Competition Policy, Bailouts and the Economic Crisis

by

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Abstract: The aims of this paper are twofold. First, I explain the economics of bank bailouts as distinct from bailouts for other sectors of the economy. Why do all the rules of good competition policy appear to fly out of the window when the banks get into trouble? Does this mean that we should abandon the rules equally for car manufacturers and other industries in trouble? I argue that a unique combination of two characteristics make it essential to bailout or nationalise the banks in the current crisis. No other sector of the economy can claim the same justification. Second, I review the threat of a retreat to politically-determined industrial policy and the need for vigilant implementation of economic effects-based competition policy.

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1. The Credit Crunch

The current crisis has its roots in a series of huge strategic errors by the banks. Permitted by weak regulation and driven by biased incentives, they borrowed (and lent) far too much given their low capital base, and were caught out when the asset price bubble began to burst heralding large-scale defaults. The global reach of this behaviour was compounded by the sale and purchase of opaque credit default derivatives between financial institutions. Although banks are the main culprits, the conditions that facilitated their recklessness included ineffective regulation and massive international flows of funds.[1] Rapid demand growth, like unlimited food in the animal kingdom, suppresses the power of competition to select only the fittest to survive. Similarly, rapid recession, like periods of limited food, soon picks off the unfit and, if the drought is severe, many of the fit as well.

There have been two enormous consequences of these events for markets and a third may be round the corner. The first was that many of the world's most renowned banks have been pushed close to bankruptcy. For some, this was the direct result of their own recklessness, but others have been sucked into the whirlpool. Governments across the world have stepped in to bail them out by guaranteeing loans, injecting capital, insuring toxic assets and acquiring their shares. Such has been this commitment that only one bank of major significance has so far drowned (Lehman Bros). This 'success' has been achieved only at huge cost to current and future taxpayers.

The second consequence was contagion into the non-financial sectors of the economy. The banks have cut lending in every way they can so they can rebuild their reserves.[2] This has created severe financial constraints for their business and private customers, resulting in investment cuts, reduced demand and a powerful negative multiplier across the global economy.

[1] These flows were mainly from developing economies with trade surpluses (notably China and oil exporters) into the most financially developed countries (notably the USA and UK) seeking a safe haven for their savings and a place to hold reserves to counter possible future exchange rate crises.

[2] Symptomatically, the banks were much more reluctant to cut their own bonuses unless required by governments to do so.

Governments and monetary authorities have been trying to reverse this by slashing interest rates, buying securities, increasing public spending and temporarily reducing taxes. Much of this is necessary as an emergency measure, even though the haste and haggling with which such packages have been put together suggests many initiatives will be wasteful.

The third potential consequence could be interventionist industrial policy in the wider economy and the emasculation of competition policy. Currently, this has not happened, but aspects of rescue packages promoted by governments across the globe point to the danger. In the last decade, competition policy has been reinvented across Europe and introduced in many emerging economies with vigour and new focus on economic foundations. This has been a huge success in protecting consumer-responsive markets. The discipline of competition policy has also allowed the reduction of inefficient forms of regulation and public ownership. While modern competition policy is economically robust, it remains politically fragile and thus 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’. A more considered analysis shows this to be untrue, but it is all too easy to see why the mistaken view might take root.

The aims of this paper are twofold. First, I explain the economics of bank bailouts as distinct from bailouts for other sectors of the economy. Second, I review the threat of a retreat to politically-determined industrial policy and opportunities for the implementation of an active competition policy. Section 2 highlights a unique combination of two characteristics that make it essential to bailout or nationalise banks in the current crisis. In section 3, I assess the dangers of bailing out failing firms in sectors that do not exhibit both these characteristics. The recent trend in interventions and the positive role of competition policy during a major recession are reviewed in section 4. Section 5 presents a brief conclusion.

2. Bailouts, Nationalisation and Regulation for Banks

After years of lecturing and lobbying from the West, China adopted its new Anti-Monopoly Law only last year (2008). China may, therefore, be puzzled to see so much government intervention in banks in recent months, including: massive individualised subsidies; direct 'interference' in business decisions; politicians promoting mergers; and nationalisation.[3] Why do all the rules of good competition policy appear to fly out of the window when the banks get into trouble? Does this mean that we should abandon the rules equally for car manufacturers and other industries in trouble? I address the first question in the remainder of this section and the second in section 3.

All markets have their own idiosyncrasies but they each work fundamentally in the same way. Only rarely are the idiosyncrasies so substantial that they warrant special treatment. It is an unfortunate truth that banking is different to other industries due to a unique combination of two fundamental characteristics. Before getting to them, note the importance of confidence and potential for panic in banking.

A bank can only survive if everyone is pretty certain that it will survive. It cannot survive a loss of confidence.[4] 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 to support their loan book. Banks lend a multiple of what has been deposited and can do this in normal times because most people leave most of their money in the bank. However, in the absence of full guarantees, individual savers have a huge amount to lose if a bank goes bust and very little to gain by keeping their money in a particular bank. Even a rumour of potential failure can result in massive withdrawals and, in the absence of intervention, failure is a self-fulfilling prophesy. This can happen even if a bank's loan book is

[3] For example, by 16 February 2009, the current crisis had seen the European Commission approve 43 separate financial sector aid schemes by Member States, and was investigating 11 more. These covered 19 Members including all 15 who joined pre-2004. See EC MEMO/09/67.

[4] See John Vickers 'The financial crisis and competition policy: some economics' *GCP Online*, December 2008.

sound because the bank will not have the liquidity to pay all depositors their money. The problem moves from liquidity crisis to a much more serious insolvency crisis when loans go bad and the bank has insufficient of its own capital to absorb losses. Depositors could not then be paid out even if all the good loans could be called in. The loss of confidence cannot then be soothed. The queues outside Northern Rock in September 2007 were an early sign of the fragility of the banking system even when most retail depositors were covered by an explicit government guarantee. Wholesale funds from other banks and international lenders were quantitatively much more important and unguaranteed, and it was these that haemorrhaged from Northern Rock to bring it down. Few other products are so sensitive to confidence.[5] Nevertheless, banks would not warrant special treatment if this was the end of the story because creditors could simply move their deposits to a rival bank.

