CHAPTER III

MECHANICS OF CREDIT CONTROL

Introduction

The weapons, sanctions and other devices used by a central bank may be operated with two points in view. They may be designed and directed to militate against a too liberal or a too stringent grant of loans. They also may be adapted in order to effect a pattern of investment that conforms most closely to the economic policy of a country, or devices may be adopted to direct the flow of funds to sectors hitherto famished. No claim to the universal applicability of the weapons can be vouchsafed without imperilling their efficacy. Hence, adaptation is inevitable when the orthodox monetary weapons fail to effect the desired changes.

The Scope of the Chapter

In this chapter an attempt is made to draw a line between general but traditional instruments, orthodox but selective weapons and unorthodox or "Test Tube" devices.

General but traditional instruments for monetary control are such gadgets that cause the depletion or repletion of the cash reserves of banks. These operations
are either effected directly, as in the case of the variable reserve ratio, or indirectly as in the case of the open market operation. With sufficient "ammunition", the open market operation bids fair to bring about a change in the liquidity pattern of the assets of banks. This is an example of an indirect assault upon the banking reserves which pushes up or down the rates of interest. Variation in the reserve ratio exemplifies the more direct and is, therefore, in the nature of a frontal assault.

Selective but orthodox devices for credit control are intended to impinge upon particular sectors. They are, thus, devoid of an omnibus character that has become the bane of the traditional weapons. Of margin requirements and consumer credit control, the former purports to tone down speculation while the latter tries to dampen demand.

Moral suasion and credit rationing have also family relationship with selective devices. They are, therefore, in this study, included under this head.

'Test Tube' devices signify weapons, sanctions or mechanisms that are either extinct or are in an experimental and theoretical embryo. These include cent per cent money, automatic reserve ratio, Geselle's Free Money. It
may be noted that the distinction made here is tenuous and arbitrary, in so far as all monetary weapons are essentially experimental under differing set of circumstances - and circumstances are invariably different. The classification is, nonetheless, designed to facilitate an orderly discussion of the subject.

The Requisite Paraphernalia Conditioning the applicability of the Traditional Weapons.

For the effective control of credit, a central bank has to influence the most sensitive and also the most vulnerable part of the banking assets. To do this and to achieve the required sensitivity, the existence of a bill market would be of a great help. However, even if this pre-requisite is fulfilled, the banking system may be in a disintegrated and an unorganised condition. This would hamper the transmission of impulses from the top to the remotest corner of the economic organism.

A. - The First Requisite: Discount Market. Discount market, is a market that specialises in short-term bills. It equips the banking institutions with eligible re-discounting and highly liquid assets. The discount market has, within itself, various sub-markets that specialise in loans of differing maturities. One of such sub-markets may specialise in very short term loans and can be called call-loan market. Another sector may be
interested in bills maturing after a longer time and can be called bill-market; and still another sub-market may deal in bills of exchange that finance the foreign trade of a country and can, therefore, be called foreign exchange bill market. All these sub-markets should make an integrated unit, in that a change in one part of the market would have its impact upon other sectors. The rate of interest prevalent in the markets should, therefore, measure the effects of risk and maturity of bills to a decimal degree of precision. Such a precision presupposes the existence of keen competition within each of the sub-markets.

The discount market may arrange its bills in a pyramiding order of maturity and may parcel out those that are most liquid to the commercial banks. These latter institutions are, thus, entrenched in their second line of defence. In case there is a too rapid depletion of their funds, banks would reduce their investments in the short-term bill market and would call back their loans to the call-loan market. Thus, the existence of a well-developed bill-market will make for the most slender margin between what cash-reserves the banks actually have and what they are legally required to possess.
The security and the discount market, however, should have breadth and capacity; otherwise the absorption or the release of papers might have a too disturbing effect upon the pattern of rates and the prices of securities. The backward economies that have not much of industrial securities or internal commercial papers and are not centres of international trade, suffer, inevitably, from this handicap. The recent aquisition of government papers by the market, might have broadened its capacity. And since the asset portfolio of the banking system has a substantial holding of such papers, it has become immensely sensitive to changes in interest rates and, therefore, to the price of such securities. This evolution has, moreover, led to a fall in excessive cash reserves. As against this acquisition, there has been a marked contraction, in developed economies, both in the volume of internal trade bills as well as in the quantum of the international bills of exchange. The shrinkage in the volume of the former is attributable to telegraphic transfers, advances by overdrafts and the spread of branch-banking system, while the fall in the quantum of the latter is due to the contraction in the volume of international trade owing to insulatory policy of various governments.
A discount market with the paraphernalia noted above may be assailed by a central bank through the sale of securities and a rise in the discount rate. It may also be overwhelmed by an adverse economic condition and a panicky withdrawal of cash, by banks. Either of these circumstances forces the market into the bank - i.e. either banks directly approach the apex bank for accommodation, as in India, or they force the market as in England, to get such accommodation, by withdrawing their liquid resources. The central bank may, then, charge the market or the banks, as the case may be, either an accommodation rate in order to alleviate the financial stringency or impose upon the market a penal rate with a view to compel the banks to follow the credit policy of the country.

The possibility of market rates following the lead of the official discount rate depends upon many factors which include: (a) the absence of prejudice to approach the apex bank for accommodation; (b) the existence of a stable reserve ratio; (c) an adequate supply of eligible rediscounting papers; (d) and what has become, in recent years of an overshadowing importance is that either there should not be a preponderant volume of government securities, or if such a situation obtains, the Treasury
should be willing to shoulder the extra costs resulting from the variation in interest rates; or alternatively it should be able to insulate effectively such securities from market fluctuations.

The Second Requisite: An integrated Banking System:

An integrated banking system is not a synonym of a centralised banking institution with the central bank acting as a nerve centre to the whole mechanism. In order that the central bank should be able to absorb the shocks generated by the ebbs and the flows of the economic system and in order that it should be able to transmit such impulses whenever necessary, to the lowest layer of the economic structure, the credit habit should also be widespread. Indeed, the integration of banking system and the spread of credit habit are cast in the image of Siamese twins, inseparable and yet distinct. The element that imparts a distinctive trait to the credit habit is the undeveloped liability side of banks.

An approximation to an integrated banking system can be achieved by establishing a nexus that would bind all credit institutions and then would make them subject to an apex bank. Theoretically, there are two diametrically opposed perfect systems interspersed with
intermediate models. A country may be blessed with a centralised, state-owned and monopolistic entity spreading out its branches to every corner; or alternatively, there may be a congeries of absolutely free and competitive credit mobilising and disseminating bodies divested of the blemishes of 'monopolism'. Both these systems can be called integrated. Intermediate systems are also possible. There may be monopolised banking system with centrifugal decentralisation of authority and management or a competitive banking system with centripetal tendency. The Indian banking system does not represent a uniform model. The organised banking system tends to be competitive with centripetal tendencies, while the other sector consisting of a congeries of more or less detached and semi-monopolistic units have defied, hitherto, all attempts at centralisation.

To sum up; therefore, the paraphernalia consists of: (i) a broad security and discount market, having specialised, competitive and highly integrated sub-markets, that would ensure a stable reserve ratio and a sensitive bill market and (ii) an integrated banking system, with widely spread credit habit, reaching the base of the economy.
The Legal Limitations, conventional and other practices & the application of the traditional weapons.

The effectiveness of traditional weapons is contingent upon many legal or conventional factors. It is contingent upon the reserve requirement, the existence or otherwise of a prejudice to approach the central bank for accommodation and also upon many other practices.

(a) The Reserve Requirement. The solvency of the banking institutions depends upon their liquidity and the promptness with which they meet their obligations. The apex institution which is responsible for the soundness of the affiliated bodies and the general tenor of the monetary health of the country requires by statute or convention that banks should have a certain amount of reserve, being determinable by the velocity of the turnover of deposits, the accident of situation, and the relationship that the bank maintains with other financial institutions. Thus the greater the velocity of the turnover, other things remaining the same, a more stringent precaution is needed against illiquidity. Or again a bank in a financial centre, maintaining "correspondent" correlation with banks in rural areas needs more reserve; for, not only the velocity of the deposit turnover, in these centres, is more, but banks, in such centres, are exposed to the risk of sudden withdrawal by correspondent banks.
Hence liquidity is the weakest spot of banks and it is exactly the spot which is mightily vulnerable to the central banking control. By threatening the solvency of banks, the central bank can cajole and coerce banks to follow the vestiges of its monetary policy. The central bank is, however, immensely interested in the solvency of banks and other financial institutions. It, therefore, lays a minimum reserve that banks have to maintain against their deposits, any infringement of which legal requirement being visited by penalty. The dependence upon such a parametric datum for regulating the banking policies may prove immensely difficult in circumstances that ensure a continual margin much above the minimum reserve requirements. It is exactly these circumstances that warrant the abandonment of the earlier concept of reserve requirement as being a buttress against insolvency in favour of such a requirement becoming a potent weapon in the hand of the central bank. Suffice it to say here, that the variable reserve ratio is a useful addition to the armoury of the central bank.

(b) The reluctance to approach for loans. The financial position of banks being reflected in their balance sheets, and the confidence which they impart to the public being contingent upon their solvency, there is, therefore, a wide-spread shyness, especially in America, in approaching the central bank for accommodation.
The discount rate itself, is of importance in this connection.

Such a reluctance can be mitigated or reinforced as the case may be by the official bank rate policy. In some countries there is a margin between the official discount rate and the prevailing rate in the market, the official discount rate being higher. Discounting of bills, in such cases, involves losses which losses the banks try to recoup by both curtailing their advances and by raising their own interest rates. These two factors are invariably inseparable.

It may, however, be the deliberate policy of a central bank to provide financial accommodation at a premium price, to certain classes of bills. This is seen, for example in the case of agricultural papers, in an underdeveloped and predominantly agrarian economy where rural finance looms large. The discount rate that the central bank charges is neither an accommodation rate, nor a penal rate. This rate may be called "preferential rate", which purports to feed a famished sector with badly needed funds.

In this context, it has sometimes been emphasised
that the functioning of the discount rate as a preferential rate cannot be reconciled, without substantial compromise, with its working as a weapon, directed to restraining the market. When the discount rate is used for the purpose of restraint, it is said that it cannot be used for the other purpose as well, and vice versa. This, however, is possible. We can have a selective distribution of funds by applying a "squeeze" on the private sector, through the use of traditional weapons, and to offset this "squeeze" by the selective distribution of funds to segments that are considered more important. There are, however, other circumstances when a preferential or pseudo-preferential discount rate is conceivable. It may be that the paper which a borrowing bank discounts has a higher value than when it is in its own hands. This is because of the assumption of risk by the borrowing bank, which risk it bears even after the paper is rediscounted. A premium rate is also changed when the central bank relies upon banks for the distribution of credit.

Moreover, most of the backward economies are dependent economies. Their banks are, therefore, likely to have substantial foreign assets held in other countries. These banks will try to draw upon such
sources when a strain is felt in the money market. The central bank being committed to the maintenance of a fixed exchange rate would purchase these instruments and thus without achieving its purpose relieves the stringency in the market. The same is true when the volume of the outstanding Government securities is considerable and the Treasury is committed to the maintenance of an orderly market.

Hence, it can be seen that the degree of the reluctance of banks to approach the central bank for loans depends, firstly upon the psychological consideration, arising out of the state of confidence that makes a solvent balance sheet of utmost importance. It secondly, depends upon the nature of the rate, i.e., whether it is a penal rate or an accommodation rate and thirdly, upon the character of the accommodation rate arising out of a deliberate financial policy. It also depends upon the liquidity of the banking system and the availability of alternative or competing source of liquid funds.
1. The Evolution of the Theory of Bank Rate.

Bank of England evolved, gradually, from an ordinary banking institution, giving aid to and discounting the bills of merchants, into a "lender of last resort". During exceptional years, it was occasionally overflooded with discount papers. One of such occasions coincided, in December 1795, with a substantial drain of gold from the country. This presented a problem to the bank. The continuance of unrestricted facilities to traders would have meant, under circumstances, the complete depletion of the serve of gold. Hence, the bank thought it expedient to ration out credit.

Rationing of credit, however, was not very consistent with the bank's position as a lender of last resort. In 1832, Horsley Palmer enunciated the theory of bank rate. It was to be a brake, restricting the amount of discounts, without refusing them. Hitherto, however, the Bank of England was restrained by Usury Laws from resorting to this expedient. This law had set a five per cent ceiling

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1 Usury Laws were repealed in 1837.
to the extent of rise in bank rates. In 1839, however, the Bank of England\(^2\), for the first time, defended its position against excessive demand by raising the bank rate above five per cent.

In 1840, Tooke emphasised the importance of a high short-term rate of interest, in attracting money from other countries. Till the appearance of Goschen's Foreign Exchange, in 1861, however, the importance of bank rate in this direction was not recognised. The view that the discount rate can be used as a brake on the unlimited demand for discount facilities and also as an inducement to the short-term inflow of funds/that it is capable of effecting a reversal in economic trends leading to a favourable balance of payment position, was subsequently upheld by Bagehot and also by Cunliff Committee.

The Impact of the Discount Rate upon Economic Structure.

In the absence of any other countervailing force, the impact of an alteration in the official discount rate is transmitted to the cost structure of the economy by a variation in the market rate of interest. The market rate

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\(^2\) The Bank of England increased the rate to 5\(\%\) on 20th June 1839 and it was again raised to 6\(\%\) six weeks later.
must, therefore, be susceptible to variations in the official rate of interest if the pursuit of any monetary policy, with an emphasis on the volume of money, is to have any meaning. The sensitivity of the market rate to a rise in the official discount rate may be either traditional, a legacy of the "old fangled" recognition of the central bank's leadership, or it may be the result of a volley of economic impulses generated by the official discount rate policy. With a highly centralised banking system the effect of a rise or a fall in rates should normally traverse to the remotest corner of the economic entity. Such a relationship does not, however, obtain even in a country with a highly centralised banking system, of which more anon. In an economy with backward banking institutions, the effects of a change in the rate of interest are primarily focussed in the peripheral fringes and are centred in a few trading marts.

A - The Effect of a change in the Long term Rate of Interest.

The effect of a change in the long-term rate of interest on the cost structure of the economy and thereby on economic decisions, depends, not only upon the relative magnitude of interest rate as compared with other stable
factor costs, but it depends also upon the relation of the total cost to the net yield expected from a given investment.

If the cost of production, other than the interest rate is a stable and a continuous magnitude and the plant has a long life, the importance of a variation in the price of loanable funds is undoubted. This is because in large majority of such cases, the net yield tends to be a stable variable also. For, the assumptions that the cost of production other than the interest rate is a stable magnitude and that the investment enjoys a long life, preclude a high degree of obsolescence due to the adoption of new technique or a high rate of depreciation. Further, investments that have very long life are usually based on long-term expectations of yield which are more stable than short-term expectations. It is most probable that such long-term investments in schemes with considerable life may constitute a big slice of the total investment of the community. Such investments are chiefly in construction industries and are primarily undertaken by building agencies, governments and municipalities. Of these, the latter two, in whose calculation profit is not the prime factor, are not sensitive to variations
in interest rates. In cases where the need is felt for an expansion or a curtailment, as the case may be, in the state activity, necessitated either by a slump or a vicious inflationary spiral, governments cannot be deterred by interest rate considerations, though as a matter of policy the interest rate is varied to supplement government efforts. As for the building industry, its importance owing to the decline in the growth of population in the West, is bound to wane. In India, however, its relative magnitude is anybody's guess. Thus it can be generalised that in the case of all kinds of capital goods for which the maintenance and the depreciation cost are large and the risk of obsolescence great, the response both of the widening and of the deepening of capital to a stimulus of a rise or a fall in interest rate, is bound to be sluggish. The deepening process may, indeed, be called insensitive to the rate of interest. For, the uncertainty accompanying the introduction of a new technique is an overshadowing factor. This is, especially vital to a backward economy. We may, for example, have to introduce a labour

2 Hawtrey, Capital and Employment, London 1937, p. 41
saving device. It is possible to measure the saving in the wages bill that is effected and also to compute the ratio of such gains to the total cost of the gadget. The net increment of yield accruing from the introduction of the machine may be so much that the interest charges are of insignificant magnitude, and therefore, there cannot be any postponement of the scheme on the inadequate ground that a small saving can be effected if the machine is introduced in a deferred future. Further, the life of such a labour saving machine is usually short mainly due to the high rate of obsolescence, so inherent in our dynamic world. The changing technique invests such projects with a speculative quality which, by defying precise economic computations render the element of interest rate an indiscursive item in the gamut of cost structure that circumscribe our economic decisions. Nor is the small proportion of such cases to render the interest rate a potent weapon. For, no manufacturer can precisely say, in advance, what his turnover is likely to be. If he expects a substantial gain by either process of widening or deepening, he cannot be deterred by variations in interest rate. It is only in marginal cases that interest rate may prove to be decisive. The result of the investigation conducted by the Oxford Economists' Research Group into the effects of
rates of interest, bears the foregoing analysis conclusively. But most of the negative answers given—and most were negative answers—came from those "who gave the fact that they had always had sufficient resources for the investments which they made as their main reason for not having been affected by the factors mentioned." In pure theory, the assumption is made that such resources can never be free. They can be made free by foregoing the earnings which they fetch in the free market. The fact is that businessmen do not consider—or at least those who responded to the questionnaire did not consider—the foregone earnings on the resources originating from their businesses when such resources are utilised for the expansion of the same business. Further, the prospective earnings are disproportionately higher, and the sum in depreciation and reserve funds are, sometimes, to be spent on maintenance and repairs which brook no delay, when any parsimony in such expenditures imply production below capacity.

