Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Putting the Brakes on LCVs

TO THE EDITOR:

In your Summer 1991 edition (Vol. 14, No. 3) Robert Farris of the American Trucking Associations asked, "Should the Federal Government Allow the States to Increase Truck-Size Limits?" Mr. Farris answered with a resounding yes.

That is the wrong answer.

Longer combination vehicles (LCVs), which weigh up to 135,000 pounds and cover the height of a ten-story building, should not be allowed to spread their range beyond the twenty states where they now operate. These "truck trains" are simply not compatible with the automobiles which must share the roads with them.

Let me commend to your attention a few statistics that Mr. Farris ignores. A study by the National Highway Traffic Safety Administration noted that although just 3.2 percent of all vehicles on the road are medium and heavy trucks, they are disproportionately responsible for 8.4 percent of fatal crashes. The specific overinvolvement in crashes of trucks with more than one trailer also has been shown unequivocally in independent studies by the Insurance Institute for Highway Safety (overinvolved for all crashes by two to three times), the University of Michigan Transportation Research Institute (32 percent overinvolved for fatal crashes), and the University of North Carolina Safety Research Center (4.3 times the average truck overturn rate).

Further, Mr. Farris pays no heed to the consistently documented views of the driving public, which overwhelmingly opposes big trucks on the highways. A national survey in April 1991 by pollsters Frederick/Schneiders Inc. shows 74 percent favor banning LCVs. More than 67 percent of professional truck drivers polled by the American Automobile Association Foundation thought triples much less safe than regular tractor trucks, while more than 85 percent did not want to drive them.

For all these reasons, groups as diverse as the American Insurance Association, the Teamsters, shock trauma doctors, and the Sierra Club oppose LCVs.

Based on all the evidence, the answer to the question, "Should the Federal Government Allow the States to Increase Truck-Size Limits?", is an emphatic no.

Anthony Garrett
Executive Director
Citizens for Reliable and Safe Highways
San Francisco, Calif.

Letting the States Decide

FARRIS replies:

Mr. Anthony Garrett seems to have missed the point of the thrust of the trucking debate in *Regulation* (Vol. 14, No. 3, 1991). The question before us was "Should the *Federal* Government Allow the States to Increase Truck-Size Limits?"

As Mr. Garrett acknowledges, twenty states are now allowed to permit such vehicle combinations and thirty states are not. It is the state governments that are charged with the responsibility of supervising the operation of these permitted vehicles. It is the states that issue the permits to the trucking companies that wish to use these special vehicles. If these units are unsafe, the states have the power and responsibility to revoke the permit. To date, no permit has *ever* been permanently revoked.

It would follow then that it is the states that should make the determination of whether these units may be safely operated in that it is the states that will be called upon to supervise their operation and benefit from their favorable economic impact. That is why I favor allowing the states to make that determination and not Congress. My position was supported by the recommendations contained in the Transportation Research Board's *Truck Weight Limits: Issues and Options*, a study requested by Congress and released last summer.

I wish to commend Mr. Garrett for his concern for highway safety and wish to assure him we share his desire to make our roads as safe as possible. I question, however, his limited focus. Is it just a coincidence that Mr. Garrett and his organization have focused on these special combinations of truck tractor and trailers that just happen to be highly competitive with the railroads? Surely, this has nothing to do with the fact that much of his organization's money has come from companies that sell or lease equipment to the railroads.

One final comment on the safety of longer combination vehicles. Insurance companies make their money on assigning a value to the risk exposure they incur when they issue a policy to an individual or company. Just compare the cost of an automobile policy for someone fifty years old with that for someone eighteen years old. The eighteen year old pays a higher premium in that his age group has a higher incidence of accidents than the fifty-year-old group. An interesting fact is that a trucking company that operates longer combination vehicles does not pay a higher rate; it pays the *same rate* for its insurance as a company that does not operate these special units. The real fact is that these units are safe, and the insurance companies that make their money on accurately assessing these units' safety record affirm this in their rate structure.

Come on, Mr. Garrett, let us put our energies where it will really count... let us get the drinking driver off the road, and we can lower our deaths on the nation's highways by nearly 50 percent! That is a goal we all can and should support!

Robert E. Farris
Counselor to the President
American Trucking Associations
Alexandria, Va.

Foundering Shipping?

TO THE EDITOR:

In his strong attack on current government policy toward the ocean shipping industry ("America's Welfare Queen Fleet," Vol. 14, No. 3, 1991), Rob Quartel criticizes both the massive government subsidy programs, including the Jones Act, and the conference system. I would not take issue with his call for ending the subsidy schemes. I do, however, have serious doubts about his attack on the conference system and his call for abolishing the conference system's antitrust immunity. Rather than address the issues raised by opponents and defenders of the conference system, he makes a host of assertions about what is and is not efficient, without evidence or even a reference to the literature where these questions have been raised.

Mr. Quartel's comparison of Federal Maritime Commission regulation to regulation of trucking, railroads, and airlines is not entirely apt. Unlike ICC or CAB regulation, the FMC does not set rates, nor does it enforce those rates. The FMC is largely a monitoring agency. The conference system is a privately run operation. A major anomaly of the conference system is the substantial amount of evidence that many conference customers support the conference system. The evidence is not definitive, but it is enough to raise serious questions that need to be answered before we jump on Mr. Quartel's bandwagon.

Mr. Quartel correctly points out that conferences fix rates, pool revenues, restrict free contracting, and have capacity restrictions. He asks whether with this is more acceptable in liner shipping than in other industries, as though to ask the question is to answer it. Although he would allow efficiency-enhancing agreements, he gives no indication of how he would decide which sorts of agreements enhance efficiency and which detract from it. Mr. Quartel's only reference to the literature on the subject is to criticize unnamed proponents of the conference system who purportedly believe that conferences have changed over the years from monopolizing to efficiency-enhancing devices. I would love to see his reference, having missed any such argument in nearly a decade of studying the industry. The FMC's own report on the 1984 Shipping Act and the criticisms of it by the Department of Justice and the FTC discuss the largely theoretical literature addressing the question of whether conferences are efficiency-enhancing or monopolizing. Unfortunately, much of the work on both sides of the issue is not very good, and there is a paucity of empirical work. There have, however, been two recent empirical studies on the conference system—one by me in the October 1989 *Journal of Political Economy* and the other a recent dissertation at the University of Chicago by Stephen Craig Pirrong, the results of which are forthcoming in the April 1992 issue of the *Journal of Law and Economics*. Although the two studies use substantially different approaches, both reach the conclusion that conferences are efficiency-enhancing devices. In particular, both studies provide evidence that competition is not possible in liner shipping.

