

# *Improving Our System of Credit Allocation*

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Many observers are dissatisfied with our current system of credit allocation. Short-term nominal interest rates have reached record levels, yet their impact on demand for resources in short supply has not been obvious. What monetary policies would be required to halt inflation and who would suffer if such policies were put in place is extremely unclear. If monetary policy is effective, we shall almost certainly experience again situations in which potential home-buyers, small businessmen, or local officials find either that no loan can be found or only limited sums are available at very high rates. At the same time, others will be able to borrow because of their situation in the market or past institutional relationships.

In contrast to other components of the stabilization effort, the Committee on Interest and Dividends has played a minor role, limiting its action to minimal jawboning. Even so, its actions have been controversial. Some objected to even this amount of interference in the decision process while others have complained because it has failed to hold down the price of credit. Because widespread dissatisfaction points up the desire for more effective policies, this appears to be a good time for us to meet and discuss possible methods of improving our existing system of credit allocation.

Let me list some major points which I shall develop in more detail:

- Our system of credit allocation has developed in a very hodge-podge manner. It lacks internal logic and is far from the model of pure, perfect competition of an ideal market system.
- We do not know how far the existing system differs from one which would efficiently distribute savings among the variety of borrowing demands.

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- We know that our financial system has been very unstable in the past. Many of our regulations and current practices developed in an attempt to increase stability. We do not know what would happen if they were removed.
- Numerous possibilities exist, in addition to those we are now using, for more selective allocation of credit. They can be found in other countries and in our own past. Just as our present system has obvious problems, so do these other approaches.
- We would be better off if we could use fiscal policy rather than monetary policy in attempts to bring about stabilization and a more desirable income distribution.
- To the degree that monetary policy is to be used instead of fiscal policy to fight inflation, our present system requires change. We may rapidly be approaching the point beyond which tightening of over-all monetary policy may be harmful rather than useful.

Policies to improve our financial markets and move them closer to the pure, perfect model of theory can take the form either of removing regulations or of replacing or supplementing existing instruments with more logical ones. It is frequently assumed, without analysis, that removal of regulations will do the job. This may be far from true. Other features of the financial system, such as its dynamic responses, concentration of resources, and our lack of knowledge, may cause it to function less well if regulations are removed than it does at present.

In contrast, regulations, taxes, licenses and other forms of selective credit allocations can be designed to insure that our market will work more like the perfect model of theory than either our existing system or any system derived merely through doing away with current regulations.

- While we cannot know what would happen, I believe that we are more likely to achieve a better operating structure through improvements in selective techniques than through attempts which seek primarily to dismantle parts of our existing structure. We should not assume that the forces which caused our system to interfere with uncontrolled market forces have disappeared.
- Our structure of credit allocation can be improved by the use of more market-oriented selective charges and taxes. As an example, controls based on market auctions rather than existing arbitrary quotas could be introduced. There is no guarantee that results would be better. They would depend on governmental policies rather than on accidental events, but the framework of policy would be more logical. Policy results would be more predictable than they are under the existing structure. A greater degree of equity could be obtained. Efficiency would be increased.

*Our Current System*

General agreement exists in the United States that if the share of economic decisions made by properly operating, impersonal, competitive market forces could be increased, the efficiency of the economy would rise. Many of our most vehement economic debates would disappear if we had a system with pure atomistic competition, perfect knowledge, minimal impediments to instantaneous adjustments; one that corrected for problems of externalities and macro-instabilities, and that properly reflected our social priorities. Because our system is so far from such an ideal one, controversies abound, and we hold conferences such as this. We hope to find those policies, tools and instruments which might reshape our current economic system and structure to utilize market forces more fully. If successful, they would bring us closer to our ideals of efficiency and, more controversially, to desired social goals.

The financial field has been characterized since the founding of our republic by especially vehement conflicts over how well our system works and how it should be improved. As a result of a long history of instability, concern over social values, entrenched oligopolists, and periods of disastrous crises and failures, we have erected an extremely complex financial structure.

