FINANCIAL SYSTEM AND ITS TRANSFORMATION

Basic definitions and concepts

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Economics and finance

- Economics – a social science that studies the production, consumption and distribution of goods and services, with an aim explaining how economies work and how their agents interact.
  - Focuses on the optimization of valued goals
- Finance – a fund management science, which deals with the interrelation of the concepts of time, risk and money.
  - Focuses entirely on the maximization of wealth

Functions of Finance (by Ross Levine)

1. Easing the exchange of goods and services
2. Mobilizing and pooling savings from a large number of investors
3. Allocating society's savings to its most productive use
4. Diversifying and reducing liquidity and intertemporal risk

Finance and Economic Growth

- Theory does not point to obvious growth benefits from having a large and developed financial sector in the economy
- There are important non-linearities even in the intermediation-growth relationship
  - most of the growth benefit comes through enterprise credit
  - most of the credit growth in advanced countries over recent years has been in household credit

Financial development

- Financial deepening
  - the extent to which past savings has been transformed into investments
  - measures as increase in the ratio of financial assets to GDP
- Financial broadening
  - an increase in the variety of financial institutions and instruments (including different types of securities, market participants, growth of institutional investors)
  - implies a greater choice for savers and investors

Financial development

- What type of financial development is integral to the growth of the economy?
- An effective financial system facilitates the sharing of information between investment projects and potential investors for an efficient allocation of risk on satisfying temporal terms
- The complex of interacting markets provides multiple channels for revealing and responding to economic shocks

Financial market

- Financial market is a mechanism that allows people and entities to buy and sell financial securities, commodities and other fungible items of value at low transaction costs and at prices that reflect supply and demand
- Financial markets facilitate:
  - The raising of capital (capital markets)
  - The transfer of risk (derivatives markets)
  - The transfer of liquidity (money markets)
  - International trade (currency markets)

Types of financial markets

- Capital markets
  - Stock markets
  - Bond markets
- Commodity markets
- Money markets
- Derivatives markets
- Futures markets
- Insurance markets
- Foreign exchange markets

Why financial markets are regulated?

- Asymmetric information – a situation in which one party of the transaction has more or superior information compared to another
- Adverse selection – immoral behavior that takes advantage of asymmetric information before a transaction
- Moral hazard - immoral behavior that takes advantage of asymmetric information after a transaction
- Mitigating the problem

Transformation or transition

- Changes of the economic system as a whole
- For our purposes, it is the process of changing an economic system from centrally planned economy to a free market after some major political changes (former Soviet Union countries and communist bloc countries of Europe) or deliberate choice (China)
- The process is characterized by the changing and creating of institutions

Possible forms of economic system

- Traditional economy
  - Barter economy
- Market economy
- Planned economy
- Mixed economy

Transition process

- Early reform steps
  - Price liberalization
  - Liberalization of foreign trade
  - Restructuring and privatization
  - Elimination of state aids for companies
  - Set of capital and financial market
  - Liberalization of proprietorship
- Long-term tasks
  - Legal framework
  - Changes in justice (especially, competition policies)

Economic transition (IMF definition)

- liberalizing economic activity, prices, and market operations, along with reallocating resources to their most efficient use
- developing indirect, market-oriented instruments for macroeconomic stabilization
- achieving effective enterprise management and economic efficiency, usually through privatization
- imposing hard budget constraints, which provides incentives to improve efficiency
- establishing an institutional and legal framework to secure property rights, the rule of law, and transparent market-entry regulations

Transformation approaches

- Gradualism
  - Slow pace of reforms
  - All negative factors could be limited
  - Optimistic situation in business
  - Social pressures
- Shock theory
  - Quick pace of reforms
  - Basic reforms in short time horizon
  - Accompanied by stabilization policy and withdrawal of government interventions

The choice of the financial system model

- Financial market-based system (US, UK)
  - Relies on the capital market and on segmented banking
  - High economic and organizational prerequisites for the efficiency
- Bank-based system (Europe, Japan)
  - Collects short-term deposits
  - Handles transfers of funds to business
  - Well capitalized to cover ordinary banking risks
  - For transition economies
    - Universal banking
    - Foreign bank entries are preferable

Readings for the next topic

1. Judis, J.B. (2009). Debt Man Walking. *US Department of State eJournal*, vol.14, 5, pp. 9-12.
2. Vedder, R. (2009). The Evolving Global Financial System. *US Department of State eJournal*, vol.14, 5, pp. 27-30.
3. Wyman. O. (2009). The Future of the Global Financial System. *World Economic Forum's World Scenarios Series*. [EXCERT]