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NEWS RELEASE

Rethink Role of State in Finance, says World Bank

Warsaw, December 3, 2012 – It is time to rethink the role of the state in the financial sector, so that governments can better balance the need for credit and emergency support for banks with measures to promote transparency and competition when crises erupt, says a new World Bank report.

"Governments need to provide strong supervision and ensure healthy competition in the financial sector. They also need to support financial infrastructure, such as better quality credit information that is shared more systematically," says **World Bank Group Managing Director Mahmoud Mohieldin**. *"But the mixed results of their direct role in issuing credits merits close examination. Indeed, as we emerge from the global financial crisis, governments may want to consider shifting toward indirect interventions."*

The *Global Financial Development Report*: *Rethinking the Role of the State in Finance*, examines how financial systems around the world fared during the global financial crisis. Coinciding with the anniversary of the 2008 collapse of Lehman Brothers, the report draws on several new global surveys and compiles unique country-level data covering more than 200 economies since the 1960s.

Analyzing four characteristics—the size of financial institutions and markets, financial access, efficiency, and stability—the report tracks financial systems in the run up to the global financial crisis and gauges the extent of their recovery to date. The authors confirm that developing economy financial systems are less deep and provide less access than those in developed economies, but they do not differ much in terms of stability.

One of the report's original contributions is on state-owned banks. During the crisis, many developing economies turned to state-owned banks to overcome the credit crunch. In countries such as Chile and Tunisia, governments pumped capital into state banks to cover existing loans or provide new credit to exporters or small- and medium-sized firms. South Korea raised the credit ceilings of its state-owned banks, India and Tunisia set up credit lines for those banks, and Brazil's and China's largest state-owned banks expanded credit considerably during the crisis.
The report finds that such interventions helped counter the spread of the crisis, but they may carry a price: inefficient lending, which in some cases is politically-motivated. In turn, that led to distortions that were amplified as capital was pumped into state banks, or as new credit lines were set up for them to encourage lending to exporters and smaller enterprises. In some instances, state

banks continued to extend credit even during economic recovery, raising concerns that they may crowd out private banks.

Past as well as new research on previous crises reveals that government ownership of banks is associated with lower financial development, more financial instability and slower economic growth. The report recommends that countries carefully consider the risks posed by state-owned banks and pay attention to how they are governed, which is especially challenging in weak institutional environments.

The report also reviews recent successes and failures of the state as a regulator and supervisor. External assessments suggest that supervision in many places, for example in Australia, Canada and Singapore, worked well. Also, many developing economies had limited exposure to the risky behaviors that precipitated the meltdown, and most averted outright distress, including Malaysia and Peru, both of which were praised for their prudent policies. Nonetheless, some countries suffered direct hits, especially in Europe and Central Asia, where reliance on foreign wholesale funding and a build-up of funding imbalances in the run-up to the crisis left many countries vulnerable.

The authors analyze common traits among countries that were hit hard by the crisis versus those that fared better. Non-crisis countries tended to have less complex but better enforced regulations. Crisis countries allowed for less stringent definitions of capital, were not as rigorous in calculating their capital requirements for credit risks, and only 25 percent of them required general provisions on loans and advances (versus close to 70 percent in non-crisis countries).

The report refutes the view that there was "too much competition" in the financial sector of the crisis countries. *"Research presented in the report suggests that with good supervision, more competition can actually help improve efficiency and enhance access to financial services, without undermining stability,"* says **Asli Demirgüç-Kunt, the World Bank's Director of Development Policy and Chief Economist for Financial and Private Sector Development**.

The World Bank Group is working with member countries to support the development and stability of their financial systems, along with economic growth and poverty reduction. *"Around 16 percent of the Bank Group's lending during the financial crisis went to the financial sector – double the 8 percent of its lending before the crisis began,"* says **Janamitra Devan, the World Bank Vice President, Financial and Private Sector Development.** *"This report is part of the Bank's continuing commitment to provide knowledge, operational support and lending to developing countries – both in times of financial crises and in eras of economic expansion."*

The *Global Financial Development Report* is available through an interactive Web site and the underlying data are free to download through the Bank's Open Data initiative.

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