Research Department
Federal Reserve
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Allocating Credit

Citing the "meat-ax, undifferentiated" impact of monetary policy upon interest-sensitive sectors of the economy, Congressman Henry Reuss (D., Wisc.) recently introduced legislation that would make the Federal Reserve System responsible for the allocation effects of policy. While conceding that the current "intractable inflation" will require considerable monetary restraint, the Congressman also argued that indiscriminate restraint is "irresponsible." Consequently, his bill would require the Fed to allocate member-bank credit so that less would be available for "non-priority uses"—gambling casinos, conglomerate mergers, non-essential real estate and "inflation-inducing" inventory accumulation—and more would be available for "priority" loans and investments. Priority areas could include, among others, loans to finance capital investments that increase productive capacity, control pollution or conserve energy; loans to finance low- and middle-income housing and small businesses; and investments in the obligations of state and local governments.

The bill calls for member-bank credit to be allocated to "priority" areas through the use of supplemental reserve requirements and credit subsidies against various bank-asset categories. Under the legislation, the Federal Reserve could require each member bank to hold supplemental reserves against "non-priority" loans and investments, in addition to the usual reserves against deposits, and could allow a bank to credit a percentage of "priority" assets against these supplemental reserves. Since these reserves (like other reserve requirements) are a form of tax, and since the credits are the equivalent of a tax reduction, their interaction would alter the relative earnings on various assets and thus provide banks with an incentive to finance priority activities.

Supporters of the Reuss proposal argue that such a system involves minimal interference with the market system and would be relatively easy to administer, and moreover, that it has been employed successfully by a number of foreign central banks. This system could be seen as a logical extension of the selective-control devices used increasingly by the Federal Reserve in recent years—Regulation Q, of course, as well as reserve requirements on a wide range of non-deposit sources of funds, such as Eurodollar borrowings by American banks and the proceeds of commercial paper sold by bank holding companies.

Flaws in the proposal
Critics of the Reuss proposal concede that, initially, more funds probably would flow to the "priority" areas favored by the credits and fewer funds to the "non-priority" areas subject to the supplemental reserves. But this might prove to be only a short-term phenomenon. For one thing, the proposal as presently constituted would apply only to banks which are members of the Federal Reserve System. Because

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the supplementary reserves are a form of tax, which increases costs, banks could be tempted to withdraw from membership to avoid the "tax." To the extent that such an attrition of membership occurred, the effectiveness of supplementary reserves as an allocating device would be reduced.

The problem of leakages would be aggravated by the exclusion of other institutions which participate actively in the loanable-funds market —nonmember banks, savings-and-loan associations and insurance companies, not to mention other financial institutions and nonfinancial corporations. Moreover, the imposition of relatively high reserve requirements on non-productive loans and investments would offer no guarantee of a reduction in the flow of credit to such uses. In all likelihood, those flows would simply shift to other sectors of the credit market, such as the commercial-paper market, as business credit demands repeatedly have done in the past in response to only slight differentials in borrowing costs. And even if we could be sure that the proceeds of a priority loan were actually being used for the intended purpose, we could not be certain that that action would not free up other resources for "non-priority" uses.

To the extent that earnings (and payouts) are adversely affected by supplemental reserve requirements, depositors and stockholders can avoid the "tax" by placing their funds elsewhere, and in an era of increasing investor sophistication and rapid technological innovation, they are likely to do so with increasing ease. (But small savers and borrowers, who are limited in their dealings to banks subject to reserve requirements, would be penalized by having, in effect, to subsidize "priority" borrowers.) At the same time, the credit aspect of the asset-reserve proposal would discriminate in reverse—against those depositors and stockholders whose institutions are not subject to any form of reserve requirement.