Another equally important question connected with the present study in the extent of the rise in cost—caused by an upward variation in the rate of

interest - that can be transmitted to the consumers. Here, the relative elasticities of the supply of, and the demand for a commodity would provide us with an answer. With an elastic supply and an inelastic demand the whole of such an increase in cost is shifted to the consumers; while in a diametrically opposite case, the producer is saddled with an increased cost. There are other possibilities between these two extreme cases, where the capacity to shift the burden of the interest rate depends upon the relative ability of the consumers to restrict their purchases and the producers to restrict their supplies.

The above argument abstracts from exogenous and governmental interventions and depends mainly upon the free play of economic forces. But the most inelastic demand for goods are demands for the prime necessaries for a decent subsistence. In an inflationary period, there is invariably a ceiling imposed on the upward movement of prices of such goods, so that consumers are ensured against extortions. This has an important bearing upon production which should be taken into consideration by government. A rise in the rate of interest which cannot be shifted in the essential sector of goods has its effects on the aggregate purchasing power of the
community which would have been less if such a shifting was allowed. The result is that the demand of the people for the less essential good is more than what it otherwise would have been. This facilitates a shifting of interest cost to the consumer and thus puts a premium on the production of non-essential consumers' goods. The price fixing authority will have, therefore, to estimate the indebtedness of companies and the cost of paying interest charges on it. Even if such a cost rises in the case of few firms, the average level of this cost for the industry has risen. Hence, allowance should be made for such an increase in cost. The digression which here is made brings forcibly to our notice the possibility of shifting the interest burden and thus neutralising the monetary policy.

Despite the negative conclusion arrived at here, it would be rash to brush aside interest rate as an unimportant element. It may be that the effects of interest rate are transmuted, indirectly, by the influence that they exercise on the propensity of consumption of the people, through changes in stock exchange prices. In the context of increasing participation of the people in such transactions - the regular, the curb and over the counter-transactions - such an indirect effect assumes a special significance. With the infliction of a capital
loss, through a rise in interest rate, the dealers curtail their consumption of goods, while a fall in the rate may encourage an opposite trend. Further, the effect of variations in interest rate on the volume of saving needs careful scrutiny. In this analysis, two divergent and neutralising effects have, hitherto, baffled the economists. These are: (a) the ability and (b) the incentive to save. With a rise in the incentive to save, arising out of an upward variation in interest rate, there is, as is noticed, a downward movement in the total consumption, the employment, the income and therefore, in the ability of the people to save. Thus a rise in the rate of interest by inflicting capital losses, reduces consumption and by reducing the ability to save or alternatively by increasing the incentive for saving and thereby the saving itself it tones down through all these effects, the tempo of economic activity.

B - The Impact of Short term Rate of Interest

The effect of a change in the short term rate of interest, according to Hawtrey has its primary impact upon the volume of inventory held by the trader and the retailer. In this connection, the effect of such a change, in rate, on seasonal products should be first
analysed and then an attempt should be made to examine its effects on the manufactured goods.

Seasonal products labour under two limitations. Firstly, the prospective yield of the soil is uncertain and secondly the prices of such commodities are highly volatile. Moreover, the value of such commodities as compared with their bulk being low and their perishability being of a high order, the cost of storage in relation to the net yield is great. All these conspire to make such commodities highly speculative in character. Under these circumstances, the rate of interest is an indecisive factor both in the determination of the volume to be produced and in the determination of the cost of production, and therefore, the price.

In the case of manufactured goods, however, the short term rate of interest is of importance, firstly because the cost of storage in proportion to the value of goods is not high; and secondly because the volume of the production of such goods and hence their price can be intelligently controlled. The rate of interest, therefore, on the capital invested in such inventories is a significant item, which has a certain stable relation to the expected net yield. The amount of inventory that a trader holds will be thus a function of the yield of convenience and the rate of interest.
Hawtrey maintains that the most sensitive sector to the short term interest rate is the volume of inventory that a trader holds.

"When the rate of interest goes up he (the trader) will be anxious to reduce his indebtedness, so far as he can without incurring serious inconvenience. He can reduce his indebtedness if he can reduce his stocks of goods, and he can reduce his stock of goods by merely delaying replenishment when they are sold.... But in the meanwhile the reduction of stocks by the dealers and the restriction of output by the producers will have been accompanied by the diminution of indebtedness ... to the banks. i.e. in the supply of credit money*.

Whether we accept this view or not, it remains true that the efficiency of the bank rate has also to be appraised in the context of the institutional and circumstantial elements that obtain in different countries.

In a backward economy a reduction in discount rate is sterile of good effects. Apart from institutional handicaps that make the bank rate ineffective, the speculative character of trade, which is mostly in agricultural goods, and the need for deepening of capital which is attendant with incalculable risks or benefits, as the case may be, a low rate or a high rate is not productive of as comparable brakes or activations in advanced economies. Since no deepening of the capital structure can take place, despite a reduction in the discount rate, a cheap money

policy by putting premiums on speculation would further help in distorting price relationships. There is, thus much to be said for a "conservative" monetary policy in a backward economy.

**Decline in the Importance of Bank Rate.**

The importance of bank rate, along with the importance of other general credit control instruments has been waning till recently. This decline may be attributed, primarily, to changes in the "stock of trade" of discount markets and the secondary reserves of banks. This alteration in the composition of the stock of trade of the discount market originated from the contraction of the internal trade and the foreign exchange bills. To replace these bills we have the long and the short term government papers arising out of large scale borrowings for the purpose of financing the war. Other contributory causes to this decline are the increasing use of other weapons and also the cheap money policy followed by various governments.

**Rate of Interest and the Debt Policy of Government.**

The Maintenance of interest rate and its implications.

The maintenance of a "pattern of interest rate"
is purported to rule out all fluctuations in rates and prices of securities. Such a stabilisation would encourage a more immediate decision by the public for their investment in government securities. It would also encourage a strong and active market for such papers and above all, it would limit the deadweight of interest burden on the government.

However, to freeze the short and the long term interest rates is to cripple the working of the traditional weapons. A number of implications emanate from the spread that existed and which was stabilised and perpetuated between the short term and the long term rate of interest. The existence and the perpetuation of such a spread is conducive, in the absence of risk and with ease in marketing, to a shift from low yielding papers to papers that have higher yields. This is, indeed, what is exactly meant by financing on "tap". Since the central monetary authority is committed to the maintenance of the pattern of rates, it absorbs, consequently all the wanted papers from the market. Such an absorption has its projection in the release of cash that becomes the basis of further pyramiding of credit. The culmination of all these is the increased demand for high yielding papers, and the increased danger of monetary inflation. Hence, there is, firstly, a
tendency for the long-term rate of interest to climb down; there is, secondly, an automatic monetisation of public debt and there is, thirdly, inflationary dangers latent in the situation. This means that the central bank loses, as a result of such a policy, its grip over the supply of money. If banks sell securities to get cash in lieu, and the market is unable to absorb all these, the residual buyer is the central bank. And if banks have surplus funds, government has to provide the market with adequate securities to absorb the surplus cash. To do otherwise, is to alter the "pattern of rate".

Measures to rejuvenate interest rate as a means of control.

Suggestions and schemes had been pouring in to revitalise the interest rate weapon. A set of people insisted on narrowing the spread between the short and the long term rate of interest, by raising the level of the short-term rate. To stabilise the downward tendency of the long-term rate, new bond issue was to be made. There had been, again, a movement afoot, to insulate government securities from the banking portfolio and thereby restore flexibility to the interest rate weapon.
As an alternative, it was also suggested that the present hyper-sensitivity of the assets of banks to changes in the rate of government securities should be made use of.

As for the first suggestion, it should be admitted that it would complicate the refunding policy of the Treasury and increase its burden. Further, with Treasury papers, widely scattered, the incidence of such a measure will have to be measured, and all the unsettling impacts taken into consideration. Such a measure would, moreover, solve only one of the problems, namely, that of monetary expansion. It would not avert the monetisation of public debt, so long as the spread between rates persists in practice. Moreover, a rise in short term rate may be seismographed by the long term rate, which would further upset the market.

These shortcomings are also points against the last scheme, which requires a flexible bank rate under present conditions. Indeed, banks have become more sensitive to changes in rates, as they hold substantial amount of Treasury papers. What is more tempting is that the new acquisition of sinew by the central bank is devoid of the weaknesses of the traditional discount rate weapon. Such a weakness originated from the inability of the central bank to tarnish the rosy view
that banks would have about the prospects of the market. With the new remodelling of the interest rate weapon, depreciation in the holdings of banks would, enormously, influence their lending policies. However, as banks have become more sensitive to changes in interest rate, the business community has, proportionately, become less sensitive. And unless the effect of such changes can be transmitted to the market, a flexible interest rate would fail to achieve its purpose. This lack of responsiveness, on the part of the market is due to the fall in the advances of banks to the market as their investments in government papers have increased. Hence, it is arguable whether a flexible interest rate, with tremendous unsettling effects which it would initiate, is very desirable.

For insulating the government papers and thus freeing the central bank's hands from a market surcharged with government papers, three schemes are suggested. The first scheme would allow the central bank to vary reserve requirements to the necessary extent. Such a variation would help to shift short-term securities of banks to the central bank in so far as banks would sell them to the monetary authority to provide themselves with additional cash requirements. This scheme would also avert the pyramiding of credit that can be based
on the proceeds of the discount of short term papers with the central bank.

A second plan contemplates a secondary reserve in terms of Treasury bills and certificates, equal to a certain percentage of the demand deposit of banks. This would insulate a great deal of government papers from market influences. The success of the scheme hinges upon the percentage that will be required. With government papers occupying such a predominant position the percentage requirement might be anywhere near twenty per cent.

A third suggestion would limit the amount of the long-term security that a bank may have. This may be made a function of demand deposits. The plan is designed to restrict primarily the shift from short-term government papers to long term government papers.

As it is noted in the second chapter, the Treasuries, by impounding liquid assets of banks in either longer term securities or in securities which if held would give high return and if liquidated by conversion would result in the infliction of capital losses, have succeeded in revitalising the weapon. At the same time they have considered it worthwhile to
bear the burden of higher interest charges in the interest of economic stability. Hence, the resuscitation of the variable discount rate as an important monetary weapon.

2 - Open-Market Operation

With ease in money markets a mere rise in the official discount rate would be an ineffective instrument. Thus, open market operation has been used, sometimes, as a supplementary adjunct of the bank rate. However, till recently, the trend was to use it as an independent instrument.

The Relationship of Economic Variables.

The open-market operation to be effective should add to or deduct from circulation an amount approximating the quantum of money released or absorbed by the central monetary authority in the country. It should, moreover, raise or lower the reserve ratio of banks in proportion to the amount that is released or absorbed. And finally, the demand for bank credit should keep pace with such adjustments. Such demands should rise when money is released and should sag when the opposite trend is noticeable.

However, these variables (the total amount of money, the cash reserve ratio, and the demand for money)
do not usually function in a balanced proportion or move in the same direction.

In the first place, money may be withdrawn from circulation, owing either to an adverse balance of payment situation or to a rise in the liquidity preference of the public. This negative impact, may coincide with the purchase of securities and the release of cash and may partially or wholly nullify the effects of such operations.

In the second place, the banking system of a country may be accustomed to wide fluctuations in the cash-reserve portfolio. The supposed link between the credit policy of a bank and its reserve situation is not as close and its policy may not be determined by its cash.

In the third place, the public may refuse to borrow money. The increase in the volume of money will, thus, remain ineffective.

It should be emphasised, in this connection, that the open market operation, by itself, cannot achieve the requisite harmonizing movement among these variables. Such a harmonious relation is, indeed, indispensable, if the open market operation is to achieve its primary purpose, namely, the activation of the market, or the retardation of its over-exuberant activity. Here, again,
one has to emphasise the importance of a proper coordination between monetary and fiscal devices.

An Evaluation of open-market operation.

Besides the activation of the market and the creation of conditions for revival, open market operation is also used for sundry other purposes. It is used to relieve seasonal strains in the money market, or to neutralise the effect of government finance. It is used to prepare the market for the issue of new loans or the conversion of the old ones. It can, again, be utilized for maintaining the prices of securities and thus supporting a pattern of interest rate. Gold movements can be neutralised and bank rates can be made effective.

Indeed, the efficacy of the instrument is more pronounced in a market with breadth and capacity, a market which has delicately balanced sub-markets and which would leave the reserve ratio of banks at the minimum possible level and in an organisational set-up that would be either shy to approach the central bank for accommodation or would be forced to pay a penal rate for such accommodations.

There are other limitations also. The central bank of a backward economy cannot, for example, dispose of most of its earning assets without imperilling its financial stability; or again, the government security and the bond
market cannot be but disturbed if over-indulgence is shown in this operation.

OPEN MARKET OPERATION IN INDIA

The sale or purchase of any security, debenture, gold or bullion by the Reserve Bank of India, within the given legal frame-work, either on the account of anyone of its departments or on behalf of the Treasury leads to a change in the cash holdings of banks and affects, thereby, their loan and investment policy.

When operating on its own account, the Reserve Bank of India has to co-ordinate the operation of two of its departments, namely the Issue Department and the Banking Department. In managing the government debt, further, it has not only to regulate their yield, maturity and quantum, but also their relation with the operation that the Bank undertakes on its own behalf. Thus, in order to ease the market stringency or in order to make the marketing of a loan successful the Reserve Bank of India while absorbing money by floating government securities, releases money by way of purchases of gold, bullion and other securities in which it is authorised to deal.

Further, though the term open-market operation precludes loans and advances made by the Banking Department,
any liberalisation of its advance policy is bound to be reflected in its open-market operation policy also. While the investment portfolio of the Reserve Bank seeks to release or absorb money in a more general way, the loan and advance department releases money on its own term, thus imposing a penal rate or charging an accommodation or preferential rate of interest.

**Assets of the Issue Department.**

The Issue Department of the Reserve Bank which is vested with the prerogative to issuing currency, is required to maintain a coverage for the currency that it issues. But in most important cases where minima are specified no maxima are fixed. Thus above a minimum level, the Reserve Bank can purchase any eligible holdings or reduce such holdings till their respective legal minimum levels are reached. Further, so long as the required assets are obtainable in the market, the Bank can manoeuvre to any desired extent. This is especially made easy inasmuch as the Department - subject to the important limitation that the forty per cent of its assets should consist of gold and bullion, at least, worth forty crores of rupees - can hold government securities of any maturity to the extent that it deems desirable. Thus, with the availability of gold and bullion in the market, the supply of money can be increased to very great extent with the co-operation of the government.
As it is mentioned, not less than forty per cent of the assets of the Issue Department should consist of gold coins, gold bullions or foreign securities. It is further laid down that the amount of gold coin and gold bullion shall not, at any time, be less than forty crores of rupees in value. After India became a member of the International Monetary Fund, foreign security is represented by any security which is payable in the currency of any foreign country which is a member of the International Monetary Fund*. Such securities should be bills of exchange bearing two or more good signatures and shall be drawn on and be payable at any place in the foreign country and shall have a maturity not exceeding ninety days; or if government security, their maturity period is limited to five years. Before India became a member of the International Monetary Fund, foreign security meant sterling purchases by the government for the payment of certain home charges, in England, and for its other requirements. It should be emphasised, in this connection, that the Reserve Bank cannot deal, on its own volition, in foreign exchanges.

