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THE TRANSITION TO FREE MARKETS

Remarks of Wm. McC. Martin, Jr., Chairman,

Board of Governors of the Federal Reserve System,

at luncheon meeting of The Economic Club of Detroit,

Sheraton-Cadillac Hotel,

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April 13, 1953.

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On behalf of the Federal Reserve System, I wish to express appreciation of the honor you do me in inviting me to be your guest at this luncheon of The Economic Club of Detroit which you are giving in connection with the dedication of the new Detroit Branch Building.

It seemed to me that this might be an appropriate time and occasion to comment on the part that the Federal Reserve System was designed to play in the economic life of our country. In particular, I would like to say something about the progress that has been made in the past two years in what, for want of better words, I have referred to as the transition to free markets.

It is not strictly true, of course, that in our complex world we can have absolute freedom in human affairs. The goal of the greatest good for the greatest number requires as a minimum a Government of laws, and, human nature being what it is, that means some regulation of our daily lives. There is this minimum in monetary management. Nevertheless, the aspiration remains to have as much freedom of choice and action as is compatible with the common good. This is true in economic as in other affairs.

Under the hard choices left us in wartime, we had to dictate even some of the smallest details of our economic life, but that strait jacketing of the economy is wholly inconsistent with democratic institutions and a private enterprise system. It produced the paradox that we seemed to be practicing the very thing we were fighting against. The Federal Reserve System was caught in this paradox under the wartime decisions. It undertook to stabilize the price of Government securities in relation to a fixed pattern of yields, and in so doing found itself feeding the forces that make for inflation. It continued to stabilize these prices, with minor modifications, after the war, in fact up to March 1951. These are facts. I am not passing judgment on what was done.

Last month marked the second anniversary of the so-called Treasury-Federal Reserve accord. It may be worth while to recall the wording of the joint statement:

> "The Treasury and the Federal Reserve System", said the announcement, "have reached full accord with respect to debt management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt."

In monetary history the accord was a landmark. In withdrawing from supporting fixed prices in the Government bond market, the Federal

Reserve System regained its influence over the volume of money. It ceased to be the residual buyer who, by its purchases of Government securities, however reluctantly made, furnished bank reserves indiscriminately and thus abetted inflationary overexpansion of the money supply.

During its 40 years of existence, the Federal Reserve System has frequently tried to formulate or define its purposes in the light of the responsibility for monetary management which Congress placed upon it. The System is, and always must be, subject to the will of the Congress. Through their elected representatives it is thus ultimately answerable to the American people.

The Federal Reserve Act contains guidance for policy and action rather than directives or a mandate. While the Reserve System does not have an explicit mandate in the law, it is governed in its decisions by a definite purpose which can be simply stated. Its purpose is to see that, so far as its policies are a controlling factor, the supply of money is neither so large as to induce destructive inflationary forces nor so small as to stifle our great and growing economy.

It is fair to say, I think, that the System has performed that task fairly satisfactorily during the past two years. During that period the economy has functioned at record levels and despite the diversion of economic resources to the defense program, it has functioned without further inflation. However precarious the balance, it has been a period of steady economic progress. It would be a mistake to claim too much for monetary policy in this achievement. But it would be equally misleading to conclude that this steady progress would have been achieved without the aid of the monetary policies and actions that were initiated two years ago.

What has occurred in the past two years in the area of money management has been a return from wartime necessities to the principles of the free market. The significance of this transition is not to be found in interest rates, but in its far greater implications, wholly apart from its economic effects. In a free market, rates can go down as well as up and thus perform their proper function in the price mechanism. Dictated money rates breed dictated prices all across the board. This is characteristic of dictatorships. It is regimentation. It is not compatible with our institutions.

Not only in this country but in the entire Western World, we are seeing a return to the principles upon which our strength rests. Under our Governmental institutions and our economic system, the maximum benefits for all of us flow from utilizing private property, free, competitive enterprise, and the profit motive in accordance with the dictates of the market place--something that was almost forgotten for a period of years.

The market place--the price mechanism--are basic essentials of the American economy and of the economy of the Western World. We have seen the countries of Europe that struggled along with Marshall Plan aid return to the earning process, one by one. We have seen monetary policy put to work in Belgium and Italy. We have seen it spread from Italy up to the Netherlands, on to Denmark, and on to Britain. For the last year Britain has been taking measures running somewhat parallel to ours.

