SOCIAL PRIORITIES AND THE MARKET ALLOCATION OF CREDIT

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In recent years we have heard much discussion concerning financial responsibility and social goals. Some contend that there is a widening gap between the performance of our financial institutions and the desires of society. They believe that society has great concern for individual sectors of the economy, whereas the financial community is concerned primarily with the function of the whole economy rather than specific areas of activity.

Many economic sectors are alleged to have received unfavorable treatment in the allocation of funds through financial markets. Such sectors include housing, state and local government, small business, and agriculture. The farm sector has been included in the "so called" credit starved category throughout most of the current century and has received favorable legislative treatment in a number of instances, including some subsidy payments in credit extension for several decades. An earlier reason advanced for the shortage of credit in agriculture was the isolated nature of farms relative to major financial centers. This was alleviated, however, with the organization of the Farm Credit Banks and the provision for their local lending facilities.

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These cooperative banks with farmer directors provide farmers with a direct pipeline to national money markets. Nevertheless, many small farmers continue to receive subsidized credit based on social priorities. The housing industry followed agriculture in receiving favorable legislative treatment in the form of special lending agencies, guaranteed loans, and, in some instances, loan subsidies. The alleged unfavorable performance of the credit and capital markets in supplying funds for small business was followed by the establishment of special credit agencies for supplying credit to such firms at special rates. The problems observed in providing credit for state and local governments are of more recent origin.

Most of the agitation for setting social priorities on credit flows has occurred during periods of high nominal interest rates. During such periods, market barriers such as usury laws, legal limits on rates that state and local governments can pay, Regulation Q, and ceilings that savings and loan companies can pay on time and savings are more effective in diverting credit flows from normal patterns than when interest rates are relatively low. These diversions tend to starve some sectors while other sectors not subject to such regulations can pay the market rates and obtain more funds than would have been available had free market conditions prevailed for all users. Such restrictions probably have little effect on the total volume of savings or new credit creation through monetary action and funds diverted from some users will enhance the supply of credit available for others.

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A number of social credit priorities was included in the original Federal Reserve Act. Agricultural paper, for example, was given the special consideration that maturities of such paper not exceeding six months (later extended to nine months) were eligible for discount. Maturity requirements were more stringent than those for other paper. Short term paper, or real bills, arising from commercial transactions were likewise given preference over most other instruments in the credit market. Discounting was based on the theory that Federal Reserve Banks should lend only on paper originally created to finance the production and marketing of goods and should not lend on paper the proceeds of which were used to finance fixed or speculative investments or to trade in stocks and bonds other than obligations of the United States Government.

With the decline of the discount mechanism as a major monetary policy instrument in the 1930's, use of the Central Bank to channel credit to areas with high social priorities likewise declined with the exception of controls on stock market credit which may have channeled marginal amounts of funds to other areas. At the beginning of World War II, the buildup of defense industries was given high priority and received aid through the V loan program administered by the Federal Reserve. Consumer credit controls were instituted about this time and both consumer and real estate credit controls were used during the Korean conflict to reduce credit flows and demand for resources in these sectors. Following World War II and the Korean buildup, the Central Bank reverted to its pre-war position of relative neutrality with respect to

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credit allocation. Inadvertantly, however, credit flows were altered in recent years as a result of interest rate restrictions, but the increased use of credit was not in the direction desired by the social priority proponents. Credit available for home purchases, for example, was excessively restricted as savers bypassed the home financing agencies in favor of investments, the returns on which were not subject to the restrictions.

With the high interest rates of recent years and the rising number of effective legal barriers to the payment of market rates, the performance of capital markets has again been a favorite subject for discussion by financial analysts. A number of proposals has been made for establishing social priorities on credit flows by using financial agencies including the Federal Reserve System to increase these flows to sectors having high social priority. Suggested means that could be made available to the Federal Reserve for altering credit flows to specific sectors include variable reserve requirements against bank assets that would require a higher ratio of reserves to assets in the lower priority groups and lower reserve ratios against high priority paper, greater selectivity in open market purchases, selective use of the discount mechanism, moral suasion, quotas, margin requirements, and direct controls.

