

Competition and Regulation in European Banking

Rome, May 17, 2002

Closing Remarks

It is a pleasure and an honor to be invited to share my comments on this important topic. You may ask yourself if the World Bank is a player in European banking matters. It clearly is not. Yet our client countries look at the current discussions in Europe very closely. The outcome of these discussions may affect the development of their financial systems which, in turn, would impact the growth potential and poverty reduction of these countries.

Our client countries will draw inspiration about their regulatory choices from the example set by Europe. They benchmarked themselves already against the Basel 1 requirements (not with unqualified success as to stability and efficiency of their financial systems) and are monitoring the protracted Basel 2 discussions very closely.

Many large countries (e.g., China, India, Russia) have a large financial system development gap. M2/GDP is still at low levels in these countries – a small fraction of the European countries (e.g., India and Russia 55% and 23% respectively). This is caused by lack of institutional depth in financial intermediation. For example, Russia, which is joining NATO in a few days' time right here in Rome, has a state-owned and central bank-controlled commercial bank that drains 75% of the retail savings. The bulk of China's financial sector is state-owned whose bad loan portfolio hides large contingent liabilities that, added to its pension shortfall, generate a considerable and potentially destabilizing fiscal need right on the eve of the WTO accession. This fiscal cost is conservatively estimated at 110-130% of GDP, accounted for in equal parts by the two components. India's development potential is constrained by the large financial intermediation share (about 80%) still controlled by state banks that need periodic recapitalization (1% of GDP in 2000).

This financial sector development gap is perhaps the main reason why poverty (measured in billions of people) still plagues the world. With 5 billion people, developing countries have a GDP of \$6.5 trillion which compares with a \$9.5 trillion GDP for the US with 330 million people. Three billion people live with less than \$2 a day and one billion two hundred million live under \$1 a day. The world development gap can be measured in terms of \$5-10 trillion – the GDP level that would alleviate the extreme poverty of most people. Against this background, you will appreciate that official aid is a drop in the sea. It stands today at \$50 billion. Even if it doubled, as suggested by many at the Monterrey conference, it would not change the life of the poor. The solution is to generate sustained broad-based growth. The financial sector contribution is key. How to mobilize the financial sector?

We at the World Bank have learned that regulation is necessary but not sufficient to foster financial sector development. Regulation does not work without an enabling competitive environment. Actually, we have observed that regulation breeds fragility in the least developed countries with limited implementation and enforcement capabilities. We have also observed that regulation facilitates corruption and administrative arbitrariness which set back development. Hence, our position is that financial sector development is best promoted by a judicious combination of regulations and market-based incentives. The debate in Europe about the future shape of the regulatory and supervisory framework is thus of the utmost importance for the development prospects of the financial sector in the rest of the world. If Europe goes the route of prescriptive regulations, developing countries will not develop their financial sectors. However, if Europe follows the path, as I understood it this morning, of a comprehensive regulatory system that reinforces, out of necessity, market competition, developing countries will have a model to follow that is adapted to their circumstances and needs.

Coming back to the presentations, we heard from Messrs. Van Dijck and Middleton how much the European financial market has changed over the past five years and how much it is likely to continue to change in the future. This flux suggests the need for a regulatory framework that is sufficient market-friendly to accommodate various combinations as required by the players. Prof. Onado has suggested a top-down approach to create a European level playing field where transparency, competition and market conducts should reinforce regulations. Mr. Green has described the FSA approach with interesting features such as cost effectiveness, comprehensiveness and cost-benefit analysis of this policy decisions. He has also stated that transparency helps stability. Then the ABI presentation gave us a valuable insight of the pervasive impact of regulations on the economics of banking – affecting many levers of banking operations. This creates uncertainties as well as distortionary effects.

In conclusion, the need for efficiency in the financial sector, both in Europe and in the rest of the world, requires the banks to articulate their needs to the authorities as well as to understand and act on the authorities' concerns. Only a collaborative process can yield to a workable and progressive framework.

Thank you.