The Review of Austrian Economics, 16:2/3, 231–251, 2003.

The Dynamics of the Institutional Change and the Market Economy: Understanding Contemporaneous Market Development Processes

PHILIPPE DULBECCO Philippe.Dulbecco@u-clermont1.fr
CERDI—University of Auvergne, 65 Bd. François Mitterrand, 63000 Clermont Ferrand

Abstract. The Austrian theory of institutions shows the particularity of being tied into a market process analysis. If such a specificity gave rise to a great number of analytical as well as methodological or epistemological contributions, its empirical dimension has been neglected to the benefit of the so-called Institutional works. The aim of my contribution is to come back to this untapped potential in order to exhibit the operational nature of Austrian analyses of institutions, particularly those of Lachmann. The objective here is to establish, through an appropriate temporal articulation of different institutions, the conditions for a harmonious development of market processes. I particularly show the great benefit of such a framework in order to, on one side, offer some explanations of the recent financial crisis faced by the emerging economies, and on the other side, to understand the specificity as well as the coherence of the Chinese economic transition.

Key Words: markets and institutions, institutional change, transition economies, financial crisis

JEL classification: B53; P11; O10.

Introduction

The Austrian theory of institutions shows the particularity of being tied into a market process analysis. Since institutions are used to explain the transmission of information and knowledge, which is integrated in the formation and revision of plans, they represent the 'key link' that makes it possible to complete the reasoning chain of the Austrian theory about market processes (O'Driscoll and Rizzo 1996).

If such a specificity gave rise to a great number of analytical as well as methodological or epistemological contributions, its empirical dimension has been neglected to the benefit of the so-called Institutional works. This statement is particularly injurious as the Austrian approach of institutions, being rooted into a general theory of market processes, has *a priori* an aptitude to propound an institutional change analysis of (towards) market economies.

The aim of my contribution is to come back to this untapped potential in order to exhibit the operational nature of the Austrian analyses of institutions, particularly those of Lachmann (1970, 1976–1978, 1986, 1994). The first section briefly discuss the main features of the Austrian analysis of the market process with the aim of highlighting the necessary irruption of the institutional component. The second section aims at exhibiting particularities of the Lachmannian analysis in institutional change. The third section proposes to use this Lachmannian analytical framework to interpret contemporary transformations of market

economies. I particularly show the great benefit of such a framework in order to, on one side, offer some explanations of the recent financial crisis faced by emerging economies, and on the other side, to understand the specificity as well as the coherence of the Chinese economic transition.

1. Information, Knowledge and the Co-ordination of Individual Plans: Institutions as Points of Orientation

Presenting the intent of his 1986's book, *The Market as an Economic Process*, Lachmann explains: "The central idea of this book is the market regarded as an economic process, that is, an ongoing process, impelled by the diversity of aims and resources and the divergence of expectations, ever changing in a world of unexpected change" (1986:x). My purpose here is to come back to the main features of this very particular conception of the market regarded as a process to highlight the role played by the institutional variable.[1]

1.1. The Processual Nature of Economic Phenomena

The first feature relates to the dismissal of the atemporal equilibrium notion.[2] Such dismissal represents, as everyone knows, one of the most obvious features of Austrian economics. By rejecting the concept of atemporal equilibrium, the Austrian school rejects the possibility of an objective knowledge of economic phenomena. Outcomes of the market system running cannot be objectively known, the adjustment process being likely to take on various forms which reflect modes of interaction between individual plans. Markets are then best regarded as processes.

The concept of process consists of two distinct elements (Ioannides 1992): (1) the principle of endogeneity which states that all economic processes are endogenously mobilised, and (2) time, underlining the fact that 'the sequence of events becomes an issue of fundamental importance, as each event really constitutes the cause of the one succeeding it' (*ibid*.:9). Finally 'the outcomes of market depend on what happens at their various stages and on the order in which events happen. This means in particular that antecedents will influence subsequent events *in so far as acting men attribute significance to them* and that therefore the order in which events happen matters' (Lachmann 1986:4).

However, the rejection of the state of equilibrium doesn't necessarily mean the rejection of the concept of equilibrium itself. First of all, because the idea of an individual equilibrium, which implies that all aspects of an individual plan are compatible with each other, is assumed, in the Austrian tradition, to hold *a priori,* even if the maintenance of such equilibrium over time requires that the data generated by the economy does not disrupt agent's expectations. Second, because the traditional Austrian theory of market processes[3] does not rule out the idea of a trend towards a market equilibrium. On the contrary, there exists between Lachmann's view of fundamental indeterminateness of the market process and Mises's belief in the *a priori* nature of the tendency toward equilibrium, a wide range of positions, which are not really inconsistent with the notion of equilibrium. The Hayekian and the Kirznerian stands are, in this point of view, representative of the place and the role assigned by this traditional Austrian theory to the notion of equilibrium. Whereas, for

Hayek (1937), the degree of indeterminateness of the market equilibrium viewed as the outcome of the interaction of several minds functioning independently from each other, is removed by the empirical convergence of expectations, the entrepreneur is the one who, according to Kirzner (1973, 1979, 1985, 1992), acts as the stabilising force and leads to the adjustment of the market process towards equilibrium, by discovering and cancelling market errors, that is by exploiting profit opportunities.

Nowadays, the idea of a trend towards equilibrium is however widely criticised within the Austrian family itself (O'Driscoll and Rizzo 1996, Boettke, Horwitz, and Prychitko 1994).[4] The important point here is that the recognition of the importance of disequilibrating forces goes together with another feature of modern Austrian economics, that is with a greater attention given to prerequisites for equilibrating behaviour. As soon as the disequilibrating tendencies in markets are not simply changes result in the exogenous data, but arise from the source of equilibrating behaviour (the indeterminate response to perceived profit opportunities), it becomes necessary to discover co-operating conditions that are needed to make equilibration more or less likely (O'Driscoll and Rizzo 1996:xxi). In other words, the problem is to determine the *ordering principles* which produce mutually reinforcing sets of expectations without denying that some expectations will be wrong (Boettke, Horwitz, and Prychitko 1994).[5] Such ordering principles will assume different forms in different markets, depending on what Lachmann (1986) calls the *proximity of agents* and their range of action.

