

THE ALLOCATION OF CREDIT AND THE MUNICIPAL BOND MARKET

Remarks of Frank E. Morris
President, Federal Reserve Bank of Boston
Before the Municipal Finance Forum of Washington
Washington, D. C., May 22, 1971

Earlier in the year, before this same Forum, I took the position that the municipal bond market, as it is presently structured, is not likely to be able to meet effectively the financial needs of state and local governments in the decade of the 70's. As long as there is a substantial amount of slack in the economy, the market will function tolerably well, but the need for restructuring and broadening the market will become apparent when we again return close to full employment levels. As I believe there is an urgent need to decentralize decision-making on state and local government investment programs, I would much prefer to see this restructuring take the form of giving to state and local governments the financial option of issuing either tax exempt securities or taxable securities with a 50% Federal interest subsidy. This approach is to be preferred, in my judgment, to the alternative of utilizing Federal Government financial intermediaries as supplements to the present system; since the latter would inevitably tend to lead in the opposite direction - - toward the further centralizing of decision-making on state and local government investment programs in Washington.

This was the essence of my talk to this group in January and I see no point in repeating that argument today. Instead, I would like to discuss the problem of financing state and local governments in the broader context of the overall allocation of credit. In so doing, I will be expressing my personal view and not the position of the Federal Reserve System.

In recent years the Congress has demonstrated a growing concern

over the question of credit allocation - - particularly during the periods of monetary restraint such as in 1966 and 1969. This reflects the unfortunate fact that monetary restraint, operating within the existing structure of financial markets, does not affect the various sectors of the economy in an even-handed way.

In the economy of the United States there are two strong claimants to the flow of funds - - the U. S. Government and the large corporations. There are, in addition, a host of weaker claimants, such as home builders, state and local governments, the consumer and small business. When the combined capital demands of the two stronger claimants are moderate relative to the total of available funds, as is the case today, there is plenty of money left over to meet the needs of the weaker claimants. However, in a tight money market (which is usually produced by heavy U. S. Government deficits or a capital goods boom - - or a combination of both), once the stronger claimants have had their needs for funds satisfied, the others are left to scramble for what is necessarily a relatively small residual.

The Congress, with some justification, has begun to question whether such a system is well designed to meet the social priorities of the country. Congressional interest in this question seems certain to grow as the economy returns to full employment and capital again becomes scarce relative to total demand. What can be done to deal with this allocation problem without, at the same time, doing serious damage to our free market system?

It seems to me that there are three basic approaches to this problem. The first approach involves measures to reduce the demand for funds by the stronger claimants in tight money periods, thereby leaving a more satisfactory residual for the rest of the economy. The second approach is to improve the

structure of the financial markets for the weaker claimants so that they may be able to compete more effectively for funds in a tight money market. The third approach is to allocate capital by administrative fiat.

I think most of us would reject the third approach as being basically incompatible with a free economic system. The solution, therefore, must lie in a combination of the first two approaches.

Turning to the first approach, one way to reduce the combined demand for funds by the two strongest claimants is for the U. S. Government to run a large surplus in boom periods. This would make it possible for a plant and equipment boom to be financed without placing an undue squeeze on the other sectors of the economy. I am sure that most economists would agree that this would be good economics, but it is obviously a difficult solution politically. An alternative way of reducing the combined demand for capital of the two strongest claimants would be by taking measures to reduce the demand for capital by the large corporations. I do not have a well-formed proposal to set before you, but I am convinced that this is where we ought to be looking for an answer.

Perhaps we need a variable investment credit which can be both positive and negative in its impact. I am persuaded of the long run merits of the investment credit. There is a strong public interest in spurring the productivity gains which we must have to be able to afford to pursue many of our social goals at home and our foreign policy objectives abroad. Nonetheless, from a short term stabilization point of view, it made no sense at all to have an investment credit in force in early 1969 when a powerful capital goods boom was the primary inflationary force in the economy. There will be times, hopefully not very frequent,

when the investment credit should be zero or negative. A sizeable Federal Government budget surplus and/or a negative investment credit could have done much in a year such as 1966 or 1969 to provide more funds through market processes to the weaker claimants.

Recently a bill was introduced in the Congress to give the Federal Reserve the authority to impose variable reserve requirements against assets. The clear purpose of the bill was to reduce the access of the large corporations to commercial bank credit in tight money periods so that the burden of monetary restraint might fall less harshly on the other sectors of the economy. There are a number of arguments which could be made against this bill, but the most fundamental argument is that it would not accomplish its intended purpose.

The proposal for variable reserve requirements against assets implicitly assumes that the large corporations are highly dependent upon commercial bank credit; but, perhaps unfortunately, this is not the case. The events of 1969 demonstrate quite conclusively that large corporations in the United States are not critically dependent upon commercial bank credit. If their access to credit is to be restricted, the controls must extend far beyond the commercial banking system or the results are likely to be quite frustrating.

