CHAPTER 2
ROLE OF QUALITATIVE MONETARY CONTROLS

2.1 Introduction:

Most of the writings on money is on the quantity of money. Monetary theory as well as policy has generally discussed and analyzed the relationship between money, prices, and income. In the keynesian theory, monetary theory and money was not considered that important. Friedman again pointed out a 'money is important'. But despite restatement one does not get a thoroughly analytical work on the qualitative aspect of money except the recently published papers by Hodgenon (1) and Silber (2).

The present chapter is an attempt to analyze qualitative monetary controls. Partly so the arguments for such controls emerged out of the limitations of traditional monetary weapons, these are discussed first.

2.2 Limitations of traditional monetary weapons:

Nominally those weapons which influence the cost and availability of credit are termed as quantitative weapons and those which influence the use of credit are termed qualitative monetary weapons. Quantitative measures such as bank rate and open market operations
influence the supply of money, credit and interest rates.

(1) As these measures could not salvage the economy out of depression that greater reliance was placed on fiscal measures. However, supporters of these tools maintained that they can be effective in general to curb inflation. But these general measures are likely to have different final impact. The final impact of the general measures, as different from the initial ones, are very unevenly distributed between the various sectors of the economic life.\(^3\) These uneven effects might not be desirable. This provides a case for qualitative regulation.

(2) The policy of supporting rates on government securities is an obstacle coming in the way of free use of quantitative weapons, since these tools would imply a fall in the government security prices, which the authority does not want.\(^4\).

(3) In those economies, where money and capital markets are not fully developed the effectiveness of these tools is reduced to that extent.

(4) Bank rate as a tool is now less preferred, because of a number of developments. Growth of
nationalised industries, negligible importance of the commercial bills etc. have insulated major sectors of the economy, against the changes in the availability and cost of credit.

Excess liquidity with the banks also reduce the need for rediscounting and where money and capital market are not closely integrated, the impulses imparted to short term rates by discount rate changes are not reflected in the long term rate. International capital movement is now a little less sensitive to interest rate changes. This is more relevant for advanced economies with freely convertible currencies.

Besides the above, as for as India is concerned, open market operation is also not useful as anti-inflationary measure. Since inception of planning, in India, it is a means of supporting governmental security prices and financing the plan.

(5) The problem of time-lag in the use of general monetary policy weapons is a great one, because they take more time to rectify a particular situation as they are effective at a time when their need is over. Hence their efficacy is limited.

(6) It is found that some of the sectors might not
be sensitive to interest cost making the general tools ineffective.

In country like USA and UK general credit policies were broadly ineffectual in curbing the demand for the consumer credit.

(7) Small banks are put at a disadvantage when strict monetary policy is adopted. The more scarce is liquidity, the more powerful are those in control of it\(^5\). Hence, small banks as against big banks are put into difficulties.

Underdeveloped economy like India, having fast the goal of rapid economic development with distributive justice, cannot rely on these tools only. The problem of dealing with specific sectors need qualitative or selective tools and the general tools cannot solve the problem. This does not mean that qualitative tools are substitute for general tools. It only means that, because of its limitations there is non-growth reliance on qualitative tools.

2.3 Definition of qualitative tools :-

As a concept qualitative monetary control is not entirely new. It is a vague idea that has a long history in every country whose monetary thought has
any history at all*(6)*. In a way concept of qualitative monetary controls owes its origin to real bill doctrine which remained quite persistent over a number of years. More recently, it has re-emerged as the doctrine of the qualitative control of bank credit*(7)*. Restricting the banks to the making of self liquidating commercial loans, would afford society, a degree of protection against recurrent credit crises that is not possible under any plan of quantitative regulations and management of the credit system*(8)*.

But real bills doctrine is not accepted today. Robertson believes that the real bills doctrine is unsound*(9)*. It may also be noted that real bills doctrine was more for ensuring sound banking rather than for purposes of monetary control.

