The Financial Crisis and Financial Nationalism

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Summary

The financial crisis has necessitated many interventions to support financial systems and resume intermediation. By nature, these measures are distortive, directly—as they support intermediaries in non-market ways, and indirectly—as they distort intermediation and in turn resource allocation. Measures also have international repercussions, most notably when governments extend guarantees to intermediaries—that directly distort financial and capital flows, and through capital and other support measures—that often favor national institutions and have a bias towards local lending. Implications for competition are not obvious, however. Competition in the financial sector is a complex issue to begin with. And support during periods of financial stress can enhance competition as it avoids the elimination of (non-systemic) institutions essential to contestability. Nevertheless, state support has led to many distortions and undermined competition. Greater efforts to harmonize support measures across countries can help (re-)level the playing field, avoid major distortions and thereby help restore competitive conditions. There also is a need for improved coordination when exiting from the various interventions. Many distortions remain unavoidable in the short-run, however, with adverse consequence for competition. For the medium term, given an ever tighter integrated global financial system, there is a need for greater cooperation and coordination across countries, also to avoid an escalation of nationalism. Existing approaches—aimed largely at greater convergence and coordination—will likely be deficient, as they do not avoid the necessary, but ad-hoc and distortive interventions in times of stress and take too much time to put in place. The necessary multilateral mechanisms with strong ex-ante commitment and ex-post enforcement powers are largely lacking—except for arrangements in closely integrated regions and even these are incomplete. New approaches are therefore necessary. I argue that an International Bank Charter (with dedicated regulator, lender of last resort, deposit insurance and recapitalization funds) specifically for large, international active banks offers the best approach to assure a level playing field and fair competition.

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1. Introduction

The financial crisis has necessitated many interventions to support financial systems and resume financial intermediation. By nature, these measures are distortive, directly—as they support financial intermediaries in non-market ways, and indirectly—as they distort financial intermediation and resource allocation. Measures also have international repercussions, most notably when governments extend guarantees to financial intermediaries—that directly distort financial and capital flows, and through capital and other support measures—that often favor national institutions and have a bias towards local lending.

Implications for (international) competition are not obvious, however. Competition in the financial sector is a complex issue to begin with. And support during financial distress periods can avoid the elimination of (non-systemic) institutions which may be essential to competition—today and in the future—and to maintain contestability. Nevertheless, and especially given tightly integrated regional and global financial systems, there is a need to avoid large distortions and an escalation of these forms of nationalism. This in turns calls for greater coordination across countries. Greater efforts to harmonize support measures across countries can help (re-)level the playing field, avoid major distortions and thereby help restore competitive conditions. There also is a need for improved coordination when exiting from these interventions.

Except for arrangements in closely integrated regions, however, mechanisms with strong commitment are lacking. Much of this arises from the weak framework for regulating, supervising and restructuring large cross-border financial institutions, which in turn leads to the excessive government support because of "too big too fail" concerns. While the ad-hoc and distortive interventions triggered by financial turmoil are unavoidable, and will continue in the short-run, for the medium term, a new approach is necessary. I argue that an International Bank Charter (with dedicated regulator, lender of last resort, and deposit insurance and recapitalization funds) specifically for large international active banks offers the best approach, possibly global, but at least on a regional basis. Only then is there scope for a concurrent, credible competition policy regime.

The structure of the paper is as follows. It first briefly reviews the causes of the financial crisis and the sources of cross-border spillovers, and the various government responses in advanced countries to date. The next section discusses the repercussions of the various interventions on competition, the policy issues and actions taken, and resulting effects on international competition. It sets the stage for the possible reforms regarding cross-border banking by reviewing financial reforms options that will facilitate better competition policy. After quickly reviewing a first best solution—a world financial regulator cum competition policy agency, it evaluates several other options for regulating and supervising large, complex, globally active financial institutions. It discusses the advantages and disadvantages of each from a competition point of view, stressing that options are difficult to rank. The last section concludes.

2. International dimensions of the crisis and state of affairs

I briefly review the causes of the crisis and the channels for its spreading, including the international spillovers, to help put interventions into perspective and make the solutions for competition policy address the deeper causes and not the symptoms. This will help identify those interventions with effects on other countries, some of which may have been anti-competitive. It will also help to identify the nature of international coordination issues and the need and scope for more general reforms.

Causes of the crisis

Although the debate on the relative importance will continue for some time, its various causes are well documented elsewhere (Calomiris, 2008). The causes concern both those common to past financial crises as well as new elements. The similarities include that the crisis was preceded by a period of high credit growth, rapid asset price appreciation, notably house prices, and accompanied by large capital flows to some countries. These patterns were not limited to just the US, but also occurred in many other markets at the forefront of the crisis (UK, Iceland, Eastern Europe). And the buildup of risks occurred in a context of relatively benign global macro economic conditions, including low real interest rates.

Differences in this crisis include more opaqueness, and a greater (perceived) lack of information. Another new aspect is the greater financial complexity and more interconnection among asset classes and parts of financial system, including increased international financial integration and heightened importance of global financial players. Increased leverage of many financial institutions and much use of short-term/wholesale funding sources, made liquidity more pertinent to the evolution of the crisis. And, varying by market, specific weaknesses existed in regulation (e.g., SIVs), supervision (e.g., mortgage markets at US state level), conflict of interests (e.g., at rating agencies), and incentives structures (e.g., in the originate-and-distribute model). A different, yet common across many markets, element is the increased household sector debt and leverage, notably but not exclusively in housing.

