Bank-oriented Versus Market-oriented Financial System (Iraq Case Study)

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المستخلص :-

أن الانظمة المالية تقسم الى نوعين ، الاول هو النظام المالي الموجه من قبل السوق ، أي النظام الذي يكون فيه معظم التمويل عن طريق الاسواق المالية ، والثاني هو النظام المالي الموجه من قبل المصارف الذي تحتل فيه المصارف النسبة الاكبر من التمويل قياساً بالاسواق المالية .

في هذه الدراسة نحاول الوصول الى شكل النظام المالي الذي يتوافق مع متطلبات الاقتصاد العراقي من خلال استعراض العوامل المحددة بشكل النظام المالي لذا قسمت الدراسة الى مبحثين .

تناول المبحث الاول العوامل المحددة لشكل النظام المالي ، أما المبحث الثاني فقد خصص لدراسة البيئة العراقية من الناحية الاقتصادية والاجتماعية والمؤسسية ، لتختص من خلال ذلك الى شكل النظام المالي الاكثر ملائمة للأقتصاد العراقي .

Abstract

The financial systems can be classified into two types . The first is the market- oriented , while the second is the bank – oriented .

This study tries to reach the most suitable choice between the two Alternatives Above , through investigating the Determinant of the type of financial system . so , the study divided into two sectors .

The first one dualt with the determinants of financial system type , while the second sector devoted to displaying Economic , institutional , and social factors in Iraqi Environment , to conclude the suitable financial system for Iraqi Economy .

Introduction :

The financing matter is regarded as an essential element for growth system, and the latter can be classified into two types, market oriented and bank oriented.

The problem we face is which one is the best. In this paper we try to prove that this matter is decided from the bottom and not from the peak. That is, the hypotheses of this study claim that the type of financial system is not determined managerially, but through the surrounding environment, such as historical, social, institutional, and economic factors.

The leading studies in denoting to the determinants of financial system type, were by (Alexander Gerschenkron 1962) and (Sigurt Vitol 2001). The first one focused on the historical factor, while the latter

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questioned this factor and concerned with the institutional and social factors. It is worthy to mention that the two studies did not use the terms (historical and institutional), which I prefer to coin.

In the research added the fourth factor, namely, the economic one. According to these factors we try to answer the question related to the best alternative of financial systems for Iraq.

So , This paper is divided into two sections , The first one is devoted to surveying the determinants of financial system type , while the second deals with socioeconomic environment in Iraq, in order to conclude which one is the best choice for Iraq .

Section 1:
Determinants of financial system typ

The choice between market-oriented and bank-oriented financial system is not arbitrary or a selective matter, because it depends on many factors, which I will deal with them as following.

1-The Historical factor

AS we know some countries entered the industrialization stage before others such as United Kingdom in comparison with Germany and Japan. The difference in timing of industrialization is supposed to have influence on the shape of financial system which was adopted by each country. So UK adopted the financial system which is oriented by market, while the two other countries adopted the bank-oriented one. The hypotheses that classified the financial systems of these countries justifies it is view by that the firms in latecomers to industry faced two disadvantages in relative to their advanced competitors in early industrialized countries(sigurt vitols,1992,p.2) the internally supplied money and the quantity of money demanded for investment in technology and infrastructures.

Secondly, it is difficult to resort to market finance, because securities markets were not developed, besides that the investors preferred to invest in more safe assets such as the government securities. So, the last financing avenue for these firms was banks .While firms in first comers to industrialization were able to finance their investment either internally or through issuing securities in relatively developed financial markets.

This hypothesis did not pass without question. For instance, (Sigurt Vitol 2001,p.3) believed that the hypothesis overstated both the significance of bank-based finance for rapid industrialization in Germany and Japan and the extent to which the financial systems really were differed. Since the hypotheses assumes that banks take the large risks involved in investing the large sums of long-terms capital needed to build industrial Plants. That is, the order of development postulated by this hypothesis is, first banks, then industry in the late industrialized .But historical record does not support the hypothesis, since number of joint-stock banks were funded by industrializes rather than the other way around, furthermore, banks in fact had quite conservative attitude toward risks.

