table 7.6 explains how important rural savings and loans are in Myanmar.

Although rural savings increased throughout the years in nominal terms, rural savings to total deposits was only round about 1 percent during 1990-2004. The reason is that an increase in rural savings was much lower than an increase in total

savings. Negative interest rates are not attractive to rural populace to buy claims on financial assets. Furthermore, they have lack of banking habits in rural areas where banks cannot reach there because of high operating costs. For these reasons, rural people prefer to buy real assets rather than financial assets.

Table 7.6 Savings and Loans in Rural Areas

Financial Year	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	Mean
Rural Savings to Total Deposits (%)	0.96	0.85	0.72	0.62	0.55	0.59	1.02	0.76	0.72	0.55	0.45	0.46	1.01	0.87	0.72
Loans to Savings Ratio (%)	913.7	974.8	1152.2	1184.2	935.6	1714.3	884.8	691.4	505.3	448.6	413.6	339.0	264.9	343.6	769.0
Borrowing from CBM, MEB to Total Loans (%)	76.1	65.4	60.8	62.8	59.5	55.8	43.3	51.1	57.3	59.9	59.5	55.7	43.9	59.3	57.9

Source: International Financial Statistics (IMF, 2004&2005); MADB (2004)

However, high loans to deposits ratio shows that demand for loans is larger than supply of loans because of subsidized interest rates in the agriculture sector. Therefore, required loanable funds by MADB, i.e., half of total loanable funds can be borrowed from the CBM and MEB. It shows that the CBM and MEB provide policy loans or directed loans to priority sectors, one of the indicators for financial repression.

The Major Factors that Hinder Financial Savings Development

Capital deposit ratio, unattractive interest rate ceilings with high inflation, overvaluation local currency, lack of banking habits, limiting the opening of new branches, and limiting private banks to offer foreign currency deposits are the factors that hinder not only savings mobilization but also the whole financial system.

(1) Capital Deposit Ratio

After the liquidity crisis in 2003, capital deposit ratio or equity to deposit ratio regulation is promulgated by the Bank Supervision Committee (BSC). The equity to deposit ratio is to restrict the amount of deposits to be within 10 times of paid-up capital. As a consequence, this causes a contraction of the banks' deposits. To prevent bank runs, deposit insurance system is more effective than the equity to deposit ratio.

A deposit insurance system provides assurance to savers and could prevent banks from certain external shocks which can be a source of financial sector stability.

(2) Unattractive Interest Rates

Even though the per capita income is low in Myanmar, people have saving capacity that can be proved with the General Service Co. or A Kyoe Saung firms as mentioned in the previous chapter. These firms provided interest ranging from 3 percent to 10 percent per month. The interest rates that those firms provided were too high, comparing with bank rates, resulting in savers shifting their savings from the commercial banks to these A Kyoe Saung firms. This case shows that the more attractive the interest rates, the higher are the saving rates.

On the other hand, if interest rates are raised to a level above inflation, the lending rates must also be raised to cover the cost of funds or deposits. This may in turn become disincentives to borrowers because the increased interests push up the cost of capital. Therefore, the other option to achieve positive real interest rates is to reduce inflation below interest rates. That is why, many economists suggest that inflation targeting is most suitable to control inflation systematically.

(3) Exchange Rate Depreciation

Double digit inflation in Myanmar causes currency depreciation but the Central Bank has not realigned the exchange rate. There exists a huge gap between the official rate and the market determined rate. If the Central Bank moves the exchange rate regime from a fixed to a managed floating regime by adjusting the exchange rate, and if the commercial banks are allowed to offer foreign currency deposits, banks will be able to provide scarce foreign currency denominated resources.

(4) Lack of Banking Habits

It can be estimated that the private commercial banks can provide their services to more than 60 people per thousand populations[113]. However, among these, most are those who live in urban areas because most bank branches cannot reach rural

[113] This figure is estimated from number of customer accounts of the private banks

areas and rural people has less access to banking services. Then although the MADB reaches many rural areas, rural people are still reluctant to utilize bank services.

According to Myanmar rural culture, if people have idle funds, they prefer to buy real assets especially gold and jewellery that people wear as decoration which may also be used as collateral. However, most rural people want to save idle funds especially for donations. It shows that they have the capacity to save. . Another reason may also be that negative real interest rates are not attractive to saving in commercial banks. The question is whether rural people have lack of banking habits or the commercial banks cannot provide efficiently the innovative services they want.

(5) Limiting the Opening of New Branches

U Tun Wai pointed out that the number of bank branches measure not only the diversification of financial assets but also is an indication of financial and economic development (U Tun Wai, 1972: 35). In Myanmar, branches of private banks increased from 96 branches in 1999 to 224 branches in 2004 without a change in the number of private banks (Table 7.7).

Table 7.7 Branches of Private Banks

	1999	2000	2001	2002	2003	2004
Head office	20	20	20	20	20	20
Branches	96	162	205	222	223	224
Total	116	182	225	242	243	244

Source: Annual Report (Myanmar Banks Association, 2004 & 2006)

The bank branches continued to decline to 145 in 2005 because some banks had to be closed and some were forced to merge after the occurrence of a liquidity crisis in 2003. The fact is that the government restricts the licensing of new banks and also limiting the opening of new branches. It means that there exists an uneven level playing field in the banking system.

