For Release on Delivery
Thursday, April 22, 1971
Approximately 4:30 p.m., EST

CREDIT ALLOCATION AND THE FEDERAL RESERVE

Remarks of

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Federal Reserve System

At a Lecture
Sponsored

by

The Banking Research Center
at
Northwestern University

Chicago, Illinois

April 22, 1971

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Whether and how monetary and credit policy might be improved by use of specific quantitative and qualitative actions has always engaged the thoughts of monetary policymakers and economists. Recently, the gyrations in interest rates and credit availability have transferred the discussion from the technical literature to the political arena. When a potential house-buyer, a small businessman, or a concerned local official finds either that no loan can be had for his purpose or a limited sum at very high rates while others appear able to borrow, albeit at high rates, questions must be asked as to whether the credit allocation system can be improved.

The general problem is that of how to insure a more even-handed credit availability for individual sectors of the economy. I think that the search for solutions has perhaps been confused and certainly inconclusive because of a failure to differentiate among several connected cases.

Although related, the necessary techniques differ greatly depending upon whether we are talking about: (a) short-run periods when money is generally tight and pressure is being exerted to restrain aggregate demand or (b) longer run periods such as five or ten years in which a problem exists as to whether the financial system is allocating credit in accordance with the country's social and economic goals.

In the same way, we must differentiate between (a) the power of the government to reshape the workings of our over-all financial structure and the manner in which it allocates longer term funds and (b) those far more limited parts of the structure which can be directly influenced by the Federal Reserve.

Speaking solely for myself, my view is that we should seize this period of relative calm in our financial markets to clarify and develop what seem to me necessary improvements in our system. Should the future require that monetary policy again be used in an attempt to curtail demand substantially, I would feel far more confident of the eventual results if policies were based on increased knowledge and included possible improved techniques of distributing credit.

In order to carry out a more efficient and effective stabilizing monetary operation, other techniques should be available to supplement traditional open market policy on the part of the Federal Reserve. These additional techniques should not be used in periods such as the present, but should be conserved for possible periods when large excess credit demands are prevalent.

It seems to me that to curtail excess demands, a graduated "charge" against increased borrowing by non-preferred sectors would be a logical addition to the kit of stabilization tools. The extent of the charges (or taxes or reduced tax deductions) can vary with the type and size of the borrower and the particular sector or sectors creating demand problems. All sources of credit funds to the potential users should be taken into account in assessing such charges.

Improvement in the manner in which our financial structure allocates longer term credits can come primarily from changes in over-all governmental policies and laws. Included would be new lending institutions and modifications in the existing institutional structure. Probably more significant would be a rationalization of taxes, tax preferences, and subsidies to insure that they aid the true priority claimants to our limited resources.

While in periods of excess demand a combination of improved long-term aid to priority borrowers and of penalties upon non-preferred borrowers would probably be adequate, policies to aid preferred borrowers in a credit squeeze either by direct subsidies or by subsidies through lenders might also be logical.

A key consideration with respect to all these proposals is how best to determine the proper scope and degree of governmental incentive or disincentive to various sectoral credit flows. Clearly, the Federal Reserve System is ill-equipped to determine such priorities under normal circumstances.

The Role of the Federal Reserve

I think it only fair to say that the attitude toward the problem of credit allocation over the past 20 years at the Federal Reserve has been ambivalent. The initial theory under which the System was founded depended upon differential uses of credit, and qualitative measures were used through the Korean War. From Korea to 1965, however, most emphasis was placed on aggregative monetary and credit policy. Indeed, during much of that period, the Fed seems to me to have welcomed selective sectoral impacts since it was believed they speeded up and increased the total effectiveness of a given degree of monetary restraint.

Since 1965, however, the Federal Reserve has frequently stated that the effects of monetary policy might be better if all sectors were restrained more evenly. The Fed has used its limited powers--regulations over maximum interest rates and reserve requirements as well as voluntary controls on foreign lending--to obtain some selective results. The question may fairly be raised, therefore, as to why the Federal Reserve did not ask for or at least welcome additional instruments when offered. My answer would be that reasons varied from person to person and that there was far from unanimous agreement on what would be precisely the right course. The opposing arguments were finely enough balanced to lead to diverse conclusions.

