Competition Policy and the Recession

Director's Letter
Catherine Waddams

In this special newsletter edition we explore the implications of the current financial and economic crisis for Competition Policy. We provide a background to the crisis and its causes, and a comment on the implications if consumers should believe that some offers are "too good to be true"; articles on the formation and detection of cartels and the transmission of base rate interest changes to the retail markets; and a look at the implications of a move away from competition policy. We are particularly grateful to Peter Freeman, chairman of the UK Competition Commission and a member of CCP's Advisory Board, for permission to reprint his overview of competition issues. Our next regular newsletter will be published in May.

Competition Night?[1]

Peter Freeman
Chairman of the UK Competition Commission and member of CCP's Advisory Board

At a recent European Competition Day, organised by the Conseil de la Concurrence and the DGCCRF, the former EU Commissioner for Competition, Professor Mario Monti, captured the sombre thought underlying the discussion when he asked whether the "Competition Day" would be followed by a "Competition Night".

This warning, in the form of a question, reflects a widespread concern that competition policy is now facing challenges on several fronts. A number of questions arise.

First, could it be that, after an extended period of mainstream consensus that competition is beneficial to the economy as a whole and consumers in particular, we are witnessing a turn of the tide? Should we assume that the "competition honeymoon" is over and that we are entering a phase where the achievements of competition law and policy are at risk of being swept away by a tidal wave of financial and economic distress?

Second, it has become an axiom that competition authorities should be free of political influence and be given an independent status, at least in Europe. For example, in my own country, the United Kingdom, does the recent approval by the Secretary of State of the proposed merger between Lloyds TSB and Halifax Bank of Scotland,[2] without detailed Phase II consideration, mean the re-politicisation of merger control and the abandonment of competition policy?

Moreover, the benefits of competition can appear ambiguous to consumers. For example, in some markets generally thought to be "competitive" (such as UK retail energy markets) what the consumer sees is higher, rather than lower, prices, which suggests that competition does not always bring immediate benefits to consumers, who are already hard pressed by other pressures on their disposable income. And in the recent *Groceries*[3] investigation by the Competition Commission in the UK, a significant part of the evidence submitted to the Commission concerned what was seen as the damaging effect that competition in grocery retailing was having on town centres, on the environment and on the security of UK food supplies.

This is without even looking at the wider debates about "national champions" and the benefits of open markets being questioned in circumstances where markets outside the European Union may be seen as much less liberal and where asymmetric competition looks unattractive.

These are real challenges, increasing the anxiety for those competition authorities who scan the western sky for signs that darkness is falling and that the "Competition Night" has arrived. There is a definite need to respond to the challenges to competition policy in a clear and resolute way. This response should be a mixture of defence of principle and pragmatic recognition of the current economic circumstances.

First it is essential not to retreat on competition policy as a matter of principle. The market economy, with its emphasis on competition, has brought immense benefits to consumers and economic participants alike. This fact is not changed by the collapse of credit and the recession in the economy. Adopting other, previously unsuccessful, policy

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models in the face of current setbacks is not an attractive course. The market economy has many drawbacks but it remains the "least worst" way to conduct economic activity.

This needs to be recognised not only by individuals and private undertakings but also by governments. Given the unprecedented turbulence affecting the financial system, governments have, quite rightly, intervened, in the public interest, to take over important economic functions, recapitalising and taking ownership stakes in private institutions and providing finance in the form of loans or guarantees to other undertakings, to provide much-needed stability both in the financial system and in the wider economy. These measures are without doubt essential in the short-term. But it would be a mistake to assume that such a degree of intervention is necessary or desirable in the longer term. As and when economic recovery occurs (and there is no reason to see why permanence should apply to the slump when it has clearly not applied to the boom) the need for a market economy, backed by a rigorous competition policy, will apply as before. It is the task of the competition authorities to keep reinforcing that message.

But an element of pragmatism is needed in the meantime. Economic downturn is likely to give rise to more situations where crisis and failure are pleaded as a defence to otherwise unacceptable activities or transactions. The authorities will no doubt take full account of the economic circumstances in which a given issue is presented. In the case of hard core cartels, hard times have never been a justification for illegal activity and there is no reason to think that will change. For mergers and markets, the authorities will remain stringently sceptical but will nonetheless be concerned to ensure that the concepts of competition and consumer welfare are applied in a way that fully recognises the economic reality and context, and that competition-based solutions are genuinely preferable to the alternative.

