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A FIRM NO TO CREDIT ALLOCATION

Remarks
of

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There was once a proposal that should have originated in Washington, even if it did not. It was to the effect that a book could be written containing brief texts on every imaginable subject -- pro, con and noncommittal -- and that each of these little masterpieces of bureaucratic pronouncement would be numbered. A companion volume would have numbered introductory remarks for all imaginable types of occasions on which speakers need to be introduced, ranging from cool to enthusiastic. Practically everyone who made or listened to speeches would have these volumes.

Persons chairing meetings would stand up and say, simply, "Ladies and gentlemen, we have with us today Mr. -- or Mrs. or Ms. -- Blank," and would add the speaker's title or position, after which the chair person would only have to say, "Number 741" to conclude the introduction. The speaker would need only to say "Thank you" in an appropriately grateful or distant manner according to the degree of enthusiasm of introductory remarks Number 741, and add, as his speech, "Number 836." Following this, all could retire to comfortable surroundings and engage in possibly highly productive personal or small group exchanges of ideas during the time that otherwise would have been taken up in delivering speech Number 836.

I mention this not because I think that, even in our present time of participation by everybody in everything it is an idea that will have a rebirth and acceptance. On the contrary, I am afraid that it is the kind of idea that is doomed to be shunned as taking all the fun out of life. I mention it because the choice of title for my talk today recalled the proposal. The title is "A Firm No to Credit Allocation." I really could stop right there, and you would have my message: having given the subject of credit allocation a good deal of thought -- and even though I began with some sympathy for the idea arising from the nation's obvious need to employ its resources wisely -- consideration has led me to a firm conclusion that it is neither an acceptable, nor even a feasible, idea.

If this were Speech Number 836 you would have my reasons as well as my conclusion. Since you do not, and since credit allocation has the appeal of a seemingly simple solution to our -- and the world's -- complex economic problems, I will try to explain my reasons. I should add that -- although the Board has pronounced itself opposed to governmental allocation of credit -- I am expressing my personal reasons, today, for opposing it.

The Proposal for Allocation of
Credit by the Federal Reserve

Legislation has been proposed that would give the Federal Reserve authority to induce banks that are members of the Federal Reserve System to make loans defined by law, and by Board decision, to be of priority importance to the nation. These would be called "National Priority Loans and Investments." Under one proposal, the Board would encourage "National Priority" loans -- and discourage others -- by granting reserve credits in relation to loans and investments in several fields stated in the bill as having high priority in national interests, and by imposing supplemental reserve requirements in relation to all other loans and investments. That is not quite how it is put in the bill, but that is what it adds up to -- a carrot in the form of reduced reserve requirements to member banks for making loans and investments falling in the preferred fields, and a stick in the form of supplemental reserve requirements for making loans and investments in other fields.

The size of the reserve credits and supplemental credits would be determined by the Board. For example, as I understand it, if a member bank's nonpriority loans totalled $50 million, the Board could require that bank to supplement its required reserves by -- say -- 3 per cent of the total, or, in this case, $1.5 million. The same percentage requirement would apply to all member banks. In the same way, the Board could give a reserve credit -- that is, reduce required reserves -- for making "good" loans.

"National Priority Loans and Investments" are defined in the proposed legislation as any loan or investment which, in the opinion of the Federal Reserve Board, is made for, or used for, any of the following:

--Useful capital investments, with particularly useful types of credits being those that would finance additions to capacity, conservation of energy, enhancement of the environment, and increases in productivity.

--Low or middle income housing.

--State or local government facilities.

--Financing of small business.

--Any other kind of financing which the Board determines -- with the approval of the Congress -- to be a matter of national priority.

Some Specific Problems

The proposed legislation specifies that reserve credits to any bank may not exceed supplements. Thus, the amount of benefits for "good" financing would be limited by the amount of "bad" loans a member bank made. Consequently, no individual member bank could reduce its over-all required reserves. But, if the bank were not careful in its portfolio planning, its required reserves could go up. There is thus little real incentive to make national priority loans. However, there is no limit to the penalties for the bank that does not do so. In my view, that is a departure from the basic incentive drive of free enterprise. And it would run contrary to the valuable experience we have before us of the world's regimented socities where a great deal of attention has been paid in recent years to replacing penalties with incentives as a way to achieve national economic goals.

I have noted repeatedly -- and with design -- that this legislation applies to member banks of the Federal Reserve System. The logic, I assume, is that member banks have most of the nation's bank deposits -- currently, about 78 per cent. Also, that the Federal Reserve Act allows the Board to set reserve requirements only for member banks. However keen the logic, the upshot would be a highly discriminatory burden on the nearly 6,000 -- out of nearly 14,000 -- banks that choose, through membership in the Federal Reserve System, to assist the making of economic policy for the nation by being subject to Federal Reserve reserve requirements. I cannot imagine any credible argument that could be used for explaining away this penalty for helping in one of the nation's prime economic tasks. Such a burden on membership could only act as a further stimulus for banks to leave the System. That would erode the basis of monetary policy, blunting the System's efforts to carry out its task of containing inflationary forces, or stimulating economic activity, according to circumstances.

