Volume Title: Financial Sector Development in the Pacific Rim, East Asia Seminar on Economics, Volume 18

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Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38684-8

Volume URL: http://www.nber.org/books/ito_07-2

Conference Date: June 22-24, 2007

Publication Date: February 2009

Chapter Title: Introduction to "Financial Sector Development in the Pacific Rim, East Asia Seminar on Economics Volume 18"

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Chapter URL: http://www.nber.org/chapters/c0425

Chapter pages in book: (1 - 9)

Introduction

Takatoshi Ito and Andrew K. Rose

Introduction

This volume is a collection of papers that were presented at the eighteenth annual East Asia Seminar on Economics (EASE). The EASE 18 was held at Singapore Management University (SMU) on June 22 to 24, 2007. The conference was organized around the theme of financial sector development in the Asia-Pacific region. The recent changes in Asia's financial sectors—especially in banking and stock markets—have been remarkable, especially since the Asian currency crisis of 1997 to 1998. There are a number of different elements in recent developments, which can be roughly categorized into four strands.

First, consider the reforms enacted by the East Asian countries most affected by the financial crisis (Korea comes immediately to mind). During and in the aftermath of the crisis, a number of countries introduced reforms intended both to open markets to foreign institutions and to liberalize these markets. A number of regulations on financial products and pricing were either loosened or eliminated, and some of these policies are studied in this volume. A few of these changes were recommended by the International Monetary Fund during the actual crisis (sometimes quite forcefully), but most were introduced afterward by governments intent on improving the quality and robustness of their domestic financial institutions and markets. As a result of the changes in policy, the region as a whole

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has shown remarkable progress and dramatic growth over the past decade, both on the real side of the economy and (especially) in financial development. Still, there have been a number of problems along the way.

Given the size of their respective economies, Japan and China both deserve special attention. While Japan avoided a *currency* crisis in 1997, it did experience a *banking* crisis. Despite sizeable injections of capital in both 1998 and 1999, the crisis was prolonged. Conventional wisdom attributes this mostly to the fact that accounting practices remained extremely opaque through the period, and the authorities avoided attempts to address this issue. Further, regulatory forbearance seemed self-evident. The regulatory reform introduced in 2002 finally ended the banking crisis by decisively intervening to handle the remaining weak banks. A number of Japanese banks were allowed to fail, while a number of banks merged (in part to preempt other failures). It was widely suspected at the time that some mergers were not motivated solely by the desire to make banking operations more efficient. Instead, it was believed that some banks were simply too big to fail, resulting in regulatory bias. A number of different aspects of these issues are examined in the articles that follow.

A third important factor in the region remains the remarkable growth in China. China has consistently achieved high economic growth during the period since the Asian crisis, averaging over 9 percent since 1998. Further, financial markets in China have been transformed. Chinese markets were once backward with a heavy regulatory burden; now they are some of the hottest markets in the world for active trading and associated activities like initial public offerings (IPOs). During the same period, the Chinese attitude toward foreign portfolio investment has also changed swiftly, from being essentially completely closed toward a cautious opening. By now, many Chinese firms have experienced IPOs, and the remarkable rises in prices on Chinese stock exchanges have created numerous opportunities, along with some risks. Mergers and acquisitions (M&As) now abound, though it remains unclear whether value is actually created by many of the Chinese M&As. The recent popularity of M&As has not been restricted to China; they have also grown in Korea, for example, since the currency crisis as family and group ownership has weakened. Cross-border M&As have also become more popular, though they are still less common in East Asia than in either North America or Europe. Understanding the reasons for this M&A activity requires careful examination, and this volume makes progress on this dimension. A related set of questions concerns the development of financial centers in Asia, both in the historically important financial activity hub of Tokyo and also the long-standing rivalry between Shanghai and Hong Kong. Here, too, the chapters of the volume provide new insights.

A final issue of great importance is the underdeveloped state of financial technology in Asia. Asian financial and capital markets often lag behind best-practice commonly seen in New York and London. For instance, there is a notable lag in financial innovation in the area of securitization, at least compared with the United States. Why is this the case? Some consider it to be a legacy of the bank-based systems that have traditionally been prevalent in Asia. Others think that it simply takes time to lure top-notch experts in financial engineering to the region or to train them domestically.

In this volume, a number of the questions and issues discussed in the preceding will be elaborated upon and addressed. The collection of papers has been written with state-of-the-art econometric techniques and modern data sets from countries in the Asia-Pacific region. Some chapters exploit a new data set, while others frame policy-relevant questions; some chapters do both. Enjoy!

I: The Evolving Nature of Regional Stock Markets

The first pair of chapters examines the past, present, and future of Asian stock markets. McCauley and Chan look forward to the future of two key financial centers, Hong Kong and Shanghai, by looking back to the past; Hamao, Hoshi, and Okazaki reflect on the historical development of the Tokyo Stock Exchange before World War I.

