FINANCIAL DEVELOPMENT AND INSTITUTIONS: A LITERATURE REVIEW

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ABSTRACT

Among the causes of differences in financial development, “institutions” have received considerable attention in recent years. In this context, the question of which institutions promote financial development seems particularly important. Therefore, the theories that explain the relationships between formal or informal institutions (law systems, trade openness, trust, social capital, political groups, etc.) and financial development have been introduced in recent literature. The aim of this paper is to present a general conceptual framework that will provide a better understanding the effects of institutional environment on the financial development.

Keywords: Financial Development, Institutions, Trade openness, Social capital, Trust, Law and Finance.

FINANSAL KALKINMA VE KURUMLAR: BİR LİTERATÜR İNCELEMESİ

ÖZ


Anahtar Kelimeler: Finansal kalkınma, Kurumlar, Ticaret açıklığı, Sosyal sermaye, Güven, Hukuk ve Finans.
1. INTRODUCTION

Financial institutions perform important functions in development processes and the economic performance of financial markets. Research on the role of financial development in growth can be traced back at least to Schumpeter (1912), who pointed out the role of a country’s banking system in that country's economic development. The inherent functions of financial systems, including mobilising savings to their highest valued use, acquiring information, evaluating and monitoring investment projects, and enabling individuals to diversify away idiosyncratic risk, have been widely believed to encourage productive investment and therefore total factor productivity and economic growth (Huang, 2005, p.6).

There is a broad consensus on the positive effects of financial development on economic development. In addition, making a stable and powerful financial system is necessary to avoid or reduce the negative effects of financial crises in countries’ economies. Consequently, a better understanding of the sources of financial development is needed in order to design effective policies that encourage financial development. Research in this area has traditionally underlined the macroeconomic (e.g., inflation, income level, saving rate), institutional and geographic factors that determine financial development. In recent years, however, there has been a growing emphasis on the institutional factors in the literature.

The word “institution” has been defined by Douglas North (1991) as humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, trust, social capital, and codes of conduct) and formal rules (constitutions, laws, property rights). Throughout history, institutions have been devised by human beings to create order and reduce uncertainty in exchange. Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline (North, 1991, p.97).

Operating under such a broad definition, the relationship between institutional quality and economic performance has been investigated by economists since Adam Smith, who have tried to answer the question of which institutions stimulate economic development under varying socio-economic conditions. Most of the empirical research on the topic provides evidence confirming the important effect of institutional quality on economic performance (e.g., Knack and Keefer, 1995; Mauro, 1995; Hall and Jones, 1999). In particular, research by Easterly and Levine (2003) and Rodrik et al. (2004) highlights the dominant role of institutions over those of geography and policy. They argue that geography and policy affect economic development through institutions by influencing their quality, and the direct effect of geography and policy on development becomes weaker (or doesn’t exist) once institutions are controlled for (Huang, 2005, pp.5). Additionally, according to Fergusson (2006), these findings show that policy is not important. Policies and regulations are often important elements of a broader institutional equilibrium. Hence, changing them is not always a simple and risk-free task, and addressing the question of what determines the emergence of “good” institutions – i.e. institutions that promote financial development – seems particularly important (Fergusson, 2006, p.30).

Good institutions promoting financial development transfer sources of savings to productive areas effectively. As in all markets, the functioning of financial markets is affected by asymmetric information, and related problems (adverse selection and moral hazard). For example, in adverse selection, people who want to borrow may hide some of their negative features that might prevent this activity. In this way, they can obtain the requested funds with low cost and without a risk premium. In this case, lenders supply funds with a higher cost corresponding to the probability of asymmetric
information by demanding a risk premium or by the limiting funds that they put on the market. Since well-qualified people who want to borrow cannot be distinguished from the others, they are affected negatively by such a situation. In general, people who want to borrow cannot find funds or have to put up with higher costs because, under such a scenario, their information cannot be trusted by the lender. This situation can prevent well-qualified people from borrowing from the market. Thereby, the proportion of borrowers with negative features will increase in the market. Consequently, it became probable that the flow of fund suppliers’ money shifted towards risky borrowers more than reputable customers. In other words, the possibility of adverse selection will increase.

