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THEORETICAL ARGUMENTS FOR AND AGAINST THE MARKET BASED FINANCIAL SYSTEM

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ABSTRACT

This study explores into some bodies of knowledge in order to establish a preference by rating the performances of bank-based and market-based financial system. A sample t-test using the credit ratio ability (in terms of GDP) to private sector of each financial system was conducted on a random sample. Holding the legal factor and the level of development of financial players constant, the result plus other bodies of evidences give a priority rating to the market-oriented over the bank-oriented financial system.

INTRODUCTION

It is imperative to identify the positive contribution of a financial system towards economic growth with the view of aiding an appropriate design especially in transitional economies or where a particular type of financial has an inverse knock-on effect on economic developments. The design of a financial system designate the type of financial system to be established, the regulatory or supervisory body and the impact of government policies related to controlling the financial system (Hermes and Lensink, 2002). Thus, the two dominant financial systems in practices are: the market-based financial system, which is found in countries like United State and United Kingdom; and the bank-based system- which is practiced in Germany and Japan among other countries (Brealey, Myer and Allen, 2008).

The bank-based financial system is where the bulk of the financial assets and liabilities consist of bank deposits and direct loans while in market-based system, equity securities that are tradable in financial markets, constitute the main source of funds to its economy (Chakraborty and Ray, 2007). In the 1970s, the banking sector provides 64% of financial resources in Japan as against only 25% in the US. Conversely, more than half of the combine asset of the US had been traded on the stock exchange market as against only 15.4% and 21.1% in japan and Germany respectively (Vitol, 2001). The Japanese system involving Keiretsu is characterised by intertwined of companies that have links through cross-holdings under the management of interlocking directorship (Gugler, Mueller, and Yurtoglu, 2004; Tricker, 2009). Banks are so vital in Japanese business that every company develops a close relationship with at least one bank so as to obtain funds, advice, market information, protection and in critical times, managerial assistance (Brealey, Myer, and Allen, 2008). Miyashita and Rusell (1996) stated that Dai Nippon Widget has been a medium-sized manufacturing company which doubled its production capacity and export potentials when it established a cross-holding with Sumitomo, Mitsubishi and Dai-Ichi Kangyo (DBK).

In some instances, financial institutions form part of a wide range of subsidiaries which in turn have their sub-subsidiaries thereby forming a pyramid. Brealey, Myer and Allen

(2008) illustrated how in the German Haus-bank system, Dresdner Bank and Bayerische Landsbank constitute third layers as subsidiaries of Dailer-Benz AG while Deutsche bank is one of the direct subsidiaries under the Daimler-Benz AG ownership group. The advent of globalization and increasing business complexity, most pyramids now have a close feature of cross-border holding. Most companies operating through a pyramid have legal, taxation and limited liability benefits. In South-Korea, financial institutions have a Relationship with conglomerate networks called the Chaebols which are dominated by strong families (Gugler,Mueller, and Yurtoglu;Tricker, 2009). Under some countries financial system dual class of shares are in practices. Each class of share has a different voting and priority right. The Ford Motor Company has dual class equity with upper class for the Ford family while other lower class is for the general public (Tricker, 2009).

The Evolution of Financial System and Role of Legal Factor

Although the state had played crucial role in shaping their kind of financial systems through regulation, the evolution of all financial systems is mostly traced to their respective industrialization phases (Lazonick and O'Sullivan, 1997; Vitol, 2001). This was why security markets developed long ago in the United Kingdom. In the second half of 19th century, the quest for development of economic activities in countries like Germany and Japan together with the unsafe nature of their security markets prompted reliance on banks as the major investment mechanism. Internally generated fund was insufficient and investors were interested in saving in more secured assets like government bonds than in risky equity securities (Vitol, 2001). Chakraborty and Ray observed that a bank-based system emerges where intermediation is vital and monitoring cost is modest while a market-based system emerges when agency problems are not severe. La porta et al (1998) reported that the legal system determines the type and efficiency of any type of financial system. They added that in part of the world where civil law operates, investors' interest is not a priority. This scare individual mode of ownership, but encourage concentrated ownership with family dominance in some instances. Under this financial system, individuals pool their resources together into a common purse such as insurance company, hedge fund, mutual fund, bank and other financial intermediaries. These institutions use their pooled capabilities to assess, grant, monitor and control funds. This explains why countries like Japan, France, Germany, and Italy falls under the bank-based financial system category. Their financial markets are smaller, less liquid and

