COMPETITION POLICY IN BANKING SECTOR AND THE ECONOMIC CRISIS

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Abstract. *The economic crisis has led to changes not only in the real economy but also in the economic theory. The identification of the factors that generated the economic recession and the measures that should be adopted to minimize its adverse effects are a common concern. The article aims to clarify on the one hand, the extent to which competition policy applied in banking sector contributed to the crisis and, on the other hand, the opportunity for changes in the same policy aiming the economic recovery. Competition policy once reconfigured, it must be carefully implemented given the banking systemic risk and its essential role in the prevention and treatment of crisis.*

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1. Introduction

The recent economic crisis, considered by some economists even more serious than the one manifested in 1930, has rally all the world's governments in looking for solutions to overcome and minimize its negative effects. The emergence and evolution of the crisis, more or less surprising questioned many of the so far economic beliefs and ideals.

The slow response of the economy to the measures taken to combat the crisis gave birth to a series of controversies on how policies should be oriented so that their results manifest in time and efficiently. Certainly, besides the effects of the current economic crisis generated in the financial system and in the real economy, it will also generate a new perspective on business models, policies and measures that provide the best results.

In terms of economic theory, the crisis of 2008 has revived the debate between proponents of state intervention and those who argue that markets alone can lead to prosperity and growth. The lessons and solutions arising

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from these ideological confrontations seem to tip the balance more and more to the need of a more regulated, more controlled system, assigning a central role to the market in the economy but that show that without state intervention markets do not function properly. Market failure requires government intervention, not only when it occurs but also in order to prevent the manifestation of such failures.

The paper is divided in two parts. The first part provides a general overview of the crisis, focusing primarily on the United States of America and Europe while the second part is focused on the competition policy applied both before and post crisis, emphasizing the changes that took place at the level of this policy as a result of the global economic imbalances.

2. A review of the events

The banking systems have suffered numerous shocks over time which led to massive withdrawals of funds and which determinate an imminent bankruptcy of several banks. The biggest economic downturn which occurred in 1930 has outlined an opinion, more or less unanimous among economists, which says that "the thing that turned an ugly recession into the Great Depression was precisely the banking crisis" (Krugman, 2009, p. 180).

Among the solutions adopted then, in order to stabilize the system and to avoid future major imbalances, perhaps the most prominent was the Glass-Steagall Act that separated commercial banks whose main activity refers to making deposits, from the investment banks whose activity did not allow this. Investment bank activities consisted in advisory services, investment management, financing and research. Taking into account the level of risk to which those two types of banks were obeyed, it was also required a differentiated form of regulation. Commercial banks were subject to stringent rules regarding the risks that they can undertake and were able to take loans from the Federal Reserve System (FED), and their deposits were guaranteed. Investment banks instead were subject to less restrictive rules, given that in their case there is no risk of massive withdrawals because these institutions do not constitute deposits. At that time, the new form of organization of the financial system proved to be

efficient keeping, on long term also, the economy away from large scale economic crisis. Therefore, many economists have put the recent economic crisis, to some extent, on account of repeal of the Glass-Seagall Act in 1999. In Stiglitz's view, the main consequence of the repeal of this act consists in a change in the culture of the commercial banking system which determined the creation of more banks too big to fail. The confidence that these banks will be saved in case of a bankruptcy represented an incentive for taking excessive risks in order to obtain high profits (Weissman, 2009).

Looking in retrospective to the events that led to the largest decline of the modern economy, many papers written on this subject provide different answers to the question regarding the causes that led to the manifestation of such failures in the economy. But, in principle, two causes are widely accepted in the literature: the first cause is considered to be banking deregulation that facilitated risks taking by the banks and the expansion of the shadow banking system whose activity was not assimilated to traditional banking activity and for which the regulation was not considered a priority by the authorities. Referring to the shadow banking system to which it was assigned a major responsibility for the crisis, Krugman believes that is necessary that "… anything that does what a bank does, anything that has to be saved in case of a crisis like the banks are saved should be regulated like a bank" (Krugman, 2009, p. 188). The second cause takes into account the excesses, especially monetary excesses. The economic boom manifested in the early 2000s, was achieved also on the background of expansionary policies practiced by governments. For example FED lowered successively the discount rate from 6,5% to 1% between January 2001 and June 2003 (Lin, 2008, p. 2). The low interest rates and the favorable economic context led to a rapid growth of loans, along with an increase in house prices which stimulated even more the granting of loans, especially mortgages.

In the first part of the year 2007, the implications of this excessive consumption on debt became more and more obvious. Although the economic crisis has been, to some extent anticipated, it represented a surprise for most. In September 2006 the economist Nouriel Roubini, in a presentation held at the Internationally Monetary Found spoke about how the economy will evolve in the near future. Although at first no one believed him, a year later his predictions were confirmed. What followed

was a contraction of the economic activity manifested simultaneously in all economic sectors.

