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The Financial Market Crisis and its Consequences for Competition Policy

The general feeling of mistrust in the ability of the markets to really regulate themselves has further grown in the wake of the financial crisis. Furthermore, free market competition has also unfairly fallen into disrepute. One major cause of the crisis was that the division of tasks between the state and the private sector did not work adequately. In the future, the role of the state should rather be to guarantee and create a comprehensive regulatory framework for economic activity and it should withdraw itself as far as possible from direct economic activity. If the state successfully creates the necessary regulatory framework and manages to ensure both its constancy and that it is adhered to, its own withdrawal from business activities need not per se involve a destabilisation of the markets.

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The financial and economic crisis brought significant new demands and challenges for competition policy. In the face of troubles on the international financial markets and the severe effects on the real economy, state intervention significantly increased as a way to "stabilise the market". Indeed this intervention did not only concern stricter regulation of the financial markets but affected practically every section of the economy. As a result, a large amount of state funding flowed into providing financial support during the crisis, the result of which was large budget deficits. At the time little regard was held for how these deficits would later be reduced. This was because, at least for the state and the businesses which had been rescued, it was never in question whether the state should intervene in economic activities but rather to what extent it should do so. Any distortions to competition were accepted as unavoidable collateral damage.

The economic environment, in which the competition authorities were working, had changed considerably. Mergers (especially in the financial sector, and more specifically in the Anglo-American part of the world), which before the crisis would have been closely inspected and indeed even prohibited, were rushed through and permitted without imposing any conditions, due to a fear of insolvency if the merger did not go ahead. All this was happening without sufficient regard to its long term consequences on competition.

Acute insolvency problems affecting banks were solved internationally using mergers or partial nationalisation. Nationalisation as an expeditious rescue measure (possibly even exempted from any merger control) can be defended as an absolute emergency measure in a singular crisis, if in the short term there is no other suitable alternative available. However, the risk of inefficiency and market distortions are inherent in any long term involvement of the state in a business (Heitzer, 2009).

The case for a government stake in a system relevant financial institution can be economically justified if, at the outset, the government's involvement is clearly defined as temporary and the conditions are also clearly laid out in advance. However, as soon as financial finding is available on the capital markets again, the state should immediately withdraw from any stakes it acquired during the crisis. The approach taken in Switzerland can be used by way of example: here the government

The framework conditions for competition policy and regulation have been changed for good

recapitalised one of the two largest Swiss credit institutions by injecting capital (by way of an ordinary shares bought by way of a mandatory convertible bond; *Keil, 2009*). As soon as finance was available again on the capital markets it withdrew as a stakeholder (within only 9 months) by selling its shares to private investors for a considerable profit (*N. N., 2009*).

Competition policy, in terms of the overriding policies which influence and shape competition in the market, became less strict during the crisis because state aid was permitted and granted to particular sectors and businesses which were classed as "too big to fail"¹. As a result of this political decision the crisis brought with it a certain amount of distortion to free competition.

During the crisis, on both an EU and country level, the role of competition authorities to pursue cartels and to impose sanctions against companies abusing a dominant market position remained unchanged. To compromise on the rules merely as a result of the crisis would, in the long term, be both generally and in specific cases, nothing more than counterproductive. However, during the crisis, at least in the financial sector, a more tolerant stance towards mergers can be observed as far as "National Champions"² were concerned. Furthermore state aid is now distributed much more liberally than before the crisis. As far as this is concerned the regulatory bodies need to return to tighter controls especially where state aid is being provided to large businesses. Returning to tighter controls on state aid is important on the one hand to avoid the distortions to competition and the ensuing inefficiencies, and on the other hand to prevent competition to receive subsidies at the cost of the tax payer.

The crisis has brought with it two key demands for competition policy in the future (*Haucap, 2009*). However, the solution to these demands does not lie with the competition authorities but rather in the competition strategy made at a political level. Generally, in order to preserve free competition only minimally invasive instruments should be used by the state and these should only be applied with precision to any weak points in the free market with the single purpose of "restoring order to the economy" (*Erhard, 1957*). Any market distortions from state aid should be kept as small and as short term as possible.

1. How should you deal with companies which are too big, or have too many dealings across the economy, so that their insolvency need not pose a potential threat to the whole economy?

The financial and economic crisis has shown that during a crisis large companies (not only in the financial sector) can force concessions to and even changes to set government policies. Since, at the end of the day these companies can count on state help, they have every incentive to take on much higher risks than they otherwise would in the absence of such an "implicit insurance contract"

Therefore the aim for any future competition policy needs to be to guarantee that the burden of rescuing any business which is too big to fail should be more equally shared between the individual company, the whole economic sector (i.e., the companies as a group) and the state.

