***The financial market problems from some developing countries point of view***

***And its policy implications***

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*Abstract*

Financial markets and institutions theories from both mainstream and heterodox schools of thought could not completely explain and predict phenomena of developed financial sphere, but in regard to the differences between developed and developing countries financial system, even the current level of success in explanation and policy making for developed countries needs more exploration for the developing countries. In this paper by utilizing institutional and evolutionary economics concepts and micro-meso-macro framework, first differences in the developing countries financial system have been identified with the acknowledgement of underdevelopment in information transition stages of states and laws, and the institutionalization of science and technology. Then most important financial system theories from different schools of thought have been reviewed in order to make some essentials for the developing countries financial economics by assistance of these theories concepts and aforementioned framework. As a result of these premises, in the developing countries micro financial economics, beside household and firms, other micro units such as tribe, clan, and village have been introduced and on the macro financial economics, state and international financial environment were considered as two important players. These elements and players interactions lead to a situation that most traditional micro units are isolated from financial system and the integration to global financial system mostly depends on state approach of international relationship with developed countries. Finally, utilizing these findings, some comments have been offered on suggested conference policy context.

**Key words:** Evolutionary Economics, Financial Economics, Historical Specificity, Developing Countries

## 1. Introduction

The financial markets failure problems in most developed countries should not divert all concerns to how formulate or regulate these markets in theory and practice. Some developing countries (especially countries with low or under middle income per capita) priority to financial market problems are relatively different; they are trying to imitate and develop their financial structures from developed countries models with least experience of crises and income and wealth inequality. Considering the WEA manifesto about increasing relevance, breadth and depth of economic thought, the aforementioned issued should be raised in current and future conferences discussions.

As Hodgson (2001, 23) states: "there are different types of socio-economic system, in historical time and geographic space. The problem of historical specificity addresses the limits of explanatory unification in social science: substantially different socio-economic phenomena may require theories that are in some respects different. If different socio-economic systems have features in common, then, to some extent, the different theories required to analyze different systems might reasonably share some common characteristics. But sometimes there will be important differences as well. Concepts and theoretical frameworks appropriate for one real object may not be best suited for another. The problem of historical specificity starts from a recognition of significant underlying differences between different objects of analysis. One theory may not fit all".

Following this work, Hodgson (2004) and Hodgson and Knudsen (2010) have argued that social evolution works unavoidably on multiple levels. They have developed an argument for identifying the most basic of these levels and outlined a hierarchy with multiple tiers of social interaction, replication, and selection. They have classified six major information transitions in social evolution highlights the emergence of new types of generative replicator and new levels and types of information transmission. Each information transition has produced a major new class of replicator that can transmit, store, and utilize more complex social information. New generative replicators are involved at each stage in the evolution of prelinguistic culture, human language, tribal customs, writing and records, states and laws, and the institutionalization of science and technology.

If these classifications have been compared with some developing countries (DC) situation, that would have been clear the last stage of institutionalization of science and technology have not been achieved and even previous stage of states and law also have a long way to go.

Most theoretical framework of economic evolution deals with last stage of institutionalization of science and technology, one of the most comprehensive works in this field have been done by Kurt Dopfer and Jason Potts (2008). They have introduced a general theory of economic evolution that is composed of a general theory of rules—i.e., of the generic domain—and of the operational consequences of change in those rules. This can be modeled at three distinct analytical levels: micro, meso and macro. From the perspective of the whole, economic evolution is the process of de-coordination of an existing macro order and re-coordination into a new macro order. The general theory of economic evolution is based upon a systematic account of the generic domain of rules as deductive procedures for operations.