Plugging leakages

Supporters of the credit-allocation proposal recognize these potential leakages and note that to some extent they would be "plugged" by other proposed legislation, which would give the Fed power over the reserve requirements of nonmember banks. Some proponents, cognizant of the $300 billion available in inter-firm trade debt and internally generated funds, would attempt to plug these leakages also by extending credit allocation requirements to the whole gamut of financial and non-financial institutions. Alternatively, they would impose mandatory credit-allocation measures upon the Fed similar to those exercised over consumer, real estate and other credit during the Korean War.

In rebuttal, critics argue that past efforts to plug leakages have not

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been too successful—witness the decade-long attempt (recently abandoned) to reduce balance-of-payment deficits through controls over foreign lending and investment. Plugging all potential leakages of credit also would require the exercise of Federal aegis over state regulatory agencies.

Moreover, what specific criteria should determine what sectors qualify for "priority" treatment? Consumers and farmers, for example, might feel deserving of treatment at least equal to that afforded middle-income homebuyers, small businesses, or large firms financing additions to capacity. Also, we cannot tell what the relative impact upon employment, incomes, savings (and prices) would be of channeling credit to homebuyers as compared with (say) large industrial firms. Then there is the question of conflicting objectives among various "priority" areas. Housing, for example, may rank high as a social need, but it does not rank high in terms of one of the other criteria adduced in support of priority treatment—namely, providing needed additions to the nation's productive capacity.

Problems of equity

Credit-allocation schemes are designed to rectify problems of inequity, which ultimately arise from unequal market power. But critics argue that this inequity can be better rectified through fiscal policy, whose costs and benefits are visible and measurable, than through a maze of portfolio regulations loaded with indirect subsidies and taxes of uncertain incidence, and riddled with leakages. This approach not only would reduce the leakage problem, but would bring into sharper focus the need for determining priorities and making the necessary trade-offs between possibly incompatible objectives—such as equity, economic growth, price stability and environmental balance. Also, priorities can change, so that assigning responsibility for their determination and implementation to the Fed means giving the central bank enormous power to substitute a wide range of assumed public preferences for private decisions.

Finally, critics of asset-reserve proposals question whether foreign experience effectively validates their use, as has been claimed. Several recent investigations of the experience of Western European countries conclude that such controls cannot replace, and may even undermine, efforts to control the money supply. Also, despite the use of such measures, prices have risen even faster in Europe than in the U.S. Given this country's relatively low degree of banking concentration, the wide availability of its nonbank lending opportunities, and the relative openness of its money and capital markets, it could be argued that selective credit controls are even less likely to succeed in the U.S. than elsewhere.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/21/74	Change from 8/14/74	Change from year ago	
			Dollar	Percent
Loans (gross) adjusted and investments*	83,251	− 585	+8,280	+ 11.04
Loans gross adjusted—	65,782	− 94	+7,950	+ 13.75
Securities loans	1,177	+ 19	+ 36	+ 3.16
Commercial and industrial	23,526	+ 52	+3,033	+ 14.80
Real estate	19,782	+ 42	+2,610	+ 15,20
Consumer instalment	9,441	− 3	+ 723	+ 8.29
U.S. Treasury securities	4,633	− 336	− 499	− 9.72
Other Securities	12,836	− 155	+ 829	+ 6.90
Deposits (less cash items)—total*	79,631	− 146	+6,936	+ 9.54
Demand deposits adjusted	21,609	− 777	+ 640	+ 3.05
U.S. Government deposits	536	+ 226	+ 74	+ 16.02
Time deposits—total*	55,968	+ 429	+5,846	+ 11.66
Savings	17,758	− 7	+ 13	+ 0.07
Other time I.P.C.	28,840	+ 292	+5,431	+ 23.20
State and political subdivisions	5,954	+ 18	− 236	− 3.81
(Large negotiable CD's)	15,787	+ 428	+3,762	+ 31.28

Weekly Averages of Daily Figures	Week ended 8/21/74	Week ended 8/14/74	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	114	31	11
Borrowings	413	226	126
Net free (+) / Net borrowed (−)	− 299	− 195	−115
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (−)	+ 739	+1,277	0
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (−)	+ 528	+ 530	+142

*Includes items not shown separately.

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