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Financial Globalization and Vulnerabilities: Lessons for Bangladesh

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Abstract: This paper examines and measures the state of external financial openness and financial integration of Bangladesh and the impact of external policy changes and financial integration on the economic growth of Bangladesh. This study also focuses on the experiences of crisis affected economies for identifying vulnerabilities of reforming Bangladesh under free capital mobility in near future.

1. Introduction

A number of Latin American countries (for example, Argentina, Chile, Colombia, Brazil, Paraguay etc) faced financial problems like debt crisis, bank failure, and securities market crash in different periods during 1980s and 1990s. However, of the Latin American countries, it is the Mexican peso crisis of 1994 that stunned the world and generated doubts about the long-term viability of the capital account openness. Mexican crisis was the most severe and a notable example of boom and bust in capital flows. The most recent East and Southeast Asian crisis has plunged the world into a global slowdown over 1997-1998. The 1997 crisis was triggered in Thailand and severely affected Indonesia, Malaysia, Philippines, and South Korea. Based on different studies, several factors may be identified as the possible causes of the Latin American and East Asian financial crisis, and lessons may be drawn out of these.

i. Empirical analysis by Caprio and Klingebil (1996) find close relation between very high real credit growth and bank difficulties in the crises affected countries. The credits in south East Asian countries were increasing substantially on the eve of the crisis. These over expansion resulted in some degree of misallocation. Moreover, in a few affected Asian countries, credit expansion (in local currency) was financed by short-term foreign currency borrowings rather than from higher domestic deposits. The practice of short-term foreign borrowing by the banks to meet long term lending requirements may be dangerous once the exchange rate of the domestic currency depreciates. Inadequate prudential regulations were behind the developments. Practically, lack of prudential regulation and supervision seemed almost universal among the crises affected countries. Though, the affected Asian countries did not completely ignore the need for prudential regulation and supervision, the manner in which regulation and supervision was implemented was not sufficient. Moreover, there were weaknesses in certain aspects of the prudential regulations especially related to loan classifications and provisioning rules. Above facts clearly reveal that a sound and strong banking system is essential to keep domestic financial system away from financial crises.

ii. According to most of the crisis analysts, one of the causes that triggered the crises was the deterioration of the current accounts in the affected countries. Persistent current account deficit offset through short-term capital inflows proved to be very dangerous for most of the affected economies. Deterioration in export growth is believed to be a crucial factor that raised current account deficits in the East Asian economies. Productivity growth is at the heart of export expansion and thus contributes to keep the current account in balance.

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iii. Unlike FDI, portfolio investments and short-term debts are fully mobile at low costs and pose special problems for the maintenance of financial stability (UNCTAD, 2001). Higher level of portfolio capital and short-term debts were believed to be contributory to the Mexico and East Asian financial market instability. Of the different forms of capital flows, FDI has proved to be stable. It is less difficult to maintain financial stability in the domestic financial market having higher proportion of FDI. Using certain types of capital controls to discourage excessive short-term flows may give positive outcome.

iv. The crisis experiences indicate that there is an inherent danger in using fixed exchange rate as a stabilization device. They tend to generate real exchange rate overvaluation and loss in externel competitiveness. Most of the affected countries` currencies were inflexible and overvalued during the pre crisis period. In most Latin American countries, capital inflows had been associated with a marked real exchange rate appreciation. In the free capital mobility the flexible exchange rate and market oriented interest rate structure are expected to give better result.

v. Inadequate reserves have been found as one of the immediate causes of the crises. Sufficient foreign exchange reserve is essential to resist downward pressure on the exchange rate or to meet sudden requirements of foreign currencies (as debt-servicing etc) following sudden capital reversal. Though any level of foreign exchange reserves may not be sufficient to defend a severe crisis, financial instability may be tackled or at least minimized to a great extent by higher level of foreign exchange reserves.

vi. Crises in both the regions generated stock market collapse, which in turn worsened the crises. Moreover, deteriorating fiscal condition and higher inflation have contributed toward aggravating the currency run in Mexico. In case of East and Southeast Asia, some non-economic factors like crony capitalism and corruption are said to be among the main causes of the crisis as asserted by a section of experts.

