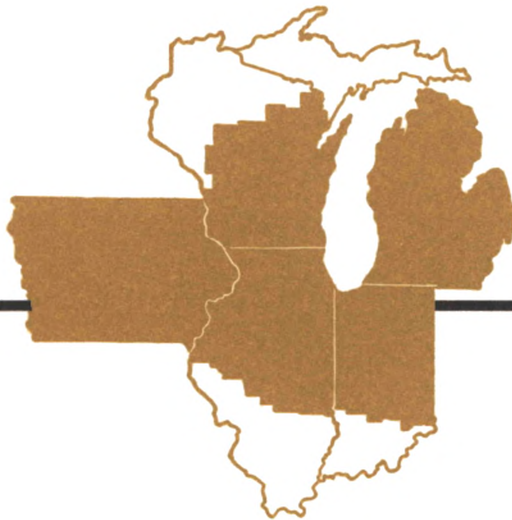
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1967 January

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ANNUAL REPORT: The 1966 Annual Report of the Federal Reserve Bank of Chicago contains the bank's financial statements, brief reviews of last year's developments in business, agriculture and banking, and a 24-page illustrated feature article, "Machinery and equipment—key industries in the Midwest." Copies of the Annual Report may be obtained from the Research Department.

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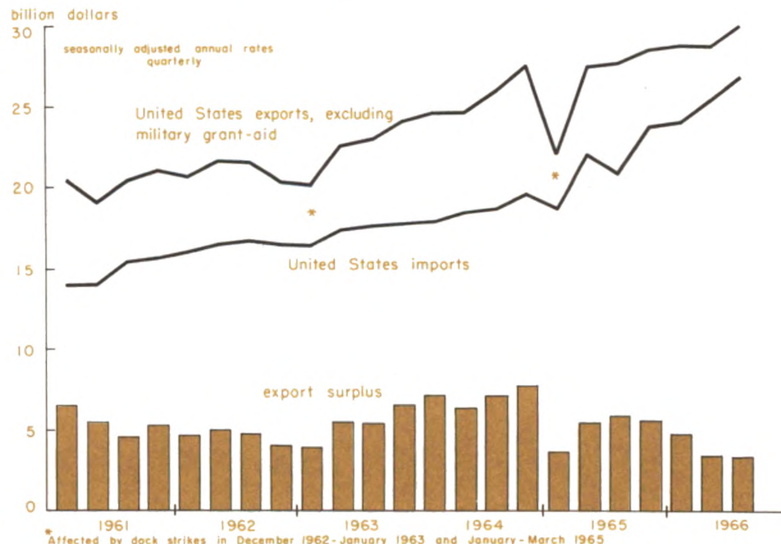
The diminishing trade surplus

The increasing prosperity in the United States during 1966 was accompanied by unfavorable developments in the nation's foreign trade accounts. The trade surplus (traditionally the source of strength in our overall balance of payments) deteriorated substantially from a seasonally adjusted annual rate of 5 billion dollars during the first three quarters of 1965 to about 3.8 billion during the same period in 1966. This reduction has been largely the result of a sharp increase in imports.

Throughout the economic expansion in the Sixties, United States imports have been increasing at an average rate of about 12 percent annually. At an annual rate of 25.3 billion dollars during the first nine months of 1966 (the latest period for which reliable data are available), imports topped the 1965 total by 19 percent. During the same period, exports at an annual rate of 29.1 billion dollars exceeded the 1965 level by only 10 percent. In any other year, such an export performance would have been viewed as excellent; in 1966 it has been insufficient to offset burgeoning

Merchandise imports rise faster than exports, beginning in 1965



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imports—hence, the deterioration of the trade surplus.

Causes of rising imports

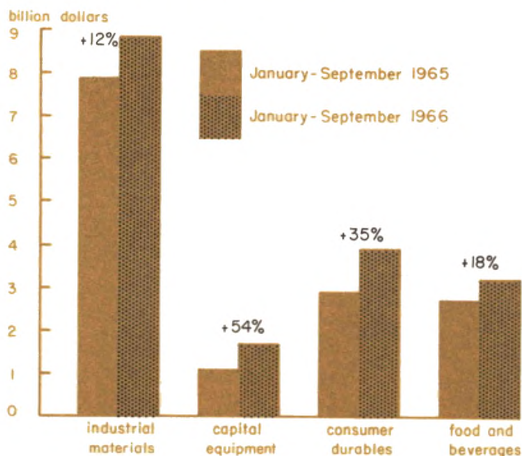
The rise in imports may be attributed in part to the continued advances in domestic industrial output. United States industry relies on imports of raw materials and industrial supplies and, thus, with production of finished goods rising, these categories of imports should also increase. As the table on this page indicates, however, gains in these categories have been relatively small. Moreover, the rate of growth of imports of industrial supplies comparing the first nine months of 1966 with the same period of 1965 was somewhat lower than the rate of growth for 1965 compared with 1964. For example, imports of crude petroleum and iron ore rose less than last year while imports of steel mill products were virtually unchanged. This was in contrast with the abnormally large rise of 60 percent last year caused by hedge buying in anticipation of the steel strike.