The concept of *pattern co-ordination* proposed by O'Driscoll and Rizzo (1996) makes it possible to incorporate this dynamic character of the notion of market process, thus providing a solution to the problem of identifying ordering principles. Based on the distinction between *typical* and *unique* events,[6] the pattern co-ordination analysis indicates that if the market is able to co-ordinate typical events and consequently to stabilise the economy, it is no more the case when unique characteristics of human actions are taken into account. Indeed, in this last case, the market process becomes entirely indeterminate and the co-ordination of plans needs alternative co-ordination mechanisms. It is here important to notice that this analysis is general, insofar as it can deal with numerous Austrian approaches of market process, the convergence towards equilibrium is a very particular occurrence in which identical events are repeated period after period.

Market processes cannot then be understood, from an Austrian perspective, with an atemporal equilibrium analytical apparatus. The meaning of equilibrium is a question of ordering principle and pattern of co-ordination, both of which harmonise and secure agents' expectations. In other words, equilibrium does not primarily depend on prices, but on expectations, information systems, and the interpretative frameworks which are used by economic agents (Loasby 1991).

1.2. The Creative Character of Human Action

A second important feature of the Austrian approach regarding the analysis of operation of markets lies in the fact that it takes into account the active behaviour of economic agents. This point is related to the recognition of the ignorance and uncertainty faced by market agents as well as to the essential complexity of the market.

The conception of the market as a system in constant flux where the flow of information is the moving force of economic activity assumes that ignorance and uncertainty will surround most market decisions. The Austrian School's method of incorporating ignorance, uncertainty, and expectations into economic theory has been to stress the entrepreneurial element in human consciousness. Entrepreneurship theory indeed offers an answer to two important questions raised by the analysis of market processes (Ioannides 1992): (1) the question of describing motives that mobilise the use of knowledge, and (2) the question of the (exact) way this behaviour is expressed in the market process. More precisely, it is possible to distinguish two types of answers which refer to two types of active behaviours, each one referring to the distinction previously pointed out between equilibrium market processes and indeterminate market processes (Boettke, Horwitz, and Prychitko 1994).

The first type of behaviour is more particularly associated with Kirzner's work (1973, 1979, 1985, 1992). Indeed as it is well known, Kirzner defends the idea that the market economy opens up *arbitrage* possibilities because of the ignorance of individuals: finding a good that sells for different prices in the market is the most obvious example, but Kirzner believes that the *discovery* of factors of production that can be transformed into consumer goods can also be considered as an arbitrage if factor prices are lower than the price of the consumer good. The essence of the entrepreneurial behaviour is thus the discovery of profit opportunities. However it is important to notice that if such an entrepreneurial activity is a product of market disequilibrium, its character is, by definition, equilibrating when taking advantage of a profit opportunity is equivalent to cancel it. The *discovery-arbitrage* behaviour represents a force that constantly pushes the market toward equilibrium.

This first kind of active behaviour is however considered as too poor, that is too mechanical, by the Austrian analyses which would rather adopt a Lachmannian reasoning.[7] Boettke, Horwitz, and Prychitko thus explain that: 'Austrians have traditionally postulated a world of Robbinsian maximisers, and allowed the entrepreneur to seek arbitrage opportunities which equilibrate the market. Such an entrepreneur only needs exercise alertness to profit opportunities. But entrepreneurship is also characterised by *judgements* about imagined future opportunities' (1994:65). The problem is hence to focus on the Lachmannian *creative* dimension of entrepreneurial behaviour: the creative agent builds plans upon her imagination of the future whereas the discoverer elaborates plans exclusively on the basis of the knowledge at her disposal (Gloria 1996:8). However, when the role of judgement is added to alertness, expectations are granted full force and the satisfaction of some individuals' expectations can come only at the expense of the disappointment of others (Lachmann 1986). The consequence of this is that the market is now described as a process characterised by unexpected change and inconsistency of plans, incompatible with a systematic tendency toward equilibrium.

It now seems obvious that the Austrian analyses contributed to rehabilitate individuals behaviours related to the coordination issue; economics is a praxeologic science, as Ludwig von Mises would state.[8] The agent is seen as a true actor (Langlois 1986) with an active and creative behaviour turned toward an uncertain, unpredictable and widely indeterminate future. This aptitude which stems from an extension of individualism to subjectivism carries out a behavioural analysis dealing with learning, adapting and acquiring the knowledge needed to face the complexity and uncertainty linked to economic action.

This last comment introduces the key role played by institutions with the aim of articulating the main elements of a market processes analysis which takes place in the economics of time and ignorance (O'Driscoll and Rizzo 1996). Indeed, when the future is unpredictable, the expectations divergent and the discoordination forces as strong as those of co-ordination, social institutions may enter the picture in order to align expectations and by so doing, they become part of a theory of plans co-ordination.

1.3. The Necessary Irruption of the Institutional Component

It is unanimously recognised that institutions are, in an Austrian approach, of great influence to explain the market process.[9] In this respect, Lachmann's argument is representative:

> "It would be wrong to think that a market economy, when faced with the problems just outlined, could, or in the ordinary course of events would, find no answer to them. History shows that whenever left sufficiently free from political interference to evolve its response to such challenges, the market economy has 'grown' the institutions necessary to deal with them" (Lachmann 1978:67).

The whole set of formulating concepts used to deal with social institutions, relies basically on the notion of *rule-following behaviour* (Langlois 1993:166): institutions are roughly regularities of behaviour understandable in terms of rules, norms and routines (Nelson and Winter 1982). According to Schotter, the definition of a social institution can be drawn from an Austrian perspective as 'a regularity in social behaviour that is agreed to by all members of society, specifies behaviour in specific recurrent situations and is either self-policed or policed by some external authority' (1981:11). Institutions are means by which agents are able to gather sufficient information in order to co-operate. In a word, institutions save knowledge and information[10] (Lachmann 1970). Institutions then consist of general or enduring pieces of knowledge (O'Driscoll and Rizzo 1996:xxii) which provide 'points of orientation' likely to make actions and expectations relatively compatible (Lachmann 1970).[11] Any practice that allows individual goals to be reached spreads until it becomes an institution.

