Tony Latter: Banking and development

Address by Mr Tony Latter, Deputy Chief Executive of the Hong Kong Monetary Authority, at the 2001 APEC Economic Outlook Symposium held in Hong Kong, 28 June 2001.

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I should like this morning to address three particular aspects of the broad topic of banking and development. One is the contribution of banking – or the financial sector more generally – to the economy in terms of activity. The second is the role of banks as providers of cross-border finance for development. The third is the implications of the internet revolution for the development of banking itself.

Contribution of banking to the economy

Our very distant ancestors survived without money, let alone banks. With the passage of centuries and the growing complexity of barter, physical money emerged as a useful unit of account, a medium of exchange and a store of value. Still later, banks emerged as intermediators between, on the one hand, those with holdings of money surplus to immediate need and attracted by the prospect of earning interest, and, on the other, those willing to pay interest in order to be able to accelerate their spending. With the further passage of time various other means of intermediation, such as marketable securities, also developed.

A key point here is that banks only emerged because of the evident utility in the service they provided. Throughout the world we can now see examples of how banks and other financial institutions have facilitated the funding of the development of the rest of the economy, and how at the same time they have enabled savers to obtain returns on their savings and to allocate desired expenditure efficiently between the present and the future. Of course, there have been shortcomings, mistakes and disasters along the way, where market failures have impaired efficiency or where banks have collapsed as a result of poor judgement or of circumstances beyond their reasonable anticipation or control; but such experiences are found in all areas of economic activity.

Despite, however, the evident benefit from having an active and efficient financial sector, there have remained people at different times in history who have been sceptical of the intrinsic worth of banking as an economic activity contributing to aggregate welfare. This attitude has often reflected a presumption that activity only has merit if it delivers tangible output – food, clothing, cars, clearly consumable services such as television programmes, and so on. But this belief contradicts the evidence of the contribution which efficient finance makes to the economy, and the necessary role which it plays. Even the strictest communist regimes of the twentieth century found it impossible to dispense entirely with banks, even if, as a result of fantastic accounting and rotten economic policies in general, the banks mostly ended up bankrupt and depositors penniless.

The essential raison d'être of banking is that an economically advancing society needs effective intermediation between savers and borrowers, and mechanisms for making payments efficiently. As already noted, the initial basic intermediary function of providing deposits and loans expanded subsequently into the organisation of alternative channels of intermediation such as bonds and equities (these activities may be conducted in some jurisdictions outside the narrowly defined banking sector, but the distinction is not material in the present context). Although it is human nature for savers to complain that the returns are inadequate, and borrowers that costs are extortionate, in the market-oriented economies competition in financial intermediation has mostly been quite intense, and most of us would probably agree that this has worked to the increasing benefit of customers on both sides of the balance sheet.

Meanwhile, the provision of payment services has developed markedly at both the wholesale and retail levels. Banks are at the centre of this activity, typically supported by the central bank as ultimate provider of liquidity. In fact, whereas many other types of institution may nowadays be involved in lending money or providing avenues for savings, banks themselves remain firmly at the core of the payments system. A sound and efficient payments system is acknowledged to be a prerequisite if an economy is to realise fully its potential.

Banking facilities have become so much an accepted and necessary part of life that access to them is sometimes regarded as an absolute and unconditional right, in the same way as is argued for universal education or health services. This has been a topic of debate in Hong Kong recently, in the context of likely changes to savings rates and to fees and charges in the light of the final deregulation of interest rates next week. As a general rule, however, businesses such as banks should be allowed to determine their own strategies in the light of market forces, although the authorities may claim a legitimate interest in ensuring that those market forces do indeed function competitively. One bank may decide that the provision and encouragement of the widest possible access to its services fits well into its business plan; another may decide otherwise. In the rather unlikely event that insufficient basic banking services are available to some section of society, the case may be argued for official intervention. But one must distinguish between different aspects of the situation – commercial, competitive and social. If, other things being equal, banks are to be pressed into assisting with the delivery of social policies, then the precise terms of that obligation, including responsibility for funding it, should be made clear – whether by law or in suitable agreements or codes.

