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. 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, Asia

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. Thus, in view of improving the efficiency of the financial system, whilst increasing the rhythm of economic growth, financial liberalization has taken three main forms : (i) the deregulation of interest rates ; (ii) the introduction of competition between the different channels of financing ; (iii) the opening of the financial system.

The process of financial liberalization in emerging markets takes place in a context of significant growth in the number of banking crises. 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. More recently, Demirgüç-Kunt and Detragiache (1998) identified a relationship between financial liberalization and financial fragility. In the light of their results, it appears that financial liberalization must go together with development in the institutional framework, if one wishes to avoid increases in financial instability, which are the source of negative macroeconomic tension for growth. In this view, with the emphasis henceforth placed on the institutional stakes of financial liberalization, it is possible to interpret the instability associated with the employed reforms since the end of the 80s, in terms of an alternative between liberalization excess and insufficiency. Such interpretation finally leads us to call into question, if not the principle, then the rhythm or intensity of the financial liberalization (1). Here, on the contrary, we develop the idea that the answer to financial instability must be sought in institutional dynamics. This involves going beyond the intermediation / market opposition, in which emerging economies would use the advantages of an intermediated system to reinforce the market process (2).

Therefore, it is more the process of financial liberalization than its result, which is the object of our analysis, so as to understand the stakes for the emerging economies in this very particular period of transition and imbalance.

1. Are financial crises the result of immoderate liberalization ? Towards an institutional approach

The implication of the state in financial intermediation is at the heart of both the idea of financial repression, and the justification of financial liberalization policies (1.1). The role played by financial liberalization in the outbreak of emerging economies' banking crises has given prominence to the urgency for an institutional approach to the conditions of banking intermediation, and in particular its regulation (1.2).

1.2 Banking intermediation, the state and financial liberalization

To understand the scope of the financial reforms launched in the emerging economies, it is important to refer to the structure of banking intermediation. Historically, for reasons linked to economic development strategies, the state has exercised a deciding control over the banks, in numerous emerging economies. Banking credits have become privileged instruments of the industrial policy, notably through the practice of directed lending to priority sectors. This also means that the public authorities have somehow been the agent, which has made the development of banking intermediation possible.

Table 1 clarifies the scope of the state’s penetration in the banking sector, for some emerging markets.

Table 1 – state-owned banks in percent of total assets (1994)

However, the penetration of the state in the banking sector is more significant than what indicates its equity participation in financial institutions. Indeed, it also appears that private banks can they themselves be subjected to the practice of directed lending, thus partly obeying the principles of public authorities. Table 2 shows, in the case of South Korea, the distortions introduced through state intervention in the financing of the economy. The priority sectors benefit from more favorable interest rates. Linked to the state's guarantee, the intermediation function is subjected to a significant distortion in favor of these sectors.

Table 2 – South Korea : interest rates of bank lending, in percent

If, as an instrument of industrial policy, the state controlled banking system has been able to take part in the development of certain emerging economies – in the spirit of the Asian economies – its efficiency is nevertheless limited, when compared to that of the private banks. Thus, the IMF's *International Capital Market* (1997) considers that the vulnerability of the banking system is rooted in past practices linked to directed loans. For example, the IMF estimates that Korean banks held around 4 500 billion won worth of these loans at the end of 1996, of which 56 % were non-performing. In fact, the state's penetration in financing decisions, has not permitted the development of a risk culture, which has led to relatively poor performances of the banks under the state's influence. Non-performing loans represent, around 68.9 % of the share capital of the eight biggest Korean commercial banks, excluding reserves. Such a situation does not confine itself to the Asian economies. In Argentina, the state banks or the parastatal banks hold comparatively more non-performing loans than the private banks. At the end of September 1996, the ratio of loans unsettled for over 3 months to the total number of loans, rose to 19 % for the federal banks, 27 % for the provincial banks, 15% for the co-operative institutions and 9% for the provincial banks[2]. The average return on shares in state banks was 3.9 % in 1996, against 10.9 % for the main private banks.

