Chapter 1

INTRODUCTION

1.1 Background of the study

Economic theory explains that the traditional function of a financial system is to serve as an intermediary between individual economic units who have surplus funds and those who face shortages of funds. An efficient financial system should allow the transfer of funds from lenders to borrowers with the best possible use for the borrowed funds. This efficient resource allocation can be realized by allowing *"......individuals who have insufficient wealth to take advantage of all their investment opportunities that yield rates of return higher than the market rate ...... to borrow funds and invest more than they would without capital markets .... As a result, all (borrowers and lenders) are better off than they would have been without capital markets....."* (Copeland and Weston 1988, p. 13)

Numerous research studies support this idea and indicate that financial market development is a crucial factor for the economic growth of a nation. In this study, attention has been placed on the role of financial intermediaries in accelerating economic growth in the less developed countries (LDCs) and Thailand is chosen as a case study. The study examines the development of the Thai financial system including the recent financial reform policies that have been implemented since the late 1980s. The dominant role of commercial banks in the financial sector is without question, hence in order to gain deeper understanding of the relationship between financial development and growth, an analysis of commercial banks' operation will be conducted. The focus of the study will be on the efficiency of resource allocation rather than the liquidity function of the financial intermediaries.

Patrick (1966), Gurley and Shaw (1967), Goldsmith (1969) and McKinnon (1973) are among the first group of economists to realize the role of financial markets in economic development. Their work indicates the importance of a financial structure in LDCs especially as a means toward increasing the levels of saving and investment. In his work, Patrick (1966), suggests two approaches of financial market development: "demand-following" and "supply-leading". The first approach implies that finance is essentially passive in the process of economic growth. Emphasis has been placed on the demand side of financial activities as a result of economic growth. For the second approach he defines "supply-leading" to mean "..the creation of financial institutions and supply of their financial assets, liabilities, and related financial services in advance of the demand for them..." Motivated by these works, Aphimeteetamrong (1980) studied the impact of financial development on economic growth in Thailand. Although his results suggest that financial institutions expanded along with the process of economic development, he could not identify the direction of the relationship to be either the demand-following or supply leading approach. Many other recent studies (e.g. Darrat, Labarge and Labarge 1994, King and Levine 1994, and Aretis and Demetriades 1996) using different econometric methods also found inconclusive answers. Thus, this study brings this issue to the forefront. With a different set of proxy variables for financial development, we attempt to shed some light in this area.

In answering the question of the operation efficiency of Thai commercial banks, this study adopts a microeconomics approach used in Gollop and Roberts (1974) and Berg and Kim (1994) in which the market structure of the banking industry is also incorporated in the analysis. The introduction of the market structure in the estimated model has never been done for Thai commercial banks. The results are expected to reflect the pattern of interdependency in the Thai banking sector and lead to the more accurate measurement.

1.2 Objectives of the study

The study has the following specific objectives:

1.2.1. To summarize the structure and development of the financial system in Thailand;

1.2.2. To examine the impact of financial development on the economic growth of the country; and

1.2.3. To assess the efficiency in the Thai commercial banking system, before and after financial liberalization.

The study will cover the period 1957-1996. During this period, the Thai financial system evolved through many structural changes in both the system itself and the economic structure of the country. Before 1960, the role of the commercial banks mostly related to the business of financing international trade. The new era of financial development started at the same time as the implementation of the first National Economic Development Plan in 1961. Since then, the commercial banks have been performing a major role as the country's financial intermediaries. However, starting in 1969, financial companies emerged as a new kind of non-bank financial institution and the intermediation role of finance firms grew increasingly important both in saving and credit extensions. In 1975, the Stock Exchange of Thailand (SET) started operations. Despite slow growth in the first ten years of operations, the trading volume began to rise sharply after 1987.

In the late 1980s, Thai monetary authorities introduced several financial liberalization schemes, including plans for diluting exchange controls, liberalizing interest rates, and improving the basic financial infrastructure. Many financial institutions were established such as the Exports and Imports Bank (EXIM), a credit rating agency, and many mutual fund companies. Financial liberalization also led to the creation of the Bangkok International Banking Facilities (BIBF) offshore banking systems which allow free flows of external capital. Thus, we can see can see that even though the commercial banks maintain their dominant intermediation role, the stronger competitive environment poses more challenges than ever before.

1.3 Contribution of the study

While extensive studies have been done in the field of economic development, none of these earlier studies can point out the clear direction of the relationship between financial development and growth. These kinds of studies are found even less in developing countries and most of the studies present ambiguous results. This study shows that when choosing the appropriate financial variables to be included in the model, we are able to identify the <u>direction</u> of the relationship between financial development and growth. In light of the findings in this study, we hope that we are adding one more interesting case study to the field of economic development process in developing countries.

Other interesting findings of this study are the measurements of scale efficiencies in commercial bank operations before and after the liberalization. All of the efficiency studies in Thai commercial banks have been done without taking in to account the oligopolistic nature of the industry, and hence, end up with biased results. With the inclusion of the conjecture variables in the model, we are offering a new dimension of banking research which should reveal more accurate results, leading to better understanding of banking activities.

Lastly, the policy implications should benefit both regulators and bank executives with evidence concerning the impact of financial development on economic growth.

1.4 *Organization of the contents*

The study has been organized to include six chapters. After the introductory chapter, the chapters are as follows:

Chapter 2 contains a literature review which is divided into three parts: a review of earlier studies related to the relationship between financial development and economic growth with concentration on developing countries; the second part deals with the studies of operational efficiency in the banking industry; and the last part reviews the studies of commercial bank efficiency that has been done in Thailand.

Chapter 3 describes the evolution of the financial system in Thailand.

Chapter 4 examines the relationship between financial development and growth, including the role of credits extended by commercial banks. The Granger causality tests supporting the supply-leading hypothesis are conducted in this chapter.

Chapter 5 specifies the market structure of the banking industry in Thailand and incorporates the oligopolistic characteristics of the market into the behavior models identifying the efficiencies in banking operations before and after financial liberalization.

Chapter 6 presents an over-all conclusion with some policy implications.