The present form of qualitative or selective monetary controls as a tool of credit management has its origin in the 1930s U.S. security market development. In depression, and then in the war, it developed in a variety of ways. C.C.C. try to regulate the credit flows to specific sectors through qualitative controls in the credit availability by fixing margin, ceiling, etc. C.C.C. are therefore referred to sometimes as qualitative credit controls*(10)*.
Generally, those monetary devices which aim to influence the specific economic activity are termed qualitative or selective. Among these tools are qualitative or S.F.C., Central Bank directive to commercial banks and the direct regulation of commercial banks loans and investments"(11). "In the U.S., the term S.F.C. usually refers to measures designed to restrict the use of credit for specific purposes, such as the purchase of securities of durable consumer goods and of houses"(12). In other countries, the concept is used in the broader sense as to include all measures designed to encourage credit flow to a particular sector as well as devices to restrict the flow of credit to any undesirable activity. Intersecting in the narrow sense Godillil writes that these controls, "represent the attempt at restricting supply of credit in particular directions"(13).

"S.F.C. attempt to influence the level and composition of output by regulating the volume and terms of lending for specific purposes"(14).

It may be concluded that some element of selectivity can be imported to general credit controls by giving concessions to priority sectors or activities as is done in India. It is also recognised that even
the general controls have selective effects while a selective control can have general effect. Therefore, the problem arises as to the category in which a particular measure may be placed. Gilber is of the opinion that the monetary control will have aggregative effect as well as differential effect, therefore how to judge a policy as selective or general is a problem. He suggests ranking of different policies according to their relative aggregate versus selective impacts. For each policy one would calculate the impact on some economic aggregate say CNE and one would also calculate its impact on the redistribution of real resources (or funds) into different sectors. The ratio of aggregate effects to redistribution effects would be the basis on which to rank a policy as primarily a selective credit policy or primarily a general credit policy. This measure varies between zero and infinity and the larger the number the more general is the particular credit policy.

Gilber attempting to define such controls writes, "Selective credit policies usually refers to one of the two things: (a) the attempt to influence general credit conditions by a policy tool other than changes in the magnitude of claims against the Central Bank, (b) the use of a policy tool to channel credit into a particular financial market hence (although not
necessarily) into a particular real market(19).

In the Indian context, it is pointed out that
"While general credit controls operate on the total
and total volume of credit, selective controls relate
to the distribution or direction of available credit
supplier".(16). In the field of distribution of credit,
there are two main aspects. One is a positive aspect
in which attempts are made to channelize credit to a
particular sector e.g. small scale etc. The other is a
negative aspect in which flow of credit to a particular
sector is restricted e.g. restricting advances against
foodgrains to prevent hoarding. The present study
concentrates on this last aspect.

2.4 Role of qualitative monetary controls -

The main thrust for/credit policy was based on
a dissatisfaction with the sectoral impact of the
monetary policy(17). This means C.C.C. can be useful
in situations where general credit controls are of a
limited effectiveness and have an inequitable impact.
If credit in one sector is to be curbed then general
credit control is not useful.

2.4.1 In a supportive role to general controls -

According to Hodgeman, there are two main reasons:

1. 

2. 

3. 

4. 


for the use of selective credit policy, (1) the
effectiveness of general monetary control may be in
question and (2) their incidence may be regarded as
undesirable[18].

O.M.O. and discount rate policy may be inadequate
for timing problem and selective policy may shorten
the lag, so they are direct.

Effectiveness of general policy may be questioned
due to insensitivity of spending to interest changes.
Hence the case for G.M.C. But the general measure
may be used with greater tightness and then they will
be effective. Here comes the problem of incidence.

"In practice, a desire to influence incidence rather
than timing has been the dominant motive of the monetary
authority in applying selective controls"[19]. Without
selective controls, the incidence of monetary restraint
will depend upon the structure of the economy, pattern
of demand, distribution of real and financial events
etc. So the desire to rectify the incidence effect of
tight money brings in the role of O.M.C. This approach
casts O.M.C. in a supportive role to general controls[20].

2.4.2 Policy of low stable interest rates:

According to Sayers, "The basic argument for a
selective policy is that while a low stable interest
rates policy provides a favourable working background for capital development, the economy is still liable to run off the rails more easily in some directions than in others and that the central bank should use the financial controls to check the unhealthy development in these particular directions" (21).

