The credit restraint program in perspective

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The anti-inflation program the President announced on March 14 included—along with promises of cuts in federal spending for the rest of this fiscal year and a balanced budget for the year beginning in October—a set of selective policy measures designed by the Federal Reserve to restrain credit growth.

Parts of the Federal Reserve program were implemented under the Credit Control Act of 1969, which the President invoked for the first time. The act empowers the President to authorize the Federal Reserve Board "to prohibit or limit any extensions of credit under any circumstances the Board deems appropriate." Such broad powers could be used to impose far-reaching controls on banks and other financial institutions and, in fact, on all private and public credit markets.

Under the new program, however, the Board chose to implement credit restraints only in a selected set of private credit markets and, within the markets directly affected, in a somewhat flexible way. The limited scope of the program reflected the Board's intention that the credit restraints supplement, not supplant, the restrictive fiscal and monetary policies that the Administration and the Federal Reserve had announced they would pursue. The program was designed partly to reinforce these general economic policies and partly to mitigate their most serious side effects.

The program

One of the most important actions taken by the Board on March 14 was the establishment of a voluntary Special Credit Restraint Program applicable to banks, bank holding companies, and finance companies. Several provisions of the Special Credit Restraint Program were addressed specifically to banks. They were advised to hold loan growth within the 6 to 9 percent range previously targeted for total bank credit by the Federal Reserve. Banks were also encouraged to restrain certain types of lending considered nonproductive, inflationary, or of low social priority. Included were unsecured consumer lending, financing of corporate takeovers or mergers, and financing of purely speculative holdings of commodities. Banks were also asked to restrain the growth in commitments for backup lines to support commercial paper borrowing. They were strongly urged to maintain the availability of funds to small business, farmers, and homebuyers.

The Special Credit Restraint Program originally called for monthly reports on lending activity at large domestic banks, bank holding companies, and U.S. agencies and branches of foreign banks. Monthly reports were also requested on commercial paper issues and overseas borrowing of a panel of large corporations and on business credit outstanding at large finance companies. Quarterly reports on lending were required from intermediate-sized banks ($300 million to $1 billion in total assets). Smaller banks were exempted from reporting under this program.

Reporting burdens were reduced on May 22 when the Board announced that lending institutions previously scheduled to report monthly would henceforth report bimonthly. At the same time, the first quarterly report for intermediate-sized banks, due in June, was simplified. The need for subsequent reports from these banks was to be evaluated by the Board after the first set was received. The Board also discontinued the reporting requirement for the panel of large corporate borrowers.

Another important action taken by the Board was the imposition of a 15 percent spe-

cial deposit requirement on increases in consumer credit. This requirement was, in essence, the first application of asset-based reserve requirements in the United States. The idea of applying reserve requirements to specific categories of asset holdings, rather than deposits, originated during the early 1950s and has been widely discussed ever since.[1]

Special deposit requirements on increases in consumer credit were adopted in the belief that consumer spending, a sizable part of which has been financed by an unprecedented expansion in consumer borrowing in recent years, has been a major contributor to the inflationary spiral. Mortgage credit, automobile loans, and other forms of secured credit involving purchase of the security with the proceeds of the loans were exempted from the special deposit requirement because of the depressed state of the housing and automobile industries.

A 15 percent special deposit requirement on increases in total assets of money market mutual funds was also instituted on March 14. This requirement, however, is conceptually different from the asset-based special deposit requirement against consumer loans. Because the deposit requirement on money market funds applies to increases in any and all of their assets, it does not represent an attempt to direct credit away from (or into) any specific uses.[2] In fact, no substantive difference would have resulted if the special deposit requirement had been applied to increases in the amount of money invested in these funds—that is, the net purchases of new shares of money market funds—rather than to increases in the assets of these funds.

