Financial Liberalization and Stability of the Financial System in Emerging Markets: The Institutional Dimension of Financial Crises

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Abstract

Emerging economies, which have implemented since the end of the 80's a process of financial liberalization, are confronted at the same time to banking crisis. The latter highlight the role played by the institutional framework in the process of financial liberalization. The objective of this paper is to go through the usual alternative too much/ too little market in order to explain that the success of any liberalization process relies on the complementarity between market and intermediation. Institutions defined as rule-following behavior represented the cornerstone of such an evolution. The point is that the solution to financial instability is to be found within the institutional dynamics in which emerging economies may benefit from intermediation in order to enforce the market process.

Key words: emerging markets, financial crisis, financial liberalization, market and institutions

JEL codes: F3; G0

1. Introduction

Since the late 80s, emerging economies[1] have begun a process of financial liberalization, which is reminiscent of that experienced by a number of industrialized countries since the end of the 70s. In view of improving the efficiency of the financial system, whilst increasing the rhythm of economic growth, this financial liberalization has taken three main forms: (i) the deregulation of interest rates; (ii) the introduction of competition between the different channels of financing; and (iii) the external opening of the financial system. In most liberalized economies, the financial structure of companies has developed in the manner wished for by authorities: marketable instruments of debt and equity market capitalization increased dramatically.

If those previous developments highlight that financial liberalization aims to improve the efficiency of the financial system in terms of a better allocation of capital, we noticed that at the same time this liberalization has been accompanied by a significant increase in the number of banking crises. This leads logically to the question of pertinence of paths chosen by emerging markets since the end of the 1980's[2]. How could we explain this paradox?

A first view relies on the traditional opposition between bank-based and market-based systems. While some stress banks comparative advantages to mobilize financial resources, to identify good projects and to monitor them in a context of asymmetric information, others ascribe to the market a positive role which consist to promote economic growth thanks to the portfolio diversification. According to the former, the market-based system has numerous shortcomings (short-termism; myopic behavior) and the latter claim bank-base system favors inefficiencies such that low risk bias and extra rents-seeking by banks. In this perspective, this frist view brings the interpretation of financial instability to the alternative between liberalization excess and insufficiency.

Some recent empirical papers –for instance, Demirgüç-Kunt and Maksimovic (2000); Beck, Demirgüç-Kunt, Levine, and Maksimovic (2000)- suggest that the preceding opposition may be irrelevant. Indeed, the type of financial system –bank-based or market-based- doesn't exert a decisive influence on economic growth. The primary factor to explain the influence of the financial system on economic growth, is the legal system. So, the efficiency of the legal system constitutes a second view to explain the financial instability in a liberalization context. According to this view, an efficient financial system must have some properties, mainly: a strong system of legal enforcement, an efficient judicial system, a precise system of proprietary rights and a good quality of accounting standards[3]. From this point of view, the process of financial liberalization must attend to the evolution of the legal system to promote an efficient financial system[4].

This paper adopts a third view –although complementary with the former- founded on the institutional dimension of financial liberalization. The whole set of formulating concepts used to deal with institutions, relies basically on the notion of rule-following behavior. More precisely, institution may be defined as "a regularity in social behavior that is agreed to by all members of society, specifies behavior in specific recurrent situations and is either self-

policed or policed by some external authority" (Schotter, 1981, p.11). This definition required to consider not only the legal framework, but also behavioral regularities associated to a set of rules, norms and routines (Nelson, Winter, 1982). Those two elements may determine both the emergence and evolution of institutions. We noticed that they are always playing together and this is also the case when considering the financial liberalization process[5]. The main idea consequently proposed in this paper is the following: the answer to financial instability must be sought in institutional dynamics -implying going beyond the bank-based/market-based opposition- in which emerging economies would use bank-based system advantages –conceived as the main legal institution which permits individual behaviors to be conveyed- to reinforce the market process. Therefore, it is the process of financial liberalization which is the object of our analysis, in order to understand the stakes for emerging economies in this very particular period of transition and imbalance.

The remainder of the paper is organized as follows. Section 2 analyzes links between financial liberalization and banking crises. Section 3 explains that emerging economies are confronted to a dilemma: how new institutions are likely to become successfully part of the existing permanent institutional structure ? Section 4 examines the significance of banks marketization process in emerging economies. Section 5 concludes in stressing the main implications of our analysis from an international political economy perspective.