Family ownerships are common in bank-based countries like Italy and France (Tricker, 2009). In their studies, Demirguc-kunt and Maksimovic (2002) confirmed that there is strong positive correlation between the level of development of the legal system and the measures of the availability of external financing. Thus, the legal system is a major determinant of the type financial system that can evolve in each economy. In the United State, United kingdom, Australia, Canada among others, corporate dispute are settled by the common law. This emphasises on the protection of investors' interests and encourages disperse ownership system. As see in table 1 above, the legal rights in bank-based countries is increasing, maybe it is could be attributed to the increasing convergence across all economic systems. However, legal right does not explain the degree of right attached to the protection of shareholders.

Theoretical Evidences

Some school of thoughts argued in favour of the market-based financial system while their opponent criticised it and support the market-oriented financial system.

Theoretical Arguments For and Against the Bank-based Financial System

Baum, Laglayan and Talavera (2010) criticized the bank-based financial system that due to government excessive influence in some of the state-own bank in the bank-based financial system, it harbours the seed of corruption and inefficiency. Other critics of bank-based financial system viewed that it mostly snuffs innovation by unnecessary protecting established firms under its groups as it is found in the keiretsu and chabol models (Quin, John and John, 2004). Also, It has been reported that the bank based system have few regulatory restrictions on their activities hence there is a high chances of violating corporate governance (Chakraborty and Ray, 2007). Koke (2004) faulted it, especially under the German supervisory board, that its role of monitoring management hinders fast decision-making and endangers confidentiality. However, some commentators argued in favour of the bank-based financial system by citing varied theoretical facts to support their claim. Demirguc-kunt and Maksimovic (2002) asserted that through a combine effort of administrative regulation of the banking system with bargaining strength, the banks have a relative capacity to accommodate a slack in legal system; thus, a poor legal system has more detrimental impacts on the securities markets.

From the point of maximum utilization of resources, Koetter and Wedow (2010) affirmed that banks have a comparative advantage in selecting investment and provision of short-term loans. This assertion is added to the views of Demirguc-kunt and Maksimovic (2002) that banks are more effective in funding new innovative projects and can commit additional resources in resuscitating a troubling firm. On a macro-economic scale, bank-based financial system is said to be less volatile to shocks and hence ensures long-run economic stability (Demirguc-kunt and Maksimovic, 2002). A developed bank-based financial system may contribute to macro-economic stability by absorbing the shocks of random business circle volatility. This, Scharler (2007) arguably stated is achieved where retail rates play an important role in determining the level of investment. From a similar perspective, it is arguably said by Gerschenkron (1962) that banks finance industrial expansion in developing economies than market-based financing, although this idea has been contradicted recently by Beck and Levine (2002). Chakraborty and Ray (2007) contrasted Gerschenkron's view after observing that the banking crises in developing economies have been caused by government widespread interventions and has increasingly brought a switch over to the market financing system. Therefore, the Eastern Europe and Latin American financial liberalization of the 1990 counter the bank-based supporting option as the key financier of growth and development.

