Financialization and Transformation of the East Asian Economies

Ji-Yong Lee
October 2012
FINANCIALIZATION AND TRANSFORMATION OF THE EAST ASIAN ECONOMIES

Ji-Yong Lee
Assistant Professor in finance and management control
ESC Bretagne Brest (Brittany Business School), France
ji-yong.lee@esc-bretagne-brest.com
FINANCIALIZATION AND TRANSFORMATION OF THE EAST ASIAN ECONOMIES

The world economy has been marked by the phenomenon of financialization during the last three decades. Financialization represents a profound transformation of capitalist economies, typified by the rise of financial activities. The increasing role of finance has been accompanied by the emergence of new financial instruments, a liberalization of international capital flows and an increase in shareholders’ demands. This paper examines the trajectory of financialization in East Asia\(^1\) during the period of 1997-2006. We see the evolution of corporate ownership and financial systems as an indicator of financialization. The paper shows that the stock markets are now playing an increasing role as a funding source. Banks are becoming involved in activities other than traditional banking services. Another important point is the clear rise of institutional investors in the ownership structure.

Keywords: Financialization, Transformation of Corporate governance, Corporate ownership, Financial systems, Institutional investors

JEL Classification: G20, G34, N25

\(^1\) In this paper East Asia is China, Hong Kong, Japan, Korea, Malaysia, Singapore, Taiwan and Thailand.
INTRODUCTION

One of the most significant economic features of the last thirty years has been the growing role of finance, often summarily referred to as financialization. Financialization is a term used to summarize the process whereby financial markets, financial institutions, and financial elites gain greater influence over economic policy and economic outcomes (Epstein, 2005). Financialization is playing a major role in the transformation of the functioning of economic systems at both the macro and micro levels (Plhlon, 2003). Its principal impacts are summarized as follows: (1) the growing dominance of financial activity over real activity, (2) the reinforcement of the power of institutional investors - in particular mutual funds, pension funds and insurance companies - who became increasingly active players pressing for more shareholder value-orientation in corporate governance, and (3) the increasing number of banks moving into investment-banking and related activities: banks have sought out new areas of profitability to offset declining profitability in some traditional banking activities such as business lending.

Financialization was made possible by the process of financial liberalization, deregulation and financial innovation (Batsch, 2002; Epstein, 2005; Plhlon, 2003). A vital dimension of the increasing financialization of the world economy is the growth of stock markets. The total market capitalization of all publicly traded companies in the USA was $4,000 billion in 1990 and rose to as much as $22,653 billion in 2006. During this period, the European zone markets grew from $2,000 billion to $15,434 while market capitalization in the Asia Pacific zone grew from under $3,000 billion to $11,838 billion (World Federation of Exchanges). The stock markets have come to play a more powerful role in corporate life and in fostering
further international financial integration (Morin, 2006; Batsch, 2002; Aglietta and Rébérioux, 2005).

In almost all advanced industrial countries, institutional investors have become the major shareholders (Gonnard, Kim and Ynesta, 2008). The implication of the increasing scale and activity of these financial actors upon corporate governance is that they have introduced the norms of shareholder value and reshaped corporate governance strategy. According to Boubel and Pansard (2004), their expansion is a result of the economic and demographic context and legal reforms. In other words, the increased rate of population ageing and the increasing wealth of the middle classes have contributed to the introduction of legal reforms and thus favored the development of institutional investors. Individuals seek to accumulate property and capital in order to finance their retirement, while the wealth of the middle classes is increasing. The key issue for the institutional investment industry is to ensure that an increasing proportion of such accumulation is dedicated to their products, which would enable individuals to satisfactorily diversify their financial capital rather than leaving it dormant in bank accounts or investing it themselves in the markets.

A series of measures to deregulate the financial sector and to liberalize international capital flows has allowed banks and other financial institutions to increase the range of services they offer, thus blurring the lines across different types of institutions and removing barriers to competition. The wave of diversification became apparent in the banking sector. Banks continue to play an important role in the financial sector but the nature of that role is continuing to evolve. In particular, financial innovation, i.e. the development of new financial instruments, has facilitated the expansion strategies of banks (Boubel and Pansard, 2004).
With these factors in mind, this article seeks to present the process of financialization through an overview and analysis of the East Asian countries between 1997 and 2006. The focus of the paper is on changes in two important aspects of corporate governance features: corporate ownership and financial systems. We begin by describing the general features of corporate governance in East Asia. We next highlight the increasing importance of stock markets and the more complex role performed by banks. Finally, we demonstrate the rise of institutional investors in the ownership structure. The paper ends with some concluding remarks.