Evolution of financial crisis and cross-border spillovers

As in any financial crisis, there have been, besides the underlying causes, triggers, and amplification mechanisms. While the crisis emerged in the US subprime, it quickly broadened to the larger US housing market and spilled over into other US financial markets (e.g., other asset backed). Surprising was the degree and speed of global spillovers, which happened in several phases. The first phase was largely limited to banks with direct exposures to the US market and affected a few selected financial markets, sometimes related with liquidity runs. The second phase of international spillovers was transmitted through liquidity shortages, freezing of credit markets, and stock price declines, and affected many more markets, notably UK Sterling, Euro, and Swiss Franc. The third phase of international spillovers occurred in October 2008 through large solvency concerns affecting systemically important global financial institutions, leading to massive sell-offs, risking a (global) financial meltdown. The fourth phase of global spillover was, and continues to be, through the real sector consequences of economic slowdowns around the world, triggered in part by financial retrenchments and deleveraging.

Interventions triggered by the financial crisis

In the third phase, starting in the Fall of 2008 and ongoing, a number of advanced countries' governments intervened in their financial systems. As asset prices plunged across markets, the risks of cascading institutional failures and financial meltdown prompted authorities in a wide range of advanced countries to act in mid-October, marking an overdue transition from concerns about liquidity to solvency. The principal forms of intervention were: (i) liquidity provision through collateralized lending and other schemes; (ii) support for short-term wholesale funding markets; (iii) (more extensive) guarantees of retail deposits and other liabilities; (iv) purchases or exchanges of non-performing or illiquid assets; and (v) capital injections to banks.

The amounts involved with these interventions have been very large, and on the basis of already announced commitments and past experiences, will increase further.[1] Table 1, for the G-20 and a few other countries, shows that advanced countries were most affected, while most emerging market countries included in the Table have had less need for capital or other forms of financial sector support.[2] Especially liquidity provision and guarantees were large, amounting to double digit fractions of GDP on average for the group of advanced countries. Capital support has been 2 percentage points and asset purchases 2.5 percentage points of corresponding GDPs. Besides the large direct fiscal costs, captured by the figures, there are many contingent costs, hard to quantify, such as the insurance schemes for assets or increased deposit insurance limits, and the implicit cost of now generalized policy that large systemic financial institutions are not allowed to fail.

While these support amounts need to be scaled by the size of the problems, or at least by the size of respective financial systems, and while there are differences among countries in terms of the level and forms of support, there are no clear patterns. Also, while modalities for support have varied somewhat, the overall approaches are largely similar. This similarity reflects to a significant degree the fact that countries were forced to adopt measures because of beggar thy neighbor effects. The spillovers, for example, from the guarantee in Ireland were large and happened rapidly, forcing countries to adopt similar policy in a matter of a few weeks. And the recapitalization and other support approaches became loosely based on what can be called the UK approach. These beggar thy neighbor effects were the more perverse since the individual country systemic bank restructurings were not first best to begin with, as often is the case in times of intense financial turmoil (Claessens et al. 2003). This in turn meant many "lowest common denominator" effects.

[1] There is a great difficulty identifying and classifying these interventions and the numbers should therefore be seen as a approximate.

[2] A number of other emerging markets have had to extend large support to their financial sectors (and also have faced balance-of-payments crises). IMF 2009b provides more details for a larger set of countries.

National effects

The interventions have generally had the aimed effects, namely stabilizing financial systems and regaining some measure of confidence in the system. By nature, however these measures are very distortive, directly—as they support financial institutions in non-market ways, or indirectly—as they can skew and distort resource allocation. A clear example of the (purposely) distortive nature in financial intermediation is intervention by central banks, notably the US Federal Reserve, in a number of (short-term) markets, either directly (e.g., through the purchases of government bonds) or indirectly (e.g., through the various liquidity facilities which aim to support specific financial markets, such as the commercial paper market). And the guarantees for new bank liabilities distort the (interbank) markets.

Another financial intermediation example is the provision of a guarantee scheme for money market funds in the US following the large outflows after one fund "broke the buck" (its net asset value fell below one dollar, i.e., below par). The guarantee in turn led to deposit outflows at commercial banks, which prompted an increase in deposit insurance coverage. A clear example of the distortions introduced by the extension of guarantees is the case of Ireland. Prior to the extension of guarantees to the largest size banks, the CDS-spreads for the large Irish commercial banks were very high. Post guarantees, bank CDS-spreads declined sharply. At the same time, the sovereign spread sharply increased. Measures like these, now numerous in many advanced countries today, distort asset prices and financial flows.

The indirect distortions affecting the real sector are more difficult to document, but there are many programs that provide suggestive examples. In many countries, programs have been put in place to support more lending to SMEs. But also large firms have been targeted for public support. In Japan, for example, in April 2009, parliament passed a law to allow for the recapitalization of (larger) non-financial firms using public funds through preferred share purchase by the (state-owned) Development Bank of Japan.[3] In US, France, and Italy car companies are being (indirectly) supported. In several countries, there were (largely informal) requirements for local lending as part of financial sector support. All of this has, directly and indirectly, affected international competition in various markets, financial and real (e.g., inefficient zombie firms may be created, driving out efficient firms).

Furthermore, the increased direct state-ownership and the large indirect roles of the state in the financial sector risk distorting financial intermediation in a deeper and potentially longer-lasting way. The perverse (long-term) consequences of state-owned banks are well-documented and, while in most countries good institutional environments should prevent the worst effects, distorted outcomes may still arise. In addition, there are many other (sometimes unintended) consequences of the interventions. One such in the US is the effect of caps on remuneration, which is affecting incentives, not only of those financial institutions now supported through public funds but also of others. These types of rules, and the more general larger role of the state, can affect the quality of financial intermediation.

