

# FINANCIAL INSTITUTIONS IN AN AGE OF POPULISM

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**The events of 2016 raise the serious possibility that populism and nationalism will play a much larger role in advanced economies in the next several decades than in the last several. This is far from certain, given the deep divisions within the public in the US and Europe, but the potential must be taken seriously. It is crucial that strategic planning and risk analyses not remain stuck in deeply embedded implicit assumptions based on the idea that anything that was true for the last 30 years must be universal.**

This takes great conscious effort, as humans have evolved to assume that if A has led to B for our adult lives, it will continue to produce B and not start consistently triggering C. Arguably, this was one of the problems that led to the massive financial crisis, as many risks existed which had not manifested themselves for 25 or more years.

The remainder of this memo highlights some key assumptions of recent decades that may be reversed if we have entered a populist era, specifically:

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## Politicization of national and international affairs

Distinct roles for business and government	→	“Bolt from the blue” government demands, but also special favors
Political stability	→	Political risk
Peace in the advanced economies	→	Threats of wars and “cold wars”
Central bank independence	→	More political direction of central bank policy

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## More volatility

Institutional stability	→	Institutional instability
Relatively predictable economic policies	→	Frequent economic experimentation with more volatile outcomes
Relatively stable financial markets	→	High market volatility, both short and long-term

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## Major changes in economic conditions

Low expected real returns	→	High demanded real returns to offset higher risks
Disinflation and even deflation	→	Rising inflation

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## Less globalization

International cooperation	→	National sovereignty
Expansion of trade and cross-border investment	→	Slowing or contraction of cross-border flows of goods, services, and capital

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**This paper identifies over 30 specific implications for financial institutions if the trends listed above do occur. Most fall into the following major categories:**

- Political risk must become a key part of strategic decisions.
- Financial institutions must develop considerably more agility.
- Diversification of business, geography, and customers would have real value.
- Strategic planning and risk analysis must consider many more possibilities.
- The risk of war, hot or cold, must be taken seriously, including cyber attacks.
- Financial institutions must be designed to function well in a balkanized world.
- Capital and liquidity buffers may need to be increased.
- Products and services would need to be redesigned for a riskier and more volatile world.

**Financial institutions need to think today about whether they could adapt as necessary if this turns out to be the era we are now in.** Actions should be taken now to re-evaluate strategic planning and stress testing processes to ensure that potential outcomes are not implicitly or explicitly dismissed as impossible. Beyond that, the potential for changes in the environment this large should be a further spur to redesigning firms to be more agile and to clear away the obstacles to good governance, sound data management, optimal financial resource management, and other key tools that will be even more clearly necessary for success.

This analysis assumes outcomes well beyond recent electoral results. The Trump and Brexit phenomena exhibit some clear populist themes and I will point to aspects of both as examples of populism at work. However, this analysis is significantly more general, as similar trends are evident in political movements in many other nations, often much more strongly. Furthermore, readers should not take this paper as a prediction of what is to come in any specific country. President Trump's policies, for example, can be described as some mix of populism, conservatism, and pragmatism, with analysts arguing about the strength of each tendency. It would be a mistake to assume that all the trends here will exhibit themselves under his leadership, although a few already are.

## WHAT IS POPULISM?

I use "populism" here as shorthand to refer to movements that have the following characteristics:

- Rejection of elites in favor of "the people".
- Focus on national interests, narrowly defined, and rejection of internationalism.
- Rejection of existing institutions, which are viewed as broken or rigged.
- Scorn for experts and the embrace of "common sense".
- Desire for a strong leader to drive change.

There is a lively scholarly debate about what "populism" is. My use is most similar to Mudde and Kaltwasser (2017)<sup>1</sup> and Inglehart and Norris (2016)<sup>2</sup>. Some other definitions differ considerably, so it is important to keep in mind the five points above that are central to the type of populism I am assuming in the rest of this paper.

President Trump's speech at his inauguration is a prime example of populist rhetoric of this nature. It describes a bleak situation in America, blames the elites for major mistakes and excessive focus on their own interests, and calls explicitly for "America First" after a period in which purportedly Washington has let foreigners prosper at America's expense. He promised that the people's voice would be listened to, not the elites, and that he would radically change how Washington, and its diplomacy, works.

