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CCP CENTRE FOR COMPETITION POLICY

March 2009

Competition Policy, Bailouts and the Economic Crisis

CCP Policy Briefing

Competition Policy, Bailouts and the Economic Crisis

BACKGROUND

- The current economic crisis has its roots in a series of huge strategic errors by the banks. Permitted by weak regulation, and driven by biased incentives, the banks borrowed (and lent) far too much given their low capital base, and they were caught out when the asset price bubble began to burst heralding large-scale defaults. The global reach of this behaviour was compounded by the sale and purchase of opaque credit default derivatives between financial institutions.
- There have been two enormous consequences for markets. The first was that many of the world's most renowned banks have been pushed close to bankruptcy. The second was contagion into the non-financial sectors of the economy.
- A third potential consequence could be interventionist industrial policy in the wider economy and the emasculation of competition policy.

METHODOLOGY

- The author explains the economics of bank bailouts as distinct from bailouts for other sectors of the economy.
- Two questions are addressed: why do all the rules of good competition policy appear to fly out of the window when the banks get into trouble? And does this mean that we should abandon the rules equally for car manufacturers and other industries in trouble?
- The author reviews the threat of a retreat to politically-determined industrial policy and the need for vigilant implementation of economic effects-based competition policy.

KEY FINDINGS

The banks

- It is argued that a unique combination of two characteristics makes it essential to bailout or nationalise the banks in the current crisis.
- The first truly distinctive characteristic of banking from the competition perspective is that banks are so interconnected that the collapse of a large bank is contagious and contaminates the whole banking system. A large bank with substantial trading activities has a negative externality on its rivals: if it collapses, the stability of its rivals is undermined. This is in sharp contrast to other sectors of the economy where others in the industry can usually benefit from the collapse of a rival.
- The second distinctive characteristic is that bank finance provides the essential oil in the economic system, allowing other firms to absorb the bumps of fluctuating revenues and payments. The product of no other industry is so essential to *every* other market in the system.
- Given the characteristics of banking, the major banks expected to be bailed out. The anticipation of bailout created a moral hazard that biased decisions towards risk taking. But while bailouts have saved many banks from collapse, they only further reinforce moral hazard.

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Other sectors of the economy

- No other sector of the economy shares the pair of characteristics that set banks apart for state intervention in the current crisis.
- Subsidies undermine market outcomes and processes. Restructuring is painful, but it is less than the harm caused to: efficient rivals who suffer reduced market share; customers who are offered costly and unattractive products; taxpayers whose real income falls; or the elderly, the sick and school children who suffer from diverted public spending.
- Ironically, if private banks continue abnormally withholding credit, nationalising a few banks and instructing them to lend on standard commercial terms may be the best way to save efficient competition in the non-financial market economy.

Competition policy

- History suggests that competition policy will be increasingly under threat as the recession bites. People will draw a plausible, though inappropriate, analogy between their own industry and banking bailouts, and those already in trouble before the crisis will grab at the opportunity to plead their case.
- The number of anticompetitive interventions worldwide currently appears relatively limited, but there are dangerous signs.
- However, the crisis enhances the need for diligent and vigilant competition policy to avoid negative long-term consequences.

POLICY ISSUES

- It would be a grave mistake to go backwards and replace competition policy with industrial policy. Government money is needed until the financial system can provide liquidity in sufficient volume, and active monetary and fiscal policies are needed to stimulate aggregate demand. It may be quicker and less costly to nationalise some banks and instruct them to lend on commercial terms.
- But activism makes it even more important for a strong competition policy so that business energies are naturally guided into satisfying consumer needs and are not diverted into cosying up to their rivals or lobbying politicians.

THE CCP

The ESRC Centre for Competition Policy (CCP), at the University of East Anglia, undertakes competition policy research, incorporating economic, legal, management and political science perspectives, that has real-world policy relevance without compromising academic rigour.

FOR MORE INFORMATION

The full working paper (CCP Working Paper 09-4) and more information about CCP and its research is available from our website: www.ccp.uea.ac.uk

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