2. Financial liberalization and banking instability: towards an institutional approach

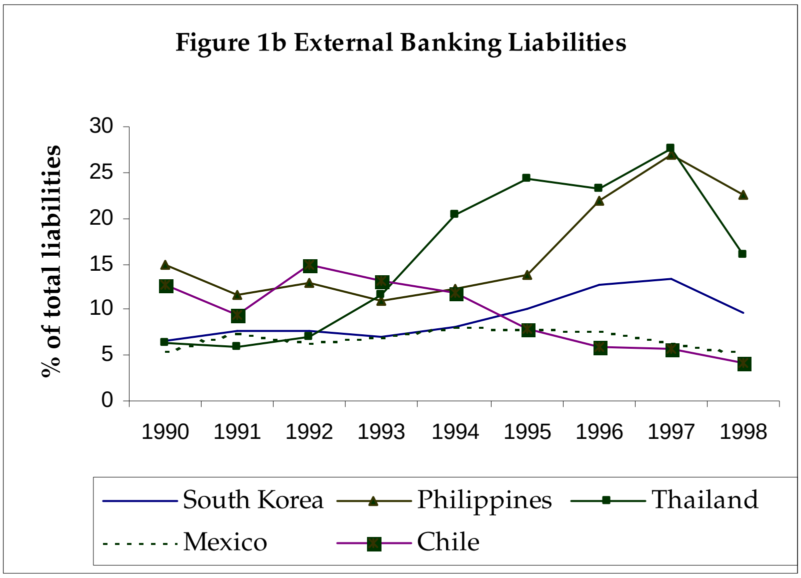
Empirical works relative to banking crises identify channels of transmission, through which financial liberalization may exerts an influence on banking stability. Beyond these indicators, we stress the decisive role of institutional factors.

Some stylized facts

Firstly, interest rate deregulation leads to an increase in the level of interest rates. Because of a maturity mismatch linked to the maturity transformation function of banking intermediaries, the latter's performance may deteriorate when deregulation leads to a rise of banking ressources cost (thus leading to short rates, which remunerate deposits). At the same time, interest rates on assets (long rates) do not react as rapidly due to their longer term.

Secondly, financial liberalization is accompanied by financial system opening. In certain cases, such as Thailand with the *Bangkok International Banking Facilities* created in 1993, financial liberalization falls within a strategy of creating regional financial centers. For banks, the opening of the financial system has the effect of offering the possibility to raise funds in foreign stock markets: it is the *currency mismatch* phenomenon, in which credits granted are secured with short term currency commitments. This phenomenon is a weakening factor in the case of capital outflows. The existence of such imbalances could have explained banking crises in Chile (1981), Mexico (1995), Southeast Asia (1997), Turkey (1994), as much as in the northern European countries at the beginning of the 90s. Figure 1 clarifies the amplitude of *currency mismatch* for some emerging economies, by considering the development of foreign banking commitments. The downturn of certain Asian economies, just before the 1997 crisis, could be predicted by merely considering the short term liabilities which, to reserves ratio, went up from 1.7 at the end of 1995 to 2.2 in mid 1997 in South Korea; and from 1.2 to 1.5 in Thailand.

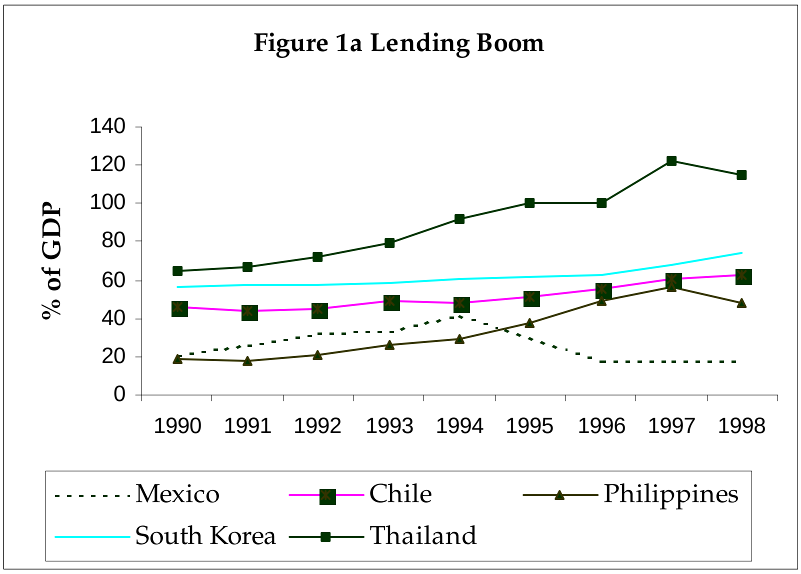
Figure 1 – Ratio foreign banking liabilities to total banking liabilities



Source : IMF, *International Financial Statistics*, CD-Rom, lines 26c / lines 24 + 25 + 26c + 26d + 26g + 27a + 27r

Thirdly, the deregulation of bank loans leads to a rapid rise in the number of commercial bank loans granted to the private sector. Figure 2 illustrates this lending boom, *i.e.* the ratio of domestic credit to GDP.

