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"Social Performance of Financial Institutions: A Monetary Perspective"

Remarks by

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It is a pleasure to join you this morning, in a discussion of one of the more provocative issues facing banking today. Ideas as to how to determine, and how to implement, social priorities are commanding increased attention. Oftentimes such ideas are characterized more by a dedication to their main objective than by any consideration of their side effects.

I think we all can aspire to a first-rate performance in satisfaction of recognized social objectives on the part of our financial institutions. Disagreements flourish, however, concerning which objectives to recognize, and how best to go about pursuing them.

Our economy, and the financial system that is such an important part of it, rely primarily upon the operation of reasonably free and competitive markets. Such markets work to reward participants who are the most productive, efficient, and responsive to buyer demands.

The results are impressive, but they are not perfect. Sometimes they offend either our sense of justice or our humanitarian impulses. At times, a new steel mill can be financed when a family home cannot; or a racetrack can be paid for when a needed hospital cannot.

Over the decades, we have valued the workings of our financial markets too much to supersede them, but we certainly have tinkered with them a great deal. Reading our history, we could call small-scale interference with market processes almost as American as apple pie. But our history also shows, I believe, that such interference has worked best when it was comparatively moderate in size, and was tailored so as not to interfere unduly with other worthy objectives of economic policy.

The objectives of monetary policy are very much a case in point. In an economy like ours, which has suffered painful episodic inflations with intervening recessions, the goal of promoting greater economic stability calls for monetary policy occasionally to become tight enough to defer some otherwise intended spending. No one I know likes to have his intended spending deferred, and the intensity of this feeling is indexed by the heights to which interest rates can be pushed as insistent borrowers bid for funds in a period of monetary restraint.

Who gets squeezed out in the end? Typically, those whose desires are most postponable, and those whose past and future earnings flows are least able to bear the interest cost. Because productivity is one of the most dependable ways to assure an income flow in this economy, the most productive tend to do well, and the least productive poorly, in this contest for credit. Such general tendencies, however, leave a lot of room for deviations in individual cases; furthermore, even when those general tendencies work out perfectly, our society's humanitarian impulses can be stirred by the inconvenience -- and even suffering -- that handicapped would-be borrowers undergo. When that happens, the situation is ripe for the injection of some new or heightened subsidy to increase the bargaining power of those with the most socially desirable priorities.

Logicians may point out that this purpose could be equally served -- and at a lower level of interest rates -- by instead placing penalties or other restrictions upon the most undesirable credit uses. Logically true, but in a practical and political sense burdens are much harder to foist on constituencies than are benefits. Consequently, subsidies by the score have come to dot the financial landscape. Mortgage guarantees, interest supplements, deductibility of interest paid and/or of interest earned for income tax purposes are but a few of the most obvious. The previous speaker has suggested several more, artfully designed to complement market processes.

I have no desire to propose additional credit subsidies today, but I would regard it as both callous and futile to hope that they would go away. What I would like to suggest, however, are a few simple guidelines that I believe would help to make credit subsidies fair, generally acceptable, and minimally counterproductive.

- First, I believe any credit subsidies should be overt, not hidden, in order to be sure they can be analyzed for their costs as well as their benefits, and that they will continually run the gauntlet of public scrutiny.

Second, I believe the general shape and scope of any credit subsidy ought to be legislatively determined. If subsidies are to foster certain social objectives at the expense of others, elected legislators are in the best position to assess the public's preferences and to be held accountable for such assessments.

Third, where credit subsidies take the form of tax concessions, the more neutral they can be relative to the tax position of their beneficiaries, the greater can be their effectiveness. Tax concessions that confer disproportionate benefits on certain types of taxpayers are likely to be bid away by the favored taxpayers from others. The result is that only a portion of the potential participants in the financial process are drawn to help in the solution of the problem.

Finally, in our evolving financial system, I believe desired subsidies will work best if they can be attached to transactions, or borrowers, or in some cases to the credit instruments themselves, rather than tied to a particular institution or location. Let me cite an explicit illustration. Trying to encourage a particular type of borrowing, such as home financing, by giving special advantages to firms making only such loans will, I believe, prove less and less satisfactory over time as a social subsidy. As other speakers on this program may point out, money is becoming more fluid, the institutions channeling it are pressing to become more homogeneous, and special-purpose organizations find themselves more and more vulnerable to change. The fairest and most successful credit subsidies of the future, I expect, will be those that can pursue loanable funds wherever they might be found, and can be sufficiently valuable to every would-be lender or borrower so as to instill a certain preference for the action which is socially desired.

By meeting the above criteria, I believe that social subsidies in the credit field can function in ways that will interfere least with monetary policy and other elements of national economic policy. At the same time -- and perhaps more important over the long run -- such subsidies should prove most adaptable to the changes that are coming in this rapidly evolving financial system.

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