Second, this hypothesis understates the regulations taken by the state in1930s, for explaining the post war difference in the financial systems. The difference began to appear during 1930s and 1940s during which the financial system of USA became considerably more market-oriented while the government in both Germany and Japan took many measures to financial regulation. These steps were motivated by the increasing tendencies of liberal financial systems toward instability culminated in the great depression, and the shifting in economic and social goals of the state.

2- The institutional factors

These contain a wide range of factors, but I will focus on three only because they are related to the subject. These factors include the pattern of income distribution, the retirement system, and the size of firms.

❖ The pattern of income distribution

According to Gini coefficient, which it is value ranging from(0) to(1) , countries said to have equality in income distribution when the value of this coefficient becomes nearer to (0), while countries with a Gini coefficient nearer to (1)are said to have inequality in income distribution. The difference in income distribution affects the choices of households in regard to the various type financial assets.

Households with high level income are characterized by risk-taking, so they prefer securities to bank deposits, while middle income households are risk-averters, so they prefer bank deposits to securities. Low income households have little ability to save, and what they save is hold in cash or highly liquid bank deposits (Sigurt Vitol 2001,p.18).

According to the difference in preference we can say that high income households are the greatest supporters for market-oriented financial systems, while low and middle income households are the supporters of bank- oriented financial systems.

We can verify the effect of income distribution on the financial system type through statistics of income distribution in Germany, UK, and USA.

Gini coefficient in Germany, which adopted the bank –oriented financial system, was ranging between (25%) and (26%) for the period 1970-2000. While it was ranging between (31%) and (36%) in USA, and between (26%) and (34%) in UK for the same period, where Financial the system in both countries is oriented by market (Sigurt Vitols 2004,p.16).

❖ The size of firms

Firms can be divided according to their size into small, medium, and large .These firms can finance their activities internally or externally. When they resort to external finance they face different finance conditions according to their size. These conditions can be illustrated by the table (1), from which we can observe a negative correlation between the firm size and the strength of conditions. That is, the large firms face easier finance conditions than small and medium firms. This difference stems from Asymmetry of information between the lenders and borrowers, which results in adverse selection and moral hazard. Small and medium firms exhibit high degree of asymmetry of information in comparison with large firms .This fact make it difficult to small and medium firms to finance their activities through markets, since finance requires monitoring and observing the performance of the borrowers from lenders, and this task can be achieved only by banks. So, small and medium firms lead to a financial system oriented by banks, while large firms set the ground for market- oriented financial system.

TABLE (1)
Conditions and methods of financing according
To the size of firms

features	small firms	Medium firms	Large firms
Period of loan	short	long	long
Interest rate	variable	fixed	fixed
Terms of contract	Multi ,hard	Less, more easy	easy
Guarantees	mostly	sometimes	rare
Monitoring from lender	intensive	Less intensive	limited
Frequency of negotiation	large	medium	limited
Method of finance	direct	indirect	underwriting

-Source: Lawrence S.Ritter and others; principles of banking and financial markets, Addison Wesley, 10 Ed, 2000, p.275.

❖ The pension (retirement) system:-

Pension or retirement system is a framework of arrangements, based on statue or private contract or both, under which individuals gains specified entitlements to a regular income in retirement (pension) in return for the payment of specified sums (contributions) made by themselves or their employers during their working lives.

This system may be voluntary or compulsory or mixed of both. In voluntary one, individuals freely enter into contracts committing themselves to making payments to intermediaries and the latter, in return, committed themselves to financing the payment of pensions on specified terms when the individuals eventually retired.

In compulsory or government operated system, workers and perhaps employers too might be legally obliged to make payments to the state and the might commit itself to paying pensions directly to retied individuals according rules laid down in statue(Peter Howells and Keith Bain 2008,p.88).

