THE ABFER ASIAN BUREAU OF FINANCE AND ECONOMIC RESEARCH DIGEST

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Disguised Corruption: Evidence from Consumer Credit in China.

Sumit Agarwal (NUS), Wenlan Qian (NUS), Amit Seru (Chicago), Jian Zhang (NUS)

Research has shown that corruption distorts resource allocation with consequential social welfare implications. The fast economic growth in China in the past three decades combined with controlling power by the central and local governments render enormous incentives for engaging in corruption activities. It is well known that corruption in China is endemic. Hence, the new Chinese Premier has embarked on cleaning up the image and implemented some symbolic gestures to signal his resolve to remove corruption.

In **Disguised Corruption: Evidence from Consumer Credit in China**, authors *Sumit Agarwal, Wenlan Qian, Amit Seru and Jian Zhang* document a rather disguised form of corruption using a unique, representative sample of consumer credit data in China. A random, representative sample of a bank's customer accounts, covering all provinces in mainland China, containing consumer credit card data of close to one million individuals dating from the first quarter of 2003 to the third quarter of 2005, is used.

For banks, support from the (powerful) local governments is crucial to their business operation and growth. However, offering explicit bribes is rather costly for bank managers as they are subject to corruption investigation. Alternatively, banks can offer bribes in a more disguised way to government officials by extending over-generous credit lines to them.

Bureaucrats are observed to receive 12% higher in credit line, compared to non-bureaucrats who earn similar income and comparable demographics. The bureaucrat credit premium is greater among higher-ranked bureaucrats, and among bureaucrats in plausibly more corruptive locations.

To disentangle the implicit bribe explanation for the bureaucrat credit line premium from one based on true credit-worthiness, the authors further study the subsequent credit card performance. Bureaucrats' credit card accounts are more likely to become delinquent, and if delinquent, experience a higher probability of gaining reinstatement.

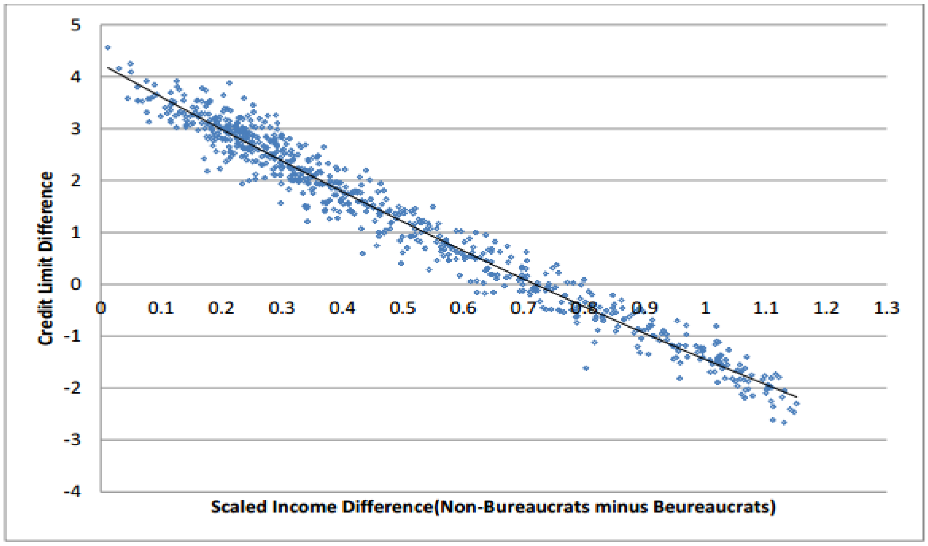
Among those whose delinquent credit accounts are subsequently reinstated, it takes a longer time till reinstatement for bureaucrats, indicating that they most likely achieve account reinstatement by the bank writing off their credit debt.

Collectively, the evidence is consistent with the interpretation that banks offer generous credit line to bureaucrats as implicit bribes—bureaucrats receive higher credit lines, become delinquent more often, following which banks forgive their credit card debt and reinstate their credit card accounts.