The Brexit movement exhibited a number of similar features, including an explicit rejection of both "elites" and "experts". Movements in much of Continental Europe have a similar goal of bringing control back home, at the expense of international cooperation, and of rejecting the formulas that experts have advocated and implemented for decades, and the institutions that are built around them.

<sup>1</sup> Mudde, Cas and Kristobal Rovira Kaltwasser, *Populism: A Very Short Introduction*, Oxford University Press, February 2017

<sup>2</sup> Inglehart, Ronald F. and Pippa Norris, "Trump, Brexit, and the Rise of Populism: Economic Have-Nots and Cultural Backlash," Harvard Kennedy School Faculty Research Working Paper, August 2016

## POLITICIZATION OF NATIONAL AND INTERNATIONAL AFFAIRS

### DISTINCT ROLES FOR BUSINESS AND GOVERNMENT→ “BOLT FROM THE BLUE” GOVERNMENT DEMANDS, BUT ALSO SPECIAL FAVORS

Populism generally shows less respect for existing limitations on government power and for legal procedures, with a greater focus on results. This creates both opportunities and burdens for populist leaders. They have fewer constraints to hold them back, but are expected by their voters to be more activist, blocking outcomes that the people oppose and forcing actions they favor, despite the risks of a more authoritarian approach.

An important way this change in attitude would manifest itself would be more active intervention by populist leaders in decisions that for decades have been viewed as pure business decisions. For example, pressure by President-elect Trump on manufacturers to avoid moving jobs out of America was not based on legality, as the firms were clearly acting legally, but on his view of how American business should behave. Such interventions by leaders into legal business decisions are not unique to populist governments. European socialist governments, and even Christian Democratic ones, have pressured manufacturers to keep plants open on multiple occasions in the past. For that matter, US presidents have pushed back on the steel industry and other businesses in the past about price rises and Congress recently loudly denounced huge price increases on certain drugs. The difference is that interventions by populist governments are likely to be much bolder and more frequent.

Businesses would need to give much greater consideration in a populist era to how their actions would play in the public arena and how they mesh with the goals of populist leaders. The positive side for businesses is that populist leaders are willing to use carrots as well as sticks. Firms that gain favor may find it much easier to gain government approvals or even subsidies for their plans. They may also find that less cooperative competitors are hobbled in some manner. At the same time, playing the political game carries its own risks. Being perceived as an ally of a populist government would backfire if that government fell and could be a problem even if a different faction of populists replaced the first leaders. Furthermore, playing the political game brings the risk of backlash from customer segments who disagree with the firm's positions. (See #DELETEUBER for a very recent example.)

## POLITICAL STABILITY→POLITICAL RISK

In addition to longer-term political risks described later in this paper, the dramatic political shift would raise uncertainty on a number of scores for years to come:

- Will the populists retain power?
- What do they want and how will that evolve?
- Will they be effective in pushing their policies?

New governments, especially when propelled by outsider movements, bring considerable uncertainty. This would be true even if the populists were expected to broadly respect existing approaches and institutions. Populist unwillingness to do so would add even greater political risk.

For example, there is a serious possibility in Italy that the Five Star Movement (“Cinque Stelle”) will win the next election. Their leaders have called in the past for a referendum on whether to remain within the Euro. Were they to be elected, there would be considerable uncertainty as to whether they would actually call such a referendum and what the outcome would be.

New parties also bring real questions as to how they will evolve once they have power and how well they will perform. Years ago, the Green Party in Germany developed major fissures between the “Realos,” who accommodated the real world demands of being part of a coalition government, and the “Fundis” who rejected ideological compromise. SYRIZA in Greece suffered a split along similar lines, although Prime Minister Tsipras held the bulk of his party together and retained power. More recently, the Five Star Movement lost some national support when their candidate became mayor of Rome and her government struggled with the problems of ruling that complex city.

On a lesser scale, many analysts are consumed with similar questions of intent and effectiveness in regard to the new Trump Administration, as well as questions of the longevity of the effective influence of President Trump and his supporters.

