THE ROLE OF MODERN FINANCIAL SYSTEM DEVELOPMENT IN ECONOMY

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Introduction

Today, the European Union seems an equal if not more challenger to American economic leadership. The historical accounting leads to the question: What did the actual and the would-be economic leaders of the past centuries have in common that made them leaders or contenders for leadership. All of them had what some historians have termed “financial revolution” leading to the development of strong financial systems before they became economic leaders or contenders for economic leadership. It means in other words that economic leadership grew out of a strong financial base. Also so did, of course, the political power in the world. In modern history, political power and economic modernization have gone hand in hand, and in the cases of the economic leaders and also perhaps in the cases of countries that also modernized, both were rooted in financial system modernization.

Besides of introducing groundwork about financial system development the article tries to clarify how the financial system development can influence Central European and Eastern European Countries (CEEEC) preparation process in joining the European Union (EU). Starting with introduction of the key components of modern financial systems and influence of the financial system development to the economic growth ending up to Estonian financial system in the lead-up to EU accession. Considering the experience of recent financial crisis, it will be useful to look at the current financial system development and emphasize the significance of the financial safety nets. CEEEC, including Estonia, are participating in the worldwide efforts to strengthen the global economy by increasing the transparency of their economic policymaking and financial institutions, adopting internationally accepted standards in order to strengthen their financial system. It leads to the attempt to overview country’s financial system development in the global framework.

Key Components of Modern Financial Systems

The considered five essential components for the strong financial base are following:

- First, strong public finance – raising revenues, controlling expenditures and servicing public debts.
- Second, stable money.
- Third, the banking system that accepts deposits of money and creates, through lending to creditworthy borrowers, the reliable bank money convertible into the stable monetary base.
- Fourth, the central bank that serves as the government’s bank, as a regulator and supervisor of a country’s financial system, and as an executor of monetary and financial policies promoting economic stability and growth. In history, central banks emerged from so-called public banks that were created as adjuncts of public finance (Kaufmann et al. 2000).
- Fifth, well-functioning securities market.
The final key component of the modern financial system is the securities market that finances governments and business enterprises by facilitating the issue of new securities (bonds, equity shares, and other financial instruments) and gives such securities “liquidity” by providing trading markets for securities after they are issued.

Given ordering of the financial system components is less important than the presence of the all five in some form. Different leading economies have chosen to vary the emphasis given to each component. But all leading economies have had a version of each component at most times in their modern histories. Even more important is that components mesh together in mutually supportive and self-reinforcing ways. This is what is meant by a “financial system”.

**Influence of the Financial System Development to the Country’s Economic Growth**

It has been observed that a country’s state of development is strongly positively correlated with the state of development of its financial sector. For example, on the basis of data from 35 countries between 1860 and 1963, Goldsmith (1969, p. 48) concludes that “a rough parallelism can be observed between economic and financial development if periods of several decades are considered”. In addition it has been pointed, that “there are even indications in the few countries for which data are available that periods of more rapid economic growth have been accompanied, though not without exception, by an above-average rate of financial development”.

Later studies suggest that this association is more than simply correlation, and financial development does, in fact, advance the economic growth. In a study of 80 countries over the period 1960 – 1989, King and Levine (1993) find that beginning-of-decade measures of a country’s financial development are strongly related to the country’s economic growth, capital accumulation, and productivity growth over the subsequent decade. Using deregulation of banking in different states of the United States between 1972 and 1991 as a proxy for a quantum jump in financial development, Jayaratne and Strahan (1996) find that annual growth rates in a state increased by 0.51 to 1.19 percentage points a year after deregulation.

**Lessons Learned**

As the recent history of the financial crises shows, there is known a lot less about what makes for good economic policy than recognized. Economies that have done well in the postwar period have all succeeded via their own particular brand of heterodox policies. Macroeconomic stability and high investment rates have been common, but beyond that many details differ.

