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Statement by

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of the

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I appreciate the opportunity to testify today on a bill to reinstate the Credit Control Act in a modified form. As you know, under that Act, which expired July 1, the President was empowered to authorize the Federal Reserve to "regulate and control any or all extensions of credit" if he found such action "necessary or appropriate to prevent or control inflation generated by the extension of credit in an excessive volume". The Act gave the Board broad powers to regulate the terms under which credit is extended and the purposes for which it can be granted, as well as to require reporting and record-keeping of credit transactions, once the President has decided that these powers should be exercised. One of the proposed amendments would enlarge the circumstances under which the President could invoke the Act to encompass recession and unemployment as well as inflation. Another proposed amendment would make explicit the Board's authority under the Act to limit credit granted for "nonproductive" purposes and to ensure the availability of credit for other uses.

The Federal Reserve Board is sympathetic to the concerns about the cost and availability of credit over recent years that apparently have prompted proposals to retain credit control authority. High interest rates have contributed to the weakness of the economy and stresses on the financial condition of entities operating within it, and have been a factor in the sharp rise in business and personal bankruptcies over recent years. However, we do not believe that credit controls are an effective, efficient, or fair method to deal with these problems or those of inflation when the more general instruments of monetary and fiscal policy can be used. Our experience with the administration of controls for a brief period in 1980 amply demonstrated the difficulties encountered in the application of credit controls.

Some have argued that direct government intervention in credit allocation may be necessary under extraordinary circumstances, such as a national emergency, and in the absence of standby authority problems might be encountered in such circumstances if borrowers moved to obtain credit when enabling legislation was being considered. The greater danger would be that distortions in credit flows could occur on other occasions when circumstances seemed to suggest controls might be activated, and the existence of credit control authority might tend to encourage its use unnecessarily. Accordingly, the Board feels that the proposed legislation would do more harm than good.

The Effects of Credit Controls

The ability of credit controls applied in this country to achieve their intended effects over any extended period is limited, and the costs to borrowers, lenders, and society as a whole from attempts to use controls to combat inflation or unemployment could become quite sizable. These difficulties stem in large measure from the availability to many U.S. borrowers of funds from a number of different sources. A large business, for example, may be able to borrow from a bank, finance company or other financial intermediary, or it could obtain funds directly in a variety of security markets ranging from very short-term commercial paper through notes and bonds and including sales of equity. These markets are mostly located in this country, but increasing numbers of corporate borrowers are gaining access to a highly integrated worldwide dollar market, over which it would be extremely difficult for U.S. authorities to exercise effective control.

This sophisticated and decentralized financial system is a great advantage to the U.S. economy, since it gives savers a variety of instruments to choose among and helps to channel these savings to investment uses in an efficient manner. However, the existence of these markets also means that control of one particular type of credit, or of a narrow range of credit instruments, is unlikely to be effective over an extended period. Borrowers may have a preference as to the terms on which they wish to fund a particular purchase, but money is fungible--that is, funds obtained from any source can be applied for any purpose--and if the incentive and opportunities are present unregulated credit will tend to be substituted for credit subject to controls. As attempts are made to maintain the effectiveness of controls in the face of continuing substitutions by borrowers and lenders, regulations will tend to become increasingly pervasive, complex, and burdensome. Moreover, because controls are most readily applied to domestic financial intermediaries, borrowers, such as households and small businesses, that depend on these institutions for credit may tend to feel the major effects of controls even when this is contrary to the intent of their designers.

The cost of credit controls, if maintained for any extended period, would include most visibly the government bureaucracy and the rule making and enforcing machinery that would be needed. Less obvious would be the costs incurred by private businesses in increased reporting burden and the expenditure of managerial ingenuity to conform with or, perhaps, get around the regulations. Least easy to ascertain would be the costs arising from distortions in resource allocation and inefficiencies that inevitably result when regulatory mandate is substituted for market decisions. Of course, the whole purpose of controls is to change the allocation of credit and presumably of spending from what would prevail in the absence of interference. There already exist a number of governmental programs to influence the flow of funds to various sectors--especially towards housing and agriculture. However, the full effect of these programs, for example on competing uses of credit, and the additional costs of credit controls are difficult to determine. Breaking into the complex web of private decisions about lending and borrowing, spending and saving, may involve considerable unintended indirect consequences from distorting the price and interest rate signals given to market participants.