Industrial supplies show moderate increase in imports

Selected imports	January-September 1965 (million dollars)	January-September 1966 (million dollars)	Change (percent)
Fuels and lubricants	1,653	1,715	+ 4
Nonferrous base metals	832	1,074	+29
Iron and steel mill products	864	864	0
Chemicals	549	725	+32
Textile fibers	329	358	+ 9
Lumber	282	319	+13

SOURCE: U.S. Department of Commerce.

All major imports advance sharply in 1966



A far more important cause of the sharp increase in imports appears to lie in the strains on United States resources in mid-1966, resulting from five years of uninterrupted rapid expansion. The slack that existed in the economy in the early phases of the expansion had been mostly absorbed by early 1966. The unemployment rate dropped to the lowest levels since the early Fifties, and the rate of utilization of manufacturing capacity reached the highest level since 1955. Moreover, increased defense requirements during early 1966 were superimposed on an already booming economy; thus, while domestic output continued to expand at a rapid pace, it could not keep up with the even more rapid increases in total spending. As a result, prices rose and demand for foreign-produced goods to supplement domestic production expanded.

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These demand pressures were particularly marked in the capital goods sector. Domestic expenditures on new plant and equipment by American firms in 1966 rose 17 percent from the record level reached last year. The order backlog of United States machinery and equipment producers totaled 23.8 billion dollars in August 1966—a 29 percent increase from the previous year. Delays in deliveries and long lead times caused some purchasers of capital goods to turn to foreign suppliers. Competitive prices and increasingly more dependable service from foreign suppliers encouraged this trend. Consequently, imports of capital equipment have risen sharply. For example, imports of metal-cutting tools jumped 135 percent from January through September 1966—more than twice the growth rate of the comparable period of 1965. As the table below indicates, the increases in other categories also were substantial.

Large jump in imports of machinery and transportation equipment

Selected imports	January-September 1965	1966	Change
	(million	dollars)	(percent)
Transportation equipment	803	1,546	+93
Machinery			
Electrical	428	687	+60
Power generating	138	239	+72
Tractor and agricultural	149	195	+31
Textile	108	162	+49
Office	94	131	+40
Metalworking	43	88	+106

SOURCE: U.S. Department of Commerce.

Imports of consumer goods rise appreciably

Selected imports	January-September 1965	1966	Change
	(million	dollars)	(precent)
Durable goods			
New cars	433	840	+94
Clothing	389	458	+18
Gems and diamonds	239	309	+29
Radio and TV sets	118	173	+47
Motorcycles	102	156	+53
Footwear	118	141	+19
Musical instruments	105	135	+29
Other consumer goods	1,413	1,712	+21
Foods and beverages			
Coffee	692	820	+18
Meat	300	442	+47
Fish	348	404	+16
Sugar	298	377	+27
Whiskey	181	226	+25
Other	903	945	+ 5

SOURCE: U.S. Department of Commerce.

The higher prosperity of the United States consumer was reflected in United States imports. Arrivals of consumer durable goods increased more than 1 billion dollars through September—a 35 percent gain over the first nine months of last year. The most notable increases occurred in the imports of passenger cars, motorcycles and electronic products (mostly radios and TVs from Japan). The acceleration of the upward trend in imports of cars was brought about largely by the relaxation of duties on automobile imports from Canada under the Automotive Products Trade Act of 1965, but imports of cars from West Germany, Sweden and Japan also rose.

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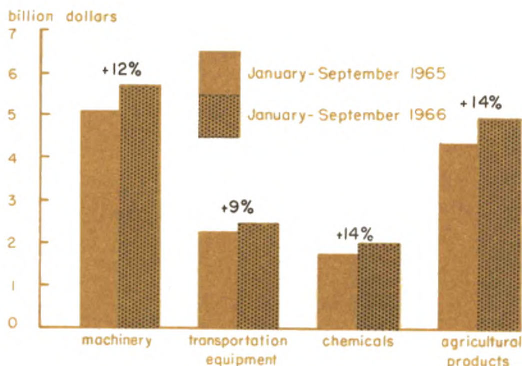
In addition, consumer purchases of imported foods and beverages advanced sharply in the first nine months of 1966. For example, imports of beef, mainly from Australia and New Zealand, increased 60 percent. Larger supplies of feeder cattle from Canada and Mexico reflected strong domestic demand and higher United States prices.