Rather than claim that these two studies have settled the issue, which they have not, I make two other claims. First, a substantial amount of research on the effects of regulation on trucking, the railroads, and the airlines was available when deregulation was proposed. There is much less solid research on ocean shipping, and much more should be done. The research documenting the wealth transfers and inefficiencies of ICC and CAB regulation was based heavily on data made available by the ICC and the CAB. A good deal of the data gathered by the FMC and the Maritime Administration is inaccessible or hidden. Freight tariffs are buried away where they can be accessed only by a very well funded researcher. I and several other researchers have been told that market share data are confidential, although in its recent report, the FMC reported such market share data as it found convenient. Perhaps Mr. Quartel might persuade the FMC to be more open with its data so that researchers might learn what is really going on in the industry.

Second, until we know better what is going on in the industry, denunciations offered without any real evidence, such as Mr. Quartel's, are unhelpful. Shipping conferences have been around for over a century, and we still know very little about them. It is high time that we have more real research about them rather than yet another polemic.

William Sjostrom
Assistant Professor of Economics
Northern Illinois University
DeKalb, Ill.

Properly Pricing Deposit Insurance

TO THE EDITOR:

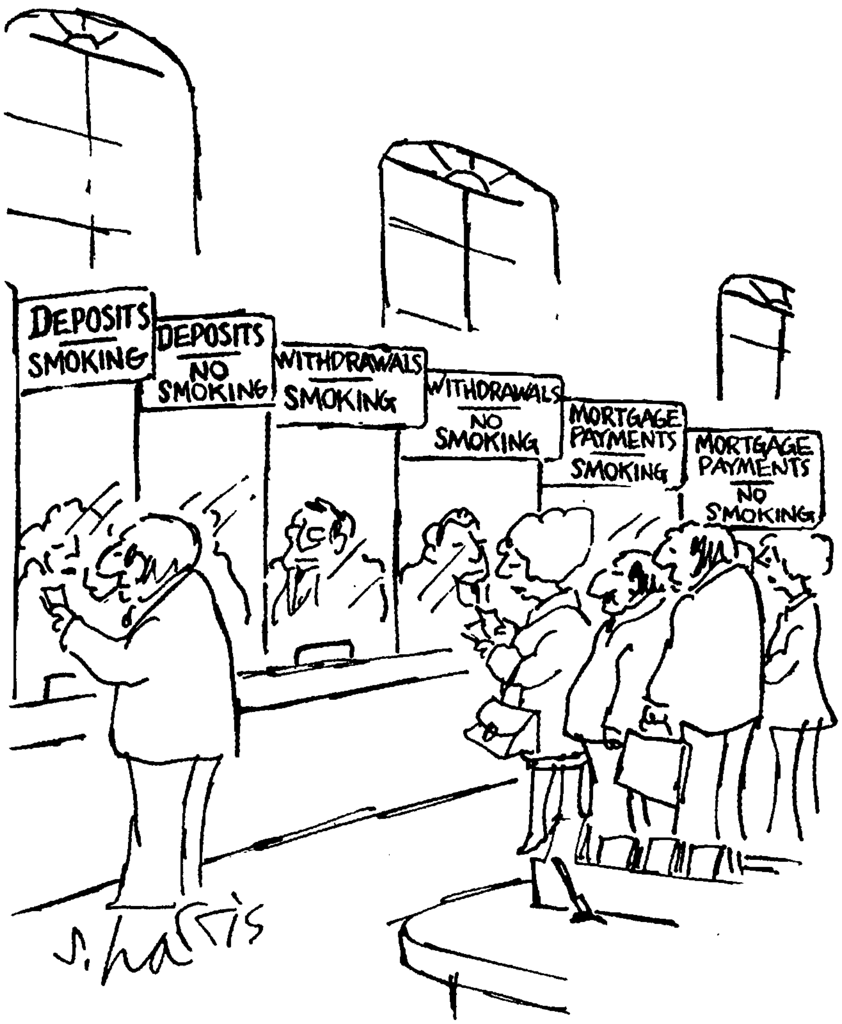
Robert Litan's reply in *Regulation* (Vol. 14, No. 3, 1991) to my criticisms of narrow banking in the Spring issue of *Regulation* cries out for a response.

Core Bank. Bob likes the lower loan-to-one-borrower limits for large banks proposed by Lowell Bryan in his core bank concept ("son of narrow bank") because it "would enhance loan diversification and thus help lower [banking] risk." Wrong. A lower limit on the total amount a bank can lend to any one borrower will not stop a large bank from concentrating its loan portfolio in Boston or Washington office buildings, for example. No, Bob, we have to find another way to avoid unwise lending concentrations. Fortunately, Congress, in a rare moment of wisdom, permanently buried the core bank concept, 312-106, when acting on this year's banking legislation.

Finance Companies. Bob stated that "uninsured finance companies maintain twice the capital ratios of banks." Wrong again. Finance companies maintain somewhat higher capital levels, but not twice as high. For example, the 327 largest commercial banking groups in the United States, holding 79 percent of all bank assets, had capital equal to 6.2 percent of their assets on June 30, 1991. GMAC, by contrast, had capital equal to 7.5 percent of its assets at the end of 1990. Higher, but not double.

Critics of the lower bank capital levels overlook the fact that deposit insurance, like any insurance, effectively is an option on the capital of others. Therefore, properly priced deposit insurance should permit insured banks to operate soundly at a lower capital level than an uninsured finance company. Interestingly, the current flat-rate deposit insurance premium of .23 percent per dollar of deposit costs banks the equivalent of carrying additional capital equal to another 1.7 percent of their assets. The banking system as a whole is not undercapitalized, and yet individual, adequately capitalized banks suffer increasingly from mispriced deposit insurance.