The first truly distinctive characteristic of banking from the competition perspective is that banks are so interconnected that the collapse of a large bank is contagious and contaminates the whole banking system. To a small extent this is because customers wonder which is the next troubled bank from which they should withdraw their funds; but if the crisis was merely one of confidence, that could easily be addressed by the central bank providing liquidity to a bank subject to a run. For relatively small bank failures, when banks have adequate capital and when specific risks and reasons for failure are understood, the banking system is typically quite stable.[6] Banks in highly developed economies do not fail due to liquidity problems alone. They are interconnected in more significant ways. Banks lend to each other so if one is unable to repay its debts, that creates bad debts in another to undermine its solvency. In the current crisis, they have also shared a similar belief about continuing asset price rises and they have not diversified the associated risk

[5] Confidence can also be important for firms whose purchasers do not receive the full benefit of the product at the time of purchase (e.g. insurance, airline tickets booked in advance, warranties, network products).

[6] For example, see: Joseph Aharony and Itzhak Swary (1996) 'Additional evidence on the information-base contagion effects of bank failures' *Journal of Banking & Finance*, 20, 57-69; Aigbe Akhigbe and Jeff Madura (2001) 'Why do contagion effects vary among bank failures?' *Journal of Banking & Finance*, 25, 657-80; Bong-Chan Kho, Dong Lee and Rene Stulz (2000) 'US banks, crises and bailouts: from Mexico to LTCM' *American Economic Review P&P*, 90.2, 28-31.

sufficiently outside the banking system. The potentially unstable dynamic became poisonous in 2008 because of self-inflicted wounds in the form of inadequate capital, bad loans notably in US subprime mortgages, and foolish trading in derivatives that spread the damage and destroyed the already limited capital of so many banks. Like firms in all industries, banks go bust when their capital is exhausted by bad trading but, because of the interconnectivity between banks, bad loans and bad assets quickly spread to the entire banking system. The defining moment of the banking crisis, a year to the day after those Northern Rock queues on UK high streets, was when the major US bank Lehman Bros was allowed to collapse and the global financial system nearly followed. In simple economic terms, a large bank with substantial trading activities has a 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 a car manufacturer where others in the industry can usually benefit from the collapse of a rival.[7]

The second distinctive characteristic is even more important. Bank finance provides the essential oil in the economic system, allowing other firms to absorb the bumps of fluctuating revenues and payments. In normal times, banks lend to each other for exactly the same reason. Additionally, investment banking puts together funding for bigger projects. Without this oil provided by the banks, the economy seizes up. The product of no other industry is so essential to *every* other market in the system. Banks are particularly important for smaller firms which do not have the scale to issue corporate bonds and do not have access to the internal capital markets of large business groups.[8] They are also important for financing large purchases by consumers (e.g. housing). Unfortunately, during a banking crisis, the first reaction of a bank is to stop making loans in order to balance its loss of deposits and asset write-offs. If the banks fail to fulfil their crucial lending

[7] If a supermarket goes bust, its rivals shed few tears as they bid to buy productive assets from the administrator and seek to supply the bankrupt chain's former customers. I return to the case of car manufacturers in section 3.

[8] See Xavier Boutin, Giacinta Cestone, Chiara Fumagalli, Giovanni Pica and Nicolas Serrano-Velarde (2009) 'The deep pocket effect of internal capital markets' CEPR *Discussion Paper* 7184.

function, this leads to a fall in demand and macroeconomic recession – the second dimension of contagion.

Thus, the deposit-side of banks is vulnerable to contagion in the withdrawal of funds and asset write-downs, and a loan-side collapse contaminates the whole economy as banks try to rebuild their balance sheets. These two characteristics combine into a compelling argument for treating the banks as a special case in the current crisis. The prospect of contagious bank failures justifies intervention both to provide them with liquidity and to keep them solvent. However bitter the taste to taxpayers, this applies even when the banks' plight is their own fault. A food product may be vulnerable to a health scare and loss of confidence, but this would not result in global recession if it was taken off the shelves.[9] Electricity may be required for the production of practically every other product, but it does not suffer from supply-side contagion – electricity supply did not collapse with Enron and would be little affected by the bankruptcy of a major supplier. Only the banking system combines both of these characteristics. A detonator alone makes only a small bang, and TNT alone is a relatively stable material, but put the two together and you have a truly dangerous bomb. As it is, the banking crisis has detonated a huge bomb under the global economy. The collapse of another major bank could have been nuclear. There was no sensible alternative but to bail out or nationalise failing major banks.

There is one more twist to the story. This specialness has been a substantial cause of the crisis. The major banks are now sure of what they already thought they knew: they will always be bailed out. The shock of the Lehman collapse was the exception that only served to prove the government guarantee. The consequences of collapse were seen to be so awful that governments have bailed out the banks ever since. The anticipation of this bailout created a moral hazard that biased decisions towards risk taking. The upside was huge potential profits and the downside was a bailout. This

[9] Also, in normal financial times, a firm whose product is not contaminated (or which can be swiftly made safe) will be able to obtain a loan to tide it over until the scare subsides. See section 3 for a discussion of policy for efficient credit-constrained firms.

asymmetry was reflected in the bonus structure for executives and the traders they employed. It allowed them to share the same bullish beliefs in asset prices without diversifying the risk. It also encouraged heavy duty lobbying to reduce the effectiveness of regulation. Some banks may have remained prudent, but others competed on upside alone.[10]

