

# Competition Policy and the Credit Crunch

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# Introduction & Summary

- Current crisis shows limits of competition policy
- Summary
  - Comp policy framework is basically sound.
  - Naive comp policy could be harmful if blocked/slowed some necessary policies
  - Political economy problem: there will be too many exceptions & we open Pandora's Box

# Structural causes of financial crisis

- History well known – sub-prime crisis sparked banking crisis & now real economic crisis [see Annex]
- Financial sector prone to instability
  - Wholesale
  - Retail
- Financial sector has huge “contagion” effects to the rest of the economy
  - “too big to fail” problem
  - Structural moral hazard creates incentives to be overexposed to risk

# Policy Response

- Short term:
  - Monetary stimulus
  - “De-toxify” the assets (e.g. Create bad banks); “bail outs” (government equity in banks; loan and deposit guarantees)
  - Fiscal stimulus [to consumers not producers]
  - A global problem
- Long Term:
  - Regulation of banks. A WFO? (IMF \$250bn only)
  - Transparency, e.g. markets for OTC (like CDOs)
  - Counter-cyclical capital holding requirements
  - Compensation structures
  - Mark to market rules

# State Aid

- Justification in 87(3)(b) of European Treaty “serious disturbance to the economy”
- But other sectors demanding aid – e.g. US auto makers.
  - Bad precedent for scarce public funds
  - Allowing firms to exit & re-structure a vital part of market economy
- Financial system is special because of contagion effects
- But new defence of “macro-stability” opens up a Pandora’s Box. Lots of lobbying. Where to draw line?

# Failing Firm defence

- Allowing a firm to merge if otherwise assets would leave the market
- Usually assets do not leave the market
- In financial crises, however, often they do (fire sales, deadweight loss)

# Conclusions: Political Economy

- An era of more influence of government in the economy
- How do we judge when times should be “back to normal”?
- Dynamic of intervention makes it hard to go back
- Further, backlash against capitalism leads to state regulation in non-financial sectors, hunt for more subsidies, etc.

# Annex

- For more discussion see <http://cep.lse.ac.uk/new/research/productivity/spillovers.asp>
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# What has happened?

- Global imbalance between savers (Asia, Middle East) and spenders (US, UK)
- US sub-prime housing crisis sparked
- Securitization (MBS, CDOs, etc.)
- Rating Agencies (key failure) AAA allowed many regulated institutions (e.g. German Landesbanks) ability to invest in highly risky assets
- Systematic failures of regulation.

# The toxic assets

- Collateralized Debt Obligations (CDOs). Example is MBS (mortgage backed securities)
- Banks have loans to individuals for home purchase. Obtain interest but bear risk of default. Pooling individual risks diversifies risk unless defaults perfectly correlated
- These can be sold on. “Tranching” further divides the risk. Senior tranche safer than junior
- This is what enabled some CDOs (esp senior and CDO2) to be AAA rated. This allows more “safe” investment by (e.g.) regulated pension funds
- In principle, a good idea

# The problems.....

- Most of these not AAA.
  - Underestimate of default risk (e.g. US Sub-prime). This should have been obvious as predicting % of those default based on early 2000s mini-slump when relatively few sub-prime
  - Underestimate correlation of default risk
- Why did Rating Agencies get it so wrong?
- Banks holding CDOs, etc. Marked down capital, but huge uncertainty as to how much. Hence big fear of default and drying up of inter-bank lending (Libor, TED)
- Escalation after Lehman's bankruptcy