1. Concentrated ownership and bank-based corporate governance systems

Corporate governance systems in East Asia are very different from the Anglo-Saxon system in which the ownership of the firm is dispersed across a multitude of various categories of shareholders—the ‘outsider’ system (Zhuang et al., 2000; La Porta et al., 1998, 1999; Claessens et al., 1999a, 1999b). Concentration of ownership, usually in an individual or a family, is a common phenomenon, and the dominant shareholders play a key management role in the firm—the ‘insider’ system. Often insiders may control a company without owning a large block of shares by using some combination of parallel devices: pyramidal ownership, cross-shareholdings, and dual classes of shares. The differences in the ownership and control structure may produce different corporate issues. The most significant corporate governance issue in East Asia is alleviating the conflict of interest between the majority and minority shareholders, whereas in the Anglo-Saxon model the agency problem basically arises between shareholders and managers. Dominant shareholders tend to prefer retaining ownership and

---

2 The data used for the empirical study cover the period 1997-2006 – a period specifically chosen to assess the scale and nature of the transformations that have taken place since the 1997 crisis but before the 2007 subprime crisis.
control to having liquidity for strategic reasons (Shleifer and Vishny, 1986; Claessens, Djankov and Lang, 2000). In general, dominant shareholders represent strategic investors who don't invest for “investment management” purposes, but rather invest for strategic stakes in companies. Consequently, institutional investors and foreigners owned only limited stakes in East Asian companies.

Financial systems have long been dominated by banks, and as a result capital markets have remained underdeveloped. Banks typically dominate the corporate finance markets and often have complex and long relationships with companies (Adams, 2008; Turner, 2007). This close relationship between banks and firms was regarded as a strength relative to the arm’s-length relationships of equity markets, since this relationship allowed firms to have a lower cost of capital and higher investment. Due to the over-dependence on banks in this area, direct financing by firms through the capital markets was not a common source of finance (Stiglitz, 2000).

However, continued financial liberalization and market opening considerably weakened these patterns. Corporate governance reform is one of the key priorities of countries within the region and the current transformations have become a key focus of scrutiny.

2. The increasing role of stock markets

Table 1 presents information on market capitalization as a percentage of GDP and the number of listed companies in eight countries using data from The World Bank database. These indicators show that stock markets have undergone expansion in recent years. Since 1997, market liquidity has more than doubled in relation to GDP, while turnover rate has almost
quadrupled (Beck and Hussainy, 2008). The number of companies listed on the stock markets has also continually increased. In 2006, there were 2,416 companies listed on the Tokyo stock exchange, as opposed to just 1,865 in 1997. Moreover, in 2006, there were 1,689 companies listed on the Korean exchange, as opposed to just 776 in 1997. The largest market based on stock market capitalization (to GDP) at the end of 2006 was the Hong Kong Stock Exchange.

**Table 1. Indicator of Stock Market Activity, 1997 and 2006**

<table>
<thead>
<tr>
<th>Market Capitalization (% of GDP)</th>
<th>Number of Listed Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>16.8</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>245.6</td>
</tr>
<tr>
<td>Japan</td>
<td>62.9</td>
</tr>
<tr>
<td>Korea</td>
<td>18.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>93.5</td>
</tr>
<tr>
<td>Singapore</td>
<td>134.5</td>
</tr>
<tr>
<td>Taiwan</td>
<td>93.9</td>
</tr>
<tr>
<td>Thailand</td>
<td>41.2</td>
</tr>
</tbody>
</table>

Source: Beck and Hussainy (2008)

Equity market growth has been accompanied by increasing international investment inflows, growing regional financial integration and structural improvements to markets. As can be seen in Figure 1, equity flows into East Asia have soared. Approximately 60% of private capital investments made in Asian countries have been portfolio investments (Akyüz, 2009). For comparative purposes, portfolio investments represent less than 40% of private capital investments in other emerging countries. Net portfolio investment flows have increased significantly in China. In the case of Malaysia, portfolio investments between 2002 and 2006 were nine times higher than FDI flows (Khor, 2008).
This trend in capital flows in East Asian countries has gone hand in hand with the liberalization of international capital movements, parallel to a relaxed restriction on foreign investor participation in equity markets (Purfield et al., 2006). Since the early 1990s, countries such as Taiwan and Korea have gradually increased their caps on foreign portfolio investments. Taiwan even eliminated these caps in 2003. Japan and Singapore are relatively open in terms of cross-border investments by non-residents. The leading foreign investors in the region are American funds. American groups hold over half the shares owned by foreign investors in certain countries, such as Korea and Singapore.

