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Competition Policy in Times of Inflation

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Competition Policy in Times of Inflation

By Richard May & Antonio Capobianco[1]

After years of appearing low and stable in many countries, inflation has recently risen across the developed world. The year-on-year percentage change in prices across the OECD for the second quarter of 2022 was nearly 10 percent.[2] This compares to an average of under 2 percent annual change in prices between 2016 and 2020 across the OECD. There are several undeniable contributing factors to this, including the disruptive effects of the COVID-19 pandemic on supply chains and on demand trends, as well as more recent geopolitical turmoil.

As in past occasions, competition authorities are likely to come under pressure from politicians and the media during times of rising prices with calls to act to protect consumers from the loss of purchasing power due to increasing prices, regardless of whether such high prices are the consequences of lack of competition or not.[3] Therefore, it is timely for competition authorities and for policy makers to consider the relationship between competition and inflation.[4]

While complex, considering such a relationship isn't novel. Over 50 years ago the OECD Council adopted a recommendation calling for increased competition enforcement as part of the fight against inflation. With persistent high inflation seemingly a thing of the past, in 2017 the recommendation was considered obsolete and abrogated.

Competition is an Important Long-term Driver in Lowering Prices

Competition affects prices and prices affect inflation. However, the relationship between them is not so straightforward.

Inflation is a macro, rather than micro, economic concept. It concerns the overall level of prices in an economy, rather than the prices of specific goods and services in economic markets. Monetary and, to a lesser extent, fiscal policy, are usually considered the main policy levers to control inflation, with many jurisdictions tasking central banks to meet inflation targets.[5]

Competition, on the one hand, affects outcomes in specific product and geographic markets, with ineffective competition enabling suppliers to raise prices above competitive levels. A reduction in competition across many markets in an economy could lead to higher prices generally. Inflation, on the other hand, does not measure whether prices are high.[6] Instead, it typically measures the annual percentage change in the average price level of an economy. High but stable prices mean low inflation and, conversely, competitive prices with regular supply shocks could lead to high inflation.

Inflation can be considered transitory if it quickly dissipates, for example if prices briefly rise steeply but then stabilize, whereas persistent inflation is more enduring, with sustained increases in prices. As an illustration, all else equal, a one-off increase in price due to a lessening of competition from a merger would create an, albeit small, effect on inflation that

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[2] OECD (2022), "Prices: Consumer prices," Main Economic Indicators (database), https://doi.org/10.1787/0f2e8000-en. The OECD-Total average inflation for the percentage change on the same period of the previous year for Q2 2022 was 9.7. The average annual inflation rate for the OECD-Total for 2016-2020 was 1.9 percent.

[3] See, for example, discussion in OECD (2012), "Competition and Commodity Price Volatility," http://www.oecd.org/competition (accessed on August 22, 2022).

[4] The topic of competition and inflation was recently the subject of policy roundtable at the OECD, with a background note prepared to aid the discussion. Details can be found here: https://www.oecd.org/competition/competition-and-inflation.htm.

[5] It is worth noting that central banks typically have no means to control the level of competition in an economy yet are generally held to account to meet inflation targets.

[6] The concept of a "high" price can be difficult to define. Here, a price is high if it is substantially above the price that one would expect in a well-functioning competitive market.

year and have no inflationary impact in the future (assuming all the acquired market power from a merger led to a direct increase in price rather than phased over time). The price increase is a one-off impact on inflation.[7]

So how could the two be related?

It is worth distinguishing two separate mechanisms through which competition could affect inflation. First, reductions in competition across the economy over time could lead to price rises in the relevant markets, together becoming inflation. Second, as competition affects the functioning of markets, the level of competition may contribute to higher or lower inflation. Put another way, holding other facts constant, would varying the level of competition lead to higher or lower levels of inflation over time?

The importance of distinguishing between these two points is to highlight that, even if the current inflationary period is not the result of competition issues, it does not mean that ensuring a competitive economy is not important for controlling inflation over the longer term. Competition may be a necessary, but not sufficient, condition for a stable inflationary environment.

In considering the relationship between competition and inflation, it is important to remember that the dynamics of inflation are complicated and addressing them, or even fully understanding them, is unlikely to be a requirement for competition authorities. Despite this, inflation is on the rise and so it is worth considering the role of competition in contributing to this.

