7. CONCLUSION

It should be noted that this paper is not intended to suggest that either the Japanese, German or Korean models is perfect for emulation and can be replicated in Malaysia. Rather, it attempts to identify the theoretical considerations for considering different industrial financing options as well as the relevance of the Japanese, German and Korean experience for developing economies, particularly Malaysia. Given the different social and institutional settings, models must be adapted accordingly to serve policy priorities in different context.

An important lesson drawn from these experiences is that the quality and nature of the state intervention does matter. It has been pointed out that the pre-occupation of Malaysian leaders led by UMNO with emphasizing inter-ethnic wealth redistribution has undermined the nature and quality of state intervention.[78] As a result, 'an alternative agenda more conducive to late industrialisation efforts has been thwarted' (Jomo, 1993: 296). For instance, banks in Malaysia have been used by the state in the social engineering and wealth redistribution policies of the NEP. The issue here is can the state assume the kind of leading role played by East Asian NIC states, particularly Japan? On this issue, Jomo (1993: 299-300) has commented that:

> Unfortunately, however, Malaysian policymakers' overwhelming obssesion with inter-ethnic redistribution of wealth including the manufacturing sector, has undermined a potentially more economically and industrially progressive role for the Malaysian state, especially in support of domestic-led manufactuiring growth. Lacking a developmentalist state capable of playing such a role, the prospects for rapid, sustained, balanced and domestic-led industrialisation are uncertain.

A broad conclusion from this study is that financial restraint, based on the stylized analysis of the policies of some high performing East Asian economies, may be a desirable policy for late industrialising countries like Malaysia as these countries historical experiences as successful late industrialised nations is clearly more relevant for the country. It is recognised that a securities market-based system and a banking-based system can develop simultaneously while being of different significance in different time periods and for different players (Patrick, 1994: 370). Financial restraint, as explained in section 2.3, suggests that the securities markets should not be emphasized at a stage of development when an effective banking system is being developed. Given the imperfect and asymmetric information in the credit market, the experiences of Japan, Korea and Germany show that their bank-based systems were able to develop close long-term relations with industrial firms, monitor them more effectively and hence have an incentives to rescue or resuscitate firms in financial distress. They have relied heavily on their banking systems rather than stock markets for corporate finance and governance. Evidence seems to suggest that their banking systems play a vital role not only in the expansion but also the survival of the existing firms. Although there will be an increasing role of the stock market, the Malaysian financial system should not be hastly switched to the 'arms-length' market-based system.

The intention of the Malaysian government to liberalise the capital market to foreign financial institutions was unveiled in June 1995 when the Malaysian Finance Minister announced a package of incentives to attract foreign fund managers to Malaysia. The role of foreign funds is, however, a point of concern. Inevitabily, this will make the natinal economy much more vulnerable both to international macroeconomic fluctuations as well as capital flight (Singh,1992). The tasks of exchange rate management and controlling inflation will be much more difficult. It has been pointed out that:

> Although it was estimated that about 20 per cent of daily market structure was attributed to foreign funds, the influence of foreign funds would well be more than

> their share of the volume, as they are generally considered as market leaders. Their presence is crucial to lend credibility and international standing which are the important elements considered for raising future capital, locally and overseas. (Mansor, 1994: 10)

Moreover, 'in a deregulated, liberal environment, banks are prone to speculate or lend excessively in areas such as in real estate, stocks or commodities' (Park, 1994a: 20). The Japanese and Korean approach to financial liberalisation reflect a lack of confidence in the efficiency of free market. Malaysia has to be extremely cautious about liberalising or deregulating the domestic financial industry. What is needed is prudent regulation by the government to maintain a balance between the competitive efficiency of the financial sector and the safety of the banking system (Park, 1994a: 21; Chowdhury and Islam, 1993: 144).

NOTES

[1] Adam Smith as cited by Drake (1980: 31) observed that:

> I have heard it asserted that the trade of the City of Glasgow doubled in about 15 years after the first erection of the banks there, and that the trade of Scotland has more than quadrapled since the first erection of the two public banks in Edinburgh . . . that the banks have contributed a good deal to this increase cannot be doubted.

