CHAPTER II

CREDIT POLICIES

(Part I)*

The Evolution of Monetary Policy:

During the heydays of the gold standard system, volumetric changes in money were subordinated to the balance of payment position of the country. Thus a change in the level of the rate of interest was directed firstly to limit the exodus of gold, caused by an adverse imbalance, and secondly to reduce the level of prices, costs and incomes of given community. These repercussions would have the effect of restricting imports through the fall in the income of the people as well as the effect of stimulating exports by giving the country a comparative cost advantage. If, on the other hand, the imbalance was favourable, it was required that the downward movement of the interest rate would help the automatic adjustment.

Alpably the monetary and credit policy did not, within this limited compass, have aims and objectives which the later developments, initiated in the wake of the global war, imposed upon it.

The Abandonment of the Gold Standard System:

The first world war wrought a kaleidoscopic metamorphosis, hitherto unprecedented in the monetary history of the world.

*The second part, reviewing the pursuit of credit policy in India, constitutes the last chapter of the thesis.
Then was the time when clear thinking on many monetary problems was the most urgent. The expediency of the restoration of the gold standard to its pristine supremacy which had worked so smoothly during the pre-war era, was the foremost issue in the mind of the monetary pundits of the time. This restoration was to impede inflation. However the actual scarcity of gold which in the event of such a restoration would have meant that certain countries had to deflate their currency drastically, ruled out the pursuit of such a policy as an immediate objective. Further, the monetary climate of the time was not conducive to such a realisation. Most of the belligerent and the non-belligerent countries were debtors and needed heavy imports for the satisfaction of pent-up demands both for consumer as well as for capital goods. The scarcity of consumers' and capital goods necessitated, under the circumstances, the selective allocation of limited exchange resources, which though not incompatible with the gold standard system, was in conflict with the "rule of the game". Nevertheless, it is important to emphasize that the restoration of the gold standard system was an objective to be most diligently pursued. For example, the Financial Committee of the Genoa Conference, meeting for the second plenary session held on the third May 1922, in its fourth and fifth resolutions state, "Il est desirable que toutes les monnaies europeennes soient basees sur un etalon commune". And that "L'or est le seul etalon commun qu'a l'heure actuelle
tous les Etats europeens, pourraient convenir d'adopter."  

In the sixth resolution, finally, it is said that the European governments should lay down the programme the fulfilment of which would make the realisation of this aim a possibility. Even a decade later, the Ottawa Monetary Report of 1932 and the Genoa Conference of 1933 were pre-occupied with the same question. For example, the Sub-commission on Permanent Measures for the Re-establishment of an International Monetary Standard adopted the following resolutions:

1) That it is in the interests of all concerned that stability in the international monetary field be attained as quickly as possible,

2) that gold should be re-established as the international measure of exchange values, time and parity being for each country to determine.  

The stabilisation of price level and exchange rates through reversion to the gold standard system as an immediate step having been ruled out, attempts were made to stabilise prices.

**Emphasis on Price Stabilisation through the establishment of a chain of independent central banks:**

In 1920, when the dangers inherent in monetary instability became very apparent, the necessity for a great effort was, on all hand, realised. In a meeting of bankers that

2. Monetary and Economic Conference Report Approved by the Conference on 27th-7-1933, resolution adopted by BECLN, 1933, p. 12.
took place in Amsterdom, it was decided, by the 13th resolution of February 1920, to convene a meeting at Brussel, with a view to study the financial crisis of the time and to find out ways of remedying and allaying its dangerous consequences. The conference met at Brussel, between twenty fourth September and the Eight of October, 1920. In this conference the causes, the dangers and the consequences of the increase of money in circulation was neatly analysed. In the first resolution of the conference the following points are noted. It is stated that governments, unable to make good their budgetary deficits, have recourse to the printing press; or, more frequently, they obtain the money needed by them from the bank of issue, which in certain cases, these banks cannot and in other cases they will not refuse. The sentiment expressed, on the subject, can be best summarised in the words of M. Vissering, the Netherland's delegate to the conference. He declared: "On a souvent critique les banques d'emission pour cette raison (l'accroissement de la circulation). A tort d'ailleurs, car dans bien des pays, ces institutions n'étaient pas investies des pouvoirs et de l'autorite necessaires pour s' opposer a cet accroissement". Hence it was upon the independence of the central banks that most of the attentions were diverted. The resolution III proposed by the Conference cautioned the "banques d'emission", wanted them to avoid all "influence politique" and advised them to follow a policy of "financiere de prudence".
The resolution XIV recommended the establishment of a chain of central banks which would facilitate the stabilisation of price level. Fifteen months after the Conference of Brussel, the representatives of the Allies were considering at Cannes, the critical financial situation of many countries. In Austria, Hungary and Poland means of payment had greatly depreciated and in Germany it was assuming a disquieting aspect. In France, Belgium and Italy the financial difficulties were accentuated and the resultant instability had its violent repercussions on the situation of all other countries. It was decided that a great conference should meet at Genoa which would aim at the economic reconstruction of Europe.

Genoa Conference, however, did not succeed in its primary aim. For the best conceived theoretical programme, in the absence of international co-operation would remain a dead letter. On the third May 1922, a number of resolutions were passed, some of which make interesting studies.

