
The Global Financial System and the Challenges Ahead

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We all share an obligation to reflect intensively on the lessons to be drawn from the financial crisis of 2008, but also to find answers to help reduce the chances of a repetition of such events. First and foremost, of course, banks themselves have an obligation to rectify deficiencies revealed by the crisis. Next, it is up to regulators, supervisors, and other policy-makers to put the right framework into place. But to do this in an optimal manner we also need (1) a sound scientific foundation for all the changes to banks' risk-management systems and the regulatory framework, and (2) to make sure that managers have the right mind-set. In the following, I will present a few ideas on what is needed to put the global financial system on a firmer footing. Of course, the natural starting point for such an analysis is the current state of the international financial system.

THE GLOBAL FINANCIAL SYSTEM: WHERE DO WE STAND?

The global financial system has recovered from the depth of the crisis. The extreme flight to quality observed in the autumn of 2008 has given way to a renewed interest in riskier, higher-yield assets. Stock markets have returned roughly to the levels they had in the summer of 2008. Markets have reopened for companies to issue debt and equity. In fact, at the end of September we witnessed the largest share issuance ever, amounting to

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USD 70 billion, by Petrobras—tellingly, a company based in an emerging-market country. More importantly, it is significant that even banks are able to tap equity markets again, as Deutsche Bank demonstrated with its EUR 10 billion rights issue in September 2010,¹ showing that investor confidence in financial institutions has returned. Even securitization markets have reopened.

Nonetheless, two observations should be made: first, the stabilization of financial markets is a precarious one. Market sentiment remains volatile and vulnerable to bad news. Investors continue to be concerned about the strength and stability of the economic recovery. They are worried about lingering public debt crises, which in many countries have followed on the heels of the financial sector bailouts. There is widespread concern about the potential inflationary impact of the loose monetary policies currently pursued by some central banks. No doubt, the recent record-high price of gold reflects these concerns.

Second, and related to the first observation, the extent of stabilization varies. Clearly, concerns about public debt levels are more pronounced in some countries where debt levels are high or rising fast—Greece, Ireland, and Portugal spring to mind—whereas other sovereign issuers, such as Germany, enjoy record-low interest rates or, like many emerging-market sovereigns, are benefitting from substantial capital inflows on the back of rising investor interest in countries with sound finances and positive debt dynamics. Similarly, with regard to financial institutions, there is a growing dichotomy between banks that again have unlimited access to equity, debt, and money markets, and banks that still have to rely on liquidity support from central banks.

Parallel to these market developments, the institutional and regulatory framework for global financial markets is being reshaped. With regard to institutions, new supervisory bodies such as the systemic risk supervisors—the Financial Stability Oversight Council in the United States and the European Systemic Risk Board in the European Union (EU)—are taking up their work. Existing bodies, such as the International Monetary Fund, have reinvented themselves in terms of their tools and policy approaches and are undergoing changes in their governance structures. Moreover, the G20 has officially replaced the G7 as the premier forum for international policy coordination. In terms of rules, the fundamental overhaul of existing framework policies, such as the Basel capital and liquidity requirements, and the creation of entirely new regulatory elements, such as bank resolution and insolvency regimes, will reshape the structure of the financial industry and the way it does business.

CHALLENGES FOR THE GLOBAL FINANCIAL SYSTEM

Based on this description of the global financial system, what are the challenges ahead and what is needed to put the global financial system on a firmer footing? Essentially, there are four challenges:

- How can we preserve the integrated nature of the system?
- What are the building blocks for a regulatory framework that is adequate for and commensurate with today's global financial markets?
- In this context, how can we address the question of balancing state intervention and market processes?
- Finally, how should we respond to the shifting economic and political geography in the global economy and, by extension, in global financial markets?

Preserving the Integrated Nature of the Financial System

Not everyone shares the view that preserving an integrated financial system is a desirable aim. Many argue that less market integration would be desirable to increase room for autonomous policy action and to shield national economies from the vagaries of international spillovers in the event of financial disruptions. This view has become increasingly fashionable—not only among the broader populace, but also in policy circles as part of a more general trend of rising opposition to internationalism.

These tendencies are highly disconcerting given that the benefits we draw from integration outweigh the risks by far. Capital market integration, if conducted within an adequate framework, allows for more efficient capital allocation, expands access to funds for firms and households, and lowers financing costs. It also offers people in aging countries faced with the prospects of declining growth rates an opportunity to engage in an intergenerational transfer of wealth by investing their high income of today in dynamic economies, so that they can draw on the returns on these investments in the future.