[2] For a survey of these views, see Kitchen, 1986: Chapter 3 and Drake, 1980: Chapter 3.

[3] Federal Republic of Germany or West Germany will hereafter be refered to simply as Germany, and South Korea as Korea.

[4] The discussion in this section is inspired by Chowdhury and Islam (1993), Akyuz (1983) and Hellmann, Murdock and Stiglitz (1994, 1995).

[5] See Akyuz (1993: 7) and the literature cited therein.

[6] In capital markets, the financial assets sold are securities with more than one year to maturity. Corporate stocks and bonds and government securities (each sold within a primary or secondary submarket) are the main sources of long-term business finance. In loan markets, we are concerned with the business loan which can be made, either by banks that draw their funds from deposits or by specialised lending institutions that draw their funds from the bond side of the equity market or from the money market. Company lending can be divided roughly into short-term and medium-to long-term loans.

[7] The information problems are sometimes referred to as 'principal-agent' problems as each agent's action affects the welfare of the principal and the principal tries to ensure that each agent will behave according to the principal's interest.

[8] See for example, Asquith and Mullins (1983).

[9] By rents, they mean returns in excess of those which would generated in a competitive market, and not income that accrues to an inelastically supplied factor of production.

[10] This simple demand-supply model assumes no transaction costs in intermediation.

[11] An important aspect of franchise value is that it creates long run equity that cannot be appropriated in the short run since banks have an ongoing interest to stay in business. Thus, franchise value creates commitment for the bank to act as a long run agent.

[12] Hellmann, Murdock and Stiglitz distinguish between two potential sources of competition. First, there may be excessive entry into the banking sector. Second, there can be excessive competition among existing banks.

[13] See, for example, Hellmann, Murdock and Stiglitz, 1995: footnote 33.

[14] The analysis in this section draws on Singh (1992).

[15] See, for example, Poterba and Summers (1988). They examined monthly data on New York Stock Exchange returns from 1926 to 1985 and annual returns from 1871 to 1985. They also analysed monthly data for 17 other equity markets over various periods. In each case, the results suggested that the presence of important transitory components in stock prices resulted in deviation 'from the stocks' fundamental values. For a non-technical analysis, see Dertouzos, Lester and Solow (1990: ch. 4).

[16] While banks and insurance companies provide long-term finance for Japanese industrial firms, they do not do so in the United States due to short-termism. For details, see Dertouzos, Lester and Solow (1990: ch. 4).

[17] If the managers were not maximising the market value of the firms, this would render the firms attractive to takeover raiders.

[18] The argument is drawn upon recent developments in the economics of information. For instance, outsiders face difficulty in determining whether a firm is or is not efficiently managed. Moreover, the takeover mechanisms are ineffective since current managers are often in a position to take strategic actions that deter takeovers.

[19] The distributional form of stock price changes reflects the riskiness of an investor's investment and standard deviation is used as a measurement of this risk.

[20] See WIDER, 1990: 6.

[21] For the effects of incorporating the transaction costs of issuing securities, see Allen (1990).

[22] Debt is a highly complex contract because it entails a promise whose fulfilment by repaying principal and interest on a loan is by its nature uncertain and will differ among borrowers. Complete contracts would have to specify the behaviour of the borrower in every possible contingency.

[23] With asymmetric information and incomplete contracts, there is an incentive for a borrower to change his behaviour after the contract has been agreed, so as to maximise his wealth at the expense of the lender. For example, the borrower might use the funds to engage in high-risk activities that entail a lower possibility that the loan will be repaid. Thus, the lender must monitor the borrower after the loan is granted to ensure that the borrower is not acting contrary to his interest during the contractual period.

[24] The borrower's deposit history provides the information that banks require to sort out good from bad risks.

[25] Schumpeter assigned such a role to banks as he points out that '. . .the banker must not only know what the transaction is which he is asked to finance and how it is likely to turn out but he must also know the customer, his business and even his private habits, and get, by frequently "talking things over with him", a clear picture of the situation' (Schumpeter, 1939: 116).

[26] In case of such a default, i.e. failure of the borrower to comply with the term of the debt (contract), the bank monitors the situation and uses the information to renegotiate the contract at a new interest rate and contingent promises (Diamond, 1984: 395).