¹ The term "systemically relevant" is in substance a synonym for the doctrine "too big to fail". According to Art. 6 para. 3 of the Directives for Supervising Banks from the German Central Bank a financial institution is considered "relevant to the system" if its failure would have significant negative effects on other credit institutions, or could lead to the instability of the financial system as a whole as a result of its size, the level of its inter bank dealings, and its amount of dealings abroad. Systemic relevance has become the killer argument to receive state aid by companies in trouble in other non-financial sectors. The question of which companies are actually systemically relevant is not something that can clearly be defined in advance. That banks are not per se automatically systemically relevant can be seen from the state rescue package for the Hypo Group Alpe Adria (*Gallarotti, 2009*).

² For the problems on a competition policy level arising from the existence of "National Champions" see *Monopolkommission (2004)*.

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**Competition policy
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With this in mind several possible approaches are currently being discussed for the banking sector although no single solution seems to be entirely convincing. It goes without saying that with a few changes any solution found for financial institutions could also be applied in other sectors or at least to other large institutions in other branches which are also too big to fail.

- One possibility would be to force de-mergers once a company has reached a particular size. However, the size of a company is not the sole factor which determines whether it is too big to fail. What is more crucial is its level of interconnection with other sectors, its so called risk to the entire system. Furthermore, the definition of the critical size of a company would depend on the sector and obtaining data for any numerical definition of critical (turnover, market share, etc.) would be difficult. Furthermore it may also transpire that smaller firms may not be suitable for a global marketplace.
- Another approach would be to link any existence guarantee (which was until now free) to the payment of an insurance premium which would cover the risk to the system carried by a company considered too big to fail. The premium would actually flow into a crisis fund which, in the case of serious problems would be used to finance any solution needed at a sector level (other businesses from the sector help the company which is risking insolvency). Or, at the very least this money could fund an organised bankruptcy procedure. Under this system a bailout using public money would only be needed as a back up since in the first instance it is the sector which has been hit which would have to pay. In order to avoid any distortion to competition such a crisis fund would have to be established at a supranational, or at least EU level.
- A third suggestion would be to transfer part of the problem to the level of the regulators by making the systemic relevance of a company a criterion which should be considered during merger control. The financial crisis has proved the classical assumption of industrial economists that market rules are actually exogenous to be false. Using this approach merger control would not only have to check potential mergers for market dominance (Market Power) but also for non-market dominance (Political Power). This would mean that the remit of the competition authorities would be expanded to include aspects of political economy. The discussion about whether and how such non-market/external power should be considered in merger control is still in its initial stages.

2. How can competition contribute to the sustainable and dynamic growth of the economy?

If you seek the cause of the financial crisis solely in the deregulation of the financial markets, you will fall short of the truth. The causes are much more complex and cannot be attributed solely to either the failure of the market or the state. Much rather it is a combination of the two: financial institutions cleverly exploit any gaps in regulation and practice "regulatory arbitrage" by outsourcing any high risk speculative business to off balance sheet special purpose vehicles, thereby avoiding financial market and banking regulations. Partly against their better judgement, the (national) state regulatory authorities allowed this development. At the same time the tougher capital requirements of Basel II and the more market oriented accounting rules ("Mark-to-Market") lured the lawmakers into a false sense of security (Url, 2010, Hahn, 2010).

It was from this regulatory arbitrage that a general mistrust in the ability of the markets to regulate themselves began to grow. Furthermore, contrary to the economic facts, free market competition was unfairly given a bad name. Current research shows that the level of competition in a market is an important factor in determining the level of growth in that market (Aiginger, 2008, Nicoletti – Scarpetta, 2003, 2005). Lack of competition means resources are wasted which in turn limits growth, whereas an increase in competition should promote innovation initiatives, and increase both employment and growth. Despite this convincing and conclusive evidence the force of competition to drive growth is still traditionally underestimated (Aiginger, 2009, OECD, 2005).

The financial crisis demonstrated perfectly that public ownership does not in itself guarantee more stable markets (e.g., state-owned banks as speculators). If the state successfully creates the necessary regulatory framework and manages to guarantee that it is both complied with and kept constant, its withdrawal from business activities need not per se bring with it a destabilisation of the markets. It is not a question of whether the state should be more or less involved in business activities. Rather what is needed is a strong state where strict regulation (of the financial markets) is indispensable. The key to any future economic strategy to achieve growth and employment is to ensure that fundamentally, the private sector is as large as possible. It is not a contradiction in terms to have a strong state which focuses on key areas and a strong private sector. Rather it is this very combination which is the prerequisite to an efficient and effective economy. However, to achieve this goal the state must be prepared to renounce public ownership, thereby foregoing a certain amount of influence and allowing the private sector to grow.