Rising exports

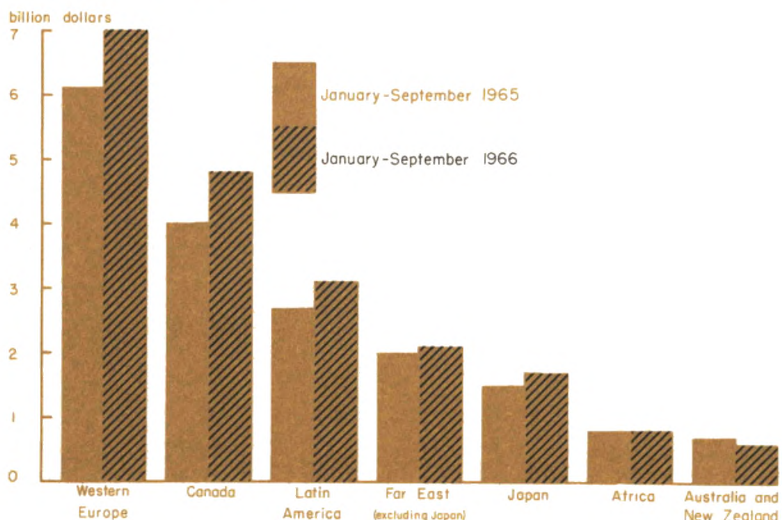
While overshadowed by the exceptionally rapid increase in imports, the United States export performance in the first three quarters of 1966, nevertheless, was excellent. Perhaps the most significant aspect of the export expansion has been its uniformity both in respect to areas of destination and to individual categories of goods exported. This was in sharp contrast with 1965 when the bulk of the rise in exports represented shipments of nonagricultural goods to Canada. As indicated below, with the exception of a slight decline for Oceania (mainly Australia and New Zealand), the advance in exports in the first three quarters of 1966 was well distributed among all areas. In terms of goods exported, the expansion was evenly distributed between agricultural and nonagricultural products. During the first nine months of 1966, agricultural shipments were running about 14 percent higher and nonagricultural products about 12 percent higher than in the comparable period in 1965.

Among agricultural products, the most significant increase occurred in the shipments of wheat. Commercial sales of wheat (mainly to Western

Major exports rise
but less sharply than imports



United States exports
expand to most areas



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Most exports rise
in first nine months of 1966

Selected exports	January-September 1965	1966	Change
	(million dollars)		(percent)
Electrical machinery and apparatus	1,219	1,393	+14
Construction machinery	727	743	+ 2
Parts for motor vehicles	617	735	+19
Coal and petroleum	675	688	+ 2
Cars and trucks	524	653	+25
Engines	498	589	+18
Aircraft	601	576	− 4
Scientific instruments	345	413	+20
Office machinery	333	395	+19
Iron and steel mill products	437	391	−11
Agricultural machinery	338	357	+ 6
Metalworking machinery	239	246	+ 3
Other nonelectrical machinery	1,710	1,957	+14

SOURCE: U.S. Department of Commerce.

Europe, South Africa and Japan) accounted for about four-fifths of the increase. The remainder has been taken up by increases in shipments of wheat under the PL-480 aid program. Growing livestock feed requirements in Western Europe and Japan account for the steady rise in American exports of corn and other feed grains, as well as for increases in soybeans. Higher prices and reduced domestic supplies of dairy products and eggs—combined with increased output of these commodities in our largest market, Western Europe—resulted in a decline in these exports in 1966.

The gains in nonagricultural products have been evenly distributed among various major categories. But the specific subcategories reflected the preemptive pressures of domestic demand and military requirements. For example, while the shipments under the general category "machinery" increased 12 percent, metalworking machinery and construction machinery increased only 3 and 2 percent, respectively.

Conclusions

Deterioration of the nation's trade surplus, coming at the time when efforts have been aimed at the reduction in the overall balance of payments deficit, has been disappointing. While various measures undertaken by United States corporations and banks in response to the President's voluntary balance of payments program have achieved and even exceeded the goals set up in the previous year, the improvements attained by these programs have been obscured by the rise in imports.