The Federal's Arguments Against Selective Instruments

Let me review some of the arguments which have been used in the past against engaging in a more selective monetary policy.

1. The Federal Reserve System's primary function is that of stabilization. As such, it should be concerned solely with the aggregate amount of money and credit which should be kept reasonably consistent with broader employment and price-level objectives.

2. Many of the suggested policies seemed aimed at credit allocations over the long run and not just the stabilization period. Central bank credit and controls are too limited to offer effective solutions to long-term problems. Longer run allocations can be handled far more efficiently by other types of governmental action.

3. There was no clear mandate from the Congress or directive from the Executive as to what sectors (or what elements within those sectors) a credit allocation program should favor (or discourage), and to what relative degree.

4. Even if clear direction from Congress and/or the Executive were obtained initially, they would rapidly become clouded by conflicting statements and pressures, official and unofficial, which represented the political passions or moods of the moment.

5. While most foreign central banks were using or had used direct selective instruments, they tended to find the experience frustrating and abandoned them when possible. The frustrations arose from constant administrative headaches, from concern over whether the market was being interfered with to too great a degree, and from the pressures of those dissatisfied with the way controls worked.

6. The fulcrum for Federal Reserve action was too small to promise useful results. Any instrument for altering credit allocations must be concerned with the interrelationships which exist among markets and institutions. Any attempt to affect the distribution of total credit flows to a significant extent through banking controls alone would result in an intolerable burden on the 5,800 member banks of the Federal Reserve System.

7. The financial system is too fungible or porous. In this country, we have more than 35,000 different financial institutions, hundreds of different types of credit instruments and financial markets, and an unquenchable innovative spirit on the part of entrepreneurs. Any attempt to alter the distribution of credit would be neutralized over time through forces of the marketplace. This is particularly true if it is desired to limit credit to large businesses with their superior market power. Flows into new markets and institutions are most evident in foreign experience. Even though most foreign countries have far simpler financial structures with a relatively small number of firms, each imposition of controls has led to a rapid growth in methods of avoidance. For example, it has been common to see shares of the market for non-banking institutions greatly increase when the primary controls have been placed on the commercial banks.

8. Our financial system, like the economy as a whole, can best be described in terms of the perfect competition model. Consequently, any attempt to interfere with the distribution of credit will represent a movement away from the optimum allocation of resources.

None of these objections can be dismissed lightly, even if some of them are contradictory. Let me deal initially with two of them and then show why the actual situation appears to suggest an occasional emergency need for more direct and specific techniques.

The Fear of Outside Pressures

The first five arguments convinced many in the System that if the Federal Reserve was responsible for the allocation of credit, pressures to meet specific needs would be so great that monetary policy could no longer be used effectively for stabilization purposes. More and more needs would be assigned high priorities. Sectors disadvantaged in the credit allocation procedures would press for political solutions to their problems. As a result, total credit could no longer be constrained to a sufficient degree for over-all stabilization policy.

This type of argument has no certain refutation. It is primarily a pragmatic question based on one's views of the American economy and political structure. The added pressures with selective powers must be compared to those which now exist. Partly, of course, this depends upon whether central bank policy can be more effective if the necessary powers exist to improve the distribution of credit and resources. Pressures, as well as results, depend upon whether there are sufficient tools to do the job. My own belief has been--and recent experience does not contradict it--that the Federal Reserve and the Administration need better techniques to deal with the problems raised by sharp movements in monetary aggregates and interest rates. Some risks of added pressures should be taken.

On the other hand, I believe it is proper for the Federal Reserve to object to being asked to use additional powers such as supplementary reserve requirements without a clearer indication of what objectives such policies are to seek and without clearer directions as to how extensive such assistance should become.

