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MEMORANDUM

To: Informal Group Selected to Consider Questions Relating to Regulation W

From: Messrs. Young, Solomon and Pawley

Subject: Philosophy of Selective Credit Policy -- With Particular Reference to Regulation W

GENERAL PRINCIPLES OF SELECTIVE CREDIT POLICY

Central banking instruments of monetary and credit policy are conventionally grouped into two broad types: (a) the bank-reserve instruments, such as discount rates, open-market operations, and reserve requirement levels, and (b) the selective instruments, such as margin requirements and consumer credit regulation. The two types of instalment are ordinarily distinguished from one another on a mechanism basis and a coverage basis.

Mechanism and Coverage Differences Between the Bank-Reserve and the Selective Instruments. - From a mechanism standpoint, bank-reserve instruments work through the supply and cost of "high-powered" reserve dollars. Their influence upon credit availability and ultimately the volume of credit and money is determined by secondary decisions of banks and other lenders. Selective instruments, in contrast, require that particular lenders, in accommodating credit demands, adhere to standards or terms fixed by regulation. Only those credit demands that meet the regulatory standards are eligible to obtain credit. Stated otherwise, the mechanism of selective instruments is direct and immediate; that of the bank-reserve instruments is indirect and scattered.

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From a coverage standpoint, the bank-reserve instruments are regarded as affecting the total amount of credit put to use throughout the economy. The selective instruments, on the other hand, are regarded as affecting primarily the amount of credit put to use in one or another particular sector of the economy. However, since the particular sectors represent strategic credit areas which are subject to wide cyclical fluctuations, the selective instruments are considered to be important supplements to the bank-reserve instruments in regulating the total volume of credit and currency.

Functional Differences Between the Bank-Reserve and the Selective Instruments. - The foregoing distinctions between the bank-reserve and selective instruments of credit policy are sufficient for ordinary descriptive purposes. When the problem is one of applying the two types of instrument in particular economic situations, however, further differences of a functional character must also be taken into account. This is necessary because the exercise of any instrument of credit policy will be found to have two different, though closely related, impacts on economic tendencies -- one specific and the other general.

The "specific" impact relates to the financing area directly affected; the "general" impact to the effects of changes in credit terms on the volume of money flows -- spending and income -- throughout the economy. The close interrelationship of all economic activities makes these two impacts difficult to unscramble in most situations. But the fact of the two impacts is important, as is also the fact that the several credit instruments vary widely in their "specific" and "general" impacts.

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By and large, the bank-reserve instruments tend to be more "general" and less "specific" in their impact, while the selective instruments tend to be the reverse. The various instruments, however, differ more in degree than in kind with respect to the extent that their effects are "specific" or "general". Even within the broad categories of "bank-reserve" and "selective" instruments, wide variations are to be expected in the "specific" or "general" impacts which the several instruments will have on the economic situation, and these variations will differ from time to time.

Illustrations of Differing Economic Impacts. - Consider briefly the monetary instruments. The "specific" impact on the Government securities market of an additional volume of bank reserves would be considerably different if the reserves are supplied by open-market purchases of bonds than if they are made available by lowering reserve requirements. On the other hand, the difference would probably be less if the open-market operations were in short-term Treasury issues. The "general" impact of the two instruments would also differ in some instances because the open-market operations would immediately increase bank deposits while the lowering of reserve requirements would wait on bank loans or investment action to affect deposit volume.

In the case of the selective instruments, the "specific" impact of a change in margin requirements would sharply differ from the "specific" impact of a change in consumer credit regulation. The "general" impacts in the two cases would likewise differ in substance and time. Restriction or encouragement of stock market credit affects primarily the profits

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of speculators and the equity financing programs of all listed corporations. Restriction or encouragement of consumer instalment financing, in contrast, affects not only the makers and distributors of articles sold on instalment terms, but other producers as well because of effects on the ability of consumers to buy other items.

For any instrument of credit policy, the two types of impact will be markedly different according to the strength or weakness of the general business situation. Thus, a policy that would mildly check credit expansion in a speculative boom might have quite disruptive "specific" and "general" impacts during a moderate recovery from depression. Both types of impact would be more severe if a boom for other reasons were ready to become a "bust".

Limitations on the "Pin Point" use of Selective Instruments. - It is well to offer a warning as to the important limitations on the "pin point" use, because of their predominantly "specific" effects, of the selective instruments. This is especially pertinent in connection with consumer credit regulation, where there is a constant temptation to use the instrument to foster or correct a particular tendency in the instalment financing or consumer durable goods field.

It must always be remembered that this selective instrument deals with a single area that is highly competitive and extremely fluid. Sale credit and loan credit are readily interchangeable. Renewals and revisions quickly merge the identities of credits that originated for different purposes. Lenders have practical operating difficulties in combining credits of different maturities. There are sharp practical limits on the extent to which lenders can be expected to delve into the ultimate origins of particular credits.

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In short, each added complexity weakens the workability and enforceability of the entire selective instrument, and a maximum of simplicity is essential. This is especially true in the case of rules regarding maturities, where complications can cause not only difficulties of compliance and enforcement, but also serious competitive inequalities. For these reasons, such complications should not be introduced into the instrument unless compensated by strong offsetting advantages.

