Rethinking the State’s Role in Finance

What should be the role of the state in financial development? What lessons can we learn from the global financial crisis?

The global financial crisis has prompted many to reassess state interventions in financial systems—from regulation and supervision of financial institutions and markets to state guarantees and state ownership of banks. But the crisis does not necessarily negate the body of evidence on these topics accumulated over the past few decades. It is important to use both the crisis and precrisis experience to examine what went wrong and how to fix it. This is the motivation of the World Bank’s Global Financial Development Report 2013: Rethinking the Role of the State in Finance, the inaugural edition of a new World Bank series.

The report reexamines a basic question: What is the proper role of the state in financial development? To address this question, it synthesizes new and existing evidence on the state’s performance as financial sector regulator, overseer, promoter, and owner. It builds on novel data, surveys, research, and wide-ranging country experience, with an emphasis on emerging market and developing economies. The report also tracks financial systems in more than 200 economies before and during the global financial crisis.

The report strikes a cautionary chord. It acknowledges that the global financial crisis has given greater credence to the idea that direct state involvement in the financial sector, such as lending by state-owned banks, can help maintain economic stability, drive growth, and create jobs. And it provides evidence that some of these direct interventions may have had an impact, at least in the short run. But it emphasizes that there is also evidence of potential longer-term negative effects. The report suggests that as the crisis subsides, there may be a need to adjust the role of the state from direct interventions to less direct involvement. This does not mean a withdrawal of the state from overseeing finance. On the contrary, the state has a very important role, especially in providing strong supervision, ensuring healthy competition, and enhancing financial infrastructure.

The report’s underlying message is that in the financial sector incentives are crucial. The main challenge of financial sector policies is to better align private incentives with public interest without taxing or subsidizing private risk taking. The design of public policy needs to strike the right balance—promoting development, yet in a sustainable way. This approach leads to challenges and trade-offs. The report studies these in depth, focusing on four main areas.

The first area of focus is regulation and supervision. The report examines new evidence from the crisis using a unique survey covering some 730 features of the regulatory framework in 143 jurisdictions. One finding is the importance of first getting the “basics” right—through strong, timely, and anticipatory supervisory action complemented by market discipline. In many developing economies this means giving priority to building up supervisory capacity. Less can mean more: less complex regulations, for example, can allow more effective enforcement by supervisors and better monitoring by stakeholders.

The second area is competition policy. The crisis fueled criticisms that “too much competition” in the financial sector led to instability. But research presented in the report suggests that for the most part instability is due to other factors, such as a poor regulatory environment and distorted risk-taking incentives. With good regulation and supervision, bank competition can help improve efficiency and enhance access to financial services without necessarily undermining systematic stability. Rather than restricting competition, the state needs to encourage contestability, improve the flow of information, and strengthen the contractual environment.

The third area relates to direct interventions, such as lending by state-owned banks. The report finds that such lending can help stabilize aggregate credit in a downturn, but it can also lead to resource misallocation and deterioration in the quality of intermediation. The report presents evidence that lending by state-owned banks tends to be less procyclical and that some state-owned banks even played a countercyclical role during the global financial crisis. But the track record of state banks in credit allocation remains generally unimpressive, undermining the benefits of using them as a countercyclical tool. Policy makers can limit the inefficiencies associated with state bank credit by paying special attention to the governance of these institutions and schemes and ensuring that adequate risk management processes are in place. This oversight is challenging, however, particularly in weak institutional environments.

Finally, the report examines the role of the state in financial infrastructure, particularly credit information sharing systems. Evidence points to a useful role for the state in promoting transparency of information and reducing counterparty risk. The report shows that the state can facilitate the inclusion of a broader set of lenders in credit reporting systems and promote the provision of high-quality credit information, particularly where there are significant monopoly rents that discourage information sharing.