The type of pension system has it is effect on financial system type, since funds raised in compulsory one find it is way to the banks, while the funds in the other one(voluntary system) lead it is way to the markets.

We can find some evidence From Germany, Japan, and United States. In the first two, which their financial systems are classified as bank-oriented, we find that the contribution of public (compulsory) pensions to GDP for the year 1988, were 10.6% in Germany, and 4.1% in Japan, while the contribution of private (voluntary) pensions in the same countries were 2.6% in Germany ,and 0.9% in Japan for the same year. In USA, which it is financial system is classified as market- oriented, we find a different image, since the contribution of public and private pensions to GDP was 6.9%, 3.3 % respectively for the year 1988(Sigurt VitolS 2001).

3- The social factors

According to the theory of constructivism, the world we live in is of our making. That is, the ideas of and communications of individuals, groups, and social structures including states serve to create structures (treaties, international organizations…etc) (John T. Rourke 2008,p.30). It is unquestionable to say that social factors such as objective laws, religious arrangements, and norms, have great influence on the behavior of people and the structures that comply with these factors. Besides that, I think there is an inverse relationship between the strength of these factors and the engagement of people in risky behaviors or activities, and Societies are classified according to the strength of these factors to strict and less strict (relaxed) societies. In the first one, where these factors are strong, people behave as agents to government, religious institutions, and norms. So, every behavior not complying with the rules of these factors will be punished severely. That is, the social cost to the wrong--doers will be high. In relaxed (less strict) societies, people tend to ignore the behavior of others, unless it is not interfere with their interests. They often neglect suspicious or even clearly criminal activities. The different strength of these factors is reflected on the shape of economic and social structures, such as the financial systems.

In strict societies it is likely that these societies will adopt the financial system oriented by banks, while relaxed society will adopt the market-oriented financial system. For example, Japan and Germany are considered strict societies, for many reasons, such as the strict bankruptcy system in both countries. Japanese bankruptcy court often refuses to hear cases, and when they do, managers often lose their jobs and stockholders receive no compensations. Because bankruptcy costs and economic uncertainty were so high, Japanese companies found it useful to hold strong relations with banks to help them in difficult times, they also found it advantageous to keep their firms relatively small. In Germany, the definite time for opening and closing the stores, rigidity of labor market, and respect for police forces are signs of social strictness (Richard sylla and Robert E. Wright 2004,p.16). All these features enhance the banks dominance over markets in channeling funds from surplus to deficit-units.

In USA and UK, which are classified as relaxed countries, where citizens in both countries generally display less respect for the law, social mores, or business ethics. The wrong-doers are less likely to be caught in compare with strict societies, and if they caught, they receive

a relatively light punishment. If the punishment is still hard, they can reduce it by skipping, state, region, or even the entire nation (Richard Sylla and Robert E. Wright 2004,p.16).

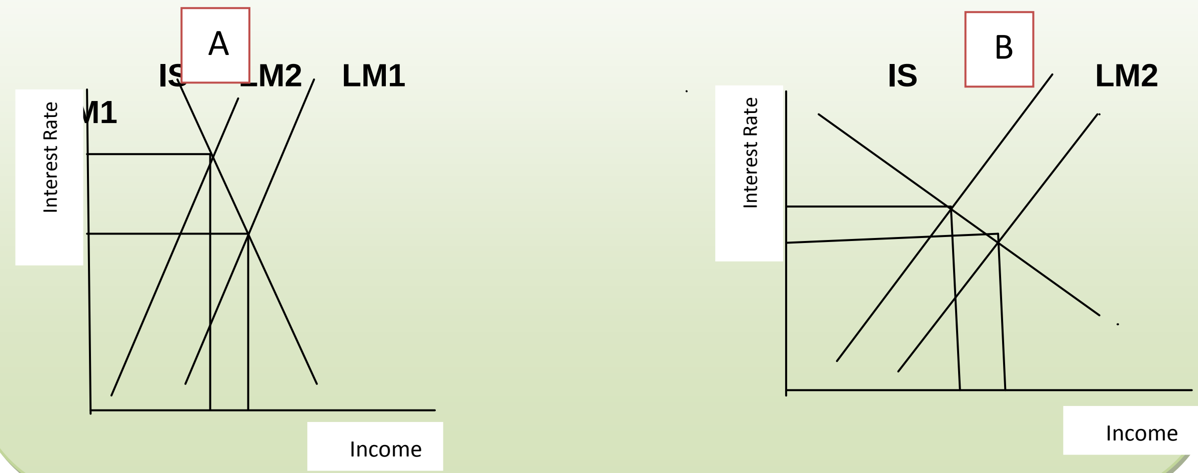
IT is evident that such climate will provoke people to engage in risky activities and make it difficult to banks to have the leading position in financing operations which will be taken by financial markets.