A prerequisite of a free market is, at least in particular areas, a strong state. To this end, on a political level, the state would be assigned three main functions (*Hüther – Straubhaar, 2009*):

- In order to ensure competition the state must create the appropriate framework conditions for contestable markets.
- In order to enable competition the state must guarantee equal opportunities for market participants to access the market.
- In order to regulate competition the state needs to combat market failures where a market solution to the problem is not available.

These three main tasks create a so called "regulatory sequence": Only when the state acts to ensure free competition and only when there are equal opportunities for all market participants to participate in a competitive market, is it actually possible to selectively neutralise/mitigate any negative side effects of a free market. In the past politics focused far too much on trying to correct the effects of competition and did not optimise its positive effects for growth and employment. In the future it would be much more efficient to prevent any market failure before it occurs rather than trying, at great cost, to combat it after the event.

A very clear lesson to be learned from the financial crisis is that the state should concentrate on its most important task, namely creating the necessary framework conditions for a functioning market. This goal can best be reached using a clear and consistent set of regulatory policies and a strict competition policy which is coordinated on an international level, as well as by using so-called "intelligent regulation" (*Smart Regulation; Lowe, 2009*). In the future for some sectors (e.g., the banking and financial sector) this might mean a stricter and more comprehensive regulatory framework. In other sectors (e.g., energy and the liberal professions especially in Austria³ there might still be room for substantial deregulation.

The competition authorities are overwhelmed with such fundamental issues without the support of a clear competition policy at the state level. The policies of the competition authorities at an operative level can actually only supplement the competition policy made at a strategic level.

³ 10 years after the liberalisation of the energy markets in Austria there is still no sign of any working competition in this market. This was due to a lack of any strict follow up regulation and a pro-active competition authority which itself had not been bestowed with the adequate powers to carry out its job. *Böheim (2005)* presents a detailed overview of the issues that restrict competition in this market, most of which are due to the conflicts of interest that arise from the multiple role of the state as law maker, owner, regulator and regulatory authority. Solutions to this problem can also be found in *Böheim (2008)*.

The level of regulation restricting competition within the various professions varies enormously (*Paterson – Fink – Ogus, 2003*). Chemists in particular have regulations which are harmful to competition and serve as a barrier to entry to the profession (namely: economic needs test, ban on third party ownership, ban on the postal order of medicines, ensuring that prescription-free medicines still have to be dispensed by chemists) and Notaries (statutory tasks, restrictions on the amount of notary jobs as in a planned economy).

Summary and Conclusions

Effective division of tasks between the state and the private sector

The state as guarantor of regulatory stability

"The policies of the competition authorities are not a substitute for actual competition policy"

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The Financial Market Crisis and its Consequences for Competition Policy – Summary

The financial crisis demonstrated perfectly that public ownership does not in itself guarantee more stable markets (state-owned banks as speculators) if the state successfully creates the necessary regulatory framework and manages to ensure both its constancy and that it is adhered to, its own withdrawal from business activities need not per se involve a destabilisation of the markets. It is not a contradiction in terms to have a strong state which focuses on regulatory policies and a strong private sector. Rather it is this very combination which is the prerequisite to an efficient and effective economy

The state as a guarantor of a stable system

Free markets require a strong state. On a political level, the state would be assigned three main functions: ensuring competition, enabling competition and regulating competition in case of a market failure.

These three functions constitute a "sequence": Only when the state acts to ensure free competition and only when there are equal opportunities for all market participants to participate in a competitive market, is it actually possible to selectively neutralise/mitigate any negative side effects of a free market. In the past politics focused far too much on trying to correct the effects of competition and did not optimise its positive effects for growth and employment. In the future it would be much more efficient to prevent any market failure before it occurs rather than trying, at great cost, to combat it after the event.

"The policies of the competition authorities are not a substitute for actual competition policy"

Competition authorities are quickly out of their depth when it comes to issues that go beyond individual cartel law cases, as they cannot draw on any support from competitive policy-makers. "Competition authorities policy" is only able to supplement competition policy at an operative level but cannot replace it at a strategic level.

This goal can best be reached using a clear and consistent set of regulatory policies and a strict competition policy which is co-ordinated on an international level, as well as by using so-called "intelligent regulation" (Smart Regulation; Lowe, 2009). In the future for some sectors (e.g., the banking and financial sector) this might mean a stricter and more comprehensive regulatory framework. In other sectors (e.g., energy and the liberal professions especially in Austria) there might still be room for substantial deregulation.

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