In addition, there is evidence that branches within the bank that grant more credit lines to bureaucrats are associated with higher government deposits, compared to other branches within the same bank located in areas associated with lower bureaucrat credit line premium.

This is consistent with banks receiving benefits in the form of government deposits in return for the implicit bribes they extend to bureaucrats.

On the other hand, non-bureaucrat consumers appear to suffer from credit under-provision in regions where banks extended more credit to bureaucrats—those living in areas with a high bureaucrat credit line premium are associated with significantly lower credit lines relative to the matched non-bureaucrat consumers in areas with a lower bureaucrat credit line premium.



Income premiums to eliminate the credit line differential
The figure describes how much more income the non-bureaucrats should earn in order to have the same credit line with bureaucrats of similar characteristics. Income is scaled by the provincial median. For each point, the propensity score matching based on age, gender and residential province is firstly performed to obtain the matching sample. Then the sample mean of income and credit line difference is computed and plotted.
Source : Authors

Capital Gains Lock-In and Governance Choices.

Stephen G. Dimmock (NTU), William C. Gerken (UKY), Zoran Ivković (MSU), Scott J. Weisbenner (Illinois)

Prior research shows that capital gains taxation affects the trading decisions of mutual funds because of a "lock-in" effect. A lock-in effect occurs when a mutual fund with a largely taxable clientele is locked into a position with an unrealized capital gain because realizing gains triggers a costly tax liability for investors. Because of this lock-in effect, the cost of exiting a position will differ across mutual funds even for the same stock at any given time, depending on the tax status of the funds' investors and the size of the accrued gain (or loss) in that stock.

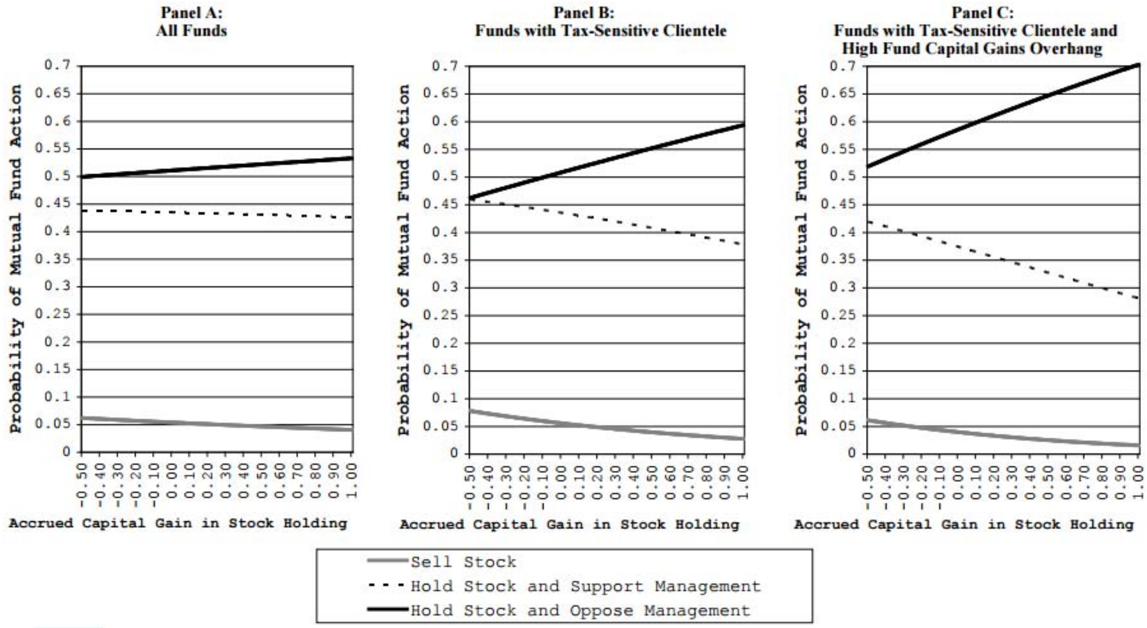
In **Capital Gains Lock-In and Governance Choices**, the authors *Stephen G. Dimmock, William C. Gerken, Zoran Ivković, and Scott J. Weisbenner* show that capital gains lock-in may affect mutual funds' governance activities. Specifically, a higher tax lock-in is found to decrease the likelihood that a fund sells a stock prior to a contentious vote, and increase the likelihood that the fund votes against management.