The peculiar status granted to the institution within the Austrian framework seems clearer now: since institutions are used to explain the transmission of information and knowledge, which is integrated in the formation and revision of plans, they represent the 'key link' that makes it possible to complete the reasoning chain of the Austrian theory about market processes. O'Driscoll and Rizzo indeed indicate that:

> "Rules provide, as it were, safe bounds for behaviour in a relatively unbounded world. Institutions are the social crystallisation of rule-following behaviour or, in other words, the overall pattern of many individuals following a similar rule (...). Thus, the circle is closed. Time and genuine uncertainty promote the following of rules and the development of institutions. The latter, in turn, serve to reduce, but not eliminate, the unboundness of the economic system by providing the stable patterns of interaction" (1996:6).

Of course, the overall demonstration supposes that the knowledge spread by institutions is stabilising (in the sense that it constantly reaffirms the stability of the social framework) whereas the one dispersed by the price system is of a dynamic nature (in the sense that it leads individuals to a continuous revision of their plans) (Hayek 1945).

An endogenous explanation about institutions dynamics is however required in order to loop the loop. Indeed, if institutions act as signposts in a world of uncertainty, we need then a theory of plan co-ordination, which integrates the fact that, not only do social institutions serve to align expectations, they may also deal successfully with the forces of change. It would otherwise be difficult to concede that the institutional element achieving completion of the analysis of the dynamic functioning of market processes will be the only one outside these dynamics. It is then a matter of assessing the Austrian representation in relation to its capacity for producing an analysis of the institutions evolution within a market economy.

2. Market Process and Institutional Change: The Permanency versus Flexibility Dilemma

Such analysis must allow solving three types of problems (Lachmann 1970:51–52). Firstly, there is the problem of institutional change and how to reconcile the idea of an institutional change with that of an institution as a 'point of orientation', which assumes its fixity. Secondly, the issue of the institutional order and its unity is formulated: if the complementarity of institutions builds the institutional order of a society, the purpose is then to identify integration forces as well as circumstances under which these forces cease to work. Finally, there is the question of new institutions rise, that is to underline the requirements needed for new institutions to fit into the existing structure. Solving these three kinds of problems comes down to provide a solution to what we have agreed to call the permanency-flexibility dilemma: 'If institutions are to remove uncertainty, they must be permanent. But if they are to be shaped by market forces they must be flexible. How, within the institutional order of modern market society, is this problem resolved?' (Lachmann 1994:50).

The analysis of change is an essential aspect of Hayek's approach to institutions. Such an approach holds in the idea mentioned above which implies that institutions embody efficient adaptation modes according to the environment. This means that institutions with inferior survival properties are removed by means of a selection mechanism. Besides the fact that in Hayek's analysis an imprecision is found through the definition of the selection criterion (Garrouste 1994), as well as through the explanation of those survival properties (O'Driscoll and Rizzo 1996:40), such discussion of institutions dynamics cannot hold if the existing complementarity[12] of institutions within an institutional order (Lachmann 1970) is taken into consideration. The routine courses of action that comprise institutions are indeed not all independent. Some truly inferior routines must be maintained in order to permit the existence of those which are actually superior: 'The implication of these considerations is that, in the absence of a clear conception of the nature of survival properties, we cannot know whether any given institution or course of action is the most adaptative' (O'Driscoll and Rizzo 1996:40).

Lachmann's interpretation of institutions dynamics holds a distinctive place within the Austrian approach. Besides the fact that it claims to go back to a logic much more rooted

in a Weberian discourse than in a Mengerian one, its main purpose consists in drawing the conditions for the attainment of both *coherence* and *permanence* of the institutional order, that is to deal with the accurate issue of complementarity.[13]

The overall demonstration is based on the distinction made by the author between 'legal norms' or 'designed institutions' which are 'the products of legislation and other manifestations of the "social will"' (Lachmann 1970:69) and the 'recurrent patterns of conduct which we call institutions' (*ibid.*:75) or 'undesigned institutions'.[14] But by following Lachmann's logic, if, on the one hand, all institutions do not take on the same status and function,[15] they share, on the other hand, the flexibility property linked to the permanency of the whole.

The matter that now arises is how to make institutional change and structural permanence compatible, since it is not so much the change *per se* which brings up problems here but rather unexpected change.[16] A much more harmful outcome from the occurrence of this kind of unpredictable change concerns the relationship between designed and undesigned institutions. Indeed, as institutions can only be indeed designed to face specific well-known situations 'the unexpected change of undesigned institutions may not merely jeopardise the coherence of the institutional structure as a whole, but in addition may obviate the very design of the designed institutions' (*ibid.*:80).

The solution put forward by Lachmann in order to cope with this last kind of problem consists in setting up designed institutions which allow to integrate change without altering the institutional structure as a whole. The notion of *interstices* within the legal order represents here a key component for the institutional dynamics: 'the undesigned institutions which evolve gradually as the unintended and unforeseeable result of the pursuit of individual interests accumulate in the *interstices* of the legal order' (*ibid.*:81). The function of those interstices is actually to lead to the accumulation of sediments coming from the evolution of undesigned institutions so that the coherence of the whole remains. Hence, according to Lachmann, if a society is fundamentally made of two types of institutions, the *external* ones which constitute the outer framework of the society and the internal ones, which gradually evolve as a result of market processes, institutional dynamics however arise from the specificity of those interstices, shared by both kind of institutions.

Such understanding of institutional dynamics therefore requires various comments.[17] The proposed pattern stems from the assumption that only undesigned institutions evolve. But it is important to notice that designed institutions also change. The analysis of the institutional dynamics then requires to consider two emerging issues: the first one is related to the structural change of designed institutions and the second is linked to the relationship existing between changes in the legal order and the evolution of undesigned institutions. In other respects, it is possible that the coherence and permanence of the current social order would be jeopardised even without change in the legal system. It is particularly the case when the slow evolution of institutions extends beyond interstices of an existing social and legal order, leading to what Lachmann has called as 'deformation of social space' (*ibid.*:83).

It is this type of problem, which has substantial implications in formulating an overall representation of institutional change dynamics that one meets when studying development mechanisms of market economies.

