

Paper on the 2nd International Conference on Industrial Organization,
Economics and Law. June 9-11 2005. Athens. 9th of June 2005.

Agust EINARSSON, Professor
University of Iceland

Faculty of Economics and Business Administration
University of Iceland, Oddi, Sudurgata, 101 Reykjavik, Iceland
Tel: 354-5254500. Fax: 354-5526806. E-mail: agustei@hi.is Website: www.agust.is

Biography of the author

Professor Einarsson is the former dean of the Faculty of Economics and Business Administration at the University of Iceland. He obtained his PhD in Germany. He is the author of 6 books on microeconomics, business administration and cultural economics and over 50 journal articles and conference papers and over 400 shorter articles on economics, fisheries and politics in magazines, newspapers, and on websites. Professor Einarsson is a former Member of the Icelandic Parliament and Chairman of the Board of the Central Bank of Iceland and served as a delegate for Iceland at the General Assembly of the United Nations in New York.

Regulations on Financing and the New Institutional Economics

Ladies and Gentlemen

The paper describes the importance and impact of proper regulation on financing in the developing and developed countries using three examples. The first concerns microfinance in the poor countries. The second describes the importance of good regulation on property rights. The third explains how functional law can contribute to rapid growth in equity trading in a developed country. The paper utilizes the concepts of the New Institutional Economics (NIE).

1. Introduction

Research within NIE emphasizes transaction costs, agency, and property rights, all of which are relevant for regulation of financing activities.

Transaction costs arise because of incomplete information. Communities with weak institutions, as in the poor countries, have fewer possibilities and less confidence in the market, which reduces specialization and prevents economies of scale.

The requirement for economic progress is technology, which can be divided into production technologies and social technologies. One of the principal problems slowing down economic progress in poor countries is their inability to apply the social technologies necessary for progress, such as well organized and secure property rights. The problems of the developing countries are largely caused by improper institutional environments.