Some encouraging signs, however, may be noted. Most important of these has been the strong performance of exports and a good prospect for further increases. The world's economic progress—and with it the demand

The United States share
of world exports increases in 1966

	Nonelectrical machinery	Electrical machinery	Transportation equipment	Chemicals
	(percent of world exports)			
1960	32.7	28.3	33.1	29.6
1963	30.2	26.8	28.2	26.9
1965	30.8	24.0	27.6	24.7
1966				
1st quarter	30.7	25.1	29.4	24.3
2nd quarter	30.9	25.6	28.3	25.0

SOURCE: U.S. Department of Commerce, International Commerce (various issues).

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for United States exports—shows no signs of slackening. While there has been some "cooling off" of demand in the economies of some of the major United States customers (such as the United Kingdom), others (for example, France and Italy) are undergoing a vigorous expansion that will undoubtedly mean further increases in United States exports.

Also encouraging has been the reversal in the decline of the United States share of world exports of manufactured goods recorded in the first half of 1966 (see table). However, some of these categories might have been influenced by a dock strike in Britain—our major competitor. Thus, it would be premature to draw conclusions on the basis of this preliminary evidence. Also, the overheating of the economy that became increasingly apparent during the first three quarters of 1966 appears to be subsiding. Imports of industrial materials other than steel and petroleum did not increase in the third quarter after having risen in each of the previous four quarters. Moreover, there are indications that domestic demand for machinery and equipment is moderating. This, together with increases in capacity, may slow the rise of this category of imports. Of course, any leveling in demand for domestic uses will free more goods for export. With minor exceptions, United States manufacturers' unfilled export orders for machinery have been expanding since late 1963; and this rate accelerated in 1966. Developments in 1967 may give the United States manufacturers an opportunity to "catch up" and thus contribute to an improvement of our balance of trade in the months ahead.

Competition in banking: the issues

In an economy characterized by private property and production for profit, competition among buyers and sellers has long been considered a prime prerequisite of economic efficiency—efficiency in this context being construed to include both the maximizing of output for any given resource used and the allocation of resources among all possible uses such that total production is maximized.

So strong has been the American belief in impersonal market forces to set prices and guide production, as opposed to joint decisions among producers or the decrees of government boards, that our country early put on the books the strictest and most comprehensive antitrust legislation in the world. The basic statutes are the Sherman Act of 1890 and the Clayton and Federal Trade Commission Acts of 1914.

To be sure, it has long been recognized that the technologies of some industries preclude primary reliance upon competition to guide investment, production and pricing. In these so-called "natural monopolies," such as the production and distribution of electric power and other "public utilities," the discipline of the marketplace has been replaced by the deliberations of public regulatory agencies.

Still other industries, although not consid-

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ered natural monopolies, have been acknowledged as greatly affecting the public interest and have been partially shielded from the impact of unrestrained competition. Put another way, the failure or other malfunctioning of an individual establishment in these industries has been deemed to have adverse effects on the economy over and beyond the injury accruing to the firm's stockholders. Consequently, public regulation has been imposed in order to assure that certain minimal operating and fiduciary standards are met. Of the industries accorded such treatment, commercial banking is probably the most prominent.

Why banks are regulated

Demand deposits of commercial banks provide the primary means of payment and, hence, are the major component of the money supply. Widespread failures of banks and sharp declines in the money supply have been associated with economic crises in past years. Furthermore, banks, while presumed by the public to be safe depositories, typically have liabilities that are very large in proportion to their capital and consequently could provide an attractive temptation to gambling by reckless entrepreneurs. These conditions alone would suggest the desirability of regulation to assure the liquidity and solvency of commercial banks. In addition historical experience lends support to the view that permitting banks to engage in unrestrained competition may lead to disastrous results. The evils of the past—specifically, the chaos and instability that attended the era of "free banking" between 1837 and 1863, the large numbers of bank failures in the 1920s and the banking collapse and economic depression of the early 1930s—have sufficed to convince most people that some measure of Government intervention is not only desirable but an absolute necessity.

The Federal and state governments have responded to the apparent need by constructing over the years a highly detailed and extensive system of commercial bank regulation that includes specific lending and borrowing restrictions, usury laws, ceilings on rates that banks may pay on time deposits, the prohibition of interest on demand deposits, capital and management requirements for the establishment of new banks, geographical restrictions on branching, requirements for periodic publication of statements of condition and examinations by public officials.

Why competition in banking?

Since official regulation imposes numerous limitations on the activities of banks, vigorous competition among banks may appear both superfluous and inconsistent. After all, one may ask, is not the public's interest in having quality services provided at reasonable prices protected in banking through public regulation, as it supposedly is for electric utilities and transportation? The answer, clearly, is in the negative.