The amount of such securities is limited by the balance of payment situation. If the balance is adverse there is need for open market operation on traditional lines in order to bring about an equilibrium in the imbalance. But foreign

* Vide: Section 35(6)(a,b,c)
exchange cannot be of much use to the open market operation policy, since it is not available in abundance and when it becomes obtainable the need for open market operation no longer exists. Open market operation can, however, be made successful by purchasing other eligible securities. Further, open market operation is undertaken for a variety of other reasons. If available, foreign securities can provide a good "ammunition" for attaining the other objectives of open market operation.

Another item in the portfolio of the Issue Department is rupee coins which should amount to fifty crores or one sixth of the total asset of the department, whichever is greater. Any surplus or short-fall over this amount is corrected by the delivery or receipt, as the case may be, of rupee coins or notes, against the payment of legal tender, gold or securities\(^1\), with the proviso that without the consent of government, the delivery of rupee coin shall not exceed five crores.

The remainder, finally, will be in rupee securities consisting of Treasury Bills and other securities issued by the Central Government. There is no restriction on the maturity period of the securities. This security holding can be supplemented by such bills of exchange or promissory notes which are payable in Indian States under section

\(^1\) Vide: Section 36(1, 2, 3)
### TABLE No. 1

**RESERVE BANK OF INDIA.**

**BALANCE SHEET AS ON JUNE 30th, 1954**

*(Issue Department) (Rupees in Crores)*

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes held in the Banking Department</td>
<td>41/-</td>
</tr>
<tr>
<td>Notes in circulation</td>
<td>1172/-</td>
</tr>
<tr>
<td>TOTAL Notes issued</td>
<td>1213/-</td>
</tr>
</tbody>
</table>

|                               | Foreign Securities ... 653          |
|                               | TOTAL 'A' ... 693                  |
| B. Rupee Coin                 | 99                                   |
| Government of India) Rupee Securities | 421     |
| Internal Bills of Exchange and other) N11 |

| TOTAL LIABILITIES: 1213        | TOTAL ASSETS ... 1213               |

100
section 17(2)(a,b) or section 18(1). The balance sheet of the Issue Department, for the year 1954 is given in table No.1.

**Assets of the Banking Department.**

As it is shown in table No.1.1, the assets of the banking department consist of notes and of balances held abroad. The latter are inclusive of cash and short-term securities held with the Bank of England and of the working balances held at the Bank of Pakistan, the Federal Reserve Bank and the London offices of the Reserve Bank of India. Then there are loans and advances made to the commercial and the co-operative banks, against government securities and the usance bills. Further there are bills, purchased and discounted. These bills are either treasury bills or commercial bills. The latter are mainly for seasonal requirements. Investment in Central and State Government securities comes next. The total value of such securities shall not exceed the aggregate of the Bank's capital and reserve fund and two-fifth of the liability of the Banking Department in respect of deposits. The value of securities maturing after ten years shall not exceed the aggregate of the capital of the Bank and the Reserve Fund and one-fifth of the liabilities of the Banking Department in respect of deposits.*

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*Vide: Section 17(8)(a,b,c.)
### TABLE NO.1.1
(Banking Department)

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th>ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital paid up</td>
<td>Notes</td>
</tr>
<tr>
<td>Reserve Fund</td>
<td>Rupee Coin</td>
</tr>
<tr>
<td>Deposits:</td>
<td>Subsidiary Coin</td>
</tr>
<tr>
<td>(a) GOVERNMENT</td>
<td>Bills purchased and discounted:</td>
</tr>
<tr>
<td>(i) Central Government</td>
<td>(a) Internal</td>
</tr>
<tr>
<td>(ii) Other Government</td>
<td>(b) External</td>
</tr>
<tr>
<td>(b) BANKS</td>
<td>(c) Government Treasury Bills</td>
</tr>
<tr>
<td>(c) OTHERS</td>
<td>Balances held abroad*</td>
</tr>
<tr>
<td>Bills payable</td>
<td>Loans and Advances to Governments</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>Other Loans and Advances</td>
</tr>
<tr>
<td></td>
<td>Investments</td>
</tr>
<tr>
<td></td>
<td>Other Assets</td>
</tr>
<tr>
<td>TOTAL LIABILITIES:</td>
<td>TOTAL ASSETS:</td>
</tr>
<tr>
<td></td>
<td>275</td>
</tr>
</tbody>
</table>

* Includes Cash and Short Term Securities.

<table>
<thead>
<tr>
<th>Year ended March</th>
<th>LIABILITIES</th>
<th>Total Liabilities or Assets</th>
<th>ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Notes in Circulation</td>
<td>Deposits</td>
<td>Other Liabilities</td>
</tr>
<tr>
<td>1936</td>
<td>164</td>
<td>39</td>
<td>0.91</td>
</tr>
<tr>
<td>1937</td>
<td>176</td>
<td>37</td>
<td>1.14</td>
</tr>
<tr>
<td>1938</td>
<td>186</td>
<td>37</td>
<td>0.87</td>
</tr>
<tr>
<td>1939</td>
<td>182</td>
<td>32</td>
<td>1.28</td>
</tr>
<tr>
<td>1940</td>
<td>209</td>
<td>33</td>
<td>1.54</td>
</tr>
<tr>
<td>1941</td>
<td>241</td>
<td>56</td>
<td>2.55</td>
</tr>
<tr>
<td>1942</td>
<td>308</td>
<td>59</td>
<td>4.33</td>
</tr>
<tr>
<td>1943</td>
<td>513</td>
<td>82</td>
<td>7.91</td>
</tr>
<tr>
<td>1944</td>
<td>777</td>
<td>114</td>
<td>10.82</td>
</tr>
<tr>
<td>1945</td>
<td>969</td>
<td>283</td>
<td>14.06</td>
</tr>
<tr>
<td>1946</td>
<td>1,183</td>
<td>514</td>
<td>16.32</td>
</tr>
<tr>
<td>1947</td>
<td>1,223</td>
<td>590</td>
<td>18.32</td>
</tr>
<tr>
<td>1948</td>
<td>1,228</td>
<td>520</td>
<td>14.55</td>
</tr>
<tr>
<td>1949</td>
<td>1,237</td>
<td>394</td>
<td>15.33</td>
</tr>
<tr>
<td>1950</td>
<td>1,129</td>
<td>296</td>
<td>15.76</td>
</tr>
<tr>
<td>1951</td>
<td>1,183</td>
<td>291</td>
<td>18.14</td>
</tr>
<tr>
<td>1952</td>
<td>1,190</td>
<td>325</td>
<td>18.62</td>
</tr>
<tr>
<td>1953</td>
<td>1,115</td>
<td>259</td>
<td>23.69</td>
</tr>
</tbody>
</table>

Source: Banking and Monetary Statistics - R.Bk. of India, 1954
In pre-war years, as the economy was gradually getting out of depression, there has been a gradual rise in the assets of the two departments of the Reserve Bank of India. During the war the same trend continues with an accelerated pace. After the partition, however, with emphasis on price stability there is a moderate decline in the asset portfolio of the Reserve Bank.

The following graph based on the total assets of the Issue Department and the Banking Department, shows that there is an amount of seasonality in the asset portfolio of the Reserve Bank of India. When the public needs funds during the busy season, funds are released by increasing the assets of the departments. At other times there is, however, a decline in the amount of assets. Though, there is no symmetrical movement, it is nonetheless clear that the assets are high during the first four months of the year.
3- Reserves and Reserve Regulations.

The genesis of the regulation of reserves can be traced to gold certificates. These certificates had no intrinsic value and were put into circulation by agencies which functioned as safe-deposit-keepers. The earliest legislation, therefore, was intended to safeguard the interest of depositors, and ensure the solvency of the "depositee". Such urgencies that were attached to the problem of ensuring the solvency of such financial institutions stemmed from the practice of issuing certificates in excess of gold that were received from the public.

Gold certificates which are, in fact, currencies issued by private financial institutions, arrogate a new form in our time. Gold gives its place to cash and gold-certificates are replaced by cheques. The importance of this evolution inheres in the fact that "metal-mentality" is now transcended by "credit-mentality". Side by side with this evolution we witness that gold-security regulations are reoriented in favour of credit security legislations.

Indeed, as Mr. Gluckstradt avers: the credit money

"is an immaterial, abstract kind of money .... Its function is based on the confidence placed in the industrial enterprise which creates it, i.e. the bank; in the confidence
placed, also in its relatively stable purchasing power; in its high technical efficiency and in the community's need of it." *

Confidence in the banking institution is primarily a function of a progressive and a stable economy. With fluctuations in business activity, the fortunes of banks are made subject to the psychological oscillation of the public mind. During a period of panic much banking failures might occur and the reserve basis of banks would remain a feeble Maginot line of defence. Indeed the solvency of banks, as British example amply demonstrates, depends upon the size of the financial institutions also. Unit-banking, which is the dominant feature of the American Banking System, is cramped and threatened by a high unit cost of administration and by the lack of sufficient diversification and dispersion of risks. Flexibility is, however, secured by a system of chain-banking, group-banking or affiliated banking system, besides the "correspondent" correlation that banks maintain with one another.

It can be seen, therefore, that confidence in the solvency of banks is prismatic. It does not depend upon reserve requirements and regulations alone, unless one wishes to back the credit of banks with anything nearing cent per cent reserves.

Objections to Reserve Regulations.

John G. Carlisle led the opposition to the principle of reserve regulation. His objections emanated from a narrow conception of reserves - a conception divested of all flexibility and lightheartedness. The reserve Regulation, it was said, would impair rather than bolster up the solvency of the banking institutions, in so far as such reserves are made legally inaccessible at the very time when it was theoretically supposed to be beneficial in sustaining the credit of banks and affording relief to their customers. It may, however, be argued that government is as much interested in ensuring a system of sound credit as the banks are themselves. It imposes only such types of limitations upon banks that would compel them to keep their investment and advances within the ambit of sound banking practices. A good banker, usually, observes those laws - laws that are gleaned, painfully, out of years of experience. The reserve requirement is, therefore, no limitation upon them. The bad bank, on the other hand, is chained and its rashness is brought within reasonable limits consistent with the interest of the national economy, the depositors and its own.

A second objection that is aimed at knocking the bottom off the reserve controversy belittles the importance of primary reserves. It stresses the importance of the secondary reserve as being of greater significance in the wider compass of time.
A bank with over twenty-five per cent cash reserves and with much of the rest of its assets tied up in loans of doubtful liquidity, is in a much worse position than one with ten to twelve per cent of cash reserves and a great deal of the rest in highly liquid loans. It seems, therefore, that concentration on primary reserves, without taking into account the overall position of the asset portfolio is not a logical attitude to adopt.

The second objection is not, however, an objection as such. It is a plea, a plea for viewing the whole investment portfolio as a unified whole. The reason for the lack of appreciation of the point is attributable to the prevailing real bill doctrine which believes in the liquidity of short-term loans, arranged on a stratified basis, so that the bills at the lowest rung have the greatest liquidity and those at the apex, the least. It was thought that as time elapses there is a rhythmic downward movement so that banks can easily supplement their primary line of defence. For the reasons already given in the first chapter*, this view is not now seriously held. Further, hitherto, there has not been sufficient papers to form a secondary line of defence. With the emergence of government securities this problem is largely solved. *The expansion of such holdings by commercial banks has been incidental rather than intentional, but the opportunity has, nonetheless arisen to

* Vide: The Liquidity Theory and the qualitative credit control & the section on the relevance of liquidity theory.
undertake a fundamental reform\textsuperscript{1}. It is thought that had this measure been adopted during the war period, besides ensuring a sounder banking system, it would have also immensely mitigated the post-war problem of debt management. The Board of Governors' proposal was not, however, intended to bring about this reform. It was rather a measure to insulate the government securities with an intent to rejuvenate the traditional credit control devices. That this proposal was not accepted is for special reasons which are discussed subsequently.

It is instructive, however, to note that in France in October 1948 the new enactment requires the holding of at least 95 per cent of the amount of the Treasury Bills that banks held in September 1948.

In Belgium, of the fifty to sixty-five per cent reserve requirement in force since 1946, four fifths have to be kept in the form of a special issue of short term Treasury Bills bearing 1-15/16 per cent interest.

In Sweden, since October 1950, sixty per cent of the required reserve takes the form of short-term Treasury Securities.

In Italy if deposit is less than ten times the capital and reserve fifteen per cent of the total amount is to be kept in the form of government or government
\textsuperscript{1} Secondary Reserve Requirement for banks AER.1951. pp.136,195.
guaranteed securities or interest bearing blocked accounts with the Treasury or with the Bank of Italy. If the deposit is, in excess of ten times, the capital and reserve, the percentage so kept rises to twenty.

In the Netherlands, again, we have a similar requirement established in January, 1951.

Reserve Requirements and the liquidity and the shiftability theories.

The impracticability of total liquidity has already been validated beyond the possibility of cavil. The seeming triumph of the shiftability theory and the apparent eclipse of the liquidity principle is, indeed, a landmark in the history of the reserve requirement. The reassertion of the latter principle would mean the resurrection of reserve requirement as a means whereby the banking liquidity can be ensured; while the ascendancy of the former theory does away with the reserve requirement as a mere cushion to bear the impacts of public demands for funds and makes it a potent weapon, which is to be used with caution and wisdom. The latter trend is now pronounced. For the report of the committee on Bank Reserves of the Federal Reserve System, 1931, states:

"Since the establishment of the Federal Reserve system, the liquidity of an individual bank is more adequately safeguarded by the presence of the Federal Reserve Banks which were organised for the purpose, among others, of increasing the liquidity of member banks, by providing for the rediscount of their eligible paper, than by the possession of legal reserves."
The Committee takes the position, therefore, "that it is no longer the primary function of legal reserves requirements to assure or preserve the liquidity of individual member banks."

Surprisingly, however, the very fact that the Federal Reserve System is not permitted to lower the legal reserves beyond a certain percentage goes far to show that the liquidity norm, though relegated to background, is, in fact, a self-effacing lady, playing as dominant a part as its compeer the shiftability principle. This is because the liquidity of banks is ensured, indirectly, at least, by reserve requirements. These reserves contribute to the liquidity of central banks and in their centripetalistic aspect, distribute nationally the geographical risks and make for a sounder banking system.

Reserve Ratio as a Weapon.

To recapitulate again, the following conditions are essential for the proper working of traditional weapons. These are: (a) a broad and active bill market; (b) a minimum and stable cash ratio; (c) an integrated banking system and (d) a well-developed credit habit. Indeed, none of these conditions are present in backward economies. The reserve variation can be devised to fill the first two lacunae. It can override the need for bill market, albeit the necessity for a bill market is not confined to the need
for transmitting impulses to commercial banks alone. It is also concerned with conveying such impulses to a wide range of clientele. A variable reserve ratio cannot obviate this latter need. But since the action is direct it has not to operate upon the liquid assets of banks through a bill market. Further, it is possible to vary the reserve ratio to the required extent in order to mop up any excess reserve with banks. It cannot, however, bring about an integrated banking system or foster credit habit among the people.

In the U.S., the variable reserve ratio were devised in the context of excessive inflow of gold. Conscious variations tended to avert the inherent inflationary dangers and the possibility of pyramiding on the basis of such acquisitions. If such variations are to be confined to mere sterilisation of gold, its usefulness would not be of much import to a deficit economy. It is nonetheless, such sterilisations prior to pyramiding rather than after it that is advocated when it is averred that the collapse of an inverted pyramid by the withdrawal of the base would be latent with catastrophic deflationary portent. The truth of this axiom should not be lost sight of. The real danger, however, rests in the crude use of the weapon.