Bob posed a delightful question: when was the last time a major finance company failed? Well, a big one, Westinghouse Credit Corp., has experienced over $2 billion of losses due to bad real estate lending. Those losses have wiped out all of its capital, and



they have put its parent, Westinghouse Electric Corp., under severe financial strain. The Westinghouse saga has created two wonderful ironies.

One, Westinghouse Credit is being forced to pull back from the ever fair-weather commercial paper market for much of its financing. And who has Westinghouse turned to to replace that financing? Why the banks, of course, the very institutions that narrow bank advocates want to prohibit from lending to companies who cannot access the commercial paper markets. If we already had a world of narrow banks, who would Jim Burnham, Bob Litan, and other narrow bank advocates suggest Westinghouse turn to? The government's lender of last resort, the Federal Reserve System?

Without its banking backup, the commercial paper market would be much smaller than it is today. How then would many American businesses finance themselves if they also could not borrow at a bank? This is a question the narrow bank advocates have failed to address because they view banks in isolation, not as an integral part of a highly interdependent financial system.

Two, the Westinghouse situation demonstrates the value of knocking down the barriers separating banking from commerce, something still seen as blasphemy by Gerald Corrigan, president of the New York Fed, Rep. John Dingell, and others. Westinghouse Credit's real estate lending was a disaster that probably exceeds, proportionally, even the Bank of New England disaster. Yet because Westinghouse Credit was owned by a major industrial corporation, the creditors of Westinghouse Credit, including those holding time deposits called commercial paper, almost certainly will suffer no loss. This will be the case because capital Westinghouse had previously invested in its nonfinancial activities is now being used to bail out Westinghouse Credit.

The October 1987 stock market crash, to which Bob referred, presents another instance when the banking system helped to rescue beleaguered firms. Broker-dealers were under severe liquidity pressures following the crash, and at times the solvency of some of these firms was in doubt. Yet the ever magnanimous Fed leaned on the larger banks to increase their lending to broker-dealers, which they did. Loans by larger commercial banks for purchasing and carrying securities almost doubled, rising by $5.5 billion, from the Wednesday before the crash to the Wednesday after.

In a comparable crisis it is highly unlikely, as Bob seems to argue, that an unregulated, and therefore hard-to-lean-on, commercial paper market would lend either to illiquid securities firms or to troubled commercial paper issuers, no matter what the spread between T-bills and commercial paper. In times of crisis it is much safer for investors to park their funds in riskless securities and wait a few days for the dust to settle rather than to risk the loss of substantial principal just to pick up a few additional percentage points of interest for a short period of time.

Risk-sensitive deposit insurance premiums. Bob and I agree that risk-sensitive premiums are needed, but differ as to how best to achieve them. The key to properly pricing anything is that the price be set in a private, competitive marketplace in which both buyers and sellers have many choices.

Sen. Alan J. Dixon's reinsurance proposal, which Bob apparently endorses, will not do the trick because it envisions a public-private partnership in which the FDIC would still be the top dog, particularly in deciding when to close a troubled bank. History is replete with failed public-private partnerships because marketplace incentives differ so dramatically from political incentives. Either one goes with a private solution or a public solution. Unfortunately, the public solution, government deposit insurance, has been a disaster, as Roosevelt warned it would be, because sound insurance principles sharply differ from welfare-driven political practices.

As Bob should know by now, I do not favor a complete dismantling of federal deposit insurance. Instead, I advocate using the 100 percent cross-guarantee concept to bring market pricing to deposit insurance and to shift the bank closure decision to those who really bear the insurance risk, the nation's healthy banks. Federal deposit insurance could be retained as a backup to 100 percent cross guarantees in the highly unlikely event that all of the earnings and capital of the banking system are wiped out by bank insolvency losses. Of course, if that happened, the federal government, already overloaded with massive debts and contingent liabilities, probably could not fully protect insured depositors either.

Using 100 percent cross guarantees to push federal deposit insurance into the background will open the door to properly priced, risk-sensitive deposit insurance. This pricing will bring wiser credit allocation to the economy and pave the way for a sounder, more efficient banking and financial services industry. None of what my friend Bob Litan advocates will do that.

Bert Ely
President
Ely & Company, Inc.
Alexandria, Va.

Seeking the Holy Grail?

LITAN replies:

In case some of your readers are not sick of our "point-counterpoint" exchanges on narrow banks, here are my replies to the points Bert raises in his letter.

Core Bank. Bert is surely right when he says that tighter loan-to-one-borrower restrictions will not prevent the failures of banks that concentrate their lending excessively in a single industry. For that reason, I would favor some type of industry concentration limitations on bank lending (for example, no bank could extend any more than one-third of its loans to a single industry) and specifically on bank lending for commercial real estate development, which has proven many times over to be highly risky. In any event, whether such industry concentration limits are in place or not, banks generally will have more diversified lending risks if they lend to many borrowers rather than to just a few.

Finance Companies. Bert assails my statement that uninsured finance companies maintain double the capital ratios of banks by citing a single example (GMAC). I prefer to rely on generally accepted industrywide averages, which clearly support my statement. Thus, according to the Treasury Department (in its *Modernizing the Financial System*, Table 1 in Chapter II), short-term business credit companies in 1989 had a capital-to-asset ratio of 13.8 percent; for personal credit companies the ratio was 13.3 percent; and for the 50 largest banks, the ratio was just 5 percent.

Bert also points to the current troubles of Westinghouse Credit, contending that if banks were not there to provide backup financing for its commercial paper, the company might fail. That is not clear. Westinghouse itself could inject more capital. And if the parent company cannot or will not do that, then the credit company *should* fail. That is what it means to be uninsured.

Would the failure of a large finance company trigger a wider panic? I seriously doubt so. After all, Drexel failed and investors in the commercial paper issued by other securities houses did not run for the hills. In any event, if there were a wider panic, the Fed could step in with open-market operations to temporarily widen the spread between T-bills and commercial paper and thereby restore the demand for commercial paper.