In Hong Kong, banking, in a rather narrow definition, is estimated to contribute about 7.5% to gross domestic product and about 3.5% to employment. Despite the withdrawal of a number of individual banks, particularly Japanese, from Hong Kong in the late 1990s, the share of banking in GDP appears to have remained roughly stable for a number of years now. However, the share in employment has declined somewhat of late – as has also been evident in, for example, the USA and UK over a slightly longer period. This implies that there have been significant productivity gains, including no doubt those arising from the process of consolidation, which has been evident among international banks with presences in Hong Kong for some time and has now been spreading to the local banks.

Permit me one further historical reflection, related partly to my earlier comment about attitudes towards banking. When I first studied economics, there was a respected body of literature which argued that productivity growth in manufacturing would always outstrip that in other sectors because manufacturing was more amenable to the application of new technologies and economies of scale. In services, output was regarded as too firmly dependent on the specific input of labour for there to be much scope for productivity gains. This reasoning even led some governments to adopt policies with a bias to promote manufacturing in the belief that this would be the route to more rapid overall growth, although this seemed to ignore the demand side – that the public would become saturated with goods and increasingly desire to consume services. I don't know whether any of the protagonists of that school of thought are still alive today. If they are, and even if they could still identify some services where productivity has not advanced very much (hairdressers and taxis are among the usually quoted examples), they would be astonished at the productivity growth which has been apparent in banking and certain other service sectors around the world in recent years, as a result of the forces of globalised competition and the opportunities presented by technological advances.

It is clear, therefore, that banking and other financial services not only provide essential support to development but also make their own contribution to national income. I am often asked questions such as what is the long-term growth prospect for this sector or how will the mix of activities within the sector evolve. The simple and honest answer is that I don't know. Plainly, there are limits to the likely domestic demand for these services. But that demand may be supplemented if overseas customers are attracted to use our local services, or, of course, diminished if local customers choose to satisfy some of their needs from overseas. At the end of the day the pattern will depend on efficiency and the laws of comparative advantage. From the official side, we in Hong Kong are anxious to provide an infrastructure and business environment on a level playing field within which such activities can flourish, but we are not capable of determining the outcome.

The role of cross-border bank finance in economic development

In the absence of an adequately developed financial sector, sound enough to enjoy the trust of the local community and offering sufficiently attractive products, it may prove difficult to channel domestic savings into domestic investment. This is a problem which confronts many less developed and emerging economies. The result is often that, despite a quite strong disposition of households to save, the preference is to exploit all means, legal or otherwise, to hold those savings offshore. In consequence, domestic enterprises and government may become more dependent than otherwise on attracting funds from abroad to fulfil their funding needs. This may have the salutary advantage of exposing the borrowers to the discipline of the international market place, but it may also saddle them with higher costs and currency risk. Moreover, historically, the lending institutions have not always possessed sufficient local knowledge to enable them to make sound credit judgements.

This role of banks as providers of cross-border funding for development is the second topic on my list today.

The subject is perhaps topical for not the happiest of reasons. For the past couple of years the banks, along with international bodies and fast-food chains, have become the main target for anti-globalisation and anti-capitalist protests. I leave others to muse on the motivation and justification for such actions, but I do note that bank finance for developing countries, and more particularly the question of debt forgiveness, are prominent items on the protest agenda. I also note that this is a subject which has for several years been keenly debated, more soberly, by governments, international organisations such as the IMF and World Bank, and banks themselves.

It is a complex issue. One must never lose sight of the fact that bank lending involves a contract between the bank and the borrower, and the parties should be expected to honour that contract. If it is treated otherwise, then the basis for all future relationships crumbles. But in practice the situation is hugely complicated if there is a syndicate of lenders, giving rise to problems of co-ordination and potential free riding, or if the World Bank or IMF are involved, which typically expect to be at the front of the queue for repayments. At the end of the day, commercial banks may decide that a degree of debt forgiveness (possibly disguised as a generous rescheduling) is advisable as the best means of minimising overall losses and, perhaps, preserving longer-term business opportunities with the country or customer in question. But this should be a commercial decision. If governments wish, for political or humanitarian reasons, to ease further the contractual debt burden of an indebted country, this should be carried forward as a conscious and transparent policy decision, which would surely involve usage of taxpayers' money unless it was reliant on coercion of banks.

