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FINANCIAL INSTITUTIONS AND DEVELOPMENT: A REVIEW

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ABSTRACT

Among the causes of differences in financial development, 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. Financial institutions and treatment of financial markets have been committed important functions in for development processes and economic performance. The researches on the role of financial development in growth can be traced back.

KEYWORDS:- Financial, Institutional, Environment, Markets, Researches,

Introduction

The inherent functions of financial systems, including mobilizing 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.Under such a broad definition,since Adam Smith, the relationship between institutional quality and economic performance has been investigated, and tried to find answer the question of which institutions stimulate economic development in varying socio-economic conditions.Most of empirical researches in the literature provide evidence confirms the importance of institutional quality on economic performance and presents that institutional quality affects the economy through which channel. Good institutions promoting financial development transfer sources of savers to productive areas effectively.

to borrow, from the market. Thereby, the proportion of borrowers with bad features will increase in the market. Consequently, the possibility of lending of the fund suppliers to people with bad features will increase instead of the people with good features. In other word, the possibility of adverseselection will increase.

The other problem which can stem from the asymmetric information is moral hazard. Itmay be emerged from careless or inappropriate behavior against the rules. However, this choice increases the repayment risk. Debtor's decision for a normal or risky business affect lender's risk while not affect lender's earnings. Therefore, lenders prefer to provide funds for normal-risk investment. In this case,due to lack of confidence to borrowers, such as adverse selection, lendersmay act reluctant to provide funds.Increasing cost of fund causes to high-risk investors who pursuehigher profitsremainsin financial marketswhile normal-risk investors keep away from the market. Consequently, in the financial markets which have adverse selection and/or moral hazard due to asymmetric information away from equilibrium.If asymmetric information is not prevented, the agents with excess savings hold their funds as liquid insteadof putting up with riskwhich they can not foresee size of it.The quality of institutions and legal framework are likely to affect financial development through the ability of 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 mobilize funds may be strongly undermined by lack of depositors'confidence. For this reason, to explore determinants of financial development is important for Development processes. In this context, the question of which institutions affect the financial development and new growing body of the literature in recent last decade have motivated us to explore effectsof institutional differenceson financial development. Therefore, the aim of this study is to present a conceptual framework in order to provide a better understanding the effects of institutional environment on the financial development. The reminder of this study is structured as follows.The laws of many countries originate in 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 thelaws of France as belonging to the civil or Roman law tradition. Systems operate in very different ways: civil law relies on professional judges, legal codes, and written records, while common law lay on judges, broader legal principles, and oral arguments.

Thus, English legal origin tends to place greater emphasis on the rights of individuals versus the rights of the state.Last of all, Hayek as expressed in the 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 the common law was associated with fewer government restrictions on economic and other liberties. (Mahoney, 2001) Legal-adaptability channel focuses on difference between legal traditions in terms of their abilities to evolve with changing conditionsand needs of the economy. The legal adaptability channel is the dynamic law and financeview. However,Frenchcivil law reflects static view of law. The reason for thisis toimpede interpretation of judges in decision processes to eliminate the mistrust to court as mentioned above. In this situation, legislature inherently cannot respond to changing economic and social circumstances and necessities quickly.On the other hand, German legal scholars rejected 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 molding and creating law as circumstances change.

Trade and Openness Hypothesis :-According to Rajan and Zingales (2003), financial development differences in the countries, which have similar economic and industrial development level, cannot be explained by only demand side approach.They explain their argumentbyasking the question that 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 not any lower than France's. They stress that it is hard to imagine that the demand for financing in the United Statesat that time was inadequate and at the timethe demand for moreand cheapercredit was a recurrent theme in political debates in the United States. Therefore, they suggest that these approaches are not incorrect but are inadequate in explaining financial development differences.

Consider, for instance, industrial incumbents canfinance new projects with itsown 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 firmscan accessto funds using their power. However, it isdifficult to obtain fund in the primitive financial systemfor potential.

