Controlling Lender Behavior: Asset and Liability Restraints

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In recent years, there has been considerable discussion on the matter of channeling credit into socially desirable investments. Among the many problems to be faced in this area are (1) identifying those social objectives or sectors that warrant special attention, and (2) reducing the resulting large number – which would certainly include housing, small business, agriculture, and environmental controls – to manageable proportions. As is well known, the more pieces of the economy that are designated as socially desirable for public policy purposes, the less useful such a designation becomes. Available funds and other resources can be channeled into designated areas of the economy only at the expense of nondesignated areas. Therefore, a balanced view of the whole question of socially desirable forms of credit must take into account the implicit reordering of social priorities that, in effect, reduces the amount of funds and resources flowing into affected sectors. Trade-offs are mandated, but may not be made very easily.

The American political process does not provide an explicit or suitable framework for arranging or reordering social priorities or objectives. Rather, the process tends to be one of compromise and of politics. As a result, policy incentives for most economic sectors are developed in a highly diffused and disorderly fashion. The result is often little net benefit to those sectors.

It can be argued that it is desirable to direct resources and funds into selected areas of high social priority when and where the private market economy either cannot or will not do the job on its own. For one thing, considerable evidence exists that the private credit market

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discriminates against certain types of borrowers. As a result, the Federal Government has developed a set of complex Federal and federally sponsored agencies, as well as federally chartered and protected lending institutions, that are designed to help fill gaps in the flow of credit to such borrowers. Second, through the Federal budget, the Government attempts to compensate for the divergence between private benefits and social benefits, as well as between private costs and social costs.

Techniques of Credit Allocation

What is the best technique for channeling funds into socially desirable sectors of the economy? The attention in this paper, not surprisingly, is on housing, or more accurately, the financing of home construction and the sale of new and existing housing. The Federal Home Loan Bank System regulates the portfolios of savings and loan associations (S&Ls) to assure that an adequate volume of funds flows into housing. A plausible, or at least possible, alternative would be to create incentives for those institutions to make selected socially desirable investments.

Before discussing the merits of these two alternatives – portfolio control versus incentives – it may be instructive to provide some additional perspective. The application of either controls or incentives can occur at any one of several levels in the delivery system of the financing of housing – to the house itself, to the mortgage instrument, or to the lending institution. Taking each in turn:

> Tied to the house: Housing allowances and the income tax deductibility of property tax payments are incentives to home ownership.
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> Tied to the mortgage instrument: Income tax deductibility of mortgage interest payments may favor the use of a mortgage rather than cash payment for a home, or may encourage high loan-to-value loans rather than large downpayments. Government programs, such as the Tandem Plans, subsidize mortgage interest returns for investors. Tax credit proposals are designed to make mortgages more profitable and, thus, more appealing to investors.
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> Tied to the lending institution: Deductions from income for bad debt reserves, which are related to the ratio of mortgage investments to total assets of thrift institutions, represent a prime example of a policy designed to bind a financial institution into specialized lending for housing.

Some economists argue that the fungibility of capital introduces an undesirable "slippage" into the delivery system for home finance. As a result, the more directly Government policy is tied to housing, the more effective that policy would be. If that is true, policies tied to the house are likely to be more efficient and more effective than those tied to the mortgage instrument, as well as those tied to the lending institution.

The fungibility concept can be used to develop the argument as follows: A major source of financing for small business is the funds obtained from refinancing an entrepreneur's home. Such refinancing presumably results in an additional sum of money being loaned by an institution – most frequently a savings and loan association – through a mortgage instrument. The "extra" funds are not channeled into housing, but instead go directly into the small business. The question could then be raised, why should the savings and loan association be allowed to utilize a tax program designed to assist home ownership to provide funds for non-housing purposes?

A part of the answer, of course, is that the great bulk of mortgage lending by S&Ls translates directly into housing. The slippage that does occur, through refinancings to generate capital for a small business or for a college education, may also be socially desirable – or not undesirable. Moreover, it can be argued that, without the ability to refinance his home in order to obtain funds for a small business or for a college education, a homeowner might be forced to relinquish ownership – to sell the house – to raise such funds. This alternative, while a free market choice for the individual, may not be considered socially desirable.