The other problem that can stem from the asymmetric information is a moral hazard. Such a hazard may emerge from careless or inappropriate behaviour that goes against the contract rules. For example, borrowers may be inclined to employ their funds in risky business ventures due to expectations of higher income. However, this choice increases the repayment risk. The borrowers’ normal or risky business decisions affect the lenders’ risk, but not their earnings. Therefore, lenders prefer to provide funds to normal-risk investments. In this case, as with adverse selection, lenders may be reluctant to provide funds due to a lack of confidence in borrowers. Increasing funding costs lead high-risk investors who pursue higher profits to remain in the market and deter normal-risk investors from entering the market.

Consequently, the financial markets that suffer from the problems of adverse selection and/or moral hazard due to a situation of asymmetric information will move away from the equilibrium. If asymmetric information is not prevented, agents with excess savings will hold their funds as liquid instead of taking unpredictable risks.

Institutional quality and the legal framework are likely to affect financial development through the ability of the financial sector to channel resources to finance productive activities. In the absence of an adequate regulatory framework and supervision, the ability of financial markets to mobilise funds may be strongly undermined by lack of depositors’ confidence. This will drift funds abroad and generally away from viable domestic investment opportunities (Grigorian and Martinez, 2000, p.5; Law and Azman-Saini, 2008, p.1-2).

For this reason, it is important to explore the institutional determinants of financial development. In this context, this paper has been motivated by the recent growing body of literature on the topic as well as clear relevance of the question of which institutions affect financial development. Therefore, the aim of this study is to present a conceptual framework in order to provide a better understanding the effects of the institutional environment on financial development by reviewing the related literature. The remainder of this study is structured as follows. Section two reviews the literature explaining the relationship between institutions and financial development. Section three provides a general evaluation of the literature and conclusions.

### 2. THEORETICAL BACKGROUND

#### 2.1. Law and Finance Theory

Legal systems are institutions that regulate social and commercial relationships and reduce uncertainty. In recent years, since the pioneer study of La Porta et al. (1997), the effects of different legal systems on financial development have been intensely investigated. The legal systems of many countries originate from those of England or France. Legal systems based on the laws of England are typically
described as belonging to the common law tradition, while those based on the laws of France are described as belonging to the civil or Roman law tradition. Structurally, the two legal systems operate in very different ways: civil law relies on professional judges, legal codes, and written records, while common law relies on judges, broader legal principles, and oral arguments (Glaeser and Shleifer, 2002, p.3). The civil law tradition itself is divided into French, German and Scandinavian systems. The civil and common legal traditions have spread around the world through a combination of conquest, imperialism, outright borrowing, and imitation. Among these legal traditions, civil law is the oldest, the most influential and the most widely distributed tradition around the world (La Porta, et al., 1997).

According to the law and finance theory of La Porta et al. (1997), the differences in the legal protections of investors and creditors and the quality of enforcement of laws can explain why levels of financial development differ among countries. In connection with this matter, they found that: a) shareholders and creditors are protected most in common law countries and in French civil law countries the least, with German and Scandinavian civil law countries falling somewhere in the middle in terms of these protections; b) the quality of law enforcement is highest in Scandinavian and German civil law countries, next highest in common law countries and again the lowest in French civil law countries.

The literature emphasises that legal systems influence financial development through two channels: the political and the adaptability channels. The political channel, which is the “static” view of law and finance, stresses that legal traditions differ in terms of the priority that they give to private property rights, which form the basis of financial development, versus the rights of state. For instance, the civil law tradition gives priority to state power. Civil law has evolved to eliminate increasing corruption in and mistrust of courts. To establish and strengthen trust in courts, legislature tried to be clear and precise in wording laws. By so doing it was believed that any need for interpreting laws by judges would be avoided. With this codification, the judiciary has produced legal traditions that concentrate on the power of the state rather than the rights of individual investors. This situation has relegated judges to a relatively minor bureaucratic role while enhancing the power of the state (Mahoney, 2001; Meryman, 1985; Beck, et. al., 2001, 2003). On the other hand, common law evolved to protect private property owners against the crown. English common law developed as it did because landed aristocrats and merchants wanted a system of law that would provide strong protections for property and contract rights and limit the crown's ability to interfere in markets. The crown attempted to reassert feudal prerogatives and sell monopolies to raise revenues (Mahoney, 2001, p.506). Parliament, which was composed mostly of landowners and wealthy merchants, along with the courts, took the side of the property owners against the crown (Beck and Levine, 2003b, p.657). Thus, English legal origin tends to place greater emphasis on the rights of individuals than the rights of the state. Hayek expressed that common law is superior to civil law, not because of substantive differences in legal rules, but because of differing assumptions about the roles of the individual and the state. In general, Hayek believed that common law was associated with fewer government restrictions on economic and other liberties (Mahoney, 2001).