Figure 2 - The lending boom



Source : IMF, *International Financial Statistics*, CD-Rom, lines 32d / 99b

The Mexican economy experienced a particularly pronounced lending boom, as the ratio of domestic credit to GDP increased by 21 points between 1990 and 1994, whereas, over the same period, Chile's ratio only increased by 2.6 points. The ratio rose by 35.5 points in Thailand between 1990 and 1995 and by 29.3 points in the Philippines between 1990 and 1996. Likewise, a lending boom also occurred in the northern European countries during the 80s, just before their monetary crisis. The common trend shared by countries which experienced such lending booms, is the prior financial liberalization, which removes political obstacles to commercial bank loans. This expansion in domestic credit is linked to monetary crises, in the sense that it implies a greater risk of swings in investors' confidence. Indeed, the lending boom reflects the growth in credit risk endured by commercial banks, which results in an increase of the probability of erosion in banking balance sheets.

The role of institutional factors

The lending boom conveys to what McKinnon and Pill (1996, 1998) call the "*overborrowing syndrome*", the result of the transition from a repressed economy into a liberalized one. According to the two authors, this phenomenon raises questions about the efficiency and solidity of the banking system. More precisely, the existence of state's implicit guarantee on banking deposits, exerts a counter productive effect on financial stability –it is therefore a question of "institutional failures"– according to a mechanism of moral hazard.

The analysis developed by McKinnon and Pill therefore leads us to question the role of institutional factors in banking crises. More precisely, the Washington Consensus, which makes economic liberalization the necessary and sufficient condition of world growth, seems inadequate because of the liberalization process underlies this consensus underestimates the need to invest in the institutional infrastructure before introducing financial reforms[6].

The traditional response –nowadays supported by IMF programs- is the so-called sequential approach in financial liberalization (McKinnon, 1991; Johnston, 1997, 1998). The sequentiality integrates financial liberalization in a program of macroeconomic and microeconomic structural reforms. Thus, for example, McKinnon (1991) explains that macroeconomic stability is the prerequisite for financial liberalization. In the same perspective, Fry (1997) considers that the five pre-requisites for successful liberalization are the following: (i) adequate supervision and prudential regulation for commercial banks; (ii) a reasonable degree of price stability; (iii) budgetary discipline, which limits the negative effects of inflation tax; (iv) commercial bank behavior aimed to maximize profits; (v) a fiscal system, which is neutral in regards to intermediation activity. International financial institutions also consider that the appropriate way to ensure stable financial liberalization is to increase the transparency of financial operations, improve *corporate governance* in the emerging economies, and to ensure adequate banking supervision.

The main limit of sequentiality is to omit an essential aspect of changes which affect emerging economies: institutional change underlying the process of financial liberalization. From this view point, Singh (1998) and Chang, Park and Yoo (1998) estimate that financial liberalization in Asia would led to destructive competition and over-investment in companies, by removing the co-ordination methods used by governments in economic decisions. Phases of financial crises would thus originate in the neglect of traditional co-ordination mechanisms, in particular (economic) planning and the *main bank* system of Asian capitalism, and not primarily in the inefficient financial supervision or regulations capacities.

Determinants of banking crises and different ways of understanding the institutional architecture underlying financial liberalization, show how hard it is to make intermediation (as it has developed in emerging economies) and liberalization coherent. The following

section proposes, in a dynamic perspective, an interpretation of institutional stakes based on an analysis of the complementarity between market and intermediation,.

3. Financial liberalization and intermediation: the dilemma of emerging economies

Let recall that institutions are based on the idea of behavioral rules (Langlois, 1993, p.166). Institutions thus represent means by which agents, which ignore each other's actions and expectations, obtain the information that enables them to co-ordinate. Put in other words institutions allow savings in knowledge and information[7] (Lachmann, 1970). They represent "orientation points", which have authority to render compatible actions as much as individual expectations (ibid.)[8].