Another part of the answer is that, if capital is indeed fungible and if S&Ls reduce their investments in mortgages, it is questionable whether other lenders would fill the breach. If they did fill the breach, what would be the cost? What would be the extent of consistency and reliability, and what would be the nonprice terms and efficiency? Residential mortgage lending is a highly specialized function where localized knowledge and talent are important. The benefits of doing away with tax incentives for lending institutions that specialize in home mortgages, in order to shift the impact of Government policy more directly to the mortgage instrument or to the house, are obviously not clear.

To summarize, the existing array of Government policies with an impact on each of the three levels in the delivery system for home finance works efficiently and effectively in practice. The social costs of the bad debt reserves of S&Ls are no less open and measurable than income tax deductibility of mortgage interest and property tax payments; likewise, the social benefits are no less open and measurable. Although mortgage funds are somewhat fungible, their ability to substitute for other sources of credit is essentially independent of the delivery system of home finance.

Against this background, the merits of portfolio regulation versus incentives for channeling an adequate flow of funds into housing can be discussed. Those who stress a free market approach prefer to do nothing, but when forced to choose would prefer incentives to direct portfolio regulation. They believe that incentives permit social costs to be made explicit and measurable, and therefore controllable. However, previous experience with expenditure and tax subsidies indicates that there is vast potential in the incentive approach for loss of control and for manipulation for politically – rather than socially – motivated purposes.

In the case of mortgage finance, it is an open question whether incentives would be applied to stimulate new home construction, to the refurbishing of older homes, or simply to the turnover of existing housing. The stimulation of home construction to lead the economy out of a recession has been a favorite countercyclical policy over the years, a policy that is usually motivated by factors other than the housing needs of consumers. It is also a major question whether subsidies should be attached to single or multi-family housing, to new or existing housing, to attached or detached homes, to low- or high-priced housing, or for housing the young or the elderly. Resolution of these alternatives would take the wisdom of a Solomon (we are pleased that Ezra Solomon is on the program).

The question may also be raised as to whether portfolio regulation is more desirable as an alternative to incentives for housing finance. Portfolio regulation of S&Ls is at the heart of the Federal Home Loan Bank System, and, as such, has some "socially redeeming value."

Admittedly, portfolio regulation can be overly rigid. The extent to which certain types of socially desirable credit are needed is not fixed, but actually varies over both time and place. Moreover, there is often no consensus on the size, intensity, or duration of the need for socially desirable credit. Housing construction is clearly one area where individuals inside and out of the Government may legitimately disagree on the dimensions of need.

Even if a consensus were to develop that construction is currently adequate, portfolio regulation may channel additional credit into housing and further stimulate construction. In theory, portfolio requirements can be varied over the cycle to meet changing needs, just as expenditure and tax subsidies theoretically can be adjusted flexibly. In practice, flexibility is highly unlikely. Indeed, this is why additional policies have been developed to supplement and to add flexibility to basic programs. For instance, the Federal Home Loan Banks have developed flexible lending programs (advances to S&Ls) to help meet the cyclical needs of mortgage lenders. In a sense, portfolio regulation satisfies the growth *trend* needs of mortgage markets served by S&Ls, while Federal Home Loan Bank advances help cushion *cyclical* needs.

A possible serious disadvantage of portfolio regulation is that, by reducing the portfolio flexibility of S&Ls, it leads to a lower level of profitability. This is in contrast to the situation under expenditure and tax subsidy inducements, where S&Ls are free to respond to such inducements in a way that still allows them to maximize profits. Thus, financial inducements may not damage the competitive position of lending institutions as much as rigorous portfolio regulation. On the other hand, a shift from portfolio regulation to expenditure or tax inducements for lending institutions in socially desirable sectors carries a serious risk of reducing the overall availability of funds to these sectors, if the added benefits from the latter do not fully compensate for the loss of benefits flowing from the former. This is a critical consideration.

Portfolio regulation may not necessarily hamper profit maximization significantly if there is, in fact, an economic rationale to such regulation that permits substantial economies of scale. Thus, during much of the "early" post-World War II period, S&Ls were more profitable than banks; the reversal of this situation dating from the early 1960s stems in large part from an unfavorable yield curve of maturities that converted the asset-liability imbalance of S&Ls from an advantage to a disadvantage.

Current Financial Institution Restraints

Although a considerable amount of detailed portfolio regulation is built into the existing financial system, most financial institutions still have a significant amount of operating flexibility. Pension funds, insurance companies, and commercial banks have broad investment powers and are certainly in a position to shift large sums of money in response to changes in private credit demands. S&Ls can make loans for single family housing, multi-family housing, residential and commercial construction, mobile homes, and for education.

