No. 1502 [EN]

IMI Working Paper

National Characteristics, Government-Market Relationship and Development of Financial System

Ma Yong and Chen Yulu

INTERNATIONAL MONETARY INSTITUTE

IMI Working Paper No. 1502 [EN]

National Characteristics, Government-Market Relationship and Development of Financial System

By **MA YONG[*] and CHEN YULU[**]**

January 2015

Abstract

This study seeks to determine an effective boundary between government and market in light of modern financial theories. According to the findings of this paper, the relationship between government and market must be conceived of asunder the "continuous spectrum of change" resulting from economic development. In practice, an effective frontier between government and market not only transforms continuously with the process of economic development but also demonstrates significant contrasts internationally according to the different national characteristics existing in each country. Determining a frontier between government and market requires that the relationship between the two be embedded into a broader set of institutional environmental constraints that incorporate consideration of the dynamic processes and mechanisms of economic development. The key issue is that government and market act with regard to the principle of comparative advantage as they play their respective roles.

JEL Classification: G18, G21, G28

Keywords: Government, Market, National Characteristics

[*] Research fellow of IMI, School of Finance, Renmin University of China. Corresponding author, email: mayongmail@ruc.edu.cn.
[**] Chairman of IMI Academic Committee, President of Renmin University of China.

1. Introduction

Few academics have effectively addressed the relationship between government and market. The conventional conception of the government's exogenous role and the value orientation of market efficiency maximization have led to the following dogma: the economy runs best when government intervention is at its lowest. This assumption has led to numerous misunderstandings on theoretical and practical issues, but in reality, both the configuration of the government's exogenous role and the maximization of market efficiency are not sufficiently supported by empirical evidence. In fact, regarding the relationship between government and market, it is not difficult to arrive at the erroneous finding after reflecting on the methodology behind mainstream economics, which derives the exogenous treatment of the government from the static methodology of dualism. This methodology not only excludes any possible compatibility between the government and the market but also neglects various considerations of the dynamic processes and mechanisms of economic development.

In reality, the government and the market are both products of allocated resources, and whether there exists a substitution or complementary relationship between the two depends on the characteristics, scope and nature of the institutions under their influence. Therefore, a proper understanding of the relationship between government and the market requires the reconstruction of a dynamic theory of comparative advantage. The implication is that the efficiency of the government and the market in resource allocation varies according to time, location and resources, which requires determining an effective frontier between the two under a dynamic path of optimization.

Aside from the above-mentioned theoretical questions, we must also consider some of the unique features of the financial system, such as the effect of externalities, spillover, and contagion as well as self-realization mechanisms. These characteristics have led to the difference in the degree and method of government intervention in financial systems compared with government intervention under normal market conditions. For typical government-dominated countries like China, a clarification of the relationship between the government and the market in the country's process of financial transformation is valuable.

Based on the above considerations, this paper aims to introduce the concept of "national characteristics", characterize the relationship between government and the market with a set of institutional constraints and incorporate considerations on the dynamic processes and mechanisms of economic development to systematically reconstruct the compatibility theory and the "effective frontier" between government and the market. This theory will help researchers overcome the theoretical dilemmas and practical questions facing the economics community.

2. Government Intervention in Financial Operations: Why Is It Important?

The government plays a key role in the operation of the financial system. Theoretically, the role of government in the financial system is derived from the following facts: first, the financial system possesses the attributes of quasi-public goods due to its externality effect, which justifies government intervention; second, the failure of the financial system has more severe consequences than that of other sectors due to its complexity. In this context, the self-regulatory and corrective mechanisms of the financial markets alone can hardly prevent the distortion and failure of the financial system, as evidenced in the recent global financial crisis.

An efficient and stable financial system can promote the efficient allocation of resources through price discovery, risk allocation and corporate governance. In this manner, the efficiency and stability of the financial system affects the availability of credit, financing capacity, trading costs and the marginal capital return of every firm. The implication is that the efficiency and stability of the financial system will influence the real economy with its spillover effects. From the micro perspective, unregulated and undisciplined financial activities may cause the distortion of micro-level information and incentive mechanisms, thereby undermining the effectiveness and stability of the financial markets. From a macro perspective, an efficient and stable financial system depends on an effective financial infrastructure and corresponding institutional frameworks, which are only effectively provided by public agencies. Given that the financial system may cause negative externalities on a large scale, maintaining efficient and stable market conditions implies that the government should assume the responsibility of correcting market distortions where market failure or inefficiency has been detected.

