EEI POLICY PAPERS

Europe - a Force for Free Competition?

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European
Enterprise
Institute

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A Word From the Publisher

During the economic and financial crisis, many have criticized the market economy. The crisis has been blamed on economic freedom, on increased globalization and in particular on de-regulations during the last decades. This is a view which is not supported by many facts. The banking crisis started in the highest regulated part, whereas the least regulated financial institutions, such as Hedge Funds, did not cause the problem. On the contrary: Monetary policy, low interest rate, flush liquidity and government interventions in the US housing market are core causes. One of the deeper roots of this crisis of is the huge global imbalances following the growth of world GDP in the last 20 years which the financial institutions could not cope with.

There may be de-regulations that go wrong and this will happen again, but freedom is not to blame for the crisis. In fact, the globalised economy has brought tremendous benefits for the world and has lead to the strongest poverty reduction in our known history. Now, we need to see how economic freedom is essential for the world and in particular for Europe to emerge from the crisis.

This Policy Paper, written by economist Stefan Karlsson, describes the benefits derived from globalization – and shows why we need more of it. Globalization will go on. The question is whether Europe will benefit from it in the future or if only other parts of the world will.

Peter Jungen

President, European Enterprise Institute

Introduction

Much of Europe is now in a deep economic crisis. Some of it is clearly cyclical, reflecting not only the global ripple effects from the U.S. economic crisis but also the bursted housing bubbles in countries like the U.K., Ireland, Spain and the Baltic states and the negative effects this in turn has had on the countries who trade with them and whose financial markets that are integrated with them. It shouldn't be denied that this is clearly a serious crisis, which may linger on for awhile.

But cyclical downturns eventually end, so in the long run, structural factors are more important. But for many European countries, the problems aren't just cyclical. Even at the peak of the cyclical boom, many Western European countries found it difficult to grow more than 2% a year. While some would argue that this reflects that they are so rich that they can't grow much more, many high income countries inside and outside of Europe have in fact had persistent (albeit sometimes interrupted by cyclical slumps) high growth, including for example Hong Kong, Singapore, New Zealand and Ireland.

There are many reasons why these countries have had particular success, but one key factor that strikes out is that all of them have had very strong commitment to the principles of free competition, free trade and globalization. One big danger with the current slump is that politicians will fall for the temptation of restricting competition, globalization and trade in the belief that this will help their economy at the expense of others, so-called beggar thy neighbor policies. This was exactly what happened in the 1930s when U.S. politicians passed the Smoot-Hawley tariff bill, something which provoked retaliatory actions from other countries and thus resulted in a global trade war-a war which will only produce losers. Similarly, country after country engaged in currency devaluations intended to subsidize its tradable goods industries at the expense of other countries.

We are already seeing many distressing signs that politicians are repeating the mistakes of the

1930s. In the United States, the stimulus package contains provisions to "buy American". We are seeing many countries which directly or indirectly try to push down the value of their currencies at the hope of gaining at the expense of others. And many leading pundits, such as Ambrose Evans-Pritchard at *The Telegraph* are calling for some euro area countries to leave the monetary union and reintroduce a devalued currency[1]. And country after country is introducing subsidies to troubled industries, most notably the financial industry and the car industry that distorts free competition. France has gone furthest in this respect and not only provided subsidies for its car industry, but attached the condition that no car company receiving those subsidies can close plants in France, with French president Nicolas Sarkozy suggesting that they should instead close plants in the Czech Republic[2].

Given how the principles of free competition and free trade are under increasing attack by short-sighted politicians who falsely believe that these principle are an impediment to economic recovery, it is therefore vital to state the case of why these principles are so important.

[1] http://www.telegraph.co.uk/finance/globalbusiness/4285331/Help-Ireland-or-it-will-exit-euro-economist-warns.html
[2] http://www.bbc.co.uk/blogs/thereporters/markmardell/2009/02/summit_to_bash_sarkozy.html

1.1 Introduction

Free competition is a principle which most people as a general rule tend to support. But they only rarely seem to understand why it is a good principle, and partially as a result of this, they usually do not support it in practice on all issues. Because of this, it is important to understand just why free competition is a good and important principle.

1.2 The Effects of Competition

The neoclassical school views competition to be a matter of different equilibrium states. The most basic equilibrium model upon which the others are based is the equilibrium known as Perfect competition. The perfect competition model is based on a number of assumptions, including firms being profit maximizing, the absence of entry or exit costs, homogeneous products and perfect information. Another key feature of the model is that all firms are price takers who face a horizontal demand curve. What that means is that they raise the price, no one will buy their products. It also means that of one company lowers the price, then everyone will buy from it unless the other companies follow suit. It also implies that a company can increase its production without having any effect on the price. This last point is quite crucial for reasons which will be apparent later.

The perfect competition model however contains many problems. Because it is often used in a way which ignores necessary fixed or semi-fixed costs for firms, it is sometimes used to misleadingly suggest that government price regulation or anti-trust regulation can improve market outcome. Because this point is not very relevant for this report, I will not elaborate upon it here, but I have elsewhere provided an example of it in the case of minimum wage legislation[3].
Related to the first problem is that it contains assumptions which in most markets are obviously unrealistic. For example, companies regularly try to differentiate their products and make their particular brands appear unique. Moreover, there are usually some forms of exit and entry

[3] http://stefanmikarlsson.blogspot.com/2009/07/can-higher-minimum-wages-increase.html

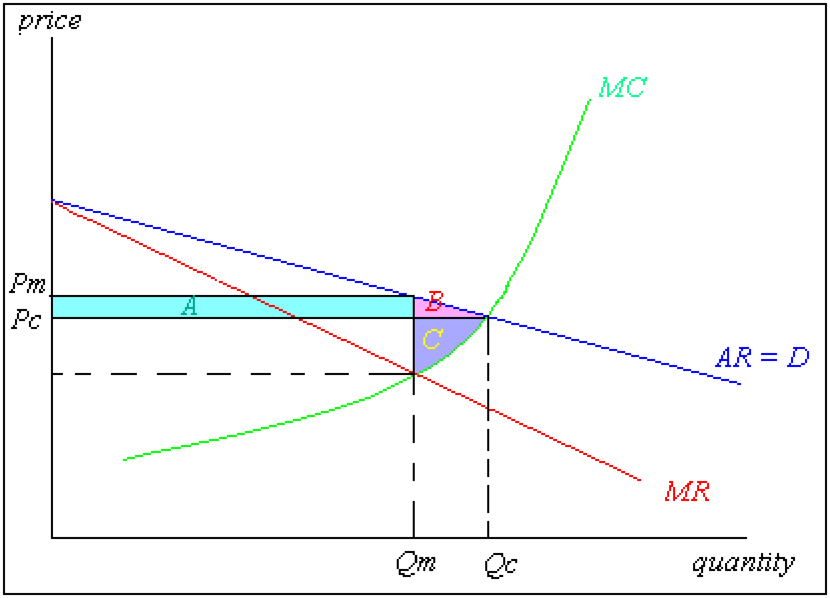
costs, some of which are created by government regulation and which are quite significant in many sectors. In addition, many sectors are dominated by just a few companies. As a result, the perfect competition models are misleading and unrealistic when it comes to describing real world markets. Instead, alternative models with more realistic models have been developed. But if perfect competition models are so unrealistic that virtually no real world markets live up to it, why do economists keep teaching it? The reason for that is that it describes an ideal state where maximum economic efficiency is achieved, and thus explains why we should work to come as close to that ideal as possible.