The development of qualitative credit controls is in a sense the logical result of the adoption of a stable bond market policy. Old policy depended upon interest rates. But it was found that interest rates is a blunt instrument. "It works too slowly in encouraging or discouraging in the right direction and has its quick effects rather in the wrong directions" (21). This is the reason why interest rates may be kept stable at low levels and S.C.E. used to encourage or discourage a particular activity.

2.4.3 Role of fiscal policy and role of S.C.E.

Role of S.C.E. assumes greater importance on the role of fiscal policy increases, since the latter may express priorities of national objectives. In a situation in which fiscal policy plays an increasing role, the monetary policy will have to be more selective, so as to confirm the objectives laid down by national authority. In such a situation S.C.E. can assist in
the reallocation of real resources to high priority objectives.

With the increased role of government money supply has also increased and it is thought that the growth in the volume of money supply may not be controlled undesirably and the flow of money and credit to certain fields may better be controlled through S.C.C.

2.4.4 S.C.C., inflation and counter cyclical policy

Sometimes excess credit to a particular dominating sector might be a factor in spreading the price rise to other sectors, e.g. stock market credit. So, if such credit is controlled with the help of S.C.C. then inflation might be prevented from spreading to other sectors (23). Millar (24) is of the opinion that S.C.C. are more effective in dealing with inflation than dealing with deflation. Counter cyclical policy will have some adverse impact on certain sectors, hence also S.C.C. can be fruitfully employed. The behaviour of certain sectors might amplify the trade cycle, e.g. the consumer's credit. This credit might amplify the trade cycle in two ways. Indirectly, through its influence on the pattern of demand and directly through its effects on total savings. There will be a shift of demand, (with the help of consumer credit)
away from the non-durable to durable consumer goods. It will intensify cycles as these goods require more investment and take more time to produce. Therefore, consumer credit must be controlled for cyclical reasons. Prof. Alvin Hansen, has advocated the superiority of the S.F.R. over interest rate policy for minimizing the swings of business cycles, particularly to check excessive stock market speculation and influence fluctuations in inventories (25).

2.4.5 Qualitative monetary controls in a developing country:

In developing economies such controls can play a positive as well as a negative role. A policy of S.F.R. may be adopted as an adjunct to a well-balanced development programme. During the process of development, inflationary forces are likely to emerge. This will be partly because of failure on the part of supply to increase and mainly because of a rise in demand. Aggregate demand rises because of huge expenditure undertaken in the plans. In such a situation, some measures are necessary so as to prevent price rise of certain important commodities, like foodgrains. Their prices must be controlled in order to prevent the spread of inflationary spiral and secondly, to protect the interest of the weaker section of the society.
In India, the primary objective of S.C.E. has been to prevent speculative hoarding of essential commodities, like foodgrains and agricultural raw materials like oilseeds and cotton, so as to press down the prices of these goods or at least to prevent an undue rise in prices (26). And “The controls are not designed to correct the general inflationary pressure in the economy” (27).

The S.C.E. operate from the side of demand within a limited sphere only. They control the credit extended by banks against the commodities in short supply and keep the demand, aided by bank finance, under check.

The rationale of the S.C.E. on advances against foodgrains, cotton and kapas etc. is the tendency of production of these commodities to fluctuate widely from year to year and the danger of speculative hoarding, especially in a situation, where a strong pool of demand operates. Although the quantum of finance provided by banks to finance the marketing and trading operations in the essential commodities is limited as a proportion to total finance, employed for such operations, bank finance is important in surplus states, where so much as 50 to 60% of produce is exported to other states. Credit restraint in such
states would discourage the build up of stocks with
the aid of bank finance and thus exercise once downward
pressure on prices or at any rate restrain a rise.
"The main objective of such controls is to reinforce
factors which help in stabilization of relative
prices" (20). This will require controlling hoarding
with bank finance and providing sufficient funds for
genuine trading activity. This may be done by exempting
such activity from the control as is done in India.

