When culture makes a difference in finance

Even with globalization, national culture still matters. Cultural differences, such as acceptance of uncertainty, even have an impact on financial systems.



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Life’s inherent uncertainty is a common thread linking all human experience. At a national level, how a country generally deals with uncertainty — ranging from avoiding it at all costs to accepting it — has been measured and validated in many studies. In fact, researchers

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have found that national “uncertainty avoidance” scores are related to a number of different things, including how the financial system is set up.

Simply put, past research has shown that countries that are relatively comfortable with life’s uncertainty tend to favor a market-based financial system (as seen in the United States and the United Kingdom). Meanwhile, countries that try to avoid surprises prefer a bank-based one (as seen in Germany and Japan).

Yet the relationship between uncertainty avoidance (as a way to measure culture) and financial system fades away when the national government rules without reliable checks and balances. When governments can behave opportunistically, distorting the functioning of banks and markets for political ends, the culture-and-financial-system relationship is disrupted.

This is according to research by Sebastian Lavezzolo, Carlos Rodríguez-Lluesma and Marta Elvira, published in the *Journal of Business Research.*

Exploring the relationship between culture and finance

Greece is a textbook case of high uncertainty avoidance. On Hofstede’s benchmark Uncertainty Avoidance Index (UAI), which was used in this study and over 1,000 more, Greece scores 112. That was the highest score recorded among the 41 countries included in this paper. Surveys say that Greeks tend to feel uncomfortable in unknown or ambiguous situations, preferring set regulations to provide more structure. As previous studies would predict, the country has a bank-based financial system, with banks playing the leading role in mobilizing savings, allocating capital, providing risk management vehicles and more.

In contrast, market-based Singapore has an UAI score of just 8, the lowest in the study. Singaporeans are relatively comfortable with ambiguity, surveys say, although they have many rules to follow. In a pro-business, market-based financial system like Singapore’s, securities markets tend to help mobilize savings, provide risk management options and more.

On the specific question of bank-based versus market-based systems, a 2006 paper by two business school professors at the University of South Carolina, Chuck C.Y. Kwok and Solomon Tadesse, found that national culture, specifically uncertainty avoidance, was statistically relevant to which type of system was in place.

Revisiting and expanding the 2006 datasets, Lavezzolo, Rodríguez-Lluesma and Elvira explored an additional component that can significantly affect a nation’s approach to

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uncertainty: politics.

Specifically, they looked at how much a government can be trusted not to interfere with the workings of markets and banks.

The authors questioned: if you were to compare two countries — one with a well-rooted system of checks and balances, and another with an opportunistic government that ruled without such constraints — would culture still provide a clear link to one type of system or another?

The short answer is no.

This helps explain why a country with a relatively high UAI score (86), like Argentina, had a market-based financial system — and a government that could interfere in the financial system with few constraints. Politics matter.

Trust and financial relationships

“Financial systems, though large and complex, are essentially about relationships: a contract between a borrower and a lender tied to the expectation of future compliance,” write the authors.

So, as in any relationship, there must be trust between parties in order for transactions to occur.

In the absence of political institutions that strengthen trust — by monitoring and constraining opportunistic governmental interference in the economy — uncertainty avoidance becomes a very murky predictor of the dominant type of financial system, the authors find.

In contrast, when political institutions provide checks and balances for a government, that government is less likely to distort the functioning of financial institutions, and national culture is still a good predictor of whether a financial system is bank-based or market-based.

Looking at cultural and political contexts

To bring politics into play, the authors aimed to measure each government’s checks and balances, counted via the number of veto players and the nature of their tenures, as seen in other political science studies.

The final measure was via the level of market concentration within the banking sector — that

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is, the weight of the three largest banks as a share of the assets for all commercial banks.

The authors' results reveal that countries with both high and low tolerance of uncertainty need a constrained government in order for culture to influence their financial systems. If the government is left unchecked, culture's role is diminished.

"Instead of addressing *whether* national culture makes a difference (in shaping financial systems), we focus on *when* it makes a difference, because a contextual approach provides a high level of precision for managers to evaluate the specific impact of culture," they explain.

Managers with an international scope can appreciate the importance of precision in work that crosses cultures.

Methodology, briefly

The co-authors analyzed data from the World Bank and other sources on the same 41 countries studied by the aforementioned paper by Kwok and Tadesse (2006), looking at an extended timeframe from 1990 to 2008. They replicated Kwok and Tadesse's index of financial architecture, compared national culture, and added an analysis of the commonly used proxies for the ability of political institutions to constrain governments, i.e., the number, stability and tenure of veto players in the political system.

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