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Smaller but Safer?

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This is the third in a series of policy briefs on the crisis—assessing the policy responses, shedding light on financial reforms currently under debate, and providing insights for emerging-market policy makers.

The Shape of Financial Systems to Come

Global trends taken for granted in recent decades—the big expansion in global financial assets compared with underlying economic activity, growing global financial integration, shrinking role of the state in financial systems, and rising share of cross-border ownership of financial institutions—may reverse over the foreseeable future. In addition, the structure of financial systems, particularly in developed countries, will likely become oriented less toward capital markets and more toward traditional (and simpler) banking activities. The impact on economic growth and overall welfare is likely to be negative—perhaps the price we have to pay for living in a brave new (and presumably safer) financial world.

It is too early to draw definitive conclusions about the changes that the financial crisis will bring to the shape of financial systems worldwide. Much will depend on the duration of the crisis, on policy responses still to come, and on reforms in financial regulation. Given this uncertainty, relying on plausible and internally consistent long-term scenarios may well be a good way to proceed.[1] While these scenarios may not be able to tell us the magnitude of changes, the direction of changes is becoming increasingly apparent.

A shift in global trends?

The financial crisis is adversely affecting four broad trends that have characterized financial systems in recent decades: the significant expansion in global financial assets compared with underlying economic activity, growing global financial integration, shrinking role of the state in financial systems, and rising share of cross-border ownership of financial institutions. The crisis will likely reverse these trends, at least over the foreseeable future. And it will spark a debate about whether each of them is desirable and appropriate under most circumstances.

Shrinking financial systems

The growing importance of financial systems—whether measured by assets, profits, contribution to GDP, stock market capitalization, employment, or the like—compared with the real economy has been one of the main economic characteristics of recent decades (figure 1). Driving this growth has been such factors as higher per capita incomes and

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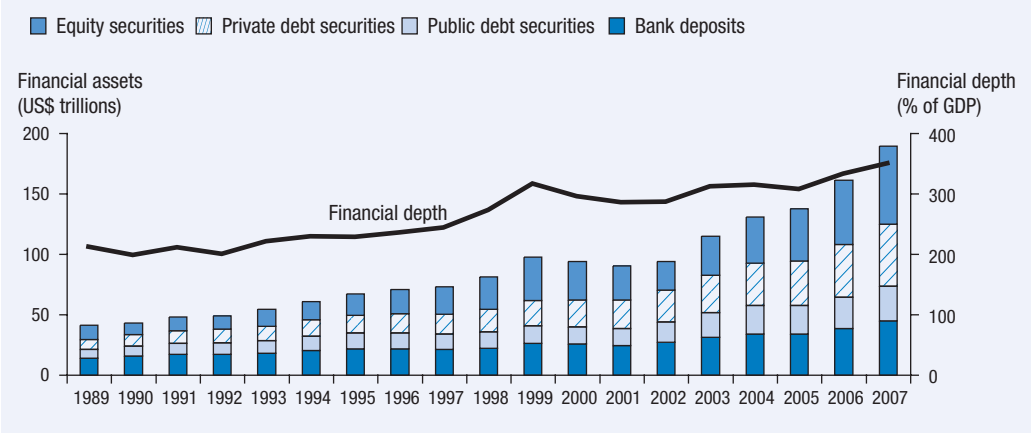
Figure 1 **Global financial assets, 1989–2007**



Sources: Bank for International Settlements; International Monetary Fund, International Financial Statistics database; World Bank, World Development Indicators database.
Note: Data are shown for year-end. Debt securities are the outstanding stock of securities issued domestically and internationally. Equity securities are stock market capitalizations. Financial depth is the sum of bank deposits and all types of securities as a percentage of GDP.

global wealth, the transition toward market-based and service-oriented economic systems, the population aging in developed countries, and the forces of globalization and financial liberalization.

It is becoming increasingly apparent that part of this growth stemmed from the unsustainable buildup of global macroeconomic imbalances and asset bubbles, as reflected by the increase in debt and leverage in the financial system as well as among households and corporations. Moreover, whether many activities of financial institutions can be deemed to have served the needs of their end clients—rather than their own proprietary positions—has become questionable in retrospect.[2]

The sharp, ongoing decline in capital market prices and issuance volumes has already begun to reverse the growth trend and—together with stricter regulation that may reduce risk, innovation, and profitability by promoting a return to "utility banking"[3]—will probably contain future growth in the size of financial systems. As a result of the fiscal fallout from the crisis, there will also be a sizable shift in the composition of financial assets away from private sector securities (both debt and equity) and toward public debt.