The state's presence in the banking sector generates intermediation inefficiencies linked to three major factors.

Firstly, banks have an opportunist behavior, creating moral hazard, in regards to financing. They are not encouraged to efficiently monitor their debtors, insofar as they anticipate public intervention in the case of significant financial difficulties. The state's implicit guarantee partly explains the reasons why Korean banks provided massive credit to the *chaebols*. The latter, being judged "too big to fail", benefited from the state's implicit guarantee, which led to two significant consequences :

- The thirty largest *chaebols* represented a very significant share of banking credits, i.e. around 27.3% of total credit in 1986, and over 40% in 1996 (Borensztein and Lee, 1999);
- The debt-equity ratios reached particularly high levels, when compared to the ratios observed in the United States and Japan. This ratio rose to around 500% in 1980 for the thirty largest Korean groups, and to 300% in 1996. If one considers the four largest chaebols, the ratio rises to almost 1000%.

Secondly, we observe in state influenced banking systems a flaw in the selection of investment. 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. Because is not a true market rate, the real interest rate cannot optimally guide the allocation of capital. 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.

Thirdly, state intervention leads to a weak diversification of assets, and therefore to significant exposure to the risk of reversal of business activity in the sectors in question. Such a deficiency was clearly apparent in Mexico at the time of the peso crisis : the banking vulnerability was partly linked to the concentration of bank loans in the exporting sectors.

More generally, financial liberalization aims to eliminate inefficiencies in four different ways :

- Liberalization of banking activities, through the elimination of interest rate caps on bank deposits and loans, the removal of interest contingents and preferential interest rates, and the reduction of obligatory reserve requirements;
- The relaxation of restrictions on non-banking financial intermediation activities, namely to increase competition between the different financing actors;

- The creation of new markets, and measures in favor of financing through marketable securities, so as to bring closer the emerging financial systems and the present systems used in developed countries;
- The progressive privatization of the state banks, and a policy in favor of foreign bank penetration.

In most liberalized economies, the financial structure of companies has developed in the manner wished for by the authorities : on one hand, equity market capitalization has experienced a very fast development in numerous emerging markets, approaching levels observed in the developed countries (table 3); on the other hand, the weight of marketable evidence of debt in corporate financing has notably increased, as is illustrated table 4 in relation to South Korea.

Table 3 – Capitalization of stock markets in some emerging economies, in percent of GDP

Stock markets bring a significant contribution to the financing of economies, in particular in South Korea, Malaysia, Thailand, Chile and Mexico, even if this observation must be weighted by the fact that privatization exercises a deciding influence in this development. Besides, *ceteris paribus*, the development of financial markets exerts a positive effect on the consolidation of the banking system, favoring a better spreading of risks.

Table 4 South Korea : sources and funds raised by corporate sector, in percent

The previous developments highlight that financial liberalization aims to improve the efficiency of the banking system (in a broader sense the financial system) in terms of a better allocation of capital. And yet, at the same time this liberalization is accompanied by a significant increase in the number of banking crises, leading logically to the question of pertinence of the paths chosen by the emerging markets since the end of the 1980's.

1.2 Financial liberalization, instability and banking regulations

Empirical work relative to banking crises identifies the channels of transmission, through which financial liberalization may exert an influence on banking stability.

Firstly, and conforming to the effects anticipated by financial repression theories, interest rate deregulation seems to go together with an increase in the level of interest rates. And yet, due to maturity mismatch, linked to the maturity transformation function of banking intermediaries, the latter’s performance may deteriorate when deregulation leads to a rise in the cost of banking resources (thus leading to short rates, which remunerate deposits), whilst at the same time the interest rates on assets (long rates) do not react as rapidly because of their longer term.

