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SUPPLEMENTAL SELECTIVE RESERVE REQUIREMENTS ON COMMERCIAL BANK ASSETS: AN OPTION FOR CREDIT ALLOCATIONS BASED ON SOCIAL GOALS.

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SUPPLEMENTAL SELECTIVE RESERVE REQUIREMENTS ON COMMERCIAL BANK ASSETS: AN OPTION FOR CREDIT ALLOCATIONS BASED ON SOCIAL GOALS

In April 1970, and again in December 1972, Governor Andrew Brimmer of the Federal Reserve Board (Fed) suggested that variable reserve requirements against commercial bank assets be established as a means of improving the Fed's control over monetary conditions. This suggestion was a direct outgrowth of the failure of the Fed's restrictive monetary policy adequately to curtail certain types of commercial bank lending during 1966 and again in 1969. In particular the Fed was dissatisfied with the volume of business and commercial loans both in absolute terms and relative to the volume of loans being made in other areas, such as real estate and housing. In 1969 business loans, particularly to well established customers, were not successfully curtailed in significant volume, causing the brunt of the impact of monetary policy to fall on the housing sector, state and local governments and, possibly, smaller businesses. This was the opposite of the Fed's direct goal of less business investment and increased construction activity.

The objective of the proposed reserve requirements would be "to raise the cost of bank lending by reducing the marginal rate of return to the bank making the loan--and thereby dampen the expansion of bank loans." 1/ Governor Brimmer asserts that reserve requirements could be varied by type of loan in order to prohibit the impact of restrictive policy from falling on any particular sectors of the economy that have been singled out for priority treatment. In the current

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1/ Andrew F. Brimmer. The Banking Structure and Monetary Management, a speech before the San Francisco Bond Club, April 1, 1970, p. 25.

social environment this would mean insulating the housing market from sharp cutbacks in loan availability.

It has been demonstrated, time and again, that the housing sector suffers the most from the high interest rates brought about by restrictive monetary policy. In fact, some studies have indicated that the major impact of tight money is borne by the housing sector. 1/ This decision to shift the burden of tight money to the housing sector, however, is made in the "market" and not by any governing body. Knowing from experience and theory where the impact of a given policy action will fall is significantly different from directing where the impact should be. In the former case the market is left free to adjust to changing circumstances, while the latter does not allow such flexible adjustment. Under the market solution those sectors willing to pay the highest price, theoretically because they can use the funds most efficiently and gain the highest return, receive the loans.

The first question posed by Governor Brimmer's proposal is who should decide where the impact of any given policy should lie. If it is determined that social priorities are more important than economic efficiency, as may often be the case, who should determine and administer these priorities? Or, if the free market is viewed to be inefficient because of existing imperfect, oligopolistic, or monopolistic competition who should determine what remedial action should be taken? The Brimmer proposal assumes a broad delegation of these powers to the Fed by Congress. Of course, broad policy statements indicating that the major

1/ For example see: Gibson, William E, "Protecting Home Builders from Restrictive Credit Conditions." Brookings Papers on Economic Activity, 3-1973, Washington, D.C.

goal would be to insulate the housing sector from its wide cyclical swings in activity, for example, could be included in any enabling legislation, but the Fed would have to be left substantial discretionary authority to react to unforeseen circumstances. Congress would set the priorities, but the Fed would be responsible for their day-to-day implementation.

A key question then, which cannot and should not be answered solely on economic considerations, is whether or not the Fed should have this authority. Many interested observers, including the Chairman of the Federal Reserve Board, Arthur Burns, believe that if the Fed were given these powers over bank's lending practices, the Fed would lose some of its highly guarded political independence. The Board is already subjected to enormous lobbying efforts, by commercial banks, legislators, and others interested in the impact of monetary policy. An increase in the Fed's discretionary powers would undoubtedly increase these pressures, particularly from members of Congress and others that are directly affected by the Fed's decisions. In the past, although the Fed could predict with a reasonably high level of accuracy the impact of monetary policy actions, it did not specifically interfere with the market mechanisms, allowing the market to make its own adjustments to the Fed's broad monetary policy goals.