While there is some evidence that competition may be decreasing overall on a global level, this in itself is not the primary cause of the current inflation, at least not directly. Numerous studies point to declining competition, but this trend has been unfolding for decades. It seems implausible that competition has suddenly hit a critical point across so many different markets to drive the inflation on its own.

However, competition may have had a minor role in exacerbating inflationary pressures, with some recent research suggesting that reductions in competition could be responsible for higher rates of cost pass-through and corporate profits, exacerbating some of the inflationary pressures. There seems to be at least an argument that inflation might be somewhat lower if markets were more competitive, but whether this effect would be significant, and how much more competitive they would need to be to make a difference, is difficult to say.[8]

Beyond the current inflationary environment, competitive markets are vital to well-functioning economies, and this includes a contribution to lowering inflation. Numerous empirical studies support this relationship and there are several

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[7] Of course, for most markets, even large increases in price would register as only minor increases in the overall inflation rate of an economy.

[8] For example, a recent paper by researchers at the Federal Reserve Bank of Boston suggests that more costs are passed through in concentrated industries. See Bräuning, F. et al. (2022), Cost-Price Relationships in a Concentrated Economy, Federal Reserve Bank of Boston Research Paper Series Current Policy Perspectives Paper No. 94265, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4118181. Using data on industry-specific cost shocks to control for the fact that many shocks affect both costs and prices, the authors consider how changes in concentration levels within industries, measured by the Herfindahl-Hirschman Index, affect how these shocks influence prices. Their results suggest a significantly higher rate of pass-through from cost shocks in concentrated industries. Specifically, they suggest that a reduction in competition akin to their estimated increase in concentration in the United States between 2005 and 2018, results in 25 percentage points higher pass-through of a cost shock for nine months.

There has also been some evidence to suggest that profitability has increased for some firms alongside inflation, suggesting that a purely cost-based explanation is unlikely. See Konczal, M., N. Lusiani & R. Institute (2022), “Prices, Profits, and Power: An Analysis of 2021 Firm-Level Markups.” That said, the supply-side factors are clear. Overall, it appears hard to argue that the effect of competition in exacerbating the current situation is substantial, particularly in the short-term, given the significance of external factors.

supporting theories for how this mechanism occurs.[9]

First, competitive markets are more productive, innovative and flexible. This makes them better placed to deal with supply shocks, and over time put downward pressure on prices. Further, competitive markets produce more than markets with ineffective competition. This can reduce the "output gap" in an economy, reducing the harmful effects to inflation of growth chasing monetary policy. There is also evidence from researchers at the IMF that more competitive markets improve the effectiveness of monetary policy, as firms with substantial market power are less susceptible to changes in financing costs.

Bottom line, there appears to be a strong basis to think that supporting competitive markets will have an overall beneficial effect on inflation. This is an important message for the competition community to consider.

It is worth noting however, that this relationship does not imply that competition is a key factor in determining inflation and, perhaps crucially, focuses on the long-term relationship between the two. Improving competition across economies should lead to lower inflation than otherwise, but competitive markets will not guarantee low inflationary environments by themselves.

Competition Policy will not Bring Inflation Down Alone or Overnight

If competition does have a link to inflation, what does this mean for competition policy? As noted in the OECD's 1971 Recommendation, competition policy is unlikely to be the most prominent anti-inflation tool used by governments. It does not follow, however, that competition policy has no beneficial effects on inflation. The recommendation noted that effective competition policy is one important factor in achieving economic growth and price stability and that, through its effects on costs, prices, and margins, competition can contribute to the fight against inflation. It is noted that the impact of competition policy is usually apparent in the long-term, suggesting that fiscal or monetary policies will be more immediate.

Does this mean there is absolutely no short-term role for competition policy in times of high inflation? Perhaps so. After all, competition policy increases competition and lower prices. For example, analysis by the European Commission suggests that competition policy enforcement reduced the overall price level in the European Union by an average of 0.63 percentage points per year over the period of 2012-2020.[10]

Lowering prices offsets inflation, although it is important to note that while the size of this effect is impressive, it suggests that one should be cautious in setting expectations that competition policy will be able to have a meaningful impact on bringing inflation down in the short-term. Clearly the impact of any individual piece of enforcement will be much lower.