Secondly, financial liberalization is accompanied by the opening of the financial system. 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 the banks, the opening of the financial system has the effect of offering the possibility of raising funds in foreign stock markets: it is the *currency mismatch* phenomenon, in which the 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 explain the 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 1b 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 : the short term liabilities 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 – Indicators of financial vulnerability in some emerging countries

Thirdly, the deregulation of bank loans leads to a rapid rise in the number of commercial bank loans granted to the private sector. Two indicators illustrate this ease in terms of credit availability.

First of all, the comparison of real domestic credit growth rates in the private sector and GDP (figure 2) suggests that, in the countries in which credit increased faster than GDP on a long term basis (for example Mexico before 1994, or the Philippines and Thailand in the 90s), this gap only preceded the monetary crisis.

Figure 2 Real growth rates of domestic credit and GDP, in percent

The second indicator is the evolution of the ratio of domestic credit to GDP (figure 1a), which serves to assess the lending boom. 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 the 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 in the probability of erosion in banking balance sheets.

The lending boom conveys 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 the 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.

McKinnon and Pill assume that the expansion of lending, linked to liberalization, affects the real sector through two independent channels :

- Easy monetary policy, in terms of lending, signals the success in structural reforms, which indirectly stimulates activity via an expected increase in permanent income;
- Access to credit makes it possible for firms to exploit technologies which deliver gains in productivity, again exercising a direct effect on activity.

Yet, if an efficient banking system renders the signal effect and the direct effect compatible, when the implicit guarantee is present, one must also take account of the fact that commercial banks behave under conditions of moral hazard. Indeed, banks demonstrate exaggerated optimism regarding future growth, and thus extend credit beyond its optimal level.

The analysis developed by McKinnon and Pill therefore leads us to question the role of institutional factors in banking crises. Demirgüç-Kunt and Detragiache (1997, 1998) looked to clarify this role in two empirical studies. With this aim in view, they test whether the presence of an explicit deposit-insurance system increases the probability that a banking crisis occurs. Likewise, by introducing proxy variables in their regressions, they try to take into account the weakness of the enforcement system in loan contracts (*i.e.* the creditors' right in the case of borrower default), the deficiencies of the legal system regarding credit regulation, and the role of bureaucracy. The results obtained in the study, published in 1997, suggest that (i) the existence of deposit insurance increases the probability of a banking crisis occurring (moral hazard prevails over the stabilizing effect of insurance, in terms of bank runs), (ii) weakness in the legal system is a significant factor in banking crises, and (iii) contractual arrangements, concerning creditor's rights over borrowers, exert a less significant impact. This study confirms the banking difficulties in the emerging and transforming economies when the judicial system does not develop in phase with the liberalization of the financing system.

In their study published in 1998, Demirgüç-Kunt and Detragiache confirm the institutional stakes linked to financial liberalization. Indeed, it appears that the probability of banking crisis occurring is higher when liberalization is not accompanied by a strengthening in both prudential control and supervision. A Stiglitz mechanism seems to be at play : the reduction in the banking franchise, linked to deregulation, tends to reduce the opportunity cost linked to the exit from the banking system, thus inciting the banks to develop risky behavior since an eventual bankruptcy or a loss of license would have a limited impact. In other words, deregulation increases moral hazard.

The consideration of all precedent elements thus leads authors such as McKinnon and Pill (1998) to highlight the inadequacies of the Washington Consensus (1996), which makes economic liberalization the indispensable condition of world growth. Indeed, according to the authors, the liberalization process underlying this consensus underestimates the need to invest in the institutional infrastructure before introducing financial reforms. In this perspective, the institutional logic advocated by McKinnon and Pill rests on three pillars :

- The first-best situation, when prudent financial supervision is completely efficient ;
- The second-best situation, when it is necessary to supervise the composition of expansion in banking lending as well as its aggregate level, because of inadequacies in the supervisory system. It is not a question of positive directed credit schemes of

the type found in a repressed economy, but a policy of negative directed credit programs based on the maintenance of financial stability ;

- The third-best situation, in which the previous measures are completed by direct and indirect controls aimed at restricting the entry of capital, when taking into account the moral hazard peculiar to the banking system.