Similarly, the other major actions taken by the Board on March 14 were aimed at increasing the costs of lending by banks and other financial institutions, rather than at selectively encouraging or discouraging particular types of loans. These actions included an increase from 8 percent to 10 percent in the marginal reserve requirements against the managed liabilities of large member banks—such as large short-term time deposits, borrowings from foreign branches, repurchase agreements, and federal funds purchases from nonmember institutions. At the same time, the base amount of these liabilities that would be free of reserve requirements was reduced from the level set when the requirements were introduced in October 1979. A 10 percent special deposit requirement on increases in managed liabilities of large nonmember banks was also included in the Board's March 14 actions. A 3 percent surcharge on member bank borrowing from the Federal Reserve was introduced temporarily but was discontinued in early May.

On May 22 the Board announced reductions from 10 percent to 5 percent in the marginal reserve requirement on managed liabilities of member banks and in the special deposit requirement on such liabilities at nonmember banks, together with an upward adjustment in the requirement-free base. Responding to the slowdown in credit-financed consumer spending, the Board also halved the special deposit requirement against covered types of consumer credit; both this requirement and the special deposit require-

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[1]For example, see *Monetary Policy and the Management of the Public Debt*, S. Doc. 123, Pt. 1, 82d Cong. 2d Sess. (Government Printing Office, 1952), pp. 484-88; and Samuel B. Chase, Jr., "Use of Supplementary Reserve Requirements and Reserve Credits to Even Out the Flow of Mortgage Funds," in *Ways to Moderate Fluctuations in Housing Construction* (Board of Governors of the Federal Reserve System, 1972), pp. 97-109.

Other countries have made extensive use of selective credit restrictions, including in some cases asset-based reserve requirements. In reviewing the experience of these countries, it is important to keep in mind that they differ widely from the United States both in terms of their financial systems and their instruments and techniques of monetary and fiscal policy. For an analysis of selective credit controls overseas, see Donald R. Hodgman, *Selective Credit Controls in Western Europe* (Association of Reserve City Bankers, 1976).

[2]An exception was those money market funds that invest at least 80 percent of their assets in short-term tax-exempt obligations. Tax-exempt holdings of such funds were exempted from the special deposit requirement. To this extent, the special deposit requirement on assets of money market funds contained a selective element.

ment on increases in assets of money market funds were lowered from 15 percent to 7½ percent.

Lessons from experience

The program was designed to cope with problems very much in evidence in previous periods of credit stringency, notably 1966, 1969, and 1973-74. In each of these periods, interest rates rose to new post-World War II highs and such interest-rate sensitive sectors as homebuilding, small business, and state and local governments were severely squeezed. This was in contrast to the growth in credit to finance business spending, including mergers and takeovers, which continued to grow until well into the recessions that followed the periods of tight credit. More and more frequently in recent years, these temporary imbalances in the economy have been seen as involving heavy social costs, as for example, the cyclical underutilization of resources in the homebuilding industry, increases in the rates of failure by small businesses, and the postponement of projects by state and local governments.

At the same time, there has also been a widespread notion that the traditional tools of fiscal and monetary policy either are inadequate or have not been used with sufficient vigor to restrain the growth of credit during business expansions—in either case, they have not succeeded in controlling inflation. It has become fashionable to observe that as high interest rates have not held down business borrowing, it is necessary to use more direct means to limit the availability of credit and restrain growth in aggregate demand. It has even been suggested that as interest is an element of business costs, high interest rates are counter-productive in the fight against inflation. They simply translate into higher commodity prices.

The purposes of the credit restraint program in an inflationary environment were to reinforce the Federal Reserve's efforts, through its pursuit of a reserve target, to slow the growth of money and credit and to mitigate some of the more painful dislocations that usually come with tight credit. To the extent that the program has succeeded in slowing the growth of consumer and total credit—and there is considerable evidence that it has—while maintaining to some extent the flow of credit to agriculture, housing, small business, and municipal finance—here the evidence is less convincing—it has done its job.

The program may also have had the salutary effect of lowering the public's expectations of future increases in prices—thereby hastening the adjustment to a slower rate of expansion of demand and reducing the severity of the impact on employment and output. If so, it has done all one could reasonably hope for. But any permanent lowering of the public's expectations for price developments will depend on the steadfastness with which restrictive monetary and fiscal policies are pursued over the coming year.

