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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Conservation and Credit

of the

Committee on Agriculture

House of Representatives

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Mr. Chairman, I am pleased to be here today to discuss with your Subcommittee some of my impressions and reactions to the recent chain of events in the silver market with emphasis on their implications for public policy. Even now, however, I am not satisfied that we in the Federal Reserve and others in appropriate government agencies have fully digested all of the facts and circumstances that threatened a few sizable financial institutions and the financial markets generally. But, it is clear to me that that episode does--in an all too vivid way--raise important questions about the structure and regulation of "futures" and "commodities" markets. We intend to pursue those questions as quickly and as dispassionately as we can, looking toward recommendations for government and private actions.

The Federal Reserve does not have direct statutory or regulatory authority over any commodity or financial futures markets. We do have statutory authority to establish margin requirements for the purchase or carrying of equity and equity-type securities. And, in cooperation with the Treasury, we have a more limited and informal oversight responsibility for the government and government-related securities markets.

While our direct authority does not extend to the "futures" markets, the commodity markets generally, and the gold and silver markets specifically, we do have a continuing interest in the performance and functioning of those markets. That interest arises in several contexts. For example, to the extent that price trends in those markets, or in segments of those markets, radically depart--

for whatever reasons--from general price movements (as was the case with gold, silver and other commodities during late 1979 and early 1980) they can directly and indirectly fuel inflation and inflationary expectations. Recurring headlines detailing the substantial and cumulative rise in gold and silver prices, for example, surely worked to reinforce inflationary expectations in 1979 and early 1980. Indeed, it was largely for this reason that the Federal Reserve, in October 1979 and again in March 1980, called specific attention to speculative tendencies in the commodities markets and requested banks to avoid speculative lending.

The Federal Reserve's general interest in these markets also stems from its responsibilities for promoting the efficient and effective functioning of the financial markets. That interest is obviously more pointed in certain interbank and government securities markets, but financial markets in the United States and around the world have become integrated to the point where it is very difficult, as a practical matter, to segregate one market or one institution from others. For example, some of the institutions with the greatest exposure in the silver situation had far-flung activities in many other markets. Had one of those institutions become insolvent, the problem would have quickly spread to other markets many of which are far removed from silver. Because of the interdependence of our financial markets, the Central Bank must be prepared, as in the commercial paper crisis surrounding the bankruptcy of Penn Central in 1970, to take appropriate steps to insure the continued viability and integrity of the markets, particularly in times of stress. To

fulfill this function, the Federal Reserve must have at least a general awareness of trends and developments in all sectors of the financial markets.

Finally, the Federal Reserve has a direct and immediate interest in the extent to which credit is used to finance transactions in financial markets. That interest can take any of several forms including a concern about credit financed speculation, a concern about the diversion of credit from more productive uses, or a concern that an excessive use of credit for these purposes can ultimately threaten the safety and soundness of individual financial institutions. And, in the recent silver situation, it would seem that, at least to a degree, all of these areas of concern were present.

Looked at from any or all of these vantage points--or from a more encompassing perception of the national interest--it seems clear that there is need for a throughgoing study to determine the kinds of legislation or regulatory remedies that are required to check potential abuses or excesses in these markets. While I have no firm view at this time as to specific actions that should be taken, I do have strong opinions about the types of questions that need to be examined in order to make decisions intelligently and productively.

The first of those questions relates to the character of the markets themselves. Some tend to use the term "futures market" as if it were a clear term of art which conveniently encompasses the full range of instruments and assets that are traded for forward delivery. In fact, all one needs to do is look at the pages

of the Wall Street Journal to capture the diversity of these markets. Agricultural products, metals--precious and otherwise--foreign currencies and Treasury and other securities are all now actively traded on exchanges which historically were developed for quite limited and specialized purposes. Indeed, it has been less than five years since financial futures were first traded on organized exchanges.

Further, in most cases, futures markets are inexorably tied to an underlying asset that trades actively in cash or spot markets not just here in the United States but around the world. These markets, whether viewed from the perspective of the relationship of the "spot" price to the "futures" price or from the perspective of the London price to the New York price are highly interdependent, and that interdependence is a reality which must weigh heavily in our deliberations as to the appropriate regulatory framework for the future. At the extreme, for example, we must recognize that excessive regulation may simply work to drive activity off the organized exchanges or offshore where the threat of abuse to the detriment of our own investors and institutions will be increased.

At this point, I am inclined to the view that all forward and futures instruments should not be treated alike. More specifically, I believe it is possible to distinguish "financial" futures from other forward-type instruments and that such a distinction may be appropriate from the viewpoint of public policy. Certainly, futures in Treasury securities, foreign exchange, and perhaps gold and silver to name a few, do have characteristics--

including low costs of transportation and storage in proportion to value--that distinguish these instruments from futures in wheat or other agricultural products. "Financial" futures, moreover, are of more direct and immediate interest to the Treasury and the Federal Reserve than are traditional agricultural futures, since they obviously have more direct potential for influencing developments in financial markets and markets for international exchange.

