

FEDERAL RESERVE POLICY & SOCIAL PRIORITIES

by

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before

THE MONEY MARKETEERS OF NEW YORK UNIVERSITY

Bankers Club, New York City

October 8, 1970

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Most of us here this evening are students of or practitioners in the money market. But we are also individuals caught up in the sweep of current events; stimulated and frustrated by the pressures of the times. I should like to speak about one aspect of these pressures--the demand for greater attention to social priorities--and its relationship to Federal Reserve policy. I speak as one who has some responsibility for monetary policy and concern for the viability and strength of the institution which determines and implements monetary policy. But what I am about to say does not necessarily reflect the official position of the Federal Reserve System--and this may be the understatement of the evening. Finally, I have some strong beliefs about the importance of the problem under discussion, but I have reached no hard and fast conclusions about its solution.

### The Problem

Let me state the problem. Assume that you are an official of the Federal Reserve System. Congress (your boss) comes to you with the complaint that what you are doing when you attempt to curb inflation is to hurt certain people whom Congress thinks should not be hurt. How do you react?

I should like to analyze four possibilities:

- (1) Hope the problem will go away
- (2) Reply that it is not your fault
- (3) Recommend direct action by the Federal Government
- (4) Explore possibilities for modifying instruments of

Federal Reserve policy

The Hope-it-will-go-away Strategy

I believe it would be irresponsible and short-sighted for a Federal Reserve official to think that the problem will go away. I say this not only because of my view of the responsibilities which such an official has but also because of my appraisal of the future.

A continuing responsibility of any Federal Reserve official is to see to it that the central bank does what it can to meet society's needs. As these needs change, the central bank must change.

I believe it is time for a reappraisal of the relationship between Federal Reserve tradition and the changing desires of society. The traditional posture of the Fed is to be concerned with the overall quantity and flow of money and credit. Society is increasingly concerned with the direction of the flow.

I am not competent to unravel all the forces behind these changing desires on the part of the public, but I think I can detect at least some of the surface manifestations. One is that the public's standards of performance for the economy and for policymakers have been rising, probably at an accelerating rate.

Another is that greater attention is being paid to subparts of the economy. Just as we have changed the focus of policy from catastrophic depressions to mini-recessions--that is, with regard to magnitude of economic fluctuations--we have placed under increasingly close scrutiny movements of various sectors of the economy.

A third is that the very success of the economy in generating affluence has afforded us the luxury of paying more attention to distribution. Concerns have turned increasingly to the question of how

various groups fare in our economy, and I detect no reason for this trend to change in the foreseeable future.

Indeed, as I look forward to the 70's, I see pressures mounting. Society--particularly as today's youth move into positions of responsibility--will be even more insistent that the economy perform in a way that meets high standards of overall performance and accommodates sectoral and distributional needs.

In short, the problem will not go away.

#### The It-is-not-our-fault Strategy

As we examine this possible response, we should be aware that there is much more involved than economics. Whatever the causes, recent periods of monetary restraint have been characterized by difficulties on the part of housing and state and local governments in obtaining funds. These are precisely the sectors containing highest social priorities and in which political nerve ends are close to the surface.

The general public and many legislators, probably more sensitive to political and social considerations than economic, are inclined to see tight money as the villain in the piece. Since it is tight money that frustrates the achievement of social objectives, the proposed solution is either to have easy money (usually put in terms of low interest rates) or to devise different instruments of policy.

The first proposal is simple for a Federal Reserve official to respond to. Whatever his inclinations, monetarist or fiscalist or something in between, he would not give up the use of monetary policy completely because of sectoral problems. Indeed, he would emphasize that greater success in using monetary tools for stabilizing the overall economy would reduce the magnitude and frequency of sectoral problems.

The second is more difficult for him. Rather than rushing off to devise new instruments of policy, he might argue that part of the difficulties experienced by certain sectors during periods of restraint is caused by imperfections of markets. He might urge politicians concerned about the uneven impact of tight money to direct their efforts toward freeing up markets. If markets were more open and competitive, funds might be more likely to flow to their "best" use.

But this kind of response often does not consider what must be done to make freer markets possible. Ceilings on interest rates must be modified so that borrowers and lenders can be more flexible in rates they pay for funds and rates they charge for the use of funds. Entry into markets must be made easier for various kinds of institutions. Restrictions which hamper economies of scale must be eased. Taxes must be adjusted to be more equitable among institutions.

I find it hard to be optimistic. Efforts to free up markets should be persistent, but progress will be slow.

I conclude, therefore, that there is a good deal of truth in the position that the uneven impact of monetary policy is not the Fed's fault. But it requires a good deal of economic sophistication to understand that. Possibilities of removing many of the imperfections in the market seem remote. And even if markets somehow were to be made perfect, the allocation of funds and resources might well not conform to social priorities.

In short, the it-is-not-our-fault strategy has a lot of economic validity behind it, but lacks something as a constructive response to this pressing problem.

The Let-Government-do-it Strategy

Because the problem will not go away and because it is not enough simply to say that the uneven impact of monetary policy is not the Fed's fault, some Federal Reserve officials would advocate direct use of powers of the Federal Government.