[27] Diamond termed these delegation costs.

[28] In his model, diversification occurs when the intermediary invest in a large number of firms with independent payoff risk.

[29] A loan contract allows managers (borrowers) to remain control as long as they do not default. But in the case of default, control transfers to lenders as they have certain rights of intervention defined by the loan contract.

[30] For example, banks often retain much discretion in altering the premiums they charge on loans.

[31] For example, *ex ante* monitoring is performed by investment banks acting as underwriters for large firms. Rating companies may be considered to be engaged in interim monitoring as well as *ex ante* monitoring as they not only keep track of the changing financial state of the firm, but their ratings also affect the firm's capacity to raise new funds from capital markets. Interim monitoring of management may be directly performed by board directors, which is in turn subject to direct and indirect pressures from major stockholders. The takeover mechanism may be regarded as an *ex post* monitoring device for the Anglo-Saxon system.

[32] Aoki (1994: 111) provides a clear example of this: 'the profitability of a steel project is affected by the availability of power, which may, in turn, be crucially affected by the construction of a new dam, if the level of accumulation in the power industry is relatively low.'

[33] This section owes much to works by various authors, especially Aoki (1995), Patrick and Park (1994), Hoshi, Kashyap and Scharfstein (1991), Cargill and Royama (1988), Hofmann (1992) and Baums (1994).

[34] See Berglof, 1990: 244-5; Vittas, 1986:3; Rybczynski, 1984: 277-8.

[35] However, it should be noted that this classification of financial systems is no longer as clear-cut as it used to be as strong forces has ben at work, reshaping the finanical systems and consequently the differences between the bank-based and market-based systems may diminish in the near future. With globalisation and internationalisation, the financial systems have converged along some dimensions. Nevertheless, the distinction should be viewed to be of significant interest for analysis purposes (Berglof, 1990: 245).

[36] See Davis (1992: 23-24).

[37] The provision of external finance from savers to end-users via financial intermediaries is termed indirect financing.

[38] Teranishi attributes the high level of financial intermediation to the reduced role of traditional financing, the underdevelopment of the securities market and limited access to foreign asset holdings. For details, see Teranishi, 1994: 37.

[39] The reason for this increasing household preference for indirect holding of securities is to avoid some of the information problems encountered if they purchase directly from the markets since they feel that the ITCs have better information than they do.

[40] Cameron (1967) and Gerschenkron (1962) are the two standard historical references on the critical role of banks in promoting industrial development in 19th century Germany.

[41] See OECD, 1995, Figure 23: 91.

[42] Because German firms have greatly relied on internal finance, they have been much less dependent on external debt financing from banks than have firms in Japan (Prowse, 1995: 22).

[43] Other salient government bodies, such as the Ministry of International Trade and Industry (MITI), the Ministry of Post and Telecommunications and the Ministry of Transportation, have had important relations with with private sector industrial credit. Calder (1993) has stressed that while MITI has long supported a developmental approach to industrial transformation, the conservative agencies (pre-eminently, the MOF and the BOJ) have been preoccupied with regulation of the private financial institutions through which credit allocation was carried out, rather than with industrial transformation. For a detailed discussion on how these diverse governmental entities have related to one another in this area of overlapping jurisdiction, see Calder (1993: Chapter 3).

[44] As a direct consequence of financial repression and credit rationing in the modern financial sector, part of the traditional Korean financial sector evolved into an unregulated, informal (curb) market. They supplied firms with short-term credit beyond what the commercial banking sector was able to provide. For a discussion of the Korean curb market, see Harris, 1988: 376-377.

[45] The main functions of the Bundesbank are (Hofmann, 1992: 1-2):

1. The sole issuer of local tender
2. The bankers' bank
3. The state's bank
4. The guardian of monetary reserves (resulting mainly from interventions in foreign exchange markets).

[46] This distinction, however, is eroding under the pressures of global competition and liberalisation. For details of the wide range of activities conducted by German universal banks, see Hofmann, 1992: 9-10.

[47] For a summary of the financial deregulation measures in Japan from 1976 to 1991, see Patrick and Park (1994: Table 3.1A).