The *Lloyds TSB/HBoS* case is a good illustration of that process at work - a balancing of the issues of possible restriction of competition against the immediate needs of financial stability, carried out by Ministers within a carefully structured statutory framework, accountable both to Parliament and the courts. This should be seen not as the abandonment of competition policy, but instead as a recognition that, in exceptional cases, other factors may carry greater weight, at least in the short-term. There will from time to time be the need to strike such a balance. What is important is the transparency and accountability of the process.

So, economic clouds may be gathering and an atmosphere of gloom may be with us for some time to come, but there is no need for a "Competition Night". We may indeed be experiencing an "Economic Night", before the inevitable dawn, but the bright light of competition policy should continue to shine through the gloom.

[1] First published in Review Concurrences No.1-2009, www.concurrences.com
[2] Anticipated acquisition by Lloyds TSB plc of HBOS plc, OFT report to the Secretary of State for BERR, 24 October 2008; Decision by Lord Mandelson, the Secretary of State for Business, not to refer to the Competition Commission the merger between Lloyds Group TSB plc and HBOS plc under Section 45 of the Enterprise Act dated 31 October 2008.
[3] CC report, *Market investigation into the supply of groceries in the UK*, 30 April 2008.

Origins of the Financial Crisis

Shaun Hargreaves Heap, Professor of Economics

Financial crises are triggered when financial institutions, particularly banks, have an unusually large number of loans that turn bad. The origin of this "toxic" debt is almost always an asset price bubble that bursts. Borrowers and lenders alike get swept along by the prospect of continuing capital gains. The borrowers feel wealthier as the price of their assets rise and they either wish to release some of this extra wealth or speculate some more on future rises through additional borrowing; and the lenders are happy to accommodate in the belief that rising asset prices make the loans safe. When the bubble bursts, hindsight makes a fool of both.

The bad debt in this financial crisis was spawned by the housing price bubbles in the UK, the US and some other European property markets. The crisis that ensued was somewhat unusual because it was not entirely clear who was holding the bad debt and this explains in part why the crisis has lurched from one low point to another.

It may seem odd that banks apparently did not know the full extent of their exposure to the sub-prime mortgage mess. But this was certainly the impression as each bank's announcements became grimmer by the month; "securitisation" helps explain how this happened. "Securitisation" is the practice that banks developed of turning some of their loans into securities like CDOs ("collateral debt obligations") which they sold on to other parties. This enabled them to get those loans off their balance sheets and make some new ones. It apparently suited investors because different types of risk could be packaged together through these derivatives to match one's preference. The repackaging of risk could sometimes directly obscure a bank's exposure and this was compounded by the fact that the banks often made the loans to the people and institutions who bought these CDOs. So, the exposure did not entirely disappear when they created a CDO. Added to this was another kind of financial innovation: CDSs ("credit default swaps"). Banks issued these as a form of insurance against the original loans defaulting and in this way became re-exposed to default on those loans. The combined result was that risk was being passed around the system in increasingly complicated ways and by the end few knew quite how much they were really carrying on their balance sheets.

As a bank's loans turn toxic, its assets shrink and this can create a solvency problem. In most businesses, this would be unfortunate, but not an obvious reason for public intervention. Banks, though, are different for two reasons. Both make financial markets prone to an instability that can damage other parts of the economy. In both instances, it is the reaction of banks to one bit of bad news that can help create another and so launch financial markets on a downward spiral, taking large chunks of the non-finance part of the economy with it.

First, banks are likely to respond to an emerging solvency problem by hoarding cash and reducing their loans. When they cut back on loan activity, somebody's spending falls and at the margin some businesses entirely unrelated to the original sources of toxic debt may default on their loans. In this way, the original bad debt creates another. Second, banks are in the business of borrowing short and lending long and as a result there is always the potential for embarrassment if too many people withdraw their deposits. This potential liquidity problem comes with the business of intermediation and a hint of a doubt over solvency can provoke just such a run (as we saw with Northern Rock at the start of this crisis). Liquidity problems of this kind can, in turn, contribute to a solvency one because banks will often respond to withdrawals by selling their more liquid assets, like Treasury Bills and Corporate Bonds; and when lots of institutions try to do this, the value of these assets will fall and again the banks' balance sheets deteriorate.