Data from multiple sources, including the CRSP Open-End Survival Bias Free Mutual Fund Database, Thompson-Reuters Mutual Fund Holdings Database, Pensions & Investments' Survey of Defined Contribution Plans, CRSP Stock File, ISS Voting Analytics Database and RiskMetrics Governance Database, are used for analyses.

The authors demonstrate that there is a negative relation between mutual funds' sale decisions and accrued capital gains in stock holding. Accrued capital gains also predict mutual funds' voting decisions. Specifically, higher accrued capital gains in a stock holding are associated with a lower probability that the fund sells the stock, relative to the probability of supporting management. Higher accrued capital gains are also associated with a higher probability that the fund opposes management (again, relative to the probability of supporting management).

Finally, the aggregate accrued capital gains of all mutual funds that hold a stock is observed to affect both *the outcome of a contentious vote* as well as *whether a contentious vote appears on the agenda of the shareholder meeting.*

This paper documents another avenue through which capital gains taxation influences the behavior of institutional investors. It finds that capital gains lock-in not only reduces the likelihood that a fund will sell a stock, but also increases the likelihood that a locked-in fund will oppose the firm's management.



Relation between Exit/Voting Decisions of Mutual Fund and Accrued Capital Gains in Stock Holding.
The sample includes all observations in the merged fund holding – Voting Analytics dataset, covering the period from 2003 to 2008, in which the ISS recommendation for a proposal does not equal the management recommendation (i.e., a sample of contentious votes). For a given proposal, the fund can sell the stock before the shareholder meeting, continue to hold the stock and support management, or continue to hold the stock and oppose management. Panel A shows results for all funds. Panel B shows results for funds with a tax-sensitive clientele (the fund's share of assets in retirement accounts is below the sample median). Panel C shows results for funds with a tax-sensitive clientele and a high fund capital gains overhang (the fund's portfolio-wide gains are above the sample median). We record the unconditional probabilities of the exit/support/oppose decision, as well as the unconditional average accrued capital gain in a stock holding. From that baseline, we extrapolate the probabilities of the exit/support/oppose decision for higher and lower accrued capital gains using the coefficients from panels of Table III for the corresponding panels of this figure.

Source: Authors

The effect of capital gains lock-in on voting has important implications for the firm. The presence of accrued capital gains among mutual funds with taxable investors leads to a higher likelihood of a vote outcome against management and a lower likelihood of a contentious proposal being voted on at the meeting.

In summary, this study shows the influence of mutual funds on corporate governance through the tax-induced capital gains lock-in channel. As open-end mutual funds continue to own an increasingly larger fraction of total U.S. equities, mutual funds' decisions regarding whether to exit, stay and support, or stay and fight a firm's management will be an increasingly important component of corporate governance.

Political Turnover, Ownership, and Corporate Investment

Jerry Cao (SMU), Brandon Julio (Oregon), Tiecheng Leng (SMU) and Sili Zhou (SMU)

The study focusing on China examines the impact of political influence and ownership on corporate investment by exploiting the unique way provincial leaders are selected and promoted in the country. The tournament-style promotion system creates incentives for new provincial governors to exert their influence over capital allocation, particularly during the early years of their term.

In **Political Turnover, Ownership, and Corporate Investment,** the authors *Jerry Cao, Brandon Julio, Tiecheng Leng and Sili Zhou* hypothesize that the incentives of provincial political turnovers can have a significant impact on local firm-level investment. When the government has great influence on corporate decisions, firm level investment may vary around the timing of political leader changes.