The process of returning to acceptance and use of the market place is slow, painful, and hard. It is not achieved because people necessarily like it; it is achieved because alternative ways don't work--and that has been found out in most of Western Europe since the war.

When we started this program of freeing the market some people were talking as if that would lead to panic and disaster. Some said that once Government bonds went below par the credit of the United States would be destroyed. Some people saw panic and collapse on the horizon merely because there had been a movement of a few thirty-seconds in the Government securities market. The word "stability" had come to mean "stagnation" and "frozen prices".

During the past year, under the authority of the Federal Open Market Committee, an ad hoc subcommittee has been reviewing our operations in the Government securities market with a view to determining what might be done to develop and improve those operations under the changed conditions.

After ten years of a pegged market, we found that once the market was freed a little bit, many of the devices and techniques we had been using tended to work in reverse. We found that the dealers, the brokers, the individuals--that composite that makes up the market--instead of making market judgments for themselves were chiefly interested in trying to find out what the Federal Reserve planned to do and how it was going to operate.

Federal Reserve support of the Government securities market over many years, because it affected the operation of the entire financial market, had developed patterns of behavior and thinking that were not easily or quickly changed. Only gradually were old practices discarded and the characteristics of a free market developed.

That is not to say that the performance of the Government securities market after the unpegging was not highly gratifying in several important respects. Considering the pressure on the economy and on the supply of savings, the range of price fluctuation on Government issues was moderate. The facilities of the market proved to be generally good.

But the market did not have the depth, breadth, and resiliency needed for the execution of effective and responsive market operations and for flexible debt management purposes. This means a securities market in which market forces of supply and demand and of savings and investment are permitted to express themselves in market prices and yields. The unsatisfactory aspects of the market seemed to be related in large part to the psychology that pervaded the market. Professional operators in the market appeared confused with respect to the elements they should consider in evaluating future market trends.

For one thing, they seemed apprehensive as to the Federal Reserve attitude on prices in the market. The market appeared constantly to expect action by the System which, by standards of a free market, would be unpredictable and might seem capricious. Investors and dealers seemed to lack adequate background for weighing and evaluating System actions in forming their individual market judgments and investment decisions. After the unpegging there quite naturally remained much skepticism as to the System's intentions or ability to permit a free private market to develop.

In important respects there was tangible justification for these doubts. For one thing, the System continued to support the market for short-term securities during periods of Treasury refunding. For another thing, it was also understood that the System had a policy of maintaining an orderly market in all sectors of the Government securities market, a phrase that was variously interpreted in the market and which the market therefore found hard to understand.

Against that background, it was our purpose to develop methods of operation which, as they became known through practice, would give those who participate in the market, and those who have contacts in the market, a familiarity with how the Federal Reserve may intervene, when it may intervene, for what purpose it may intervene.

Since the unpegging, we have endeavored to confine open market transactions to the effectuation of credit policy, that is, to maintain a volume of member bank reserves consistent with the needs of a growing and stable economy. We have tried to confine our operations to short-term securities, in practice largely Treasury bills. Prices of these issues, which are the closest substitutes for cash, are least affected by Reserve System sales or purchases. Gradually investors in Government securities have, I believe, come to expect and understand this phase of System activity in the market.

We have had a particularly acute problem during periods of Treasury refundings. It had become the practice under pegged and supported markets for the System to intervene to support Treasury refundings. This seemed a reasonable use of Federal Reserve resources, provided it was limited and excessive purchases were later disposed of in the market. This practice was followed for eighteen months after the accord.

We found, however, that when the Federal Reserve, with its huge portfolio and its virtually unlimited resources, intervened in the market during Treasury refundings, many other investors tended to step to the sidelines and to let the market form around the System's bids. This was a natural and highly rational investor reaction. But the result was that with the System supporting a refunding, offerings failed to get fair market valuation until some time after the refunding period. Under the circumstances, it was very difficult for the market to make a satisfactory judgment of the worth of a new offering or of the relationship it should bear to other Government obligations already outstanding. This was particularly true since it was usually obvious to investors that the System might act to absorb reserves by sales during or after the refunding operation in order to offset its support purchases.