4- The economic factor

This factor is related to the consequences of regulation and deregulation of financial systems on monetary policy and the stability of Of financial systems on one hand, and the economic development on the other hand. We are not concerned here with the arguments of proponents and opponents of financial systems deregulation, but with the economic consequences of regulation and deregulation. We can trace these effects through IS/ LM model.

The slope of both two curves in deregulated financial systems will be steeper than that of regulated ones. This difference results from the fact that the concept of money supply will be very wide in the case of deregulation, besides that, the demand for money will be less stable than it is in regulated financial systems. The implications of these differences are related to the monetary policy. When monetary authority finds it is wise to follow a contractionary policy, the results of this policy will be different according to the degree of regulation. This can be illustrated by figure (1). We can see from panel (A), which represents the IS/LM in deregulated financial systems, that the decreasing of money supply to achieve a decline in GDP(y), will result in increasing of rate of interest by amount greater than of panel (B) which represents the IS/LM in regulated financial system. That is, any action taken by the monetary authority will cause more instability in the deregulated financial system, because of the great changes in rates of interest.

Figure (1)
IS/LM curves in deregulated and regulated Financial systems

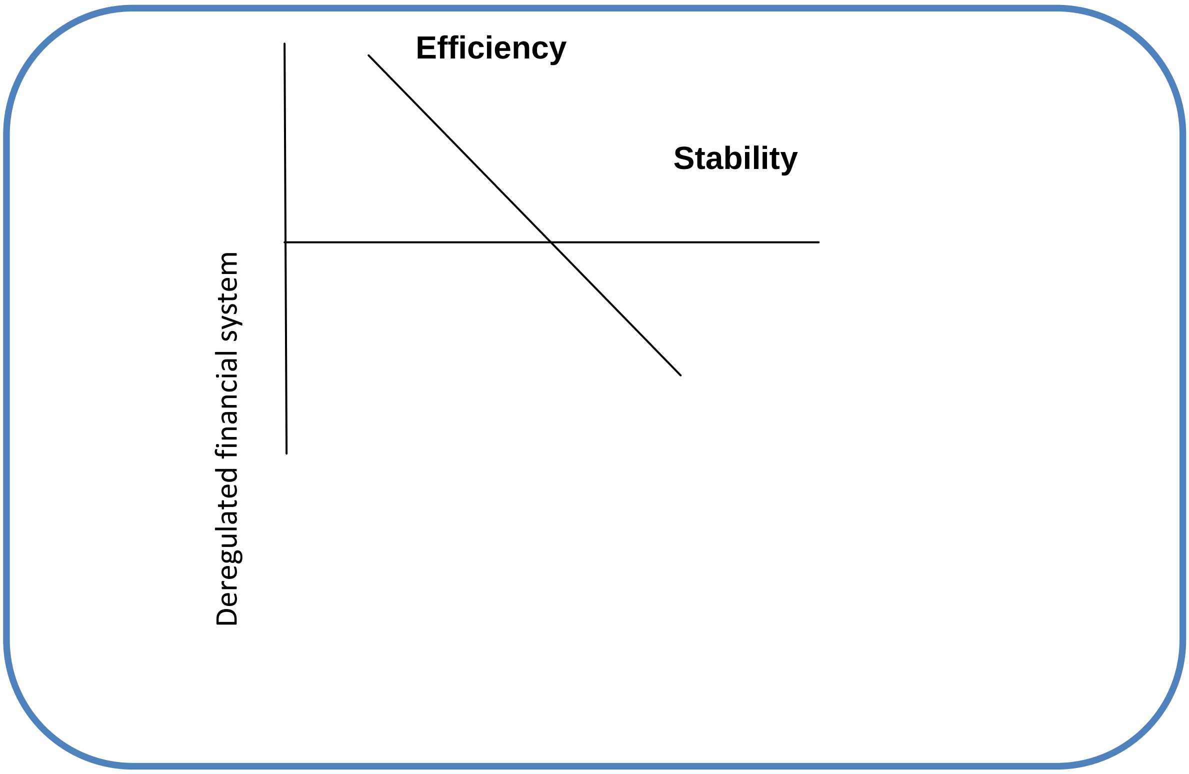


Source: Robert Gordon J, Macroeconomics, 8th.ed, McGraw-Hill, 1999,p.441.

We can see from the figure above the different results of decreasing the money supply in the two cases. the decrease in the money supply from M1 to M2 to achieve decline in GDP from y1 to y2 results in changing rate of interest in deregulated financial markets (panel A) in amount greater than in regulated financial markets (panel B).If we accept the argument of the proponents to deregulate financial systems, that deregulation of financial systems leads to efficiency, it is right to say that we face a trade-off between efficiency and stability in deregulated and regulated financial systems. That is, deregulated financial systems achieve efficiency at the expense of stability, while the regulated ones achieve stability at the expense of efficiency, and this trade-off can be illustrated by the figure (2).

Figure (2)

The trade- off between efficiency and stability in deregulated and regulated financial systems



Regulated financial system

