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 Competition and Regulation: Micro-economic support for macro-economic recovery London
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Figures and graphics available in PDF and WORD PROCESSED
 London School of Economics

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Ladies and Gentlemen,

First of all, I would like to thank Prof. Chalmers for his kind invitation. The London School of Economics is a remarkable institution.

- I am delighted to be with you today because I feel we have so much in common. A believer in market forces, which recognises that markets by themselves cannot deliver social justice.

I've always been concerned about the relationship between markets and social justice; an issue that has come back into fashion over the last couple of years.

In the wake of the financial and economic crises, many have questioned the merits – and sometimes the sanity – of free markets and wondered about the implications for the social body.

And rightly so.

- Often unregulated bankers have operated beyond their ability to understand risk. Their failures led to a spiral of losses, bankruptcy, bailouts, and yet more losses.
- The financial services sector – once regarded as the haute couture of free markets – was found to be wearing the emperor's new clothes.

The problems caused by the banks have spilled over the entire global economy. In other words, micro-economic mistakes led to macro-economic problems.

Now, we need both macro- and micro-economic solutions to put the economy back on track. As Economic and Monetary Affairs Commissioner I used the former, now that I have become Commissioner for competition I am using the latter.

Today, I want to talk about the micro-economic aspects.

The current financial and economic crisis is the best example I know of the need to find a better balance between the markets and the rest of society.

On the one hand, society benefits from free markets; on the other, it needs to protect itself from the risks of unregulated markets.

On the one hand, governments should be ready to intervene in the economy; on the other, their intervention should be kept under controlled limits to be efficient and sustainable.

What, then, are the basic principles of this delicate balancing act?

The **first principle** is that government is not good at predicting how people want to spend their time or money – there is ample evidence of that.

Over the past decades, we have moved away from state monopolies and heavy regulation towards more liberalised models.

For years, we have tried to get rid of measures that gave the control of key markets to government and special-interest bodies. Those were often wise moves.

Private entrepreneurship reaped the benefits of innovation, globalisation and technological change.

And this brought tremendous success to many sectors; such as the telecoms, transport, and the financial services sector itself.

Looking back before the present crisis, liberalised financial markets allowed private entities to take over sectors managed by government bodies and bring fresh dynamism to them.

Firms do not need to be protected by special-interest regulation and they do not need a lifeline of financial support to be competitive.

In fact, firms are weakened by these safety nets in the long run. A degree of discomfort keeps them on their toes and pushes them towards better performance.

As to the **second principle**, I submit to you that in the phrase 'state monopolies' the problematic bit is not the 'state' but the 'monopolies'.

A monopoly, whether it is controlled by a public body or a CEO, will never deliver dynamism and innovation as a company competing on a free market does.

Sir John Hicks – who won the Nobel prize for economics and taught here at the LSE – wrote that "the best of all monopoly profits is a quiet life". This applies regardless of who runs the monopoly.

So, taking control of a market away from the state only to place it de facto in the hands of a single firm or group is a big mistake.

Private firms will adopt practices that entrench their dominance and get rid of competition, if they are badly regulated or – worse – left unchecked.

The **third lesson** learned the past decades is that deregulation can go too far, and too fast. Instead of creating a free market utopia, it can create a lawless dystopia.

If the telecoms operators had simply been privatised in the '80s and '90s, we would not have seen the tremendous changes in the sector from which we have all benefited.

Privatisation was followed by regulatory measures designed to foster competition on the telecoms markets. It is because of regulation that we have seen so much dynamism in the industry.

Deregulation can also go too far if companies are allowed to engage in behaviour that destroys their value and the value of other companies as well.

Financial firms' behaviour has produced losses that nearly brought down the world economy. We need to put in place regulatory reforms that will prevent this from happening again.

Ladies and Gentlemen:

Let me recap my main argument so far. Our capacity to grow and to innovate finds its best environment in free markets. However – as with any human endeavour – there must be rules to follow.

This is the delicate balance I referred to earlier: markets should be allowed to function freely and, at the same time, rules must be set.

In particular, some rules are designed to enhance competition – rather than serving other public objectives. In these cases, another sort of balance needs to be found between competition rules and specific regulation.