Another way in which S.C.C. can be useful is by
encouraging flow of credit to certain desired sectors.
Some sectors may be classified as weaker sectors and
the credit needs of these sectors may be fulfilled with
the help of S.C.C. During the process of development
one can expect major differences among the rates of
growth in several sectors of the economy. This may be
due to (a) varying income elasticities of demand for
different products (b) differences in technical changes
in different industries and regions (c) positive excess
demand in some markets; (d) different rates of invest-
ments in different sectors. In order to encourage a
particular sector whose growth rate is below the desired
level, S.C.C. may be employed.

Thus small scale industries, agriculture, export,
etc. are encouraged in India with the help of either
finance at concessional rate, or by providing insu-
lation from the control frame.

Yet another role that S.C.C. can play is by
helping development of infrastructure. Development of
infrastructure is considered very important. S.C.C.
can help in a variety of ways e.g. providing exception
from the central frame for advances against warehouse
receipts as in done in India. But the experience
shows that not much can be achieved by such exceptions.

Planning essentially involves priorities. Fiscal
and monetary management must be in conformity with the
objectives of plan. Monetary policy on its part has to
be selective if it has to help planned development e.g.
government might undertake procurement programmes.
S.C.C. can be useful in assisting the government by
providing lower margin and exemption from ceiling to
government agents etc.

As the government adopts planning the size of
public debt is likely to increase to a great extent.
Consideration of servicing the debt reduces the role
of dear money policy. The central bank can help both
in maintaining the government security prices and provid-
ing finance for development. Both these restrict the
use of bank rate and ESC to a great extent. The huge
size of public expenditure often financed by created money enhances the importance of use of C.E.C. in combating inflation.

A number of problems are likely to arise during the process of planning. Solving them will require continuous adjustments and modifications in the policy. C.E.C. on their part must also be modified accordingly.

"In a developing economy, experiencing structural changes, new sensitive spots appear from time to time and the locations of old spots continually change. Central Bank must find out these spots and take necessary action.

Finally financial and capital aspects of developing economies might not be efficient enough to bring out desired transformation of the economy according to time bound programmes. This situation reinforces the argument in favour of use of C.E.C.

However the role of C.E.C. over a longer period is limited. In other words they are considered more useful in the short run than in the long run. Dr. ... noted points out that, "Nevertheless, C.E.C. have only a limited role to play in the process of well being development"(38). A country cannot achieve development with inflation while C.E.C. may help removing evil of costs
of inflation over a longer period. Dr. I.C. Patel also points out that, "S.C.E. may be adopted long as a long term objective than in response to some short term difficulties, e.g. during a period of active inflation."

In the whole S.C.E. are advocated both for the developed as well as underdeveloped countries on the grounds of greater flexibility and their capacity to treat the parts of the economy rather than the whole economy, which might not be necessary. Its role can have different emphasis depending upon the type of economy, institutional background, objectives of the economic policy in general and type of the specific problem that the measure is called upon to attend. According to Prof. Williams, S.C.E. is revolutionary development in the field of monetary policy.

2.5. Types of S.C.E.

Conventionally, Bank rate, S.C.E. and reserve requirements are held as quantitative tools while margin and credit ceiling are held as qualitative tools. However in due course it was found that a selective use of general tools as well as a general use of selective tools is possible. Quantitative tools can be used in both positive way as well as negative way. When controls are operated to encourage the flow of credit
to a particular sector they can be termed positive, and when used to restrict the flow of credit to a sector, they are negative or restrictive. Concessional financing schemes, lower margins etc., are devices to encourage flow of credit to a particular sector, say, agriculture in India. It may be noted that, "The ultimate objective of S.C. policies is to influence the composition of real investment, and not merely to influence financial markets". Whether the credit facilities made available will be availed or not depends upon a number of factors including the level of demand, other resources available such as raw materials, etc.

Raising of margins etc., are examples of negative or restrictive aspect, the purpose being to reduce the flow of credit to a particular sector considered not important or given lower priority. Even when controls are tightened, some types of credit considered of higher priority might be executed from the controls, e.g., advances by newly opened branches of a bank. This is to encourage branch expansion while retaining tight policy.

