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THE FREE MARKET AND MONETARY POLICY

Remarks by

Henry C. Wallich
Member, Board of Governors ot the Federal Reserve System

at a meeting sponsored by the

Association pour l'Etude des Problemes Economiques et Humains de l'Europe

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It is a pleasure to address this distinguished audience on the subject of the free market and monetary policy. I hope to discuss with you the state and progress of the everlasting struggle to preserve the best part of our economic system -- the free market. In this context, monetary policy has an important role to play.

I would like to begin, if I may, with a long perspective. Nearly 130 years ago, a young man began his career in banking here in Paris. From notes and letters he left, it is apparent that people at that time were much concerned about the survival of capitalism. Some sixty-odd years later, that young Paris banker, who meanwhile had become my grandfather, was writing his memoirs. They are full of concern about the threat of socialism, mounting taxes, diminishing return on capital. Those apparently were the preoccupations of bankers and businessmen in what we now look back to as a Golden Age. Almost three-quarters of a century later, the same concerns are still with us. They seem to have achieved a higher degree of urgency. But the principal fact that can be deduced from this footnote to history is, I believe, that after all these years filled with fears and forebodings, our economic system is still, in its basic principles, intact.

The system has demonstrated a degree of durability that presumably would have surprised some of its early observers, practitioners, and critics. I believe it is fair to say that it has been durable because it has been flexible. Not only has it produced enormous increases in income and wealth and has raised living standards many times, but it has also responded to many criticisms that were made of it. We may take for granted that one condition of its survival will be continued ability to adapt to change and to take account of legitimate criticism. It will not do to take credit for past flexibility and resist future change.

Supporters and Critics

Today I would like to examine with you where we stand and with whom we stand. There is no clear direction in which developments are moving. Economic freedom is advancing on some fronts, but on many others it is being driven back. The market system is gaining new supporters while old opponents continue their attacks. New demands are being made on it as old demands are being satisfied. In this struggle, support and opposition come from many sides and these need to be carefully analyzed. There are opportunities for forming alliances in support of a free economy if the objectives of each group of supporters are correctly understood. By meeting new needs, by attracting new supporters, the vitality of the system can be renewed and sustained. Flexibility is essential to that end.

The essence of the market system is the belief that economic affairs should be guided as much as possible by the free interplay of supply and demand based on individual initiative rather than by the political process depending on a powerful government.

The market system is seen by some primarily as an efficient mechanism of production, that makes optimal use of the economy's resources. It is seen by others as providing an opportunity for individual self-expression and initiative, a system of incentives and penalties, which they prefer to a collectivized society. It is seen by still others as a form of insurance against the dangers of an overbearing big government that could destroy individual freedom and democracy. And it is seen by many, of course, as a source of comfortable privilege and a sheltered existence.

More specifically, what kind of support can the market system hope to elicit and from what supporters?

The market system will have the support of businessmen, but not always their undivided support. If the system is to be more than a source of privilege, if it is to carry conviction, businessmen must accept the challenges it poses for them. They must be prepared to take risks, and they must be serious about competition. They must be consistent in their frequently voiced view that the government should keep its hands off business, even when business faces problems that could be more painlessly met with government intervention and support.

The market system can attract support from citizens and politicians who have observed that decision making by the political process is more difficult than decision making through the market. In the market, decisions are made implicitly, with a minimum of conflict. The political process creates confrontations -- proposals must be stated overtly and must be voted up or down. Everybody must stand up and be counted. If these pressures become very heavy, democracy may suffer in the end.

Support for the market system may come also from the many who are disenchanted with governments' fumbling efforts to solve problems. For many years, the line of least resistance in the face of any problem has been to seek a solution through government. Government more often than not has been more than ready to take on any challenge, because that has meant more power. But government has not solved the great economic problems of our day -- of inflation, unemployment, instability, and poverty. Some of these problems, on the contrary, are of the government's own making. Skepticism of and disenchantment with government provide important support today to the market system.

