FROM CRISIS TO OPPORTUNITY: FINANCIAL GLOBALIZATION AND EAST ASIAN CAPITALISM

Edited by Jongryn Mo and Daniel I. Okimoto



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CONTENTS

Acknowledgments / VII

1. Financial Globalization and East Asian Capitalism: An Overview / 9

Jongryn Mo
Daniel I. Okimoto

2. The Politics of Reform in Japanese Finance: Assessing the Relative Influence of Foreign Investors / 23

Jennifer Amyx

3. Policymaking in the Era of Financial Globalization: The Battle for Japanese Corporate Reforms, 1996–2002 / 41

Yves Tiberghien

4. Turning a Crisis into an Opportunity: The Political Economy of Korea's Financial Sector Reform / 85

Wonhyuk Lim Joon-Ho Hahm

5. East Asian Capital Flows: Political Networks, Liberalization, and Crises / 123

A. Maria Toyoda

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FINANCIAL GLOBALIZATION AND EAST ASIAN CAPITALISM: AN OVERVIEW

Jongryn Mo Daniel I. Okimoto

since the mid-1990s, China, Japan, and Korea have come under severe pressure to restructure and reform their economic systems. Indeed, across East Asia, governments are attempting to address their structural problems with a variety of reform programs. Now, after the process has been under way for more than five years, certain patterns are beginning to emerge.

The following generalizations can be made. Korea seems to have advanced the most in changing its system. Japan's efforts have been extensive and visible but fundamentally incremental. Reform in China has been more limited and less intense than in the other two countries. Looking more closely at the individual cases, it is clear that these three countries have taken divergent reform paths as they assigned different priorities to different areas of reform. To be sure, differences in the nature of the problems that each country confronts should account for some difference in their approaches and priorities. Yet technical imperatives cannot provide all the answers: politics, too, play a key role in shaping the sequencing of economic reform measures and their overall outcome.

This overview attempts to identify empirical regularities across East Asian countries/sectors and to explain them. Previous studies have left certain important empirical variations across countries and sectors unexplained. The general conclusion of this overview is that the interaction between the forces of financial globalization and domestic politics hold the key to explaining the process of reform. In particular, this essay addresses a number of issues important to the study of East Asian political economies, including their receptivity to the forces of financial globalization; their financial integration; the convergence or divergence of their economic institutions; and the implications that their institutional transformations hold for their national competitive advantage and the global economic system.

Key Dimensions of East Asian Capitalism: Finance and Corporate Governance

Although each East Asian country has unique policies and institutions, they collectively share enough common elements to define a regional model

of economic development. The key features of this East Asian model are macroeconomic stability, high savings rates, and export/industry promotion based on close business-government relations.

The financial and corporate governance systems that have been associated with the East Asian model are especially important to the study of comparative capitalism. As part of their industrial policy regime, East Asian governments created financial systems in which banks dominated in channeling savings into corporate investors; consumer lending was purposely discouraged. Given the government's extensive role, it is not surprising that East Asian banks were slow to develop market-based business practices; they suffered from symptoms of moral hazard (created by the implicit government protection), such as excessive risks and favors to cronies.

The East Asian model has also been associated with a system of corporate governance that is said to represent stakeholders—as opposed to shareholder—capitalism. East Asian corporations were neither organized nor governed to maximize shareholder interests. Instead, they reflected a desire to balance shareholder interests with those of other stakeholders, such as banks, workers, and government.

Over time, what one might call this "old" model came under increasing economic and political pressure. Traditional systems simply could not satisfy the growing popular demand for transparency, accountability, openness, and competition. Worse, they failed to deliver economic benefits; economic growth slowed, and by the late 1990s, every East Asian country found itself in a state of crisis.

In this climate of crisis, East Asian governments carried out extensive economic reforms. Across the region, the goal of the reforms was broadly similar: to reform "governed" markets and create in their stead a system more based on markets and good governance. Good governance, liberalization, and deregulation became catchphrases in policy debates and pronouncements.

At the time, the outcomes of reform efforts were not predetermined. The post-crisis policy environment turned out to be fluid and dynamic. It was not clear *ex ante* which policies or groups would be blamed for the crisis, who would frame the issues and offer solutions, and which issues would emerge as key points for reform.