On one hand, it appears close to the competitive ideal. We have more than 35,000 financial institutions, hundreds of different credit instruments and financial markets, and an unquenchable innovative spirit among entrepreneurs. They interact with millions of borrowing units in innumerable decisions as to how and when to borrow and lend.

On the other hand, as in many economic processes, activity is concentrated in a fairly small number of institutions. In most sectors fewer than 50 firms account for a majority of assets and lending. In many localities a single institution has a monopoly in its own market. Overall, a relatively small number of institutions or borrowers — say 500 to 1,000 — accounts for the bulk of lending and borrowing. Numerous market problems arise because of costs of information, returns to scale, uncertainty, delays in the adjustment process, externalities, and frequent periods of disequilibrium.

Our money and credit system contains numerous laws granting rights and privileges in particular markets. Many sectors are highly regulated as to entry, interest rates, portfolio policy, and operations. Borrowers receive subsidies or indirect aids through tax deductions and exemptions. The Federal government helps others through direct lending, insurance and guarantees, and sponsored agencies. Some borrowing or lending is controlled directly.

We are all familiar with some of the ways in which these regulations work out in practice. The Federal government has delegated to commercial banks the government's right to create money, subject only through reserve requirements to a small franchise tax. The banks are forbidden to pay interest on these funds. They are, in addition, granted whatever protection from geographic competition they can extract from their state legislatures. The Federal government, by guaranteeing both liquidity and solvency, has aided banks and thrift institutions to develop a highly desirable type of deposit primarily for households. In turn it has restricted the uses to which these funds can be put, as well as the interest that can be paid on them.

The list of lenders and borrowers who benefit from tax exemptions, excess tax deductions and direct subsidies is long. Savings institutions, life insurance companies, banks, credit unions and pension funds have all been granted special tax treatment. Corporations are helped by excess depreciation allowances and the ability to retain undistributed profits. State and local governments, home owners, owners of apartment houses, and others are also on the list of beneficiaries. In addition, borrowers and lenders are helped or hindered by ceilings on interest paid and received, usury laws, and other efforts of both the Federal and state governments to influence financial markets.

Most observers agree that, as a result, credit distribution in the current financial system or structure deviates considerably from that which might obtain in a better constructed and operating system. The existing market is segmented by geography, types of savers, lenders, and borrowers. While some overlaps exist, and while large borrowers may encounter quite effective competition, non-competitive pockets remain for many. The procedures by which credit is allocated contain many non-price elements. They lead to rationing on a haphazard basis that is not well understood. They may raise the average level of interest rates. They express in only the dimmest way national priorities for credit.

Nor is it clear whether the existing system increases or reduces instability compared to other possible market structures. Under the present system interest-rate movements appear to be increasing in volatility. As this trend continues, the probability of a major financial crisis rises. A system which works under conditions of minor instability may not be viable if financial institutions and corporations find they must adjust to ever-larger fluctuations in interest rates and liquidity.

As an interesting aside, in the recent past when some commercial banks announced they would use so-called "market determined rates," they made clear that they were talking in terms of their customers' but not their own prices, i.e., the amount of margins or mark-ups they charge between their borrowing and lending rates. They based their pricing on techniques which could not occur in a competitive market, but could exist only in an imperfect-oligopolistic market with administered prices. They announced they would alter their prime lending rate weekly or bi-weekly to insure themselves a constant mark-up on margin for their services. Such movements could not occur (except under most unusual circumstances) in any type of a well-operating competitive system.

In addition to the questions our current system raises with respect to domestic financial markets, still larger ones are found when we examine the international sphere. The growth of multinational corporations and banks, as well as increased international lending, has been dramatic. These firms have the ability to borrow and lend in a wide variety of separated domestic markets. As the number of available markets grows so does the variety of financial structures faced by a firm. All of the problems of different regulations, tax systems, subsidies, information, etc., rise exponentially. Unique features are offset or multiplied by an overlay of regulations dealing specifically with foreign borrowing and lending.