To evaluate the credit restraint program properly, it is necessary to keep in mind its goals and the difficulties that would be likely to accompany any effort to broaden its scope or purposes. The program was designed to limit the cyclical variation in the supply of credit for housing, agriculture, and small business, not to increase the share of credit going to these sectors over the long run. It was not intended to remain in effect beyond the period of difficulty that gave rise to it.

Accepting for purposes of discussion the validity of the arguments for increasing the share of resources going to certain sectors, the program is not well suited to the pursuit of such long-term goals. Because of the broad categories it established, its basically voluntary character, and the fact that it has left all individual credit decisions to the private lending institutions, the program could more accurately be described as a call for cooperation than a system of rigid controls. In what was widely regarded as a short-term quasi-emergency, the cooperation the program relies on was forthcoming. But in the long run, the program would be unlikely to be effective in the face of contrary forces affect-

ing the profits of participating institutions. In blunt terms, a dollar loaned to a large business may be more profitable than a dollar loaned to a family buying a house.

Experience with mandatory credit controls on consumer credit during World War II and on both consumer and mortgage credit during the Korean War showed that controls become progressively less effective the longer they are in force. Lenders find ways to circumvent regulations. Reflecting its fungible nature, credit extended for one purpose is actually used for another. When controls are in force long enough, new institutions arise to service demands left unmet by regulated institutions. To keep up with such developments, regulation must be constantly expanded in detail and institutional coverage. Otherwise, it gradually loses its potency.[3]

The decisions that shaped the key elements of the program announced March 14 were taken in light of a full consideration of experience in terms of the scope, cost, and efficacy of previous credit restraint programs. For example, some features of the program were designed to increase its efficacy and prevent its circumvention.

Consumer credit, the sector singled out for special attention, is the one in which the borrowers typically have limited alternative sources of credit. Unlike large corporations, consumers cannot turn to the open market to sell bonds or commercial paper when traditional institutional sources of credit dry up. Within this sector, moreover, the program covered all major sources of credit, not only banks but also finance companies, credit unions, thrift institutions, retail establishments, oil companies, and travel and entertainment card companies.[4]

To get the maximum effect from a limited commitment of resources, the program focused on lenders, who are relatively few in number, instead of borrowers, who number in the millions. It concentrated, then, on the supply of credit rather than the demand for it. Because of the huge administrative problems entailed, few efforts have been made to control the demand for credit. The most prominent example was the Federal Reserve Board's Capital Issues Committee in World War I. The committee screened proposed issues of stocks and bonds over $100,000, approving only the issues conducive to the war effort.

Unlike the credit controls of both World War II and the Korean War, the program did not prescribe specific limits on the nonprice terms of credit transactions, such as minimum downpayments and maximum maturities. The special deposit requirement raised the cost of extending consumer credit. However, the program relied on disclosure and consultation to limit overall extensions of credit. But, aside from an admonition in the Special Credit Restraint Program that "rates should not be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirement on managed liabilities," it was left to individual institutions how best to ration credit among particular borrowers.

All these characteristics of the program serve to point up its limited scope and expected short duration. Even more decisive proof of its limited aims is the relatively small commitment of resources and personnel to its implementation.

Fallacies regarding credit control

The temporary nature of the program recognizes fully the demonstrated limitations of credit restraints. However, some proponents of credit controls persist in seeing a

[3]U.S. experience with credit controls beginning in World War I is discussed in Arnold Dill, "Selective Credit Controls: The Experience and Recent Interest," *Monthly Review*, Federal Reserve Bank of Atlanta (May 1971), pp. 78-86.

[4]An unsuccessful Congressional drive for mandatory allocation of bank credit to selective uses was mounted in 1975. A major criticism of these legislative proposals was that nonbank financial institutions were virtually ignored. For a discussion of the 1975 proposals, see Randall C. Merris, "Credit Allocation and Commercial banks," *Business Conditions*, Federal Reserve Bank of Chicago (August 1975), pp. 13-19.

larger and more enduring role for them.

Recent stabilization policy. Although there is no indication that the cyclical behavior of homebuilding has lowered the industry's long-run growth, it is well established that the extreme swings of homebuilding involve social costs—periodically idle resources and foregone production, bankruptcies of construction companies, excessive startup costs, and inconvenience to the public due to postponement of housing purchases until a later phase of the interest rate cycle. This instability, sometimes diagnosed as the inevitable result of an unregulated economy or of the basic inability of monetary and fiscal policy to moderate the business cycle, has formed the basis for many proposals for imposing permanent credit controls.