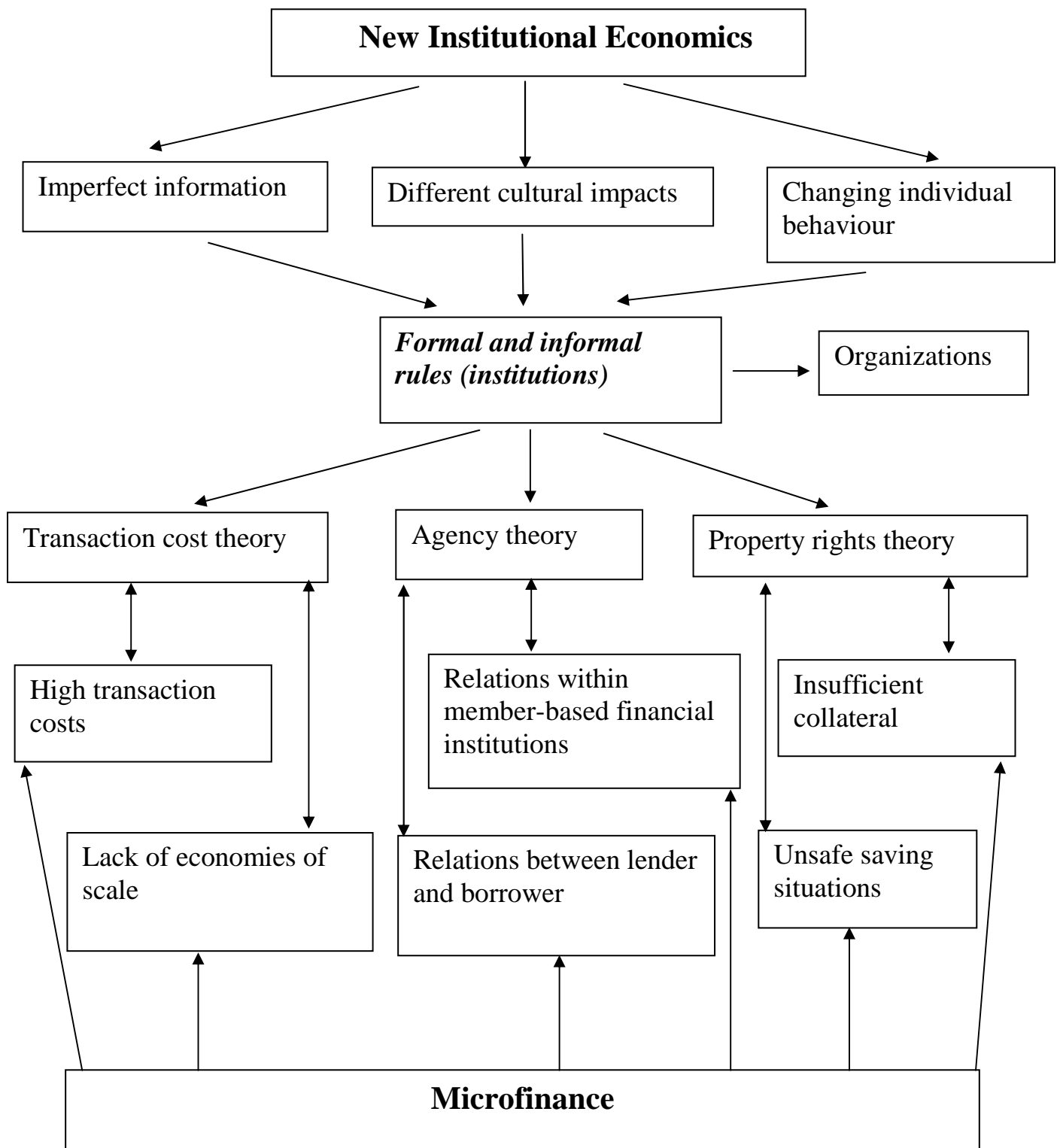


Figure 1: The new institutional economics and microfinance

2. Microfinance Institutions in the Developing Countries

Lending to poor entrepreneurs in the poor countries is characterised by high cost and risk where security is lacking. 80% of the world's population have no access to banking services. The distribution of income among the nations of the world is very unequal; of the six billion people in the world, 1.2 billion exist on less than one dollar a day.

A must for effective lending to entrepreneurs in the poor countries is saving. The poor people are quite capable of saving, but one of the main problems is the lack of a solid infrastructure to secure savings. The most common form of enterprises in the developing countries is the family business. Microfinance is a system of lending to entrepreneurs. Most of the enterprises using microfinance are small and medium sized enterprises (SMEs) and family businesses. Fig. 1 shows the relation between the conceptual framework of NIE and some elements of microfinance.

The Grameen Bank in Bangladesh is a good example that microfinance can give good results because it is adapted to the current environment. The bank is operated as a member-based financial organization.

The Grameen Bank has over two million members; 94% of the borrowers are women, who have proven a three times better credit risk than men. The high proportion of microfinance loans to women as entrepreneurs highlights the importance of this form of lending for women's rights in the developing countries. Increased participation of women in the economy, together with their increased education, is one of the most effective means of bringing about progress in the developing world.

Microfinance in the developing countries is a particularly suitable task for entrepreneurs. Entrepreneurs operate in an environment which is characterised by a shortage of capital, regardless of whether the operation is conducted in the undeveloped or developed countries. The activities of entrepreneurs fall within the category of creative activity. Creative activity is the foundation of the creative industries, which fit well into NIE as a part of the institutions of the economy.

3. The Problems of Property Rights

In many parts of the world, extensive economic activity takes place outside the domestic legal order, and NIE is particularly suitable for analyzing many aspects of such extralegal activities, especially the structure of property rights.

In this context the views of Hernando de Soto regarding to secure titles to property are very interesting. He claims that the primary problem of the developing countries is that assets are not registered and therefore not creditworthy and this is the same problem that the industrial states faced 150-200 years ago. The problem of the poor countries is primarily that they have no possibility of obtaining credit based on assets which are extensive but unregistered.

The difficulty of lending to the poor is due precisely to the lack of security, which in many cases is not that there are no assets to pledge, but that these assets are to a greater or lesser degree unregistered and the title to them is not even clear.

A western entrepreneur will normally obtain capital for his enterprise through loans which are provided through the banking sector. This sums up the difference between the entrepreneur in the developed countries and his counterpart in the developing countries. A western entrepreneur with a project can frequently

obtain a loan, for which he will usually post security, e.g. in the form of his own home or property belonging to his close family. This way is closed to the entrepreneur in the developing countries, even if he owns a piece of real estate, because the property is not registered to his (or anyone else's) name in any proper manner.