Bert suggests that this would not work in a repeat of the 1987 stock market crash. Perhaps. But then if the Fed is seriously concerned with a systemic liquidity crisis at many securities firms—or, perhaps more relevant today, a run-triggered collapse of many life insurers—it can always, as a last resort, exercise the authority it has under existing law to lend to those solvent enterprises directly on a collateralized basis. After all, that is what it means to be a "lender of last resort."

Bert then suggests that without banks as backup lenders (or guarantors of commercial paper through their letters of credit), the commercial paper market would be much smaller. Perhaps that would be the case if any narrow banking requirement were suddenly introduced. But no narrow bank advocate has suggested that. Instead, by phasing out lending authority for banks, one would give the market time to come up with alternative guarantee mechanisms or credit enhancements—including partial collateralization (commercial paper issues today are generally unsecured), financial guaranty insurance (already a thriving business), and backup guarantees from parent companies (as is the case right now for many of the larger finance companies).

Finally, I should point out that I would only impose the "narrow asset" requirement on depositories that wanted to affiliate with a wide array of nonbanking enterprises, whereas Jim Burnham, Jim Pierce, and others have suggested applying the narrow asset requirement to *all* banks. Accordingly, in my world many banks that did not want to or could not (because of capital weakness) exercise the broader affiliation rights would still be able to make ordinary loans and thus provide the kind of "backup" support that Bert mentions.

One Hundred Percent Cross Guarantees. I have no quarrel with Bert's elegant proposal, in principle. Given the sorry record of bank regulators during the past decade, a good case can be made for going, in effect, to the privatized monitoring system that Bert's cross-guarantee mechanism would implement, provided the Fed or some type of deposit insurance guarantee were there to back it up.

The central real-world problem with the proposal, however, is that it is simply too radical for our political system to digest at one time. Look what happened when the administration proposed even a minor tampering with the $100,000 deposit insurance ceiling! It quickly got shot down. I am thoroughly convinced that for the foreseeable future, Congress would have an even less hospitable reaction to any such plan that effectively privatized the bank regulatory system—namely, both the monitoring of bank risk and the closure decision.

The Dixon plan, in contrast, is a way to get started. It offers a nonthreatening but useful way to get started with private monitoring. It also can start off slow—for example, by assuming only 5 percent or 10 percent of the FDIC's risk on the largest banks—and then gradually be expanded to cover more banks and more risk. The public would then have a chance to see whether private monitoring of bank risk actually works or whether it is simply the Holy Grail sought by a few public policy analysts. And if it does work, then Bert's case for "going all the way" to 100 percent replacement of government monitoring and closure decisions with the marketplace would be much more convincing.

Robert E. Litan
Senior Fellow
Brookings Institution
Washington, D.C.

Computing the Costs of Regulation

TO THE EDITOR:

In "The Total Cost of Regulation?" (Vol. 14, No. 3) Bill Niskanen argues that the $44 billion we derive for the net cost of regulation represents a lower bound. Niskanen goes on to argue that the cost could easily be as much as ten times that number.

We basically agree with Niskanen's point that our analysis of the costs and benefits of regulation leaves out many important aspects of the equation, including such key elements as the cost of banking regulation and the cost of new environmental regulations. Moreover, we think that a key limitation of our analysis is that it fails to adequately account for the impact of regulation on innovation.

We are less certain about Niskanen's claim that the most important cost associated with regulation has to do with rent-seeking (or rent-defending). We readily concede that such costs could be large. One need only look at the cadre of lawyers and lobbyists hired to protect special interests involved in the regulatory process. At the same time, we are not convinced that such costs would necessarily be lower if there were substantial moves towards deregulation, or kinder and gentler forms of social regulation. In both cases lobbyists would still be hired to make mischief, and there would be substantial rent-defending costs associated with maintaining the new status quo.

Niskanen's primary concern appears to be that the outside world may misinterpret our $44 billion number, arguing that regulation's impact on the economy is in the noise. Like Niskanen, we believe such a conclusion is *unwarranted*. We believe the correct conclusion to be drawn from our analysis is that the static costs of the regulatory measures we reviewed represent a small fraction of GNP, but the actual costs or regulation are probably much higher. How much higher we simply will not know until researchers get a better handle on regulatory impacts that are intrinsically difficult to measure.

Robert W. Hahn
Resident Scholar
American Enterprise Institute
Washington, D.C.

John A. Hird
Assistant Professor of Political Science
University of Massachusetts at Amherst
Amherst, Mass.

Devaluing Derivative Instruments

TO THE EDITOR:

In the aftermath of October 19, 1987, I was surprised to learn that there were people interested in defending program trading. In the years since then, as the emotion of that moment has subsided, I found that consideration of the subject changed my beliefs a bit, but I retain a strong distaste for the entire options and futures scene.

Many writings on this subject begin with arguments that anyone who is against "program trading" is against technology and expanding knowledge. I really do not know anyone who is opposed to bringing modern technology into the trading arena. My objections to program trading have certainly never been centered there. I objected first to the form of program trading called portfolio insurance, and I continue to have serious concerns about the form of program trading called index arbitrage.

Dean Furbush noted in "Program Trading in Context: The Changing Structure of World Equity Markets" (Vol. 14, No. 2, 1991) that some people were happy to tag program trading as the culprit for October 19, 1987, describing it as a mindless form of trading. The truth is that "mindless" is a good word to describe the trading that is generated by portfolio insurance.

Portfolio inurance had very little to do with an evaluation of securities. The key element was a decision by a portfolio manager that he would like to keep the market value to which his portfolio had risen. (I use the past tense here because portfolio insurance was a dismal failure in October 1987, and I almost never hear the term anymore.) If the market dropped by some predetermined amount, the portfolio manager would initiate a process of selling or hedging his equities, and he would continue this process for as long as the market kept dropping. It was not an analytical decision. It was purely arithmetic; for example, if the market dropped 10 percent, he sold or hedged 10 percent of the portfolio. On a day like October 19, 1987, such activity would certainly accentuate a falling market, especially since the type of portfolios practicing portfolio insurance, such as pension plans, were very large. There was without doubt a potential for market impact. While Furbush says portfolio insurance had little or no impact, other researchers such as Hans Stoll of Vanderbilt University are not so certain, and, in fact, some acknowledge that there was an impact. What is obvious is that the methodology of portfolio insurance is ideally suited to accentuate a market downturn.

