

Competition and price convergence – a Swedish perspective

Speech by Director General Claes Norgren, Swedish Competition Authority, at the 8th Annual SNEE European integration conference in Mölle, May 16, 2006.

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1. Globalisation or economic patriotism – forces and counter forces

During the last couple of years the discussion on globalisation has intensified. There are many reasons for this and one of the underlying reasons are the increase in global trade and the emergence of countries like India and China as major global trading partners. Their integration in the global economy marks an important change and the repercussions are felt in many local markets. It means new economic opportunities but also increased competition for many producers in EU countries such as e g Sweden.

One of the reasons for the increase in international trade are technological advance. Lower transport costs, falling costs for telecommunications and the use of the internet facilitate cross-border trade. This means increased competition for the export industry and it is a major driving force behind the increase in productivity that we have seen. The possibility to compensate increases in costs by increases in price has been radically reduced. This in turn leads to an increase and variation in the supply of goods to producers and consumers. Price increases have been dampened and all in all the advantages for consumers are clearly visible.

Companies on the other hand have new opportunities to localise their production in regions where factor prices are lower and where new markets emerge for their goods. In many cases this means a relocation of production and a structural change in the developed countries. This structural change leads to new tensions

and makes it necessary to create a competitive economic environment in order to be able to cope with the new economic environment or globalisation if you like.

This development is no doubt creating its counter forces. Stake holders in threatened industries in combination with political interests sometimes try to slow down the effects of globalisation by isolating sectors or countries from the increase in competition. Tariffs on Chinese exports to the EU, the blocking of cross-borders mergers or the use of technical trade barriers such as environmental regulation are examples of those measures.

In the case of Sweden my view is that our response to globalisation must not be to isolate ourselves and thereby decrease our competitiveness. Instead we must increase the dynamism in our economy by releasing competition on a broad and coherent scale. The opening up of markets and systematic reduction of unnecessary regulatory barriers would no doubt create new opportunities and facilitate necessary changes.

Liberalisation and free trade have an important potential to increase welfare by the more efficient use of comparative advantages. However, there are a number of examples where counter forces are visible.

- In the WTO negotiations subsidies and regulations still constitute major stumbling blocks for liberalisation.
- In the EU new anti-dumping measures have been introduced as a response to increased Chinese exports of leather shoes.
- The EU agricultural policy, CAP.

These examples demonstrate that the increased trade and competitive forces are not unchallenged. Instead counterforces might be strong and might be seen as a sort of economic patriotism. These are symptoms of a short-sighted and counter productive behaviour that only will result in a prolongation of a necessary structural adjustment. In order to cope with those forces it will be important for countries like e g Sweden not only to advocate free trade, but also at home make the necessary adjustments in our economy that make the impact of globalisation less dramatic and to exploit the benefits of this development. For governments it will be important to formulate policy on a broad scale to create the necessary momentum. From this perspective a formulation of a "competition strategy" as a mean for change would be important.

2. The role of Competition Policy

Competition is a mean to achieve well functioning markets to the benefits of consumers. The use of competition will thus lead to a development of free and efficient markets. On such markets innovation will be stimulated and unnecessary price and cost increases will be countered.

An important building block for our economy is the EU internal market. The creation of the internal market has been based on a number of important building blocks laid down already in the Treaty of Rome and still in force.

- Competition rules that set restrictions for company behaviour.
- State Aid rules that counter distortions in the market by the use of subsidies.
- Procurement rules that have been introduced in order to develop the internal market by creating transparent and objective criteria for public sector entities. These rules are not only aimed at reducing the costs for the public sector but also at developing markets for the public sector.

These rules are in place to make markets more integrated and to counter the possibilities for firms to price discriminate between different member states.

It should also be noted that these rules have important side effects that are consistent with the overall objectives of the internal market. One such side effect is visible in the area of procurement rules. Not only do those rules create more effective goods and services for the public sector. They are also an important weapon against corruption in the public sector.

These objectives and instruments are to create well functioning markets where distortions are minimised so that an internal market is established. In theory and in the end this might result in integrated markets and a more uniform price level in the EU. With this in mind the question is how the impact on prices in the EU looks like.