2. Identifying Vulnerabilities as Early Warning Signals for Bangladesh

Based on the causes and lessons of the crises affected countries, some macroeconomic variables of Bangladesh economy may be identified that may prove to be vulnerable under free capital mobility in future although these may not appear to be problematic at the current state of capital account openness.

i. **Condition of Domestic Banks:** As in most developing economies, the financial system of Bangladesh is dominated by banking sector. Bangladesh has undertaken a series of financial reforms with the objective of changing market structure, bringing competition and efficiency. A number of new private sector banks were licensed since early 1980s however, market share remained concentrated to a few NCBs. NCBs of Bangladesh hold very high market share as compared to the selected emerging economies of East and Southeast Asia and Latin America. Credit boom has been common with the crises affected countries during their reform periods earlier to the crises. Over last two decades, growth of banks' credit decreased and level of private credit to GDP registered significant increase. The level of private credit (to GDP) however remained at much lower level compared to most of the selected counties. Clearly, the credit expansion of banks remained under control during the reform period since early 1990s. Ratio of total credit to deposit is also showing decreasing trend.

In regard to foreign currency liabilities, commercial banks had considerable foreign currency liabilities during the pre crisis period in most of the crises affected economies. In this regard Bangladesh is at relatively safe position. Though Bangladesh's foreign currency deposit liabilities of commercial banks increased by about ten fold between 1990 and 2002, total liability was below 3% of total deposit liabilities in 2002(Bangladesh Bank, 2002-03).

It is a positive development that profitability level of banks improved in recent years. Though, the positive change for the public sector banks was marginal, private banks attained statistically significant change mainly due to good performance of some newly established banks. However, comparative picture is not appreciable. As of 2002, profitability ratio of all banks (.52%)remained at much lower level compared to the mean figure of emerging Asian countries (1.0) though marginally, the operational productivity level of NCBs and PCBs improved in the second half of 1990s as compared to the first half. But as expected, FCB maintained considerable lead over domestic banks, and PCBs are far ahead of the NCBs.

The problem of non-performing loans (NPLs) has been severe in Bangladesh and volume of NPL (as % of total loans) is the highest among the selected group of countries. It is mainly the NCBs that have been suffering from huge NPLs. The annual average classified advances (as percentage of total outstanding advances) of all banks rose to about 40% in 1996-00. Though the NPLs of PCBs declined during the second half of 1990s, it should be noted here that it is the collective picture of old and newly established private sector banks. Aggregate NPLs of total loans of banks show encouraging trend since 2000, though the ratio is still as high as 28.01% (as of December 2002). However, the provision shortfall against the NPLs increased to about 47% in 2002 that reflects the inability of NCBs and some PCBs to generate sufficient profit. While FCBs and PCBs are maintaining required ratio of capital to risk weighted assets (9%), NCBs are far away from the target.

Overall picture clearly indicates the fragile state of the banks of Bangladesh that primarily reflect the poor profitability, very high classified advances, shortage of provisioning requirements, and huge capital shortfall of the NCBs of the country.

ii. Prudential Regulation and Supervision: Inadequate prudential regulation and supervisory arrangement are seen to be almost universal in the crises affected countries. During last few years, a number of prudential measures have been undertaken in Bangladesh to address the problem of loan default, to ensure better recovery, better risk management, and to ensure financial discipline. Loan classification norms have been made more stringent; and a programmed for upgrading loan classification and provisioning to the international standard was completed. New laws enacted, existing laws amended, and the required level of minimum capital and capital adequacy requirement of risk-weighted assets raised. Under reforms, major changes also took place in the on-sight and off-sight supervision. However, the changes could not bring much (as revealed by the existing level of NPLs and state of recovery) in improving the recovery of defaulted loan, punishing the defaulter and improving capital adequacy level of NCBs. Stiglitz (1999) rightly asserts, it is very sad irony that a handful of elite households refuse to repay their huge outstanding debts in a country that has proved to the world that poor can repay: and adds, this is a classic case where the rule of law is obviously missing and it is the governments responsibility to put this straight. BRC blamed supervisory arrangement and regulatory forbearance for the accumulated banking problems. BRC gave highest importance on supervisory and regulatory enforcement for ensuring financial discipline in the banking sector. The August-2001 Task force Report of CPD made recommendation to keep BB free from all sorts of influence and ensure effective supervision of BB over NCBs. Some recent initiatives have been undertaken for speedy recovery of default loans, for ensuring better risk management and preventing concentration of large loans. Bangladesh Bank has also formulated new guidelines for loan rescheduling and loan write-off. Successful implementations of these steps are expected to have positive impact on the recovery of default loans and its legal enforcement, and on the effort to prevent new loans to become classified.