It is my belief that most of the actions contemplated on the basis of these proposals are not in the public interest, that they would result in inefficient use of resources, and, if aid to the lower income groups is the objective, such

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social priorities are an inefficient way of providing the assistance. I question whether most credit controls actually alter resource use in a signficant manner. Furthermore, it is my belief that the monetary authorities can make a greater contribution to national welfare by concentrating on overall economic stability rather than attempting to maintain stability or enforce collective decisions in specific sectors. If we provide the appropriate actions for overall stability, market forces will assure that individual sectors are treated equitably in the absence of restrictions in a competitive enterprise economy.

I suggest that for most economic activity we have little justification for setting social priorities. I recognize that a number of functions should appropriately be included in the public sector. Benefits received from some functions such as ideas, theories, social order, inventions, air pollution control, common defense, and monetary control cannot readily be captured by an individual without the aid of collective action. A lighthouse is a classic example of a function that should be in the public sector. It provides equal benefits to both owners and nonowners of ships in its vicinity, and its use by one ship does not reduce its services for other vessels. We justify expenses for public education on the basis that all citizens receive some benefits from the educated individuals. In order for the public to enjoy the benefits of such public goods and services, collective expenditures are necessary. Such expenditures do not ideally provide benefits to taxpayers in proportion to the taxes collected from each individual, but the alternative is no services in these areas which may mean a reduction in welfare to the entire community.

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In contrast to functions which are clearly in the public sector, benefits from most economic activity can readily be captured by the individual without community action. Given the incentive for individuals to spend their funds in such a way as to provide maximum want satisfaction, their demands for goods and services provide a better guide to producers than social priorities. The establishment of legal social priorities is simply the modern method of substituting the collective decision of government for individual decision-making. In defense of this position for individual decision making, I would point out that any diversion of resources to enhance output in one sector such as residential housing requires a reduction of resources in other areas. Such reductions more than offset the gains in well-being from the additional houses if marginal expenditures resulted in maximum want satisfaction prior to the diversion. Such priorities force individuals into a pattern of expenditures which provides less than optimum want satisfaction in a free market setting. The problem simply resolves into a case of whether or not each individual is better off while spending his own income on goods and services of his own choice or when society takes over the job of deciding through social priorities how his income is to be used and what goods and services will be available for consumption. I lean strongly toward leaving such rights to income with the individual unless there is overwhelming evidence that vital activity cannot be performed in the absence of social action.

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One prime example of the inefficiency in ordering production on the basis of social priority in the United States is the result of our agricultural programs during the past several decades. In the 1930's and again in the 1950's we decided that the market system was functioning poorly in the farm sector, resulting in farm incomes that were too low relative to incomes in the nonfarm occupations. We first moved to remedy the assumed problem by setting a floor under farm commodity prices with the aid of a government price support program. The price supports established were generally above free market levels and provided incentive for excessive production of farm products. Our stocks of farm products in government holdings purchased in its price support operations rose to excessive levels. We have taken numerous measures to reduce these stocks, including subsidized exports, subsidized school lunches, food stamps to low income groups, a land rental program to remove millions of acres of cropland from production, and crop allotments which arbitrarily limit the acreage planted of many crops. Overlooked entirely, however, was the fact that the market price was the only one that provided just enough incentive for farmers to produce the quantity of farm products that would clear the market. It is the only price which will avoid the accumulation of excesses or shortages of farm products. The market price is also the only price that will provide an appropriate rate of return to labor, and other resources and thereby the right amount of incentive for adjustments of resources between agriculture and other sectors

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to maximize overall economic output. Any other rate of resource adjustment will tend to penalize output and reduce the volume of goods and services available to consumers.

Agriculture like other sectors of a competitive economy is self-adjusting, provided market forces are permitted to operate freely. If incomes to farm resources are too low relative to returns in other areas, more farmers and farm youth will obtain employment in the nonfarm sector. Similarly, if incomes rise higher in agriculture relative to other sectors, we will have an expansion of farm workers, until returns to workers of equal ability are equal in all sectors of the economy after allowance for nonmoney factors.