3. Price convergence from a Swedish EU perspective

The effect of globalisation and the enlargement of the EU internal market can be seen in terms of higher productivity and reduced import prices. In the case of Sweden productivity increases has grown by 3.3 per cent per year, in the business sector, over the past decade. This is 1,5 times more than the OECD average.

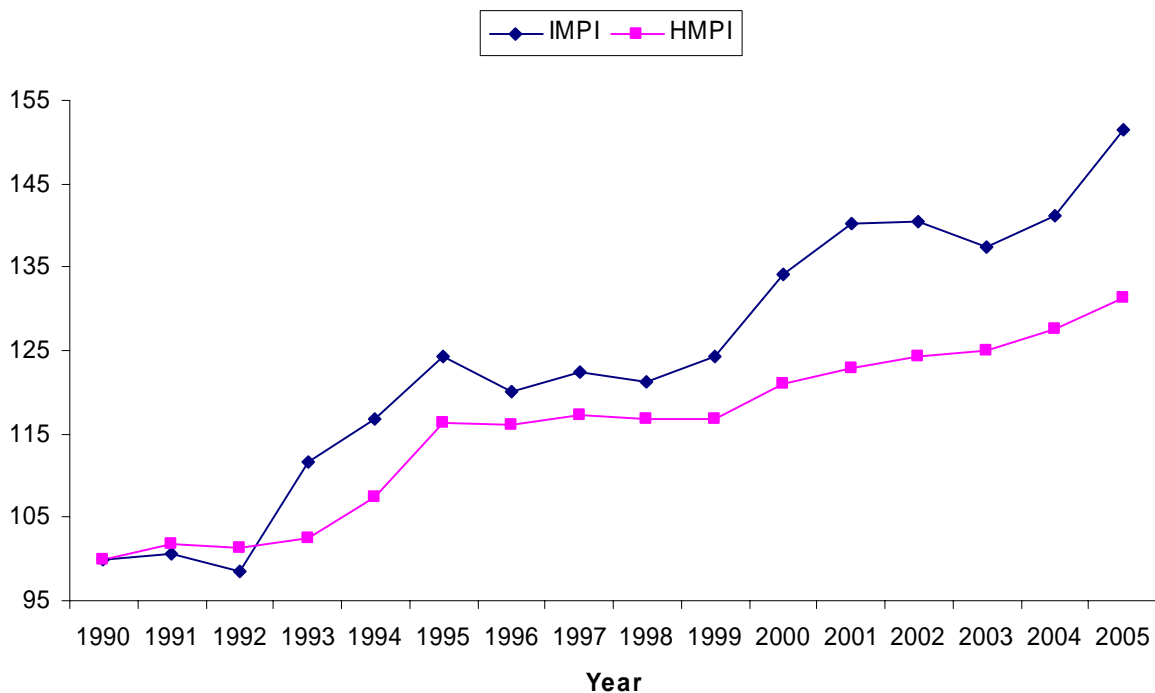
Diagram 1 Cumulative labour productivity in the Swedish business sector, 1990-2004



Source: Statistics Sweden

As regards price developments, inflation in Sweden has been low and for some time undershooting the Monetary Policy objectives. Part of the explanation of this is due to the effects of internationalisation and globalisation. In terms of the statistics a quick look at import prices and prices on goods supplied to the Swedish home market by Swedish companies give an ambiguous picture.

Diagram 2. Import Price Index and Producer Price Index, home sales, 1990-2005



Source: Statistics Sweden

As can be seen import prices seem to be raising more than sales from domestic production. However, if one takes into account the price developments of raw materials such as petroleum, metals, etc one finds that the price developments on those materials, to a great extent, explain the relatively high import prices registered in the statistics. Thus the economic development in newly industrialised countries leads to a scarcity on raw materials that drives prices up while on the other hand prices on imported manufactured goods have become cheaper due to globalisation. The improvement of competition from abroad in form of imported goods has, as a side effect, dampened the price development for sales from domestic producers.

This pattern is by no means a unique Swedish characteristic. Instead market forces are arbitraging the price differentials between countries and there are clear indications of a convergence of prices. This convergence is an effect of market integration. Thereby the Swedish price level is approaching the prices in other EU countries. Expressed differently the geographical markets are broadening which leads to less market concentration, more competition and a greater variety in supply. This is good news for the consumer.

