CHAPTER VI

CONCLUSION

6.1. Summary

This paper analyzes the relationship between an entry of foreign banks and economic growth in Thailand. On one hand, a participation of foreign banks which are assumed to be more efficient than domestic banks will encourage economic growth as several previous literatures such as Cetorelli and Peretto (2000) and Francois and Schuknecht (1999) concluded. Besides, the efficiency of domestic and foreign banks is represented by managerial cost of loans which is varied across countries. In Thailand, that domestic banks on average face higher overhead costs than foreign ones is reported by the work of Bayraktar and Wang (2004). An entry of foreign banks will lower overall costs in domestic loan market. As a consequence, firms face cheaper cost of financial resources and hence expand their production resulting in higher output. In addition, the higher is the difference in managerial cost between domestic and foreign banks, the lower is the overall cost which means a higher growth rate.

On the other hand, we find that foreign entry will reduce profit of domestic banks parallel to the empirical evidence provided by Demirgüç-Kunt et al. (1999). The managerial cost gap between domestic and foreign banks obviously means that their profits also differ. That is, foreign banks which are assumed to possess a competitive advantage over domestic banks can gain higher profits. In some circumstances that the managerial cost gap is wide and there are a large number of foreign banks, domestic banks can face negative profits and are thus bailed out from the loan market. Even though domestic banks could finance the losses by their deposit business and remain on the loan market, the economy will face a negative growth rate. This consequence occurs when a number of foreign banks exceed a critical number of foreign banks. It is a trade-off between boosting economic growth and protecting domestic banks. In addition, we also find that entry of foreign banks will reduce net interest margin correlated to empirical finding of Demirgüç-Kunt et al. (1999).

Our empirical study confirms that foreign entry has a positive impact on economic growth. In addition, we find that asset share of all foreign banks as well as that of foreign branches is positively related to GDP growth but they have no significant, though negative, impact on an interest rate on loans. In contrast, assets share of foreign-owned domestic banks has no significant effect on domestic market. Agree with Herberholz (2002), we suggest that a number of foreign banks are not a proper measure of a foreign participation in domestic market because a number share does not distinguish a large bank from a small branch though their market shares, or their influence on the domestic market, are different.

6.2. Policy Implication

In several previous literatures, it is almost a consensus that foreign entry will serve as a force for fostering competition efficiency in banking market. At this point, we would like to conclude that foreign entry in banking sector can potentially encourage economic growth in Thailand as we show in our model and empirical study if a proper policy is adopted. Substantial difference in cost gap which theoretically used as a proxy for competitive advantage between foreign and domestic banks may potentially be harmful for either domestic banks or economy as a whole. To prevent this consequence, the critical number of foreign banks should be determined and taken into account the limitation of a number of foreign banks. Also, we agree with Putrakula, Rodprasert and Nakorntan (2004) that the gradualism approach is justified and add that domestic banks could have adequate time to improve their competitiveness which means decreasing cost gaps and that therefore the new foreign banks can be allowed to enter the market to further foster competition. BOT have to prudentially track domestic banks' competitiveness to determine the critical condition.

According to the results of empirical study, decreasing interest rate on loans is proved to be beneficial to economic growth but the linkage from foreign entry to interest rate is missing. In order to connect the missing link, the BOT could release a restriction for foreign banks to establish new branches to allow foreign banks to maximize their operational efficiency and consequently drive down interest rate on loans. However, this may be harmful to domestic banks so that the BOT has to determine the appropriate restriction.

Foreign entry might be a good tool to enhance banking sector efficiency but, as foreign banks could whenever withdraw their investment from Thailand, the better ways to foster banking sector efficiency are to depend on domestic banks themselves while elevate domestic banks' efficiency themselves to be equivalent that of foreign banks, or theoretically narrow down a cost gap between domestic and foreign banks. We agree with the new guidelines for equity holding in that foreign banks could help improve domestic banks that in the end turn into domestic-owned.

Besides, the advent of Basel II would serve as another potential force of modernization for domestic banks and supervisory authorities. Not only would the new capital adequacy regulation provide a better safety measure for Thai banking sector, but the new risk management practices would also foster competitiveness of Thai banks which in our model theoretically implies a lower managerial cost. The implementation of this framework might incur substantial costs for Thai banks at first place but in the long run the competitive inequality arise from the difference of capital adequacy regulation and risk management capability would be eliminated. Nevertheless, competitive advantages of foreign banks might exist in other practices such as managerial know how, financial innovations and operational efficiency. Therefore, the enormous tasks to foster competitiveness of Thai banks still remain along with implementation of this capital adequacy framework.

An appropriate point between liberalization and protection is very crucial but somewhat abstruse: not to be too rash to allow foreign entry with unprepared domestic banks and not to be too conservative that Thailand cannot gain from the internationalization and be left behind by other developing countries. In brief, the BOT should apply gradualism approach and implement effective procedures to monitor banking sector liberalization to serve as elements for making liberalization policy from which Thailand can fully benefited.

6.3. Limitation of Study and Suggestion

This paper conducts an empirical study on Thailand only whose data are quite limited in a number of observations. A longer time frame, either in the past or the future, might enable us to reach more accurate, or even different, finding. It is also possible to apply the framework to other countries' data to arrive at a broader conclusion. In addition, our model assumes that banks' managerial costs are constant. To make the estimation more dynamic reflecting actual foreign and domestic banks competitiveness, the proxy of banks' managerial cost, an overhead cost per asset, can be included in the econometric models. Time-series data of each bank's overhead cost can be calculated from previous income statements though obtaining private banks' data and previous income statements might be a huge work.

The theoretical model can be extended to investigate more detail in dynamic banks' behavior by endogenizing managerial costs and adjustment costs to simulate banks' incentive to improve their efficiency. This bank dynamic behavior will serve as an important element for the optimal liberalization policy that may be possible to derive from the model. On the other hands, the foreign and domestic banks' managerial cost which serves as characteristic of each bank can be modeled as a random variable to make the model more realistic. To make this model valid, a mean of foreign managerial costs must be still higher that that of domestic banks. However, descriptive statistics of them should be investigated to determine their appropriate distributions.

The analysis nevertheless focuses only on efficiency side of a foreign entry. By the fact that banking sector liberalization is multi-facet issue, in order to reach more sophisticated conclusion, our theoretical model needs some extension to capture other crucial sides such as financial stability. Asymmetric information between firms and banks can also be modeled by distinguishing low and high risk firms. Besides, lending behaviors of foreign and domestic banks are also interesting in that if domestic banks suffer losses from an entry of foreign banks and their lack of competitive advantage, they might have an incentive to gamble by lending to risky firms to survive in the market. This kind of behavior will result in a higher financial fragility and as opposes to economic growth and the trade off between them could therefore be investigated.