It is instructive to examine the experience of 1969 when a surge of capital expenditures frustrated the aims of economic policy. Using the flow of funds accounts and comparing the last half of 1969 (when monetary restraint was most severe) to the last half of 1968, we find that capital expenditures by non-financial corporations rose by \$10 billion (annual rate) while internally generated funds declined by \$1.3 billion, producing a net increase in external financial

requirements of \$11.3 billion over the rate of the last half of 1968. The financial versatility of the large corporations was clearly demonstrated in the manner in which they met this external capital requirement in the last half of 1969.

Bank loans provided almost \$6 billion (annual rate) less to non-financial corporations in the last half of 1969 than they had in the last half of 1968, and bonds and mortgages about \$5 billion less. All told, bank loans, bonds and mortgages provided \$11.3 billion (annual rate) less than had been provided in the last half of 1968 while requirements were \$11.3 billion higher. How was this enormous financing gap of \$22.6 billion closed? It was closed primarily by the running down of liquid asset positions, by the sale of a record volume of new equity issues, by the sale of commercial paper and by a substantial growth in trade credit - - the financially stronger corporations lending to those not quite as strong.

In my judgment, variable reserve requirements would not have been helpful in 1969. The large corporations would have found the money they needed outside the commercial banks. The commercial paper market would probably have grown even larger than it did, and the crisis in that market in mid-1970 would have been even more hazardous to the stability of the economy. One of the lessons which I hope we have learned from the experience of the past two years is that it is unwise to encourage the build-up of masses of short-term corporate debt outside the banking system.

The 1969 experience persuades me that the capital expenditures of large U. S. corporations cannot be controlled solely by the application of constraints on commercial banks. Small business is dependent on commercial bank financing; large business is not. If it is desired to control the access to capital of the large

corporations in boom periods a much more comprehensive set of controls over all capital markets would have to be imposed. It would seem much more feasible to work on the demand side through measures designed to reduce the demand of the large corporations for capital in boom periods.

I was recently privileged to attend the Annual Conference of Central Bankers of the Western Hemisphere as a member of the United States delegation. One full day of the conference was devoted to the subject of the allocation of credit. A general principle which emerged from those discussions is that the more primitive the financial system the easier it is to control the allocation of credit. In most Latin American countries, if one controls the allocation of credit by the commercial banking system, one controls virtually the entire flow of credit. In the sophisticated financial markets of the United States, however, this is clearly not the case. If we are to be successful in achieving a more balanced allocation of credit in the United States, it must be with tools which give full recognition to the sophistication and dynamism of our financial markets.

There is much that can be accomplished by the second approach to the problem of credit allocation - - measures to improve the financial markets for the securities of the weaker claimants. A great deal has been done to improve the structure of the mortgage market in recent years and, as a result of these measures, the impact of tight money on the housing industry in 1969 was significantly dampened. These measures could not prevent a substantial contraction of housing starts in 1969, and there were many leakages in the system (\$1 injected into the mortgage market by Government intermediaries did not produce a \$1 net increase in mortgage funds); nonetheless, the adjustment imposed upon the housing industry in 1969 was much less than would otherwise have been the case.

There is another lesson which I think we should have learned from the experience of 1969; i. e. , to the extent that the capital demands of the stronger claimants are insufficiently moderated, efforts to provide a special shelter for one of the weaker claimants is likely to result in increasing the pressures on the other sectors of the economy for which we have not created special shelters. In the 1969 case, the success achieved in buffering the housing market was achieved primarily at the expense of increased pressure on state and local governments and small business. Clearly, this was not the intent of governmental actions to help the mortgage market, but I think this was the result.

As I stated here in January, I believe that the municipal bond market can be restructured in a way which would render that market much less sensitive to swings in monetary policy than it is today. I have grave doubts that state and local governments will be able to get through the decade of the 70's with a bond market which can only function with reasonable effectiveness if the commercial banks are in a position to take up at least 80% of the new offerings. Sooner or later, a broader and more stable market for state and local government securities must be found. However, given the probable magnitude of the future financial demands of state and local governments, even a much stronger market for their securities will not solve all their financing problems unless we can also maintain a reasonable degree of balance and stability in the economy at large.

In most recent discussions of the allocation of credit, attention has tended to be focused solely on the supply of credit. In my judgment, the fundamental answers are going to be found in measures to influence the demand for credit. While I certainly support measures to improve the structure of both the mortgage market and the market for state and local government securities, I suspect that

the single most important thing we could do for housing and for state and local governments is to develop, perhaps through an examination of the Scandinavian experience, a workable system of incentives and disincentives for business investment.