[3] The main eligibility criteria are (i) firms that employ more than 5000 people; (ii) firms whose sales contract more than 20% within one quarter or 15% within half year.

International effects

While the large government interventions were necessary and often unavoidable, they have led to unintended effects on other countries, creating large distortions in international capital flows and financial intermediation in the short-term. Liquidity support provided the first manifestation. Actions in the US initially focused on providing domestic support, even though interbank market prices suggested significant dollar funding pressures for European banks and emerging markets. For mature markets, it took several weeks to act on these stresses. And, even after ad-hoc bilateral swap lines between central banks were set up and their scope gradually increased, market prices continued to suggest problems remained. The response was slower and amounts provided more limited in the case of emerging markets, even though problems existed as well. With US dollar central bank swap lines provided only to a handful of countries, liquidity shortages were keenly felt by many emerging markets. Large external financial support from various sources has been necessary for several emerging markets hit by deleveraging process, but the real consequences had already been incurred.

Guarantees on deposits and other liabilities issued by individual countries provide another example. These have led to beggar thy neighbor effects as, starting with Ireland, they forced other countries to follow with similar measures. Some advanced countries, especially those closely integrated (such as the EU/EMU) quickly coordinated policies, e.g., adopted uniform minimum deposit guarantee coverage. The rapid spread of guarantees led to further financial turmoil in other markets. Many emerging markets not able to match guarantees suffered from capital outflows and large currency depreciations as investors sought safe havens. Distribution of risks sharply changed over time and across circumstances. The CDS spreads for many banks, for example, fell as governments provided guarantees, while many sovereign CDS spreads increased. Furthermore, policy measures aiming to encourage lending often had a bias toward local lending, putting international operations at a disadvantage.

Countries were also quick to “ring-fence” assets in their jurisdictions when cross-border entities showed signs of failing, reflecting the absence of clear burden sharing mechanisms for banks with international operations. Prominent examples of defensive “asset grabs” were: the decision by UK supervisors, fearing an imminent collapse of Icelandic bank branches (under the authority of Icelandic supervisors, who did not provide a commitment to fulfill UK bank liabilities), to resort to the Anti-terrorism, Crime and Security Act to ring-fence Icelandic bank assets within the UK; and the German initiative to freeze Lehman’s assets to assure the availability of cash to satisfy depositors before they could be attached to the parent under US bankruptcy proceedings. Such actions constituted in part also anti-competitive behavior in that they tended to favor local interests.

Most government interventions to date have been at national levels. Although there were some coordinated actions (e.g., those among Belgium, Netherlands and Luxembourg, and with some involvement of France, to resolve Dexia and Fortis), these largely remained driven by pure national interests (as suggested by the fact that the intervened entities were often broken up along national markets, and in line with support). The main exception was the coordinated (although

only after some serious disruptions) provision of liquidity support. And, in the Euro-area, central bank actions are, by design, (nearly) fully coordinated among Eurosystem members.[4]

Current state and short and medium term international repercussions

While the relatively comprehensive actions over the last half year have provided some sense of stability, the crisis is still evolving, with rapid slowdowns spreading through financial and economic channels. Continued turmoil means extraordinary government interventions will continue and the (international) rules of the game will remain in flux. The coverage and scope of interventions and other policy measures will evolve depending on effectiveness and conditions and support amounts will likely increase further. As circumstances evolve, governments will (need to) adjust the rules, such as how to treat shareholders and creditors when restructuring large financial institutions, creating further uncertainty. If political support diminishes, support may become (even) more nationally-oriented and distortions increase further.

While risks remain, it is also generally agreed that distortions should be removed as quickly as possible to return to a sustainable system in line with a new financial architecture. As the crisis abates, governments need to plan for exit, also given fiscal constraints. These are difficult, and largely unprecedented processes, especially so in the context of highly integrated financial systems. It is clear, however, that lack of coordination can create (new) distortions. If the unwinding of interventions is not coordinated internationally, it can aggravate still weak confidence, create new distortions, and potentially be anti-competitive. Especially for the removal of guarantees, governments would do well to coordinate to avoid large capital movements. Yet, while more coordination would be desirable, in practice it is difficult.

3. State intervention and competition: conceptual issues, approaches and options.

Before analyzing the effects of state intervention, it is important to review the general conceptual and empirical issues related to competition in the financial sector. I then consider how state intervention can hurt, but also enhance competition, different than in other sectors (see also OECD, 2009 and EU, 2009).

Competition in the financial sector: general issues

When considering the effects of state interventions, it is important to keep in mind that the issue of competition in the financial sector is quite complicated and different from that in many other sectors. Because of network externalities, sunk costs, economies of scale and scope, switching costs, substitution and complementary among financial services, etc., standard principles of competition (policy) do not easily apply to financial services provision. This in turn means that measures such as market structure do not easily map into a degree of competition (for a review, see Claessens 2009).

[4] Some minor differences still exist among members, for example, in the registration of collateral.