Fry (1997) seeks to establish what he considers to be the five pre-requisites for successful liberalization : (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 at maximizing profits; (v) a fiscal system, which is neutral in regards to intermediation activity.

Stiglitz (1998a and b) points out that the emerging economies have regulation capacities inferior to those of the developed countries. Therefore, they are particularly vulnerable to shocks after financial opening, which could justify the permanence of state intervention in the financial sector. From this point of view, one may interpret the increase in banking crises in the emerging markets as the result of excess financial liberalization, when taking into account an inadequate institutional infrastructure.

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

2. Institutional dynamics, liberalization and intermediation : beyond financial crises

If we now agree to revalue the institutional dimension in the explanation of emerging countries' financial crises, we must still make use of an analytical structure in order to understand why financial institutions are a necessary complement to markets. The latter only being imperfect substitutes to financial institutions. Our analysis, centered on the complementarity between institutions and markets (2.1.), should explain the difficulties encountered by the emerging economies engaged in a process of financial liberalization (these economies are not known to have a sufficiently developed institutional market structure). We shall try to lay the foundations of an analysis of the evolution of institutional order over time. Our aim will be to study the conditions in which new institutions are likely to become successfully part of the existing institution structure, turning to good account the coexistence between intermediation and the market.

2.1 The Complementary nature of the relationship intermediation -market

Most definitions relative to social institutions are based on the idea of behavioral rules (Langlois, 1993, p.166). To begin with, institutions may be considered as behavioral regularities associated with a set of rules, norms and routines (Nelson, Winter, 1982). According to Schotter, the notion of institution may indicate : "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" (1981, p.11). Institutions thus represent the means by which the agents, which ignore each other's actions and expectations, obtain the information that enables them to co-ordinate.

More precisely, institutions transmit knowledge in three different ways. As a crystallized form of social knowledge (O'Driscoll, Rizzo, 1996), institutions initially make it possible to bring down the set of options available to individuals. This reduces the uncertainty relative to other's actions. The role of institutions is to transmit both knowledge, and the way this knowledge, which could never be possessed by a single individual, is used. The idea is that if each individual expects the others to play their (specific) role, then the expectations formulated by all are more likely to be co-ordinated. Finally, institutions transmit knowledge, in the sense that they embody lists of routine behaviors, reputed to constitute efficient modes of adaptation to the environment. In summary, institutions allow savings in knowledge and information[3] (Lachmann, 1970). They represent "orientation points", which have authority to render compatible actions as much as individual expectations (ibid.)[4].

The important point here, is that institutions represent 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[5]. 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 the markets, by supplying stable models of interaction (O'Driscoll, Rizzo, 1996). 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 markets and financial asset markets, financial intermediaries are institutions, which reduce uncertainty. The consequent production of stability can be appreciated on two levels.

First of all, 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 the one hand, the intermediary reduces theses costs by benefiting from a learning effect: its judgement 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 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 (Hellwig, 1989 and 1990; Von Thadden, 1990). Indeed, the length of the relationship densifies the agents' informational environment, and leads them to behave differently than 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:

- enforcement mechanisms must be implemented to avoid opportunist behaviors ;
- 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 bring the actors' expectations to converge. According to this point of view, the informational approach of intermediation leads 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 the advantages of the former over the latter.

According to this point of view, 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[6]. However, in both cases, there is a true complementarity between the market and the institution, *i.e.* between the financial asset market and financial intermediation. However, one may at the same time accept that market and intermediation are compatible, or even complementary, and distinguish them as regards their place in the financial system. Some kind of mediation is achieved in both cases: it depends on the traded asset alone when pure market is involved, whereas it implies the intervention of a specialized agent with intermediation. The market, as such, is a two person game, the buyer and the seller. Intermediation is necessarily a three person game: two "client" operators and the intermediary. A non-intermediated market, a pure market, is self-liquid; this means that the intrinsic qualities of the financial asset which is sold are enough to make the buyer and the seller agree on a price, without incurring information or transaction costs. The two operators have complementary needs and a perfect knowledge of these reciprocal needs, they have no difficulties to meet. It remains to be known whether such pure markets exist, and whether all markets are not intermediated.

