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Markets and institutions: Global perspectives ☆

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Abstract

The purpose of this paper is to highlight some of the key developments of markets and institutions at the global level over the past few decades by referring to the evolution of institutions from the government-led system to a market-led system. The paper argues that innovation and deregulation in the financial sector led to acceleration of the process of globalisation in which both markets and institutions are becoming increasingly integrated and more efficient. The paper highlights the role of trade liberalisation in financial services as a way of increasing efficiency and better use of national resources. The paper also highlights the role of consolidation of financial institutions as one of the ingredients of the new developments of markets and institutions. The paper also provides brief highlights of six other papers in this special issue that analyse and discuss some of the global aspects of markets and institutions.

JEL classification: G15; G25
Keywords: Financial system; Financial institutions; Globalisation

1. Introduction

The 20th century has witnessed unprecedented development, expansion and evolution of both markets and institutions. Slow economic growth, high unemployment, high inflation and regulated financial markets were replaced by economic growth, relatively low unemployment and gradual deregulation of the financial markets in the Post War period.

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The Post War period of the financial system was a government-led system designed to promote financial stability and promote free trade in non-agricultural goods. The governments and other relevant institutions were mainly responsible for the safeguarding and the integrity of the system. The Bretton Wood System worked reasonably well due to the fact that there was not much financial integration and national economies were relatively isolated from each other. However, the increase in the flow of private capital within the OECD countries and to the emerging markets, the deregulation of financial markets, the increasing role of the private sector and the multinational corporations in the economy created a market-led system which is far more powerful than the one controlled by national governments. Innovation and deregulation in the financial sector led to acceleration of the process of globalisation in which both markets and institutions are becoming increasingly integrated and more efficient.

The Uruguay round of trade negotiations in trade in financial services paved the way for an increase in the volume of trade in financial services and the expansion of both banking and insurance companies to different parts of the world and an increase in competition between domestic and foreign companies for an increase in their market shares and that of larger markets.

The deregulation of financial markets and closer macroeconomic coordination amongst the OECD countries has also led to an increasingly integrated and interdependent global financial market. Innovations in the financial instruments have created a new environment for companies to raise capital and to relate to both the financial institutions and the capital markets. Telecommunication technology and the emergence of e-banking has also raised a number of issues that should be considered by policy makers and financial institutions including bank's risk management responsibilities with respect to cross-border e-banking and the requirements for adequate home country supervision of cross-border e-banking activities.

The innovations associated with deregulation of the market, such as securitisation, have provided opportunities for financial institutions to expand their businesses and benefit from these innovations by freeing up more resources for other lending. Technology and a better ability to process information allowed for independent pricing of risk factors and gave banks and other financial institutions more ability to effectively respond to an increasing demand for hedging instruments. The new financial instruments have greatly enhanced the ability of risk management and increasingly changed the role of financial institutions in managing global financial risk and has significantly enhanced the quality of both real and financial investments.

Consolidation of financial institutions has also been one of the ingredients of the new developments of markets and institutions in the last few years. The study by Berger et al. (1999) contains a number of relevant issues which have led to consolidation of the financial institutions. While consolidation of institutions took place mainly across one financial sector, the current globalisation forces and the change in the nature of financial institutions are creating an environment in which financial institutions such as pension funds, mutual funds, insurance companies and banks are consolidating their operations at national, regional and global levels and at the same time allowing for some kind of market specialisation to remain in these increasingly growing integrated markets.

2. Some of the developments of markets and institutions

This special issue of the Journal of Banking & Finance presents some of the key papers that have been presented at the 14th Australasian Finance and Banking Conference. [1] The six papers selected for this issue cover some of the issues related to the global aspects of markets and institutions. As these issues are highly relevant to the current evolution of the financial sector, in the remaining pages of this article, we intend to analyse some of the issues relevant to the global aspects of markets and institutions. In doing so, we will refer to some of the specific points and findings as reported in the papers selected for this special issue.

Globalisation and financial market integration are increasingly changing the way the financial institutions operate. One of the consequences of the globalisation of financial markets is the expansion of multinational banks in different parts of the world. These banks compete with the source countries' banks and also contribute to the process of the integration of financial markets. One of the key questions to be asked is whether the banking sector will be fully globalised. Berger, Dai, Ongena and Smith in their article (To what extent will the banking industry be globalised? A study of bank nationality and reach in 20 European Nations) argue that the right question to ask is the extent to which the banking sector will be globalised rather than if or when the banking sector will be globalised. The reason for this is that some banking services may always be provided primarily by small, local institutions operating in the nation in which the services are demanded. Berger et al. identify two distinct dimensions of globalisation-bank nationality and bank reach and apply a two stage nested multinational logit model to estimate the extent of globalisation in banking. They find that foreign affiliates of multinational companies choose host nations' banks for cash management services more often than home nation or third country banks. They also find that bank reach is strongly associated with bank nationality. Furthermore, they find that bank nationality and bank reach both vary significantly with respect to the legal and financial development of the country in question. Overall, their findings suggest that future bank globalisation may be limited as many corporations continue to prefer local or regional banks for at least some of their services.