The institutions, the market and the financial system

The important point here, is that institutions represent consequently an essential element, a necessary condition, for the harmonious functioning of the markets. This idea has been largely developed by what is currently called the Austrian theory of market processes. According to this theory, institutions possess a particular status: from the moment when institutions are considered as the main conveyors of information and knowledge affecting the formation, as well as the revision of individual plans, they represent no more no less than the key link which settles all analytical reasoning, in terms of market processes. Time and uncertainty, which characterize in an Austrian perspective all market processes, encourage agents to follow common rules. The latter lead to the emergence and development of institutions, which then reduce the uncertainty prevailing in markets, by supplying stable models of interaction (O'Driscoll, Rizzo, 1996). Money, legislation but also firms and regulating agencies… represented some well-known examples of such emerging or implemented institutions. This argumentation naturally rests on the idea that the knowledge disseminated by institutions is of a stabilizing nature –in the sense that it reaffirms the

stability of the social structure at regular intervals– unlike that disseminated by the price system, which is of a dynamic nature –in the sense that it leads individuals to continuously revise their plans (Hayek, 1945).

In the field of financial system, financial intermediaries are institutions which reduce uncertainty. The consequent production of stability can be appreciated on two levels.

First, financial intermediaries in charge of selecting and monitoring investment projects appear to produce information under information asymmetry. The important point is that, with respect to the market relation, the existence of repeated contracts between the lending financial intermediaries and the borrowing agents makes it possible to accumulate knowledge which can be used across the whole economic system. Therefore, the comparative advantage of financial intermediaries regarding the screening of loan requests rests on their expert capacity, which allows them to deal with information at a lower cost than an external non-financial investor. On one hand, the intermediary reduces these costs by benefiting from a learning effect: its judgment of project risks improves as the number of cases it handles increases. On the other hand, the volume of cases handled, encourages the intermediary to implement efficient selection techniques. This comparative advantage, in terms of production of information, bears a positive externality: the cost of capital reflects, to a greater degree, the company's specific risk, rather than the average risk determined by the market, which implies a reduction in the additional risk premium. Similarly, the production of information related to the monitoring of investment projects proves to be less costly in the presence of intermediaries. Without them, each lender would bear high costs to monitor the borrower, thus leading to the duplication of verification costs. Furthermore, the length of the relationship guarantees a better knowledge of the borrowers, which may facilitate their control. As this must reduce the costs of control, and thus the financing costs, one may infer

that companies prefer to borrow from the most informed investors, *i.e.* the financial intermediaries.

It is advisable to emphasize the informational implications of the long-term relationship between the financial intermediary and the borrower. Indeed, the length of the relationship makes the agents' informational environment more dense, and leads them to behave differently from in a situation where relationships would have no memory. Thus, in an environment marked by incomplete contracts, the long-term relationship implies the implementation of state-dependant payment contracts. Two significant implications for our argument derive from this: (i) enforcement mechanisms must be implemented to avoid opportunist behaviors; (ii) a system of rules must be drawn up, in order to establish a common knowledge, which controls and defines the agents' behavior.

Therefore, the bank/company relationship is based on a process of strategic interaction. Regulations cause the actors' expectations to converge. According to this point of view, the informational approach of intermediation leads us to underline the complementarity between financial intermediaries -understood as institutions which reduce uncertainty- and the market. This complementarity means that financial intermediaries participate in the functioning of the market process, by producing information. In other words, we consider as irrelevant the opposition between intermediation and the market, which is proposed by the informational approach on the basis of former advantages over the latter.

Second, complementarity between market and intermediation may be viewed differently: through the creation of liquidity. Indeed, this creation of liquidity occurs on two different levels, depending on whether it is a question of market intermediation or balance sheet intermediation. On the one hand, the intermediary's contribution is a service rendered on the market for a financial asset. For example, the intermediary may bring the buyer and the seller together in a brokerage contract. It may simply perform intermediation when it paid

by percentage when it performs a floatation for its client, or when it buys for its own account to resell, behaving as the counterpart, going to the point of displaying a buying and selling price, as a securities trader which is remunerated by a *spread*. In all cases, the intermediary mediates at the level of asset negotiation, of which it increases market liquidity. This function is described as a market intermediation. On the other hand, the intermediary's contribution is of a very different nature, insofar as it transforms characteristics of financial assets. We are thus in the presence of two financial assets at the same time. This transformation, which may only be understood through the analysis of the intermediary's balance sheet, is called balance sheet intermediation. When it buys a certain type of assets, it will keep as a balance sheet asset (where they are, the counterpart of all other types of assets which it issues enlisted as liabilities on its balance sheet), rather than resell, the intermediary transforms risk and terms in a general way. By doing so, it produces availability and/or security (risk reduction).

A successful financial liberalization process must take into account this complementarity between institutions –and more precisely financial intermediaries- and market[9]. The problem becomes then the analysis of the institutional order evolution over time.