Social priorities are an inefficient means of providing welfare to lower income groups. For example, if the nation decides to place a high social priority on residential housing for these groups, the following series of impacts on the economy can be expected. First, resources must be diverted from other sectors to the housing sector. This reduction of resources will mean fewer goods and services produced in these sectors or less capital for future consumption. Consumers can give up other goods and services which they prefer under free market conditions for an equivalent dollar volume of goods in the form of residential housing, but they have demonstrated through the price system that the diversion of income to housing is of a lower value to them. It is a case of the public imposing its collective values on the individual.

There is the possibility of a trade-off between housing and other forms of wealth with no reduction in current consumption. For example, given full use of resources, more houses can

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be built at the expense of reduced investment elsewhere. The long-run impact of this action is less national wealth and fewer goods and services available for consumption in future periods. More importantly than the trade-off feature of social priorities from an economic view is the fact that the well-being of the lower income groups would be further enhanced by money income than by the same amount of income diverted to them in the form of housing subsidies. The housing subsidy, for example, forces the population to spend more funds on something which provides less than maximum satisfaction, whereas, if the funds are allocated to individuals, they would make individual spending decisions which provide greater welfare.

In addition to the above efficiency problems social priorities which divert flows of goods and services are extremely biased against those individuals who already possess adequate amounts of the goods and in favor of those in the process of making such purchases. For example, those persons in the lower income groups who already have adequate homes are penalized when resources are diverted through social action to home building from other areas. They must pay a higher price for nonhousing goods and services. In contrast, the prospective home purchaser gains to the extent of the subsidy on home construction or home financing.

In view of the problems in establishing social priorities in the private sector of our economy, it is my belief that such priorities should be limited to transfers of funds to the lower income groups rather than the provision of goods and services. Just because someone else doesn't spend his income for the same purposes that we spend ours is not a sufficient reason for collectively altering his spending pattern. Our own spending patterns may similarly appear unwise to others.

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Reasons for not attempting to promote social priorities through central bank action to alter credit flows in the private sector are even more persuasive. The recent period in which Regulation Q limited the payments on savings by banks and the Home Loan Banks restricted savings and loan association payments to savers contains evidence of the complex nature of the problem. While an objective of the restrictions was to maintain low rates to home purchasers, the reverse was closer to the actual result. Important supply and demand forces in the financial markets were overlooked. The flow of savings through the financial agencies was reduced as a result of the rate restrictions, while the cutting edge of loan demand shifted to the right with the excessive money creation, and the rates charged on new mortgages rose sharply. Since business loans and investments continued upward, the restrictions may have actually diverted funds away from home mortgages and caused higher than free market rates to home purchasers.

Even in the case of the suggested variable reserve requirements on bank assets, the results cannot be outlined in simple terms. It is true that if the Federal Reserve System were to set reserve requirements higher on business and consumer loans than on residential housing loans, commercial banks would tend to increase their loans to home purchasers and reduce loans to businesses and consumers. As in the case of Regulation Q, however, it is easy for funds to bypass the commercial banking system when the incentive prevails. Thus, if rates charged businesses and consumers rise relative to rates on home loans, the diversion of bank credit flows may be offset by changes in

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the flow of nonbank funds. The nation's larger business firms have direct access to the money markets and can readily bypass banks if banking efficiency in meeting their demands is impaired. Other credit agencies can take up the slack in most other loan demands where attempts are made to divert bank credit flows.

Commercial banks are only one of several agencies which channel funds from savers to investors. On the basis of estimates published by Bankers Trust Company, New York, commercial banks supplied less than 20 per cent of all investment funds raised in 1969 and less than 25 per cent of all short-term funds raised. Of the total investment funds supplied, both the contractual type and the deposit type savings institutions exceeded the quantity raised by commercial banks. The contractual institutions which include life and fire and casualty insurance companies, private pension funds, and government retirement funds, raised an estimated $23 billion, or more than double the amount of such funds raised by commercial banks.