The importance of getting a grip on extralegal property rights is clearly exposed by de Soto, who points out that “the recognition and integration of extralegal property rights was a key element in the United States becoming the most important market economy and producer of capital in the world” (de Soto, 2000, p. 148).

The reference to the developments in the United States in the late 19th century and early 20th century is interesting in light of the trends in China in recent decades. China is the most populous country in the world with approximately 1.3 billion inhabitants, and it is the largest economy in the world, with a Gross Domestic Product of USD 6,400 billion in Purchasing Power Parity, following the United States with USD 10,900 billion. Here, property rights are of the greatest importance, particularly in light of the fact that China has a Communist administrative structure while the business environment is a strange blend of market economy and Communist administration, where foreign investments enjoy liberal financing regulation, while financing of domestic parties is subject to completely different rules. The methodology of NIE is particularly suitable for the analysis of this environment, including in the area of financing regulation.

4. Legislation on Stock Exchange Trading in Iceland

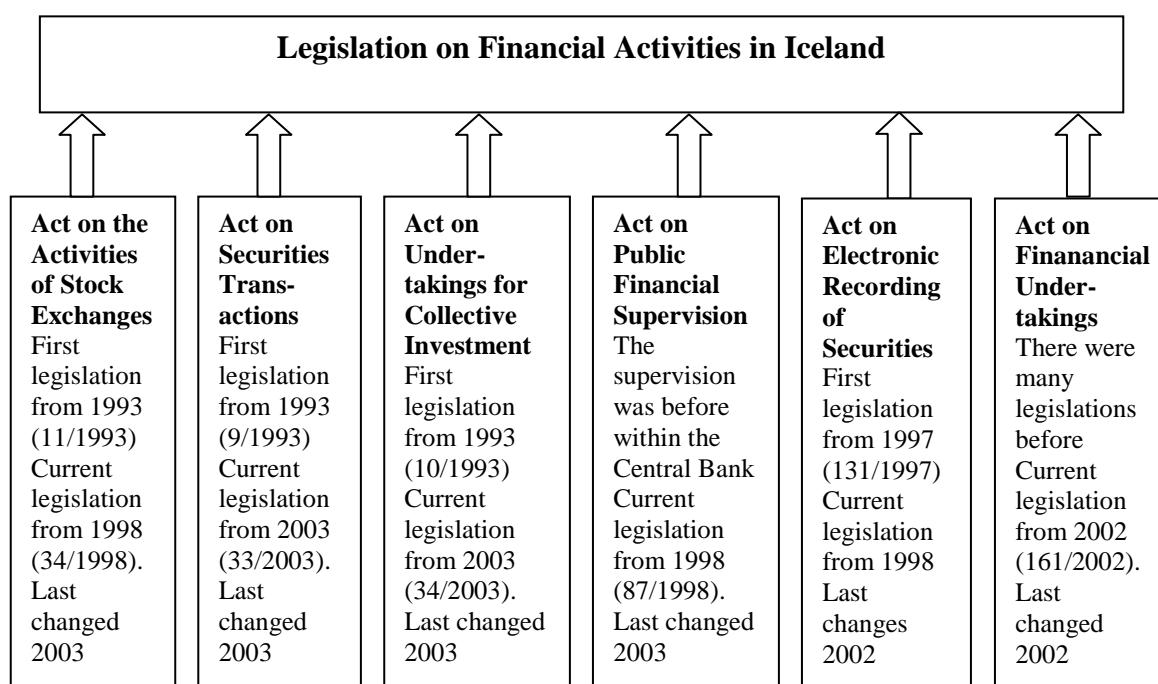


Figure 3: Principal legislation on financial activities in Iceland

Legislation on stock exchange trading in Iceland is a good example of regulations which were implemented by following foreign models. In the process of legislation due account was taken of the existing situation and the economic environment. Over the past 20 years, legislation and procedures in Europe concerning equity trading have converged to become more and more similar in individual countries.