The Perfect Competition Model

It is rather simple to erect a theoretical model of a most efficient financial structure--that with pure atomistic competition, perfect knowledge, and minimal impediments to instantaneous adjustments. If a pure-perfect market existed, interest rates would move so as to adjust demand and supply. Borrowers would obtain all funds for which they were willing or able to pay. In a perfect market, lenders would not differentiate among borrowers. Rates would depend upon risks, length, size, and type of loans rather than depending heavily on institutional relationships as they do at present.

Many seem to argue that no techniques should be introduced into our system which would not exist in such a theoretical model. Others go so far as to state that steps to dismantle our existing financial structure make up the only proper solutions to current problems.

I believe these views are myopic and based neither on facts nor on well-reasoned theory. In varying degrees, models of resource allocation embody assumptions about the divisibility of production and consumption, the costs of information, returns to scale, certainty, the speed of any adjustment process, and the absence of externalities. It is not a novel contribution to economic analysis to point out that these assumptions are consistently violated in the realities of the marketplace.

But it is worth emphasizing that unambiguous answers to the question, "How do we improve the functioning of our markets?" are extremely difficult to derive from any of these models. The existence in the real world of so many departures from the formal assumptions which are necessary to the models of optimal resource allocation renders answers derived from them of limited value.

Furthermore, in practice and in proper theory and analysis, one must face the problem of how to get from here to there. Before dismantling even parts of the existing system, we clearly need a step-by-step chart that shows how we expect to go and where we expect to be at any time in the future. We want to know if the path is a feasible one to follow. We don't want a path that would leave us on a much lower level of income and welfare for long periods while we were seeking Nirvana.

In addition, even if the theoretical structure could come into existence, it would still be plagued with all the problems of instability and of determining social priorities. It would have to incorporate ways of giving weight to social needs and desires. More important is the fact that it is clearly possible that a freely functioning dynamic system might be inherently unstable.

The Background

Table 1 and Charts 1 and 2 picture some of the factors which have increased interest in the problem of credit allocations. It is obvious that as monetary policy has alternated between ease and restraint the flow of credit and, therefore, the ability to purchase the nation's resources has varied widely among the major sectors of the economy. Many believe the allocation process has been far from optimal. At the same time, interest rate movements have followed an erratic course that was not necessarily desirable.

These movements both reflect and contribute to an unsatisfactory situation. It would not be difficult to show that these relationships depart from those which would be considered desirable for a financial system that functioned well. The system is both unstable and erratic in its allocation functions. The divergence between actual and more desirable flows creates demands for a re-examination of the system's operating mechanism.

Operation of the System in the Short-Run Stabilization Period

For purposes of stabilization, we would like a financial structure in which policy operations would be predictable and rapid. As demand was restricted in inflationary sectors, it would still be maintained in other spheres either critical in an economic or social sense or with available non-inflationary resources. Smaller requisite movements of interest rates would diminish the redistribution of incomes among sectors as well as the institutional problems which arise from asset revaluations.

Our current structure fails in a comparison with such a concept. Today, even if inflationary demand arises primarily in a single sector, aggregative techniques curtail demand and output across the board. The total impact may be more than desired while a major shift in resources may come from sectors with high national priorities. We do not yet have enough knowledge about the timing and magnitudes of policy effects. Our chances of error in policy decisions remain high. Movements in interest rates and their unfortunate redistributional effects seem to have increased.

Our current financial structure and institutions have developed to meet historical needs. They reflect the fact that throughout most of our financial history instability and imperfect knowledge have led on occasion to disastrous failures and panics. A few years ago, we could have assumed that financial stability was increasing as a result of an evolutionary growth in knowledge. This no longer appears certain. The past year has seen the failure or rescue by governmental action of some major institutions, in fact, the largest in number and size of the past 30 years.

Allocation and Instability

Our money and credit system contains numerous laws granting rights and privileges in particular markets. Many sectors are highly regulated as to entry, interest rates, portfolio policy, and operations. Borrowers receive subsidies or indirect aids through tax deductions and exemptions. The Federal Government helps others through direct lending, insurance and guarantees, and sponsored agencies. The Federal Reserve and other regulatory agencies control interest ceilings and reserve requirements. Some borrowing or lending is controlled directly.