In a world where capital is internationally mobile and short term liabilities have exploded thanks to financial liberalization, confidence becomes the sine qua non of macroeconomic stability, and hence a prerequisite for economic development. (Rodrik, November 1999). Without confidence, money flees, interest rates shoot up, and the currency plummets. And the culprits are not only just wicked foreign speculators. Domestic investors can crash the economy equally well, by converting their short-term assets into foreign currency and taking them out of the country. But where does confidence come from? For building the confidence it makes sense to justify reforms on the basis of their expected impact on market confidence. There is need to do things that the markets want to see to build
the confidence. It does not mean that the market’s ideas about what constitutes sound economic policy are entirely arbitrary.

Recently one of the most relevant issues has been the new financial architecture, especially international architecture, after the financial crisis of the 1990s. A key lesson from the financial crisis has been considered that information plays a vital role in maintaining the stability of the world economy. The Asian financial crisis has demonstrated that a functioning world economy needs an institutional infrastructure. Markets work well when they are underpinned by institutions that provide three functions: regulating market behavior, stabilizing aggregate demand, and redistributing the risk and rewards of market outcomes. World markets are no different. In particular, a truly global financial market would require an equally global set of institutions that provide regulatory, lender-of-last resort, and safety-net functions (Rodrik, June 1999). One has to consider that with a currency board in place the central bank’s role as a lender-of-last resort is severely circumscribed.

Restructuring the banking system has been a massive task in all transition economies and is still under way in a number of CEEEC. Several countries suffered severe banking crisis during the 1990s as a result of both corporate distress and the absence of regulatory and legal environment. Poor corporate governance and payments discipline exacerbated the problems. (Nord, 2000). The Russian crisis of 1998 exposed the continued vulnerability to external shocks of some countries, especially those with close trade ties to Russia and those, whose banks had high exposure to Russian debt instruments. Looking ahead to success in attracting high levels of foreign direct investment can also carry risks for these countries’ banking systems if accompanied by a sharp increase in domestic credit expansion.

The objective of the new architecture is to close the cap between the scope of institutions – heretofore mostly national – and the scope of markets – increasingly international.

In the framework of the new financial architecture the international standards have led to improvements in many areas, such as data dissemination, fiscal transparency, monetary and financial policy transparency, banking supervision, securities and insurance regulation, payment systems, deposit insurance, accounting, auditing and insolvency regimes.

Financial Safety Nets

Designing financial safety nets has the crucial meaning in financial system development from national and global perspectives. All real-world economies establish a framework of centralized bank monitoring and deterrent response. Centralizing these functions aims at increasing depositor confidence while solving three coordination problems: avoiding redundant monitoring expense; standardizing contracting protocols; and timing and calibrating disciplinary action. In general the financial safety nets serve not just to protect borrowers, depositors and taxpayers from being harmed by financial-institution mistakes, but also to encourage individual institutions to accept the risks associated with funding economically productive activities.

Safety nets for banks may be instructively conceived as a nexus of contracts that help them cope with runs and other economic shocks (Kane, 1995). Each net is a multidimensional policy scheme that is alleged to balance the costs and benefits generated by:

- protecting bank customers from being blindsided by bank insolvency;
- limiting aggressive risk-taking by banks;
- preventing and controlling damage from bank runs;
• detecting and resolving insolvent banks;
• allocating across society whatever losses occur when an insolvent bank is closed.

For strategies of crisis prevention to be maximally successful, the web of contracts must hold top regulators accountable for measuring and managing the social costs and risk-taking incentives generated by their decisions about the net’s various design features. Ideally, the design of the regulatory portion of net should tie securely into the characteristics of the particular financial system and economy in which it is embedded.

For financial safety-net managing it is not enough to aim at blocking corrupt and unwise flows of institutional credit and avoiding depositor runs. They have to seek also to minimize the social damage caused by temporary bank illiquidity and by lasting bank insolvency.

In practice, a safety-net manager must have the expertise to six categories of regulatory instruments efficiently:

• First, record-keeping and disclosure requirements;
• Second, activity limitations;
• Third, capital, loss-reserving and other position limits;
• Fourth, takeover rights and other enforcement powers;
• Fifth, lines of credit;
• Sixth, performance guarantees. (Kane, 2000).