During the past two transition years, the Treasury and the Federal Reserve have been experimenting with various ways of minimizing or eliminating this intervention. In connection with a small refunding, the Federal Reserve decided last December to refrain entirely from purchasing maturing securities, or "rights" as they are called. Again in February, when the Treasury refinanced a large maturity with an attractive offer no support was given by the System. Both refundings were highly successful and demonstrated the value of reliance on freely functioning markets rather than on official intervention.

The transition has major advantages to the System, to the Treasury, and to investors in general. The System no longer needs to inject periodically into credit markets large amounts of reserve funds which are difficult to withdraw before they have resulted in undesirable credit developments. On the other hand, private investors, whose funds the Government seeks to attract, may now fairly appraise a new Government security offering through market processes. They may invest in the new issue with confidence that its market price reflects not just an arbitrary decision by the Treasury and the Federal Open Market Committee but instead the composite evaluation of its worth by thousands of investors in the light of their judgments as to the current and prospective demand and supply of credit.

We also had to deal with the concept of "maintaining an orderly market". I tried before committees of the Congress to define "orderly market". I was not very successful, but I do think that gradually our emphasis has been shifting toward a realization that we should not be the judges of what an orderly market is; that our efforts should be directed more toward correcting disorderly conditions--you can see the difference in emphasis--and that even there, we ought to be extremely careful about intervening unduly.

In a properly functioning market, and particularly in a well organized money and credit market, fluctuations resulting from temporary or technical developments are self-correcting without any official intervention. Of the movements that are not self-correcting, most reflect basic changes in the credit outlook which should be permitted to occur. Only very rarely is there likely to be a disorderly situation that would require Federal Reserve intervention for reasons other than credit policy.

As investors continue to operate in a free market for Government securities I am confident that they will develop a fuller understanding of the minimum role to be played by the System in such a market. They will then feel freer to express their own judgments about market values and will thus develop a market with greater depth, breadth, and resiliency. Certainly much progress has already been made.

With the changes in its own policies and practices and with the development over the past two years of this self-reliant market for Government securities, the Federal Reserve has been able to bring into full use its instruments for influencing the general credit situation in order to promote economic and financial stability. Open market operations and the discount rate are again being used for this purpose as twin reserve banking measures, each complementing the other in affecting the availability, volume, and cost of credit.

Primary reliance is once more placed upon the discount mechanism as a means for supplying the variable short-term needs of individual banks for reserves. Experience has demonstrated that when member banks are heavily in debt to the Federal Reserve Banks, the tone of the money market is tight. Marginal loans are more likely to be deferred and some credit risks may have to shop around for accommodation. Conversely, when member bank borrowing is low, the tone of the money market tends to be easy and credit accommodation is less discriminating. The Federal Reserve borrowing privilege and the discount rate, after years of disuse, have come to play once more their intended role as flexible, impersonal instruments of monetary management.

Open market operations can be employed when needed to condition the current tone in credit markets and the general availability of credit. By these operations the Federal Reserve can tighten or ease the pressure on member bank reserve positions and thus cause banks to borrow or enable them to reduce borrowings at the Reserve Banks. Subsequently, this tightness or ease is transmitted and magnified in money and credit markets.

I have sought to outline for you the progress that the Federal Reserve System, within the framework of its purposes and functions, has made in these past two years of transition. With credit and monetary measures in effective operation, and with a Federal fiscal situation that does not depend excessively on credit to finance expenditures, reasonable stability in the value of the dollar is again a valid assumption in making economic decisions.

This is in sharp contrast to the era of pegged markets from which we have emerged. There are still some who would have us return to a pegged market. If we did, we would have no reliable safeguard against the erosion of our savings, our pensions, our life insurance policies--the capital upon which the institutions of private enterprise rest. There are no reliable substitutes for free markets which have been reinstated during the past two years. A redundant money supply can be dammed up by direct controls for a time, but as we saw in the early postwar years, once the controls are lifted, as the public insists that they be in peacetime, the economy is engulfed with the flood of money that has already been created and only temporarily held back.

If we handle our fiscal, monetary, and debt management problems wisely we will not have to worry very much about the value of the dollar.

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