## PEACE IN THE ADVANCED ECONOMIES→ THREATS OF WARS AND “COLD WARS”

For the last several decades, there has been little threat of war between advanced economies. Even the “Cold War” between the Soviet Union and the West ended almost thirty years ago. Thus, businesses could essentially plan on peace in their largest markets. However, there would likely be greater international antagonism in a new populist era, sometimes fanned by unstable governments (populist or under threat from populists) looking to unite their own people. This could easily escalate to at least a “cold war” that accelerates defense spending, reduces commercial ties with the antagonist, and hurts consumer and business confidence.

A “cold war”, or even shorter-term antagonisms, could spawn a wave of cyber attacks, which would benefit from public deniability while still sending a message to the government of the nation under attack. Banks would likely be one of the prime targets, as might asset managers, insurers, and other financial institutions.

Actual wars cannot be ruled out, especially the kind of proxy warfare that we have seen in Eastern Ukraine. Another possibility would be at least isolated military incidents between the US and China in the South China Sea. Actual warfare could push nations onto a war footing, with higher taxes, diversion of resources from productive investment to arms, loss of key personnel to the military, and other knock on effects of ramped up military activity.

## CENTRAL BANK INDEPENDENCE→ MORE POLITICAL DIRECTION OF CENTRAL BANK POLICY

Central bank independence has become a central canon of modern economic policy, but has never been complete and rests for protection on a set of laws, customs, and assumptions that can change. Even when nominally independent, all central banks are moved to a greater or lesser degree by political currents.

### **Populism undermines several key assumptions supporting central bank independence:**

- The credibility of non-political economic experts.
- Faith in accepted economic theory.
- The desire to constrain politicians.
- The relevance of decades of history showing problems with overt political direction of monetary policy.

Populism puts little faith in experts, history, and theory and it generally embraces the idea that a strong leader is needed to sweep away the obstacles blocking progress, including resistance from established institutions. Further, central banks are often seen as excessively responsive to the needs of banks, especially large ones.

A populist era should provide fertile ground for a leader to force the central bank towards his or her preferred position, which will usually be towards easy monetary conditions. In this regard, it is notable that as a candidate, President Trump took the step of painting Janet Yellen and the Fed as running monetary policy in a way designed to help elect Hillary Clinton. Questioning the non-political nature of central bankers can be a step towards greater intervention in their activities.

It is worth noting that in the UK, Her Majesty’s Treasury only transferred the task of setting policy interest rates to the Bank of England in 1998 and this decision could be reversed by future legislation. This is not to suggest it is a likely result, but simply a reminder that independence is considerably more conditional than we often remember, even in advanced economies.

## IMPLICATIONS FOR FINANCIAL INSTITUTIONS

**Political analysis will have to become a key part of strategic planning, governance, and most important business decisions.** Political risk shows up in a myriad of ways.

Virtually everything financial institutions do is profoundly affected by political structures and decisions. Firms will need to spend more resources on predicting, and perhaps influencing, political processes. If populism blurs the line between business and political decisions, financial institutions will have to be aware that they are participants on both sides of that line going forward.

**In particular, all major strategic moves should be considered with an eye to potential political intervention.** Firms can no longer assume that legality and avoidance of immorality will be sufficient to justify their business decisions to the public. They must keep in mind the objectives, approaches, and viewpoints of those in power. Sometimes actions will be absolutely necessary or worth the risk of sparking political intervention, but often they will not be. Smart companies have always paid some attention to how politicians might react, but this will have to be a considerably higher priority. Further, firms will have to consider not just the immediate political impacts, but whether they will provoke a later backlash if a company is seen as cozying up to politicians who then fall out of power.

**Big banks will have to manage their own political risk even more carefully than other firms.** Large banks have been a target of many populists, with calls in the US for breaking up the largest banks or imposing a “Modern Glass-Steagall”, and similar messages popping up in some other nations at various times. This could become a greater concern in the future.

**Lending and investment decisions will also have to consider very specific political risks.** In addition to the increased importance of broad political risks, financial institutions will also have to watch out for specific risks to customers or investees in industries where political intervention is most likely.