As well as the size of any pricing effects, another important point to consider is that even if competition were a factor in the current inflationary trends, competition policy takes time to implement. There are three aspects to timing:

a) Time to reach decisions, including identifying a potential issue and commencing the investigation or action.

b) Implementation time for any remedies or outcomes.

c) Time for the effects of remedies and outcomes to occur.

[9] For example, see Hosny, A. (2014), "Product market competition and inflation persistence," Contemporary Studies in Economic and Financial Analysis, Vol. 96, pp. 211-219, https://doi.org/10.1108/S1569-375920140000096008/FULL/XML; or Duca, J. & D. VanHoose (2000), "Has Greater Competition Restrained U. S. Inflation?," Southern Economic Journal, Vol. 66/3, p. 729, https://doi.org/10.2307/1061435; or Andrews, D., P. Gal & W. Witheridge (2018), "A genie in a bottle?: Globalisation, competition and inflation," OECD Economics Department Working Papers, No. 1462, OECD Publishing, Paris, https://doi.org/10.1787/deda7e54-en.

[10] See EU, D. (2022), Modelling the macroeconomic impact of competition policy: 2021 update and further development, Directorate-General for Competition; Directorate General for Joint Research Centre; Directorate General Economic and Financial Affairs, https://competition-policy.ec.europa.eu/system/files/2022-03/kdaq22001enn_macroeconomic_impact_of_competition_policy_2021.pdf (accessed on September 19, 2022).

While making robust and procedurally sound decisions as quickly as possible will be the aim of all authorities, this does not change the fact that making decisions takes time. This is notwithstanding the time it takes for any decision to have an effect. As an example, analysis by the OECD Competition Division's Competition Enforcement Trends work suggests that the average duration for an international cartel investigation is 2.8 years.[11] This is however a significant decrease in length, having averaged over 3 years until the early 2000s. It would seem optimistic however to predict that the timeframe could be shortened drastically in the future.

Taken together, this suggests caution in considering the potential role for competition policy as a short-term anti-inflationary tool.

What Can be Done?

Many authorities and policy makers will likely question the need for any changes in the face of high inflation.[12] Indeed, there are perhaps good arguments that this is as it should be; if there is nothing wrong with the current approach, then why should it change?

In general, any changes competition authorities might wish to make to their approach are likely to be minor by nature. Further, they can be considered reactions to the times rather than changes in approach. Certainly, long-term priorities should not be abandoned.

As discussed in detail above, the main benefits of competition policy in bringing down inflation is through the promotion of competition generally over the longer-term. Drastic change is therefore unlikely to be needed. In this respect, competition policy should be considered as a longer-term anti-inflationary tool even when conducted in a "business as usual" capacity.

In many respects then, competition authorities can continue as they have before, prioritizing across a range of actions, such as advocacy and enforcement, for the long-term benefit of competition. The sections below discuss additional factors that may be worth considering, on the margin, in the context of high inflation.

In times of high inflation, when contemplating complex decisions between prioritization of different actions, authorities may wish to consider some increased preference for intervention or action against:

a) Sectors that have a large effect on inflation, or where price reductions would have a meaningful impact on bringing inflation down. While this will likely seem business as usual, this suggests giving slightly more priority to interventions in larger sectors directly, rather than in interventions that are aimed to deter a wider set of conduct.

b) Sectors with spill-over effects, such that increased competition could have effects downstream as well. Analysis by the European Union notes that sectors with strong downstream links are likely to result in stronger spill-over pricing effects, and notes that industries such as finance, insurance and business services, resource extraction, the energy sector, basic manufacturing, and aspects of the transport network, are sectors that might elicit strong spill-over effects.[13]

c) Conduct that, if prevented, would impact sooner rather than later on prices rather than on other competitive factors, such that the benefits to consumers can be felt as soon as possible. For example, considering conduct related to price, rather than that focused on other dimensions of competition. Looking at such conduct is more likely to have a pricing effect.

d) Sectors that may provide particular benefits to consumers if prices could be reduced, for example if a relatively small sector

[11] OECD (2020), OECD Competition Trends 2020, https://www.oecd.org/competition/oecd-competition-trends.htm.

