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Global Forum on Competition

CRISIS CARTELS

-- Executive Summary --

17-18 February 2011

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EXECUTIVE SUMMARY

By the Secretariat

1. A discussion on Crisis Cartels from a competition perspective took place during the third session of the 2011 Global Forum on Competition. To prepare this discussion, a background paper, three additional papers prepared by experts and twenty-one contributions from official delegates were circulated. A number of important points regarding this topic were made and are summarised below.

(1) *Should resorting to crisis cartels ultimately become widespread then it would go against the two decade-long trend of tougher enforcement of price-fixing and other forms of cartels in developing and industrialised countries.*

2. The term crisis cartel has been used in two ways: to a cartel between private firms that is not approved by the state or to an agreement between firms that a government body sanctions during a period of economic distress. The first type of crisis cartel may contravene the competition law of the jurisdiction in question, while the second type of crisis cartel may well require an exemption from that law.

3. Competition authorities have to decide how much priority to give to cartel enforcement and whether that priority should change over the business cycle. Other government bodies may have to decide whether to intervene, permit, or even encourage the formation of cartels. Some have argued that these questions are of greater relevance to developing countries with fewer public policy instruments effectively available to them during downturns.

4. Widespread toleration of crisis cartels would go against two decades of tougher enforcement against cartels in both developing and industrialised countries. If the policymaking community were to accept that there are circumstances under which crisis cartels could be justified then this would mark a significant point of departure from prevailing views on cartel enforcement. Many country contributions to this session made specific references to the significance that a policy shift would imply by a greater resort to crisis cartels. Cyclical and structural overcapacity is better dealt with by other means available to firms and to governments.

(2) *Although the arguments for crisis cartels have few supporters, and the historical and contemporary evidence that such cartels are the best way to tackle crisis-era problems is thin, as a practical matter governments should have the means and transparent procedures to evaluate proposals for such cartels during economic crises. Any exempted cartel should be granted a finite lifetime and be subject to review according to pre-specified criteria.*

5. The economics of crisis cartels is contested. The dominant view among the competition policy community is at odds with that of certain development economists, who argue that the institutions and circumstances of developing countries warrant a different approach. The first view is that crisis cartels - as with other cartels - raise prices above incremental costs and so harm customers, limit output, and distort market outcomes away from efficient outcomes.

6. In contrast, the heterodox view emphasises a different set of factors. Cartels facilitate the closure of excess capacity. Moreover, some have argued that one purpose of cartels was to prevent crises resulting in the monopolisation of a sector by the lowest cost firms in an industry. Cartels were seen as a way to constrain the most efficient firms, although this begs the question as to why the latter would voluntarily agree to or comply with any cartel accord.

7. More recent defences of crisis cartels point to the importance of comparing the following two costs: the cost of market power created by a cartel and the cost of forgone economies of scale if the total output in an industry is allocated across a large number of smaller firms instead of being spread over a small number of large firms as a result of the cartel accord. Some have argued that the former are smaller than the latter, and so conclude that cartel-encouraged rationalisation is to be supported.

8. Turning to the evidence, there is relatively little quantitative evidence of the impact of crisis cartels. Still, five findings were discussed. First, it is sharp price falls--rather than other features of crises--that appear to trigger the creation of crisis cartels. Second, when a government intervenes to create or allow a crisis cartel, the government's intervention rarely stops there. Over time there is a strong tendency for other regulations to be sought by incumbent firms and policymakers to pursue their own objectives through additional interventions. Third, in sectors facing competition from imports, the creation of a crisis cartel is often associated with measures to curb or eliminate those imports. Crisis cartels, therefore, frequently involve an international trade dimension. Fourth, although studies have shown that crisis cartels have raised prices and limited output, not a single estimate of the harm done to customers could be found. An important piece of information for policymaking is, therefore, missing. Finally, none of the alleged benefits of crisis cartels - mentioned above - have ever been estimated. So there is no way of knowing if the losses to customers that follow from the creation of a cartel are offset, partially or fully, by benefits to other parties.

9. Even though the available empirical evidence makes it hard to sustain an argument in favour of crisis cartels, governments still face the practical matter of how to respond to requests for the creation of cartels during times of extreme sectoral, national, or global economic dislocation. Competition authorities can play an important role here, using evidence-based and transparent procedures that follow specific criteria stated in their jurisdiction's respective competition law.

10. One criteria discussed was that the industry in question should demonstrate that its woes could only be rectified by the creation of a cartel and not by some other private sector action. In this regard, it was noted that firms have alternatives to cartelisation including mergers, joint ventures, and engaging in other forms of legal co-operation.

11. Should a competition agency or other government body decide to allow the creation of a crisis cartel, it was recommended that the cartel be allowed to operate for a specified limited time frame and should be subject to periodic review. Concerns were expressed, however, that even the temporary granting of a cartel exemption would have longer term consequences as firms got used to co-operation.

(3) *The very fact that there are alternative public policy measures available to governments that can improve market outcomes more effectively than crisis cartels points to an important role for competition advocacy by competition authorities, as they seek to influence governmental decision-making during economic crises.*

12. Evidence presented in the background paper plus statements in many of the country contributions suggest that resort to crisis cartels has been rare in recent years. This conclusion is subject to the caveat that some crisis cartels remain undetected. Instead of resorting to crisis cartels many governments have engaged in subsidisation of firms in difficulties.