Refinements are also possible. The use of reserve variation on fractional basis may, thus, be attempted with an intent to impart more flexibility and adjustability to the weapon. Another improvement in the all-round applicability of the weapon can be occasioned when the variation
in reserve is used, in conjunction with other devices. Thus reserve variations may be combined with and supplemented by open market operations. The rough work of levelling may be done by the variation of reserve and the more delicate work of adjustment can be performed by open market operations. Again, when flexibility is important, especially in an extensive area of varying reserve situation, an inflexible reserve requirement, which does not take into account local peculiarities, may prove onerous to some banks, while it may not be an additional burden to others. Decentralisation of central banking functions is, thus, inevitable, and in the case of individual banks differentiation may seem necessary, albeit on a closer observation the charge of discrimination and favouritism may wreck the whole project. Moreover, the central bank may avert the dangerous situation arising out of an en masse unloading of papers for the purpose of adjustment with the required reserve. This can be done in two ways. The central bank can support the market by buying securities, and thus relieving the strain. Or it may advance loans as is done by the Commonwealth Bank of Australia, to individual banks that find it difficult to adjust themselves to the new requirement or to contribute to the Special Account.
Backward Economies and the Application of Variable Reserve Ratio.

The suitability of variable reserve ratio is mooted by some and is mutilated by others. One strain of this discourse hinges its validity upon the assumed insignificance and, therefore, insensitivity of reserves. The liquidity of such financial institutions, thus runs the argument, does not determine the loan policy of these banks. Backward economies being primary producing countries, their balance of payment is subject to volatile changes which render the liquidity position of the banks, unstable and fortuitous.

Others viewing this argument with scepticism maintain that a banker usually takes an over-all view of his portfolio. Hence modification in one part of its liquid and sensitive position will have the desired effect. Besides, the zone of indifference, arising out of the unstable reserve situation, can be mapped and made susceptible to reserve changes. The size of this indifferent zone, moreover, is not fortuitous since it decreases in the busy season and increases in the slack one. In the busy season when the zone is at its minimum, changes in the reserve ratio has the necessary effect.

It remains true, after all, that the balance of payment position is, in itself, fortuitous generating and withdrawing cash, sometimes, at inconvenient moments. It
can, however, be said that such inflows can be sterilized to the required extent either by employing reserve variation device, or by resorting to other methods. Among such methods mention should be made of the issue of Special certificate, as is done in Argentina. Such certificates are sold, when there is a favourable balance of payment, thus immobilising the effect of the excess cash reserve. These certificates are bought, however, when a reversal in trend takes place. The limitations of this plan are obvious. It, firstly, depends for its success, upon (a) the co-operation of banks, (b) the attractiveness of the Certificates as compared with loan possibilities in the market. Moreover, these certificates are rediscountable and whenever, there is a pressure for loans they can be liquidated. Another way to reduce the excess resulting from a favourable balance of payment position is to freeze it, in the hand of exchange banks, by requiring them to have a certain percentage of their turnover, *ad valorem*, in the form of foreign exchange.

**Dual Reserve Proposal.**

In the third part, the cent percent reserve plan is studied. Here, however, a brief review of a more limited form of that plan may be attempted. Dual reserve proposal requires after a certain specified date, higher reserve for additional deposits. This additional deposit may have to be
backed even by hundred per cent reserve. The scheme is useful when the economy is threatened by inflationary dangers either arising out of financial commitments of war or consequent upon an excessive inflow of gold.

Special Account.

Another variant of this scheme is the Australian Special Account. Under the regulations introduced in 1941, the Commonwealth Bank of Australia could require the commercial banks to lodge with it the equivalent of the large deposit increase during the war, in a special account, at a very low rate of interest. The power given in 1945 is as blunt. The commercial banks besides the outstanding amount in the special account might be required to maintain the equivalent of any post-war increase in their asset. This implies that absolute power was given to the Commonwealth Bank to sterilise new cash. Moreover, the release of this cash from the special account was left to the discretion of the Commonwealth Bank. It is clear that with such a weapon Commonwealth Bank was empowered to enforce its will on any issue.

Another important question that was mixed up with the merit of this reform was the question of nationalising the commercial banks. The Commonwealth Bank could, by demanding payment, in full, to the Special Account render all the trading banks technically insolvent and then take them over
under the Special Procedure laid down under the Banking Act. Hence, it was thought by the Conservative Government that checks were needed to safeguard the special position of the commercial banks. The new enactment cancelled the outstanding uncalled liability and also reduced the maximum amount that may be required from hundred per cent to seventy five per cent. Automatic releases were ensured by requiring that in cases where the amount callable fell below the amount actually called releases were to be made. If, for example, the amount called is equal to two-third of the amount callable and just as happened in 1952, there is a sharp fall in deposits that makes the amount called exceed the amount callable, releases have to be effected.


The secondary reserve proposal is not devised to add a new monetary weapon to the armoury of a central bank. It is primarily a "monetary reform" measure intended to rejuvenate the traditional credit weapons by isolating the long-term government papers. The reasons for this, as it is already noticed are three. It is, firstly, to avert a widespread adverse change in the balance sheets of financial institutions; secondly, to inhibit saddling the government with additional burdens and finally to avoid impairing the public confidence in the credit of government. The Secondary reserve proposal
by abolishing marketability does not obliterate this last problem but it attempts a Debt Reform. It is proposed that the reserve should be in the form of short-term government papers. This is to be kept, in addition to the legal cash reserve. It is, moreover, to be related to the amount of deposits, being ten per cent of time and twenty-five per cent of demand deposits. These requirements are to be introduced, step by step, for a period of three years and the power for their regulations and enforcements is to be vested in the Open Market Committee.

Such a high requirement, however, would leave many a bank with a wide margin of deficit which they have to make good by selling bonds to the Federal Reserve System and purchasing, in return, short-term securities. When confronted with new demands for loans the commercial banks, under the proposed regime, would have to sell either bonds to obtain the necessary reserve or to refuse such lendings. Nor is the multiple lending by commercial banks unaffected. For the secondary reserve requirement along with legal cash requirements would greatly reduce this capacity. With the enforcement of the proposal, short-term securities would have been, thus, isolated and their prices stabilised. The impact of this on long-term government bonds is, however, difficult to gauge. For the proposal was not intended to withdraw support from this market. Confronted with new reserve requirements and/or loans there is no reason why banks would not liquidate their holdings of bonds, or,
other institution not doing so when credit stringency was also transmitted to the private sector. Unless the ability of the public and banks to liquidate bonds is also exhausted, such unloadings would definitely neutralise the effects of any restrictive measures adopted by a monetary policy. For, in that event, the liquidity of banks would be at the mercy of the central bank which would be in a position to enforce a monetary discipline by raising its rates and forcing the market into the bank. In the absence of such an eventuality, it is more likely than not that the orthodox weapons, despite their secondary reserve accoutrements would retain their unorthodox ineffective trait.

Even assuming that banks co-operate with monetary authorities in not selling their bonds to the system and thus raising their rates, the borrowers would seek an alternative channel in the security market. Their biddings for funds in that market would raise the rate and create a lucrative inducement for the liquidation of government bonds with fixed rates and the diversion of funds to channels already balked by the banking system. For, insurance companies and saving institutions hold large quantities of government bonds above their liquidity requirements. The only deterrent left to the system is the abandonment of par support. But the withdrawal of such a support is, in itself, drastic enough to obviate the
need for special reserve requirements. A special characteristic feature of the new regime would be the difficulty of selling long-term marketable bonds - which would lose much of their attraction. Thus the secondary reserve plan if confined to only one segment of public loan, would not rejuvenate orthodox weapons. For, with the application of such weapons, even if banks do not liquidate their bond holdings, other saving institutions would do so, thus cutting across monetary discipline. The monetary authority, apart from discriminating against the commercial banks, would be left under the foregoing circumstances, with no market for its long-term bonds. The logical corollary of the insistence on a secondary reserve would be a Debt Reform rendering all bonds non-marketable before maturity. The legislative and administrative difficulties involved in this, the degree of centralisation that this system would entail to which most banks are opposed in America, is to be considered against an additional cost to the Treasury arising out of an increased discount rate. Thus there is much to be said in favour of Mr. Sproul's 'market restraint' policy which by increasing the manoeuvrability of the Treasury in the market would induce caution rather than impose discipline, thus forestalling inflation without precipitating deflation.

Secondary Reserve in some other countries.

In France the commercial banks were directed to
maintain a specified minimum of Treasury Bills and other public securities. This was intended to restrict private credit expansion in so far as banks had earlier disregarded the gentleman's agreement arrived at with the Bank of France by unloading in 1946 and 1947 sizable amounts of government securities. According to this law, the commercial banks were to keep a holding of government securities at not less than ninety-five per cent of the volume held by them at the end of September 1948. They were, however, permitted to lower this percentage to the tune of eighty per cent of a fall, when such a fall was occasioned in the amount of their liabilities. In case of an increase, twenty per cent of new accretions was to be invested in government securities.

In the Netherlands, again, a minimum of two-thirds of any increase in the deposits of banks over the amount held in September 1950 is to be held in the form of very liquid asset. Since 1951, Mexico instituted a form of very rigid control. It requires all the increment in the demand deposits to be held with the central bank.

In the U.K., though the control does not take the usual statutory form, yet it is effective when the need for it is felt. The T.D.R. that the Bank of England issued at very low fixed interest rates at the commencement of the week was accepted by the Clearing Banks without demur.
Comments on Traditional Instruments:

In the course of the preceding analysis, it is observed that there have been changes in the asset portfolio and in the stock of trade of the market. These changes have generally tended to cripple the traditional instruments. Under these conditions attempts have been made to make the interest rate a flexible weapon - both by conversion or Funding Operation or by some form of secondary reserve requirements which aim at impounding the short-term liquid securities, and by desisting from open market purchases, in order to support the price, albeit such purchases are made when the market trend becomes too disturbing. Open market operation has also acquired sufficient "ammunition" to force a change in money rates. Variable reserve ratio is a useful instrument for sterilising potentialities that are laden with inflationary germs. However, in the absence of government support, when banks are compelled to unload their securities under new reserve requirements, the repercussion of such sales may be too disturbing to the pattern of rates in the market. Refinements, however, are possible which can make its applications on fractional basis practicable. Further, in order to circumvent the difficulties inherent in the prescription of a new reserve requirement, monetary authority can give loans on its own term, to those banks that cannot conform to new requirements.
Traditional weapons, moreover, are used for the purpose of control in a negative way. They check inflation but cannot revive a depressed market. However, a proper combination of monetary and fiscal policy can stimulate the private sector which, then, would take advantage of favourable conditions created by the new monetary policy.

There is, again, an increasing recognition that the use of traditional weapons for the purpose of tightening credit for all purposes when excessive use of credit is being made for some purposes, is not only laden with deflationary portent but is unjustifiable. Hence, there is a new emphasis on selective weapons. It is, however, possible to use the general credit instruments for the purpose of restraint while the selective credit devices for the purpose of giving relief to sectors that deserve it. It is exactly this line of policy, i.e., progress with stability, which has become the corner stone of the monetary policy in India.
(ii)

THE MECHANISM FOR THE SELECTIVE CONTROL OF CREDIT

Definition:

The devices used for the selective control of credit do not influence or affect the reserve ratio, i.e., the most vulnerable and sensitive part of banking assets. They prescribe, instead, the conditions under which loans can be obtained. It is clear, from the definition that the immediate impact of selective control is not on the total amount of money and credit but on the amount that goes to a definite and selected sector of the economy.

Comments and views as to the efficacy and admissibility of selective weapons.

The earlier approach to selectivity as purporting to conform the use of credit to an established standard has been severely castigated on the following two grounds. Firstly, it is averred that it is not sufficiently recognised that the purpose for which a paper is drawn may have no relation to the use of its proceeds, when the paper is discounted. Secondly, it is imperfectly realised that the proceeds of the discounted paper may become the basis of a multiple creation of credit which may have no relation to the purpose for which the original paper was drawn.
The new approach, i.e., the one since 1934 differs from the earlier one in that it is divested, firstly, from the fancied relationship that was to be established between the security and its use; and secondly, credit control is no longer fetched in the regulation of member banks alone. The approach is now direct and besides the banker, the coverage is encompassing all those entities which are engaged in an enterprise of a specified character. Margin requirements, for example, has its incidence, primarily, on brokers, while the consumer credit has its impact on distributors.

The comments on this latest approach is favourable so far as it goes. Ellis, for example, approves generally the use of the weapons but holds the view that if the inflationary movements become really strong, they would be quite insufficient, since they pertain to borrowings leaving the mass of existing purchasing power untouched. He, however, believes in the further extension of the field of selectivity since it is less extreme and impinges upon proper strategic points without penalising other sectors.

Hanson is at one with this view. He says that it is speculation that is to be clubbed down and not the stable industries. Since the speculator makes a great

deal of profit, a rise in the discount rate does not affect him, while other vital industries which do not make much profit will be adversely hit. Hence the importance of the selective margin requirements.¹

Sproul, however, believes in resurrecting the general weapons of credit control. For, a craze in extending the scope of selective gadgets may compromise the basis of a free enterprise economy.²

It is, moreover, the considered opinion of Simmons that selective weapons are cumbersome. Firstly, the area of its coverage is extensive since besides the banks, lenders of all types are to be included and in the case of consumer credit control the range of control encompasses a great number of establishments. This is reflected in the Table No.2 and 2.1. It should, however, be noted that as far as the instalment credit is concerned more than ninety per cent are provided by financial institutions which can be made subject to control. Secondly, the selective weapons, it is said, do not have the precision that usually goes with "relatively simple reserves - reserve ratio apparatus"³. Thirdly, the great deal of regulations that such instruments entail makes it desirable to nationalise the lending operations.