In spite of the fact that Sweden joined the EU in 1995 the Swedish price level is still considerably higher than in comparable EU countries such as Belgium, France, The Netherlands and Germany. Compared to EU15 the Swedish prices were around 15 per cent higher in 2004. International price comparisons are difficult for a number of reasons, not least methodological problems. This means that results must be treated with caution. That being said it is clear that the price differential in relation to EU15 has decreased during the last 10 years.

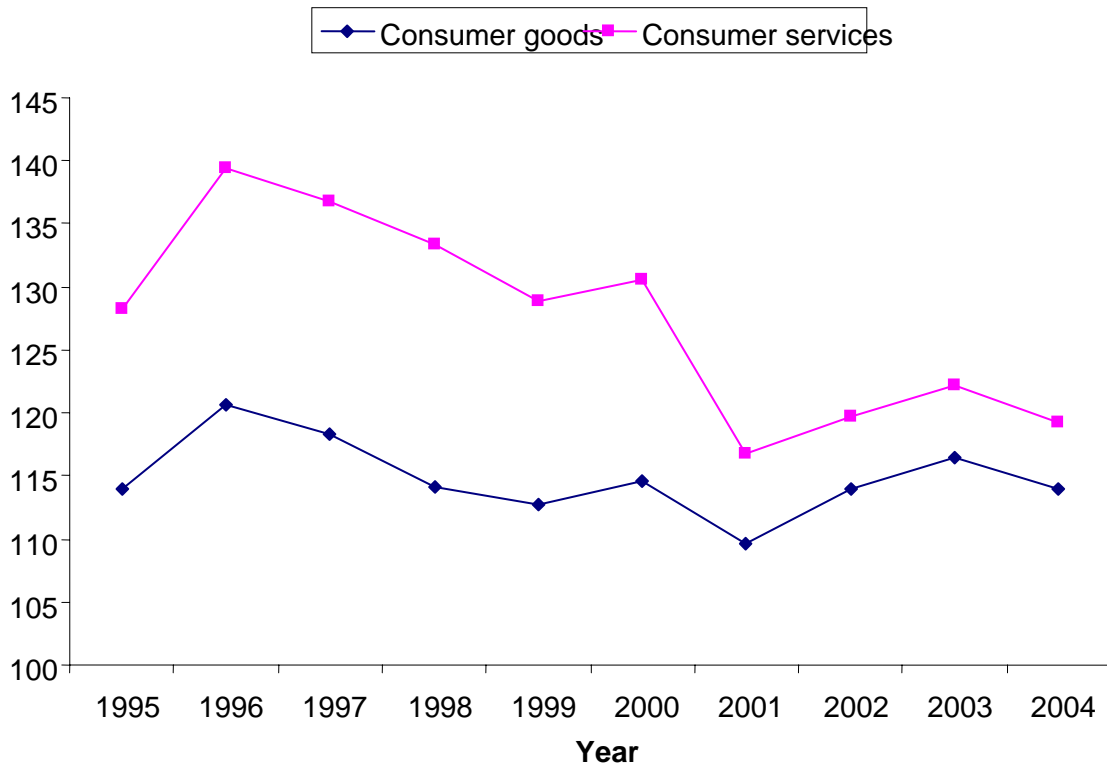
The relative price level in a country can be explained by a number of macroeconomic variables such as national income and taxes. A country with a higher national income tends to have a higher price level than others. Higher taxes tend to increase prices. The same can be said of transport costs and costs of labour. Furthermore, the impact of exchange rates needs to be taken into consideration.

In order to analyse price convergence it is necessary to look at the situation in different sectors.

- Areas where Swedish prices are especially high are beverages, furniture, household equipment and hotel- and restaurant services. In 2004 those prices were 20 -25 per cent higher than in EU15.
- Prices on clothing and shoes are only about 10 per cent higher in Sweden than in EU15.
- Telecom services are relatively cheap, around 25 per cent lower than in EU15.

One interesting feature is that services are relatively more expensive than goods. There might be a number of explanations for this but there are reasons to believe that trade in services is not so intensive as is the case for goods. However, as can be seen from the diagram below this is changing. The price differential for services compared to EU15 has decreased radically since 1995. For goods the reduction in relative prices is not as impressive.