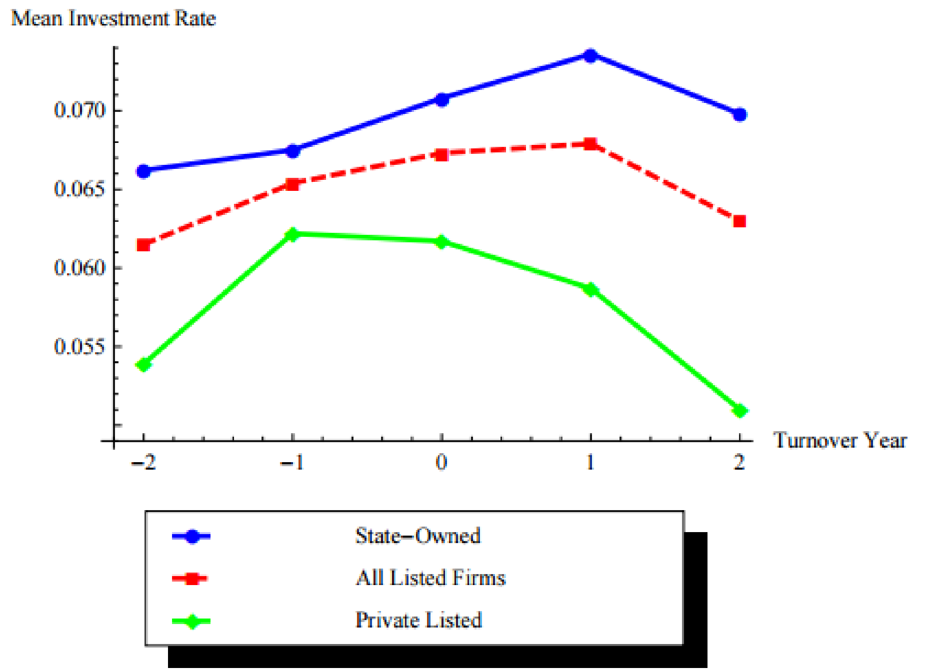
Using manually collected information on the transition of top provincial leaders in China for both governors and party secretaries, they relate the event of the turnover of governors to investment of state owned enterprises (SOEs) and non-state owned enterprises (non-SOEs).

The authors find that there is a divergence in investment rates between SOEs and non-SOEs following political turnover. SOEs experience an abnormal increase in investment by 6.0% in the year following the turnover, consistent with the incentives of a new governor to stimulate investment.

In contrast, investment rates for non-SOEs decline significantly post-turnover, suggesting that the political influence exerted over SOEs crowds out private investment. The effects of political turnover on investment are mainly driven by normal turnovers, and turnovers with less-educated or local-born successors. The authors provide evidence that the political incentives around the turnover of provincial governors, represents a misallocation of capital as measures of investment efficiency decline post-turnover.

The paper contributes to the literature on the effects of political change on corporate investment in general and in China specifically. The study on firm-level investment behaviors around political turnovers sheds lights on the channels through which top provincial leaders attempt to prop up provincial economic performance by affecting the investment policies of SOEs.

Post-turnover, there is a large wedge between the investment rates of SOEs and private firms. Investment rates for SOEs are abnormally high while investment rates of non-SOEs are lower than normal.



Investment Rates around Turnover Years
The figure depicts average investment rates around turnover event years for all listed firms (red line), SOEs (blue line) and non-SOEs (green line) respectively. Year 0 indicates the calendar year in which governor turnover event occurs.

Source: Authors

The results are consistent with the view that the incentives of new provincial governors influence the investment rates of SOEs in an effort to boost provincial economic growth and increase the chance of personal promotion.

Furthermore, the study finds that the investment behavior of SOEs post-turnover has a crowding-out effect on the investment rates of private firms. These divergent patterns of investment reflect a misallocation of capital as measures of investment efficiency decline significantly following the turnover of a provincial governor.

The research sheds lights on the interaction between political economy and corporate finance in an important emerging economy like China, which with a unique political system, provides an interesting laboratory for studying how corporations react to both political uncertainty associated with leadership turnovers and the incentives politicians face to boost investment. The empirical findings show that in China, SOEs corporate decisions often follow the political lead, while non-SOEs face great political uncertainty and diminished capacity for investment. Non-SOEs are not equipped with safeguards against political interference from the government, while SOEs are more likely to serve the interest of political leaders since their personnel decisions are controlled by these leaders and not by the shareholders.

