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GUEST EDITOR'S INTRODUCTION

Banking in Emerging Markets

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Do banks play a special role in developing economies? Or is economic development held back by inefficient banking systems? If so, how will world financial integration affect economic and financial development? These are some of the questions addressed in this symposium. Given the importance of these issues, it is surprising that there are still few generally accepted answers to these fundamental questions. Most of the theory on financial intermediation is concerned with the role of banks in developed economies. It assumes that a well-functioning institutional structure is in place and, with some recent exceptions,[1] it generally abstracts from macroeconomic issues such as inflation, budget deficits, and currency crises. Much of the theory deals with the fundamental questions of why banks exist, what added value they bring, whether they are inherently susceptible to runs, whether they tend to take excessive risks, and how they should be regulated (see Bhattacharya and Thakor, 1993).

Another central issue concerns the structure of the whole financial system and why some developed economies (Germany, Japan) have bank-dominated systems, while others (UK and USA) have market-dominated systems. The issues related to the role of banks and the structure of the financial system have gained special prominence with the collapse of the communist regime in the Soviet Union in 1989 and the transition of East and Central European countries away from central planning to market-based economies. An immediate question arose for these countries. How should they set up their financial system? Which type of financial system should they adopt, a bank- or market-dominated system? More generally,

[1] See, for example, Allen and Gale (1998, 2000a, 2000b) for recent models of financial intermediation in the presence of macroeconomic shocks.

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what regulatory structures were required and how open to foreign investment should the newly created financial systems be?

Much of our theoretical and empirical knowledge of these issues is quite recent and is based on research that postdates the collapse of the Soviet Union. The theoretical literature points to, among other factors, bank-dominated systems' comparative advantage in monitoring, flexible lending, and intertemporal consumption smoothing. In contrast, market-dominated systems' advantage is seen mainly in better information provision to guide investment and better sources of capital for entrepreneurs (see Allen and Gale, 2000b, for an extensive discussion of these ideas).

The early empirical literature, which is mainly based on cross-country regressions, is not so much concerned with the structure of the financial system per se as with the overall impact of the financial system on growth. A central finding is that financial development—as measured by the ratio of bank lending to GDP, or the ratio of stock market turnover to GDP—is positively correlated with future per capita economic growth (see King and Levine, 1993; Levine and Zervos, 1998). This result obviously raises the question of what determines financial development in the first place? Several recent studies have pointed to the role of a country's institutional infrastructure and its legal environment. Thus, a statistical relation between legal origin, indices of investor protection, and financial development has been identified (see LaPorta *et al.*, 1997, 1998).

Three articles in this symposium pursue further the general question of the link between legal protection of investor rights and financial development. Levine (2002) provides some striking results, which are sure to draw much attention and be widely debated. Levine's article explores the relationship between the structure of the financial system (whether it is bank or market dominated), the legal infrastructure, and growth. Remarkably, his cross-country regressions do not seem to identify any effect of the financial system *per se* on growth. Differences in legal environment, on the other hand, are significantly related to differences in growth performance.

Tadesse (2002) approaches the question from a different perspective. He also looks at different data and finds on the contrary that the structure of the financial system does matter for growth. He finds that among financially underdeveloped economies, the countries with the higher growth rates have bank-dominated financial systems, while among financially developed economies, the countries with the higher growth rates have market-dominated financial systems. His study suggests that the structure of the financial system does matter but in opposite directions depending on the level of financial and economic development of a country. This may be one explanation for the different results in the two studies.

One reason that bank-dominated systems may be especially well suited to emerging economies is suggested in the article by Da Rin and Hellmann (2002). Many emerging economies may be trapped in an underdevelopment equilibrium. It would take the coordinated investment efforts of many firms across several industries to ignite an economic takeoff in these countries. Under *laissez faire*, many of these countries may end up in the wrong equilibrium. Da Rin and Hellmann point to key phases of economic development in Belgium, Germany, Italy, and Japan, where banks have played a key coordinating role in engineering a takeoff, to suggest that banks may play a key role as 'catalysts' of economic development. Their theory points to the importance of market power and limited competition in banking as necessary conditions for banks to be able to play such a role.

The article by Miller and Puthenpurackal (2002) takes up a related important question on the link between financial development and growth. In a fully integrated world financial market, one would not expect to see a relation between investment, growth, and the financial development of a country. Arbitrage in financial markets would equalize the cost of capital for firms across countries, and differences across countries would then be reflected mainly in the different size of the financial sector and levels of profitability across national financial systems. Miller and Puthenpurackal's study shows that the world financial system is still far from being perfectly integrated and that a firm located in an emerging economy that issues a bond in the USA faces a 26 basis point increase in the cost of debt relative to an identical firm located in the USA. Firms in emerging economies also face significant exchange rate risk when they issue dollar-denominated debt in US markets.

Miller and Puthenpurackal also find that companies pay a premium for being located in countries with weak legal investor protections. While their study is consistent with the view that local financial conditions are relevant for local development, it also provides a hint that, at least in emerging economies with open capital markets, the maturity of the local financial sector only matters up to the premium local firms need to pay when raising their capital abroad. In other words, the link between financial development and growth should be weaker for countries that are more integrated in world financial markets.

Despite the important insights that have emerged from existing research on financial development, the theoretical and empirical literature on the link between financial and economic development is still in its infancy. More often than not, empirical research is running ahead of the theory or is too disconnected from existing theory. This makes it difficult to interpret some of the key findings. Also, cross-country regressions are a blunt method for identifying the link between the real and the financial sector. They do not take into account interdependencies between economies. They treat small and large economies as data points with equal weight, and they often do not adequately account for geographical, cultural, historical, and religious factors.

Even leaving these methodological issues aside, some of the key mechanisms the literature has focused on, such as the positive effect of greater legal protection on financial development and growth, appear to be more complex in reality. As Rajan and Zingales (2000) have pointed out, in leading European nations financial development at the beginning of the 20th century was significantly higher than that throughout most of the middle and late part of the century.

It is also likely that factors other than the legal environment play an equally important role in explaining financial development. Political and economic polarization may undermine both financial and economic development (see Benabou, 1996, for a review of research exploring this factor). Government macro-mismanagement, fiscal and monetary instability, and currency crises may be other important factors (see Padilla and Requejo, 1998; Berglof and Bolton, 2002, for a discussion of these factors).

Even if much remains to be explored and refined, the existing literature on financial development and the articles in this symposium have clearly made important contributions toward understanding these complex issues. They point the way to new questions and new ideas for further research.

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