As there exist over 300 branches under the state-owned banks in the banking system, altogether more than 460 branches provide bank services to the whole population i.e., over 50 million. According to this data, it can be estimated that over

90,000 persons can have access to each branch to utilize the bank facilities especially in urban areas.

Because of lack of fair competition and an uneven level playing field among banking institutions, the banking industry tends to be either oligopolistic or strictly segmented. The lack of competition means that there is little pressure on domestic financial institutions to become efficient and viable.

(6) Limiting the Scope of Financial Products

Apart from normal banking services i.e., taking deposits and making loans and advances, banks provide credit card, debit card (ATM), hire purchase, bill payment services, gift cheque, and remittances. These financial services and products are extended by the banks in line with the development of private banks. When private banks are allowed to participate in the banking system, the competition in financial services and products become one of the strategies to have success in the banking businesses as interest rates are ceiling rates.

Since private banks gave more efficient services than the MEB, one of the largest state- owned banks, many customers from the MEB shifted to the private banks (Table 7.8). Nevertheless, some of the financial services and products are no longer available in the banks because of the liquidity crisis of some banks that occurred in 2003. Thus, some customers from the private banks have moved back to the state-owned banks again from loosing confidence in the private banks. Moreover, the Central Bank has restricted financial products that limit the scope of the commercial banks. After the crisis, only some products remain, i.e., taking deposits and making loans and advances, and remittances.

Table 7.8 Savings Share of State-Owned Banks and Private Banks (%)

	1989-99	2000-01	2002-03	2004-05
Savings Share of State-Owned Banks	49.1	36.0	40.1	54.1
Savings Share of Private Banks	50.9	64.0	59.9	45.9
Total	100.0	100.0	100.0	100.0

Source: Selected Monthly Indicators (CSO, various issues)

A Proposal for Savings Mobilization

The incentive to develop savings mobilization is interest rates that should be positive. Since inflation is double digits, an increase in interest rates up to positive level raises the cost of capital. To reduce cost of capital, inflation should be controlled. Inflation targeting is the effective way to reduce inflation.

According to Dornbusch and Reynoso (1989: 23), they pointed out that financial liberalization without correcting fiscal imbalances will accelerate inflation. Interest rate deregulation with reducing inflation can increase financial savings that deepens the financial sector. By introducing interest rate deregulation, financial resources can be diverted or transferred from informal to formal sector that reduces the size of informal sector while at the same time expand formal sector, leading to growth.

A fixed exchange rate regime does not reflect market determined rate. High inflation resulted in the depreciation of local currency. An absence of realignment causes a huge gap between official and parallel exchange rates; as a result dollarization occurs in Myanmar. Since the CBM does not allow private banks to accept foreign currency deposits, some illegal foreign currency (US dollar) transactions take place outside the banking system. Moving to a managed flexible exchange rate regime and allowing foreign currency deposits in the private banks can restore more financial resources especially from foreign currency earners.

Even though Myanmar people have saving capacities, banking facilities are still limited and that hinder saving mobilization development. Thus, Hellman et al., pointed out that creating a network of depository institutions to collect savings and making further investments to integrate depositors into the formal financial sector is an important part of financial deepening for a developing country (Hellman, Murdock, and Stiglitz, 1995: 7)[114]. According to Hellman et al., encouraging new depository institutions that are suitable for rural populace to collect savings become an important part of financial deepening for Myanmar.

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[114] Hellmann, T., Murdock K., and Stiglitz J., Deposit Mobilization through Financial Restraint, London: Routledge, 1995: 7

In particular, it may not be profitable for a bank to develop rural branches because rural markets incur higher cost relative to urban markets. However, when competitive entry is allowed, new branch development will be able to collect additional savings. In addition to incentives to seek out new location for branches, banks will make investments to bring new depositors to their existing networks to attract incremental savings. To persuade all potential depositors who have not joined the formal financial system, banks should invest in educational advertising campaign to open new deposit accounts thereby expanding the scope of the financial products.

Caprio (1996) stated how important human capital is for efficient banking system, that is, the skill-based banking system and also that its internal incentive system are at least as important as its portfolio in the determination of the banks' long run performance. Without skilled and appropriately motivated staff, even the best portfolio can quickly turn sour (Caprio, 1996: 59)[115]. To restore the health of the financial sector, human capital, management, and incentives in the commercial banks are crucial.

7.4.2 Savings in Financial Markets

The current structure of the financial market in Myanmar consists of bank loans, equity shares, and Treasury Bonds issued by the Central Bank. Even though Myanmar banking sector is small, bank loans are important in the economy, that is, because the amount and composition of bank loans is larger than the other types of securities. A capital market has not yet developed in Myanmar and for the development of a capital market, the Myanmar Securities Exchange Centre Co., Ltd. (MSEC) was established in 1996 with 50-50% joint venture between the Myanma Economic Bank (MEB) and the Daiwa Institute of Research Ltd., Japan (DIR).

The MSEC's objectives are to introduce the development of a securities market in Myanmar to support marketisation, privatization, and internationalization of Myanmar economy. The MSEC offers the following functions: assisting companies to become public companies; brokering, dealing, and underwriting securities; publishing investment information; providing investment consultancy services; managing venture capital funds and acting as an agent for joint ventures; and selling Myanmar

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[115]Caprio, Jr. G., Banking on Financial Reform, Cambridge University Press, 1996: 59

Treasury Bonds as an agent of the CBM, and shares of listed companies in Myanmar as an agent of those companies (Yin Yin Mya, 2000: 62)[116].

