Should Competition Policy be relaxed during the current financial crisis?

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It seems clear that despite the need for intervention temporarily to offset inefficiency caused by the arbitrary credit constraints, a relaxation of competition policy should not be adopted in response to the current crisis. Whilst competition policy relaxation may appear to be cost-effective in that it does not require tax-payer funds, the true costs of a relaxation may be an increase in prices, alongside decreased product quality, efficiency and innovation. History has shown that relaxing competition policy in times of crisis can often exacerbate recessionary effects and slow down recovery speed. Given the expected consolidation of firms and the increased scope for anti-competitive behaviour, competition policy needs to remain stringent during the recession.

I will first introduce the concept of competition, before outlining the institutions that ensure markets remain competitive. I will then look at how the recession may have been expected to affect competition through use of the BE-COMP model. I will then look at 3 areas of competition policy; Antitrust, Mergers, and State Aid, and examine the case for a relaxation of the rules in these areas in response to the current economic climate. In doing so, I will first assess the case for goods markets, before assessing the case for the financial sector. I will conclude that the role of stringent competition policy is as strong during the current economic recession as it is when the global economy is growing, and as such competition policy should not be relaxed.

I. Competition - what is it and why is it desirable?

Defined as 'the effort of two or more parties acting independently to secure the business of a third party by offering the most favorable terms' (Mirriam-Webster, 2010), competition (when perfect) ensures that resources are allocated to those who value them the highest. In the basic diagram below, it can be seen that perfect competition (many small firms, each whose actions have no effect on the price in the market) provide a far better allocation of resources than a monopoly (one firm). In perfectly competitive markets, price is set equal to marginal cost- if the price was above marginal cost, firms would undercut each other, until price equals marginal cost (at this price, firms make normal profit- 'break even'). We assume that the primary ambition of a firm is to maximise profit. When there is only one seller in the market, it maximises its profit by setting prices where marginal revenue (the increase in

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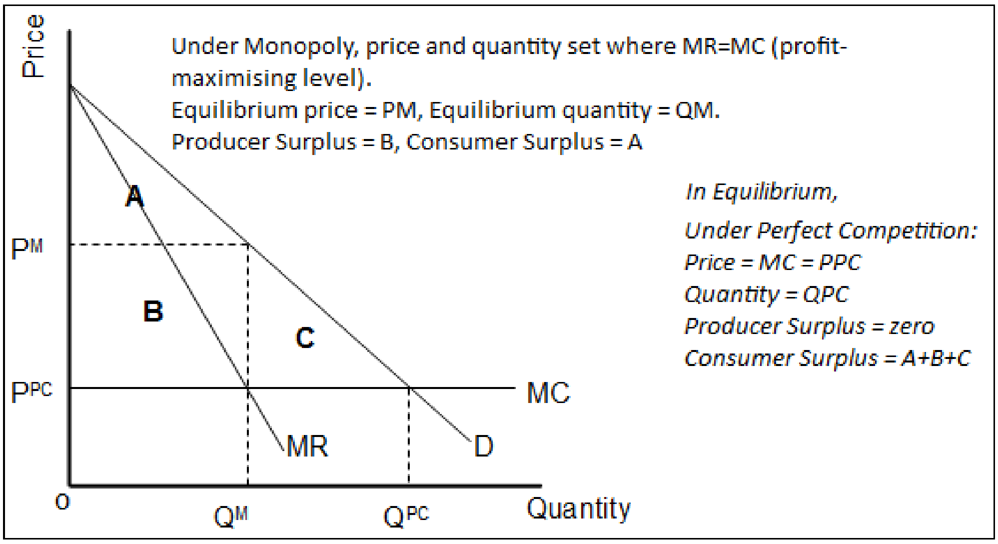
total revenue attributed to an increase in production by one unit) equals marginal cost (the extra cost of producing an extra unit). It can be seen that increased competition results in lower prices (PPC < PM) and higher levels of consumption (QPC > QM). Consumer surplus is increased through a transfer of surplus from producers to consumers and efficiency gains are achieved under Perfect Competition which are not realised under Monopoly (area C in the diagram).

