Selective Credit — No Substitute for Monetary Restraint

A speech given by DARRYL R. FRANCIS, President, Federal Reserve Bank of St. Louis, at the 23rd Annual Conference of Bank Correspondents, First National Bank of St. Louis, November 13, 1969

THE USE of selective credit controls for economic stabilization is not of recent origin. The eligible paper provisions of the Federal Reserve Act passed in 1913 are a form of selective credit control. They provide for easier Federal Reserve Bank credit terms to borrowing member banks who offer short-term commercial paper as collateral. This provision implies that, if bank credit is limited to short-term commercial loans, monetary conditions will approach an optimum.

Selective credit controls were given a major boost in 1934 with the passage of the Securities Exchange Act, which delegated authority to the Board of Governors to control margin requirements (Regulations G, T and U) on securities traded on the major exchanges.[1] This control was provided for the purpose of preventing the "excessive" use of credit for purchasing or carrying securities. It was generally believed that a large volume of bank credit led to a major increase in stock prices and the ultimate collapse of the stock market in the late 1920's and early 1930's.[2] It was assumed that the expansion and contraction of stock market credit was a major factor contributing to the Great Depression of the 1930's.

[1]Securities Exchange Act, 1934, Federal Reserve Act as amended through Oct. 1, 1961, p. 222.

[2]See John J. Abele, "Black Tuesday, '29: Forgotten Lesson?" *New York Times*, Oct. 26, 1969 for a discussion of this view.

Another boost to selective credit controls was provided by the passage in 1933 and 1935 of interest rate restrictions on demand and time deposits. Under authority granted by this legislation both member and nonmember banks were prohibited from paying interest on demand deposits. This legislation also authorized the Federal Reserve Board and the F.D.I.C. to limit the rates that banks could pay on time and savings deposits. At that time it was contended that these restrictions would tend to reduce the rates charged to bank customers, slow the movement of funds from smaller to larger communities where it was believed that they were used for "speculative" purposes, and prevent the excessive bidding up of rates, thereby reducing bank failures. More recently, time and savings deposit rate controls have been intended to reduce competition between banks and savings and loan associations, and thereby to speed the flow of funds into the housing market. This move away from free competition implies that it is better for the nation to have larger credit flows to the housing industry than to bank creditors, who may use the funds for plant and equipment expenditures and other purposes judged to be less worthy.

In 1941 the Board of Governors of the Federal Reserve System was authorized by an Executive Order of the President to restrict the use of credit for consumer purchases (Regulation W). This was done by requiring a minimum down payment and a maximum time to maturity for such credits. The immediate reason for the restriction was to reduce the inflationary danger during the war by restricting the demand for consumer goods.[3] Actually, however, the legislation was associated with the thought that excessive consumer credit in the 1920's had contributed to the 1929-33 depression.

Restrictions on real estate credit were imposed in 1950 as part of a program to check inflation after the start of Korean fighting (Regulation X). These restrictions followed the general pattern of consumer credit controls by requiring minimum down-payments and maximum maturities on new one- and two-family houses. Credit restrictions were later extended to other real estate.

As an indication of the wide interest in the use of selective credit for controlling inflation, *Time* magazine, in discussing the reluctance of the Administration to impose price controls, reported that "credit controls, which were last imposed on the U. S. during the Korean War, might work more selectively to restrain lending, and in turn, demand for some kinds of goods".[4] In recent testimony before a Senate subcommittee, the President of the National Association of Home Builders stated that "we are now convinced that some type of credit controls must be undertaken".[5]

Selective Credit Controls — Pros and Cons

The argument for selective credit controls rests primarily on the assumptions that restrictive monetary actions cause high interest rates, and that high interest rates have an unduly harsh impact on some sectors of the economy such as residential construction. Proponents of selective credit controls believe that the "undesirable" impact of aggregate monetary controls can be eliminated by controlling the volume of credit used for specific purposes.

The view that credit controls in a specific sector will have an impact on total credit outstanding and total demand for goods and services may be looked upon as a variant of the Income-Expenditure approach to economic activity. For example, if one viewed total economic activity as resulting from autonomous expenditures in each of the separate sectors of the economy, a variation of expenditures in any one sector would have an impact on total expenditures and total income. This is consistent with the fiscal view of economic stabilization, which asserts that an increase in Government spending on goods and services results in an increase in total expenditures and total income. However, I do not mean to imply that all proponents of fiscal stabilization would recommend the use of selective credit controls for stabilization purposes.

