CHAPTER 4: INTERNATIONAL TRADE AND COMPETITION POLICY

4.0 International Trade And Competition Policies

It is suggested that illegal anti-competitive behaviour is 'less feasible if the domestic markets are more exposed to international trade competition. In the absence of barriers to trade, domestic monopolists or oligopolists lose their ability to exercise market power irrespective of actual imports share of the domestic market, in view of the threat of potential competition[42]'. If this is statement is true, does international trade or trade liberalisation present sufficient conditions to foster competition? Can international trade policies replace competition policies? To answer the questions above, we need to understand how trade and competition policy interacts with one another.

4.1 Interaction Between Trade And Competition Policies

James Levinsohn from the University of Michigan in his paper titled International Trade And Competition Policy (published in NBER) states that trade policies are typically implemented to protect producers (sometimes called 'at the border' measures, OECD) while competition policies are aimed at protecting consumers (also called 'behind the border' measures).

Some of the notable similarities between the two policies are their pursuit for **economic efficiency**. Competition policies is concerned with the 3 aspects of efficiency namely the allocative, productive and dynamic efficiency. 'Allocative efficiency is concerned with ensuring that economic resources are distributed to those who put the greatest value on them. Productive efficiency is concerned with ensuring that a given level of output is achieved at the lowest cost. In competitive markets, both allocative and productive efficiency are achieved at the same point. While allocative and productive efficiencies are static concepts, dynamic efficiency is concerned with the process of discovering the best technologies, processes and products for meeting changing consumer tastes and incorporating them efficiently into the economic system[43]'. Likewise, trade liberalisation policies are similarly oriented towards 'removing tariff, non-tariff and internally based barriers to trade through negotiated concessions as the principal means of achieving the allocative and productive efficiency objectives[44]'. Some of its differences lie in the perspective that trade liberalisation focuses on global consumer welfare and global productive efficiency, for example GATT while competition policy focuses more on consumer welfare in defined markets. 'While both policies are concerned with micro economic issues, competition policy emphasises a fact specific, case by case approach, and is usually applied *ex post* (although merger review is an exception), while trade policy often involves more of a sectoral or economy-wide approach and is usually applied *ex ante* (although trade remedies are an exception)[45]'. This is also why we sometimes perceive competition policy has having short-term effects while trade policy has longer-term effects.

Understanding the dynamics above, Levinsohn in his paper states that there may be some complementary as well as some offsetting effects between trade and competition policies. He continues to add that it is important to ensure that the <u>implementation of both trade policies and competition policies are coordinated with specific economic goals in mind so that its effects can be mutually reinforcing</u>. Below are some examples

42 Unknown internet source.
43 OECD, 'Consistencies and inconsistencies between trade and competition policies, page 6, 1999
44 ORCD, Ibid, page 6

of how both the policies are interact based on different industrial structures and level of openness to trade liberalisation:

Interaction effects in small open countries – In smaller countries that maintain an open trading system like Hong Kong, trade and competition policy will have similar effects because a majority of the goods are tradeables and the overall domestic market demand is small. 'If the borders are open, the fact that a domestic industry has a very high concentration of sales by a few firms should not be all that worrisome, as international competitors take the place of minimal domestic competition. Levinsohn has found some empirical evidence in this notion, and calls it the '*imports-as-market-discipline*' hypothesis. He cautions though, that we should not be too hasty to abandon competition policies for small economies because:

- The service sectors play a bigger role, thus vertical relationships such as banks and manufacturers may constrict competition particularly if conglomerate manufacturers own the banks. Importers who need lines of credit for their businesses may find difficulty in getting financing under these circumstances.
- In a differentiated products industry, 'if the cross-price elasticity of demand for home varieties with respect to the price of foreign varieties is not very elastic, domestic firms will still be able to exert market power[46]'.