From these theoretical achievements, some common concepts may be adopted for the financial system analysis. Moreover, beside these common concepts, differences should be identified for the DC special analytical framework. These differences may be introduced in micro-meso-macro framework with acknowledgement of underdevelopment in information transition stages in DC as below:

A. Differences in micro financial system:
- Presence of micro financial units such as: Tribe, clan, village beside family and firms
- The existence of non-market valuation in allocation of financial resources
- The difficulty in understanding concepts of financial markets such as finance, venture capital and equity, because of non –market oriented cognitive and behavioral characteristics
- Absence or limited access of firms to credit market
- Absence or limited access of household to credit cards
- Most loans are asset based rather than credit based
- Family or firm Low ratio of debt to asset

B. Differences in meso financial system:
- Some financial sectors still have not shaped or developed such as: stock and commodity bourses, exchange markets, hedging, future, option and other derivatives markets, sovereign and other kind of debt markets, venture capital and mutual funds

C. Differences in macro financial system:
- Law rate of saving
- Low level of capital formation and investment
- Limited access to global financial system
- Misallocation of current capital because of corruption or lack of institutional context for market performance
- Low ratio of sovereign debt to GDP
- Scarcity of capital
- Abounding investment opportunities because of large gap between potential and actual production capacity
- Lack of sustainable peace and security

As heterodox economic scholars in their petitions announce, given the complexity of the global economy, what is needed is a broader range of models and techniques governed by a far greater respect for substance, and much more attention to historical, institutional, psychological and other highly relevant factors, therefore, financial markets and institutions theories from both mainstream and heterodox schools of thought could not completely explain these phenomena, but in regard to the aforementioned differences between developed and developing countries financial system, even the current level of success in explanation and policy making for developed countries needs more exploration for the DC.
In order to achieve this objective, in section 2 most important financial system theories from different schools of thought will be reviewed and afterwards in section 3, some essentials will be described for the DC financial economics. Finally, some comments will be offered on the WEA conference policy context.

## 2. Review of financial economics theories

The first pioneering contribution in the field of financial economics was made in the 1950s by Harry Markowitz who developed a theory for households' and firms' allocation of financial assets under uncertainty, the so-called theory of portfolio choice. This theory analyzes how wealth can be optimally invested in assets which differ in regard to their expected return and risk, and thereby also how risks can be reduced. A second significant contribution to the theory of financial economics occurred during the 1960s when a number of researchers, among whom William Sharpe was the leading figure, used Markowitz's portfolio theory as a basis for developing a theory of price formation for financial assets, the so-called Capital Asset Pricing Model, or CAPM. A third pioneering contribution to financial economics concerns the theory of corporate finance and the evaluation of firms on markets. The most important achievements in this field were made by Merton Miller, initially in collaboration with Franco Modigliani. This theory explains the relation (or lack of one) between firms' capital asset structure and dividend policy on one hand and their market value on the other (Nobel Prize Website, 2012).

The Modigliani-Miller theorems concern decisions about aspects of the composition of the accumulated savings stock. Although closely related, these two subjects are usually regarded as belonging to two different disciplines: economics and corporate finance. The first Modigliani-Miller theorem concerns the question of how the market value of a firm is affected by the volume and structure of its debts. The central proposition of the theorem gives a clear answer to this question: neither the volume nor the structure of the debts affects the value of the firm provided that the financial markets work perfectly, that there are no taxes and that there are no bankruptcy costs. They formulated another theorem stating that, for a given investment policy, the value of a firm is also independent of its dividend policy (Pressman, 1999).

Moreover, Tobin's most important contributions are based on a theory which describes how individual households and firms determine the composition of their assets. This theory, of which he is one of the foremost originators, is known as portfolio selection theory. Tobin has developed these ideas into a general equilibrium theory for financial and real assets and analyzed the interaction between financial and real markets. An essential component in this analysis is the study of transmission mechanisms which transfer changes on financial markets to households' and firms' expenditure decisions. Portfolio selection theory is used to study households' and firms' decisions to hold different real and financial assets, and, simultaneously, incur debts. Tobin shows how these decisions are governed by weighing risk and expected rate of return. Unlike many other theorists in the field, Tobin does not confine his analysis solely to money, but considers the entire range of assets and debts.