The evolution of the portfolio regulation of S&Ls has not represented an active, conscious, or overt attempt to attain certain social objectives. Put simply, the lending practices of S&Ls have developed to fill the void created by the unwillingness of other financial institutions to make housing loans. The establishment of the Federal Home Loan Bank System and the system of federally chartered savings and loan associations can be viewed originally as a response to the chaotic conditions in the housing credit market that existed during the 1930s. As such, these systems were among a number of measures adopted by Government to restore the viability of many sectors of the American economy.

The history of S&Ls since the 1930s shows a continuous broadening of portfolio powers. While most of the broadening has occurred within housing and real estate, it still constitutes a substantial liberalization. This liberalization at both the Federal and state levels has generally been a reaction to both the demands imposed on the S&Ls and the changing lending philosophies of S&Ls. As such, it does not necessarily reflect a *conscious* attempt by Government to dictate the direction in which S&Ls should evolve.

Whatever the case, recent experience indicates that S&Ls are better equipped to respond to sharp changes in the economy and financial markets than earlier. For example, S&L mortgage lending held up better in 1969-70 than it did in 1966, even though savings outflows were considerably worse in 1969-70. On the other hand, it should be acknowledged that the Federal Home Loan Bank System, through an aggressive advances program, more actively supported S&L lending in 1969-70 than in 1966.

Regulatory changes beginning in 1969 have further broadened the lending powers and improved the ability of S&Ls to attract and retain savings capital. Secondary mortgage market changes are continually underway, making the mortgage instrument a more liquid and marketable security and enhancing the ability of the savings and loan industry to improve profitability through mortgage banking activities. Implementation of these changes takes time. Indeed, the regulatory changes that have occurred since 1969 were promulgated with the implicit assumption that Regulation Q would remain substantially unchanged until such time as the average portfolio earnings of S&Ls had risen sufficiently to permit removal of the ceilings.

What is needed now is a time span during which S&Ls can adjust to recent regulatory changes, and after which the operational success of these changes can be assessed. Forces are already in motion within the savings and loan industry and the secondary mortgage market to enhance the profitability of S&Ls and the investment qualities of home mortgages. These developments promise to deliver long-run improvements to the capability of the Nation's delivery system for home finance.

Of particular importance is the need to make the mortgage instrument more competitive with other investment alternatives. This is, of course, easier said than done. At least until very recently, the socially desirable character of the mortgage has kept it as a low interest-rate vehicle. These two conflicting requirements are not easily reconciled. To compensate for lower yields, the mortgage instrument must be made as liquid, as riskless, and as acceptable to investors as is possible. An improved secondary market, such as the automated trading facility proposed by the Federal Home Loan Mortgage Corporation, would be a step in the right direction.

Housing capital requirements are far greater than any other credit needs of households. As a result, a specialized institution aimed at satisfying the entire range of financial requirements of households inevitably would still have to allocate the largest percentage of its resources to housing. Thus, there need be no serious conflict between permitting reasonable portfolio flexibility designed to enhance profitablity and to help the consumer, and the objective of channeling credit into housing.

Additional broadening of the regulatory authority of S&Ls would necessarily generate some risk of an adverse impact on home finance. But there is also a risk to housing in not making improvements in portfolio regulation that would be necessary to strengthen the competitive viability of S&Ls. In the final analysis, the risks must be weighed against each other.

Liability Restraints

There is always the basic question of whether specialized institutions such as S&Ls can thrive – indeed, survive – in a world of completely unfettered rate competition. If asset portfolio regulation is likely to bring with it some constraints on profitability, S&Ls cannot compete on the liability side in a completely free market. Interest-rate controls of the Regulation Q variety, which are imposed on depositary institutions, are currently necessary for the survival of S&Ls. It should be noted, however, that despite restraints on the asset composition of S&Ls prior to 1966, interest-rate controls were not essential. Indeed, S&Ls and mutual savings banks (MSBs) had no ceilings on rates payable, and commercial banks in general offered returns on savings that were lower than permitted under Regulation

Q ceilings. It may be asked, what has changed since 1965 that now dictates the need for interest-rate controls for depositary institutions?