Besides that, historical evidences proved that all countries resort to regulate their financial systems during crises, and some claimed that Germany and Japan shifted from market-oriented to bank-oriented financial system, because the former is more characterized by instability (Sigurt Vetols 2001,p.4), and I can add that this trait (instability) was proved by the financial crisis of 2007, in which the financial systems of USA and UK were at the brink of collapse, While the financial system of both Germany and Japan absorbed the shock to a great deal. In fact, as if it were, Germany was the financial leverage for European countries during the recent financial crisis, and that cannot be achieved without the nature of it is financial system, which is oriented by banks.

From above we can conclude that countries can adopt the market-oriented financial system when they prefer efficiency to stability, while countries that prefer stability to efficiency will adopt the bank- oriented ones.

Section two
The suitable type of financial systems
To Iraqi economy

In the previous section we surveyed the determinants of financial system type, and here we will display some socioeconomic features of Iraq such as the industrial sector, pension system, firms size, patterns of income distribution, social factors….etc, in order to get a picture of the Iraqi economy that will help us in choosing the best type of financial systems, in the light of determinants we mentioned in the previous section, that serve development in Iraq.

1- The industrial sector

At the beginning of sixties of 20th century, Iraq followed the imports-substitution policy in industry, and this policy was characterized by roughly full independence of these industries on imported raw materials. So when economic sanctions were imposed on Iraq through the nineties of 20th and the beginning of new millennium, most of these industries, if any, failed to continue. After the political change, Iraq adopted the liberalization policy of economic sectors excluding energy sector, which results in forcing many industries to leave the service. In fact most of them were idle. Adding to this situation the reluctance of domestic and foreign investors to invest in Iraq because of the political instability, we can say that Iraq as if at the first stages of industrialization and this fact can be verified by the percentage of manufacturing industries production to GDP, which is illustrated in table (2).

2- The social factors

Developing countries and Iraq is no exception, can be classified as strict societies because norms, religious arrangements, and law have great effect on the people's behavior.