The first resolution says that "La condition essentielle de la reconstruction economique" is that each country should succeed in stabilising "la valeur de sa monnaie". The second resolution recommends, again, the establishment of a chain of central banks that are independent of political controls. And the third resolution recommends the development of the "pratique d'une co-operation constante" among "les banques centrales d'émission" and among the banks which are entrusted with the control of the credit policy followed in different countries.
The frantic appeal of Austria to the Allies against internal monetary instability culminated in an erudite protocole by the financial committee of the League of Nations. The reform of the old and the establishment of new central banks in Austria, Hungary, Stonea, Greece and Bulgaria are based on this protocole. The re-organisation of central banks in other countries might not have been directly helped by the Financial Committee of the League of Nations, but it was certainly influenced by its pronouncements.

To repeat, once more, the reform of the bank of issue continued, throughout, to be the key plan for stabilisation. Reichbank was one of the important conditions of the Dawes Committee and it materialised a few days after the London Conference, in August 1924. In the four years that follow, this movement gained momentum. Czechoslovakia, Poland, Belgium, Italy and France either modified the statutes governing the operation of their central banks or established new banks.

Here are the summary of the principles that were to govern the operations of a central bank. These principles are best laid down by the Financial Committee of the League of Nations, in its report of 14th June 1927, on the monetary stabilisation of Greece.

A central bank had to be given independence and the sole right to the issue of currency. Its loan and discount operations were to be in liquid and limited short term papers. The government debt to the bank was to be reduced and a limit
was to be set to such new advances. All the monetary operations of the state and state enterprises were to be centralised in a national bank, and the money in circulation was to be backed by an appropriate cover.

As we see, therefore, the dominant trend of the decade was the establishment of a chain of independent and untrammelled central banks, which were thought to be in a better position to ascertain the monetary needs of a country, and thus apply measures which though politically inexpedient were economically justifiable. Hence, these various central banks had, by an ingenious use of monetary weapons and financial prudence, to preserve the internal price stability.

The Dominant Monetary Theories:

As it is noted, independent central banks were created primarily to combat price instability. It is not, therefore, surprising that the attention of many economic thinkers was focussed on the stabilisation of the general level of prices. Keynes, for example, in his Tract on Monetary Reform, in introducing his own version of the equation of exchange, stresses the importance of reserve ratio as a variable which is amenable to the control of a central bank. Thus the reserve ratio which, in the equation of exchange, is institutionally given can be affected consciously by the deliberate open-market and bank rate policy of a central bank.

Hawtrey also believes in the effectiveness of bank rate in changing the level of activity by affecting the cost of holding inventories. Robertson is, indeed, cautious when
he approaches the question of interest rate as a means of stimulating economic activity. He says, unhesitatingly, however, that "the most obvious weapons at the disposal of banking system for mitigating the rise in the price-level is of course the manipulation of its money rates of interest." 1

He also asserts that it is the duty of the banking system, so far as possible, to prevent or check the secondary phenomena of trade expansion. If, however, the banking system loses its grip over the situation, "the only remedy the banking system can apply is to enforce a drastic reduction in the demand for Short Lacking through the liquidation of stocks of goods and the curtailment of swollen productive capacities." 2

The effectiveness of monetary policy:

The depression of the thirties cast a pale spell over many of these controversies. For, the monetary weapons, excellently fitted to precipitate, in a reckless way a downward swing, were inept in generating an upward movement. The question was, then why the monetary weapons would not work?

As it is noted, so far, the stress was mistakenly placed upon price stability, rather than upon a stabilised price level at a high level of employment. A better understanding of the economic problems is seen in the shift of emphasis in Keynes' 3

2. Ibid, p. 79.
General Theory of Employment, Interest and Money. In his Treatise, Keynes neglected the consideration of stability at a high level of employment by assuming E/O as given and instead he attempted to ascertain the circumstances that would bring savings into equality with investments, thus giving to the economy the much coveted price stability. This is done by equating the market rate with the natural rate of interest. On a perusal of the British Empire Currency Declaration of July 1933 which laid the framework for the monetary policy of the British Commonwealth countries, one is struck with the same trend of thought. In the words of the Declaration "The Governments of the Commonwealth should persist by all means in their power, whether monetary or economic, within the limits of finance, in the policy of furthering the rise in wholesale prices until there is evidence that equilibrium has been re-established, and thereupon they should take whatever measures are possible to stabilize the position thus attained."

In the then Keynesian terminology the same line of thought can be put thus: Because of a divergence between the natural rate and the market rate of interest, we have depressions and decline in prices. To bridge the gulf between investments and savings both monetary and economic measures are necessary. Monetary measures mean lowering the interest rate, thus

stimulating investments and limiting savings. Economic measures mean government spending. These measures, if adopted, would go far in narrowing the gap. When an equilibrium between investments and savings, the market rate and the natural rate is established this position is to be maintained. The same objective of price stability is underlined in the President Roosevelt's declaration when he said the "U.S. seeks the kind of dollar which a generation hence will have the same purchasing power and same paying power as the dollar we hope to attain in the near future."

The period of the 'twenties and the early 'thirties is thus distinguishable from the pre-war era, in that, price stability was made the objective and it was realised that government intervention, both monetary and economic, was necessary for bringing about stability. It was, further, realised that monetary weapons could not per se, effect the needed change. And the question that was asked was why monetary policy was ineffective? Why, with a low rate of interest people did not borrow money? Some averred that it was because interest rate could not be pushed below zero? But why is there losses that the minus interest rate is supposed to cover? The low level of income and economic activity is perhaps the cause. But why such a lack of demand develops when according to the adherents of Say's law the money withdrawn from circulation is again injected into it?