Briefly, the primary difference would be the heightened competition for consumer savings deposits, which has been caused mainly by the increasing inadequacy of demand deposits as a source of funds for commercial banks. It also reflects the fact that savers are increasingly sophisticated in money management. This situation has evolved slowly over time. The raising of Regulation Q ceilings by the Federal Reserve in December 1965, in response to the changing priorities of banks, officially marked the beginning of a new era in rate competition. An era(?) of even greater competition may have been inaugurated on July 5, 1973.

Do rate controls work? Two features of rate controls – ceilings *per se* and rate differentials among different lenders – must be evaluated separately. In 1966, many S&Ls and MSBs for a time lost savings to commercial banks until differentials were established to favor the S&Ls and MSBs. In addition, savings funds at all depositary institutions were lost to open market investments. In 1969-70, rate differentials prevented sizable transfers of funds out of the S&Ls and MSBs into commercial banks, but did not prevent serious disintermediation from all deposit-type institutions into the open market. In the current situation, with interest ceiling differentials either narrowed or nonexistent for some categories of savings certificates, S&Ls and MSBs are again losing deposits to the open market but, unlike 1969 and like 1966, are also losing deposits to commercial banks. Interest-rate ceilings *per se* obviously affect the total flow only when they are below yields on alternative investments in the open market. On the other hand, differentials among deposit-type institutions tend to be effective throughout the interest-rate cycle.

Thus, it can be concluded that rate controls "work" with respect to a two-pronged impact on the volume and allocation of savings. With respect to housing, to the extent that ceilings *per se* do not cause more disintermediation from the S&Ls into the open market than differentials retain for the S&Ls, then rate controls in general would tend to cushion declines in mortgage lending during tight money periods.

Concluding Comments

Government policy tools provide a large number of trade-offs designed to stimulate housing or other social objectives. Limited knowledge with respect to the impact of each of these tools suggests that greater reliance is needed on a mix of different approaches to attain socially desirable goals, rather than depending on any one approach. Nothing is ideal or sacrosanct in the present system of portfolio regulation to achieve socially desirable ends. Yet, considering the problems with other policy approaches, portfolio regulation is not yet ready to be relegated to oblivion.

A possible approach that would move the financial system a step closer to the ideal solution may be to improve the rules to make institutions more effective in carrying out their objectives, rather than to abandon portfolio regulation. Even the most fervent supporter of specialization for S&Ls in the field of housing would have to concede that such specialization can be self-defeating if it does not allow for sufficient profitablility for S&Ls. Without adequate profitability, S&Ls cannot pay a return to savers that is competitive in private markets, but there is a limit to the extent to which S&Ls should or can be sheltered from the competition of more profitable lending institutions. Any system of portfolio regulation must, therefore, not only be designed to channel funds into appropriate areas, but also allow a reasonable level of profitability that makes it possible to compete for funds.

In this connection, it would be helpful to broaden and deepen the portfolio choices of the S&Ls in order to provide a broad complementary package of services to households and families, which would increase the inducement for them to do business at S&Ls. This would permit S&Ls to shift funds among different types of investments, and to better balance asset maturities with liability maturities, so as to meet liquidity needs and to exploit profit opportunities more effectively and more efficiently.

Many portfolio restrictions are nothing more than a by-product of concern for the soundness and solvency of financial institutions and, in large part, reflect the unfortunate experience of financial institutions during the Great Depression. To the extent that stabilization policies of Government have been successful, a number of portfolio restrictions have been relaxed. Nevertheless, there are so many different types of financial institutions, with such broad lending and investment powers, it is reasonable to conclude that in the context of the overall composition of credit, portfolio regulation has probably had only limited impact in redirecting the *total* supply of credit into socially desirable channels. Probably the major impact of portfolio controls on S&Ls has been to reduce somewhat the degree of fluctuation in housing credit in the short run, but not to change significantly the flow of housing credit over the long run.

When portfolio restrictions on S&Ls are viewed in the more limited context of other policy measures taken to stimulate housing credit in the economy, the impact has been a much more substantial one. Thus, taking into account the Federal Home Loan Bank System, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Government National Mortgage Association, and the Farmers Home Administration, as well as Government-sponsored devices to stimulate housing credit (such as GNMA passthroughs), the overall impact is even greater. These other policy tools do not involve portfolio regulation. They provide incentives (or institutional mechanisms) of one type or another to stimulate or stabilize housing credit. All of which forcefully illustrates the fact that we have a very mixed system for attaining the Nation's housing – as well as other social – objectives.

