Institutional Voids and Policy Challenges in Emerging Markets

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The recent economic turmoil in Asian economies such as those of Thailand, Malaysia, Indonesia, and South Korea highlights the need for a reexamination of the policy challenges in emerging markets. This paper suggests that the fundamental characteristic of an emerging economy is its lack of the well-developed institutional structure that facilitates the smooth functioning of product, capital, and labor markets in advanced economies. Institutional voids increase transaction costs significantly and lead to massive inefficiencies in the long run. Governments, therefore, need to develop a strategy to build these institutions, which form the "soft" infrastructure of a market economy. This paper proposes a framework for formulating such a strategy.

The Importance of Institutional Infrastructure

Most analysts define an emerging market according to characteristics such as size, growth rate, or length of time since emerging in the global economy. However, as Khanna and Palepu (1997) point out, the most important characteristic of an emerging market from an economic perspective is the degree of difficulty buyers and sellers have in conducting transactions in product, labor, and capital markets.[1] Advanced markets have a range of intermediary institutions which minimize these transaction costs, whereas emerging markets often suffer from significant institutional voids which exacerbate the market transaction costs.

Sources of Transaction Costs

Economists have long recognized that there are two important sources of transaction costs in a market: information problems and incentive problems. Information problems arise when two transacting parties have different levels of information about something that can materially affect the transaction. A well-known example of this situation is the used car market where, compared to buyers, sellers typically have superior information on the quality of the car. Other examples include a potential employee in a labor market who has better information on his or her own skills than the information available to the employer, or an entrepreneur seeking financing who has superior information about the value of his or her business idea and management talent. In all of these contexts, the information asymmetry gives rise to what economists call a "lemons" problem.[2]

In the absence of the development of the institutions that make developed markets work so well, emerging economies are likely to discover, as did some Asian countries recently, that globalization is unlikely to bring economic prosperity and stability.

In the used car market, for example, buyers, facing an information problem regarding the quality of the cars being offered for sale, will offer prices that are too low for high-quality cars and too high for low-quality cars. As a result, sellers of high-quality cars will be unable to transact in such a market without incurring a loss. Furthermore, buyers will experience remorse, having overpaid for low-quality cars. Unless the information asymmetry problem is resolved, the transaction costs in this market will be high.

The second source of transaction costs in a market arises from the potential inability of buyers and sellers to write and enforce contracts which mitigate conflicts of interest. Buyers and sellers often have conflicting interests, and contracts provide a means to resolve these potential problems. Lack of reliable information on performance or inability to enforce contracts because of failures of the legal system make contracting difficult. In the absence of sound contracts, employers will be unable to motivate employee productivity, corporate owners and lenders will be unable to ensure that managers undertake value maximizing activities, and joint venture partners will be unable to assure themselves against ex post opportunistic behavior. Economists label the increased transaction costs arising from contracting as agency costs.[3]

The Role of Institutions

A variety of institutional mechanisms are created in advanced economies to solve the information and agency problems. For example, in U.S. financial markets, a number of financial intermediaries and regulatory agencies exist to address these problems—independent public accountants who audit corporate financial statements, financial analysts who analyze and disseminate information, sophisticated institutional investors (such as venture capitalists, commercial banks, mutual funds, private equity investors, and leveraged buyout funds) who monitor corporate performance and channel savings to value-creating activities, corporate raiders and takeover specialists who threaten entrenched managers, and the Securities and Exchange Commission and courts which protect the interest of public investors.

Similarly, several intermediaries make the U.S. product markets work well—reputed retailers such as Walmart or the Home Depot provide a channel through which products with little brand recognition can be distributed successfully, magazines such as Consumer Reports disseminate objective and high quality product information, government agencies such as the Food and Drug Administration set and enforce product standards, and activist consumer groups such as the Public Interest Research Group monitor corporate activity. Strict enforcement of product liability laws protects consumers from shoddy and dangerous products.

The labor markets and the market for management talent in the U.S. benefit from a strong institutional infrastructure as well. For example, labor economists believe that a critical function of universities and business schools is to provide a certification of talent which resolves information problems in the labor markets.[4] The abundance of business schools, a unique U.S. phenomenon, makes the managerial labor market dynamic. Stock-option compensation contracts, again unique to the U.S. labor markets, are viewed by many observes as critical to the successful launching of many Silicon Valley ventures. These contracts provide a mechanism to resolve difficult incentive and information problems between talented technical experts and venture promoters.

Institutional Voids in Emerging Markets

Many of the institutions discussed above are either underdeveloped or altogether absent in many emerging markets. Worsening this situation are the misguided government policies that attempt to address these institutional voids. These institutional voids and misguided policies are at the root of the recent economic crisis in Asia. For example, there is a growing realization that the recent troubles in Korea are due in part to the failure of financial intermediaries, such as banks, to allocate capital and to monitor corporate performance effectively. This failure, in turn, is blamed on cozy relationships between banks and the Korean cheabols (an incentive problem), and on the failure of the financial reporting system to provide signals to poor corporate decisions (an information problem). The problems in Indonesia and Thailand are attributed to an arbitrary and capricious regulatory structure leading to "crony capitalism."

As many experienced multinational executives know, institutional voids make it costly or difficult to do business in many emerging markets. For example, a multinational company searching for a joint-venture partner in an emerging economy, such as India or China, faces significant information problems in assessing the reliability of its partners. Furthermore, even when a partner is found, it is often difficult to enforce contracts, leading to concerns regarding the protection of intellectual property rights. Finally, the absence of well-developed product distribution systems and poorly developed labor markets make it difficult to reach potential consumers and talented employees.