1. A.W. Crawford, Monetary Management under the New Deal, 1940, p. 50.
When it was shown that because of the declining tendency of the marginal propensity of consumption and therefore because of its adverse effect on the marginal efficiency of investment, Say's Law did not hold good, the monetary intervention which was restrained and often indirect in the second period, played but a second fiddle to the more direct budgetary measures unshackled with the concept of "within the limits of finance" which the British Empire Currency Declaration, just quoted, is wedded to. Further, it was only after the appearance of the General Theory that a rational explanation was given as to the ways the government disbursements affect the different economic variables. When this was shown, it was, then realised that the maintenance of a stable price level and the maintenance of a high level of income and employment is to be the objective of a rational credit policy. In many instances, however, as the following pages show, when these two objectives namely the maintenance of a stable price level and the maintenance of a high level of income and employment were to be pursued by conflicting methods, it was the second objective that pre-dominated. Hence one witnesses in post war years much vacillation in the pursuit of a consistent monetary policy, both in America and in Canada.

In the monetary sphere among the new measures adopted in this period, mention may be made of selective credit controls and the variable reserve ratio. Pump priming, compensatory and deficit financing are also among the budgetary measures that are used to broaden, in the private sector, the demand for funds. This sector would, then, use the cheap money made available by the monetary authority of the country. Hence, cheap money policy became the order of the day and most of the reliance was placed on open market operation in order to smoothen the "roughs" of the market.

Table No. 1 gives the discount rate of a number of countries in the 'thirties.
<table>
<thead>
<tr>
<th>Country</th>
<th>Rate 1939</th>
<th>Previous Rate</th>
<th>Change 1939</th>
<th>Rate 1935</th>
<th>Previous Rate</th>
<th>Change 1935</th>
<th>Discount Rate in 1933 : 1932 : 1931 : 1930</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>4.25</td>
<td>4.50</td>
<td>1.11.34</td>
<td>4.25</td>
<td>4.5</td>
<td>1.11.34</td>
<td>4.75 : 5.25 : 6.00 : 6.50</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.50</td>
<td>3.00</td>
<td>6.7.39</td>
<td>2.00</td>
<td>2.5</td>
<td>April, 35</td>
<td>3.50 : 3.47 : 2.5 : 2.96</td>
</tr>
<tr>
<td>Canada</td>
<td>2.50</td>
<td>...</td>
<td>11.3.35</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>France</td>
<td>2.00</td>
<td>3.00</td>
<td>3.1.39</td>
<td>6.00</td>
<td>3.00</td>
<td>Nov. 35</td>
<td>2.50 : 2.50 : 2.11 : 2.71</td>
</tr>
<tr>
<td>India</td>
<td>3.00</td>
<td>3.50</td>
<td>28.11.35</td>
<td>3.00</td>
<td>3.50</td>
<td>28.11.35</td>
<td>3.56 : 5.03 : 7.09 : 5.89</td>
</tr>
<tr>
<td>Germany</td>
<td>4.00</td>
<td>5.00</td>
<td>22.9.32</td>
<td>4.00</td>
<td>5.00</td>
<td>22.9.32</td>
<td>4.00 : 5.21 : 6.86 : 4.93</td>
</tr>
<tr>
<td>U.K.</td>
<td>2.00</td>
<td>3.00</td>
<td>1.11.33</td>
<td>2.00</td>
<td>3.00</td>
<td>1.11.33</td>
<td>2.00 : 3.01 : 3.93 : 4.42</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>1.00</td>
<td>1.50</td>
<td>27.8.37</td>
<td>1.91</td>
<td>2.13</td>
<td>April,35</td>
<td>3.22 : 3.43 : 3.01 : 3.92</td>
</tr>
</tbody>
</table>

It follows from the table that the rates in 1939 were below the rates prevailing in 1930. This tendency towards cheaper money is, particularly evident in the case of the U.S.A. and the U.K.

The Era of Cheap Money Policy:

With the onset of depression we have, therefore, a change of policy. In England, in 1930, the bank rate was brought down to three per cent. and though this was temporarily interrupted by the exigencies of the break with the gold standard system, in 1931 the reversal in bank rate became all the more possible since a national monetary policy was then within the ambit of practicability. The British Treasury, then, embarked upon the conversion of £2,000 million War Loans from 5 to 3½ per cent. In 1933 bank rate was further reduced to 2 per cent. Such a reduction was supplemented by open market operation which broadened the cash base of commercial banks; by foreign exchange control which inhibited the flight of capital and also by the informal control of the capital market which prevented the floatation of foreign loans that might have dried up the supply of cheap finance so necessary for the continuance of cheap money policy.

Cheap Money and the War:

The bank rate which was within the pnumbra of oblivion, owing both to the eclipse caused by the emergence of other budgetary measures that were more potent in fighting
depression, might have been expected to be given, with the onset of war and an era of inflation its legitimate share in checking inflation. For, as a measure which aims at combating inflation, it excels many a budgetary devices. For example, the two congressional sub-committees, under the Chairmanship of Senator Paul Douglas and representative Wright Patman, respectively, consider, in their report, the fiscal policy as a more powerful of the two main stabilisation tools, especially in combating depression. Yet, to monetary policy is conceded a strong role in checking the inflationary spiral. This recent accretion of power is no less due to the inability of a democratic government to create a sufficiently big surplus budget to stabilise prices. We can, then echo the tone of the Douglas Sub-Committee in the following vein: "Money is important after all. Restore monetary policy." But Patman Sub-committee following the Douglas Sub-committee would say: "Yes - but how can we really make monetary policy work in a world of vast public debt and 1 huge government expenditure."

It was exactly these vast public debts and immense government expenditures that robbed the Treasury of a potential tool, and what is more, made the pursuit of the cheap money policy a necessity.

The table No. 2 gives the growth of public debt in a number of countries.

