Competition Policy during economic crisis.

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Outline

• The role of competition policy in the economy and the causes of the current economic crisis.

• Discuss whether there is a case for a different approach to competition policy in the current economic environment.

• Focus on some of the challenges the competition regime may face in a recession and financial crisis and the possible role that the CC and other competition authorities may have going forward.
**Competition and the economy**

- Near consensus among economists: competition policy has a strong role to play in improving the productivity (and therefore the growth prospects) of an economy, regardless of the position of that economy in the business cycle.

- Competition encourages firms to allocate resources efficiently and to innovate. Competing firms are forced to develop new products, services and technologies at the lowest possible cost.

- This process gives consumers greater choice, and better products at lower prices. It causes prices for products to converge to their marginal cost.

**How did the current crisis come about and was competition a factor?**

- The causes were: (Turner Report Review*)
  - unsustainable credit boom and asset price inflation.
  - Transmitting financial system problems into real economy effects.
  - impaired ability to extend credit to the real economy by the banking system

* [http://www.fsa.gov.uk/pubs/other/turner_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf)
Link between the degree of competition in financial sector and causes of financial crises

- No obvious link between the degree of competition in the financial sector and the causes of current financial turmoil as set out in the Turner review.
- Number of factors include:
  - The growth and increasing complexity of the securitized credit model
  - Extensive commercial bank involvement in trading activities,
  - High leverage,
  - Increasing dependence on market funding,
  - Hardwired pro-cyclicality in banks’ systems and processes and a lack of adequate capital buffers.

The role of competition policy in the economy as a whole and the causes of the current economic crisis.

- Discuss whether there is a case for a different approach to competition policy in the current economic environment.
- Focus on some of the challenges the competition regime may face in a recession and financial crisis and the possible role that competition authorities may have going forward.
Is there a case for a different approach to competition policy in the current economic climate?

• Calls for state intervention for firms in difficulty, including calls for a temporary or even permanent softening of competition policy.
• Recent examples of interventions to support firms include state assistance for banks and other financial institutions in the US and the EU, and state aid for car makers in the US and other regions.
• Calls for relaxation of merger controls e.g. newspapers in both the US and the UK.
• So far assistance to firms are broadly within existing competition frameworks.
• However, in the past competition policy enforcement has softened in periods of economic crisis.

Is there a case for a different approach to competition policy in the current economic climate? (cont’)

• Reasons to soften competition policy may be superficially attractive in periods of financial crisis;
• Relaxation of certain elements of competition policy enforcement, can appear, to be a relatively ‘cheap’ option in that they will not entail funds from taxpayers.
• Instead the costs typically accrue in the form of higher prices, lower product quality, reduced efficiency and reduced innovation.
• These costs tend to fall on the customers of firms who are often a large and disparate group of individuals.
• The benefits of a relaxation of competition will flow to a smaller group of business.
Is there a case for a different approach to competition policy in the current economic climate? (cont’)

• Reasons for policymakers to be wary of calls to relax competition in recession:
  1. inefficient means to assist firms in financial difficulty.
  2. ineffective, and even counterproductive,

• Competition policy designed to counteract market failure (power)

• Firms with market power have incentives to restrict output, to raise prices and have weaker incentives to invest and innovate.

• Policies to increase market power can prove counterproductive: restrict output and productivity and exacerbate the effects of recession and slow the recovery

Is there a case for a different approach to competition policy in the current economic climate? (cont’)

• No good economic reasons why competition policy should, differ in periods of economic growth or periods of recession.
• Competitive industries, utilize resources more efficiently, are more innovative and produce more output at lower cost than industries where competitive pressure is weak.
• Historically, setting aside competition law temporarily during recession has proved to be an unsuccessful policy
• Evidence says policies acted as a drag on economic activity and hindered economic recovery.
Is there a case for a different approach to competition policy in specific sectors of the economy?

**Intervention in the financial sector**

- Unique features of banking justify policies, such as significant state aid, that would not be considered appropriate in other industries.
- The role of banks is to help smooth consumption and investment of consumers and firms, allocate assets to their most efficient use, improve the problem of asymmetric information between investors and borrowers.

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Is there a case for a different approach to competition policy in specific sectors?

**Intervention in the financial sector**

- Three key features of banking that make banking inherently unstable:
  1. Banks collect short-term deposits and invest in long-term assets. Maturity mismatch between a bank’s liabilities (deposits) and its assets (loans) and creates an inherent instability.
Is there a case for a different approach to competition policy in specific sectors of the economy?

Intervention in the financial sector

2. Banking sector is unstable due to the negative effects of the failure of one bank on the stability of its remaining rivals (the failure of a bank can harm its rivals ‘contagion’)

3. Banking services are essential for almost all other economic activity in the economy.

*** Combination of the three features render individual banks, and the banking system, unstable and may provide a rationale for ‘special treatment’ of the banking sector.

Is there a trade-off between competition and stability in financial markets?

