

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 with specific areas of activity.

Many economic sectors during the past several decades allegedly received unfavorable treatment from the market allocation of resources, especially the allocation of funds. Such sectors include housing, state and local government financing, small business, lower income groups, and agriculture. A natural consequence of this alleged inefficient allocation of resources is an improved system of resource allocation.

In a world of scarcity the allocation of resources is an important function. It determines the type and quantity of goods and services that will be available to consumers. This function can be performed either through social priorities or through competitive markets. Allocations through social priorities are in reality subjective decisions of society which are administered by

the government. In contrast, allocations through the market place are the result of individual decision making in the daily purchasing of goods and services. Such purchases indicate to producers the type and quantity of goods and services to produce. Producers in turn purchase the resources as labor and capital to provide a level of production necessary to meet consumer demands at market prices. In making the choice between these systems of resource allocation we are faced with issues relative to both economic welfare and freedom.

It is my belief that the market system of allocation of resources provides both greater economic welfare and more individual freedom of choice and that most of the alleged imperfections in financial market performance have been the result of excessive restrictions.

I shall contend in this discussion that most of the actions contemplated on the basis of social priority proposals would result in inefficient use of resources, and that if aid to the lower income groups is the objective, goods produced on the basis of social priorities are an inefficient way of providing the assistance. I question whether most credit controls actually alter resources in the socially desired direction. 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. In the absence of restrictions if we provide the appropriate actions for overall stability, market forces will assure that individual sectors are treated equitably in a competitive enterprise economy.

Most of the impetus for setting social priorities on credit flows has occurred during periods of high nominal interest rates or of great depressions (notably housing in recent years and agriculture in the 1930's). With the high interest rates in recent years, market barriers such as usury laws, legal maximum rates on state and local government debt, and commercial bank and savings and loan company interest rate ceilings on savings have been more effective in diverting credit flows from normal patterns. Such restrictions probably have little effect on the total volume of savings or credit. Such market barriers have tended to starve some sectors, while other sectors not subject to the regulations have paid the market rates and obtained more funds than would have been available had free market conditions prevailed for all users.

In order to correct these assumed defects of the capital and credit markets, a number of proposals have been made for establishing social priorities on credit flows through financial agencies including the Federal Reserve System. Variable reserve requirements against bank assets, open market purchases, selective use of the discount mechanism, moral suasion, quotas, margin

requirements, and direct controls have been suggested as means for altering credit flows to specific sectors. If reserves are required against assets and it is desired, for example, to increase investment in housing relative to other investments, the reserve requirements on other investments could be increased and the rate on residential mortgages reduced. It has been suggested that Federal Reserve Open Market purchases include FNMA securities, thereby increasing the volume of funds available for homes. Most of the direct means of altering credit flows, such as Regulations W and X, have at one time or another been used for social priority purposes.

Social Priorities Included in Federal Reserve Act

A number of social priorities were included in the discount provisions of 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 for other paper. Short term paper, or real bills, arising from commercial transactions was likewise given preference over most other instruments in the credit market.

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. An exception was the 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 the 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 credit allocation. Inadvertantly, however, credit flows have been altered in recent years as a result of interest rate restrictions which became increasingly effective in reducing flows through normal channels as rates increased. These restrictions probably resulted in a loss of funds to the housing industry and a gain to many businesses where returns on investments were not restricted.

The problem of whether or not economic activity should be based on social priorities resolves into whether the individual should decide what goods and services will be available for consumption or whether this decision shall be imposed on the individual through social action. I lean strongly toward leaving such rights to income with the individual, unless there is overwhelming evidence that vital activity cannot otherwise be performed.

Some Activities Require Public Action.

I recognize that a number of functions should appropriately be included in the public sector. Benefits received from such functions as ideas, theories, social order, inventions, air pollution control, common defense, and monetary controls provide general benefits which cannot be completely captured by an individual without the aid of collective action. Clean air which may require considerable expenditures on the part of some individuals and some industries provides substantial benefits to the entire community which cannot be completely captured by those making the investment. 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.

Other Activities Performed More Efficiently
In Private Sector

In contrast to activities which are clearly in the public sector, most economic benefits 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 more efficient guide to producers than do priorities established by legislative action. The establishment of legal priorities is simply a method of substituting the collective decision of government for individual decision-making.

The establishment of social priorities is a tradeoff of one type of activity for another. Total volume of goods produced remains unchanged in the case of full employment. The diversion of resources to enhance output in one sector such as residential housing, with a reduction of resources in other areas, however, is not neutral with respect to economic welfare. If marginal expenditures by each person resulted in optimum satisfaction prior to the diversion, the goods and services foregone will be of greater value to consumers than the gains from the additional houses. In other words the additional houses provide less welfare than would have been provided by the goods and services foregone, as indicated by the free market purchases prior to the arbitrary diversion. Such priorities thus force individuals into a pattern of expenditures which provides less than optimum want satisfaction.