The repeated eruption of the financial crises has indicated how unrestrained market forces have led chaos and inefficiency in the market. Prior to the recent global financial crisis, the guiding philosophy of Neoliberal economic theory was to restrict government intervention and ultimately replace it with market mechanisms. This policy is derived from the belief in the superiority of the unregulated market, which is grounded in the theory of the effective market hypothesis (Malkiel, 2003). According to the radical version of this theory, market-based self-regulation and income distribution possess a “self-evident” rationality and the government is an “intruder” in the market. The dilemma of the Neoliberal theory is that it can neither ensure long-term economic stability nor contain risks. There is no evidence supporting the thesis that rebuilding confidence, reshaping balance sheets and re-initiating economic growth occur through market-based self-repair. Each of these requirements for rebuilding the economy may only be accomplished by government institutions. For instance, the government has played a leading role in the three major areas of the recent global financial crisis rebuilding: acting as a lifeboat for financial system; providing direct stimulus to the economy to offset the slump in consumer demand; and designing national and global regulatory mechanisms to avert the eruption of a similar crisis in the future. In fact, in the aftermath of the systemic financial risks and crises, no alternative private financial market solutions have been identified to replace government intervention. Government policies strive to assist private credit markets in surmounting difficulties resulting from the crisis, preventing major fractures in the chain between the financial system and the rest of the economy thereby maintaining the normal operation of the financial system and the economy as a whole.

The theory of the relationship between government and the market and the systemic risks arising from an unregulated market must also be reviewed. Of course, conceding the key role of the government in economic and financial systems does not mean that the government should take over the fundamental role of the market in the allocation of resources, but it does allow for a demarcation of an effective frontier between government and the market according to the principle of comparative advantage to ensure the long-term efficiency and stability of economic and financial development. The common concern about "whether government can outsmart the market" is fundamentally irrelevant because this concern presumes the antagonistic and substitutive relationship between government and the market, neglecting the possibility of coordination and complementarity between the two. The latter happens to be the key issue under the spotlight of our discussions.

3. Frontier between Government and the Market in Financial Development: From the General Pattern to the "National Characteristics"

The validity of a given theory or policy depends on whether it can effectively link general patterns with a country's particular "national characteristics" to achieve the transition from theory to practice. "National characteristics" include not only the country's resources in the general sense but also its social environment, cultural sensibilities and political system, all of which are closely related to the operation of the financial system (Chen Yulu, Ma Yong, 2013). These factors largely determine the development of a country's financial system.

Based on the philosophy above, in determining the effective frontier between government and the market, consideration must be given to the country's basic patterns of institutional choice and development process as well as its economic foundation, political structure, cultural background and institutional framework to create a framework of an effective financial system. For the convenience of illustration, it is assumed that a country's economic and financial systems will sequentially experience the following development stages: stage A, B and C, each of which corresponds to the following optimal levels of government intervention denoted as g_A^*, g_B^* and g_C^*. A represents a developing economy with the lowest level of economic development and the most primitive financial system; B represents an emerging market stage featuring a moderately developed economy and an imperfect financial system; C corresponds to the stage of a developed economy featuring sophisticated market mechanisms and a complex financial system.

The efficiency and stability of the financial system are poor in stage A due to the low levels of economic development and the imperfect market mechanisms, which result in market gaps and failures. Hence, government intervention is necessary to foster the immature market, offset market gaps and increase the efficiency of resource allocation. Therefore, direct government intervention is essential at this stage. With the preliminary establishment of market-based financial mechanisms in stage B, market-based regulation can play a fundamental role, but a certain degree of government intervention remains necessary to compensate for the defect of market mechanisms, including the imperfection of the financial system, the insufficiency of market competition and the incompletion of institutional mechanisms and potential market distortion from both the micro and macro level. Thanks to the sophisticated market and advanced financial system present in stage C, market mechanisms are able to allocate resources in a highly efficient manner, and the government only needs to make moderate intervention in certain instances of “natural failure” of market mechanisms, such as areas with significant positive externalities, to strengthen market mechanisms by improving their institutional design and providing effective regulation with a view to safeguarding the efficient and stable operation of those market mechanisms.

