# *Monetary Policy and Credit Allocation -- The Basic Issues*

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The financial system of the United States contains two large sub-systems. The function of the first, generally referred to as monetary policy, is to control the total volume of credit for the purpose of aggregate economic stabilization. The second sub-system, which has no name, consists of a maze of regulations, institutions and tax practices designed to influence the allocation of credit, and hence of resources, among different classes of potential users.

The two sub-systems interact in complex ways. In its attempt to control the volume of credit, monetary policy inevitably influences the cost and allocation of credit. Similarly, the existence of an allocative sub-system and changes in it, have an important influence on the conduct of monetary policy. A third form of interaction arises because the monetary authorities exercise control over part of the allocative sub-system and use this control in conjunction with their more general powers over the volume of credit.

As its title indicates, this conference deals with issues in all three areas: the conduct of monetary policy, the allocation of credit, and the actual and potential influence of each on the other. While the title does not so indicate, the origin of the conference itself lies in the growing dissatisfactions with the performance of the system as a whole, particularly during periods of credit restraint such as 1966, 1969-70 and 1973.

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*The Issues*

My assigned task is to introduce the subject by making a few preliminary skirmishes around the interrelated whole for the purpose of isolating the principal issues.

At first glance it would seem that the major problem area to be explored is the *interface* between monetary policy and credit allocation; this is where the principal source of dissatisfaction seems to lie and where the chief suggestions for innovation and change seem to concentrate. Along these lines, the relevant questions would be:

> Can the use of direct controls over credit allocation improve the way the present system functions? If so, what form should these direct credit controls take?

A second look at the problem suggests that this approach is too narrow, and being too narrow it could lead too easily to answers favorable to direct credit controls – answers which may not follow if the problem itself is viewed in its entirety. Although the stream of dissatisfaction with the functioning of the present system is large, it does not flow from a single source. Even an incomplete listing of the sources from which dissatisfaction does flow would show that they are numerous, diverse and by no means confined to the *interface* as such. While all of us, including the Federal Reserve, are dissatisfied to some extent, each has a different diagnosis of what really is wrong and each has a different axe to grind. In this conference, confining the discussion to the *interface* alone is too constrictive. The relevant questions should be couched more broadly:

> What is wrong with the present system and how can it be improved? What role should explicit or direct controls over credit allocation play in this improvement?

If the case for direct controls is a good one it should be able to survive the broader approach outlined above.

*The Present System*

It is useful to classify the real sources of dissatisfaction with the present system into three broad categories: Those primarily related to the stabilization objective; those primarily related to resource-allocation priorities; and those that arise entirely from the interface between the two.

*Stabilization Policy*

(1) For many people, including myself, the real root of the system's recent and present problems can be found in the unwillingness or inability, or both, of the Executive and the Congress to recognize that fiscal policy is an essential tool for disinflationary policy. Consequently, too large a burden for disinflation has been placed on monetary policy, and this has repeatedly resulted in very sharp increases in market interest rates, serious disintermediation, and the credit allocation problem. Direct credit controls can help alleviate the credit allocation symptoms, but in themselves they can do little to solve the root of the problem itself.

(2) For others, again including myself, a secondary root of the system's difficulty stems from the fact that increases in interest rates, which are wholly or largely due to inflation itself, do not serve to reduce the demand for credit in a world of tax-deductibility. Indeed in some situations their effect can be perverse. Assume for example that the nominal rate of interest is 5 percent in a world that perceives zero inflation. At a 50 percent tax rate the real cost of credit is 2.5 percent. Assume that expected inflation rises to 4 percent per annum and that the nominal rate rises to 9 percent. The after-tax nominal cost would be 4.5 percent, but the real after-tax cost *falls* to 0.5 percent! To the extent that earnings are subject to the full 50 percent tax rate the expected rate of return measured on a real after-tax basis also falls. However if part of earnings is subject to a lower rate of tax the fall is not commensurate and the effect of higher inflation-induced interest can be perverse. Thus with rising inflation, at least one engine of monetary policy is likely to be churning its wheels ineffectively upon a very slippery slope!