While purists may believe that all of these international variations can be encompassed and such market differences can be corrected for through adoption of flexible exchange rates and international speculation, the problem in practice is far more complex. Shifts in exchange rates which primarily reflect market structures rather than underlying economic values may cause extreme variations among local markets in credit and resource allocation and costs. Just as the current internal systems do not guarantee that we will reap the benefits of pure, perfect competition, so differences among them mean that flexible exchange systems may exacerbate, not reduce, the amount of instability and divergences from an efficient or desirable solution.

### *Possible Improvements in Credit Allocation*

Just as general agreement exists that a well-operating market can improve economic decisions, so also most observers believe, even though they may not agree on specifics, that improvements are possible in our financial structure.

*Secular Aspects.* In an improved market, borrowers would be more likely to obtain the funds which they were willing and able to pay for. Savers would receive competitive rates of interest from financial institutions. Lenders would not discriminate among potential borrowers. Rates would depend on risk, duration, size, and type of loans and would not be affected as much by institutional relations as they are at the present. The profits of institutions would be at the competitive level.

Each observer probably has a different list of the types of changes he believes necessary to bring about a more perfect market. Some place great stress on reform of our system of regulations, taxes, and subsidies. Many emphasize changes in organizations, chartering and better information. Still others stress new tools and instruments for credit allocations. Some feel improvement in how the market reflects social needs and desires is most necessary.

Even if the financial markets were completely rational and allocated resources efficiently on the basis of existing private earnings or wealth, logical reasons could exist for governmental policies to alter such allocations. Just as tax and spending programs have been used to express social priorities, so have special claims on financial markets or below-market rates been used in many countries for these same purposes. Financial income is a significant part of the whole. It can be redistributed through financial policies. Governments provide increased access to the credit market for demands such as schools, lower income housing, ecological improvements, redevelopment of urban centers or rural areas, or other needs which appear to promote national welfare more than other less vital expenditures.

*Stabilization Aspects.* Perhaps more significant at the moment are changes in the financial system which would aid our stabilization goals. If monetary policy is to fight inflation successfully, we may need to find new techniques to make such policy effective.

For purposes of stabilization, even as demand is restricted in inflationary sectors, we might want to maintain other demand in sectors critical in an economic or social sense or which use available non-transferable resources. At the present, even if inflationary demand arises primarily in a limited number of sectors, aggregative techniques curtail demand and output across the board. The total impact may, consequently, be more than desired, or adequate curtailment may be possible only through major shifts in resources away from spheres with high national priorities.

When monetary policy is tightened, the burden on different sectors is both uneven and haphazard. It depends not on any necessary

or valid economic principles but upon the particular shape of the financial structure as it has developed to this time. If our credit allocation system is improved, the burden may be made more even and less random.

A good deal of concern is expressed about the major redistributions in wealth which accompany rising interest rates. Just as with inflation, changes in wealth and income which arise from rapidly shifting interest rates have only slight economic logic. A family may experience a large capital loss or gain, depending on when its head is transferred to a new city. Two adjacent school districts may have most uneven tax burdens, depending on when they happened to finance their new high schools.

Under a system which relies primarily on the control of total credit, the burden of restraint falls very unevenly. Who pays for the battle against inflation depends not on equity or economic efficiency, but upon the particular distribution of debts, assets and cash flows that exist at the start of the period. The greater the variations in interest rates required to bring about the desired level of restraint, the greater are the inequities that result from major shifts in interest rates and credit flows.

Interest rates are prices. The more they can be stabilized, the easier will be the fight against inflation. Narrower movements in interest rates would serve another useful purpose. Many people place a high priority on the consequent stabilization of asset prices, which would remove the inequity that arises from their wide swings. It would appear not only logical but necessary that such factors be considered in developing and using our tools of economic policy.