On 15 September 2008 Lehman Brothers Holding Inc. went bankrupt, after its takeover negotiations by Barclays PLC and Bank of America have failed. The equivalent value of its assets evaluated at U.S. $ 639 billion, has made it the largest bankruptcy in United States of America history (Onaran and Scinta, 2008). The panic created has spread rapidly throughout the financial system, outside the American borders. In this context, the main problem derived precisely from the relation debtor/creditor. Bank funding has been made, in most cases, for long periods of time by short-term liabilities, which created a high sensibility of the system to massive cash withdrawals. This type of problem has manifested itself much more seriously in the shadow banking system where the deposits did not benefit from hedging expose. The immediate reaction of the banks was to limit the loans, not only the ones given outside the banking system but also the loans given between banks, through this action the effects of the crisis have been transmitted to the real economy and the results were devastating. Many of the companies that did not meet the conditions to qualify for funding from the banks, have closed their activity, while others were forced to pay higher interest. The cessation of firm activities has led to a rise in unemployment, a decline in production and inevitably an increase in the non-performing loans within the economy.

The interconnections of the global banking system have facilitated the transfer of toxic assets in the European states as well, causing serious problems in many of these states. The lax regulation made pre crisis and the important role given to the banking system within the economy has made the cost of saving the financial system even higher. In United Kingdom, Northern Rock, the fifth British mortgage lender faced a typical situation of massive withdrawals of funds from depositors, situation unseen since 1866. The panic was caused precisely by the announcement made by the Bank of England regarding the support given to Northern Rock, which was meant to prevent withdrawals of funds, but the effect was the opposite one. The withdrawals amplified and all attempts to secure control of the situation have failed. The restoration of depositor's confidence was achieved only after they were assured that their deposits were safe (The

Economist, 2007). By early October 2008, United Kingdom was forced to recapitalize eight of its banks. The action was followed by an agreement at the euro area level regarding new liquidity injections into the banking system and providing guarantees for interbank loans, the cost of these actions was around $ 1.3 trillion (Wim, 2009, pp. 3-4).

The overvaluation of housing prices created in Spain as well, a real estate bubble that strongly affected the economy after 2007, along with the collapse of the international markets. The breaking of the housing bubble has affected especially the banks that were holding mortgages and loans to developers. The nationalization of the third bank of Spain, Bankia, in 2012, highlights the risks in the Spanish banking system.

A main problem of European states in the current economic crisis is debt. In Portugal, the increasing debt simultaneous with the economic contraction was the main preoccupation of the government. The inter-connections of the banking system have made many Portuguese companies to be financed by Spanish banks, creating the danger of a domino effect, through which the instable economy of Portugal could cause a deepening of the Spanish banking sector imbalances.

The bank failures have not spared France either, and the governments intervention to save the banks has not delayed. The crisis effects have manifested in all sectors of the economy, the funds reserved for investments were reoriented to support banks, while the decrease in trade and production led to a significant contraction of the gross domestic product in this country as well.

The aggravation of the problems in America and Europe triggered a decline in aggregate demand in all developed and developing countries. Developing countries were facing a decline in capital flows entering the country and in some cases even a reversal of this process, phenomenon produced in 2009 in Romania as well. The lack of funding to support the economy has forced many countries to turn international lenders. These loans have come accompanied by harsh austerity measures.

The increase in magnitude of the global economic crisis and of its negative effects has brought into focus the rating agencies and their lack of performance in identifying and assessing the risks to which the new products of the banks have exposed the economy. The erroneous decisions of the rating agencies have questioned their credibility. In September 2008,

Lehman Brothers went into bankruptcy with an investment rating of level A-. The same rating that insurance company American International Group (AIG) had when it was saved from bankruptcy by the government. In none of the two cases, no error or fraud in the institutions actions were found, that might justify the misinterpretation of the rating agencies.

Nevertheless, some causes of poor performance of these institutions can be identified. These include: conflicts of interest, credit rating agencies were paid by the same banks who's products they were evaluating; oligopolistic market structure of rating agencies, the three institutions Standard and Poor's, Moody's and Fitch have 95% of the market; the inability of the credit rating agencies to verify the information or to require any additional information needed in the evaluation process etc. (Rafailov, 2011, pp. 37-38).

The excessive risks taken by the banks in order to obtain high returns, the failure of rating agencies to assess and warn about these risks and the new policies of the governments, aiming the deregulation of the banking sector, have determined the biggest economic contraction in the last eighty years. The present and future concern should consider the causes and the modalities through which this economic downturn could be overcome and the tools which should be mobilized in order to prevent and stop such failures in the economy.