Interaction effects in 'constant returns to scale' oligopolists – In the absence of scale returns, trade policy is often used to protect the domestic sectors by shifting the profits away from foreign entrants; e.g. via quotas or import taxes. Competition policy, on the other hand, is used to prevent these same domestic sectors or oligopolists from

45 OECD, Ibid, page 7

exercising too much market power, with exception to export cartels. In this type of market dynamics, then, trade and competition policy works in offsetting directions. For example, the Malaysian automobile industry has a protection domestically from foreign imports based on tariffs levied (at least until AFTA is enforced). If a competition policy were introduced to prevent a domestic monopoly, it would surely work against the trade objectives of exporting the local cars at competitive world prices; i.e. without leveraging on the local domestic demand to support production levels, the export price of these cars will be higher since opportunities to lower its per unit cost or cross-subsidise the cars would virtually be eliminated.

Interaction effects in 'increasing returns to scale' oligopolists and monopolistically competitive industries – Levinsohn proceeds to explain that in monopolistically competitive industries, trade policy or competition policy will be welfare decreasing. 'The basic idea behind this class of models is that there are efficiency gains on the production side to having just one firm produce each variety of good, due to the increasing returns to scale, while on the consumer side, consumers benefit from the larger number of varieties available with free trade and hence from an efficient domestic production structure[47]'. If restrictive trade policies are imposed, prices would be raised and consumers will have to pay although profits are not shifted due to its monopolistically competitive industry structure (i.e. increased production of a similar good drives profits down to zero). If the industry structure was oligopolistic, it can produce more at a lower marginal cost with afforded protection by against international competition. Levinsohn continues to say that at these lower marginal costs, the oligopolists also will gain competitiveness in the international markets. We must take

46 James Levinsohn, 'International trade and competition policies, page 13, NBER Working Paper No. 4972.

caution though that if domestic competition policies are not coordinated with the trade policies, it may restrict its market share and growth rates – offsetting the efficacy of the trade policy.

4.2 Can Trade Liberalisation Replace Competition Policies?

Having said the above and using the notion that imports limits market power gains; can we just focus on using trade policies to foster competition? There are several arguments to say that even if trade barriers are limited, there are still other factors that can impede competition, for example:

- If import supply is inelastic, the demand for the imports will be met with higher prices and not additional supply from the domestic players.
- International cartels like OPEC can still divide up markets by controlling supplies, price-fixing or geographic market sharing agreements.
- Non-tradeable goods and services is still part of domestic industry dynamics and will require competition policies to regulate anti-competitive behaviour and not trade openness.

A common argument against trade liberalisation's position as being pro-competitive is that some proponents say that this only works in countries with large domestic demands like the United States. This typically nationalist argument believes that domestic industries in smaller countries need to be protected as **infant industries** from foreign competition until it achieves economies of scale or productive efficiencies. Larger countries with high domestic demand need not worry about this phenomenon because it has sufficient demand to achieve volume efficiencies. Malaysia has a tendency to adopt

47 James Levinsohn, Ibid, page 16

this typical nationalist stand as part of its early import substitution industrialisation strategies in the early 70s-early 80s. The counter argument to the above is 'if the domestic market is small, economies can be attained through exports – as in Singapore, Sweden, Switzerland and Taiwan[48]', thereby, making competition policy still plausible despite smaller scale demand opportunities.

Another interesting debate that we can also discuss is if we assume that trade liberalisation policies and competition policies are complementary in its objectives, can we say that the openness of a developing country economy like Malaysia is less than countries with formal competition frameworks? The table below shows uses a simple measure like import penetration ratios of countries with a competition policy and compares them against a country without such a framework. 'In developing countries, it is reasonable to consider import penetration ratios as a measure of import liberalisation. While average tariff rates or tariff revenue ratios may capture changes in actual tariff rates, import penetration ratios will probably better capture the effect of both tariff and non-tariff barriers[49]'.

Table 1 – Import Penetration Ratios

Country	Competition Framework	Import Penetration Ratios
Malaysia	No	0.87 (1992)
India	No	0.11 (1981-1988)
United States	Yes	0.18 (1992)
Japan	Yes	0.17 (1992)
Germany	Yes	0.44 (1992)
France	Yes	0.43 (1992)
United Kingdom	Yes	0.45 (1992)
Italy	Yes	0.49 (1992)
Slovakia	Yes (1995)	0.438-0.446 (1994-1996)
Belgium	Yes	0.56 (1996)

Source: www.bnm.gov.my, Slovak Statistical Yearbook & Census of Manufacturing (1997), AMADEUS CDRom on European Manufacturing Rev3.1998 Brussels, US, Japan, Germany, France, UK, Italy data from http://www.nsf.gov/sbe/ srs/seind93/chap6/ atab/at60493.xls. Note: Calculated in constant dollars.