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 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.

One prime example of the inefficiency in ordering production on the basis of social priorities in the United States is our agricultural programs of the past several decades. In the 1930's and again in the 1950's, farm incomes were assumed to be 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 to many crops. The alleged problem and the inefficient programs continue. Overlooked has been the

fact that the long-run 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 incentive for adjustments of resources between agriculture and other sectors 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.

Another example of the wasteful use of resources based on public ordering of production is much of our public housing. Despite the sizable subsidies provided the occupants, a large proportion of the units in St. Louis are vacant and the operations

are in a constant state of insolvency. Such waste is not limited to our nation or our time. Modern hotels have been built in some of the underdeveloped countries where few potential customers exist. The numerous edifices of the Middle Ages and the very expensive mausoleums of ancient times to provide appropriate tombs for royalty are examples of resource diversions which were detrimental to the masses.

Cash Payments Most Efficient for Welfare

The allocation of goods and services through social priorities are an inefficient means of providing welfare to lower income groups. The well-being of the lower income groups would be more 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 a pattern of consumption on these groups which conforms to the taste of the authorities rather than to that of the individual. It is thus less valuable to individual users than if an equal amount of funds were allocated to them.

In addition to the above efficiency problems, social priorities which increase flows of some types of goods and services are extremely biased against those individuals who already possess adequate amounts of these goods and in favor of those in the process of purchasing such goods. For example, those persons who already have adequate homes are penalized

when resources are diverted through social action to home building from other areas. With fewer resources allocated to 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.

It is true that the private sector makes errors in resource use. Here, however, the decision-maker suffers a financial loss when resources are used inefficiently, giving him great incentive to avoid waste. I would also agree that all individuals and firms do not have equal access to the credit markets. Access to such markets is determined in part by the assets of the borrower and borrowers are not equally endowed with assets to offer. On the other hand the market system limits waste of scarce credit resources to a minimum whereas other methods of allocation offer no assurance that efficient use of credit will be achieved.

In view of the problems of establishing social priorities in the private sector of our economy, it is my belief that such priorities should be limited to direct 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 similarly to our own spending habits is not a sufficient reason for collectively altering his spending pattern. Our own spending patterns may similarly appear unwise to others.

Precise Control of Financial Flows Difficult

There are additional reasons for not attempting to promote social priorities through central bank action. Our attempts to alter financial flows in the past have been less than satisfactory. The recent period in which Regulation Q and other restrictions limited the yield on savings accounts evidence s the complex nature of the problem. While an objective of the restrictions was to maintain low interest rates to home purchasers, the reverse was closer to the actual result. Important supply and demand forces in the financial markets were not given sufficient consideration. The flow of savings through the financial agencies was retarded as many savers invested their savings at higher rates in other assets not subject to the restrictions. This tended to reduce the supply of funds to the savings institutions and thereby lessened the flow of funds into the housing market. In addition, loan demand rose as a result of rising total demand caused by 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 rates to home purchasers than would have been charged if banks and savings and loan associations had been free to compete for funds at higher rates.

Likewise, 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 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 increases in 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 - 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.

Federal Reserve Should Concentrate On Economic Stabilization

Finally, and more important 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 policies for economic stabilization. The latter is a job which the Federal Reserve System is eminently qualified to do, provided it is not hampered by excessive nonstabilization duties and 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, such as in agriculture where we have incurred 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 restrictions on economic activity in the private sector, is a further unnecessary encroachment on individual freedom.

Conclusion

In conclusion, I believe that the case for establishing high social priorities for output in specific sectors of our competitive 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 suggestions for setting priorities on credit flows have occurred during periods of high interest rates or major depressions when ill-advised regulations and public policies were the chief factors in creating the excesses and shortages. The removal of these restrictions and the maintenance of a fairly stable rate of growth in the stock of money will permit the system to work effectively and alleviate most of the observed problems.

Our record of performance on the basis of social priorities in the private sector has not been a success. Our farm programs designed to correct the alleged illness of income allocation is an example of such failures. 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 still have not been able to get the government out of agriculture, and the

expanded programs continue at great social cost. Such regulations have been a factor in retarding our 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. The nonfarm programs contain the same inefficiencies that can be observed so clearly in the farming sector. Resources are reduced in some sectors and increased in others 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 low 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 stabilization. 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 appropriate stabilization policies for the total economy. If a stable rate of growth is achieved in total economic activity the credit and capital markets functioning freely will provide the most efficient allocation of funds to specific sectors. It is through this route of providing sufficient flows for an appropriate level of total activity that the central bank can make its maximum contribution to national welfare.