iii. **Government Bond and Security Market Development:** Bangladesh Bank engaged in open market operation since 1990, and provision of auction has been introduced in the bond market for ensuring market-determined rates. But secondary market for the government bond is yet to develop. Though a number of measures have been undertaken to promote growth of security market in Bangladesh, the market remains under developed and resource raising facilities are available only to some large –scale enterprises. With a few institutional players, the market remained essentially retail investor based. The stock markets experienced some improvements in terms of value traded and market capitalization between 1993 and 1996. However, the capital market had to face a big crash in 1996. Laxity in regulation is believed to be the prime reason. The market is yet to recover fully from the upheaval. In regard to the causes of stock market upheavals of 1996, Mahmud (1998) notes, this is mainly created by some unscrupulous share-traders who took the advantage of the laxity in regulation. Thus, though the small investors have been taking interest on the primary market, they continue to stay away from the secondary market (Bhattacharya, 2001).

iv. **Current Account, Export Growth and Foreign Exchange Reserves:** The levels of current account deficits of Bangladesh were clustering around 1% of GDP toward the end of 1990s that became positive in 2001 and improved in the following year, Bangladesh Balance of Payments (BOP) stability and international reserve largely depend on export earnings. The country's exports of goods and services (to the GDP) increased by about 9% over 1990s, but it remained in the category of low exporting countries. Though, capital account appeared to be the main force in pulling up foreign exchange reserve in many economies (as in India), the impact of increase in FDI flows of Bangladesh's reserves has been limited. Bangladesh's foreign exchange reserve position improved during 1993-1996 however it worsened over the following years. In 1995, foreign exchange reserve was equivalent to about 8 months of imports that had fallen to around 2 months in 2000(Bangladesh Bank date). Practically, there is no unanimous definition of 'sufficient reserve'. In this age of financial globalization, it is much more popular to assess reserve position in terms of short-term capital. In this regard, Bangladesh is clearly out of danger having restrictions on short-term debt and with its limited portfolio capital flows. The reserve position has shown some sign of improvement since early 2003. However, still it was lower than 3 months of imports of the country as of June 2003.

Composition of Capital Flows: Crises experiences indicate that FDI is comparatively stable of all forms of capital and can show tremendous resilience at the time of financial crises. Bangladesh's private capital flows mainly consist of FDI. Capital market flows to Bangladesh have been very negligible. Outstanding short-term debts of Bangladesh increased only marginally between 1990 and 2001.

v. **Exchange Rate:** There is no doubt that floating exchange rate has become an increasingly relevant choice in the atmosphere of increasingly financial globalization. Adoption of floating exchange rate does not seem to pose any difficulty for Bangladesh with its current restricted capital account and state of capital flows. The step may be an indication that the country is moving towards more openness of capital account soon. It would not be easy for BB to handle exchange rate in future under condition of free capital mobility without underdeveloped security market, tiny foreign exchange market And bond market without secondary market.

vi. Fiscal balance: After crossing 6% mark (of GDP) in 1999, overall budget deficits of the country showed decreasing trend over 2000-2002. However, the declining trend in the overall budget deficit figures is due to the decreasing development expenditure during the period, while revenue expenditure showed increasing trend. In regard to government revenue, both tax (main source of revenue) and non-tax revenue registered marginal improvement over 2000-2002 (GOB, 2003). One notable development in 2000 was the increasing contribution of direct taxes in total tax revenue.

vii. Governance: Along with a number of financial and external vulnerabilities, some factors like corruption, lack of transparency and bureaucratic red tapism are also held responsible for the crises in some instances. It is widely accepted that these are very crucial in ensuring effective investment climate and in raising absorptive capacity of foreign capital in an economy. The governance of Bangladesh show mixed performance plotted on a 'governance hexagon' developed by Kaufmann and Kraay (2002), using six aggregate measures: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption. Bangladesh performs relatively better in voice and accountability, regulatory quality and governmental effectiveness. On control of corruption Bangladesh performed fractionally better than the average for low-income countries. And on both political stability and rule of law, Bangladesh performs worse than the average for low-income countries (World Bank and Bangladesh Enterprise Institute, 2003). Global competitiveness report 2001-2002 ranked Bangladesh 60 th out of 75 countries in terms of difficulty of starting a new business in the country, worse than the ranking of all the selected countries.