Retreat of financial globalization

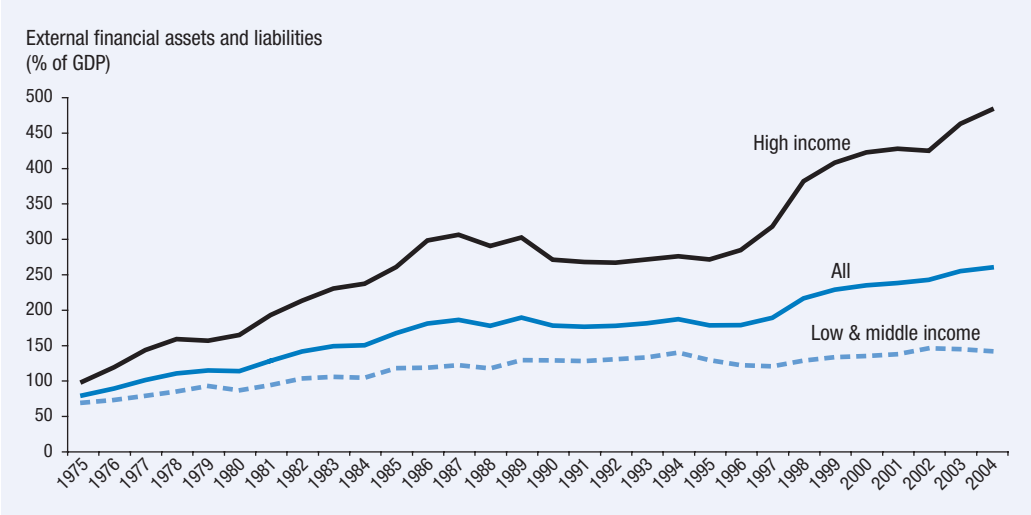
The growth in financial integration between countries—whether measured by the stock of cross-border financial assets and liabilities or by other indicators—has been another important characteristic of recent decades (figure 2; see IMF 2007 for a discussion). Part of the explanation for this trend lies in the removal of de jure controls on capital flows in recent decades. The trend has also been driven by improvements in information technology, greater financial deregulation, the recycling of income flows by export-oriented countries (particularly in the Middle East and Asia), and broader trends of global economic integration.

Both the global scale of the recession and the policy responses under way—some of which have inadvertently promoted "financial protectionism"—are likely to reverse this trend, at least for the foreseeable future. The unwinding of global macroeconomic imbalances, the increase in risk aversion, and the retreat of global financial institutions and institutional investors to their home countries are likely to reduce cross-border financial integration in the near term. Moreover, stricter financial regulation and the reimposition of capital controls in some countries to deal with the crisis may keep financial globalization at bay for some time, particularly if these actions are accompanied by broader protectionist measures.

Greater state involvement

The state's direct involvement in financial systems has been in retreat around the world in recent decades, a response to its documented inability in most cases to spur financial development and growth.[4] Accompanying this has been a greater willingness to transfer financial risks to individuals—whether in the form of pensions, insurance, or investment products—in the belief that they (and the financial institutions serving them) can better manage their own financial affairs.

Figure 2 **Financial integration by country income group, 1975–2004**



Source: Analysis based on data from Lane and Milesi-Ferretti (2006).
Note: The figure shows the unweighted averages of countries' ratios of the sum of external financial assets and liabilities to GDP. It is based on a sample of 34 high-income countries (OECD and non-OECD) and 64 low- and middle-income countries for which data are available for the entire period.

The crisis is beginning to prompt a fundamental reconsideration of the state's role in the financial system, not just indirectly, through stronger oversight, but also directly, through state ownership (particularly in crisis countries). A corollary will be reduced reliance on market mechanisms to achieve financial sector policy objectives and a slowing—or even reversal—of financial liberalization in emerging economies. Perhaps surprisingly, with a few exceptions (see below), the crisis has not yet led to broad-based calls for governments to shoulder greater responsibility for individuals' retirement needs—although these may still come.

In many economies (developed and emerging) the need to kick-start lending to the real sector in response to financial market deleveraging and risk aversion has led their governments to expand the role of state-owned financial institutions and the use of directed credit lines and guarantee schemes. It may also lead these governments to involve themselves in the resource allocation decisions of recently nationalized banks. Ensuring that such institutions operate on a level playing field with private entities and under sound governance arrangements will prove challenging in these countries, as shown by the well-documented distortions caused by political interference in financial institutions with dual mandates.

Reduced foreign ownership

Mirroring the decline in state ownership of financial institutions in some regions has been an increase in foreign ownership (figure 3). This has arisen in response to a range of factors, including the expansion of global trade links, the growth of multinational firms, the assimilation of transition economies in the global financial system, and the increased consolidation and concentration of major financial institutions.[5]

As in earlier crises (such as those in Latin America in the 1990s), countries experiencing a crisis will see greater consolidation around stronger players in their financial system. Unlike in most previous episodes, however, the process is likely to be driven not by developed country banks but by regional or local actors—including the government, through nationalizations or the absorption of failing banks by state-owned entities. The retrenchment of weakly capitalized financial institutions to their home countries will not be easily reversed in the future as host countries tighten prudential requirements (capital adequacy and liquidity standards, foreign entry through subsidiaries rather than branches, and the like) and demand costly duplications in operating infrastructure at the local level.