Restatement of Functional Differences. - Examination of the monetary and selective instruments in terms of their effects on economic tendencies shows that the two types of instrument have both "specific" and "general" impacts on the economic situation; that usually in the case of the selective instruments the "specific" impact is immediately more important; that the relative force of both the "specific" and "general" impacts of any credit policy instrument varies widely in different circumstances; and that the "pin point" use of selective instruments to cope with "specific" effects is subject to important administrative limitations.

APPLICATION OF GENERAL PRINCIPLES

It follows from the foregoing discussion of differences between the bank-reserve and selective instruments that these instruments together constitute an armory of methods for influencing changes in the volume of credit and the soundness of the credit structure. It also follows that use of the several methods, separately or in combination, will depend upon the particular economic circumstances and tendencies at a given time.

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In some situations, their combined use in the direction of credit restraint or encouragement would be fully justified, the several instruments operating to reinforce one another. In other situations, the bank-reserve controls might be used vigorously, and the selective controls relatively moderately or not at all. In still others, either to deal directly with undesirable tendencies largely localized in one or the other or both of the selective credit sectors or to serve as a substitute for use of the bank-reserve instruments, the selective instrument might be aggressively applied while little or no reliance would be placed upon the bank-reserve instruments.

Policy Changes in Selective Instruments. - Discretionary credit policy authority is basically justified by the continuing need for prompt adjustment in the volume and structure of credit to the changing financial requirements of the economy. Flexibility is therefore an essential feature of the use of each policy instrument.

While use of the bank-reserve instruments may be largely guided by over-all tendencies in the economy, the selective instruments must also be responsive to tendencies in the strategic sectors to which they relate. Alertness to localized tendencies is especially important because the use of credit in these sectors shows unusually wide cyclical and seasonal fluctuations and further because the economic effects of the selective instruments tend to be more "specific" than "general". It is particularly essential that the active relationship between the "specific" and "general" impacts of selective instruments be kept under constant review, so that a proper coordination of their use with the use of the bank-reserve instruments may be obtained.

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The following rule-of-thumb principles may help to guide separate changes in selective credit policy:

(a) Grounds for a change in policy would exist if objectives of existing selective policy had been substantially achieved, unless the result would be to weaken the objectives and effectiveness of the bank-reserve instruments.

(b) Separate action might properly be taken, even at the risk of some weakening of the bank-reserve instruments, first, if tendencies to be influenced in the selective credit area threaten to affect other areas, or second, if the "specific" effects of failure to act would be so restrictive or stimulative as to outweigh any undesirable "general" effects of selective policy action.

(c) The case for flexible action in the selective credit area, independently of any change in over-all credit policy, will be the stronger the more directly sales and employment activity are affected by the use of the selective instrument.

Purposes and Expected Effects of New Regulation W. - Regulation W, when reimposed in September 1948, had the following purposes: (a) to restrain inflationary credit spending for consumer durable goods; (b) to reduce the threat to future instability of excessive instalment debt; (c) to prevent financial positions of lenders from being dangerously over-extended, and (d) to reinforce a general program of anti-inflation monetary restraint then being applied. Thus, both specific tendencies in the consumer durable goods area and the general inflationary conditions in the economy combined to determine the coverage, terms, and timing of the regulation.

The coverage and terms of the new Regulation W were designed to be restrictive enough gradually to eliminate excessive further expansion in instalment credit outstanding, although, as was affirmed in testimony

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before Congressional Committees, a contraction in outstandings was not intended. The Board felt that as much restraint as would be desirable under conditions then prevailing or likely to prevail in the near future would be accomplished by restraining growth in outstandings. It was the expectation that the instalment credit terms adopted would probably eliminate further growth within a period of from six to eight months.

The leveling off of growth in instalment credit outstanding was an expected specific effect of the regulatory terms adopted, and it was also expected to serve as an index of some of the general effects being achieved. However, restraint of rapid credit growth was only one of the results anticipated. This is evident, among other things, from the above listing of major purposes which the reimposed Regulation W was designed to serve. Still other effects expected from the Regulation W action, both of which are specific, were some checking of additional price advances in the consumer durable goods area and some correction of the existing gray market situation in the new and used car field.

Criteria for Policy Changes in Regulation W. - Under principles set forth in this memorandum, a policy change in Regulation W would be examined in relation to specific tendencies in the instalment credit and consumer durable goods sector and also in relation to the general credit and economic situation.

Relevant criteria with respect to its specific effects would include conditions and trends in:

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(a) Total consumer credit and instalment credit outstanding;

(b) Retail sales and inventories of consumer durable goods;

(c) Production and employment in affected industries;

(d) Special factors in the markets of individual goods, i.e., backlog demand, gray market conditions, etc.;

(e) Consumer spending for durable goods in relation to total spending and income;

(f) Consumer financial positions;

(g) Financial positions of instalment lenders.

If the composite showing of these conditions and trends at a particular time should support a limited or comprehensive policy change in the terms of Regulation W, it would also be important to evaluate the "general" impact of the change, and especially the effects of the change upon the existing use of the bank-reserve instruments of credit policy. When the specific tendencies suggested action to change the terms of Regulation W, such action would be adequately justified in relation to the general effects if it appeared that:

(a) The indications of credit and monetary developments generally suggested a definite change in inflationary or deflationary trends; or

(b) No appreciable weakening of the over-all credit policy program would result, or

(c) Any such weakening would be more than compensated by a need for avoiding unduly harsh or stimulating "specific" impacts in the instalment credit and consumer durable goods sector.

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