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## **The power of the markets, the role of public policy**

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Honoris causa acceptance speech

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Mr Rector,  
Mr Dean,  
Members of the Senate of the University,  
Excellencies,  
Ladies and Gentlemen,

First of all, I would like to thank Dean Negut for his flattering laudatio. I am not sure I deserve every word of it, but I can tell you that it is an accurate and factual description of the current juncture. I am very grateful for and humbled by the honour you are conferring upon me today. It is a great privilege for me to accept this degree honoris causa from the Bucharest Academy of Economic Studies.

Since 1913 when it was founded, your institution has formed leading economists and politicians and it has instilled a sense of entrepreneurship and excellence in Romania's most successful business leaders. Among the many notable alumni and teachers of the Academy of Economic Studies, I would like to recall the figure of Virgil Madgearu, one of the leading economists and political personalities of the inter-war period. On the strength of your past achievements, I am sure that many of the innovative ideas that Romania will need in the coming years to fuel economic growth and return to prosperity will be hatched in these rooms.

Entrepreneurship and excellence are essential values both in Romania and in the rest of Europe in these difficult times. Europe's economic outlook is still uncertain and the effects of this enduring crisis are being felt by the people with increasing intensity. And because of the social and political implications of the crisis, it is also true that our work must seek to balance economic issues and the interests of our people.

People have taken to the streets last Saturday in the capitals of Europe and in about 80 countries around the world. The events of October 15 are just the latest in a wave of mass protests which – since the first Arab uprisings last December – has touched every continent. This global movement has a wide range of targets, but most people voice their frustration against the inequality, insecurity and social injustice that have spread in advanced economies and even in emerging countries since 2008.

The political and social losses the crisis is producing call for a serious reflection on our basic economic model and on the shape it has taken over the last three decades; and this is the topic I have chosen for my speech today. I would like to reflect on the virtues of a free market economy, its limits and its potential for failure, and the proper role of public policy.

## The virtues of a free market economy

But first I want to clarify my stance vis à vis the market; I am convinced that a free market economy is the best model we have to organise our economic behaviour, allocate resources, and work towards our personal and collective wellbeing.

The 20<sup>th</sup> century has seen one attempt at organising the economy without relying on the market. Many people in this room will have vivid memories of a centrally planned economy and of the sufferings it has brought. Fortunately, Communism was consigned to history in Europe two decades ago and nobody is asking for its return. The very few who have not accepted its demise are lingering at the margins of history. The attempt to impose a centrally planned economy entails the loss of basic freedoms in other domains as well. Dictatorship, the suppression of civil liberties, and a disregard for human rights are all necessary elements of the system.

When the Iron Curtain was starting to crumble, market economy clearly emerged as the only paradigm; however, the aspiration to build a fair and open society needs solid values, broader intellectual foundations and additional instruments. Indeed, Europe's model of society relies on the combined efforts of market forces and political action.

The era of deregulation that started 30 years ago with Thatcher and Reagan, has moved the boundaries between the two; the *laissez faire* paradigm has been gradually extended to cover domains that had traditionally been the responsibility of the State and of public policies. This shift – and the new balance that resulted from it – was based on the assumption that the risk of State failure would be bigger than the risk of market failure. In what follows, I would like to discuss some aspects of this assumption.

## The limits and the failures of markets

Let me repeat that the market is the best mechanism we know to organise our economic behaviour; but it cannot deliver outside of its proper boundaries and is prone to failure even inside these boundaries. To the best of my knowledge, one of the earliest comprehensive treatments of the issue of market failure is a 1958 article by Francis Bator titled *The Anatomy of Market Failure*. In it, the Hungarian-born economist explores the “phenomena which [...] fail to sustain Pareto-efficiency allocation” beyond the errors, uncertainty, and miscalculations which inevitably affect “the efficiency of ‘real life’ market institutions operated by ‘real life’ people”.

The limitations of a socio-economic model which relies excessively on market forces are becoming increasingly apparent. I have a feeling that, in our current conditions, we are on the verge of profound changes and we should not let the market alone determine the purpose and the direction of these changes. I will argue that we need to make more room for public policy and political action to complement market mechanisms and to correct their failures.

### Why markets can fail

I can see several reasons why market forces by themselves do not always produce an efficient allocation of resources and do not guarantee an adequate level of social welfare. I will start with the provision of public goods such as security. It is the responsibility of the government to make sure that every citizen is protected from crime and fraud. In this domain, market forces cannot replace public action in any significant way.

Another area for government intervention includes the so-called merit goods such as education, health care and social housing. There is plenty of evidence that when these public services are provided mainly or exclusively by market forces, the market fails. Market operators cannot guarantee that the services will be available to all; and in some cases that they are available at all. And this is not a desirable outcome,

because – for instance – a good and universally accessible system of education translates into practice the ideal of giving equal opportunities to every member of the society.

As you know, the European Commission has the responsibility to control that the public funds that go to finance services provided through the market – they are called services of general economic interest – do not distort competition within the EU. I have to deal with many cases like these in my current capacity. Take for example the case of a city government which grants a subsidy to a company to run its buses. It is our duty to check that the public support does not give an unfair advantage to the company at the expense of its competitors.

