IMPACT OF GOOD GOVERNANCE ON BANKING SECTOR DEVELOPMENT IN ASIAN REGION

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Abstract

After the socio-economic revolution and the establishment of the free market institutions, the development and improvement of living standards in post-transition economies are deemed to depend more and more on the so called secondary 'generating' reforms, at the core of which is the good governance. Drawing from this approach, this study seeks to address the role and the effect of the good governance in the banking sector development of the Asian countries. The main objective of this study is to evaluate the impact of good governance on banking sector development in Asian countries using a panel of 23 countries from 2008-2015. It utilizes the system Generalized Method of Moments (GMM) dynamic panel model estimator. The researcher creates a new governance indicator (NGVI) that summarizes the existing six governance measurements in the Worldwide Governance Indicators (WGI), using the Principal Components Analysis (PCA) method. Proxies for banking access by commercial bank branches per 100,000 adults (BB), size by deposit money bank assets to GDP (DBGDP), stability by concentration ratio (CR) and efficiency by bank returns on assets (BROA) measure the banking sector development. Results indicate that governance indicators strongly influence to the development of banking stability. Finally, study found that good governance is very important to increase top 3 banks' market share in the Asian region. Since, the relevant authorities should take the decision to enhance the institutional quality promoting good governance to further improve the banking sector towards the overall growth of the financial sector in the region.

Keywords: good governance; banking sector development; concentration ratio; Generalized Method of Moment.

Introduction

Financial sector is considered as the back bone of the economy. In a financial system, banks take the main portion in many economies. Since to achieve sustainable economic development effectively and efficiently, strong banking sector development are primary requirement (Levine, 1997). However, it is clearly evidenced that good governance through institutional quality has immensely contributed to sustainable development of the economies also. During past two decades, world financial crisis brought many consequences to whole world and life of the people. Among the diverse perspectives of the scholars, economists have identified that poor institutional quality among the operations of the banks became a pivotal cause for the global financial crisis. Essid, Boujelbene and Plihon (2014) viewed that Poor institutions constitute the key determinants in explaining the emergence of banking crises. Since the need for good governance is extensively accepted by the economies and global institutional like World Bank and International Monetary Fund. Thus, the objectives of such organizations have expected on the exhortation for good governance to achieve economic development is widespread.

Studies on banking sector development with financial sector development have enough evidences on its relationships with institutional qualities and governance matters worldwide. Such studies highlighted that though there are many determinants for the banking sector development, good governance influence higher manner to enhance the institutional quality of the banks to prevent negative consequences (Francesco & Beniamino, 2017). Early studies were researching the interaction between the qualities of public administration, institutional qualities on financial development. Institutional qualities are the one aspects of the good governance. Further, it is expected to build economies that are socially inclusive and environmentally sound will be vital for achieving sustainable development. Measuring the good governance through six indicators, World Bank objective is to enhance empirical research on governance to provide an advocacy tool for policy reform and monitoring worldwide. Since, Kaufmann, Kraay & Zoido-Lobaton (1999) initially developed the six aggregate indicators as the basic governance concept for cross-section of more than 150 countries with a new data base containing more than 300 governance indicators. They have defined governance as the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected and replaced, the capacity of the government to formulate and implement sound policies, and the respect for citizens and the state for the institutions that govern economic and social interaction among them. However, in present Worldwide Governance indicator data base is comprised with six dimensions of governance for more than 200 countries. The Asia region which is the largest and most populous continent, located primarily in the Eastern and Northern Hemispheres. Despite the region's success in producing fast-growing economies, many countries still face a host of governance issues, including poor public services, weak government institutions, and corruption.