In contrast to the Income-Expenditure approach to economic activity, I hold to the view that the stock of money is a major influence on total demand and the course of spending. Preferences for specific goods and services determine amounts that consumers will spend in each sector. If specific credit controls or other nonmarket controls are applied in any one sector, I believe that any reductions achieved will be offset by higher expenditures for other goods and services.

Despite the merits attributed to selective credit controls, I believe that they are socially undesirable for the following reasons: they are useless in controlling inflation; most of the hardships attributed to general monetary restraint are actually caused by selective controls or self-imposed rigidities; they are difficult to enforce; they are biased in favor of the wealthier groups; to the extent that they reduce demand for particular goods and services, they also reduce national welfare; and they are a restriction on individual freedom.

Selective Credit Controls — No Substitute for Quantitative Controls

The argument that selective credit controls will restrain inflation is not consistent with the functioning of our monetary mechanism and the factors which determine total demand. With our fractional reserve system of banking, the volume of bank credit is strongly influenced by total reserves and the reserve ratio requirements. Within limits, total credit is determined by the Federal Reserve System simultaneously with the determination of bank reserves and the stock of money. With fixed reserve ratios, other monetary multipliers, and a given level of bank reserves, credit restrictions on some purchases are fully offset by credit expansion for other purchases. Thus the total stock of money or credit remains unchanged after application of the restrictions. Money created

[3] Charles R. Whittlesey, Arthur M. Freedman and Edward S. Herman, *Money and Banking: Analysis and Policy* (New York: Macmillan Co., 1963), p. 256.

[4] *Time*, Oct. 10, 1969, p. 87.

[5] U.S., Congress, Senate, Subcommittee on Financial Institutions of the Committee on Banking and Currency, Hearings on S-2499 and S-2577, 91st Congress, 1st session, September 9, 1969, p. 17.

by one type of credit expansion is equal in quality to money created by another type of credit, and total demand is unchanged.

Even if one subscribes to the idea that monetary management exercises its influence primarily through the credit market rather than through the money stock, selective credit controls are not a solution to the problem of excess demand. Credit restrictions on some purchases will cause rising demand for uncontrolled goods and services. Prices for uncontrolled goods will rise faster and resources will, in turn, flow from the production of controlled to uncontrolled goods. Output will be enhanced in the uncontrolled sectors and reduced in the controlled sectors, but prices for all goods will continue up, assuming excessive credit and monetary expansion has been permitted.

The argument that quantitative controls are perverse and create undue hardships in some sectors implies that the judgment of the controller is superior to market decisions. To the extent that the controls work, the controller is essentially transferring to others his own values as to what the nation should produce and sell. I contend that the market place can determine with least welfare loss which goods and services should be produced at slower or accelerated rates as a result of stabilization actions. Consumer purchases of goods and services under aggregate monetary controls are determined by utility at the margin, thus providing greater welfare than purchases arbitrarily determined for specific products through selective credit restrictions. Furthermore, appropriate monetary policies will reduce the wide swings in demand of recent years. A reduced amplitude of demand fluctuations would eliminate the unevenness of the effect of controls on total money and credit.

Credit used for purchasing and carrying common stocks has been given major attention because of the widespread belief that stock market credit and stock prices tend to trigger major swings in economic activity. Proponents of this view contend that speculators, when borrowing to make stock purchases, bid up stock prices to excessive levels and the following sharp declines tend to produce recessions.

I believe that both the impact of credit on stock prices and the impact of stock prices on economic activity have been greatly overestimated. Much of the fluctuation in the stock prices can be traced to the unevenness of aggregate monetary controls. Stock prices may be influenced temporarily by the volume of credit extended for security purchases. Reverse causation, however, is more likely the case. In other words, movements in stock market credit are influenced by changes in stock prices. Statistical analysis tends to demonstrate this reverse causation.[6]

Causation likewise runs from economic activity to stock prices. Rather than being an important factor contributing to the Great Depression as some contend, the sharp decline in the stock market in the late Twenties and early Thirties was mainly the result of a decline in earnings and in earnings expectations. This outlook for earnings can be traced to a decline in demand for goods and services, which, in turn, can be traced to a sharp reduction in the stock of money.