Today, we believe that the reform landscape became sufficiently clear to investigate reform results. The key question is whether the character of East Asian capitalism has actually changed. In terms of system performance, have each country's corporate and financial systems become more transparent, accountable, open, competitive, and responsible (i.e., without moral hazard)?

To effect institutional change, institutional structure must be altered. Institutional structures are important because they enhance the performance of financial markets and/or the corporate sector, especially when they satisfy global standards. Key indicators of new institutional structures include size, composition, ownership, and concentration of financial systems; the protection

of shareholder rights; and the acceptance of business practices based on arm's-length relationships.

Table 1: Measures of Institutional Change in the Financial and Corporate Sectors

System Performance	Transparency
	Accountability
	Openness
	Moral Hazard
Institutional Structure	Size and Composition of Financial Systems
	Type of Bank Ownership
	Concentration of Bank Assets and Equity Market Capitalization
	Regulation of Bank Activities and Ownership
	Regulatory Structure
	Corporate Governance
	Concentration of Corporate Ownership and Market Power

Among the factors contributing to institutional change, the role of financial globalization is particularly interesting and important. After all, the crisis of the late 1990s began as a financial one. Unprecedented amounts of foreign capital have flowed into East Asian economies as a result of the crisis, making foreign investors active players in domestic policy and economic activities.

Since the economic crisis, many studies have focused on economic reforms and financial globalization, but they have been treated as, and remain largely, separate issues in the literature. We do not yet understand the interaction between foreign capital and economic reform, particularly the active role that foreign investors played in reforming economic institutions.

Dependent Variables: Reform Outcomes

Changes in System Performance

One important measure of the system performance of post-crisis East Asian financial and corporate sectors is economic freedom. Economic freedom has brought about greater transparency and accountability in the financial and corporate sectors and also indicates, to some extent, how market-based those sectors have become. Economic freedom data are collected from Economic Freedom of the World: 2002 Annual Report (EFW). EFW measures the degrees of economic freedom present in five major areas: 1) size of government:

expenditures, taxes, and enterprises; 2) legal structure and security of property rights; 3) sound money; 4) freedom to trade with foreigners; and 5) regulation of credit, labor, and business. Because the EFW index relies mostly on third-party data, it can be calculated back to as early as 1970.

Other data on system performance come from the Global Competitiveness Report. Some questions in the report are intended to measure the soundness of institutions and policies designed to promote accountability and transparency. Others determine the actual degrees of transparency and accountability:

- •Is the level of financial disclosure required extensive and detailed?
- •Is insider trading not common in the domestic stock market?
- Are corporate boards highly effective in monitoring management performance and representing shareholder interests?
- •Does antitrust or anti-monopoly policy effectively promote competition?

Since the economic crisis, the Korean and Japanese economies have become freer while China saw its economic freedom fall between 1995 and 2000. Korean economic freedom, in particular, shows a marked improvement, with its EFW rating increasing to 7.01 in 2000 from 6.38 in 1995. Clearly, the wide range of liberalization measures in both capital and goods markets that the Korean government has implemented are taking effect.

With respect to corporate accountability and financial market transparency, progress has been much slower, even in Korea and Japan. Korea's scores on the quality of disclosure requirements, the prevalence of insider trading, and the effectiveness of corporate governance remain well below the world averages. The Japanese record is mixed. While insider trading has become less prevalent since 1996, the trust in board performance has fallen markedly. In both Korea and Japan, antitrust policies have become more effective since 1996. Indeed, both countries have come under strong external pressure to strengthen their antitrust policies.

Table 2: Economic Freedom in East Asia

	1970	1975	1980	1985	1990	1995	2000	Δ70–90	Δ70–00
Korea	5.11	5.04	5.33	5.35	5.85	6.38	7.01	14.5%	37.2%
Japan	6.87	6.33	6.78	6.74	7.02	6.88	7.31		
China	4.28	4.94	4.41	4.99	4.59	5.60	5.28		
World mean	5.95	5.36	5.39	5.40	5.59	6.34	6.81	6.5	26.9
Mean49	5.95	5.48	5.77	5.81	6.11	6.76	7.06		
SD	1.64	1.43	1.40	1.47	1.44	1.26	0.98	22.4	37.4
SD49	1.64	1.39	1.38	1.40	1.30	1.21	0.96		
Mean +SD	7.59	6.79	6.79	6.87	7.03	7.5	7.79	28.9	64.3

Source: James Gwartney and Robert Lawson, with Walter Park, Smita Wagh, Chris Edwards, and Veronique de Rugy, *Economic Freedom of the World:* 2002 *Annual Report*, Vancouver: The Fraser Institute, 2002. Data retrieved from http://www.freetheworld.com, August 1, 2004.