If rules for credit allocation were to be equitable among banks, they would have to apply to all commercial banks, if the means to do so legally could be found. Perhaps the only practical approach would be adoption of the Board's recommendation to the Congress that all commercial banks be subject to uniform Federal Reserve reserve requirements. In my view, that would be doing the right thing for a very wrong reason.

But even if the credit allocation mechanism were made equitable among banks, it would still discriminate against banks in favor of other lenders. To be equitable as among all financial institutions, therefore, it would have to apply to all institutions that make loans and investments.

That is, once its feet were set upon this path, the allocating authority would have to be endowed with power to influence every loan and every investment of every kind of financial institution unless very large gaps in the allocation of credit were to be tolerated. And this assumes that the enforcement power of the allocator would be effective, a highly dubious assumption.

But the centralization of economic power could not stop there. It would have to extend also to market sources of funds, such as the use of the proceeds of the sale of commercial paper, acceptances and the like. It would have also to extend to the use of the proceeds of all long-term commercial bonds, and to equity issues. All this would be necessary because money is fungible. Block its use by one financial institution, or one type of financial institution, or several types of institutions, and the money will flow into whatever channels will lead it to the most profitable use.

Consequently, only a complete dictatorship of money, extending to every possible way in which money could be used, would provide the basis for a successful system of governmental credit allocation. But such an administrative centralization of economic power is not necessary. The price system -- including the price of money, the interest rate -- is a credit allocating mechanism, and an efficient one, reaching all the uses of money, when it is allowed reasonable freedom to work. The price/interest rate mechanism functions as a system of locks in the financial irrigating network, that directs money -- in a well-functioning free enterprise economy -- to those outlets where money can be used most effectively. And -- again -- that is why incentives, rather than penalties, are the preferred influence for controlling the use of credit. Incentives are as fungible as money. Punitive authority, on the contrary, is as vulnerable as human ingenuity in getting around it. We must assume that what the mind of man can devise, the mind of man can circumvent.

Other defects could be marshalled against the proposal that the Federal Reserve -- or any other agency -- be supplied with the power to decide what is a good and useful use of finance, and what should be discouraged.

The already exceedingly difficult task of controlling the monetary aggregates would be accentuated under any system of credit allocation resting upon differential use of reserve requirements.

The basic reason is simple: any change in the composition of a bank's portfolio would change its reserve requirements. Thus, both banks, and the monetary authority, would have an almost infinite set of unknowns and variables, shifting from day to day, to take into account in foreseeing the behavior of the money supply.

The Basic Fault --
Loss of the Efficiencies
of Freedom

The objections to credit allocation by fiat that I have raised thus far are technical in part -- and whether a plan is technically feasible is always a primary consideration. In part also, they have concerned the adverse impact of such a system on the control of credit through the price system and especially interest rates. No one would deny that the free enterprise system has serious flaws, that it is a system searching for ways to embrace other than merely material goals, that it is in the process of revision and reform; a system that should, and, to its credit, is being, and will be improved. But the basic fact is that nothing invented to date works as well, in terms of efficiency, humaneness or equity. Economic systems that have tried to substitute human committee decisions for the autonomous decisions of the price-interest rate system in directing credit to its most productive use have had to use immense punitive forces to achieve compliance. And, as I have indicated, the limited success they have had has driven them to invent surrogates for free prices and interest rates.

That, in my mind, is the crux of the matter. No single human mind, nor any committee, has yet shown itself able to collect and master enough information to determine with any acceptable degree of accuracy where investment should go, and when. At the Federal Reserve we have neither the data nor the wisdom to undertake such an Olympian task and believe me, at 20th Street and Constitution Avenue, N.W., we probably have more data than most. Furthermore, the job is not only technically difficult and socially repugnant -- it is beyond human capability. Nor does the computer bring it within human capacity. The computer can only amass and manipulate data, it cannot point, as prices and interest rates can, when they are allowed to work, to what is wanted, where it is wanted and how much one thing is wanted, or needed, in comparison to all others.

In summary then, these are my reasons for casting a very firm vote against governmental allocation of credit, at least in any way that has yet been proposed. It is technically so difficult that it would require a truly gigantic bureaucracy to operate. Its only chance to succeed would be under full authoritarian conditions, extending throughout the entire economy and into every use of funds. But even if these objections were overcome -- or overridden -- in the name of a national need for the best use of scarce resources -- the task should still not be undertaken, because it is not within human capabilities to do it well.