Table No. 2

Public Debt (Domestic)  (Figures in Billion)

<table>
<thead>
<tr>
<th>Year</th>
<th>Australia</th>
<th>Belgium</th>
<th>Canada</th>
<th>France</th>
<th>Germany</th>
<th>India</th>
<th>U.K.</th>
<th>U.S.A.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£</td>
<td>Franc</td>
<td>$</td>
<td>Franc</td>
<td>RM.</td>
<td>Re.</td>
<td>£</td>
<td>$</td>
</tr>
<tr>
<td>1914</td>
<td>0.10</td>
<td>4.7</td>
<td>0.23</td>
<td>39.0</td>
<td>5.2</td>
<td>1.8</td>
<td>0.7</td>
<td>1.2</td>
</tr>
<tr>
<td>1918</td>
<td>0.23</td>
<td>9.6</td>
<td>1.22</td>
<td>123.8</td>
<td>5.1</td>
<td>2.9</td>
<td>9.9</td>
<td>12.2</td>
</tr>
<tr>
<td>1920</td>
<td>0.41</td>
<td>22.9</td>
<td>2.46</td>
<td>222.2</td>
<td>105.3</td>
<td>3.8</td>
<td>6.6</td>
<td>24.3</td>
</tr>
<tr>
<td>1922</td>
<td>0.46</td>
<td>29.8</td>
<td>2.39</td>
<td>250.1</td>
<td>220.3</td>
<td>4.7</td>
<td>6.6</td>
<td>23.0</td>
</tr>
<tr>
<td>1924</td>
<td>0.48</td>
<td>31.3</td>
<td>2.22</td>
<td>282.1</td>
<td>362.1</td>
<td>4.8</td>
<td>6.6</td>
<td>21.3</td>
</tr>
<tr>
<td>1926</td>
<td>0.50</td>
<td>27.1</td>
<td>2.13</td>
<td>280.4</td>
<td>2.4</td>
<td>5.4</td>
<td>6.5</td>
<td>19.6</td>
</tr>
<tr>
<td>1928</td>
<td>0.51</td>
<td>25.8</td>
<td>2.10</td>
<td>284.7</td>
<td>6.9</td>
<td>5.7</td>
<td>6.5</td>
<td>17.6</td>
</tr>
<tr>
<td>1930</td>
<td>0.53</td>
<td>26.0</td>
<td>2.03</td>
<td>283.0</td>
<td>6.9</td>
<td>6.5</td>
<td>6.5</td>
<td>16.2</td>
</tr>
<tr>
<td>1932</td>
<td>0.59</td>
<td>29.0</td>
<td>2.24</td>
<td>276.1</td>
<td>9.3</td>
<td>7.1</td>
<td>6.5</td>
<td>19.5</td>
</tr>
<tr>
<td>1934</td>
<td>0.63</td>
<td>30.4</td>
<td>2.44</td>
<td>324.0</td>
<td>8.9</td>
<td>7.1</td>
<td>7.0</td>
<td>27.7</td>
</tr>
<tr>
<td>1936</td>
<td>0.67</td>
<td>34.1</td>
<td>2.62</td>
<td>347.7</td>
<td>12.3</td>
<td>7.1</td>
<td>6.9</td>
<td>38.5</td>
</tr>
<tr>
<td>1938</td>
<td>0.69</td>
<td>37.6</td>
<td>2.75</td>
<td>413.7</td>
<td>14.0</td>
<td>7.2</td>
<td>7.1</td>
<td>42.0</td>
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<tr>
<td>1940</td>
<td>0.75</td>
<td>55.8</td>
<td>3.24</td>
<td>695.8</td>
<td>18.3</td>
<td>7.6</td>
<td>8.1</td>
<td>48.5</td>
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<tr>
<td>1941</td>
<td>0.83</td>
<td>75.3</td>
<td>4.11</td>
<td>874.9</td>
<td>50.8</td>
<td>9.1</td>
<td>10.5</td>
<td>55.3</td>
</tr>
<tr>
<td>1942</td>
<td>1.03</td>
<td>95.8</td>
<td>5.39</td>
<td>1060.9</td>
<td>88.4</td>
<td>10.0</td>
<td>13.1</td>
<td>77.0</td>
</tr>
<tr>
<td>1943</td>
<td>1.41</td>
<td>119.7</td>
<td>8.11</td>
<td>1328.1</td>
<td>140.8</td>
<td>13.0</td>
<td>15.7</td>
<td>140.8</td>
</tr>
<tr>
<td>1944</td>
<td>1.79</td>
<td>162.6</td>
<td>11.26</td>
<td>1674.0</td>
<td>196.4</td>
<td>15.0</td>
<td>18.5</td>
<td>202.6</td>
</tr>
<tr>
<td>1945</td>
<td>2.07</td>
<td>199.5</td>
<td>14.51</td>
<td>1823.3</td>
<td>274.0</td>
<td>18.3</td>
<td>21.3</td>
<td>259.1</td>
</tr>
<tr>
<td>1946</td>
<td>2.27</td>
<td>242.4</td>
<td>17.59</td>
<td>1974.5</td>
<td></td>
<td>21.9</td>
<td>23.4</td>
<td>269.9</td>
</tr>
<tr>
<td>1947</td>
<td>2.32</td>
<td>246.8</td>
<td>17.53</td>
<td>2117.6</td>
<td></td>
<td>25.0</td>
<td>258.4</td>
<td></td>
</tr>
</tbody>
</table>

It can be seen from the table that in the U.K., the public debt increased from £7.1 billion, in 1938, to £21.3 billion, in 1945, or by threefold. In the U.S.A. the figures for the same years are $42.0 billion and $259.1 billion, respectively, i.e. the debt in the U.S.A. has risen by a little less than 6.2 fold. The rise in public debt is, however, all pervasive. The countries that were worst affected were Germany, France and Belgium.