The legal-adaptability literature focuses on the differences between legal traditions in terms of their abilities to evolve with changing economic conditions and needs. The legal adaptability channel is a dynamic view of law and finance. However, French civil law reflects a static view of law. The reason for this is to impede interpretation by judges in decision processes to eliminate mistrust of the court. In this situation, the legislature inherently does not respond to changing economic and social circumstances and necessities quickly. On the other hand, German legal scholars reject the static nature of French law and give importance to cases.
The English common law tradition is almost synonymous with judges having broad interpretation powers and with courts moulding and creating law as circumstances change. The common law is obsessed with facts and deciding concrete cases, rather than adhering to the logical principles of codified law (Beck et al., 2003b, pp.660). According to the findings of La Porta et al. (1997), the legal adaptability channel operates ideally in German civil law countries, close to ideally in common law countries, and poorly in French civil law countries.

La Porta et al. (1997) also show that countries with poorer investor protections, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets. Additionally, they present that civil law, and particularly French civil law, has both the weakest investor protections and the least developed capital markets. In another study, La Porta et al. (1998) found that common law countries provide companies with better access to equity finance than civil law countries and French civil law countries in particular. The findings of Beck et al. (2001) provide considerable support to law and finance theory. In addition, they show that differences in legal origin help explain the differences in development of financial markets among countries today even after controlling for the level of economic development, regional dummy variables, religious composition, ethnic diversity, openness to international trade, initial endowments, and the political environment. In another study, Beck et al. (2003) argue that legal adaptability explains cross-country differences in financial development, but political channel does not. Law and Azman-Saini (2008) also found such significance for the rule of law in determining banking sector development. Their findings were consistent with those of La Porta et al. (1997). However, they found that none of the institutional quality variables, including rule of law variables, were statistically significant determinants of stock market development. They therefore suggested that economic development must reach a threshold level in order for a stock market to develop.

2.2. Openness Theory

According to Rajan and Zingales (2003), financial development differences in countries that have similar economic and industrial development levels cannot be explained by a demand side approach alone. In order to illustrate the inadequacy of the demand side approach, the authors ask why France’s stock market was much bigger as a fraction of its gross domestic product (GDP) than markets in the United States in 1913, even though the per capita GDP in the United States was no lower than France’s. They stress that it is hard to imagine that the demand for financing in the United States at that time was inadequate, since the demand for more and cheaper credit was a recurrent theme in political debates in the United States. Rajan and Zingales also suggest that supply side approaches are inadequate in explaining financial development differences. As mentioned earlier, La Porta et al. (1997) state that common law countries seem to have better minority investor protection, and furthermore these countries have more highly developed equity markets. In contrast to these findings, Rajan and Zingales show that common law countries did not have more developed financial markets in 1913. Therefore, they suggest that these approaches are not incorrect but are inadequate in explaining financial development differences.

According to Rajan and Zingales, the strength of political incumbents is a major variable as an institution that promotes or implements financial development. They propose an “interest group” theory that emphasises the interests of incumbents in shaping policies and institutions. Incumbents in the financial sector or in industry may not always be able to benefit from financial development because of growing competition and diminishing rents. They show that simultaneous openness of both trade and capital accounts provide financial development by controlling incumbents and enhancing competition.
Consider, for instance, industrial incumbents can finance new projects with their own capital without recourse to external finance or can find the funds by using reputation. For such a loan, there is no need for a developed financial system. Large firms can access funds using their power. However, it is difficult to obtain funds in the primitive financial system for potential firms. This situation prevents the entry of potential firms into the markets and hence increased competition, and this situation provides rents to industrial incumbents (see Rajan and Zingales, 2003).