Having identified some of the problems, what should be done to solve them? In the short term, the urgency is to get banks lending again and so to limit the contagion of the banking crisis to the rest of the economy. Most governments have been trying to do this by recapitalising the banks often in return for some form of preferred stock (i.e. something between a standard loan and common equity). This allows them to say that a bank is not being nationalised even when the taxpayer becomes the majority stock holder and takes a high risk of not being repaid. Governments have also provided credit insurance, toxic asset insurance (*ex post*) and purchased large quantities of bonds from the banks.[11] While this bailout has saved many banks from collapse, it has not got them lending again on a sufficient scale. These banks have instead used this funding to rebuild their own capital but they still operate in the shadow of collapse, creating 'zombie banks' which drain funds while failing to fulfil their raison d'être. Government loan guarantees have had similarly limited success. Unfortunately, against this limited success, the bailouts will further reinforce the asymmetry in risk-taking by banks once more normal times return. Meanwhile, the recession bites harder.

Consequently, it looks increasingly likely that a form of temporary nationalisation (beyond passive ownership of preference shares) will be

[10] Excessively risky activities included exposures to complex securitisations, trading of derivatives and 'off-balance sheet' activities that undermined capital adequacy. In particular, CDOs (collateralised debt obligations) based on mortgages have been central to the failure of banks in the current crisis; and multiple trading of credit default swaps also created problems as the economic crisis deepened and firms became unable to repay loans. Problems were multiplied by ratings agencies wrongly attributing AAA status to these complex derivatives despite the absence of market prices (they had to rely on highly complex computer models). Furthermore, these CDOs often stayed within the banking system unsafely hidden off-balance sheet in SIVs (structured investment vehicles). The cavalier attitude to risk was not only found in US and UK banks developing 'innovative' financial products. For example, Austrian banks lent excessively to Eastern European consumers and firms and Japanese banks bought corporate equities.

[11] The latter is part of a monetary policy of 'quantitative easing' (in the UK, USA and several other countries) but it still supports the banks.

necessary. The idea would be for those banks which were nationalised to be run by trustees and concentrate on traditional lending based on investment and repayment prospects. It would draw on the traditional skills and expertise of bankers in assessing loans and creditworthiness, but importantly should not undercut terms provided by private lenders in normal times. Their loans would be made on full commercial terms and such banks would be privatised as soon as economic conditions permit. A competition authority should be instructed to monitor that each nationalised bank is indeed operating on genuine commercial terms both in attracting funds and in lending activities.[12] Nationalisation would also permit a clearout of failed senior executives. There are major problems with such a strategy both in the process of nationalisation and in the State running a commercial bank. Nationalisation of a bank that would be bankrupt in the absence of government help would, quite fairly, wipe out the common shareholders and reduce the payout for bondholders and other creditors. It would probably also cause shareholders and subordinated creditors of some other banks to flee in anticipation of nationalisation. This means that several major but weak banks would have to be nationalised simultaneously. This would undoubtedly be politically uncomfortable. Since pension and insurance funds also invest in banks, the spillover could be far-reaching and the state may have to absorb some of the creditor losses, though there is no reason to provide *ex post* insurance to shareholders.[13] Furthermore, the aim of a nationalised bank to make loans only on commercial terms has limited credibility because politicians are genetically prone to fiddling with any high profile asset they own. Nevertheless, these problems must be balanced against the prospect of further bailout of zombie banks that are not lending and so causing a protracted recession.[14] As soon as the economy recovers and an appropriate regulatory regime has been established, these banks should be privatised, though in a restructured form to minimise the risk of future contagious bank failures. These banks are likely to be much smaller than the ones that failed.

[12] The OFT fulfilled this monitoring function with Northern Rock during its first year in public ownership. See OFT (March 2009) 'Northern Rock: the impact of public support on competition' OFT1068.
[13] For similar reasons, it is probably not possible to use debt-for-equity swaps, which are a standard way of saving a firm in financial distress.
[14] This was a feature of the Japanese economy in the 'lost years' of the 1990s.

In the medium term, major revisions of bank regulation are necessary so that banks can compete as private firms with balanced incentives. Financial markets are not unique in having special features that require a specific regulatory framework to align competition and welfare. For example, too many coal-fired power stations would be built and so impose a dangerous carbon externality on the rest of society unless the power generation market is subject to an appropriate regulatory framework to internalise social costs. Some industries (e.g. infrastructure networks distributing electricity, water or rail services) are subject to such strong economies of scale that they are natural monopolies and so require a specialist regulator to control maximum prices; banks do not fall into this category. A more relevant example is pharmaceuticals, for which there are powerful health and safety reasons to regulate new drugs. In late 1950s Europe, this regulation was entirely insufficient, with the result that thalidomide was prescribed to pregnant women. The resultant tragedy brought about a new and necessary regulatory approval regime, subject to which pharmaceutical companies can compete with each other.[15] It is essential that the current crisis should similarly bring about more effective and appropriate financial regulation. An international regulatory system does exist with a view to setting minimum standards for banks and so to channelling competition into appropriate behaviour. This takes the form of the agreement known as Basel II, which has three 'pillars': minimum capital requirements; regulatory supervision; and risk disclosure to facilitate market discipline.[16] Unfortunately, the application of this framework has proved inadequate in the face of complex financial innovations and distorted incentives.

The following elements of regulation are additional to a necessary review of the standard components of Basel II.[17] First, incentives given to individuals

[15] Though it has to be acknowledged that the nature of pharmaceuticals customers, particularly national health authorities and price regulators, creates a tangle through which competition policy must operate in most countries; see Stephen Davies and Bruce Lyons (2007) *Mergers and Merger Remedies in the EU*, Edward Elgar, chs. 8 and 9 for how this affects merger control.

[16] Basel II was agreed in 2004 and modified in 2005, so in principle it should have been up-to-date with modern banking.