In practice, there are many developing countries which are effectively cut off from commercial bank finance because of a track record of default, political instability, economic mismanagement, corruption and so on. Banks generally need certain minimum assurances, relating to the political climate, the legal system, transparency, corporate governance, etc, over and above the narrower assessment of the servicing capacity of the borrower. Fortunately, most economies in the APEC fold can be classified as open for bank finance. But there are many other countries in the world which are passed over by the international banking community because of the lack of the basic essential attributes, or because they are simply too poor to afford credit on commercial terms, in which case they become dependent on concessional finance from the international institutions as the only reasonably accessible source of external funding.

Banks have to abide by prudent standards. Regulators, depositors and shareholders all expect as much. Most banks would leap at the chance to lend more to assist development, if such lending was assessed to be commercially viable. But as a general rule banks should not be prevailed upon against their better judgement to be providers of economic aid or social services, whether domestically or internationally, unless there is the political consensus that taxpayers are willing to fund them in that role.

The internet

Turning now to the internet, I believe that this has some relevance to the overall theme of this symposium, not so much because of questions about the availability of banking services to those who need them, but rather because of possible implications for the location and structure of banking activity.

Let me begin by observing that, ever since the telecommunications and IT revolutions began substantially to impact on banking – and that, depending on how exactly one defines the terms, was at least two or three decades ago – some commentators have been forecasting the imminent demise of financial centres as such. The argument is that all the humdrum work will be carried out in computer centres and call centres in low wage countries, while the high value adding executives can locate where they wish – depending on their preferences for recreation, culture, climate and so on – and tele-conference one another when necessary. The former – the migration of routine operations to low-cost places – has happened to a degree, but the latter has not. Even if colleagues within a bank can sometimes substitute a conference call for a meeting, their customers have been less eager. Although for basic banking services little personal contact may be necessary, deals in such fields as corporate finance and investment banking appear to require interaction between a number of parties face-to-face. Indeed, in recent years the world's major financial centres may, if anything, have become more rather than less dominant as a result of the demonstrable benefits of co-location and critical mass particularly in the context of the higher value-added activities.

How does the internet fit into this picture. The new dimension which the internet brings is to revolutionise the access of customers to banks – and banks to their customers. Already we know that huge numbers of customers have moved over to using the internet to carry out their basic banking business. This may in turn have enabled banks to realise cost savings, although it is as yet not easy to find hard evidence to this effect.

The implications for the structure of banking are unclear. One may envisage two extreme outcomes. One would be where banks, both established ones and new ones created as internet-only providers, compete fiercely in all areas of banking where human contact is not required. Consumers flit around from one to another in response to the best deals, splitting their banking relationships across a number of banks if that appears cost-effective. The prices of these services are driven down to "commodity" levels. None of the banks makes much of a profit from it. Some of the "old" ones suffer loss of their bread-and-butter business. The outcome in the longer term is unclear. It is conceivable that banks cease to exist as integrated multi-product businesses. They become instead product specialists in a rather fragmented landscape, finding it tough to earn more than commodity profits even in areas where, in the case of the longer established banks, they used to enjoy niche advantages.

The other scenario emanates from the same starting point of intense competition. But in this case the new entrants do not have the resources to continue with their generous initial terms for long enough to secure a firm business foundation. The established banks reluctantly but necessarily take on the newcomers aggressively, utilising their financial strength and making extra efforts to build robust relationships across a broad range of services and to exploit the underlying inertia that customers may exhibit. In other words, they use the internet to consolidate their relationships and to see off the competition. Customers are persuaded that it's not worth sacrificing the relationship for the sake of a few basis points. Some customers may be lost, but some of these may anyway be ones which the banks can afford to say goodbye to. As a variant to this model, the banks may adopt different brands for their internet services, exploiting any opportunities available from product differentiation and market segmentation, but retaining the capacity from their standpoint to manage multiple relationships with any individual customer as one.

One can envisage many other outcomes besides these examples. I know of no sure way of predicting what will happen, but my personal view is that the internet is likely to emerge more as a channel to build on existing relationships and to increase the efficiency of basic services than as something which changes the landscape of the banking industry. But perhaps I am guilty of thinking that everyone else possesses the same inertia as I do when it comes to changing one's habits.

Concluding remarks

I have skimmed over a few issues which can rather loosely be said to fall under the heading of banking and development. There are many experts attending this symposium who will, I am sure, offer much deeper and more provocative insights into the economic outlook in general, and the relationship between financial development and growth in particular. I wish you all a fruitful and enjoyable couple of days.