Does that mean we can only relax and wait until we have evolved sufficiently as people and as societies to undertake successfully central economic control? That is not what I am saying.

Institutional Reform

There is a probable answer. Its name is institutional reform. Its objective is to permit autonomous factors to tell us where and when investment should take place. But such institutional reform can and should be undertaken with two controlling conditions in mind. The first is that we cannot turn the clock back to the days of laissez faire and let matters take their course, heedless of human suffering. Together with reform of our financial system for the more efficient marshalling of credit, we must, in parallel, adopt measures to avoid waste of human talent and energy -- unemployment -- and to avoid the waste of scarce capital by making a scapegoat of any economic sector, such as housing and the mortgage market. Further, institutional reform should permit flexibility that would yield the kind of growth and diversification that people want in their lives. There is much more to be said here, but I do not want to get into philosophy -- I think my point is made that I am not talking about cold efficiency, but, rather, of avoiding waste or misuse of human and other resources, so that they may be used to best advantage to yield what society desires.

I have said repeatedly that the competitive market system, when allowed to function in relative freedom, can go a long way toward solving the problem of credit allocation. The key here is the proviso that it should permit prices and interest rates freedom enough to do their job of indicating what is the most desired, and most desirable, use of credit. Consequently, a prime objective in arriving at national priority use of credit is the removal, through institutional reform, of obstacles to the market determination of prices and interest rates.

A good deal of thought has been given recently to the problem of institutional reform of our financial system. The proposals we have before us in most immediately usable form -- the proposed Financial Institutions Act based on the Hunt Commission recommendations -- may not be perfect. But this should not keep us from starting the necessary restructuring and revision of the system by which we bring funds to market, and put them to work. It is true that the best can be the enemy of the good.

Let me, then, indicate some of the changes in our financial system that seem to be most needed now. I believe that these changes represent the best and quickest way to obtain the most desirable use of scarce capital.

First on my agenda is the unhobbling of interest rates. By this, I have in mind doing away with governmentally imposed interest rate ceilings -- chiefly, usury ceilings, and a phasing out and suspension of ceilings on time deposits. An interest rate is a financial sensory apparatus, indicating, by its rising and falling levels, changes in preferences for various types of investment, and where funds are most needed, or wanted, in comparison to all other uses. But interest rates can only do this if the bureaucratic hand does not smother the responsiveness of rates to economic conditions and desires. Such smothering eventuates in serious economic mistakes, distorting incentives and causing wasteful investment. The result may be a failure to produce capacity or product where and when needed, or the over-production of capacity or product, wrong job training, failure to carry out needed research and investment in unproductive research, and a long list of other economic wrongdoings. Two current and painfully evident mistakes are the withholding of capital from utilities and from home-building, the one due to regulation distorting the price incentive to invest, the other due directly to ceilings on the interest that may be paid for savings that go into mortgage investment.

Second, the depository base of thrift institutions should be expanded, and the allowable investment alternatives should be broadened. For example, thrift institutions should be permitted to put at least a significant portion of their funds into short-term assets, primarily in the consumer loan field. This would help to cure one of the worst difficulties the thrift institutions face in meeting smoothly -- despite rising and falling of interest rates that are not under control -- the need for mortgage money. They would be able, through such short-term investment, to adjust their earnings to better compete with the earning power of other financial intermediaries. Presently, the thrift institutions are locked into housing loans that, in times of high interest rates, make their portfolio a relatively low-earning conglomerate of interest rates reaching back, on the average, some eight years.

Further, I am certainly in accord with the expressed conviction of the Federal Reserve Board that the variable rate mortgage should be most seriously looked into, again as a means of permitting thrifts to adjust their earnings base as other interest rates rise and fall.

The fourth item on the agenda should be a variable, rather than a fixed, investment tax credit, so that the tax structure could provide additional incentive to invest, or reduce the incentive to invest, contra-cyclically.

These are a few of the specifics of institutional reform that I think stand at the head of the list. There are many other candidates, and the list should include methods to accomplish the removal of each and every blockage to the free formation of prices and interest rates. Where adjustments might temporarily damage existing institutions, phase-in programs, govermental assistance and tax incentives can be used to assist the transition. The same types of devices could be of assistance where the passage to a freer price structure threatens established industries and established employment. I think such transitional incentives should be used with a free hand, because I do not think some people, some industries or some institutions should be asked to bear the burden of reform that will benefit us all. All of us should contribute to the cost of the reform. And, I am convinced, the cost will be small by comparison to the vast gains that are in store for the free enterprise society that finds a way to try free enterprise. One of the chief benefits will be good allocation of our scarce resources.