Furthermore, intraregional financial integration has been increasing. East Asian assets constituted 14% of the total holdings for eight East Asian economies in 2001 and 24% in 2006 (IMF)\(^3\). China and Hong Kong are the main beneficiaries of the flow of portfolio investment (Figure, 2). China has now become a more attractive destination than Singapore, which was the second destination behind Hong Kong prior to 2000. The privileged mutual relationship between China and Hong Kong could be reinforced as China continues to receive

a high proportion of capital flows through the financial services provided by Hong Kong, while the latter benefits in turn from the strong economic potential of China.

**Figure 2. Intraregional portfolio flows, 2006**

Source: Author’s calculation based upon data from Thomson Reuters.

According to Ghosh (2006), East Asian governments have launched several initiatives to develop domestic capital markets and to be less dependent on bank loans. One reflection of these efforts over the past decade is that the stock market is now playing an increasing role as a funding source. In general, equities represent approximately 10% of corporate financing in Asian countries, which compares favorably with emerging markets outside Asia (3.7%) (Purfield et al., 2006).

**3. The new role of banks**
The new role of banks is another key part of financialization. In the last decade, there has been substantial privatization and consolidation in the banking sector. Responding to growing competition and liberalization in the investment banking sphere, many East Asian banks in recent years have significantly altered their strategy from providers of debt finance to active actors in the capital markets (Adams, 2008; Lee and Park, 2008; Mohanty and Turner, 2010; Pomerleano, 2009). Banks in the region have traditionally been engaged in lending and deposit-taking activities with corporations and households. Although retail banking financial activities remain their core business, many retail banks have begun to move into investment banking and related activities.

New banking activities include securities underwriting and trading, securitization, and in some cases insurance. These changes have resulted in a blurring of the lines between different financial institutions, and have been facilitated by a relatively liberal legal environment in banking and securities trading, but also by regulatory reforms. Banks within the region now take an active part in securities trading, foreign exchange transactions, leasing, and insurance activities. Following the implementation of government measures aimed at developing capital markets, banks are now encouraged to actively participate in the development of local capital markets by acting as issuers, insurers, investors, and guarantors in view of their dominant role in the domestic financial markets (Adams, 2008; EAAU, 1999; Lee and Park, 2008).

Table 2 illustrates the increase of the security holdings owned by banks. Financial innovation, together with new technology, has encouraged the use of securitization as a financing tool. The development of securitization may also result in an increase of potential partnerships between large foreign financial institutions and local banks with branches capable of offering loans but without strong enough balance sheets to guarantee them (Adams, 2008; Lee and
Local banks will be able to retain clients by virtue of their ability to offer new products more quickly. Partnerships between large financial institutions and local banks may provide attractive business opportunities for foreign financial institutions, enabling them to make use of their skills in the areas of risk management and loan offers. Consequently, a significant number of foreign financial institutions have taken a majority or minority stake in East Asian banks. Standard Chartered, ABN Amro and the Development Bank of Singapore are among the most dynamic foreign banks in this area.

Table 2. Banking Sector Securities Holdings and Activities

<table>
<thead>
<tr>
<th></th>
<th>Securities Holdings (as a % of Total Assets)</th>
<th>Income Diversification Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>7.8</td>
<td>19.2</td>
</tr>
<tr>
<td>Korea</td>
<td>8.5</td>
<td>20.8</td>
</tr>
<tr>
<td>Malaysia</td>
<td>11.7</td>
<td>10.6</td>
</tr>
<tr>
<td>Singapore</td>
<td>9.1</td>
<td>17.1</td>
</tr>
<tr>
<td>Thailand</td>
<td>3.9</td>
<td>16</td>
</tr>
<tr>
<td>Japan</td>
<td>18.4</td>
<td>29</td>
</tr>
</tbody>
</table>

Notes: Income Diversification Index 0 = when a banking system derives its income from a single source.
Sources: Adams (2008), Lee and Park (2008)

The consolidation of the government-managed financial sector has also resulted in a blurring of established boundaries in this sector. For example, the Thai government now offers banking licenses to encourage mergers between banking and non-banking financial institutions. In Malaysia, the largest mergers in 2000 involved banking and non-banking financial institutions, with the exception of insurance companies, while a number of Korean merchant banks have also merged with commercial banks (Molnar, 2003a, 2003b; Turner, 2007). The blurring of the barriers between the different financial markets has favored the
emergence of highly capitalized large institutions (including foreign financial institutions) with the necessary resources to invest in profitable new activities.