Because of these methodological challenges, combined with lack of adequate data, the degree of competition is hard to determine empirically in the financial sector. When attempts have been made to properly measure the degree of competition, a few regularities have been found, notably the degree of contestability, the (perverse) effects of state-owned banks, and the beneficial effects of foreign banks entering markets. But much remains unknown on what drives competition, especially in a dynamic context, and the gains and costs of greater competition.[5]

Furthermore, a link has often been made between competition and financial stability in the conduct of (prudential) regulation and supervision. Whether this link exists and for what reasons, however, is debatable.[6] Nevertheless, this view has affected policy making and still does so. More generally, finance can suffer from many market failures, calling, at least in theory, for extensive government interventions.

State intervention for systemic reasons and competition: conceptual issues

The complexity, stability and market failures elements should affect how one considers the effects of any public policy, including forms of state intervention in financial crises, on (international) financial sector competition. During times of financial turmoil and crises, coordination failures and adverse impact of a failing financial system on the real economy justifiably call for government interventions. While few doubt the need for government intervention, (continued) interventions do create distortions, not only domestically but also across borders, leading to various competition effects (see Fingleton, 2009, Lyons, 2009, and Vickers, 2008 for recent reviews). What does support mean for competitive conditions? What is the balance between support and competition? Does support lead to, besides weaker market discipline, unfair competition or can it actually enhance competition? Does it vary by forms of government support, by circumstances? Are there ways to mitigate potential anti-competitiveness effects?

On the positive side, support for individual financial institutions especially those that are systemic can have beneficial effects on other financial institutions, and thereby on competition. This is because those financial institutions that themselves are not systemic can benefit as otherwise they could have risked insolvency. Since these non-systemic financial institutions may be important to overall competition—perhaps more so than the systemic financial institutions themselves, intervention during this period can help with competition, in the short-run but especially in longer run. This is also so at the international level: support from one state for banks in its jurisdictions can enhance other countries' financial systems and overall international

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[5] For example, financial institutions create natural entry barriers by investing in technology so as to better process and overcome information asymmetries. This in turn has effects on competition, but also on consumer welfare that can be at odds with (static) competition.

[6] For one, conceptually is not obvious that greater competition leads to instability, either in a static or dynamic sense. Financial intermediation may benefits from new technology spurred by competition since it allows for greater risk-sharing. And empirically, evidence on the link has indeed been found both ways. Second, it is not obvious that restricting competition is the first best way to reduce instability; rather prudential regulation and supervision should be used.

financial system's stability. It could thereby lead to better preconditions for competition internationally. Whether it does, depends in part on how the support is being provided across financial institutions and markets.

As noted, most of the support measures did not start from a deliberate government policy and were adopted in the middle of the crisis, with little time for consultation, nationally, let alone internationally. Nevertheless, as the crisis progressed and countries subsequently adopted support measures, a greater commonality among measures materialized—in part as countries faced being left behind in the various dimensions. This was reinforced by attempts by some international agencies and groups to harmonize various interventions to reestablish a level playing field. The overall general principles behind these attempts are similar. More extended retail guarantees need to cover all deposits uniformly within a jurisdiction and preferably across jurisdictions. This is especially critical where financial markets are closely integrated. Also, guarantees for interbank lending, bond issues and other wholesale funding have to be clearly stated and be available for all financial institutions. Capital injections should bring capital up to recognized standards at all institutions (with buffers for future losses), as undercapitalized institutions may undermine competition. And general programs for purchasing assets should not discriminate between institutions or nationality.

The premise underlying these principles is presumably that, as long as these interventions are applied to all (national) financial institutions and all forms of financial intermediation equally, there need not be negative consequences for competition. This is not necessarily so, however. Solvent financial institutions, for example, do not benefit (as much) from guarantees. At the same time, these interventions, in part as they are anticipated, condition market behavior. This happens not only through the channel of moral hazard, which relates to excessive risktaking of inefficiencies at the individual institution level, but also affects markets' general conduct, since not necessarily the least efficient firms exit and the best survive, and creative destruction is suppressed.

As such, even when applied evenly, interventions in times of financial stress can have overall negative effects on competition. Furthermore, political economy issues are important to consider. In practice, financial sector regulations and interventions are not always aimed at first best outcomes—the influences of political economy and vested interests are especially large in finance, even in advanced countries. As such, separating good from bad regulations and interventions can be very hard, and the premise may have to be that a more liberalized financial system with little state intervention is closest to first best, even in financial crises.[7]

Competition approaches regarding impact of state interventions and coordination attempts

As the various support measures for individual financial institutions attracted much attention of regional and international organizations, they have led to actions to reduce their distortive

[7] Clearly, opinions vary with, some observers seeing the financial crisis as due to massive government failures, including moral hazard, and others seeing it as a combination of market failures, with obviously very different policy implications.

impact. The competitiveness impact of specific cases have been most discussed in the context of the EU, not surprising given on one hand its tight financial integration and extensive cross-border financial services provision, and on the other hand the existence of an institutional environment for formally investigating competition policy issues—the DG for Competition Policy. The EU view on aid to the financial sector has been phrased as follows (open letter of the DG to the Financial Times, April 22, 2009): "We are applying the tried and tested code of good economic governance that the EC Treaty's state aid rules represent to ensure four things: 1) that banks receive sufficient support to avoid financial meltdown; 2) that Member States' cures for their own banks do not put those banks in an artificially advantageous competitive position that would kill off banks in other Member States; 3) that banks are restructured to ensure their future long-term viability so that the mistakes of the past are not repeated, that taxpayers' money does not disappear down a black hole and that lending to the real economy is secured; 4) that the Single Market is preserved, with no discriminatory conditions attached to aid and no barriers to entry for cross-border banking. This is because the Single Market is crucial to ensuring Europe's economic recovery."