However, under this scenario, the Asian region is considered as the most emerging continent to reach its highest potentials in an economy than Europe and America during future time. As mentioned above, to capture the expected growth potentials, banking sectors of the region must perform effectively and efficiently without further crisis among the countries. Since, explore the effect of good governance on banking sector is a primary and expected need of the policy makers. However, countries in the Asian region have been experiencing diverse nature of governance issues due to the various kinds of political and socio-economic reasons. So, database evidences that the South Asian region always ranks below the average of the sample with some other Asian countries and It is found that governance issues have played a significant role in countries' progress towards achieving the Millennium Development Goals (MDGs). Since the effective implementation of policies for achieving MDGs required the appropriate governance structures as well as the overall application of good governance principles. Now the Sustainable Development Goal has been introduced to enrich the world on 17 goals and its 17th goal also talks that strengthen the means of implementation and revitalize the global partnership for sustainable development. It is obvious that, to achieve such a progress, financial sector including banks must play a significant role in this regard. Since, some evidences showed that good governance is a most important factor when considering about the banking sector development. Out of many empirical evidences, Yilmaz (2017), researched the interaction between various dimensions of public governance and the development of financial sector in 15 Central and Eastern European economies over the period 2002-2015 employing panel regression and found that all the six dimensions of good governance had positive influence on the development of financial sector. Acemoglu and Johnson (2005) asserted that institutional development affects the development of financial sector positively, because the quality of public administration and rule of law have direct impact on the manipulative, regulating, and the functioning of the financial system. However, Baltagi, Demitriades & Law (2007) found that institutional development influenced development of banking sector and capital markets positively. Laura, Codruța and Maria (2016) found that governance has significant influence upon life insurance market in 31 European countries during 2002-2012 using an overall governance index by principal

component analysis using system-GMM. Zoli (2007) also revealed that the institutional improvement affected the development of financial sector positively in emerging European countries over 1995-2006 periods. Further, Huang (2010) also found out that institutional development affected financial development positively in 90 non-transition economies over 1960–1999 period employing in panel regression study.

To assess the banking sector development, many researchers have used only the traditional measures, such as size, depth and development of a country's banking (financial) sector using ratio of M2 to GDP, the ratio of private credit to GDP. However, it is important to focus on new dimensions in assessing banking sector development as efficiency and stability indicators. In particular, both these traditional measures have been used to show the causal effects of financial development on economic growth. However, both measures have some limitations. The ratio of M2 to GDP captures the degree of monetization in the system, but does not capture the degree of bank intermediation; ratio of private credit to GDP does not control for non-performing loans and, more generally, the quality of credit allocation. Not only that, both measures do not capture the broad access to bank finance by individuals and firms, the quality of bank services and the efficiency of providing banking services. Further, Globerman and Shapiro (2002) viewed that in relation to governance indicators, which are considered as superior, since they are estimated using 31 different qualitative indicators from 13 different reliable sources. Thus, these meta-indices would encompass most of the other measures. However, being these indices highly correlate with each other, Globerman and Shapiro (2002), have suggested that aggregate measure of these by estimating their first principal component, which would efficiently represent the institutional excellence.

Literature Review

The World Bank (1989) viewed that good governance as a provision of efficient public services, responsive administrative system and reliable judicial system and it is a good model for structural reform in order to developed aid-recipient countries. After implementation of structural adjustment policies and emboldening developing countries for deregulation, privatization and other reforms, which were mostly economic, and their failure in target countries; good governance is the most important one, proposed by other perspective. The concept of good governance closely linked with evolution of human civilization. Governance is the manner in which public officials and institutions acquire and exercise the authority to shape public policy and provide public goods and services (World Bank, 2007). Simply the word and concept of governance refers to accountability and responsiveness in both policy and execution. As reported by Klimovsky (2010), the applying of the Good Governance concept is also promoted by international, multinational and national subjects such the World Bank, United Nations, International Monetary Fund, Organization for Economic, Co- operation Development, European Union or Council of Europe.

However, the World Bank (1999) defines the good governance in the project of making Worldwide Governance Indicators (WGI), as the ethnicity and institutions by which is exercised the power in the country. In here, Good Governance is considered as a set of three interconnected aspects; Process of selection, monitoring and stand-in of governments, Capacity of the government to effectively invent and execute suitable policies, and Respect of general public and the state to institutions that conclude the socio-economic environment in the country. After the World Governance indicators were first developed (Kaufmann, Kraay & Zoido-Lobatón, 1999), Kaufmann, Kraay and Mastruzzi (2011) defined governance as the traditions and institutions by which authority in a country is exercised. They have included three dimensions as the process by which governments are selected, monitored and replaced, the capacity of the government to effectively formulate and implement sound policies and the respect of citizens and the state for the institutions that govern economic and social interactions among them. For the purpose of empirical studies each dimension has been included two indicators of each as follows. Process by which governments are selected, monitored and replaced is measured by Voice and accountability, Political stability and absence of violence/terrorism, Government effectiveness,

Regulatory quality, Rule of law and Control of corruption. The banking sector development indicators introduced by Financial Sector Development Indicators (FSDI) project, has compiled indicators that go beyond size, and can help assess access, efficiency and stability of financial systems across and within countries. According to this traditional and new category there are number of indicators shows in Table 1.