**Strategic planning, capital positioning, stress testing, and other exercises would need to take international tensions seriously, in addition to other sources of increased instability.** Any major forward looking decisions would at least have to consider the possibility of war or near-war conditions.

**Financial institutions may have to adapt fairly rapidly to substantially altered economic and political circumstances.** Threats of war, for example, can come quickly and have major effects. Even the First Gulf War changed economic and market conditions to a significant extent, quite swiftly. Less dramatic changes in economic and political policies, such as large changes in economic policies or the raising of trade barriers, could also have major effects on financial institutions.

**Risks of hot and cold war provide yet more reasons financial institutions must be well prepared for cyber attacks.** State actors would likely have the best resources and most expertise of any hackers a financial institution would ever face.

## MORE VOLATILITY

### INSTITUTIONAL STABILITY→INSTITUTIONAL INSTABILITY

A direct result of the new populist focus on restructuring power relationships and rejecting the long-established formulas of the elites is the likelihood of much less institutional stability. Internationally, this is already obvious in the moves to exit the European Union or to rewrite the rules by which it operates and in America's pulling back from existing trade agreements.

Since the populists do not trust elites and experts, the institutions they have designed are open to revision. In addition to moves to limit central bank independence, many other institutional arrangements that we take for granted would be up for grabs. In more extreme forms of populism, judicial independence and the rule of law may even be infringed.

Independent regulators may become less independent. Over the decades, governments in many Western countries have invested financial regulatory bodies with a large measure of independence. This decision is always reversible, with varying degrees of difficulty, and a strong populist leader with less deference to existing institutional arrangements may well reduce that independence considerably. For example, the independence of US financial regulatory bodies, such as the FDIC, or the Fed in its supervisory role, is grounded in law and accepted political theory, not the constitution. The constitution envisions three branches of government (Executive, Legislative, Judicial) and does not have an explicit place for a fourth branch of independent regulators. Some proponents of a strong Executive have called for greater direct control of "independent" regulators. Even if this were not achieved by some combination of Executive Orders and new legislation, the potential for intervention by the President may cause regulators to hew more closely to approaches and decisions favored by the Administration. The limitations on such intervention are essentially political – the potential backlash against an Administration perceived as overly powerful and the risk of taking responsibility for decisions which go bad, instead of being shielded by independent regulators who can be blamed. There is also the potential for foreign countries to take actions to protect themselves if they are worried by increased politicization. This could be a further spur to balkanization of banking regulation.

Global standard setting bodies would become less important, likely leading to more fragmentation of capital and liquidity standards. For instance, most analysts believe that the Trump Administration will push for a less active role for the Financial Stability Board, Basel Committee on Banking Supervision, and similar global standard setters. Governments that are more strongly populist and nationalist would be even more likely to ignore or defy such global bodies.

## RELATIVELY PREDICTABLE ECONOMIC POLICIES→ FREQUENT ECONOMIC EXPERIMENTATION WITH MORE VOLATILE ECONOMIC OUTCOMES

Populist movements tend to be less attached to specific economic plans, as their policies are driven more by popular emotions and perceived “common sense” than by a more intellectual approach to the complexities of economics. Similarly, they are less concerned with lessons from the past. This contrasts with more conventional approaches that are informed by an elite consensus that tends to be more cognizant of economic theory and the effects of past economic policies. This is not to say that such elite consensuses are always right, but they do derive policies from the lessons of the past and are also slower to change.

Populist leaders may on some occasions provide the policy breakthrough that is needed to move beyond a failed consensus approach to one or more economic problems or to bust through barriers raised by vested interests. More often, however, I suspect that their initial moves will repeat mistakes of the farther past and that they will be forced to change. Further, the first changes may also fail in ways that will seem fairly predictable to more conventional economists.

For example, it would not be surprising if a populist leader were to rev up an economy with fiscal and monetary stimulus beyond a sustainable point, leading to a surge in inflation. Ignoring this for a while, out of political expediency, could produce a rise in inflation that becomes worrisome to the voters and therefore the government. One could easily imagine a repeat of the jawboning exercises of past leaders, followed by an attempt at price controls or at indexation. These are natural impulses of an interventionist government that does not heed lessons of the past, but they never work for any extended period, at least not without costs that outweigh the benefits of holding inflation temporarily in check.