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1 Ibid pp. 251-252
2 American Economic Review, 1947
3 Ibid p. 639
The general opinion of competent economists including the ones just mentioned is favourable to the retention of the margin requirement and consumer credit control. For it is believed that "wild-cat speculation on a shoestring" is not possible when margin requirement is high. Moreover, Haberler and others believe in consumer credit control as an important factor, regulating the ups and downs of a trade cycle. While Goldenweiser pleads for the extension of selective regulation to real estate and construction credit also.4

The Progress of Instalment Credit in America.

| TABLE No.2 |

Instalment credit (in billions of dollars)

<table>
<thead>
<tr>
<th>End of the Year</th>
<th>Total</th>
<th>Automobile paper</th>
<th>Other Consumers Goods</th>
<th>Repair &amp; &quot;Modernization&quot; Loan</th>
<th>Personal Loans</th>
<th>Increase/Decrease</th>
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</thead>
<tbody>
<tr>
<td>1939</td>
<td>4.50</td>
<td>1.50</td>
<td>1.62</td>
<td>0.30</td>
<td>1.09</td>
<td>+ 1.01</td>
</tr>
<tr>
<td>1940</td>
<td>5.51</td>
<td>2.07</td>
<td>1.83</td>
<td>0.37</td>
<td>1.25</td>
<td>+ 0.58</td>
</tr>
<tr>
<td>1941</td>
<td>6.09</td>
<td>2.46</td>
<td>1.93</td>
<td>0.38</td>
<td>1.32</td>
<td>- 2.92</td>
</tr>
<tr>
<td>1942</td>
<td>3.17</td>
<td>0.74</td>
<td>1.20</td>
<td>0.26</td>
<td>0.97</td>
<td>- 1.01</td>
</tr>
<tr>
<td>1945</td>
<td>2.46</td>
<td>0.46</td>
<td>0.82</td>
<td>0.18</td>
<td>1.01</td>
<td>- 0.71</td>
</tr>
<tr>
<td>1946</td>
<td>4.17</td>
<td>0.98</td>
<td>1.29</td>
<td>0.41</td>
<td>1.50</td>
<td>+ 1.71</td>
</tr>
<tr>
<td>1947</td>
<td>6.70</td>
<td>1.92</td>
<td>2.14</td>
<td>0.72</td>
<td>1.91</td>
<td>+ 2.53</td>
</tr>
<tr>
<td>1948</td>
<td>8.97</td>
<td>3.05</td>
<td>2.84</td>
<td>0.64</td>
<td>2.23</td>
<td>+ 2.27</td>
</tr>
<tr>
<td>1949</td>
<td>11.52</td>
<td>4.70</td>
<td>3.49</td>
<td>0.89</td>
<td>2.44</td>
<td>+ 2.55</td>
</tr>
<tr>
<td>1950</td>
<td>14.49</td>
<td>6.34</td>
<td>4.34</td>
<td>1.01</td>
<td>2.81</td>
<td>+ 2.97</td>
</tr>
<tr>
<td>1951</td>
<td>14.84</td>
<td>6.24</td>
<td>4.27</td>
<td>1.09</td>
<td>3.24</td>
<td>+ 0.35</td>
</tr>
<tr>
<td>1952</td>
<td>18.68</td>
<td>8.10</td>
<td>5.35</td>
<td>1.41</td>
<td>3.85</td>
<td>+ 3.84</td>
</tr>
<tr>
<td>1953</td>
<td>21.81</td>
<td>10.29</td>
<td>5.61</td>
<td>1.61</td>
<td>4.31</td>
<td>+ 3.13</td>
</tr>
</tbody>
</table>

Source: Federal Reserve Bulletin, June 1954, p.632

### TABLE No.2.1

**INSTALMENT CREDIT, BY HOLDERS**

<table>
<thead>
<tr>
<th>End of year</th>
<th>Total installment credit</th>
<th>Financial Institutions</th>
<th></th>
<th></th>
<th>Retail Outlets</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>Commercial Banks</td>
<td>State &amp; City Finance</td>
<td>Credit Unions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1939</td>
<td>4.50</td>
<td>3.07</td>
<td>1.08</td>
<td>1.20</td>
<td>0.13</td>
<td>0.66</td>
<td>1.44</td>
<td>0.35</td>
<td>0.44</td>
<td>0.18</td>
<td>0.12</td>
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<tr>
<td>1940</td>
<td>5.51</td>
<td>3.92</td>
<td>1.45</td>
<td>1.58</td>
<td>0.17</td>
<td>0.72</td>
<td>1.60</td>
<td>0.39</td>
<td>0.47</td>
<td>0.20</td>
<td>0.17</td>
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<tr>
<td>1941</td>
<td>6.08</td>
<td>4.48</td>
<td>1.73</td>
<td>1.80</td>
<td>0.20</td>
<td>0.76</td>
<td>1.61</td>
<td>0.32</td>
<td>0.50</td>
<td>0.21</td>
<td>0.19</td>
</tr>
<tr>
<td>1942</td>
<td>3.17</td>
<td>2.18</td>
<td>0.86</td>
<td>0.59</td>
<td>0.13</td>
<td>0.60</td>
<td>0.99</td>
<td>0.18</td>
<td>0.33</td>
<td>0.11</td>
<td>0.05</td>
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<tr>
<td>1943</td>
<td>2.46</td>
<td>1.76</td>
<td>0.75</td>
<td>0.30</td>
<td>0.10</td>
<td>0.63</td>
<td>0.69</td>
<td>0.13</td>
<td>0.24</td>
<td>0.02</td>
<td>0.03</td>
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<tr>
<td>1944</td>
<td>4.17</td>
<td>3.24</td>
<td>1.57</td>
<td>0.66</td>
<td>0.15</td>
<td>0.84</td>
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<td>0.21</td>
<td>0.32</td>
<td>0.04</td>
<td>0.05</td>
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<tr>
<td>1945</td>
<td>6.70</td>
<td>5.26</td>
<td>2.63</td>
<td>1.36</td>
<td>0.24</td>
<td>1.04</td>
<td>1.44</td>
<td>0.38</td>
<td>0.47</td>
<td>0.08</td>
<td>0.10</td>
</tr>
<tr>
<td>1946</td>
<td>8.97</td>
<td>7.09</td>
<td>3.53</td>
<td>1.99</td>
<td>0.33</td>
<td>1.24</td>
<td>1.98</td>
<td>0.47</td>
<td>0.60</td>
<td>0.13</td>
<td>0.16</td>
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<tr>
<td>1947</td>
<td>11.52</td>
<td>9.25</td>
<td>4.44</td>
<td>2.95</td>
<td>0.44</td>
<td>1.42</td>
<td>2.27</td>
<td>0.60</td>
<td>0.72</td>
<td>0.17</td>
<td>0.24</td>
</tr>
<tr>
<td>1948</td>
<td>14.44</td>
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<td>5.80</td>
<td>3.79</td>
<td>0.59</td>
<td>1.65</td>
<td>2.67</td>
<td>0.74</td>
<td>0.79</td>
<td>0.24</td>
<td>0.28</td>
</tr>
<tr>
<td>1949</td>
<td>14.84</td>
<td>12.98</td>
<td>5.77</td>
<td>3.77</td>
<td>0.64</td>
<td>1.90</td>
<td>2.76</td>
<td>0.92</td>
<td>0.76</td>
<td>0.21</td>
<td>0.26</td>
</tr>
<tr>
<td>1950</td>
<td>18.68</td>
<td>15.41</td>
<td>7.52</td>
<td>4.33</td>
<td>0.34</td>
<td>2.22</td>
<td>3.27</td>
<td>1.12</td>
<td>0.87</td>
<td>0.24</td>
<td>0.31</td>
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<tr>
<td>1951</td>
<td>20.81</td>
<td>18.53</td>
<td>8.88</td>
<td>6.15</td>
<td>1.06</td>
<td>2.47</td>
<td>3.27</td>
<td>1.07</td>
<td>0.87</td>
<td>0.28</td>
<td>0.41</td>
</tr>
</tbody>
</table>

Source: Ibid.
Two Views on the Subject.

There are, however, two sets of views on the question of selectivity. One set regards the selective control as a second line of defence. This view has gained importance owing to the paralysis of traditional credit control devices. But such an approach is not sufficient. For, even in the event of successful application of traditional devices, selective weapons are advocated inasmuch as they impinge upon particular sectors. Consumer credit control, for example, is designed to control an important sector while margin requirements are intended to dampen speculation. So also the real estate credit control. Thus the housing boom of 1948-1950, in America, which was financed by credit creation was to be brought within manageable dimension if a collapse was to be averted. It is in this case that the selective control in the field of real estate would have been very useful and not a resort to an orthodox monetary device that would have precipitated all round economic restraints. Hence selective weapons are not the second line of defence that have to be resorted to when the first line collapses.

The second approach thinks of the selective weapons as substitutes for the general credit control devices. Unsupported by general monetary or fiscal measures, selective devices are not, by themselves, effective in imposing monetary discipline. This is firstly, because the coverage of
selective weapons has, hitherto, remained quite restricted, and that there is an underlying opposition to regimentation that such an extension would involve. It is feasible, if we reconcile ourselves to the idea of regimentation that such an extension would involve. It is feasible, if we reconcile ourselves to the idea of regimentation, to render passive and not to supersede the general credit weapons. To do this we may, through certain institutional reorganisation, introduce compulsory direction of resources. In such a setup selective distribution of funds, as a counterpart of physical allocation of strategic materials in accordance with a given priority scheme can be effected. It depends, however, upon what we mean by "selective credit weapons. Whether we want to supplement them with other forms of control that widen its range and facilitate its application or would purely mean monetary devices divested from direct controls. It should be added in this context that selective controls are selective and are distinguishable from the general credit weapons in that they are more directly applied. However, if we do not want to widen the range of their application, it remains true that increasing reliance must be placed on general credit and fiscal measures for controlling inflation. Thus it is obvious that in periods, such as, 1948 to 1950, when there was a large scale bond sale in America and its proceeds were invested in the mortgage market, the government
if it was not wedded to the practice of maintaining a pattern of rates, could discourage this swing by allowing the bonds to depreciate and the rate structure to harden. Instead, it resorted to Regulation X which set a limit to the purchase or improvement of new construction. Though the Regulation X was useful, if such a hardening of the rates was permitted a heavy penalty would have resulted from the switch.

Secondly, it is said that selective weapons operate best when the general weapons have already absorbed the excess reserve. For example, the essential condition for the success of consumer credit control is that the liquid asset holdings of consumers should be relatively low. With sufficient liquidity, increases in down payments would merely result in an increase in payments without much of a restrictive effect. However, when the liquidity is at its minimum the restrictive effects would be greatly felt.
1. INSTALMENT CREDIT CONTROL

Connotation of the term.

Two things in the instalment credit control are of real importance. The first is the "down payment" and the second is the subsequent instalment payments. By controlling the initial and down payments a brake is put on the ability of people to purchase. The effect is the same when people are required to pay the remaining sums, after the initial payment, over a shorter period of time. On the other hand government can encourage the consumption of goods or the purchase of estates or the construction of new buildings by reducing the down payment and by extending the period of payment. Losses that are caused by this scheme may be borne, in the interest of economic stability by the government.

Thus, the encouragement of consumer's credit occupies an important and strategic place in the national economy. Such an extension of credit which is a highly sensitive and unstable slice of people's spending can, from time to time, cause an intensification of the ups and the downs of the trade cycle.

It is realised, firstly, that with incomes equal to bare level of subsistence, the propensity to consume approximates unity. However, with an increase in its level, more and more money is spent on luxury or semi-luxury goods of
durable character. The consumers buy goods when trade is active and their income handsome; and they curtail their purchases when there is a slack in trade and their income is low. This fluctuation of outlay on dispensable goods oscillates when the purchases of durable goods are based on instalment payments. For instalment payments sustain booms by scaling up the demand for goods, and reduce the demand at the time of depression. This latter tendency is due to the fact that with the inception of depression, people, besides refraining from any new commitments have to pay the remaining instalments on goods they have already purchased. The fall in their effective demand will be, then equal to the decrement in their income plus the instalment payment that they have still to make. The producers seeing that the demand for their goods have fallen more than otherwise would have been the case, curtail their production by an increased proportion, albeit the effect of unpaid instalments on their consumption, which in the absence of instalment would not have paid during the depression, has also to be taken into account. This tendency towards the reduction of production can, however, be offset by reduced initial and instalment payments in order to sustain demand.

It is in this light that the consumer credit control should be viewed and not in the light of war expediency. Indeed, the size of such credits may not be very large.
It is, however, very unstable and its area can be further widened by the extension of control, or rather the facility, to the building societies and to the purchasers of the real estate.

The foregoing analyses are based on theoretical considerations. The effectiveness of the weapon as a contra-cyclical device is not, however, amenable to statistical computation. Some maintain that consumer credit control is regressive in character. With an increase in down-payment uniformly applied for the same article irrespective of the income of the purchaser, the richer the man is the lesser is the difficulty of payment. It is felt, nonetheless, that when the need for credit control becomes imperative it has to be checked where it is found. Nor are other forms of credit control less onerous. It is, further, said that since this form of control is imposed on goods which are not necessaries the rigour of the control cannot be crippling especially when the control is meant for a temporary period of time.

Theoretically, the restraining influence that such controls exercise release funds for other purposes. If such funds are lent to government, the effect of such a control is more salutary than when such funds are utilised for the purchase of other uncontrolled but scarce articles thereby
necessitating the adoption of other forms of controls/well. This point is of great significance to a shortage economy.

Another point that needs attention is the protection that this form of control gives to small dealers who cannot give the same facilities to the consumer as the unscrupulous dealers may do. It is arguable that these unscrupulous dealers are simply "a part of that Schumpeterian entrepreneurial process of creative destruction, their innovation in this case having been to show that they could stay in business and sell on thinner terms and to more marginal credit risks than had been considered possible".\(^1\) It may be that they by their salesmanship would broaden the market, so essential for the growth of industry in an advanced economy.

Passing from the economic effect of the weapon to the question of the timing, it can be said that the consumer credit control is most effective when the liquidity of the consumer is not great. But this form of control is required at such times when the consumers' liquidity is very great. This point not only emphasises the complementary nature of the selective devices and the general weapons of credit control, it also focusses the attention to the expediency of increasing at such periods the frequency of payment as compared with down-payments.

**Bonds for the Purchase of Real Estate.**

Encouragement of bonds for the purchase of real estate

\(^1\) A.E.R. 1952, p.272
is another device for extending the field of instalment payments. Such instalments may take the form of Springfield payment method which is preferable to other methods. In all these cases the instalment consists of two components, the principle and the rate of interest. The Springfield payment method leads to a decrease in both these components; while other methods lead to a decrease in the interest payment and an increase in the payment of the principle, thus leaving the total sum paid unchanged. The manipulation of such instalment payments and other variations of the kind, which is an attempt in instalment credit facility would, indeed, be very beneficial to underdeveloped economies with no acute agrarian problem.

The method of financing may be that of "pooling the bond system". The credit agency pools the loans that it has advanced and on the security of such loans, it issues bonds at convenient denominations. If the investors fail to respond in the slack time, government may step in to support the issue. Government may also encourage the peasants to purchase lands by bearing the cost of reduced instalment payment and recovering it from the richer income group peasants by way of tax. Further, since much speculation in land is a regular feature of an underdeveloped economy, such speculations can be greatly clubbed down by instituting some form of control, by limiting acquisitions to such purchases that are made by actual cultivators.
Ceilings may also be placed on the lands that an individual farmer can purchase and time lag may be introduced in the transferrability of the acquired lands.

**Purchase or Improvement of New Construction.**

There is a difference between the control exercised under this head and the one exercised under the consumer credit control. In the case of the consumer credit control the down-payment and the time lag for a list of articles are regulated on a uniform basis. In the case of purchases of new buildings, however, such down-payments increase with the rise in the value of a house, and the payment of instalments may be made correspondingly more frequent.

Thus, with differing down payments and time lags the richer people may be discouraged from buying buildings while the people with lower income may actually be encouraged to do so. We may call this a progressive form of control.

Administratively speaking, this form of control is less flexible and less easily enforceable than the consumer credit control. In the first place there is need for exemption of great many cases, otherwise gross inequality may creep in. The consumer might have actually purchased the land, assembled the materials and even started the
actual construction and all these on the assurance of being able to raise eighty or even more per cent of the finance by way of credit. If such facilities are, suddenly made difficult, the consumer may be adversely affected. In the second place, people in the higher bracket may actually purchase buildings that are meant for the lower bracket income group. This cannot, therefore, be stopped altogether, and finally, since the enforcement of the regulation takes time, it is not as prompt as the exercise of the consumer credit control.

India and the Instalment Credit Control.

Despite the rapid progress achieved in the grant of this form of credit in the U.S.A., the U.K., and Germany, in India it has not made much of a headway. In the U.S.A., the total amount of instalment credit increased from 4.5 billion dollars in 1939, to $22 billion in 1953 (table No.2). Germany also, in post-war years adopted this form of credit facility which did much to lighten the burden of her shattered economy.

Instalment credit, in India, is, however, in its infancy. Little interest is shown by the manufacturers in promoting the sales of their product on hire-purchase basis. There have been, at one or other time, companies in India that had based their business on hire purchase basis. Singer Sewing Machine Company and Messrs Govan Bros., which specialised
in automobile sales on hire purchase basis are instances to the point. At present there are some companies dealing in sales of radio sets, sewing machines and bicycles, or sales of furnitures, watches, jewellery or wollen suitings that give such credit facilities.

In India, the instalment credit facility should be viewed not so much as a measure that would popularise the purchase of an article but as a scheme that would promote such purchases that increase the tempo of economic progress and help in achieving social objectives. The needs of Indians are not so much the purchases of foreign consumer goods that would worsen the balance of payment situation, but the making of such purchases that help to enhance productivity. The establishments of factories, the rationalisation of technique, Refugee Rehabilitation Schemes, Own Your Home Schemes are some of the important measures that can be expedited by the grant of instalment facilities. Co-operative societies can also extend such facilities increasingly to the farmer for such purposes as the purchase and renovation of working capital, the effecting improvement in land or consolidating their holdings. In the context of small scale industries, the International Planning Team observes: "A sound system of instalment credit primarily directed to the purchase of machinery, equipment and useful utensils but not excluding consumers goods would contribute
to a rapidly expanding economy\textsuperscript{1}. Thus there is a vast field that is susceptible to selectivity, if proper machinery is devised for the purpose.