Tobin emphasizes the effect of financial events on the demand for real assets, i.e., investments and consumer demand. By designating the channels of contact between financial and real phenomena, Tobin has indicated, theoretically and empirically, the effects of changes in the real value of financial assets on the volume of consumption. A particularly important aspect is the analysis of factors that affect firms' real investments.

Fischer Black, Robert Merton and Myron Scholes also developed a new method of determining the value of derivatives. Their innovative work in the early 1970s has provided new ways of dealing with financial risk, both in theory and in practice (Bailey, 2005).

George Akerlof, Michael Spence and Joseph Stiglitz pioneering contributions have showed how informational asymmetries can give rise to adverse selection in markets. When lenders have imperfect information, borrowers with weak repayment prospects may thus crowd out everyone else from their side of the market, stifling mutually advantageous transactions.

From other economic school of thought literature, Hayek (1935) wrote that financial markets with the natural rate of interest will lead to equilibrium but because of excessive money creation by central bank the market interest rate will force to fall below the natural rate of interest, therefore, equilibrium in financial market will achieve with breaking monopoly of central banks in producing of money. Moreover, In Minsky's interpretation of Keynes, the monetary economy in which uncertainty and liquidity preference, there are highly advanced financial relations within capitalist economies. Due to these interrelated financial positions in which one firm's asset is another's liability, as a result of reliance upon external financing, each successive state within a business cycle can be explained by a corresponding position of financial behavior. This allows Minsky to transition to an early exposition of his famous Financial Instability Hypothesis in which each successive financial position of the economy inevitably creates conditions leading to its own demise, and later on, a transition to recovery. Hence, Minsky was able to provide economic theory with an endogenously produced explanation of the business cycle instead of relying on exogenous factors (Minsky, 2008).

In sum, financial economist including Markowitz, Miller, Sharpe, Tobin, Modigliani, Merton and Scholes expressed their theories based on rational individuals and prominent micro institutions of household, firms and competitive financial markets and institutions with knowable and manageable risks and complete information, but Akerlof, Spence and Stiglitz left complete information assumption and stated markets with asymmetric information. On the macro level, these theories assume a macro economy with complete relationship between real and financial economy. On the global economy level, they implicitly assume open market with neutral international money. Even Minsky hypothesis assumes most of these foundations, but his view about rational individuals is different and also enters uncertainty into analysis.
Overall, these theories together to some extent explain the financial system of capitalism mode of production, but as North (1994) contends neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that induce development. It is concerned with the operation of market, not with how markets develop. As a result, the operation and development of financial market and institutions in the DC needs a considerable reconsideration in the above theories. This objective is more than this paper goal and author capability, but regarding to the DC financial system differences and financial economics concepts and framework, some essentials may be derived for the financial economics in the DC.

## 3. The essentials of financial economics in DC

According to Potts (2000) All conceivable systems of microeconomics must necessarily begin with the existence of a set of elements (agents, commodities, endowments or whatever) placed in some form of relationship to one another. The concept of economic space refers to the nature of these interactions, and the geometry of economic space defines a particular set of interactions.
These elements in the DC are micro units such as tribe, clan, and village beside household and firms, these agencies and even small and medium size firms (that are mostly family oriented)

objectives and priority are survival of their members with their income per capita standard not profit or growth, but large private or state owned firms (sometimes owned with foreign investors) usually follow priority of growth or profit.

The assumption of survival for so micro units result in minimum dependency on financial system in favorable agricultural or small industries production, but in the unfavorable situations (like drought or flood) because of survival threat and providing urgent life means the dependency rate will increase.

This relationship has this important implication that in the DC micro units except the large firms, financial system is relatively isolated from production and consumption circle. But in the large firms, the usual relationship of capitalism firms may be observed.

In the macro level, most important internal financial players are national bank and insurance industries, social security funds, central bank and state budget. Moreover, on the upper level and international scale, the DC confront some currencies including U.S. Dollar, Euro, Yen, Swiss Franc that respectively dominates almost all international debt securities, bonds outstanding, foreign exchange reserves and banks international assets (The World Bank, 2011). Under these conditions, regarding the degree of openness to international financial markets and institutions, interest rate change in developed world may have spillover effects in emerging markets, moving up or down exchange rate, asset and commodity prices.