Table 3: Financial Market Transparency

	1999	2000
Korea	4.73	4.60
Japan	5.25	5.30
China	3.71	4.30
World mean	5.16	5.10
Mean+SD	5.92	5.89

Table 4: Insider Trading

	1996	1997	1998	1999	2000
Korea	3.81	4.30	3.74	4.10	3.80
Japan	4.85	5.66	5.05	5.26	5.60
China	3.47	3.62	3.31	3.45	3.40
World mean	3.87	4.39	4.34	4.31	4.26
Mean+SD	4.66	5.33	5.19	5.24	5.14

Table 5: Effectiveness of Corporate Boards

	1996	1997	1998	1999	2000	2001
Korea	3.67	3.30	2.88	3.63	3.90	3.50
Japan	3.85	3.93	3.62	4.14	4.10	2.90
China	4.15	4.06	3.95	3.83	3.70	3.30
World mean	3.90	4.21	4.13	4.53	4.44	4.14
Mean+SD	4.39	4.80	4.82	5.16	5.03	4.97
Mean-sd	3.41	3.62	3.44	3.90	3.85	3.31

Table 6: Effectiveness of Competition Policy

	1996	1997	1998	1999	2000	2001
Korea	3.86	3.79	4.54	4.41	4.80	4.70
Japan	4.07	4.52	4.80	5.01	5.00	5.00
China	3.80	4.73	4.14	3.60	3.40	3.70
World mean	3.86	4.06	4.44	4.33	4.44	4.24
Mean+SD	4.47	4.86	5.20	5.25	5.35	5.30

According to survey data, China lags behind in system performance. In every category, Chinese performance has either deteriorated or remained flat. Apparently, high economic growth in the latter half of the 1990s did not bring about effective structural reforms.

Changes in Institutional Structure

Because of lack of data, it is not possible to compare systematically the postcrisis structures of East Asian financial markets and corporations with those of North American models. One key area to watch is the development of capital markets in East Asia. The main focus of financial reform in East Asia has been to increase direct financing (i.e., stocks and bonds) and reduce dependence on indirect financing as a source of corporate finance. On the corporate side, ownership structure is a key issue, especially in Korea and China. Structurally, the Korean and Chinese corporate sectors are family-dominated. Some argue that a desire to maintain family control is the main cause of bad corporate governance in East Asia.

Theories and Evidence

The Political Economy of Reform

Dependent variables are the overall outcomes of reform efforts. In evaluating the outcome of reform efforts, one may have to make subjective judgments based on reformers' stated objectives, the expectations of various stakeholders, and objective measures of change or distance to an ideal-type market economy model.¹

Independent variables are the initial conditions that prevail before the buildup of reform pressure. It would be controversial to identify a given year the year of initial conditions, but it seems reasonable to choose 1996, a year before the Asian economic crisis broke out, since it has significantly impacted all three countries.

At least four variables characterize initial conditions: 1) the nature and severity of economic crisis; 2) the initial level and composition of foreign capital penetration; 3) the preferences and capabilities of the bureaucracy; and 4) the character and strength of domestic reform coalitions.

These four independent variables shape the relative bargaining power of three main drivers of reform: foreign investors, bureaucrats, and pro-reform groups. The severity of an economic crisis and the existing level of foreign investment can indicate how influential foreign investors can be in "forcing" their agendas. One may argue that the more serious the crisis and the smaller the existing level of investment, the more influential the foreign investors. Using similar logic, we can evaluate the bargaining power of the other reform groups. But the policy preferences of pro-reform groups cannot be deduced *ex ante*, since they depend on the economic and political conditions of each country.

Although more research is necessary, the consensus view, as noted earlier, is that economic reforms have been most extensive in Korea, followed by Japan and China.