On the other hand, intermediation implies the convergence of final operators –the "clients", the buyer and the seller– towards a third person, in charge of adding value and providing a service which they are ready to pay him / her at the market price. Imperfections, difficulties in bringing together the operators, incompatibilities in their needs, namely in terms of risk-taking, the lack of liquidity of the pure market, justify the internalisation of these costs by the intermediation firm. Its existence should not be imposed by the state, it spontaneously stems from market principles. Moreover, there is no reason for the price of its intervention to be governed, it should rather be determined on a competitive market for intermediation services. If one wonders about the nature of the value added by the intermediary, and of the services rendered to its "clients", the answer may be given in terms of greater liquidity, provided we distinguish two cases.

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 together the buyer and the seller 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, 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 market intermediation.

On the other hand, the intermediary's contribution is of a very different nature, insofar as it transforms the characteristics of the 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, that 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).

Information and liquidity thus converge to highlight the complementarity between markets and institutions. Indeed, in both cases, financial intermediaries are dominant agents of the market process, which underlines their intrinsic connection with the market.

2.2 Financial liberalization and intermediation : the dilemma of emerging economies

If institutions partake of the efficient functioning of markets, we must here emphasize the fact that they are not always the result of a process of legal creation, *ex nihilo*. The process of interaction between individuals is fundamentally the main motor behind the emergence of institutions (North, 1990). Any practices which enables individuals to reach their personal goals is *a priori* susceptible to spread until it becomes an institution. Therefore, the status of institutions appears relatively ambiguous: institutions are external structures aimed at limiting, if not eliminating uncertainty, thus making it possible to carry out transactions. As such, they create the incentive structure of an economy, whereas they appear at the same time as internal to individual transactions (the latter determines their adjustment and development). All theories concerning the dynamics and functioning of market economies must therefore take into consideration the idea that if economic change shapes the institutional development of the economy –in the sense that economic change partakes of an incremental process which reflects the actors' individual choices–, it also translates the opportunities stemming from what North named the institutional matrix.

In the case of developed economies, and for mature markets, the question of the relationship between economic change and institutional change does note raise great difficulties, insofar as institutional development operates *via* gradual changes through alterations in pre-existing institutions. However, such is not the case for emerging economies and markets, for which, market institutions, *i.e.* the institutions of market economies, are by definition relatively undeveloped.

In an evolutionary perspective, processes of liberalization may be understood as a special step in the development of a market economy, *i.e.* that of emergence within an old system. The relevant question is more how markets develop and evolve over time, rather than the conditions required for a successful adoption of the market mechanism.

The institutional dimension has a critical role to play in this perspective. The idea is that the institutional structure, which prevails at a given moment in an economy, may encourage or hinder the liberalization process, according to its capacity to integrate new elements.

Indeed, all economies which have chosen a process of liberalization, face the problem of institutional change. It is thus necessary to render compatible the idea of institutional change with that of the institution, understood as a permanent orientation point. Although this problem is not specific to emerging economies, it is posed for them in very particular terms. There is an asymmetry between abandoning –rapidly destroying– previous institutions, and adopting –slowly constructing– new ones. The consequences is that individuals incur the risk of confronting, sometimes over long periods, with the lack of rules that enable them to co-ordinate their plans efficiently. The adoption of market mechanisms thus shows a deterioration in their positions.

Furthermore, 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. Yet, the amount of economic change possible per unit of time is always limited, because agents have limited training capacities. 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)[7]. 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– the 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 in general both radical and fast, 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 rules of the game when they find an interest, individual behavior is the result of a cumulative process of collective learning, which often started generations before, *i.e.* of apprenticeship "that 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).

