

# Law, Development and Finance in Rising Powers

## Project Description

The aim of the project was to analyse to what extent the quality of legal and other formal institutions affected financial development and economic growth in the BRIC countries, and whether reliance on informal institutions posed an obstacle to their future growth.

For over a decade, with the encouragement of the World Bank and western governments, developing countries have adopted programmes of legal and financial reform combining privatisation of state-owned banks and enterprises with the enactment of enhanced legal protections for shareholders and creditors. According to some accounts, China's recent experience demonstrates the value of a developing legal framework in overcoming limits to growth in an informal, trust-based economy, while Russia is actively seeking to put in place the necessary legal and regulatory structures for market-based financial development. In Brazil, the example of the Novo Mercado, a new stock market segment which has attracted a large number of high-tech IPOs, suggests that a strategy of allowing firms to opt into a shareholder-rights based regulatory regime can work in promoting flows of equity finance in an emerging market context. In India, too, there is some evidence that recent corporate governance reforms have led to greater transparency on the part of listed firms and to increased investor confidence, although critics of the reform process argue that it has not gone far enough. The picture emerging from these experiences is one in which formal and informal institutions do not necessarily operate in tension. Rather, they may complement each other in providing the foundations for sustainable economic growth and societal development.

The project researched these issues using an inter-disciplinary, multi-methods approach, combining quantitative analysis of the extent and nature of correlations between legal and financial development in the countries under review, with qualitative, fieldwork-based research aimed at building up a detailed, micro-institutional account of the perceptions and strategies of actors involved in legal and financial reforms. We used legal and financial datasets to carry out time-series and panel data analysis capable of specifying causal links between legal institutions and economic development in the rising powers and, by way of comparison, in a wider sample of developed and developing countries with over 30 annual observations per country. The fieldwork focused on the role played in each country by the banking sector and capital markets as alternative (or possibly complementary) sources of finance for firms; on how government reconciled or combined its continuing role as owner of financial and industrial enterprise with its emerging role as regulator of banks and securities markets; and on how firms met their financing needs.

Data collection for legal datasets began in the spring of 2013 and revised versions of the CBR Shareholder Protection Index and Creditor Protection Index, covering 30 countries for the period 1990-2013, were completed. Econometric analysis of the datasets began in 2014. Interviewing in the case study countries was completed in the course of 2015.

The new datasets enabled us to measure the global diffusion of laws for the protection of investors and creditors, and to estimate their effects on stock market and credit market development. We found that while the impact of legal convergence was mediated by country-specific effects including

local laws and institutions, there were some common trends. A key finding is that the strengthening of shareholder rights is associated with a rise in equity values although not, consistently, with increases in stock trading or in the number of listed companies. Thus a provisional conclusion is that enacting shareholder rights may not be enough on its own to create deeper and more liquid capital markets in developing economies.

In China our fieldwork led us to be sceptical of the claim that China's recent economic growth is mainly the result of guanxi or interpersonal trust coupled with strong direction from central government. Instead we found increasingly sophisticated use of contracts and growing demand for the rule of law. There was less reliance on guanxi in product markets, in particular in the more economically advanced regions and in developing sectors such as IT.

However, the move towards market-based transacting and transparent pricing was less evident in the case of Chinese financial markets. Chinese stock markets were not regarded as transparent and were dominated by state-owned enterprises. They did not provide a reliable source of equity finance for private-sector firms. Start-ups in sectors such as IT tended to rely on family members and angel investors for funding, rather than venture capital or IPOs. However, some of our interviewees expected Chinese stock markets to become more transparent over time.

In Russia we observed a somewhat different picture: there was pent-up demand for the rule of law but less confidence in the legal system, a stronger perception of judicial corruption, and more concern over a 'predatory' state, than in China. At the same time there had been a discernible change in the business environment in Russia since the turbulence of the 1990s. Medium-sized and smaller businesses can generally operate successfully as long as they stayed 'below the radar' of state officials.

The experiences of Brazil and India, both democracies, make for an interesting contrast. In both cases we observed positive effects of legal and corporate governance reforms aimed at promoting transparency in stock markets and encouraging bank-based lending to private sector firms. At the same time, larger enterprises played an important role in the stock market and in the economy as a whole, and convergence on a western model of deep and liquid capital markets was a gradual process.