The first four categories define the net managers’ authority to regulate the bank and the two last categories provide credible ways for regulators to bond themselves to exercise their supervisory authority in the interest of depositors and other creditors. To complete the web of contract enforcement, taxpayers must be able to observe and discipline the economic value of their stake in the rulemaking and enforcement activities that regulators undertake. Ideally, taxpayers must impose reporting requirements and establish deterrent rights sufficient to persuade net managers to deploy their examination, supervisory, and lending powers at minimum economic cost to society as whole. These costs must be defined comprehensively and include both the costs of operating the net and the costs of managing its occasional breakdown.

Taxpayer-regulator contracting is important because the practical politics of financial regulation tend to make regulatory authorities responsive only to immediate bank and depositor concerns. The ideal or optimal safety net is one that efficiently mitigates the particular monitoring and policing difficulties that present themselves to banks, depositors and taxpayers in the informational, ethical, legal and economic environment of a particular country at a particular time.

For the web to establish incentives for bank and regulators that are compatible with the interests of all other parties, net design must be environment-specific. As a rule of thumb, information system and supervisory technology for monitoring bank capital and risk exposures should be made transparent at least to outside experts and regulatory discipline should mimic market procedures. In most countries the major element of the safety net is deposit insurance. Even in times of prosperity (in fact, precisely in those times) it is wise to generate some forms of safety net, to minimize the strength of an anti-market revolt in a time of crisis (Rajan, 2000). This is beneficial even if it has some cost in terms of efficiency.
Estonian Financial System in the lead-up to EU accession

CEEE countries arrive at different times to EU and EMU route, that is clear, but how the different exchange rate and monetary policies should handled before membership in the monetary union. New entrants are envisaged to undergo three stages: EU accession, participation in ERM II (with a horizontal currency band) and joining the euro zone.

In a case as Estonian, if policies and circumstances remain right, a direct transition from a currency board arrangements to EMU without any transitional period of greater exchange rate flexibility could be the first-best policy for prospective EU membership. However, if country choose to maintain its currency board up to the point of adopting the euro, it will face a number of challenges. Country needs to maintain the strict discipline required by currency board arrangement, which contains conservative fiscal stance, healthy financial system, cautious external debt management, and flexible labor markets. Also country needs to be prepared to deal with possible large capital inflows and asymmetric external shocks. Indeed, for the currency board arrangements countries (for example as Estonia, Lithuania and Bulgaria) the requirements for good economic performance are already very similar to those of EMU participants. Of course, temporary disequilibria are possible, and it is important that exchange rate pegs are not maintained by excessive recourse to foreign borrowing or at the expense of growth. (Gulde, 2000).

To temporary switch to a more flexible regime during ERM II would also create a host of legal, institutional, and practical problems for countries with currency board now in place. The laws and regulations forming the legal basis for the currency board arrangement would have to be amended. One should also not underestimate the loss of policy transparency and discipline from moving away from currency board and the impact of greater uncertainty on domestic and foreign investors, and on households willingness to hold savings in the domestic financial system.

The structure and development of the financial sector affect the decision to participate in ERM II and subsequently monetary union. Already, the current euro area members themselves have significant differences in their financial sectors. However in many accession countries the level of financial intermediation is still quite low, which make the economies respond quite differently to the common monetary policy. It is also critical from the perspective of the other euro area and EU members that banking and financial supervision is adequately handled in the new member countries. The new member countries must ensure that all banks in their countries are ready to use the euro system’s monetary instruments. From point of view financial stability effective supervision of banks’ domestic and cross-border exposures, also as well the activities of other growing sectors, such as insurance and pension funds are highly relevant.