This approach has a number of advantages claimed for it. It would adhere to the traditional view of the Fed's responsibilities; and as recent experience indicates, the Federal Reserve has its hands full in effectively carrying out these overall duties. Also, by avoiding the appearance of involving the Fed in the matter of social priorities, it would avoid embroiling the central bank in some political hassles and help to maintain its traditional position of "independence." As I'll point out in my conclusion, I'm not sure these arguments are as black and white as they may seem, but for the moment let's accept them at face value.

What proponents of this position have not done very thoroughly, however, is to explore the implications of turning the job over to the Federal Government. Considerable thought needs to be given to criteria that should govern this approach.<sup>1/</sup> One, obviously, is that it should work. An expenditure for a given purpose, for example, would channel resources more directly than would credit controls. The efficacy of other Governmental approaches would have to be examined. One possible shortcoming of Governmental action is cumbersomeness of decisionmaking.

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<sup>1/</sup> I don't mean to suggest, however, that similar criteria should not be applied to other approaches, including credit controls. As noted in the next section, application of the same criteria examined here raises similar questions about the efficacy of credit controls as for Governmental action.

Consider, for example, the recent difficulties of Congress in redistributing the tax burden.

A second criterion probably should be to minimize Government participation in markets. Some schemes would meet this criterion better than others. For example, those that would offer incentives to the private sector to allocate resources in accordance with social priorities would seem to be preferable to outright Government participation. The danger is that the Federal Government could end up dominating large parts of credit markets and the economy. During the recent period of monetary restraint, for example, a substantial proportion of new mortgage funds was supplied by the Federal Government. If one visualizes Government action as a built-in stabilizer coming into play only during relatively short and rare periods of monetary restraint and then unwinding as money eases, there is no particular cause for concern. But if one foresees a sustained period of pressure on resources, say, for the 70's, considerable care should be exercised in turning the problem of credit and resource allocation over to Government.

Direct Governmental action may, however, turn out to be the best solution. All I mean to say is that even a superficial consideration of pros and cons suggests that the case is not as clear-cut as some apparently assume.

#### The New-instruments-of-credit-control Strategy

A fourth response to Congressional pressures would be to explore possible instruments of credit control. Despite its tradition,

the Fed has had considerable experience in directing credit flows.<sup>2/</sup> The main lesson it has drawn from this experience is that the task is distasteful and results have not been outstandingly successful. Unfortunately, however, the Fed has not tried by means of systematic analysis to formulate a body of theory from this experience.

Careful examination of the past might indicate, for example, the significance of the fact that attempts to deal with sectoral problems almost invariably have occurred in periods of economic and financial stress in which orthodox approaches appear inadequate. Again, if the need for such action were rare and brief, it might not be too serious to meet acute problems in the future by ad hoc efforts; but if the demand for sectoral control is to be more or less chronic, an approach based on sound theory is necessary.

This theory would help to tell us whether control of the flow of credit actually would significantly influence the direction of flow of resources. What we do know raises questions. Experience with real bills, for example, has convinced most economists that the central bank can have little effect on the flow of credit and resources by defining the eligibility of discountable paper.

In the realm of open market operations, the Fed recently resisted suggestions that it buy agency issues in order to funnel funds into housing. One of the reasons for its reluctance was that after a complex of adjustments were made, significantly more resources would not, in fact, go into housing.

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<sup>2/</sup> For example, real bills, "direct action" in the late 1920's, margin requirements, moral suasion, Regulations W and X, "Operation Twist," the September 1, 1966 letter from the Federal Reserve to member banks, and Regulation Q.



So far as Regulation Q is concerned, no one can say precisely what would have happened in the absence of the ceilings that have prevailed. The fact that the Fed has issued a series of loophole-plugging regulations suggests, however, that the ceilings have not been very successful in directing the ultimate flow of funds and resources. This experience suggests an important lesson: restrictive controls like Regulation Q merely place an obstruction in the path of someone's objective without greatly changing his desire to get there. In a market economy, men are ingenious enough to find many new paths around an obstruction. As a consequence, the authorities must pile one obstruction on top of the other to try to close off each new path.

One proposal which has been receiving some attention recently is to impose different reserve requirements on different kinds of assets. Suppose, for example, it were desired to increase investment in housing relative to investment in plant and equipment. The Fed could set a high reserve requirement on business loans and a low requirement on mortgages. At existing interest rates, this would tend to increase the return on mortgages relative to the return on business loans. Then the very market forces which tend to frustrate restrictive kinds of controls, like Regulation Q, would work to induce banks to switch some assets out of business loans and into mortgages.

The difficulty, of course, is trying to figure out what would happen next. If this portfolio shift by banks resulted in a corresponding shift in real resources, the desired objective would be achieved. But, as you know, it is by no means clear that this second shift would occur.