This prescription presupposes that the aggregate demand policies followed in recent years have been the best that could be achieved. But for at least two decades, the homebuilding industry has been alternatively the beneficiary and victim of overly expansive and excessively restrictive monetary and fiscal policies.

To take the most recent example, as the economy and the homebuilding industry recovered from the recession of 1974-75, the narrow money supply (M-1) accelerated from an annual growth rate (fourth quarter over fourth quarter) of 4.6 percent in 1975 to 5.8 percent in 1976, 7.9 percent in 1977, and 7.2 percent in 1978, before slowing to 5.5 percent in 1979. That this acceleration was unintended appears clear from repeated statements of Federal Reserve Board Chairmen Burns and Miller that inflation is the nation's most serious economic problem and that a precondition to reducing inflation is a gradual reduction in monetary growth.

Given that the most widely accepted estimate of the lag between changes in the rate of growth of money and the maximal impact on the rate of inflation is two to three years, the strong inflationary pressures seen since late 1979 are not hard to explain. As is generally understood today, the efforts of lenders to protect the purchasing power of their principal cause actual and anticipated rates of inflation to be incorporated in nominal market interest rates. To this preexisting upward pressure on interest rates was added a sharp cutback in the growth of money and credit initiated by the Federal Reserve's more vigorous efforts to achieve its monetary targets and thereby to combat inflation, particularly since adoption of its new reserves targeting procedure on October 6, 1979. It is not surprising that interest rates skyrocketed in the months immediately following the change in operating procedures.

Fiscal policy has not helped much. After being in surplus in 1974, the worst year of the recession, the high employment federal budget went from a deficit of $18.2 billion in 1975 to $18.6 billion in 1977 before declining and turning into a $9.8 billion surplus in 1979. The actual budget has been in deficit consistently in recent years, putting heavy pressure on the credit markets and pushing interest rates even higher than the required degree of monetary restraint would otherwise require.

The overly stimulative fiscal and monetary policies followed during the expansion were shaped, at first, by what was considered the sluggishness of the recovery in 1975 and 1976. They may have continued through 1977 and 1978 because of an exaggerated estimate of the excess capacity in the economy. It has been estimated that economic obsolescence due to the sharp rise in oil prices since 1973 may have reduced the effective capacity of the American economy as much as 5 percent. Failure to give full recognition to this loss may have led policymakers to overestimate the economy's capacity to expand before encountering inflationary pressures.

Policymakers—and many economists, public and private—may have also been deceived by historically high levels of nominal interest rates into believing policy was more restrictive than it turned out to be. Nevertheless, there is little or nothing in the recent expansion to suggest monetary and fiscal policies have lost their potency. What has been demonstrated is that inappropriate policies continued too long can build up a great deal

of momentum that is not easily reversed. On the positive side, there is reason to believe that avoidance of the same mistakes in the future could prevent much of the enormous volatility in interest rates that has driven homebuilding from a state of frenzy in 1977 and 1978 to a projected depression in 1980, while putting severe financial pressure on farmers, small businesses, and municipal governments.

Availability versus interest rates. The discredited, long dormant, but never dead assertion that high interest rates cannot slow credit expansion has been heard more and more frequently in recent years. Interest rates have risen continuously, but credit has continued to grow. The lesson—as often observed by Governor Wallich—is that a 17 percent prime rate, though historically high, is not restrictive when the annual inflation rate (as measured by the Consumer Price Index) is also around 17 percent.[5] It should be recalled, moreover, that as late as early September 1979, the prime rate stood at only 12¼ percent. Depending on how price expectations are measured, the real (inflation adjusted) burden of borrowing at the prime rate may have been no higher than 2 or 3 percent, and conceivably negative, through last September.