*The Structure of the System*

For other groups of people, and once again I am happy to be counted in their number, a good part of the problem lies within the *structure* of the financial system, especially in the fact that credit allocation depends on the existence of narrowly-specialized and restricted institutional practices and the adjacent fact that one form of direct regulation – Regulation Q and its cousins – provides a vulnerable dike between the protected lagoon and the open sea. Whether you like my mixed metaphor or not, what this group is saying is clear: Regulation Q cannot prevent disintermediation into the open market and the only real safety lies in developing a far less-specialized set of financial institutions which can adjust on both the asset and the liability sides of their ledgers. If housing has to be protected, society should do so explicitly. If Hunt Commission-type changes can be introduced, the worst of the *interface* problem, as such, will virtually vanish.

### *The Allocation-by-Social-Goals Objective*

An altogether different source of dissatisfaction with the present system arises because some people believe that the marketplace does not allocate the right to credit, and hence the right to real resources, in an appropriate way. At its mild end this group would argue that social priorities may differ from those expressed through a free market for credit – and hence that direct intervention via taxes or controls is necessary to ensure that credit is somehow reallocated in a way more consonant with social priorities. At its un-mild end the group would assert that the power to create credit is a social grant in the first place and that social priorities should have a clear right over priorities determined by the untampered marketplace.

Each of these views takes two forms – one defensive and the other assertive. Both are interesting and important, but only the former is relevant to the present discussion. It says: (a) "Tight money" may have to be used from time to time; (b) "Tight money" hurts good social uses of credit more than it hurts less-worthy uses; (c) Therefore direct controls should be used to insulate and protect the worthy uses.

In contrast the assertive form of the proposition has little to do with the subject of this seminar. It says: Whether or not there is any interconnection between monetary policy and credit allocation, i.e. during periods of loose or tight money, both sub-systems should be actively used to assign credit in conformity with politically-determined and expressed priorities.

### *The Role of Direct Credit Controls*

Viewed against the large and diverse background of those who are dissatisfied with the present system, the size of the group which looks to direct controls as a solution to the *interface* issue, as such, is not as large as it might have appeared at first glance. The question of the need for direct credit controls and the accompanying question of which and how, still remain, but the level of both their urgency and support become contingent on other solutions.

(1) Will the United States come round to using fiscal means to suppress excess demand? The answer is surely "yes". It took a whole generation of economists and millions of words to demonstrate that fiscal policy can, and should, be used when it is necessary to stimulate aggregate demand. Unfortunately this effort somehow left the wrong impression that monetary policy alone, although not sufficient to induce expansion, *was* sufficient to hold down demand. Another whole generation has been at work trying to persuade society that fiscal policy is also an essential tool on the restrictive side of the equation. Devising a simple system through which the Executive and the Congress can jointly trigger a temporary, self-terminating program of fiscal restraint without the usual ritual of delay and debate is not an impossible task, and very soon, it must succeed.

(2) Eliminating the full tax-deductibility of interest is possibly a more difficult venture. It will require the corresponding elimination of interest as income, and this, in time will require other adjustments. But it is at least as feasible as giving the Federal Reserve System a genuine set of differential powers over credit allocation.

(3) The adoption of the Hunt Commission recommendations, as revised by the Administration, will also take debate and time. However these recommendations do provide viable alternatives to direct credit controls.

(4) Finally, provisions can and will be made to alter the basic pattern and allocation of credit flows – although this is a continuing, rather than a one-shot, process.

Where does all this leave the basic questions: Are direct credit controls necessary? Are they desirable? Are they feasible? What form should they take?

These are questions the conference will try to answer. My purpose is to set the context within which they should be approached. Given the availability of alternative solutions my own guess is that the answer to the first three questions on direct credit controls is "No". Given the fact that every single form of credit not now controlled has had support as a "priority item" from some segment of society, I will make one further guess: If the question of just *how* direct credit controls should be applied is answered first, the support for the idea of using direct credit controls at all will fall by at least one-half.