Financial liberalization and institutional changes in emerging economies

All economies which have chosen a process of liberalization face the problem of institutional change. Indeed, it is necessary to render compatible the idea of institutional change with the institution, understood as a permanent orientation point. There is an asymmetry between abandoning –rapidly destroying– previous institutions, and adopting –slowly constructing– new ones. Consequences is that individuals incur the risk of confronting, sometimes over long periods, with the lack of rules that enable them to co-ordinate efficiently their plans. The adoption of market mechanisms thus shows a

deterioration in their positions. Although this problem is not specific to emerging economies, the main point is that it is posed for them in very particular terms.

To understand this point, it is important to stress that institutions –defined as a behavioral regularity- are not necessary the result of a process of legal creation. The process of interaction between individuals but also between legal institutions and practices adopted by individuals- is fundamentally the main motor behind the emergence of institutions. Any practice which enables individuals to reach their personal goals is *a priori* susceptible to spread until it becomes an institution. Market economies dynamic and functioning rest on the fact that economic change partakes of an incremental process which reflects the individual actors choices. It also translates opportunities stemming from what North named the institutional matrix.

From an historical perspective, in the case of developed economies, and for mature markets, the question of the relationship between economic change and institutional change does not raise great difficulties, insofar as institutional development operates *via* gradual changes through alterations in pre-existing institutions. Except in some specific cases[10], financial reforms in mature markets resulted from an incremental process in which authorities decided to implement reforms in association with private agents. In this context, the choice of specific institutions result from an interaction process between governments and private agents[11].

The situation is very different in emerging economies and markets, for which, market institutions. On the one hand, institutions of market economies are by definition relatively undeveloped. On the other hand, and more importantly, the financial system in many emerging markets, resulted from policies implemented by political authorities. That means, that in these economies, financial practices developed in a less spontaneous way than in mature markets. Thus, any financial reform is rarely a process of incremental institutional

changes but always a process of radical changes. This characteristic is accentuated by the fact that recent financial liberalization respond largely to external pressures.

In this perspective, one must take into account the fact that the adoption –the transfer–, just like the creation of new institutions, is subject to delays: delays of implementation in the first case, and delays of construction in the second one. Yet, the amount of economic change possible per unit of time is always limited, because agents have limited capacities to learn. And once again, this constraint is bigger in emerging economies.

Let us consider for example the adoption –the transfer– of market institutions. It may be useful here to recall the distinction, made by the Austrian economists, between legal norms or designed institutions, which are "the products of legislation and other manifestations of the 'social will'" (Lachman, 1970, p.69) and spontaneous or "undesigned institutions", understood as "recurrent patterns of conduct" (*ibid*., p.75)[12]. Thus, if it is always possible, in theory and in practice, to imagine a situation in which an economic or political authority decides to implement market institutions –for example through a process of financial liberalization– benefits expected from this type of measure are a controversial issue. Indeed, inasmuch as such a policy is, by definition, limited to designed institutions, its success depends on the capacity of these new elements to meet the demand for change in institutions not yet designed. The difficulty comes from the fact that, if the transformation of designed institutions is both radical and fast in general, that of undesigned institutions is of an incremental nature, and is necessarily subject to path dependence constraints. The reason is that, apart from the fact that individuals only accept to subject themselves to changes in the game's rules when they find an interest, individual behavior is the result of a cumulative process of collective learning, which often started generations before, *i.e.* which "have passed the slow test of time" (North, 1994, p.364). Therefore, the adoption of institutions is in no case equivalent to their institutionalization: "economies that adopt the formal rules of

another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement" (*ibid.*, p.366).

For instance, in Morocco and Tunisia, authorities have promoted the development of equities markets. But such markets don't correspond to the traditional structure of these economies in which familiar relations are predominant. That means that equities market cannot constitute a relevant response to deficiencies of these financial systems. Indeed, they are not an institution in the sense that are not adopted by economic agents[13].

The main implication of these observations is that the transfer of the western economies' formal economic rules towards the emerging economies constitutes in no way a sufficient condition for achieving good economic performance.

The permanence-flexibility dilemma

The solution to this problem is also the solution to what we call the permanence-flexibility dilemma faced by emerging economies[14].

If institutions do not possess the same status or do not exactly perform the same functions[15], according to Lachmann (1970), they nevertheless share the same flexibility property in relation to the idea of permanence of the entirety. The permanency of the institutional and legal order in no way, requires the permanence of each of its components. The question which is thus posed is then the compatibility of institutional change with a permanence of the structure.

The solution proposed by Lachmann to solve this type of problem consists of implementing designed institutions, which are likely to integrate the change without it affecting the institutional structure of the entirety, *i.e.* the legal order. All economies would thus be characterized by a small number of designed institutions *a priori* unable to undergo transformations, associated with a large sphere of contractual freedom, within which the

occurrence of frequent changes would determine the development of non-designed institutions.