Before 1990, stock trading was relatively rare in Iceland and stocks were not generally regarded as an attractive investment option. There were no rules regarding such transactions. In 1984, the Central Bank of Iceland took the initiative in introducing regulated securities trading in Iceland. The Agreement on the European Economic Area, which entered into force in 1994, provided for the free flow of capital. The first legislation of 1993 took account of the Central Bank rules on securities trading and of legislation in neighbouring states, as well as all provisions which

were binding for Iceland as a result of the membership of the European Economic Area.

The bills resulted in threefold legislation, i.e. an Act on Securities Transactions, an Act on Undertakings for Collective Investment, and an Act on the Iceland Stock Exchange. In addition to these three statutes, the framework for financial activities in Iceland is completed by an Act on the Supervision of Financial Operations, which, until 1999, was in the hands of the Central Bank, and an Act on Electronic Recording of Securities and several other acts on financial undertakings. Icelandic legislation on financial markets still rests on these six pillars which are showed in Figure 3.

Provisions which are unique for Iceland are not prominent in this legislation; on the contrary, Icelandic legislation has been adapted to trends abroad, partly by reference to legislation in the other Nordic Countries and partly by fulfilling the provisions of the Agreement on the European Economic Area.

The ratio of market value and volume to gross domestic production provide a good illustration of the activities of a stock exchange and their development over a longer period of time. In 1991, the market value of listed stocks corresponded to 0.4% of GDP, but by 2003 this ratio had reached 80%. The trading volume as a ratio of GDP rose from nothing in 1991 to 70% in 2003.

5. Conclusion

The success of member-based financial institutions, such as the Grameen Bank in Bangladesh, has demonstrated the importance of good regulation of microfinance for entrepreneurs, particularly for women, small and medium sized enterprises and family businesses. The New Institutional Economics offer numerous possibilities for analyzing the problems of microfinance, such as

the complicated agency relationships between lenders and borrowers. The methodology of the creative industries offers a good tool for analyzing the activities of entrepreneurs in small enterprises, also regarding finance and regulations on financing.

The absence of formal property rights is one of the principal problems of developing countries. One of the most important contributions of NIE to microfinance is the analysis of uncertain property rights.

A regulated stock market has only been in operation in Iceland for slightly more than 14 years. In the last decade of the last century, and the first years of the current century, the economy has been in an upswing at the same time as there has been extensive reform in legislation on stock trading. This upswing, together with the reformed legislation and regulations in financing based on foreign models, is the principal reason for the success in the development of regulated equity trading in Iceland.

Regulations on financing are very important for the developing and developed countries and this importance can be described very well within the concepts of the New Institutional Economics.