[12] See for example the note from the Portuguese Competition Authority on its response to inflation. Autoridade da Concorrência (2022), "Competition and purchasing power in times of inflation."

[13] See EU, D. (2022), Modelling the macroeconomic impact of competition policy: 2021 update and further development, Directorate-General for Competition; Directorate General for Joint Research Centre; Directorate General Economic and Financial Affairs, https://competition-policy.ec.europa.eu/system/files/2022-03/kdaq22001enn_macroeconomic_impact_of_competition_policy_2021.pdf (accessed on September 19, 2022).

nonetheless attributed a significant amount to the cost of living for vulnerable consumers.

e) Conduct that is particularly related to inflation itself, such as coordination of price rises. Acting against such conduct could provide deterrence against others following suit.

Action in Times of High Inflation

There may be some risks that competition authorities should be wary of during times of inflation, and these may also contribute to their mix of activities.

In an inflationary environment it is likely that both businesses and consumers will expect price increases. This mutual understanding could provide an increased risk of coordinated action between firms, even without a traditional cartel. Of course, a desire to coordinate and communicate could lead to open, and illegal, discussion and agreement on prices or other factors. Most firms will be aware of the potential costs of being caught and, hopefully, be sufficiently deterred. For example, there is a risk that industry organizations or trade associations could play a role in facilitating the conditions for collusive behavior.[14] These organizations have the potential to play an important and positive role and, in the present context of rising cost pressures, may be especially needed now. However, there is the potential that information exchanged during these meetings can be used to align price increases.

Further, and potentially of highest concern during times of inflation, firms may seek to use public announcements to signal their desire to increase price and use this to find a mutual understanding with competitors. Pricing announcements could be made through press releases or interviews, wide emails to customer lists, or even on earnings calls. Some economists have described earnings calls as a common tactic for coordinating. In an inflationary environment, there may be a desire by firms to communicate pricing with consumers, and it is important that authorities are able to distinguish between genuine public announcements and those made with the intention of forming a collusive outcome, or mutual understanding or agreement.[15] This may not always be straightforward.

Another issue to consider is how inflation affects consumers.

Prices that change regularly require consumers to frequently access pricing information to make informed purchasing decisions. Obtaining pricing information is likely to be costly for consumers, and these search costs will lead to consumers having lower quality information on prices. There may also be reasons that they do not choose to engage in those costs if they perceive limited value in doing so, for example if they have a general perception that all prices are rising and there are therefore limited gains to be made by exerting switching effort.

If consumers are less aware of prices, this reduces the incentive for firms to reduce prices. This is because reducing prices has two opposing effects: firstly, a reduction in per unit profit due to the lower price and secondly, higher profits due to more sales as customers switch to the now lower priced product. For firms to have the incentive to lower prices, this second effect needs to outweigh the first. This is less likely as consumers become less well informed about prices.

There is evidence to suggest that high search costs lead to increased profits for firms in the face of inflation.[16] More generally, there has been significant study of the relationship between inflation and relative price variability, although the evidence overall appears to be mixed.[17] Relative price variability can be one measure of increased search costs as, all things

[14] OECD (2008), Trade Associations, OECD Competition Division, http://www.oecd.org/competition (accessed on October 17, 2022).

[15] OECD (2012), Unilateral Disclosure of Information with Anticompetitive Effects, OECD Competition Division, https://www.oecd.org/daf/competition/Unilateraldisclosureofinformation2012.pdf (accessed on October 17, 2022).

[16] Gwin, C. & B. Taylor (2004), "The Role of Search Costs in Determining the Relationship between Inflation and Profit Margins," Journal of Money, Credit and Banking, Vol. 36/1, pp. 139-149, https://ideas.repec.org/a/mcb/jmoncb/v36y2004i1p139-49.html.

[17] Siklos, P. et al. (2018), "The Anatomy Of Inflation: An Economic History Perspective," CAMA Working Paper No. 8/2018.

equal, it implies that consumers are not taking advantage of potential price reductions.

Authorities may therefore wish to consider how consumer search costs could be eased in a high inflation environment and be concerned about firms not providing easily accessible information to consumers. It is worth noting here the careful balance between this and the potential for price announcements to be used to facilitate collusion discussed above.

Not All Roads Lead to Enforcement

Authorities should also consider the need for advocacy.