The paper shows how political systems interact with ownership structures in China. It suggests that SOEs, though partially privatized through share issuance, are still subject to heavy political influence. The government still plays an important role in firm investment decisions, especially in the case of those that are state-owned.

Learning about the Neighborhood: The Role of Supply Elasticity and Housing Cycles

Zhenyu Gao (CUHK), Michael Sockin (Princeton), and Wei Xiong (Princeton)

The study is motivated by an intriguing observation during the recent U.S. housing cycle that counties with housing supply elasticities in an intermediate range experienced the most dramatic price booms and busts. The paper develops a model to analyze information aggregation and learning in housing markets.

In the presence of wide gaps in information, housing prices serve as important signals in the households learning of the economic strength of a neighborhood. Supply elasticity affects not only housing supply but also the informational noise in the price signal.

In **Learning about the Neighborhood: Supply Elasticity and Housing Cycles,** the authors *Zhenyu Gao, Michael Sockin and Wei Xiong's* model predicts that the housing price and the share of investment home purchases exhibit the greatest variability in areas with intermediate supply elasticities, which is supported by their empirical analysis.

As supply elasticity weakens housing cycles, housing prices are expected to be more volatile in areas with more inelastic housing supplies. However, during the recent U.S. housing cycle in the 2000s, some areas such as Las Vegas and Phoenix experienced more dramatic housing price booms and busts, despite their relatively elastic housing supply, compared to areas with more inelastic supply, such as New York and Los Angeles. By systematically examining the cross-section of the booms and busts experienced by different counties during this housing cycle, the authors find that the fully decreasing relationship between the magnitude of housing cycles and supply elasticity is more fragile than commonly perceived.

A key feature of the author's model is that the housing market is not only a place for households to trade housing but also a platform to aggregate private information about the unobservable strength or quality of the neighborhood. In addition to its direct role in affecting housing supply in the neighborhood, supply elasticity also indirectly affects the informational noise in the housing prices.

The model also builds in another important feature that households underestimate supply elasticity. Households overreact to the housing price signal due to the underestimation of supply elasticity. The increased volatility induced by the learning effect is strongest in a neighborhood with an intermediate supply elasticity. The authors further extend the baseline model to include immigrants attracted to the neighborhood by its economic strength later, and the speculation of current households in buying secondary homes for selling or renting to immigrants.

The paper highlights a not fully decreasing relationship between the magnitude of housing cycles and housing supply elasticity in the cross-section of U.S. county data during the U.S. housing cycle of the 2000s. The authors develop a tractable model to analyze information aggregation and learning in housing markets to explain this phenomenon. In the presence of pervasive informational frictions regarding economic strength and housing supply of a neighborhood, households face a realistic problem in learning about these fundamental variables with housing prices serving as important signals.

The model highlights how the households learning interacts with characteristics common to local housing supply and demand to impact housing price dynamics. In particular, supply elasticity affects not only housing supply but also the informational noise in the price signal for the households learning of the neighborhood strength. The model predicts that housing price and share of investment home buying are both most variable in areas with intermediate supply elasticities, and that these variances are positively correlated, which is supported by the practical experience.

Guru Dreams and Competition: An Anatomy of the Economics of Blogs

Yi Dong (UIBE), Massimo Massa (INSEAD), Hong Zhang (Tsinghua)

The rise of social media has been one of the most interesting phenomena in recent times. Nowadays, almost anyone can use the Internet (e.g. blog) to express his or her opinions on a variety of issues ranging from stock valuation to fashion and politics.

As bloggers, people can potentially have a large following. Blogging also offers opportunities to attract public attention in a way that traditional media does not. These characteristics have given rise to bloggers pursuing the "dream to become a guru".