Some of these regulations and controls have been established to deal with very specific problems: instability; uneven access to funds; past panics and crises; desire to promote certain uses for credit; weaknesses in certain institutional structures. Others have occurred, probably unwittingly, from such factors as differential taxes, desires to inhibit competition, and mistaken policies.

These procedures through which our economy allocates credit contain all types of non-price elements. They lead to rationing on a haphazard and not well-understood basis. They may well raise the level of interest rates. They express in only the dimmest way national priorities for credit.

In addition, it is not clear whether the existing structure increases or reduces instability compared to what would occur in a properly functioning market. Under existing techniques, interest rate movements appear to be increasing in volatility. If this trend continues, so will the possibility of a financial crisis. More and more, financial institutions and corporations will find that they are not equipped to handle major shifts in interest rates and liquidity.

It is the recognition of the past and future problems of the existing structure that has led to increased demands for rationalization as well as for new techniques to reduce the costs and dangers of stabilization policies.

Longer Term Allocation Problems

We have seen that our existing financial structure follows very uncertain rules in the manner in which it allocates credit both in intervals of financial stringency and over longer run periods. Its actions depend upon all of the hit-or-miss results of regulations, policies, taxes, etc., which have developed historically to meet other problems, but which have major impacts on how credit is allocated.

Even if the financial markets were completely rational and followed a system of allocating resources based on wealth or earnings, logical reasons could still exist for governmental policies to alter such allocations. Such policies enable the country to express its social priorities. In a period characterized by a general shortage of resources, the government may properly provide increased access to the credit market for demands such as that for schools, lower income housing, redevelopment of urban centers or rural areas, or other needs which may increase national welfare more surely than less vital expenditures.

Balance of Payments

The problem of speculative and other flows through foreign exchanges is a similar, but special, problem. As interest rates vary among nations, major short-term flows of funds can occur. These may be unrelated to longer term equilibrium flows. In fact, frequently, they have been predicated upon a successful attack upon and a breakdown in the exchange system. Similarly, the relationship among exchange markets is such that there is no reason to believe that flows for longer periods necessarily are equilibrating. While major debates take place as to the best solution for these problems, it appears clear that those who believe unstable fluctuating exchange rates are not desirable must, as a corollary, support the use of other measures to control the amount of flows through the foreign exchanges. As a result, hardly a country in the world does not use very specific mechanisms to deal with problems created by actual or potential flows of funds across its international borders.

The Goal of Improving Credit Flows

We have examined some of the problems inherent in our existing credit allocation system. The question arises, "What mechanisms or techniques are available to add to or subtract from existing elements to obtain a more efficient and effective distribution of credit?" To achieve a more efficient structure, we must both remove certain existing inefficient features and add other elements which would improve the speed and certainty with which the financial structure reacts to change.

Let me summarize my argument up to this point.

--- The present system has a tendency towards instability as evidenced by the events of this past year, as well as our nation's prior financial history.

--- The present system is not efficient in the manner in which it reacts to existing stabilization policies.

--- The present system is haphazard. Credit is frequently allocated among competing borrowers on a non-price basis. Prior business connections, firm size, and industry market structure appear to dominate access to credit.

--- The present system appears to result in a distribution of credit which may fail to reflect accurately the public's social priorities, particularly during a period of monetary restraint.

--- The present system has a major unresolved problem in its techniques of dealing with foreign capital flows.

A haphazard system is an inefficient system. As a goal, we would like the allocation of funds to be as effective as possible. This would give a minimum cost for operating the mechanism by which claims on resources are allocated. Tax and subsidy programs would also be of a minimum necessary size; administrative and regulatory costs would be reduced. An efficient system is probably one in which borrowers (after taxes and subsidies) can obtain all the funds for which they are willing and able to pay the going rate.

This leads me to a second goal for our financial system. The ability-to-pay criteria can be made consistent with a proper expression of the public's social priorities by ensuring that those sectors which are accorded priority have the ability to pay. This can be approached by optimizing our taxation, subsidy, lending, and direct government appropriation policies and programs.

