The pressure to suspend competition policy enforcement in banking is formidable. In Britain, the government blocked a referral of the HBOS-Lloyds TSB merger to the national competition commission, on the grounds that the stability of the U.K. financial system was an overriding concern. The French, German and other governments have complained that the European Commission is slow in approving bank-recapitalization packages, and that this is delaying the granting of credit to firms and consumers.

The truth is that the massive bank bailouts in the European Union, as in the U.S., are distorting competition in financial services. This is in part because not only failing institutions have been recapitalized. Even relatively sound institutions, thanks to public help, are gaining a competitive advantage in terms of a lower cost of capital and probability of failure. This race to recapitalize national banking systems has the flavor of a national champion contest and, not surprisingly, does not help in getting credit to the private sector. Private banks will only give credit if they think that doing so will be profitable.

Also problematic is the moral hazard which these bailouts induce. Saving today those institutions that have taken excessive risks will encourage imprudence tomorrow. The systemic banking crisis risks debilitating competition policy in a fundamental way -- and not only in banking. Witness the calls for help from other sectors, with the automotive industry at the forefront. The policy issue is how to prevent the present distortions in banking from becoming permanent and spilling over to other sectors.

It is worth recalling that, not so long ago, competition was thought to be detrimental to stability. Central banks and regulators were complacent about collusion agreements among banks. This has changed progressively because the lack of competition led to too much inefficiency. Now competition policy is taken seriously in the banking sector. Brussels has intervened against national protectionism, cartels and anticompetitive mergers. All this is for the good since competition in general is not responsible for the fragility of the banking system: Even a monopoly bank may be subject to a run.

Yet EU and U.S. competition authorities have treated banks as if they were like any other sector. They are not. There is a trade-off between competition and stability.

Competition that is too intense may erode the charter value of a bank -- that is, its value as a going concern -- and give it incentives to take excessive risks. When there is not much to lose, there is a tendency to gamble. This tendency is accentuated in the presence of limited liability, which restricts the losses but not the gains. Zombie institutions, distressed and barely alive, may awake to gamble for resurrection, using very risky strategies with scant chance of success.

The problem, obviously, is that a failure of the banking system may grind the economy to a halt. This is what happened in the Great Depression, and this is the threat we face now. No sensible government will allow this to happen, if it can be avoided.

To minimize the risk of a systemic crisis, and to take account of any public intervention, competition policy should recognize the uniqueness of the banking sector. We should consider whether a higher degree of market power could be tolerated and some limits to competition established in certain conditions. For example, the activities of...
distressed institutions in danger of gambling for resurrection clearly should be limited. The same should apply to institutions that are de facto fully insured because they are “too big to fail.” Regarding mergers, we should consider whether the standard concentration thresholds -- which, roughly speaking, proscribe unions that would create a company with market share above a certain level -- should be relaxed somewhat. Finally, state aid rules should account for the need for swift intervention when there is a systemic problem, and should be adapted to the specific restructuring needs of banks.

Replacing the naive view that banking is like any other sector would have another important benefit: It would prevent the spillover of the current added flexibility of competition policy to other sectors. Banking's partial exception to the competition policy regime would be founded in its systemic position in the economy. To put it crudely: The U.S. can survive without the Big Three auto makers, but it cannot survive without the banking system. The same applies in Europe, where the automotive and biotechnology sectors are next in line to beg for public money.

Such recognition of the singularity of banking would allow Europe's competition policy to keep playing its fundamental role of keeping markets open and protecting the single market -- goals which today are under threat because of the uneven playing field generated by banking bailouts and the lobbying of other sectors seeking help. The alternative is to be pragmatic and flexible -- today with banking, tomorrow with the car industry -- until competition policy is fatally weakened. A protectionist, anticompetitive spiral was one factor that aggravated the Great Depression. We should move now to avoid repeating that mistake.