Diagram 3. Price differentials for goods and services, 1995-2004



Source: Eurostat

Sweden is as an open economy but there are still a number of sectors that are characterised by a lack of competition and high market concentration. In many cases this can be explained by barriers to entry which protect the prevailing market structure. Examples of such sectors are the market for convenience goods trade. This market has for a long time been characterised by restrictions of the supply of premises for shops and cooperative structures between retailers. This has an important bearing on the willingness to invest and open up for competitors.

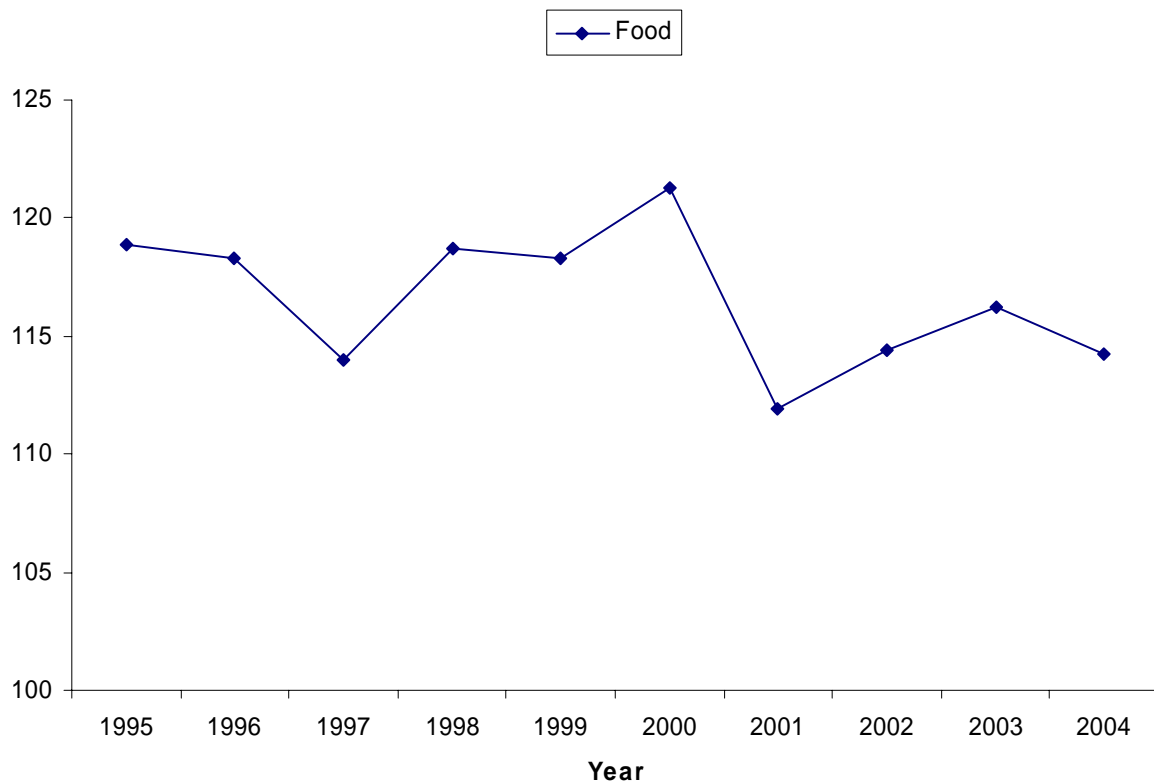
Although we can register a relatively significant reduction of relative prices of consumer services there are still a number of obstacles in the service sectors.

Two examples

Price convergence can look differently depending on what market you are looking at. Let's take a closer look at price developments in the convenience goods trade and the energy markets.

In the convenience goods trade reduced price differentials can be registered in comparison with EU15. Although there are large variations in relative prices there seems to be a trend towards a reduced price differential. In 1995 this price differential was about 20 per cent and today it is around 15 per cent.

Diagram 4. Relative prices on convenience goods trade, 1995-2004



Source: Eurostat

The last couple of years this differential have been even further reduced. During some periods there has been a deflation in the Swedish market for convenience goods trade which is different compared to other EU countries. During the period 2005 – March 2006 inflation on food in the EU was 2 per cent, whereas in Sweden it was only 0.2 per cent.