2 - MARGIN REQUIREMENTS

The difference between the value of the collateral security required for getting accommodation and the actual amount of advance obtained constitutes the margin. Thus, if a loan of Rs.75/- can be secured for a collateral security worth Rs.100/-, the difference which is, in this case, Rs.25/- constitutes the margin. The Rs.25/- is also the twenty-five per cent of the value of the security. If this margin which is twenty-five in the above case is raised to 100 per cent no loan can be secured if it is ninety-nine per cent one rupee can be obtained, etc.

It is significant that from January 1946 to February 1947 a cent per cent margin was required by the United State Federal Reserve Board.

Hypothetical illustration of the Effectiveness of the Weapon.

If a broker who has a security worth Rs.X and who customarily adheres to a margin of 10 per cent, now enters the speculative market his deal may approximate Rs.10 X.

\[
\begin{align*}
\text{Rs. X} & \quad \cdots \quad \cdots \quad \text{Original Security.} \\
\text{Rs.}(90/100)\text{X} & \quad \cdots \quad \text{The first loan obtained on the security of 1st purchase.} \\
\text{Rs.}(90/100)^2\text{X} & \quad \cdots \quad \text{The second loan obtained on the security of 2nd purchase} \\
\text{Rs.}(90/100)^n\text{X} & \quad \cdots \quad \text{The n loan obtained on the security of (n-1) purchase} \\
\end{align*}
\]

Total = X (1 + y + y^2 + \ldots \ldots y^n), where y is (90/100)
A speculator who has purchased out of an original owned capital of Rs.10,000, one hundred shares, each costing Rs.1,000 and the range of fluctuation in the value of which shares is between (+)Rs.75 and (-)Rs.75, his total gain or loss would oscillate round the level of plus Rs.7,500 and minus Rs.7,500. If now the monetary authority intervenes and raises the margin requirement from 10 to 75 per cent, the purchase of the broker is reduced to 15,000 rupees only, i.e. to fifteen shares as against one hundred. The range of fluctuation is also correspondingly reduced, to plus 1,125 and minus 1,125.

Whereas in our first illustration, the original security which is a part of the borrowers' capital forms only ten per cent of the total transactions, in the case of controlled margin it forms about sixty-seven per cent of the total. The marked decrease in the range of profits and losses will again be conducive to a lesser frenzied mood in the market.

A second effect of the margin requirement is the restriction that it imposes on the pyramiding that takes place, on the basis of the increased value of the stock. If on a stock worth Rs.1,00,000/- a profit of twenty-thousand is realised, on the basis of twenty-thousand profit another pyramid to the tune of 200,000/- rupees can be erected. The
higher the margin, however, the lesser the pyramiding that can take place.

Margin Trading in India.

When a member of the stock exchange has no money with which to speculate in the market, he falls upon such credits that can be obtained from brokers and banks. The procedure that is followed is as given below. In purchasing a scrip the client pays part of the price while the broker pays the residue. The latter takes delivery of the securities which will be held by him as the collateral security for the advances that he has made. The part payment which the client makes is known as the "margin" or "equity". Thus the client keeps a running account with the broker. The amount paid as the "margin" is credited to his account while the part payment which is made by the broker is debited to it. There is, however, a stipulation binding on the client to furnish additional margin in case his stock depreciates. In the case of stock appreciations the client is enabled to make additional purchases. Thus with rising prices the speculators go on adding to their stocks and increasing credit is absorbed by the market resulting in further increases in the price level and additional speculative buyings.

As most of such transactions take place "on account", speculations which gain gradual impetus culminate in short
sellings which, as the time for settlement draws near, lead to corners. If short sellings and corners do not develop, the "bull raid" may be followed by a "bear raid" resulting in precipitous fall in prices with inadmissible consequences to the economy. The result of either of these sequences is disturbing. In the former case there is the possibility of the bears failing while in the latter case, with fall in security prices the clients may not be able to fulfil the terms of their agreements resulting in crisis.

Palpably with the development of any such debacle not only the brokers but other credit institutions are also embroiled. In an Indian Stock Exchange where the inadequacy of qualified papers does not warrant functional specialization of dealers into brokers and jobbers, the broker does business on his own as well as on his clients' behalf. In a rising market when the fund of brokers is not sufficient, steps are taken to secure advances from banks. This is done by giving to banks the stock that is at the disposal of brokers, as collateral for securing advances. The banks before lending deduct a flat margin from the value of the securities and then grant credit.

As far as the organised banks are concerned the Reserve Bank has power under section 21(1)(2) and 36(a) to
determine the policy in relation to advances to be
governed by banking companies generally or by any banking
company in particular. It can give directions also to
any or all of the banking companies as to the purpose for
which the advances may or may not be made, the margins to
be maintained in respect of secured advances and the rate
of interest to be charged. The unorganised banking sector
is, however, beyond the pale of control.

Gorwalla Committee on the "Legislation for the Regu-
lation of Stock Exchanges & Contracts in Securities" visual-
ise far reaching changes. Briefly, a special commission,
in touch with stock exchanges, is to be set up, which will have
to tender advice to the government as to the necessary steps
that are to be taken. Recognised stock exchanges will be
under the constant surveillance of the government. The
government is to be empowered to direct rules to be made or
to make rules or amend by-laws of recognised stock exchanges.
Further, the Central government will have representation,
beside the one for the Reserve Bank of India, in the Governing
Board of Stock Exchanges. Such wide powers are useful
in clubbing down speculations with heavy hands.

It is, however, the considered opinion of the Bombay
Stock Exchange that "no practicable system administratively

1 Details are given in the Sixth Chapter."
enforceable can be devised\(^1\). In India, it is stated, where funds employed on the stock market are largely derived from private sources the system while handicapping bona fide business fail in its chief objective.

The table No.3 and No.3.1 give an insight into the availability of funds to stock markets through the commercial banks. The various columns given in the second table are representative of different facets of banking operations and are to that extent overlapping. For example, the advances made against shares of joint stock companies may also be advances to dealers in Government securities, stock and shares. The fact remains, however, that such advances are not much considering the value of the stocks that are dealt with in the market.

Thus even if the Reserve Bank of India is in a position to control the margin for commercial banks, there are other unorganised channels through which funds may flow for speculative purposes. With the interlocking of transactions as well as of finances between the organised stock exchanges, the curb markets and the street dealers the possibility of imposing an effective form of control is very slender. Much again, depends upon the management

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of the stock exchanges. If many of the existing defects are remedied, the weapon may become sharper in edge. An interesting proposal, which would have a favourable effect on the capital market as well as the stock exchanges, is the institutionalisation of investment in the capital market as well as of dealings in the stock exchanges. Hence the importance of investment trusts to the selective form of control, in so far as they can be made subject to statutory, albeit flexible form of control.

**TABLE NO. 3**
TABLE No.3
CONSOLIDATED STATEMENT OF ADVANCES AGAINST SHARES MADE BY SCHEDULED BANKS

<table>
<thead>
<tr>
<th>Margin</th>
<th>Outstanding as on 30.11.45</th>
<th>Outstanding as on 24.5.46</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5 per cent</td>
<td>1.50</td>
<td>1.13</td>
</tr>
<tr>
<td>Between: 5 to 10%</td>
<td>31</td>
<td>48</td>
</tr>
<tr>
<td>10 to 15%</td>
<td>32</td>
<td>36</td>
</tr>
<tr>
<td>15 to 20%</td>
<td>43</td>
<td>50</td>
</tr>
<tr>
<td>20 to 25%</td>
<td>1.10</td>
<td>1.72</td>
</tr>
<tr>
<td>25 to 30%</td>
<td>2.70</td>
<td>3.19</td>
</tr>
<tr>
<td>30 to 35%</td>
<td>7.42</td>
<td>10.05</td>
</tr>
<tr>
<td>35 to 40%</td>
<td>2.07</td>
<td>3.68</td>
</tr>
<tr>
<td>40 to 45%</td>
<td>2.87</td>
<td>14.51</td>
</tr>
<tr>
<td>45 to 50%</td>
<td>1.40</td>
<td>1.73</td>
</tr>
<tr>
<td>Above 50%</td>
<td>5.68</td>
<td>11.49</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>30.80</strong></td>
<td><strong>48.84</strong></td>
</tr>
</tbody>
</table>

Total Advances of*)
Scheduled Banks)  | 288.43                      | 391.02                     |


| As on | SCHEDULED BANKS | | | NON-SCHEDULED BANKS | | |
|-------|----------------|-------|------------------|----------------|-------|-------|-------|
|       | Advances       | Investments |       | Advances       | Investments |       |       |
|       | Against shares of Jt. stock companies | To dealers in Govt. securities, stock & shares | Joint Stock Cos. Shares | Debt- |  | Against shares in Government securities, Joint Stock Cos. Shares | Debt- |  |  |
|       | Amt. | % | Amt. | % | Amt. | % | Amt. | % | Amt. | % | Amt. | % |
| Dec. 50 | 53.3 | 11.2 | 19.1 | 4.0 | 14.4 | 3.5 | 1.7 | 3.9 | 1.7 | 3.8 | 1.04 | 9.5 |
| June 51 | 51.8 | 8.9 | 18.3 | 3.1 | 13.9 | 3.9 | 1.4 | 3.3 | 1.4 | 3.3 | 0.93 | 8.3 |
| Dec. 51 | 51.4 | 8.8 | 15.8 | 2.7 | 8.7 | 2.5 | 4.0 | 1.1 | 1.3 | 3.1 | 1.5 | 3.5 | 0.55 | 5.3 | 0.25 | 2.4 |
| June 52 | 45.2 | 8.0 | 13.9 | 2.5 | 7.5 | 2.1 | 3.7 | 1.0 | 1.1 | 2.6 | 1.5 | 3.7 | 0.93 | 4.4 | 0.42 | 1.9 |
| Dec. 52 | 43.0 | 8.5 | 13.0 | 2.6 | 7.4 | 1.9 | 3.6 | 1.0 | 1.1 | 2.8 | 1.4 | 3.5 | 0.84 | 3.8 | 0.39 | 1.8 |
| June 53 | 42.3 | 7.8 | 12.8 | 2.4 | 7.4 | 2.0 | 4.1 | 1.1 | 1.0 | 2.5 | 0.7 | 1.6 | 0.48 | 3.5 | 0.19 | 1.4 |
| Dec. 53 | 43.4 | 8.7 | 12.8 | 2.6 | 7.3 | 1.9 | 3.8 | 1.0 | 0.9 | 2.3 | 0.7 | 1.8 | 0.93 | 3.9 | 0.29 | 1.2 |

Source: *Trend and Progress of Banking in India*

% means proportion to total advances or investment, as the case may be.
3. THE RATIONING OF CREDIT

Credit restriction means that the central bank of a country absolves itself from the responsibility of acting as a lender of last resort without attaching conditions. The imposition of such a restriction involves, as German experiment demonstrates, a definite change in the credit policies of various banks. The liquidity pattern of banks' investments will be altered and shifted, the emphasis being on short term advances. In Germany banks till cash augmented, their Giro deposits with the Reichbank and their demand deposits with other banks went up, their bills, reports, lombards and acceptances fell, the pattern of their loans changed, and all these took place with an emphasis on short term credit. Further, the interest rate charged on advances and loans increased, with similar movement in the interest payable to the depositors.

Credit restriction, as a weapon, can also be made to serve the Demacle's sword without actually being made use of. In some cases the device is used as a temporary expedient purported to meet a difficult situation or to serve the peculiar needs of a backward economy. In other cases, it has been integrated into the economic policy of the state and instead of remaining a weapon it has become a channelising device used for the distribution of funds, in accordance with a certain preconceived pattern of investment.
A - Cheap Money Policy and Credit Rationing.

A reference is made to the operation of credit restrictions in Germany and in England which are not of much recent origin. In both these instances the recourse to credit rationing was not reconcilable with the position of the respective central banks as lenders of last resort.

An analogous situation emerges from a policy that insists upon and is wedded to the idea of keeping bank rate as low as possible under shortage conditions. In the thirties, indeed, such a policy did not usher in regimentation and control; since the supply of funds was adequate to cope with the demand. Hence there was no rationing of credit. War heralded a different situation. Governments, in many countries, were compelled, by the exigencies of the situation, to borrow large sums from the public. They could, therefore, allow no possible competitor that would bid up the rate of interest. Hence, the control of the capital market, besides the imposition of physical controls on scarce commodities became the sine qua non of government's cheap money policy and priority scheme. In post-war years, we have, again, an urgent demand for funds to rehabilitate many a ravages wrought by the war. Hence the Daltonian drive for cheaper money. Since capital was scarce and the rate of interest was artificially kept at its minimum, the system could not work in the absence of controls. Such controls coupled with the system of issuing directives
to the Capital Issue Market as well as to the commercial banks have the effect of channelising funds and rationing credits for particular purposes.

Another interesting experiment in the same field is attempted in France\(^1\). The beginning of 1949 witnessed a change in the unlimited access which commercial banks had to the rediscounting facilities given by the Bank of France. With certain exceptions a ceiling was established on the amount of bills that could be rediscounted. For each individual bank the ceiling was fixed and this was considered absolutely confidential.

**B - Credit Rationing as a permanent adjunct of the Economic Policy of a State—Soviet Experiment.**

The discussion of credit restriction as a permanent adjunct of the economic policy of a state should be preceded by an examination of the antecedent circumstances that make the use of the weapon possible. The most salient feature of this set-up is the ubiquitous centralisation of every economic entity, on a hierarchical principle. Such a system brings the central direction and control of economic resources within the ambit of Gosplan.

In industrial sphere, such a centralisation means grouping together the most widely scattered enterprises into

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\(^1\) *American Economic Review, 1951* - Credit Control in France, Kriz.
trusts. Such trusts may be made answerable to a Chief Administrator who in turn is responsible to a Commissariat. Such an arrangement is all pervasive and its exact nature depends upon the nature of the industry in question. Enterprises that are of national importance are made directly responsible to a Commissariat. What is important, however, is the fact that a hierarchical order is established which paves the way both to the pooling of resources and the distribution of such resources according to a given plan. This material aspect of planning is checked and supplemented by a financial plan. The distribution of resources, in the material plan is in terms of tons of steel, cement, coal and voltages of electricity, etc., while the distribution of resources in the financial plan is in terms of roubles. Such roubles are granted for specific purposes and once such purposes are achieved, they are not granted. The purpose is, indeed, laid down in the plan. To be more exact, there are two kinds of roubles that are given. The one is a grant and is non-returnable in nature. The grant of such a money by Prombank would mean the execution of a certain scheme over which the bank exercises direct control. There are also credits which have to be refunded. These are primarily short term in nature. Every enterprise draws up a quarterly financial plan and submits such plans to one of the branches of Gosbank of which it is a clientele. Such plans are checked and co-ordinated and finally a scheme for a short-term credit is drawn. This credit is above the
the "normative" or the working capital that each enterprise has and it stops as soon as the purpose for which the credit is granted is achieved.