3. The Institutions and the Development of the Market

The point here is to insist on one of the most important implications of the processual market concept which is the one related to the complementary nature of the different co-ordination forms. Indeed, if the analytical framework presented above permits us to take into account such a complementarity, an empirical investigation should offer the opportunity to demonstrate that this relationship represents a key element in the development process of any market economy. This is, in any case, what we have demonstrated through an analysis of the institutional dimension of the financial crisis in emerging economies, as well as through an examination of the role played by decentralisation in the adoption of market mechanisms in China.

3.1. Financial Liberalisation and Stability of the Financial System in Emerging Markets: The Institutional Dimension of Financial Crises[18]

Since the late 80s, emerging economies[19] have begun a process of financial liberalisation, which is reminiscent of that experienced by a number of industrialised countries since the end of the 70s. However the process of financial liberalisation in emerging markets takes place in a context of significant growth in the number of banking crises.[20] In this perspective, it is possible to interpret the instability associated with employed reforms since the end of the 80s, in terms of an alternative between liberalisation excess and insufficiency. Such interpretation leads to call into question, if not the principle, then the rhythm or intensity of the financial liberalisation. Our analysis is different. We develop the idea that the answer to financial instability must be sought in institutional dynamics. This involves to go beyond the intermediation/market opposition, in which emerging economies would use advantages of an intermediated system to reinforce the market process.

The Complementary Nature of the Relationship Intermediation-Market. Empirical works relative to banking crises identifies channels of transmission, through which financial liberalisation may exert an influence on banking stability. Firstly, and conforming to the effects anticipated by financial repression theories (McKinnon 1973), interest rate deregulation seems to go together with an increase in the level of interest rates.[21] Secondly, financial liberalisation is accompanied by the opening of the financial system. For banks, the opening of the financial system has the effect of offering the possibility of raising funds in foreign stock markets: it is the *currency mismatch* phenomenon, in which credits granted are secured with short term currency commitments. This phenomenon is a weakening factor in the case of capital outflows.[22] Thirdly, the deregulation of bank loans leads to a rapid rise in the number of commercial bank loans granted to the private sector. If we accept the idea that commercial banks behave under conditions of moral hazard, we must consider that they demonstrate exaggerated optimism regarding future growth, and thus extend credit beyond its optimal level.[23]

The consideration of all precedent elements leads authors such as McKinnon and Pill (1998) to highlight inadequacies of the Washington Consensus (1996), which makes economic liberalisation the indispensable condition of the world growth. Indeed, according to

the authors, the liberalisation process underlying this consensus, underestimates the need to invest in the institutional infrastructure before introducing financial reforms.[24]

If we now agree to revalue the institutional dimension in the explanation of emerging countries' financial crises, we must still make use of an analytical structure in order to understand why financial institutions are a necessary complement to markets. The latter only being imperfect substitutes to financial institutions. The analysis of market processes dynamics presented above, centred on the complementarity between institutions and markets, should permit us to study conditions in which new institutions are likely to become successfully part of the existing institution structure, turning to good account the coexistence of intermediation and the market.

In the field of financial system, financial intermediaries are institutions which reduce uncertainty. The consequent production of stability can be appreciated on two levels.

First, financial intermediaries in charge of selecting and monitoring investment projects appear to produce information under information asymmetry. The important point is that, with respect to the market relation, the existence of repeated contracts between the lending financial intermediaries and borrowing agents makes it possible to accumulate knowledge which can be used across the whole economic system. Indeed, the length of the relationship makes the agents' informational environment more dense, and leads them to behave differently from in a situation where relationships would have no memory. Thus, in an environment marked by incomplete contracts, the long-term relationship implies the implementation of state-dependant payment contracts. Two significant implications for our argument derive from this: (i) enforcement mechanisms must be implemented to avoid opportunist behaviors; (ii) a system of rules must be drawn up, in order to establish a common knowledge, which controls and defines agents' behavior.

Second, complementarity between market and intermediation may be viewed differently: through the creation of liquidity. Indeed, this creation of liquidity occurs on two different levels, depending on whether it is a question of market intermediation or balance sheet intermediation. On one hand, intermediary's contribution is a service rendered on the market for a financial asset. For example, the intermediary may bring the buyer and the seller together in a brokerage contract. It may simply perform intermediation when it is paid by percentage when it performs a floatation for its client, or when it buys for its own account to resell, behaving as the counterpart, going to the point of displaying a buying and selling price, as a securities trader which is remunerated by a *spread*. In all cases, the intermediary mediates at the level of asset negotiation, of which it increases market liquidity. This function is described as a market intermediation. On the other hand, the intermediary's contribution has a very different nature, insofar as it transforms characteristics of financial assets. We are thus in the presence of two financial assets at the same time. This transformation, which may only be understood through the analysis of the intermediary's balance sheet, is called balance sheet intermediation. When it buys a certain type of assets, it will keep as a balance sheet asset (where they are, the counterpart of all other types of assets which it issues enlisted as liabilities on its balance sheet), rather than resell, the intermediary transforms risk and terms in a general way. By doing so, it produces availability and/or security (risk reduction).

A successful financial liberalization process must take into account this complementarity between institutions—and more precisely financial intermediaries— and market. The problem becomes then the analysis of the institutional order evolution over time.

Financial Liberalisation and Intermediation: The Dilemma of Emerging Economies. In an evolutionary perspective, processes of liberalisation may be understood as a special step in the development of a market economy, i.e. that of emergence within an old system. The relevant question is more how markets develop and evolve over time, rather than the conditions required for a successful adoption of the market mechanism. The institutional dimension has a critical role to play in this perspective. The idea is that the institutional structure, which prevails at a given moment in an economy, may encourage or hinder the liberalisation process, according to its capacity to integrate new elements.

Indeed, all economies which have chosen a process of liberalisation, face the problem of institutional change. It is thus necessary to render compatible the idea of institutional change with that of the institution, understood as a permanent orientation point. Although this problem is not specific to emerging economies, it is posed for them in very particular terms. There is an asymmetry between abandoning —rapidly destroying— previous institutions, and adopting —slowly constructing— new ones. Consequence is that individuals incur the risk of confronting, sometimes over long periods, with the lack of rules that enable them to co-ordinate their plans efficiently. Then, the adoption of market mechanisms shows a deterioration in their positions.