Of course, none of these reactions is likely to feed on itself in these ways if a single or a few banks find themselves in difficulties. But when many or all are affected by a shock to their balance sheets, these "natural" reactions to worsening solvency and liquidity conditions can feed on each other to initiate a vicious downward cycle in loan activity. In the extreme case when this happens, as it did after Lehman Brothers was allowed to go into administration, credit literally dries up as banks desperately try to rebuild their cash assets and almost every economic transaction is threatened. This is when governments and central bankers have to intervene. It goes against the grain if poor judgement or bad practice were responsible for the original sub-prime mortgage problem for reasons of moral hazard. But when the collateral damage of such poor decision making is the prospect of a major economic contraction, policy makers have no alternative but to overlook such scruples. They are for the future.

Too Good to be True?

Morten Hviid, Professor of Competition Law

In the wake of the financial crisis, it has been argued that some offers were "too good to be true" and that as a consequence anyone taking up the offers should have known better and only have themselves to blame. Maybe as consumers we have become too greedy and our expectations about what is **NOT** too good to be true (TGTBT) far too optimistic. Maybe we should become more cynical and reject or ignore more offers on the basis of them being TGTBT. Not all offers caught by such a TGTBT filter are likely to be problematic and the more conservative this filter is, the more unproblematic offers are likely to be caught. The effect of this, at least in part, depends on whether the heuristic TGTBT triggers a careful (re)evaluation of the offer or simply an outright rejection. In the former case, any adverse effect arises from an increase in transactions costs as consumers spend more, occasionally unnecessary, time evaluating offers and increase switching costs. In the latter case, the effect is more subtle and the subject of the remaining discussion.

Avoiding TGTBT Offers is an Obvious Rule

There is a tradition in the UK of a "buyer beware" attitude and a reluctance to mollycoddle consumers. As a matter of policy, there is a preference for consumer empowerment rather than consumer protection, as evidenced for example by Public Sector Agreements PSA3 of the Department for Business, Enterprise and Regulatory Reform to "[p]romote fair competitive markets by ensuring that the UK framework for competition and for consumer empowerment and support is at the level of the best by 2008".[1]

From a competition policy perspective, it is clearly the case that markets will fail to work well if consumers do not do their part and think carefully before they buy, especially where they are looking to finance buying a big-ticket item such as a house.[2] If consumers are perfectly insured from making mistakes, there is a serious danger that they will not acquire the necessary information to ensure that the demand for the bad or fraudulent deals is low enough to drive such offers out of the market.

Dangerous of Too Sceptical a Heuristic

While it may be easy with hindsight to tell that an offer was TGTBT, it may have been harder to do so at the time of the decision. The rhetoric following an economic crisis can generate a greater scepticism about offers either because people fear being ridiculed for their actions or because they will receive no consumer protection. This can then lead to a rule-of-thumb or heuristic that more offers are classified as TGTBT and rejected as there is a different danger to the function of the market.

Competition involves firms constantly improving their offers, either by offering new or better products or lower prices on existing products in order to attract business from their rivals. If consumers are more likely to classify and reject an offer as TGTBT, competition may be stifled.

Looking at Established Firms and Products

Here capturing new customers means offering better prices. However, if consumers are made more suspicious of low prices, how is a firm to attract new business? This really depends on the relative size of the switching costs of the consumer and the level at which an offer is deemed TGTBT. If consumers face very low switching costs, the necessary price discount would only need to be modest, keeping this well below the point at which even the most sceptical consumer would classify the deal as TGTBT. However where switching costs are significant, price discounts have to be substantial to lure consumers away from their current supplier and such a deep discount may well take enough consumers past their TGTBT point so that a significant group of consumers would ignore the offer. Once consumers no longer respond to price differences, firms have no incentive to undercut each other and one would expect consumers to be at or near the monopoly price. As a consolation, at that point, there is at least no way that the price is TGTBT.