Reflective of this view, and triggered by the many state interventions, the EC has issued a number of communications aimed both at forcing similarity in interventions among countries and inducing practices that are closer to market principles.[8] These communications, for example, state that government guarantees for new bank borrowings need to be priced in line with the currency specific risk-free rate plus a spread related to the CDS spread for the particular bank in the period before the financial crisis. Another communication states that capital injections need to carry yields that relate as well to the safe interest rate and the risks involved (e.g., whether it involves common or preferred equity). These and other communications, such as on deposit insurance have reduced some of the intra-EU distortions.

The WTO has also made some statements on the effects of the financial crisis on competition (WTO, 2009). And the G20 adopted in its two communiqués broad language to indicate its members are committed to prevent financial protectionism, albeit it has not adopted any further specific guidelines. While these rulings will help to reduce of some of the distortions, however, by nature they remain imperfect.

Decisions regarding state specific interventions

The DG for Competition Policy has also made decisions on 49 specific cases (until end of April). In some cases, it has asked for financial measures. In only a few cases, has it asked for some operational restructuring conditions, such as a spin-off of branches, specific units or other actions. In most cases, however, it has not taken any action, i.e., it has allowed the state aid or intervention to continue as proposed.[9] The fact that there were often no "actions" decisions does

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[8] See EU (2008), and EU(2009a-2009c). Note further that there already existed EU-rules aimed at avoiding distortions from state interventions. For example, EU (2004). See also Rossi and Sansonetii (2007).

[9] Obviously, there would have been a back and forth between the various interested parties—financial institutions and government—with the Commission before a decision was announced. As such, the terms are likely to have been adjusted prior to the decision if the Commission had objections.

not necessarily mean that the EC judged that there were no, general or specific, anti-competitive implications. Rather the judgment might have been that these possible anti-competitive effects were necessary given the risks of economic and financial consequences of not intervening at a time of financial turmoil.

This no-action choice is somewhat akin to the balance of payments exception in the General Agreement on Trade in Service (GATS). GATS explicitly includes a balance of payments safeguard that allows the member to impose temporary restrictions that suspend its of commitments - on a nondiscriminatory basis - in the event of "serious balance-of-payments and external financial difficulties or the threat thereof." Indeed, the Commission's general approach to government support as stated above is consistent with this.

Evaluation of competition policy approaches

The need to balance these various objectives is repeated in the rulings and statements made by the DG or individuals from the DG (e.g., Neven, 2009). It suggests that direct effects of state aid on competition have played less of a role in its rulings. And to the extent that competition was a key question for the EC-DG, it has been the effect on intra-EU competition, not on local competition that has occupied it, consistent with its mandate.

Nevertheless, the EC-DG decisions have been critiqued, both by private market participants, academics and public sector officials. The former is not surprising, as some have obviously been adversely affected by decisions. The academics' views have varied (e.g., Vives 2009). The criticisms from public sector have (obviously) been more muted. Nevertheless some have. For example, Bundesbank President Axel Weber (as reported by Atkins, 2009) judged that the EC-DG requirements for state supported financial institutions have had a bias towards hiving off financial institutions' international, cross-border but intra-EU operations, thereby undermining the objective of creating a single market in the EU. This has led to some further reactions (e.g., Stark, 2009).

A final judgment on the international competition impact of the various state interventions is hard to make and will have to await some further analysis. The premise nevertheless is that these state interventions have reinforced the position of those incumbents that already had favored (national) preferences. As such, although unavoidable, the interventions have been anti-competitive. Going forward to avoid these outcomes, a method has to be found that allows competition policy to be conducted with less regard for systemic stability. In the interim, measures to harmonize the rules for state support and level the playing field can serve a useful role, even though they do not eliminate many of the anti-competitive effects of the interventions.

4. Broader problems of cross-border banking

The various interventions have raised many international competition issues (the national issues are not discussed here, even though many are obviously similar).[10] Some of the international competition issues relate to the still poorly developed rules and mechanisms for dealing with large financial institutions which activities span many markets and activities. The crisis has made even clearer the lack of sound mechanisms to deal with these institutions. This is most evident in the resolution of global banks headquartered in relatively small countries but with balance sheets that can exceed their home-country's GDP (as is the case for Belgium, Hong Kong, Iceland, Luxembourg, the Netherlands, Switzerland, and the UK, a few countries in that position). Few single countries can deal with such institutions on their own, yet they affect many markets. But the tension also exists for banks that are relatively smaller as (authorities in) countries have preferences for national champions, which end up distorting ex-ante and ex-post. And coordination issues arise in general with regards to cross-border banking, with Central and Eastern Europe a clear current case in point.[11]

Clearly, in this crisis, and even more so in the future—as financial institutions may keep getting larger—and more complex, a better method has to be found to handle these institutions. Solutions have to be found in a broad reform of the international financial architecture, which is a large agenda with many public good aspects. It also importantly depends on other, more national-oriented financial sector reforms currently being discussed (for an overview of needed financial reforms see IMF, 2009a). This need for reforms has long been acknowledged in an international context, and specifically in the context of EU's and even more so Euro's closely integrated financial markets.

Reforms underway include greater convergence in financial sector regulation and supervision practices across countries. The major international standards (such as Basel II) are already attempts to create greater uniformity in rules, especially for international active banks. And the Financial Sector Assessment Program of the World Bank and IMF is a means to check the implementation of rules and adequacy of practices, and thus assure greater convergence in practices. These reforms will help reduce coordination problems and create a more level playing field. These general issues will not be discussed here. But what will be discussed are the current approaches to cross-border banks and some specific solutions needed to deal with large cross-border banks, given their externalities and adverse competitive effects during times of financial stress under the current system.