Intellectuals, and especially economists, also find new attractions today in the market system. Since the Great Depression, most economists have favored solutions of problems through government, have identified with government, and have in that way pushed back the market system. But the failures of government have given them much to be modest about with regard to their own discipline. The simple prescriptions of big government spending and easy money no longer seem persuasive. Meanwhile, the lessons of their discipline demonstrate to economists the virtues of a market economy. While many non-economists seem to believe that free competition in open markets creates chaos, economists know that competition means order. It is only in competitive markets that economic analysis permits predictions of how much will be produced and at what price. In markets that are infected with monopoly, many outcomes are possible and none is sure. Likewise, it is only when firms seek to maximize profits that predictions concerning their behavior and their achievements can be made in economic theory. Once that assumption is given up, uncertainty takes over.

Finally, the computer has helped economists to discover and document the virtues of the market. Thanks to the computer, it has become possible to study the response of producers and consumers to changing prices, wages, and interest rates. Innumerable studies of markets at a macro or micro level have demonstrated that market participants react to price changes. Supply and demand respond and come into balance. Government efforts to interfere with the price mechanism, like private efforts, lead to imbalances in the market, and to inefficient use of resources. For economists, these observations are major factors in favor of the market system.

There exist the makings, therefore, of a broad base of support for the market system. This support can be drawn not only from the ranks of those directly interested in it as producers, but can be recruited from a much wider range of individual interests and intellectual positions. Nevertheless, the market system is questioned by many because of its identification with profits. Profit, in the eyes of many, represents inequality, exploitation, and injustice. Two responses can be made by the supporters of the market. One is to point to the functional role of profit, as a test of business performance, as a reward to effort, and as a source of funds for investment and growth. In recent years, when growth of productivity has become so inadequate in the United States, the need for more investment and therefore profits has gained growing acceptance. Accordingly, references to "obscene" profits seem to have become less frequent.

The other response is more a broadly based participation in profits. If more people owned shares in businesses, there would be fewer complaints about excessive profits. In the United States, most members of the privately employed labor force indirectly are shareholders through their participation in pension funds; this fact incidentally refutes the view that profits go only to the rich. But outright stock ownership by the broad public has severely diminished in recent years, ironically because profits have not been sufficient to keep the price of common stocks from falling.

Government Intervention

But the principal damage that is done to the market system does not originate from intellectual criticism. It derives from very practical efforts to interfere with the system in one way or another. Interference has come from many sources -- on behalf of particular producer interests, on behalf of political constituencies, through demands for larger government benefits, on behalf of consumers, and, ultimately, in pursuit of objectives often intrinsically desirable, such as environmental protection, that are largely unrelated to economic objectives.

Let me give a few examples. There are the familiar demands made by producer interests, usually well heeded by government. These include protection against foreign competition, price supports, marketing controls, and outright subsidies.

There are interventions on behalf of political constituencies other than producers, such as price controls, employment regulations, labor market intermediation, and other actions reducing work incentives and productivity.

In the United States, regulation on behalf of the consumer has greatly increased in recent years. Much of it pursues worthy objectives. It is the spirit of much of this regulation that is alarming, because it amounts to a denial of the market system. It rejects the view that competition produces the best result for producers and consumers, that there is an invisible hand which guides private self-seeking toward public benefits. The producer is depicted as the enemy of the consumer who seeks to deceive him, exploit him, overcharge him, and engage in all those practices that, in a competitive market with alert buyers, should be eliminated by the operation of the market itself.

Consumer legislation, like the anti-trust policy of the U.S. Government, starts with the presumption, undoubtedly justified, that markets and competition are not perfect. The invisible hand often fumbles. There is a need, consequently, for enforcement of competition and for protection of the consumer. At issue is how far these policies should go. Anti-trust policy that breaks up efficient firms simply because they are large, consumer protection that makes the consumer pay more for the protection than he finds worthwhile, go beyond their legitimate objective.

Environmental legislation also has opened a new source of intervention in the market. Principally it has done so by imposing high costs upon producers in order to attain arbitrary standards. The result has been misuse of productive resources for unproductive purposes, a reduction of productive investment, and a general slackening in productivity gains.

The consequences of this increasing market intervention are reflected in lagging productivity. In the United States, productivity gains in recent years have been disappointing in the extreme. For the last five years, productivity has grown at only 3/4 per cent annually, contrasted with 1-2/3 per cent during the preceding five years and over 3 per cent during the early 1960's. If growth of GNP in the American economy has been quite satisfactory nevertheless, exceeding substantially the growth experienced in Europe since the recession of 1973-74, it has been due mostly to the rapid increase in the labor force and in employment, including an increase of 21 per cent of working-age women.