[48] DMBs include commercial banks, government-owned special banks and the banking activities of three groups of primary sector cooperatives.

[49] For detailed elaboration of each of the reforms, see Park (1994: 150-3).

[50] Despite being required by law to support the Federal Government's general economic policy, the Bundesbank Act granted the Bundesbank continued independence in monetary policy issues; the government and other parties are not entitled to give instructions to the Bundesbank in this field (Hofmann, 1994: 1).

[51] For a historical treatment of zaibatsu and the early development of keiretsu, see Hadley (1970).

[52] See Table 1 in Berglof and Perotti (1994: 265).

[53] Financial distress occurs when a firm cannot meet its contracted obligations. In empirical studies, it is defined in terms of operating income being insufficient to cover interest income in a given period (Sheard, 1994: 189).

[54] This term is used interchangeably with gearing, and refers to debt as a proportion of the gross value of total assets of the firm. High leverage due to excessive borrowing may not be desirable because the firm may become insolvent and be proclaimed bankrupt, due to demands for interest payments and repayment of loans, in spite of the good prospects that the firm may have.

[55] For details, see Nam and Kim (1994: 462).

[56] See Baums (1994: Table 12.5) for data on German bank shareholdings in large industrial firms

[57] Often acquired as part of capital reconstruction in rescue operations, or in the course of arranging stock market flotations (Cable, 1985: 120).

[58] The German universal banks also offer their customers custodial services for shares deposited by owners with the banks, administer them (e.g. cash-in dividends) and vote for them at shareholder meetings.

[59] For details, see Baums (1992: 506-7); Cable (1985: 120).

[60] The complete survey is well-documented in BNM (1994).

[61] Those institutions whose principal liabilities are generally accepted as money.

[62] Those institutions which are closely linked to the monetary institutions and whose liabilities are generally accepted as near money.

[63] These Acts include the Central Bank of Malaya Ordinance, 1958; the Banking and Financial Institutions Act, 1989 (BAFIA); the Islamic Banking Act, 1983; and six laws settings up Labuan as an International Offshore Financial Centre.

[64] This power to regulate interest rates does not apply to Islamic banks.

[65] The 'indigenous' population comprising the Malays, Dayak, Kadazan, Murut and so on.

[66] From 1981, small-scale enterprises were defined as businesses with net assets of up to $250,000 each. The limit was raised to $500,000 per enterprise from 1988. In view of the high risk involved in lending to small-scale enterprises, the Credit Guarantee Corporation (CGC) was established by the state in July 1992 to provide guarantees against default for loans extended by commercial banks to eligible small-scale enterprises.

[67] This is to ensure that this provision does not allow 'back door' nationalisation by the state.

[68] The first step to liberalise interest rates was taken as far back as 1971 when fixed deposits placed with commercial banks for maturities exceeding four years carried market-determined interest rates. In January 1972, interest ceilings for all commercial bank deposits with maturities exceeding one year were lifted. From August 1973, interest rates on deposits placed with finance companies were freed of BNM control (BNM, 1994a: 43).

[69] The real sector reform by the state in the early 1980s was necessary to tackle the problem of a prolonged and deep recession which hit the economy then.

[70] Initially, these regulations were imposed on commercial banks but were later extended to merchant banks from 1979.

[71] Among the banks initially set up and owned by Chinese were Kwong Yik Bank, Lee Wah Bank, Malayan Banking and United Malaysian Banking Corporation. Ban Hin Lee Bank is one of the last family-owned banks in Malaysia.

[72] Comprising construction, housing and real estate.

[73] Recently lending for the purchase of stocks and shares and loans secured by stocks has been growing sharply, rising at a rate of 8.4 per cent in 1989 but more than doubled the growth in 1990 (Zainal *et al.*, 1992: 42).

[74] For details of the composition of the GDP by industry of origin, see Table 1.2 in Bank Negara Malaysia (1994a: 6).

[75] For details of how the ERF has operated, see BNM (1988: 98).

[76] This conclusion is drawn from the author's interviews with bankers and credit officers of three local banks and MIDA officers.

[77] For more examples of financial abuses by Malaysian politicians, see Gomez (1994: 59-60).

[78] See Jomo (1993: 296) and the literature cited therein.