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integral part of open societies. Intensifying links between countries, for instance by integrating capital markets, is one of the channels that binds not only economies, but also societies. Nowhere is this more evident than in the transatlantic arena: half of the foreign assets held by U.S. investors originate in Europe. Likewise, the share of EU investments in U.S. equity stands at almost 40 percent and in U.S. debt securities at nearly one-third of total foreign investments.

In light of these benefits, there is an urgent need to align regulatory approaches to the highest extent possible. It is necessary to create global rules and frameworks. Members of the G20 have solemnly committed themselves to take coordinated action. However, in the recent past, we have seen isolated actions on the part of individual G20 members, a behavior that should not become entrenched.

Building Blocks of the New Regulatory Framework

Saying that regulatory initiatives should be aligned does not, of course, address the question as to *what* is to be aligned. The process of reshaping the regulatory framework has taken almost two years now, and it seems that the key building blocks are now falling into place. A consensus is emerging that the overarching objective of all reforms should be to enhance the resilience of the global financial system. This, in turn, has two dimensions: (1) reduce the probability of shocks to the financial system, and (2) limit the repercussions of such shocks, should they occur.

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Many of the initiatives currently being pursued do, indeed, follow this overarching objective. With the aim of reducing the likelihood of failure, toughening capital and liquidity requirements is at the heart of these efforts. Overall, it seems that the Basel regulators, with their proposals presented on September 12, 2010, struck the right balance between establishing greater stability through tougher rules and limiting the repercussions on the financial system's capacity to fund growth and innovation. There are still three concerns, though:

- First, the cumulative impact of all regulatory changes must not be underestimated. These changes, of course, go far beyond capital

requirements, which are just one instrument that will weigh on banks' capital and profitability, alongside levies, reformed deposit insurance schemes, and higher collateral requirements in derivatives markets, to name only a few.

- Second, while regulators have commendably set long transition periods for attaining the new capital ratios, markets (i.e., investors, counterparties, and rating agencies) may not be so patient. It appears that they are not actually willing to wait until 2019 but want to see the requirements fulfilled as early as 2013. Clearly, this entails the risk that some banks might become overstretched and that the impact on the economy might be more severe than desired.
- Third, some of the measures, such as counter-cyclical buffers and surcharges for systemically important banks, have not been fully fleshed out yet, creating uncertainty as to their impact on banks and the economy.

Among the measures to limit the potential spillover from failures, strengthening market infrastructures is probably the most important one. Trade repositories and the use of central counterparties will make the distribution of risk within the financial system more transparent. In a crisis, this will help to avoid uncertainty, which was one of the causes for the freezing of the money markets and the sell-offs during the last crisis: market participants who are not sure about the health of potential counterparties shy away from trading at all. But stronger market infrastructures will also help when it comes to separating failed institutions from the rest of the system in an orderly fashion. In this sense, stronger market infrastructures complement other instruments—such as recovery and resolution regimes, insolvency regimes, and an obligation to redesign banks' organizational structures—so that systemically important parts (like payment activities, for example) can be easily split off.

Overall, then, there is a sound conceptual framework for increasing the resilience of the global financial system. It is true, as always, that the devil is in the details, but the broad thrust of the current regulatory efforts is right. Having said this, however, it is also undeniable that some of the elements in the current regulatory debate are essentially driven by politics and will contribute little, if anything, to making the financial system more robust. Limiting the size of banks is one such example, financial transaction taxes are another, and the Volcker rule is a third. Such measures may go down well with parts of the electorate but will do more harm than good in economic terms.

Balancing State Intervention and Market Processes

Designing new regulations inevitably entails the question of how to achieve the right balance between market forces and state intervention. It is fair to observe that this balance has shifted in the wake of the crisis toward a greater reliance on hard rules and more extensive intervention rights for the state. This definitely brings to a halt almost three decades of liberalization, deregulation, and a shift towards more principles-based regulation, all of which started in the 1980s.

How far the pendulum will actually swing back, though, remains to be seen. On the one hand, a return to state interventions in the financial markets certainly enjoys strong backing in wide parts of the population. Having gone through the trauma of the financial crisis, the electorate wants greater stability. During the crisis, people also observed that the state was the rock in a sea of market turmoil, the only institution that had the capacity to act in order to address panic and instability.

On the other hand, people are aware of the limits to the power of the state. They know that the financial crisis was preceded by state failure as much as by market failure. They realize that excessive debt increasingly limits a government's capacity to act. At the same time, governments themselves do not appear to be all too inclined to go back to being in command of the economy. This is evidenced, for instance, by their efforts to reprivatize the equity stakes taken in distressed banks as quickly as possible, not least with the aim of reducing their debt levels.