But given these problems with the model why should it be considered ideal with perfect competition? The reason is that in the abscence of it, assuming the problem of fixed and semi-fixed costs is taken into account there will be unrealized gains of trade. And the reason for that is that if companies do not face a horizontal demand curve, then if they decide to increase output, this could lower the price they receive for their products. And since price discrimination is often difficult in practice, this would imply not only a lower price for the additional products they sell, but also a lower price for the products they produced before that production increase. The lower price for the previous production level means that revenue falls. This in turn implies that the additional revenue that companies will receive if they increase production, what economists likes to call the marginal revenue will be lower than the price the new customers pay.

For society, this is not a loss as the loss for the company will be compensated by how previous customers will see their purchasing power rise. And as the new customers will receive products they consider to be worth more than the price they paid for it, society as a whole will gain. But since, again, the company will lose and since the company will avoid any strategy which will cause them losses, this means that they will not lower the price which in turn means that the potential gains that could be made will not be realized. This situation shows that what economists call positive externalities will exist. The concept of positive externalities means that certain actions will bring benefits to others, but as many individuals or companies will only look after their self-interest they will overlook these benefits to others and so in many cases abstain from actions that will increase overall economic utility because that increase only goes to others.

If for example a car company that produces a million cars at a marginal production cost of €8,000 per car and sells it for €10,000 decides to reduce its price to €9,000 because it reckons that they'll still make an additional €1,000 per car when they sell to the 200,000 customers that are only willing to buy it if it costs €9,000 (plus a little extra in consumption taxes and car dealer margins). In this case, the previous million customers gains €1 billion from a lower price, the value of the new customers of the cars will be €200 million more than the cost of producing the cars. For the company however, its revenues will rise from €10 billion to €10.8 billion, while the cost of production will rise from €8 billion to €9.6 billion. As revenues because of the lower price for previous customers only rose €800 million thanks to the 200,000 extra cars, the marginal revenue was only €4,000 per car, lower than not only the price of €9,000 but also the cost of production of €8,000. As a result, the company actually lost €800 million from the price cut. Yet as that €800 million loss is lower than the total concumer gain of €1.2 billion, society as a whole would have seen its wealth rise €400 million.

This can also be illustrated in a chart



In a perfectly competitive market, the price would have been Pc and the quantity produced would have been Qc. But in a imperfectly competitive market, where marginal revenue is lower than prices, the price will instead land at the higher level of Pm while quantity will be at the lower level of Qm. For producers, the gains from the higher price consist in the ”A”-area while they lose the smaller potential gains in the ”B”-area. Consumers for their part will lose both the potential gains in the C-area and in the ”A”-area. The ”A”-area thus simply represents a redistribution from consumers to producers, while the ”C” and ”B”-areas represents economic efficiency-losses.

Generally speaking, the effect that increased output will have on price increases as the size of the company increases. This is because a given percentage increase in sales for a large company is bigger relative to the total market than the same percentage increase in sales for a small company, and all other things being equal a greater increase in supply will depress the price more.

The conclusion then is that it would be better for economic efficiency if companies were really small so that their production plans would have no effect on the price of their products. That would provide an argument not only for breaking up any legal monopolies and priviligies, but also to enact draconian anti-trust laws which would forcibly reduce the size of many companies.

1.3 Policy Implication For Competition Policy

While most economists would recognize that the neoclassical model has a limited value in identifying how the distinction between price and marginal revenue creates potential economic inefficiencies, many would also recognize how other factors imply that draconian anti-trust laws may not be best for economic efficiency. The reason is the phenonemon known as economies of scale. That means that larger companies will generally be more efficient. The reason for this is that most production involves some form of fixed costs. And fixed costs per produced units will fall as it is divided by a larger number of units. This is of course particularly true in very capital intensive sectors like the automobile sector.

If legislators decided that only small businesses with two or three persons were allowed to produce cars, then cars would cost as much as hundreds of millions, or even billions, of euros per car to produce given the enormous amounts of money that it costs to build car factories, buy all the necessary equipment and raw materials and work on the actual construction of the cars. Not to mention of course, the amount of money it takes in research and development for new car models and features. But with such high costs, almost no one would be able to afford cars and economic efficiency would clearly be far lower, not higher because of the forced break up of large companies. This example might seem a bit extreme, but the logic really applies to all sectors: namely the logic that benefits from economies of scale usually outweigh the negative effects of having marginal revenue below the price for many companies.

Another way in which anti-trust laws could have negative effects is that large companies may be hesitant to expand their capacity and improve their offers to consumers is that they fear that authorities will break them up if they become too big.

But while it is not certain whether the positive effects of increased competitive pressure from enforcing anti-trust laws outweigh the negative effects of reduced economies of scale, what can be certain is that free competition will have positive effects. B free competition, I mean removal of legal monopolies or other forms of legal restrictions to competition. This stands in contrast to anti-trust laws which constitute legally coerced competition.

But why should this be different from the issue of anti-trust laws? Couldn't removal of barriers to competition similarly lead to losses in economies of scale that could to some extent cancel out the positive effect of increased competitive pressures?

No, and the reason for this is that here any reduction in company size will be the result of market processes rather than government fiat. The relevance of this is that smaller companies will only out-compete the larger ones if they have some kind of other advantage that compensates for the lack of economies of scale. For example, Swedish fast food chain Max was able to out-compete its much larger American adversary McDonald's in Luleå and once also in three other northern Swedish cities: Umeå, Skellefteå and Piteå[4], despite the much larger marketing resources of McDonald's and its bigger distibution chain. This was mostly because Max was much better in touch with the preferences of burger consumers in northern Sweden, something which compensated for the economies of scale advantage of McDonald's.

Sometimes for various reasons, including cronyism, complacency or out of touch management, large companies do not act as efficiently as they should. In the absence of free competition, that will leave the consumers and the overall economy helpless in terms of the effects of that. But with free competition, independent entrepreneurs unable to get any executive role in the larger company can start business of their own that take advantage of the opening created by incompetence in the larger company.

[4] http://www.aftonbladet.se/matvin/article1313686.ab

By contrast, any reduction in company size created by the enforcement of anti-trust laws will happen not because the larger company has been unsuccessful in providing value to consumers, but often in fact because they have been too successful in providing value to consumers, as has been the case, for example, with the various law suits against Microsoft on the basis that it has provided consumers with the convenience of a web browser built in to the operating system. And as that example illustrates, free competition will provide a competitive check anyway. Netscape which tried to fight Microsoft with the help of anti-trust authorities eventually died out, but for example Linux provides a competitive check on Microsoft when it comes to operating systems. Similarly Chrome and Mozilla Firefox have challenged Internet Explorer when it comes to web browsers.

Thus, anti-trust laws provide, at best, only small benefits in terms of increasing competitive pressures and even these benefits are counteracted by decreased company efficiency. By contrast, free competition will not only increase competitive pressures, these effects will be reinforced (and not counteracted) by increased company efficiency.

2.1 Introduction

The point of the first chapter was that free competition will always serve to maximize economic efficiency both because it means that the companies that provide the best value for consumers (or other producers) and that it also means that the difference between price and marginal revenue will be smaller, and so increasing the incentive to expand production. In this chapter, I will demonstrate just how globalization means a deepened level of free competition, by examining more of the benefits of free competition, whilst refuting some of the common objections to free competition over borders.

Globalization means that the scope and depth of globalization is greatly expanded. Indeed, in some sectors it is hardly meaningful to even talk about free competition. This can be analyzed from several different perspectives.