Carrying the securities market analysis a step further, we can assume that business capital will expand according to profit incentives and the cost of capital to entrepreneurs. If margin restrictions restrain the opportunity for raising capital through security sales, business will likely resort to borrowing directly from financial institutions to meet capital demands. I can see little difference between making loans to corporations and making them on securities which represent ownership of corporations. Furthermore, like other credit restrictions, if margin requirements alter credit or monetary flows, they also reduce national welfare as indicated by individual expenditure preferences.

The Apparent Need for Selective Credit Controls — A Result of Other Restrictions

Most of the hardships attributed to general monetary restrictions by advocates of selective credit controls would disappear if other useless impediments to credit flows were eliminated. Quite often the alleged victims of financial market imperfections are actually the victims of other controls. First, let us look at the argument that restrictive monetary actions discriminate against residential construction. Recent studies indicate that relatively slow rates of monetary growth

[6]Statistical analysis of the Standard and Poors 425 Industrials and of the 500 Stocks gives better results for the hypothesis that changes in stock values cause changes in credit for stock purchases than the reverse-causation hypothesis. The hypotheses were tested by regressing first differences of monthly data (stock price indices and credit extended to margin customers by banks plus customers' net debit balances at member firms of the New York Stock Exchange) on current and three lagged periods. The time period used was February 1953 to July 1969. The response of credit to changes in stock values was positive and significant for the current plus the first and second lagged month for each index. In contrast, the hypothesis that stock market credit causes stock prices to rise gave positive and significant results only in the current period. The coefficients were negative in the first and second lagged month for both indices.

do not cause excessive cutbacks in spending on homes. Conversely, all marked and sustained declines in housing starts began in periods of rapid monetary expansion after excessive demands for goods and services had driven up prices and interest rates. The sharp rises in costs and interest rates were the major factors in reducing housing demand, and the reduced flows of funds into housing during these periods of high interest rates can be traced in part to such market impediments as usury laws, interest rate ceilings, and other regulations on financial intermediaries. When market rates reached these imposed ceilings, funds were diverted to other uses where rates could move to market-determined levels.

An additional side effect of this diversion of credit from its normal flows through intermediaries is its bias against small savers and borrowers. Small savers are relatively unable to place their savings in funds and securities and are relatively limited to controlled rates. These rates are lower than market-determined rates and small savers are the losers. Similarly, small borrowers are limited to the use of financial agencies for credit, and when this credit dries up because of rate regulations, small borrowers are, for all practical purposes, banned from the credit market. In contrast, large borrowers can participate in the capital markets through either new common stock offerings or other securities.

Self-imposed rate restrictions by state and local governments and rate restrictions on public utilities likewise reduce their expenditures during periods of high market rates. Rather than serving to reduce interest costs, the restrictions simply serve to postpone the expenditures until supply and demand conditions for credit cause market rates to return to levels that these spending units are willing to pay.

Enforcement of Selective Credit Controls is Difficult

Selective credit controls are extremely difficult to enforce uniformly among all groups. Enforcement officials can apply restrictions on a basis of the collateral offered as security, on the borrower's declaration of intended use of proceeds, and on the indicated use of proceeds. None provides a sure test of the use of loan proceeds. If proceeds from loans are commingled with other income such as salaries, wages, commodity sales, or other funds, one cannot determine which funds were used for the various expenditures. For example, if an individual wants to use his salary, wages, or other sources of income to purchase securities, he may borrow funds to make home payments or provide for other living expenses. The borrowed funds are similar to the other funds and the destination of the respective funds is difficult to trace.

The collateral offered is likewise a poor indicator of how loan funds are used. Proceeds from loans on common stocks or real estate may be used for medical payments, to purchase automobiles, or for numerous other purposes having no connection with stocks or real estate.

Trade-ins are also a means of by-passing down-payment requirements of selective credit controls. With anything that can be considered a trade-in item, the prospective buyer and seller can get together and make a mutually satisfactory deal by setting up a fictitious down-payment which meets both legal and personal requirements.

Selective Credit Controls Biased in Favor of the Wealthy

Selective credit controls are biased in favor of wealthy groups and against those with limited assets. Real and financial assets can always be used as collateral for loans. From such proceeds down-payments on purchases of controlled items can be made unless each dollar can be traced to its ultimate use. Furthermore, those with assets for collateral can avoid instalment credit restrictions altogether by obtaining commercial credit and purchasing consumer items with the proceeds. In addition, those with wealth are also likely to have sufficient cash flows to mingle with borrowed funds to make fund-tracing almost impossible. Control officials cannot determine whether the borrowed money was used for down-payments on controlled items or whether other cash flows were used for such purchases.