From the policymaker's point of view, an important reason for desiring new techniques of credit allocation or changes in the existing system may be to improve the predictability of policy while decreasing existing lags. A major school of monetary thought believes that monetary policy is not a useful tool because of its lags and lack of certainty. They prefer to accept the changes in income distribution and potential crises which can arise from a fixed monetary rule. Those who disagree with them that poor knowledge renders monetary policy inoperative would, however, welcome the improved efficiency which would ensue if new tools could insure a more exact response within a narrower time period.

Finally, changed methods of credit allocation may be necessary so demand can be cut back sufficiently without the need to raise interest rates so high as to cause a financial crisis or crunch. It is entirely possible that, given our existing financial structure, the level of interest rates required to halt inflation may not be a feasible one from

either an economic or a political point of view. The necessary degree of restraint may only be obtainable through a combination of instruments. If demand can be curtailed by selective controls in specific sectors, the lower will be the interest rate needed for a given degree of restraint.

*Foreign Lending and Borrowing.* Because the knotty problems of lags, speculation, income and interest rate elasticities in the international sphere are well recognized, our international monetary system has contained a large number of specific tools aimed at influencing credit flows across foreign borders. Virtually the identical arguments for and against the need to adopt specific new tools and instruments can be found in the international as in the domestic sphere.

#### *Methods of Altering Credit Flows*

A vast number of instruments and techniques can be used to help achieve a better operating financial structure for both stabilization and long-term allocation purposes. The literature, our past experience and the experience of foreign countries all contain a variety of suggestions. The Conference has been called to discuss in greater detail some of these possibilities.

In examining such methods I have found it useful to classify them into three types, even though several may fall into more than one category: (1) changes in the financial structure; (2) limits on quantities of credit; and (3) changes in price relationships.

*Changing Institutions.* Recognizing that our financial structure is a hodgepodge of institutions, habits, rules, market relationships, subsidies and tax preferences, observers find many actions which hopefully would improve the structure and its reactions in order to do a better job of dividing the scarce resource — credit.

Of course, the structure is constantly changing anyway. Present institutions have a long history of development. Obvious regulatory discriminations exist, praised by those they benefit and denounced by those feeling deprived. During the past five years many institutions found themselves with very unsatisfactory portfolio policies and limited flexibility. The financial market has been in a constant state of learning as it has tried to solve some of its basic problems.

The problem is whether, or to what extent, the developing structure will meet the market's basic needs. Some believe that we can now make sufficient changes so that any need for selective action

may not be necessary. We can do away with many of the selective controls of our existing system. But many are less optimistic, arguing that as knowledge increases and communications speed up, critical problems also increase. Both views reenforce the constant need to search for methods of institutional improvement.

Another approach stresses the need to create new institutions which would be more efficient in the raising and channeling of funds into deficit areas. The revised FNMA, new functions for the Home Loan Bank Board, and an environmental financial authority all are examples of this type. The improved operations and market results of FNMA and the FHLBB show that major gains can be made through institutional change.

We are currently experimenting with deregulation of deposit interest-rate ceilings. A wide variety of other suggested institutional changes are being debated. Some of these proposals are aimed directly at the problem of credit allocation. Others seem to flow from a narrowly theoretic approach to a particular part of the overall problem and may be expected to worsen rather than to correct some of the poorly working features of the existing system.

*Altering Quantities.* Several selective controls attempt to limit the quantities of credit which may be made available. Ceilings or quotas may be placed on total credit, on credit to specific spheres or to individual borrowers on credit through individual lenders or types of lenders, or preferences may be granted to credit in particular sectors.

In recent years the United States has used ceilings to control foreign, but not domestic, lending. For stock market credit, limits are placed on the amount which can be borrowed on particular types of collateral. In the past, consumer and mortgage credit were also limited in terms of the amount of a transaction which could be financed and by the length of time during which loans could be repaid. Another technique used has been through controls over capital issues — limiting the type of size of issues in the market or which could be purchased by lending institutions.