13. In at least one important respect, injections of liquidity are more effective than cartels because financial infusions impact firms that are facing demands to pay for supplies and staff immediately before revenues are received. In contrast, the creation of a cartel takes time to affect prices, sales, and revenues of cartel members. An important implication for policymaking is that it is not that subsidisation is the optimal policy response to firms in distress, but that proponents of crisis cartels must show that their proposals are less harmful than other available policy instruments, including subsidies.

14. In this regard it is important to point out that developing countries may not have the resources to offer subsidies from their state budgets. However, it should be noted that some developing countries have directed their banking systems to advance loans to distressed firms, which is an indirect form of subsidisation. In industrial and developing countries, there are plausible alternatives to crisis cartels and so the case for the latter should not be made without reference to the former.

15. Furthermore, competition advocacy by competition authorities should involve identifying and highlighting plausible alternatives to crisis cartels. Such advocacy need not be confined to those government bodies responsible for the evaluation of requests for exemptions for cartel law, but also to the press and to other opinion formers that might be influential.

(4) *In markets where prices are volatile or where the consequences of volatility are severe (possibly for poor producers as well as for consumers) crisis cartels are an option but, again, not necessarily the only practical option. Financial market and other innovations should be considered as well, if they are available.*

16. Transitory shocks in these development-sensitive sectors can jeopardise the survival of marginal market participants threatening, for example, farmer's livelihoods when prices are very low and the welfare of poor customers when prices are very high. Given the substantial increases in the level and volatility of food and associated commodity prices in recent years, the question of whether the creation of cartels might have pro-development consequences has arisen.

17. A case study concerning the production and international trade in coffee from the 1950s through to 1989 was presented. Much production of coffee then took place in developing countries while most consumption was undertaken by industrialised countries. Concerns about the volatility of coffee prices led 37 governments to sign the International Coffee Agreement (ICA) which was in effect from 1962 to 1989. A noteworthy feature of this accord is that it was supported by the largest buyer of coffee, apparently on foreign policy grounds and seeking to stabilise the economies of producer nations.

18. An assessment of the ICA noted four findings of potential contemporary relevance. First, the lack of diversification of production in many developing countries meant that the volatility of coffee prices has developmental implications, not least through affecting the incomes of vulnerable farmers and the like. Second, the international cartel that existed between 1962 and 1989 did maintain prices and reduce price instability and so met the objectives of the ICA signatories.

19. Third, while certain financial instruments could have insured producers against price volatility, they were not available at the time this cartel was in operation. Other alternatives, such as mergers, would not have been feasible on a large enough scale without generating huge concentrations of land ownership in developing countries. Fourth, while a niche strategy was an alternative for some producers, whether it is a generalised solution remains to be established.

20. Still, for all the benefits of this international agreement, concerns were raised that the adaption to market and technological developments might have been faster in its absence. This case study demonstrates that even if a national or international cartel stabilises prices there may be unintended side-

effects that are detrimental to development. Financial instruments or production innovations may be able to smooth fluctuations in prices - thereby stabilising prices paid by and to the poor - without generating adverse side effects. Once again evaluating the merits of crisis cartels must make reference to alternative interventions available to policymakers and international development organisations.

(5) *The competition perspective has much to offer on important contemporary deliberations of development-sensitive matters such as food security. Creating crisis cartels cannot tackle some of the competition-impeding practices that exacerbate food insecurity.*

21. Producers of certain commodities as well as consumers can face poverty in developing countries. Moreover, such market participants are affected by the level as well as the volatility of prices. A competition policy perspective typically privileges customer welfare over producer welfare, while a developmental perspective would consider the impact of changes (firm-led or policy-led) in agricultural and commodity markets on poor producers as well. It is for this reason that in certain markets in developing countries the application of competition principles should be more flexible.

22. Understanding of the factors determining the intensity of competition in development sensitive markets sheds light on other interventions by governments that might advance development goals. The extent to which shocks in global markets influence national prices may speak to the level of competition in the distribution sector, for example. Moreover, trade in agricultural and commodities, and in the inputs necessary to make them, can be affected by cross-border anti-competitive practices. Reference was made in this regard to recently proposed - but failed - international takeover that would have had implications for the prices charged in world fertiliser markets. Likewise, an export cartel for rice involving certain Asian governments, implemented during the recent global economic downturn and associated with the recent price spikes on world commodity markets, highlights how competition-related factors can shape market outcomes in these development-sensitive markets.

(6) *Experience reveals that the tension between competition and stability in the financial sector is more apparent than real.*

23. Whether higher levels of concentration in certain segments of global financial markets leads to greater financial stability is contested. In principle, since every concentrated financial player is a counterparty to most, if not all, other major players in the same market, concentration is in reality associated with greater potential global financial instability. Should one such firm fail the financial viability of all of its counterparties is called into question.

24. Given the takeovers and exit of certain financial firms that occurred during the recent global economic and financial crisis, the resulting greater concentration in certain financial segments of the global financial system is associated with the twin ills of greater pricing power and the higher likelihood of another financial crisis. These concerns are reinforced by adverse non-competition-related factors such as poor internal risk management practices by the financial firms themselves, government guarantees to depositors, and moral hazard.

25. The experience of some industrialised countries during the recent global financial crisis points to the positive contributions that competition authorities and financial regulators have played in avoiding the adverse consequences of greater financial concentration. The prices charged by banks and other consumer-facing practices should fall under the remit of the competition authority while another body is concerned with the degree of risk-taking by financial institutions large enough to pose a systemic threat to the economy and the national payments system. In this manner, incentives to compete without threatening financial stability can be presented to banks and other financial institutions.