Looking at New Entrants or Products

A potentially even more disturbing effect arises when it comes to the introduction of a better quality product by an established firm or the entry of a new rival. Because consumers know what and from whom they have bought in the past but are uncertain about the merit of the new good or the new supplier with no or little track record, switching will be perceived as risky and hence costly. The implication is that to attract customers to a new product or a new firm, a new product must be discounted deeply. This necessary discount may take the entrant product or firm past the TGTBT point, making either innovation or entry impossible. The more sceptical consumers become, the more likely is this to happen. As a consequence established firms have no incentive to innovate or lower their prices to fend off new rivals.

Disturbingly, established firms have a very strong incentive to say, "We told you so! You should all have known it was TGTBT. You really should be more sceptical about generous offers in the future".

How to Manage the Balancing Act?

Being careful and using enough resources to assess offers, while increasing switching costs, is sound advice. However if consumers respond to more vocal concerns about TGTBT offers by adopting ever more sceptical heuristics, we risk stifling competition both among the existing suppliers and between these and potential new suppliers. What might be an appropriate policy response to this?

The first thing one can do is to focus on fraud. If offers are so obviously TGTBT, they are also likely to be fraudulent and the first clear step must be to protect consumers against that, saving switching costs for all types of consumers. The second is to improve consumer education so that more respond to concerns about TGTBT offers by seeking out more information rather than revising their rule-of-thumb. However, in doing so, one needs to ensure that the benefits from such education exceed the costs.

[1] For a full list of PFA's for BERR, see http://www.berr.gov.uk/aboutus/corporate/performance/performance_Framework/page23502.html. See also Harker, M, Akman, P, Lovdahl Gormsen, L, Mehta, J and Waddams, C, "Benchmarking the performance of the UK framework supporting consumer empowerment through comparison against relevant international comparator countries - a report for the Department for Business, Enterprise and Regulatory Reform" (August 2008).

[2] For more on remedies aimed at activating consumers, see the CCP report for the Office of Fair Trading: Garrod, L, Hviid, M, Loomes, G and Waddams Price, C - "Assessing the Effectiveness of Potential Remedies in Consumer Markets - a report for the Office of Fair Trading" (April 2008).

Will the Recession Make Cartels More Likely and Cartel Enforcement More Difficult?

Andreas Stephan, Lecturer in Law

The theoretical view is that a sudden drop in demand will break up many existing cartels. Assuming that cartelists constantly weigh the costs and benefits of cheating a collusive agreement, break up is more likely if the drop in demand is anticipated, as the short-term gains from cheating are expected to be at their greatest. Moreover, dealing with demand instability will test both the mechanics of a cartel and put an enormous strain on the trust which exists between the parties to the agreement. One might thus expect an increase in leniency applications as a result of the downturn.

However, contrary to some findings in the economics literature on cartels, empirical studies of infringements punished in the last 10 years indicate that many collusive agreements may be formed as a consequence of an economic downturn: French Beef, Auction Houses, German Banks, Graphite Electrodes, Seamless Steel Tubes and Carbonless Paper, to name a few. Cartels allow competitors to deal with the overcapacity which results from a sudden fall in demand, and to reduce the risk of bankruptcy - especially where there is uncertainty as to the relative efficiency of one's competitors. There may also be an expectation that demand will increase again soon, making the incentive to deviate from a collusive agreement minimal. Naturally, the cartels which have been punished by competition authorities in recent years may not paint a complete picture, as these may simply represent the agreements that were ill-conceived or badly administered.

Economic downturns might also influence businessmen's normative perceptions of cartel laws. When faced with the prospect of losing one's job or becoming insolvent, the range of options or strategies for increasing a firm's performance may become wider. Individuals who would normally consider price fixing to be objectionable (and thus not consider it as an option) might in desperate times put any ethical objections aside. Business attitudes to competition law are, in any case, weak as compared to other forms of corporate crime; something that was recently demonstrated by British Airways in promoting to the board an employee pending trial for cartel behaviour.