Wrongdoers may escape the direct penalties such as prison or firing, but they cannot escape the indirect ones, represented by social costs.

TABLE (2)
The percentage of manufacturing industries production to Iraqi GDP For period (2004-2010)

Years	%
2004	2.46
2005	1.48
2006	1.83
2007	1.93
2008	2.03
2009	2.41
2010	2.21

-Source: ministry of Planning, statistical bulletins for years 2008-2009, and 2010-2011.

Wrongdoers will be considered from the point of society's members' view, as bad and not trusty ones, and these attributes will so badly affect their social and political position .In Iraq, people shows a little degree of readiness to forgive wrongdoers. Besides that, most of Iraqi people especially in popular districts opt to watch every one other. For example, my colleague told me that he used to make shopping, and before doing that, he said, I check the kitchen to be sure what I should bring. One day I found we do not have onion, so when I went out, I bought many goods including the onion, but my wife did not know what I brought. Next day at the morning, our neighbor asked my wife some pieces of onion, and my wife replied, sorry we ran out of onion, but our neighbor replied, I saw your husband yesterday carrying many things including onion.

One Iraqi famous socialist (Ali AL-wardi 2007), in his book, the nature of Iraqi personality, said that though Iraq has many educated peoples and genius thinkers, but it lacks the leading personality, which he attributed it to the belief that the leader, according to the point of Iraqis' view, must not have a mistake, that is, the leader, as if it were, must be an angel, and it's not necessary to say that is impossible dream.

All the conditions above help, as I think, to create personalities sensitive to critics and appeal to avoid engagement in risky activities.

3- The income distribution

According to table (3), the value of Gini coefficient in Iraq for a selected years, is ranging between (0.355) and (0.540). We can see that the value shows a declining trend, after 1998, because during the years before 2003, namely 1990-2003 Iraq was under economic sanctions which led to redistribute income for traders, ruling family and their relatives and farmers, leaving people especially those with limited income (workers and most the members of middle class) to live nearly

on nothing, but the scales were rebalanced after the political change in 2003.

It is not matter, in Iraqi case, if the values of coefficient are considered relatively small, medium or large, because most of the high ranked income categories were inclined to invest directly in lands, shopping centers, and restaurants, avoiding deposit their funds in banks, which can be attributed to three reasons. The first is related to real interest rates, which were negative during the period 1990-2003, because Iraq experienced hyperinflation in this period without propensity from banks to index the nominal interest rates. The second is relating to the religious arrangements which prohibit taking interest rates on funds (Reba). The latter is about the desire of many people to hoard their funds, because of the underdeveloped of both banking system and peoples banking habits.

This behavior may continue to last for the medium term, if the authorities don't take some actions that may help to reverse the trend. It is need not to say that this behavior does not apply to that of the firms and corporate.

Table (3)
The value of Gini coefficient in Iraq for selected years

Year	Gini coefficient
1976	0.360
1984	0.398
1988	0.355
1993	o.429
1998	0.540
2005	0.422
2007	o.370