Furthermore, one must take into account the fact that the adoption —the transfer—, just like the creation of new institutions, is subject to delays: delays of implementation in the first case, and delays of construction in the second. Yet, the amount of economic change possible per unit of time is always limited, because agents have limited learning capacities. And once again, this constraint is bigger in emerging economies. Let us consider for example the adoption —the transfer— of market institutions. If it is always possible, in theory and in practise, to imagine a situation in which an economic or political authority decides to implement market institutions—for example through a process of financial liberalisation—benefits expected from this type of measure are a controversial issue. Indeed, inasmuch as such a policy is, by definition, limited to designed institutions, its success depends on the capacity of these new elements to meet the demand for change in institutions not yet designed. The difficulty comes from the fact that, if the transformation of designed institutions is in general both radical and fast, that of undesigned institutions is of an incremental nature, and is necessarily subject to path dependence constraints. The reason is that, apart from the fact that individuals only accept to subject themselves to changes in the rules of the game when they find an interest, individual behaviour is the result of a cumulative process of collective learning, which often started generations before.

Finally, arises the question of institutional order, and of its unity: if institutional order is the product of the complementarity of institutions, what are integrating forces of institutions, and under which circumstances are these forces over? The analysis of the process of liberalisation requires to specify the conditions of the institutional order coherence, because system's components evolve at different speeds. The main implication is that the transfer

of western economies' formal economic rules towards the emerging economies does in no way constitute a sufficient condition for achieving a good economic performance.[25]

The solution to this problem is also the solution to what we call the permanency-flexibility dilemma faced by emerging economies.[26] I've explained that the solution proposed by Lachmann to solve this type of problem consists to implement designed institutions, which are likely to integrate the change without it affecting the institutional structure of the entirety. The particular status of financial intermediation in emerging markets then appears: the financial intermediary, the commercial bank, represents indeed the main legal — designed— institution, which authorises development of the contractual sphere —market development— whilst guaranteeing coherence and permanence in the institutional order, necessary for the carrying out of individual transactions.

By focusing on institutional stakes of financial liberalisation, we have four main types of answers, aimed at taking into account a new financial context, marked by liberalisation and banking instability. The first response consists of underlining the need for accelerating liberalisation in the banking sector, notably by favouring the penetration of foreign operators, in order to increase competition and allow transfers of know-how (Goldstein and Turner 1996). Secondly, international institutions also consider that the appropriate way to ensure stable financial liberalisation is to increase the transparency of financial operations, improve *corporate governance* in emerging economies, and to ensure adequate banking supervision (Group of Ten 1996; IMF 1997). Thirdly, McKinnon (1991) and Johnston (1997, 1998) put forward what is called the sequential approach in financial liberalisation: financial liberalisation must be part of a programme of macroeconomic and microeconomic structural reforms. Finally, from a different view point, Singh (1998) and Chang, Park, and Yoo (1998) estimate that financial liberalisation in Asia led to destructive competition and over-investment in companies, by removing the co-ordination methods used by governments in economic decisions.

These different responses seem to omit an essential aspect of the changes which affect emerging markets: institutional change underlying the process of financial liberalisation. This raises the question of the resilience of financial systems in emerging economies, i.e. of their capacity to change structurally while preserving their basic properties. Yet, in emerging economies, where asymmetric information is plenty, the question faced by authorities is how to maintain an intermediated system compatible with growth in the market process. But, as is underlined by Stiglitz (1998c), building robust financial systems is a long and difficult process. Thus, beyond the debate concerning the validity of liberalisation, it is the financial system's institutional architecture, based on the pre-eminence of financial intermediation, which is called into question in emerging markets.

Lessons drawn from the Asian crisis, but also from the behavior of numerous banks in Latin American countries, lead us to stress this following point: any reform concerning the banking behavior faces an important challenge. It is to find the appropriate tradeoff between a strong financial constraint—which could slow down the investment—and a soft financial constraint—leading to an inefficient resources allocation. In other words, promoting banking reforms, whose the main objective is to bring banking practices in emerging economies to converge towards practices adopted in numerous mature markets, is not necessarily the most efficient way to favor economic growth. Interpersonal relationships are less prominent in

developed countries because of the presence of liquid financial markets with a strong legal rules and contracts enforcement mechanisms.

Despite this positive value of the relationship banking, numerous authorities in emerging markets after the crisis implemented reforms in which the role of banks is reduced in order to promote the financial markets. South Korea is a striking example from this viewpoint.[27] If the role of state limited banks capacity to monitor and credibly threat non financial firms, it does not imply that the relationship banking system is inefficient per se. The main response of Korean government has not been to implement a reform in which banks could stay at the heart of the system but effectively monitor non financial firms. To the contrary, the government followed advises of International Financial Institutions and introduced principles of corporate governance originated from the Western experience. It seems to us that such strategy could be dangerous because it could destabilize basic properties of the financial system. Recall that in numerous emerging economies, and particularly in South Korea, banks are the main institution which allows the development of the contractual sphere. A better strategy will be to promote a strong banking system as in Japan where the main bank disciplines non financial firms because control rights shifts from firm's internal management to the main bank when the financial state of a firm falls below a threshold level.

It is in a very close perspective, that is by using the same analytical framework, that we proposed to characterise dynamics of the institutional change at work in the transition of the Chinese economy.

3.2. The Institutional Change and the Transition Towards a Market Economy: The Role of Decentralisation in Chinese Economic Reforms[28]

The Chinese reform is so particular that one sometimes speaks of the Chinese model of reform. This specificity has been explained by numerous analyses which insist on the smooth view of the reforms as opposed to the big bang approach (shock therapy). In this way, authors like Perkins (1994) or Liew (1995) use different arguments to discuss the *gradualism* thesis: whereas for the former, gradualism reveals all the obstacles that stand between the partially reformed Chinese economy of the early 1990s and a full market system, the latter considers that gradualism, on the contrary, is associated with a strong central state who alone is able to provide conditions favourable to reform. In a very narrow perspective Sing (1993) defends the idea of a *step by step* approach to Chinese reform, based on the notion of an optimal combination of market mechanisms and planning. Still in the same line of thought, Jin and Haynes (1997) use a *dualist and leading sectoral* approach to explain that China has used some leading sectors in order to help the emergence of new elements of the market economy while continuing to exploit the basic components of the old system, the whole contributing to the maintenance of a relative stability of the economic and social framework.[29] Finally Fan (1994, 1996) characterises the Chinese model of reforms as a *dual-track* transition model, which underlines the rapid development of a new system alongside the old one, the latter being momentarily preserved from any fundamental reforms.