With the increasing sophistication and perfection of market mechanisms through each of the described stages of economic development, or A, B and C, the degree of government declines, i.e.: $g_A^* > g_B^* > g_C^*$. Through this process, government intervention will gradually evolve from direct intervention to increasingly indirect intervention. Furthermore, if we see a country's economic development as a process of continuous transformation, as a market economy evolves from its preliminary stage T_1 to an advanced stage T_n, i.e., in the process of $T_1 \to T_2 \to T_3 \to ... \to T_{n-1} \to T_n$, multiple compatible levels of optimal government intervention exist $g_1^* \to g_2^* \to g_3^* \to ... \to g_{n-1}^* \to g_n^*$ and satisfy the condition: $g_1^* > g_2^* > g_3^* > ... > g_{n-1}^* > g_n^*$. The following demonstrates the variation in the level of optimal government intervention:

$$\{(T_1, g_1^*), (T_2, g_2^*), (T_3, g_3^*), ..., (T_{n-1}, g_{n-1}^*), (T_n, g_n^*)\}$$

Satisfying: $g_1^* > g_2^* > g_3^* > ... > g_{n-1}^* > g_n^*$

The level of government intervention decreasing over the course of market-based operation is a long-term tendency. In reality, in the event of a temporary fracture of the market mechanisms as a result of a sudden shock to the economy, such as an economic or financial crisis, the government must intervene immediately to offset the inadequacy of market forces caused by the slump of the market factors. With the gradual recovery of market mechanisms after the sudden shock, the government will return to its long-term tendency (as shown by Figure 1).

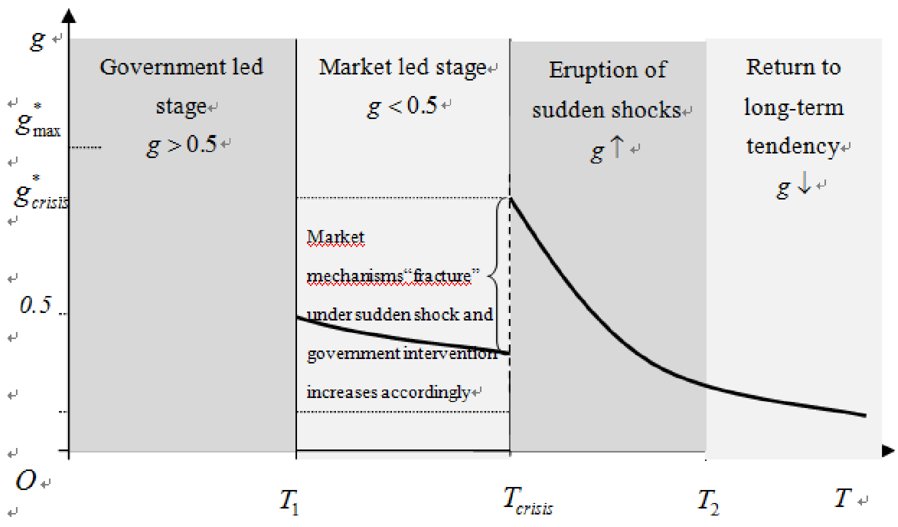

Figure 1: Continuous Economic Transformation and Dynamic Evolution of the "Government-market" Relationship

As a general depiction of the evolution of "government-market" relationship through continuous economic transformation, Figure 1 demonstrates the entire process from high-level government intervention to low-level intervention, including the interruptions caused by sudden shocks. In reality, key points in this figure vary greatly by country. In other words, if the degree of government intervention decreases with the increase in the role of the market during a country's economic transformation, what ultimately determines the optimal dynamic between the government and the market is the country's "national characteristics", which are universally correlated to the country's economic foundation, political structure, cultural environment and institutions.

First, with regard to a country's economic foundation, assuming all other factors are constant, the better a country's economic infrastructure and market network, the more efficient market information transmission and processing become and the more likely deals will be clinched. This provides for greater space for the effective functioning of the market and a smaller likelihood that government intervention will be necessary. Levine (2002) partially verified this conclusion when he discovered that in countries with higher per capita income and more advanced economic and financial systems, there is a smaller share of government involvement in the banking and financial system.

Second, in terms of the effect of a country's political framework, countries in which individualism and democratic decision-making systems prevail tend to allow market mechanisms to play a key role, while countries where collectivism and central decision-making prevail tend to have greater government intervention. Generally, the supreme authority of the government will become increasingly involved in a country's economic and financial development (Li Yiqi, 2005). This has been proven by the empirical study of 78 countries by Ma Yong (2012) .

Thirdly, from a country's cultural context, it is generally less costly and more efficient to organize and allocate resources through market-based means.

Lastly, in economies with well developed institutions, such as a clear property system and a fair judicial system, as it is easier to guarantee the rights and interests of market stakeholders with contracts, the efficiency of market-based resource allocation is high and there will be greater space for the market to play its role. This is one of the key propositions of the "law and finance" theory. As indicated by La Porta et al. (1987, 1998) and Levine (2002), countries ruled by a common law judicial system appear to be more effective at protecting investors, which allows the market to play a dominant role in regulating the financial system. Due to their weak protection of market mechanisms, however, countries using civil law generally require greater government intervention.