Decisions like these need to balance, on the one hand, the public interest that we all have in receiving the service and, on the other, the commercial interest of keeping a level playing field for business. There is not a trade off between the two interests – at least not necessarily – because in an open and competitive market another provider may offer cheaper, better and more efficient collective transport services to the local authority and to the people.

This example leads me to the potential market failures arising from externalities. Protecting the environment is a clear example, because rational choices that are made by individual operators produce outcomes that fail to meet the needs of the community as a whole. In other words, the private optimum and social optimum diverge.

The last reason I would like to give you is the anti-competitive behaviour of companies, such as the tendency that companies have to form cartels or to abuse dominant market positions. It seems that the tendency is as old as the free market itself; back in the 18<sup>th</sup> century, Adam Smith wrote: “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices”. So, ‘conspiring against the public’ is a traditional failure of the market, and it is our duty as a public competition agency to prevent and repress it. Among all our tasks, the fight against cartels is indeed the most straightforward; when we have enough evidence, a cartel will always be an illegal business practice.

## **The excessive power of the markets and the crisis**

Ladies and Gentlemen,

I would now like to turn to the issue of market failure in the present context. The crisis that exploded in 2007 in the US subprime mortgage market had been prepared by a period of growing financial and commercial imbalances at global level. For instance, it had been clear to observers and policy makers for several years that the excessive level of private and public debt in certain countries and the excessive level of savings in others would not be sustainable. And the same conclusions were drawn observing current-account deficits and surpluses. I believe that these imbalances accumulated over time also because of the inability of the markets to automatically correct them and bring them within manageable limits.

Another trend that prepared the crisis was the age of deregulation and the belief in the power of financial markets to produce efficiency gains. As I said earlier, the era of deregulation excessively extended the scope of the market. To give you a complete and fair picture, one cannot ascribe these phenomena to market agents alone; these events are also the product of decisions and practices involving the authorities that were supposed to regulate and supervise financial activities. The market did not send adequate signals through pricing of the risks that investors were taking, but this failure was compounded by the inadequate regulation and oversight on the part of public authorities.

Financial markets were let to stray too far from their traditional functions. Textbook economics assigns a specific function to financial services, that is to allow market operators to defer their savings and investments decisions in time. In contrast, in the run-up to the crisis, financial markets had eventually become increasingly self-referential. I believe that it is now the responsibility of public authorities – from

international organisations to national governments – to bring finance back to its original function. More than ever, we need our banks to finance the recovery and help companies create jobs and better prospects for our people. This task is urgent.

Europe's public authorities and political leaders will have to do their part in the next couple of days. As everyone knows, we are on the eve of important meetings for the future of the euro area. Important political decisions must be taken; the business community is asking for them and there is no time to waste. Every analyst is calling for a better system of governance of the euro area. No European country is large or strong enough to go it alone. If we stand together, Europe will find the right solution – and I have no doubt that we will. Relying on our unity is a historical necessity and we can turn for guidance to the voices of wisdom from the past, such as the one of Nicolae Titulescu who – as far back as the 1920s – was an advocate of a united Europe.

## **A new balance**

Ladies and gentlemen,

I will close my lecture as I started it; recalling the mass demonstrations that have culminated in last week's global protest. More than four years into this crisis, people demand answers. They want solutions for the global economic slowdown; they want jobs; and they want better prospects for the future. Today, I have addressed one challenge that – in my opinion – these movements have in common; setting limits to the power of the markets and strengthening the role of political institutions and of public policy.

This is how Nouriel Roubini put it: “To enable market-oriented economies to operate in more stable and balanced ways” – he wrote in a recent article – “we need to find the right balance between markets and the provision of public goods by governments”.

There are two reasons why we need to find the right balance: first, as I said, because the growing sense of inequality and insecurity generates socio-political instability and popular discontent; and second, because these levels of inequality favour transfers of income from agents with a tendency to spend to agents with a tendency to save and – as a consequence – weaken demand and growth. It is clear that we need to abandon a path which leads both to an unacceptable social order and to unsustainable economic outcomes.

Almost 80 years ago John Maynard Keynes famously wrote that “Practical men [...] are usually the slaves of some defunct economist”. The time has come to set ourselves free of the ideological shackles of the past. These troubled times call for original and non-dogmatic solutions; for a new collaboration between the invisible hand and the public hand.

To do this, I have argued that public policy should correct market failures when they occur and they should complement – and even, in some cases, substitute – the market in domains where it does not provide the goods and services the people need and have come to expect in a modern European society. This new and extended role for public policy need not be large or intrusive, because the markets produce the best outcomes when they operate under few, simple, and strictly enforced rules.

However, public authorities should not shy away from their responsibilities when market mechanisms turn out to be not efficient enough in the absence of rules and public interventions. Above all, we should stop regarding a free market economy as an end in itself. The market is a means to ensure our economic wellbeing; but our freedoms, our democracies and our model of society should be based on values and principles that go well beyond the supply and demand of good and services.

Thank you.