[17] For example, Tier 1 asset requirements should be strengthened and made less pro-cyclical (the current fixed rations mean that in a recession, capital gets written off, which means loans must be

within banks must not be one-sided (i.e. paying bonuses for short-term profit with no downside for long term losses). Second, while credit default swaps and other elements of diversification and insurance must be allowed as prudent trading activities, they should not be traded by banks multiple times as bets on future prices or defaults. Liquid markets also need to be created to get genuine prices for all supposedly safe assets. Third, banks should be charged *ex ante* (i.e. before they get into a mess) for the explicit (and implicit) guarantees they receive from government, and the size of these charges should reflect the risk profile chosen by each particular bank, including the amount of debt financing relative to its equity base.[18] Fourth, idiosyncratic assets, CDOs and other complex or opaque financial innovations might be required to pass regulatory scrutiny and receive positive approval from a regulatory body, and not from a credit rating agency which is beholden to issuers for fees and supplementary services.[19] Credit rating might also be privatised at a later date once an appropriate regulatory regime is established. Finally, and arguably most important, a credible bankruptcy regime must be established for banks so that contagion is limited. This is likely to require pre-emptive action by a monitoring central bank (and not the daily regulator which may be reluctant to admit that it has failed to keep the bank on track).

reduced, which deepens recession). Also, the value of assets at risk needs to take account of apparently improbable severe crises (sometimes known as the 'fat tails' problem in the distribution of returns). Consideration might also be given to limiting loan sizes relative to asset value, though such micro-regulation of lending is generally undesirable. In non-bank firms which cannot expect to be bailed out, even foolish practices can be left to shareholders to determine and should be a matter for good corporate governance, not regulation. This does not hold for banks which have to be bailed out in a crisis. For more macroeconomic suggestions, see Mathias Dewatripont, Xavier Freixas and Richard Portes [eds.] (2009) 'Macroeconomic Stability and Financial Regulation: Key Issues for the G20' CEPR.

[18] Viral Acharya and Julian Franks 'Capital budgeting at banks: the role of government guarantees' *Oxera Agenda* (February 2009) argue that government guarantees of bank survival have driven the cost of debt finance down to risk-free levels, which has encouraged excessive leverage.

[19] Unfortunately, banks cannot be trusted to assess their own strategic risks. Paul Moore, former head of group regulatory risk at HBOS was dismissed (with a reputed £0.5m gagging payment) for pointing out in 2003 and 2004 that the bank was taking on too much risk in relation to excessive growth in lending (evidence to the House of Commons Treasury Committee; 10 February 2009). It is unlikely that this overruling of risk managers was unique to HBOS or to concern over lending growth. The Icelandic bank Kaupthing, Singer & Friedlander dismissed its heads of both risk and compliance when they complained about risky practices (Channel 4 News, 24 February 2009). In both the HBOS and Kaupthing cases, the concerns were also reported to the FSA (the UK financial regulator) but neither bank was reprimanded. In 2003, Ron den Braber warned his bosses at RBS that their models wereunderestimating risk (FT, 10 March, 2009). Other similar, sometimes anonymous, stories are emerging in the newspapers in relation to excessive risks in the trading of complex derivatives (e.g. Sunday Times, 22 February 2009). The systemic problem is a failure to balance upside risk with the downside.

In conclusion, the banking system combines two explosive characteristics of contagious failures and universal need by every other business. This combination means that major banks cannot be allowed to fail. The risk this entails and the recklessness it encourages mean that tough prudential regulation is essential. This is all the more important because current bailouts only reinforce the moral hazard. With this and the standard tools of competition policy in place, competition between private banks can be left to work to the benefit of efficient businesses and consumers. The appropriate regulatory framework is necessary to align competition and welfare, bringing sustainably low prices for banking services and safe, innovative product development. If governments bite the bullet and fully nationalise some banks with a view to stimulating lending activity, there is no reason to privatise them in the same concentrated structure as when we entered the crisis. It provides an opportunity to create a more effectively competitive and less contagious system.

3. Competition versus Bailouts for the Rest of the Economy

The banking crisis caused banks to try to rebuild their capital by cutting back on lending and the consequent credit crunch has triggered a global recession. Minor banking crises do not always bite on the real economy, but history tells us that when a banking crisis does bite, it bites the economy's leg off. We are very much in the latter category today. A comprehensive IMF study of all systemically important banking crises for the period 1970 to 2007 covering 42 crises in 37 countries shows the average fiscal costs of crisis management to be 13% GDP, though they can be as high as 55%.[20] The consequent recessions are even more damaging with average losses of 20% GDP in the first four years, but ranging from zero to 98% GDP.[21]

[20] Luc Laeven and Fabian Valencia (2008) 'Systemic Banking Crises: A New Database' *IMF Working Paper* WP/08/224.
[21] John Boyd, Sungkyu Kwak and Bruce Smith, 2004, 'The real output losses associated with modern banking crises', *Journal of Money, Credit and Banking*, 37.6, Dec., 977-999 (see particularly p.978 and Table 4) estimate even larger output losses. A study of 23 such crises found only four countries that attained their pre-crisis *trend level* of output within 17 years. Typically, there was a drop in output, followed by a period of stagnation, until a return to the *trend growth* rate. The same study measures the accumulated loss of output this entails in several ways, and depending on which they take, the authors

It is from this perspective that we must view the massive fiscal stimuli that governments are putting in place as an attempt to limit the decline and shorten the period of stagnation. Even on an optimistic scenario, however, there will be a deep and protracted recession that will see numerous firms fighting for their survival. In these circumstances, should we abandon competition policy, particularly as it relates to state aid? I consider only aid to specific firms or industries, and not general fiscal or employment measures that are reasonably neutral in their impact on competition.[22]

Competitive markets certainly work to the benefit of consumers and efficient firms when financial markets are oiling them well. In good times, firms expand and enter new markets as they seek to attract customers and consumer spending away from rivals. Profits are made by those who have invested well, produce efficiently and make the most attractive product offers (i.e. those who provide what consumers want at a better price than offered by rivals). 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 (i.e. those who make unattractive offers). Firms with the least attractive products or highest costs exit the market. Exit is as fundamental as entry in making markets work well. It is part of natural selection, leaving room for efficient firms to expand and new firms to enter. The same essential story applies to shops, restaurants, steel and cars. The role of competition policy is to ensure that firms do not conspire to evade this harsh but socially productive competitive discipline by fixing prices, excluding efficient rivals, merging with significant competitors or receiving discriminatory state subsidies or protection.