48 Unknown internet source.
49 Yung Y. Yang (California State University, Sacramento) and Min Hwang (University of California, Berkeley), 'Effects of trade liberalisation on domestic prices: the evidence from Korea 1983-1995', page 4

The results show that Malaysia still shows high economic openness despite the fact that it does not have formal competition policy. And although US' import penetration ratios shows a presumably low rate, we acknowledge that a 'low (or declining) import penetration may reflect a competitive domestic industry that is capable of withstanding competition from imports[50]'.

4.3 Interaction Between WTO, APEC And AFTA & Domestic Competition Policies

The close relationship between trade policies and competition policies has long been recognised and attempts have been made to try to ensure that they can **co-exist alongside** - especially by GATT and WTO. 'Over the years, GATT and the WTO have increasingly dealt with specific aspects of the relationships. For example, one type of trade covered by the General Agreement on Trade in Services (GATS) is the supply of services by a foreign company setting up operations in a host country, i.e. through foreign investment. The Trade-Related Investment Measures Agreement (TRIMS) says investor's right to use imported goods as inputs should not depend on their export performance. The same goes for competition policy. GATT and GATS contain rules on monopolies and exclusive service suppliers. The principles have been elaborated considerably in the rules and commitments on telecommunications. The agreements on intellectual property (like TRIPS) and services both recognise government's rights to act against anti-competitive practices, and their rights to work together to limit[51]'.

50 Simeon Djankov (World Bank) and Bernard Howkman (World Bank and CEPR), 'Conditions of competition and multilateral surveillance', page 11
51 http://www.wto.org

A specific example of how the co-existence between a domestic competition policy and international trade policy needs to be managed - is in the area of government procurement. The WTO conference in Singapore (1996) set up a multilateral working group (that includes all WTO members) to work on transparency in government procurement practices. 'The group will not look at preferential treatment for local suppliers, so long as the preferences are not hidden. The first phase of the group's work is to study transparency in government procurement practices, taking into account national policies. The second phase is to develop elements for inclusion in an agreement[52]'. While WTO plays its part in accommodating local policies; a nation introducing domestic competition policies should also try to ensure consistency between its adherence to international trade agreements and local competition policies.

If Malaysia decides to implement a domestic competition policy, it needs to analyse how each area within the proposed competition policy will interact with not only the WTO agreement but also the AFTA agreements. The year 2002 marked the full implementation of the ASEAN Free Trade Area (AFTA) and by now 95% of the products traded within the region is already covered by the AFTA schemes. (The Common Effective Preferential Treatment (CEPT) is targeted at a region of 0-5 per cent for all member nations).

Industry speculation on presently protected Malaysian automobile industry is rumoured to say that AFTA will not lower the cost of owning imported cars because the government can always compensate its loss of tariff revenue by raising or fixing discriminatory prices for imported cars in the annual road tax premiums. This renders

52 http://www.wto.org

may render the CEPT ineffective unless a domestic competition policy framework is in place to disallow blatant price discrimination.

Thankfully though, 'under the CEPT agreement, all quantitative restrictions will have to be eliminated immediately upon enjoyment of the CEPT preferences, and all non-tariff barriers (NTBs) will have to be abolished in stages within five years of CEPT implementation. This means that all trade measures that limit and/or distort trade, which include among others quota, import licensing, and production subsidies, will have to be abolished. And going by the strict definition of NTBs, even domestic price controls currently being enforced by the Ministry of Domestic Trade and Consumer Affairs, too, will have to be discontinued[53]'.

53 Dr. Haflah (MIER), 'Take AFTA challenges seriously or lose out', page 3, www.mier.org.my (MierScope)