Finally, arises the question of institutional order, and of its unity : if institutional order is the product of the complementarity of institutions, what are the integrating forces of institutions, and under which circumstances are these forces over ? The analysis of the process of liberalization requires to specify the conditions of the coherence of institutional order, because the system's components evolve at different speeds.

The main implication of the previous section is that the transfer of the western economies' formal economic rules towards the emerging economies does in no way constitute a sufficient condition for achieving good economic performance.

The solution to this problem is also the solution to what we call the permanence-flexibility dilemma faced by the emerging economies[8].

If institutions do not possess the same status or do not exactly perform the same functions[9], 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 judicial order in no way requires the permanence of each of its components. The question which is thus posed is that of the compatibility of institutional change with a permanence of the structure. For Lachmann, the main motor of institutional dynamics is not so much the change in itself, but rather, a non-anticipated change[10].

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 judicial order. The notion of *interstice* of the judicial order thus represents a key element in this explanation of the dynamics of institutional change. The function assigned to these interstices by Lachmann is to allow an accumulation of *sediments* generated by the development of spontaneous institutions in such a way that the overall coherence be preserved. 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 obligations, within which the occurrence of frequent changes would determine the development of non-designed institutions.

The particular status of financial intermediation in the emerging markets then appears: the financial intermediary, the commercial bank, 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.

2.3 The role of financial intermediation in liberalization

By focusing on the institutional stakes of financial liberalization, we know have four main types of answers, aimed at taking into account a new financial context, marked by liberalization and banking instability.

The first response consists of underlining the need for accelerating liberalization in the banking sector, notably by favoring the penetration of foreign operators, in order to increase competition and allow transfers of know-how. The presence of foreign banks could help limit the scope of brutal reversals of capital flows. This approach is based on the weak foreign penetration in the banking sectors of emerging economies (Goldstein and Turner, 1996). Yet, it seems that banking instability is far less important, the more significant the foreign penetration, as is demonstrated by the examples of Singapore and Chile. Secondly, international 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 (Group of Ten, 1996, IMF, 1997). Thirdly, McKinnon (1991) and Johnston (1997, 1998) put forward what is called the sequential approach in financial liberalization: financial liberalization must be part of a program of macroeconomic and microeconomic structural reforms. Thus, for example, McKinnon (1991) explains that macroeconomic stability is the prerequisite for financial liberalization. Finally, from a different view point, Singh (1998) and Chang, Park and Yoo (1998) estimate that financial liberalization in Asia led to destructive competition and over-investment in companies, by removing the co-ordination methods used by governments in economic decisions. The 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.

These different responses seem to omit an essential aspect of the changes which affect emerging markets: institutional change underlying the process of financial liberalization. This raises the question of the resilience of financial systems in emerging economies, *i.e.* of their capacity to change structurally while preserving their basic properties. Yet, in the emerging economies, where asymmetric information is plenty, the problem faced by the authorities is how to maintain an intermediated system compatible with growth in the market process. But, as is underlined by Stiglitz (1998c), “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 the emerging markets.

In the perspective adopted in this study, if the role of the commercial banks remains dominant in the financial systems of the 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, just like any another company. They will then be subjected to competition both for the determination of the price of their services, and for their financing conditions. Marketization is a process, which increases the importance of the market mechanisms in the allocation of resources. This goes far beyond the negotiability of assets involved in securitization. It involves spreading pricing competition and interest rates (be the assets negotiable securities on a secondary market or not) to the whole financial system.

Liberalization moves along in fits and starts. The banks are first liberalized, because they are highly constrained in their activity, due to the compartmentalization of their status, the administration of interest rates and the forced orientation of part of their jobs towards the state or other priority sectors. Then, liberalization hits the financial market, with the modernization or creation of a Stock Market from which everybody expects a lot, but the reform of the other parts of the financial system mark time, and banks experience no real transformation. The orientation towards short term financing remains highly dominating and the liberalization of the administered interest rates does not end up producing true competition between the banks.