Although commercial banks are subject to a great number of specific regulations limiting the scope of their activities, a broad range of discretion still remains open to them. As far as their lending and investment activities are concerned, banks retain the prerogative of emphasizing particular kinds of loans (for example, business, consumer, agriculture and mortgage loans) and of setting prices for these loans at whatever levels they choose, subject only to the ceilings on some types of loans established by state usury laws. Thus, there is ample room for the play of competitive forces to establish the actual levels of charges.

The scope for nonprice competition in banking is even wider. The services provided

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in conjunction with the bank's lending and deposit business provide a variety of opportunities for nonprice maneuvers designed to win new customers and retain old ones. It is the incomplete nature of regulation which, while imposing definite constraints on each bank's choice of alternative policies, nevertheless permits a wide latitude for the exercise of individual discretion that provides a meaningful role for competition in banking. This is the consideration that lay behind the Supreme Court's dictum in *U. S. vs. Philadelphia National Bank* that the regulated character of banking "makes the play of competition not less important but more so."

Changing views on competition

Interest in banking competition has intensified in recent years. After virtually ignoring the commercial banking industry for many years, the Justice Department brought suit in the late 1950s in a number of cases involving clearinghouse agreements to set uniform service charges. In more recent years, despite a long and widely held belief to the contrary, the courts have ruled that the antitrust laws apply to acquisitions and mergers in banking as well as in other areas.

It may appear rather anomalous that the Federal Government, having established a superstructure of regulation designed at least in part for the purpose of limiting competition in banking, now undertakes to restrict banks' actions which might tend to reduce competition. The issue is further confused by the fact that the Office of the Comptroller of the Currency and the Department of Justice —two agencies of the Federal Government— have been on occasion cast in the roles of opposing parties in recent bank merger cases. It would be inaccurate to portray these events as reflecting merely a jurisdictional dispute between Federal agencies. Instead there appears to be a growing conviction on the part of public officials and bankers alike that a reevaluation and revision of policy may now be in order—though there is little agreement on specific issues.

Until recently students of banking were generally agreed that competition was not only less essential in banking than in most other industries but in many circumstances inherently destructive. However, new evidence and reexamination of old arguments now suggest that competition in banking may not have been the culprit it has been painted to be in bringing about the financial crises of earlier days. The banking troubles of the era before 1863 are now considered to have been the result of the absence of a uniform national currency as well as excessive competition and the lack of detailed controls over banking. This deficiency was remedied in part by the passage of the National Banking Act of 1863, which substituted national bank notes for the bewildering variety of state bank issues then in circulation.

Similarly, the periodic epidemics of bank failures of the late nineteenth and early twentieth centuries, as well as the striking and unprecedented attrition of banks in the decade following World War I, appear to have had their roots more in cyclical factors and secular changes in transportation and agriculture than in any inherent tendency toward destructive competition in banking. Even the banking debacle of the early 1930s is no longer uncritically viewed as the inevitable result of imprudent banking practices attributable largely to excessive competition for deposits. On the contrary, all of these instances of injury to the banking system—and in most cases, to the economy as well—are now generally agreed to have had their major cause in developments much broader than local competition and often far removed

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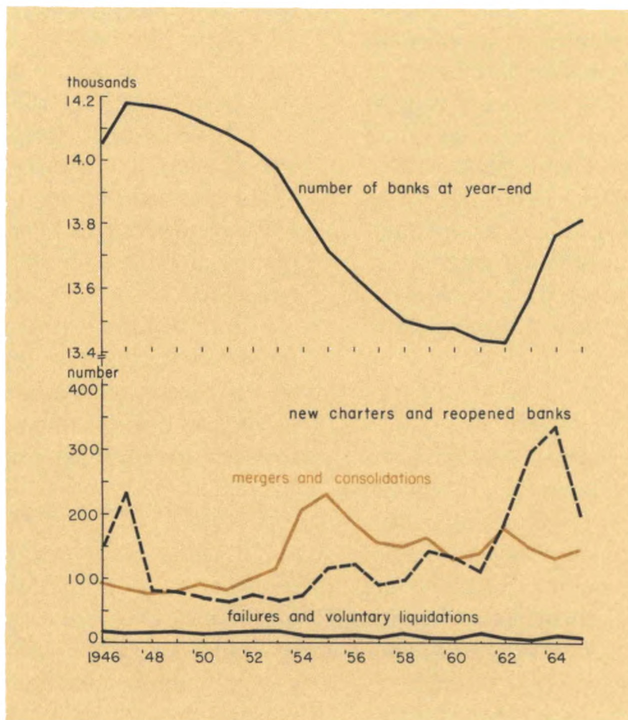
from the sphere of individual bank management.

