

For release on delivery
10 00 a m , E D T
June 16, 1998

Statement by
Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
before the
Committee on the Judiciary
United States Senate
June 16, 1998

It is my pleasure to appear today to discuss the current merger wave that is affecting a wide range of industries in the American economy. This nation has always viewed concentrations of power, whether in government or the private sector, as a threat to individual political freedoms and the equality of opportunity. In the public sector we seek democratic institutions and a rule of law to tether excessive political power. In the private sector we encourage competition as the perceived most effective way to contain the undue concentration of power. Such power is presumed to thwart individual initiative and to prevent the efficient allocation of resources, which would interfere with the creation of wealth and its wide distribution. The acceleration of megamergers in recent months across a broad range of industries has once again stirred these latent concerns.

Waves of mergers are, of course, not new. The current one is the fifth in this country during the past century. Previous waves occurred at the turn of the century, in the late 1920s, the late 1960s, and, most recently, in the early 1980s. The first two almost certainly did produce significant increases in economic concentration in manufacturing as industrialization accelerated with the shift of resources out of agriculture into many new budding industries. The more recent merger waves, however, do not appear to have materially altered industry structure, perhaps owing, in large part, to the increased adaptability of our more mature and competitive industrialized economy. Other countries have also experienced merger waves in recent decades with no perceptible increase in concentration overall.

The effects of the present merger wave on concentration have yet to be determined, but there is little reason to expect their influence will differ substantially from the merger wave of the early 1980s, which produced at most a slight increase in manufacturing concentration.

To be sure, recent bank mergers have led to a substantial rise in national concentration measures. Nonetheless, they have had little or no evident impact on average concentration measured at the more relevant local market level. This stability of local market concentration owes, in part, to the dynamic nature of American banking, with substantial entry of new firms as well as exit of others. In any event, on balance, while the average number of competitors within local banking markets has not materially changed in recent years, they tend to be the same competitors in an increasing number of markets. Beyond banking, useful studies on the effects of mergers on concentration in other nonmanufacturing segments of our economy are regrettably few.

Evidence concerning the effects of mergers on economic efficiency is mixed. While some studies find no evidence of profit and efficiency improvements following mergers, others indicate that, on average, mergers have led to significant productivity gains. In the banking industry, the data suggest that while some mergers have engendered improved operations, others have not. Thus, there are no clear-cut findings that suggest bank mergers uniformly lead to efficiency gains. However, the evidence suggests that there are considerable differences in the cost efficiencies of banks within all bank size classes, implying that there is substantial potential for many banks to improve the efficiency of their operations, perhaps through mergers.

Numerous empirical studies, nonetheless, have found a statistically significant positive relationship between market concentration and profits which, upon closer examination, appears to derive from a link between market share and profits. Economists have differed in their interpretations of this finding. While one group argues that high levels of concentration allow firms to exercise market power, resulting in above normal profitability, another group argues that

high concentration levels and high profits are both the consequence of greater efficiency. Studies of the relationship between concentration and prices tend to support the market power interpretation, but the magnitudes of the positive, statistically significant coefficients relating prices to concentration measures tend to be fairly small.

Some empirical studies also suggest that high concentration and presumed lack of competitive pressure may also be associated with the failure of firms to produce efficiently.

More generally, it is concern over the lack of the leveling force of competition in highly concentrated markets that has fostered the fear of bigness. But, unless a relationship between bigness and market concentration can be more firmly rooted in anticompetitive behavior, bigness, per se, does not appear to be an issue for national economic policy. Rather, it appears that bigness should be primarily the concern of shareholders whose returns could be muted by large company inefficiencies, and their customers who may face bureaucratic inflexibility.

There is an evident general consensus in this country that competition, in the abstract, is good for the consumer, for economic growth, and standards of living. This notion is buttressed by studies that suggest the more open to competitive forces, the greater the growth of an economy. Much more immediately and directly, the areas of greatest growth in output and productivity in this country--Silicon Valley and its counterparts around the country--are extremely competitive judging from the turnover of business and the evidence of a high degree of what Joseph Schumpeter many decades ago called creative destruction. Many new products emerge with great fanfare and soaring stock prices only to flare out when confronted with a still newer competitive innovation.

There are, nonetheless, differences at the margin (some would go further) of what constitutes appropriate competitive behavior and what the role of government in this country should be in enforcing it. At root, what differences exist stem from varying views of precisely how our economy functions and which activities are wealth producing and which are not.

The notion of what we mean by competition is not altogether without dispute. Most would agree that producers try to emphasize their new products or the comparative advantages of existing products. Where they sense that improved quality will enhance sales more than costs, they will direct resources to quality improvement and try to differentiate their product, often through brand name advertising. All seek, or at least hope, to achieve market dominance. Where they cannot differentiate their product from others because they choose to produce, for example, electrolytic copper or any other so-called commodity, they will endeavor to improve their market share and spread overhead through innovative improvements in service. Other producers may turn to mergers and acquisitions to increase market share. Acquirers may seek to enhance efficiency, but they may also seek to increase their market power, and hence their profits, through practices that are often considered less than sportsmanlike, to use an analogy to another prominent arena of competition. Where producers cannot achieve a profitable market niche, some, but fortunately few, will seek political protection from markets through subsidies, tariffs, quotas, or outright government franchised monopolies.