2.2 Economies of Scale & Globalization.

To understand the importance of globalization in increasing the potential advantages of economies of scale, we should recall the discussion we had in the previous chapter about just how expensive it would be for single individual firms to produce cars. For a single individual to build a single car would take years of education and efforts and at least hundreds of euros in equipment and input. Including the opportunity cost of not working with other jobs, the total cost would be several hundreds of thousands of euros. Compare that to the cost of modern cars of €10,000 to €20,000 for the more regular models now that cars are produced in large companies with tens or hundreds of thousands of employees.

It should be evident that simply working together with one person can reduce the cost per person for producing one car for each person. That way one person can concentrate on learning some of the aspects of building a car, while the other person can concentrate on learning the other aspects, cutting the time spent on education in half. Moreover, as they can share equipment, the cost of equipment is also cut in half. Even input costs can probably be reduced as it is usually cheaper to buy in large quantities[5].

The same logic that applies to the move from a one man company to a two man company applies also to a move to three or four persons as that enables further specialization in terms of learning tasks and sharing equipment and so reduces the cost of education and equipment per person. And it similarly enables even the purchases of even larger quantities, and so reducing the per capita cost further. This logic really applies to any expansion of quantities, and so is the basis of economies of scale.

What does this have to do with the issue of globalization? It is very much related to the issue of globalization as it expands the number of potential customers and so enables greater production volumes. If for example Swedish drug maker Astra (now merged with British drug maker Zeneca to form Astra Zeneca) could have only produced drugs for the Swedish market for a disease that affected 1% of the population then there would only be a potential market of only about 90,000. With such a small customer base, only very low research and development spending can be justified. If however Astra could sell in the European market, then the potential customer base would rise to about 5 million, potentially making research and development spending more than 50 times larger potentially profitable. And if it could be sold on the global market, then the potential customer base would rise to 67 million. Even if we exclude some countries that don't respect patent rights or where people can't afford it, we would still be talking about tens of millions of potential customers, compared to the 90,000 they would have if they had been limited to Sweden, enabling R& D spending several hundreds times larger to be profitable.

Note that this doesn't just apply to R & D spending. It applies to all forms of fixed costs. The greater the market, the lower fixed costs per unit produced will be and as globalization means

[5] It may be objected that discounts at large quantities is merely a sales strategy and so does not produce any economic efficiency gains. Yet this overlooks how large quantities increases the ability of sellers to gain from economies of scale and further makes demand more predictable.

that markets become bigger, globalization implies that production efficiency will increase.

To some extent, the potential for increased economies of scale from globalization will be limited by the fact that the number of competitors will increase. For example, while Swedish car makers Volvo and Saab can expand their production capacity through exports, their domestic market is seemingly undercut by the imports of cars. And as Swedish imports of cars are nearly as great as Swedish exports of cars, it might appear to some that there won't be any significant gains from globalization. After all, if both exports and imports of cars are stopped, then they would be able to produce almost as many cars as they are producing now.

Yet this overlooks two key points. First of all, even if we don't gain very much from increased economies of scale we would gain from increased competitive pressure. As was noted in the first chapter, a higher level of competitive pressures will produce economic gains by reducing the gap between marginal revenue and price and by increasing the pressure to improve productivity. A study by the Dutch statistical authority found a positive correlation between the extent of foreign competition (as measured by the share of imports) and productivity growth in that sector[6].

So in other words, globalization will either mean increased economies of scale or increased competitive pressures or a combination of the two. Whatever the case, globalization will mean higher economic efficiency.

Moreover, by both importing and exporting cars, Swedes and others get a greater variety of brands allowing greater satisfaction of different preferences. Some consumers want luxurious cars and can so choose to buy cars like Maserati and Porsche. Others, like large families, want big cars, like SUV's and so they can buy for example Hyundai Santa Fe or Toyota RAV4. Other consumers value safety most, and so choose for example larger Volvo cars. Other consumers want cars with minimum carbon emissions so they can buy for example Toyota Prius. Yet for others a low price is most important so they can buy for example Skoda cars.

[6] http://www.cbs.nl/en-GB/menu/themas/macro-economie/publicaties/artikelen/archief/2008/2008-2613-wm.htm

Had car makers been confined to their home market, it would have been difficult or impossible to justify the high research and development costs needed to develop this large variety of cars that cater to so many different preferences. Assume for example that 10% of car buyers want to buy cars with particularly high levels of safety. Had Volvo and Saab been able only to sell in Sweden, where roughly 300,000 cars were sold in 2007[7] then this would limit the potential market for high safety cars to 30,000 per year. Given the high cost of developing new car models, it would be impossible to justify such investments. But if they're allowed to sell on the global car market of 55 million in 2007[8], then the potential market would be 5.5 million. Even assuming that fierce competition from others would only make a 10% global market share of the high safety segment possible, that still leaves them with a market potential of 550,000 or 18 times that if Volvo and Saab could only sell in Sweden.

Moreover, if only Volvo and Saab were allowed to sell in Sweden there wouldn't be much pressure on them to spend much money in new research as they would figure that most car buyers in the absence of alternatives would be forced to purchase from them anyway.

Globalization thus greatly increases economic efficiency by increasing competitive pressures given any level of use of economies of scale and by allowing increased use of economies of scale given any level of competitive pressures. The increase in economies of scale reduces the cost of production and so enables lower prices and/or better products, while the increased competitive pressures will increase the incentive of producers to hold down prices and improve their products.

These positive effects are greatest and most apparent in small countries like Sweden, but while the effects are smaller in large countries like the United States, they exist there too.

2.3 The Misleading Arguments Against Free Competition

[7] http://www.teknikensvarld.se/nyheter/080103-bilforsaljning-rek/index.xml
[8] http://www.scotiacapital.com/English/bns_econ/bns_auto.pdf

Despite the strong case for free competition and globalization, a lot of resistance exists against it. This is to a large extent a case of special interests working against it in the hope of benefiting at the expense of the rest of society. An obvious example of this is farmers who with the present farm policy not only get partially shielded from foreign competition through tariffs and other import restrictions; they also receive subsidies both for farming and for not farming. Furthermore, they get subsidies for the farm products that are exported. The subsidies for not farming have the purpose of holding up prices on farm products, and export subsidies have a similar effect on the domestic supply and so also on the domestic price. The apparent benefits from this for farmers come mainly at the expense of domestic consumers and tax-payers (usually the same persons) which have to pay both higher food prices and higher taxes. Also, farmers in other countries will suffer as they cannot export to the EU and as they face competition from highly subsidized EU farm products even in their domestic markets.

It should, in this context, be noted that I wrote about “apparent benefits” for a purpose. Namely, to highlight how the existence of farm subsidies by reducing the competitive pressure for innovation and increased productivity could very well hurt even the farm sector. A good example of this is New Zealand’s successful abolition of farm subsidies. New Zealand used to have quite high level of farm subsidies, at roughly 33% of farm output. Then during a 6-year period, these subsidies were abolished. While some farmers experienced problems during the transition, the effects were surprisingly positive. Not just for consumers and tax-payers of New Zealand that could enjoy lower food prices and taxes, but even for the farm sector, where output increased faster than ever. Total productivity growth rose from 1.5% a year before the reforms to 6% after the reforms. Real farm incomes rose and today 90% of farm output is exported[9]. The fact that the New Zealand farm sector could thrive despite abolished subsidies illustrates just how strong the benefits of increased competitive pressures can be.