McCauley and Chan predict that China will ease its remaining capital controls and make the renminbi fully convertible into foreign currencies. Shortly thereafter, they predict, Shanghai will reemerge as an international financial center. The prospect of this reemergence has sharpened speculation regarding the relationship of Shanghai and its historical Hong Kong, the established international financial center that reverted to Chinese sovereignty in 1997. McCauley and Chan argue that Hong Kong will *gain* stature as an international financial center when China is more open financially, coincident with the return of Shanghai to its traditional role as a financial center. His thesis is that the development of an *onshore* international financial center (Shanghai) can contribute to the continued development of a nearby *offshore* international financial center (Hong Kong). Thus, a country (or, more precisely, a federal state) can support more than one financial center, an issue that has been much debated in the literature. It also is interesting to note that McCauley and Chan's idea is, in some ways, the inverse of another idea in the literature, namely that financial competition from offshore can spur the development of an onshore center (as happened in, e.g., Europe). McCauley and Chan develop their thesis using a century of historical evidence, while also considering the current range and intensity of financial activity in the two centers. They also provide a more prospective analysis of the evolution of China's international balance sheet and Hong Kong's share thereof. McCauley and Chan's method is eclectic and includes data ranging from rankings based on nose counts of banks, through multidimensional measures of balance sheets and trading activity, to regression analysis for future projections.

Hamao, Hoshi, and Okazaki study the role that the Tokyo Stock Exchange (TSE) played before the First World War (WWI) to draw lessons for more recent events. Recent studies have shown that the Japanese stock market had a substantial size in the prewar period and played an important role in financing economic development. However, the initial market capitalization of the TSE was not only low but also remained that way for quite a long period early on in its existence. Though the TSE eventually grew into one of the two largest stock exchanges in prewar Japan, its growth occurred surprisingly late. Hamao, Hoshi, and Okazaki examine why the TSE's development was so slow from its establishment in 1878 through the 1910s and why it then took off in the late 1910s. The chapter argues that the TSE stayed small because low liquidity discouraged new companies from listing their stocks. In turn, the lack of growth in new listed stocks meant that liquidity remained low. This equilibrium was broken in 1918 when the TSE changed its listing policy slightly and began to start listing companies without waiting for their listing applications. The chapter provides empirical evidence that shows the size of the market did indeed matter for their listing decisions, at least before 1918. Hamao, Hoshi, and Okazaki rely on an interesting data set, the listing behavior of cotton spinning firms. Before 1918, the size of TSE affected this relationship, but afterward, this relationship disappears. That is, companies found listing their shares on the stock exchange more attractive if the stock market is more liquid (in a more liquid market, the underpricing after IPO will be smaller). That is, the low liquidity and small number of listed companies mutually reinforced each other until this inferior equilibrium was altered in 1918.

II: Consequences of Financial Development

Asia is not known as being at the leading edge of financial innovation. A number of chapters in the volume investigate the reasons for this lag and explore the consequences of policies aimed at spurring financial market development. Green, Mariano, Pavlov, and Wachter attempt to find why asset securitization is not more widespread in Asia. This has been an important recent development in many financial markets and is a good example of an area in which Asia is still far technically behind the European and American markets.[1] Often financial market development has been hampered by regulations that persist as a legacy of financial repression. Ito and Chinn investigate the relationship between financial market development and macroeconomic current account imbalances. Using data for both developed and developing countries, they conclude that increases in the size of financial markets induce a decline in the current account balance in industrial countries, but the reverse for developing countries. Finally, Park pres-

1. Though it must be said that this gap in Asian financial markets has recently stood it in good stead, at least from the short-run perspective of early 2008!

ents a case study of policy failure in financial markets. He studies the Korean deregulation of the mortgage and credit card businesses and the associated boom-bust cycle.

Green, Mariano, Pavlov, and Wachter present a compelling argument for the potential importance of asset securitization in Asia, arguing that it has the potential to increase Asian financial transparency dramatically. They provide a conceptual basis for price discovery potential for tradable market instruments, specifically focusing on mortgage securitization. A model is presented to explain how misaligned incentives can lead to bank-generated real estate crashes and macroeconomic instability. They then examine the performance of Asian banking sectors with respect to securitized real estate returns, thus providing evidence on the importance of misaligned incentives. They also argue that the addition of mortgage-backed securities may help to protect markets from the shocks that can arise from bank-financed mortgage lending. However, in a subtle but powerful comment on the chapter, Lamberte argues that the incentive problems faced by Asian banks may not be especially important; he argues that any issues with inappropriate lending can be more effectively dealt with by improved regulation.