Overall, for all of the failures of modern economic theory and government implementation of it, I expect that populist leaders will have less economic success and will frequently try new experiments to overcome their failures, leading to instability that will bring further harm.

One might be tempted to assume that such problems will inevitably bring down populist governments, meaning that businesses need merely to get through a few bad years and then the tide will turn and we will be back to a version of the previous world. However, political success turns on much more than just economic output levels, witness the long-term hold of the Cuban government in recent decades or the political success of populist leaders in Latin America some decades ago.

## RELATIVELY STABLE FINANCIAL MARKETS→ HIGH MARKET VOLATILITY, BOTH SHORT AND LONG-TERM

With the exception of the financial crisis of 2007 onwards and its immediate aftermath, financial markets in the last thirty years have shown a remarkable degree of stability in the advanced economies. Volatility is an inherent characteristic of financial markets, reflecting unexpected changes in the wider world, as well as sudden turns in sentiment about the future. However, we have gotten used to a quite stable world.

Elsewhere in this paper, I lay out a case for high economic volatility, both in terms of aggregates like GDP and inflation, but also the details of economic policy and the effects on different industries. Further, political instability and frequent interventions in business decisions would also shake the environment periodically. Taken together, these major sources of instability must lead to considerably more market volatility, as both reality and perceptions change sharply.

That volatility would also discourage investment, especially by retail and mass affluent investors, with a number of implications for financial institutions.

## IMPLICATIONS FOR FINANCIAL INSTITUTIONS

**Financial institutions must be fully prepared for rapid changes in the political and economic environment and even in the “rules of the road” by which they operate.** It will be dangerous to take long-standing arrangements for granted. Instability in institutional structures, more rapid changes in overall political philosophies, and greater political intervention in rulemaking and supervisory decisions should translate to instability in the rules under which financial firms operate. Risk management and strategic planning more generally have to consider a wider range of outcomes, as familiar institutions risk losing influence and the overall environment changes more rapidly and radically. As just one example, large US banks currently face a real question as to whether their binding capital constraint going forward will be the Fed’s stress tests, Basel risk-weighted assets, or the leverage ratio. There is a reasonable chance of each of these, depending on who is appointed to the key regulatory positions and what their relative level of influence is.

**Strategic planning needs to take account of a wider range of potential conditions.**

There will be more potential states of the world and more differences between them, than businesses have been used to for some time. It will be important to design strategies that are either more robust than before or that provide more options to alter the strategy if adverse conditions are encountered. One consequence of this will be to favor investments that pay off in the shorter run and to be more cautious about long-term investments.

**Diversification of business portfolios would be wise, all else equal.** Uncertainty and volatility put a premium on diversification of businesses, customer bases, geographies, and overall approaches.

**Culture, governance and incentive structures will need to be designed to allow more agile reactions to a rapidly changing world.** The impact of populism will just add to the pressures already being felt from technological progress and the advent of new competitors. Financial institutions will need to be able to make and reverse decisions more quickly and to drive the changes through the rest of the organization more swiftly than under more predictable environments.

**Emerging market credit risk may rise as potential support from multi-lateral lending institutions becomes harder to provide.** The IMF and World Bank have provided important support to emerging market economies in ways that may become more difficult if populist nationalism erodes their capabilities by cutting their resources and room to maneuver. This would happen at the same time that reduced private sector capital flows and greater economic and market volatility are likely to place bigger demands on these institutions.

**Stress tests will also need to consider a wider range of potential conditions.** These would include combinations of events that have not been seen for some time. Price controls, for example, can cause economic outcomes that are temporarily quite different than occur in a less constrained economic environment. Financial institutions may also have to model for their own purposes the potential for economic conditions to change quite rapidly even within a relatively short period of time, if a populist government switches from one experiment to another or is replaced by a more conventional one. Formal stress tests imposed by national regulators are unlikely to include such political risks, however, as they would overtly reflect a lack of confidence in political leaders.