While the first question of who should have the powers to set lending priorities is primarily a political issue, the second question of universal Federal Reserve membership is more of a blend of political and economic considerations. Without universal Fed membership, or at least universal compliance with Fed reserve requirements, a commercial bank could avoid any and all required reserves on assets by merely dropping its Fed membership. In view of the problems the Fed is already experiencing in attracting and retaining members, any new limitations on members would probably precipitate a widespread withdrawal from the Federal Reserve System. As a result of past membership withdrawals from the System the Board has requested annually for the past several years that all commercial banks be brought under Fed control. Chairman Burns and many other supporters of universal membership maintain that allowing some commercial banks to be separate from the Fed inhibits the Fed's ability adequately to control monetary policy. Governor Brimmer not only agrees with these arguments, but also points out that, "to avoid adding further to the already existing inequities between nonmember and member banks of the Federal Reserve System, all commercial banks should be made subject to the new provision." 1/ These arguments, however, do not consider the advantages of a dual banking system, and may overestimate the ability of the Fed to increase its control over money markets through reserve requirements. 2/ Imposition of selective required reserves on assets, however, would give strong support to those favoring universal membership. If the selective reserve requirement were to be effective, nonmember banks would have to be restricted from filling the loan supply void created by the new regulations for whatever types of loans are receiving the lower priorities, most likely business and consumer loans.

The third question of interest in considering the proposal is primarily economic in nature. How effective would the required reserves on assets be in actually redirecting capital flows into the desired areas?

First of all, it is clear that establishing reserves against loans will increase the effective cost of making a loan or, approached from the other side,

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1/ Andrew F. Brimmer. Op. cit., p. 28.

2/ For a more detailed discussion of these issues see: Warren E. Farb, "An Analysis of the Case for not Requiring Nonmember Bank's Adherence to Federal Reserve Requirements," CRS, June 14, 1973.

decrease the effective yield of the loan. Establishing different reserve requirements for the various loan classes would, therefore, change the relative price structure of the asset accounts. Assuming a world of only two loan classes, business loans and mortgage loans, the imposition of reserve requirements against business loans, but not mortgage loans, would increase the market interest rate of business loans relative to mortgage loans. In effect the initial impact on the market would be to reduce the amount of funds available for these business loans at each and every interest rate (shifting the supply schedule for these loans upward to the left). 1/ In other words, commercial banks would be willing to loan fewer dollars at each and every interest rate. To this point the Fed or any other controlling authority could be reasonably certain of the impact of their actions.

Imperfect knowledge of the demand side of the loan market, however, tends to cloud the picture. Given past history, and particularly the current high prime interest rates and continuing high levels of demand for business loans it seems reasonable to infer that the demand for business loans is relatively highly inelastic. Also, it seems reasonable to conclude that mortgage loan demand is highly elastic, particularly at interest rates above 8 percent. At minimum, it is reasonably certain that the elasticity of demand for mortgage loans is greater than for business loans. This means that small increases in the interest rate (shifts in the supply schedule) for business loan funds brought about by the increased costs associated with reserves would not have much impact on the volume

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1/ Actually the two loan markets combine to make up one joint supply schedule. Thinking of the markets separately, while not totally accurate, is useful in conceptualizing the problem at hand.

of business loans. It can then be concluded that supplemental reserves on assets would probably be no more effective in curtailing business loan demand than have high interest rates, brought about through other types of policy actions, in the first round.

The mortgage market, however, might be made somewhat better off, or at least not as severely burdened as would be the case with traditional restrictive monetary policy. Assuming an initial position of "normalcy," however that may be defined, traditionally the imposition of restrictive monetary policy would raise all interest rates, sharply curtailing mortgage loan volume as supply shifts along the elastic demand schedule. Selective reserve requirements on non-mortgage loans would not inititally affect the supply or demand for mortgages, leaving the mortgage loan volume unchanged.

The secondary impacts, however, are much less clear. They might attenuate the overall impact of the new reserves or they may give additional support to the mortgage market. As the market adjusts to the new pattern of relative prices of business and mortgage loans, to the extent that the demands for various types of loans are interdependent, the demand for mortgage loans will be generally raised. This would be caused by the fact that borrowers would be willing to take down more mortgage loans at each and every market interest rate, because these loans are now perceived to be relatively cheaper than before the policy change. This shift would have the effect of increasing the mortgage interest rate and narrowing the spread between business and mortgage loan interest rates. In the limit the spread would shrink to that which existed before the imposition of required reserve on business loan balances. The commercial banks would then be willing to provide a larger volume of mortgage funds than previously, because of the higher interest rates. In terms of insulating the mortgage market from the disruptive impact of restrictive monetary policy this solution would be relatively satisfactory,[1/] but it is based on the tenuous assumption that there is a significant amount of substitutability between the demand for business loans and the demand for mortgage loans that may be in opposite directions.

