For release on delivery
Expected 10:00 A.M. E.D.T.

Statement by

Nancy H. Teeters

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

U.S. Senate

May 24, 1979

I am pleased to have the opportunity today to testify on behalf of the Federal Reserve Board on proposals to repeal or modify the Credit Control Act of 1969. As you know, under the Act the Board could be authorized to control and regulate extensions of credit if the President "determines that such action is necessary or appropriate for the purpose of controlling inflation generated by the extension of credit in an excessive volume." The President's authorization may specify particular classes of credit that should be the target of Board regulations, or it may be a more general request to the Board for actions to limit what he deems to be an inflationary expansion of credit.

To implement controls under the President's authorization, the Board is given a broad range of powers over credit transactions, which it may exercise at its discretion. Those powers encompass not only the regulation of the terms of credit contracts, such as downpayments, maturities, and interest rates, but also the licensing of borrowers or lenders and requirements for record-keeping. In addition, the Board may set maximum loan-to-deposit or loan-to-asset ratios for creditors or debtors. Assistance in implementing these sweeping regulations may be obtained from any appropriate State or Federal agency.

Credit controls as an instrument of anti-inflation policy have most appeal at times when fiscal and monetary policies cannot, for one reason or another, be employed flexibly. During World War II and for a while thereafter, monetary policy was constrained by a pledge to maintain a low interest rate on U.S. Treasury securities. As a result, the Federal Reserve could not effectively control growth in the monetary and credit aggregates since it had to supply as much bank reserves as needed to maintain an unchanged level of interest rates. Regulating nonrate terms of credit extensions seemed to be one of the few ways to discourage borrowing in such an environment. Thus, regulations limiting consumer credit were used on three occasions in this period--World War II, 1948-49, and the Korean War--and regulations affecting mortgage credit were used during the Korean War.

However, with monetary and fiscal policies able to adapt to changing circumstances--as they are at present--there is little need to risk the market distortions, administrative burdens and complexities, and problems of equity that are inherent in credit controls. If credit controls are to be used, it would require circumstances when the need is clear and obvious--a national emergency, such as a war, or a clearly perceived imbalance in the distribution of available credit.

The nature of financial markets in this country make credit controls both unneeded--save for very exceptional circumstances--and extremely difficult to administer. Our credit markets reflect the borrowing and lending decisions of vast numbers of consumers and businesses, and are an important means through which our economic resources are efficiently allocated among competing uses. The market is so large and fluid that credit is generally available to all qualified borrowers, though the price--that is, interest rate--will vary so as to ration the supplies of funds.

Imposition of controls in such a free, well-functioning market inevitably invokes a response by market participants, who attempt to circumvent the controls. Lenders seek the most profitable outlets for their funds, whether at home or abroad. And borrowers, who may be blocked out of one market, may seek funds in another. The fungibility of money and credit makes it most difficult to administer credit controls selectively, and enhances the likelihood that one set of controls will only give rise to another.

One of the principal problems with attempting to control inflation by controlling credit is that the increases in credit often observed during inflations may be a result, as well as a cause of increases in prices. In many inflationary situations credit will be growing simply to keep up with the rising costs of items usually purchased with borrowed funds. In addition, rapid inflation can occur, at least for a short period, without a marked pick-up in credit usage. Since last summer, for example, aggregate credit use by private, domestic nonfinancial borrowers is estimated to have changed little on balance, despite an acceleration of inflation.

Nor can credit-financed purchases by certain sectors or in certain markets be easily pinpointed as significant stimulants to inflation. Credit expansion has been reasonably well balanced during the current cyclical upswing, and there has been no evidence of developing speculative excesses. Much attention has been focused on borrowing by households, with concern expressed that consumers were assuming excessive amounts of debt in order to make purchases in anticipation of future price increases. The rise in household indebtedness has slowed recently, however, as growth in net extensions of both mortgages and consumer instalment loans have fallen off, and debt repayments also have begun to decline slightly when compared to the level of disposable income. Moreover, objective indicators of debt servicing trouble, such as delinquency and default rates, do not indicate widespread problems in handling the debt load.

Business borrowing has picked up, in part to finance the rebuilding of inventories depleted at the end of last year, but thus far inventory stocks appear to have been kept in close alignment with sales. Nonetheless, this situation will bear careful watching for signs of an excessive buildup.

Selective credit controls might be effective in holding down a narrow category of spending and might be appropriate if there were shortages of particular goods, such as automobiles and other consumer durable goods during World War II. However, even if such shortages occurred, rationing or excise taxes might be a more effective and equitable means of treating the problem.