Progress towards a more stable system is also desirable. In a stable system, uncertainty is reduced, as are the lags between policy changes and final spending. The policy instruments would be adequate to the job set before them. With such characteristics in our financial system, we could expect less variation in financial flows through institutions and the open market and less volatile interest rate fluctuations.

Methods of Altering Credit Flows

I have already noted that there are a vast number of instruments and techniques which can be used to help achieve a better operating financial structure both for stabilization and long-term allocation purposes. The literature, our past experience, the experience of foreign countries can all be mined for suggestions.

In examining these methods, it is useful to classify them into three types: (1) changes in the financial structure; (2) limits on quantities of credit; and (3) changes in price relationships.

Changing Institutions

Recognizing that our financial structure is a hodge-podge of institutions, habits, rules, market relationships, subsidies, and tax preferences, observers find many actions which hopefully would improve the structure and its reactions in order to do a better job of dividing the scarce resource--credit.

Of course, the structure is constantly changing anyway. Present institutions have a long history of development. Obvious regulatory discriminations exist, praised by their benefactors and denounced by those feeling deprived. During the past five years many institutions found themselves with very unsatisfactory portfolio policies and limited flexibility. The financial market has been in a constant state of learning as it has tried to solve some of its basic problems.

The problem is whether, or to what extent, the developing structure will meet the market's basic needs. Some believe that we can now make sufficient changes so that any need for selective central bank action can be delayed for many years. On the other hand, many are less optimistic arguing that as knowledge increases and communications speed up, critical problems also increase. Both views reinforce the constant need to search for methods of institutional improvement.

Another approach stresses the need to create new institutions which would be more efficient in the raising and channeling of funds into deficit areas. The revised FNMA; new functions for the Home Loan Bank Board; an environmental financing authority; are all examples of this type. The improved operations and market results of FNMA and the FHLBB last year show that major gains can be made through institutional change.

Altering Quantities

Recent studies have publicized the fact that the central banks of most major financial countries except for the United States, Canada, and Germany make widespread use of direct controls of credit. The techniques employed are of many types: limits on total credit; limits on credit to specific spheres; and preferences granted to credit in particular spheres.

Ceilings can be placed on either borrowers or lenders. In recent years, the United States has used this technique to control foreign lending and borrowing, but not elsewhere. Abroad it is also not uncommon to grant higher ceilings for loans in preferred fields by such techniques as supplementary primary or secondary reserve requirements.

The popularity of all of these techniques rises and falls depending on the degree of crisis and the length of time they have been in place. As noted, their efficiency deteriorates with time as a result of a learning process. Their "half-life" varies with such factors as the size of the economy, complexity and interrelationship of financial markets, their scope, and their enforcement provisions.

Changing Prices

Even more common than restrictions on quantities are attempts to change credit flows by altering prices (frequently through subsidies), particularly of interest payments, or the terms of loans. Subsidies usually come from the government, but they are also paid by central banks, and frequently by one group of savers, lenders, or borrowers to others.

Most countries have subsidies or tax preferences similar to those which housing receives in this country. The ability to borrow at subsidized interest rates is also common. Frequently who is subsidizing whom becomes almost impossible to determine. We have such an example in our system where it is not at all clear whether the regulations against paying any interest on demand deposits, or full market interest rates on time and savings deposits, aid financial institutions, large business borrowers, or mortgage borrowers. We also do not know who foots these bills. Similarly, how much of the Federal forgiveness of income taxes on state and municipal bonds goes to the localities and how much to the individual or firm buying the bonds is almost impossible to calculate since it varies greatly over time and among issues.

Conclusion

Today I have not planned to analyze specific suggestions for action. Given the variety of possibilities such an analysis would require a much longer paper. Instead, I have attempted to outline some of the background and reasons why the Government and the Federal Reserve might properly be dissatisfied with the manner in which credit is now allocated both in periods of financial stringencies and for the longer term ahead.