Government Treasury Bond Market

The Central Bank of Myanmar (CBM) has issued two types of government treasury bonds: three-year and five-year treasury bonds with effect from 1993. They are issued in varied denominations of Kyat 10,000, Kyat 100,000, and Kyat 1,000,000. Table 7.9 presents the composition of treasury bonds in Myanmar.

Table 7.9 Treasury Bonds in Myanmar (%)

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
3-year bond to total	84.1	86.6	94.4	79.4	57.6	41.6	12.7	26.1	51.4	21.7	85.2
5-year bond to total	15.9	13.4	5.6	20.6	42.4	58.4	87.3	73.9	48.6	78.3	14.8
Total	100	100	100	100	100	100	100	100	100	100	100

Source: Statistical Year Book (CSO, 2003 & 2004)

The trend of both three-year bonds and five-year bonds fluctuated throughout the years (Table 7.9). Because of unattractive interest rates, these treasury bonds are not marketable. Table 7.10 answers who are the bond investors. Most of the private investors are bankers. This shows that the banks hold large amount of government bonds because individuals and other investors are reluctant to buy them because of low yield.

Tables 7.9 and 7.10 express that the bond market is not so active in Myanmar. However, the average figure of yearly turnover of Government Treasury Bonds increased from Kyat 15.8 millions during 1997-2000 to Kyat 28.4 millions during 2001-2004 at the Myanmar Securities Exchange Centre (MSEC). Why do bankers hold Treasury Bonds more? Because financial markets such as money market, equity market, and security market are not well developed, bankers have no choice to hold

[116] Yin Yin Mya, Establishment of a Capital Market in Myanmar: Perspectives and Problems, Institute of Southeast Asian Studies, Singapore, 2000: 62

other securities rather than Treasury Bonds. If there exist money market instruments, for instance, Treasury Bills, bankers will want to hold that kind of liquid assets for temporary liquidity needs.

Table 7.10 Bond investors in Myanmar (%)

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
General Public to total	76.6	89.7	10.6	5.3	3.4	1.2	0.6	0.4	0.4	0.4	0.5
Private Enterprises to total	23.4	10.3	89.4	94.7	96.6	98.8	99.4	99.6	99.6	99.6	99.5
Total	100	100	100	100	100	100	100	100	100	100	100

Source: Statistical Year Book (CSO, 2003 & 2004)

7.5 Proposed Financial Market Structure in Myanmar

Interest rate ceiling distorts the economy because low interest rates produce a bias in favor of current consumption and thereby reduce savings. To accelerate the rate of sustained economic growth, the financial sector must mobilize domestic resources effectively, allocate them efficiently to finance new productive economic activities, and at the same time maintain macroeconomic stability (Fry, 1995: 450-451). According to Fry, interest rate deregulation with reducing inflation will mobilize domestic resources effectively, and allocate them efficiently that will increase savings and investments contributing to growth.

To restore more financial resource, financial system has to encourage not only indirect financing through the commercial banks' savings but also direct financing from the financial markets to become a sound financial system.

A report of the International Chamber of Commerce mentions five prerequisites for the elimination of obstacles to increasing savings in developing countries: an increase in income level; stabilization of the currency; betterment of the savings climate; improvement of the investment climate; and provision of the necessary legal framework, giving recognition and protection to private property (U Tun Wai, 1972: 32).

Capital markets includes all financial and non financial institutions dealing in long-term credit instruments, and short-term instruments including stocks, bonds, term loans, mortgages, and time or saving deposits.

According to Anglo-American theory, issues of stocks and bonds, like other forms of finance, increase the saving rate by making savings more attractive and allocate that savings to the most efficient investors and investment activities (U Tun Wai, 1973: 255)[117].

From the experience of Asian financial crisis, one of the factors that causes the crisis is that firms' investments depend heavily on bank loans and short-term loans and that the banks did not function efficiently because of crony relations among banks, firms, and governments (Dr. Yoshitomi and Dr. Shirai, 2001: 37-41). That is why general consensus has emerged that economic development should rely not only on banks but also on capital markets. These views conclude that policies should place less emphasis on bank loans. For that reason, domestic capital markets should be developed as an alternative and also as a more important source of financing.

In Myanmar, the financing behavior of business firms are self-financing, bank-financing, and financing from informal sector such as relatives, friends, and money lenders. As most small and medium enterprises (SMEs) rely heavily on informal sector rather than bank financing (Table 7.3). This raises the issue whether the informal sector is more efficient than formal sector due to the negative interest rates in real terms.

Although ceiling rates are much lower than market determined rates, some SMEs do not have opportunities to borrow because of tight lending practices, i.e., collateral based lending. For that reason, SMEs acquire loans from informal sector rather than formal sector. Even though interest rates are very high in informal sector, SMEs and agricultural firms have to take the loans with or without collateral for the needs of working capital.

The second factor is that the firms should not rely heavily on loan financing according to the lessons from Asian financial crisis. Liquidity crisis in Myanmar that

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[117] U Tun Wai and Hugh T. P., Stock and Bond Issues and Capital Markets in Less Developed Countries, Staff Papers, International Monetary Fund (IMF), 1973: 255

occurred in 2003 showed inadequacy of the banking sector where this banking sector alone cannot meet the requirements of SMEs. Therefore, the firms should rely not only on banks but also on capital markets.