Through skill, perseverance, luck, or political connections, competitors have always pressed for market dominance. It is free, open markets that act to thwart achievement of such dominance, and in the process direct the competitive drive, which seeks economic survival,

towards the improvement of products, greater productivity, and the amassing and distribution of wealth. Adam Smith's invisible hand does apparently work.

To be sure, markets do not always work fully to the standards of our abstract notions of perfection, that in turn rest on particular notions of the way human beings do, or should, behave in the market place. There appears to be general agreement among economists that the test of success of economic activity is whether, by directing an economy's scarce resources to their most productive purposes, it makes consumers as well off as is possible. Moreover, it is generally agreed that the chances of achieving these goals are greatest if prices are determined in competitive markets and reflect, to the fullest extent that is feasible, the costs in real resources of producing goods and services. While relatively straightforward to state in theory, how such a standard should be applied in practice is often subject to dispute.

The focus of much debate in recent years is just what constitutes a "market failure," or the tendency for market prices not to reflect appropriately all relevant production costs. In addition, what constitutes the interest of consumers in the abstract is, of course, by no means self-evident in a large number of cases. As a result of certain transactions, some consumers will benefit, others will not. Moreover, conditions can differ with respect to whether it is the short- or long-term interest of consumers that is at stake.

Any notion of market failure, of course, presupposes a concept of market perfection. In that sense, perhaps the only market that achieves this standard of unequivocal benefit to consumers is the outcome of an auction market with very tight bid-ask spreads. Such markets represent a very small share of bilateral transactions.

In one sense, markets generally are always in some state of imperfection in that businesses never fully exploit, perhaps can never fully exploit, all opportunities for profitable, productive, investment. Consumers do not always seek out the lowest prices or the best quality, owing to the costs of searching across sellers. Rationally acting individuals may choose not to exert the additional effort that they perceive will only marginally enhance their state of well-being. Then, of course, people do not always act rationally.

In addition, market effectiveness is clearly a function of the degree of market participants' state of knowledge. The critical signals that make markets function--product and asset prices, interest rates, bid-ask spreads, etc --depend on market participants' perceptions of the state of demand and supply and future prospects, to the extent they are discernable. There is inevitably considerable asymmetry of information among producers and consumers, and buyers and sellers. Moreover, any voluntary transaction comprises not only a good or a service but a representation, explicit or otherwise, of the nature of the product being transferred. Misrepresentation to induce an exchange is theft, in that the transaction was not voluntary. Laws against fraud are demonstrably a necessary fixture of any free market economy.

But what information is a seller obligated to convey to a buyer in an exchange? Misrepresenting a lead brick for a gold one is unambiguous. But are producers required to divulge information about potential new products that would make obsolete an offered product and depreciate its value? More generally, how far does protection of intellectual property rights go in protecting what is, or what is not, divulgable to a counterparty to a transaction? Clearly, this dilemma is only one of many such conundrums resulting from the awesome complexity of the operations of free markets. In this case, too heavy a hand of government regulation will

surely stifle innovation and wealth creation. Too little will infringe the legal property rights of counterparties.

Still more difficult is the relevance of the effects on third parties from the actions of two individuals acting voluntarily, with or without conspiratorial intent, in their mutual interest through exchange. In the most general sense, all bilateral transactions, to a greater or lesser extent, affect the markets with which third parties deal for good or ill. Some actions open new markets for unrelated third parties. Other actions increase competitive pressure. Indeed, that is an inevitable consequence of the division of labor in a society. But it is almost impossible in the vast majority of cases to judge with any confidence that one act creates wealth or another destroys it. Nonetheless, while certain aggressive, competitive behaviors may, as the evidence suggests, enhance wealth creation, our society has, in addition to taking actions against presumed failings in the marketplace, chosen to set noneconomic limits to competitive behavior. In effect, we have established a set of Marquis of Queensberry rules for the marketplace, i.e., noneconomic criteria for the types of behavior that are judged tolerable in business relationships. We may in the process, of course, be losing some wealth creation, but the value of market civility, at various times in our history, appears to have tempered our drive for maximum efficiency. Nonetheless, that markets, however faulted, are a productive means to coordinate human behavior for most remains beyond doubt.

Markets enforce a degree of trust among participants that may not be so prevalent in other aspects of life. People cannot be untruthful without cost in a market context where credibility has distinct commercial value. A reputation for an inferior product might not be damaging in a centrally planned economy, but has heavy consequences in markets where choice is available.