The relationship between *explicit* and *tacit* collusion is also worth exploring. Tacit collusion (i.e. no agreement or direct contact) is less likely to be sustained through a period of sudden demand shocks because firms are unable to adequately communicate to each other as to the best way forward. By contrast, explicit collusion (i.e. something more akin to a hard core cartel) involves competitors meeting up to reassure one another, to plan for the future, as well as monitoring each other and ensuring the agreement is being adhered to. In this respect, industries that were previously subject to forms of tacit collusion or parallel pricing may become cartelised during a recession. However, there is no empirical evidence confirming this. Cartels and tacit collusion are the subject of CCP's Fifth Annual Conference on 18-19 June 2009.

Recession can also have a serious implication for cartel enforcement. The increased risk of bankruptcy places constraints on a competition authority's ability to impose pecuniary fines. On the European Community level, we have seen how D-G Competition is willing to grant substantial reductions in fines (in addition to leniency and the application of the 10% cap) on the grounds of financial constraints. SGL for example, was granted a 33% discount twice for its involvement in two of the three carbon product cartels. In the UK, the OFT will be struggling to calculate appropriate fines for small firms under investigation for price fixing in the construction industry, as many are already facing bankruptcy as a consequence of the economic downturn.

Understandably, competition authorities do not want to fine firms out of business as this will result in a more concentrated market, although it should not be the role of competition law to protect the number of competitors. However, bankruptcy also involves a number of social costs, such as loss of jobs. These are considerations that are extremely sensitive politically, and which will always outweigh competition concerns if deemed serious enough. The Lloyds TSB-HBoS merger demonstrates the extent to which social policy can supersede competition concerns during an economic crisis. The difficulty is calculating the size of penalty a given firm can incur without going bankrupt, something that is compounded by a firm's ability to deliberately present their finances in such a way as to argue financial constraints or an inability to pay - especially given the length of time that normally elapses between the opening of an investigation and the imposition of fines. One might argue that the bankruptcy issue strengthens arguments for the effective use of criminal sanctions against individuals, as a complement to corporate fines. A criminal offence exists within the UK and a number of other EU member states, but has been invoked infrequently and cannot operate on the community level.

One upshot of the bankruptcy issue may be a greater willingness amongst firms to sue upstream cartelists for damages. Under normal trading conditions, these firms may be unwilling to upset the long-term relationship with their suppliers, whereas if the firm is on the verge of insolvency every avenue for extra revenue will be explored. This was one of the findings of the Georgetown study undertaken into private antitrust litigation in the US during the 1980s.

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The Effectiveness of Base Rate Changes

Recent Work Assessing the Form and Distribution of Interest Rate Change in the UK Deposit Account Market

John Ashton
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A principal strategy in alleviating the economic problems witnessed in the last year has been the frequent downward re-adjustment of the base rate. Over the last year the Bank of England has changed the base rate 6 times moving this from 5.5% in January 2008 to the level (current at the time of writing) of 1.5% in January 2009. This form of monetary policy is focused on controlling the money supply through altering the rates of interest paid by firms and households of their debts and the interest received on savings and deposits. Central to this form of economic management is the assumption of the swift change by banks and other financial services providers of interest rates within their financial services to reflect base rate changes. Indeed understanding how banks alter their interest rates in response to base rate changes, the transmission mechanism, has a substantial importance for the success of this form of macro-economic management.

Two recent studies at the ESRC Centre for Competition Policy have addressed this concern by assessing how banks and other financial services providers change interest rates in the UK deposit account market during the 1988-2006 period. These studies have both employed a comprehensive dataset of the UK financial services and interest rates developed using data from Moneyfacts PLC.

One study[1] assesses the frequency and form of these interest rate changes for multiple savings products offered by individual banks and also how interest rate changes are undertaken relative to other banks. This work considers monthly observations of deposit accounts offered in the UK between November 1988 and December 2006. In total 1,618 deposit accounts which have operated for over 24 months and offered by 152 financial institutions are considered.