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calculate the average capitalised loss as equivalent to between 7 months and 3 years of real GDP. One example of a crisis of this order of magnitude is the Norwegian banking crisis and recession in the early 1990s.

[22] Competitively neutral macroeconomic stimulus is necessary for Keynesian reasons. Subsidies for retraining, regions, environmental protection and fundamental R&D should rightly be given to correct a specific externality or for distributional reasons.

In the absence of the special features discussed in section 2, subsidies undermine market outcomes and processes.[23] The problem most familiar to the European debate on State aid is that subsidies create international distortions to competition. 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. However, the problems are not only international. Subsidies undermine the market mechanism because the prospect of a bailout leads to reckless behaviour, as is so vividly illustrated by the banks. It also leads to 'rent seeking' as the most successful CEOs become those who can best work the political system for subsidies, and not those who efficiently produce the best and most innovative products. There is abundant evidence of the failure of politicians or civil servants to pick winners. More insidiously, there is also a negative effect on efficient firms and entrants who are incentivised to hold back on investment and aggressive marketing because they know that inefficient rivals will hang on to segments of the market with inappropriate product offers and bloated capacity without fear of the consequences.

In structurally competitive industries (i.e. in the absence of sunk costs, state subsidies or entry barriers), entry into and exit from a market can rapidly adjust to demand changes. Firms respond to expected prices relative to average costs to trigger entry and exit. Incentives do change in the presence of sunk (i.e. non-recoverable) costs; for example, not only will they want to stay in the market as long as variable (non-sunk) costs are covered, but they may want to hang on even if price falls below this as long as there is a prospect of the market recovering.[24] Thus, firms will be more cautious to enter and slower to exit. This provides a natural balance for such markets with less entry when demand is high and less exit in recession. Profits in good times balance losses in bad times and properly working financial markets will appreciate this and provide the necessary financial buffer.

[23] See the EAGCP advice on Rescue and Restructuring Aid which was written shortly before the current crisis: available at http://ec.europa.eu/dgs/competition/economist/eagcp.html.
[24] This can be thought of as an option value of being in the industry should demand pick up. Similarly entry is delayed by the option value of not having committed to the sunk costs of entry. See Avinash Dixit 'Entry and exit decisions under uncertainty' *Journal of Political Economy*, 1989, 97.3, 620-38; also Robert S. Pindyck (2009) 'Sunk Costs and Risk-Based Barriers to Entry' *NBER Working Paper* #14755 .

It would be a concern for evolving competitive market structures if the exit process favoured the least efficient or the largest firms, so exit ratcheted towards inefficient or more concentrated market structures. However, both economic theory and most of the empirical evidence suggest the reverse.[25] The research shows that in the absence of intervention the market selects the best adapted firms to survive. The least efficient plants exit first, including those too small to achieve available economies of scale. If firms are equally efficient, then the largest downsize first. Once these adjustments have been made, if demand is insufficient relative to economies of scale and the toughness of competition, there may be a period of attrition with prices below cost until one of the remaining firms exits. This is a painful process for all in the industry and the transaction costs are substantial but it has the desirable attribute of leaving a sustainably efficient and competitive market structure.[26]

How do things change when financial markets fail to provide lubrication and instead throw grit into the economic system? Problems can be caused at two levels. First, banks and other providers of finance play a vital role in appraising investment projects and the long-term viability of firms. It is possible that arbitrary financial constraints due to the banking crisis might force the exit of a firm that serves consumers better than a rival; yet the inefficient rival might survive because it happens to have a stronger line of credit.[27] Second, financial constraints on customers may depress demand for a whole sector if purchases are widely funded by borrowing (e.g. construction, cars, machinery), which might result in the scrapping of skills and assets that would be productive once the credit crunch clears.

[25] See Marvin B. Lieberman 'Exit from Declining Industries: "Shakeout" or "Stakeout"?' *RAND Journal of Economics*, Vol. 21, No. 4 (Winter, 1990), pp. 538-554 for empirical evidence and references to the theoretical foundations and other empirical findings. See also: Andrew B. Bernard and J. Bradford Jensen 'Firm Structure, Multinationals, and Manufacturing Plant Deaths' *Review of Economics and Statistics*, (May 2007), LXXXIX.2, 193-204; and Mary E. Deily 'Exit Strategies and Plant-Closing Decisions: The Case of Steel', *RAND Journal of Economics*, Vol. 22, No. 2 (Summer, 1991), pp. 250-263.

[26] This is not a claim that all free market structures are ideal in the theoretically abstract sense of what might be designed by a perfect planner with all the available information.

[27] Highly leveraged or indebted firms are more likely to exit before their less leveraged rivals, at least in concentrated markets. See Dan Kovenock and Gordon M. Phillips 'Capital Structure and Product Market Behaviour: An Examination of Plant Exit and Investment Decision', *Review of Financial Studies*, Vol. 10, No. 3 (Autumn, 1997), pp. 767-803.