Popular theories of Rajan and Zingales (2003) focused on the political incentives for financial development. In their discussion, the interest group theory suggests that development of the banking sector as well as the capital market improves competition and allows the entry of credit-constrained firms. However, as a major barrier, incumbent interest groups oppose financial development. However, their opposition is weaker in case of liberal trade policies and free cross-borders capital flows. Property rights institutions between the transactions of private debtors and creditors showed a major influence on financial development (Acemoglu & Johnson, 2005). However, the international donors like the International Monetary Fund (IMF) and the World Bank seek the best use of aid to achieve economic development in receiving countries, these donors use good governance characteristics introduced to evaluate the performance of receiving governments. Economic crisis in late 2000s caused many countries to suffer politically and economically as a result of weak economic infrastructures at both global and local level (Bernanke, 2009). The economic crisis can be defined as general slowdown of economic activity characterized by a decrease in GDP, a drying up of liquidity, and a high rate of unemployment. Thus, it would influence to decrease the international trade and investment. Because of the economic crisis, it has caused to the economic rescission in past years in many countries. Due to this economic and financial crisis, many countries have taken economic and political actions in response to such economic crisis. It was accepted that economic crisis is not started at once and is a result of series of earlier events. Good governance as a market-promoting governance strategy emerged of the development strategies attempted by developing countries.

Table 1: Banking Sector Development Indicators

Traditional	New
Size	**Access**
Deposit money bank assets to GDP	Branch and ATM density
Central bank assets to GDP	Average loan and deposit size
M2 to GDP	Loan & deposit accounts per capita
Deposits to GDP	% of people with bank account
Private credit to GDP	Collateral needed for loan
Private credit to total credit	% of firms with financing constraints
Private credit to deposits	**Efficiency**
	Return on assets
	Net interest margin
	Operating costs
	Lending spread
	Days to clear check
	Concentration ratio
	Ownership
	Stability
	Capital adequacy ratio
	Loan concentration
	Firm leverage

	Liquid asset ratio
	Net FX position-to-capital
	Non-performing loans
	Real credit growth
	Large loan exposures to capital
	Interest coverage ratio
	Household debt to GDP
	Default probability of banks

Source: Financial Sector Operations and Policy

When consider the evidences from previous empirics, law-finance hypothesis (La Porta, 1997) and the hypotheses of endowment and economic institutions of Acemoglu and Johnson (2005) asserted that institutional development affects the development of financial sector positively, because the quality of public administration and rule of law have direct impact on the manipulative, regulating, and the functioning of the financial system. According to the Bayar (2017), the interaction between various dimensions of public governance and the development of financial sector in 15 Central and Eastern European economies over the period 2002-2015 employing panel regression found that all the components of public governance including political stability, quality of governing institutions and regulatory environment (government effectiveness, regulatory quality, and control of corruption), and rule of law except voice and accountability had positive influence on the development of financial sector. However, in the study of Baltagi, Demitriades & Law (2007) found that institutional development influenced development of banking sector and capital markets positively. Demirgüç-Kunt and Huizingha (2001) found that in the context of developing economies, too express and uniformed liberalization of the banking industry might not bring best possible outcomes. Specifically, the higher banking sector development is related to lower banking sector performance mostly appropriate to the tougher competition. Laura, Codruța and Maria (2016) evaluates the relationship between governance and the development of the life insurance market in 31 European countries during 2002-2012 using an overall governance index by principal component analysis. Results found that governance has significant influence upon life insurance market. Study employed the dynamic panel methodology in the system-GMM form with several socio-economic control variables and a dummy variable. Zoli (2007) also investigated the determinants of financial development in emerging European countries over 1995-2006 periods with panel regression and revealed that institutional improvement affected the development of financial sector positively. Huang (2010) researched the interaction between institutional development and development of financial sector in 90 non-transition economies over 1960–1999 period employing panel regression and revealed that institutional development affected financial development positively. Gries and Meierrieks (2010) also examined the factors behind the development of financial sector in 19 African countries during the period 1984-2007 and revealed that institutional improvements influenced the development of financial sector positively.