Moreover, if financial liberalization makes the development of financing by securities, stocks and shares a deciding factor in the success of reforms, one should not overestimate the quantitative aspect of the Stock Exchange's contribution to the financing of the economy. 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 the 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.

However, from a qualitative point of view, stock market reform is perfectly justified if accompanied by a change in firm behavior. Financial liberalization requires prerequisites in order to be successful, as much on the Stock Exchange as in the banks. The report written by the Group of Ten and the representatives of emerging markets (Group of Ten, 1997), relative to the conditions of stability and consolidation of financial systems, stresses the access to information and transparency. 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.

From then on, with the emphasis placed on *corporate governance* and transparency, there will be repercussions on commercial banking practices. To this end, the trends recommended by the international institutions revolve around the adoption of an appropriate prudential regulation, based on a sound accounting structure and efficient control institutions. They also focus on the reduction of the public authorities’ involvement in financing, and on the improvement of incentives for banks', shareholders, managers and creditors to develop competitive profit-seeking behavior. The banks, when subjected to the market constraints, should be able to issue bonds on the international financial market, and thus direct the raised funds towards numerous promoters of development projects, which because of their size, remain dependent on bank lending. This would revive the financing function of the old development banks, but private financing and the market should also be used, which implies keeping up with the transformation of the bank's behavior, which is still very much directed towards short term, and not open to competition. Therefore, a successful transition depends on the sudden emergence of market principles in banking intermediation.

Conclusion

The financial developments at work in the 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 the implications of institutional dynamics. 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.

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Table 1 – state-owned banks in percent of total assets (1994)

India[1]	87	Indonesia	48
South Korea	13	Thailand	7
Argentina[1]	36	Brazil	48
Chile	14	Mexico	28

[1]. 1993 for India and 1996 for Argentina

Source : Goldstein and Turner (1996), p.19

Table 2 – South Korea : interest rates of bank lending, in percent

	General	Export*	National Investment Fund**	Inflation
1970	24.0	n.a.	n.a.	15.6
1975	15.5	9.0	12.0	25.2
1980	20.0	15.0	19.5	19.6
1985	10.0 - 11.5	10.0	10.0 - 11.5	3.9
1990	10.0 - 12.5	n.a.	10.0 - 11.5	5.2
1993	8.5 - 12.0	n.a.	9.0	5.1

* Abolished in 1988 ; ** Established in 1974 to support the heavy and chemical industries.

Source : Borensztein and Lee (1999), p.15.

Table 3 – Capitalization of stock markets in some emerging economies, in percent of GDP

	1990	1995	1996
China	0.5	n.a.	13.8
India	12.6	56.9	35.1
South Korea	44.0	40.2	25.4
Indonesia	7.6	33.9	41.2
Thailand	27.9	85.4	54.0
Argentina	2.4	13.4	15.7
Brazil	3.7	26.2	28.6
Chile	44.9	109.4	90.8
Mexico	14.1	36.3	37.1
United States	56.3	94.7	108.7
Germany	21.6	23.9	29.4

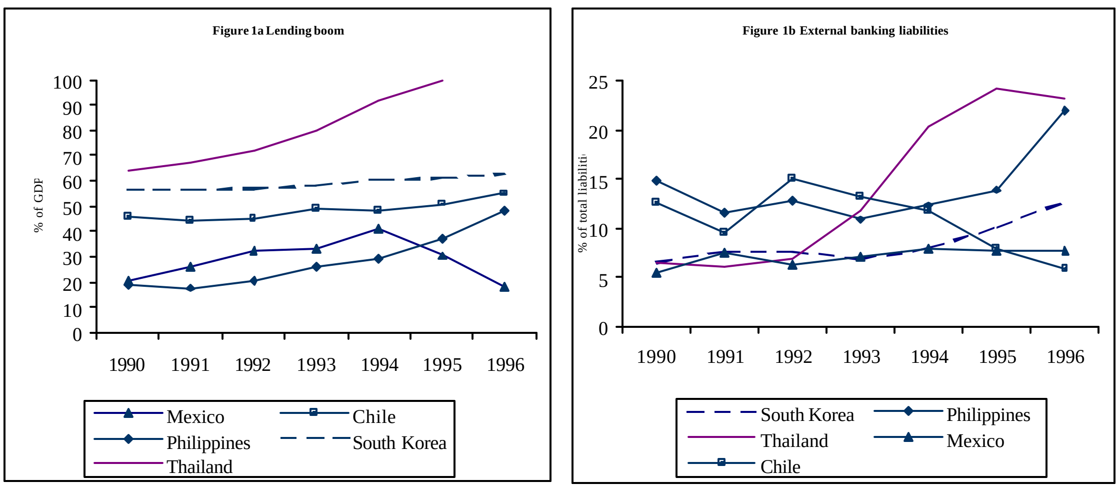
Source : *Bank for International Settlement*, Annual Reports.