A similar mechanism could be at work with regards to regional subsidies. By subsidizing certain

[9] http://www.tcsdaily.com/article.aspx?id=050907B

regions, businesses in those regions will feel less pressure to become more efficient. Similarly, it is often the case that weaker regions pursue more socialist policies, as is the case with the northern parts of Sweden and the French-speaking parts of Belgium. Without regional subsidies, there would be greater pressure for these regions to reduce taxes and other obstacles for business activity. This illustrate again that not only could subsidies be bad for those who have to pay for the subsidies, they could perhaps be bad even for those that are subsidized. And even in the cases where subsidized sectors do benefit, the benefits will be reduced by the lower competitive pressures, while no such mitigating factor exists for the rest of society that have to pay for these subsidies.

Yet there are also those that argue certain violations of the principle of free competition and globalization could be good not only for a limited special interest group, but for the overall economy. I will comment on and disprove the two most common arguments.

One common argument is that certain companies or industries will supposedly bring greater benefits to society and must so be subsidized. This argument is most frequently used with regard to sectors with a high level of research and development. The Lisbon Agenda for example set a numerical target of 3% of GDP for total R&D spending in the EU[10] and in for example Sweden, the government has set a 1% of GDP target for government spending on R&D[11].

Yet while few would dispute that R&D is generally a good thing, the resources devoted to it have an opportunity cost , meaning that they could be used in other business projects. The government subsidies of certain industries could have instead been used to reduce corporate income taxes that discourage investments in general. As pointed out in the chapter on "strategic trade policy" (which is meant to mean both direct subsidies and barriers on import meant to benefit domestic companies) in Paul Krugman's and Maurice Obstfeld's book "International Ecconomics-Theory

[10] http://www.lse.ac.uk/collections/pressAndInformationOffice/newsAndEvents/archives/2006/CEP_LisbonAgendaResearch.htm
[11] http://www.dn.se/opinion/debatt/alliansens-dyraste-reform-blir-satsning-pa-forskning-1.594143

And Policy"[12] , the empirical record on such industrial policy is very low.

While the subsidized sectors have in most cases expanded as a result of the subsidies, that is not enough to demonstrate that the policy was successful, as again the production factors used have an opportunity cost in other industries. And as was pointed out, subsidized industries generally had a lower rate of return than other industries, indicating that resources were in fact used less efficiently. In most cases, labor compensation wasn′t higher either. And even in the cases that it was, it doesn't prove that labor received a higher compensation as the workers in those industries were better educated and more productive in the first place.

One argument for such targeted subsidies is that even though the direct return of investments may be lower, the subsidies will create positive so-called externalities in the form of so-called technological spill-over. There is a limited degree of truth in that argument, but it overlooks how all investments and indeed all productive activities generate positive externalities. New investments of all kind generate extra productive capacity, which generates increased purchasing power that benefits not only the workers and capital owners in that particular factory, but also suppliers and customers of the company and producers of the goods and services demanded by the workers and capital owners and so on. The same thing goes for increases in labor supply, which also helps boost production, which create similar positive benefits for the rest of society.

Another argument frequently advanced especially in these days is that if certain companies are allowed to fail in the sense of going bankrupt[13] then this will have such negative repercussions for the rest of society that saving them is necessary to avoid a really disastrous slump and mass unemployment. This argument is used for bailouts both of financial companies and automobile makers.

[12] Krugman-Obstfeld (1996) pages 285-295.

[13] I here assume that bankruptcy means liquidation. It might however have the less dramatic meaning of ownership simply being transferred from shareholders to the bankruptcy estate, with operations continuing, as has been the case for many American airlines. Since the effects of that is much less dramatic, the case for bailouts is even weaker.

If you only look at the immediate effects then this is to some extent true. While some economic models assuming "perfect markets" with completely flexible prices (including completely flexible wages) and homogenous and therefore also interchangeable capital goods and workers, would predict no economic hardship at all from such an event. More realistic models that assume sticky prices and wages and heterogeneous and therefore partially specific capital goods and workers would see that such an event would indeed result in increased unemployment and a slump in output in the short-term. If the companies are large enough, that slump in output and increase in unemployment could indeed be very substantial in the short-term.

But as Frederic Bastiat and Henry Hazlitt pointed out, the job of a good economist is to look beyond the immediate consequences of a certain policy. As Hazlitt puts it in his classic book "Economics in One Lesson"[14]:

"The bad economist sees only what immediately strikes the eye; the good economist also looks beyond. The bad economist sees only the direct consequences of a proposed course; the good economist looks also at the longer and indirect consequences. The bad economist sees only what the effect of a given policy has been or will be on one particular group; the good economist inquires also what the effect of the policy will be on all groups."

In this case, we must look beyond the immediate effects for the workers, suppliers, owners and creditors for a particular company, and even the aggregate short-term effect on the overall economy.

While even the aggregate effect on the economy would probably be negative in the short-term, obviously some would be hurt even in the short-term. More well-run competitors both in the particular industry and others would lose as the badly run company's products would be sold instead of theirs. Moreover, some workers and some capital equipment could relatively quickly be taken over by more efficient companies, but since the badly run companies were bailed out,

[14] Hazlitt (1996) pages 1-2. Also available online here http://jim.com/econ/chap01p1.html

they won't be able to do that. And in the case of car companies, the bailed out companies will buy commodities to be used in their products, something which will mean higher prices for the more well run companies.

And it gets a lot worse if you look at the long term. While not all workers would have been able to find a new job in the short term if their company was liquidated, virtually all should be able to do so after a while, and now in more efficient and well-run companies. But if the company is bailed out, the resources represented by the workers will instead be tied to the less efficient bailed out company. Similarly, most capital equipment can probably eventually be sold to other companies. And even the equipment that can't be used in its current form can see its commodity content recycled and used enable new investments by the new more efficient companies. If free competition is replaced by bailouts and subsidies, the process which weeds out less efficient companies and replaces them with more efficient companies will not work and we will be left with a less efficient business structure.

Moreover, the bailouts will create what is commonly referred to as "moral hazard". That is, because companies seeing the precedent set by the bailout will figure that –consciously or unconsciously- it's not really so important with competent management and that it is not so important to avoid taking large risk, because if everything goes wrong, the government will come along and bail them out. That will of course mean that we will have more of the irrational and risky business decisions that created the (perceived) need for the initial bailout, which in turn will of course create the "need" for even more bailouts. A good case can be made that one of the causes of the current financial crisis was the numerous bailouts by former Federal Reserve chairman Alan Greenspan, which placed a lot of financial institutions under price risk.

EU & Competition

3.1 Introduction

The first chapter discussed the benefits of free competition, while the second discussed the link between globalization and free competition. This chapter will focus on how the EU both promotes and works against globalization and free competition. Particular emphasis will be placed on how the introduction of the euro has acted to reduce barriers to cross-border global competition as it is perhaps less apparent

3.2 How EU Has Limited Globalization

Unfortunately, the European Union has acted in many ways that has limited competition and globalization. The three main ways in which this has been done are through its regional policy, its farm policy and through its trade policy.

EU regional policy distorts free competition by subsidizing companies and/or governments and households in certain economically weak regions, such as much of Southern and Eastern Europe and certain parts of northern Sweden and Finland. This means that resources will not be allocated efficiently as companies operating in weak regions will receive an advantage compared to companies in other regions. This damages the EU economy as a whole and might for reasons explained not even benefit the subsidized regions.