According to the Aluko and Adebayo (2017) investigated that institutional quality, population density, and trade openness increases the depth of the banking sector. Study done by the Özkan-Günay, Günay and Günay (2013) assessed the impact of regulatory policy which is a proxy under the regularity quality of World Governance Indicators on the efficiency of different sized commercial banks in the over the period 2002-2010 and results found that regulatory policies have a positive effect on the efficiency of banks. Particularly, large and medium size banks outperform small banks. Boutin-Dufresne, Peña, Williams and Zawisza (2013) fond that institutional factors are very important when explaining high interest margins in the East African community using the bank level data of four regional blocks in Sub-Saharan Africa and one comparator block in the Eastern Caribbean. In here it is considered that World Bank Governance Indicators average (GIs) is the best available proxy for institutional quality, not only for its greater accuracy, but also for its wider geographical coverage as cited by the Kaufmann, Kraay and Mastruzzi (2006).

Methodology

The following figure 1 depicts the conceptual framework which represents the relationship between good governance, banking sector development with control variables. Independent variables are consisting with governance indicator (GVI) which is composed by the principal component analysis using six governance indicators, lagged variable of the banking sector development (BSD_{t-1}) proposed by the GMM in to the model to remove the endogeneity and seven control variables. Then Banking sector development is separately measured through four indicators; Commercial bank branches per 100,000 adult (BB), Deposit money bank assets to GDP (DBGDP), Bank return on assets (BROA) and Bank concentration (BC).

Population and Sample

Among the 10 major geographic regions; Africa, Asia, North America, South America, Central America, Eastern Europe, European Union, Middle East, Caribbean, Oceania, Countries of the Asian region is considered for the study to represent the sample which is the largest region in the world. Asian region consists of 48 countries and 23 countries is included for the sample due to availability of the data for relevant variables from 2008 to 2015 time period.

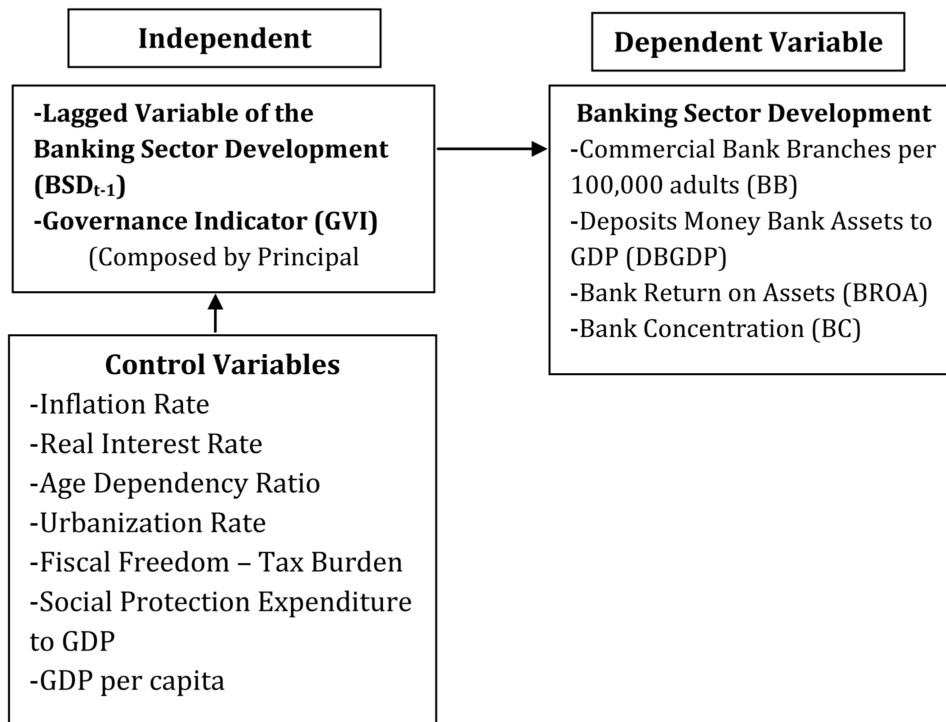

Figure 1: Conceptual Framework

Model Specification

As mentioned above, indicators of the BSD are proxied by the four variables under four analysis models for dependent variable. Then independent variable governance indicator (GVI) estimated by Kaufmann *at el.,* (1999) covers most of the features of institutional environments. They are: Control of Corruption, Government Effectiveness, Political Stability and Absence of Violence/Terrorism, Regulatory Quality, Voice and Accountability, and Rule of Law. According to Globerman and Shapiro (2002) these indicators are considered as superior to other that have been used elsewhere, because they are estimated using 31 different qualitative indicators from 13 different reliable sources. Thus,

these meta-indices would encompass most of the other measures. However, these indices highly correlate with each other. Therefore, following Globerman and Shapiro (2002), an aggregate measure of these is obtained by estimating their first principal component, which would efficiently represent the institutional excellence. Furthermore, the model is extended by introducing a lagged dependent variable. Because BSD is persistent, failure to capture that persistency would lead to inconsistent estimates. Therefore, the dynamic panel model developed to measure the effect of the determinants on BSD would take the following form.