Table 7: The Political Economy of Reform

	Japan	Korea	China
Influence of foreign capital	Medium	High	Low
Bureaucracy	Fragmented	Partially Unified	Unified
Pro-reform coalitions	Initiated by Ministry of Economy, Trade, and Industry (METI)	Government-IMF- NGO coalition	
Institutional change	Incremental Limited Convergence; Liberal Democratic Party (LDP)- dominated path	Drastic Convergence; Government-led path	Limited Diversity; Chinese Communist Party (CCP)- controlled path

The three countries have also displayed different patterns of reform process, suggesting that the importance of each independent variable depends upon the country in question. In the case of Japan, changes in domestic coalitions as a result of financial globalization caused restrictions to loosen. However, in Korea's case, reforms have come about mainly because of pressure from international investors after 1998. In China, foreign investors do not constitute a significant factor in the domestic economy and, as a result, fail to influence reform politics significantly.

The Role of Foreign Capital

What is the role of foreign capital in domestic reform politics? It is important to know where and how actively foreign capital was involved in the reform process. The actual impact of foreign political action on reform outcomes is not a central concern here. Rather, simply gauging the level of foreign involvement will help us better understand how financial globalization translates into specific political actions by agents of international capital.

Foreign investors typically have policy agendas distinct from the old model and from many domestic stakeholders. It is straightforward to demonstrate this when foreign investors or their representatives make explicit policy demands as part of trade or bailout negotiations. While there are certain reforms that all foreign investors favor, different individual investors may have different

preferences in other areas, so it may be necessary to disaggregate them into politically meaningful sub-groups, such as financial intermediaries, short-term, and long-term investors. Conceptually, foreign investors can contribute to institutional reform in three ways: 1) advocating government policy change; 2) exercising existing investor and shareholder rights; and 3) practicing best practices and setting examples.

There is no reason to limit the analysis to government actions. Foreign investors can and do monitor private sector implementation. Foreign investors may be more effective in forcing domestic economic actors to comply with new rules than in having the new rules adopted in the first place. If this is true, the contributions of foreign investors may narrow the gap between formal rules and actual practices.

Political economy theory is equipped to explain the pattern of foreign capital's political participation. Even if the role of foreign capital is minimal, it is worth considering—as Jennifer Amyx does in her chapter in this volume—why that is the case. Several variables affect the level and type of such participation. First are initial conditions: some home countries are capital importers, while others (like Japan) are capital exporters. Configurations of foreign capital portfolios (direct investment versus portfolio investment) may also be an important initial factor. The existence of external debt crisis is another variable. Second are government policies. Host government policies toward different types of capital largely shape the environment in which foreign capital participates in domestic policy process. The third group of variables can be described as domestic political variables. These variables determine the political strength of foreign capital, including the strength of traditional policy networks, the presence of domestic allies (e.g., NGOs and reform-oriented bureaucrats), and the quality of idea markets (e.g., media, think tanks, and experts).

Table 8: The Role of Foreign Capital in the Reform Process

Methods for Exercising Influence (in order of increasing causality)	Methodological Issues
Ideas/Persuasion	 Foreign ideas are not uniform. Ideas are a difficult variable to measure. The effects of ideas are indirect.
Example Making/Competitive Pressure	 Foreign examples may not diffuse widely to domestic firms. It takes too long for global standards to drive out local standards in market competition. Foreign firms tend to adapt to local environment instead of seeking to change it.
The Electronic Herd •Credit ratings	 Capital flows respond to economic fundamentals, not necessarily to institutional performance. Financial markets suffer from herd behavior. Threat of exit is less effective against capital surplus countries.
International Rule Making •BIS •IMF •OECD Guidelines/Conventions	 Institutional rules on second-generation reform issues such as transparency, accountability, and prudential regulations are still at an early stage of development. Formal subscription to international rules does not always indicate effective compliance.
Ownership activism •Shareholder rights •Organizing associations	 Ownership activism is rarely coordinated. Foreign investors are reluctant to take political action in the host country.
International Certification •Foreign listings	Only those who are already good seek international certification.
Bilateral Inter-State Negotiations •IMF •WTO •Section 301	 Opportunities for bilateral negotiations are rare. Bilateral negotiations tend to focus on market opening.