As noted previously, since it is clear that we now face a considerable period of satisfactory credit availability, this seems to me a good time for policy discussions. It is in such periods that we should develop contingency plans for action to be taken if we once again face a period of credit stringency. Clearly even a slight probability that such a period will arrive and that it would be severe makes such planning worthwhile.

Some of the future problems of short-run stringency can be avoided if we improve our existing institutions. I have advocated in the past more logical portfolio policies; more flexible interest and arrangements for principal payments on debt instruments; unified Treasury borrowing for agencies; and additional special purpose agencies. It is important that steps such as these plus others be taken in order to equalize the future impact of monetary policy.

Beyond changing institutions, however, I believe that new techniques--similar to those used in most of the remainder of the world--may be necessary when monetary policy is used again to curtail demand. Such policies should be as automatic as possible and require the minimum of administration. They should primarily influence market decisions and not attempt to supplant them. They should apply across the board and not be dissipated by shifts in the channels of borrowing or lending. They should vary as the problem areas alter. Controls should be used only for stabilization purposes and only for minimum periods. Their effectiveness decreases and their cost increases with time. Policies for stabilization should differ from long-term aid to priority borrowers.

It has seemed to me that a technique which meets many of these criteria is that of raising the marginal cost of non-preferred borrowing in periods of monetary tightness. Many instruments for raising such costs are available as through taxes, decreased tax exemptions, or charges for borrowing or lending permits. Steps of this type can both increase the effectiveness of policy and lower its cost.

Finally, I agree that a longer term credit allocation problem covering parts of the next decade might be possible--although it is far from inevitable and perhaps not even likely. Such a problem would be very difficult to deal with through monetary policy. The problem of an adequate level of total saving is primarily one for fiscal policy. The question of how any level of saving is to be distributed among priority uses requires a rationalization of our tax and subsidy programs.

As I noted before, I do not believe that a central bank is in a particularly good position to determine the amount or degree to which different institutions or users should be subsidized (except possibly in response to more complete governmental criteria). These are questions of major national political importance that should be determined through authorization or appropriation policy.

It probably is true that if the Federal Reserve were to become greatly involved in these long-run problems, it would reduce its ability to react to stabilization needs. This is another reason for dividing the responsibility for altering the credit allocation mechanism.

The Fed has a major responsibility for short-term stabilization and this may well require the use of new techniques. On the other hand, whatever central bank instruments are developed should be carefully retained for periods of acute need and not frittered away in attempts to deal with problems much more amenable to other forces. These other forces must be developed through the legislative process.

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Table 1

SIZE AND DISTRIBUTION OF CREDIT DEMANDS[a/]

	1961-1965	1966-1970	1966	1967	1968	1969	1970
Total Funds Raised							
Billions of dollars	$59.2	$86.9	$68.5	$83.5	$96.9	$90.3	$95.4
Per Cent of GNP	9.9%	10.1%	9.1%	10.5%	11.2%	9.7%	9.8%
U.S. Government	.9	.9	.5	1.6	1.5	- .4	1.3
Other Borrowers	9.0	9.2	8.7	8.9	9.6	10.1	8.5
Total Funds Raised by Other Borrowers							
Billions of dollars	$53.9	$79.1	$64.9	$70.5	$83.5	$93.9	$82.7
Per Cent Distribution	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Business Borrowing	39.1%	52.2	46.8	48.7	46.5	52.8	56.0
Home Mortgages	26.0	16.8	17.5	16.5	18.2	16.7	15.3
State & Local Govts.	11.5	11.6	9.8	12.5	11.9	9.1	14.7
Consumer Credit	12.7	9.2	11.1	6.5	13.2	9.9	5.3
Other	10.7	10.2	14.8	15.8	10.2	11.5	8.7

a/ Net borrowing by non-financial sectors in credit markets. Excludes trade credit, security credit, and borrowing by financial institutions.

Source: Federal Reserve Flow of Funds Accounts.

