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FREE MARKETS IN THE WORLD TODAY

Remarks by

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

on the occasion of receiving the

Ludwig-Erhard-Preis fuer Wirtschaftspublizistik

Bonn, Germany

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When a prize is awarded in the name of Ludwig Erhard -- a signal honor that I deeply appreciate -- it seems fitting to turn our thoughts to the role that Erhard's heritage of ideas and achievements plays in the world today. Erhard was concerned with the application of the concept of freedom to the economic affairs of his and all countries. Today, as in Erhard's days, freedom and how it is respected and applied in economic affairs is a dominant issue. Today, freedom advances in some countries and some economic sectors. It may be retreating in others. My remarks will be addressed, first, to these broad tides in the world's affairs, and, second, to the particular progress that some of Erhard's principles are making in my country today, under the unprepossessing title of "deregulation." I understand the best translation into German to be "Deregulation."

Erhard took his historic decision to cut German prices loose from controls in 1948 in the most adverse climate of opinion imaginable. In Germany, few could then visualize economic activity uncontrolled by the state and perhaps even by cartels. Among Americans, some residual belief in markets had survived the skepticism of the New Deal period and the war. But the German economy, in its postwar paralysis, surely must have seemed the least promising place to apply the principles of free prices, competition and incentives. The fact that today Erhard's solution seems so obvious shows how much the climate of world opinion has changed.

It was in good part by the example of the German miracle that the world, and particularly the United States, became motivated to rediscover the role of markets, of money, and of multilateral trade. It was a predominantly free-market world that produced, after World War II, one of the strongest surges of economic growth in modern history.

But Ludwig Erhard's principles did not prevail consistently. The role of government, both as a user of resources and a manipulator of markets, advanced in many countries. At times it seemed that a doctrine enunciated by an earlier German economist, Adolf Wagner, was being validated. He argued that the share of the state in economic life was destined to increase secularly. Thus the social purposes of the market economy, which were to be achieved through free competition and equal opportunity for all, often were preempted by government action seeking to achieve them by "dirigiste" means. Excessive demands on the economy often produced inflation. Erhard's dictum that the working of a socially oriented market economy requires moderation on the part of all participants -- government, labor, and business -- frequently went unheeded. The responsiveness of the market mechanism and its ability to reallocate resources and overcome unemployment often was blunted by government restrictions. International trade, which had been one of the main success stories of the postwar period, was increasingly placed in jeopardy by protectionism. Profit, which should be a driving force in a market economy, at times became a dirty word.

The verdict is still outstanding whether such departures from Erhard's principles will prove aberrations or rather symbols of a trend. I derive some confidence, however, from increasing worldwide recognition of the role of the market price as a steering mechanism. At the level of theoretical economics, price is widely accepted as the mainspring of economic decision making. The use of econometric methods, backed by computers, makes possible more complete -- though hardly infallible -- analysis than was possible in Erhard's day. For countries whose economic policies have gone astray and that are experiencing foreign debt problems, a return to the principle of market prices is the standard prescription. As administered by the International Monetary Fund, it means to get back to market-based, i.e., uncontrolled and unsubsidized prices for producers and consumers, to positive real interest rates, to realistic exchange rates. Even in some socialist economies, market prices and, in a small way, sometimes even profit have begun to play a role.

Perhaps the most dramatic expression of the market principle today can be found in the area of international finance. International borrowing and lending increasingly take place in a true world capital market. National markets are becoming part of the world financial market, as barriers like withholding taxes and regulatory restraints are beginning to yield. It is in this general area that, for the United States today, markets are asserting themselves as regulation retreats. I would like to say a few words about this process, which I believe is very much in the spirit of Ludwig Erhard.

Before focusing on the financial field, however, which for me is a natural topic, I would like to point out that the process of deregulation has gone forward in much broader areas.

One such area has been the oil and natural gas industry. Both were the object of regulation long before the oil shocks of the 1970's, in a misguided effort to stimulate domestic production and benefit consumers. Under the impact of the oil shocks, both oil and natural gas were further subjected to very detailed discriminatory price controls. It is this congeries of controls that gradually has been relaxed since 1978, with benefits to consumers. Decontrol is by no means complete, but significant steps toward free-market pricing for these commodities that have been subject to such tremendous price upheavals is a real victory for the market principle.

Transportation also has been deregulated in the United States. For the railroads, which were the first industry to be regulated at the federal level (1887), the new trend may have come too late. But deregulation of airlines and trucks since 1978 has been another victory for free markets. Air fares and trucking services have been priced more economically, traffic patterns have become more efficient. Some lines have been unable to compete under the new conditions, since protection of uneconomical service had been one of the principal results of regulation. But new lines have come into existence, and while some localities have lost service, a larger number appear to have gained.[1]

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1. Roger G. Noll and Bruce M. Owen, The Political Economy of Deregulation, Washington, D.C.: American Enterprise Institute for Public Policy Research, 1983, pp. 121-29, 140-50.