Ito and Chinn are interested in understanding the evolution of global trade and financial imbalances and investigate the role of budget balances, financial development, and openness. Financial development—or the lack thereof—has received considerable attention as a possible contributing factor to the development of persistent and expanding current account imbalances that have characterized both the United States and East Asia of late. Several observers have argued that the depth and sophistication of American capital markets has caused capital to flow "uphill" from relatively underdeveloped East Asian financial markets toward the United States. In this chapter, Ito and Chinn extend their previous work by examining the effect of different types and aspects of financial development. While the theoretical reasons for these linkages are not especially clear, Ito and Chinn rely on empirics almost entirely. Their data analysis relies on a cross-country data set that encompasses a sample of nineteen industrialized countries and seventy developing countries during the period from 1986 through 2005. The large amount of variation in their comprehensive study yields a number of new results. First, they confirm a role for budget balances in industrial countries when bond markets are incorporated. Second, they find that in practice both stock market capitalization and private-sector credit appear to be important determinants of current account behavior; countries with more sophisticated financial markets tend to run current account surpluses. Third, while increases in the size of financial markets induce a decline in the current account balance in industrial countries, the *reverse* is more often the case for developing countries. Fourth, a greater degree of financial openness is typically associated with a smaller current account balance in developing countries.

The V-shaped macroeconomic recovery of Korea from the currency crisis of 1997 is, by now, a well-known story. But much less is known of a smaller Korean financial crisis that occurred in 2003 as a result of a bust in the credit card market. Park provides a fascinating case study of this failed policy reform; he includes an overview of the development of the market, the subsequent crash, and the associated policy response. Park attributes the increase in household debt to financial deregulation and a paradigm shift in the financial industry that began to place more emphasis on reallocation of resources for profits. The consequence of this shift was to introduce bullet or balloon mortgages. Before the currency crisis of 1997, banks basically lent to big corporations; afterward, banks became eager to lend to consumers, using residential property as collateral. Deregulation in 1999 removed a ceiling on cash advance services for credit card holders, despite the absence of adequate credit evaluation systems. Nonbanks—credit card companies and credit-specialized financial companies—increased their lending from 14 trillion won in 1999 to 51 trillion won just three years later. Much of this increase was in cash advances. Credit card delinquency subsequently increased sharply, followed by a hard crash with numerous defaults and bad debts. As credit card companies got intro trouble, there were bailouts by the government, with associated moral hazard. Unsurprisingly, lending declined to just 18 trillion won by 2005.

Park concludes that the Korean credit card crisis is a classic example of regulatory failure. The deregulation was inappropriately done without the requisite infrastructure (in this case, a central institution to administer credit information). The government intervention was timed poorly, and an abrupt regulatory change in 2002 resulted in a crash of credit card lending. With more timely and proper policies, many of these difficulties could have been at least alleviated if not averted altogether.

III: Financial Consolidation

Using financial markets to consolidate activity in the real economy is a topic of perennial interest, but especially so in Asia where such M&As have historically been rare. However, there has been a noticeable increase in the pace of financial consolidation of late in Asia, and it is accordingly appropriate to examine these developments. Three chapters in the volume deal with M&A activities in Asia. The first chapter by Shen and Lin provides an overview and analysis of the characteristics of financial consolidation in Asia. The remaining two chapters focus on individual countries, albeit ones of great size and importance. Wu looks at M&As in China using an event study approach, while Hosono, Sakai, and Tsuru concentrate on bank mergers in Japan.

Shen and Lin study the motives that drive Asian financial institutions to engage in financial consolation; they focus on the interesting case of cross-border M&As. They are interested in distinguishing between a number of commonly discussed motivations for M&As and have a special interest in determining whether the reasons for M&As changed with the financial crisis of 1997. Five hypotheses are examined, all from an empirical perspective. These are (1) the *gravity hypothesis,* (2) the *following the client hypothesis,* (3) the *market opportunity hypothesis,* (4) the *information cost hypothesis,* and (5) the *regulatory restriction hypothesis.* While none of the hypotheses can be directly tested, they gather data on proxies for each of the hypotheses and use these to explain the number of financial M&As in Asia from 1990. It turns out that the proxies that are statistically significant for the periods both before and after the crisis include (a) the distance between the countries, (b) the level of gross domestic product (GDP), (c) bilateral trade, and (d) net foreign direct investment. Distance has a negative impact in both periods, which tends to support both the gravity hypothesis and information cost hypotheses. Gross domestic product has a negative coefficient in both periods, which is contrary to the gravity hypothesis. On the other hand, trade is found to have a positive coefficient for both periods, which supports the following the client hypothesis. Foreign direct investment also exerts a positive effect, which supports the both information cost and the following the client hypotheses. Summing up then, the results of Shin and Lin suggest that both the following the client hypothesis and the regulatory restriction idea seem reasonable, with no great differences between the periods before and after the crisis.

