National culture and financial systems: The conditioning role of political context*

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ABSTRACT
Building on research that addresses why some financial systems are based on banks and others on markets, this study stresses that culturally-based social preferences regarding uncertainty avoidance help explain cross-national differences in financial system configuration. We propose a theory in which political institutions condition this relationship. National culture is a good predictor of financial systems as long as governments are constrained and therefore able to credibly commit to not interfering in the functioning of banks and markets. We adopt a strict definition of culture that focuses only on inherited dimensions, while postulating uncertainty avoidance as a proxy for the societal attitudes that channel those cultural priors. We find that in a political context with unconstrained government, national culture fails to explain financial system variation. In contrast, when political institutions limit governmental action, culturally-driven preferences for uncertainty avoidance affect significantly financial configuration.

1. Introduction

Why are some national financial systems based largely on financial intermediaries, such as banks, while others rely mostly on markets? In the last two decades, scholars from different disciplines have advanced different explanations for financial system variations around the world. Researchers have consistently shown that divergences loom large in factors such as legal traditions (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1997, 1998), structures of governance and levels of the protection of property rights (Williamson, 1981, 1989), structures for risk sharing (Allen & Gale, 1997), and endowments or informational frictions in countries’ economies (Boot & Thakor, 1997). However, national culture as a long-term force has remained largely underexplored as a potential explanation for the configuration of financial systems.

National culture has featured prominently in business studies. An extensive research stream shows that culture relates to several aspects of firms, such as technology adoption (Erumban & de Jong, 2006; Steers, Meyer, & Sanchez-Runde, 2008), market orientation (Kirca, Cavusgil, & Hult, 2009), cross-border acquisitions (Malhotra, Lin, & Farrell, 2016; Malhotra, Sivakumar, & Zhu, 2011) and workplace behaviors and attitudes among other organizational outcomes (Kirkman, Lowe, & Gibson, 2006). National culture has also been proposed as a key explanatory variable for several financial phenomena, such as stock market participation (Guiso, Sapienza, & Zingales, 2008), a bank’s earnings quality (Kanagaretnam, Lim, & Lobo, 2011), corruption in bank lending (Zheng, Ghoul, Guedhami, & Kwok, 2013), bank internationalization (Petrou & Thanos, 2014), and firms’ risk taking (Mihet, 2013).

On the specific question of bank-based versus market-based systems, Kwok and Tadesse (2006) proposed that the characteristic features of national cultures such as uncertainty avoidance levels play a significant role in the configuration of financial systems. Relying on a theory that postulates banks as intermediaries with a greater ability to reduce risk over time (Allen & Gale, 1997), these authors suggest that bank-based systems should be prevalent in countries that score higher on uncertainty avoidance, while market-based systems should be preferred by societies that score lower on uncertainty avoidance.

We build on this research and emphasize the idea that financial systems are strongly influenced by how people address uncertainty culturally given that finance essentially concerns social relationships. Although current financial systems are large and complex, the fundamentals of a financial transaction remain the same; such a transaction is a contract between a borrower and a lender united in their expectation of future compliance. Hence, attitudes toward uncertainty in a financial
transaction are likely to be influenced by cultural priors.

We propose a nuanced specification of this cultural explanation based on a conditional relationship with political institutions. Thus, rather than addressing whether national culture impacts financial systems, we focus on when it has an impact. We argue that political context matters when examining the association between a country’s culture and its financial system because the structure of the latter is politically relevant and hence appealing to capture. Financial systems play a key role in the allocation of an economy’s resources among households and firms, producing redistributive consequences. Thus, building on institutional economics theories about the role of institutions as mechanisms for establishing credible commitments (North, 1990), we argue that checks and balances in a political system, as exerted by veto players, are a necessary for a working relationship between the national culture and the structure of the financial system. We theorize that an unconstrained government cannot credibly commit to preserving the functioning of banks and markets because it has an incentive to behave opportunistically in that type of a political context. Therefore, people’s expectations regarding financial institutions will not be met, and hence, the association between national culture and financial system should not hold.

To test this theoretical proposition, we collect data on financial systems for the same 41 countries used in the sample of Kwok and Tadesse (2006) from The World Bank’s Global Financial Development Database for a longer and more recent time period (1990–2008), which allows us to avoid the potential biases of prior findings that resulted from the short observation period. We replicate the authors’ index of financial architecture – measuring the relative importance of the stock market compared with the banking sector to an economy – and run cross-sectional regressions to evaluate the effect of culture on financial system configuration. We then explore the conditional effect of the political context via interactions between uncertainty avoidance and a set of variables that are commonly used as proxies for the ability of political institutions to constrain governments, i.e., the number, stability, and tenure of veto players in the political system. The role played by veto players in a political system captures different aspects of a political actor’s ability to control the government and allows us to assess the extent to which a government’s opportunistic behavior is limited.