The particular status of financial intermediation in emerging markets then appears: the financial intermediary, mainly banks, represents indeed the main legal –designed– institution, which authorizes development of the contractual sphere –market development– whilst guaranteeing coherence and permanence in the institutional order, necessary for the carrying out of individual transactions.

4. The role of financial intermediation in liberalization

From economic policy perspective, institutional implications of financial liberalization raise the question of financial systems resilience in emerging economies, *i.e.* of their capacity to change structurally while preserving their basic properties. These latter differ according to the financial system. In market-based systems, like in the United States and the United Kingdom, basic properties refer to the prominent role of tradable financial assets (bonds and equities) and the decisive role of financial markets to discipline firms managers. In bank-based systems, basic properties concern the double role of banks which simultaneously are creditors and shareholders of non financial firms. In Japan and Germany, banks are at the interface between the credit market and the financial market. They play, particularly in Japan, the role of insurer in periods of financial distress in order to facilitate firms restructuration.

When basic properties are hurt by financial liberalization, the financial system lost its stabilizing properties. Thus, the main challenge of financial reforms in emerging economies is to implement a liberalization process and at the same time to protect basic properties of their financial system[16].

Financial liberalization and banks in emerging economies

In emerging economies, where asymmetric information is plenty, the problem faced by authorities is how to maintain an intermediated system compatible with growth in the market process. But, as is underlined by Stiglitz (1998b), "building robust financial systems is a long and difficult process". Thus, beyond the debate concerning the validity of liberalization, it is the financial system's institutional architecture, based on the pre-eminence of financial intermediation, which is called into question in emerging markets.

In the perspective adopted in this study, if the role of banks remains dominant in financial systems of emerging countries, it is not necessarily in opposition with market development. This largely intermediated structure, is not in itself an obstacle to financial liberalization. The long relationship between administrated banking systems and public authorities in the model of financial repression must not outshine the theory, which shows the compatibility of the market economy with financial intermediation in the presence of information costs. The critical stake for financial liberalization is the marketization of banks, that is their conversion from a restricted to a full-service institution in the market economy. Marketization is a process which increases the importance of market mechanisms in resources allocation.

Indeed, strong bank-firms relationship may lead to a flaw in the selection of investment. In such a system, decision-making did not rest exclusively on economic considerations, which does not favor the most profitable investment financing. This characteristic is accentuated through the monetary authority's control over interest rates. For example, various studies (among others Corsetti, Pesenti, and Roubini, 1998; Borensztein and Lee, 1999) established that the rise in Asia's debt happened in correlation with a decrease in investment profitability. In their study, Borensztein and Lee (1999) focus on thirty two industrial branches in South Korea, and show that the rate of return in the manufacturing industry fell from 25% in 1972 to 10% in 1990, in a context of increasing rates of investment and debt. This

selection failure is accentuated in the case of connected lending, for which there appears to be no objective evaluation of industrial risks.

The main financial consequence of this behavior is the accumulation of non-performing loans. According to the IMF (1996), these loans represented, in 1995, around 68.9 % of the share capital of the eight biggest Korean commercial banks. In this context, the emphasis placed on *corporate governance* and transparency is a necessary way to strength the banking sector in emerging economies.

In this perspective, the adoption of an appropriate prudential regulation -based on a sound accounting structure and efficient control institutions- the reduction of public authorities' involvement in financing, and the improvement of incentives for banks' stakeholders -shareholders, managers and creditors- to develop competitive profit-seeking behavior, are measures susceptible to modify the banking behavior. But it is necessary to take into account that such prudential measures cannot alone lead to a new financial system in which market mechanisms should be more important. Recall that the implementation of new legal regulations by authorities does not necessary lead to institutions emergence. Indeed, not only such new laws must be coherent with the basic properties of the financial system, they must also be adopted by private agents.

These two problems are linked by the following remark: the main challenge of such a liberalization process is to preserve advantages of the strong bank-firms relationship. In such system, banks are incited to search information about firms because they can hold the informational rent. As a result, the reduction of information asymmetries decreases the borrowing costs for firms and promote a cooperative behavior in case of financial difficulties. Indeed, thanks to long term relationship, banks can insure firms against uncontractible events such as financial distress. Such insurance mechanism is absent in market-based system. In emerging economies, especially in Asian countries, long term relationships

between banks and firms had promoted high-investment-high-growth regime. One of the main reason is that a strong bank-firms relationship reduces the liquidity constraint to invest. At the same time, firms can implement long term projects which favor a long term growth. Ferri, Kang and Kim (2000) show that, during the financial crisis in 1997-1998, Korean firms with stronger pre-crisis relationship banking suffered less than other firms from the credit shortage.