The poor productivity performance of the United States, to be sure, cannot be blamed exclusively on recent government intervention in the market. Higher energy prices, declining research and development expenditures, and mounting inflation have all contributed. However, some of these seemingly exogenous events also are consequences of government actions that could be listed under the heading of market interference.

Freeing the Markets

Not all that is happening in the United States goes against the free market, however. There have been some notable moves in the opposite direction. Dissatisfaction with big government has been demonstrated, for instance, by the passage of "Proposition 13" in the State of California. That proposition placed a ceiling on property taxes, confronting local authorities with the need to adjust the level of public services to the reduced level of revenues. Deregulation of airlines by the Federal Government has broken a long trend in that field toward more regulation, and the success of the measure is leading to pressure for similar action in other regulated fields, including railroads, trucking, and radio. A strong movement is afoot to amend the Federal Constitution to require a balanced budget. President Carter has set as an objective the reduction of Federal spending from its present level of 21.5 per cent of GNP to 20 per cent by 1982.

Much more needs to be done, of course, to reverse the trend toward mounting government intervention in the United States. The great difficulty is that by now the passage of new interventionist legislation has become institutionalized. Large numbers of able and conscientious people see their function in life as passing and administering such intervention. They have strong political support from organized groups. Nevertheless, I believe that the trend can be turned as popular discontent with the state of affairs mounts. A better understanding of the way in which the free market works would contribute to that end.

Monetary Policy

In the restoration and preservation of a free market economy, monetary policy has an important role to play. Traditionally, monetary policy has been regarded as congenial to a market economy. Its purpose is to maintain stability in the broadest sense. By helping to promote price stability and avoid recession, it contributes to a framework within which the market can operate with greater confidence. The same has been true with regard to the international sphere. There, monetary policy, historically, has aimed at maintaining stable exchange rates which have contributed to the framework of stability within which the market is expected to operate. Failure to achieve this objective is not, I believe, the sole fault of monetary policy, although monetary policy carries its share of responsibility.

There are some forms of monetary policy, however, that are interventionist. In the United States, they are referred to as credit controls and credit allocation. They take the form of restricting or favoring particular forms of credit and particular purposes. The Federal Reserve has always taken the position that these policies are not appropriate for a central bank except under emergency conditions. I might add, however, that reserve requirements to be held by banks against deposits are not regarded in the United States as anything but a means of carrying out a general monetary policy compatible with a free market, since the effect of such measures on the supply of credit has no significant selective or allocative impact.

In the international field, the counterpart of selective credit control is foreign exchange control. It, too, reaches deeply into market processes, interfering with trade or capital movements. The United States has experimented with controls over capital movements in various forms, such as through the Interest Equalization Tax which was in force from mid-1963 to early 1974 and the Voluntary Foreign Credit Restraint Program imposed on banks and other financial institutions from early 1965 to early 1974. In my judgment, the experience with these measures demonstrates that, as far as controlling capital flows is concerned, they were not successful enough to do much damage. They did, however, succeed in driving much of the international lending business abroad, so that today many large American banks do an important share of their business offshore and are urging the creation of an International Banking Facility in the United States that would allow them to operate as they would abroad.

Exchange Rates

I have said earlier that I regarded the maintenance of stable exchange rates as one of the traditional functions of monetary policy, in support of well-functioning international markets. The view has sometimes been expressed that floating rates, such as we have now between the dollar and other major currencies, are more consonant with free market principles. A fixed exchange rate is regarded by some as a form of price fixing inimical to the working of the market like any other form of price control. Others have welcomed floating exchange rates because they supposedly allowed governments to pursue independent monetary and fiscal policies, without regard to the state of the balance of payments. In their view, the floating exchange rate was to be placed in the service of more forceful government action rather than of a well-functioning market.

Whatever the theoretical merits of this debate, I believe that the experience of recent years has shown that floating exchange rates involve considerable problems. We have seen wide swings in rates, that soon were reversed. We have seen currencies polarized into strong and weak. We have seen the mounting threat of protectionism. Floating rates are superior to a system of exchange controls, and to a system involving frequent and violent foreign exchange crises. They do give expression to the market-oriented principle that exchange rates should reflect fundamental market forces, such as prices, interest rates, payments balances, and incomes. But to the extent that these fundamentals permit, stable rates clearly are to be preferred. Fixed rates imposed by government action, such as in the European Monetary System (EMS), will have a wholesome effect to the extent that they bring these fundamentals into better alignment among nations at low rates of inflation and adequate levels of employment, and to the extent that they do not lead to distortion of exchange rates for third currencies such as the dollar.