ADVANTAGE IN FINANCIAL INSTITUTIONS

This situation prevents the entry of potential firms into the markets and increased competition, and provides rents to industrial incumbents. Similarly, trade openness without financial openness, will lead to increase competition with entry of foreign firmsinto the market. In this situation, domestic firms need to improve their technologies and make more investment to competewithforeign firms.To satisfy their increasing needs for finance, industrial incumbents can press for greater financial repression so that the available finance flows their way or petition the government for loan subsidies in the face of foreign competition instead of improving the quality of the domestic financial system.The reason of why the incumbents donot prefer financial development is to impede potential firms find to funds easily. While financial development provide new earnings field for financial incumbent, on theother hand, increasing competition may diminish their rents

impairing their comparative advantages.In an undeveloped financial system, financing is typical 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, ther lenders, suppliers, politicians, i.e.) and the ability to monopolize the provision of finance 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 an entrance into the financial sector. The incumbent financier's old skills become redundant, while new ones of credit evaluation and risk management become necessary. Moreover, financial openness without trade openness allow that large firms access to foreign capital while small or new firms can not be able to access foreign capital, because of asymmetric information among the markets.Financialincumbents impede financial liberalization to impair their rents because of industrial incumbents can access to foreign funds easily. Find that trade and financial openness are statistically significant determinants of banking development in their study byusing dynamic panel data techniques.

Their findings showthat 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. Besides, they do not find any evidence to suggest that opening up one without the other could have negative impact on financial sector development. However,they present that bothtrade and financial openness will have a larger impact on financial development than opening one of them. Their findings demonstratedthat

while simultaneous opening of both the trade and capital accounts may be a sufficient condition for financial development in relatively closed economies, but it is not necessary condition. He foundthat simultaneous opening of both trade and capital accounts will promote financial development mainly in the middle-income countries, and the effect is much lower in low-income and high-income countries. Their findings also suggestthat trade openness affects countries' financial development differentially. Tradestimulates 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 capital market development, regardless of which stages of economic development. Theirfindings demonstratethat simultaneously stimulating capital and trade openness, improving institutionsand economic development will encourage financial development, especially in middle-income and low-income economies.

Other Institutional Theories

Recently, economists have investigated so-called 'informal institutions' such as trust, social capital, culture, religionand their impact on financial markets. In this section, we briefly review some of contributions along these lines. Informal institutions such as trust, social capital, i.e.are complementary factors of formal institutions such as legal systems. The effects of informal institutionson financial operations are observed as larger in underdeveloped financial marketsthan developed ones Financial system canbe faced problems which stem from

asymmetric information, such as moral hazard, adverse selection because of its structure. Therefore,trust becomes the one of the most important factorsin financial marketsdue to the characteristics of financial contracts. 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 behavior, additional clauses such as collateral requirements are added to the contracts. However, there is not only need appropriate legal system but also enforcement of law for proper functioning of financial system .They find that in high social capital areas, households invest a smaller proportion of their financial wealth in cash and a bigger proportion in stock. Besides, these findings demonstrate that in social capital intensive areas households are also more likely to use personal check 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 greater. The other source of trust may be environment. The importance of environment can not be neglected in shaping the behavior of people. This environment also reflects cultural features of region. Hence financial development is related to culture by using religion and languages as a proxy for culture. They show that religion is important for creditor rights but not for shareholders rights. And they point outthatstock market developments depend on a country's legal origin while dept markets and banking system depend on culture. Besides this, according to their findings, principle religion in a country helps predict the cross-sectional variation creditor rights better than its language, per capitain come, 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. Additionally, they 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 show that, culture is related to enforcement of rights, with Catholic and especially Spanish-speaking Catholic countries having weaker enforcement rights.

Endowment Theory

The importanceof institutional quality has been accepted by many economists in explaining cross-country differences in per capita income and financial development. In the endowment theory, they developed, argue that initial endowment encountered by the colonizer and how these endowments shaped both colonization strategy and construction of long-lasting institutions quality.

Conclusions

In the literature, there is a broad consensus on positive effects of financial development on economic growth. In this context, searching for determinants of financial development for improving policies promoting financial development has become important. However, the body ofliteratureabout this subject has arisen recent decade. Among the determinants of financial development, emphasis on institutions has increased in the literature. The theories trying to explain effects of the institutions on financial development base on analyzing institutional differences between the countries which have developed and undeveloped financial markets rather than analyzing only one country. In other words, determining of common features of the countries, which have developed financial markets,
underlies these theories.

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