Andreas Dombret: Competition policy and regulation in a global economic order

Welcome address by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the reception given by the Deutsche Bundesbank at the Annual Congress of the Verein für Socialpolitik, Düsseldorf, 5 September 2013.

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1. Welcome

Mr Burda
Members of the Verein für Socialpolitik
Ladies and gentlemen

On behalf of the Deutsche Bundesbank, I would like to warmly welcome you to this reception. It gives me great pleasure to be your host again this year.

As you will all be aware, the Verein für Socialpolitik and the Bundesbank have enjoyed very close relations for many years now, and it is a relationship that is fruitful for both sides. Academic study and research are indispensable foundations underpinning the work of central banks. And central banks offer an attractive research environment. Added to this, the issues facing central banks often stimulate new research projects.

However, research conducted by members of the Verein für Socialpolitik is not only relevant to central banks, as your annual congresses clearly demonstrate. Competition policy and regulation are topical issues which have attracted broad public attention.

The ongoing negotiations between the European Union and the USA over a transatlantic free trade area are a case in point. This agreement could herald the creation of the largest free trade area in the world, which is something I would warmly welcome.

As for the topic of regulation, I'm sure I'm not alone in thinking first and foremost of financial sector regulation. As it happens, the G20 heads of state and government are debating reforms to financial sector regulation this very day at their St Petersburg summit.

And yet competition policy and regulation not only matter to policymakers and the public at large; they are equally relevant to all kinds of sub-genres of the economic sciences, as we can see from the impressive range of topics covered by today's annual congress.

Let's now take a brief look at the relationship between competition policy and regulation in the financial sector.

2. Competition policy in the financial sector

The political order envisages a clear-cut relationship between state and market: the state creates a setting in which market forces can thrive. Hence, the state's role in competition policy is to ensure effective competition. It sets the rules of the game but stays off the playing field.

There have always been instances where reality has failed to live up to this ideal. All along, politicians have enjoyed having a stake in the game; the Landesbanken are just one example of this.

But one thing became clear when the crisis began – if not before: the financial sector setting was only partially suited to ensuring a competitive environment that was consistent with market economy principles.

In retrospect, a great deal of trust, probably too much at times, was invested in market forces and market discipline. After the crisis erupted, there was a sharp increase in government interventions to stabilise the financial system. In many countries, banks were propped up by the state or even taken into national ownership.

This government response was motivated, among other things, by a distinctive feature of the financial sector. Relative to other industries, players in the financial sector are very highly interconnected.

This high degree of interconnectedness means that if one participant exits the market, it can potentially bring down others as well. In extremis, this might cause the entire market to collapse and endanger financial stability. What this means, therefore, is that the financial sector is lacking a key aspect of an effective competitive environment – the possibility of businesses exiting the market.

A major financial institution exiting the market can ignite a systemic crisis, leaving the state with little choice but to intervene in order to prevent matters going from bad to worse. And then the taxpayer is left to foot the bill. The no bail-out principle has lost all effect. As Walter Eucken might have put it, those who benefited did not bear the costs.

This very phenomenon has come into play during the crisis. The state no longer merely sets the rules, it has also joined the game, whether by choice or otherwise, because the markets anticipated that it would be forced to intervene in an emergency. Naturally, this no longer fits the ideal of the state envisaged in our political order.

If the state wants to get back off the playing field, it will have to adapt the rules of the game. What we need is improved financial sector regulation.

3. Financial sector regulation

However, as I see it, we should not go from occasionally placing too much trust in market forces to making excessive demands of state regulation. Regulation is designed to prevent market failure, but it shouldn’t put market mechanisms out of action.

Our aim should still be to use regulation to create an appropriate setting which provides the right incentives for risk-aware behaviour. So the key question should be this: how can regulatory measures help to reassert fundamental market economy principles, first and foremost the no bail-out principle?

How, for instance, can we make it possible for financial institutions to exit the market without endangering systemic stability and without the taxpayer having to foot the bill? What we need are insolvency frameworks that are in tune with the interconnectedness and complexity of the financial sector. Even large and complex institutions need to be able to fail without bringing down the entire system. Only when that is possible will the state no longer be forced to intervene at the taxpayer’s expense. Thus, setting up a credible resolution mechanism for financial institutions can help to strengthen the no bail-out principle within the financial sector.

Major steps have already been taken in this regard at the international level. The Financial Stability Board has already presented key attributes of effective resolution regimes for financial institutions, which were endorsed by the G20 heads of state and government in November 2011.

Since then, work has been under way to transpose this new international standard into national law. A draft directive for the recovery and resolution of credit institutions has now been presented at the EU level. This proposal clearly sets forth the sequence of liability for failing financial institutions – shareholders and creditors are now first in line, and rightly so.

So we’re on track to reassert the no bail-out principle in the financial sector. But being on track doesn’t mean that we’ve already reached our final destination.

The design phase of the regulatory reform has been concluded; now it’s time for us to put the reforms into practice. That means following the path we've taken right through to the very end.

First and foremost – and this is a crucial point as far as I'm concerned – all countries need to follow this path together. Players in the financial sector operate in global markets, in integrated markets, so we need to make sure our regulation takes account of any cross-border interaction and coordinate regulatory measures internationally. In global markets, the rules of the game need to be global, too.

The reforms endorsed by the G20 can only have the intended impact if they are fully and consistently transposed into national regimes. Otherwise, evasive action or regulatory arbitrage might endanger their success.

That's why we will need to devote even more attention to the question of consistency going forward, particularly so given the impact of the rules across national borders.The Financial Stability Board's stringent oversight and regular reporting to the G20 will play a key role in this regard.

4. Conclusion

Ladies and gentlemen

The good news, as far as I'm concerned, is that the path we have taken to regulate the financial sector is the right one. Now we need to stick to this path until we reach our destination. And I think a somewhat brisker pace would certainly not go amiss.

As for my speech here today, I would now like to return to my introductory remarks on the Verein für Socialpolitik and on academic study.

Sound regulation is built on robust scholarly foundations. And these, in turn, are the outcome of academic discourse – exchanging ideas means disseminating them; discussing ideas means refining them.

Gustav Schmoller, one of the co-founders of the Verein für Socialpolitik, once said that a frank debate on conflicting convictions and principles cannot harm a cause; it can only benefit it.

On that note, I hope to see many more lively debates in the future, and the Verein für Socialpolitik provides an ideal platform for such academic discourse to thrive.

And I am delighted that we will be awarding the Gustav Stolper Prize this evening to an outstanding scholar – one who does not shy away from debate, a quality which has enabled him time and again to provide important input for policymakers, notably so in the prevailing crisis but at other times as well.

But I do not wish to pre-empt the awards ceremony itself and therefore thank you for your attention.