In **Guru Dreams and Competition: An Anatomy of the Economics of Blogs**, authors *Yi Dong, Massimo Massa and Hong Zhang* seek answers to the following two questions crucial for understanding the economics of social media:

(1) Are "gurus-to-be" bloggers more informed than public media?

(2) Given the low entry barrier of blogging, how does competition affect bloggers' behavior and their guru dream?

By using a unique hand-collected database of blogs covering all S&P 1500 stocks over the period of 2006-2011 from LexisNexis, the authors find evidence that supports the informativeness of blogs. They use linguistic analysis to define the tone of a blog, including positive tone, negative tone, tone difference and tone extremism, which is the maximum value for the positive and negative tone in the same blog article.

Tone difference is found to help in predicting abnormal stock performance over the following month. Further, positive tone and negative tone predict positive and negative stock returns, respectively. By contrast, tone extremism does not predict future stock returns.

The authors then explore the impact of competition in the blog market. They find that competition amplifies tone difference via negative but not positive tone. However, the part of blog tone driven by competition does not have any predictive power on future stock returns. This evidence indicates that the impact of competition on negative tone is due to an exaggeration on negative opinions rather than more precise negative information.

This study sheds new light on the role of social media in information provision. Interestingly, competition appears to distort information and thus weakens the informational contribution of social media.

Mandatory Retirement and the Consumption Puzzle: Prices Decline or Quantities Decline?

Yingying Dong (UC Irvine), Dennis T. Yang (Virginia)

The permanent income hypothesis states that people are expected to smooth their consumption over their lifecycle through borrowing and saving. However, empirical evidence tells a different story. The well-known "retirement-consumption puzzle" states that people reduce their consumption significantly at retirement.

In **Mandatory Retirement and the Consumption Puzzle: Prices Decline or Quantities Decline?**, authors *Yingying Dong and Dennis Yang* investigate the household consumption changes at retirement in China and provide evidence on the "retirement-consumption puzzle" from a large developing country.

Mandatory retirement policy in China provides a good quasi-experimental setting for identifying the causal effect of fully anticipated retirement on consumption.

Using the comprehensive, diary-based Urban Household Survey (UHS), the authors seek to verify the consumption decline at retirement in China, and identify the expenditure changes in terms of price and quantity.

The authors find that given the unique social norm, cultural and economic environment in China, the composition of consumption decline at retirement differs from what has been observed in Western developed countries. While the consumption decline at retirement in the West is mainly induced by work-related expenditure such as clothing and transportation, the major change for consumption at retirement in China is in food expenses.

Work-related expenditure does not exhibit significant decline as there is less dress code requirement in China and most people take inexpensive public transportation to work. Food expenses decline more significantly for the low education group than those with a college degree.

The authors also demonstrate that the food expenditure decline is due to price change. The quantity demanded for each category of food does not change significantly.

Is the price change due to quality decline or more time spent to shopping for bargain after retirement? Data from the China Health and Nutrition Survey suggest that there is a significant increase in food shopping time upon retirement for low education group. Hence, the price decline observed among the low education group is at least partially induced by retirees shopping for bargains.

In conclusion, the reasons for decline in food expenditure are increased shopping time for bargain, cut in meal out expenses and increased home production. These findings provide evidence to support household rational behaviors upon retirement and to resolve the retirement-consumption puzzle.

Are Shorts Equally Informed? A Global Perspective

Ekkehart Boehmer (SMU), Zsuzsa. R. Huszár (NUS), Yanchu Wang (Purdue), Xiaoyan Zhang (Purdue)

Prior studies provide evidence that short selling plays an important informational role in the stock market. Yet, it may not come as a surprise that shorts are not necessarily equally informative everywhere.

Ekkehart Boehmer, Zsuzsa. R. Huszár, Yanchu Wang and Xiaoyan Zhang in **Are Shorts Equally Informed? A Global Perspective** use daily data from 25 countries between July 2006 and August 2010 to construct alternative shorting measures including the shorting demand, degree to which short selling is constrained and uncertainty about shorting fees.