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So, all in all, we may not be seeing a full swing of the pendulum, but rather only a partial adjustment. As the jury is still out on this, the final results may very well differ from country to country and will crucially depend on the final costs of the crisis as well as how they are perceived. In any

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Coming to Grips with the New Economic Geography

The crisis also produced a new economic geography. Anecdotal evidence of this regularly hits the headlines: just think of the reports on China, as the largest foreign creditor of the U.S. government, and how important their interests were in guiding the Bush administration's decisions to rescue government-sponsored entities.² Another example is the series of recent reports on how China used its powerful investment position to send a not-too-subtle message in the dispute on global currency issues, by apparently signaling its intention to buy Greek debt to underline its interest in a strong euro, in other words, in a multi-polar currency regime.³ Or just think of hard facts, such as the USD 4 trillion in sovereign wealth funds, most of which are based in emerging markets. One need only look at the fact that the industrialized countries' share in global GDP has dropped to less than 50 percent—down from two-thirds as recently as the 1990s.

The new economic geography is, of course, not limited to the country level. It is also increasingly being felt at the company level. Six of the top 50 listed companies based on turnover are headquartered in emerging markets. Also, as a corollary to the rise of their home countries, banks from emerging markets
 are climbing the global league tables. Whereas at the end of 2006, before the start of the crisis, no bank from outside the U.S., Western Europe, or Japan had made it into the top-30 league based on market capitalization, by the end of 2009, banks from these industrialized regions accounted for only 70
 percent of banks' global market capitalization. In their place, banks from China and Brazil have entered the top league. Today, four of the world's ten biggest banks by market value are Chinese—in 2004, there was not a single bank from China in that category.

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There is also an intellectual dimension to this, of course: the financial crisis, originating in what was once considered the world's most sophisticated financial market, has, in the eyes of many, severely undermined the credibility of the Western economic model. Paul Volcker got right to the point when he said in an interview in late 2009 that the crisis was "symbolic of the relative, less dominant position the U.S. has, not just in the economy but in leadership, intellectual and otherwise."⁴

What is the right way to deal with these challenges? At the individual company level, the answer remains the same as it always was—by being smarter, better, and more customer-focused than your competitor, whether old or new.

Of course, building a competitive edge also has a public policy dimension. A strong, profitable home base is the foundation of all internationalization strategies. In the European context, with its predominantly small economies, the need to preserve a strong home base highlights the importance of continuing the drive to build a single market for financial services in the EU. Europe must not waver in this effort if it wants to hold on to its chances to seriously compete in the global economy.

Furthermore, the new challengers make it even more important that we do not fall into a trap of our own making when designing new

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rules for the financial markets. Go-it-alone strategies that may be popular with voters but simply shift business elsewhere are vastly inferior to internationally coordinated approaches, even if these require greater efforts and are harder to achieve initially.

Moving from the level of business and industry to the level of international politics, I believe it is important to integrate the new emerging-market powers into the new system. Broadening the membership in the Financial Stability Forum and the

Basel Committee and transferring responsibility for economic governance from the G7 to the G20 were good steps in the right direction. They incorporate the new powers into the disciplined approach of these bodies and give them a proper forum to bring their views to the table. Even if not everything is running smoothly in this context, it is the best chance we have and we need to make the most of it.

Europe is aware of its responsibility in this context. As the largest economic area in the world and issuer of the globe's second most important currency, Europe's contribution to building a stronger, more resilient financial system is crucial. European countries have been the driving force in the G20 process and were also decisive in bringing plans for the International Monetary Fund's governance reform to a successful conclusion. Now,

the realignment in governance will have to go hand-in-hand with greater responsibility on the part of emerging-market countries in the shared aim of promoting a healthy, open, and balanced global economy.

CONCLUSION

The financial crisis has been a watershed event in many respects. But it gives us a chance—or rather, an obligation—to participate in redesigning the global financial system with a view to enhancing its resilience and preserving its efficiency. The challenge is monumental, but it can be managed if we work on it together with drive and imagination, diligence and perseverance. ■

ENDNOTES

- 1 Ulrike Dauer, “Deutsche Bank Seeks EUR9.8B to Buy PostBank, Lift Ratios,” *The Wall Street Journal*, September 12, 2010.
- 2 See, for example, Daniel Drezner, “Bad Debts: Assessing China’s Financial Influence in Great Power Politics,” *International Security* 34(2) (Fall 2009): 7-45.
- 3 Maria Petrakis and Natalie Weeks, “China Supports Stable Euro, Strong EU Ties, Wen Says,” *Bloomberg Businessweek*, October 3, 2010.
- 4 James Tyson and Michael McKee, “Volcker Says China’s Rise Highlights Relative U.S. Decline,” *Bloomberg*, September 29, 2009.