The previous chapter discusses weaknesses of banking system in Myanmar. In addition, why bond markets are underdeveloped in Myanmar is also stated in the previous part. This part tries to present how Myanmar should develop capital markets to attract financial resources from informal to formal sector.

Before preparing the design of a financial market structure in Myanmar, the existing structure of businesses shall be explained first and then how Myanmar businesses to become public companies, shall be discussed.

7.5.1 The Structure and Financing Behavior of Businesses in Myanmar

During the Socialist era, the majority of businesses are owned by the state whereas those owned by the private and co-operative sectors are small. After adopting a market-oriented economic system in Myanmar, the ownership structure includes state, private and co-operatives. The size of businesses depends upon the ownership structure. The main large industries, i.e., SEEs are still owned by the state whereas most of the SMEs are owned by the private and co-operative sectors.

As most SMEs are small and family-owned businesses, they have not kept their financial and cash flow statements systematically. These businesses do not want to expand into larger ones because the owners are afraid of loosing control rights and suspicious that there still exists a so called socialist attitude overhang. The first and important factor is how to encourage SMEs to become larger scale enterprises systematically and how to support to changing their financing structure from self-financing to bank-financing.

On the other hand, since most bank loans go to the trading sector, the expansion of manufacturing SMEs is still limited. The second factor is how commercial capital can be transferred to industrial capital that contributes to industrial sector development and how to develop venture capitalist.

Alternatively, although most large enterprises are SEEs that are strategic and engine of growth, these SEEs are not able to contribute to national revenue. SEEs

deficit to GDP increased sharply from 2.8 percent in 1990-91 to 5.3 percent in 1998-99 and decreased to 3.3 percent in 1999-00 again[118]. Even though they are of poor management, the government subsidizes those SEEs' losses through the State Fund Account (SFA). The fact is that SEEs are not allowed to take loans from commercial banks as mentioned earlier. By using SFA, the subsidization of SEEs' losses increases the government expenditure that worsens fiscal imbalances.

To reduce the subsidization of SEEs, one possible way is that it should be transferred to private hands to become more efficient by privatizing those inefficient ones. At the same time, fiscal imbalances may also be improved. The fact is that reducing deficit financing will reduce the inflation rate.

When SEEs are to be privatized, a huge amount of capital will be needed. By issuing shares, equity capital can be obtained directly from equity market. Developing equity market is crucial in order to provide a benchmark that would function as a guidance in issuing equity shares. After launching equity market, attractive government bonds and corporate bonds through Over The Counter (OTC) market should be established by the Myanmar Security Exchange Centre (MSEC).

7.5.2 A Proposed Financial Market Structure in Myanmar

Asian financial crisis tells that financial liberalization with weak domestic financial system can cause a crisis. From the Asian financial crisis, it can be learned that sound financial system can prevent the financial fragility when financial liberalization is introduced. As sound domestic financial sector is crucial for economic development, this study emphasizes on the development of domestic financial market in Myanmar.

In Myanmar, the strategy of government regarding financial development is to build up sound domestic financial system to become more efficient and competitive before allowing foreign banks to operate in the financial system. According to government strategy, the sequencing is that domestic financial sector liberalizes first, and then external and trade liberalization is second.

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[118] Calculation is based on Statistical Yearbook (CSO, 2003 & 2004)