Recent U.S. Monetary Policy

U.S. monetary policy now confronts a particularly critical period. Consumer price inflation during early 1979 has accelerated to a 13 per cent annual rate. At the same time, there is a general expectation of either a substantial slowdown or an actual recession ahead. At this critical juncture, the road signs that monetary policy makers in the United States normally use have ceased to point reliably. Interest rates have long ceased to be a good guide to policy, because inflation distorts their meaning. In nominal terms, and by historical comparison, interest rates in the United States today are very high. In real terms, i.e., after allowance is made for expected inflation, they may well be negative. Certainly after applicable taxes they are negative to most taxable debtors and creditors.

Lacking clear guidance from interest rates, U.S. monetary policy for a number of years has been oriented principally by the growth of the money supply. By that standard, which has been periodically published and communicated to the Congress, policy probably was too easy during the first half of 1978, since the announced targets were continually being exceeded. Since the fall of 1978, however, the money supply (M_1) virtually ceased to expand for a period of six months. This phenomenon could have been interpreted as an extreme tightening of monetary policy, although that certainly was not the intention of the Federal Reserve. It could have been interpreted as evidence that a recession was immediately ahead, causing a reduction in the demand for money. It could be interpreted as a shift out of money, particularly demand deposits, into other assets offering better returns, in order to escape the drastic losses inflicted by inflation on non-interest-bearing balances. Meanwhile, bank credit continued to expand rapidly, which the banks were able to finance from sources other than deposits, including from the Euro-dollar market.

The Federal Reserve's reaction, in the face of these perplexities, was to ignore largely its monetary guideposts. Continued adherence to these guideposts would have required a reduction in interest rates in order to induce the money supply to resume its projected rate of growth. In fact, interest rates were raised on November 1 in order to strengthen the dollar. Thereafter, the Federal funds rate, i.e., the inter-bank rate which the Federal Reserve directly influences, rose somewhat further while most other short-term rates have shown little net change. Meanwhile, the inflation accelerated to a rate of 13 per cent, thus reducing real interest rates.

Since money supply as well as nominal interest rates has ceased to be a reliable guide to monetary policy, some other standard clearly is needed. It is needed at least until such time as the monetary aggregates re-establish some stable relation with the economy, or until inflation is brought down so that nominal interest rates once more become meaningful. A standard that seems plausible to me is that real interest rates should be positive. This is a calculation that can readily be made for short-term rates, although for long-term rates it is necessary to derive some measure of expected inflation by one of the techniques employed by econometricians. To be meaningful, real rates should be positive by a good margin in order to overcome the effect of taxes. That effect differs among different groups of lenders and borrowers according to their income tax bracket.

As I have noted, short-term interest rates in the United States have been negative in real terms of late. I believe that this has implied an insufficiently restrictive monetary policy, as indicated by my votes in published records of the Federal Open Market Committee (FOMC).

Most recently, conflicting and confusing signals have continued in the American economy. The money supply has once more resumed its expansion. Signs from the real sector of the economy, on balance, have pointed toward a slowdown. The dollar has been strong. Inflation has advanced to a very high rate. Accelerating inflation itself constitutes the major threat to continued stable expansion of the economy. It also, unless brought down visibly and convincingly, poses the principal existing threat to the free market system that we confront.

Under these conditions, good counsel is to be found in a view that has been gaining ground in recent years and that is particularly consistent with what I believe to be the proper role of government in the economy. It is a policy of steadiness, of avoiding brusque changes in monetary as well as other macro policies, and of avoiding what has come to be called "fine tuning." The belief that we can steer the economy with precision reflects a belief in the virtues of big government. Experience has not borne out this belief. Efforts to steer the economy closely have probably exacerbated cyclical fluctuations. They have also pulled the government more and more deeply into interventionist activities. A policy of steadiness, not reacting sharply to every cyclical move in the economy, seems to be the best way not only to reduce these fluctuations in the long run but also to limit the role of the government and assure the survival of a free market.

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