Moreover, even if the expansion of certain types of credit could be identified as adding to inflationary pressures, control of such credit might well be ineffective in reducing demands. If controls were imposed on one type of credit, other credit could be substituted by lenders or borrowers, or liquid assets could be drawn down to support spending. This problem would be heightened by the large volume of existing credit commitments, the use of which would be difficult to regulate. Consumers, for example, have access to sizable pools of credit through credit cards issued by banks, stores and oil companies. Businesses have loan commitments from banks and insurance companies among others. Even if new commitments were controlled, the outstanding volume would take some time to draw down, delaying and reducing the potential impact of credit controls. Over the longer run, as controls began to impinge on borrowing ability, both borrowers and lenders would be likely to discover and utilize alternative credit instruments to finance spending.

The flexibility of credit markets, and the inherent fungibility of money, would tend to vitiate any form of credit control. In periods of demand pressures, credit controls would have to be pervasive to have any chance of being effective. Controls on business borrowing probably would be even more difficult than for consumers, given the wide array of funds available from different sources, especially to large corporations. For example, regulations would have to cover accounts receivable financing and international capital flows to constrain effectively all sources of funds for business spending.

For this reason, a large bureaucracy would probably have to be created to administer controls. In the absence of a national consensus as to their necessity, detection of violations would depend almost entirely on the regulators, since both borrowers and lenders may have an incentive to circumvent the controls. Regulatory staff also would be needed to decide on exemptions to the controls, as obvious inequities arose. Their cost also would include the paperwork and compliance burden borne by lenders and borrowers. These direct costs would likely escalate with the duration of the controls as they were extended to counter the ingenuity of the private sector.

But the costs of controls probably would substantially exceed those that could be directly measured by the labor and materials devoted to compliance. Perhaps the most important costs would be the hardest to measure--distortions to markets and resource allocation. With many normal avenues for competition among lenders no longer allowed, energies and resources probably would be directed into the socially wasteful activity of devising methods to circumvent the regulations. Moreover, to the extent that controls retained any effectiveness, credit allocation and the underlying resource allocation it supports would be responding to the signals given by the controls, rather than by relative interest rates reflecting competitive opportunities in private markets. Although, to some extent, this realloca- tion may conform to the wishes of the regulators, our experience with con- trols in other markets teaches us that unintended side effects from inter- ference with private decisions are not infrequent. Furthermore, the burden of the regulations is likely to fall most heavily on small businesses and households with moderate or low incomes. These borrowers or lenders probably would have the most limited access to alternative means of financing or to liquid assets with which to blunt the effect of the controls, and small businesses would be especially inconvenienced by the paperwork load.

All these factors suggest that under most circumstances policies other than credit controls would have superior results with fewer undesirable side effects. Measured application of fiscal and monetary restraint over the coming years would seem to be the best method for achieving our goal of reducing inflation, and thereby lowering interest rates, without unduly disrupting the expansion of income and employment. The reduction of infla- tion will not take place quickly--it probably will require an extended period of moderate growth in output and demand. Credit controls seem particularly inappropriate for such an extended time horizon, since the longer they are in force, the lower is their effectiveness and the higher is their cost.

There may be situations in the future, however, in which mandatory credit controls could be a useful component of national economic policy. One such circumstance could occur if it were necessary to undertake a major and rapid redirection of resource allocation in response to a national emergency, like an outbreak of war. At the beginning of the Korean War, for example, there was a considerable amount of panic buying of consumer durable goods in anticipation of future shortages. The quick imposition of strict credit controls could temporarily dampen this type of reaction and would initiate the process of freeing resources to meet the emergency. The greater public support for controls likely to exist in such a situation would enhance the feasibility of administering them.

The Credit Control Act of 1969 is useful to the extent that it provides a means for dealing with such contingencies promptly. It does not appear that voluntary credit controls could be employed under such circumstances without additional statutory authority. However, if the Congress feels that the availability of credit control measures may lead to unwise use of them, it may want to repeal the Act, as proposed in S.35. In view of the widespread recognition of the drawbacks associated with mandatory controls, there would appear to be little chance they would be used unnecessarily. Certainly, the history of the past ten years is consistent with this view.

If it ever became necessary to impose credit controls in a national emergency, like the Korean War, they would need to be applied with minimum delay to avoid anticipatory and counter-productive actions by borrowers and lenders that would dilute their effect. Thus, if the Act is to be retained, the changes suggested by S.389 would seem unwise. In the time that Congress was acting on a concurrent resolution, businesses and consumers would be making purchases, negotiating credit and credit lines, and drawing on existing loan agreements to accumulate liquid assets. All these actions would tend to aggravate the condition that occasioned the need for credit regulations in the first place.