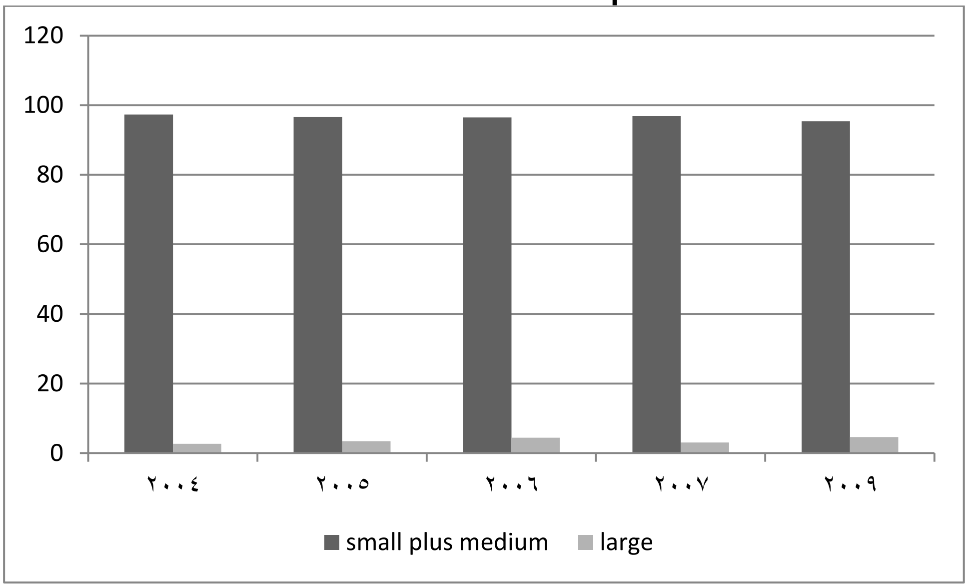
Source:-
Source: ministry of Planning, the central system for statistics and information technology, study no.2, for years, 1979, 1984, 1988, and1993.
-Ministry of planning, the central system for statistics and information technology, report of survey of households balance for year 2005.
-Ministry of planning, the central system for statistics and information technology, report of social and economic survey of household, for year 2007.

4-The firms' size

There are many measures used to classify firms according their size, such as the number of employees, value of firm's assets, and etc. It is preferable to use more than one measure for classification.

In Iraq, ministry of planning uses the number of employees as unique measure for classification , and this procedure will not give a clear and precise image of the size of firms ,because most firms, namely the public ones, suffering from disguise unemployment. Nevertheless we can see from the chart below, that number of small and medium firms have dominance over large ones in total number of firms.

Figure (4)
The relative importance of small and medium firms to total Number of firms for the period 2004-2009



Source: ministry of Planning, statistical bulletins for years 2008-2009, and 2010-2011.

(*)- 2008 was neglected because of the lack of data.

5- The pension (retirement) system

Iraq adopts the compulsory retirement system. The government takes away a certain percentage of the salaries received by employees who work at public sector, and this percentage varies a according to the class of salaries, while there is no contribution from private sector. That is, the unique source of pension funds (retirement system) is public sector. Because the lack of data about the retirement tax, I used the proxy of it, namely the salaries of the retired persons, and I think it is justifiable procedure, since none can receive a retirement salary if he or she was not employed in the public sector. We can see from the table (4) that these salaries consist in average about 3% of Iraqi GDP for the period 2004-2010.

Table (4)
The percentage of retirement salaries to Iraqi GDP for the Period 2004- 2010

Year	%
2004	2.41
2005	2.o6
2006	2.48
2007	4.06
2008	2.14
2009	2.8
2010	3.70

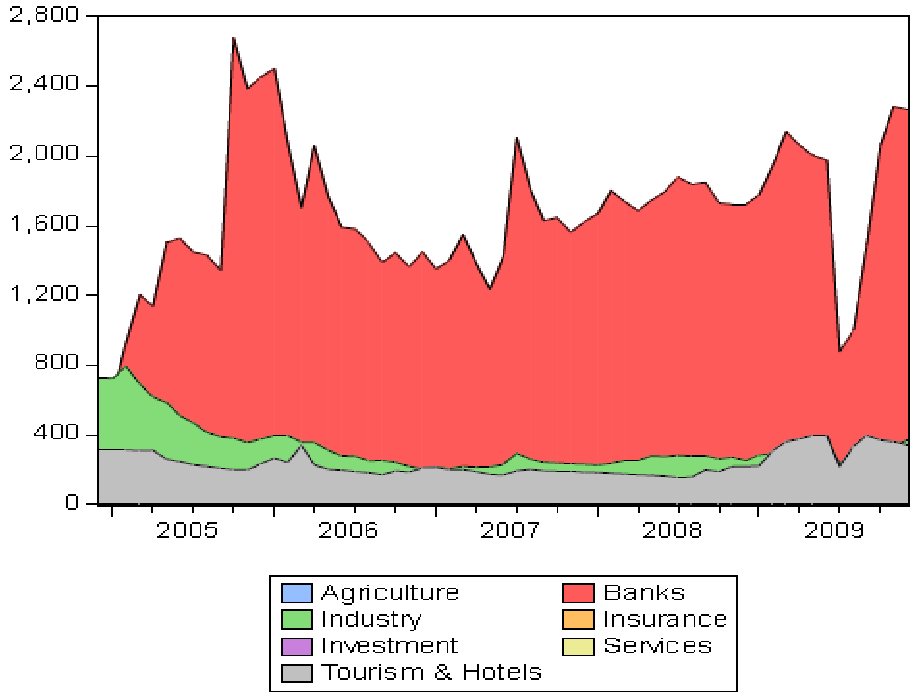
Source: Ministry of planning, statistical bulletin for years 2008-2009 and 2010-2011.