Although such analyses help to characterise the Chinese model, they do not specifically take into account the institutional element of reforms. However the transition dynamics

cannot be analysed by reference to market criteria only; transition is, above all, a change in institutions. Every transition economy faces thus the problem of creating a new institutional framework which associates the co-ordination of activities by the market with the preservation of a centralised mechanism of resource allocation. We explained that, in China, this role is played by decentralisation. Indeed we demonstrated that Chinese economic reforms, of which the main institutional vector is decentralisation, show the particularity of reconciling, within one single logic, the permanency of a well-established institutional order required for the co-ordination of individual plans, and the flexibility of institutions necessary for the move towards the market.

Institutional Change and Economic Reforms in Transition Economies. In any explanation of economic development as well as of the differential performance of economies through time, the importance played by institutional change is hardly controversial (North 1990, Lin and Nugent 1995). Following this line of thought, a growing number of works are today underlining the role played by institutional changes in transition economies.[30]

I have explained that the main function assigned to institutions is to save knowledge and information and consequently to make actions and expectations relatively compatible. If one recognise here the 'point orientation' dimension of institutions, it is also important to recall that institutions are not always the result of an *ex nihilo*—or legal—creation process but also arise because of individuals interactions. Institutions thus have a very ambiguous status: not only do institutions constitute an external framework that removes uncertainty from market transactions and consequently form the incentive structure of a society, they also appear to be internal to individual transactions, the latter leading to their adjustment and evolution. Any theory of economic change must consequently integrate the fact that, if economic change shapes the institutional evolution of the economy—in the sense that economic change is an incremental process resulting from day-to-day choices of individuals actors,—it also reflects opportunities provided by what North (1994) has called the institutional matrix.[31] In the case of a developed market economy, such a relationship between economic change and institutional change is no longer problematic, since institutional change may occur through gradual modifications, that is, by the alteration of prevailing institutions. This is not the case, however, for transition economies which, by definition, have chosen to reform their entire institutional framework.

More precisely, every transition economy must face three inter-related kinds of problem.[32] Firstly, there is the problem of institutional change and how to reconcile the idea of an institutional change with that of an institution as "a point of orientation", which assumes its fixity. The danger here is that a too-rapid process of transition may shift the comparative advantage of governance structures to Mafia-like organisations rather than to market institutions, the former preventing the effective emergence of efficient market institutions, even in the long run.[33] Secondly, the issue of institutional order and its unity is formulated. Indeed as it is the complementarity of institutions that builds the institutional order of a society, analysing the transition of a planned economy to a market-oriented economy requires that we specify conditions for attaining the coherence of the institutional order,[34] whereas the parts of the system are evolving at divergent speeds. The efficiency criterion can hardly be used, since "inefficient" institutions may always persist due to factors such as path

dependencies, technological irreversibilities, political resistance to change, etc... There is finally the matter of the adoption, the transfer, of new institutions and consequently the analysis of conditions in which new institutions fit successfully into an existing structure.

Solving these three kinds of problems comes down, here again, to resolve the contradiction which exists between the necessity for the institutional order to be permanent and coherent, and the necessity of flexibility. It is decentralisation that permitted China to resolve such a contradiction; the permanent character in the Chinese economy of pre-existing decentralised institutions indeed authorised governments to play the role of "points of orientation" thus encouraging the development of the contractual sphere.

The Decentralisation and the Institutional Dynamics of Reforms in China. Chinese Reforms began in 1978 with the choice of an incremental approach. One of the main proposals was the development of agricultural and industrial activities out of the plan. This experience is original because the search for a market economy does not imply the end of the state. Chinese economy is still a mix of public, private and collective economy. The role of the central state remains important, even if it appears to be less dominant than before.

Considering the size of the country, no one program can be discussed without taking into account spatial considerations.[35] To understand foundations and reforms evolution, one must consequently refer to the organisational dimension of the Chinese economy. In China, there is a long tradition of decentralisation, whose evolution reflects the changing orientation of economic and political strategy. The decentralised framework of the Chinese economy has always been used by central authorities as the main transmission vector of the successive economic reforms. The Maoist strategy dominated Chinese development until 1978. The regional development policy over the whole period reflected various strategies—economic as well as political—which prevailed at state level: at the beginning, the main objective was to achieve a balanced distribution of industry and of power between regions, whereas after 1964, projects had few links with local economies and were based on military-strategic considerations. All these investments followed, however, a common redistributive logic. Two waves of decentralisation occurred in 1958 and 1970 which gave great power to local governments with respect to regional economic development. As the objective of the Maoist era was local self-sufficiency, the main types of industry were duplicated in each region. The result was described as a "cellular" and encouraged localism. With Deng Xiaoping, decentralisation remained important, but took another form, exhibiting a radical reorientation of Mao's policy: the central government encouraged specialisation, and the significant growth of rich coastal regions was supposed to stimulate growth in inland regions. The sixth and seventh *Five-Year Plans* emphasised different paths in regional development. The objective was to accelerate the development of the coastal regions. The permanency in the Chinese economy of local governments, thus, went together with the flexibility of their attributions; the reform program has, then, been applied logically, not only by central government but also by local governments.

Indeed, the important point is that decentralisation thus conceived as a permanent designed institution handled by authorities, encouraged the development of a sufficiently large sphere of contractual freedom required for the move toward a market-like economy. Focusing on two of the main reforms, that is first on the adaptation of Township

and Village Enterprises (TVEs) to market rules and to competition at the beginning of the reforms, and second on the privatisation of State Owned Enterprises (SOEs) from the mid-90s, it is possible to explain how local governments have been the mainspring of the evolution.