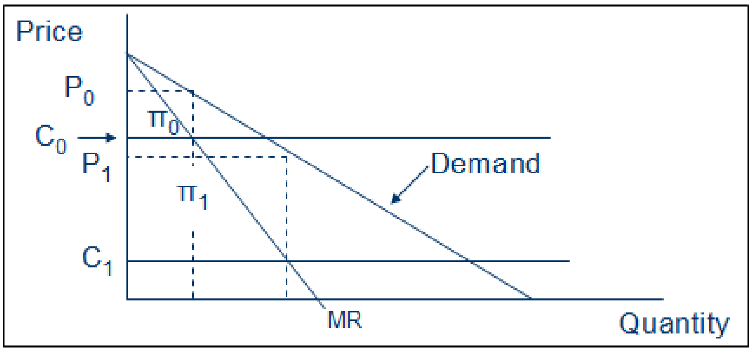


Competition benefits consumers not only through lower prices, but also through firms competing to provide high quality and innovative products. The level of competition in a market, determines the market structure, which in turn plays a role in determining the level of research and development (and therefore innovation) in a market.

For example in the diagram below, assume that prior to successful innovation (here we assume process innovation, not product innovation), the marginal cost of production is C_0 (note: we assume constant marginal costs), and that post-innovation marginal costs fall to C_1. It can be seen in the case of a monopoly, the maximum the monopolist would be willing to spend on research and development is the difference between the profit it makes prior to innovation (π_0) and the profit it makes post-innovation (π_1). This amount is smaller than the amount that a firm who prior to innovation makes no super-normal profit (such as a firm in a perfectly competitive market) - which would be the whole amount of profit post-innovation (π_1).

It should be noted that although the willingness to pay to achieve the process innovation is lower for a monopolist than for a firm in perfect competition, the ability to pay for the process innovation is highly unlikely to be the same in each case- a monopolist would be assumed to have more resources to hand.

It is clear that keeping markets competitive and making capital available to smaller firms is vital to ensure consumer welfare is maximised and optimal levels of investment in research and development.



II. The expected effects of the recession on the competitiveness of markets

In short, because banks stopped lending in an effort to build up their capital, firms with a high reliance on finance have struggled to survive. The result of this struggle has been increased lay-offs and redundancies, as firms try to cut costs in a bid to survive. Already it can be seen that the negative effects on firms' chances of survival are two-fold; initially capital constraints play their part, but then as result of the constraints on lending and job losses, private consumption in the economy falls as consumers reduce their spending to adjust for reduced income (as a result of becoming unemployed or the fear of becoming unemployed). In essence, the recession has caused markets to shrink, meaning fewer firms can survive at a given mark-up of price over marginal cost- 'In bad times, firms contract and leave the market as they adjust to reduced customer spending. Losses are made by those who fail to provide what their customers want or who set prices that are too high… Firms with the least attractive products or highest costs exit the market.' (Lyons, 2009, p. 12)

The consolidation of markets caused by the recession could be seen to reduce competitiveness as fewer firms remain. Typically, it is assumed that the fewer the number of firms in the market, the less competitive the market will be- as the number of firms falls, the easier collusive behaviour becomes to sustain. It should be noted that the link between market structure and competition is not always straight forward- sometimes competition is what causes there to be only a few large firms operating in an industry, achieving economies of scale. Therefore market structure may not always be a good indicator of the level of competition. However for the purpose of this essay I will assume that the consolidation of firms has occurred as a result of the demand-side shock to the economy and not as the direct result of an increase in market competitiveness.

III. The role of Competition Policy

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IV. The effects of Antitrust, Mergers, and State Aid on Competition

Within the EU, the antitrust area of competition policy covers two prohibition rules; firstly that there exist no ‘agreements between two or more firms which restrict competition’ (European Commission, 2010a), and secondly ensuring that ‘firms in a dominant position may not abuse that position’ (European Commission, 2010a), which prohibited by Article 101 of the Treaty on the Functioning of the European Union (TFEU), and Article 102 of the TFEU respectively. It is clear that without these prohibitions, consumer-harming anti-competitive behaviour could prevail as a result of the incentives for firms to collude.