In many countries there are and have been special quotas for loans in preferred fields as well as supplementary primary or secondary reserve requirements. Reserve ratios can work in many ways. If the reserve must be kept at the central bank, it allows the central bank to control total but not specific assets. If particular liquidity ratios are required, these insure larger markets for certain types of assets — most frequently borrowing by the government. Asset reserve requirements can be still more general. They can require that specific or

cumulative fractions of each financial institution's assets be held in certain types of assets. For example, savings and loan associations are constrained to hold residential mortgages, both by regulation and by tax advantages.

*Changing Prices.* Even more common than restrictions on quantities are attempts to change credit flows by altering prices (frequently through subsidies) particularly of interest payments or the terms of loans. Subsidies usually come from the government, but they are also paid by central banks and frequently by one group of savers, lenders or borrowers to others.

Most countries have subsidies or tax preferences similar to those which housing receives in this country. The ability to borrow at subsidized interest rates is also common. Who is subsidizing whom often becomes almost impossible to determine. We have such an example in our system, where it is not at all clear whether financial institutions, large business borrowers, or mortgage borrowers are aided by the regulations against paying any interest on demand deposits or full market interest rates on time and savings deposits. We also do not know who foots these bills. Similarly, how much of the Federal forgiveness of income taxes on state and municipal bonds goes to the localities and how much to the individual or firm buying the bonds is almost impossible to calculate, since it varies greatly over time and among issues.

The opposite may also occur, of course. The price of credit to particular borrowers or classes of borrowers can be raised through taxes or other change. In the case of the interest equalization tax on foreign lending, the tax is paid by the lender. It is also possible to tax borrowers either directly or by not allowing full deductibility for tax purposes of marginal or total borrowing. Reserve ratios imposed on lenders against particular types of loans would have a similar impact in raising specific rates. By increasing credit availability elsewhere, they would also serve to lower rates on other types of loans.

#### *What Changes Should Be Made?*

We have examined some of the problems inherent in our existing credit allocation system. To achieve a more efficient structure, we must both remove certain existing inefficient features and add other elements which would improve the speed and certainty with which the financial structure reacts to change.

A haphazard system is an inefficient system. As a goal we would like the allocation of funds to be as effective as possible. This would

give a minimum cost for operating the mechanism by which claims on resources are allocated. Tax and subsidy programs would also be of a minimum necessary size; administrative and regulatory costs would be reduced. An efficient system is probably one in which borrowers (after taxes and subsidies) can obtain all the funds for which they are willing and able to pay the going rate.

This leads to a second goal for our financial system. The ability-to-pay criteria can be made consistent with a proper expression of the public's social priorities by ensuring that those sectors which are accorded priority have the ability to pay. This can be approached by optimizing our policies and programs for taxation, subsidy, lending, and direct government appropriations.

Progress toward a more stable system is also desirable. In a stable system uncertainty is reduced, as are the lags between policy changes and final spending. The policy instruments would be adequate to the job set before them. With such characteristics in our financial system, we would expect less variation in financial flows through institutions and the open market and less volatile interest-rate fluctuations.

In examining the possible ways to improve the present situation, we find major conflicts in views. The situation is like the proverbial half-empty, half-full glass, depending on the outlook of the beholder. Observers who are basically pessimistic with respect to government action and optimistic with respect to what an uncontrolled market can do stress the advantages of deregulation. Others, more skeptical, stress improvements in the existing structure.

One solution to the difficulties raised by our present methods of credit allocation might be to use only fiscal, not financial, policies to help achieve economic goals. In a perfectly functioning flexible system with complete information and without any policy lags, we might find that fiscal tools were always more efficient than monetary and financial instruments for stabilization purposes. Furthermore, it is possible that under more perfect conditions, using only fiscal tools would be a better way to express social priorities. However, in the world as we know it, this seems not to be the case. Monetary policies for both stabilization and social priorities developed and are used primarily because they have been more adaptable and politically easier to instigate.

If we could abolish all existing regulations, the average family might be better off. But, unfortunately, there would be many families not as well off. The present system has evolved through innumerable financial and political battles and actions. A sudden shift in the structure would raise strong opposition from those who would be hurt. Problems of compensating them are difficult, both because equities are not clear and because losses are hard to measure.

