FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 9, Issue 1 Monetary Policy, Low-Income Communities, and the Federal Reserve System

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The crisis of affordable housing in the United States is persistent and, by some measures, worsening. One such measure is cited in the Department of Housing and Urban Development's report last spring on the "worst case housing needs" of the country. "Worst case" refers to households that are renters whose incomes are no more than half the local median income, and who pay more than half of their income for rent and utilities, but who receive no government assistance. According to this report, the number of "worst case" households is now 5.3 million, a record high; furthermore, the report documents that a growing number of households in this group include families with children as well as families with a working adult. These statistics are disturbing. But for anyone who has spent time in the neighborhoods where these numbers represent real people--San Francisco's Hunter's Point, Los Angeles's Watts, Chicago's Cabrini Green, New York's South Bronx, Philadelphia's North Philly--the statistics are truly alarming.

In the face of this ongoing crisis, there are a number of individuals, organizations, and government agencies working hard to find solutions. And they are as varied as the citizens and neighborhoods they serve. Take, for example, The Greenlining Institute, a non-profit organization based in San Francisco. It advocates and lobbies for increased private investment in low-income communities by lending institutions and corporations. There are the numerous non-profit housing developers, like Esperanza Housing Corporation in South Central Los Angeles, that ingeniously combine scarce resources to help build safe and dignified rental housing. There are thousands of community development corporations (CDCs), large and small, that work in their neighborhoods to provide job training, credit counseling, and small business loans. Seasoned professionals like Lori Gay of Los Angeles Neighborhood Housing Services and Al Fleming of the Marin City CDC are part of the growing cast of characters committed to the improvement of people's lives.

The Federal Reserve also plays a specific role through its commitment to the principles and enforcement of the Community Reinvestment Act (CRA). For nearly 20 years, the CRA has served as a catalyst for increased access to credit for historically underserved groups, most notably minorities and low- and moderate-income citizens. As a result, billions of dollars have been reinvested into our nation's communities, providing increased economic stability and, in many cases, job opportunities and safe, clean places to live.

But the question often arises why the Federal Reserve doesn't also use monetary policy to help these neighborhoods. And it seems like a natural question to ask. After all, U.S. monetary policy is one of the most powerful economic forces in the country. By managing short-term interest rates, monetary policy influences demand for goods and services in the U.S. economy. It affects people's decisions about consuming or saving; it affects firms' decisions about expanding production or laying people off; it even affects economies in other countries--most notably those that link their currencies to the U.S. dollar. Monetary policy can help lift the economy out of recession, and it can be used to keep inflation low so that the country can achieve its maximum sustainable rate of economic growth and employment.

Why, then, doesn't the Federal Reserve "flex" its monetary policy "muscle" in Hunter' Point, or Watts, or any of the other neighborhoods that need an economic boost?

There's both a simple and complex way to answer this question. The simple answer is that it just wouldn't work--it wouldn't work to target monetary policy at individual neighborhoods; it wouldn't even work to target a whole state. The complex answer is the primary focus of this article; that is, why targeted monetary policy doesn't work, both from a practical standpoint and from a policy standpoint.

The explanation involves stepping back briefly to understand how the Federal Reserve implements monetary policy--in other words, to understand the tools we use, such as the federal funds rate and open market operations. The Federal Reserve influences credit conditions, and thereby demand, primarily through transactions in the market for bank reserves. On any given day, individual banks may have a surplus or a deficit of reserves. Since reserves don't earn interest, banks with a surplus of reserves want to unload them, so they lend reserves to banks with a deficit. The yield on reserve lending is known as the "federal funds rate," and it adjusts to equate supply and demand for reserves. The Federal Reserve can affect the supply of reserves--and thereby short-term interest rates--through its open market operations, that is, through buying and selling government securities on the open market. For example, when the Federal Reserve wants short-term interest rates to fall, it goes to the open market to buy government securities, and it pays for them with bank reserves. The ultimate effect is to increase the overall quantity of reserves, which puts downward pressure on the federal funds rate.