Although some mergers can be justified, by expected efficiency gains which make markets more competitive, there are mergers that, if approved, may lead to the creation of or enhance the market power of a dominant firm, which could then harm consumers through restricting output to artificially raise the prices, or through reduced innovation. For example, on the 18th February 2010, the European Commission ‘approved under the EU Merger Regulation the proposed acquisition of the internet search and search advertising businesses of Yahoo! Inc. by Microsoft.’ (European Union, 2010), claiming that the combined market shares of Microsoft and Yahoo! Inc. in internet search and online advertising are below 10%. State aid is defined as ‘an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities’ (European Commission, 2010b) A firm can be considered to have received state aid if there has been a government intervention through the use of state resources, from which the firm obtains an advantage over its rivals, such that competition either has or may be distorted, and that there is a high probability that trade between Member States is affected. Clearly,

unless there is coordination of or prohibition of state aid contributions, distortions of competition would occur. With this in mind, I will now assess the case for competition policy relaxation.

V. Competition Policy for the Goods Sector- Should we sit back and relax?

In this section I will discuss whether or not a relaxation of competition policy would be advisable during the recession.

Crane argues that if history of the U.S. is anything to go by, we are likely to see a relaxation of competition policy ‘across the water’, as in crisis a ‘strong tendency toward abandonment of competition principles arises’ (Crane, 2008, p. 3). Indeed in times of crisis, it is only natural that a temptation to relax competition policy may arise- the abandonment of State Aid restrictions would no doubt please some of the member states of the European Union. In fact in light of the current financial crisis, the European Commission has introduced the ‘Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis’, which I will discuss later. It is natural that governments will want to employ protectionist policies in order to prevent firms on home soil from going bust, and therefore prevent unemployment. However, allowing countries to do this, particularly in the European Union, without coordination of subsidisation policies would undermine the idea of a ‘level playing field’. In stark contrast to ‘no props for lame ducks’ approach that the European Commission claims to enforce, member states could provide financial support for their firms that are not breaking-even. If the difference in subsidies more than offset the differences in efficiency, between ‘inefficient’ domestic firms and ‘efficient’ foreign firms, the result will be foreign firms going bust (instead of domestic firms)- ‘Inefficient firms receiving subsidies take market share from more efficient foreign suppliers. This can result in retaliation and a mutually destructive subsidy war funded by taxpayers.’ (Lyons, 2009, p. 13) Lyons argues that subsidies provide further problems- they ‘undermine the market mechanism because the prospect of a bailout leads to reckless behaviour’ (Ibid), and stifle investment and marketing by efficient firms. Efficient firms, with the knowledge that inefficient (‘failing’) firms will retain some market share through bailouts, will hold back investment because they will benefit relatively less than if there were no bailouts. Relaxing competitive constraints during a recession could actually achieve the opposite of what is desired- if firms want to raise their prices, they have to cut back output. ‘When the economy is already contracting, a shift in antitrust enforcement that enables such monopolistic output reductions only deepens the economic contraction’ (Crane, 2008, p. 10).

Taking the above into consideration, there is still a case for intervention in the non-financial sector during a recession:

> ‘In a period where credit markets are not operating normally and the availability of credit is heavily constrained, efficient firms may exit markets due to a combination of reduced demand and arbitrary financial constraints.’ (Competition Commission economics staff, 2009, p. 7)