These possibilities only serve to emphasise the need to get banks lending. As argued earlier, if recapitalisations and loan guarantees prove insufficient or too expensive to get the banks to do this indirectly, it will be necessary for governments to take active control of those banks they are subsidising. These banks should be run by independent trustees for the duration of the recession and with a policy of lending on ‘market investor’ unsubsidised terms.[28] The idea is to correct the cause of the problem, the credit crunch, and to avoid giving politically determined subsidies to specific firms or industries. The resultant loan book will then be attractive when the bank is privatised as soon as the market conditions allow. There are two highly unattractive alternatives. Either no intervention, so competition is distorted and firms reliant on bank funding are affected asymmetrically, or handouts can be determined by the ministry where firms will be helped according to political impact and not according to reliance on bank funding. The key lending skills lie within the banking sector whereas government departments find an easy route through grand gestures to big firms and big industries (even if the recipients were in long-term decline pre credit crunch). Ironically, if private banks continue abnormally withholding credit, nationalising a few banks may be the best way to save efficient competition in the non-financial market economy.

With appropriate measures to get banks lending, are some firms still ‘too big to fail’ in a recession? ‘Too big’ may be interpreted in several ways. The firm might be: a monopoly provider; a large direct employer; or a firm supporting a large supply chain.[29] For a monopoly provider, for example the owner of a rail network or a vital tunnel, the asset does not disappear if the owner gets in financial difficulty. If the assets have any positive value they can be bought out of administration and operated under new ownership. If the firm is not a monopoly but a large employer, then it would be harmful if it received preferential treatment over an efficient rival. The same argument applies to a

[28] This form of state lending is accepted by the European Commission under what is known as the ‘market economy investor principle’ and is relevant for both State aid and State owned firms.

[29] Recall that it is the horizontal interconnectedness of banks, not their size or vertical interconnectedness, that is the first characteristic identified in section 2.

long supply chain, for example, in the car industry. More subtly, an efficient and an inefficient manufacturer may share key suppliers who benefit from economies of scale. The loss of a major customer may put a supplier at risk and so potentially harm the efficient manufacturer's supply chain. However, an efficient supplier can respond by expanding into the market opportunities created by the exit of the inefficient firm and scaling down.[30] This is the way markets work to select efficient producers. Subsidies to support a whole industry are normally less distortionary, but they inevitably divert demand and resources away from substitute products and so shift the pain. No other sector of the economy shares the pair of characteristics that set banks apart for state intervention in the current crisis.[31]

There is no doubt that restructuring is painful. However, this is less than the harm caused to: efficient rivals who suffer reduced market share; customers who are offered costly and unattractive products; taxpayers whose real income falls; or the elderly, the sick and school children who suffer from diverted public spending. It is important that those thrown out of work should receive strong support both financially and in retraining, but it is they who should receive the subsidies and not the shareholders and senior executives of failing firms. It is the latter who benefit most from bailouts.

4. The Positive Role for Competition Policy during the Recession

Most of the analysis so far has related to State aid because this is the obvious front line in a recession. History provides some worrying lessons also for other dimensions of competition policy. Anticompetitive agreements and mergers cause long-term harm which gets discounted heavily in a crisis. In international trade policy, there is a well known and strong correlation between recession and protection, with causation going both ways and

[30] Arguments may also be made in relation agglomeration economies by which a region develops a network of supply links and support services that benefit many independent firms. However, it is unlikely that even the current recession could overturn genuine long-term agglomeration economies.
[31] Nevertheless, specific sectors clearly have an incentive to obscure this fact and firms may collude in search of State aid. For example, GM and Chrysler approached Washington together, and Renault and Peugeot-Citroen approached Paris together.

feeding a negative spiral.[32] Effective enforcement of national competition policy in most of the world is relatively recent, so has yet to be challenged by recession. However, the USA has had the Sherman Act since 1890 and the last 120 years have seen numerous wars and slumps. Both types of crisis have dampened enforcement of the Act and the consequences have been particularly bad during recessions.[33] Business cooperation can be bought (superficially cheaply) by politicians: 'Antitrust laxity is often the government's first bargaining chip when it urgently needs something from industry'.[34]

Much has been made of the similarities between the current crisis and the Great Depression, especially the fiscal role of the New Deal. A closer look, however, does not settle one's nerves.[35] Franklin D. Roosevelt was persuaded by industrialists that it was necessary to suppress the enforcement of competition policy to gain cooperation and he agreed this as an integral part of the deal. In twelve months from June 1935, the Interior Department received identical bids from steel firms on 257 different occasions, and these bids were 50% higher than foreign steel prices. It has been estimated that wholesale prices in 1935 were 24% higher than they should have been and even by 1939 they remained 14% higher. Cartel prices fed through to unrealistic wages and unemployment was 25% higher than it would have been otherwise. These estimates suggest that the depression may have lasted seven years longer than necessary.[36]

At the time of writing (mid-March 2009), the number of anticompetitive interventions worldwide appears relatively limited. However, there are dangerous signs. In the UK in October 2008, the OFT recommended that the

[32] For a review, see Kyle Bagwell and Robert W. Staiger 'Protection and the Business Cycle' January 2003, mimeo.
[33] See Crane (2008) 'Antitrust enforcement during national crises: an unhappy history' *Global Competition Policy*, December 2008.
[34] Daniel A. Crane, 'Antitrust enforcement during national crises: an unhappy history' *Global Competition Policy*, December 2008, p.9
[35] The examples and estimates in this paragraph are taken from Harold L. Cole and Lee E. Ohanian, 2004, 'New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis', *Journal of Political Economy*, vol. 112, no. 4. These findings have been challenged by Gauti Eggertsson (2006) 'Was the New Deal Contractionary?' Federal Reserve Bank of New York Staff Report no. 264, but Cole and Ohanian are more persuasive.
[36] There is also evidence that lack of competition unnecessarily prolonged the 1990s Japanese recession. See Michael E. Porter and Mariko Sakakibara (2004), 'Competition in Japan', *Journal of Economic Perspectives*, 18.1, pp.27-50.