It is also true that we do not know whether a more competitive market would solve the problems of stabilization and equity as well as the existing system, or how it would compare if we improved rather than abolished current techniques. Almost all of the analysis one sees of this question tends to be static. Very little work has been done on dynamic solutions, particularly ones which take into account poor information and significant time lags. Yet it was the existence of these forces which led to the development of the present structure.

Because no one knows or has analyzed what would happen, recommendations for changes depend primarily on personal value judgments and individual points of view. Those who believe that, contrary to history, the financial market left to itself would operate with stability, equity and efficiency, and who place little value on existing rights stress deregulation as the solution to our problems of credit allocation. Those who recognize the difficulties and costs of massive changes in the structure, who believe that past policies have increased, not diminished, stability, who are somewhat optimistic that logical governmental policies can be operated — or at least that monetary policies can be changed more easily than fiscal ones — tend to argue for improvements in monetary tools and better selective techniques rather than for their elimination.

### *The Role of the Federal Reserve*

I think it only fair to say that the attitude toward the problem of credit allocation over the past 20 years at the Federal Reserve has been ambivalent. The initial theory under which the System was founded was based on differential uses of credit, and qualitative measures were used through the Korean War. From 1953 to 1965, however, most emphasis was placed on aggregative monetary and credit policy. Indeed, during much of that period the Fed seems to me to have welcomed selective sectoral impacts, since it was believed they speeded up and increased the total effectiveness of a given degree of monetary restraint.

Since 1965, however, the Federal Reserve has frequently stated that monetary policy might be more effective if all sectors were restrained more evenly. The Fed has used its limited powers — regulations over maximum interest rates and reserve requirements as well as voluntary controls on foreign lending — to obtain some selective results. But at the same time there has been strong support for deregulation, particularly in the sphere of interest-rate ceilings on time deposits — Regulation Q.

On the whole, I believe it would be fair to say that the majority of those in the System have opposed the use of a more selective monetary policy. They did not argue against the use of monetary policy *per se*, but did oppose more Federal Reserve involvement in the system of credit allocation. In many cases the view seemed to be that if the Federal Reserve had greater responsibility for credit allocation, pressures to meet specific needs would be so great that monetary policy could no longer be used effectively for stabilization purposes. More and more needs would be assigned high priorities. Sectors disadvantaged in the credit allocation procedures would press, even more than now, for political solutions to their problems. As a result, total credit could no longer be constrained to a sufficient degree for overall stabilization policy.

This general view was reenforced by two specific points. Most suggestions involved the use of Federal Reserve regulations only with respect to member banks. This fulcrum for Federal Reserve action is too small to promise useful results. Any instrument for altering credit allocations must be concerned with the interrelationships which exist among markets and institutions. Any attempt to affect the distribution of total credit flows to a significant extent through banking controls alone would impose an intolerable burden on the 5,700 member banks of the Federal Reserve System. Foreign experience shows that attempts to control only one part of the financial system do not work. New institutions and methods of lending proliferate.

Furthermore, it seemed unlikely that there would be any clear mandate from Congress or directive from the executive as to what sectors (or what elements within those sectors) a credit allocation program should favor (or discourage), and to what degree. The Fed feels uncomfortable enough with the changes in income distribution it causes with its existing powers and policies without seeking added duties.

These arguments have no certain refutation. Answers must be pragmatic, based on one's views of the American economy and political structure. The added pressures exerted by selective powers must be compared to those which are now felt. Partly, of course, this depends on whether central bank policy can be more effective if the necessary powers exist to improve the distribution of credit and resources. Pressures, as well as results, depend on whether there are sufficient tools to do the job. My own belief has been — and recent experience does not contradict it — that the Federal Reserve and the Administration need better techniques to deal with the problems raised by sharp movements in monetary aggregates and interest rates. Some risks of added political pressures should be taken.

On the other hand, I believe it is proper for the Federal Reserve to object to being asked to use additional powers such as supplementary reserve requirements without a clearer indication of what objectives such policies are to seek and without clearer directions as to how extensive such assistance should become.