The 1980 Experience

In many respects, the problems and pitfalls of utilizing credit controls were illustrated by our experience in the spring of 1980, when, as consistent with the order of President Carter, the Board took a series of actions designed to curb inflationary pressures by slowing the overall growth of credit, while directing it to uses considered most beneficial to the economy. The components of the program, not all of which required the authority of the Credit Control Act, included: a voluntary Special Credit Restraint Program intended to reduce the expansion of short-term credit, primarily by holding the growth of bank loans below 9 percent for the year, with restraint to be applied mainly to loans for speculative purposes or for effecting takeovers or stock repurchases, rather than to loans to small businesses, farmers, and purchasers of homes and autos; special deposit requirements on increases in certain types of consumer loans; an increase in the reserve requirement on growth in managed liabilities of member banks and extension of the marginal reserve requirement to nonmembers to further discourage the expansion of bank credit; a special deposit requirement on increases in money market fund assets, in the expectation that lower yields on these intermediaries would slow the diversion of deposits from local institutions; and a surcharge on frequent borrowing from the Federal Reserve discount window by large banks.

When the President authorized the imposition of credit controls in March of 1980, conditions in credit markets had been deteriorating in many respects. Interest rates were rising, with concern about impending federal government deficits and a pickup in inflation driving bond yields to record levels, and bank credit growth was running well above the range considered appropriate by the Federal Open Market Committee. It appeared that the public had little confidence that the usual fiscal and monetary policy instruments would be used to effect a lasting reduction in inflation. Under these circumstances, it seemed appropriate to supplement these techniques temporarily with the special measures of the credit restraint program; it was hoped that these actions would speed the response of the economy to the more general policies already in place.

The program did contribute to a sharp reduction in interest rates, but this downward movement in rates accompanied a steep decline in economic activity. One reason for this was the great amount of uncertainty and confusion that accompanied the onset of controls. Borrowers reduced their use of all types of credit, including those the credit restraint program was not intended to curtail, and with this reduction went a sharp drop in credit-financed purchases. Some lenders, fearful of violating Board guidelines, drew back from the credit markets, cutting sharply their credit extensions; others used the credit restraint program as the occasion for accelerating a tightening of loan terms that had been in train for some time. In response to incoming information about the economy and credit markets, the Federal Reserve quickly took steps to ease the credit restrictions. With the credit restraints off, interest rates lower, and underlying demands for goods and services still strong, the economy rebounded rapidly in the third and fourth quarters of 1980, carrying interest rates to even higher levels. In the end the credit controls appeared to add to the volatility in financial markets and the economy in 1980 and, in some ways, by distorting underlying economic and financial conditions, made sound fiscal and monetary policies more difficult to formulate.

In addition, the numerous practical problems encountered in implementing the program tended to demonstrate the essentially arbitrary nature of governmental direction of credit decisions and the burdens imposed by controls. The general principles guiding the credit restraint program seemed reasonably straightforward, but constant modification, interpretation, and clarification were needed as these general principles were applied to the complex financial relationships that characterize our economy. In the few months they were in effect, the consumer credit regulations, by themselves, required 31 pages of answers to common questions in addition to innumerable responses to inquiries specific to individual institutions, even though they were aimed at a quite limited sector of the consumer credit market. The voluntary credit restraint program for banks and other lenders necessitated numerous judgments by the Federal Reserve and the lenders as to whether individual loans for takeover, purely financial, or speculative purposes were justified under the guidelines. Lenders and borrowers rarely enter loan contracts that they do not feel will produce some economic benefits, and we found that the longer the program was in effect, the more numerous and difficult became the issues of this sort that had to be confronted. Problems also were encountered in verifying whether credit had continued to be made available to borrowers, such as farmers and small businesses, who were supposed to receive favored treatment under the regulations.

Recognizing that larger corporations might be unfairly advantaged by access to a variety of credit markets, the Board required these corporations to report directly to us so we could monitor their total use of credit. There was great difficulty in standardizing and interpreting these reports, however, especially the information dealing with transactions with foreign subsidiaries. Moreover, the regulations and accompanying reports placed a substantial burden on corporations and lenders, who often were asked to develop and report data in unfamiliar and difficult categories. The Federal Reserve Banks and Board also found that considerable resources had to be diverted from regular duties to interpret and monitor compliance with the regulations, answer questions, and analyze incoming reports.