Given that the enforcement of competition policy is supposed to ensure the most efficient allocation of resources, intervention to override these arbitrary credit constraints should be permitted to ensure market efficiency. This has indeed been seen in the temporary framework introduced in April 2009 by the European Commission. Article 2 of the ‘de Minimus Regulation’ which appears in Article 87(1), already allows for financial assistance that falls outside of ‘State Aid’ restrictions, and so can be applied at member states’ own discretion- ‘The total de minimis aid granted to any one undertaking shall not exceed EUR 200 000 over any period of three fiscal years’ (European Commission, 2009, p. 6). Currently, member states are allowed to grant aid up to the value of EUR 500,000 per undertaking, providing certain criteria are met. The criteria includes; that ‘aid is granted to firms which were not in difficulty on 1 July 2008… but entered in difficulty thereafter as a result of the global financial and economic crisis’ (Ibid, p. 7), ‘the aid is not export aid or aid favouring domestic over imported products’ (Ibid), and that the aid must be granted before January 1st 2011. The importance of aid for Small and Medium sized Enterprises (SMEs) must be noted, for it is these firms that are likely to be hit hardest by constraints on credits- their reliance on access to finance is greater than that of larger firms.

To conclude this section, it seems clear that despite the need for intervention temporarily to offset inefficiency caused by the arbitrary credit constraints, a relaxation of competition policy should not be adopted in response to the current crisis. Whilst competition policy relaxation may appear to be cost-effective in that it does not require tax-payer funds, the true costs of a relaxation may be an increase in prices, alongside decreased product quality, efficiency and innovation. As Crane argues, ‘antitrust laxity during the current financial crisis is likely to reduce producers’ incentives to expand sales and hire- the very measures needed to get the economy back on track’ (Crane, 2008, p. 10).

VI. Do the same rules apply for the financial sector?

I will now briefly assess the case for competition policy relaxation in the financial sector. Should the application of competition policy in the financial sector imitate its application in the real economy? The financial sector has been identified to contain two distinct characteristics differentiating it from other sectors. Firstly there is a high degree of inter-dependency, with banks ‘so interconnected that the collapse of a large bank is contagious and contaminates the whole banking system.’ (Lyons, 2009, p. 4) In the real-economy if a firm goes bust this would usually be seen to benefit a rival, however given the existence of inter-bank lending and high sensitivity to consumer confidence, a run on one bank can soon lead to runs on other banks too. The second and arguably more important characteristic is that banks are fundamental to the smooth operation of the economy in general. The resulting cut back of credit availability, as banks refuse to lend leads to a fall in demand in the economy. The combination of these characteristics leads to an argument that intervention in the financial sector is justified (see Lyons, 2009).

The need to bailout the banks has been evident- the quicker governments get banks to start lending, the sooner economic growth can occur- ‘Sufficient and affordable access to finance is a precondition for investment, growth and job creation by the private sector’ (European Commission, 2009, p. 1) While

State Aid has been permitted to save financial institutions from going bust, it has not been competition-distorting aid which contradicts the principles of competition policy. The adaptation of procedural rules regarding mergers may be advisable during the current crisis, to save time- where rapid mergers which may be key to keeping a 'failing firm' operating, the pre-recession rules regarding time between notification of and completion of mergers could be reduced. In this sense, a 'failing firm' is regarded as one that would fail to be a 'going-concern' in the absence of a merger- therefore making the merger efficient in that prevents assets from leaving relevant markets. Heretofore during the current crisis, competition policy with regards to the financial sector has not been relaxed- the benefits of competition policy here are similar to the benefits in the real economy. Notably in the U.S., financial market 'innovation has increased the availability of capital to a wide range of markets in the real economy' (OECD, 2009, p. 3) speeding up the recovery.

To conclude, history has shown that relaxing competition policy in times of crisis can often exacerbate recessionary effects and slow down recovery speed- the introduction of rationalization cartels in response to post-war recessions in the 1950s resulted in long term anti-competitive effects on the Japanese economy, while antitrust exemptions in the have been considered to be responsible in part for the persistence of the Great Depression in the U.S..

Given the expected consolidation of firms and the increased scope for anti-competitive behaviour, competition policy needs to remain stringent during the recession. Competitive markets should provide the most efficient allocation of resources regardless of whether the state of the economy, and for this reason I believe that competition policy should not be relaxed in the current economic climate. To finish I would like to cite Philip Collins, Chairman of the Office of Fair Trading- 'If business does not innovate, the recession will be prolonged, our economic prosperity will be threatened and recovery will be slower and more difficult.' (Philip Collins, 2009, p. 5)

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