Often, these are presented as cases of ex-post control by competition rules, compared to ex-ante control by regulation. I find this division too simplistic and general.

Competition rules can have an ex-ante impact as well: when the implications of the rules are clear, the actors affected by them should adjust their behaviour accordingly.

Take for example the measures against the creation of cartels: companies know that price fixing is against the law, and most do not engage in it.

In general, our decisions and guidance provide companies with the information they need so that they can adapt their behaviour to the rules

Two examples are the recently adopted exemption and guidelines on vertical restraints, and the drafts on horizontal agreements that are currently being discussed.

This does not apply to antitrust measures only; look at State aid rules, for example. Governments know that straightforward operating aid is illegal and that the Commission will block it. As a consequence, we now no longer see the massive cash gifts of the past.

Even during the crisis, aid to industry was not disbursed as a gift, but has taken the form of loans and guarantees granted at the same terms and on the basis of the same European-wide rules. Our economy, and our taxpayers, are better off as a result.

The State aid cases that were handled during the financial crisis established precedents that financial firms will have to bear in mind for the future.

I believe that we, the European Commission, are the only jurisdiction that has explicitly tackled moral hazard.

Through our State aid rules we make sure that government bailouts come with conditions – such as haircuts or restructuring requirements – so that companies that have run their businesses badly pay the price.

Companies will bear this in mind in the future when deciding – for example – how much risk to take on board. Again, this ex-post control can lead to ex-ante regulation and changes in behaviour.

I would like to expand on this point. Markets deliver productive, allocative, and dynamic efficiency. They do not – in and of themselves – deliver social justice or other public-policy objectives.

Markets cannot be asked to reduce pollution, protect the safety of consumers, or broaden access to essential services such as energy, water, and basic means of communication.

These are tasks for public policies.

Thus competition policy – among other things – ensures that we don't pay too much and don't place too heavy a burden on economic activity to attain public-interest objectives.

Let me give you a couple of examples.

The vast majority of people in Europe expects public authorities to protect the environment for the present and the future generations.

Thanks to our competition policy, we try to make sure that environmental regulations do not create unnecessary distortions on the market.

At the same time, State aid rules authorise aid to companies to support environmental projects in sectors as different as steel, car or energy.

Similarly, last year, we published a Communication clarifying under which conditions EU countries can support public-service broadcasting.

Thanks to these guidelines, European governments can fund the public service mission they have identified, while keeping distortions of competition to a minimum.

Ladies and Gentlemen:

I have been telling you about general policies; however, the bulk of competition policy is about enforcing European law on a case-by-case basis and after the fact.

As competition Commissioner, I intend to maintain a strong enforcement function. I will continue to promote a dynamic and competitive economy using all our instruments on merger control, antitrust, and state aid.

But competition laws are not enough. Competition rules work best when market abuse is occasional.

However, when markets are structurally prone to capture and abuse, case-by-case action is likely to be inefficient and even ineffective. In these cases, ex-ante regulation is needed to go to the

root of the problem and fix it.

I will take once again the telecoms industry as my example. The right degree and sort of regulation has actually brought more openness and competition to the industry.

In telecoms and other network industries such as transport and energy, regulation has ensured that newly privatized incumbents did not foreclose the market.

I hasten to add that regulation should decline over time as markets become more competitive. We have narrowed down the number of recommended markets that could be subject to regulation in 2009, and I expect a further narrowing in the future as competition matures.

But regulation should be kept whenever help to market entry is needed, because new players should have their fair chances and incentives to challenge the incumbents and shape the future.

I would like to point out a methodological aspect. If we keep our focus on how markets function, we can identify the areas where we can withdraw from regulation, and the areas where regulation is still needed.

This is the approach that we have adopted, for example, in relation to next generation networks in telecoms.

We will strive for the appropriate balance between regulation and competition-law enforcement while acknowledging the need for private incentives to drive the market.

Pro-competitive regulation is also the line that we pursued when, after the energy sector inquiry, we pushed a regulatory mandate to unbundle network operations from trading services in the energy market.

This goes to show that there is no inherent conflict between regulation and competition. The only conflict I know is between bad protectionism and competition. To make markets work well, wise regulation and competition often go hand in hand.