Ireland is sometimes held to be a success story for EU regional policy. Supposedly the spending by EU there helped create the economic boom there. But that is not true. The reason why Ireland enjoyed such a boom was because the Irish government sharply reduced government spending, thereby helping to eliminate the budget deficit and also enabling it to lower taxes, particularly the corporate income tax. By contrast, other countries and regions that pursued more socialist economic policies, like Portugal, the French speaking regions of Belgium and northern Sweden didn't experience any boom of that kind.

EU farm policy limits competition both within the EU and with the rest of the world. It limits competition within the EU by the extensive use of production quotas to prop up prices in areas such as milk, sugar and grains. It limits competition with the rest of the world through the use of tariffs as well as quotas and other non-tariff barriers.

The EU's trade policy limits global competition in three ways. One is through the aforementioned farm policy which first of all subsidizes EU farm products and so makes it more difficult for non-EU farmers to compete. The second is through taxes on imports, commonly known as tariffs. The average EU import tariff is now 4.1%, down from 6.9% in 1995[15]. However, that level differs widely between different products and different countries. For many products and countries (which includes many former French colonies) no tariffs at all are applied, while for many other products, often farm and textile products, tariffs are substantially higher than 4.1%

The third way in which trade is restricted by the EU is through the use of quotas and other non-tariff barriers. The most conspicuous example of this was the quotas imposed on textile imports from China in 2005, quotas that have now expired[16]. Another form of non-tariff barrier consists in requiring exporters to the EU to fulfill requirements which ostensibly have other purposes than restricting trade, but which in reality is often motivated by a desire to restrict trade. One example of this was the ban on the import of Brazilian beef in January 2008[17]. The official reason for this was that Brazilian authorities did not track and supervise Brazilian farms in the way that EU authorities does with EU farms in order to prevent diseases, notwithstanding the fact that Brazil has not had the same kind of problems with for example Mad cow diseases that the EU has experienced.

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[15] http://sreichenberger.newsvine.com/_news/2008/11/25/2148953-eu-trade-policy-liberal-or-protectionist

[16] http://www.chinadaily.com.cn/bizchina/2007-10/10/content_6162349.htm

[17] http://www.javno.com/en/economy/clanak.php?id=119160

The real motive behind the ban could be detected by the fact that the farm lobby in beef exporting Ireland lobbied hard for the ban and the fact that a motive for the decision was a study performed by the Irish farm lobby[18].

3.3 How the EU Promotes Competition

However, it must be noted that there are also many ways in which the EU promotes competition. This is mostly with regard to internal competition, but it also applies to a lesser extent to external competition. The latter concerns trade agreements that open up trade with various countries, such as former French colonies in Africa. Many argue that these treaties are unfair as they give preferential treatment to former French colonies over other poor countries. A good example of this is seen in how the EU gives preferential treatment to bananas from the former French colonies over bananas from Central America. These critics have a point in that the current situation is unfair to Central America, but the unfair element consists in the trade barriers against Central America, not the lack of trade barriers against the former French colonies. Limited free trade is not as good as complete free trade, but it is better than complete lack of free trade.

More important is the way in which the EU promotes competition within the EU. The EU generally forbids government subsidies of industries, though exceptions are made, most notably in the financial sector with the fear of systemic risk to the financial system. As previously discussed, state subsidies to companies will mean that less efficient companies will at least in the short-term expand at the expense of more efficient companies, which will With the introduction of the Single European Market in 1992, all internal trade barriers have been swept away, with again only a few exceptions. Among those exceptions is the retail monopoly on sales of alcoholic beverages which is motivated for public health reasons.

The benefits of the EU Single Market are estimated to be highly significant, and are estimated by the European Commission to have increased GDP by 2.15% or €240 billion per year and to

18 _http://www.irishtimes.com/blogs/pricewatch/2007/08/26/so-whats-your-beef/

have created 2.75 million new jobs[19]. While you should perhaps take these very precise estimates with a grain of salt, there can certainly be no doubt that the effect is very positive given the strong theoretical case for the removal of free competition across borders described in chapters 1 and 2.

3.4 The Euro and Competition

One way in which the EU has promoted competition is through the creation of the euro. The effects of the euro on competition are much more complex and therefore less immediately apparent than the other EU policies discussed previously. This is probably why there is more political opposition to the euro, particularly in countries like Sweden, Denmark and the U.K., than to most other EU projects promoting competition [20]. Here focus will be on the way in which the euro promotes cross-border competition and trade.

One reason why the existence of separate national currencies will inhibit cross-border trade is that it will necessarily be associated with transaction costs when people are forced to exchange their currencies at a bank or other currency dealer. Of course, these costs are not big, particularly for large companies, but they still reduce trade somewhat. This means that the costs for the economy not only include the unnecessary diversion of resources to the currency exchange business but the cost also includes all the transactions not made because of the transaction costs. This will be true not only for trade with goods and services, but also for financial transactions.

Another reason as to why separate currencies represent a barrier to trade is that it decreases transparency. That is, it becomes somewhat more difficult to compare prices in different countries and perform calculations. The costs of this will consist in the unnecessary time devoted to »translating« the prices in foreign currencies as well as the transactions not made because of the extra trouble this means. This is of course an even smaller barrier to trade than transaction costs as most people, not to mention large corporations, have little trouble multiplying or dividing

[19] http://ec.europa.eu/internal_market/top_layer/benefits_en.htm

prices in foreign currencies with the latest exchange rates. But given the fact that this to some people creates a psychological barrier greater than it should be for rational reasons, it still creates a small barrier.

A more important reason for why different currencies are a barrier to trade is exchange rate fluctuations or more importantly the fear of exchange rate fluctuations. This is of course not applicable to credible fixed-exchange rate regimes, but only to countries with floating exchange rates as well as fixed-exchange rate systems which lacks credibility.

Exchange rate fluctuations create a great deal of uncertainty which makes people less inclined to make investments which involves trade with other currency zones. This is because a changing exchange rate might undermine the profitability of a investment project deemed profitable at the current exchange rate. Take for example a businessman in England who considers an investment which will enable exports of cookies to Germany. His costs may be say £0.75 per box of cookies and he will be able to sell them in Germany for €1.26 per box. At the time, the exchange rate may have been €1.50/£ and he would therefore be able to sell them for £0.84 per box, making a profit of £0.09 per box. But if the exchange rates moves to €1.75/£ then his income will only be £0.72 and he will make a loss of £0.03 per box.

The dampening effects on trade from exchange rate risks is enhanced from the fact that export firms often also imports some of the materials needed to make the goods . Say that this businessman imported raw materials like sugar and wheat from the United States worth of $0.63 per box, which at the hypothetical exchange rate of $1.75/£ meant £0.36 per box. If the exchange rate goes to $1.50/£ then the costs will rise to £0.42 and overall costs will rise to £0.81. The effects of the pounds movement on the dollar and the euro will then turn the projected net profit of £0.09 per box into a net loss of £0.09 per box.

One counter-argument to the »exchange rate risk« argument is that the risk can be traded away with different forms of financial market instruments. If a British company expects a income of

$70000 at a certain date then they can use a futures contract to make sure they can exchange it for the current exchange rate of $1,75/£, meaning they'll get exactly £40000 .