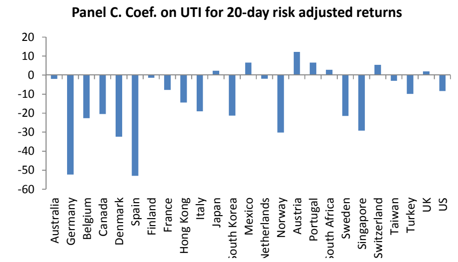
Most of the shorting measures significantly predict future stock returns, suggesting they are informative in stock markets. However, their informativeness varies substantially across countries.

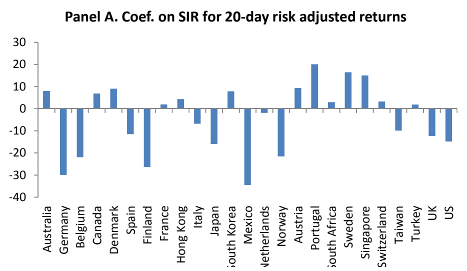
Several factors account for the variation in informativeness—short sale regulation, country openness, and market quality.

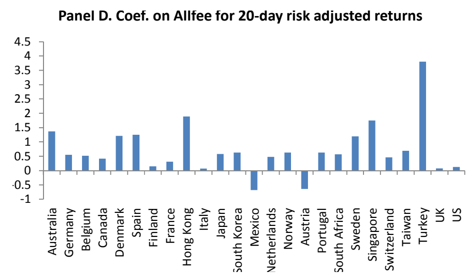
The authors find that more restrictive regulations, such as shorting bans, significantly strengthen the informativeness of shorts. This is consistent with the idea that the higher costs of short trades drive out less well-informed short sellers.

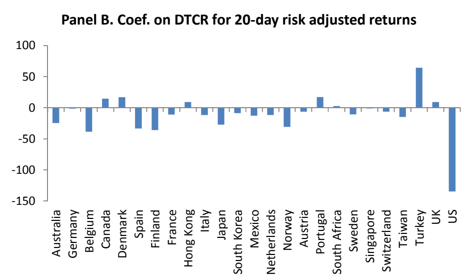
They also show that a centralized lending market weakens the informativeness of shorts. Following the same argument, a centralized lending market reduces the cost of short selling, and hence, attracts less well informed traders.

Lastly, shorts are more informative in countries with better accessibility and better investor protections.









Alternative short sale measures return predictability at the 20-day horizon

Coefficient estimates from stock level regression of future 20-day abnormal returns by country in relation with shorting variables, Short interest ratio (*SIR*), Days-to-cover ratio (*DTCR*), Utilization ratio (*Uti*) and all fee variable.

Source: Authors

Do Analysts with Close Ties Improve the Firms' Information Environment? Evidence from a Relationship-Based Economy

T.J. Wong (CUHK), Zengquan Li (Shanghai), Gwen Yu (Harvard)

Relationship matters much in China. China's listed firms rely heavily on relationship-based contracts because the country's capital market and legal institutions are not well developed.

These relational contracts, due to their implicit nature, create a challenge for public disclosure because the information is often imprecise and hard to verify. In addition, public reporting may reveal sensitive information about network ties (for example, political connections or strategic partnerships), which can jeopardize the firms' competitiveness and possibly destabilize the connection itself.

Thus, when firm managers determine their disclosure strategy, they need to balance between the political and proprietary costs of disclosing information associated with relationship-based contracts and the high cost of financing as a result of information opacity.

In **Do Analysts with Close Ties Improve the Firms' Information Environment? Evidence from a Relationship-Based Economy**, authors *Zengquan Li, T. J. Wong and Gwen Yu* examine the informational role of social and business ties between financial analysts and firm managers. The sample includes 2,372 firms that issue A-shares traded on the Shanghai and Shenzhen Stock Exchanges and earnings forecasts of 4,516 analysts from 2005 to 2013.