Three features of interest rate change are assessed to indicate whether the pricing of interest rates by financial services providers is undertaken in a synchronised manner as would be expected when reacting to a base rate change, or in a staggered manner over time, consistent with firms changing interest rates a number of times a year with a degree of regularity. First, the proportion of deposit products where interest rates changed in a single time period is assessed. A very high or low proportion of banks changing interest rates in the same time period in a synchronised manner is consistent with the interest rate changing in response to a base rate change. Alternatively an intermediate proportion of banks changing interest rates simultaneously is consistent with interest rate change being staggered over a period of time and slower than pass-on base rate changes. Second, the frequency and duration of consecutive interest rate changes are considered. It is proposed that when banks are more responsive to base rate changes, a higher number of consecutive interest rate changes can emerge. This scenario is particularly important when base rate changes are frequent and occur repeatedly, as has occurred during 2008. Alternatively when banks are less sensitive to base rate changes and interest rates change in a staggered manner or with a particular frequency, consecutive interest change will be minimal. Third, the regular cyclicality of interest rate change is assessed. If banks change interest rates in response to base rate changes, interest rates should not change at regular intervals with a consistent and predictable time lag. This aspect of interest rate change is assessed by assessing the probability of interest rate change subject to past interest rate changes. These features are all considered at product level and at firm level to indicate how banks which provide multiple deposit accounts change interest rates in the UK deposit market. Results for all UK banks are summarised in Table 1.

Key findings: firstly, interest rate change of UK saving deposit accounts is staggered with a periodic frequency between banks. This is consistent with a slow transmission of base rate changes into saving deposit accounts. Distinctly individual banks which offer multiple saving products tend to change all their deposit account interest rates simultaneously. Secondly, consecutive interest rate changes are infrequent and evidence

Proportion of Deposit Accounts where interest rates changed in a given month

Proportion with changing interest	0	>0 to ≤0.2	>0.2 to ≤0.4	>0.4 to ≤0.6	>0.6 to ≤0.8	>0.8 to ≤1
Banks	0.0046	0.6713	0.2083	0.1111	0.0046	0.0000
All Products	0.6729	0.0151	0.0263	0.0304	0.0248	0.2305

Percentage of Consecutive Interest Rate Changes (%)

Duration	0	1	2	3	4	5	6	7	≤8
by Bank	76.407	16.396	4.164	1.407	0.712	0.446	0.202	0.058	0.207
by Product	79.511	15.363	3.667	0.754	0.420	0.187	0.036	0.014	0.047

Tests of Cyclicality (%)

Between Banks			Within Banks		
T+1/T	No change	Change	**T+1/T**	No change	Change
No change	45.5	86.6	**No change**	54.6	92.5
Change	53.9	12.9	**Change**	45.4	7.5

Table 1: Synchronisation and Staggering in UK retail deposit interest rates 1988-2006

consistent with interest rate cyclicality is reported. Further (though not reported in the table), statistically significant differences exist between types of financial institution in how interest rates are changed. In particular retail high street banks and converted building societies change rates in a more synchronised manner and are more responsive to external shocks such as base rate changes.

The second study[2] assesses how banks and other financial services providers set interest rates around the UK. Whilst most banks adopt universal pricing policies, no single UK bank has universal branch coverage of all areas of the UK. Using monthly data on saving deposit accounts from 1992 to 2006 from 167 banks and 1,225 products, two forms of assessment are employed. Initially, regional differences in levels of interest on instant and notice savings accounts are assessed using an ANOVA model. Secondly, the influence of overlapping branch networks is measured using a regression model.

Using the ANOVA model, systematic differences in the level of interest paid on deposit accounts are reported across the different nations and regions of the United Kingdom. These differences are indicated in Figure 1, where nationally and remotely distributed deposit accounts provide the highest returns and regionally based financial institutions within Northern Ireland offer the least.