The following table gives the rate of interest during the war and the post-war period.
<table>
<thead>
<tr>
<th>Country</th>
<th>1955</th>
<th>Date of</th>
<th>Pre- 1954</th>
<th>Date of</th>
<th>Pre- 1950</th>
<th>Date of</th>
<th>Pre- 1949</th>
<th>Date of</th>
<th>Pre- 1948</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rate</td>
<td>Change</td>
<td>Rate:</td>
<td>Change</td>
<td>Rate:</td>
<td>Change</td>
<td>Rate:</td>
<td>Change</td>
<td>Rate:</td>
</tr>
<tr>
<td>Belgium</td>
<td>2%</td>
<td>29.10.53</td>
<td>3</td>
<td>2%</td>
<td>29.10.53</td>
<td>3</td>
<td>3%</td>
<td>9.50</td>
<td>3%</td>
</tr>
<tr>
<td>Canada</td>
<td>1½</td>
<td>15.2.55</td>
<td>2</td>
<td>2%</td>
<td>17.10.50</td>
<td>1½</td>
<td>2</td>
<td>10.50</td>
<td>1½</td>
</tr>
<tr>
<td>France</td>
<td>3%</td>
<td>2.12.54</td>
<td>3%</td>
<td>3%</td>
<td>17.9.53</td>
<td>4%</td>
<td>2%</td>
<td>6.50</td>
<td>3%</td>
</tr>
<tr>
<td>Germany</td>
<td>3%</td>
<td>20.5.54</td>
<td>3%</td>
<td>3%</td>
<td>11.6.53</td>
<td>4%</td>
<td>1-6</td>
<td>10.50</td>
<td>1-4</td>
</tr>
<tr>
<td>India</td>
<td>3½</td>
<td>15.11.51</td>
<td>3</td>
<td>3%</td>
<td>28.11.35</td>
<td>3½</td>
<td>3%</td>
<td>11.35</td>
<td>3%</td>
</tr>
<tr>
<td>U.K.</td>
<td>4½</td>
<td>24.2.55</td>
<td>3½</td>
<td>3½</td>
<td>17.9.53</td>
<td>4%</td>
<td>2%</td>
<td>10.39</td>
<td>3%</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>1½</td>
<td>14.4.54</td>
<td>1½</td>
<td>2%</td>
<td>16.1.53</td>
<td>1½</td>
<td>1½</td>
<td>8.50</td>
<td>1½</td>
</tr>
</tbody>
</table>

Source: Federal Reserve Bank Bulletins.
It can be seen from the table that the rates during the war were maintained at the lowest possible level. It is only in the 'fifties that many countries made an upward revision, for a few years and with the exception of the U.K. and India, others have partially reversed the earlier rise in the discount rate.

Cheap money policy, however, could not be pursued during the war, if the cheap finance was also utilised by industries that had little to contribute to the successful prosecution of the war. For, cheap money did not mean excess funds and unlimited resources, as it did, in the 'thirties. Hence the pursuit of such a monetary policy was accompanied with physical controls as well as with the control of the capital market.

Cheap Money After the War:

The cessation of hostilities ushered in an era of inflation and pent-up demand. Exhausted by war efforts and weary of the long austerity period, people clamoured for the relaxation of stringent economic controls. This demand was not conceded by the British Socialist Government bent on reconstructing the country on a planned basis. Thus, cheap money policy coupled with economic controls continued. Attempts were made, however, at cheapening the rates further. The various conversions that the Chancellor attempted, both by reducing the rate and by prolonging the maturity period, were aimed at the realisation of the same objective.
The suitability of the cheap money policy for an advanced economy, committed to the pursuit of a planned expansion and capable, administratively speaking, of enforcing many economic controls - primarily through moral suasion - is indubitable.

With the change in political alignments, and under the stress of an imbalance in foreign trade, the new Government of Britain reverted to traditional lines by increasing the rate of interest in order to reduce imports and stimulate the export of goods.

The Abandonment of the Cheap Money Policy in England:

The recent resort to monetary weapons, in England, was accompanied with certain preliminary spade-works. A penalising rate of interest imposes certain restrictions on the Treasury. It requires the abstention of Treasury from purchasing government securities in order to support their prices. Secondly, the imposition of monetary discipline presupposes a sufficiently illiquid market situation - a market divested of short term treasury bills.

In November 1951 when the bank rate was raised by half a per cent a special provision was made for seven day loans against Treasury Bills, which meant that the rate of the Treasury Bills was not affected. But, the Bank of England reserved for the monetary authority, the position of a special buyer, which meant some uncertainty as to the support of the par.

Besides, the Exchequer undertook another step, in order
to immobilise the liquid resources of the banks. Thus it funded £1,000 million of short-term Treasury Bills into 1½ per cent. Serial Funding Stocks. The effect of this operation was profound. The liquid assets of banks which constituted 39.9 per cent. of their deposits slumped to 32.1 per cent. as against the customary liquidity ratio of 30 per cent. This narrow margin and the co-operation of the banks in maintaining it, was instrumental in restricting advances. At the same time the uncertainty created by the rise in the rate led to the fall in the price of gilt-edged securities which inflicted capital losses. This Serial Funding Operation was, again, repeated in the autumn of 1953. Such operations were not left unscathed. They were called arbitrary intervention and a departure from orthodox practices. For, the traditional weapons were supplemented with manipulations that did not work through a free market mechanism. Frequently, such regulations were disguised as polite requests, though the autumn funding operation was allowed to be supported according to its merits.