This argument is partially true. It is indeed true that the existence of such financial market instruments substantially reduces the costs of exchange rate risks, but it does not eliminate them. To begin with, to use such instruments you have to pay the person who takes on the risk premium, which means that there is a extra cost compared to if you were trading within a currency zone. Secondly, it is often difficult or impossible for small businesses and non-wealthy individuals to use them, so for them the currency risks remain. Thirdly, these instruments are mainly available for transactions in the near future (next 6 to 12 months). Long term protection against currency risks are very difficult even for big companies to obtain since investors demand higher premiums and since companies, in most cases, aren't sure how big their cross-border transactions are. Thus, it is only short-term fluctuations that people can insure themselves against. Long-term fluctuations, which are clearly more important for companies making long-term investments in factories or research and development, are still present.

This is important because opponents of the euro in countries with national currencies, such as Sweden and the U.K. , often point to the boost to the export sector from a weaker currency[20]. While it is true that a weaker currency will at least in the short term increase profits at export companies, they will likely not want to make any long term investments to take advantage of that because they can't be sure that this favorable exchange rate will really last.

So how important is this? How much damage does transaction costs, decreased transparency and exchange rate risks create? A study by Harry Flam and Håkan Nordström[21] indicated that the introduction of the euro had boosted trade by 13-14% between 1998 and 2005. And there are actually reasons to believe their study might have underestimated the effect. First of all, they've statistically accounted for differences in economic growth. While that is basically valid

[20] See for example here: http://www.telegraph.co.uk/finance/comment/rogerbootle/3760449/Ignore-the-europhiliac-chorus---we-need-the-pound-now-more-than-ever.html

[21] http://www.kommers.se/upload/Analysarkiv/Arbetsomr%E5den/EUs_inre_marknad/Euro_flam_nordstrom_svensk.pdf

as economic growth do influence trade and is mostly caused by factors unrelated to monetary unification. But if trade has really increased then that would raise economic growth. And secondly, the 13-14% number was the difference between the increase in intra euro zone trade and the increase in trade between euro zone countries and the control group. But as statistically adjusted trade between euro zone countries and the control group have increased a lot more than trade between countries in the control group, then there is reason to believe the euro have stimulated trade there too, which also means the boost to intra euro zone trade is larger.

This problem does not also exist within the realm of trade in goods and services, but also regarding financial transactions of course. If there is a risk that loans nominated in foreign currencies will rise in value, then people are going to be less willing to take these loans. And if there is a risk that assets nominated in foreign currencies will fall in value then people will be less willing to invest in those assets. And of course, the problems with transaction costs also exist in this area.

This has significance for two reasons. Firstly, if people can invest in several countries then their risk level can be reduced as they can invest not only in domestic assets but foreign assets too. Secondly, the bigger the currency area the bigger the credit market will be. The bigger the market for credits is, the greater the societal gains will be as this means a greater transfer of funds from people with a low time preference to people with a high time preference Which in turn means that saved funds will come to a better use. This is of course also true for countries. In some countries or regions the average time preference will be higher than in others. Partly because of different time preference on consumption but also because of differences in the amount of investment opportunities. This means that there should be a net transfer of credit from the country with low time preference to the country with high time preference. With a common interest rate in different countries and no exchange rate risks then the level of such transactions can of course be much greater. Just as a common interest rate within a country causes some companies who don′t hav any investment plans that can pay off to return money to its stockholders, who can then transfer this money to companies which have investment opportunities which will yield higher than the prevailing interest rate, so a common interest between different countries will benefit both investors in a country with low time-preference since they will have a higher return and benefit companies in a country with a higher time preference since they can invest more.

The fact that the risk free interest rate is equal in all countries is sometimes held to be a big negative thing about monetary unions. According to this Keynesian logic, supposedly a country with a weaker economy should have lower interest rates to boost its economy. Yet whatever one may think about this from business cycle point of view, this constitutes a violation of the principle of free competition and should in fact be seen as a form of state subsidy. To understand why this is, assume that in a certain country, the economy of a certain region is weaker than other regions. This is hardly an unrealistic scenario, as there are many concrete examples of this, for example in Sweden, the northern part of the country, in Italy the southern part of the country and in Belgium the French-speaking parts of the country. If the governments of any of those countries declared that the businesses and households in the weaker parts of the country should pay lower interest rates, then they would have to subsidize these loans, as lenders are unlikely to agree to charge people in economically weaker regions lower interest rates (indeed due to the higher risk of default, they will charge them more). Thus, having lower interest rates for business in weaker regions or countries in effect constitute a state subsidy for them, something which distorts competition.

Similarly, another supposed advantage of separate currencies according to Keynesian business cycle logic, is that currencies of weaker countries will fall[22], which will bring businesses in those regions a competitive advantage. Yet this competitive advantage will in fact be a form of subsidy for businesses (though certainly not for households) in that country. To understand why this is the case, let's again consider the case of a weaker region within a country. Suppose that the government of that country had decided that in order to make businesses in that region more competitive, the government will subsidize products made in that region that are sold in other

[22] In practice, it is not always the case that weaker economies have the weakest currencies, as is illustrated by the strength of the U.S. dollar and the Japanese yen during the second half of 2008, despite weakness of both the U.S. and Japanese economy. But this issue is not relevant to the more important issue that exchange rate fluctuations will result in de facto subsidies for certain industries in certain countries.

parts of the country, and that these subsidies will be paid for by slapping a tax on products made in economically stronger regions that are sold in the weaker region. It should be obvious that this would distort competition to the disadvantage of more efficient and well-run businesses in the economically stronger parts of the country. But the effect of a weaker currency is in fact identical to the effects of a combined import tariff and export subsidy.

To take a specific example of this which is very similar to recent actual exchange rate movements, assume that the Swedish krona falls in value, so that a euro cost 10 kronor instead of 9 kronor before, which in inverted terms means that the value of the krona falls from €0.111 to €0.10. This means that Euro area goods suddenly become 11.1% more expensive for Swedes while Swedish goods suddenly become 10% cheaper for Euro area residents[23]. Imagine instead that Sweden had been part of the euro area and that currency depreciation of this kind thus would not have been an option, and that Swedish politicians instead would have slapped on an 11.1% tariff on imported goods from the euro area while also providing all euro area residents a 10% subsidy on all goods from Sweden. What would be the difference, except for the formal technicalities? The answer is: none at all, the effect in meaningful economic terms would be identical. Because it, in formal terms, would be such a blatant form of subsidy to businesses in sectors of tradable goods, this would be forbidden by EU rules, but the more hidden form of currency depreciation.

[23] For simplicity it is assumed that neither Euro area nor Swedish exporters change their prices. If they did, that wouldn't change the impact for businesses that instead would lose/profit from lower/higher profit margins instead of lower/higher market share. The similar consideration would also be applicable to the alternative combined import tariff/export subsidy which this paragraph is meant to illustrate the similarity with.

The Importance Of Free Financial Markets For Free Competition

4.1 Introduction

The financial crisis that has almost engulfed pretty much the entire world and that originated from the U.S. housing bubble and to a lesser extent similar bubbles in many other countries has created a backlash against deregulation and globalization of financial markets, which are wrongly blamed for the crisis. I will not discuss in the real causes of the crisis, suffice to say that the main cause was various forms of government interventions, most importantly the Federal Reserve's low interest rate policy in 2001-05 and the moral hazard created by the various bailouts it has engineered. For more on this subject, see this article by this author[24] and the European Enterprise Institute paper by Johnny Munkhammar and Nima Sanandaji[25].

As it was not the cause of the financial crisis, restricting the financial markets will do nothing to prevent future problems of this kind. It will however partially or completely destroy some of the benefits of these markets.