A Framework for Government Policy

Governments in many emerging economies have been concerned about market imperfections for a long time. However, the traditional response to these concerns was heavy government intervention in the economy. Brazil, India, Israel, and Mexico, for example, opted for a significant role for state-owned enterprises to combat market failures. China and former communist countries in Eastern Europe opted for full control of the economy by the government. To varying degrees, many of these countries have acknowledged during the last decade that government failures have proven to be worse than market failures.

In response to the failure of past government policies to combat market failures, many countries in Eastern Europe, Latin America, and Asia dismantled state controls and opened up their economies to global markets, to varying degrees. While this is undoubtedly a welcome development, it is important for governments in these emerging economies to realize that a prerequisite for a well-functioning market economy is the development of an "institutional infrastructure." In the absence of the development of the institutions that make developed markets work so well, emerging economies are likely to discover, as did some Asian countries recently, that globalization is unlikely to bring economic prosperity and stability.

There are at least five important steps in institution building in emerging markets:

1. Recognizing the importance of institutional infrastructure
2. Having a clear focus
3. Creating effective regulations
4. Appreciating the need for expertise
5. Understanding the complex institutional interrelationships

Recognizing the Importance of Institutional Infrastructure

Considerable efforts are being made in emerging markets to build physical infrastructure such as transportation systems, telephone networks, and power plants. Unfortunately, there appears to be little realization that building institutional infrastructure is equally, if not more, critical. For example, China made considerable investments in physical infrastructure after the liberalization of its economy but made virtually no progress in creating a strong institutional infrastructure for the financial, labor, or product markets. Chinese policymakers have just begun to recognize the importance of this task in the context of reforming the country's financial sector. Meanwhile, trading in the gleaming new Shanghai stock exchange is stymied by an inadequate financial reporting system, and entrepreneurs seeking finances to take advantage of the plethora of new business opportunities are left to face an inefficient banking system. Unlike the consequences of bad physical infrastruc which are usually obvious, the costs of institutional voids are often indirect and subtle. Therefore, it is doubly important for policymakers to be sensitive to the importance of institutional infrastructure.

Clear Focus

A second challenge to building a world-class institutional infrastructure is having a clear focus. Our earlier discussion of market intermediaries shows that they all serve one important purpose: to mitigate information or incentive problems between buyers and sellers. When governments fail to realize this critical issue, their efforts to build institutions lack a clear focus. For example, India has built an impressive banking system over the last several decades. However, a very significant portion of Indian banking is in the hands of state-owned banks, which are plagued by their own internal agency problems. As a result, they lack the critical credit analysis skills and the incentives to use these skills effectively. These banks are, therefore, hardly in a position to perform the critical intermediation function of allocating scarce savings in the Indian economy to the most productive corporations.

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Appropriate Regulations

A third challenge governments face in institution building is the development of appropriate regulations. The goal of regulations has to be to minimize the transaction costs and to discourage value-destroying activities by intermediaries. Unfortunately, flawed regulations in many emerging markets make the existing institutional infrastructure ineffective. Once again, the banking sector provides a good example. Financial economists have highlighted the role of flawed regulations in the costly Savings and Loan crisis in the U.S. in the mid-1980s.[5] For example, flawed accounting rules allowed banks to hide the true nature of the risks they had taken and to report significant accounting capital even when banks depleted their economic capital. Capital requirements were not adequately tied to risk-taking, and deposit insurance provided incentives to take risks at taxpayers' expense. Finally, regulatory forbearance in dealing with badly managed banks prevented mistakes from being addressed on a timely basis. Unfortunately, the lessons from this costly U.S. experience seem to have gone unnoticed in Japan, Korea, Thailand, and Indonesia. There is now a growing realization that reforming the banking regulations is an integral part of addressing the financial crisis in these countries.

Appreciation of Special Skills

Another critical challenge in institutional infrastructure building is to recognize that intermediation, like all other economic activities, requires special skills and expertise. While many governments appreciate the need to attract foreign suppliers of technology in product markets (such as building automobiles or computer chips), they fail to appreciate the need to attract world-class "technology" for intermediation. In fact, in most counties government policies discourage the entry of multinational companies into sectors such as financial services, retailing, and management development. As a result, advances in intermediation from developed markets do not often spread into emerging markets.

Recognition of Interlinkages

The final challenge for governments seeking to develop a world-class institutional infrastructure is to recognize that it is an inherently complex problem because of the interrelationships among various institutions in an economy. For example, building an excellent financial system involves creating a sound regulatory framework; evolving sophisticated financial intermediaries such as banks, insurance companies, investment banks, and venture capitalists; building a strong financial reporting system; and encouraging information intermediaries such as independent auditors, financial analysts, and financial publications. The creation of all these institutions requires the creation of a judicial system that enforces contracts in a fair and predictable manner. Furthermore, all these institutions require professional talent (lawyers, accountants, and MBAs, for example), which in turn requires the building of educational institutions. The development of a well-functioning financial system, therefore, requires the simultaneous nurturing of many of these institutions—a very complex challenge indeed.

In summary, emerging market governments seeking to liberalize their economies face an important institutional building challenge. Failure to build such institutions is likely to be very costly and may expose their economies to catastrophic economic crises. Policymakers, therefore, need to evolve a coherent strategy to address this apparently underappreciated challenge.

Notes

1. See Tarun Khanna and Krishna Palepu, "Why Focused Strategies May Be Wrong for Emerging Markets," *Harvard Business Review* (July/August 1997).
2. See George Akerloff, "Market for Lemons."
3. See Jensen and Meckling, *Journal of Financial Economics* (1976).
4. See Michael Spence, "Job Market Signaling," *American Economic Review.*
5. See, for example, Vic Bernard, Robert Merton, and Krishna Palepu, "Mark-to-market accounting for U.S. banks: Lessons from the Danish Experience," *Journal of Accounting Research* (1991).