Commercial banks likewise supplied a relatively small portion of the short-term funds raised. Such banks supplied only $9.5 billion of the $38.6 billion total. All other savings institutions supplied $6.4 billion. Almost two-thirds of the total raised, $24.4 billion, was supplied by other business corporations. Other investor groups such as brokers, consumer lenders, and foreign investors were net users of $1.7 billion of short-term funds.

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Finally, and more importantly from my own view, is the fact that attempts by the Central Bank to stimulate activity in areas with high social priority will reduce its effectiveness in maintaining appropriate monetary and economic stabilization policies. The latter is a job which the Federal Reserve System is iminently qualified to do, provided it is not hampered by excessive nonstabilization duties and other restrictions which have little in common with this overall objective. Once the System becomes excessively concerned with activity in individual sectors rather than with the economy as a whole, its usefulness will be greatly impaired.

It is doubtful that the Federal Reserve can detect the reasons for changes in economic activity in specific areas better than other market participants. Some lines of activity decline because of declining demand, obsolescence, and other factors not associated with financial impediments. Conversely, activity in other areas may increase as a result of changes in basic supply or demand factors. Such basic factors are readily detected and acted upon in the market place. The appropriate resources are adjusted to meet the changed conditions. A minimum of waste occurs during the adjusting process. It has been my experience that the application of social priorities to ease the burden of such adjustments has usually prolonged the adjustment unnecessarily and has been incurred at excessive social cost. The Federal Reserve is not likely to improve on this poor record of other government agencies by attempting to achieve social priorities through credit allocation. Furthermore, the loss of rights to equal access to credit markets, like other

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restrictions on economic activity in the private sector, is a further unnecessary encroachment on individual freedom.

In conclusion, I believe that the case for establishing high social priorities for output in specific sectors of the competitive sector of our private economy has been greatly overstated. The use of legislative action to establish social priorities is a means of determining through collective rather than individual decision-making what goods and services will be produced. We can justify collective decision-making in most activity during national emergencies on the basis that it is necessary for survival, but during normal conditions the competitive market through individual rather than collective decision-making is a more efficient allocator of resources. Most of the agitation for setting priorities on credit flows has occurred during periods of high interest rates when ill-advised regulations were the chief factor in creating the excesses and shortages. The removal of these restrictions will permit the system to work effectively and alleviate most of the observed problems.

Our record of establishing social priorities in the private sector has not been a success. Our farm programs designed to correct the assumed illness of income allocation is an example of such social action. Earlier price support programs which ignored basic supply and demand forces were followed by more expanded programs to correct newly observed problems. Like the proverbial punching bag that expanded elsewhere when punched from the front, each new regulation created another problem that required new legislation. We have still not been able to get the government out of agriculture, and

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the expanded programs continue at great social cost. Such regulations have been a factor in retarding farm export markets, they have reduced output in both the farm and nonfarm sectors of the economy, and have been relatively ineffective in increasing returns to individuals. Their proponents fail to recognize that resources including labor adjust to income incentives in all sectors.

To the extent that social priorities are effective in altering credit flows in the private sector, they reduce national welfare. Resources are reduced in some sectors and increased in other sectors through collective decisions. The collective spending pattern imposed on the individual, however, is not compatible with maximum want satisfaction. If an increase in transfer payments to the lower income groups is the objective of social priorities in the financial area, we can purchase more welfare with the same amount of money through cash grants than through grants of goods and services. Through cash expenditures each person can obtain maximum want satisfaction for each dollar spent.

Finally, the Federal Reserve is not an appropriate agency to be in charge of social priorities. The use of such gadgets as reserves on bank assets to alter credit flows increases the problem of maintaining control over monetary aggregates. Such control is essential for economic stablization. But more important is the fact that such duties as the maintenance of economic health in specific sectors of the economy will likely detract from the Central Bank's overriding responsibility for approrpriate stabilization policies for the total economy. It is through this route of providing sufficient flows for an

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appropriate level of total activity and permitting the credit and capital markets to function freely that appropriate sector allocation of funds is achieved. In this manner the Central Bank can make its maximum contribution to national welfare.

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