It would be remiss not to mention the Hunt Commission report and the more recent document, "Recommendations for Change in the U.S. Financial System," which, of course, stems from the Hunt Commission report. As is widely known, both of these purport to be able to solve many of the problems involved in controlling lender behavior. At least two basic questions need answering before there can be agreement that this is the case. By providing S&Ls more flexibility on the asset side, will there be greater ability, in fact, to compete for funds and thus maintain an adequate flow of funds into housing; and second, will a mortgage tax credit of reasonable size entice other lenders into the mortgage market?

The first question can be debated indefinitely. The only real data available were presented by Jaffee and Fair at the Nantucket Conference last year. They argue that, by giving S&Ls expanded lending authority, the flow of funds into the mortgage market will actually be increased. The one serious flaw in their argument is that the non-rate control data used were of a pre-1966 vintage. As indicated earlier, commercial banks are now much more interested in consumer savings than they were in the early 1960s. (The activity of commercial banks in the new four-year consumer CDs since July 5, 1973, has been a sight to behold.) Subsequent simulations performed by Jaffee, with commercial banks competing head-to-head with S&Ls, have shown much different and disheartening results for both the mortgage market and S&Ls. Also, Jaffee and Fair assumed almost instantaneous portfolio adjustment by S&Ls. This is obviously impossible, in view of the asset composition of these institutions. Parenthetically, even the Treasury has recognized that the adjustment could take as long as five years.

With respect to the second question, the answer would seem to be a definite and resounding "no." Ignore for a second the effects of eliminating the bad debt reserve, and take, for example, an 8 percent mortgage. Tax credits of 1 percent, 3 percent, and 5 percent would raise before-tax yields to 8.16 percent, 8.48 percent, and 8.80 percent, respectively, assuming the 50 percent tax bracket. It is conceivable that an increase in yield of 80 basis points would entice *some* investors, but marginal investors in mortgages may only be offered a tax credit of 1 percent or less – if that much. An increase of 16 basis points in yield, or less, is unlikely to shift or attract many funds. In addition, pension funds, which are a primary source of untapped mortgage funds, are not taxed, so there is no marginal benefit to them.

These comments should not be construed to imply opposition to the kinds of reform of the financial structure that are being proposed. Reform of financial markets, financial institutions, and financial flows is all to the good and is sorely needed. But reform should not contradict those established policies and practices that have worked well in the past. Nor should reform be at the uncompensated expense of the housing market. In short, the crucial thing is to guarantee that the first question raised above is answered in the affirmative. Unfortunately, much more evidence than is available now will have to be developed before the jury can be brought in for a verdict.

Discussion

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The role of a discussant is largely one of comparing what the discussant would have said with what the paper did say. Since I received the Mann-Friedman paper too late to digest it properly, I am left with the role of reporting what I think it should have said. However, the late receipt of the paper is a good sign, for it suggests that the authors, very informed and able students of capital markets, were occupied by the pressing problems of the Federal Home Loan Bank System.

Before briefly discussing their paper I want to establish a context for my remarks. In doing so I will present my view of why we are discussing credit-allocation techniques and the criteria by which these techniques can be evaluated.

I believe that our reasons for considering controls are primarily related to the conflict among social goals arising from the cyclical behavior of the financial structure of our economy. Thus, I see controls as a means of improving the tradeoffs which are implicit in the use of macroeconomic stabilization policies. I do not see credit controls as a device for altering the secular behavior of the composition of aggregate expenditures. Our concern with the secular behavior of the shares of "high priority" claims on aggregate output has already been expressed through such "tax expenditures" as the deduction of mortgage interest and the tax-exemption of state-local interest, as well as through other methods such as Federal mortgage guarantees.

In order to support this view of credit-allocation techniques as a short-run supplement to macroeconomic policies, I offer answers to three questions. First, what are the problems with our financial structure which lead some of us to reject the observed cyclical behavior of

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the allocation of credit? Second, what are the conflicts among policy goals which lead to our willingness to consider credit-allocation techniques, and how well have our existing credit-allocation policies performed? Third, what are some desirable characteristics of an effective credit-allocation control program?