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[10] In the UK, the Office of Fair Trading has issued opinions in a few cases, such as in the context of the Lloyds takeover of HBOS, but these were subsequently found to be overruled by the public interest of systemic stability (see Vickers 2008 and Lyons 2009 for discussions).

[11] Banks in Western Europe are at risk due to their exposure in Eastern Europe, much of it in the form of wholly-owned subsidiaries. Exposures are very large, for example, lending by Austrian banks to Central and Eastern Europe amounts to 80% of its GDP. Given strong interbank linkages within Western Europe, defaults of a limited number of banks would have strong domino effects across a wide range of countries. Yet, coordinated solutions appear very difficult to organize. For example, calls for pan-European recapitalization funds have repeatedly been rejected in recent months. In the mean-time, emerging markets in Eastern Europe are under siege as it is not clear that local subsidiaries of foreign banks will be fully supported.

Cross-border activities: current approaches

The current approach is largely based on the home-host principle which says that home countries have to supervise the branches and subsidiaries of their banks in foreign countries (see Basle Committee on Banking Supervision, BCBS, 2006). Yet, many, including BCBS itself, have recognized that this principle is not sufficient, particularly in light of rapid internationalization. Fundamentally, a foreign subsidiary of a major international bank may be significant in the market in which it operates but be of little significant for the banking group as a whole. Conversely, a subsidiary that is significant for a banking group may not be significant for a host country, for example, if it is located in a major financial centre. Potential conflicts also exist in terms of management within the bank or group. These differences in interests can adversely affect host and home markets, and thereby overall international financial stability and competition.

The convergence process will remove some of these conflicts of interests. There will remain, however, severe economic, legal, political and other limits to convergence in rules and practices (see Caprio et al. 2006, for a collection of papers on this topic). Similarly, while many improvements are possible to the home-host principle—and some are being implemented, these will in practice be fraught with significant limitations, especially for relative large local entities in host markets. And it remains the case, similar to within a domestic context, that many of the precise channels through which international spillovers and contagion occur are not always well understood.

Possible other options

As such, it is likely that international financial instability will continue to trigger ad-hoc government interventions. In essence, the problem of interventions boils down to coordination problems. There is both limited ex-ante coordination in dealing with cross-border financial institutions and there are poor mechanisms for burden sharing ex-post, when cross-border institutions risk failing.[12] Various solutions have been proposed over the years, each with their own advantages and problems. They vary from centralization, a new regime, enhanced coordination, to increased convergence in rules and practices.

World Financial Authority. The very first best would be an international financial regulator, perhaps called a World Financial Authority (WFA) that would regulate and supervise all, or at least all large financial institutions. This was perhaps first proposed by Eatwell and Taylor in 1998, and it has an analogue to the World Trade Organization (WTO).[13] It is the obvious solution

[12] While poor regulation and supervision also give rise to negative externalities, these are not the subject of discussion here. To some extent these can be addressed through the various convergence processes (standards, FSAP, regional integration). And, while also imperfect, countries do have the option to exclude financial institutions from some countries from their own markets on prudential grounds.

[13] The idea was first mentioned in a working paper of 1998, and then published in their book of 2000.

to any coordination issues, and thus reduces the anti-competitive effects of ad-hoc government interventions during financial crises. It could also be complemented by greater powers of the WTO on competition in the financial sector and trade in financial services.

At the same time, this model is very demanding to be fully consistent in all dimensions. The international financial regulator would need to be complemented by lender of last resort liquidity facilities, an international deposit insurance and recapitalization fund, similar to the requirements in a domestic context (see Boot 2006 for the EU case). This WFA would also be difficult to govern as its objectives would be hard to establish. And it is unlikely to materialize in the near future. The experiences of the EU suggest that, even after moving towards very close financial, economic and political integration, adopting a common, single regulatory and supervisory authority is very hard.

Three other solutions, not first best, but perhaps second or third best, are: an international bank charter, increased harmonization in rules and convergence in practices without increased coordination, and increased coordination with less or no harmonization or convergence.

International Bank Charter. One approach closely related to the first best, but perhaps more feasible in the medium term, is to establish a separate regime for large, internationally active financial institutions, with some elements of voluntarism. Under this "International Bank Charter" (IBC) model international active banks would only be globally chartered and under the supervision of a single regulator. The European bank charter that has been proposed some time ago (Cihak and Decressin, 2007; see also Decressin, Faruqee and Fonteyne, 2007), and possibly similar charters, could be the equivalent of this on a regional basis.[14]

Under this model, there would also be an international regulatory and supervisory body. The set of actions available to this body would again be the regular licensing, regulatory and intervention tools of any national financial regulator. Complementary measures needed are again common liquidity support and lender of last resort facility, shared intervention resources with fiscal backup, and an International Deposit Insurance Corporation, perhaps supplemented by a recapitalization fund, both receiving fees from the banks. The IBC banks could operate around the world (or at least in sponsoring countries) without any further permission, regulations or needs for reporting and compliance.[15] This model would avoid the messy constellation of home and host supervision. Importantly, it assures coordinated actions, especially of those actions aimed at containing and resolving a crisis. With coordination assured, ad-hoc and distortive interventions by governments would be avoided, and a more competitive landscape would result.

[14] Technically, European banks can already establish themselves as a European Company ("Societas Europaea"), but there would not be a corresponding shift in regulation and supervision.