Fortunately, that is a theoretical argument at this point. One great lesson of October 19, 1987, is that portfolio insurance is a bankrupt idea. I noted in a speech to an *Institutional Investor* conference in Los Angeles a couple of years ago that when portfolio insurance was presented to our company in January 1986, we were most interested. We did not buy in (because we judged it overly expensive), but we missed the key point. Portfolio insurance was an idea that had to be considered for its effect on all participants, not just ourselves. When everyone ran for the door simultaneously, portfolio insurance broke down.

Just as our analysis of portfolio insurance began in the wrong place, so too does analysis of index arbitrage. The arguments about two expressions of the same market, liquidity, and other factors may have some validity. But I start at a different place. Why do we need those derivative instruments?

I ask that question because of my own observations over the years. For example, a couple of years ago USAA did a very large equity portfolio restructuring. It seemed an ideal test case of the very circumstances typically cited as the reason derivatives exist—the desire to trade large amounts of stock in a short time with minimal execution cost. Yet the experience turned out no better than a similar transaction we attempted around 1982. The reason that futures and options did not help was given us by a Salomon Brothers employee: "They immediately run to a premium, and we can't use them to hedge something like this."

On a smaller scale, there are many examples of people who try to devise trading strategies for derivatives and suffer grievous losses. I have looked for years for and have never found a publicly measured portfolio using derivatives as an integral part of its portfolio management that has established an outstanding record.

Yet there is great passion for these instruments. Hans Stoll laid out several reasons why options and futures are useful. They are, in retrospect, curious reasons.

He described several situations of market timing: an allocation decision to increase or decrease equities or a cash flow timing problem where a desire to purchase precedes receipt of cash. Those he said are among the legitimate reasons behind the need for options and futures.

Is that not a curious argument from an academic, especially in view of the excitement over the award of the Nobel Prize to other noted academics whose rewarded work renders such timing decisions as unworthy of serious consideration? I have wondered since first reading that justification whether there are courses being taught today on "Successful Market Timing Using Derivatives."

If one questions the worth or need for options and futures, then it is difficult to regard index arbitrage as a great good in the maket. It is also curious to see who come together as allies on the subject of index arbitrage—for example, trading desks and index funds. These two are natural enemies if ever that phrase had meaning. Yet to both index arbitrage is a godsend.

The trading desks at major houses have long lamented the fall in commissions. Much of that fall has been pressured by indexers. Now, index arbitrage is a new riskless profit center for trading operations. And for indexers, index arbitrage offers a way to overcome transaction costs and achieve a rate of return at or better than the market. So the natural enemies enthusiastically endorse index arbitrage and become quite strange bedfellows.

We know that index arbitrage moves the market. We see it almost daily. I believe it is a game played with instruments of questionable value for the benefit of people with specialized interests. The argument that it works to the advantage of investors ignores serious questions about the usefulness, indeed the very need for, the derivative instruments involved.

Michael J.C. Roth
President
USAA Investment Management Company
San Antonio, Texas

Revisiting Derivative Markets

FURBUSH replies:

Mr. Roth brings strong credentials to the table when he discusses *financial* topics. He is president of USAA Investment Management Company and has built a successful family of no-load mutual funds, many of which appear on those lists of top-performing funds. USAA's discount brokerage operations, from which one can buy stock options and stock index options, fall under Roth's purview. Roth and USAA are class acts.

That is what makes his "strong distaste for the entire options and futures scene" so perplexing. I frequently forget that it is possible to look at a market and see it as a bad thing. But this is more extreme: Mr. Roth indicates distaste for one of the products that he sells.

In his comment Mr. Roth touches on the two strategies that people associate most with program trading—portfolio insurance and index arbitrage—but his fundamental problem is with the derivative markets as a whole. I shall respond in kind.

First, portfolio insurance. This is free advertising for Mr. Roth. One can buy portfolio insurance from USAA by buying a put option covering the stock he owns, or if he owns a diversified portfolio, by buying a put option on the S&P 100. It is insurance in the sense that he pays a premium—the cost of the put—he participates in upward price movement, and he does not lose if his stock burns down. The predominant form of portfolio insurance in place during the October 1987 crash used dynamic trading in the futures market to mimic put options. Because of mispricing in the futures market, due in part to insufficient index arbitrage, dynamic hedging in the futures market became exorbitantly expensive, and many trades were executed in the stock market as program trades. Interestingly, October 19, 1987, was probably the only day ever that portfolio insurance was a substantial program trading strategy. In a fast-moving market the dynamic trading portfolio insurance method was shown to be less effective than buying the put directly, but the idea of portfolio insurance is not bankrupt. We just understand its costs and constraints better than before.

Regarding index arbitrage, Mr. Roth appears to accept its validity as a method for linking markets, but he doubts that we need the derivative market that is being linked. He is right that index arbitrage has no intrinsic value; if the derivative market is worthless, index arbitrage will not stand on its own. But let us examine the derivative market. It is not worthless.

The derivative market, like all markets, is characterized by two people arriving at an agreement that each thinks is a good thing. In the massive worldwide derivative markets, that happens thousands of times each day. For me, that is enough. How could the market be anything but useful? But let me briefly discuss why it is useful.

The party line is that derivative markets provide price discovery and hedging. That is true, but not overly informative. The way to think of derivative markets is as providing flexible avoidance or access to the financial components of ownership: price play, use value, storage costs, and capital expenses. Derivative markets allow securities investors the same product flexibility that markets provide to people who want to go from place to place in a car: the various costs and benefits of ownership can be unbundled, or bundled and priced with other products.

