
Credit Controls: Reinforcing Monetary Restraint

by John M. Godfrey

As part of his March 14 anti-inflation program, President Carter provided the Federal Reserve with authority to restrain the growth of certain kinds of credit. Recently, the Fed has begun to scale down the restraints, but the reasons, timing and effectiveness of the program, have been a controversial topic for bankers, businessmen, and consumers. Research officer John M. Godfrey examines the program and places it in the context of the financial developments that led up to the controls.

Why Credit Controls Were Imposed.

When the Federal Reserve embarked on new procedures for implementing monetary policy on October 6, 1979, many people felt that the Federal Reserve at long last had a firm handle on monetary restraint. Indeed, during the final quarter of 1979, growth in the monetary aggregates slowed to within the Federal Reserve's announced long-run target ranges. Economic and financial developments seemed to indicate that the Federal Reserve would be able to control monetary growth and thereby bring down inflation.

However, in early 1980, it became increasingly clear that the economy was performing differently than had been expected. Many people expected that the economy would begin to slow down and, in fact, enter a recession, or at least that the results of the earlier tightening would be beginning to appear. However, the

economy actually experienced positive growth in the last quarter of 1979, and there was still little or no indication it was moving into a recession in early 1980. Short-term interest rates, as measured by the Federal funds rate, drifted down during January 1980 from slightly over 14 percent to slightly under 12 percent. And while the Federal Reserve no longer emphasizes the Federal funds rate quite so much as a policy guide, some people interpreted the downward drift in this rate as a sign that the Federal Reserve was not seriously attacking inflation.

At the same time that short-term rates drifted down, rates in the long-term bond market moved up during January by 50 to 100 basis points. Also, credit demands were extremely strong. Business loans, and particularly those at the larger banks, accelerated to a 25-percent or higher annual rate. The President's budget,

submitted in late January, projected a deficit of \$15.8 billion for fiscal 1981, the year beginning October 1, 1980, and ending September 30, 1981. Many people were disappointed with this deficit figure because they feared increased defense spending (in light of the Soviet invasion of Afghanistan) would lead to an even larger deficit.

Perhaps the most significant realization to take place in early 1980 was an increasing awareness that inflation would be much worse than previously expected. Inflation had accelerated to slightly over 12 percent during late 1979, and by early 1980 prices were running at close to a 20-percent annual rate. Speculation was heating up the commodities markets: notably, gold soared to over \$850 an ounce, and silver was up to over \$50 an ounce. Clearly, expectations of inflation had changed for the worse.

By early February, the long-term credit markets began to deteriorate quite rapidly. Long-term interest rates rose sharply, and analysts began to characterize bonds as being in a "free fall." On February 15, after the producer price index was announced for January, the Federal Reserve Board reacted by raising the discount rate from 12 percent to 13 percent. Still, the credit markets continued to deteriorate, and some people began to fear that the disorderly conditions would lead to a credit crunch (i.e., credit would be denied to many otherwise credit worthy borrowers at any price.) These deteriorating conditions called for a strong policy reaction to deal with the worsening inflationary expectations.

The President's Anti-Inflation Proposal. On March 14, President Carter announced a 5 point anti-inflation

President Carter's Anti-Inflation Proposals

- Increased Discipline in the Federal Budget
 - Restraints on Credit
 - Wage and Price Actions
 - Greater Energy Conservation
 - Economic Structural Changes to Encourage Productivity, Savings, Research and Development
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proposal. The President first announced there would be increased discipline in the Federal budget. He indicated that the budget for fiscal 1981, submitted just six weeks previously, would be resubmitted and would show a small surplus. By late March, a new budget had been drawn up where spending was reduced slightly and revenue projections were raised so that a small surplus would develop. The second part of the President's program was increased restraint on credit. Specifically, President Carter empowered the Federal Reserve Board to regulate credit under the Credit Control Act of 1969. And almost overlooked in the President's set of proposals was his renewed commitment to seek congressional passage of a credit budget to enable the Federal Government to control government loans and loan guarantees.

The President also announced wage and price actions. He reaffirmed his opposition to mandatory wage and price controls but accepted the recommendations of the Pay-Advisory Committee for higher permissible

Federal Reserve Monetary and Credit Actions

- *Special Credit Restraint Program*
 - Restraint on Consumer Credit
 - Increased Marginal Reserve Requirement on Managed Liabilities
 - Special Deposit Requirement on Managed Liabilities of Nonmember Banks
 - Special Deposit Requirement on Money Market Mutual Funds
 - Surcharge on Discount Borrowing by Large Banks
-

wage increases during 1980. Prices were also to be more closely monitored. The fourth part of the anti-inflation proposal called for greater energy conservation, including a gasoline conservation fee (later rejected by Congress). Finally, the President called for economic structure changes to encourage productivity, savings, and research and development. As part of this approach, he again requested the lifting of interest rate ceilings that have limited the rate of return that smaller savers can receive on time and savings deposits. This part of his program, of course, was enacted in the omnibus banking bill signed by the President on March 30 of this year, which will phase out interest rate ceilings over six years.

The Six Part Credit Restraint Program. With the broad authority of the Credit Control Act of 1969, the Board of

Governors of the Federal Reserve System announced a voluntary Special Credit Restraint Program. This program applies to all domestic commercial banks, bank holding companies, finance companies, and credit extended to U.S. residents by U.S. agencies and branches of foreign banks.

The Board also announced a program of restraint on certain types of consumer credit, including credit cards, check credit overdraft plans, unsecured personal loans, and secured credit where the proceeds are not used to finance the collateral. Specifically, the Board established a special deposit requirement of 15 percent for all lenders' increases in covered types of consumer credit (for lenders with more than \$2 million in such credit outstanding). This special deposit requirement applies to all banks, finance companies, retailers, and anyone extending these types of credits.