### *Conclusion*

Because my paper is primarily introductory to a conference in which most papers are concerned with specific tools and techniques, I have not attempted to discuss the pros and cons of particular suggestions. However, I believe it only fair to state my own views.

I believe that for both stabilization and fulfilling social priorities, taxes and subsidies are preferable to monetary or credit policies. Fiscal policy can constrict all spenders and investors rather than only those whose expenditures in a particular period happen to depend on credit. Even more vital is the fact that reactions should be more certain as well as more equitable.

On the other hand, fiscal policy in fact has not been flexible. The lag in recent years between the time a policy need is recognized and is finally enacted has been long. In 1972 and 1973, as in 1966 and 1967, both the Administration and the Fed appeared to believe that fiscal action was required. To fight inflation successfully, specific taxes should have been increased. But in both periods the Nixon and Johnson administrations failed to include the policies they thought proper and best among their suggestions because of political considerations and because they were pessimistic and believed that Congress would not enact them.

Because fiscal policy is not used, the need for action in the monetary and credit fields arises. I believe, too, that there are strict limits on what monetary policy can, and therefore should, attempt to do in a fight for stabilization. Having made monetary policy, I am more concerned than most over the uncertainty of when and what will happen if monetary tools are used. Because of all we do not know, I believe the magnitude of policy changes should be limited. Neither extreme of policy action — the fixed rule or drastic monetary moves — is feasible with our existing instruments and structure.

Some of the problems of short-run stringency can be avoided if we improve our existing institutions. I have advocated in the past more logical portfolio policies, more flexible arrangements for interest and principal payments on debt instruments, unified Treasury borrowing for agencies, and additional special purpose agencies. It is important that steps such as these plus others be taken in order to equalize the future impact of monetary policy.

Beyond changing institutions, however, I believe that new techniques, similar to those used in most of the rest of the world, may be necessary if monetary policy is used to curtail demand sharply. Such policies should be as automatic as possible and require the minimum of administration. They should primarily influence market decisions and not attempt to supplant them. They should apply to all, not banks alone, so as not to be dissipated by shifts in the channels of borrowing or lending. They should vary as the problem areas alter. Controls should be used only for stabilization purposes and only for minimum periods. Their effectiveness decreases and their cost increases with time. Policies for stabilization should differ from those aimed at long-term aid to priority borrowers.

It has seemed to me that a technique which meets many of these criteria is that of raising the marginal cost of non-preferred borrowing in periods of monetary tightness. Many instruments for raising such costs are available, for instance through taxes, decreased tax exemptions, or charges for borrowing or lending permits. Steps of this type can both increase the effectiveness of policy and lower its cost. Under the Credit Control Act the President has the authority to introduce such instruments immediately.

More selective controls are necessary primarily if more impact from financial policy is desired in the fight against inflation. Added instruments will increase both the certainty and the equity of policies. Under the existing authority, action can be taken to raise the costs of money to specific borrowers or from particular lenders. In addition, policies can take into account whether funds are flowing overseas or internally; they can consider type of use, size of borrower and similar factors. They can thus fill the gap which aggregate moves in money and credit cannot.

Clearly, the introduction of variable charges would be controversial and hard to apply. I believe, however, that it would be less dangerous and harmful than possible alternatives such as deregulation or pushing much farther with an unchanged structure and current instruments in attempts to solve problems that are really beyond the scope of existing tools. Attempting to do too much through tight money could start us on the road to financial crisis and panic.

Our financial system has evolved over the past 200 years to this point. We should not assume that further improvement is impossible. At the same time, minor tinkering may not suffice. We should strive for a system which truly allows the market to make the maximum number of decisions within a structure that assures more stability, certainty and equity. This may well require a structure which is more

logical in the way it allocates credit to specific uses. It may mean that we place more emphasis on raising costs specifically to classes of nonpreferred borrowers or uses rather than across the board when we want to use monetary and financial policy to restrict demand.