

Research Department
Federal Reserve
Bank of
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Allocating Credit

The job of allocating credit among the various sectors of the U.S. economy is performed primarily by natural market forces. But, at various times in our history, we have heard calls for selective intervention in the credit-allocation process to control total credit, or to ensure that adequate credit is available to preserve the level of activity in "high priority" sectors of the economy.

During the Korean War, for example, the Federal Reserve imposed minimum-downpayment and maximum-maturity regulations on real-estate and consumer credit, as a means of cooling the demand for housing and durable goods. In addition, regulations of a different type have developed in the mortgage-lending industry, designed to increase the flow of credit to the housing sector and to protect that sector from the sharp downturns which it tends to experience during tight-credit periods. For example, the limitation on consumer lending by savings-and-loan associations, and the quarter-point differential in deposit-rate ceilings between S&L's and banks, reflect a continuing effort to allocate credit to housing and thereby stimulate more building activity.

The present tight-credit period may lead to further efforts to protect credit flows to special sectors of the economy. Political pressure is mounting, for example, to revive the Emergency Housing Assistance Act, passed during the last recession to assist low- and medium-income homebuyers through mortgage-rate subsidies. Similarly, the National Savings and Loan League has called for the extension of the quarter-point deposit-rate differential to any institution making a substantial commitment to mortgage lending. Whether or not policymakers should heed these calls depends upon the answers to two basic questions: First, is there a sound economic rationale for allocating credit? And second, is it actually possible to allocate

credit effectively? This article discusses each of these basic issues in turn.

Why allocate?

The aim of credit allocation is to influence the sectoral distribution of real resources. But why interfere in the normal resource-allocation processes of the economy? Proponents of credit allocation argue that some markets contain externalities or imperfections, which make it impossible for them to perform their resource-allocation task correctly. For example, the allocation of resources to housing would be "too low," it is often argued, without government intervention, because the private market is blind to the social importance of housing. In this view, housing is not only shelter, but also a key ingredient in a stable society.

A similar logic is often used to restrict the flow of credit to certain activities. Policymakers maintain high margin requirements on loans for purchasing corporate stocks, for example, because of fears of destabilizing speculative activities, which could have destructive consequences for the rest of the economy. Analogously, banks and S&L's presently resist making mortgage loans to individuals who don't intend to occupy the dwellings they purchase, on the grounds that such borrowing may lead to speculative excesses. Policymakers generally accept this line of reasoning about market imperfections, although economists have found it difficult to quantify such considerations.

Some wish to change the allocation of real resources in the economy because of concerns about the distributional effects of monetary policy. When the aggregate supply of money and credit in the economy is altered, the various sectors of the economy are seldom affected equally. During the early stages of a tight-credit period, for example, homebuilding activities seem to be hurt disproportionately. Proponents of credit

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allocation thus would like to use controls to spread the monetary-policy burden more evenly over the various sectors of the economy. But would the effectiveness of stabilization policy be affected by altering its incidence? Some monetary economists believe that the "natural" allocational impacts of monetary policy are important in promoting policy effectiveness, and that selective credit controls should not be used to redistribute the burden. Opinions vary on this point, however.

Finally, some economists reluctantly embrace selective credit controls as a means of offsetting the effects of other controls that are already in place in the economy. Thus, for example, when Regulation Q deposit-rate ceilings interact with rising market interest rates to precipitate disintermediation of funds from primary mortgage lenders, some economists would support attempts to rechannel resources to the housing industry with credit-allocation devices.

Can credit be allocated?

Even if a case can be made for interfering with the distribution of real resources, the manipulation of credit flows may not be a very effective or economically efficient means of achieving this objective. There are both theoretical and practical bases for this viewpoint.

First, credit conditions affect the cost of only one factor of production—the cost of capital. (For example, increasing the availability of mortgage credit may affect the interest cost.) When credit policies alone are used to stimulate (or retard) output in a particular sector, the *mix of inputs* is also affected because of a change in relative factor prices. Distortion of the input mix introduces a new source of inefficiency, which offsets part of any efficiency gains that could be expected from the redirection of output. Mechanisms which affect output directly—such as per unit subsidies or taxes on output—would thus be preferred to credit-allocation policies on theoretical grounds. (Politically, of course, the reverse is true. Tax or subsidy policies generate highly visible line items in government budgets, whereas the costs of credit-allocation policies are concealed by the complexity of the economy. Hence, most policies to promote housing activity involve credit-allocation devices even though it would be cheaper—in an overall efficiency sense—to achieve a given objective with direct subsidies.)

Secondly, credit-allocation policies may be criticized because of the practical difficulty of allocating credit in a modern economy in a way that actually restricts or enhances a particular real sector. The reason is quite simple: both borrowers and lenders have considerable flexibility in substituting one type of credit for another.