At the outset, there may be a role for advocacy aimed at reducing the risk that competition policy is seen as a short-term anti-inflationary tool. As discussed above, there are limits to the role that it can play, and it is important that policy makers understand these limitations. To the extent they can, authorities may be able to highlight these limitations, whilst being clear of the steps that are being taken.

In this regard, as noted in the introduction, attention may turn on competition authorities during periods of high inflation. While a lot of this attention will be to put pressure on the authority to act, with competition in the spotlight, it also provides a potential opportunity to advocate for the importance of competition generally.

There could be several elements to this. It could provide an opportunity to explain the work of the authority and how this contributes to society. For example, an authority may wish to draw attention to work that it has undertaken over recent periods and the benefits of that work. An important tension to manage is expectations on short-term results regarding inflation and longer-term effects. While a difficult message to get across, given the opportunity, it may well be worth trying.

With high inflation leading to rising prices, governments may be considering the adoption of various forms of price control regulation. Price control regulation has the potential to deliver benefits in some circumstances, but also risk undermining competition. It is important that price controls, especially if implemented temporarily, are not also a means of making sensitive business information public such that coordinating with rivals becomes easier in the future.[18]

The second type of advocacy work that could be particularly relevant to times of high inflation is advocacy that seeks to improve competition in a particular sector. For example, this could take the form of market monitoring or market studies. Market studies or probes can help understand the extent to which inflationary pressures are related to competition issues.[19] Even if limited in scope and with an accelerated pace, while they may be faster than some forms of enforcement action, they are unlikely to lead to fast resolutions since even fast studies often require governments to implement any recommendations. Nonetheless, factual market studies can provide a straight-forward way to study a sector and understand the causes of any increases in price, including whether there are any competition issues in the sector or potential breaches of competition law.[20] This can be particularly useful if authorities are under pressure to act but are unsure as to the cause of potential issues.

Conclusion

Ultimately, the dynamics of inflation are complicated and competition authorities do not need to fully understand how competition contributes to it. There are good reasons to consider competition an important contributor to a long-term low inflationary environment, both in terms of reducing the exacerbating effects of market power on rising costs and in overall better market functioning.

Despite this, competition policy should not be seen as a prominent short-term anti-inflation tool. Competition interventions take time, both to assess and implement, limiting their ability to

[18] Autoridade da Concorrência (2022), "Competition and purchasing power in times of inflation."

[19] OECD (2018), Market Studies Guide for Competition Authorities, http://www.oecd.org/daf/competition/market-studies-guide-for-competition-authorities.htm.

[20] OECD (2012), Competition and Commodity Price Volatility, http://www.oecd.org/competition.

impact pricing level in the short term. Further, despite having the potential to reduce prices significantly, competition enforcement is unlikely to be capable of reducing prices substantially enough on its own. Interventions typically focus on a few markets, meaning that even strong price reductions will have limited impact on the overall price level.

In many ways, the wording of the 1971 OECD Recommendation appears equally valid today. Competition is vital for a low inflationary environment and competition enforcement should be prioritized, but not at the expense of fiscal or monetary policy. To hold weak competition accountable for general inflation is likely to be both unrealistic and unproductive.

Competition authorities should, however, consider how best they can play their important, but lower-key, role in restoring inflation to normal times. This includes being aware of how inflation may affect competition itself. Given inflation affects pricing, it could increase the risk of coordinated price announcements from firms, as well as undermining competition by raising consumer search costs.

Further, while for the most part it may be business as usual for authorities, it is worth considering how their mix of work might best contribute to lowering inflation. For example, there may be merit in minor changes to how different potential sets of action are prioritized. This should not be seen as a significant departure from usual, but authorities may wish to consider placing more emphasis on actions that induce faster pricing effects, have spill-over effects in as many markets as possible and seek to deter conduct that appears to exacerbate inflation.

Advocacy and enforcement activity from authorities may also need a revised focus. This includes being aware of risks to competition from government interventions, such as price controls, as well as being wary of certain kinds of conduct, such as coordinated price announcements. It is also worth considering how pressure on competition authorities to act on inflation may provide an opportunity to pitch the benefits of competition to a wide audience. This could include a suitably cautious note about the importance of competition policy in fighting inflation over the longer term.