Secondly the influence of bank branching on the differential level of interest rate setting is considered. In most cases the degree of overlap between bank branches has little influence on the level of interest paid, suggesting that factors other than geography may be influential. Indeed banks which operate regionally and nationally adopt different business models and behave distinctly in the deposit market. Regionally-based building societies and banks are generally far more reliant on deposits to fund other aspects of their banking business, such as loan provision, than nationally based banks, which have had greater access to money market funds until recently. Further while larger national

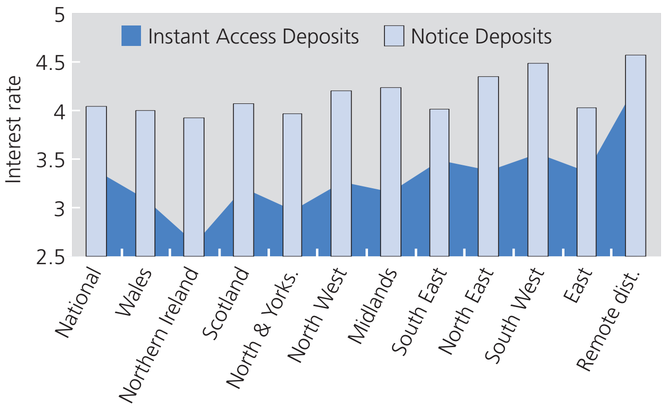

Figure 1: Geographic differences in UK deposit account interest rates when £5000 deposited. (1992-2006)

banks compete with each other they are less likely to compete directly with smaller regional banks.

To conclude, the practice of using base rate changes as a central tool of monetary policy is problematic. The transmission of base rate changes to retail deposits is slow. Banks clearly alter interest rates regularly throughout the year, rather than in reaction to base rate changes. Equally the distribution of interest rates for deposit accounts across the UK differs significantly. While the cause of this uneven distribution of interest rates is unclear, it can be stated that base rate changes will have a differential effect on bank customers in different parts of the UK. Overall, the effect of base rate changes may be slow to influence the real economy due to the concerns raised in these two studies.

[1] Ashton, J. K. (2009), "Synchronisation and staggering of interest rate change by UK financial services firms", *International Review of Applied Economics*, 23(1), pp.55-69.
[2] Ashton, J. K. (forthcoming), "Does the United Kingdom have regional banking markets? An assessment of UK deposit provision 1992-2006", *Applied Financial Economics Letters.*

Competition Policy and the Economic Crisis[1]

Bruce Lyons, Professor of Economics

The Crisis

The current crisis has its roots in a series of huge strategic mistakes by the banks. They borrowed (and lent) far too much given their equity base, and were caught out when the asset price bubble burst heralding large-scale mortgage defaults. There have been two near-lethal consequences for markets and a third may be around the corner.

The first was that many of the world's most renowned banks have been pushed close to bankruptcy. Governments across the world have stepped in to bail them out by guaranteeing loans, injecting capital and buying their shares (i.e. part-nationalisation). Second, the banks have cut lending in every way they can (except, needless to say, on their own bonuses) and so created financial constraints for their business and private customers. This has reduced demand and created a powerful negative multiplier across the whole economy. Governments and monetary authorities across the world have tried to reverse this multiplier by slashing interest rates, increasing public spending and reducing taxes. Much of this is sensible and necessary. Unfortunately, anticompetitive interventions are also creeping into these 'rescue packages'.

The third danger is that competition policy may be emasculated. In the last decade, competition policy has been introduced or reinvented across Europe with vigour and applied using economic foundations. It is still fragile and vulnerable to crude, populist, deeply flawed claims that it is an unnecessary luxury in times of recession or even that the crisis itself is due to 'too much competition'.

Banks are a Special Case…But There are Limits

The crisis started with the banks and they are particularly testing for competition policy. After years of lecturing and lobbying from the West, China adopted its new Anti-

Monopoly Law only last year. China may, therefore, be puzzled to see so much government intervention in banks, including: massive individualised subsidies; government 'interference' in business behaviour; politicians overriding independent merger regulation; and nationalisation. Do they justify the suppression of competition policy?

All markets have their own idiosyncrasies but they fundamentally work in the same way. Only rarely are the idiosyncrasies so substantial that they warrant special treatment. It is an unfortunate truth that banks are different in three fundamental and interlocking ways. First, they provide the essential oil in the economic system, allowing other firms to absorb the bumps of fluctuating revenues and payments. Without this oil, the economy seizes up. The product of no other market is so essential to every other market in the system. Second, banks necessarily borrow short (i.e. customers can withdraw their money at short notice) and lend long, which means they must rely on customer confidence to keep funds flowing in. In the absence of government guarantees, savers have a huge amount to lose if a bank goes bust, so the slightest rumour of potential failure results in massive withdrawals and, in the absence of intervention, a self-fulfilling prophesy. The queues outside Northern Rock in September 2007 were an early sign of the fragility of the banking system and looming crisis.