It is evident, however, that the departure from the cheap money was not a resuscitation of the traditional weapons. Firstly, the bank rate was raised by only half a per cent. Secondly, the penal rate was meant only for commercial papers. And thirdly reliance was placed on funding the floating debts which impounded the liquid assets of banks and made them loth to make advances above seventy per cent. of their liabilities.
Nor is the co-operation of banks with the authorities of the least importance. The banks realised that any intransigence on their part would lead to severer steps and to further infliction of capital losses.

Dear Money National Priorities and Selective Credit Control:

In addition to the measures discussed above, new directives were issued to the Capital Issue Committee, which were also meant for the guidance of the Commercial Banks. The directives underlined a policy of applying a "squeeze" to the private sector while meeting adequately the requirements of the public sector. At such times, however, when the private sector is specially subjected to control, it is necessary to see that loans and credits given to the public sector is preceded by a careful scrutiny. There was thus a controversy over the flotation of £60 million for the Transport Commission which was generally regarded as an expenditure less worthy than certain other schemes sponsored by the private sector.

Further Steps:

Eleventh March 1952 witnessed, yet a further 1½ per cent. rise in the discount rate. The effect of this was immediately reflected, to the full, in market rates. September 1953, witnessed a fall of ½ per cent. in the bank rate. This was, however, not a fall as such. It was an adjustment between the loans made on the seven day commercial papers and that made
against Treasury Bills, thus eliminating the half a per cent spread which was introduced in the rise of November 1951, and was maintained by the second rise. And since this special rate was the only rate at which the market had ever borrowed money at the "penal" rate, the fall in the bank rate was less significant. May 1954, witnessed yet another half a per cent reduction. This was necessitated by the reduction of rates in other international centres, which led to the movement of hot money to Great Britain with the possibility of withdrawal, thus leaving the economy in the lurch. The last week of January 1955 witnessed ½ per cent rise, caused by the revival of inflationary conditions in the British economy. The rate was, further, raised by one per cent towards the end of February.

**Cheap Money in America:**

*The 'Thirties:* The pursuit of the cheap money by the Federal Reserve System in the 'thirties, did not differ much from the same all-pervasive trend in the Western European countries. However, America devised after the more turbulent half of the 'thirties, a monetary control mechanism that differed from similar controls that were exercised by the central banking authorities in the Western European countries. After the earlier debacle it was thought expedient to use qualitative and selective control devices. It is important to realise that the pursuit of a cheap money policy is reconcilable with the application of these selective control weapons and also with the manipulation of the reserve ratio which is used
to avert the serious consequences resulting from an untimely inflow of gold. Cheap money policy aims at galvanizing the various constituents of the economy into activity; while the selective control weapons are intended to impinge upon sectors that would precipitate an economic crisis.

The year 1937 was the beginning of the preoccupation with the preservation of "orderly conditions" in the government security market which gradually prevented the utilisation of the central bank's power for the purpose of controlling through the use of traditional weapons, the supply of money. Subsequently "orderly conditions" came to mean the maintenance of a level and a pattern of rates, in government security market.

War Years:

During the war, the circumstantial elements involved in the pursuit of a consistent cheap money policy differed in America as compared with other belligerent and non-belligerent countries. For, the last world war did not affect the consumption of the Americans very adversely. The immense idle resources that were at the disposal of America were brought, by and by, under the plough. Increased production, thus, coped adequately with the increased demand. Hence, there was no need to enforce all the stringent economic controls which were so necessary a concomitant element of the cheap money policy, under a shortage economy. Being wedded to the concept of a free enterprise economy, and being pestered by political buffets, the government of the U.S.A.
tried their best to reconcile the exigencies of the war and the rather "ancient" theory of minimum governmental interventions in the free play of economic forces. The monetary, fiscal and physical controls that were applied were, therefore, less exacting and less stringent than those imposed in other countries. The government, thus relied more than otherwise would have been justified, upon borrowings as a method of financing the war. Douglas Sub-committee, for example, thinks that even during the war, a policy of more taxations and less borrowings would have helped to reduce the inflationary potential which developed subsequently. This policy, it is further averred, could be pursued without ill effects on war efforts. It is shown in table No. 2 that while the rise in public debt in the U.K. was threefold, the debt owed by the U.S. Treasury increased by a little less than 6.2 times. Thus saddled with an immense debt and handicapped by the paralysis of monetary weapons - a direct result of the maintenance of the level and the pattern of rates - the authorities had to face the monetisation of public debt with divided and vacillating counsels, which was publicly lighted by the controversy over the secondary reserve.

The Post-War Period, Upto the Start of the Korean War:

The peculiar problem which America was facing, in post war years, was caused by the pursuit of a cheap money policy which was accompanied by the dismantling and the liberalisation of

many an economic controls - partly because they were thought to be unnecessary and chiefly because such controls were deemed to be pushing the economy into the deep mire of depression. The obsession with depression led, further, to wage increases, reduction in taxes intended to bolster up a presumed sagging of the purchasing power of the community.

Alarmed with the whirlwind that they had raised, the authorities abrogated war time measures that assured adequate bank reserves for the successful floatation of war loans; initiated the Victory Loan Drive and attempted to reverse the monetisation of public debt by a scheme of debt retirement, by using the Treasury balances accumulated from the Victory Loan Drive and the Treasury Surpluses of 1947 and 1948.

