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Statement of
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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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THE GOVERNMENT SECURITIES MARKET AND ECONOMIC GROWTH

Mr. Chairman:

In this opening statement, I would like to comment first on one aspect of the problem you are considering--the importance of freely competitive markets to maximum economic growth. In so doing, I do not wish to understress the importance of any other conditions necessary to healthy economic growth. Indeed, if there is one essential for sustained growth that stands out above all others, it is the maintenance of a volume of real saving and investment sufficient to support continuous renewal, adjustment, and expansion of our total capital resources. As you know, the maintenance of adequate saving and investment depends upon broadly based and justified confidence in a reasonably stable dollar.

Role of Free Markets

No one here would deny that free markets are essential to the vital and vigorous performance of our economy. No one would urge that we encourage monopolistic practices or administered pricing, and few would advocate Government interference with the market process as a general principle. On the contrary, nearly everyone would agree that such developments are injurious to the best use of our resources, that they distort the equitable distribution of final product, and that they interfere with economic progress.

Differences of viewpoint on free markets arise only when the complexities of specific market situations make it difficult to discern whether markets are, in fact, functioning as efficiently as we might reasonably expect. Well-informed and well-intentioned observers will

disagree as to whether an appropriate degree of competition exists in particular markets and, if not, as to what corrective steps, if any, it is appropriate for Government to take.

If the policies we follow in the financial field are to be fully effective in promoting growth and stability, they must be able to permeate the economy through the mechanism of efficient markets. This generalization applies to all markets, for all types of goods and services. Naturally, the Treasury and the Federal Reserve are most immediately concerned with financial markets, both because we have some direct responsibility for these markets, and because they represent the main channel through which the Government financial policies to foster growth and stability must pass.

The Market for Government Securities

We are especially concerned with the market for United States Government securities. With a Federal debt of \$285 billion, Government securities are a common and important asset in the portfolios of businesses, financial institutions, and individuals. An efficient market for Government securities is obviously needed for the functioning of our financial mechanism. We are fortunate in this country to have such a market. From the standpoint of the Federal Reserve, it is hard to conceive of the effective regulation of the reserve position of the banking system without some such facility through which to conduct open market operations of large magnitude.

The initial results of our study of this market with the Treasury are encouraging in many ways. As was pointed out in the summary of the study made available to you on Friday, huge transactions

are carried out every day in an orderly fashion and at very small cost to ultimate investors. One cannot fail to be impressed by the fact that there are dealers who stand ready, at their own initiative and at their own risk, to buy or sell large blocks of securities. Frequently, single transactions run into millions of dollars. Despite the absence of any assurance that a given purchase will be followed by an offsetting sale, dealers quote bid and ask prices that typically have a spread of less than 1/4 of 1 per cent on the price of long-term bonds and range down to a few one-hundredths of 1 per cent on Treasury bill yields.

If you have had an opportunity to examine the preliminary study manuscripts, you are aware that they do suggest that some improvements in the Government securities market may be in order. We would hope that these improvements can be made within the framework of existing authority and through voluntary cooperation with various market participants. There is, however, a possibility that further authority might be necessary or desirable. We expect to have a clearer idea about how to accomplish desirable improvements after we have had an opportunity to consider carefully the findings of the staff study just completed last week.

There is one possible change in the organization of the Government securities market that would not, as I view it, lead to improvement. That change would be the enforced conversion of the present over-the-counter dealer market into an organized exchange market. The reasons why this change would not be constructive or even practicable are set forth in the joint statement on the study's

findings. On the other hand, any efforts on the part of existing organized exchanges to extend or strengthen the facilities now made available to buyers and sellers of Government securities should certainly be encouraged. There is no reason why better exchange facilities would not prove to be a helpful supplement to those provided by the present dealer market.

Another change affecting the Government securities market that has been suggested relates to Federal Reserve participation in it, and pertains in particular to the extension to longer term maturities of Federal Reserve open market operations. Some discussion of this suggested change is appropriate here, for it is not a matter encompassed by the Treasury-Federal Reserve study.

System Operations in Short-Term Government Securities

Since the Treasury-Federal Reserve accord in 1951, the System's day-to-day trading in Government securities has largely been in short-term issues. In 1953, after extensive re-examination of System operations in the open market, the Federal Open Market Committee formally resolved to make this a continuing practice.

