

Summary

Advanced economies have experienced a prolonged episode of low interest rates and low growth since the global financial crisis. From a longer-term perspective, real interest rates have been on a steady decline over the past three decades. Despite recent signs of an increase in long-term yields, particularly in the United States, the experience of Japan suggests that an imminent and permanent exit from a low-interest-rate-environment need not be guaranteed. A combination of slow-moving structural factors, notably population aging and slower productivity growth common to many advanced economies, could conceivably generate a steady state of lower growth and lower nominal and real interest rates in these countries.

What would be the consequences for the financial sector of such a scenario? This chapter examines this question, abstracting from the role of monetary policy and from temporary effects. The chapter argues that the persistence of a prolonged low interest rate environment would present a considerable challenge to financial institutions. Over the long term, the scenario would entail significant changes to the business models of banks, insurers, and pension funds and the products offered by the financial sector.

In such an environment, yield curves would likely flatten, lowering bank earnings and presenting long-lasting challenges for life insurers and defined-benefit pension funds. If bank deposit rates cannot drop (significantly) below zero, bank profits would be squeezed even further. Smaller, deposit-funded, and less diversified banks would be hurt most, which could increase the pressure to consolidate. As banks reach for yield at home and abroad, new financial stability challenges may arise in their home and host markets. These hypotheses are supported by the experience of Japanese banks.

Low growth and aging populations would likely lower credit demand by households and firms and increase household demand for liquid bank deposits and transaction services. Consequently, in this scenario, domestic banking in advanced economies may generally evolve toward provision of fee-based and utility services.

Pension arrangements and the products and business models of life insurers would also likely change significantly in the long term. In this scenario, defined-benefit pension plans provided by employers would tend to become less attractive relative to defined-contribution plans, which offer more portability. Rising longevity would likely boost the demand for health and long-term care insurance. Demand for guaranteed-return, long-term savings products offered by insurers could be expected to weaken, while that for passive index funds offered by asset management firms would likely grow.

Policies could help ease adjustment to such an environment. Prudential frameworks would need to provide incentives to ensure longer-term stability instead of falling prey to demands for deregulation to ease the short-term pain. For banks, policies should help facilitate smooth consolidation and exit of nonviable institutions, while limiting excessive increases in risk taking and ensuring that the too-big-to-fail problem does not worsen. Implementing economic solvency requirements that encourage life insurers to undertake necessary adjustments to their business models would be vital. Surveillance and regulation of asset management activities would become more important as this industry's share in the financial sector grows.

Summary

How much influence do countries retain over their domestic financial conditions in a globally integrated financial system? This question has recently been attracting increased interest in policy and academic circles alike. Financial conditions broadly refer to the ease of obtaining finance, and measuring them can be valuable for appraising the impact of policy and economic prospects.

Greater financial integration can complicate the management of domestic financial conditions in several ways. First, policymakers may need to take external factors into greater consideration when pursuing domestic objectives. Second, global financial integration may make it harder for domestic policymakers to control financial conditions at home—for example, it may hamper the transmission of monetary policy.

This chapter examines the evolving importance of common global components of domestic financial conditions. It develops financial conditions indices (FCIs) that make it possible to compare a large set of advanced and emerging market economies. It finds that a common component (global financial conditions) accounts for about 20 to 40 percent of the variation in countries' domestic FCIs, with notable heterogeneity across countries. Its importance, however, does not seem to have increased markedly over the past two decades.

Global financial conditions loom large, but evidence suggests that, on average, countries still appear to hold sway over their own financial conditions—specifically, through monetary policy. Nevertheless, the rapid speed at which foreign shocks affect domestic financial conditions may also make it difficult to react in a timely and effective manner, if deemed necessary. Given that global financial conditions tend to account for a greater fraction of FCI variability in emerging market economies, these countries, in particular, should prepare for the implications of global financial tightening. Governments can promote domestic financial deepening to enhance resilience to global financial shocks. In particular, developing a local investor base, as well as fostering greater equity- and bond-market depth and liquidity, can help dampen the impact of external financial shocks.