THE FINANCIAL CRISIS AND COMPETITION POLICY: SOME ECONOMICS

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What went wrong?

- Global imbalances, macroeconomic stability and *laissez faire* policy led to vast expansion of balance sheets of banks &c
- US sub-prime defaults and asset price drops exposed systemic financial fragility, not just re-pricing of risk
- Solvency fears about some institutions
- Liquidity problems for many as credit markets seized up
- Bank balance sheet interconnectedness globally
- Downward spirals in asset prices
- Real economy hit

[See the Bank of England's Oct 2008 *Financial Stability Report* for full analysis]

Some events

- Aug 2007: sub-prime crisis hits, credit spreads leap
- Sept: run on Northern Rock, rescue package
- Mar 2008: Bear Stearns
- Spring: rights issues by banks
- Sept: Fannie Mae, Freddie Mac, Lehman, BoA/Merrill Lynch, AIG, WaMu, Wachovia, ... ; spreads leap further
- Lloyds TSB/HBOS merger announced on 18 Sept
- Oct: Fortis, Iceland, ...
- Markets slump

Policy responses

- Central bank liquidity schemes
- Deposit guarantee extensions
- Bans on short selling
- Troubled assets relief programme
- State ownership of banks
- Official rate cuts
- Disapplication of merger control for Lloyds TSB/HBOS
- UK package of 8 October to support recapitalization of UK banking system

Some economics of confidence

- Banks &c borrow short-term and lend long-term
- This is efficient and desirable but also vulnerable to loss of confidence
- In good equilibrium, funders (e.g. depositors) continue funding and banks hold assets (e.g. business investments) to maturity
- In bad equilibrium there is a rush to the exit − a bank run or refusal of refinancing − and the institution goes broke
- Lender-of-last-resort and deposit guarantee policies aim to keep us at the glad confident equilibrium
- But what if even the long-term value of the bank’s assets falls short of what it owes to funders? Solvency problem

Some economics of contagion

- How did global contagion spread from US house prices?
- Confidence effects just part of it
- Also heightened counterparty risks, pro-cyclical leverage (Shin) and international balance sheet multipliers (Krugman):
  - counterparty fears and falling asset prices lead highly leveraged institutions to shrink exposures,
  - which they do by selling assets,
  - which ... you’ve guessed it
- On this view the problem is not just confidence but insufficient bank capital to cushion the knock-on effects

Need for systemic recapitalization

- Need to strengthen bank balance sheets
- October package promotes this by Government willingness
  - to subscribe capital (pref shares or equity) s.t. conditions
  - to guarantee debt for a fee
  - BoE liquidity schemes extended and money market ops reform
- System-wide, so no distortion of competition among UK banks
- Moreover, good for non-UK banks given contagion risks, and scheme principles have been emulated internationally
- So no real tension with competition policy

No merger control of Lloyds TSB/HBOS

- May have seemed quite a good idea in mid-September to hope to solve the HBOS confidence problem at invisible expense
- But a mistake in fact:
  - manifest risk of substantial lessening of competition
  - weakened credibility of UK competition regime
  - does little to solve the real problem, which is systemic and one of capital
  - lacking rationale once the October package addressed the real problem
- What to do if competition problems materialize *ex post*?

Competition policy in an economic recession

- Double risk to competition policy:
  - field day for established vested interests
  - debt-ridden governments seek non-financial ways to “help”
- Risks must not be allowed to materialize:
  - compared with competition, firms with market power *restrict* output and raise price
  - bad macro-economically as well as otherwise
- Like puppies, competition policy is not just for Christmas