Chart 1

RESIDENTIAL MORTGAGE LENDING, 1952-II - 1970-IV

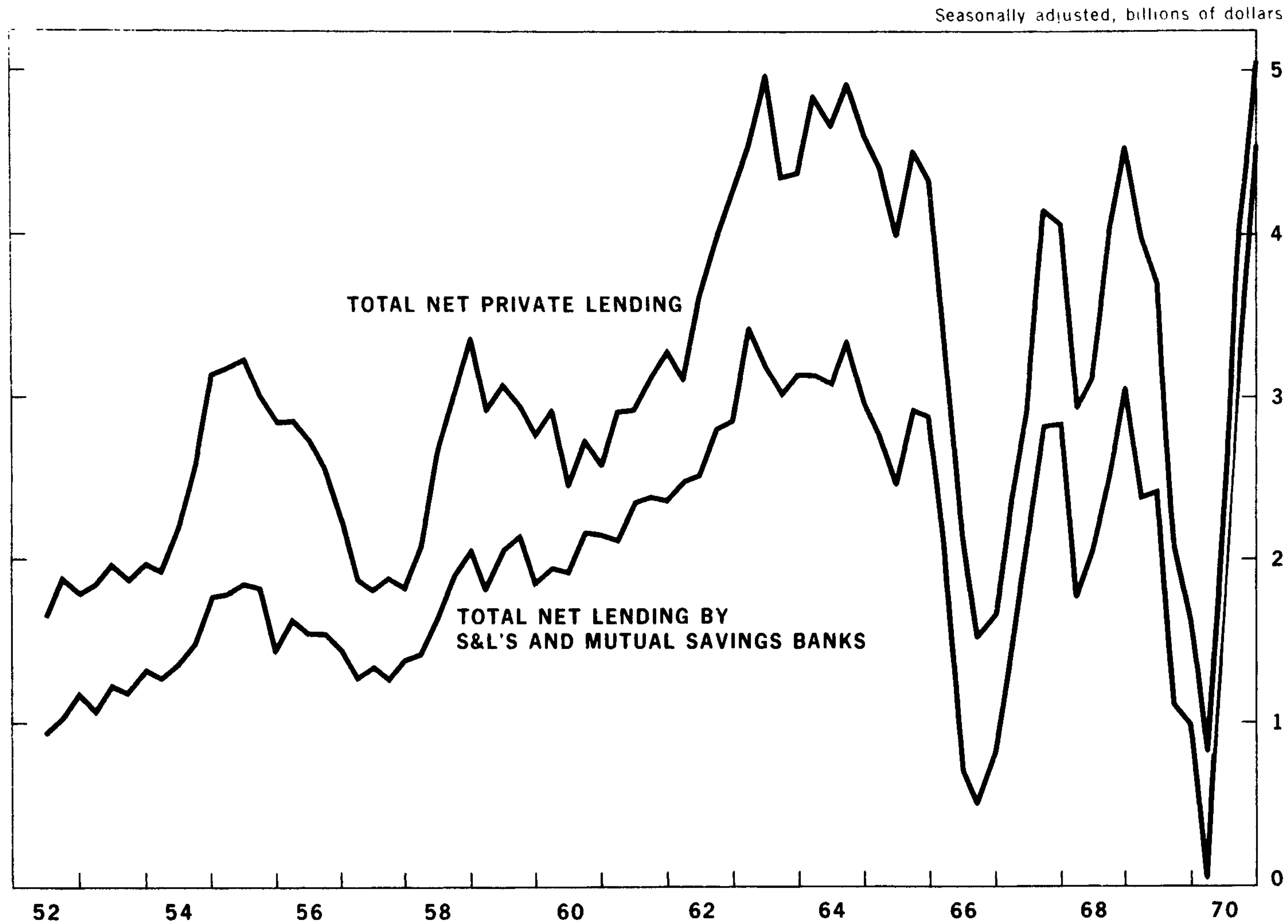

Chart 2

PERCENTAGE CHANGE IN SELECTED FINANCIAL FLOWS, 1960-I - 1970-II

CENTERED FIVE-QUARTER MOVING AVERAGE