For example, renting a car is the same as owning it and taking a short futures position. (I tried to apply this exact relationship last spring on a trip to Europe. Because car rental rates were so high, I looked into buying a car on arrival and simultaneously agreeing to sell it back to the dealer after the trip; transaction costs swamped the arbitrage opportunity.) Taking a taxi is equivalent to a rental position that is hybrid with piloting and (less often than we would like) navigational services. Car insurance, available through USAA (is this a setup?), is equivalent to owning a car and a put option.

In the car market (except for antique cars and ownership in places with high land value), the use value component of ownership dominates the others. In some markets storage costs are very important. In secondary securities markets price play is the important component. Derivative markets allow investors to customize price play to their own objectives, as in the case of true portfolio insurance that allows upside participation without downside risk. There are many other examples.

That Mr. Roth has "never found a publicly measured portfolio using derivatives as an integral part of its portfolio management that has established an outstanding record" is testament to the Byzantine regulations that still apply to mutual funds, similar to ancient (and perhaps all too modern for credit cards) usury laws. The SEC's 1940 act limits the use of short positions, limits the use of margins, and imposes other restrictions that essentially deny derivative markets as a tool for mutual funds. Other institutions are using derivatives in a big way. About two-thirds of S&P 500 futures volume is due to institutions' hedging their stock holdings. Of the top 200 pension funds, 40 percent, representing about $600 billion, use derivatives to hedge their investment. One can see where this is going; but that is another article.

Dean Furbush
Consultant
Economists Incorporated
Washington, D.C.

Preserving Competition?

TO THE EDITOR:

Judge Douglas H. Ginsburg's essay, "Antitrust as Antimonopoly," which appeared in the Summer issue of *Regulation* (Vol. 14, No. 3) advocates a bold—indeed, drastic—"reform" of United States antitrust law. Unlike some who would repeal the antitrust laws in their entirety, Judge Ginsburg would tolerate a watered-down, two-pronged antitrust law limited to preventing "mergers to monopoly and marketwide noncompetition agreements." Mergers short of actual monopoly would be acceptable. His law would not reach horizontal price-fixing agreements unless they were marketwide in scope; and vertical price-fixing, tying, and other vertical restraints would be per se lawful.

Judge Ginsburg's thesis is a simple one. We know that competition is good and that monopoly is bad; but in his view economists and government authorities do not have enough knowledge or the analytical tools to determine whether concentration and market power short of monopoly are harmful to competition. "The problem is not the lack of many but the lack of any competitors." Competition will prevail "[a]s long as there are even two significant competitors in a market. . . ." At the same time, he seeks to impugn on empirical grounds the conventional view that high "concentration short of monopoly tends to dampen competition and hence market performance." For these reasons, as developed at length in his essay, Judge Ginsburg argues that the "only proper goal" of antitrust enforcement should be to interdict "palpable monopoly" created by merger or marketwide horizontal agreement.

Would Judge Ginsburg's minimalist approach to antitrust law well serve the interests of our democratic society? Are its underlying principles consonant with economic theory and empirical reality? Would it, in fact, "preserve competition" as Judge Ginsburg claims? In our view, the answer to each must be a resounding no.

It is today out of fashion even to mention the political and social objectives that figure so prominently in our antitrust tradition. Antitrust lawyers and teachers side with econometricians in developing narrowly focused models. In the mainstream of this tradition, Judge Ginsburg asserts that economic "rivalry that benefits the consumers . . . is what antitrust is supposed to be all about." In fact, antitrust law has historically been about both political and consumer welfare.

The fundamental insight behind the traditional American preference for competition is that economics and power are inextricably linked. The Jeffersonian-Jacksonian-Wilsonian tradition makes no bright line separation between economic and political power such as Judge Ginsburg implies. The Jeffersonian tradition, which has roots in British antimercantilism, assumes that competition is at bottom a quest for power that needs to be moderated. The rationale for favoring competition is not only, as Judge Ginsburg argues, that "[m]onopoly . . . produces economic inefficiency. . . ." It is also that economic competition is vital in political terms. None of the pathbreaking economists, certainly neither David Ricardo nor John Maynard Keynes, thought of economics as mere materialism, and when Judge Ginsburg describes it so, he obscures the insights of these economists as he does those of the Founding Fathers.

Our antitrust statutes likewise were not driven only by efficiency and consumer welfare. Judge Learned Hand observed, "Throughout the history of these statutes it has been constantly assumed that one of their purposes was to perpetuate and preserve . . . an organization of industry in small units which can effectively compete with each other." In a message to Congress just two years before it enacted the Sherman Act, President Grover Cleveland complained that ordinary citizens were being "trampled to death beneath an iron heel" wielded by trusts, combinations, and monopolies that were "fast becoming the peoples' masters." It is clear from this history, as well as from the Sherman Act's prohibition of "contract, combination... or conspiracy" in restraint of trade, that Congress was concerned with concentrations of economic and political power short of actual monopoly.

In 1938 President Franklin D. Roosevelt warned Congress of a growing "concentration of private power without equal in history" and observed "that the liberty of a democracy is not safe if the people tolerate the growth of private power to a point where it becomes stronger than their democratic state itself." As the Supreme Court later observed, Congress, in strengthening the Clayton Act's antimerger provisions, feared "accelerated concentration of economic power [not only] on economic grounds, but also [because of]... the threat to other values a trend toward concentration was thought to pose."

We do not mean to argue that an ideal antitrust law must strive for atomistic competition or that mergers should be outlawed on sociopolitical grounds in the absence of substantial anticompetitive effects. Our point is, rather, that the extremely narrow antitrust law proposed by Judge Ginsburg would allow transactions that are harmful not only to consumers and the country in economic terms but also to important noneconomic societal values. (Two of Judge Ginsburg's examples help to make the point. Thus, he finds ample competition with only three television networks and two wire services. Since more diversity of news, information, and entertainment is better than less, society would be badly served by an antitrust law that would tolerate anticompetitive mergers that reduced the number of competing television networks or wire services from three or four down to only two.)