Similarly, trade openness without financial openness will lead to increased competition with the entry of foreign firms into the market. In this situation, domestic firms need to improve their technologies and make more investments to compete with foreign firms. To satisfy their increasing financial needs, industrial incumbents can press for greater financial repression so that the available finance flows their way, or they can petition the government for loan subsidies in the face of foreign competition instead of improving the quality of the domestic financial system. The reason why the incumbents do not prefer financial development is to prevent potential firms from finding funds easily. While financial development provides new earnings field for financial incumbents, increasing competition may also diminish their rents, impairing their comparative advantages. In an undeveloped financial system, financing is typically relationship-based. The financier uses connections to obtain information to monitor loans and uses various informal levers of power to cajole repayment. The key, therefore, to the ability to lend is relationships with those who have influence over the firm (managers, other lenders, suppliers, politicians, etc.) and the ability to monopolise the provision of finances to a client (either through a monopoly over firm-specific information or through a friendly cartel amongst financiers). Disclosure and impartial enforcement tend to level the playing field and reduce barriers to entrance into the financial sector. The incumbent financier’s old skills become redundant, while new ones of credit evaluation and risk management become necessary (Rajan and Zingales, 2003, p.1). Moreover, financial openness without trade openness allows large firms access to foreign capital while small or new firms cannot access foreign capital because of asymmetric information among the markets. Consequently, financial incumbents impede financial liberalisation that decreases their rents because industrial incumbents can gain access to foreign funds easily.

Baltagi et al. (2008) find that trade and financial openness are statistically significant determinants of banking development in their study by using dynamic panel data techniques. Their findings show that the marginal effects of trade (financial) openness are negatively related to the degree of financial (trade) openness. Hence, closed economies can benefit more by opening up both their trade and capital accounts. However, they do not find any evidence to suggest that opening up one without the other could have a negative impact on financial sector development. On the other hand, they present that both trade and financial openness will have a larger impact on financial development than opening one of them. Their findings demonstrate that, while the simultaneous opening of both the trade and capital accounts may be a sufficient condition for financial development in relatively closed economies, but not necessary condition. Because of this, their findings provide partial support to Rajan and Zingales’ hypothesis.

Law (2007) tested the theory of Rajan and Zingales, using data from 68 countries for the period 1980-2001. He found that the simultaneous opening of both trade and capital accounts will promote financial development, mainly in the middle-income countries, and that this effect is much lower in low-income and high-income countries. Their findings also suggest that trade openness affects countries’ financial development differently. Trade stimulates financial development in middle-income and high-income countries, and the effect is smaller in low-income economies. On the other hand, capital inflows have
a positive effect on financial development, and particularly on capital market development, regardless of which stage of economic development the country’s economy is in. Their findings demonstrate that simultaneously stimulating capital and trade openness, improving institutions and economic development will encourage financial development, especially in middle-income and low-income economies. Besides of this, Ito and Chinn (2006) also suggest that a higher level of financial openness contributes to the development of equity markets only if a threshold level of general legal systems and institutions is attained, but they do not test the simultaneous openness hypothesis.

Do and Levchenko (2004; 2007) analysed the effect of comparative advantage in international trade on a country’s level of financial development. They assessed this matter in terms of the demand approach. According to them, opening to trade will affect the demand for external finance, and thus financial depth, in the trading countries. In particular, when a wealthy and a poor country open to trade, this situation will naturally increase production and export the financially dependent good, leading to growth of the financial system in the wealthy country. On the other hand, in the poor country, the financially dependent sector will shrink, leading to decreased demand for external finance and deterioration of the domestic financial system. In summary, Do and Levchenko (2004; 2007) demonstrate that trade openness is associated with faster financial development in wealthier countries and with slower financial development in poorer ones.