**Capital and liquidity buffers may need to be increased.** More volatile markets increase the potential for sudden losses and the importance of having sufficiently high safety buffers to reassure customers, funders, regulators, and other key constituencies. In this respect, Western economies may start to look more like emerging market ones, where financial institutions have systematically carried higher buffers in recognition of the greater uncertainties and risks.

**Financial institutions may need to charge more for taking market risk.** Market making and other activities related to financial markets may need to generate more revenue or take less risk in order to maintain an acceptable risk/return profile in a more volatile world.

**Counterparty risk will increase.** Counterparties with exposure to market conditions will become more risky unless they take countervailing actions. This may particularly be a problem in the early phases of a new era, before firms have learned to navigate the new environment.

**Products may need to be redesigned or introduced to assist customers who fear volatility.** Businesses and households will have a greater need and desire for risk management products and services.

## MAJOR CHANGES IN ECONOMIC CONDITIONS

### LOW EXPECTED REAL RETURNS → HIGH DEMANDED REAL RETURNS TO OFFSET HIGHER RISKS

The sharp rise in market volatility and overall risk should move us from a period in which markets accepted historically low real returns to one in which expected returns have to rise substantially in order to lure investors to take risk. It is true that expected real returns are heavily influenced by the supply and demand of investable funds and that other factors such as demographics affect these. However, the postulated increase in risk is large enough that the supply of funds from those willing to take investment risk is likely to dry up, unless real returns rise enough to lure them back in. One should not rely on the assumption that there may be nothing else to do with the funds other than to invest them. History has shown that money can be stuffed under mattresses; put into gold, real estate, and other non-financial assets; or invested solely in the safest and shortest term investments available. The latter might mean that a considerable amount was “invested”, but it would still require a rise in expected returns to fund the bulk of investments that do not have an extremely safe profile.

### DISINFLATION AND EVEN DEFLATION → RISING INFLATION

There are multiple reasons why the era of disinflation that we have lived through for over thirty years may well be ending. Most basically, inflation is now about as low as policymakers are comfortable with and, indeed, there are already efforts underway to raise inflation rates to 2% or so in the advanced economies. Beyond that, it is at least two decades since citizens in most advanced economies have felt threatened or particularly harmed by high inflation rates. Therefore, there would initially be little popular pressure to keep inflation from rising. (Germany is an exception, as there remains a widespread and deeply ingrained belief in the country that high inflation in the 1920's destroyed Germany's economy and led to the Nazis, so that even modest levels of inflation are viewed negatively.)

The insidious side of inflation is that it is frequently the by-product of otherwise excellent developments. Increases in inflation are often due to economic strength and low unemployment, in particular during periods of overheating. Strong economic growth, low unemployment, and rising wages are welcomed by voters and their elected leaders. That is why central banks have been represented in jokes as the folks who take the punch bowl away just as the party is starting to get good. Being the spoilsport will become harder if populism erodes the ability of central banks to withstand political pressure.

Unlike most links between populism and the economy, for which there is a fairly sparse academic literature, there has been considerable research showing that populism tends to increase inflation.<sup>3</sup>

<sup>3</sup> See, for example, “The Political Economy of Inflation and Stabilization in Middle Income Countries,” Stephan Haggard and Robert Kaufman, World Bank Working Papers, W 444, June 1990. In addition to describing the situation in Latin America, there are a number of citations to work on advanced economies.

## IMPLICATIONS FOR FINANCIAL INSTITUTIONS

**Prices of existing instruments would fall, all else equal.** If the real returns demanded by investors rise, prices of existing instruments will fall, in order to raise the returns to new investors to an acceptable level. Financial institutions with substantial balance sheets may thus be hurt during a transitional period in which prices start to reflect the new environment.

**Initially, higher inflation may offset the hypothesized longer-term trend towards higher real interest rates.** Unexpected bouts of inflation reduce actual real returns. On the other hand, if firms, households, and markets correctly anticipate the prospective rise in inflation, then real returns will be preserved by an increase in nominal returns. As the 1970's showed, investors do catch on over time, even if they miss the first surges of inflation. Indeed, they tend to eventually overcompensate until inflation is clearly brought to heel.