Chart 7.2 Proposed Financial Market Structure in Myanmar

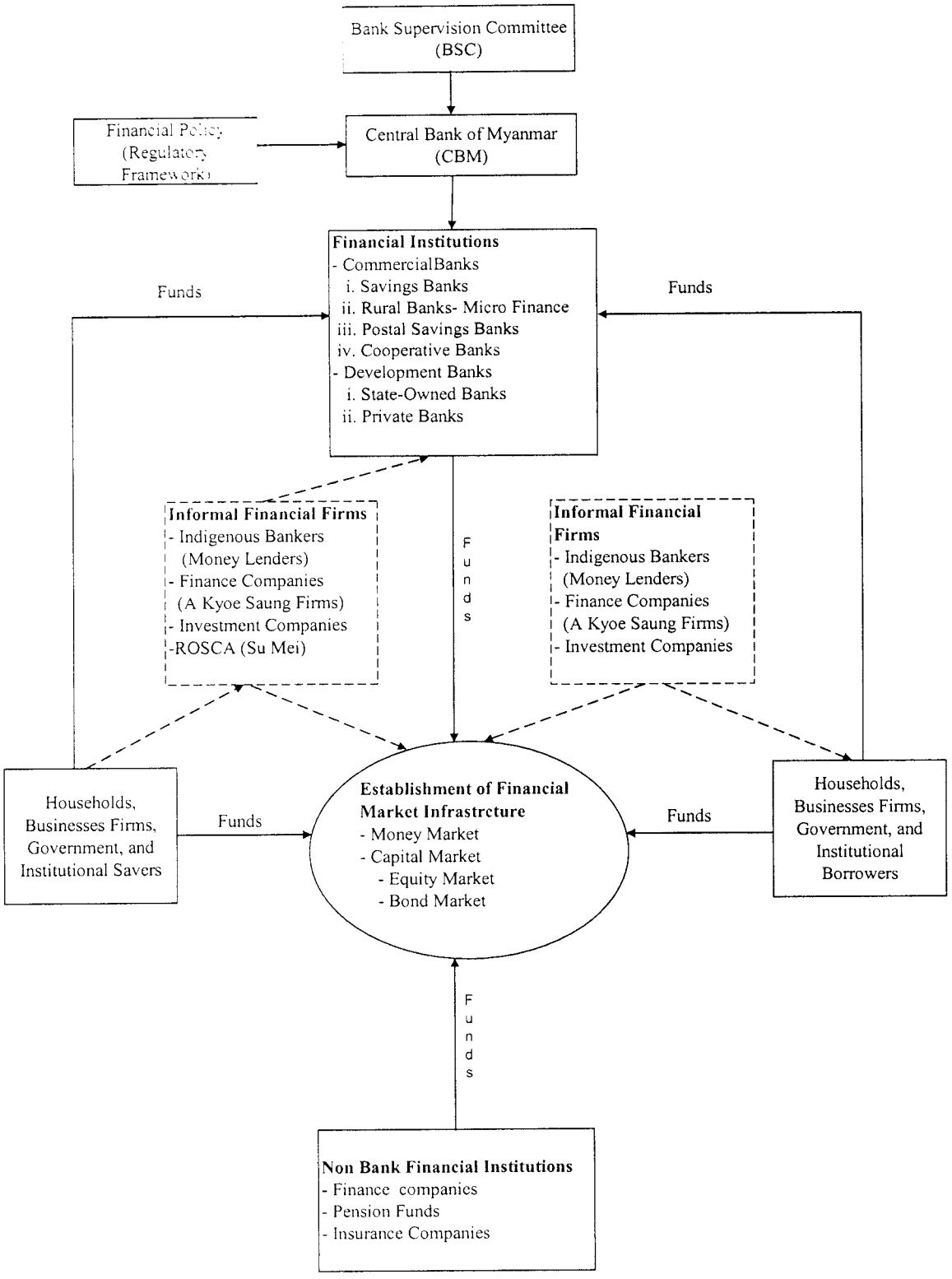

Chart 7.2 presents a proposed financial market structure in Myanmar. Before developing financial markets i.e., equity market, and bond market, the most important prerequisite is interest rate deregulation, that is, interest rates should be raised up to

the acceptable rates or close to the market determined rates. Attractive interest rates are incentives to improve savings mobilization. An increase in supply of loanable funds fulfills the requirements of loans for small and medium enterprises in the private sector. The implication is that the attractive interest rates can channel the funds efficiently that leads to encourage financial intermediation function. An efficient financial intermediation function will improve saving-investment process that enhances economic growth.

At the same time, non-financial institutions should be developed to diversify the saving opportunities. The non-financial institutions such as mutual funds and pension funds can collect idle funds and then invest in diversified portfolio in financial markets.

On the other hand, large enterprises including SEEs should expand their businesses by issuing shares and corporate bonds in the financial markets. They should also disclose their performance to their existing and potential investors. The implication is that financial markets will be efficient for the flow of funds from savers to investors directly.

The implication for this chapter is that the flows of savings to investments in Myanmar are through formal and informal financial intermediation, and self-financing. Low savings and investments explain that formal financial intermediation is still limited. It means informal sector and self-financing contributes to economic growth to some extent. However, the informal financing increases the high cost of capital that causes low levels of private investment. The fact is that local finance and poor intermediation are the major causes of low domestic savings and investments.

Since unattractive interest rates discourage savings, the informal sector becomes larger, results in limiting the size of the formal banking sector. Attractive interest rates with reduced inflation will be a bridge from informal to formal sector. Although Myanmar people have saving capacity, the opportunities of savings are still limited. By developing a capital market, portfolio diversification will restore financial resources from informal to formal sector.

CHAPTER VIII

CONCLUSION

As banking industry plays a major role in financial sector development in Cambodia, Lao PDR, Myanmar, and Viet Nam, efficient financial intermediation can contribute to the deepening of the financial sector. To deepen and widen the financial sector, financial reforms particularly interest rate deregulation need to be introduced. By deregulating the interest rates, stable real interest rates increase the financial saving and bank deposits strengthening the banking system.

Interest rate liberalization in Cambodia, Laos, and Viet Nam made broad money grow rapidly. Since Cambodia and Laos were highly dollarized economies, the growth of broad money was mostly contributed by foreign currency deposits. The growth of broad money in Viet Nam was absorbed by local currency. The efficient channeling of funds from savers to investors shows the extent of financial intermediation and level of deepening. The private sector credit to GDP ratio of Viet Nam was higher than that of the other countries. This ratio of Cambodia started to increase but was still low, while that of Laos and Myanmar started to decline. Viet Nam has been successful in financial deepening that contributes to economic development because of interest rate deregulation with macroeconomic stability. In the case of Cambodia, macroeconomic stability and political stability after deregulating interest rates deepens the financial sector, encouraging economic development. However, in Laos, though broad money increases after deregulating interest rates, it cannot contribute to growth because of high inflation.

In Myanmar, on the other hand, negative interest rate ceilings with high inflation cannot contribute to financial sector development. In Myanmar, broad money started to decline as a result of the negative deposit rates. Although the weak financial sector cannot contribute growth effectively, self-financing and informal financing does contribute to growth. Nevertheless, if inflation cannot be controlled to a stable condition, high inflation will weaken economic development. As mentioned earlier, it is too early to say that the financial sector of CLMV has been developed because these countries are still in transition. Moreover, their financial sectors are still in the early stage of development.

