Financial Newcomers Will Have Global Impact

By Nicolas Veron

The rise of emerging economies has long been recognized as a defining feature of our times when it comes to trade, manufacturing, and an increasing range of services businesses. Until recently, however, there was a widespread sentiment that international finance was somehow escaping the trend. A dominant share of financial assets, financial companies, financial centers and financial regulatory power remained concentrated in the North Atlantic. Even as the world's economic center of gravity was moving away, the financial one seemed firmly anchored in the West. But this feeling was an illusion that is rapidly dissipating.

In this shift the crisis has had a powerful accelerating effect, even though cracks in the West's financial dominance had appeared before its start. Since early 2009, financial institutions from emerging countries consistently weigh more than those from either the US or Europe among the global top 100 by market capitalization, and Chinese banks have dominated global rankings since late 2007. Their relative position has strengthened while that of Western peers was undermined by market turmoil and deleveraging. Non-Western financial centers such as Hong Kong and Singapore are similarly climbing up the league tables. Sovereign wealth funds make their impact felt on global markets. Increasingly, emerging economies produce not only huge savings but also investable financial assets.

It is not just the numbers. At a more intangible level, the crisis has hit the pre-eminence of Western models. Not only have icons such as Merrill Lynch or Citi bitten the dust. The world's most influential financial bodies, such as the US Federal Reserve and Securities and Exchange Commission or the UK Financial Services Authority, have had to acknowledge major misjudgments. By contrast, the Chinese, Indian or Brazilian supervisors, long derided as underdeveloped, have successfully prevented domestic financial turbulence and even applied "macroprudential" instruments (such as limits to loan-to-value ratios) that were ignored in the West. Emerging economies feel no responsibility for the crisis, even as they suffered from it. The West's moral authority is at a correspondingly low point.

These shifts will inevitably have an impact on financial regulatory policy. The Basel 3 capital accord, announced this month, may be the last prominent piece of international financial rulemaking whose negotiation took place mainly among (if not only) developed countries. Last year, several financial bodies, including the Basel Committee and the Financial Stability Board, enlarged their membership to include the largest emerging nations. A parallel transformation of their working processes is only a matter of time.

The "de-Westernization" of global finance is not a mechanical or uniform process. Some emerging stock valuations, especially of state-owned banks, may be inflated. Certain rising players, including China, are reluctant to engage in some global debates. Many have only a limited number of skilled officials, which limits their ability for global influence. Their levels of financial development often remain low. Some of them may face major financial instability in the years ahead. Even their strongest financial firms have capacity limits, and may focus on the rapidly-expanding domestic market for some time rather than going global. But none of these factors is likely to reverse the general trend.

This transformation is obvious to many, but not to all. Some Western players, perhaps especially in Europe, are still in denial. Conversely, some emerging actors are quick to see the opportunities, but not the new responsibilities it creates for them. The rapidity of the changes generates anxiety and mistrust. As they re-regulate their financial system as a consequence of the crisis, developed countries fear the newcomers will practice unfair competition based on less demanding rules, or “regulatory dumping.” Symmetrically, some in emerging countries suspect that Western-driven re-regulation might be a way for the more established financial centers and firms to freeze the competitive playing field and prevent the rise of new entrants. Some of the incumbents may shift quickly from a patronizing posture to seeking refuge in financial protectionism. Overcoming these attitudes will require a lot of effort and quick learning from all sides.

The existence of systemic risk means that international competitive dynamics are different in finance from what they are in other activities, as regulation plays a paramount role. But as in other industries, the rebalancing of the global landscape with the rise of emerging players will not condemn Westerners to irrelevance. Many established financial institutions can build on their skills base, organizational capacity and innovation track record to maintain a comparative advantage and develop successfully on a global scale. What is needed is a candid acknowledgement among policymakers of the irreversible alteration of global financial geography. A highly visible symbolic change, such as moving the headquarters of one of Bretton Woods institutions to Asia, may help accelerate the evolution of collective representations. Conversely, those incumbents who rely on what they may see as rights of inheritance are sure to become the next losers of the global financial game.

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