Our empirical strategy attempts to avoid potential endogeneity in the estimation of the effect of culture by adopting a narrow definition of national culture based on a two-step conceptualization. We focus only on those dimensions that are inherited from previous generations by an individual (ensuring that they are relatively time invariant) while using Hofstede’s uncertainty avoidance index (UAI) as a proxy for the social attitudes that channel those cultural traits. The effect of culture on the configuration of financial systems is thus tested by the instrumenting countries’ UAI with fixed cultural traits, i.e., with an instrumental variables (IV) model.

We find a negative association between a country’s level of uncertainty avoidance and the market orientation of its financial system. The ability of banks to smooth intertemporal risk makes these financial intermediaries more attractive in societies with low levels of tolerance for uncertainty. This result holds even when controlling for two of the literature’s most appealing hypotheses (the country’s level of economic development and legal systems).

We also find empirical support for the conditional impact of the political context. The ability of political institutions to limit government behavior influences the relationship between national culture and financial systems. First, we find that for uncertainty avoidance to be a good predictor of a country’s financial structure, a certain level of time stability is needed for veto players in the political system. As the political stability of the actors who constrain government action becomes more volatile, the association between national culture and financial systems weakens. Second, we find that the longer the tenure of the veto players lasts, the stronger the effects of cultural prescriptions are. Finally, following a political-economic account of regulatory capture (Peltzman, 1976; Stigler, 1971), we present evidence of the conditional role of politics in evaluating the relationship between a country’s culture and its financial structure as a function of market concentration in the banking sector. If the banking sector is highly concentrated, then financial intermediaries are no longer credible in terms of their ability to smooth intertemporal risk; the effects of culture no longer help to explain cross-national differences in financial systems.

In presenting evidence that the influence of culture is moderated by governmental constraints, we contribute to the extant theoretical and empirical literature. From the theoretical side, we advance the idea that more constrained governments appear credible in their commitment to not interfere in the functioning of banks and markets. From the empirical side, our contribution involves a new implementation of Hofstede’s UAI, with a focus on countries’ societal attitudes toward uncertainty that are exogenously determined by time-invariant cultural traits. Our approach is novel relative to classical studies since it helps to avoid reverse causality problems.

Next, we review the literature on the determinants of financial systems and propose that the political context conditions the relationship between culture and financial system configuration. We then outline the study’s research design, including the econometric specifications and data used. Finally, we present the results of the empirical analyses, followed by several conclusions.

2. Why do financial systems differ across nations?

Scholars studying the reasons for differences among financial systems configurations across nations have argued on multiple, diverse grounds, making dialogue very difficult. Generally, research in finance and economics assumes that efficiency trumps any other consideration and that institutions and culture survive either because they contribute in some way to that efficiency – by providing a common language, for example – or at least because they do not run counter to it. However, more humanism-oriented work presents financial and economic factors as devoid of meaning if considered in isolation from their cultural, institutional and legal contexts.

We have found Williamson’s (2000) analytical model of social analysis to be an apt tool for making sense of the various attempts at establishing the determinants of cross-national financial system configuration. This model consists of four levels, each of which is longer-ranging timewise than and constrains the one below it. The first level contains the cultural realm in which “norms, customs, mores, traditions, etc. are located” (p. 596); these vary on the order of centuries or even millennia. The second level is institutional and consists of “formal rules (constitutions, laws, property rights) (North, 1990). The third level holds the governance mechanisms of contractual relations and constitutes what Williamson calls, “the play of the game,” that is, the adjustment of the contract to shifting circumstances due to the costly definition and enforcement of property rights. Finally, level four concerns optimality analysis, which is typical of neoclassical economics and occurs continuously. Scholars have offered explanations as to why national financial architectures differ at all four levels.

Level 4 explanations typically analyze which financial configuration is most efficient. For example, actor-based explanations examine such features as the type of actors, assets or endowments; the nature of informational asymmetries; and other environmental constraints. One such explanation appears in Boot and Thakor (1997), who hold that banks arise as coalitions of actors to solve moral hazard problems, while markets arise to allow actors to compete, facilitating the transfer of valuable information through prices. In turn, Allen and Gale (1997) build a model of overlapping generations to show that long-lived banks smooth intertemporal risk (which cannot be diversified at a given point in time) better than incomplete markets.

In part, level 3 phenomena determine the economizing described above. In fact, transaction cost economics (TCE) (Williamson, 1981, 1989, 2000) has been the dominant lens through which to explore

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