Ladies and Gentlemen:

In the examples I have previously given, regulation was needed and competition policy guided and informed regulatory initiatives. But it is not always easy to achieve the right balance between competition and regulation or to decide when to use what.

However, it is not uncommon to receive pressure for competition policy enforcement in areas where regulatory measures would in fact be more adequate.

Some recurrent problems caused by the structural characteristics of an industry are better dealt with through a good regulatory measure rather than with a merger or antitrust remedy.

But because legislative initiatives are difficult, the temptation is there to take the opportunity of an antitrust case to try and resolve structural problems, real or perceived.

As Abraham Maslow observed, "It is tempting, if the only tool you have is a hammer, to treat everything as if it were a nail."

An example of this is the Google/DoubleClick merger where a lot of pressure was put on the Commission competition services to address – and remedy – issues of privacy over the internet.

Online privacy however, is a much larger issue than this particular merger case.

It is clearly an issue that calls for regulatory measures common to the entire industry, not for an opportunistic remedy in the context of a merger.

The financial sector is another example where there are calls for antitrust and merger rules to be used to solve problems going beyond their scope.

We need reasonable financial regulation to facilitate sustainable and healthy competition, and to deal properly with the problems caused by the nature of the sector.

For example, the financial crisis demonstrates very clearly how a lack of effective regulation created incentives for financial institutions to pursue excessive risk-taking in order to achieve short-term gains.

The interconnectedness of the institutions led to systemic effects that ultimately brought the entire sector to the verge of self-destruction.

To make matters worse, there was no regulation enabling the orderly winding up of banks without

endangering financial stability.

This meant that an essential principle of competition – the exit of inefficient non-viable players from the market – was not operational.

Member States were forced to rescue banks by injecting large amounts of State funds in order to prevent a financial meltdown.

For this I believe regulatory actions are necessary to enhance sustainable and welfare creating competition in the financial sector.

And I certainly believe that current problems cannot be solved only through case-by-case anti-trust, merger or State aid measures. A regulatory framework is needed for a sustainable and competitive industry to be able to develop.

Therefore although there is an important role for competition policy, I am unwilling to address regulatory problems through the competition rules.

The opposite problem also exists: we have to be careful not to impose a regulatory measure where a corrective remedy targeting a firm or group of firms would be more efficient.

If as a consequence of the crisis the tide was to turn and legislators became more regulation friendly, overregulation would be a problem to watch for.

Ladies and Gentlemen:

To sum up, as a matter of principle competition law is the proper tool to ensure a level playing field in markets open to competition. Regulation is the exception, not the rule, and regulatory intervention needs to be properly justified.

The experience of the financial and economic crisis over the last two years, and recent trends involving the pace of technological change and increased globalisation, have thrown up appeals to use competition policy to solve real or perceived market problems.

There will be calls for more competition policy interventions in the financial sector and in relation to the internet where markets are changing rapidly creating some serious structural disruptions. Some will likely be justified, some – including as I have said in the financial sector – will be better addressed through regulation.

But I also fear there will be calls for less competition interventions in mature sectors or sectors with low growth potential where there will be an instinct by some to preserve large industrial groups at any cost.

Overall, in the face of these challenges what we need to do is to clarify very carefully about the problems that require a competition solution, or a regulatory solution, or those that require the solution of the market.

I do not propose to enlarge the scope of competition policy – but I do not propose to shrink it either. What I propose is to enforce the competition rules where competition is being damaged, whether in a new or an old sector.

In these times of dire straits, our model of European social economy needs a functioning single market to recover and start growing again. And a strong single market to go forward needs a strong and rigorous enforcement of our competition policy instruments.

Competition is thus a key part of Europe's exit strategy from the financial and economic crisis and it must be applied intelligently.

This means it must continue to do what it was always meant to do: promote efficient and innovative firms to the benefit of consumers in Europe.

I would like to finish by returning to the host of today's conference, the LSE. Its motto is *rerum cognoscere causas*, to know the causes of things.

I hope that with today's lecture, and the discussion that is about to follow, we are a little closer to knowing the causes of how markets work, why they fail, and what we can do about it.

Thank you.