The commitment of local governments to organise local business originated in the commune system, when community governments were responsible for agricultural production. Local governments acted consequently as industrial firms because first, their autonomy vis-à-vis the central government is strong, and second, the fiscal reform stimulated this kind of behaviour. One of the main implications of the mid-1980s local government reform was to substitute a hard budget constraint for a soft budget constraint[36] for the TVEs, managed by such governments.[37] Indeed instead of government automatically appropriating all profits of the enterprises under their jurisdiction, enterprises were to be taxed according to a fixed rate (Walder 1995); the residual, retained by enterprises managed by local governments, constituted a strong incentive for the former to be more profitable. With regard to tax revenues collected from enterprises under their jurisdiction, the reform authorised, by another way, each level of government to turn over a contractually specific amount to the level of government immediately above, the potential residual being kept by the lower level. Conversely, local governments became responsible for covering shortfalls. Different regions experimented with different systems and, consequently, a wide variety of contracts. Even if villages were officially outside that system, they often had the strongest incentives. Indeed, although villages had to pay a tax to the township government, all the residual went to the village government; "the villages are treated by the township government exactly as a private enterprise under the township would be" (Oi quoted by Walder 1995:280). Furthermore, reforms created the possibility of extra-budgetary funds; this possibility constitutes a strong incentive for sub-national governments to set up a hard budget constraint and to close non profit firms. The idea is that the budget constraint of enterprises can be hardened through fiscal decentralisation which gives local governments an incentive to enter into fiscal competition. It is obvious that in China there is competition in infrastructure investments to attract foreign investment. For example, the campaign initiated by the Centre to restrict investment over the period 1989–1991 had only limited effects on the level of investment in Shanghai and Guangdong (Li 1997). The reason is that fiscal competition under factor mobility increases the total marginal local value of infrastructure investment above its marginal social value, and therefore induces more infrastructure investments.

Empirical evidence shows that, during the period of the austerity programme in 1989–1990, about three million TVEs went bankrupt or were taken over by other enterprises (Jefferson and Rawski 1994). All of this confirms the fact that local governments, which applied the central plan during the era of Mao, adjusted themselves to new conditions of the reform era in order to facilitate the adoption of new market mechanisms in the Chinese economy.

Local governments also played a key role in the privatisation process of SOEs. The urgent need for a reform of the State Owned Enterprises became evident in the mid-90s. The SOE were owned by the central government, but they were supervised by the central, provincial, city and county governments. The philosophy of the reform is contained in the

idea: "grasping the large and letting go the small". Practical consequences of such an idea are as follows: (i) the central government kept the largest enterprises, (ii) the other large enterprises were offered to conglomerations and corporations by means of mergers, (iii) the small SOE were privatised at county level, (iv) a mass lay-off of SOE workers appeared at the city level.

It is important to note here that local governments, after the TVE experience, initiated SOE privatisation and consequently played a critical role in the implementation of this reform. The central government used provincial governments to make privatisation possible. The local governments' incentives are partly similar to those we met with in analysis of TVEs: the access to a harder budget constraint and to competition.[38] It played an active role in the introduction process of market rules not only by selecting enterprises to be privatised but also by determining the rhythm of reforms (Cao, Qian, and Weingast 1999). The objective was to take into account the occurrence of regional disparities and to manage the privatisation process through specific economic and social measures in order to compensate for the negative effects of privatisation. For example, when Shanghai's textile and measurement instruments industries became non-competitive compared with TVEs, the city chose to organise two "re-employment service centres" in these industries. These centres are responsible for subsistence level support for the redundant workers and for training. They are financed by the city government, the new textile and measurement companies and by social sponsors.[39]

Thus the TVEs, as well as the SOEs experiences, highlight the role played in China by decentralisation. By organising the development of contractual transactions, decentralised institutions of the Chinese economy have indeed played a decisive role in making the planned economic logic compatible with that, radically opposed, of a market economy. In the case of China, decentralisation represents one of these legal institutions which authorises the integration of changes without altering the institutional structure as a whole. Both the originality and the success of the Chinese reforms are to be found in this aptitude to resolve the permanency-flexibility dilemma.

4. Conclusion

This paper exhibits a double dimension. From a theoretical point of view, it gave me the opportunity to specify outlines of a market process analysis standing in the economics of time and ignorance. Such an analysis which explicitly takes into account the processual dimension of both behaviours and forms of co-ordination is likely to offer the analytical structure required for a general study of the co-ordination in time of individual plans. The institutions, as well as the other forms of co-ordination are analysed through their contribution to a market order, that is to a harmonious running of markets which does not systematically square with the state of equilibrium.

From an empirical point of view it gave me the chance to demonstrate that the question of the complementarity of the forms of co-ordination is at the heart of the development of the market economies. The objective here is to establish, through an appropriate temporal articulation of the different institutions, conditions for a harmonious development of the market processes.

Acknowledgments

I wish to thank the referees of the review for their comments on this paper. I am alone responsible for the errors that remain.