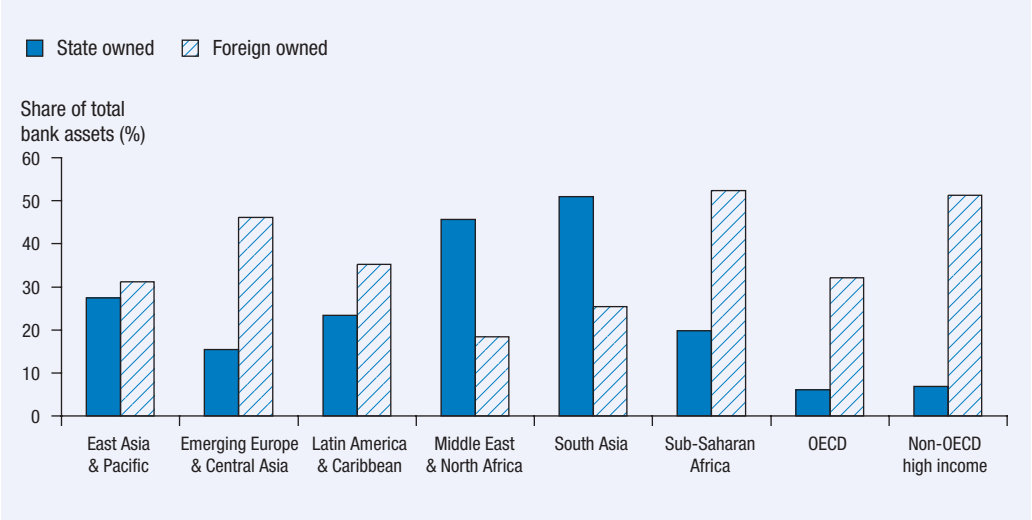
Changes in financial system structures

Accompanying the broad shift in global trends will be important changes in the structure of financial systems in both developed and emerging economies.

Developed countries

One important global trend whose future remains uncertain is the increased conglomeration of

Figure 3 **Public and foreign ownership of banks by region, 2005**



Sources: World Bank survey of bank regulation and supervision; Fitch Ratings.
Note: The figure shows the unweighted average for countries in each region.

financial system activities through the blurring of boundaries between products, markets, and players.[6] Even in the absence of policy measures to once again separate commercial and investment banking activities, the lessons from the crisis for financial institutions that have gone outside their core expertise (for example, insurers writing credit default swaps), as well as the types of regulatory responses (such as significantly higher capital charges for banks' trading portfolios under a revised Basel II framework), are leading to structural changes in the competitive landscape.

Among developed countries, some of the biggest changes may occur in the United States. The U.S. financial system was in many ways unique because of the much greater role played by institutional investors and other nonbank financial institutions and because of the extensive use of capital market instruments, including securitization (table 1). The structure of the banking system may change significantly, with greater concentration around a few mega-universal banks (to the extent that such banks are not broken up as a result of government rescue programs or stricter financial regulation), less emphasis on proprietary trading activities, the rebirth of the boutique investment banking model, and greater attention to traditional activities such as commercial lending and retail deposit-taking. The secondary mortgage market will also be significantly restructured; the dominant players now in conservatorship (Fannie Mae and Freddie Mac) are likely to be reduced in size, broken up, or privatized.

Several types of nonbank financial intermediaries—such as mortgage lenders, finance companies, structured vehicles, and hedge funds, making up the "shadow financial system"—have been badly affected by the crisis. As a result of this, along with increased regulation, these institutions will probably see their relative importance decline. Just as after earlier crises, much of the U.S. financial system's unique biodiversity is likely to return in the form of new institutions and business models—although future developments will depend on the scope for regulatory arbitrage and the nature and intrusiveness of the regulatory response.

The crisis in European financial systems is unlikely to change their basic structure. But European banks, because they had generally been more leveraged and had proportionally greater cross-border exposures, will likely need to make greater adjustments in their balance sheets and business models. In addition, the country-level responses to the crisis to date have led to greater concentration and strengthened domestic incumbents, which could impede future progress toward a European single market in financial services.

The deleveraging process and the regulatory response to structured finance will likely lead to a smaller securitization market characterized by higher-quality issuance and simpler structures.

The explosive growth in the credit derivatives market will also likely come to an end as institutional mechanisms are adopted to introduce greater standardization of instruments (by moving from over-the-counter markets to exchanges) and reduce counterparty risk (by setting up central clearinghouses).