Further, the government eliminated half a per cent preferential rate on the Federal Reserve Bank advances against the collateral of government securities with a maturity of one year and abrogated 3/8 per cent buying rate on Treasury bills and increased the reserve requirement. The Federal Reserve System, further, imposed higher margin requirements and maintained regulation on construction credit. Some of these measures had, in effect, hardened the short-term interest rate. Despite the measures adopted, activity and employment was at a high level through 1948 and except for a short interregnum, in 1949, which did not develop into depression, inflation was permitted to rule and to proceed at a substantial rate, so that the wholesale prices at the end of 1949 were 45 per cent above their level at the end of the war and the consumers' prices had advanced by more than thirty per cent.
It is in this period - the period before the Korean crisis - that there was a great deal of vacillation and indecision in the pursuit of a consistent monetary and fiscal policy. The questions that were often asked were: (a) was there a need for monetary discipline and (b) what particular approach was needed? There were three strains of thought in this controversy. The first, stressed by Mr. Eccles believed in a "banking regulation policy". This was to be done by the introduction of a secondary reserve that would circumvent the consequences of an officially supported market in government securities. The pros and cons of the proposal is discussed elsewhere. It was, however, found that the proposal if introduced, might result in the liquidation of long-term bonds in order to furnish sufficient short-term papers for the purpose of the secondary reserve requirements. This would disturb the market in government securities which Mr. Eccles' proposal had intended to obviate. The second line of policy, namely the "market restraint policy" is associated with Mr. Sproul and the Reserve Bank of New York. This second view which later was accorded a free field, emphasised the need for taking advantage of certain endemic weaknesses and features of the market and to manoeuvre these in such a way that a brake is applied on an unrestrained credit expansion. This policy can, for example, be achieved by making the market uncertain about the prices of government securities and without precipitating a fall in the price of government securities to make that eventuality a likely event if credit expansion
proceeded unbridled and unchecked. This event actually occurred in March 1951 when par support of the key 2½ per cent bonds was removed. Hence, infliction of capital losses and uncertainties in a highly sensitive market became a part of the monetary policy which was designed to restrain the monetisation of the National Debt, without creating a disorderly and unstable market. The third view which was that of the Treasury and Mr. Snyder opposed the secondary reserve proposal, belittled the effects of market restraints and objected to any variation in the cost of long-term Treasury borrowings. Despite these differences, there was a large area of agreement. The need for larger fiscal surplus, a vigorous saving drive and a stricter supervision of bank loans along with a voluntary restraint campaign and the imposition of instalment credit control was conceded on all hands. Further, by reaffirming the support of the 2½ per cent long term rate, debt retirement policies were to be vigorously pursued and though the secondary reserve proposal was shelved, it was averred that with the slackening of debt retirement measures, stronger steps would be necessary.

Departure from Cheap Money and Trends after the Korean Crisis:

Korean Crisis brought the U.S. Treasury face to face with a serious inflationary problem. There was, in the first place, an all-round stock-piling predilection, and in the second place, in the context of the increased appropriation for defence services there was a greater need for some form of selective devices. On the fourth March 1951, the Treasury and the
Federal Reserve System reached an agreement. It was decided to immobilise the long-term government bonds by offering the long-term 2-3/4 per cent bonds in exchange for the longest term outstanding 2½ per cent marketable bonds not eligible for bank ownership. The new bond is not marketable and therefore is insulated from market influences. To render it marketable a choice is given. The holder can exchange it for a five year marketable note with a 1½ per cent interest rate. Thus liquidation is permitted but at a price determined by the Federal Reserve System and by market conditions. Of $19.6 billion dollars of convertible issues outstanding, about $13.6 billion were exchanged.

The departure from the cheap money policy in the form discussed above had the effect of restoring to the system its initiative. Except for the maintenance of orderly market which did not mean support of the par, the Federal Reserve System reduced and subsequently discontinued its purchases of long-term bonds. Further, the support of the short-term rate ceased also, which means that adjustments through market mechanism is given a free hand - a mechanism that is susceptible to the Federal Reserve discount policy.

A reasonably stable market for government securities, particularly around the refunding period is, however, the most important pre-occupation of the Open Market Operation Committee of the Federal Reserve System. For this, the Federal Reserve System has to make occasionally large purchases. The purchases are for a short period and are offset by sales in other periods.
The cessation of the Federal Reserve purchases of government securities averted the release of funds for the purpose of expanding credit and increased considerably the borrowing of the commercial banks from the Federal Reserve System. This has largely restored to the traditional device for monetary control its pristine ascendency. American banks are, traditionally, averse to such borrowings from the Federal Reserve System and liquidate such indebtedness at the earliest possible opportunity. That they increased in this period their borrowings from the Federal Reserve System is an indication of the success of monetary weapons. As a result of variations in the market rate, the holders of short-term securities did not liquidate their possession at a low price (i.e. at a high rate) and then buy it at a high price (i.e. at a low rate), in order to replenish a sagging reserve ratio. The adjustment in their reserve requirements was done by temporary borrowings from the System.

Besides the departure from support practice, some selective devices were either adopted or reinforced. Installment credit facilities given to consumers or granted for new construction activities and also for estate purchases were tightened. A Voluntary Credit Restraint Policy was also instituted which was rather made a compelling force, owing to the difficulty of obtaining funds from the Federal Reserve System.
Some other countries:

**France After Liberation**: After the liberation cheap money policy was abandoned in France. In this, as well as in the circumstances obtaining in that country, the credit policy followed, is unique in many respects. Firstly, prices and costs were allowed to rise which neutralised inflation. However, the recurring deficits in government budgets and political instability obtaining in the country resulted in higher prices and costs. Hence, a great deal of emphasis was laid on the qualitative and the quantitative control of credit.