Thus, lessons drawn from the Asian crisis, but also from the behavior of numerous banks in Latin American countries, lead us to stress this following point: any reform concerning the banking behavior faces an important challenge. It is to find the appropriate tradeoff between a strong financial constraint –which could slow down the investment- and a soft financial constraint –leading to an inefficient resources allocation. In other words, promoting banking reforms, whose the main objective is to bring banking practices in emerging economies to converge towards practices adopted in numerous mature markets, is not necessarily the most efficient way to favor economic growth. Interpersonal relationships are less prominent in developed countries because of the presence of liquid financial markets with a strong legal rules and contracts enforcement mechanisms.

Despite this positive value of the relationship banking, numerous authorities in emerging markets after the crisis implemented reforms in which the role of banks is reduced in order to promote the financial markets. South Korea is a striking example from this viewpoint[17]. If the role of state limited banks capacity to monitor and credibly threat non financial firms, it does not imply that the relationship banking system is inefficient per se. The main response of Korean government has not been to implement a reform in which banks could stay at the heart of the system but effectively monitor non financial firms. To the contrary, the government followed advises of International Financial Institutions and introduced principles of corporate governance originated from the Western experience. It seems to us

that such strategy could be dangerous because it could destabilize basic properties of the financial system. Recall that in numerous emerging economies, and particularly in South Korea, banks are the main institution which allows the development of the contractual sphere. A better strategy will be to promote a strong banking system as in Japan where the main bank disciplines non financial firms because control rights shifts from firm’s internal management to the main bank when the financial state of a firm falls below a threshold level.

What role for financial markets?

What could be the role for a strategy promoting the expansion of liquid financial markets? On one hand, the quantitative aspect of the Stock Exchange's contribution to the financing of the economy should not be overestimated. Even in a relatively large emerging market, for instance Taiwan, firms transfer resources to households, dividends exceeding the acquisitions of new shares (Fry, 1997). Theories based on imperfect information also show that financing through the issue of shares on the market generates higher costs than internal financing or debt financing. The *pecking order* is the illustration of such financial behavior. Despite a high cost of credit, firms hesitate before appealing to markets: self-financing and short term banking credit remain largely predominant. The situation described by Singh (1997), of some developing countries where firms resort heavily to external financing through shares, seems to be quite exceptional. This situation is in complete contradiction with the *pecking order*, because of the relatively low cost of the appeal to shareholders, following the surge in share prices due to the internal liberalization and the flow of foreign institutional investors. Good stock market results in some emerging countries are often the result of an inadequate supply in securities. Privatization has often been the main source of quotation provisioning, and private companies seem reluctant to enter on to the stock exchange. The toughening of informational requirements imposed on quoted companies

clashes with the culture of discretion linked to the family structure of capital, and with a long tradition of fiscal distrust.

On the other hand, from a qualitative point of view, stock market reform is perfectly justified if accompanied by a change in firm behavior. Financial liberalization requires prerequisites to be successful, as much on the Stock Exchange as in banks. The access to information and transparency is a precondition for stability and consolidation of financial systems. However, by imposing transparency and developing rules of *corporate governance*, the Stock Market plays an important role in the learning process of the market economy. It is thus an important channel of transmission of market spirit, first to the quoted firms, and then indirectly to the whole economy.

5. Conclusion

Financial developments at work in emerging economies since the end of the 80s have led to major upheavals in their financial systems. Emerging economies are thus the privileged field of study for the analysis of institutional dynamics implications. In this view, the controversies resulting from financial crises highlight the institutional stakes related to financial liberalization. In this paper, we have tried to avoid the traditional "market excess *vs*. market insufficiency" debate, by underlining that complementarity between market and intermediation is the key to viable financial reforms in emerging countries. This position raises difficulties in institutional terms: how can we reconcile a higher degree of market discipline (in an *outsider* logic, from the underlying point of view of *corporate governance*) and the pre-eminence of intermediation based on an *insider* logic, which has proven itself in terms of economic development.

Our analysis deliberately omitted the influence of political factors to explain financial crises in emerging economies. There is an extensive literature on this subject (see, for instance Haggard and Mo, 2000; Leblang, 2000). These studies suggest that the ability of the

government to respond to specific negative shocks depends on factors such the electoral timing, constituent interests and policy decisiveness. This latter point is particularly important in some emerging countries which introduced more democratic regimes. For example, Haggard and Mo (2000) show that the response of the South Korean government to financial crises resulted from strong political relations between the leader party and some *chaebols*. Taking into account the electoral timing, the government tried to favor some *chaebols* in order to win their political supports even if these decisions were inadequate from an economic viewpoint. Again, this type of analysis does not conclude to the necessity to reject the developmental state model. It suggests that, when a component of the regulation system is modified, it is crucial to find new institutional procedures in order to keep advantages of close business-relationship. We consider that political factors are precisely a component of these institutional changes due to a liberalization process.