One of the incentives that can deepen and widen the financial sector is the introduction of real interest rates to a positive level together with reducing inflation. Moreover, commercial banks should give more efficient service and product range to attract depositors and borrowers. That encourages the rechanneling of funds from the informal sector to the formal sector, and thus, deepens and widens the financial sector.

The major factor that weakens the banking sector is inflation, as a consequence of inflationary finance by monetary growth. In the case of Laos and Myanmar, the government relied heavily on the central bank borrowing to finance the budget deficit that increased inflation into double digit level. Governments invested in long term infrastructure projects and provided subsidized loans to SOEs or SEEs, which had poor economic performance. These loans became nonperforming loans (NPLs) that worsen the balance sheet of the state-owned banks. Because of the huge amount of SOEs loans, the state-owned banks have less opportunity to create new loans for private sector development. Especially state-owned commercial banks become less profitable.

To resolve the non-performing loans and to restore public confidence, state-owned commercial banks need to be restructured and recapitalized. This would create a healthy banking system. At the same time, government should make a correction of fiscal imbalances. One scenario that would reduce government expenditure is the restructuring of SOEs or SEEs, to reduce budget deficit due to increase in government expenditures. An efficient tax collecting system, for instance, value added tax (VAT) as a replacement for commercial tax should be introduced to increase government revenue. Because of the tax evasion nature of private firms, the government could not collect tax revenue to the maximum extent, leads to a decrease in government revenue. An increase in government expenditure and a decrease in government revenue worsen fiscal imbalances. By reducing fiscal imbalances, the banking sector can channel the resources efficiently and thus deepen the financial sector.

The second factor that weakens the banking sector is the imposition of high reserve requirements particularly in Cambodia, Laos, and Myanmar. That implicit tax collected from commercial banks reduces the spread between lending rates and deposit rates. This discourages financial intermediation and lowers financial deepening. The cost imposed on banks from high reserve requirements make them less competitive and weaken the health of the banking system. High reserve

requirements increase idle funds that cannot be channeled resulting in a decrease in lending to private sector. In Viet Nam, on the other hand, the reduction in reserve requirement ratio imposed by the central bank was to relax credit supply to encourage private sector development. Cambodia, Laos, and Myanmar should reconsider reserve requirements to an acceptable level to encourage more lending to the private sector.

Before adopting a financial reform, all CLV countries suffered from high inflation. By introducing interest rate deregulation with reduced inflation, financial intermediation could be improved more efficiently. However, financial reform without correcting fiscal deficit could increase inflation, the effect of fiscal deficit and inflation was dollarization. In Cambodia, Laos, and Viet Nam, the financial system is allowed to offer foreign currency deposits, as a result foreign currency deposits increase. However, banks cannot channel the foreign currency deposits into foreign currency loans because of lack of reliable borrowers and exchange rate uncertainty. The banks redeposit their foreign currency funds at offshore banks to reduce currency risk and credit risk. The banks acting as capital exporters lower the financial depth. One important reason is that in all these countries other financial institutions and a financial market have not yet developed. Other financial institutions like mutual funds and financial markets need to be developed to introduce new financial instruments.

In the case of Myanmar, private banks are not allowed to accept foreign currency deposits; the response is buying foreign currency as a store of value. Under the fixed exchange rate regime, the overvaluation of exchange rate and negative real interest rates encourage transactions outside the channel of the banking system. This discourages the financial intermediation function and lowers the financial depth. To attract deposits into the banking system, interest rate should be raised to a positive level and foreign exchange rate should be realigned. Furthermore, the financial sector should be liberalized together with the correction of the fiscal deficit to attract deposits and reduce capital outflow.

For saving-investment process, it can be found that in Viet Nam and Cambodia, interest rate deregulation with reducing inflation increase savings and investments that leads to economic growth. In the case of Laos, interest rate deregulation increase savings and investments but however, double digit inflation discourage economic growth. In the case of Myanmar, however, negative real interest rates with double digit inflation decrease savings and investments. It can be noted that

financial developments in CLV support a general finding, that is, there exists a positive relationship between financial sector development and economic development. For Myanmar, the finding is different from the general finding i.e., the financial sector is underdeveloped but however, there is still growth in the economy. It may be due to many factors. One important factor is the sizeable increase in infrastructure investment by the government. Another factor is the important role played by informal financial sector and increasing role of the private sector in the economy. However, a sound banking system will contribute more to economic growth. Nevertheless, it is early to say that there is development of banking sector in CLMV countries as they are still in transition.

The implication for the first part of this study is that interest rate deregulation with macroeconomic stability deepens the financial sector. The efficient domestic banking sector increases savings and investments, encouraging economic development in the case of Viet Nam and Cambodia. In Laos, the trend of banking sector development follows Viet Nam's banking sector development but macroeconomic instability cannot maintain economic development. In the case of Myanmar, on the other hand, negative real interest rates weaken the financial sector which decreases savings and investments. Myanmar does not follow the general finding of saving-investment and growth process. It can be seen that GDS in Myanmar is decreasing because of the deposits are not flowing into the formal banking sector as a consequence of negative real interest rates and high inflation. However, informal sector also contributes to the economy to some extent. In this case, most small and medium scale enterprises with a substantial contribution to the economy rely heavily not only on self-financing but also on informal sources of financing that contributes to economic development. Nonetheless, high and instable inflation hinder development.