I think that nearly everyone who has studied these matters would agree that the bulk of Federal Reserve operations must be conducted in short-term securities; that necessarily means largely in Treasury bills. The short-term sector of the market is where the greater part of the volume of all trading occurs. Dealer positions are characteristically and understandably concentrated in these shorter issues. Differences of view on whether System trading should extend outside the short-term area

hinge upon whether or not some small part of our regular buying and selling should be done in the longer term area.

To appraise this difference in viewpoint, we need first to consider the basic economics of System open market operations. Federal Reserve operations in Government securities influence prices and yields of outstanding securities in three fundamentally different ways:

(1) They change the volume of reserves otherwise available to member banks for making loans and investments or paying off debts;

(2) They affect the volume of securities available for trading and investment; and

(3) They influence the expectations of professional traders and investors regarding market trends.

Of these effects, the first is by far the most important. Under our fractional reserve banking system, additions to or subtractions from commercial bank reserves have a multiple expansive or contractive effect on bank lending and investing power. Other things being equal, this means that any given change in System holdings of securities will tend to be accompanied by a change in commercial bank portfolios of loans and investments several times as large. Unlike many other institutional investors, commercial banks maintain Government security portfolios with a wide maturity distribution although the largest component will be short-term securities. Hence, the major effect on market prices and interest rates will result from the actions subsequently taken by commercial banks to expand or contract their asset portfolios, and the impact will be distributed throughout the market.

With regard to the effect on the availability of securities in the market, substantial System purchases or sales of short-term securities exert a minimum influence on the market supply. For example, most of the \$35 billion of bills outstanding is in the hands of potential traders. On the other hand, much the largest part of the marketable longer term issues is in the hands of permanent investors. Current trading in them is confined to a very small fraction of the outstanding volume. For this reason, the long-term area of the market shows greater temporary reaction than the short-term area to large purchase or sale orders.

Any attempt to use System operations to influence the maturity pattern of interest rates to help debt management would not produce lasting benefits and would produce real difficulties. If an attempt were made to lower long-term interest rates by System purchases of bonds and to offset the effect on reserves by accompanying sales of short-term issues, market holdings of participants would shift by a corresponding amount from long-term securities to short ones. This process could continue until the System's portfolio consisted largely of long-term securities. Accordingly, the System would have put itself into a frozen portfolio position.

The effect of thus endeavoring to lower long-term yields, without affecting bank reserves, would be to increase the over-all liquidity of the economy. Not only would the supply of short-term issues in the market be increased, but also all Government bonds outstanding would be made more liquid because they could be more readily converted into cash. The problem of excess liquidity in the

economy, already a serious one, would be intensified. The Treasury now, even with the present interest rate ceiling, would have no difficulty in reaching the same result. It has merely to issue some \$20 billion of short-term securities and use the proceeds to retire outstanding long-term debt. Fortunately, it is not contemplating any such action.

The effect of System open market operations on the expectations of market professionals, can be of critical importance depending upon the market area in which the operations are conducted. In the longer term area of the market, dealers, traders and portfolio managers are particularly sensitive to unusual changes in supply and demand. One important reason is that long-term securities are subject to wider price fluctuation relative to given changes in interest rates than are short-term issues. Therefore, trading or portfolio positions in them incur a greater price risk.

These traders and investors in long-term securities are aware that the System holds the economy's largest single portfolio of Government securities. They also know that the System is the only investor of virtually unlimited means. Consequently, if the System regularly engaged in open market operations in longer term securities with uncertain price effects, the professionals would either withdraw from active trading or endeavor to operate on the same side of the market as they believed, rightly or wrongly, that the System was operating.

If the professionals in the market did the former, the Federal Reserve would become in fact the price and yield administrator of the long-term Government securities market. If they did the latter, the total effect might be to encourage artificially bullish or bearish expectations

as to prices and yields on long-term securities. This could lead to unsustainable price and yield levels which would not reflect basic supply and demand forces. The dangerous potentialities of such a development is illustrated by the speculative build-up and liquidation of mid-1958, described in detail in the Treasury-Federal Reserve study.