Table 4 South Korea : sources and funds raised by corporate sector, in percent

	1975-79	1980-84	1985-89	1990-94	1995	1996
Borrowing from banks	15.6	12.8	13.3	12.1	10.7	10.9
Borrowing from non-banks	9.1	13.8	9.6	15.8	12.3	10.8
Equity	11.3	11.3	13.6	11.3	12.6	9.1
Debt securities	4.6	10.8	10.7	17.7	23.0	27.5
Foreign borrowing	10.0	3.8	1.2	5.1	6.1	8.0

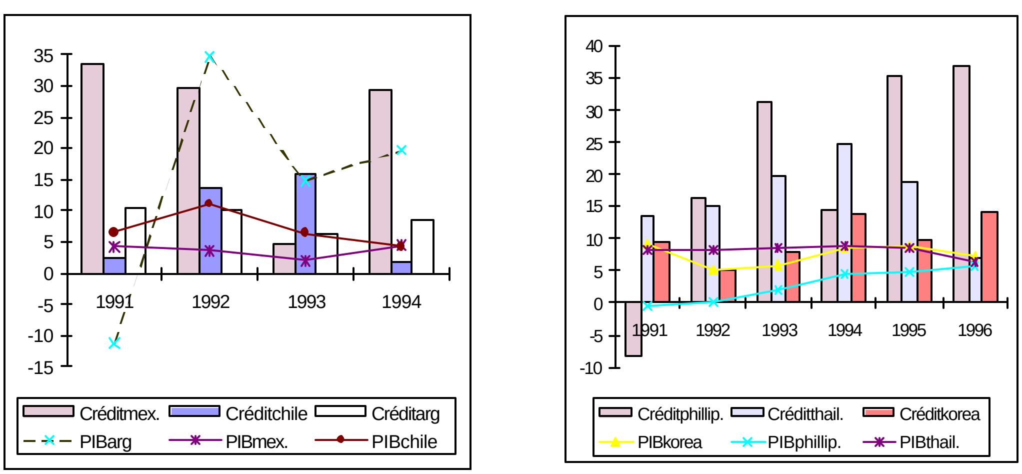
Source : Borensztein and Lee (1999), p.13.

Figure 1 – Indicators of financial vulnerability in some emerging countries



Source : IMF, *International Financial Statistics*, yearbook 1997, lines 32d / 99b for figure 3a and ratio foreign debt (lines 26c) to total liabilities (lines 24 + 25 + 26c + 26d + 26g + 27a + 27r) for figure 3b.

Figure 2 Real growth rates of domestic credit and GDP, in percent



Source : IMF, *International Financial Statistics*, Yearbook 1997, lines 32d / prix de 1990 ; line 99b

Notes

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 marketisation in this system of intermediation.

2 - For other emerging economies, see IMF, *International Capital Markets*

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

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

5 - Here we could refer to Dulbecco, Dutraive (1999)

6 - See Courbis (1987)

7 - One recognises Menger's distinction between *pragmatic* and *organic* institutions.

8 - Our analysis is based on that of Lachmann.

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

10 - Only this last form of change is likely to frustrate the implemented plans.