Did healthy competition sicken the economy?

Many blame the recent collapse of the banking sector on previous decades of deregulation and the unfettered competition it inspired. But when banks are ruled with an iron fist, we pay the price of market dictatorship by a strong few.

July 14, 2010

Remember when your local bank was regarded as a pillar of society? But before hearkening back to some golden age of finance, when stability and rules were the order of the day, remember the downside, too: inefficiency, collusion, high entry barriers for new banks, and complacency.

Recognizing the importance of free-market competition, successive governments attempted to strip away the layers of regulation that prevented it. But with these leaps and bounds came booms and busts, culminating in the recession we now find ourselves in.

Was the liberalization of the sector the catalyst for this instability? And is competition policy to blame?

In his paper, "Competition and Stability in Banking," IESE Prof. Xavier Vives reviews existing literature and studies on the subject to draw correlations and make recommendations for regulators and policy makers.

He finds that liberalization of the banking sector has indeed led to some potential negative consequences: worse coordination between depositors and investors, giving rise to depositors quickly withdrawing all their funds ahead of possible bank insolvency. He also finds that competition increases incentives to take risks.

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But it's not all bad news. Competition, he says, is essential for preventing another evil: excessive market power held by a select few.

So what's the answer? Regulators and competition policy makers must work together more closely, so that regulation is tailored to the level of competition at a particular time.

Banking trends

Vives compares the banking sector before and after liberalization. After the Great Depression of the 1930s, everyone was keen to protect the economy, so regulation was introduced, such as the U.S. Glass-Steagall Act, prohibiting savings banks from diversifying with investment banking, and vice versa. Deposit insurance, which covered people's savings in the event of a bank's collapse, was also established.

In the 1980s, the repeal of parts of the Glass-Steagall Act and general globalization contributed to liberalization, which revolutionized the sector. During this time, banking grew in real terms, with financial assets of intermediaries in the United States going from less than 100 percent of GDP to more than 300 percent by 2007.

Vives asserts that banks need special regulation because they are, by nature, fragile. Because the banking sector deals in cash, there can be a problem with coordinating the timing of depositors and borrowers. They are susceptible to runs, when people withdraw out of panic.

As we all know, there is also a high social cost if banks fail. This is why we have deposit insurance. But this can have the effect of moral hazard, when banks don't make an effort to achieve good results, or take too many risks because they know they'll be bailed out.

By examining available literature on the relationship between competition and stability, the author finds that instability is caused by bank runs and when the actions of depositors and investors don't match up. While any bank is susceptible to these problems because of their inherent fragility, competition may make the problem worse.

Vives also looks at the empirical evidence to support the view that competition increases instability. In a competitive market, the stakes are high: If a bank does well, its charter value goes up, thereby increasing its market power and the bank becoming more conservative.

Admittedly, risk-taking can be a problem independent of competition: Deposit insurance can encourage "safe" banks to take risks because the consequences of failure aren't dire. Even

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so, there's no getting around the fact that deregulation, designed to stimulate competition, also increases risk.

Can we regulate away the trade-off?

After establishing that the trade-off between competition and stability exists, Vives asks whether regulation is the answer. He argues that, in imposing rules on the sector, we shouldn't regulate away competition. Instead, rules should become tighter as competition intensifies. Capital requirements, or the amount of money banks have to keep aside for a rainy day, should be adjusted according to friction in the market.

Here the author looks at the policy responses of the United States and European Union to the recession. It seems that, as the dust of the financial crisis begins to settle, we are seeing a return to traditional banking. Governments have had to bail out the banks, and in some cases even forced banks to sell off some of their operations.

While liberalization has gone hand in hand with competition to revolutionize the banking sector into service provision, we are now seeing more consolidation that is counter-competition. For example, in the United Kingdom, Lloyds TBS took over HBOS, even though this was opposed by the Office of Fair Trading for creating a large entity.

While such measures may be necessary to restore stability, competition should not be stifled, warns the author. Instead, regulation should be fine-tuned with competition in mind. What also needs to be addressed is whether banks should be allowed to get so big that they influence regulation.

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