The evidence is clear, however, in the form of falling prices of sensitive commodities, slowing retail sales, and other signs of declining economic activity, that the subsequent rise in interest rates to 20 percent was adequate to the task. As tight credit continues to do its job, perhaps to excess, the recurring doctrine of its impotence should at last be put to rest. The timing of the introduction of the credit restraint program may result in its receiving the credit (or blame) for what were actually the results of high interest rates. Its primary effect was to cushion the harsh impacts of those high rates on particular sectors.

Interest rates and inflation. Another particularly durable fallacy with widespread support today is the notion that high interest rates are not only ineffectual in combating inflation but perverse. The argument is that interest represents a major cost to business and increases in interest costs are passed along in the prices of products. It is hard to trace the origins of this doctrine, but it was conclusively discredited by the prominent Swedish economist, Knut Wicksell, around the turn of the century. Maybe because of its common sense appeal, it remains a staple among many bankers and businessmen today.[6]

The essential error of the doctrine is that it combines a partial equilibrium analysis of the effects of high interest rates (an analysis limited to the adjustment of a single firm, taking other factors as given) with a naive cost-plus theory of product pricing, ignoring demand. Although the immediate effect of rising interest rates may be to raise business costs and induce price increases, the dampening effect of higher rates on spending will eventually reduce demand, idle productive resources, and put downward pressure on all prices.

Much of the support for the doctrine comes from the evident empirical association of high interest rates with high rates of inflation. However, as indicated above, this association largely reflects the incorporation of inflationary expectations into nominal interest rates. That both high interest rates and persistent inflation are generally associated with sustained high rates of monetary growth buttresses this conclusion.

This particular fallacy might seem to have crept into the credit restraint program in the form of its imposition of a surcharge only on persistent borrowing at the discount window by large banks and the admonition to lenders in the Special Credit Restraint Program not to base lending charges on the high cost of marginal funds. A close reading of the program's provisions, however, reveals that the Federal

[5]A recent statement to this effect is in Henry B. Wallich (remarks to the Swiss-American Society Basel, Basel, Switzerland, June 10, 1980; processed).

[6]For a thorough analysis of the doctrine, see Thomas M. Humphrey, "The Interest Cost-Push Controversy," *Economic Review*, Federal Reserve Bank of Richmond (January/February 1979), pp. 3-10.

Reserve's effort to moderate increases in rates was based not on the mistaken notion that high interest rates are inflationary, but on its concern over the sectoral incidence and distributional effects of high rates.

Inflation and the uses of credit. Like its predecessors, the credit restraint program distinguishes between productive and nonproductive activities. Banks were urged "to avoid financing for purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation" and "to discourage financing of corporate takeovers or mergers and the retirement of corporate stock." The primary reason for avoiding such speculative lending is to help maintain the flow of credit to, and moderate dislocations in, the interest-sensitive sectors of the economy.

But it is also occasionally argued that lending for nonproductive activities is inflationary. This is an extraneous argument that appears to involve the fallacy of generalization about wholes based on analysis of parts. Credit used to finance speculation in commodities and inventories will certainly help drive up prices of the affected goods in the short run. But it will prove profitable in the long run only if speculators have correctly anticipated future demand. To the extent that they guess right, the net effect is that prices rise sooner than they would otherwise and there is a socially beneficial reallocation from present to future consumption. If they guess wrong, prices will fall as speculative positions are liquidated.

More critically, credit used to speculate in one commodity is not available for bidding up (or maintaining) the prices of other commodities. Hence, any undue upward pressure on some prices due to speculation on credit will be offset by downward pressures on other prices. The net effect on the price level overall should be limited to increases that can be attributed to increases in total credit.

In the case of credit used to finance mergers and takeovers and other purely financial transactions, the concern seems to be that these represent a withdrawal of credit from more productive uses, such as net investment in plant and equipment. But here a distinction has to be drawn between credit as seen by individual enterprises and credit in the context of the economy. To a firm, having credit available is tantamount to having a desired new piece of equipment. One is exchangeable for the other in the marketplace. But for the economy as a whole, credit, like money, is simply a claim on real resources. Multiplying the claims does not multiply the resources. It simply bids up their prices.