Competition Commission should investigate the proposed merger of Lloyds-TSB and HBOS, but this advice was overridden by the Secretary of State.[37] This was the first case of such an intervention since the reforming Enterprise Act of 2002 was meant to take mergers out of political decision making.[38] The merger has turned out to be a financial disaster and the interventions discussed in section 2 would undoubtedly have been better.

More interventions have taken the form of subsidising specific firms, particularly in the car industry. The USA is reviewing major subsidies for GM and Chrysler. In France, President Sarkozy has offered €6b government support for Renault and Peugeot-Citroen subject to no factories located in France being closed and reassurance on jobs in France. The EC is investigating this State aid closely as it implies direct cuts and closures elsewhere in the EU. Italy and Spain also have major car subsidy plans under scrutiny. More widely, the traditional instruments of trade protection are also visible. For example, tariffs have been raised in India on some steel products, in Russia on cars and in Ecuador on 940 products. The EC has re-introduced subsidies for the export of milk and milk products.

National procurement has also been tied to the fiscal policy. The February 2009 $800b fiscal stimulus bill of the new Obama administration included 'Buy American' clauses (e.g. for steel to be used in state projects), though the original plan was modified in the face of potential retaliatory action by the EU.

[37] In the state of panic at the time, the Secretary of State was supported by a powerful triumvirate of the Bank of England, Financial Services Agency and Treasury on grounds of short-term financial stability. John Vickers argues that this aim might have been achieved in a less anticompetitive way (Vickers 'The financial crisis and competition policy: some economics', *Global Competition Policy*, December 2008). The merger creates a balanced duopoly in SME banking in Scotland, with the other duopolist being the crippled and near-nationalised RBS (see #158-9 of the OFT's 'Anticipated acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform' 24 October 2008, available at http://www.oft.gov.uk/shared_oft/press_release_attachments/LLloydstsb.pdf). In the USA, emergency takeovers of Bear Stearns, Merrill Lynch and Wachovia appear to have fared little better.

[38] The Act does allow for such a political decision on the grounds of public interest though this was intended to be interpreted narrowly, with national security as the only stated example (Whish, R., 2001, Competition Law, Butterworth, p.898). There are additional public interest provisions to maintain media plurality. A new public interest 'to ensure the stability of the UK financial system' had to be created in a formal Order to be passed urgently by both Houses of Parliament. Note that national security and media plurality are appropriately long-term considerations for a merger, whereas this merger's contribution to financial stability could only have been short-term at best. In fact, subsequent events have shown that HBOS was sitting on a loss of £10b in bad debts that Lloyds TSB failed to notice in its highly compressed and partial 'due diligence'. Consequently, two banks have been crippled instead of just one.

Paul Krugman has argued that in the absence of an internationally coordinated fiscal stimulus, this may not be protectionist in that it need not reduce trade below the viable alternative. As he puts it: 'My fiscal stimulus helps your economy by increasing your exports — but you don't share in my addition to government debt'.[39] He continues that if all countries were adopting a similar fiscal stance, 'Buy American' would be unnecessary, but as they are not, it might be a second best way to get the economy moving. This is a coherent argument but it is politically impossible to limit the procurement bias to the appropriate level. The best option remains an internationally coordinated stimulus without protectionism.

At the time of writing, these measures cannot be described as a full retreat into protectionism, but the threat remains. The G20 meeting in London in April 2009 provides an opportunity to rehearse the powerful arguments against protectionism, but it will be the actions that follow it that really count. The danger presented by the above examples is that a sequence of 'special cases' will result in a flood. This is why it is important to understand precisely why the 'precedent' of the banks is so inappropriate for other sectors.

It is difficult to prevent discriminatory interventions even within the EU. Article 87 of the European Treaty prohibits state aid that may distort trade between Member States but permits non-distortionary forms of aid. For example, the Commission requires that aid to banks should be non-discriminatory, priced according to market investor principles,[40] and subject to behavioural restraints against aggressive growth at the expense of non-subsidised banks.[41] The last needs interpreting carefully in the context of banks failing to make sufficient loans (see section 2). The EC has also invoked Article 87(3)(b) of the EC Treaty, which permits further, but strictly limited, aid intended to

[39] Paul Krugman 'Protectionism and stimulus' on his blog dated 1 February 2009: http://krugman.blogs.nytimes.com/2009/02/01/protectionism-and-stimulus-wonkish/.

[40] The Market Economy Investor Principle (MEIP) allows a State injection of funds as long as this is on 'terms which a private investor would find acceptable in providing funds to a comparable private undertaking when the private investor is operating under normal market-economy conditions'; OJ C307, 13.11.1993, #11.

[41] For a succinct explanation of EC state aid rules as applied to banking, see Christopher Vajda (2009) 'The banking crisis and EC state aid rules' *Butterworths Journal of International Banking and Financial Law*, February, 67-69.

remedy a serious disturbance in the economy of a Member State. In December 2008, it adopted a 'temporary framework' to allow Member States to tackle the effects of the credit crunch on the real economy in a minimally distortive way.[42] One aim was to restrict aid only to firms in difficulty due to the financial crisis and not allow it for firms in long-term decline.[43] The EC rules are aimed at keeping the playing field level internationally within Europe, but they provide a helpful model for national rules in the current crisis.[44]

As a supranational organisation, the EU is as tight and powerful as they come and it is backed by the legal force of a strong treaty, yet it still has difficulty keeping its members in line. The global institution charged with reducing impediments to international trade, the World Trade Organization (WTO), has far less control over its membership and has a very limited mandate.[45] Nevertheless, it can have a significant reporting role for changes in national trade policies, it can host talks to resolve disputes and it can speak especially for those developing countries that have little retaliatory power in negotiations.[46] The lack of powers over sovereign states means that if diplomacy fails, the only credible bargaining chip is retaliatory tariffs or subsidies. Of course, actual trade wars are mutually destructive and the aim is that governments will realise this so the threat does not have to be implemented. It remains to be seen how rational governments are in holding back from protectionism as the recession deepens.

