

From Bricks to Cheese:
The Competition of Laxity

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The financial crisis is also connected to states having acted as competitors and having supported their banks with a targeted regulation dumping.

“We had agreed only to approve a financial product if at least one of us understands how it functions”, a top official at Banque de France recently told me. “But”, he continued, “we were unable to keep to this rule because we were afraid the product would then be marketed in London.”

This is how many regulatory authorities must have thought in recent years. For this reason banking regulation eroded or never materialised to a sufficient extent. Regulation was subject to a competition of laxity that rendered it ineffective. Whoever had less severe regulations could give his banks an advantage over banks from other countries. Everyone knew that lax regulation could damage the customers of financial products because the redemption likelihood would be reduced. But the customers had no lobby and most of them were abroad anyway. Why should one worry about them? At most a loss of confidence that would be expressed in a lower price for the financial products would have induced the banks of the countries of origin to regulate more strictly. But what customer knew how well or badly a country’s financial market supervision functioned? The rating agencies, which could have brought about more clarity, did not function well, as we know, because of their commercial links to the banks they examined. Lehman Brothers still received an A+ rating a week before it went bankrupt. Not until today, amidst the crash, are we aware of the bad quality of the Anglo-Saxon banks and the financial products they sold.

There was a system behind all this. Competition among states cannot function because states do things that the market cannot deal with. If attempts are made to reintroduce the market at the higher level of competition between states, the same market failures occur for which the state originally got involved. In my book *The New System’s Competition* (2003) I called this the selection principle. The selection principle explains why tax competition cannot function, why welfare states erode in systems competition, why the regulation of the quality of food products is weakened by competition, why bank regulation disappears in the com-

petition of laxity and why there can be no reasonable competition among competitive systems. It is misleading to compare the competition among states with the competition among companies because there is no regulatory framework for the former – and it would be difficult to find one that would be analogous to the price mechanism that has made private competition such a superior control system of human activities.

Today the competition among banks is the focus of attention. In bank competition the quality of bank products has eroded because the customers cannot properly assess the probability of their being able to get their money back. The banks took advantage of this by reducing the quality of their products behind the backs of their customers. They operated with too little capital reserves to guarantee the redemption of the bank securities they issued and they sold collateralised debt obligations, claims against other claims, leaving the purchasers uncertain about the credit worthiness of the customers at the beginning of a now very long chain of securitised credit claims. For this reason the states should safeguard the quality of financial products by means of credit lines, governmental certification and especially by requiring high capital reserves. However, as the opening example shows, they did not comply with this task because they themselves acted as competitors that sought to achieve an advantage for their own banks over those of other states. In the final analysis no one profited from the broken system that arose in this way.

In Europe, at least, the banks recognised and with the Basel II system mutually obligated themselves to minimum capital reserve requirements. That is a certain protection that still benefits the continental European banking system today. But the system is a long way from the ideal. It is based on the wishes and proposals of the banks themselves and uses commercial risk models that do not reflect systemic risks. In addition it exempts the offshore activities outside in the form of foreign conduits, failing to require minimum capital reserves for these transactions.

This needs to be changed. Establishing the framework conditions for private economic activity is a sovereign task of the state that cannot be left to the lobby of the regulated enterprises. As history shows, it can also not be expected that national states that are in competition with each other perform well in this regard. The world needs a uniform regulation system for banks and financial institutions that is managed by the International Monetary Fund and implemented by the respective central banks in their areas of jurisdiction. At the 2007 G8 Summit in Heiligendamm, Chancellor Angela Merkel was banging against a brick wall when she sought support for such a system. In the meantime the bricks have turned to soft cheese.