Any consideration of possible changes in the regulation of futures markets must, of course, take into consideration the whole question of the form and amount of margins. As the Subcommittee knows, initial margins in these markets have traditionally been quite small--generally only large enough to cover one day's maximum expected price movement--and participants have been able to meet these requirements not only with cash but with other forms of collateral. In the main, however, the markets rely on maintenance margins to insure contract performance. Under these arrangements positions are marked to market daily, and cash payments are funneled through the clearing houses from the daily losers to the gainers.

The exchanges have worked out these margin arrangements in order to keep capital costs low so as to permit participation by legitimate users of the market. While this approach is quite understandable, however, it must be recognized that the initial margins held by the exchanges (or the clearing house) are the first line of defense in the event liquidity or other problems develop with individual brokers or their customers. Because of

this, the level and the form of initial margins do have importance for the integrity of the markets generally.

Margins on futures contracts are a kind of performance bond, as money or other assets are put up in advance of a purchase to provide assurance that contractual obligations will be met. Thus they differ from the margin that pertains to the acquisition of securities which involves an extension of credit to help finance an immediate purchase. Despite this clear distinction, however, the point should be made that in some instances credit is indirectly involved in meeting margins on futures contracts. In the recent silver situation, for example, it appears that some participants relied heavily on borrowed funds to meet margin maintenance calls. This raises the question then as to whether there should be regulations either limiting the amount of credit that may be used to finance the acquisitions or maintenance of positions or whether, at the least, there should be regulations governing the kinds of collateral that may be used to finance such credits.

Aside from the credit questions there are other issues with regard to margins that need to be explored. For example, under present arrangements the Commodity Futures Trading Commission has only emergency powers to set margins, which, as I understand, have only been used once. The basic authority to set margins and other terms of trading lies with the exchanges. Since the exchanges are in competition with each other, this arrangement, inevitably, raises the question of competition in laxity. Thus, while this arrangement apparently has, with a few exceptions, worked well, I cannot help but conclude that it too should be reexamined. I reach

this conclusion not just because of the obvious question whether, in the process of setting and changing margins, legitimate self-interests of the exchanges can be separated from the broader public interest. In addition, it seems to me that some form of direct governmental participation in the process of setting margins and other terms of trading would, by elevating these decisions to the realm of public policy, clearly work to remove inevitable pressures from the exchanges that must arise in the context of setting such margins.

There is also a question in my mind as to the manner in which margins are administered. Initial margins, as noted earlier, are understandably low. These low margins, however, permit a considerable amount of leverage. And, moreover, because of the policy of funneling maintenance margin payments from losers to gainers, there is the clear potential, which we may have seen in silver, for the pyramiding of positions to thus achieve still greater leverage. All of this raises the question in my mind as to whether it might not be practical and appropriate--at least in some circumstances--to limit in some fashion the cash payments made to those on the "plus" side of the market in connection with the daily marking to market.

This range of questions and issues is meant to be illustrative, not exhaustive. There are many others that also need to be examined--the potential use of position limits, and the nature of surveillance activities across futures exchanges and into the cash market, among others--before reasoned judgment can be made about the nature of regulatory measures that might be needed in this

area. And, it seems to me that only when we have answered those questions, will we be in a position to judge effectively how any new regulations can best be administered.

There are several government agencies, including the CFTC, the SEC, the Treasury and the Federal Reserve that have a natural interest in at least some segments of these markets. Conceivably, authority for the regulation of these markets could be vested with any one of these agencies or perhaps divided among the agencies. Alternatively, it could be placed with an oversight Board or Commission with representatives from all of the agencies, as well as with representatives of the exchanges or the public. Ultimately, however, that judgment is best made in a context in which some of the issues I have raised are more fully analyzed. We in the Federal Reserve, in cooperation with other government agencies, have undertaken a broad-based study of these and related questions, and I fully expect that the primary result of that effort will be a set of legislative recommendations that would be submitted to the Congress. That effort will take some time.

In concluding, let me make two final observations. First, I am fully aware that some would argue that the recent episode in the silver markets should not be cause for concern. This position appears to be based on the point that, in the final analysis, the situation worked itself out without major and permanent damage. There may be something to that assessment, but from my vantage point it was simply too close a call to permit us to take the liberty of a "business-as-usual" attitude.

Secondly, I would also emphasize that the silver episode illustrates, very forcefully, the kinds of distortions, instabilities, and risks associated with unchecked inflation. Indeed, in a manner far more convincing than the best of our economic studies, or the most resounding rhetoric, this situation can serve as a reminder to us all of the importance of standing fast in our efforts to bring inflation under control over time.

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