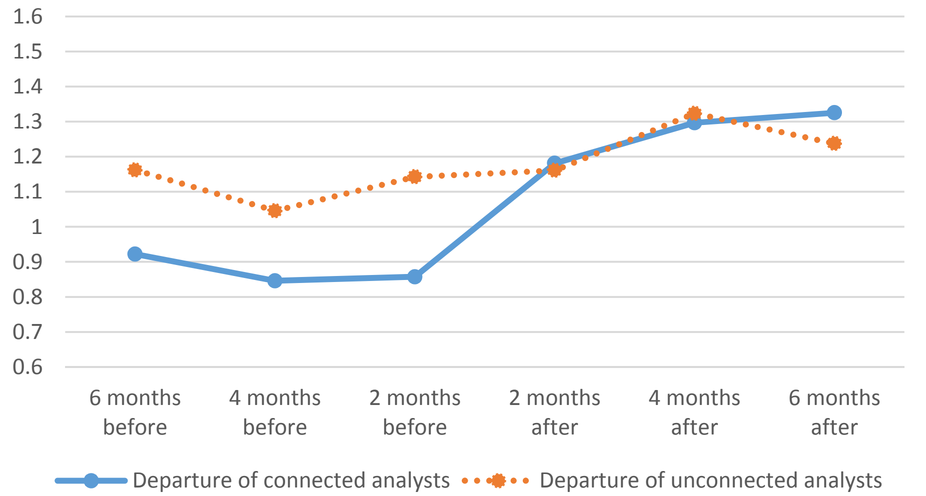
They find that social and business ties can facilitate the private transfer of information and create positive externalities that improve the firm's information environment. Specifically, they find that forecasts by analysts connected through social and business ties are more accurate and timely than those of unconnected analysts. The forecasts by such connected analysts are 8.35% more accurate and 6.35% timelier than those of unconnected analysts. The forecasts by connected analysts are also more likely to provide new, relevant information to the market.

Also, the authors find that the activities of connected analysts have a positive spillover effect on the forecasts activities of other unconnected analysts. Firms with more connected-analyst following have more accurate consensus forecasts and lower forecast dispersion than those with less connected-analyst following. The benefit of connected analysts' activity, measured in terms of consensus forecast accuracy and forecast dispersion, is greater when the firm's economic activity relies heavily on relational contracts.

The authors also show that following the departure of a connected analyst, the accuracy of consensus forecasts reduces significantly. In contrast, following the departure of unconnected analysts, there are no changes in consensus forecasts' accuracy.

Specifically, following the departure of a connected analyst, the increase in the forecast errors of the consensus forecasts is 23% greater than the increase following the departure of an unconnected analyst. Also, the effect a connected analyst's departure has on the firm's information environment is greater when the departing analyst plays a pivotal role, such as when the departing analyst is the only connected analyst following a firm.

The results imply that in emerging markets where contracts are implicit and public reporting and disclosure of contracts may jeopardize firms' competitiveness and strategic connections, alternative channels such as network information transfer may serve the firms well. In such markets, selective disclosure through networks can lead to an improvement in the information environment and increase the aggregate amount of disclosed information.



Changes in the consensus forecast errors after the departure of a connected vs. unconnected analyst

The figure plots the average changes in consensus forecast errors following the departure of an analyst. Each unit on the x-axis is the number of months before and after the departure event. Y-axis is the consensus forecast errors defined as the difference between the forecast and the actual EPS, scaled by the stock price at the beginning of the year × 100%.

Source: Authors

About ABFER

The Asian Bureau of Finance and Economic Research is an institute founded by academics from Asia, North America, and Europe. The Bureau intends to create a virtual and independent network of high-quality academics akin to the NBER/CEPR, as well as conferences and workshops. The purposes of the Bureau include:

- *to promote Asia-Pacific oriented financial and economic research at local, regional and international levels;*
- *to connect globally prominent academic researchers, practitioners and public policy decision-makers on Asia-Pacific related financial and economic issues;*
- *to enhance the research capabilities and development of strong clusters of finance and economic research groups in academic institutions and other institutions in Singapore and Asia-Pacific.*

This Digest summarizes selected papers presented in the ABFER's 3rd Annual Conference which was held in May 2015 at the Shangri La Hotel, Singapore. More information on the conference can be found here

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