Now suppose the Federal Reserve tried to use monetary policy to ease credit conditions in just one city--San Francisco, for example. That is, suppose the Federal Reserve pumped a lot of reserves into the city's banking system in order to make the federal funds rate lower there than in the rest of the country. Any regional difference in the federal funds rate would be immediately apparent to the banks and brokers that routinely monitor the financial wires for news about the market for reserves. And those banks and brokers would do their best to take advantage of any rate differential, borrowing the less expensive reserves from San Francisco banks and lending them at a profit to banks in New York, Chicago, Miami, Bangor, Boise--you name it. In the course of these transactions, the quantity of available reserves falls in San Francisco and rises elsewhere, and that ends up putting upward pressure on the federal funds rate in San Francisco and downward pressure on the funds rate everywhere else--until eventually the funds rate is the same throughout the country. With the high-powered technology of this country's financial markets, this whole scenario wouldn't take very long to unfold--in fact, it could happen in minutes!

This description of the market for reserves highlights two of its most important, and most valuable, characteristics. First, it is national in scope; there are no significant barriers--physical, financial, or regulatory--in trading reserves across state lines. Second, the market is highly liquid; that means there are plenty of buyers and sellers, and they can make the transactions very easily, thanks, of course, to the many advances in communications technology. Because of these characteristics, any attempt by the Federal Reserve to target monetary policy at one part of the country just wouldn't work--the market would simply obliterate the disparity in rates in no time at all.

Aside from the practical difficulty of targeting a neighborhood, a city, a state, or a region, there's another reason that monetary policy isn't the right tool to resolve the problems of economically weak areas. Because these problems in our poorest communities are chronic, using monetary policy to address them would mean stimulating the whole economy all the time. While such a strategy might produce gains against unemployment for a while, this positive effect would not last. The reason is that, in the long run, unemployment depends on things that are beyond the reach of monetary policy--things like technological change, education, and people's preferences for saving and risk. What does last when monetary policy overstimulates the economy is accelerating inflation--and that's a bad outcome for everybody. Indeed, it may be worst of all for the neediest among us. Those on fixed incomes get squeezed hard by rising prices for the basic necessities; those who might have qualified for a mortgage get pushed out of the market by higher long-term interest rates; and the specter of layoffs and joblessness looms near, since the only way to wring inflation out of the economy is either a long period of slow growth or a recession.

While monetary policy, then, is clearly the wrong tool for the Fed to use to target the problems of the less fortunate in our society, there is a tool we can, and do use that does work. That tool, of course, I mentioned at the outset of this article--it is our role as enforcers and promoters of the CRA and related fair lending laws. At the Federal Reserve Bank of San Francisco, the Community Affairs Department provides leadership and support to programs that address problems like the "worst case housing needs" documented in the HUD report. In California, for example, we worked to establish and foster the California Community Reinvestment Corporation (CCRC). Over the seven years of its existence, CCRC has generated $216 million in commitments and 6,500 affordable housing units. Similar stories can be told of Community Reinvestment Corporations in other states around the Twelfth District. The Fed's compliance examiners also provide support, addressing regulatory queries and providing oversight as banks work toward a satisfactory or better CRA rating.

The Federal Reserve System, and the San Francisco Fed in particular, wholeheartedly supports the CRA function and views it as integral to our public mission. Through it, we hope to help address the complex, difficult, and painful problems of the needy in our society--through it, we hope to strengthen and expand the array of tools to provide all our citizens with better opportunities for jobs, housing, and a decent way of life.

About the Author:

Robert T. Parry took office on February 4, 1986 as the tenth chief executive of the Twelfth District Federal Reserve Bank at San Francisco. Mr. Parry is currently serving a third, five-year term that began March 1, 1996. Mr. Parry first became associated with the Federal Reserve System when he joined the Board of Governors as a research economist in 1965. He served at the Board until 1970 and helped build a financial model of the U.S. economy. Joining Security Pacific National Bank in 1970 as vice president, Mr. Parry became chief economist in 1973. He was promoted to senior vice president in 1976 and to executive vice president and chief economist of Security Pacific Corporation and its principal subsidiary, Security Pacific National Bank, in 1981. Mr. Parry received a B.A. degree from Gettysburg College in 1960 and was elected to Phi Beta Kappa. He attended the University of Pennsylvania where he received an M.A. in economics in 1961 and a Ph.D. in economics in 1967. He has received honorary doctorates in Public Administration from Gettysburg College and in Finance from Southern Utah University.