From an international political economy viewpoint, our analyze suggests the importance of the degree of adaptability of the prevailing domestic institutions when financial reforms are implemented. The question becomes now how to ensure the compatibility between the standardization of financial practices implied by the dominant role now played by international investors, and the adaptation at a specific rhythm in each economy, according to the critical role played by domestic institutions during transition. The challenge for the so-called "new financial architecture" then becomes the organization of a multi-speed financial liberalization process, which consist to establish the institutional infrastructure which may authorize each country to enter in the global liberalization process at its own rhythm and intensity. This new architecture implies a renewed role for capital controls –dedicated to a "reforms promotion" strategy- and a strengthening of the political legitimacy of the Bretton Woods institutions[18].

Notes

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[1]. By emerging economies, we mean developing countries, which have experienced a financial deepening, and significant capital inflows since the mid 80's thanks to significant financial reforms. According to the Institute of International Finance, 29 countries are concerned : in the Asian-Pacific region (China, South Korea, India, Indonesia, Peru, Uruguay, Venezuela) ; in Europe (Bulgaria, Russian Federation, Hungary, Poland, the Czech Republic, Romania, Slovakia, Turkey) ; in Africa (South Africa, Algeria, Egypt, Morocco, Tunisia). Despite the diversity in both economic positions and economic systems adopted in the past, these emerging markets all experience a common problem of institutional transformations in their financial systems – in particular, in their systems of banking intermediation - in the sense of a marketization in this system of intermediation.

[2]. Thus, Kaminsky and Reinhart (1996) – studying 20 countries between 1970 and mid 1995 – identify a rupture concerning the frequency of banking crises between 1980 and 1990 and previous decades. While three banking crises are identified during the 1970-1979 period, this number increases to 22 over the 1980-1995 period. Above all, in 18 of the 25 banking crises, the financial sector had been liberalized in the five preceding years. By another way, the combination of liberalisation and dubious policy choices is a theme which recurs in all the country analyses by Johnson (1998).

[3]. See La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998). In an empirical paper, Demirgüç-Kunt and Detragiache (1997) suggest that (i) the weakness in the legal system is a significant factor in banking crises but (ii) the contractual arrangements, concerning creditor's rights over borrowers, exert a less significant impact.

[4] The legal view suggests the endogeneity of the type of financial system. Indeed, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) stress that "the differences in legal protections of investors might help explain why firms are financed and owned so differently in different countries". According to Levine (1998), "the legal system materially influences the banking development.

[5]. We go consequently beyond the traditional analysis which stresses only the role of the legal structure and or the shareholder rights (see for example Lopez de Silanes XXXX).

[6]. See also Stiglitz (1998a).

[7]. Game theory investigates how institutions reduce information costs, through the concepts of *conventions* (co-ordinated games) and *norms* (prisoner's dilemma) (Schotter, 1994).

[8]. The idea of a orientation point expresses to a greater degree risk reduction rather than risk elimination (Lachmann, 1994).

[9]. It is important to stress that recent papers adopting a neoclassical approach recognize this complementarity. See Allen and Gale (2000); Hellwig (1998).

[10]. For instance, the Glass Steagall Act of 1933 in the United States which impeded the development of the universal banking system.

[11]. A famous example is the implementation of financial reforms in France between 1984 and 1986. During this period, the French Directory of Treasury took important initiatives to modernize the financial systems, but because the strong relationship between bureaucrats and financial leaders, the strategy adopted in France can be interpreted as a result of a consensus between these actors. In fact, all of them agreed on the inefficiencies of the French financial system.

[12]. One recognises Menger's distinction between *pragmatic* and *organic* institutions.

[13]. As a result, in Morocco, equities market is the object of speculative pressures and does not contribute to the financing of private firms. In fact, firms introduced in the market had been privatized and had not specific financing needs.

[14]. Our analysis is based on that of Lachmann.

[15]. Some institutions are more fundamental than others, in the sense that they are core elements of a market economy (Lachmann, 1994, p.50).

[16]. This problem is not specific to emerging economies. See for example the financial distress in Japan which results in part from the financial liberalization process. By decreasing the traditional solidarity between banks and non financial firms, the financial liberalization reduced the coherence and the efficiency of the Japanese financial system.

[17]. For an overview of reforms in South Korea, see World Bank (1999).

[18]. Allegret and Dulbecco (2000).

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