Merger Control

Challenges During Economic Crises

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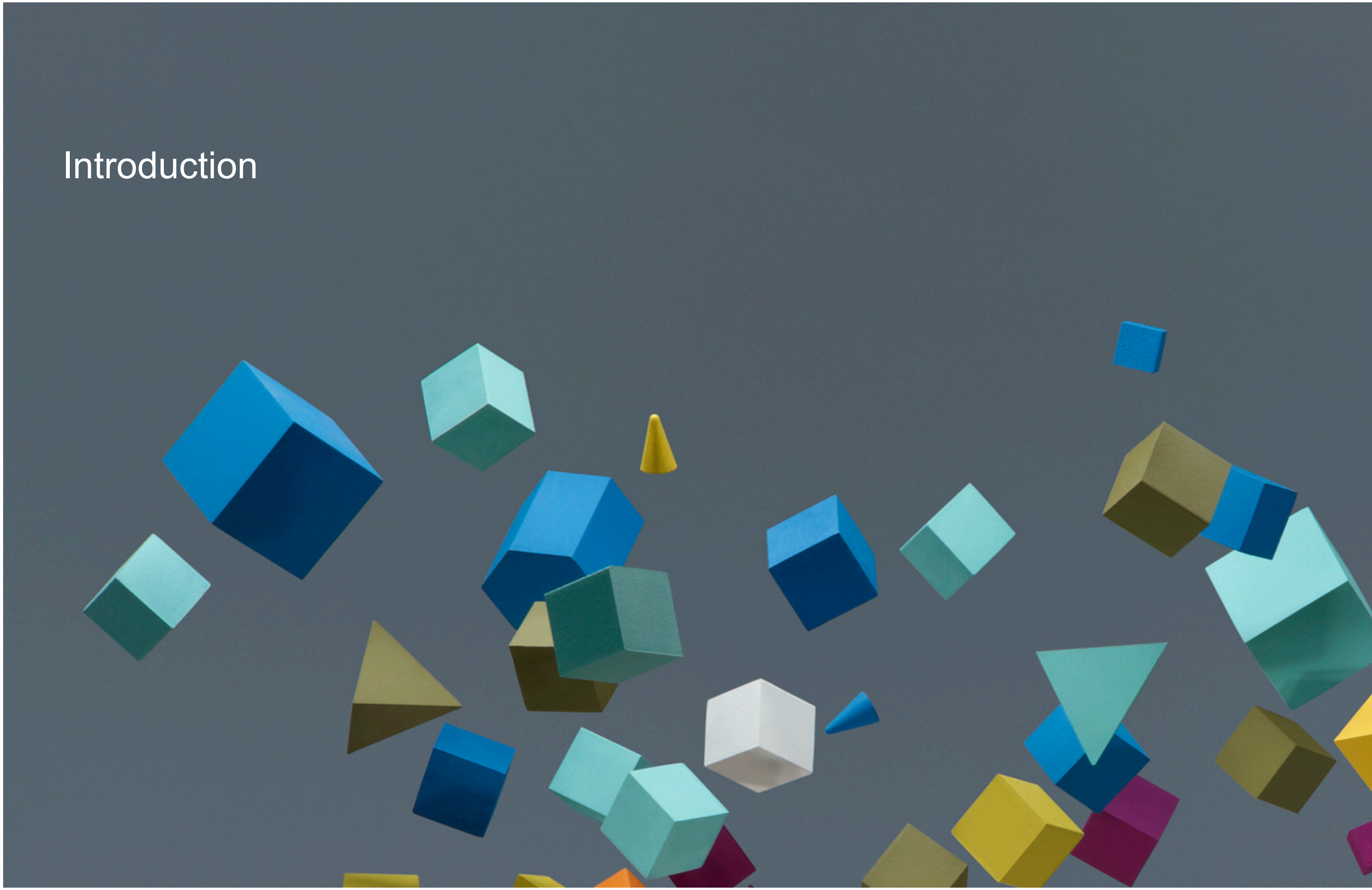
Introduction