3. Competition policy and the global economic crisis

The economic crisis has not questioned a bit the general economic principle that competition leads to a more efficient allocation of resources, fosters technological progress and innovation, and leads to an improved national competitiveness as a whole. The doubts about the effectiveness of competition were considering a particular sector, namely the banking sector. The modern financial system is characterized by less competitive environment with large banks, which are highly interconnected and can represent a big problem for the uncertain future of the economy.

The repeal of the Glass-Steagall Act has created the possibility for the commercial and investment banks to unite. This lead to a more complex financial system, expanding the group of products that banks could offer thus creating large institutions whose failure became unacceptable due to

the widespread negative effects that it could produce with direct impact on consumers. The regulation of the financial system had the porpoise to avoid risky behavior of the banks and to ensure financial stability, taking into account the damage that the financial market failure can cause to the economy as a whole. The problems that emerged afterwards in the financial system were not determined by the existence of the regulation itself but by deficiencies in regulation and in the enforcement of the existing rules, which facilitated the transfer of the collapse costs of the financial system from the banks to the consumers.

The engagement of the resources in order to rescue the banks, created an incentive for taking new risks. Given the economic environment and the level of the capital injected into the global financial sector, inevitably comes the question: if banks are too big to fail, and need to be saved, on the taxpayers' expense, why are them let to become so big? The only justification for allowing the existence of such large institutions would be, if they would produce significant economies of scale or scope that would otherwise be lost. In other words, their existence would be justified only if these institutions would be more efficient than the small ones and the reduction of their size would be possible with an extremely high cost (Stiglitz, 2010, p. 165).

The protection granted by the state to these institutions creates an anti-competitive framework in relation to the other banks who do not enjoy the same treatment and who survive because of their effectiveness. This treatment provides to large institutions a competitive advantage, one that is not based on efficiency and performance but one generated by the distortions that government guarantees create.

However, the problems of the financial system are not a strict consequence of the size of institutions but also a problem of the high degree of interconnection between banks. The failure of even a small but highly interconnected institution can cause the same negative effects as the failure of a large institution. Therefore, regulation of the banking system is difficult and specific. Competition policy and the legal framework of the banking sector may be the necessary tool to prevent and combat the problems of the financial system and minimize the chances of new large imbalances in the global economy.

The benefits that competition policy creates are generally more important in times of recession, and the link between competition policy and economic growth should be considered first. The application of efficient competition measures, which prevent illegal mergers between companies or the ones that consider cartels dissolution produce benefits to consumers through lower prices and increased buyer power. However, a competitive environment stimulates firms to innovate, automatically determining an improvement in productivity witch boosts economic growth.

The changes in the economic environment raise new challenges for competition authorities and competition policy. The economic crisis requires adjustment measures to meet the new situations arising. Such adjustments may take into account: temporal adjustments of the measures implemented, so that it could respond to the urgent situations arising; competition policy focus on sectors that directly or indirectly affect household spending to minimize the burden on consumers and the sectors in which competition can increase productivity; supervision of the implementation modalities of state aid (Lowe, 2009, p. 6).

In the context of the global economic crisis, especially in the European Union there have been pressures on the competition rules regarding state aid, to minimize the interference effects and distortions created by liquidity injections in order to support the economies. To this end, the European Commission adopted a Communication to smooth the way for the application of state aid rules for financial institutions receiving assistance from the state. Through this Communication it will be ensured the implementation of measures such as not to create distortions in the common European market.

Regarding the antitrust measures applied in the European Union, there were pressures to relax these measures and to tolerate cartel and abuse of dominant position, where they were needed, but the competition authorities at the level of the Union considered the relaxation of these measures as contraindicated.

Consumer protection must remain a priority for the competition authorities even in periods of economic recession. The crisis cannot be used as an excuse to pass the costs of the recession through cartels or abusive practices of firms that face problems, to consumers (Lowe, 2009, p. 22).

4. Conclusions

Understanding the events that led to the global economic downturn is of particular importance and should consider finding the answer to the question; *why* such events were possible in a system that seemed safe and stable, founded on the lessons of the crisis from 1930.

The economic crisis has highlighted weaknesses in the regulation, the development and the expansion of the financial system has not been accompanied by legislative rules that could limit the reckless behavior of the banks and could guarantee the safety of the population savings. Easing credit conditions and using a deficient economic model which took into account a continuous increase in housing prices led to the collapse of the banking system that brought down with it the entire economy. The negative effects manifested in the real economy were hardly supported by the population, and the costs of recovery can be seen in the high levels of debt and financial deficits held by most states.

But behind the banking crisis, which through various measures and efforts of the governments and states will be outdated sooner or later, another type of crisis is emerging, a crisis of confidence in financial systems and in the economic efficiency of the model followed so far. This type of crisis will be much more difficult to overcome and it will slow down the global economic recovery.

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