Moreover, today there exist numerous safeguards against any widespread and self-reinforcing epidemic of bank failures. To the extent that violent cyclical fluctuations in aggregate economic activity may have been responsible for the waves of bank failures in the past, the announced readiness of the Federal Government and the Federal Reserve System to take whatever fiscal and monetary measures are required to maintain a high and growing level of income and employment serves as protection against similar future disturbances. To the extent that bank failures were the result of "runs" on banks occasioned by general fears on the part of the public of the inability by banks to redeem their deposits for currency, Federal Deposit Insurance and the readiness of the Federal Reserve to act as the lender of last resort appear to afford a sufficient remedy. These safeguards suggest that competition can play a more important role in banking than it has until recently without leading to undesirable consequences.

Number of commercial banks

rises in recent years
following many years of decline



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Regulation frequently has been unsuccessful in suppressing competition even where it has undertaken to do so. For example, the attempt to reduce interbank competition by erecting strict legal barriers to entry has been at least a major contributing cause to the rapid and continuing growth of such nonbank financial intermediaries as savings and loan associations, a growth that has brought with it increased interindustry competition.

The attempt to relieve effects of unduly severe competition among banks by prohibiting them from paying interest on demand deposits has been only partially successful at best. Far from eliminating competition, the prohibition simply caused banks to substitute less overt but nonetheless vigorous nonprice rivalry for the rate competition that previously existed. In effect, "interest" on demand deposits continues to be paid through an earnings credit offset to deposit service charges and numerous "free" services, all dependent largely on the size of the average balance and the number of transactions associated with each account. On the other hand, the depositor has been deprived of the option of being paid in cash.

Increased number of branches more than offsets decline in number of banks

State classification*	Change, 1946-64					
	Banks		Branches		Banking offices	
	Number	Percent	Number	Percent	Number	Percent
Branch banking						
Statewide	−323	−23	3,922	24	3,599	118
Limited	−979	−15	6,097	290	5,118	60
Unit banking	1,018	17	338†	148†	1,356	21
Total	−284	−2	10,357	260	10,073	56

*Includes 50 states and District of Columbia.

†Includes offices that do not offer a full line of banking services. In addition, a few full service branches that were established before legal prohibitions of branching or after removal of such prohibitions are included.

SOURCE: U. S., Comptroller of the Currency, *Annual Report 1964* (Washington, 1965).

Changes in number of banks

While much of the recent interest in competition in banking has been focused on the system of bank regulation as presently constituted, expressions of concern have also been voiced concerning the merging and branching activities of the banks themselves. Despite virtually uninterrupted prosperity and population growth in the postwar period, the number of commercial banks in the United States has been declining until very recently.

After a small immediate postwar rise from 14,011 in 1945 to 14,181 in 1947, the number declined steadily, reaching a low of 13,427 at the end of 1962. Since then the number of banks has increased slightly to 13,784 in November 1966. The net decrease of 227 banks since World War II—an average of about 10 a year—is small compared to the rate that prevailed throughout the generally prosperous 1920s when the average net annual attrition exceeded 700. However, in contrast to the earlier period when a significant part of the attrition resulted from bank failures and voluntary liquidations, virtually all the recent decline has been the result of mergers and acquisitions that have absorbed formerly independent banks.

Numbers and competition

To many observers this decrease in the number of banks provides evidence that the availability of alternative sources of supply of banking services, and hence the vigor of competition, is undergoing a decline. This conclusion is based on the theory that the

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chances of collusion are less and the likelihood of independent rivalry greater when sellers are many than when they are few.

However, in evaluating the effect of the decline in the number of banks, it must be noted that all of the more than 13,000 banks in the United States do not compete in a single, nationwide market. A relatively few giant banks do operate in what is loosely referred to as the "national banking market"—the market for the loans and deposits of the largest corporations that have banking connections throughout the country.

But it is a widely acknowledged fact that, for most bank customers, the national market is segmented by the real and psychic cost of distance into relatively narrow regional and local submarkets. For this less mobile majority of customers, the most relevant consideration is the number of independent banks within the confined area in which their reputations are known and in which they find it practicable to seek accommodation. This number of banks, however, is not deducible from a knowledge of how many banks there are in some broader area, such as the state. Given the ability of banks to have branch offices in approximately two-thirds of the states, it is possible for the average number of individual banks competing in each local market to increase even though the number of banks in these states or in the nation overall is declining.