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Introduction

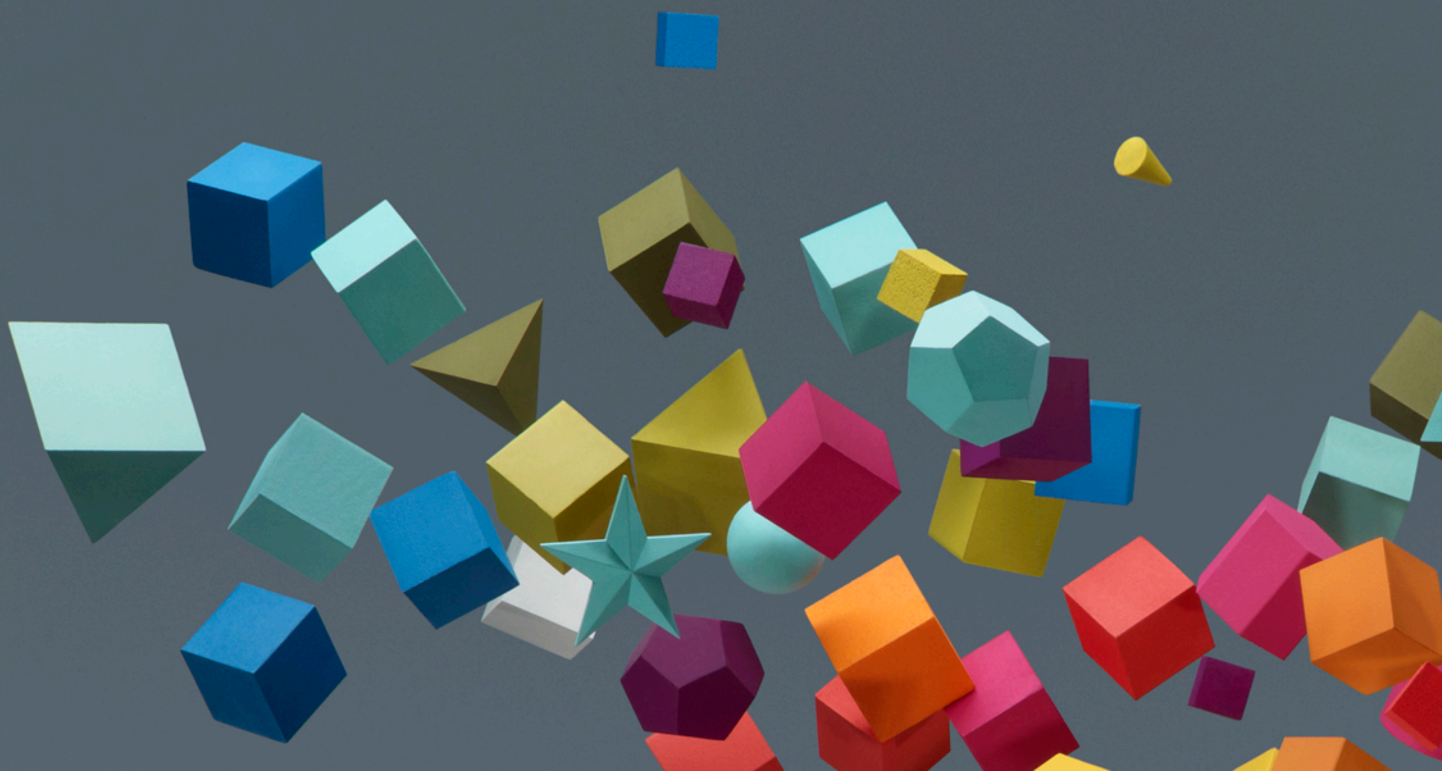
This presentation addresses the question of whether merger review should be **different in times of economic crisis**.

We will discuss **three different aspects** of this question in what follows:

- Should the **standard of merger review** be altered during an economic crisis?
- Should the **outcome of merger review** be different in times of crisis?
- Are there any special implications for merger review in **declining industries** during an economic crisis?

I will illustrate the concepts we discuss by way of reference to three **recent merger decisions** at EU and national level.

1. Should the standard of review be altered in times of economic crises?



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Standard of review

In times of economic crises, competition law has traditionally **come under pressure** both from firms lobbying for softer enforcement and from governments who viewed antitrust as an obstacle to economic recovery of damaged industries.

Not surprisingly, therefore, such calls for a relaxation of standards were also voiced in the context of **the current crisis** on numerous occasions.

The primary argument that is put forward **is one of profitability**: competition undermines profits; lack of profits is why firms contract in a crisis; hence, competition law enforcement exacerbates the detrimental impact of crises.

Should merger enforcement then be **softer when the going gets rough**?

Standard of review

To find a satisfying answer to this question, a look back to **previous economic crises** promises some insight.

Subsequent to the **Great Depression in the 1930s**, there were strong calls to limit competition law enforcement to permit rapid recovery.

U.S. President Roosevelt followed this advice and largely **suspended the antitrust laws** in the context of his “New Deal” policy.

In return for higher wages, firms were effectively **permitted to instate cartels** in their industry.

It was hoped that higher wages and **higher profits would boost recovery**.

Standard of review

Almost a century later, the ramifications of this policy have been **explored by researchers** in minute detail.

The most comprehensive study was conducted by Cole & Ohanian (2004), who find that the suspension of competition law **dramatically slowed down recovery** from the Great Depression.

Indeed, about **60% of the gap between actual and trend output** can be accounted for by the cartelization policy of product and labor markets (firms with market power restrict output rather than expanding it).