Kindleberger’s (2005) history of financial crises facts shows that countries such as Thailand, Malaysia, Indonesia, Mexico and several other Asian countries how fell in the global financial crises. But that is worth to note that even these countries are more developed and open in financial market rather than some other developing countries.

In fact, in the DC macro financial economics although the total numbers of micro units such as tribe, clan, village, small firms are considerable but their share and importance in the financial relationship is trivial. Overall, two important players in the DC macro financial economics are state and international financial environment. These two key players performance differentiate the level of development in the DC financial market and institutions. State in the DC usually directly interfere in the financial system by governmental bank, insurance an investment funds. Moreover, central banks also have not achieved professional independence and their decisions are influenced by state authorities. Beside these instruments, the state approach of international relationship is also critical for financial system.

There is also a package of 'good institutions' frequently includes democracy; a clean and efficient bureaucracy and judiciary; strong protection of (private) property rights, including intellectual property rights; good corporate governance institutions, especially information disclosure requirements and bankruptcy law that are important for good financial market operations and acceleration of economic growth, But Chang (2002) believes two significant qualifications need to be made. First of all, in pushing for institutional improvement in developing countries, we should accept that it is a lengthy process and be more patient with it. The second qualification is that 'good' institutions produce growth only when they are combined with 'good' policies.

4. Policy context

According to the above essentials, the following comments may be added to Westbrook (2012) suggested policy context titles for the DC:

1. Recent history and the art of possible

Although crises often provide opportunities for reform, but in some DC these crises pose a new threat to their efforts to design and develop financial market by imitation of developed market and they have to think about problems that developed countries themselves have not solved them. This situation is similar to environmental and inequality considerations beside high economic growth, what developed countries mostly ignored them in their similar stage of development. In fact, their destination to development does not have any real prototype and they need to imagine some parts of that beside imitation of developed countries models. The integration to financial markets and benefit from global financial pool is a advantage but great disadvantages of financial crises consequences for their fragile economic development is also important. Therefore, their short term plan may shift to isolation or less relationship with global financial market but in the long term plan they had to find a solution for their integration problem.

2. Fiscal & monetary policy

Small countries fiscal and monetary policies do not influence world currencies valuation, therefore, they had to follow dominant currencies fluctuations and coordinate their internal policies with them. Beside this constraint, their expansionary policies have the problems of sufficient financing resources, misallocation of current resources and the high potential of inflation.

3. Tax, capital formation and inequality

The tax issue also has its differences. The increase of tax basis, using of value added tax method effectively, transparency on people incomes and wealth list and finally the low economic power of a society with low and under middle income per capita all are the most important problems of taxation in countries without sovereign debt crises or austerity measures.

4. Financial instruments

   Ignoring the corruption problems, because of the DC custom and traditional conventions dominance on formal rules, the rule of law and formal regulations in any field often face major issues. As a result, development of financial market with regulations hindering crises, have the problem of execution.

5. Financial markets

As mentioned before, the transparency and information efficiency issue exist, therefore, any attempt to stabilize market volatility is often correlated with more misallocation of resources and inequality.

6. Financial institutions

In the meso level, regarding to development stage, most service sector institutions still have not developed, like investment bank, venture capital fund and so on. Most financial institutions are classic banks and insurance companies with limited sovereign debt bonds. Economic and commercial regional integration has not developed well, especially in financial sector. The reduction of systemic risk should be considered in conjunction with how to develop new financial institutions and the relationship among them.

7. Custodial relations

Social capitalism mode of production still has not established in some developing countries, therefore, they are facing to shortage of entrepreneurs for their development. Now, custodial relations effects on their progress are more problematic than developed countries, because they need to fill their gap between actual and potential production.

8. Labor markets and social capitalism

The problem that capital formation may not lead to growth and growth may not lead to employment in situations that difference between actual and potential production is large does not make sense generally.

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