Either of these effects would permeate, and tend to be disturbing to, the whole capital market. Accordingly, instead of working as a stabilizing force for the economy, such open market operations in long-term securities could have the opposite result. In other words, if the Federal Reserve were to intrude in the adjustment of supply and demand in order directly to influence prices and yields on long-term securities or in a way that resulted in unsustainable prices and yields, it would impair the functioning of a vitally important market process.

Some public discussion of the Federal Reserve's present practice of conducting open market operations in short-term securities implies, it seems to me, that the System has assumed an intractable and doctrinaire position on this matter. This is not a correct interpretation of what we have done. We adopted this practice after a careful study of experience and of the effects of our operations upon the market and the banking system. In this review, we were naturally mindful of the specific tasks of the System, namely, to regulate the growth of the money supply in accordance with the economy's needs and to help maintain a stable value for the dollar.

The practice or technique was adopted, not as an iron rule, but as a general procedure for the conduct of current operations. It is subject to change at any time and is formally reconsidered once each year by the Federal Open Market Committee in the light of recent experience. Exceptions can be, and have been, authorized by the Committee in situations where either Treasury financing needs, conditions in the money market, or the requirements of monetary policy call for such variations. The System, at times has been a subscriber to longer term issues in Treasury exchange offerings when appropriate, and at other times has purchased such securities in the market.

In other words, we endeavor to apply this practice flexibly as we do all of our practices in the administration of monetary policy. As I have stated to this Committee on other occasions, flexibility is an essential ingredient of our entire reserve banking operation. When reserve banking loses flexibility, it will no longer be able to do the job that is required of the central bank in the market economies of the free world.

Measurement of Economic Growth

Before concluding my statement, I want to mention one entirely different matter that has special relevance to the broad scope of this Committee's interest. That is the measurement of growth. As you know, one of the frequently used indicators of growth in the industrial sector has been the Board's index of industrial production. One of the great

lessons we learn from the compilation of this index, which we try to do as carefully and competently as we know how, is that the mere matter of measuring growth is a very tricky thing.

As the structure of the economy keeps changing, the job of combining measures of its many parts into a single index cannot be done, despite our best efforts, without having to make major revisions every few years. We again have underway a basic revision, the final results of which will be available soon. The nub of what this revision shows is that the growth rate in the sectors covered by the Board's index has been materially greater over the past decade than has appeared from the unrevised index.

The statistical data that we have to use from month to month, can only be cross-checked in a comprehensive way when we have available the results of a full census. Congress authorized the Department of Commerce to conduct one of these in 1947, and another as of 1954. The immense task of digesting and reappraising the results of these censuses, and then refitting all of the monthly data into these basic benchmarks, has now progressed far enough to indicate that the revised index, with the 1947-49 period as the starting point at 100, will show a level of around 165 at mid-1959. That is 10 points higher than the figure shown by our unrevised index for June.

Some of this difference results because we are now able to include, with appropriate proportional weight alongside other items, more of the fuel and energy production that has been going on all the time without being represented in the index. More than half of the difference, however, results from improvements in measurement of presently included industries. The monthly movements of the revised and present indexes

are quite similar, so that main effect of the revision in the total is to tilt upward this measure of industrial growth over the past decade. For example, it now appears that industrial output of consumer goods on a revised basis has risen at an average annual rate of 3.8 per cent as compared with 3.2 per cent shown by the unrevised index for the consumer goods sector. Population growth has been at a rate of 1.7 per cent per year.

Industrial production, to be sure, is only one of the ways that growth might be measured, but it is a measure in real terms and so is free of price influences. Crude measurements of growth in aggregate dollar terms can be seriously misleading, not only with respect to what the economy has done but also in marking out guidelines as to how we may reasonably expect the economy to grow in the years ahead. It is no achievement to have a rise of 10 per cent in the general price level such as occurred in the months after the Korean outbreak--even though that does puff up the figures on gross national product quite handsomely. The increase of 15 per cent in the current dollar value of gross national product from 1955 to 1957 was only half of what it seemed to be because it was inflated by a general price increase of 7 per cent.

Throughout its entire history, this economy has grown by staggering magnitudes. It is because I, for one, want to do everything I can to keep it growing that I urge the maintenance of free markets and reasonably stable prices as primary objectives of public policy.