[15] One key issue is the degree of "voluntarisms": should international banks be allowed to choose themselves or should they be forced to be subject to the international regime? Obviously there can be adverse selection here: weaker banks may not be interested to subject themselves to presumably a stronger international regime. Required participation may therefore be the better approach. But then there need to be clear and common criteria, say banks above a certain cutoff in terms of size of international operations (although that may not be a sufficient criteria, since, especially in times of financial turmoil, even small banks can have negative externalities).

Decentralized, but converged approaches. One "third" best could be a decentralized approach, i.e., where actions are not coordinated, but frameworks are adapted, with the expectation to mimic outcomes similar to those under a first or second best regime. This would at the minimum involve more convergence in five areas (see further Financial Stability Forum, 2009). One, the rules and regulations governing international active banks. Second, clarity on who will supervise what aspects of international banks, with in particular the coverage of branches and subsidiaries and treatment regarding off-shore financial centers to be clarified. Third, consistency in the rules for lender of last resort, liquidity support, deposit insurance and other forms of safety net. Fourth, internationally consistent resolution regimes (e.g., foreign creditors should be treated equivalently to domestic counterparts, collateral security to be recognized across legal jurisdictions, modalities for (prompt) corrective action, including areas such as the scope and threshold of public intervention, especially for large, complex cross-border financial institutions). Fifth, ex-ante agreed upon rules on burden sharing and resolution in case of failures that require bail-outs or pay-out, including more common recovery procedures for impaired assets and uniform approaches regarding state ownership in intervened institutions.

Common rules along will not be enough as differences in practices can still arise, in part because of competition among regulators (Dell'Ariccia and Marquez, 2006). Participation by many countries in rulemaking will increase legitimacy and facilitate the enforcement of rules. Practices, however, still need to be assessed. The existing apparatus for assessing policy implementation (such as FSAPs) need to be sharpened and procedures improved, their voluntary nature reassessed, and modalities for raising concerns clarified.

In principle, this could reduce many of the current problems, create a more level playing field and thereby improve competitive conditions. It will not be enough to mimic the first best solution, however, since it does not consider the many externalities at the international level (Schinasi, 2005). Just as proper regulation and supervision of individual financial institutions does not guarantee systemic stability, similarly (proper) national regulation and supervision does not guarantee international financial stability and efficiency. Coordination issues at the international level, both among private sector participants and between national authorities, are simply too plentiful. The key for this model to work is probably that the ex-ante agreed rules on burden sharing are binding ex-post, very hard obviously (Freixas, 2003; see also Goodhart and Schoenmaker, 2006). As such, the model will not easily assure a fully competitive, level-playing field among countries.

Enhanced coordination, including through colleges. Another, substitutionary or complementary model is to rely on more coordination of actions, even in the absence of (further) convergence of rules. This is the model, for example, for the EU as laid out in the most recent De Larosière report (2009). Under this model, some body would have the power to legally binding mediate between national supervisors, adopt binding technical decisions in regards to specific financial institutions, and play a strong coordinating role, especially in financial crises. When backed up by appropriate legal changes, this structure could presumably overcome many of the ex-post coordination issues, even in the presence of national structures and rules that are still quite different.

The current approach of adopting supervisory college for large financial institutions (now 28) is a decentralized form of this model, albeit with its own limitations, such as limits on information sharing (due to confidentiality but also pure power plays). Importantly, since colleges are designed to concern themselves only with individual financial institutions, they will not explicitly consider overall international financial system stability. The risks may be, however, that these measures create a false sense of security, with the possibility of financial crises remaining.

5. Conclusions

The state interventions necessitated by the financial crisis have led to many and massive distortions, directly—as they support financial intermediaries in non-market ways, and indirectly—as they can distort financial intermediation and resource allocation. Measures also have had international repercussions, most notably when governments extend guarantees to financial intermediaries—that distort capital flows, and through capital and other support measures—that often favor national institutions and have a bias towards local lending.

Implications for competition are not obvious, however. Competition in the financial sector is a complex issue to begin with. And support during financial stress periods can enhance competition as it avoids the elimination of (non-systemic) institutions essential to contestability. Efforts to harmonize support measures across countries can help leveling the playing field, avoid major distortions and thereby help maintain competitive conditions. But these remain imperfect as de facto weaker financial institutions will be supported, thus undermining market principles.

Nevertheless, and given the tightly integrated global financial system, there is a greater need for cooperation and coordination across countries to avoid large distortions and an escalation of these forms of nationalisms. There also is a need for coordination when exiting from these interventions. Except for arrangements in closely integrated regions, however, global mechanisms with strong commitment are lacking. While unavoidably in the short-run, for the medium term, a new approach is necessary to avoid the ad-hoc and distortive interventions. There is especially a need for improved mechanisms to deal with cross-border banks and other large financial institutions, which few single countries can deal with on their own, yet they affect many markets and which keep getting larger and more complex.

To address this, I present a number of options. A first best approach—called a world financial regulator—is unlikely to be attainable in the short-run. I argue that an International Bank Charter (with dedicated regulator, lender of last resort, and deposit insurance and recapitalization funds) specifically for large international active banks offers the second best approach. Other options—such as increased convergence in rules and policies and enhanced coordination in actions—are obviously difficult to rank. But, over the medium term, any of these approaches can help with assuring competitive conditions, even in times of financial stress.