Chakraborty and Ray (2007) posited bank-based system is having better mechanisms for monitoring the management performances than the market. They also added that banks stipulates stringent conditions and closely monitors borrowers thereby eliminating high risky projects and that is equally vital in economies where the banks monitoring ability is sufficient in resolving the agency problems at an optimum cost. But a there is a cost and

benefit trade-off in this regard since monitoring is costly, this could imply that bank financing is more expensive to be established (Scharler, 2008; Koetter and Medow, 2010). After studying the German and Japan's experiences, some advocate asserts that bank-based financial system is a better mobiliser of savings, identifying good investment, creating an atmosphere for corporate governance control and prudent risks management system (Herman, 2001; Koetter and Medow, 2010).Chakraborty and Ray (2007) firmly asserted that where bank-based and market-based ec onomies grow at similar rates and wealth distribution, per capital GDP in the former has been empirically proved higher.

Theoretical Arguments For and Against the Market-based Financial System

Chakraborty and Ray (2007) said it remains unclear why market-based system dominants the global financial system over its bank-based counterparts. The market-based financial system also has its own criticism. Singh (1997) opined that an under-developed equity market in transition economies may lead to a volatility of share prices which in turn can hampers economic development. However a wide range of arguments have been put forth in favour of the market-oriented financial system. Some proponents of market-based financial system put that the stock market facilitate the quick conversion of securities into liquids; encourages savings, investment and liquidity assurance in an economy since investors have the option of swapping between securities and liquids, depending on the performances of companies and the investors' need for cash (Chakraborty and Ray, 2007).

Market-based financial system is said to be preferred in terms of enhancing firms' productivity and growth. Hermes and Lensink (2000) advocated that stock market ensures the optimum allocation of scarce resources by attracting them towards investment that has the highest returns. Similarly, liquid equity market may decreases management inefficiency by facilitating hostile takeovers (Quin, John and John, 2004). Where the compensation of managers is tied to the value of stock as is obtainable under the market-oriented financial system, Hernes and Lensink (2000) argued that such measure reduces agency problems between owners and management of firms. Stock market is in better position to overcome the problems of asymmetric information during the course of liberalization of financial system in a faulty functional equity market (Chakraborty and Ray, 2007). This is because, unlike the bank-based system, does not suffer from moral hazard affiliate selection in the course of allocating resources.

Earlier Empirical Studies

In an attempt to measure the overall performances of financial institutions, Beck and Levine (2002) use finance-aggregate to measure the overall activities of the intermediaries and markets (i.e. the value of credits by financial intermediaries in bank-based or total share traded on the stock market in market-based in relation to their respective GDP. Their result proved the existence of strong positive correlation (>0.9) between finance-activity/size and financial development at 0.1 significant level. The result concluded that financial developed economies tended to be more market-oriented with flexible bank regulations and minimum state ownership. The result also showed that there is a strong positive relationship between overall financial development and industrial performance

irrespective of the financial system since it encourages the development of new establishment. Beck and Levine (2002) found no empirical evidence after controlling some variables to verify earlier studies that claim that bank-based system is ideal for economic performance in underdeveloped economies with weak functional institutions. They instead reported some empirical evidence in favour of the market-based financial system but cautiously warned that is ambiguous to recognise a universally accepted classification of bank-based versus market-based system as it is adopted in some countries.

Demurgur-kunt and Maksimovic (2002) conducted analyses of the performance of bank-based and market-based in terms of funding growth, the turnover index showed that bank-based economies have the rated highest three (Germany 1.25, Korean 1.21, and Thailand 0.77) and the lowest three (Colombia 0.09, Pakistan 0.29, and New Zealand 0.25); while there market-based counterpart (United State 0.71, United Kingdom and Ireland 0.62). The mean turnover of this analysis showed that the market-based has 0.523 which is higher than the bank-based value of 0.478. Hermes and Lensink (2008) reported the findings of Murinde conducted in 1996 which provided evidence of positive effect of stock market development on the rate of 40 pacific

CONCLUSION

Although most of the empirical studies viewed, together with the sample t-test conducted in this study have rated high the market-based financial system over its bank-based counterpart, it still remain critical to warn that other vital considerations such as the level of development of financial institutions and the legal factor should not be ruled out.

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