Table 9: The Role of Foreign Capital in East Asia

	Korea	Japan	China
Pre-crisis dependence on foreign capital	High	Low	Low
•External borrowings •Foreign ownership share of stocks	•13.0 percent in 1996	•11.0 percent in 1996	
Post-crisis dependence on foreign capital	High		Low
•External borrowings •Foreign ownership share of stocks	•36.0 percent in 2002		
Role of foreign capital in the reform process	•Alliance between foreign institutional investors and NGOs as key to corporate governance reform and IMF-mandated financial reform •Significant restructuring funds came from foreign sources •Foreign investors move stock markets	Little input into financial market reform Significant influence on stock markets and corporate reform	•Not a significant actor in corporate reform process •China agreed to some financial liberalization measures as part of the WTO accession agreement

In 1996, both Japan and China were capital exporters; Korea was a capital importer. Because of large current account deficits, Korea had to borrow from abroad to finance its deficits. This difference in initial conditions largely explains how reform politics has played out in the three countries. In Korea, foreign capital was the driving force behind reform efforts, but played a subsidiary role in Japan and China. Further, although both Japan and China relied little on foreign capital in the beginning, Japan's dependence on foreign capital in equity markets has steadily increased, but remains absent in China. Correspondingly, the influence of foreign capital on corporate reform is growing stronger in Japan than in China.

The case of China poses an analytical challenge. Although China's external borrowings are currently manageable, one cannot deny the importance of foreign investment to the Chinese economy's stability and future. So far, foreign investors have exerted little influence on the Chinese reform process. Some say that it is only a matter of time; once the China rush ends, foreign capital inflows will slow and fluctuate, subjecting China to the discipline of global capital markets.

Conclusion

The East Asian experience in the late 1990s shows that financial globalization is finally catching up with East Asian capitalism. Because of external pressure, East Asian economies are being forced to change at a pace they currently do not find comfortable. Yet it would be too early to declare the triumph of financial globalization. In terms of both structure and performance, East Asian financial and corporate systems still fall far short of attaining global standards. It is clear that they have left the old model behind, but where they are heading is less apparent. Even in Korea—where foreign capital has a prominent presence—the role of foreign capital in the reform process should not be overemphasized. Most of the reforms that Korea agreed to as part of the IMF bailout agreement were measures that the government had long pursued; the government itself even placed some on the agenda during negotiations. On the corporate side, too, foreign investors would have been less effective had they not had the support of local NGOs that pioneered shareholder activism in Korea.

One way to resolve the gap between the appearance and reality of foreign capital in reform politics is to evaluate its influence at different stages of reform. Contributors to this volume, notably Hahn and Lim, and Tiberghien, argue that foreign investors tend to be influential in the early stages, when issues are being recognized and framed. But foreign investors have limited ability to influence the reform process at later stages, when measures are contested, adopted, and enforced in domestic political arena. Even in countries with heavy foreign capital dependence, foreign investors tend to "exit" (i.e., cutting losses and leaving) rather than "voice" (i.e., staying to pressure the

government), which undermines their effectiveness as political actors. Above all, market rationality, rather than political logic, seems to guide foreign investors' behavior.

Notes

¹ Identifying the meaningful patterns of the reform process is also crucial, since they provide additional dependent variables. One way of conceptualizing the patterns of the reform process is the sequencing of reform measures. For example, the problems of corporate reform in Korea could be divided into several largely distinct sub-areas: restructuring of insolvent firms, corporate organization (i.e., chaebol organization), and corporate governance (transparency and accountability of management and the organization and role of boards of directors). Among these, the government had to decide which would receive priority. The problem did not end here. Each area, in turn, had its own set of alternatives. Three different policy instruments, for example, were available for improving corporate governance: external discipline (the market for corporate control and institutional investors), internal discipline (outside directors, cumulative voting, small shareholder rights), and accounting transparency (which falls between areas of external and internal discipline). Since the government could not attack every problem area and choose every instrument at the same time, it had to sequence them according to their need, which was inherently a political process. An interesting issue in Korea is why shareholder rights have been heavily emphasized, as opposed to accounting transparency. That is, this particular pattern of sequencing has to be explained.