In addition to the influence of a country's "national characteristics" on the optimal "government-market" relationship, a country's "government-market" frontier for each stage in the process of economic development and institutional transformation will be subject to the influence of the "government-market" frontier existing in the previous stage of its development. According to the successful experience of China, if the adjustment of the "government-market" frontier follows a gradual pattern of transition and the introduction of incremental reform has taken account of the country's national characteristic, it will likely be successful. Contrarily, if the adjustment of the "government-market" relationship follows a radical change in the process of the country's economic transformation and incremental reform deviates from the country's national characteristics, such reforms will likely fail as occurred in Russia (the former USSR) and some countries in Eastern Europe and Latin America such as Hungary, Romania, Bulgaria, Brazil and Argentina. The historical "government-market" frontier adjustment pathway of selected countries are illustrated in Figure 2[1].

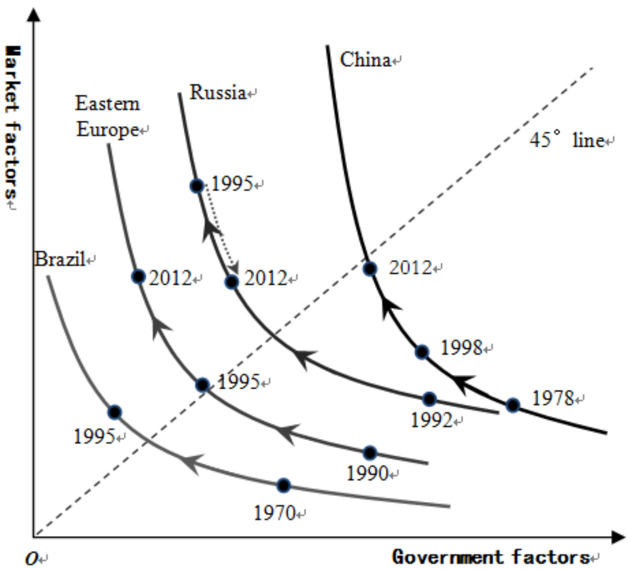

Figure 2: The Adjustment Pathways of the "Government-market" Frontier in Selected Countries

[1] In this diagram, we have referenced Djankov *et al.* (2003) for information on Russia and Eastern Europe prior to 1995.

Under the general equilibrium perspective, the government-market relationship is no longer antagonistic but characterized by an optimal dynamic relationship. For some countries, determining the frontier between government and the market may follow the general pattern of institutional development and proceed from a country's political, institutional and cultural background. Zhang Jie (2005) also suggests that a different institutional combination corresponds to different types of market economies and institutional arrangements and that a market combination effective in one country may not be also effective in another. Hence, a country should create its own economic system according to local conditions. In addition, determining an effective frontier between the two must take the country's changing economic status into account.

4. Dual Priorities: Nurturing the Development of a Financial System and Optimizing the "Government-market" Relationship in Developing Countries

If recent rounds of financial crises have revealed the failure of the hands-off approach to managing financial markets in developed countries, the priorities for handling the relationship between government and the market in developing countries are twofold : enhance effective government intervention when needed, and withdraw from inappropriate and excessive intervention.

Implementation of effective supervision over the financial industry remains to be one of the most challenging of the government's responsibilities. Financial regulation must ensure that banks and other financial institutions be able to serve as the medium of exchange between savings and investments while preventing the financial system from becoming a source of economic instability. This requires regulation to ensure that each individual financial institution meet regulatory standards and prevent systemic risks. An important lesson made evident by the recent round of financial crises is that stricter regulatory standards should be created for certain financial institutions and the rate of executive compensation in financial institutions should create a long-term incentive to maintain the health of the financial system.

Financial supervision must consider the impact of financial institutions because systemic financial stability itself is a public good, and the supply of public goods should always enjoy priority over private claims of profit maximization. Additionally, in order to ensure that financial development serve the real economy rather than become isolated from the real economy, financial supervision must seek a reasonable balance between encouraging effective innovation and preventing excessive innovation.

In addition to the above-mentioned areas where supervision should be enhanced, another equally important question is how to phase out distorting interventions. This is particularly important for developing countries (i.e., transition economies). The key issue for minimizing the impact of distorting interventions is understanding the limits of the power of government. Judging by the pattern of economic and financial operations, given that financial institutions' low-level operational activities generally involve the application of specialized knowledge, information and skills, the government frequently does not have adequate knowledge to effectively intervene in the low-level operations of many enterprises in the corporate credit and financial sectors. On the other hand, relevant government financial policies and regulations at the macro level must maintain a reasonable balance between the efficiency and stability of the financial system. Although moderate financial regulation is favorable to creating a smooth economic transition, excessive regulation in the long-term will create financial constraints, which will bring about severe damages to the development of the financial system. Furthermore, China's experience indicates that the gradual selective withdrawal of the government in economic and financial sectors is key to ensuring a successful transition toward an increasingly market-based system. In addition, Justin Yifu Lin (2011) suggests that a pragmatic and a gradualist model of government exit from the economy is a strategy successfully adopted by Vietnam, Mauritius and other economies that have successfully transitioned to a more market-based economic system.