2.3. Other Institutional Theories

Recently, ‘informal institutions’ such as trust, social capital, culture, and religion and their impacts on financial markets have been investigated intensively by many economists. Informal institutions are complementary factors of formal institutions such as legal systems. The effects of informal institutions on financial operations have been observed to be larger in underdeveloped financial markets than in developed ones (Knack and Keefer, 1997; La Porta et al., 1997). Because of its structure, the financial system may face problems, such as moral hazards, and adverse selection, that stem from asymmetric information. Therefore, trust becomes one of the most important factors in financial markets due to the characteristics of financial contracts. According to Guiso et al. (2004), financial contracts are trust intensive contracts par excellence. In a financial contract, the lender transfers money to the borrower in the present, expecting that the borrower will return it in the future. In order to avoid opportunistic behaviour, additional clauses, such as collateral requirements, are added to the contracts (Calderon et al., 2002, p.7). In this situation, however, there is a need for not only an appropriate legal system but also the enforcement of law for the proper functioning of financial system. According to Fukuyama (1995), the level of trust inherent in a national culture can reduce transaction costs and thus promote financial market efficiency and economic development.

What is the source of trust, or, in other words, what are the components that create trust between individuals? The answer to this question may be social capital. According to Coleman (1990), in communities that have high social capital, people may trust each other more because the community’s networks provide better opportunities to punish deviants. Guiso et al. (2004) analyse the effect of social capital on households’ portfolio allocations by considering use of checks, availability of loans and reliance on informal lending. They find that, in high social capital areas, households invest a smaller proportion of their financial wealth in cash and a bigger proportion in stocks. These findings also demonstrate that, in areas with high social capital, households are also more likely to use personal checks and obtain credit more easily. Additionally, they stress that the effect of social capital is stronger when legal enforcement is weaker or education levels are lower.
The other source of trust may be environment. The importance of the environment cannot be neglected in shaping the behaviour of people. The environment also reflects cultural features of a region. Stulz and Williamson (2003) define “culture” as a system of beliefs that shape the actions of individuals in society. Since the work of Weber (1930), “culture” has been considered an important determinant of economic institutions. Hence, culture may be the cause of differences in investor rights protections and financial development in countries. Stulz and Williamson (2003), using religion and language as a proxy for culture, find that investor protection, and hence financial development, is related to culture. They show that religion is important for creditor rights but not for shareholder rights. Additionally, they point out that stock market developments depend on a country’s legal origin, while debt markets and the banking system depend on culture. Furthermore, according to their findings, the principal religion of a country helps predict the cross-sectional variation in creditor rights better than its language, per capita income, legal origin, and trade openness. For example, creditor rights are the strongest in countries where the main religion is Protestant, regardless of legal origin. In other words, there is no difference between common law Protestant countries and civil law Protestant countries in terms of in creditor rights. They also show that Catholic countries have significantly weaker creditor rights than other countries. On the other hand, they find that openness reduces the influence of religion on creditor rights. They also suggest that culture is related to the enforcement of rights, with Catholic, and especially Spanish-speaking Catholic, countries having weaker enforcement rights.

2.4. Endowment Theory

The importance of institutional quality has been accepted by many economists in explaining cross-country differences in per capita income and financial development. In the endowment theory developed by Acemoglu et al. (2001), the authors focus on the initial endowment encountered by the coloniser and how these endowments shaped both colonisation strategy and construction of long-lasting institutions. Their arguments rest on three premises: i) Europeans adopted very different colonisation policies, which created different sets of institutions. At one extreme, as in the case of the United States, Australia, Canada, and New Zealand, Europeans migrated and settled in the colonies and tried to set up institutions that protected private property, encouraged investment and checked power of government. At the other extreme, as in the Congo and much of Latin America, the main aim of colonisation strategy was to transfer as much of the resources of the colony to the colonisers. In these “extractive states”, Europeans set up institutions that empowered the elite to extract gold, silver, etc. (Beck et al., 2003). Therefore, the main purpose of institutions in these colonies was not the protection of private property rights or control of the expropriation power of the government. For this reason, these institutions had detrimental effects on investment and hence economic growth. ii) The colonisation strategy, in part, depended on countries being appropriate for European settlement, in other words, on the living conditions in the colonies. Europeans did not prefer the places where mortality rates were high due to disease environment. The disease environment encountered by colonisers affected the formation of institutions. In these colonised areas, Europeans were more likely to set up extractive states. iii) The institutions shaped by colonisation strategies have survived, even after the independences of the colonies, because the factors determining formation of colonisation strategy still have an important effect on institutions today.