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[42] 'Temporary framework for State aid measures to support access to finance in the current financial and economic crisis' *Communication from the Commission*, 26 November 2008. By mid-February 2009, four countries had taken advantage of the new rules and eight aid schemes had been approved by the Commission under the Temporary Framework. See EC MEMO/09/67. Specific allowable measures are: up to €0.5m cash grant per firm, provided the aid does not favour exports or domestic over imported products (which will be very hard to police); reductions of 15% (25% for SMEs) on loan guarantee premia for loans up to the size of the annual wage bill; relaxed rules on interest rate subsidies; 25% subsidies (50% for SMEs) for investment in green production; and provision of risk capital for SMEs.

[43] More precisely, the relaxation is limited to firms that were not in difficulty before 1 July 2008 plus SMEs.

[44] See Dewatripont and Seabright (2006) '"Wasteful" public spending and state aid control', *Journal of the European Economic Association*, 4.2/3, 513-22, on the commitment value of EU State aid rules. The USA has no equivalent to the EC for reviewing rescue and restructuring aid. One commentator suggests the US needs a DoJ Deputy Assistant Attorney General for emergency restructuring to represent the interests of competition. See Albert Foer (2009) '"Too big to fail?" The role of antitrust law in government-funded consolidation in the banking industry' statement before the US House of Representatives Judiciary Committee, sub-committee on courts and competition policy (17 March).

[45] For example, the Doha round of trade liberalisation was started in 2001 and is still struggling for agreement.

[46] Other international institutions are also advocating an appropriate role for competition policy during the recession. For example, the Director-General of the OECD, Angel Gurría, has called for strong competition policy to speed recovery (OECD press release, 19 February 2009).

The crisis only enhances the need for diligent and vigilant competition policy. Rather than fall into the fallacy of sacrificing competition supposedly to avoid the short-term consequences of recession, there is a need to enforce it robustly to avoid negative long-term consequences. The anticompetitive features of government interventions are not always noticed in the heat of a crisis. Such features may or may not be intentional, but they are often long-lived. It is unwise to bend competition rules for short-run expediency.[47] Examples abound in each traditional area of competition policy:[48]

- *Agreements between firms*: 'crisis cartels' are liable to form when prices drop, and such coordination becomes addictive.[49] Seductive excuses may emerge along the lines of fixing prices in order to protect the number of post-recession suppliers. However, such cartels are more likely to delay recovery and fossilise an inefficient market structure. Firms in an industry may also try to get together to agree an 'ordered reduction in capacity'. Such cartels have occasionally been allowed under Article 81(3) in the past, but this would be misguided as collusion is unlikely to select the most efficient market structure (see section 3).[50]
- *Abuse by a single firm*: there is a potential danger of a financially strong firm taking the opportunity to foreclose a smaller or more financially constrained rival. Recession, especially one induced by financial crisis, may prove fertile ground for unfair means to tip a rival over the edge. Competition authorities must be alert to such foreclosure though they should not simply protect inefficient rivals.
- *Mergers*: it is possible that the failing firm defence will be rehearsed many times over, though there are few high profile merger proposals at the present time. If a firm is clearly going bankrupt, and if a particular merger is the least anticompetitive way to ensure the

[47] See also John Fingleton 'Competition policy in troubled times' (speech dated 20 January 2009 on OFT website).
[48] For further examples, see John Fingleton 'Competition policy in troubled times' op cit.
[49] See, for example, Simon Evenett, Margaret Levenstein and Valerie Suslow, 'International cartel enforcement: lessons from the 1990s', *World Economy*, 2001, 24.9, pp.1221-45.
[50] See: Andre Fiebig 'Crisis cartels and the triumph of industrial policy over competition policy in Europe', *Brooklyn Journal of International Law*, XXV.3, 607-38; and Richard Whish, 2003, C*ompetition Law*, Butterworths, pp.577-8.

survival of efficient resources in the industry, then such mergers should be allowed.[51] But this is simply a statement of sensible policy in any circumstances and there is nothing special about the current recession in this respect.[52] It is only the frequency of this argument that may test the authorities.

5. Conclusion

History suggests that competition policy will be increasingly under threat as the recession bites. People will draw a plausible, though inappropriate, analogy between their own industry and banking bailouts. Those already in trouble before the crisis will grab at the opportunity to plead their case. Politicians seeking short-run popularity will think it is little sacrifice to cast aside the long-term benefits of competition to bribe businesses to support their pet schemes. And if the backlash against selfish, reckless bankers gets confused with the democratic benefits of competitive markets, it may even become tempting for politicians to knock competition policy directly as a populist gesture towards centralised industrial policy.[53]

However, it would be a great mistake to go backwards and replace competition policy with industrial policy. Certainly, government money is needed until the financial system can provide liquidity in sufficient volume. And at the macro level, active monetary and fiscal policies are needed to stimulate aggregate demand. But this activism makes it even more important for a strong competition policy so that business energies are naturally guided into satisfying consumer needs and are not diverted into cosying up to their rivals or lobbying politicians.

[51] The Lloyds TSB HBOS merger was not allowed on a classic failing firm defence, which is that if a firm is going to exit the market anyway, there will be no additional loss of competition due to the merger. As already described, the ministerial intervention in that case was on public interest grounds supposedly 'to ensure the stability of the UK financial system'.
[52] The OFT appreciates this in its 'Restatement of OFT's position regarding acquisitions of 'failing firms'', December 2008, OFT1047.
[53] For example, Olivier Besancenot has achieved instant popularity in France by setting up the Nouveau Parti Anti-Capitaliste (NPA).