The telephone service has been subjected to a more competitive regime. Under the earlier highly regulated system, the long-distance service subsidized local service, with resultant inefficiencies. Under these anticompetitive conditions (the industry in the United States is privately owned), entry for newcomers both into the transmission and the equipment end of the business was difficult. Today, competition has become the rule.

In the financial field, deregulation is going forward apace, though it is by no means complete. Interest ceilings on bank and thrift deposits previously controlled under Regulation Q have been virtually eliminated. This is a matter of great importance for the functioning of mortgage markets given the tendency of volatile market rates to exceed regulatory ceilings from time to time. Periodic financial crunches, that occurred as thrift institutions were disintermediated, came largely to an end, although problems by no means disappeared altogether. As a corollary, savers increasingly received positive real returns. It should be noted that controls over deposit and lending rates were abolished in Germany at a much earlier date, although it is not clear to what extent they are now determined by the free play of market forces. Fixed commission rates for securities transactions on U.S. stock exchanges have been ended. Since 1975, commissions have been negotiable. A similar movement is now in process in the United Kingdom. The effect, in the United States, has been to squeeze out inefficient brokerage firms. On the negative side, the cost of securities transactions to the small individual investor has approximately doubled.

Today, broader powers for U.S. banks are being proposed, allowing them to engage in securities, insurance, and real estate, all subject to specific limitations. If this legislation passes, it would end existing narrow restrictions on what American banks can do. In Germany, of course, the country of "universal banks," these limitations have been largely absent, although the "universal" or "department store" principle does not seem to be without its critics. The main benefit from the proposed new activities in the United States is likely to be intensified competition in the areas opened up to bank entry.

Reducing geographic limitations on American banks is also under consideration. At present, banks are not allowed to establish branches outside the state of their head office. This, too, incidentally, is a kind of regulation I believe is not present in Germany. Among the benefits anticipated would be greater competition and efficiency. Also, a broader deposit base would become available to banks that today find their access to deposits constrained and must, therefore, rely more heavily on volatile purchased funds.

Whether or not these legislative intentions bear fruit, the market today is in effect overcoming many regulatory restrictions. Banks have found ways of operating nationwide in more limited forms. "Nonbank banks" are springing up, i.e., institutions that, by surrendering either the power to accept demand deposits or to make commercial loans, can circumvent geographic restrictions while in other respects performing normal banking functions. They have made some inroads in the securities and real estate business. Meanwhile, firms in those and other industries have found means of entering major parts of the banking business. Regulatory divisions, in other words, are being undermined from both sides.

The free-market principle is making its most dramatic progress in international finance. National capital markets, as I noted earlier, are becoming internationally integrated. The role of the Euromarkets has been growing for many years. The development of this market is a textbook example of the response of finance to domestic regulation. In the case of American banks it has been principally the freedom from reserve requirements and Federal Deposit Insurance Corporation insurance premia that has caused funds to move into the Euromarket. The segmentation of the world capital market into national compartments is being overcome. Floating exchange rates are no longer a serious obstacle to international flows of capital. Currency swaps, properly used, reduce exchange risks. Interest-rate swaps reduce market imperfections that give different borrowers unequal access to various types of money. Under the impact of these opportunities for innovative finance, regulatory and tax obstacles to the free international flow of funds also have been reduced. Large banks participating in international lending and, recently all too frequently, in rescheduling operations, have learned to cope and live with different national regulatory, accounting, and tax situations, in a common effort to maintain the international flow of capital. An international banking community has developed.

Safety

Free markets imply risks. It is appropriate that these fall to the extent possible on those who as entrepreneurs and shareholders have claims to profits. But failure of a bank, when it occurs, has wide repercussions on other sectors. Regulation to enhance bank safety, therefore, is not inconsistent with market principles. In the United States, enhanced safety is being pursued by mandatory increases in banks' capital relative to their assets. In my view, further increases of this sort are needed. Proposals are afoot also to improve the deposit insurance system. Fuller disclosure of international exposure has been mandated in order to enhance the discipline of the market. In Germany, banks with foreign subsidiaries have been strengthened by consolidation of their accounts.

A balance between market freedom and safety is necessary in the financial system. Recent moves in the United States have been mainly in the direction of freer markets, but the safety factor is simultaneously being enhanced. Further progress in both directions is needed.

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