Third, loss of confidence is contagious as customers wonder which is the next troubled bank from which to withdraw their funds - and think 'better safe than sorry'. The defining moment of the global crisis - a year to the day after those queues on UK High Streets - was when the iconic US bank Lehman Bros collapsed. In simple economic terms, a large bank has an unusual negative externality on its rivals - if it collapses, the stability of its rivals is undermined. This is in sharp contrast to, say, a grocer or car manufacturer. These three idiosyncrasies combine into a compelling argument for intervention to keep them solvent. However, it does not justify the suspension of competition policy either for banks or any other sector of the economy. Rather than distorting well considered competition policy rules, if non-discriminatory interventions are insufficient it would be better to nationalise failing banks for a temporary period until confidence is restored and appropriate regulation is in place.

The Threat to Competition and Competition Policy

There is no space in this newsletter to trace the impact of the financial crisis into the wider economy, but there is again no reason to suppress competition policy for cars or any other sector of the economy. In fact, history suggests that this would be seriously counter-productive. Cartels raise prices and cut output, yet President Roosevelt suspended competition policy during the 1930s New Deal. Recent economic research suggests that this was responsible for raising unemployment by 24% and extending the Great Depression for seven years. Recessions have also provided opportunities for anticompetitive mergers to concentrate markets unnecessarily. In international trade policy, there is a well known and strong correlation between recession and protection, with causation going both ways in a destructive spiral.

At the time of writing (early February 2009), the number of anticompetitive interventions worldwide appears relatively limited. However, there are dangerous signs of gathering momentum. For example, in the UK in October 2008, the OFT recommended that the Competition Commission should investigate the proposed merger of Lloyds-TSB and HBOS, but this advice was overridden by the Secretary of State. This is the first case of such an intervention since the major reform in the Enterprise Act of 2002 was meant to take mergers out of political decision making. In France, 3b government support for Renault and Peugeot has been offered only subject to no jobs being lost in factories located in France. The EC will investigate this state aid closely. Meanwhile, the EU itself has re-introduced subsidies for the export of milk and milk products. In the USA, the fiscal stimulus bill of the new Obama administration includes 'Buy American' clauses (e.g. for steel to be used in state projects), though there are signs that these might be modified in the face of potential retaliatory action by the EU.

Neelie Kroes is currently holding the line well at the European Commission in abiding by the rules of competition policy but she is under pressure. National governments are more motivated by short-term popularity and most other international institutions have weak powers other than persuasion.

The Opportunity for Competition Policy

Rather than fall into the fallacy of sacrificing competition policy supposedly to avoid the short-term consequences of recession, we need to enforce competition policy robustly to avoid the long-term consequences. Examples abound in each area of competition policy:

- *Agreements between firms:* 'crisis cartels' are liable to form when prices drop. The New Deal example provides a strong warning and such coordination can become addictive.
- *Abuse of dominance:* there is a danger of a financially strong firm taking the opportunity to foreclose a rival. Recession, especially in the presence of financial constraints, may prove fertile ground for unfair means to tip a rival over the edge and competition authorities must be alert to such foreclosure.
- *Mergers:* we are likely to hear the failing firm defence being rehearsed many times over. If a firm is clearly going bankrupt, and if a particular merger is the least anticompetitive way to ensure the survival of efficient resources in the industry, then such mergers should be allowed. But this is simply a statement of sensible policy in any circumstances and there is nothing special about the current recession in this respect. It is only the frequency of this argument that will test the authorities.
- *State aid:* There will be many cases of applications for rescue and restructuring aid to prop up ailing firms. This can be highly distortionary, harming efficient firms and slowing down necessary adjustment to new investment and jobs. Funds are far better spent on helping workers adjust than on a subsidy that primarily benefits shareholders.
- *International trade:* the WTO has strong advocacy and monitoring roles in deterring protectionism. These can be put to good use, for example, at the London meeting of the G20 this April.

[1] An extended version of this short note will be published shortly as CCP Working Paper 09-4.