Notes

1. For a more circumstantial presentation of the Austrian concept of the market process see Dulbecco and Dutraive (2001).
2. That is 'an equilibrium in which economic actions at a particular point in time are co-ordinated independent of what transpired just before that instant and what may transpire just after' (Garrison 1986:89).
3. The 'traditional' Austrian theory of the market process refers to the contributions of Hayek, Mises, Kirzner and Lachmann.
4. Of course, Kirzner does not share this position.
5. Let us remember that 'The concept of order (. . .) has the advantage that we can meaningfully speak about an order being approached to various degrees, and that order can be preserved throughout a process of change. While an economic equilibrium never really exists, there is some justifications for asserting that the kind of order of which our theory describes an ideal type, is approached in a high degree' (Hayek 1978:184).
6. Typical events are events, that an observer perceives as being repeated regularly, as long as the process itself is being repeated. Unique events are the ones that occur only once and are thus time dependent; they can never be discovered (O'Driscoll and Rizzo 1996).
7. That is, a reasoning which tries to take into account the subjective character of both anticipations and knowledge (Lachmann 1976).
8. Let us remember that 'praxeology rests on the fundamental axiom that individual human beings *act*, that is, on the primordial fact that individuals engage in conscious actions toward chosen goals. This concept of action contrasts to purely reflexive, or knee-jerk, behaviour, which is not directed toward goals' (Rothbard 1976:19).
9. See for example the new introduction of the second edition of O'Driscoll and Rizzo's book (1996:xxii); see also Garrouste (1994) and the contributions in Boettke and Prychitko (Eds.) (1994). It is the very same motive which induces Langlois to state that 'Menger has perhaps more claim to be the patron saint of the New Institutional Economics than has any of the original Institutionalists' (Langlois 1986:5).
10. The role of institutions in reducing information costs is outlined by the game-theory approach through such notions as 'convention' (co-ordination game) or 'norm' (prisoners' dilemma game) (Schotter 1994).
11. 'An institution provides means of orientation to a large number of actors. It enables them to co-ordinate actions by means of orientation to a common signpost' (Lachmann 1970:45). The so-called concept of 'orientation points' expresses the idea of a decreasing instead of an elimination of uncertainty (Lachmann 1994).
12. O'Driscoll and Rizzo use the term *indivisibility* (1996).
13. We do not however introduce the analysis about coherence.
14. One may recognise here the Mengerian distinction between pragmatic and organic institutions.
15. Some are more fundamental than others in the sense that they are basic institutions of market society: 'They must exist before there can be markets which function smoothly' (Lachmann 1994:50).
16. Only the last type of change is likely to upset some plans in the course of actions.
17. Lachmann himself has first suggested these remarks.
18. This section is based on Allegret and Dulbecco (1999).
19. By emerging economies, we mean developing countries, which have experienced a financial deepening, and significant capital inflows since the mid 80's thanks to significant financial reforms. According to the Institute of International Finance, 29 countries are concerned: in the Asian-Pacific region (China, South Korea, India, Indonesia, Peru, Uruguay, Venezuela); in Europe (Bulgaria, Russian Federation, Hungary, Poland, the Czech Republic, Romania, Slovakia, Turkey); in Africa (South Africa, Algeria, Egypt, Morocco, Tunisia). Despite the diversity in both economic positions and economic systems adopted in the past, these emerging markets all experience a common problem of institutional transformations in their financial systems—in particular, in their systems of banking intermediation—in the sense of a marketisation in this system of intermediation.

20. Thus, Kaminsky and Reinhart (1996)—studying 20 countries between 1970 and mid 1995—identify a rupture concerning the frequency of banking crises between 1980 and 1990 and previous decades. More recently, Demirgüç-Kunt and Detragiache (1998) identified a relationship between financial liberalisation and financial fragility.
21. In certain cases, such as Thailand with the *Bangkok International Banking Facilities* created in 1993, financial liberalization falls within a strategy of creating regional financial centers.
22. The existence of such imbalances could have explained banking crises in Chile (1981), Mexico (1995), Southeast Asia (1997), Turkey (1994), as much as in the northern European countries at the beginning of the 90s.
23. The Mexican economy experienced a particularly pronounced lending boom, as the ratio of domestic credit to GDP increased by 21 points between 1990 and 1994, whereas, over the same period, Chile's ratio only increased by 2.6 points. The ratio rose by 35.5 points in Thailand between 1990 and 1995 and by 29.3 points in the Philippines between 1990 and 1996. Likewise, a lending boom also occurred in the northern European countries during the 80s, just before their monetary crisis. The common trend shared by countries which experienced such lending booms, is the prior financial liberalization, which removes political obstacles to commercial bank loans. This expansion in domestic credit is linked to monetary crises, in the sense that it implies a greater risk of swings in investors' confidence. Indeed, the lending boom reflects the growth in credit risk endured by commercial banks, which results in an increase of the probability of erosion in banking balance sheets.
24. Stiglitz (1998a, 1998b) points out in the same perspective that the emerging economies have regulation capacities inferior to those of the developed countries. Therefore, they are particularly vulnerable to shocks after financial opening, which could justify the permanence of state intervention in the financial sector. From this point of view, one may interpret the increase in banking crises in emerging markets as the result of excess financial liberalisation, when taking into account an inadequate institutional infrastructure.
25. For instance, in Morocco and Tunisia, authorities have promoted the development of equities markets. But such markets don't correspond to the traditional structure of these economies in which familiar relations are predominant. That means that equities market cannot constitute a relevant response to deficiencies of these financial systems. Indeed, they are not an institution in the sense that are not adopted by economic agents. As a result, in Morocco, equities market is the object of speculative pressures and does not contribute to the financing of private firms. In fact, firms introduced in the market had been privatized and had not specific financing needs.
26. One may recognize here the terms of the Lachmannian analysis.
27. For an overview of reforms in South Korea, see World Bank (1999).
28. This section is based on Dulbecco and Renard (1999).
29. For Jin and Hayes (1997:86–91) the leading sectors that have successfully created positive feedbacks for economic transformation are the agricultural, service, and foreign trade and investment sectors.
30. See, for example, the numerous contributions to *The Journal of Economic Issues*, especially Adkins (1991), Ostas (1992), Koslowski (1992), Brown (1993), Elliot and Dowlah (1993), Schlack (1993), Liew (1995), and Lichtenstein (1996) . . .
31. That is, "if the institutional framework rewards piracy then piratical organisations will come into existence; and if the institutional framework rewards productive activities then organisations-firms-will come into existence to engage in productive activities" (North 1994:361).
32. One may once again recognize here the terms of the so-called Lachmannian analysis.
33. One may recognise here the case of Russia.
34. That is "a situation in which all institutions will easily fit into a coherent whole" (Lachmann 1970:69).
35. In China, there is a very strong spatial hierarchy in administration and local power is really effective. There are six layers of government hierarchy: central, provincial, prefecture, county, township and village.
36. The notion of a soft budget constraint upon which, in any planned economy, the behaviour of the enterprise is based, refers to the idea that the government cannot credibly commit to stopping an enterprise activity because of the losses in private benefits for workers and managers (Qian and Roland 1996). The analysis of a soft budget constraint generally assumes that the state is the single owner in the economy.
37. Another implication was to secure the property rights environment necessary for the development of market transactions.

38. The reduction of transaction costs constitutes another incentive.
39. The experience of Heilongjang represents another good example. Heilongjiang is well known for its heavy industries, of soviet type, which are no longer attractive for foreign funds. Confronted by the problem of restructuring, the region found its own original solution. After an experiment in the coal mining sector, the provincial government adopted the "3-3 scheme": one third of employees would continue in their jobs, one third would engage in new tertiary industries and one third would go to agriculture because of abundant uncultivated land. The program was applied to the main sectors of the region and the results were successful with 16% industrial growth in 1996 (Yang 1997).

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