As indicated in the experience of several Latin American and Southeast Asian countries, when the government is free from legal and institutional constraints, officials often aim to expand their authority by creating new positions or engaging in rent-seeking activities (Stigler, 1971; Buchanan, 1987). Through this process, official create redundant positions and political agencies that compete for the same regulatory rights. These activities not only consume significant resources but also compromise market efficiency and disrupt effective operation of the country's market mechanisms. Obviously, under a "government-market" framework based on efficiency and stability, the expansion of the government frontier for rent-seeking is an ineffective expansion policy. A favorable institutional framework usually includes transparency requirements, economic incentives and regulatory restraint mechanisms. These institutional constraints aim to narrow the government's ability to engage in rent-seeking activities, increase the cost of rent-seeking and enhance government accountability.

Most developing countries cannot rely entirely on market forces for management of their immature financial systems; meanwhile, their transformation also entails the consensus and synergy of various key players in the economy. Of course, the fundamental position and role of the market must be recognized while the government maintain its ability to respond to various uncertainties on the basis of compensating for, promoting and improving market mechanisms in order to achieve a stable economic transition. Hence, developing countries confronted with a dual priority to strike a balance between government and the market.

5. Concluding Remarks

The recent global financial crisis may be characterized as the peak of an era in which the respect of the market guided economic theory and policymaking. This era began from the economic stagnation of the 1970s. However, Neoliberals failed to deliver the ultimate solution to ensure economic prosperity, and the defects of market mechanism have made a comeback after a temporary period of disguise and latency. In fact, the key question regarding the ideal level and degree of government intervention remains to be determined, and the fight between supporters of government intervention and advocates of the free market persists.

Voltaire famously suggested that "a long dispute means that both parties are wrong and this quote may accurately depict the debate on relationship between government and the market. Over the years, discussions of the relationship between government and market have generally been based on the methodology of dualism, encouraging both sides to choose between the two alternatives. As a matter of fact, long-term economic development and the associated institutional transformation are a continuous "spectrum of transformation" (Justin Yifu Lin, 2011), which indicates that the relationship between government and the market must be considered on a dynamic continuum. In practice, the relationship between government and the market not only transforms continuously over the course of economic development but also demonstrates significant differences with regard to the national characteristic in different countries and economies.

No fixed optimal pathway or single static optimal solution exists for the effective frontier between government and market. Instead, the effective frontier between government and market is subject to multiple equilibrium pathways and combinations.

References:

Chen, Yulu, and Yong Ma. 2013. *A General Theory of Macrofinance*. Beijing: Renmin University Press.

Buchanan, James M.1987. "The Constitution of Economic Policy." *American Economic Review*, 77(3): 243-50.

Djankov, Simeon, Edward Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer. 2003. "The new comparative economics." *Journal of Comparative Economics*, 31(4): 595-619.

Li, Yiqi. 2005. "Financial Development and Government Exit: A Political Economy Perspective." *Journal of Financial Research*, 297(3): 88-99.

Lin, Yifu. 2011. "New Structural Economics: Reconstructing the Framework of Development Economics." *China Economic Quarterly*, 10(1): 1-32.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. 1997. "Legal Determinants of External Finance." *Journal of Finance*, 52(3): 1131-50.

——. 1998. "Law and Finance." Journal of Political Economy, 106(6): 1113-55.

Levine, Ross. 2002. "Bank-based or Market-based Financial Systems: Which is Better?" *Journal of Financial Intermediation*, 11(4): 398-428.

Ma, Yong. 2012. "What Determines the Financial System Structure for a Country?" *Journal of Finance and Economics*,38(1): 61-71.

Malkiel, Burton G. 2003. "The Efficient Market Hypothesis and Its Critics." *CEPS Working Paper* No. 91, Princeton University.

Stigler, George J. 1971. "The Theory of Economic Regulation." Bell *Journal of Economics and Management Science*, 2(1): 3-21.

Zhang, Jie. 2005. "What Determines the Choice of Banking System for a Country?" *Journal of Financial Research*, 303(9): 1-18.