$$BSD_{i,t} = \beta_0 + \lambda BSD_{i,t-1} + \beta_1 WGVI_{i,t} + \sum_{i-1}^{n} \beta_i . CV_{i,t} + \mu_i + \cup_{i,t}$$

Where;
μ_i = Country specific factors
$\cup_{i,t}$= Error term of the model
According to this study there will be run four models which are going to explore the world governance indicators on banking sector development as follows.

$$BB_{i,t} = BB_{i,t-1} + \beta_1 WGVI_{i,t} + \sum_{i-1}^{7} \beta_i . (INFR_{i,t} + RIR_{i,t} + AGEDR_{i,t} + UNR_{i,t} + TAB_{i,t} + SPEGDP_{i,t} + PCGDP_{i,t}) + \cup_{i,t}$$

$$BDGDPB_{i,t} = BDGDPB_{i,t-1} + \beta_1 WGVI_{i,t} + \sum_{i-1}^{7} \beta_i . (INFR_{i,t} + RIR_{i,t} + AGEDR_{i,t} + UNR_{i,t} + TAB_{i,t} + SPEGDP_{i,t} + PCGDP_{i,t}) + \cup_{i,t}$$

$$BROA_{i,t} = BROA_{i,t-1} + \beta_1 WGVI_{i,t} + \sum_{i-1}^{7} \beta_i . (INFR_{i,t} + RIR_{i,t} + AGEDR_{i,t} + UNR_{i,t} + TAB_{i,t} + SPEGDP_{i,t} + PCGDP_{i,t}) + \cup_{i,t}$$

$$BC_{i,t} = BC_{i,t-1} + \beta_1 WGVI_{i,t} + \sum_{i-1}^{7} \beta_i . (INFR_{i,t} + RIR_{i,t} + AGEDR_{i,t} + UNR_{i,t} + TAB_{i,t} + SPEGDP_{i,t} + PCGDP_{i,t}) + \cup_{i,t}$$

Where i = 1……23 countries, t = 1…..8 years

Estimation Technique

For this research GMM model (generalized method of moments) will be used as the estimation technique. Traditional panel estimation methods would be biased and inconsistent, because the lagged effect of BSD is correlated with the error term. Due to the development of effect of GMM model. GMM model has been evolved through the diverse by scholars so far. First difference GMM has introduced with the instrumental variable due to the auto correlation of error term and explanatory variable to get rid of this problem. After that Arellano and Bond (1991) suggested the previous mode in the first difference to eliminate the fixed effect by two-step GMM. Then Arellano and Bover (1995) and Blundell and Bond (1998) highlighted that when autoregressive process is highly persistence, the lag level between weak instrument, so they introduced system GMM eliminate this estimation of the efficient method., which combined the movement condition to the different model with theses level model. Post estimation tests of Sargan-test, and Arellano and Bond serial correlation tests are then applied to test the validity of instruments and the serial correlation of the disturbances, respectively.

Results and Discussion

As per the Table 2, results indicate that coefficient of the lagged value of commercial bank branches per 100,000 adults (BB) (0.8971739) and deposit money bank assets to GDP (BDGDP) (1.044262) are high persistence. Since such models are removed from the interpretation. However, the results of the bank return on assets (BROA) (0.074) and bank concentration (BC) (0.279) can be considered as valid models for the interpretation. Furthermore, results of the BC model indicate that impact of the GVI in regard to the BSD is only shows the significant result (t = 22.04). Since, such model is selected as the most valid model out of all models which further highlight with the results of the post estimation tests.

Table 1: Coefficient Results of BB, BDGDP, BROA and BC.