Some economists at our Bank have been doing preliminary work to try to determine what the likely results of differential asset reserve requirements would be. So far they have been working entirely at the theoretical level, developing and manipulating a small-scale general equilibrium model.<sup>3/</sup>

So far the results are inconclusive but not very encouraging. They do show that chances of success would be greater if reserve requirements were placed on all intermediaries and not just banks; if business firms were denied the alternative of raising funds directly in credit markets; and if households were allowed to use mortgages only to finance houses. But even with all these conditions, it's difficult to rule out the possibility that the scheme would not work. Our staff is continuing to work with the model and later results may suggest a more hopeful outlook for reserve requirements on assets. We expect also to evaluate and test other possibilities for influencing the flow of funds.

### Conclusions

Let me review where we have come so far.

First, my observation of developing trends tells me that society will be demanding that more control be exercised over the allocation of resources. The problem will not go away. This outlook raises important questions for the Federal Reserve, which has traditionally disavowed responsibility for allocating credit and, hence, resources.

Second, although there is much economic validity to the position that the uneven impact of monetary policy is not solely the Federal

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<sup>3/</sup> D. C. Rao and Ira Kaminow, "Asset Reserves and the Real Investment Mix: A General Equilibrium Approach," Federal Reserve Bank of Philadelphia, unpublished manuscript.

Reserve's fault, much of the public and many legislators probably believe otherwise. They feel that these impacts do not conform with social priorities. And although the allocation of funds is considerably influenced by market imperfections, I am pessimistic about the degree of success we can expect in removing them. Even if imperfections were completely removed, allocation might well not accord with social priorities.

Third, one possible way of directing funds and resources in accordance with social priorities is through Governmental action rather than by credit control. This approach has several advantages, especially that of determining priorities by elected representatives rather than by the central bank. But more careful examination may raise questions about how effectively and efficiently the Government can direct resources. Moreover, depending on how it is done, there is a possible disadvantage over time of Federal domination of considerable parts of credit markets and the real economy.

Fourth, the Federal Reserve's past experience in directing flows has not been analyzed systematically, and there is no adequate theory on which to base policy. Results are generally believed to have been less than completely successful, however, and the present state of the art is rudimentary.

Given this train of thought, what do I conclude about whether the Federal Reserve should change its traditional focus of policy to include more attention to the direction of credit flows?

I should like to think that such a step might not be necessary. More success than we had in recent years in our overall stabilization

functions could minimize severe distortions in resource allocation caused by inflation and recession.

On the other hand, I should like to think that if the need were to become great enough, such a step would be possible. This is, first, a matter of philosophy. Few people, myself included, relish the idea of Federal Reserve involvement in the allocation of resources. The task would be difficult and thankless. It would get uncomfortably close to issues where political interests are strong. And it would raise questions about the propriety of the involvement of an organization traditionally aloof from partisan politics and "independent."

These are all formidable objections. As you may gather, however, I am less ready to dismiss a philosophy of involvement than are some others. The Federal Reserve is already influencing the allocation of resources in carrying out its overall functions. Moreover, it does not need to set priorities in order to help achieve them. Congress exercises considerable surveillance over the Federal Reserve in its attempts to meet its overall objectives. The Fed could function in a similar way with respect to Congressionally determined objectives for the allocation of resources.

As for Federal Reserve "independence," I believe the Federal Reserve can continue as a viable institution in the long run only if it is responsive to changing public demands. If the Fed is insensitive to the allocation of resources, I wonder whether it can continue as an effective, "independent" central bank with sufficient political and popular support to be able to carry out its traditional stabilization functions.

In short, I believe a good case might be made--philosophically--for involvement. My main difficulty, however, comes with the practical question of our ability to do the job. Much work needs to be done in analyzing past experience and applying sophisticated techniques of analysis to the problem. Existing controls should be analyzed; specifically, immediate attention should be devoted to revamping or dismantling Regulation Q. Alternative methods of allocating resources should be compared.

So the position I would recommend the Federal Reserve take on the question of allocating funds would go something like this: Our main job has to do with growth and stability of the overall economy, and greater success in doing this job will help to reduce problems in particular sectors of the economy. Nevertheless, we can't ignore the effects of our actions on sectors of the economy. Although the fact that certain groups are hurt when money is tight is not entirely our fault (and, of course, someone must be restricted if a restrictive monetary policy is to be effective), we recognize that this may not be a very constructive position. Everything possible should be done to make markets more competitive, but we realize that this is difficult and that even in perfectly competitive markets funds and resources might well not be allocated in accordance with social priorities. We don't know as much as we'd like about how effective credit controls may be in directing resources, but past experience does not seem outstandingly successful. Direct Governmental action to allocate resources seems preferable in a number of ways to credit controls, but there are also disadvantages in this approach which should be weighed. Although we are not anxious to get into the permanent business of directing credit flows, and although this would be a departure from

our tradition, we recognize that this might be considered a legitimate function of the Federal Reserve so long as priorities are determined by elected representatives rather than by the central bank. Therefore, we hope to explore possibilities sufficiently to be able to evaluate alternatives and to offer positive recommendations. These probably will call for action on several fronts and by several groups--Government, the Fed, and private industry--if the problem is to be solved.