Although states which permit branch banking have experienced wide declines in the number of banks, it does not necessarily follow that significantly fewer different banks are represented in individual communities in these states than in those that prohibit branch banking. This apparent contradiction is explained by the great expansion in the number of branch offices during the past several decades. Similarly, even when mergers have decreased the total number of banks in the country and the number of alternatives available to customers in particular local markets, they may have added to the number of effective competitors in the markets serving large- and medium-sized corporate customers by permitting the merging banks to attain the minimum size required to operate in these markets.

Concomitant with the decline in the number of banks, the average size of bank and the percentage of banking resources concentrated in the hands of a relatively few large banks have increased in many broad areas of the country. Concentration in this sense is often considered to have a potentially adverse effect on competition because, however large the total number of banks in a market, if one or a few of them control most of the total supply, they will be able to influence prices strongly.

Available data on concentration of deposits in major metropolitan areas indicate that concentration levels were generally higher in the early 1960s than a decade earlier. On the other hand, they appear to have been lower than in the prewar year of 1939. Inasmuch as concentration and changes in concentration have significance for competition only in relation to specific product markets and particular groups of customers, it is necessary to take account of important interarea differences. For the period 1960-64 increases in concentration have been typical in metropolitan areas in states where statewide branching is prevalent (see table on page 14). In metropolitan areas where restricted branch banking is the rule, increases and decreases were about equally frequent. Decreases predominated in these areas where unit banking was the most common form of bank organization.

Some would interpret these figures as demonstrating that unit banking is more con-

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ducive to competition than branch banking. However, such a conclusion follows only if certain conditions are satisfied. Among these is the rather crucial assumption that metropolitan areas serve equally well as approximations to local banking markets under both branch and unit banking. To the extent that locational convenience serves to restrict the practicable range of alternatives of some customers to an area smaller than the whole metropolitan area, concentration in unit banking areas is understated by the measure used here. A more important qualification is that competition has not been shown to depend in any simple and reliable way on the degree of concentration in bank markets.[1]

Public policy toward bank mergers

In deciding whether to approve or disapprove a particular application to merge, the appropriate regulatory agency must arrive at a judgment concerning the probable effect of the merger on the public interest. The fundamental questions that must be answered include the justification of the consolidation in terms of economies of scale or the ability of a larger bank to render better, cheaper and more complete banking services and its effect, via changes in the number and size distribution of banks, on the competitive relations among the remaining firms. It is over answers to these questions that much of the interagency conflict has arisen.

For example, advantages in the form of lower operating costs have often been advanced as a major factor in bank mergers. Yet, available empirical studies tend to indicate that such economies may be quite modest—at least when the differences in output mix between large and small banks are taken into

[1]These and other measures of the degree of competition are discussed in *Business Conditions*, December 1965, pp. 11-16.

Metropolitan areas in statewide branch banking states show greatest increases in concentration

SMSAs including reserve cities*	Percent of total deposits held by three largest banks		
	1960	1962	1964
Branch banking			
Statewide			
Baltimore	59	73	72
Los Angeles	78	75	71
Portland, Ore.	87	90	89
San Francisco	60	79	77
Seattle	68	72	72
Limited			
Atlanta	72	75	74
Birmingham	93	93	97
Boston	79	83	83
Buffalo	77	93	95
Cincinnati	82	84	84
Cleveland	78	77	76
Columbus	88	87	93
Detroit	78	76	74
Indianapolis	97	96	96
Louisville	68	76	76
Memphis	93	93	93
Nashville	89	92	93
New Orleans	85	80	79
New York	49	53	54
Philadelphia	64	62	64
Pittsburgh	82	83	81
Richmond	80	78	73
Toledo	90	88	88
Washington, D. C.	74	75	73
Unit banking			
Chicago	48	53	52
Dallas	80	79	76
Denver	69	68	68
Fort Worth	77	76	73
Houston	60	59	64
Jacksonville	79	75	72
Kansas City, Mo.	63	61	58
Miami	41	43	40
Milwaukee	68	67	66
Minneapolis	60	62	60
Oklahoma City	70	72	71
Omaha	82	80	79
St. Louis	52	50	48
San Antonio	67	64	62
Tulsa	81	79	76

*Metropolitan areas of Reserve Cities having populations in excess of 400,000 as of April 1, 1960.

SOURCE: Federal Deposit Insurance Corporation, *Annual Reports*.

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consideration, as they must be.

A second argument in support of mergers emphasizes the ability of a bank with greater resources to hire better management and to utilize more fully the services of a large number of specialists. This argument appears to have fairly general validity as indicated by both casual observation and a number of recent studies. Large banks generally do offer a broader variety of services than is obtainable at small banks in the same locality. However, whether this constitutes a net advantage is not immediately obvious. It must be determined whether a decrease in the number of alternative sources of banking services is adequately compensated by the availability of a number of special, but infrequently utilized, services that only large banks can supply.