	BB	BDGDP	BROA	BC
BSD_{t-1}	0.897*	1.044*	0.074*	0.279*
	(29.19)	(11.80)	(2.71)	(22.04)
GVI	1.545*	2.326	0.122	7.169*
	(6.28)	(1.31)	(0.73)	(4.43)
INFR	-0.003	0.184*	0.016	-0.264*
	(-0.18)	(2.53)	(0.45)	(-4.16)
RIR	0.006*	0.403*	-0.005	-0.259*
	(1.93)	(9.01)	(-4.72)	(-4.65)
AGEDR	0.005*	-0.338	0.005	0.478*
	(0.40)	(-1.40)	(0.52)	(5.18)
UNR	-0.049*	-0.258	0.175*	0.200*
	(-2.70)	(-1.92)	(2.67)	(3.42)
TAB	0.028	0.398*	-0.003	0.146
	(1.75)	(4.10)	(-0.51)	(1.72)
SPEGDP	0.164*	-0.869*	-0.072	-0.148
	(4.12)	(-2.19)	(-4.38)	(-0.32)
PCGDP	-0.001*	-0.001	-0.001	-0.001*
	(-1.65)	(-0.87)	(-1.22)	(-4.72)
Sargan Test	0.9173	0.9890	0.9794	0.9807
Order 1	0.1757	0.0891	0.1240	0.1180
Order 2	0.0329	0.1134	0.4945	0.4331

Initially, the resulted p-values for the Sargan-test are greater than 0.05, confirm the hypothesis that over identified instruments are valid for the models ($p>0.05$). Meanwhile, Arellano and Bond serial correlation tests indicate that though first order serial correlation ($p<0.05$) was insignificant, the second order serial correlation ($p>0.05$) for BC are in order. The coefficient of lagged value of the BC is significant (t = 22.04) and positive. The coefficient of 0.279 indicates that the one unit of changes in the Bank Concentration (BC) of previous year has improved the Bank Concentration (BC) of current year holding other predictors in the model constant. Therefore, it further indicates that development of the BC in previous year in selected countries is expected to increase the BC in current year by 27.9%. Then, the results show that GVI significantly determines the development of BC (r = 7.168, t = 4.43). Since, one unit of change of GVI has improved BC by 716% while holding constant other predictors in the model. Being the governments of selected countries operated the sound governance infrastructure facilities with strong rules and regulations has increased the assets of 3 largest commercial banks as a share of total commercial banking assets of an Asian region. Ultimately good governance has improved the banking sector development (Bayar, 2017; Cherif & Dreger, 2014; Zoli ,2007; Huang, 2010 and Gries & Meierrieks, 2010).

In the case of INFR, it has discouraged the development of BC which is significant (r = -0.264, t = -4.16). Results indicates that for every additional percent of inflation rate is expected to decrease the BC by 26.4% while holding other predictors in the model constant. Then coefficient of the RIR, (r = -0.259, t = -4.65) also has negatively behaved toward the BC. Since, every additional percent of real interest rate is expected decrease the BC by 25.94% while holding other predictors in the model constant. Further result of AGEDR indicates that (r = 0.478, t = 5.18) every additional unit of age dependency ratio is expected to increase the BC by 47.8%. However, UNR has significantly determined the development of BC (r = 0.200, t = 3.42) and every additional percent of urbanization rate of the selected countries is expected to increase the BC. The results of the TAB, (r = 0.146) is insignificant (t = 1.72) and positive toward the development of BC. Since, results depicts that every additional unit of tax burden is expected increase the BC by 14.6% while holding other predictors in the model constant. Then, the results show that SPEGDP insignificantly determines the development of BC (r = -0.148, t = 0.32). The coefficient indicates that the changes in the social protection expenditure in GDP one percent is decreased BC while holding other predictors in the model constant which is 14.8%. Finally, the result of PCGDP indicates that it has significantly discouraged the development of the BC. Since changes in per capita GDP of one unit has decreased the BC by 1% while other variables are in the model constant (r = -0.001, t = -4.72) Since, results show that, significant of the system GMM model confirmed by the significance of the lag variable of BC (Laura, Codruța and Maria, 2016; Aluko and Adebayo, 2017).

Conclusion and Recommendations

Results confirm the persistency of BSD as the lagged dependent variables are highly significant in all the models. Therefore, this study intensifies the importance of considering lag dependency of BSD when determining its determinants. However, god governance infrastructure has improved the banking sector development bay way of developing market share of 3 largest commercial banks in the selected countries. On the other hand, it intensifies that though the banking system faces different obstacles during the financial crisis time, good governance has strived to add favorable surpluses for the banks' market share and which have improved the strength of the banking systems among selected countries in Asian region.
It is recommended to further improve the governance infrastructure among the banking sector, since it will be help to increase the banking sector development in Asian region. Further it is vital to provide required facilities and constructive monitoring in the scenarios of tight governance practices to overcome the issues and challenges face by the banks to maintain the healthy profitability level.

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