A withdrawal of some part of the available supply of credit from financing real investment and consumption to financing transfers of ownership or purchases of common stock should actually reduce the demand for real goods and tend to lower their prices. In no sense can this be called inflationary.[7]

A striking illustration of this point was the credit-fueled boom in the stock market in the late 1920s. Although banks withdrew credit from industrial purposes to lend to speculators that, in turn, bid stock prices up to unprecedented—and as is now clear, unsustainable—levels, there was no similar evidence of overheating in the real sector of the economy. Consumer prices actually fell throughout the second half of the 1920s.[8]

Investment and inflation. The only distinction between uses of credit that has any major significance for inflation—and one also stressed in the credit restraint program—is that between consumption and investment. As often observed, the use of credit to increase productive capacity can increase the supply of goods in the future relative to any given level of demand, reducing future inflation.

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[7]This point was made recently in Paul M. Horvitz, "In Defense of Nonproductive Loans," *American Banker*, November 5, 1979.

[8]The divergent behavior of commodity and security prices during the late 1920s is discussed at some length in Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton University Press, 1963), pp. 251-66, 289-92, and 699. The same point was made earlier in Clark Warburton, "Monetary Difficulties and the Structure of the Monetary System," *Journal of Finance*, vol. 7 (December 1952), pp. 523-45.

Though true, this argument needs to be qualified. First, the division of current output between consumption and investment reflects the preference of people for current consumption over future consumption. It is not clear that any compelling social reason can be adduced to override those preferences.

Second, redistributing demand from consumption to investment cannot be expected to have any effect on current inflation. The increases in the supplies of goods it promises lie in the future. Most important, even a doubling of the increase in productivity from its historical rate of 2.5 percent a year—a wholly unrealistic goal—would make only a minor contribution toward curing an inflation rate of more than 10 percent.[9]

[9]The limited role of investment in combating inflation is described in Martin Feldstein, "Inflation and Supply Side Economics," *The Wall Street Journal*, May 20, 1980.

Conclusions

The emphasis in the credit restraint program on curbing the growth of total credit had an important but distinctly limited contribution to make in controlling inflation. The program may, however, have made the application of tight monetary policies more politically palatable by mitigating the harsh sectoral impacts of high interest rates.

The role of credit in the inflationary process is still a matter of debate. Some would argue that the crucial element in controlling aggregate demand and, therefore, inflation is not total credit, but money. Nevertheless, given the close secular relationship between the growth of money and the growth of credit, the implications for monetary and fiscal policy are similar in either case. Without long continued restraint in both the expansion of bank reserves and government spending, no anti-inflation policy can be effective.

Phase-out of the Selective Credit Restrictions

The Board on July 3 released a schedule for the complete phase-out of its program of selective credit restrictions. Stating that the program was no longer necessary, the Board cited the moderate credit growth, particularly at banks, for the first six months of 1980 and the slowing of demands for consumer credit and credits of an anticipatory or speculative nature.

Effective with the reserve computation week beginning July 10, the 5 percent marginal reserve requirement on managed liabilities of large member banks, and similar special deposit requirement on large nonmembers, were eliminated. (A 2 percent supplementary reserve requirement on large time deposits of member banks, introduced in November 1978, also was eliminated.) The Board abolished the 7½ percent special deposit requirements on increases in consumer credit and assets of money market funds—effective for consumer credit extended in June and for previously covered assets of money market funds after July 20.

The Board on July 3 also announced its intention to phase out the Special Credit Restraint Program limiting domestic loan growth at banking institutions and finance companies to a 6 to 9 percent range. The Board's decision to dismantle the program was conditioned on the slower expansion of bank loans to domestic borrowers, which grew at an annual rate of only 3 percent during the first five months of the year. Experience with the program was to be discussed with individual banks following receipt of final reports due July 10. Although the Board indicated that the Special Credit Restraint Program had served its purpose, it remained concerned over the volume of credit extended for speculative purposes in the past and was considering ways to monitor such developments in the future.

In announcing these measures, the Board emphasized the temporary nature of the credit restraint program and the fact that it had been designed to supplement more general measures of monetary restraint. The Board reaffirmed its goal of restraining the growth of money and credit in order to achieve a further reduction of inflationary pressures in the economy.