Bank consolidation has accelerated in the latter part of the 1990s to the extent that half of the total consolidated assets in the US from 1980 to 1998 occurred between 1995 and 1998. A recent study by the group of 10 indicates that mergers and acquisitions in the banking sector are happening in all the OECD countries. The recent study by Hughes et al. (2001) demonstrates economies of scale for large banks and hence one would expect to see further consolidation in the banking sector in the

[1] The conference, which was organised by the School of Banking and Finance at the University of New South Wales, was held between 17 and 19 December 2001 in Sydney, Australia.

immediate years ahead. Based on this recent study, the paper by Hughes, Lang, Mester, Moon and Pagano in this special issue use data on bank holding companies in the US and find that the existence of managerial entrenchment influences how assets acquisitions and sales affect financial performance. This study, which measures bank financial performance both by Tobin's q ratio and by its failure to achieve its highest potential market value, finds that there is strong evidence of entrenchment in banks with a higher level of managerial ownership, better growth opportunities, poorer financial performance, and smaller assets size. They also find that an increase in assets size achieved by internal growth is associated with better performance by banks with entrenched managers. In contrast, they find that a large amount of sold assets by banks with entrenched management is related to improved performances. This study is able to reinforce the existence of economics of scale as the basis for consolidation in banking. However, it also argues that the benefits of asset acquisitions are not obtained by entrenched managers, who may be able to resist market discipline to build empires.

The information sharing and transparency of operations of financial institutions is one of the important elements of the New International Financial Architecture. The Asian currency crisis and inadequate discipline and transparency on the part of the financial institutions led to the call for a new international financial institutions standards in which all financial institutions would follow a set of internationally accepted standards for financial and economic reporting as a way of ensuring better and more effective operations of financial institutions. The paper by Kallberg and Udell is an attempt to demonstrate the significance of information exchange at the lending decision level. This study is a great contribution to the debate on information sharing and transparency at both national and global levels. This study highlights the significance of the exchange of credit information by lenders, particularly through a formal exchange mechanism. This paper investigates the value added by private information exchanges that share information on business payment performance. They discuss how this information is collected and disseminated by the world's largest private information broker, Dun & Bradstreet. The empirical results of this study indicate that exchange-generated information provides significant explanatory power in failure prediction models controlling for other credit information that is easily available to lenders. The finding of this study is significant in the process of building global financial architecture in which financial institutions as well as other market participants are bound by a set of internationally accepted codes as a way of safeguarding the free market forces and ensuring less market failures in the future.

Trade liberalisation in financial services through the Uruguay round of trade negotiations led to the emergence of a number of studies dealing with the comparative advantage of financial institutions and the role of foreign direct investment by financial institutions in different parts of the world, including the Asia-Pacific region. One of these studies was by Moshirian (2001) in which he highlighted the role of the multinational banks in expanding overseas and the effects of the cost of labor in this process. As trade in financial services has grown in the last 20 years, financial services in the Asia-Pacific region has also been evolving rapidly, particularly due to the deregulation of the Japanese financial market in the 1980s. Financial markets in the Asia-Pacific region are becoming more integrated and the Asian financial institutions are becoming more efficient, in an attempt to compete more effectively against banks from the US or Europe. Simon Kwan in his paper on (Operating performance of banks among Asian economies: An international and time series comparison) argues that the Asian bank operating costs declined prior to 1997. However, since the Asian financial crisis in 1997, the banks have been incurring additional costs in dealing with their problem loans while output was declining simultaneously. The empirical results of this study show that labor cost share declined significantly between 1997 and 1999. This indicates that banks were able to reduce their labor force after the financial crisis. However, they were less flexible in reducing their physical capital. Kwan found a significant difference in labor cost share across countries, suggesting that different countries have different bank production functions.

An effective monetary policy is crucial for the efficient operation of companies. There have been significant changes in the three key economic factors, often referred to as the "impossible trinity" (i.e., fixed exchange rates, free capital mobility and an independent monetary policy). The evolution of the financial institutions led us to accept that price stability is the crucial factor for an effective monetary policy and hence we should accept a flexible exchange rate regime and free capital mobility. The role of an independent central bank in pursuit of price stability has been debated by both academics and policy makers. Suffice to say that most central banks which have had an effective interest rate policy in the short term, have succeeded in establishing price stability in the medium term. The paper by Zhangkai Huang (Evidence of a bank lending channel in the UK) uses balance sheet data for a panel of UK listed firms and finds that a higher interest rate induces more bank lending to listed companies, but this effect diminishes if monetary policy becomes tight enough to impose severe constraints on bank loan lending. This paper finds that small firms bear most of the reductions in bank loan supplies, and since they do not have many alternatives to bank finance, they suffer more from monetary tightening than big firms.

The last, but certainly not the least, article in this special issue is written by Douglas Cumming and Jeffrey MacIntosh and deals with venture capital. (A cross-country comparison of full and partial venture capital exits.) A number of studies attempted to model the role of venture capital financial contracts in mitigating agency costs and informational asymmmetrics between venture capitalists and entrepreneurial firms. This paper, as it is stated, extends previous research on the complete class of venture capital exit vehicles and the associated selection effects for measuring the risk and return to venture capital investing. They distinguish between full and partial exits for the complete class of venture capital exits. They provide empirical tests of the factors that determine the choice of a full or partial venture capital exit over the complete class of exits, and provide evidence that the risk and return to venture investing differs by the extent of exit for each exit vehicle. Partial exits are typically associated with a higher risk and return, which is consistent with the proposition that partial dispositions are more common among exits whereby informational asymmetries are more pronounced.

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