Consider the case of a household that desires to acquire additional consumer durables but faces (as it did in 1950-52) a limitation on the available amount of consumer credit. If there is a one-for-one relationship between purchases of consumer durables and assumption of consumer debt, the credit restriction will translate into a restriction of consumer expenditures. However, the typical household has alternative means of satisfying its excess demand for durables. (For example, it may take on a greater home-mortgage debt than otherwise, draw down financial-asset balances such as savings accounts, or sell other real assets to obtain the

funds to purchase additional durable goods.) An attempt to restrict consumer credit affects only one of the avenues that a household has available to facilitate a desired rearrangement of its portfolio. Thus, depending upon the substitutability (or "fungibility") of consumer debt and asset sales in the household portfolio, a credit-allocation policy may fail to translate into the desired restriction on consumer-durable expenditures.

Similarly, restrictions on lending institutions can be "evaded" by substitution of assets across financial institutions. Portfolio restrictions on S&L's, for example, are designed to increase S&L mortgage lending and thereby to increase the overall volume of mortgage credit. However, by causing S&L's in effect to increase their mortgage holdings above what they would desire in an unregulated environment, the restrictions increase S&L's demand for mortgages and drive the mortgage yield down relative to the yield on alternative types of loans. This tends to reduce the willingness of other institutions to offer mortgages while increasing their willingness to offer alternative loans, and thereby offsets the intention of the original S&L portfolio restriction.

The longer a credit-allocation device is in place, the more likely is the development of some means of circumventing it. Thus, restrictions against consumer lending by S&L's very likely have promoted the development of alternative sources of consumer credit, such as credit unions and consumer-finance companies. Similarly, today's money-market funds would surely not exist at their present scale if deposit interest-rate ceilings had not been used to control credit flows at banks and S&L's.

The evidence

Several studies have attempted to evaluate empirically the extent to which these substitution effects thwart the intent of credit-allocation policy. Most such studies suggest that it is very difficult to manipulate the real economy with credit controls, except in the very short run, because of the ability of

borrowers and lenders to innovate and effectively circumvent such controls. Hamburger and Zwick (Federal Reserve Bank of New York), for example, found that controls on consumer credit failed to affect purchases of consumer durables during the Korean War period. Similarly, most studies point to the negligible long-run effect of attempts to stabilize housing by directing credit to this market. Apart from the redistribution of economic activity in the short run, the only effect of credit-allocation restrictions thus may be the inefficiency that results from efforts to evade them.

Altogether, the case for credit allocation is clearly not a strong one. Anyone arguing in favor of credit allocation must demonstrate (a) that there will be economic benefits from the intended reallocation of resources, and (b) that such a policy will not be thwarted by innovative behavior on the part of households and institutions. At best, credit allocation may be effective in a short-term countercyclical context to alter the sectoral incidence of monetary policy. But this application has unknown implications for the conduct of macro-economic policy. In this light, it is not surprising that Federal Reserve Chairman Volcker emphasized his opposition to selective-credit controls in recent Congressional testimony.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/6/80	Change from 1/30/80	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	137,670	+ 509	+ 16,990	+ 14.10
Loans (gross, adjusted) — total#	115,213	+ 790	+ 16,750	+ 17.00
Commercial and industrial	33,101	+ 336	+ 4,143	+ 14.30
Real estate	44,270	+ 125	+ 8,664	+ 24.30
Loans to individuals	24,691	- 9	+ 4,170	+ 20.30
Securities loans	1,368	+ 65	- 240	- 14.90
U.S. Treasury securities*	6,980	- 219	- 642	- 8.40
Other securities*	15,477	- 62	+ 882	+ 6.00
Demand deposits — total#	44,851	+ 1,505	+ 5,061	+ 12.70
Demand deposits — adjusted	31,944	- 167	+ 2,489	+ 8.50
Savings deposits — total	28,278	+ 148	- 1,564	- 5.20
Time deposits — total#	58,948	- 152	+ 8,062	+ 15.80
Individuals, part. & corp.	50,217	- 55	+ 8,862	+ 21.40
(Large negotiable CD's)	21,111	- 212	+ 2,346	+ 12.50
Weekly Averages of Daily Figures	Week ended 2/6/80	Week ended 1/30/80	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	- 19	- 9		20
Borrowings	19	336		31
Net free reserves (+)/Net borrowed(-)	- 38	- 345		- 12
Federal Funds — Seven Large Banks				
Net interbank transactions [Purchases (+)/Sales (-)]	+ 3,723	+ 1,526		+ 881
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (-)]	+ 69	- 436		+ 346

* Excludes trading account securities.

Includes items not shown separately.

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