Although Myanmar is a bank-based economy, Myanmar banking system is underdeveloped because of negative interest rates in real terms. Furthermore, bank loans concentrate more in trading than in manufacturing partly because private banks provide working capital loans. To reduce credit risk, the commercial banks emphasizes on trading loans rather than others. Since the banking system uses collateral-based lending, most traders can submit sufficient amount of collateral and

the cash flow of traders is much faster than the manufacturers. For these reasons, a large portion of loan assets goes to trading. On the other hand, as small and medium enterprises are relying less on bank loans because these enterprises rarely meet the strict collateral-based lending practices in Myanmar. Even if the commercial banks offer the cash flow-based lending, SMEs could not provide accurate financial statements because most small and medium firms still rarely keep accounting records systematically. One reason is that the firms want to evade tax and this result in the firms' performance being rarely disclosed. It may also be due to the fact that the socialist ideology has not changed completely yet. In addition, SMEs need long-term capital to expand their businesses but the commercial banks can provide only one year short-term loans because of the need to avoid mismatch of funds. For these reasons, SMEs rely heavily on self-financing and informal sources of financing. Although they have obtained short-term loans from informal sources, they can easily roll over the loans.

From the side of savers or depositors, they have the capacity to save in accordance with Myanmar's culture but negative saving rates push the savers to the informal sector. For instance, A Kyoe Saung firms which offer attractive interest rates i.e., 36 percent to 60 percent per annum. This shows that if the commercial banks offer attractive interest rates, they will prefer to save in banks. The interest rates should be raised up to the market rates or a little lower than market rates to attract savers and depositors. Moreover, some banks should also disclose their performance to the public to restore their confidence. As a result, households and firms will be able to determine which bank is viable and which one is not. To build up trust, not only banks but also businesses should disclose their performance. In addition, banks and businesses should adopt sound corporate governance to earn public confidence. As mentioned earlier, not only raising interest rates can attract people to save but also building up public confidence is required to increase bank deposits. As public confidence is critical to the success of banks, banks need to take necessary measures to foster trust in banks. Therefore, a further study will be necessary to investigate the requirements for building public trust.

There exist many factors that hinder financial intermediation function in Myanmar. Nonetheless, this study points out some major factors that weaken the

banking system: interest rate ceilings, fiscal imbalances, high reserve requirements, fixed exchange rate, collateral-based lending, weak lending practices, and lending to related firms. Because of these factors, banking sector could not meet the requirements of savers and borrowers.

In Myanmar, an liquidity crisis occurred in 2003. This shows that the banking system is inadequate in supervision. The gap exists between regulation and supervision in practice. It can be learned that the economy should not rely solely on the banking system alone but it should also rely on capital markets.

The implication for the second part of this study is that a large portion of bank loans are given to the enterprises in the trade sector. It is important to find out how to transfer loans for commercial capital to loans for industrial capital. As mentioned before, because of many weaknesses in the banking system, SMEs are compelled to rely heavily on self-financing. SMEs should expand their businesses by obtaining external source of funds i.e., bank-financing. By keeping systematic records, the firms can acquire the funds not only through commercial banks but also directly from capital markets. On the other hand, the commercial banks should not rely on collateral-based lending that reduces credit risk but should also develop cash flow-based lending, for instance, cash flow-based contract. In addition, the commercial banks should also introduce development banking function to extend the requirements of SMEs.

The liquidity crisis occurred because of asymmetric information and excessive lending by some banks. The commercial banks should disclose their performance to restore public confidence. At the same time, the Central Bank should introduce restructuring process in the banking sector like Cambodia to separate viable banks and non-viable ones to improve public confidence and to build up sound financial system.

Interest rate ceilings, high inflation, and exchange rate depreciation discourage financial intermediation function that reduces the size of the banking system. In addition, the low per capita income also limits the size of formal banking system. It implies that the smaller the formal banking sector, the larger will be the informal financial sector. Although informal sector contributes to economic development to some extent, high cost of capital and low grade technology cannot contribute to the economy efficiently. Low savings and low investments cannot contribute to the application of capital intensive technology. Therefore, efficient financial system

reduces information and transaction costs, influence high saving rates, good investment decisions, technological innovation, and long-run growth rates.

Hausmann et al., suggested to focus on one or more binding constraints to development, e.g., the high cost of finance causes low levels of private investment and entrepreneurship (Hausmann et al., 2005: 14)[119]. The high cost of finance in Myanmar is caused by limited local finance and international finance. Among others, dual or multiple exchange rate is one of the underlying factors behind limited international finance (FDI), whereas limited local finance and weak intermediation are amongst the major causes of low domestic savings and investments.

To escape from binding constraints, one possible way is to improve domestic savings mobilization through the banking system and to develop money and capital markets. To improve domestic savings mobilization, major hindrances of financial saving development should be removed, such as, capital deposit ratio, unattractive interest rates, exchange rate depreciation, lack of banking habits, and limiting of the opening of new branches. The policies should place more emphasis on the following:

1. The Central Bank should introduce restructuring and recapitalization package to both state-owned and private banks to make a sound banking system and to strengthen banks and restore public confidence. The SOCBs should urgently launch recapitalization process and eliminate NPLs. By introducing restructuring process, viable banks can regain public confidence and build up a sound banking system.
2. The restriction on capital deposit ratio, that is, deposits could not be accepted more than 10 times of paid-up capital, should be relaxed. Although capital deposits ratio is to protect savers' deposits, this ratio causes the contraction of banks' deposits, results in limiting the capacity of banks to lend and the growth of banks. Hence, many scholars suggest that deposit insurance system should be introduced not only to protect the depositors and but also to encourage the development of banking sector also. An early establishment of a suitable deposit insurance scheme would protect small depositors and prevent

[119] Hausmann, R., Rodrick, D., and Velasco, A., Growth Diagnostics, 2005: 14

banks from sudden external shocks. This deposit insurance scheme would also build up public confidence that support the deepening of the financial sector.