Branch banking

Any discussion of the relative merits of large and small banks must include consideration of the arguments in support of and opposition to branch banking. One of the major advantages claimed for branching is that it is often the quickest way a bank can grow to large size. Also, since the full resources and facilities of the bank can be made available to the customers of each branch, branch banking provides a means of bringing a fuller range of banking services and larger lending capacity to individual communities.

The advantages and disadvantages of branch banking constitute one of the oldest and most vitriolic controversies in American banking. The arguments involve questions both political and economic in character. Without evaluating the merits of the arguments, it may be noted that the unit-branch issue is an inseparable part of the larger public debate over competition in banking reviewed above.

The precise relationship between the branch banking and banking competition is a matter of dispute. A number of economists, bankers and public officials maintain that branching is an essentially procompetitive form of banking that facilitates the penetration of additional banking markets and brings to bear the force of potential competition on even the smallest and most isolated banking markets. On the other hand, many students of banking hold that branching is a monopolistic device whose prime purpose is the attenuation of competition. Which characterization is the more accurate may depend as much on what one understands by competition as on the objectively determinable facts of the case.

It is hardly open to serious doubt, for example, that some portion of the criticism of branch banking is of a protectionist nature, more concerned with preserving locally owned unit banks than with fostering vigorous interbank rivalry. Independent bankers frequently feel themselves threatened by the presence of a nearby office of a large branch bank.

On the other hand, it is not always easy to distinguish in practice between the protection of competitors and the preservation of competition. One reason is related to the difference between the incentives required to induce merger and those required to induce *de novo* establishment of a new bank or branch. It appears easier for two existing banks to come to terms on a merger agreement which has as one of its "fringe benefits" the elimination of competition than it is for a potential entrant into the banking field to obtain financing and run the regulatory gauntlet required to obtain a charter for a new bank. As was indicated above, it is in these areas where the possibility of operating an acquired bank as a branch maximizes the incentive to merge that the disappearance of

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banks and the concentration of banking have proceeded most rapidly. This pronounced assymmetry between merger and entry is the primary reason why branching via merger, which *ipso facto* involves the elimination of an independent source of supply, may have adverse and irreversible effects on competition. It is also one of the considerations that prompted Congress in 1950 to strengthen the Clayton Act and to pass the Bank Merger Acts of 1960 and 1966.

It might still be maintained, on the other hand, that *de novo* branching could have nothing but beneficial effects on competition. Its immediate effect is always to introduce a new competitive force into a banking market or submarket. When, for example, a branch bank sees a potentially profitable location for a banking office and opens a branch there—perhaps years in advance of the time when it would have been profitable to organize a new unit bank—it benefits the community to have banking facilities where none existed before or would otherwise have existed for a considerable period of time. Whether this is a net gain in the long term depends on the potential benefit to the local populace of having an independent source of supply of banking services when it would become feasible to open a new unit bank.

Where banks find it easy to establish branches within a local banking market they may—and often do—anticipate profitable locations and saturate entire areas with branches, thereby largely foreclosing future entry by competitors. In this they may be inadvertently aided and abeted by the regulatory agencies, which are frequently reluctant to grant a new charter that could conceivably result in "overbanking." Overbanking typically implies a situation in which insufficient banking business is considered to exist to support all of the banking institutions in the area and which must eventually result in the forced exit of one or more of them.

At a theoretical level a good case can be made for removing all geographic restrictions on branching, while simultaneously discouraging concentration in particular local banking markets. However, this would require a uniform national policy with respect to branching and the chartering of new banks, a development not now on the horizon. Legislation regarding branching traditionally has been left to the states. Nevertheless, the competitive environment created by state branching restrictions is clearly one of the many factors that must be taken into account in Federal Agency decisions governing mergers.

Conclusion

There exists a great deal of uncertainty at the present time as to what public policy would promote optimum competition in banking. Ideally, policy should undertake to attain a degree of interbank rivalry that assures that consumers will be provided bank services of high quality at minimum cost, without sacrificing the private and public benefits of large-scale production or the regulatory aim of ensuring the liquidity and solvency of the banking system. The extent to which these goals can be realized simultaneously and even the direction in which policy should move to approach them as closely as possible is still imperfectly understood. However, a start toward collecting and interpreting the data that would permit a more objective basis for deciding these issues has been made. In a subsequent article the limited but growing body of empirical knowledge of the relationship between banking structure and performance will be reviewed. This information, limited and inconclusive as it is, constitutes the hard-won fruit of numerous past and current research studies.

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