On the other hand, those without assets are forced to use purchased items as collateral. Thus, to the extent that selective credit controls serve to retard demand in a particular sector of the economy, they are a boon to persons with assets, providing them with products at lower prices, while those without assets for collateral are frozen out of such markets until the necessary down-payments can be accumulated.

Selective Credit Controls Distort Resource Use and Reduce Welfare

Fortunately, most selective credit controls are not readily enforceable. To the extent that they reduce demand and production of goods and services in any sector, they tend to reduce welfare. The welfare of an individual is maximized, other things being equal, when he can spend both proceeds from loans and funds from other sources without restrictions or impediments. Each expenditure then provides him with maximum satisfaction at the margin. On the other hand, the capricious use of restrictions to alter individual spending, either in the form of higher downpayments or shorter terms, requires consumers to make less desirable choices. Fewer goods and services are purchased in terms of their usefulness for the same level of expenditures. An economy operating under selective credit restrictions fails to produce an optimum amount of some goods and overproduces other goods, with a consequent loss in total welfare.

Selective Credit Controls Reduce Freedom

Equally as important as the economic considerations is the useless infringement of selective credit controls on freedom. We can easily moralize as did the Medieval rulers that the poor should stay out of debt or that someone should set limits on their loan terms in order to assure that their credit is used for "appropriate" purposes. It is my belief, however, that man is happier when subject to the market forces rather than to arbitrary decisions of one or a few individuals. Freedom did not come easily to mankind, but we tend to take it for granted. Yet, in most of the periods since man's early history, he has been forced to bow in both thought and action to harsh taskmasters. In my view, we should not take losses of freedom lightly, despite the fact that controls are imposed upon us only a fraction at a time.

Summary

The current inflation has brought to the forefront proposals for using selective credit controls to stabilize prices and prevent the allegedly perverse effects of aggregate monetary restraint. Despite the possibility that selective controls may reduce the volume of credit used for specific types of purchases, they do not achieve the announced stabilization goals of the controllers. They do not restrain total demand for goods and services. Dollars created by one type of bank credit have the same purchasing power and the same impact on demand as dollars created by another type of credit. It is the total amount of credit and money created that determines average prices for all goods and services. Actually, to the extent that selective controls cause misallocation of resources, they have an inflationary impact.

Selective credit controls are almost impossible to enforce with equal results among all groups of individuals and businesses. Their use imposes much greater credit restraint on the small borrower, who is without other assets for collateral or large cash flows which can serve to disguise the actual use made of borrowed funds.

To the extent that selective credit controls are effective in changing credit flows, they reduce total output of goods and services and national welfare. Furthermore, they are an infringement on freedom because they impose restraints on how one can utilize his credit resources.

Last but not least is the fact that selective credit controls tend to provide their own breeding grounds. One control must ultimately lead to another as market forces tend to bypass each new regulation. The proliferation of ceilings on time and savings deposits is a good example. First, the ceilings were established uniformly on all accounts. Then there was a "need" to segregate deposits by size because of major losses of larger deposits. Smaller depositors could be paid less under monopolistic pricing because of lack of alternative investment opportunities. Rates to small savers were seldom changed. They remain at levels insufficient to cover the rate of inflation. Permissible rates on the larger accounts were raised at intervals as market rates continued up. Observing an opportunity to capture funds, bank holding companies and bank affiliates began to issue savings-type instruments which were not covered by the regulations. Now controls have been proposed in this leakage area. These attempts to cover all bypasses are like the man who built a dam to curtail the normal flow of a stream and discovered a leak. He used his finger to plug the hole. As water backed up, however, other leaks occurred requiring more fingers. The process of leak springing and finger plugging continued until the builder ran out of fingers.

Inflations can be controlled, but not through the use of specific controls on arbitrarily selected goods or services. The solution to inflation lies in the adoption and maintenance of appropriate monetary policies, which attack the cause of inflation. It requires an appropriate rate of growth in the stock of money. We moved toward a reduced rate of monetary growth near the end of last year and a still slower rate last June. I am confident that these actions will soon reduce the excess demand which was created by overly rapid monetary expansion in 1967 and 1968.