4.2 The Importance of Free Currency Markets

As was indicated in the section on the euro, the optimal solution would be to have a monetary union, which would mean that currency trading would be abolished. Yet while monetary unification is possible and desirable within Europe, and would in a better world be desirable on a global scale too, it is for political reasons not possible and hardly desirable on a global scale in the foreseeable future. And in any case, free currency markets are certainly the second best solution.

While the division of the world into different currency areas does create economic efficiency losses, they are small compared to how bad it would have been in the absence of currency trading, as that would force all countries to cease international trade and financial transactions, or limit

24 http://mises.org/story/3244

25 http://www.munkhammar.org/blog/pdf/TheFinancialCrisisEEIfolder.pdf

it to pure bartering. That would end all global competition and division of labor and cause a catastrophic decline in living standards. A practical example of the great damage that would create is North Korea.

Of course, few outside North Korea actually favor the end of all currency trading. Instead, they argue for things like the Tobin tax to curb speculative activity. If a Tobin tax was implemented, it is claimed that this would minimize speculative activity while having little effect on "legitimate" cross-border transactions and at the same time bring in revenue.

No doubt it would bring in revenue and it would clearly also reduce speculative activities. Yet it would damage the people who engage in non-speculative transactions too. And this would not only be because they would have to pay the Tobin tax too. Indeed, even if there were some way to tax only speculators, those engaged in currency transactions for non-speculative reasons would still be hurt.

The reason for this is that without speculators, liquidity in the currency markets would be dramatically reduced. Lower liquidity would in turn mean that any large transaction would cause what is known as slippage. Slippage means that the price would fall because of the transaction and so people will always get a worse deal than the current quoted price, as any buyer would have to pay more and any seller would receive less. This will make people less willing to engage in these non-speculative transactions. This is a similar mechanism to the one described in the first chapter about how economic efficiency will be hurt if marginal revenue is lower than the price.

A Tobin tax would therefore limit globalization, which for reasons described in the second chapter will damage the economy. The damage will be particularly great in the case of small currency areas, whereas the damage will be more limited for greater currency areas like the United States and the euro area.

4.3 The Importance of Free Stock Markets

The stock market is a very important institution for the economy for three reasons.

First, because it increases the ability to raise capital. It is a well-known market where people who want to invest in companies can be matched with companies that needs to raise capital. And as the ability to trade shares on a secondary market means that investors can sell their investment if they suffer from liquidity problems or change their assessment of the company they have invested in, that will make them more willing to invest compared to a situation where they couldn't sell their shares. And the more liquid a stock market is (the greater the number of transactions is), the better it will fulfill that function as it will reduce the problem of slippage,

Secondly, it fulfills an entrepreneurial function and creates a way to calculate for investors and companies where money should be invested. A company does not exist for its own sake, but to create value for its shareholders. If a company cannot use capital in a more efficient way than others then it should distribute them to their shareholders in the form of dividends (or stock repurchases, but they could be seen as a form of dividend) so that they could then reinvest that money in more efficient companies. But how can management know whether it would be best with new investments, purchases of other companies or dividends?

They can know this by looking at stock prices. If the stock price is high, then that means that the cost of capital is low. The company's operations could thus be expanded without much extra investments from the shareholders. At the same time there is less point in paying out more dividends as it would only slightly increase shareholder wealth while in a more substantial way limiting company expansion. If by contrast the share price is low this would require much greater extra investments from the shareholders to achieve a certain level of expansion, while dividends would produce a much greater boost for shareholders given any limitation of a company's operations. And quite obviously, the lower the price of a certain company, the more attractive will it be for others to acquire it.

From the latter point it should be obvious that extra taxation of companies that pay out a high portion of their profits in dividends is economically irrational.

Another stock market phenomenon that is frequently under attack is short selling. Many countries, including the U.S., the U.K., Portugal, France and Ireland[26] have recently instituted various restrictions on short sales.

Banning short-selling delays price adjustment to the correct value. The efficient market hypothesis is based on the assumption (as well as many other assumptions) that short-selling is possible. While there are reasons to remain skeptical to the efficient market hypothesis in other regards,[28], it is correct in noting that the ability to sell short helps move markets closer to that ideal.

If a certain stock (or other asset) is overvalued, yet the people who realize this have already gotten out of the stock, then the way for them to correct this overvaluation is to sell the stock short. That way, these informed investors can bring the price closer to its fair value. But if short-selling is banned, this kind of adjustment can′t take place.

Another aspect of this is that people who for some reason believe a certain stock is too cheap can use their money or even borrowed money to buy stocks they think are too cheap. Yet people who come to the conclusion that a certain stock is overvalued can′t do anything about it unless they already owned the stock in the absence of short-selling. And even those that already owned the stock are limited to their stocks, while people bullish about the stock could possibly borrow to buy more of it. This creates an asymmetric situation where people bullish about a stock will have much greater influence than those that are bearish about it, which increases the risk that some stocks will be over-valued.

This would be similar to say an American election where both Republicans and Democrats had the possibility of voting for the Republican candidate, but only those who had previously voted

[26] http://www.iht.com/articles/2008/09/19/business/sell.php

for the Republican candidate could vote for the Democrat, while previous Democratic voters who wanted to support the Democratic candidate could only have the option of abstaining from voting (abstaining from buying, so to speak) for the Republican. It should be obvious just how great a bias for the Republican candidate this would create. Similarly, bans on short-selling create a significant bias for bulls for stocks subject to intense short-selling that distort stock prices and makes markets less efficient.

To avoid any misunderstandings, it should be emphasized that "bias for bulls" means bias in the case of the particular stocks that are sold short more than others, and not stocks in general. While bans on short-selling could in the short-term boost the aggregate value of stock prices, it is unlikely to do so in the long-term as the proceeds from short-selling will either directly (through purchases of other stocks by the short-seller) or indirectly (by going into interest bearing securities, lowering their yield and so encouraging others to buy stocks).

Moreover, it should be emphasized that by engaging in stock transactions, short sellers help boost market liquidity, which for previously explained reasons increase economic efficiency.

4.4 The Importance of Free Bond Markets

The bond market is primarily associated with the market for government bonds, and that is of course an important function for it. Regardless of what one might think of the appropriateness of deficit spending, to the extent it is made, a well-functioning bond market is important to minimize the cost of borrowing for government. Since governments at least in modern industrialized countries are considered 100% safe, a government bond market also provides a rough estimate of the risk free interest rate.

But perhaps as important is the role of the bond market in raising capital for private companies. But why would private companies want to issue bonds when they could raise capital through bank loans or by issuing shares? Well, many entrepreneurs find themselves unable to get bank loans because the banks distrust their ideas. And that is not just a problem for newly started companies, it is often a problem for companies that have existed for a while and want to start new projects. By issuing bonds, they can turn directly to investors, and they might be able to find someone willing to buy their bonds, which therefore enable new business expansion while providing investors with superior return. Usually companies and particularly companies have to pay significant risk premiums compared to governments to compensate investors for the higher level of risk. Because of the higher risk, these bonds are often referred to as "junk bonds", but studies have shown that companies issuing junk bonds are more successful than other companies[27].

The alternative of issuing stocks might be a good alternative in many cases, but for others less so. One reason could be that by issuing stocks, the current owners would lose their control of the company. Also, if the project is deemed to be profitable enough, it will be cheaper to raise capital by issuing junk bonds than by issuing shares that would give the new investors part of the abnormal profits.