• Competition should have similar benefits in the financial sector as it has in other markets.
• Encourages financial institutions to allocate capital efficiently, to minimize cost and to innovate.
• Deep and efficient financial systems are important for economic growth and poverty alleviation (see, for example, Beck, Levin and Loayza, 2000).
• But, Is there a causal link between increased competition and instability in the financial system?
• In general, the theoretical literature is mixed and economic theory makes ambiguous predictions about the relationship between competition and stability.
Intervention in the non-financial sectors of the economy (cont’)

- Are there arguments for intervention to support firms in difficulty, or to relax competition policy in sectors of the economy, outside of the financial sector, during a recession or economic crisis?
- In general, non-financial sectors of the economy do not display the unique combination of features of banking which make that sector unstable and which make banking crises particularly damaging to the wider economy.
- The ease for intervention to support firms in other sectors of the economy is therefore less compelling. For example, in more stable sectors the collapse of one firm may not disrupt the operation of whole market.
- The competition authorities may have reconsider the way forward.

- No general reason to alter competition policy in a recession.
- The exit of inefficient firms is an important aspect of a well-functioning market.
- Periods of recession can lead to longer-term productivity gains by inducing the exit of inefficient firms.
- The process of firm exits in a recession can be painful, particularly where impact of firm failures is geographically concentrated.
- Common view among economists: “The most effective policy response to deal with the negative consequences of firm exits is to focus state support on the adjustment process (retraining workers to allow them to move quickly to other, more productive, firms or industries)”.

Intervention in the non-financial sectors of the economy (cont’)

• Features of the current economic crisis which may warrant a more active approach: The process whereby inefficient firms exit markets is an important aspect of well-functioning markets.
• But, may be distorted by the current financial crisis.
• If credit is heavily constrained, efficient firms may exit markets due to a combination of reduced demand and arbitrary financial constraints, affecting small firms.
• The combination of these factors may lead to more concentrated or inefficient markets in the future in some sectors.
• “The general case for intervention outside the banking sector, during recession, appears relatively weak. However, it may be that the current financial crisis provides a rationale for intervention to prevent a distortion in the normal market exit process.” Turner Review Report.

The role of the competition authorities in times of recession

The current economic crisis might affect the work of the competition authorities in three key areas of competition policy:
1. Merger control,
2. Cartels, and

Merger:
• To work in two different directions:
  • Either they become very difficult to fund due to the credit crunch, so we may see less activity.
  • Or, the current economic climate is likely to increase the number of failing firms and lead to attempts at consolidation in some sectors.

Challenge: increase in mergers where the parties put forward a failing firm defense. Mergers involving genuinely failing firms may not pose serious competition issues.
The role of the competition authorities in times of recession

**Mergers**

- Allowing anti-competitive merger introduces market failures.
- In contrast to state aid, the benefits to firms after anti-competitive merger are slow to take effect, as the monopoly profits often take time to accrue.
- Merger policy as a tool to assist firms in difficulty may result in increased prices, lower-quality products and reduced innovation, and could potentially persist.
- State aid can be made conditional on certain actions by the target firms, such as restructuring.
- Difficulties in applying conditions to the clearance of an otherwise anti-competitive merger.
- Changes to the operation of the merger regime such as speeding up the merger process for failing firms or replacing structural remedies that prove impossible to implement with behavioral ones.

**In Cartels**

- As with mergers, it may be the case that the recession results in an increased case-load for the competition authorities as recessions can result in:
  1. so-called ‘crisis cartels’.
  2. calls for the relaxation of price-fixing rules, or a reduction in enforcement activity.
  3. Calls for ordered restructuring of industries or firms colluding on the removal of spare capacity,
  4. Calls for reduced fines.
The role of the competition authorities in times of recession
- State aid –

• State aid an effective policy tool to deal with economic crisis in key sectors (banking)

• Intervention must be taken with care as can create distortions of competition.

• Difficult for government to distinguish efficient and inefficient firms and selective support can lead to ‘picking winners’ or supporting ‘national champions’

• Badly handed state aid may distort competition in the market, distort incentives, increase moral hazard and weaken the overall competitiveness of a sector.

The role of the competition authorities in times of recession
State Aid

• However, several countries including US and EC and other countries have recognized that restructuring banks in difficulty may be necessary to avoid serious disturbances in their economies

• A case for an adapted approach to state aid in times of financial crisis?

• Will it recognize the current economic reality?

• The need for action in the short term, whilst maintaining the longer-term benefits of competitive markets.
The role of the competition authorities in times of recession

**Competition Advocacy**

- Role to competition authorities in:
  - making sure that competition is in the wider policy arena
  - providing a counterweight to calls in favor of relaxing competition policy
- Competition authorities should advocate in:
  - Making the case for robust competition policy in recession.
  - Contributing to an informed debate on specific issues.
  - Providing support to other government departments.
  - Clarifying policy.
  - Sensitivity to the wider policy context