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Table 1. Headline Support for the Financial Sector and Upfront Financing Need

(As of April 15, 2009; in percent of 2008 GDP)

	Capital Injection	Purchase of Assets and Lending by Treasury	Central Bank Support Provided with Treasury Backing	Liquidity Provision and Other Support by Central Bank 1/	Guarantees 2/	Total	**Upfront Government Financing 3/**	
	(A)	(B)	(C)	(D)	(E)	(A+B+C+D+E)		
Advanced North America								
Canada	0.0	8.8	0.0	1.6	13.4	23.7	**8.8**	
United States	3.9	1.3	1.1	42.1	31.3	79.6	**6.3**	4/
Advanced Europe								
Austria	5.3	0.0	0.0	0.0	30.0	35.3	**5.3**	
Belgium	4.7	0.0	0.0	0.0	26.2	30.9	**4.7**	
France	1.2	1.3	0.0	0.0	16.4	19.0	**1.5**	5/
Germany	3.8	0.4	0.0	0.0	18.0	22.2	**3.7**	
Greece	2.1	3.3	0.0	0.0	6.2	11.6	**5.4**	
Ireland	5.3	0.0	0.0	0.0	257	263	**5.3**	
Italy	1.3	0.0	0.0	2.5	0.0	3.8	**1.3**	6/
Netherlands	3.4	2.8	0.0	0.0	33.7	39.8	**6.2**	
Norway	2.0	15.8	0.0	0.0	0.0	17.8	**15.8**	
Portugal	2.4	0.0	0.0	0.0	12.0	14.4	**2.4**	
Spain	0.0	4.6	0.0	0.0	18.3	22.8	**4.6**	
Sweden	2.1	5.3	0.0	15.3	47.3	70.0	**5.8**	7/
Switzerland	1.1	0.0	0.0	10.9	0.0	12.1	**1.1**	
United Kingdom	3.9	13.8	12.9	0.0	51.2	81.8	**20.2**	8/
Advanced Asia and Pacific								
Australia	0.0	0.7	0.0	0.0	N/A	0.7	**0.7**	
Japan	2.4	11.3	0.0	1.2	7.3	22.1	**0.8**	9/
Korea	2.7	5.4	0.0	0.3	13.8	22.2	**0.4**	10/
Emerging Economies								
Argentina	0.0	0.9	0.0	0.0	0.0	0.9	**0.0**	11/
Brazil	0.0	0.0	0.0	1.5	0.0	1.5	**0.0**	
China	0.5	0.0	0.0	0.0	0.0	0.5	**0.0**	12/
India	0.0	0.0	0.0	5.6	0.0	5.6	**0.0**	
Indonesia 13/	0.0	0.0	0.0	0.0	0.1	0.1	**0.1**	
Hungary	1.1	0.0	0.0	4.7	1.1	6.9	**1.1**	
Poland	0.4	0.0	0.0	0.0	3.2	3.6	**0.4**	
Russia	0.3	0.5	3.2	3.2	0.5	7.7	**0.8**	14/
Saudi Arabia	0.6	0.6	0.0	8.2	N/A	9.4	**1.2**	
Turkey	0.0	0.0	0.0	0.2	0.0	0.2	**0.0**	
Average (PPP GDP Weights)								
G-20	1.9	2.5	1.0	12.4	14.3	32.1	**3.4**	
G-20 EU	2.7	3.8	3.2	0.5	22.1	32.3	**6.7**	
Advanced Economies	2.9	4.0	1.3	18.8	22.8	49.8	**5.3**	
Emerging Economies	0.2	0.1	0.4	1.6	0.1	2.4	**0.1**	

Source: IMF, 2009 FAD-MCM database on public interventions. See the IMF Paper: "The State of Public Finances", Chapter II. for details.

1/ This table includes operations of new special facilities designed to address the current crisis and does not include the operations of the regular liquidity facilities provided by central banks. Outstanding amounts under the latter have increased substantially, and their maturity has been lengthened in recent months in many cases.

2/ Excludes deposit insurance provided by deposit insurance agencies.

3/ This includes only those components of A, B and C that require upfront government outlays.

4/ Upfront financing is USD 900 bn (6.3 percent of GDP), consisting of TARP (700 bn) and GSE support (200 bn). Guarantees on housing GSEs are excluded. For details, see the IMF Companion Paper: "The State of Public Finances", Chapter II.

5/ Support to the country's strategic companies is recorded under (B); of which E14 bn euro will be financed by a state-owned bank, Caisse des Depots and Consignations, not requiring upfront Treasury financing.

6/ The amount in Column D corresponds to the temporary swap of government securities held by the Bank of Italy for assets held by Italian banks. This operation is unrelated to the conduct of monetary policy which is the responsibility of the ECB.

7/ A part of the capital injection (SEK50 bn) will be undertaken by the Stabilization Fund.

8/ Costs to nationalize Northern Rock and Bradford & Bingley recorded under (B), entail no upfront government financing.

9/ Budget provides JPY 3,900 bn to support capital injection by a special corporation and lending and purchase of commercial paper by policy-based financing institutions of the BoJ.

10/ KRW 76.7 trillion support for recapitalization and purchase of assets needs upfront financing of KRW 3.5 trillion.

11/ Direct lending to the agricultural and manufacturing sectors and consumer loans are likely to be financed through Anses, and would not require upfront government financing.

12/ Capital injection is mostly financed by Central Huijin Fund, and would not require upfront government financing.

13/ Extensive intervention plans that are difficult to quantify have also been introduced recently.

14/ Asset purchase will be financed from National Wealth Fund; and the government will inject 200 bn rubles to deposit insurance fund financed from the budget.