Another form of bonds that have become increasingly controversial are asset backed securities, and various financial instruments that were based upon them, including Structured Investment Vehicles (SIV). Nouriel Roubini, president of RGE Monitor and economic professor at NYU famously called for a ban on SIVs[28], and SIVs and the asset backed securities they were based upon were similarly indicted in the famous humorous "interview" between comedians John Bird and John Fortune about the financial crisis[29]. The reason why they have become so controversial is that they have been blamed for reckless lending standards by banks and other mortgage lenders. The idea is that if mortgage lenders can sell the mortgage to investors as the collateral in mortgage backed securities; this means that they can issue loans to people who can't afford them and then sell the loan to others who will then take the loan losses. Yet this begs the question as to why investors would want to buy such dodgy debt. Or to put it another way: how could

[27] The Fortune Encyclopedia of Economics (1993) pages 589-590 "Junk Bonds"
[28] http://skepticaltexascpa.blogspot.com/2007/12/mlec-rip.html
[29] http://www.youtube.com/watch?v=mzJmTCYmo9g

mortgage lenders fool investors to not demand such high risk premiums so as to cover the likely loan losses? If investors had demanded sufficiently high risk premiums, then the initial loans wouldn't have been profitable.

The most likely explanation for this is the moral hazard created by Greenspan's previous bailouts, as well as the guarantees that Fannie Mae and Freddie Mac created for the various mortgages they bought and either kept or sold to others with that guarantee. Yet that moral hazard would have existed without securitization, so this is not an argument against mortgage backed bonds.

What, then, are the advantages of creating asset backed securities? The main advantage is that they make these loans tradable. By making them tradable investors can fairly quickly get out of their investments, but as it is a new investor instead of a bank that provide the original investor with money, no need exists to keep large reserves, as is the case with deposits. And as reserves are expensive to keep because of the opportunity cost from the interest it could have earned if invested, this enables investors in asset backed securities to earn a higher return than depositors, while it could at the same time lower borrowing costs for those who borrow.

4.5 The Importance of Free Derivatives Markets

Derivatives are securities whose value is derived from other securities, including stocks, bonds, commodities and currencies. They come in different forms: options, warrants, futures, forwards and swaps. These different forms of derivatives differ somewhat in their technical forms, but they have some common characteristics. Apart from all deriving their value from some other underlying security, they all consist of making a deal now about a future transaction under pre-determined conditions.

When derivatives are discussed in the public debate, it is often assumed that all parties that trade with derivatives are speculators. Yet a key function of the derivatives markets is hedging (elimination or reduction of risk), and that is a key reason why many enter the derivatives markets.

Many farmers for example have long sold their crop in advance to a predetermined price using futures contracts. That way they have been able to know exactly how much they will get paid, providing stability for their business and enabling them to focus on their core business activities. Speculators take on the risk of losing money on the spot market (in contrast to futures deals, spot deals involve immediate deliveries of securities or commodities) for the farmers in return for the possibility of earning significant returns if the spot price is higher

Similarly, companies that sell and/or buy from suppliers and/or customers in other currency zones can trade away the risk that they will get less paid or will have to pay more than they think by already selling or buying using futures contracts. As in the previous example, this means that risk is transferred from buyer to seller. As was noted in the chapter on the euro, the existence of such contracts significantly reduces (although it doesn't eliminate it) the problem of currency risk, and so help increase global competition. Studies suggest that the use of currency derivatives help boost company growth[30].

As derivatives thus transfer risk from hedgers to speculators, they could thus be seen as a form of insurance market, where speculators act as insurance companies selling insurances to hedgers. The "insurance premium" consists in speculators getting the upside potential if things go even better than expected. In the case of options and warrants though, the buyer of the "insurance" keeps the upside potential and instead pays a direct premium for getting relieved of the downside risk.

The existence of options and warrants can for this reason help bring in new investors to the stock market. Say you want to own a stock of say Ericsson, yet given that stock's high historical volatility, you are afraid of potentially losing a lot of money. What you can do then is to buy a sell option, commonly known as a put, that gives you the right, but not the obligation to sell a stock (in this case Ericsson) for a pre-determined price at (or in the case of American options before) a pre-determined date, regardless of what the spot price might be at that date. That way,

[30] See for example and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=138498 and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=46983

your potential loss is limited to the premium you pay to the issuer of the put (plus any possible difference between the price you buy the stock for and the strike price). At the same time, if Ericsson instead rises you get to keep the entire gain minus the premium. By enabling people to insure away most of the risk, options will thus help bring in more capital to the stock market, making it easier for companies to raise capital.

The form of derivative most commonly attacked is credit default swaps, which many have argued should be severely restricted[31]. The argument for this is more or less the same as the argument against asset backed securities, namely that it encourages excessive risk taking. Yet while it is true that it encourages risk taking, there's nothing excessive about it. In order for any business investment to take place, someone has to assume risks, since all investments can go wrong. Credit default swaps enables people with high risk aversion to make such investments and in exchange for some of the possible return sell the risk to people more willing to take on risk. This enables a higher level of investments and therefore also more prosperity. The risk taking only gets excessive if some third party, such as government, assumes risk without anything in return., which is the case when central banks artificially lowers interest rates and bails out failed financial institutions.

[31] http://economictimes.indiatimes.com/News/International_Business/US_drafts_law_to_check_credit_default_swaps/articleshow/4049849.cms

Summary And Conclusions

This report has been about the importance of free competition, and its relationship to globalization and free financial markets, as well as the role of the EU in limiting and promoting competition. As was demonstrated in the first chapter, there is a clear cut theoretical case for free competition as it will both bring the benefits of increased competitive pressure and increased production efficiency. This stands in contrast to anti-trust laws where any benefits from increased competitive pressure will come at the expense of and be counteracted by lower production efficiency. In the second chapter it was demonstrated that globalization implies an extension of the principle of free competition and that it will therefore imply higher production efficiency and/or higher competition, which will boost the economy. In the second chapter, various arguments against globalization was analyzed and refuted. It was shown that while subsidies will always hurt those who pay for it, the gains for those who receive it will are more dubious as it will make them less willing to improve their ways. It was further shown that arguments for subsidizing certain activities because of the benefits they will bring to others overlook how such subsidies will require taxes that will harm other activities beneficial to others. The argument for subsidizing crisis prone companies was refuted by pointing to how while such subsidies may limit the short-term pain, they will stop the necessary restructuring which will boost future growth and increase the risk of similar problems in the future.

The chapter on the EU pointed to how the EU in many cases, most notably regional policy, farm policy and trade policy acts to limit competition and globalization and therefore hurts the economy. EU has on the other hand acted to remove various national barriers to competition, including trade barriers within the EU and corporate subsidies and monopolies. The chapter also contained a lengthy case as to why the introduction of the euro is important in increasing competitive pressure and growth within the EU.

The chapter on the importance of free financial markets explains the role of various forms of financial markets in promoting competition and economic growth, something which needs to be emphasized because of the attacks on free financial markets in the wake of the recent financial crisis, which is falsely blamed on too little government control of them, when in fact the problem is too much government intervention.

While free competition is widely accepted as something good in general terms, few understand why it is a vital principle, something which this report has endeavoured to address. Partly for that reason, most people who embrace the principle in general terms are far too eager to accept deviations from that principle, A lack of understanding the principle of free competition makes it easier for the special interests to have their way. By understanding this principle - and indeed by understanding Frederic Bastiat's classical principle of looking beyond the immediate effects of policies - it will be easier to identify policies in the general interest.