Problems with the Cyclical Behavior of Credit Allocation

It is well known that in periods of tight monetary policy the share of total credit taken by small businesses, home buyers and state and local governments declines while in easy money periods these shares recover. What is not well known is why this happens. Those who view credit allocation as determined primarily by interest rates argue that this is the natural, and necessary, consequence of the relatively high interest sensitivity of spending by small businesses, home purchasers, and state and local governments. Since these sectors are especially sensitive to interest rates and since capital expenditures are easily postponable, we should not worry about such a cyclical behavior of credit allocation. Rather, we should welcome it as enhancing the effectiveness of monetary policy.

Such an optimistic view of credit allocation has its opponents, who note that interest rates do not tell the whole story. Nonprice means of rationing credit are widespread in the commercial loan and residential mortgage markets, due largely to the loan-rate setting behavior of commercial banks and thrift institutions as well as to the existence of usury ceilings established by states and by the FHA and VA. State and local governments have also been faced with usury ceilings. In addition, the tax-exemption of state-local interest payments imparts an especially great volatility to the cost of credit for state-local governments as commercial banks increase or decrease their participation in the municipal bond market.

It requires no major search to find evidence that the structure of financial markets does not allow interest rates to provide the sole explanation of the cyclical behavior of the allocation of credit. What is not known, however, is the extent to which market imperfections shape the allocation of credit. While extensive research is needed to establish the suboptimality of credit allocation, there is clearly a potential role for credit-allocation techniques in moving more toward an appropriate composition of credit. Even if all usury ceilings were eliminated, the behavior of major financial intermediaries is not likely to allow us to ignore the thesis that credit markets discriminate against small businesses, home purchasers, and state-local governments.

Conflicts Among Stabilization Policy Goals

For my purposes I will concentrate on the conflicts among four stabilization goals: stability of real income growth, stability of the rate of inflation, stability of interest rates, and stability of the composition of aggregate spending. By stability I do not mean constancy. Instead I mean that we are concerned with the amount of short-run swings in macroeconomic variables. Clearly the weights attached to achievement of each of these goals vary considerably among informed individuals. For example, my interpretation of "monetarism" leads me to believe that the primary weight is attached to the real income and inflation goals while "Keynesians" place relatively more weight on interest rate and expenditure-composition goals. This accounts for at least part of the disdain which "monetarists" often express for credit controls.

Whatever the relative importance of each goal, the 1960s provided abundant evidence on the conflicts among them as well as on potential methods to reduce these conflicts. In the early 1960s, when we experienced rapid real income growth along with interest rate and inflation stability as well as a reasonably high share of "high priority" spending, there were few conflicts among goals. If anything, we wanted to promote spending, which now seems classified as "low priority," – plant and equipment investment and consumer durables.

In the mid-1960s this harmony of interests was shattered by a return to full employment in conjunction with a highly expansionary fiscal policy brought about by the Vietnam War and the 1964-65 income tax cuts. It seemed clear in prospect that a need for tax increases existed in 1965-66, and it is now clear in retrospect what were the costs of the failure to raise taxes. Most of the stresses on our financial structure as well as the disruptions resulting from a stubbornly accelerating inflation could have been avoided by an appropriate mixture of traditional stabilization policies.

Since the burdens of achieving our inflation goals rested on monetary policy, we experienced a volatility in interest rates and in the composition of spending, which has been the subject of several of the Boston Fed's monetary conferences. We also found that the policies adopted to promote secular changes in the composition of spending promoted undesired cyclical instability in the share of resources going to high priority sectors. For example, tax-exemption of state-local interest aggravated the cyclical instability of municipal finance, and restrictions on the asset and liability choices of nonbank financial intermediaries aggravated the housing cycle. The tradeoffs became more apparent than they had been – to achieve real income and inflation goals required interest-rate and expenditure-composition volatility.

The major policy responses were, as Paul Smith puts it, to add new wheels to the car rather than to fix the flat tire. While experiments with fiscal policy were undertaken, largely through the brief repeal of the investment tax credit in 1966 and the income tax surcharge of 1968, the basic problem was seen to be one of financial structure, calling for credit-allocation policies, rather than of an excessive reliance on monetary policy.

One of the first credit allocation strategies was the reduction of Regulation Q ceilings in 1966 (after they had been raised in late 1965) and the extension of deposit rate ceiling powers to the FDIC and the FHLB System. These changes, it was hoped, would mitigate the problems of cross-disintermediation between commercial banks and thrift institutions, thereby supporting housing while weakening the rise in interest rates. I believe that this step was of little, if any, benefit. The bulk of thrift deposit losses in 1966 were not primarily due to commercial bank competition but were due to disintermediation with the open market. Furthermore, the administration of deposit rate ceilings exacerbated the open market disintermediation since thrift institutions could not raise their deposit rates. Finally, empirical evidence indicates that the reduction in Regulation Q ceilings raised, rather than lowered, the level of yields available in the open market. This means that the deposit rate ceilings may have promoted thrift deposit losses as well as increased interest-rate volatility.