**Direct Credit Control**: In December, 1945, the Conseil National du Credit was empowered to issue directives to banks in regard to the type of credit which they were to encourage. In 1946, it was made obligatory for banks to report all advances above five million francs. In October 1947, the prior approval of the Bank of France for all advances and overdraft commitments, above thirty million francs, was made necessary. This did not include the discount of commercial papers, leaving, thus, an important sector beyond the pale of direct control. In September 1948, a more comprehensive scheme was adopted. The additional features of this measure were firstly, the exercise of control over banks' reserves and secondly the limitation of rediscount facilities.

In 1949-50, the inflationary pressure eased considerably and there developed a tendency towards the liberalisation of credit controls. Thus, in April 1950, the limit beyond which the advances could not be made was raised from fifty to
hundred million francs. The ceiling on rediscount was also raised and the discount rate was reduced from 4\% to 3\% per cent. (vide table No. 3).

With the onset of the Korean crisis, the monetary control was tightened, though the massive rise in prices made the revision of ceilings, in upward directions, imperative.

Although no conclusion on the efficacy of controls, can be drawn, a flexible monetary policy supplemented with other direct controls did help in stabilizing the economy.

Federal Republic of Germany: With the currency reform initiated in 1948, a real activisation of monetary policy was started. The currency reform wiped out all the old debts of the Reich and reduced the money in circulation by nine-tenth. A hundred of old currency - the Reich Marks - was converted into 6$ of the new currency - the Deutsche Marks. Out of this six and a half Deutsche Marks, one and a half were held in a blocked account which could be invested in a limited range of securities.

The new Central Bank, the Deutscher Lander, initially fixed the discount rate at five per cent. This was supplemented by the issue of directives concerning the types of bills and acceptances which were eligible for rediscount with the central bank. The Bank is also empowered to prescribe reserve requirements.

During 1948 and the first half of 1950, Germany pursued a deliberate policy of encouraging credit expansion which was made imperative by the rising level of unemployment. The
Korean Crisis ushered in a tighter monetary policy necessitated by the deterioration in the balance of payment position. Bank rate was raised from four to six per cent, and minimum reserve requirements were raised by an average of fifty per cent. The rediscounting facilities were also subjected to a credit ceiling. Certain types of credit, such as those meant for the promotion of exports, were encouraged.

Belgium: After liberation, drastic measures were taken to reduce the latent inflation. A flexible bank rate policy supplemented a variable reserve requirement technique. Selectivity was also ensured by directives which were effective so long as banks needed discount. Thus, at the time when tighter money was the order of the day, selectivity also held the field.

The Netherlands: In the Netherlands, the principal attack on the redundant money supply was made in September 1945, when all currency and deposit money were withdrawn from circulation and blocked. The idea was to reduce the money supply to practically nothing and to inject new money into the system by a gradual deblocking of old accounts in such a way that means of payments could be made available only to enable the people to make their current contributions to production. Part of the blocked money was to be released gradually. Part was to be withdrawn permanently from the stream of circulation, by floating medium term and long term loans and by capital levies. Unlike the procedure in Belgium, no specific fraction of blocked money was compulsorily converted into government
debt. The subscription to government loans from blocked money was voluntary. The following table indicates the change in the supply of money, both in Belgium and in the Netherlands.

Table No. 4

<table>
<thead>
<tr>
<th>Year</th>
<th>Belgium (Billion francs)</th>
<th>Netherlands (Billion Guilders)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939</td>
<td>28.0</td>
<td>1.15</td>
</tr>
<tr>
<td>1940</td>
<td>34.5</td>
<td>1.59</td>
</tr>
<tr>
<td>1941</td>
<td>48.5</td>
<td>2.23</td>
</tr>
<tr>
<td>1942</td>
<td>67.9</td>
<td>3.17</td>
</tr>
<tr>
<td>1943</td>
<td>83.2</td>
<td>3.70*</td>
</tr>
<tr>
<td>1944</td>
<td>44.3*</td>
<td>5.08*</td>
</tr>
<tr>
<td>1945</td>
<td>70.4</td>
<td>1.39</td>
</tr>
<tr>
<td>1946</td>
<td>42.1</td>
<td>2.74</td>
</tr>
</tbody>
</table>


It follows from the table that a considerable part of the currency was effectively impounded.

In the Netherlands, however, banks were left free to grant small loans for specified purposes. This was made subject to the prior approval of the Netherlands Bank for all loans in

*In October 1944 noted withdrawn and for the most part placed in blocked accounts.
@In March 1943, in July and September 1945 notes partly withdrawn. Beginning Oct. 1945, excluding notes not yet presented for exchange.
excess of 50 thousand guilders. Apart from this, there was, by virtue of a gentleman's agreement with the credit institutions an informal control over credits for non-essential purposes.

Conclusion:

In many countries, suasive controls supplemented by legislative enactments in regard to the selective distribution of resources have played a dominant role in the post war era. This was necessitated, under a condition of latent inflation and a paralysis of the orthodox monetary discipline. Cheap money which was abandoned, in many countries, is gradually coming to its own. It can be predicted, therefore, that in the absence of any new international development and with a reduction in the pace of rearmament an era of cheaper money is bound to hold the field for a considerable time. This, however, depends on the importance which a government attaches to budgetary devices, vis-a-vis the monetary measures. It is possible, for example, that a government might raise the bank rate in anticipation of certain budgetary concession to be given. Such a manoeuvre is, in itself, selective and aims at progress with stability. It follows that the weapons and the devices that the central banks and the treasuries will use, in future, will be selective in character.

Selective credit controls are, however, no justification for the pursuit of an inflationary policy. It is rather progress in selected fields, with dynamic stability, in general, which is the objective.