3. Findings and Policy Recommendations

The paper came up with the following findings in regard to Bangladesh's openness/integration status, impact on the change on economic growth of the country and vulnerabilities under free capital mobility in future.

i. It is evident that Bangladesh has become more open over the reform period since early 1990s. However, it is found least open /integrated as compared to the selected group of Latin America and East and Southeast Asian economies.

ii. Overall growth scenario improved and financial sectors deepened in the inflow period of 1997-2002. However, domestic savings and investments remained at much lower levels in global perspective. Growth rates of investment and savings decelerated and return on domestic investment decreased in the post openness period as compared to the pre openness period. The changes in the selected growth-related variables during the inflow period do not establish any clear link between external financial integration and growth of the country. Lower level of capital inflows might have been one of the reasons.

Changes in domestic investment and consumption expenditure during the inflow period indicate positive trend of composition of absorption in the country. However, still high level of consumption expenditure seems to be an obstacle in lifting domestic savings in Bangladesh. The examination of absorptive capacity indicates that Bangladesh has less absorptive capacity compared to the selected economies.

iii. The paper finds a set of financial sector, external sector and macroeconomic variables as vulnerable under free capital mobility in the future.

Firstly, Banking sector weakness has been one of the major concerns in Bangladesh. Reforms and greater participation of private capital market players brought marginal changes in the structure of banking market and the market share remained concentrated to a few public sector banks. Lower profitability of overall banking system is largely contributed by the lower level of profitability of NCBs burdened with huge non-performing loans.

Secondly, developed securities and bond market are believed to be crucial for effective monetary policy operations. However, securities market of the country remained under developed and secondary market for the governmental bond market has not yet blossomed.

Thirdly, Growth of merchandise exports decreased since mid 1990s and the country's exports and foreign exchange reserves remain at much lower level in global perspective. FDI inflows failed to accelerate exports and could not pull up Bangladesh's reserves.

Fourthly, development in the fiscal sector in recent years has been a matter of concern. Such a weak fiscal sector cannot provide much flexibility to the policy makers in handling capital surge into the country.

4. Policy Recommendations on the Way Toward Capital Account Convertibility

In the ongoing globalization process, the opportunity cost of maintaining capital account restrictions may be high. Following steps may be suggested for Bangladesh on the way to its capital account convertibility.

i. Higher level of capital accumulation is essential for achieving greater economic growth, which can alone pull the growth at the earlier stages of openness. There are scopes for cutting down very high level of consumption expenditure of the economy to raise domestic savings.

ii. In moving towards capital account convertibility, financial sector vulnerability is probably the most serious concern for Bangladesh. Some appreciable prudential measures have been adopted in recent days; however, only strict execution and application of the adopted policies would provide expected result.

iii. Bangladesh's tiny stock market and government Bond market need a big push for effective monetary policy operation. Moreover, it is essential to have cooperation from fiscal authorities in adopting effective monetary policy in appropriate time to have indirect control on inflation and interest rate under floating exchange rate and free capital mobility in the future.

iv. At present, Bangladesh needs the type of FDI that will have significant impact on incremental exports in order to offset rising payment liabilities over time and to pull up foreign exchange reserves. High proportion of portfolio capital in the total capital inflows may be dangerous in the context of an economy having underdeveloped securities market. So, some forms of control on portfolio capital and on short-term foreign currency debt would be required at least at the earlier stage of capital account convertibility.

v. It is of course impossible to predict crises reliably. However, based on vulnerability indicators, it can be said that progress towards capital account convertibility with the existing weakness of the economy may not bring expected results or even may results in adverse developments.

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