A second strategy employed in 1966 was the large increase in the acquisition of Federally insured and guaranteed mortgages by FNMA. While this did support the market for FHA-VA mortgages, it did so at the expense of reinforcing interest-rate volatility.

Essentially the same strategies were used in 1969, when the existence of accelerating inflation and the *apparent,* though not necessarily real, failure of the 1968 surtax led to a highly restrictive monetary policy. This time deposit rate ceilings were kept at their 1967-68 levels and both FNMA and FHLB advances were actively used to support the mortgage markets. As interest rates rose to the highest levels observed in this century, while the rate of inflation failed to decelerate, thrift institutions suffered a sharp decrease in deposit inflows and a new credit-allocation instrument was used – in early 1970 the Treasury raised the minimum denomination of Treasury bills to $10,000.

On balance there is no evidence that the credit-allocation policies of 1966-70 provided a net benefit. While housing was probably supported, especially in 1969, some of this support was at the expense of other high priority forms of spending such as state-local government capital outlays and capital spending by small businesses. Furthermore, the support of housing undoubtedly contributed to interest rate volatility and to an inequitable shift in income distribution away from small savers. Finally, the restrictions on interest rate competition among financial intermediaries led to the growth of new methods of bypassing financial restrictions – among these being Real Estate Investment Trusts, the commercial paper market and the Euro-dollar market. These changes in financial structure have, if anything, worsened the conflict inherent in stabilization policy.

The array of policy instruments which either exist or are under consideration has expanded in recent years in recognition of the need to increase our ability to achieve the multiple goals we have set. To the traditional monetary and fiscal policies have been added the housing-oriented credit-allocation policies discussed above. We have added wage-price controls to help deal with the slow response of inflation to monetary and fiscal policies. We have begun to consider alternative methods of municipal finance, such as a direct Federal subsidy through taxable municipal bonds, in order to stabilize state-local capital outlays. We have experimented with a dual prime rate in order to reduce the costs (though not necessarily increase the availability) of credit for small businesses.

Finally, and the subject of our attention here, we are considering the strengthening of fiscal policy and the development of new techniques for the allocation of credit.

Desirable Characteristics of a Credit-Allocation Controls Program

Several approaches to cyclical credit-allocation controls have been suggested. Sherman Maisel presents a case for flexible tax-subsidy policies affecting the marginal borrowing costs of non-preferred borrowers. It is not clear from his paper whether he prefers that these fiscal instruments be applied to the debt issue choices of borrowers, to the asset choices of lenders or to both sides of the market.

My view is that if credit controls are adopted it would be better that they be applied to the borrower rather than to the lender. The basic reason is administrative; there seem to be two basic non-preferred borrowers – consumers and large firms, with the latter being the least preferred. On the other side, there are a large number of financial markets with many lenders in each. Effective lender-oriented controls require policies to affect the asset-choices of individuals, commercial banks, thrift institutions, life insurance companies, pension funds and other less important sources of funds for large corporations. Borrower-oriented controls, on the other hand, can be placed more directly and certainly on the non-preferred sectors.

An effective controls program must also have a clear list of priorities and be sufficiently flexible. Priorities are needed to ensure that the controls serve the purpose of achieving a shift of credit from non-preferred to preferred borrowers rather than merely to shift credit among preferred sectors. The largely random method of creating priorities in response to crises has left us with policies which might be offsetting. For example, FNMA support of the mortgage market might aid housing largely at the expense of capital expenditures by state-local governments or by small businesses.

The need for flexibility in our policy instruments is clear from the cyclical nature of the allocation problem. We should ensure that policies to affect short-run allocation decisions do not retard the efficiency of the allocation of resources over longer periods of time. There is abundant evidence that tax-subsidy programs intended to achieve short-run goals remain in effect after the need for them has passed. An example is the administration of deposit rate ceilings since 1966 – there was little foundation for the failure to increase thrift deposit rate ceilings between 1967 and 1969. Another example is the continued high rate of mortgage acquisitions by federally sponsored credit agencies in 1971 and 1972.