On the insurance side, the institutions underwriting credit risk (for example, financial guaranty monolines and large diversified insurers such as AIG) have been the most affected by the financial crisis. But life insurance companies also may see serious effects. Sustained falls in investment returns triggered by declining prices of equities and high-grade securities—combined with an increase in liability levels (driven by the decline in interest rates) and reduction in new business revenues—may become problematic, triggering further consolidation.

Emerging economies

The basic structure of the financial systems of most emerging economies should not change significantly, since banks still play a dominant role and capital markets are generally less developed. But these countries should not all be placed in the same bucket; much will depend on how—and how much—they are affected by the crisis.

The significant retrenchment in cross-border capital flows—whether bank lending or capital market investments—will prove painful in the emerging economies whose banks and firms are overextended and reliant on foreign borrowing. Some of these countries, including several in Central and Eastern Europe, are already experiencing significant funding problems. It remains to be seen whether the exit of foreign banks from noncore markets will be limited and orderly, or whether governments will need to intervene to prevent the collapse of major domestic subsidiaries of such banks. The crisis may also provide an opening for "South-South" expansion in financial services in some regions, such as for Chinese financial institutions in Asia.

The crisis will have an adverse impact on capital market development in several emerging economies where foreign investors were important participants in local markets, contributing substantially to their liquidity and overall development. Countries with large domestic institutional investor bases will be better positioned to handle this effect. Indeed, the return of large domestic corporations to local capital markets for funding might even boost the development of such markets, as occurred in Chile in the late 1990s.

Finally, the sharp decline in securities prices has hit hard the portfolios of pension funds in emerging (and developed) economies, particularly in Latin America and Central and Eastern Europe. These funds do not face a solvency issue because they generally operate on a defined contribution basis. Moreover, most private pension systems in emerging economies are still immature, and participants could still benefit from a recovery of asset prices before retirement.

Even so, the decline in retirement savings, at least for some cohorts, could lead to important social concerns. Some governments may question the feasibility of the new private systems and be tempted to roll back the reform, switching all the participants to the public pay-as-you-go system. The removal of private pension funds would be a major setback in attempts to develop a domestic institutional investor base and could further

Table 1 Financial system structure in the United States and other countries, 2006 (% of GDP)

	Deposit money bank assets	Institutional investor assets	Stock market capitalization	Public bond market capitalization	Private bond market capitalization
United States	65	198	148	47	125
High-income countries	114	117	97	42	41
Middle-income countries	67	31	67	32	16

Sources: International Monetary Fund, International Financial Statistics database; World Bank, World Development Indicators database and various reports; Bank for International Settlements; Organisation for Economic Co-operation and Development; International Federation of Pension Fund Administrators; AXCO Insurance Information Services; Investment Company Institute; national sources.
Note: Besides the United States, the table covers a sample of 20 high-income countries and 11 middle-income ones for which data are available. Median values are used for each income group. Institutional investors include pension funds, insurance companies, and mutual funds.

hinder the future development of capital markets in emerging economies.

Conclusion

The effects of the crisis on the future shape of financial systems are far from obvious. Just a year ago, for example, who could have predicted the demise of investment banks and the bank nationalizations in several developed countries? Still, the discussion makes clear that global financial trends that have been taken for granted in recent decades—the significant expansion in global financial assets compared with underlying economic activity, growing global financial integration, shrinking role of the state in financial systems, and rising share of cross-border ownership of financial institutions—may reverse over the foreseeable future. In addition, the structure of financial systems, particularly in developed countries, will likely become oriented less toward capital markets and more toward traditional (and simpler) banking activities, such as commercial lending and retail deposit-taking.

What will the implications of these changes be? The literature on finance and growth strongly suggests that the effects on economic growth and overall welfare are likely to be negative.[7] That may be the price we have to pay for living in a brave new (and presumably safer) financial world.

Notes

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1. See WEF and Oliver Wyman (2009) as an example.
2. For example, the gross nominal value of over-the-counter derivatives rose from around 3 times global GDP in 2000 to more than 10 times in 2007.
3. According to Philippon and Reshef (2009), the U.S. financial sector was a high-skill industry before the Great Depression and from 1980 onward, commanding a significant (and sometimes excessive) wage premium relative to the rest of the private sector. This can be explained by lower levels of regulation and the growing complexity of financial sector tasks over the relevant periods, both of which were reversed in the interim period from the 1930s to 1980. A similar process may be taking hold now—in particular, tighter regulation may lead to an outflow of human capital from the financial industry.
4. See Caprio and others (2004) for an overview of issues relating to state-owned financial institutions.
5. See World Bank (2008, ch. 3) for an overview of international banking in emerging economies.
6. See De Nicoló and others (2003) for a description of trends in financial conglomeration.
7. See, for example, Demirgüç-Kunt and Levine (2008) for a recent review.

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