To further limit the ability of banks to attain funds from managed liabilities (including large denomination CD's, federal funds purchased from nonmember banks, Eurodollar borrowings, and repurchase agreements against U.S. government securities), the Board increased the marginal reserve requirement on managed liabilities of member banks from 8 to 10 percent and lowered the base amount by 7 percent. It also applied a special 10-percent deposit requirement on the managed liabilities of nonmember banks. To curtail the rapid growth of credit extended by money market mutual funds, the Board applied a special deposit requirement on any increase of these funds' assets over the March 14 base period. To discourage borrowing at the discount window by large banks, the Board announced a surcharge on frequent discount borrowings.

Special Credit Restraint Program

1. RESTRAIN

bank loan growth to
6-9 percent

2. DISCOURAGE

financing of corporate
takeovers or mergers
and retirement of
corporate stock

While the Federal Reserve actions contained six parts, there is no question but that the Special Credit Restraint Program lies at the heart of the restraint and has received a great deal of the attention. While the Special Credit Restraint Program applies to nearly all lenders, it has been particularly directed to banks.

The Program's Effect on Banks.

Banks, specifically, have been asked to restrain the growth in their loans in 1980 to between 6 and 9 percent over the amount of loans outstanding in December 1979. Banks with assets of \$1 billion and over were asked to report monthly, those with assets of \$300 million to \$1 billion will report quarterly and the smaller institutions will be monitored for compliance during their regular examination by their federal bank examiners. This quantitative control was announced because although the Federal Reserve has been relatively successful in recent years in meeting its monetary growth targets, it has been less successful in holding bank loan growth within the desired ranges.

The broad Special Credit Restraint Program also contains a number of qualitative guides. Banks were discouraged from financing corporate takeovers or mergers and from financing the retirement of corporate stock, except where there is a clear justification in terms of production efficiency. They were asked to avoid

financing purely speculative holdings of commodities and precious metals and extraordinary inventory accumulations beyond normal business needs. At the same time and most importantly, banks were asked to maintain reasonable availability of funds to small businesses, farmers, and others without ready access to nonbank credit. To curtail the increased use of the commercial paper market by large businesses, banks were asked to restrain the growth in commitments for the backup lines of credit that firms often use to support their commercial paper issues. Also, banks were asked to maintain an adequate flow of credit to their smaller correspondent banks, particularly those servicing agricultural areas.

Thus, the Special Credit Restraint Program places an overall limit on bank loan growth and attempts to ensure an adequate flow of bank credit to small businesses, farmers, and others. It encourages banks to reallocate their credit to these areas, and they can do so by avoiding making nonproductive loans. Since the Special Credit Restraint Program covers most major lenders and not just banks, banks can turn down loan requests without fear that their competitors will step in and make the loan. Banks can use the quantitative guidelines and the qualitative standards under the Special Credit Restraint Program to turn down requests for undesirable types of new loans.

3. AVOID

financing of purely speculative holdings of commodities or precious metals or extraordinary inventory accumulations

4. MAINTAIN

reasonable availability of funds to small businesses, farmers, and other forms of financing

5. RESTRAIN

growth in commitments for backup lines in support of commercial paper

6. MAINTAIN

adequate flow of credit to smaller correspondent banks serving agricultural areas

Program's Success Brings Scale-Down. In May, the Federal Reserve Board began to phase out the special and extraordinary March measures while stressing that these actions do not represent any change in basic monetary policy. As short-term borrowing costs for banks plunged in early May, the 300 basis point surcharge on discount borrowings for large and frequent borrowers was eliminated effective May 7.

By late May, there was clear evidence that bank loan growth had slowed. From a nearly 18 percent January-February annual pace, bank loans rose less than 3 percent in March and actually declined at over a 5 percent rate in April. Consumer loans were down sharply. As a result, the Board acted to reduce gradually many of the restraints over coming weeks. They reduced the marginal reserve requirement on managed liabilities of large member banks and agencies and branches of foreign banks from 10 percent to 5 percent, and adjusted the base upward by 7½ percent. Similar changes were made with respect to the special deposit requirement on managed liabilities of large nonmember banks. The special deposit requirement that applied to increases in covered consumer credit was decreased from 15 percent to 7½ percent. Finally, the Board modified the Special Credit Restraint Program to ensure that the more urgent credit needs are being met — such as those for small business, auto dealers and buyers, the housing market,

agriculture and energy products and conservation. To reduce reporting burden, large banks will report bimonthly, and reports from large corporate borrowers will be discontinued. Also, the first quarterly report from intermediate-size banks will be simplified.

A final question remains: how does the Special Credit Restraint Program fit into the basic monetary policy of the Federal Reserve? The answer is best summarized by a statement Chairman Volcker made before the Senate Banking Committee just three days after the Special Credit Restraint Program was initiated. He noted that “the core of our policy ... is the steady application of restraint over the growth of money and the growth of credit through our traditional instruments.” The Special Credit Restraint Program remains a complement to the Federal Reserve’s basic monetary policies as formulated on October 6. Credit restraint is not a substitute for that policy; it is a complement. The Special Credit Restraint Program, by holding down loan growth, will give time for the basic restraint under the traditional monetary policy tools to hold down banks’ reserve growth and, therefore, monetary growth. Credit restraint will give the traditional reserve restraint the time to dampen the inflationary pressures in our economy that have been fostered by the use of credit and rapid monetary growth. 