Wu provides the first-ever study of Chinese financial consolidation, a notable and worthy achievement. He studies 752 mergers and acquisitions involving 587 companies traded on the Shanghai and Shenzhen stock exchanges in 2005. He uses the event-study method, using a period that stretches back to fifty days before the M&A to forty days afterward; he also pays careful attention to accounting information during this window of time. The analysis indicates that within the event period, the value of most companies involved in M&As actually increased. He estimates the cumulative abnormal return for acquiring firms and target firms at 1.68 percent and 2.03 percent, respectively. Wu then examines whether the type, industry, and ownership structure of the companies has an impact on the returns; he also checks the impact of the stock market's aggregate performance. When Wu takes exploits his accounting information within a longer observation period (four years), he finds that the financial conditions of M&A companies showed a decline in the first year after consolidation, but a subsequent improvement. This is one of the first serious studies of the newly emerging issue of financial consolidation in the world's largest manufacturer, China. The positive results indicate that there is reason to think that even though China's financial markets are quite young, they seem to be doing the job of vale creation for which they are intended.

Hosono, Sakai, and Tsuru analyze the merger wave that occurred in the

Japanese banking sector in the 1990s. Using a comprehensive data set, the chapter investigates the motives for bank consolidations in Japan between 1990 and 2004, as well as their consequences. The analysis suggests that the attempts of regulators to stabilize local financial markets through consolidation played an important role in M&As conducted by both regional banks and credit cooperatives (*shinkin*). It is interesting to note that these attempts were not very successful. By way of contrast, the M&As conducted by major banks and regional banks in the early 2000s seem to have been driven by motives of value maximization. Hosono, Sakai, and Tsuro test four motives for M&A: (1) improving bank efficiency; (2) strengthening market power; (3) exploiting a policy of too-big-to-fail; and (4) managerial empire building. Their results suggest that M&As tended to occur when overall bank health is poor and where the market is less concentrated. These results are consistent with the too-big-to-fail and market power hypotheses, respectively. However, they find no evidence that supports the managerial motive of empire building.

IV: Reform and Dynamism

The last two chapters in the volume examine the effects of reform on economic performance, as measured in the stock market. Sakuragawa and Watanabe evaluate the effects of the reforms introduced in 2002 by the Japanese minister for economic and fiscal policy, Heizo Takenaka. The results demonstrate convincingly that the credibility of economic reforms increased after weak Japanese banks were decisively handled in 2003. Fogel, Morck, and Yeung examined the impact of low turnover in top companies on a variety of measures of social justice. They show that a more dynamic corporate sector is not associated with greater inequality, pollution, injustice, or other social ills.

Sakuragawa and Watanabe study how the stock market evaluated the Japanese financial reform (the "Takenaka Plan") using a conventional event study methodology. They focus on a number of financial events that occurred in 2002 and 2003, including the announcement of the Takenaka Plan, the release of the work schedule implementing the financial reforms the package of monetary policies initiated by the new governor of Bank of Japan, and the failures of Resona Bank and Ashikaga Bank. Sakuragawa and Watanabe find that market participants came to believe only gradually in the government's intentions to reform bank governance. However, the credibility of the reforms drastically increased in 2003. Thus, at least some of the widely held skeptical attitudes toward economic reform seem unwarranted, at least so far as the financial markets are concerned. Further, the evidence from the failures of Resona and Ashikaga reveal that bank shareholders differentiated between individual banks on the basis of their financial conditions, rather than cynically lumping all banks together (as might be expected if the reforms were not serious).

In earlier work, Fogel, Morck, and Yeung developed a measure of turnover in a country's biggest businesses and examined whether this measure of corporate turnover promotes or hurts economic growth. One might imagine that a more stable business sector encourages larger research and development (R&D) and faster growth, simply because monopolist firms have both the resources to encourage R&D and the incentives to protect their market power. In fact, though, the results clearly show that greater turnover in a country's list of top businesses associated with *faster* growth in per capita gross domestic product (GDP) and productivity. A corporate sector with great turnover is a vibrant one that creates value, while a more stable business sector also tends to be more stagnant. In low-income countries, the turnovers are associated with capital accumulation. All this accords with Schumpeter's early concept of "creative destruction."

In this chapter, the authors follow up their earlier analysis and ask whether countries with more business stability pay the price of lower growth but also reap the benefits of greater social justice. That is, they ask whether greater business turnover is systematically associated with a worse social infrastructure, as manifested in less liberty, fraternity, or equality (to use the French taxonomy). They use a wide range of indicators of social well-being, including measures of environmental degradation, health, education, poverty, inequality, and fundamental rights. However, despite a wide-ranging and ambitious search, they find no evidence that business stability is associated with better social outcomes.