Responding to this process, the East Asian economies have adopted a new integrated model designed to supervise and regulate the financial sector – a sector in which all (or almost all) supervision and regulation remains the entire responsibility of a single organization rather than several bodies (Adams, 2008). Consequently, coordination issues that may potentially arise as a result of the involvement of several supervisors overseeing various financial institutions or activities can be reduced.

4. The growth of institutional investors

Institutional investors have been gaining in importance in East Asian countries. The equity holdings of institutional investors were examined using the ownership data of all companies listed on the East Asian Stock Exchanges. The data were obtained from Thomson Reuters and show the ownership structure at the end of 2006. A sample of 10,686 investors managing 2,160,177 billion dollars was examined in the analysis. Ownership of the companies by institutional investors — including mutual funds, pension funds, insurance companies, hedge funds, banks, private equity and sovereign wealth funds — was up to 38% in 2006 and from 9% in 1997. Broadly speaking, the fall in market share of strategic investors has been balanced by the increase in institutional shareholders in overall capitalization\(^4\). The impressive multiplication took place after 2000: institutional investors tripled the value of their holdings throughout East Asia between 2000 and 2006.

\(^4\) Strategic shareholders include corporations, banks, insurance companies and government agencies.
Regarding the type of institutional investor, mutual funds accounted for the largest block of institutional investor assets, with 33% of the total institutional investor assets, as of year-end 2006. Among mutual funds, the strong presence of Anglo-Saxon fund managers may be noted. Anglo-Saxon holdings represented 19% of the total capitalization of mutual funds in 1997, as against 49% in 2006 (38% by the Americans and 11% by the British). Market penetration by large American groups is marked by the presence of their asset management subsidiaries.

Moreover, the emergence of sovereign wealth funds (SWF) as increasingly important participants in equity assets is one of the distinguishing features of the present financial landscape in East Asia. As can be seen in Figure 4, 29% of assets are held by SWFs in the total capitalization of institutional investors. Two Asian SWFs\(^5\) are the biggest institutional investors based on the total assets managed.

\(^5\) Central SAFE Investment Ltd. (China) and Temasek Holdings (Singapore).

In contrast with the sovereign wealth funds of the Gulf States, which benefit from the rise in price of raw materials, Asian sovereign wealth funds are supplied by foreign exchange reserves and trade surpluses. The
Analysis also highlights the involvement of banks in the new financial activity via their investment banking activities (25% in figure 4). As noted above, the new role of banks as institutional investors is connected with the recent extension of their activities into capital markets. The rise of institutional investors as financial intermediaries may suggest a gradual erosion of the weight of banks. However, we find that banks have adapted to the new financial context by becoming increasingly present on the stock markets. Even if their role has changed, it is clear that they remain important actors within the shareholding structures of East Asian countries.

creation of these funds is by no means recent. The first two Singapore funds (Temasek Holdings and Government Investment Corporation) emerged in the 1970s and 80s, and were designed to re-balance savings (from a high level of internal saving) and investment (from a relatively low level). Chinese funds are more recent, since they were created in 2006 for geopolitical purposes. Asian sovereign wealth funds have tended to favor local investment or investment in neighboring countries. The total assets managed by sovereign wealth funds on East Asian stock markets have not ceased to increase: from 49,457 to 83,488 million dollars between 2000 and 2006.
CONCLUSION

This paper has described the spread of financialization in East Asia. The expansion of stock markets, fueled by international capital flows and regional financial integration, constitutes a central aspect of the financialization process. Transformation has also occurred in the activities of the banking sector. Banks are diversifying their activities and new products and services are blurring the boundaries of banking. In addition, the emergence of institutional investors in ownership structures has reshaped the corporate governance landscape in recent years. These new investors would be the main architects of the integration of shareholder value measures that create opportunities for financial activism. This is an issue worth exploring further. Another useful avenue to explore is to discuss the impact of the new role played by stock markets in the process of mergers and acquisitions and in changes in corporate financing.
REFERENCES