Finally, if the primary reason for short-run credit-allocation policies is to overcome market imperfections, we need to know not only when and where these market imperfections are important, but how important they are. Without this information we cannot develop effective policies which are sufficiently flexible in both the ranking of priorities and the administration of the policy instruments.

Summary

I have tried to identify the primary case for credit controls and to present some characteristics of an appropriate controls program. As I see it, judgments about the secular allocation of resources can, and have been, reflected in Federal tax policy. We have, unfortunately, done something for everyone. While I believe that rationalization of our tax system is necessary in order to achieve an optimum secular allocation of resources, the main argument for credit-allocation policies lies in the cyclical movements of credit.

The objective of credit-allocation policies is to achieve a better credit (and expenditure) mix without the sacrifice in other goals such as interest rate stability. These conflicts arise largely from the heavy weight placed on monetary policies to achieve stabilization goals. Since I believe that flexible fiscal policy based on variable tax rates can achieve the goals which are set for credit-allocation policies, our major efforts should be devoted to more timely use of fiscal instruments. This would allow us to achieve stabilization goals without the creation of market imperfections implicit in monetary policy.

Even in the absence of improvements in fiscal policy the case for credit controls is weak. While such a case does exist, the requirements for an effective controls program – a clear list of priorities, flexible administration, and information on the distribution and importance of market imperfections – do not exist at this time. As Maisel notes, "...minor tinkering may not suffice." And given the state of our knowledge, major tinkering may be detrimental.

The Mann-Friedman Paper

In my opening remarks I said that I had not had time to digest the Mann-Friedman paper properly. This was before I had seen the paper. Having read it, I am not sure that it is digestible.

The paper might have been titled "An Ode to Existing Housing Policies." I suspect that it will help members of the FHLB system feel they have a friend in Washington, or in San Francisco, as the case may be. The paper opens with the observation that credit-allocation policies must be based on a list of sectors which warrant special attention. It then proceeds to discuss housing and the profits of savings and loan associations solely. Other sectors apparently are not social objectives.

But this provincial outlook is understandable. The authors' primary concern is with housing. Therefore, let us look at the meat of the paper and accept the "housing only" orientation.

The authors' efforts are devoted to justifying existing housing policies. Their main argument can be summarized in the following points:

1) The existing array of government policies with an impact on housing finance works efficiently and effectively in practice.
2) Portfolio regulation is at the heart of the FHLB system and, as such, has some socially redeeming value.

3) Reform should not contradict those established policies and practices that have worked well in the past nor should reform be at the uncompensated expense of the housing market.

While the authors pay some attention to the idea of reform embodied in the Hunt Commission report they do so only half-heartedly. The main message is clear: the existing policies, with the FHLB system at the center, work well and should not be tampered with.

The authors make a weak case for portfolio restrictions rather than tax incentives as a method of mitigating cyclical fluctuations in mortgage finance. Portfolio controls for SLAs have, they report, reduced cyclical fluctuations in housing without affecting the housing stock in the long run. The evidence suggests, I believe, the reverse – portfolio rigidity has exacerbated the housing cycle while adding to the long-run housing stock. The study by Ray Fair and Dwight Jaffee presented at a previous Boston Fed Conference reaches this conclusion. Furthermore, the conventional wisdom of the mortgage market that SLAs lose deposits during tight money because they "cannot" pay higher deposit rates due to their portfolio composition also suggests that the authors are too optimistic about the role of portfolio restrictions in the housing cycle.

On the topic of liability restrictions the authors come out for deposit rate ceilings. Their main argument is that a fixed structure of deposit rate ceilings prevents commercial banks from taking deposits from SLAs and this offsets any increased disintermediation against the open market. While I believe the conclusion is correct, it hardly makes a case for deposit rate ceilings in a broader context. The net gain to SLAs is, I suspect, small, and rate ceilings are inequitable in their impact on small savers. Finally, if rate ceilings do tighten overall credit conditions, they discriminate against other borrowers who may have as strong a social claim on resources as housing.

In summary, Mann and Friedman appear to me to be addressing the members of the Federal Home Loan Bank system rather than a conference devoted to broad questions of social policy. While I note their arguments for policies favoring housing, I do not share their view that housing is our only credit-using sector with socially redeeming value, nor can I accept their arguments for a status quo. Perhaps we are in the "best of all worlds" in terms of current policies. But Mann and Friedman provide little support for this view.