Global Financial Development Report 2013: Rethinking the Role of the State in Finance

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Both markets and governments fail. Government intervention is most often advocated in order to correct market failures but government officials can use state power to achieve different goals: help friends, families, cronies, and political constituents. When this occurs, the government can do serious damage in the financial system.

The World Bank's first-ever *Global Financial Development Report* re-examines a basic question highlighted by the crisis: what is the proper role of the state in financial development? In the Report the state includes not only the country's government but also autonomous or semiautonomous agencies such as a central bank or a financial supervision agency. As it is usually the case with World Bank publications, the Report is very user-friendly. It is organized in five chapters and each of them has the main messages highlighted at the beginning. Moreover, there is an "Overview" that summarizes the whole Report. The publication also has an accompanying website (http://www.worldbank.org/financialdevelopment) that contains new datasets and research papers.

What are the main messages highlighted by the authors in the Report? Firstly, there should be caution when it comes to the state's role in financial development. Active state involvement may be helpful in the short run but there is also evidence of potential longer-term negative effects. The state has an important role in providing supervision, ensuring healthy competition and strengthening financial infrastructure, but direct interventions are less welcome. Secondly, incentives are crucial in the financial sector. Policies aimed at the financial sector should better align private incentives with public interest without taxing or subsidising private risk-taking. Thirdly, when it comes to regulation and supervision, the basic ingredient is a solid, transparent and not too complex institutional framework. Supervisory action should be strong, timely and anticipatory.

Fourthly, competition is good; it can improve efficiency and enhance access to financial services without necessarily undermining financial stability. Instead of restricting competition, it is necessary to deal with distorted competition, improve the flow of information, and strengthen the contractual environment. The state should encourage contestability through the healthy entry of well-capitalized and the timely exit of insolvent institutions. Fifth, lending by state-owned banks can play a positive role in stabilizing aggregate credit in a downturn, but it can also lead to resource misallocation and deterioration of the quality of intermediation due to the serving of political interests. Oversight of state banks is challenging, especially in weak institutional environments. Finally, the state's role can be useful in promoting transparency of information and reducing counterparty risk, particularly when there are significant monopoly rents that discourage information sharing. These are the common lessons and guidelines but appropriate policies differ across countries and time.

The Report makes it clear that the main reasons, besides macroeconomic factors, behind the global financial crisis were major regulatory and supervisory failures. The main weakness in the pre-crisis approach was that it focused on risks to individual institutions and did not sufficiently take into account systemic risk. The second weakness was that regulation and supervision of banks, insurance and securities markets was not complemented by strong oversight at the financial group level. This enabled transactions to be carried through entities that were subject to weaker regulation, or even to completely avoid regulation. Third, some regulations were poorly designed, for example the Basel capital adequacy measures considerably misrepresented the solvency of banks. Fourth, implementation of the rules was constrained by the capacity and incentives of regulators and supervisors. Financial institutions grew too complex and became interconnected. Some regulators lacked independence and others found it difficult to resist pressures and temptations coming from the financial industry.

Common features of non-crisis countries were: a more stringent definition of capital, higher capital levels, and a less complex regulatory framework. They had stricter auditing procedures, limits on related party exposures and asset classification standards. In addition their supervisors were more likely to require shareholders to support distressed banks with new equity. Furthermore, non-crisis countries were also characterized by better quality of financial information and greater incentive to use that information – among other reasons because they had relatively less generous deposit insurance coverage.

The Report stresses that "finance is central to development". In other words, "finance matters, both when it functions well and when it functions poorly". Almost the same message was given in the Foreword of another World Bank (2001) report published more than a decade ago. The authors of both reports claim that finance causes economic growth and even though they acknowledge that there are different opinions on this issue, the references they quote are from the last century (e.g. Lucas, 1988; and Robinson, 1952). The authors ignore a vast recent literature that casts doubt on finance as an engine of growth (for a literature review see Bađun, 2009).

Researchers working at the World Bank must be given a lot of credit for collecting and organizing data in a new *Global Financial Development Database* (available online), which is a great supplement to previously released *Financial Development and Structure Dataset*. The former has data organized in four main categories: financial depth, access, efficiency, and stability. It shows that financial systems widely differ.

Even though conclusions and policies from the Report seem straightforward, an impression stays that it is all easier said than done. The introductory sentence from the 2001 Report was: "As the dust settles from the great financial crises of 1997-

98, the potentially disastrous consequences of weak financial markets are apparent”. The dust has still not settled from the last financial crisis, far from it, but the mere fact that it happened again shows that John Steinbeck was partly right when in *The Grapes of Wrath* he wrote: "The bank is something more than men, I tell you. It’s the monster. Men made it, but they can’t control it.” However, the same could be said about government.

It seems that the relationship between government and banks/financial sector will always be strong because history shows that crises are inherent to the financial sector, which means that bankers will always be looking for a safety net and rescue by the government. In addition, bankers have a vested interest in promoting government deficits, which they finance and earn interest on that. Furthermore, the government has a constant conflict of interest since it both regulates banks and uses them as a source of finance. Also, government officials are not benevolent social planners and they will try, if not prevented by law, to maximize their own wealth, not social welfare. Finally, banks can capture the regulators. In the end, the taxpayers or future generations of taxpayers "foot the bill” of this complex relationship.

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