This is a useful reminder that exit from a crisis is not undertaken by restricting markets and **creating artificial profits**, but requires substantive (and painful) pro-competitive reform.

Lloyds TSB/HBOS (2008)

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Lloyds TSB/HBOS (2008)

In the wake of the financial crisis in 2008, the chronically undercapitalized **HBOS was taken over by Lloyds TSB**.

The OFT concluded that the transaction is likely to materially **harm competition** in personal banking accounts and SME banking, in particular in Scotland (where a duopoly was created).

This concern was **overruled by the Secretary of State** on the basis of public interest considerations.

On economic grounds this **interference seems doubtful**, as it is not indispensable to eliminate future competition to recapitalize a bank (disconnect between short-term aims and long-term consequences)

2. Should the outcome of review be different in times of economic crisis?

Outcome of review

In the foregoing, I have argued that the **principles of assessment** in merger control should not be altered during an economic crisis.

The fact that the same framework of review is employed, however, by no means implies that the **outcome of review** for a given merger should necessarily be the same during an economic crisis.

The primary change brought about by a lasting economic crisis is that it **alters competitive realities** in the market—a fact that must be accounted for in merger control.

Specifically, economic crises usually imply a **slump in demand** on account of higher uncertainty and lower lifetime income projections.

Outcome of review

A reduction in consumers' willingness to pay regularly brings about an **increase in the elasticity of demand** faced by firms, as consumers are less willing to accept higher prices to purchase from their preferred supplier.

Hence, the result of an economic crisis is often that **pre-merger closeness of substitution** between different brands increases. For a given number of firms, competition is more intense.

In such circumstances, any given merger is **less likely to impede effective competition** than would otherwise be the case.

Clearly, a key variable for assessment here is the **expected duration of the economic crisis**.

Outcome of review

When we are speaking of a **cyclical downturn**, such short-run effects on demand should be properly ignored.

In case of systematic crises (like the current one), by contrast, one simply **cannot apply the market share thresholds** that would be appropriate in times of imminent economic growth.

Effects-based merger control should therefore account for market realities.

The key question here is: does the merger create a market structure that is materially more concentrated than would be the case in a **long-run (sustainable) competitive steady state**?

Aegean/Olympic (2011)

Aegean/Olympic (2011)

This 2011 merger was supposed to combine two Greek airlines, leading to a **quasi-monopoly on numerous routes** from Athens.

On the face of it, the Commission's prohibition **appears obvious**.

However, other than in the case of *Lloyds TSB/HBOS*, it is much less obvious that the pre-merger market structure is a **sustainable (long-term) competitive equilibrium** going forward.

The economic crisis has fundamentally depressed demand in Greece, the parties suffer from lack of scale and have made **ongoing losses for years**.

Not surprisingly, this merger has very recently been **announced again**.

3. Are there any special implications for mergers in declining industries?

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Mergers in declining industries

When economies slide into recession, it is usually the industries which were facing commercial **distress already prior to the crisis** where commercial calamities surface first.

This is particularly the case for industries with **structurally declining demand** (such as paper, recorded music or print publishing).

In such industries, **structural overcapacities** force firms to adapt (from the supply side) to a new adverse situation on the demand side.

Viewed from the outside, this **adaptation often looks slow**, raising the question of whether commercial difficulties are mainly due to inflexibility and poor management decisions.

Mergers in declining industries

From an economic perspective, there is usually more to it, however, as transition to a new sustainable market equilibrium is often inherently **hampered by strategic incentives**.

Responding to a decline in demand through exit, plant closures etc. has the economic **nature of a public good**:

Capacity reductions exert a positive externality on competitors, so firms do **too little, too late** (in the hope that others downsize or exit first).