Even in the narrow economic sphere to which Judge Ginsburg confines antitrust policy, his minimalist approach is counterintuitive and nonempirical. He defends his proposed reform on the ground that the government cannot "predict the likely competitive effect of a transaction or a business practice that does not, here and now, actually create a monopoly." As this implies, he sees no public policy or antitrust difference between having, say, ten competitors and only two. "As long as there are even two significant competitors in a market," he says, "there is reason to believe that each firm will be under constant pressure to decrease price or to improve quality...." But does not our experience and experience in other countries show that the pressure is *greater* if there are ten or twelve instead of only two rivals? Would not the presence of ten or twelve, instead of only two, competitors provide more sources of innovation in technology, greater pressure to lower costs, more incentive to explore export markets, and more diversity in pricing and marketing strategies?

Intuitively, the answers to each of these questions must be yes, and that intuition is confirmed by experience. United States industries with high concentration short of monopoly have not shown themselves to be "economically efficient." Michael Porter of the Harvard Business School suggests that one of the reasons for Japan's recent success is not that it has fewer competitors than the United States has, but more. Among the factors favoring the competitiveness of nations, Porter finds that "domestic rivalry is arguably the most important because of the powerfully stimulating effect it has on all the others."

Our auto industry had three major auto companies, plus American Motors, during its steep decline in the 1970s and 1980s. Japan had nine or ten in a domestic market too small to contain them. Japan had five integrated steel companies with the same drive to compete that pushed them into exports. The United States had an ancient steel oligopoly that had fought against antitrust since at least 1903, and in more recent years against foreign competition as well. Japan, according to Porter, has twenty-five companies making audio equipment, fifteen producing television sets, ten making videocassette recorders, fifteen in construction equipment, thirty-four in semiconductors, and fifteen in cameras.

Judge Ginsburg denigrates this evidence as merely "anecdotal," and seeks to offset it with evidence that "numerous firms are *not* necessary for vigorous competition to take place." He cites the international success of Boeing; but, unless it forbears for political reasons, Japan could well challenge Boeing's supremacy in the next decade. It is doubtful, to say the least, that "the old three-firm market of television networks" was as competitive as the market is today since the advent of the Fox Network and competition from cable and other media. Without "before and after" evidence from advertisers, there is no reason to accept Judge Ginsburg's *ipse dixit*.

Even accepting Judge Ginsburg's limited "empirical" evidence that there can sometimes be intense rivalry in a market with only two or three competitors, our experience and Japan's certainly suggest that ten or fifteen is a better number. Confirming this, the most internationally competitive United States industries—pharmaceuticals, energy companies, paper, entertainment, retailing, and university education—have many competitors, not just two or three. If General Motors, like Standard Oil, had been broken up at an appropriate time, it would have been much more difficult for the U.S. auto industry to develop the bureaucratic rigidities, high costs, and willingness to trade market share for high prices that still beset it and are documented in a half-dozen books. Had the U.S. steel oligopoly in the mid-1950s been broken apart, this vital precursor industry might have been a help rather than a burden to dozens of metal-working industries that have paid the price for its five decades of decline. Had Standard Oil faced only one other competitor, however, as Judge Ginsburg's thesis would allow, no doubt Japanese drilling crews and German drilling equipment would be all over this country and the world.

It is true that government enforcement agencies cannot know enough about most industries to predict the precise anticompetitive effect of mergers that do not create a monopoly. There are, however, a body of oligopoly theory and numerous empirical studies that predict a positive relationship between concentration and price, at least where barriers to entry are high. While Judge Ginsburg apparently finds that theory to be irrelevant for antitrust policy, the Reagan administration's Department of Justice relied on it in formulating its *Merger Guidelines*. The *Guidelines* state: "Where only a few firms account for most of the sales of a product, those firms can in some circumstances either explicitly or implicitly coordinate their actions in order to approximate the performance of a monopolist. This ability of one or more firms profitably to maintain prices above competitive levels for a significant period of time is termed 'market power.' Sellers with market power also may eliminate rivalry on variables other than price. In either case, the result is a transfer of wealth from buyers to sellers and a misallocation of resources." Applying that theory to horizontal mergers, the *Guidelines* state that "[o]ther things being equal, concentration affects the likelihood that one firm, or a small group of firms, could successfully exercise market power"; and they establish certain numerical enforcement criteria based on the level of postmerger concentration, as measured by the Herfindahl-Hirschman index, and the increase in the index caused by the merger.

The radicalism of Judge Ginsburg's merger-to-monopoly rule is illustrated by the fact that the *Guidelines* condemn horizontal mergers that increase that index by 100 points or more and produce a postmerger index above 1,800. In contrast, in a three-firm market consisting of one 50 percent and two 25 percent firms, Judge Ginsburg's rule would allow the two 25 percent firms to merge. The result would be a postmerger index of 5,000 points and an increase due to the merger of 1,250 index points. The massive difference between Judge Ginsburg's merger-to-monopoly rule and the *Guidelines* must cause one to view his rule with great skepticism. The *Guidelines* are not the work of antitrust zealots but are the product of lawyers and economists with a strong allegiance to the Chicago School (for example, Assistant Attorneys General William F. Baxter and Charles F. Rule) and a determination to establish a realistic and effective merger enforcement policy.

Our focus on the fallacies—economic and noneconomic—that we find in the merger-to-monopoly rule, does not imply a lack of concern with other gaps in the antitrust scheme proposed by Judge Ginsburg. Vertical price-fixing and other vertical restraints can and have impeded, rather than preserved, competition. The demise of state fair trade laws and legalized resale price maintenance has contributed to widespread discounting at the retail level. We question whether consumers would be well served by again legitimizing fair trade agreements. Long-term exclusive agreements by monopolists or near monopolists can retard entry and deny market opportunities to would-be competitors. Such exclusivity would preserve monopoly, not competition. Yet nothing in Ginsburg's proposed antitrust law would prevent it.

In sum, our experience tells us that erring on the side of excessive competition is much less likely to be a political and economic problem than following the path Judge Ginsburg lays out. Concentrated industries in our American experience usually do not control costs or remain competitive internationally. While intense rivalry may exist in two- or three-firm markets, our experience shows that concentrated, oligopolistic industries, such as autos and steel, have tended to let bureaucratic and labor costs balloon and to accept high-cost, substandard work from suppliers.