Credit Controls to Combat Inflation or Recession

As in 1980, the usual reason for imposing credit controls has been to combat inflation, or prevent its outbreak. In the past this has primarily occurred during war when resources were being diverted from the production of consumer goods, and the exigencies of war finance were thought to constrain the degree to which monetary and fiscal policies could be used to hold down overall demand pressures. In this context the terms or availability of credit to finance consumer purchases were controlled in order to discourage consumer spending. Such a policy might be successful in a national emergency when a public consensus existed that would discourage finding ways to reduce the effect of the controls, but even in these circumstances, avoiding an eventual upward movement in prices requires policies that bring aggregate supply and demand into more lasting balance. The use of credit controls--with the attendant costs, distortions, and possibilities for evasion--is unlikely to produce a permanent reduction in inflationary pressures, unless it is also accompanied by limitations on the overall growth of money and credit.

In the proposed bill, credit controls may also be authorized by the President to combat unemployment and recession. The success of credit allocation for this purpose is likely to be even less than for holding down inflation.

Regulations to prevent or limit a proposed extension of credit or to raise its cost would have a far better chance of being effective than would regulations to induce credit extensions that do not appear beneficial to the lender or borrower. Lenders require a fair return on their investments; for financial institutions this implies a reasonable margin over the cost of obtaining funds. To encourage borrowing and spending as a method of boosting economic activity, credit controls would have to result in greater volumes of credit at lower interest rates. It is difficult to see how this would ever work.

Controls also can be used in an attempt to effect a redistribution of credit, perhaps to rechannel spending in directions considered more socially desirable or to reduce unemployment in particular sectors. They may be successful in this, but only at the expense of increasing unemployment or reducing spending in other sectors, and the effectiveness of controls even for this purpose may be limited over time if constrained borrowers can substitute credit from noncontrolled sources.

There has been wide discussion of credit availability differences between productive and nonproductive (usually takeover credit) uses. In that connection I should note that borrowing to finance takeovers does not draw significantly on the Nation's total volume of savings--our ultimate source of credit. These transactions involve an exchange of financial assets, and, while the purchaser of stock may borrow to obtain the necessary funds, those selling the stock generally will recycle the proceeds back into financial markets through deposit in a bank or other financial institution or purchase of another security.

Although the overall balance of credit supplies and demands will not be greatly affected by such transactions, there may be some distortions in the distribution of credit and the structure of rates in different markets. In addition, the tendency for banks to take on large obligations to individual firms in very short periods in conjunction with takeover financing may have implications in the context of the Federal Reserve's supervisory responsibilities. For these reasons, we monitor the volume and terms of this activity carefully. When there are firm constraints on bank credit growth, loans for one use would reduce funds from banks available for other purposes, with potentially adverse consequences for those borrowers without access to other credit sources.

The most recent example of our asking banks to limit takeover loans was during the credit restraint period in the spring of 1980, when, as I noted above, we asked the banks not only to curb lending for nonproductive purposes but to maintain the flow of credit to homebuyers, small businesses and others whose credit needs seemed important to satisfy. The problems we encountered then--for example, determining which takeovers were justified and monitoring the use of foreign credit to finance mergers--highlighted the difficulties of enforcing such restrictions in an equitable manner without impairing the efficient funding in our financial markets of necessary and legitimate changes in business ownership. In this area, as in others, problems of anticipations also complicate administering controls.

It seems to me that the problems facing borrowers today do not stem from a lack of availability of funds from certain lenders that might be remedied by redirecting credit flows, but rather from the generally high level of interest rates. Liquidity pressures and balance sheet imbalances of many years standing are prevailing throughout our credit markets. Of particular concern is the elevated level of long-term rates, which has depressed our housing markets and discouraged businesses from undertaking the capital investment and balance sheet restructuring so urgently needed. One factor keeping those rates so high is investor fears of a reemergence of inflation at even higher levels as the economy recovers--repeating the pattern of recent decades; another is the prospect of the crowding out of private borrowers due to the financing of massive and growing federal budget deficits in the midst of economic expansion. Unless the Congress and Administration structure a federal budget that will move toward balance instead of toward greater deficits at higher levels of employment and output, the federal government will continue to use an outsized share of our Nation's savings. Private borrowers, under these circumstances, will continue to face high interest rates, and the credit sensitive sectors of our economy will not regain their former vigor. Stimulus to private activity cannot be obtained by promulgating rules favoring one sector over another. Instead we must work to increase the flow of credit to all private borrowers and to assure that this credit will be available at reasonable rates by pursuing monetary and fiscal policies that promise a lasting abatement of inflationary pressures.