In their study, Acemoglu et al. (2001) show that a strong negative relationship exists between GDP per capita and settler mortality rates. Their regression results show that the mortality rates faced by the settlers more than 100 years ago explains over 25 percent of the variation in current institutions. Drawing from their findings, they hypothesise that (potential) settlers' mortality rates were a major...
determinant of settlements, that settlements were a major determinant of early institutions (in practice, institutions in 1900), and that there is a strong correlation between early institutions and institutions today.

According to Beck et al. (2003), endowment theory focuses on institutional development in general, but their theory is also applicable to examine cross-country differences in financial development. In an extractive environment, colonisers will not construct institutions that favour the development of free, competitive financial markets because competitive markets may threaten the position of the extractors. In settler colonies, however, colonisers will be much more likely to construct institutions that protect private property rights and hence foster financial development. Thus, according to endowment theory, differences in endowments are shaped early institutions, and these initial institutions have had long-lasting repercussions on the protection of private property rights and financial development (Beck, et. al, 2003a, p. 140). In their study, they analysed both law and finance theory and endowment theory and found strong evidence for the validity of endowment theory. According to their results, countries with poor geographical endowments, as measured by settler mortality, tend to have less-developed financial intermediaries and stock markets and weaker protection of property rights. Additionally, in comparing law and finance theory and endowment theory, they found that initial endowments explain more of the cross-country variation in financial intermediary and stock market development than does legal origin. Furthermore, they demonstrated that initial endowments are more robustly associated with financial intermediary development than is legal origin.

3. SUMMARY AND CONCLUSIONS

In the literature, there is a broad consensus that financial development has a positive effect on economic growth. In this context, it is important to find the determinants of financial development in order to improve policies promoting financial development. The body of literature concerned with this topic has arisen in the last decade. Furthermore, an emphasis in the literature on institutions as determinants of financial development has grown. This paper therefore tried to introduce a conceptual framework for better understanding the effects of the institutional environment on financial development by reviewing related literature.

Law and finance theory, which was developed by La Porta et al. (1997), is the pioneer theory in the literature. The theory is based on the argument that the level of legal protection for investors and creditors and the quality of law enforcement determine the level of financial development. According to La Porta et al., the different legal traditions provide different levels of legal protection and adapt to changing economic conditions and commercial needs differently.

In the openness theory developed by Rajan and Zingales (2003), simultaneous openness of both trade and financial provide financial development by enhancing competition and by controlling political and industrial incumbents. The main idea behind the theory is that incumbents impede openness policies because they believe that trade and financial openness decreases their benefits by increasing the competition.

Since there is no a general title that gathered the effects of informal institutions such as trust, social capital, culture, religion, etc. on financial development, in this paper these effects were grouped together as “other institutional theories”. In general, intercommunity trust differences underlie these theories because trust is one of the most important factors in determining the cost and density of
financial transactions. Furthermore, the other informal factors are determinant of level of trust in a country. Therefore, the effects of informal institutions may also be grouped together under the title of “trust theory”. Most of the studies on the topic find that the effects of informal institutions on financial markets are larger in underdeveloped financial markets than developed ones. These findings also indicated that informal institutions are complementary factors of formal institutions.

The endowment theory developed by Acemoglu (2001) was adapted for financial development by Beck et al. (2003). The theory attempts to explain the role of colonisation strategy in shaping the institutions of countries. The initial endowment conditions in the colony as measured by settler’s mortality rates determine the colonisation strategy. The findings of studies on the topic indicate that colonies where settler’s mortality rates were low due to better initial endowment conditions tend to have stronger protection of private property rights and higher level of financial development.

Consequently, as can be seen from the literature, a broad variety of institutions affect financial development. Therefore, the historical and political characteristics of countries, as related to their institutional structures, should be analysed in improving policy suggestions for financial development. Ignoring institutional factors in policy planning, means ignoring the economic and sociological reality of a country. In this situation, policy suggestions (especially regulation and supervision policies) will be inadequate for financial development and may even lead to negative results in a country. However, related empirical literature generally base on analyses of cross-country institutional differences rather than the analysis of only one country. In other words, determining of institutional differences between the countries with developed and undeveloped financial markets underlies these theories. Therefore, I suggest that this issue should be taken up by considering institutional structure changes over time in a given country.

REFERENCES