Estonia has considered to have already made substantial progress in building sound banking practices. Estonia and Hungary were among the first countries to participate in the IMF’s two-step Financial Sector Assessment Program. The recent banking supervision in context of the Financial Sector Assessment estimated compliance with the Basel Core Principles for effective banking supervision. The assessment showed that Estonia has made strong strides in strengthening its supervisory framework. (Report, 2000). There is mentioned that progress has been particularly strong in the area of banking supervision. Supervision of insurance firms is also improving, but still some concerns remain. Main concerns stay in the weak
securities sector. While payment system is viewed as relatively strong, payment system oversight could be improved. Also findings regarding transparency practices were quite favorable. No significant weaknesses were identified with respect to either monetary policy or the deposit guarantee scheme. At the same time the transparency practices in securities supervision were assessed as somewhat weaker than others.

Conclusion

Sound financial system is crucial for country’s economic growth and competitiveness and also for the strengthening global economy at the same time. For sound financial system the most important is that all the main components for the strong financial base are in place in mutually supportive and self-reinforcing ways.

Lessons from the history of financial crisis of the 1990s showed that information plays a vital role in financial system development. The new financial architecture is considered to contain three key pillars: transparency, standards and sound financial system. Mentioned three are equally important from the point of view the particular country and international perspectives. In the framework of the new financial architecture designing financial safety nets remains relevant.

CEEE countries, including Estonia, are envisaged to undergo three stages in the near economic future: EU accession, participation in ERM II and joining the euro zone. The structure and development of the financial sector affect the decision to participate in ERM II and monetary union. Estonia has considered to have already made substantial progress in building sound banking practices. Main concerns are stated in the weak securities sector, which has to be improved in order to achieve the strong financial base.

References


Kokkuvõte

FINANTSSÜSTEEMI ARENGU OSAST MAJANDUSES

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Käesolevas artiklis on vaadeldud finantssüsteemi arengu osa ja mõju riigi majanduskasvule maailma majanduse raamistikus. Mis siis ikkagi viis ühed riigid sajandeid tagasi maailmamajanduse juhtpositsioone ja jättis teised konkurentsis tahapoole. Osade majandusajaloo uurijate seisukoha lõpetamiseks oli selleks aluseks tugeva finantssüsteemi rajamine. Küsimuse püstitamine on autorite arvades oluline mõttearenduseks Eesti Euroopa Liitu pürgimine seisukohalt kaasaja globaliseeruva majanduse kontekstis.

Tugev finantsbaas koosneb: tugevast riigirahandusest; stabiilsest rahast; usaldusväärsest pangandussüsteemist; riigi keskpangast, milline tegutseb antud riigi valitsuse pangana reguleerides ja juhtides selle finantssüsteemi ning hästifunktsioneerivast väärtpaberiturust.

Maailmamajanduses 1990-ndate ajal on finantskriisi analüüsimine viinud järeldusteni nn. uue finantsarhitektuuri väljakujuudamise mõõdapatäismatust vajalikusest. Rahvusvaheliste standardite raamistikus on see uus finantsarhitektuur andnud paremaid tulemusi info edastamise, fiskaal- ja rahapolitika transparentsuse, pankade järelvalve, väärtpaberite turu ja kindlustuse reguleerimise, maksete süsteemi, deposiitide kindlustamise ning auditeerimise valdkondades. Eelpool mainitud deposiitide kindlustamine ongi üheks peamiseks elemendiks finantskindlustus võrkude loomisel enamikus maailma riikides.

Eesti teel Euroopa Rahaliitu on määravaks riigi finantssektori suutlikkus ja areng. Seejuures näib valuutakomitee vahetuskursisüsteem omavat nn. esimest parimat rahapoliitikut rahaliiduga ühinemiseks pikas perspektiivis. Samas aga peab riik järgima konservatiivset fiskaalpoliitikut, hoidma välisvöla kontrolli all ja tööjõuturu paindliku ning kindlasti oma finantssüsteemi heas funktsioneerimiskorraks.

Eestit on teiste siirderiikide hulgas peetud üldiselt edukaks oma pangandussüsteemi ülesehitamisel. Peamiselt on etteheited tehtud nõrga väärtpaberituru kohta. Viimane aga on teatavasti üks viiest tähtsast nurgakivist tugevas finantssüsteemis.