Thank you very much

References

- Adams, D.W. (1998). Altruistic or production finance? a donor's dilemma. In Kimenyi, M.S., R.C. Wieland, & J.D. von Pischke (Eds.), *Strategic issues in Microfinance*. Aldershot: Ashgate.
- Barca F. & M. Becht (2001). *The Control of Corporate Europe*. Oxford: Oxford University Press.
- Berglöf E. (1997). Reforming corporate governance: Redirecting the European agenda. *Economic Policy*, 12(24), 91-124.
- Blixen K. (1960). *Skygger paa Græset*. København: Gyldendalske Boghandel
- Burrus W. (2002). Microenterprise Development in the United States. Closing the Gap. *Journal of Microfinance*, 4 (1), 81-98.
- Cabinet bill on public financial supervision* (1998). 122nd legislative session. Document 951/560. Reykjavik: Althingi.
- Clague, C. (1997). Institutions and Economic Performance: Property Rights and Contract Enforcement. In Clague, C. (Ed.). *Institutions and Economic Development*. Baltimore: The John Hopkins University Press.
- Copisarow, R. (2000). The Application of Microcredit Technology to the UK: Key Commercial and Policy Issues. *Journal of Microfinance*, 2 (1), 13-41.
- Csikszentimihalyi, M. (1999). "Implications of a Systems Perspective for the Study of Creativity," in *Handbook of Creativity*, R.J. Sternberg, ed., New York:: Cambridge University Press.
- De Soto, H. (2000). *The Mystery of Capital. Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York: Basic Books.
- Douma S. & H. Schreuder (2002). *Economic Approaches to Organizations*. (3rd ed.). Harlow: Pearson Education.
- Eggertsson T. (2002). Social Technologies and Progress (Icelandic). In Eggertsson (Ed.). *Taekninnar ovissi vegur*. Reykjavik: University of Iceland.
- Eggertsson, T. (1990). *Economic Behavior and Institutions*. Cambridge: Cambridge University Press.
- Eggertsson, T. (1996). A note on the economics of institutions. In Alston, L.J., T. Eggertsson, & D.C. North, (Eds.). *Empirical Studies in Institutional Change*. Cambridge: Cambridge University Press.
- Einarsson, A. (2001). *Logistics in the Future - Lessons from the Past* (2001). The 13th NOFOMA Conference. Reykjavik: Nofoma.
- Flôres R.G. & A. Szafarz (1997). Testing the Information Structure of Eastern European Markets: The Warsaw Stock Exchange. *Economics of Planning*, 30(2-3), 91-105.
- Gelos, R.G. & A.M. Werner (2002). Financial liberalization, credit constraints, and collateral investment in the Mexican manufacturing sector. *Journal of Development Economics*, 67 (1), 1-27.
- Getubig, M., D. Gibbons, & J. Remenyi (2000). Financing a Revolution: An Overview of the Microfinance Challenge in Asia-Pacific: In Remenyi, J. & B. Quiñones (Eds.). *Microfinance and Poverty Alleviation. Case Studies form Asia and the Pacific*. London: Pinter.
- ICEX Indices*. Iceland Stock Exchange. Retrieved February 28, 2004, from www.icex.is
- Johnson, S. & B. Rogaly (1997). *Microfinance and Poverty Reduction*. Oxford: Oxfam.
- Khandker, S.R. (1998). *Fighting Poverty with Microcredit. Experience in Bangladesh*. Oxford: Oxford University Press.
- La Porta R., F. Lopez de Silanes, R. Shleifer, & R.W. Vishny (1998). Law and Finance. *The Journal of Political Economy*, 106(6), 1113-1155.

- Mitura-Zalewska A. & S.G. Hall (2000). Do Market Participants Learn? The Case of the Budapest Stock Exchange. *Economics and Planning*, 3(1-2), 3-18.
- Morduch, J. (1998). *The Microfinance Schism*. Development Discussion Paper No. 626. Harvard Institute for International Development. Cambridge: Harvard University.
- North, D.C. (1990). *Institutions, Institutional Change and Economics Performance*. Cambridge: Cambridge University Press.
- Report of the Economic and Trade Committee* (1992). 116th legislative session. Document 393/13. Reykjavik: Althingi.
- Richter R. & E.G. Furubotn, (1999). *Neue Institutionenökonomik*. 2. Auflage. Tübingen: Mohr Siebeck.
- Robinson, M.S. (1998). Microfinance: the paradigm shift from credit delivery to sustainable financial interrelation. In Kimenyi, M.S., R.C. Wieland, & J.D. von Pischke, (Eds.). *Strategic issues in Microfinance*. Aldershot: Ashgate.
- Rosenzweig, M.R. (1998). Risk, Implicit Contacts and the Family in Rural Areas of Low Income Countries. *The Economic Journal*, 98 (4), 1148-1170.
- Toye, J. (1995). The New Institutional Economics and its Implications for Development Theory. In Harris, J., J. Hunter, & C.M. Lewis, (Eds.). *The New Institutional Economics and Third World Development*. London: Routledge.
- United Nations (2000). *United Nations point to agriculture as escape from 'poverty trap'*. Press Release DEW/2260, PI/1296. New York: United Nations.
- Williamson O.E. (1985). *The Economics Institutions of Capitalism*. New York: Free Press.
- Winter-Nelson, A. & A. Temu, (2002). Institutional Adjustment and Transaction Costs: Product and Markets in the Tanzanian Coffee System. *World Development*, 30 (4), 561-574.
- World Bank (2001). *World Development Indicators 2001*. Washington: World Bank.
- World Bank (2002). *World Development Indicators 2002*. Retrieved March 3, 2004, from <http://www.worldbank.org/data/wdi2002/tables/table1-1.pdf>
- World Bank (2004). Data and Statistics. Washington. Retrieved April 11, 2004, from http://www.worldbank.org/data/databytopic/GDP_PPP.pdf