**Higher inflation would need to be factored into the whole range of credit, investment, and strategic planning decisions.** Inflation is a core input into the returns from almost all financial decisions. The low and stable levels of recent years have meant that managements have spent less time considering this factor than they would have to do in a more inflation-prone future.

**Real estate markets may be hit by crises.** Existing floating rate mortgages may become unsustainable if nominal and real rates both rise, driving up the burden of mortgage payments. This is a particular concern outside the US, which is unusual in having a substantial percentage of fixed rate mortgages. Further, new mortgages may become less attractive and harder to qualify for, limiting the flow of new money into real estate.

**Product demand, and optimal product designs, would change.** A world with higher real returns and more demanding funders would present a different set of opportunities and challenges for the design of financial products. This would be magnified by rising inflation, increasing nominal rates still further.

**Profits would rise due to higher real returns, all else equal.** A big chunk of the profits for financial institutions with significant balance sheets come from returns on securities and loans. If real returns on these rise, profits will rise, all else equal. "All else equal," though, ignores the many ways in which economies and markets may be harmed in a more populist era, as described elsewhere in this paper.

**But, share prices of financial institutions may not rise.** Higher profits may be offset or more than offset by a rise in the returns demanded from their own shares, in addition to other damaging factors from populism.

## LESS GLOBALIZATION

### INTERNATIONAL COOPERATION→NATIONAL SOVEREIGNTY

A key element in the form of populism I describe is a pulling back from international cooperation and coordination and a focus on a nation's interests, narrowly defined. This is clearly shown in President Trump's calls for "America First" and his immediate moves to stop the Trans-Pacific Partnership negotiations and to renegotiate the North American Free Trade Agreement with the threat of American withdrawal if the negotiations are not successful. Brexit equally clearly was centered on a return of powers to the UK and most of the Continental populist movements look to take back power from Brussels.

We have grown used to a world in which, with some exceptions, there is a serious attempt at global harmonization of laws and rules that affect global industries and the removal of impediments to global business. In Finance, this includes the work of the Basel Committee on Banking Supervision, the Financial Stability Board, and many other global organizations. Industry may often dislike the specific standards, and politicians and regulators certainly do not achieve perfect harmony, but it is largely taken as a given that there should be harmonization.

Going forward, there is the potential for much less harmonization across borders and even outright conflict between the laws and regulations of different countries. Further, global emergencies, such as the Global Financial Crisis, may not be met with the same degree of international cooperation as in the last few decades, potentially prolonging a crisis or worsening its depth.

### EXPANSION OF TRADE AND CROSS-BORDER INVESTMENT→ SLOWING OR CONTRACTION OF CROSS-BORDER FLOWS OF GOODS, SERVICES, AND CAPITAL

For many years, international trade grew faster on average than domestic business and multi-nationals consequently exhibited faster earnings growth than other firms. Both trade volumes and capital flows rose substantially as a result of reductions in tariffs and other barriers, declines in transportation costs, improved communication and information technology, and, in many cases, falling political risk as more nations chose to abide by global norms.

Trade and capital flows may still rise, as technological innovations continue to lower costs and barriers, however populism is likely to substantially limit that growth and may result in outright contraction for periods of time. Competing nationalisms threaten trade wars, especially with declining influence from global and regional organizations and agreements. Further, foreign capital may come to be viewed with greater suspicion and the providers of that capital would likely face significantly higher risk of expropriation or unreasonable laws and regulations that hurt their profitability or limit their ability to return their capital back home.

Populism appears to be a major driver of the moves in the US and the UK to pull back from regional trade agreements. In a populist era, this pattern would be repeated in many other countries, leading to conflict between them over trading arrangements. The poster child for the risk of this behavior is the series of damaging trade wars that exacerbated the Great Depression and helped lead to World War II. Lesser trade frictions have done considerably less harm, but still leave countries fighting over the distribution of a global pie that grows more slowly.