It is in this sense that the grant of credit is on a rationing principle. The allocation of such grants do not entirely depend upon the credit-worthiness of an industry. Social and national interests are also properly appraised, before credit is granted. Even if the existing situation does not conform to this model, the model itself needs emphasis. Thus the needs of each enterprise are ascertained, co-ordinated and embodied in a country-wide scheme of priority. Such a scheme implies that too much credit cannot be given to any single branch of industry without penalising another branch. Hence the rationing of the short-term credit and the selective allocation of non-returnable grants as a permanent adjunct of financial planning and credit policy.
4 - MORAL SUASION, VOLUNTARY CREDIT RESTRAINT
POLICY AND DIRECT ACTION

As the caption shows, there is an attempt to eschew a separate treatment of many an important and primarily voluntary and therefore, democratic devices. The important point about the pliability of banks and other lending institutions and their co-operation with the central monetary authority is the democratic evolution of a mechanism intended to serve exactly the same objectives as the more rigid restrictions, under differing situations, subserve. Such a mechanism, once evolved, would usher, in its wake, a quasi-planned distribution of credit on a selective basis and thus it would prevent the percolation of funds into undesirable channels. What is involved in this form of control is the subordination of the individual's (or body corporate's) interest, voluntarily and by the same individual (or body corporate) to the national interest. If banks and other credit disseminating entities co-ordinate their lending policies with that of the government we have, in that event, achieved a mechanism which is nationally conscious and is democratically operated. The need for such a mechanism is especially felt in a shortage economy where the government has either undertaken considerable development projects or is preoccupied with financial

* Moral Suasion - whether accompanied by direct action or not - is a form of control, in so far as it is intended to bring about a certain change in the pattern of distribution of funds, albeit voluntarily. Hence the word 'control' used in the context of "moral suasion" should not be misconstrued.
disbursements on defence. However, in the absence of an integrated banking system which is the invariable trait of a backward economy, much should be done to achieve integration.

Britain, endowed with a centralised banking system is in a better position to influence her banks than America which is dotted with unit banks.

**Moral Suasion and the British Experience.**

In Britain, despite the enforcement of temporary controls on the capital market, in 1932, and the regulation of the new issues, vested in Foreign Transactions Advisory Committee, 1936, which was intended to debar the external borrowers from intruding into domestic market, the banks were left free from legal obligations.

With the onset of the war, the control over the capital market was entrusted to the Capital Issue Committee which is guided, in its operations by Treasury Memoranda, and save for the Exchange Control Act, 1947, the banks remain outside the purview of the statutory control. Banks' policy is, however, influenced by Treasury Directives, the first of which appeared in September 1939. The objectives, laid down in that directive, were the conservation of resources for war efforts and the prevention of inflation, under a system of cheap money. This was to be achieved both by discouraging
non-essential goods industries as well as by giving special treatment to essential categories of industries. With the end of hostilities, a fresh directive was issued which requested the banks to conform their lending operations to the terms of reference contained in a white paper1. In accordance with the objectives of the directive, defence industries, exports, development areas, agriculture, production of basic raw materials, transport and the re-equipment of the basic manufacturing industries were recommended for preferential treatment; while hire-purchase finance speculation and acquisition and expansion of existing undertakings, save in special circumstances, were to be discouraged.

It should, however, be emphasised that so long as the war was in progress, there was a unity of interest and therefore the determination of credit as falling under the headings of "permitted", "restricted" or "declined" was not difficult. In the post-war period, the difficulty of determining borderline cases appeared difficult and, therefore, sought to be resolved by the guidance which the banks were invited to get from the Bank of England.

1 Vide "Capital Issues Control - Memorandum of Guidance (Cmd 6645) issued on May 31, 1945."
The success of moral suasion, in England, may be gauged by the following facts. The success of the Treasury Deposit Receipt which was taken up without any enabling legislation by the British banks, albeit the decline in banks' advances may be partly attributed to the shrinkage in home and in international trade. As table No. 9.6(a) - the fifth chapter - shows, in 1948, 21.7 per cent of the deposit liabilities of London Clearing Banks consisted of T.D.R. From the end of the war to 1948, however, despite an increase in the deposits of banks to the tune of £1,000 million, the increase in the advances made by banks was half the growth of deposit. This rise in advances can be attributed to the legitimate need of industries and the expansionary policy of the government. Moreover, the advances of British banks which at its minimum level stood at forty per cent of the deposit, during the pre-war period was, further, reduced to the low average of thirty-three per cent in post-war years. Nor did the refunding operations of Treasury push the liquid position of banks below the recognised thirty per cent level. The average percentage that was maintained was 33 to 34. All these go far to show the effects that the non-statutory directives did have upon the lending operations of banks.

A not too refreshing contrast to the unstinted co-operation received from the banks is the uncontrolled position of "Capital Credit". Larger concerns which had
internal resources have advanced loans to smaller concerns that were refused accommodations from banks.

In conclusion to this part it can be said that much which requires complicated legislation in other countries are smoothly carried out, in England, without any formal statute.

Voluntary Credit Restraint Policy in America.

In America, the decentralised banking system and the strong individualistic disposition of the people are not conducive to the growth of suasive control of the type discussed above. In the throes of 1929, the discount facility accorded by the System was considered as a privilege rather than as a right. Hence the threat of direct action hanging upon the heads of the various banks. This form of direct action donned on by the Banking Act of 1933 a legal mantle.

A not too dissimilar position obtains in present day France. In order to divert credit to pre-determined channels, banks are asked to justify their credits to the Bank of France by obtaining extensive supporting data from the borrower. Borrowings, other than discount, which bring the total amount of the indebtedness of a firm from a bank above 100 million francs are to be submitted for approval to the Bank of France. Direct action in this case, again, for such infractions of
of the instructions of the Bank of France and the National Credit Council is the compelling factor.

Voluntary Credit Restraint Policy, in America, was a recent attempt in the suasive control of credit. Under Section 708 of the Defence Production Act of 1950, a voluntary country-wide organisation of commercial banks, insurance companies, saving banks and saving and loan associations sponsored by the Federal Reserve authorities, started in March 1951, a programme of voluntary credit restraint policy. The programme terminated in May 1952. The objective of the campaign was the diversion of the flow of credit from the non-essential and speculative uses to such avenues as were considered to be nationally desirable. What was considered desirable was, however, voiced by the "open mouth" policy of the Federal Reserve System, and sometimes less publicly. Further, bulletins were issued by the central organisation indicating the lines of policies that were to be followed by the regional and local sub-groups of the participating institutions.

Patman Sub-committee on General Credit Control and Debt Management was, however, of the view that programmes of this character are easily subject to abuse and are likely to be uniform in their distribution of burden. With the passage of time, such programmes also become less effective. The resort to such programmes were, therefore, recommended, only under extra-ordinary situations.
Australia and New Zealand.

Even in Australia, the Commonwealth Bank has been issuing periodical directives to guide the commercial banks' lending policies. Five major directives have been issued, the earliest of which appeared late in 1947 and others in May 1949, in November 1950 and in May and October 1952.

In New Zealand, since early war years, banks have observed an informal agreement to follow a policy, determined from time to time by the Reserve Bank. Thus the proportion of banks' advances to deposits fell from the pre-war level of 80 per cent to 40 per cent in later war years. This percentage increased to 50 by 1948.

INDIA AND MORAL SUASION

The ideal that is coveted in this section would have been realised if the statutory enforced subservience of banks to a central body would have had the sanction of an age-old tradition, born out of a close co-operation of banking system with the central bank of the country. Such a gradual evolution, is not, however, what we find in India. The unworkability of the earlier plan, making the most forward and dominant commercial bank, in India, a central bank, ruled out, once for all, the possibility of following the vestiges of the British experience in India. For, the convention of
that type never existed between the Imperial Bank on the one hand, and the other joint stock banks upon the other; nor could that tradition be fostered soon. Even if that could be done, the organised banks in India, would have been deprived of their sole principal pillar. We have, therefore, the Reserve Bank grafted, as an exogenous growth, on the banking system of this country. To build up tradition and to wield the necessary moral influence over the entire banking system and that without statutory provisions, requires both time and a community of interest. To expedite such a consumption recourse had to be had to legal enactments. Hence the enactments of the Indian Companies (Amendment) Act, 1936 and the Indian Banking Companies Act, 1949.

Selective Control of Credit in India.

This form of control, in India, was first given a legal form by the promulgation of the Banking Companies (Control) Ordinance in 1948, the fifth section of which empowered the Reserve Bank to determine the policy that is to be followed by banking companies in relation to the advances to be made by them and to tender advice to the banking companies as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rate of interest to be charged.
Indeed, in defining eligible discount papers, and in discriminating between the agricultural and other papers for the purpose of accommodation, attempts have been made, by the Reserve Bank of India Act, 1934, to give preferential treatment to one sector which would not have otherwise enjoyed. But the Banking Companies (Control) Ordinance went clearly much further, in that it gave an uncharted, vague and wide power to the Reserve Bank. The control over commercial banks' advances, the margins that are to be kept in respect of such advances and the rate of interest to be charged - these are the most drastic power wielded by any central bank.

With the steep rise in price level, following the wake of the decontrol policy initiated in 1948, the Reserve Bank issued a Circular\(^1\), advising banks to make credit available only for production, import and the distribution of external goods in short supply. It also made a plea for stepping up the saving drive and withholding supports from speculative holding of stocks and making it difficult for enterprises to replenish constantly and automatically their liquid resource requirements necessitated by a rising level of prices. Production and the availability of goods through imports, and the increase in the turnover of goods were to be encouraged. Credit was to be withheld or withdrawn if the nature of the activity of the borrower was

\(^1\) Vide: Circular, DBO. No.5259/C.217-48.
objectionable. Banks were to know their clientele and the nature of their business. This advice tendered in the Circular was not intended to be a resort to the Ordinance.

Section 21 of the Banking Company Act, 1949, which came into force in March 1949, embodies all the provisions of the earlier Ordinance. With the devaluation of rupee in September 1949, the possibility of speculative activity was very great indeed. The Reserve Bank, therefore, issued a Circular letter to all the scheduled banks to submit a daily return of fresh limits of advances of Rs. One Lakh and over in a specified form. It is stated that the resort to the statute was not necessary when it was found on a scrutiny of the returns that the banks have appreciated the need for a cautious policy.

In 1950, when bullion and commodities were the object of speculative interest, banks were requested to furnish to the Reserve Bank a statement showing their advances against them, thus keeping the Reserve Bank informed of market situation and enabling it to take appropriate steps, in exigent circumstances. In 1950, again, when raw jute was scarce, banks operating in Calcutta area were requested to recall, within a specified

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time, their advances to purchasers other than mills and balers and to refrain from making fresh advances. This helped the flow of jute to mills and with an improved supply position in 1951, the restriction was withdrawn. Again, in April 1951, advances against bullion were not to be favoured.

With the tightening of general credit control in November 1951, provisions had to be made for advances on a selective basis for special purposes. With the arrival of large consignments of cotton in 1952, the purchasers were hard put to get finance. Government, however, intervened by guaranteeing to buy cotton held by banks against advances given by them at specified prices and the Reserve Bank gave the necessary facilities for the purpose. In August, 1952 again, owing to the accumulated stock of sugar and a decline in their prices, the sugar mills had to keep larger margins (in kind) with banks for such loans that were granted to them. At the instance of the Government of India, Reserve Bank suggested to the commercial banks that they should reduce their margin on such stocks from 25 per cent to 15 per cent. In view of the financial difficulties that were experienced by the gardens in 52-53 season, Government undertook to meet to a specified extent the deficits of scheduled banks and apex co-operative banks, which agreed to continue to provide normal advances to their tea garden constituents,
in the 1953-54 season. Subsequent to the decontrol of coarse foodgrains and gram in January 1954, the Reserve Bank requested from 20 selected banks to submit weekly returns of advances against foodgrains so that to keep a watch over the situation.

Thus it can be seen that there is an amount of suasive controls behind which stands the formidable power vested in Reserve Bank by the statute.

A section of the bankers represented to the Shroff Committee that one of the factors that impedes the development of banking and also the flow of finance to private sector is the various directives issued by the Reserve Bank of India. "For instance it is stated that the Reserve Bank advises banks that the ratio of their advances to deposits should not exceed a specified percentage and that the Bank gives various instructions after inspection or otherwise... The Reserve Bank is trying to apply to the smaller banks whose deposits consist principally of time liabilities, the criteria which would be appropriate to the bigger banks". The committee feels that the restrictions imposed, under the Act and the directives issued by the Reserve Bank are in the interest of sound banking. It, however, suggests for the consideration of the Reserve Bank, whether any

criteria could be suitably modified, without prejudice to sound banking principles, taking into account the special characteristics of the smaller banks, such as their deposit structure and other locational situations.

What, however, needs to be realised by the commercial banks is that planning on a democratic basis involves co-ordination of activities, and the integration of credit policies. Thus, if private banking has to have any place in a planned economy, it has to justify its existence by the pursuit of such policies that are laid down in the "directives", the "open mouth policy" of the central bank. The American experience shows that the existence of many banks cannot be conducive to such a regime and if such campaigns as Voluntary Credit Restraint Programme is launched it is likely to be onerous to some banks. However, the existence of a few banks with representation over a considerable part of the economy is likely to lead to the uniform distribution of burden so important for a feeling of comradeship and co-operation. Hence, the importance of amalgamation and branch expansion on a planned basis, the analyses of which occupy considerable parts of the following chapter.
CONCLUSION

In the first chapter an attempt was made to show that there are certain sectors in the Indian economy, or generally speaking, in a backward economy, where there is an institutional bias against investments in them. Such a bias is, often, justified by the prevailing condition in the sector. There are also other sectors which are ill-organised and, therefore, their need for credit is not satisfied by the existing institutions.

In this context, it should be emphasised that the attempt to accord preferential financial treatment is only one of the steps. If the subsidized facility, thus given, is not accompanied with attempts to remove certain forces that make for uneconomic holdings - either agricultural or industrial - a selective distribution of funds will lead only to bad debts and hidden subsidies, thus deflecting the attention of the public from the real but hidden malais of the economy. A development which is well-balanced can do without recourse to selective distributions. If the balance is tilted, the emphasis should be more on the elimination of the retardatory factor rather than on the subsidized credit. However, a stagnant economy which is trying to stir up may be badly in need of such initial stimulants
which should be administered along with other far reaching measures intended to make investment in such propositions economic. Further, invariably the very measures that aim at eliminating certain deficiency are only possible if increasing finance is made available for the purpose.

The second chapter of the present study dealt with credit policies. In that chapter an emphasis was laid on progress with stability. This study, therefore, is not in accord with attempts that are made to devise selective measures in order to impede the bad effects of inflation which is presumably embarked upon in order to increase savings and investments. Selective devices, however, may be used as a part of the stabilisation process. For, if restrictive measures prove too stringent, the deserving sectors may not get the needed funds. Selective weapons may also be used to supplement general credit control devices in an effort to stop inflationary spiral.

There are various other ways of distributing funds on a selective basis:

(a) Specialised credit institutions may be set up. Among such institutions mention may be made of the Industrial Finance Corporation or Agricultural Finance Corporation where the government in cooperation with the central bank underwriters risks, makes advances and undertakes investments.

(b) Credit distribution may be also centralised

1 Vide Chapter V
in official and semi-official bodies by such measures as higher margin and reserve requirements and by fixing ceilings on the amount of loans and advances that can be obtained. The Australian experiment with Special Account indicates that it is possible to use these devices as alternative to banking nationalisation. In some other countries, notably Argentina, deposits may actually be taken over by the government, in the interest of economic planning.

(c) Medium term or long term loans for productive purposes may be encouraged by appropriate guarantee or rediscount facilities. The attempt to divert funds to agricultural sector through special rediscount facilities, as to the maturity and the interest rate charged; the proposal made by the Shroff Committee to make the investment in the shares of Industrial Finance Corporation eligible for rediscount and also the prescription of approved securities in which Insurance companies may invest their "controlled funds" are and may be utilised for the attainment of the above objective.

(d) There may also be joint participation of commercial banks, other financial institutions and the state in underwriting risks and supplying capital. The contemplated consortium under the leadership of the Imperial Bank, if it materialises after the establishment of a State Bank would be the Indian version of the scheme.

(e) In France, again, an attempt was made to divert funds by the fixation of ceilings for certain type of loans. The drawback of the scheme is in the difficulties inherent in the prescription of standards to which loans and advances may conform. In U.K., the difficulties were obviated when the commercial banks were requested to solicit the advice of the Bank of England.

(f) Central Bank of a country may also lay down percentages of the deposit that should go to agriculture, industry, commerce, etc. Such a power is already vested in the hands of the Reserve Bank of India, in terms of Sections 20 and 30(a) of the Banking Companies Act, 1949. The powers conferred by these sections coupled with the licensing and inspection provisions of the Act makes the Reserve Bank a formidable body.