3. The Central Bank of Myanmar should deregulate ceiling rates up to attractive interest rates to increase savings and increase investments that encourage using state-of-the-art technology to increase productivity. At the same time, the Central Bank should control inflation by adopting inflation targeting and controlling and adjusting monetary growth in line with the inflation target. By raising interest rates to positive level together with reducing inflation, financial resources can be transferred from informal to formal sector which would reduce the size of informal sector while at the same time enlarge formal sector, leading to growth.
4. The central bank should realign exchange rate and move from a fixed exchange rate regime to a flexible managed floating exchange rate regime. Furthermore, private banks should be allowed to offer foreign currency deposit and foreign businesses to reduce foreign currency deposits outflow. This would also prevent capital outflow across the border.
5. Potential depositors and borrowers lack banking habits because bank branches cannot reach to urban poor and rural areas. Encouraging the opening of new bank branches to suitable rural areas to collect savings is an important part of financial deepening for Myanmar. It may not be profitable for a bank to develop rural branches because rural markets incur higher cost relative to urban markets. However, when competitive entry is allowed, new branches can mobilize additional savings. In addition to incentives to seek out new location for branches, banks will make investments to bring new depositors to their existing networks to attract incremental savings. To persuade and attract all potential depositors who have not joined the formal financial system, banks should invest in educational advertising campaign to open new deposit accounts with incentive features thereby expanding the scope of the financial system.
6. As human capital and skills are important in modern banking system, internal incentive system should be introduced to upgrade skills and performance of bank staff in the long run. To step up the efficiency of the financial sector, investment in human capital, risk management, the application of modern

banking technology and incentives in the commercial banks will be crucial.

7. Sound financial system should be fostered and good governance principles should be adopted to encourage efficient financial system to prevent liquidity crisis. The Central Bank should establish financial market and requisite financial infrastructure to attract incremental savings and investments. At the same time, the policy implication for policy makers is that an efficient banking system complemented with a capital market is optimal for the long run. From the experiences of Asian financial crisis in 1997 and Myanmar liquidity crisis in 2003, firms' investment should not rely heavily on short term bank loans but also on financial markets. Apart from relying only on bank loans, the economy should also rely on equity market and bond market. Hence, domestic capital market should be developed as an essential component of a sound financial system and also as a complementary source of financing.
8. The Central Bank should replace or substitute direct controls with prudential supervision and market-based instruments. In addition, CBM should also adopt international best practices (Basel II) in risk management, risk-based capital requirement and risk-based loan pricing, etc., to promote sound banking practices. To develop and enlarge the scope of banking sector, the CBM should remove current restrictions on the scope of bank operations and branch opening by providing fair competition.

In conclusion, banking and financial sector reforms should be stepped up. In the banking sector best international banking practices should be adopted. Direct controls and administrative instructions should be eliminated gradually. The objective is to provide a more flexible regulatory framework to strengthen the banking sector and to develop new financial instruments and products.

A sound financial system will encourage the improvement of financial intermediation functions and deepen the financial sector. A sound financial system can mobilize financial resources and channel these resources to productive investments efficiently. By strengthening the supervision of the banking sector, financial intermediation function may become more efficient, and thus, contribute to financial deepening.

By reducing state ownership, promoting competitive financial markets and creating level playing field for banks, the financial system will be more competitive

and efficient which would promote the financial sector development and deepen the financial sector. Moreover, financial markets and requisite financial infrastructure should be developed to improve the diversification of financial resources for investment and also to contain capital outflow and eventually to attract investments from surplus funds and savings in the region. Last but not least, banking and financial sector should be decentralized and liberalized gradually and sequentially according to the changing environment and based on political and economic development of Myanmar.

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APPENDICES

Appendix 1 The Development of Banking Sector in CLMV Countries

	Economic Reform - Planned Economies to Market Oriented Economies	Mono banking system to Two Tier Banking System	Entry of Private and Foreign Banks	Market Share of SOCBs
Cambodia	Enhanced Structural Adjustment Facility (EFSA),1985	1989	1991	19.30%
LaoPDR	New Economic Mechanism (NEM),1988	1989	1989	73.60%
Myanmar	Major Economic Reform (1988)	1990	1992	51%
Viet Nam	Renovation or Doi Moi (1986)	1989	1991	74%

Source: Olaf Unteroberdoerster (2004: 2-22); International Financial Statistics (IMF, 2004)

Appendix 2 Monetary and Exchange Rate Policy in CLMV Countries

	Cambodia	Lao PDR	Myanmar	Viet Nam
Monetary Policy				
Interest Rate Policy	Interest Rate Deregulation (1995)	Early 2000	Ceiling Rates	Deposit Rates (1996), & Lending Rates (2000)
Reserve Requirements	8%	6%-8% (Local), & 15% (Foreign)	5% (Time Deposit), & 10% (Demand Deposit)	3% (Local), & 8% (Foreign)
Exchange Rate Policy	Managed Floating	Managed Floating	Fixed	Flexible