6- The economic factor:-

The importance of regulation or deregulation of financial system, and then the choice between market-oriented or bank-oriented financial system in Iraq is not related to the stability and efficiency of financial system, though it is generally not a secondary matter, but related to the economic development. Because Iraq has a very weak stock market, for example, the capitalization in this market reached about 2% of GDP, and most of this capitalization comes from banks as illustrated in figure (5).

Iraq witnessed many wars, and economic sanctions continued thirteen years, leaving it with a highly damaged infrastructure, so it is not reasonable to hand the financing matters to market, because market gives profits supreme priority over socioeconomic aspects. Some refers to the difference between the financial systems of USA, UK, Japan, and Germany did not occur until the end of Second World War, because both Germany and Japan realized that it is reasonable to shift from market to banks-oriented financial system, since the latter can be easily controlled. Besides that, the market-oriented one was characterized by instability, which reached it, is peak in the great depression. In brief, banks-oriented financial system can be used to achieve social and economic goals, which comply with the needs of Iraq.

Figure (5)
Market Capitalization by Sector



Source: Juergen Kaehler & Haider Salahal-Din Aref , The Iraqi Stock Market: Development and Determinants , Institute of Economics , University of Erlangen-Nuremberg, Erlangen, May 2010 , p.8 .

Conclusions

If we match the two previous sections, we can specify the best alternative financial system for Iraq. Before that, two points must be mentioned. The first is, it is better to take into consideration more than one determinant in deciding the best choice.

The second is related to the building of economic models. It obvious that the good models ignore those features of the real world those are not relevant for the issue under consideration and focus on the important ones. For example, Labor economists have been using quite different models when studying European labor markets than when looking at the United States. Because trade union in united states are very weak, so it is reasonable approximation to ignore their role and focus on in individual behavior in the wage bargaining process, while in Europe, trade unions have traditionally been much stronger, and for many countries it may be severely misleading to ignore their role in the centralized bargaining process that has been established (Manfred Gartner 2009). This fact applies thoroughly on the shape of institutions that should be chosen in any society, since institution must reflect it is environment, and the financial system is no exception. As far as Iraq is concerned, we can summarize it is social and economic features as the following:

1- Iraq is a latecomer to industrialization.
2- The dominance of small and medium firms on the total number of firms.
3- Relative low income inequality.
4- Compulsory retirement system.
5- Strict society.
6- Relative low level of development.

Using these features and compare it with the following diagram, we can conclude easily that the best alternative of financial systems for Iraq, is the bank oriented one, because it fulfills most of it is requirements.

Diagram (1)
The determinants of financial system type

Low degree of industrialization
Low income inequality
The dominance of small and Medium firms
Compulsory retirement system
Strict society
Stability and development

Bank-oriented financial system

High degree of industrialization
High income inequality
Voluntary retirement system
Dominance of large firms
Relaxed society
Efficiency

Market-oriented financial System

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