*Wide Chapter V, Part (II) Rural credit.
(iii)

TEST TUBE DEVICES

This part deals, briefly, with certain devices which are automatic in their operations and/or wedded inextricably to a free enterprise system of economy. The study presents us with the other side of "conscious control" which has been the subject of the earlier part of this chapter. Further, the study focusses attention on certain economic indicators and on certain shortcomings of the present partial reserve system. Among the devices that have been selected for the study are:

(a) Reserve Variation according to the Velocity of Deposit Accounts,
(b) Silvio Gesell's Free Money,
(c) Cent per cent Money, and
(d) Commodity Reserve Currency System.

The study of the proposal to establish a nexus between the supply of money and price level is precluded in so far as "what price level?" as well as "what supply" - since velocity of money is an important factor - have intrigued many a proponents.

(a) Reserve Variation according to the Velocity of Deposit Accounts.

In order to circumvent the inevitable difficulties that go with the "conscious System of
Control" and the trail of controversy which it unleashes, the United State Committee on Bank Reserve recommended an ingenious automatic system that would supplement the general credit control weapons. By moving in correct directions, such adjustments would enfeeble a furious boom and would help to bolster prosperity when such a trend sets in.

Briefly, the recommendation of the committee envisages variations in reserve ratio that are directly related to the ratio of the debit accounts of banks to the total current deposit account. A system of averaging is also designed to give banks advance notice as to their future reserve requirements. Since the turnover of a bank's deposit on any one day or any single week is not a proper indicator of the real activity of its accounts, the committee recommended that the basis of variation of reserve should be fifty per cent of the bank's average daily debits to deposit accounts during the eight weeks preceding its current reserve computation period.

The objections to the plan are either directed to the discrimination that the plan involves in its treatment of banks; or are focussed on the inability of the device to effect the desired change in the credit situation of the country.
As regards the first objection it is stated that, particularly in America, the city banks holding a great deal of deposits owned by their correspondent banks are normally subject to rapid deposit turnover. Further, there is a large differential advantage enjoyed by the time deposit as against the demand deposits. In India the discrimination that the system would involve between the organised and unorganised banks is immense. The scheduled banks, further, with great demand deposit would be worse off as compared with non-scheduled banks.

These discriminations are justified, sometimes, on the plea that such deposits require more safeguards. This argument, however, justifies discrimination on a ground, which can be secured by some other devices, such as Deposit Insurance Corporation. Nor can special provisions for such cases be made without unduly complicating the whole mechanism.

The second objection has three aspects. Firstly, it is stated that in the event of panics, the increase in the debit accounts would mean higher reserve requirements with additional burden for the affected banks. Secondly, seasonal changes in the debit account entails, under the proposed plans, higher reserve requirements and would, therefore, intensify the shortage of funds.
Nonetheless, the statistics of the velocity of deposit turnover are useful economic indicators. Since the velocity of money is as important as the volume of money, it exercises as much influence on the economy of a country. Further, while the volume of money is a more or less autonomous factor, the velocity of money is directly related to the economic forces and gives us important inferences.

Data relating to such a velocity are two-fold. One is the clearing statistics which is available since 1890. Clearing data do not include the amounts of cheques where the drawer and collecting banks are the same. They also exclude the amount of such cheques drawn on the offices of banks, where no clearing facility exists. Thus in India where such facilities are limited to a few houses in big cities, it is natural that the bulk of retail trade are done outside such towns. Further, credit habit not being widespread, cheques are most often cashed and such debit items are not considered. The best way, therefore, to determine the velocity of turnover of deposit is by calculating debit side of the depositors' accounts. There is, however, a small defect in this which does not detract from the usefulness of such data, namely that since debits to different accounts may be incurred for goods in different stages of production a degree of duplication
## TABLE NO.4
CHEQUE CLEARANCES AND BANK DEBITS, 1937-1946

<table>
<thead>
<tr>
<th>Year</th>
<th>Demand Liabilities (Average of Friday Figs.)</th>
<th>Cheque Clearances</th>
<th>Rate of Turnover (Col.2 over Col.1)</th>
<th>Average of current deposits</th>
<th>Total Debits to Current Account</th>
<th>Rate of Turnover</th>
<th>%age of Col.2 to 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>1937</td>
<td>129.1</td>
<td>2061.4</td>
<td>16.0</td>
<td>72.0</td>
<td>2965.1</td>
<td>41.2</td>
<td>69.5</td>
</tr>
<tr>
<td>1938</td>
<td>124.0</td>
<td>1903.3</td>
<td>15.0</td>
<td>7*2</td>
<td>2841.2</td>
<td>38.3</td>
<td>67.0</td>
</tr>
<tr>
<td>1939</td>
<td>122.7</td>
<td>2120.6</td>
<td>16.5</td>
<td>84.0</td>
<td>3312.7</td>
<td>39.4</td>
<td>64.0</td>
</tr>
<tr>
<td>1940</td>
<td>147.9</td>
<td>2143.3</td>
<td>14.5</td>
<td>108.8</td>
<td>3706.9</td>
<td>34.1</td>
<td>57.8</td>
</tr>
<tr>
<td>1941</td>
<td>139.6</td>
<td>2535.1</td>
<td>13.4</td>
<td>144.0</td>
<td>4562.5</td>
<td>31.7</td>
<td>55.6</td>
</tr>
<tr>
<td>1942</td>
<td>272.1</td>
<td>2713.6</td>
<td>10.0</td>
<td>226.4</td>
<td>4999.5</td>
<td>22.1</td>
<td>54.3</td>
</tr>
<tr>
<td>1943</td>
<td>418.7</td>
<td>4228.9</td>
<td>10.1</td>
<td>360.0</td>
<td>7490.0</td>
<td>20.8</td>
<td>56.5</td>
</tr>
<tr>
<td>1944</td>
<td>561.3</td>
<td>5401.9</td>
<td>9.6</td>
<td>449.5</td>
<td>9041.3</td>
<td>20.1</td>
<td>59.7</td>
</tr>
<tr>
<td>1945</td>
<td>631.3</td>
<td>6272.6</td>
<td>9.9</td>
<td>480.1</td>
<td>10399.7</td>
<td>21.7</td>
<td>60.3</td>
</tr>
<tr>
<td>1946</td>
<td>722.1</td>
<td>7262.2</td>
<td>10.1</td>
<td>570.4</td>
<td>12038.9</td>
<td>21.1</td>
<td>60.3</td>
</tr>
</tbody>
</table>

is inevitable. A recent research work published in the Reserve Bank Bulletin makes a limited study of the subject from which the above table is taken. The table shows that cheque clearances are but sixty per cent of the debit items. Further, the rate of turnover in column 3 and column 6 are almost symmetrical.

(b) Silvio Gesell’s Free Money.

Silvio Gesell considers that money as a "store of value" is the cause of many economic problems. Since all commodities, particularly the primary articles of consumption, rot and become stale, the owners of these goods are at a disadvantage compared with the holders of money. The truth of this fact is evident in depressionary periods. At such times the "liquidity preference of the people" outweigh all other considerations. To forestall such a dangerous drift to deflation, when it yet is in its embryonic stage, a special device of attaching stamps, of specified values, to notes, after the expiry of a given time, is advocated.

The effect of the plan on the rate of interest.

Contrary to Gesell’s expectation interest does not disappear. It will be disguised. Nor need there be any scramble for the grant of loans, since the bankers, even as they are at present constituted, do pay interest
on their borrowings from the public. In other words, the money in their banks depreciates, if it is not lent out which will be a burden to them rather than to depositors. There is also at least the theoretical possibility of varying the value of stamps that Gesell's plan envisions. In such a case, again, banks may bargain with their depositors. They can give their depositors, in extreme cases, less than the amount that have been lent out to them. The depositors will have no hesitation to give their money to banks in so far as the depreciation of money will be more in their own hands than in the vault of bankers. Thus there will be a lower rate paid to the depositors and a lower rate charged from the borrower.

**The Effect of the Scheme on Consumption, Investment and Saving.**

It is claimed that when a stamp duty is charged on notes all these three variables rise in magnitude. With money depreciating people will be ready to store up goods that do not fall in value. This is true when prices are stable or when they are rising. In the latter case, indeed, the storing of goods is instinct in the situation. With falling prices, people are induced to wait, if the rise in the value of their money due to the fall of prices swamps the stamp charges on their holdings of currency. However, the possibility of varying
The stamp charges on the circulating medium is of far-reaching consequence. Discount rate has, hitherto, been emasculated by the increase in the volume of the Treasury papers and the general insensitivity of business activity to changes in interest rate. Moreover, a fall in the rate of interest cannot be pushed beyond zero. The stamp charge on money can not only be pushed to any considerable extent, but the time within which depreciation takes place can be reduced also. This is, indeed, a revolutionary departure. The interest rate has an indirect effect upon consumption, by changing the volume of employment and income - if it succeeds in changing these variables at all. The stamp duty has, however, a direct effect upon consumption by compelling the money to move.

The next question is whether such a device would change the magnitude of investment. The device will, indeed, influence investment if it can change business expectation or if it can force the people to invest. By holding up the threat of cent per cent confiscation of their money, in case it is not spent, the people will, in general be forced to invest or to consume. With increased consumption and increased investment a change in expectation is bound to occur.

What happens, then to savings? If we take an ex post view of saving it increases with the increase in investment. If an ex ante view is taken, the percentage of its magnitude to the aggregate amount of investment as compared with
other periods, falls. The extent of the fall depends upon the extent of consumption and investment stimulated by the change in the stamp duty.

It seems, therefore, that a new weapon is hewn which can supplement the general credit weapons. The device is not, however, free from conscious application. Yet, it does not directly interfere with the working of the economic system. It is designed to preserve the system rather than to destroy it.

The Appropriate Field of its Application in Backward economies.

In an underdeveloped economy the basic need is to increase the volume of saving - ex post and ex ante - as well as the volume of investment. A device is conceivable, however, that would increase the money which is not spent. This may be helpful when government embarks upon an ambitious scheme of expansion through deficit financing. The regressive effect of the subsidy can be recovered by way of tax, which is not likely to be very important. This process is analogous to that of increasing the rate of interest on deposits. There is, however, a difference. While in the case of a rise in bank rate, the ignorant people may not be very conscious of its effects, in this case they will feel its very benefit, and, therefore, they may refrain from consumption.
Cent per cent Money.

To a number of economists, disaffected with the revelation of appalling cracks in the structure of capitalism and who, therefore, conceived of "Chicago Plan" and to Mr. L. Currie who worked out independently a similar scheme, goes the credit of introducing in the polemics of the day a new theoretical scheme. The kernel of cent per cent money rests in the plea that the demand deposit should be fully backed by cash; while the time deposit should not be backed at all.

What, then, are the defects that were believed only this scheme would cure or that it could cure better or with lesser transitional friction and difficulty?

It was seen, firstly, that the "location of the right to issue fiduciary circulating medium" was not where it was originally intended to be. The prerogative to the issue of currency that goes to a sovereign body and not to private financial entities is infringed in its spirit. For, deposits that are withdrawable by cheques are as much a part of circulating medium as cash currency is. The seigniorage, therefore, that legally belongs to the state and which amounts to as much as ninety per cent of the deposits held by the banks is misappropriated by them. The cent per cent plan, however, cannot

reverse this process, it can only affect future trend which can be done by cent per cent reserve requirements for future increment in deposits.

It is maintained also that the usurpation of such a right was responsible for the heterogeneity of currency, though a system of gold standard was actually in operation. An inflow of gold would mean a multiplier effect depending upon the customary reserve ratio, and an outflow of gold would have an exactly opposite effect. With differing banking systems and credit habits differing inflationary and deflationary movements take place which are not in accordance with the 'rule of the game'.

It is argued again, that when governments fear inflation they issue securities to banks in order to immobilise the reserve which they would otherwise utilise for pyramiding credit. Governments thus pay interest without any good justification. Cent per cent money is an obvious remedy. This can be overcome again by the institution of such schemes as Special Account in Australia, Cent per cent Treasury Deposit Receipt, etc.

Partial reserve system, it is argued, has caused many bank failures, the convertibility being a delusion in so far as it is dependent upon the rights not being
fully exercised. Deposit insurance which is an invitation to reckless banking would, therefore, be necessary under the present partial reserve system.

Further, it is said that partial reserve system accentuates the business nervousness during depression. For, banks afflicted with illiquidity of their resources try their best to liquidate their assets. Moreover, a small withdrawal by individuals would lead, in such periods, to magnified fall in the total advances of banks. Thus banks are biased towards inflation. Inflation will rescue them from the fear of bank failures and affords new opportunities for exploitation. Further, the partial reserve ratio invests the banks with features that are more appropriate for Investment Trusts. The only restraining counterforce being the incubus of depression which would leave them in the lurch.

It can be said that cent per cent plan though may cure some of these defects is inadequate to tackle the main cyclical changes in business activity. Further, as Moulton and others have shown, to the fractional reserve system goes the credit of providing finance for the development of capitalist economy. Cent per cent plan implies that banks should not only be subsidised for their services to the community and that initial loan is to be given to them, but it also demands a ban on short term credit that
can be easily converted into cash. Further, the control of institutions that receive deposits outside the banks presents formidable problems both in converting these deposits into long term bond and also in requiring that the demand deposit should not be accepted.

In recent years certain governments have accepted the cent per cent money in a modified form. Special Account in Australia, the Treasury Deposit Receipts, the Secondary Reserve Requirement to the full amount of the increase in the level of deposits are the variants of the plan. In Argentina, again, the current deposit of banks have been taken over under the banking reform of 1946 by government in the interest of planning. Thus the new emphasis is in the direction of selective application of the resources.

d) Commodity Reserve Currency System.

Commodity reserve currency system is conceived as a system that is invested with the virtues and is divested from the defects of the gold standard system, while preserving at the same time an improved form of automatic adjustments. Currency, according to this system, is to be backed by a "package" of collaterals, into which package is dumped a number of representative commodities. It is claimed that the system

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2. The question is more recently studied in International Commodity Stock-piling as an economic stabiliser - by M.K.Bennett & Associates, California, December, 1949.
would bring a recession to a halt and would stop reflations from developing into booms.

With the onset of recession, the value of currency would go up. This means that it would be profitable to produce the commodities listed in the package and to sell these to government, in exchange for money. Since these articles would not be confined to a few unimportant items, it is evident that there would be a stimulus to increased production.

On the other hand, with the inception of reflation, the value of currency would tend to sag and with that the value of the commodities in the package. There would, thus, develop a tendency towards a lower tempo of economic activities, offsetting the rise in prices. A monetary authority, moreover, will be in a position to intervene by the sale or the purchase of commodities at crucial points, thus effecting the desired monetary changes.

The support given to agricultural prices is a limited application of this system. Further, the system is amenable to selective manoeuvres. Thus the government being the purchaser of commodities can fix the prices in such a way as to exercise a selective bias in favour of some goods. Price support policy may thus become an important tool of economic planning.

The adoption of the system, on an international scale, replacing the gold standard system has no chance of success.
The least difficulty which such an international system would encounter would be the difference of opinion in regard to the selection of the commodity in the package. A tussle thus may develop between the advanced economies that may insist on the inclusion of predominantly manufactured articles, while the primary producing countries may like to see the predominant representation of goods which they produce.

**CONCLUSION**

While all the devices studied in this part are wedded to the free enterprise system of economy, none of them can do away with 'conscious control'. The first device, is one among many others that cannot be accepted because it cannot be consciously varied. The second device can be varied analogous to variations in the reserve ratio, otherwise much of its usefulness is lost. The third device is not of much use in curing cyclical fluctuation, and is in fact intended to concentrate variation in monetary supply in the hand of the state which is worthy of serious attention. The last system, though does not interfere directly is capable of selective distortion which goes ill with a system free from conscious control.

1. Mr. Benett and Associates modify the no. of commodity units recommended by Benjamin Graham in World Commodities and World Currency, 1944. Three commodities are to be excluded from a list of 15. These are coal, pigiron, and petroleum. The rest which are retained are: wheat, corn, sugar, tobacco, coffee, tea, cotton, wool, wood, pulp, rubber, copper and tin. In addition to these the following commodities are recommended for consideration namely rice, peanuts, linseed, cocoa, silk, jute, lumber, hides, and lead - vide p. 114.