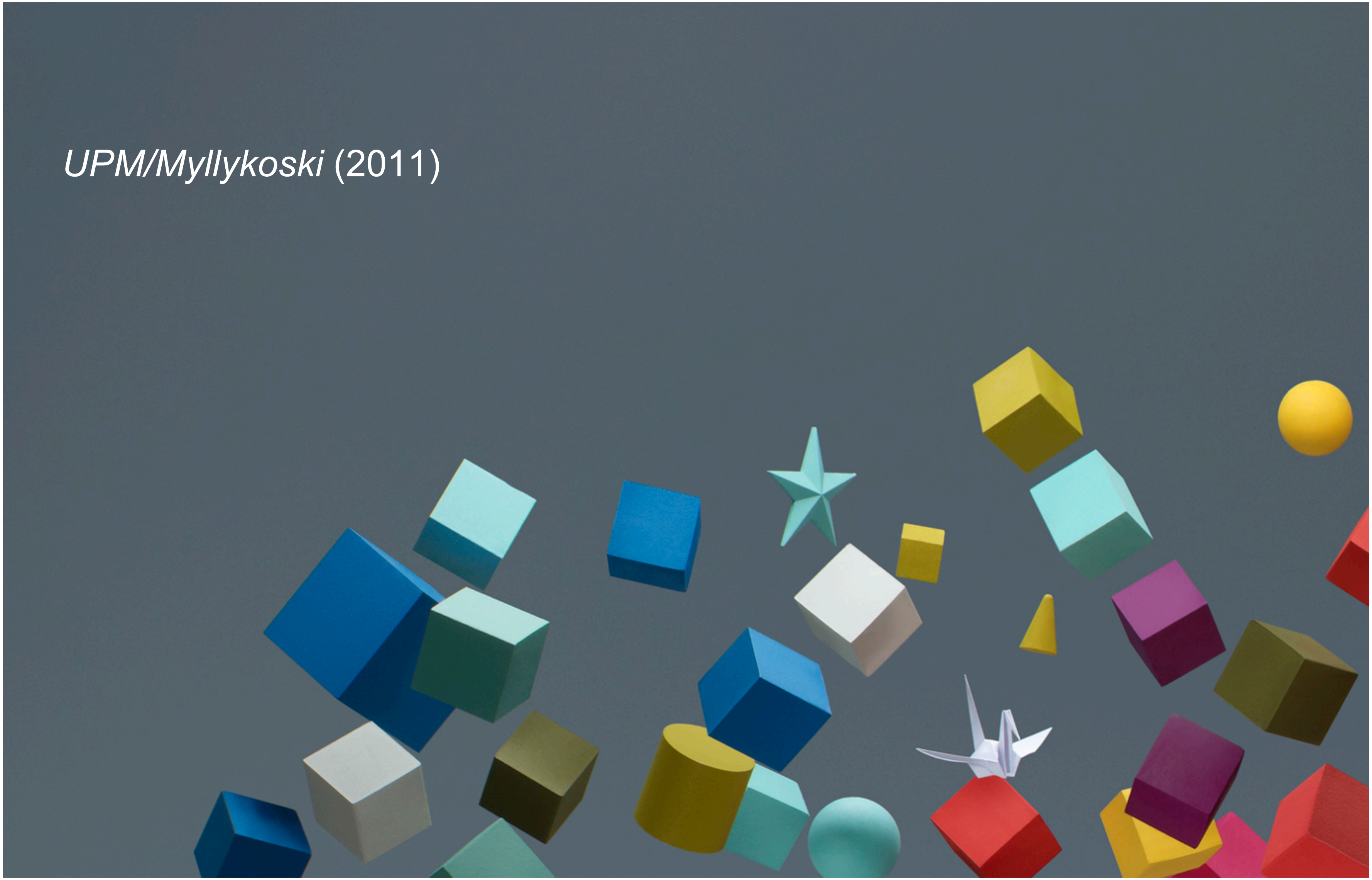
Mergers can then play an important role in **facilitating necessary consolidation measures** in a declining industry by enabling firms to engineer an efficient transition.

Mergers in declining industries

Some **specific considerations** should be taken into account:

- Due to inertia in transition and declining demand, mergers are **less likely to generate** excessive levels of concentration.
- When demand structurally declines, the **social trade-off** between price competition (calling for many firms) and scale economies (calling for few firms) must be rebalanced—a lower number of firms becomes optimal from the perspective of consumer welfare.
- Mergers often **facilitate transition to a new sustainable competitive equilibrium** and can make transition more efficient (e.g., through cost-based selection of plant closures).
- Ailing firms lose competitive strength, so a **merger may foster firms' ability to compete** (e.g., by improving access to investment capital or permitting better exploitation of scale economies).

UPM/Myllykoski (2011)



UPM/Myllykoski (2011)

This merger in the paper industry (which had been facing structurally declining demand and perpetual overcapacities) was permitted despite **substantial market share additions**.

The parties had submitted significant **efficiency considerations** (in particular relating to a more efficient selection of plant closures).

While the decision ignored those, it appears that they may have been **implicitly taken into account** (from the decision's vagueness of arguments, one suspects that this may not have been a clearance otherwise).

It is dangerous, however, to conduct effects-based analysis only implicitly, as this creates **case law that may haunt an authority later** (when similarly large market shares are added—but without efficiencies).

Conclusion

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Conclusion

Existing merger review standards are **generally well equipped** to deal with concentrations in times of crisis.

In EU merger control, **effects-based analysis contains built-in adjustments** for market specificities, which permit taking aspects such as depressed demand, higher price elasticities etc. into account.

The view I have proposed is to consider whether a merger leads to a substantial lessening of competition **relative to a long run (sustainable) competitive counterfactual**.

This implies that “quick fix” relaxations of antitrust should be avoided, but also that merger control **should not be in the way of an efficient transition** to a new steady state equilibrium resulting from demand decline.

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