But above all, by constructing institutions that enable the value preferences of consumers to be reflected in prices and other market signals, a society can produce far greater wealth than any of the nonmarket alternatives

One of those essential institutions is a rule of law that protects property rights, both real and intellectual, against force or fraud, enforces contracts, and adjudicates the bankrupt. More controversial are the laws that endeavor to improve the workings of the marketplace, the Sherman and Clayton Acts being the most prominent

While no one, I presume, is against improving markets, the issue is clearly what constitutes improvement and by what means, if any, it can be achieved. How this issue has been addressed since the passage of the Sherman Antitrust Act of 1890 has ebbed and flowed with evolving theories and empirical evidence about how markets function, and the degree of acceptance in our society of free markets to determine the distributions of income and wealth

In the 1970s and 1980s, there was a significant shift in emphasis from a relatively deterministic antitrust enforcement policy to one based on the belief (under the aegis of the so-called Chicago School) that those market imperfections that are not the result of government subsidies, quotas or franchises, would be assuaged by heightened competition. Antitrust initiatives were not seen as a generally successful remedy. More recently, limited avenues for antitrust policy are perceived by policymakers to enhance market efficiencies

That markets, on occasion, can be shown to be behaving in a manner presumed inferior to some presubscribed optimum is not a difficult task. For example, suboptimal product or operational standards are seen by some to persist because, once in place, they are difficult to dislodge. Often cited is the word processor keyboard whose key placement still reflects the

manual typewriter's need to prevent its keys from sticking, rather than convenience to the typist. A more recent example pointed to by some is the universal adoption of VHS-based VCR technology. The more general proposition is that the success of competing technologies depends more on the relative size of their initial adoptions than on the inherent superiority of one over the other (what economists term "path dependence"). I should point out, however, that these examples, and the more general proposition, are not without challenges.

To demonstrate that a particular antitrust remedy will improve the functioning of a market is also often fraught with difficulties. For implicit in any remedy is a forecast of how markets, products, and companies will develop.

Forecasting how technology, in particular, will evolve has been especially daunting. The problem is that the various synergies of existing technologies that account for much of our innovation have been exceptionally difficult to discern in advance. For example, according to Charles Townes, a Nobel Prize winner for his work on the laser, the attorneys for Bell Labs initially refused, in the 1960s, to patent the laser because they believed it had no applications in the field of telecommunications. Only in the 1980s, after extensive improvements in fiber optics technology, did the laser's importance for telecommunications become apparent.

Moreover, almost by definition, antitrust remedies are applied mainly to firms dominant in their industries. Yet the evidence of sustained dominance where markets are generally open are few. There has been a tendency for one firm to dominate in the early development of many of our industries where economies of scale enabled significant reductions in unit costs and hence prices. U.S. Steel, General Motors, and IBM are only the more prominent cases of market share erosion after early virtual dominance of their industries was achieved. One wonders how long

the Standard Oil Trust's near monopoly of refining would have prevailed, even without the landmark antitrust breakup in 1911, as upstart competitors Royal Dutch Shell, British Petroleum, Gulf, and the Texas Company (Texaco) undercut Standard

I am not saying that dominant positions in industries cannot be maintained for extended periods, but I suspect in free competitive markets that it is possible only if dominance is maintained through cost efficiencies and low prices that competitors have difficulty matching. By the measure of what benefits consumers, such enterprises should not be discouraged. Natural monopolies are an exception, but technology is increasingly reducing the areas of our economy where such monopolies can prevail. Banking and other regulated industries are of course a further exception.

The possibility of economies of scale leading to very large firms relative to any one nation's economy illustrates and emphasizes the importance of international free trade policies in maintaining domestic competition. In some industries, free trade may be essentially the only way to maintain truly competitive markets to the benefit of consumers in all of the nations involved. Nevertheless, it is also interesting to note that some, such as Professor Michael Porter at Harvard, have found that the most successful exporters have evolved out of domestically competitive industries.

In any event, we have come a long way in attitudes about market power and antitrust enforcement from the days, more than a half-century ago, when a Federal Appeals Court opined in the Alcoa case, that "we can think of no more effective exclusion [of competitors] than progressively to embrace each new opportunity as it opened, and to face every newcomer with

new capacity already geared into a great organization, having the advantage of experience, trade connections and the elite of personnel "

If competitors are excluded because of a company's excellence in addressing consumer needs, should such activity be constrained by law? Such a standard, if generally applied to business initiatives, would have chilled the type of competitive aggressiveness that brings efficiencies and innovation to the marketplace. Fortunately, that principle was subsequently abandoned by the Supreme Court. More importantly, antitrust actions of recent years have sought to enhance efficiencies and innovations. I leave it to others to judge their degree of success. But the regulatory climate in antitrust, indeed throughout government, has moved in a more market-oriented direction. I believe that is good for consumers and the nation.

In conclusion, the United States is currently experiencing its fifth major corporate consolidation of this century. When trying to understand and deciding how to react to this development, I would hope that we appropriately account for the complexity and dynamism of modern free markets. Foremost on the agenda of policy makers, in my judgment, should be to enhance conditions in our market system that will foster the competition and innovation so vital to a prosperous economy.