The most uncertain part of this analysis concerns the secondary effects on the supply schedule for mortgages. Clearly, the supply schedules of all loan classes are jointly determined. As the relative price structure between these classes of loans changes because of a policy action it is bound eventually to affect all loan markets. The loan distribution within a commercial bank's portfolio, however, is determined by taking into account many diverse criteria. These include relative prices, term, risk, and expectations as well as many others. Numerous econometric studies have shown that a simple decision rule is not adequate. It is, therefore, possible to make reasonable assumptions that would lead to shifts in the supply of mortgage loans. Any general reduction, with selective reserve requirements on assets, however, is most likely to be less severe than would be the case with traditional restrictive monetary policy. The net effect of reserve requirements on business loans can then be summarized as being at least no more disruptive to the mortgage market (or other markets assigned favorable treatment) than traditional policy.

The analysis thus far has assumed that business loan demanders have either paid the higher rates caused by the selective reserve requirements on assets or abstained from borrowing. In the real world there are alternatives which will be

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1/ The problem of business borrowers simply paying the higher interest rates, or turning to alternative sources would remain.

used and which are likely to feed back on the supply and demand schedules of the various loan classes.

The most obvious of these alternatives is the bond market, or other sectors of the capital market. Commercial banks could be affected by increased corporate borrowing through the bond market, either through the loss of deposits, or through direct purchase of the bonds for their own asset portfolio. In the case of deposit withdrawal, or disintermediation, the lending ability of the commercial banks would be curtailed and all loan classes at commercial banks would suffer. In effect this would be equivalent to the impact of traditional monetary policy restrictive actions. If the commercial banks choose to increase the proportion of bonds, corporate or governmental, in their own portfolio, they would necessarily have to purchase (make) fewer loans. Again, the exact distribution of the cutback in loans as a result of purchasing bonds would depend on the relative yields and other portfolio decision criteria. Of course, it must also be noted that under the Brimmer proposal the Fed could also establish reserve requirements against assets such as bond holdings as well as business loans.

In addition to bonds, business and corporate borrowers could turn to other credit instruments. In the past, whenever credit has become tight, these borrowers have not only used the traditional borrowing means, convertible bonds, preferred stock, and commercial paper (short term usually unsecured loans to private corporations), but have been able to innovate whenever these have become "too" expensive. Some examples of these innovations would be the growth in negotiable certificates of deposit, the Eurobond and the Eurodollar markets over the past decade. The use of these alternatives would have a direct and restrictive impact on the flow of funds into the commercial bank system. To the extent that these alternatives lead to disintermediation the effect on the mortgage loan market, or any other commercial bank loan class, would be identical to that experienced during periods of restrictive monetary policy in the past. To the extent that commercial banks can participate in the alternative loan originations, such as through the purchase of bonds, the proposed reserve requirements might have some impact, but would require close supervision and constant updating.

Summary

The proposed new monetary tool--supplemental selective reserve requirements on commercial bank assets--would increase the Federal Reserve Board's ability to control monetary policy. The primary question to be answered, however, is whether or not this power would be effective and whether or not the Fed is the proper agency to have this power. The foregoing analysis indicates that although the first round effects of supplemental selective reserve requirements on commercial bank assets would be in the intended direction, there is some doubt as to their strength. Moreover, as the economy adjusts to the new situation alternative forms of borrowing or raising funds would develop. These alternatives might be in the form of currently existing capital market instruments, or they may be new instruments developed to meet an existing situation. In any event, the secondary market adjustment to these new reserve requirements are likely to attenuate the overall impact on the restricted loan classes.

Even if the proposed regulations were capable of meeting their objectives and it is decided that the Fed should have the power to set social priorities, it would be necessary to consider an additional problem, namely that universal membership in the Federal Reserve System would be needed to maintain its viability. The state banking system could not be permitted to exercise independent control because (1) state banks would not otherwise be subject to the Fed rules, and (2) Fed members, many of whom already consider the cost of membership too high, could avoid the new reserve requirements by dropping their membership.

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