Eastern Europeans and Latin Americans know about this already. Their problem is huge, overmanned industries with the political power to stay that way. That is America's problem, too, but because the American industries are "private," we often miss the point. The American problem is that oligopolistic industries wield a power that is more veiled than in countries where state-sponsored industries are called by name. Judge Ginsburg says that he is concerned about the government's exercising its monopoly power to substitute its view of competition for that of the market; however, he appears to ignore the fact that the U.S. steel industry and other juridically "private" industries like it have been able to mobilize government power on their side when their competitive weakness is exposed. Those industries thus become de facto state companies whose survival is too important to be left to the market. Their overseas competitors are restricted. Their high prices become a burden to their customers. Their pension plans are funded by the taxpayer. Their workers are retrained, while workers in small businesses fend for themselves.

While Judge Ginsburg's thesis is a bold one, he has not come close to making the case for it. If merger-to-monopoly were to be the law of the land, oligopoly and even duopoly would be unrestrained. Competition would not be preserved but diminished, and Judge Ginsburg's avowed goal of preserving competition would be frustrated rather than served.

Howard Adler, Jr.
Partner
Davis Graham & Stubbs
Washington, D.C.

Paul A. London
Independent Economist
Washington, D.C.

Deregulating Antitrust

TO THE EDITOR:

Judge Ginsburg ("Antitrust as Antimonopoly," Vol. 14, No. 3, 1991) correctly argues that historical attempts to use antitrust to "promote competition" have caused much economic mischief. He suggests, instead, that antitrust regulation be employed only to preserve an existing competition, that is "antitrust should be concerned only with preventing mergers to monopoly and marketwide noncompetition agreements."

Clearly the use of Judge Ginsburg's reform would be a step in the right direction, that is, toward less antitrust regulation. Yet the reform itself, although it appears reasonable, is fraught with theoretical and practical difficulties. Ironically, Judge Ginsburg himself raises the bulk of these difficulties in his well-reasoned argument before his reform conclusions.

For example, he tells us that there are serious conceptual difficulties in defining any relevant market, that "every product is in at least some degree of competition with every other," and that market definitions are often drawn arbitrarily. Yet in the next breath we are told—as if no such ambiguity existed—that mergers or horizontal agreements that produce "monopoly" ought to be outlawed.

We are also told that "monopoly" need not mean 100 percent of the market. Judge Ginsburg approvingly quotes *Alcoa* (1945) that 90 percent "is enough to constitute monopoly" and Robert Bork, who would allow mergers up to 70 percent of the market but no more. But which is the correct percentage and how do we tell? Is monopoly 100 percent or is it 90 percent or is it 70 percent or is it 68.76 percent? What theory or what empirical evidence would allow us to define monopoly in terms of *any* market share? I find it inexplicable that after 100 years of antitrust regulation, supporters of antitrust still cannot agree on what constitutes "monopoly." (I guess they just know it when they see it.) Nor can they cite *any* empirical evidence that would allow the setting of percentage limits in specific industries.

It must also be apparent that the use of the term *monopoly* depends upon some reasonably defined relevant market. But if, as Judge Ginsburg admits, all products compete to some extent (what extent?) with other products, then there is no objective way to define *monopoly* in terms of specific product market share. As even he suggests, an orange juice monopoly dissolves into beverage competition. And the beverage "monopolist" must compete for scarce dollars with the publisher of this magazine.

Despite the best of intentions, Judge Ginsburg falls headlong into the classic static microeconomic trap. He proceeds to treat competition (and monopoly) as an objective magnitude to be measured by counting numbers of independent firms or computing market share. This is most obvious in his cavalier dismissal of potential competition (entry) as some "exotic economic theory." Exotic, indeed. As Schumpeter would have retorted, all of the important "competition" in the twentieth century has come from "outside" the narrow traditional market structure definitions. But once we admit the correctness of Schumpeter's observation and see competition as an open process, the entire market structure approach to defining monopoly collapses.

But all is not lost. There is a way to define competition and monopoly unambiguously. Competition can be defined as an open market process where business organizations are free to be rivalrous and free to cooperate—as they do in professional sports. Monopoly is a state of affairs in which government restricts market entry, rivalry, or cooperation. Such definitions require no arbitrarily defined relevant markets, no cross-elasticity tests, no measurement of market share. And deregulation, not antitrust regulation, becomes the appropriate public policy for permiting competition and cooperation and for eliminating monopoly.

Dominick T. Armentano
Professor of Economics
University of Hartford
Hartford, Conn.

Defining the Relevant Market

GINSBURG replies:

A coherent antitrust policy requires two things. First, there must be a defensible criterion for determining whether a particular transaction or type of business conduct is to be proscribed as anticompetitive. Second, there must be what Dr. Armentano correctly refers to as a "reasonably defined relevant market" within which to evaluate the competitive significance of such business activity.

My article dealt with the former requirement. I proposed that the antitrust laws be applied only to prevent the creation of monopolies, that is, mergers to monopoly and market-wide noncompetition agreements. I argued that we have neither empirical nor analytical grounds sufficient to warrant acting against market concentration short of monopoly, and no basis whatsoever for proscribing vertical restraints or other means by which firms may choose to compete. I did not deal with the problem of market definition except to note that "any improvement in antitrust analysis, including the reform advocated in this article, can be set to naught by a procrustean approach to market definition that creates the appearance that there are little monopolies everywhere."

Dr. Armentano's letter goes primarily to the problem I did not address, namely that of market definition. His principal claim seems to be that no defensible approach to market definition is possible at all. From my observation that "every product is in at least some degree of competition with every other," he concludes that "there is no objective way to define 'monopoly' in terms of specific product market share." This is simply a non sequitur; not all products compete with each other to the same degree, and there are in fact objective criteria for distinguishing immediate from more remote competitors. The point, after all, is not to define a "market" in the abstract, but practically to identify the *"relevant market,"* that is, the market relevant to antitrust analysis. But that is a different subject for a different day, at which time Dr. Armentano's observations may prove more pertinent.

Douglas H. Ginsburg
U.S. Circuit Judge
U.S. Court of Appeals
Washington, D.C.