In addition to the risk of outright trade wars waged with increased tariffs, import quotas, and other barriers, the same populist and nationalist impulses are likely at times to make a battle field of the foreign exchange markets. It is interesting that the Trump Administration has made exchange rates a major focus starting early in the campaign and continuing in the nascent days of the new Administration. Peter Navarro, head of the president's new National Trade Council, has already argued that Germany has an unfair trade advantage because it is part of the Euro and has a lower exchange rate than it would if not part of a union with less competitive economies. President Trump has also explicitly stated that the US dollar is over-valued, going against more than two decades of Administrations that have at least publicly favored a "healthy" dollar.

Populist governments are likely to be more willing to intervene directly in currency markets, and/or to put controls on capital movements, in order to achieve their targeted currency values.

All of these related trends would slow global growth by reducing or eliminating efficiencies that would be available in a more globalized world, including the movement of capital into nations with greater opportunities to put capital to use, especially in the emerging markets.

## IMPLICATIONS FOR FINANCIAL INSTITUTIONS

**"Balkanization" of banking is very likely to be reinforced.** Policymakers across the advanced economies have increasingly been demanding that banks have separate subsidiaries or ring-fenced activities in each country they operate. Cooperation between home and host regulators has given way in many cases to host regulators insisting that foreign banks effectively operate within their country as a local national bank with capital and liquidity dedicated to that country. This trend will doubtless become even sharper in a populist era. In particular, resolution and recovery plans will generally assume that help will not be available from cross-border parents or affiliates.

**Regulatory arbitrage may increase.** Pushing in the opposite direction, cross-border regulatory arbitrage would be encouraged to the extent that rules differ significantly across jurisdictions. This would be reduced to the extent that balkanization makes global banks into a coalition of national banks, but the global nature of finance should still allow for substantial flexibility in where companies borrow or do other financial activities.

**Cross-border investment by customers would be handicapped.** Balkanization will make it harder, although not impossible, for banks to intermediate cross-border flows. Unless financial markets buck the balkanization trend and become substantially more global, this will make it more difficult for customers to fund cross-border projects.

**Lending across borders and to multinationals would become less important.**

Financial institutions would have to find more of their lending opportunities at home. It is possible, though, that this increased national focus would result in higher margins as competition decreases.

**Trade finance may suffer.** Growth in trade would slow or reverse, leading to a lower demand to finance that trade.

**Foreign exchange markets would become substantially more volatile.** This would open up trading opportunities and, all else equal, increase client demand for risk management products, but also raise risks and reduce the willingness of customers to undertake activities that are affected by currency rates.

**Capital controls could limit most opportunities for banks.** Limitations on the ability to move funds across borders would eliminate some opportunities for financial institutions and place constraints on how they and their customers do business. This again would lessen the importance of multinationals as customers.

**But, artificial constraints on capital flows and exchange rates also open arbitrage opportunities.** Financial institutions that have more favorable opportunities than their customers would also benefit from artificial barriers. Sometimes, controls are less binding on financial institutions than on their customers, either as explicit policy or because of the range of activities those institutions engage in, which provide back-door solutions to capital or other controls.

## MANAGING FINANCIAL INSTITUTIONS IN A POPULIST WORLD

**As noted up-front, these potential trends would imply the need for major changes at financial institutions, including:**

- Political risk must become a key part of strategic decisions.
- Financial institutions must develop considerably more agility.
- Diversification of business, geography, and customers would have real value.
- Strategic planning and risk analysis must consider many more possibilities.
- The risk of war, hot or cold, must be taken seriously, including cyber attacks.
- Financial institutions must be designed to function well in a balkanized world.
- Capital and liquidity buffers may need to be increased.
- Products and services would need to be redesigned for a riskier and more volatile world.

These major adaptations would require strong leadership from the top, changes to governance and planning mechanisms, tough strategic decisions dependent on the actual environment, and a myriad of detailed business changes.

**Financial institutions need to think today about whether they could adapt as necessary if this turns out to be the era we are now in.** Actions should be taken now to re-evaluate strategic planning and stress testing processes to ensure that potential outcomes are not implicitly or explicitly dismissed as impossible. Beyond that, the potential for changes this large in the environment should be a further spur to redesigning firms to be more agile and to clear away the obstacles to good governance, sound data management, optimal financial resource management, and other key tools that will be even more clearly necessary for success.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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