One explanation for this is that we have seen new entry by companies such as the hard discounters Lidl and Netto. Another explanation is that the number of large supermarkets have increased and thereby economies of scale have had an impact. It can also be assumed that the more widespread use of retailers' own brands have had an impact on this development.

There are reasons to believe that the retailers bargain power has strengthened leading to increased competition for wholesalers/suppliers. One important part of this puzzle is the improved possibilities to buy products on a larger geographic market than before due to improvements in transports, technology and the reductions of restrictions for trade.

The situation is of course different in different local markets in Sweden. In 2002 a report showed that the price differentials in the market for convenience goods trade might be around 10 per cent depending on the region.

Although we have seen improvements it is also important to stress that there is a high market concentration both on the retail and wholesale level, and that further measures are necessary for convergence to reach its full potential. One obvious measure is to improve the possibilities for retailers to find new premises. A more competition-oriented application and formulation of the Swedish Planning and Building Act could force down consumer prices, enhance diversity and improve quality in the market.

Due to national preferences, it is not realistic to believe that we shall - and should - reach a full price convergence in Europe. In other words the Swedish "knäckebröd" will even in the future, probably, still be more expensive in Milan than in Stockholm. Furthermore in a more internationally integrated market firms can be expected to respond to increased competition not only by adjusting their prices but also by the quality in their products or services. Such a price differentiation could tend to hold back price convergence.

On the energy market the situation is quite different. The prices on electricity are increasing and the effects for industry and consumers are clearly visible. One part of the price increase is due to increases in taxes and environmental fees. Another part is due to increase in market demand when competitiveness investments are dampen due to uncertainty over the impact of the planned nuclear phase-out, and the limitation for hydroelectric investments.

It means that we have to closely monitor that companies do not abuse their market power. This must be done both on wholesale markets and on retail markets. Infrastructure must be open and we must open up the EU internal market so that countries which have excess supply can sell energy to those regions where there is a lack of energy. A greater reliance of consumer choice and active measures in order to promote the possibilities to switch between different suppliers are also important measures.

In comparison to other EU countries Sweden has had low energy prices due to production based of hydroelectric and nuclear power. As the Swedish electricity market is integrated with the other EU countries it can be expected that it will be difficult to maintain a lower price level and it is probable that prices will converge. The Nordic countries are already integrated on the wholesale market and further integration can be expected. This means that consumers and industry will have to adapt in the longer term. A change in the relative price for energy should mean a great challenge for the Swedish industry to become more energy effective, or lose in competitiveness.

The development in the convenience goods market and the electricity markets illustrate that convergence on the whole is beneficial for countries and consumers. How far convergence will go depends on to what extent firms compete by adjusting their prices or the quality of goods and services. However, there are some markets, at national level, where convergence might lead to higher prices. Globalisation and competition will clearly lead to structural change; new entry must be allowed to occur. For this to be efficient and to be acceptable to the citizens it will be important to develop a strategy, a competition strategy. One relevant parts of such a strategy must be enhanced enforcement of competition regulation. It will also be important to review other regulations and structural policy. Important elements are efficient sector regulation focusing on access conditions to infrastructure, promoting structural investments in new infrastructure to increase competition and reviewing rules and regulations that create obstacles to competition.

Conclusions

When markets are broadened from national to wider markets such as global, European or Nordic, competition will follow. This leads to price convergence and structural change. Such structural change allows a more efficient use of resources and a better supply of goods and services.

In order to cope with this process, policy must be oriented at safeguarding well functioning markets and efficient regulation. This means further reduction of obstacles for market entry. On the other hand regulation must be capable of dealing with the problems of access to important market infrastructure. It also means a greater use of harmonisation of regulation between countries.

A full convergence of prices will of course never occur. Firms will also respond to increased price competition by adjusting the quality in their goods or services. Cultural differences and national preferences will make prices differ. However, the forces of convergence and globalisation are strong and there are good reasons for developing and implementing a competition strategy in order to cope with the

winds of change and to reap the full benefits. To reach the goals of consumer welfare we should liberalise a larger number of sectors in the economy. In that context is it often necessary with relevant sector regulations to avoid teething troubles. Other ways to open up markets may be to use the tools that are in the legal framework of competition and competition advocacy. Competition is the word.