Selectivity: Direct and Indirect:

The allocation of bank credit may be influenced directly by stipulating the loans that can be made, the amounts, the rate of interest, the duration, the type
that is not desirable, the amount of collateral etc. Control bank may influence indirectly by keeping different rediscount rates for different types of loan etc. Some tools are discussed below.

2.5.1 Margin :-

Margin is the difference between the value of the collateral and the amount lent. In a way, margin is the amount that the borrower must finance. If the flow of credit to a particular sector is to be restricted, margin against it is raised and if the encouragement is to be given margin is lowered. Margin though affecting the lender directly, puts restraint upon the borrowers, and dampens the demand for credit (34). Even though lenders are willing to lend, borrowers are less willing now due to rise in margin.

When the market is rising traders can borrow more against the securities which are already used for borrowing purposes; as its value also rises. With the help of additional finance they can go on pyramiding. If margin is raised this type of pyramiding is constrained. Although the main objective of margin requirement is with reference to expenditure in specific sectors, let us examine some of the anti-inflationary effects of such measures.
(A) If margin is raised, the borrower will have to find out larger amount or revise his plan of expenditure. He may decide to carry his plan of purchase by drawing upon his idle balances or by reducing his expenditures in other directions or by disposing of some of his liquid assets in the market or by borrowing from alternative channels or by a combination of all these methods, or he may give up his plan of purchase and resources released, may be kept idle or spent in other directions. If he decides to spend, there would be no reduction in inflationary pressure either in controlled or other sectors. There would be no net anti-inflationary impact. Expenditure in the specific sector will not decline.

(B) It is possible that the borrower may not have sufficient idle balances, so he may cut down expenditures in other directions. Then there will be no reduction in the aggregate expenditure (equal to the additional sums needed to meet the higher margins). Though there would be no abatement of the inflationary pressures in the controlled sectors, but the demand would fall off in the other sectors and the net anti-inflationary effect will depend upon the how important these sectors were in the generation of inflationary forces. In any case, the maximum anti-inflationary effect would be obtained only in this particular case.
(C) In so far as the additional payments are not, partly by a depletion of idle balances and partly by a reduction of expenditure in other sectors - the most likely situation if plans are carried out - there would of course, be some reduction in aggregate expenditure and hence in inflationary pressure, of an order depending on the nature of the combination of the methods adopted. There will be no fall in expenditure in the controlled sector.

(B) In cases where plans for purchase or investments are abandoned, there would be an abatement of the inflationary pressures in the controlled sector. But such pressure might increase in other sectors unless the sum thus released were added to the idle balances. In this it is unlikely to be the normal practice, the net effect of the imposition of selective controls would be partly anti-inflationary (in the controlled sector) and partly inflationary (in other sectors) and the actual results would depend on such factors as the relative importance of the controlled and expanding sectors and the extent to which additions were made to idle balances etc.

Banks on their part, would like to maintain their profits and increase lending in the non-controlled sectors and thus there would be no net reduction in the
total of bank advances. But the decline in expenditure in the controlled sector plus the reduction in aggregate expenditure would have on balance a not anti-inflationary effect over the impact of larger bank lending in other sectors. Even in the case of rejection of plans, if no addition in mode to idle balances, there would be no decline in aggregate expenditure even after banks lend the balance in other sectors. But the expenditure in controlled sector has declined, and if this sector is sensitive and dominant, it would have some anti-inflationary effect. This is the reason why foodgrain sector in an underdeveloped economy is controlled.

If selective credit controls are effective here, then a good deal of heat can be taken off the inflationary fire, even if the aggregate expenditure or the total volume of bank lending does not decline.

Again banks on their part, will have either to raise interest rate or grant more loans to maintain their earnings. If banks are lending to a sector, they will have to raise interest rates and this will have some anti-inflationary impact. But in inflationary situation banks loan might not decline, even when interest rates are raised.

It may be noted that if the borrower posed...
idle balances he may use it to meet the higher margin requirement and there would be some reduction in the total amount of bank loans to the controlled sector. This means, part of the expenditure, which was previously financed by bank loans is now financed with the help of idle balances. If banks lend the difference to other sectors, the result would be an increase in the aggregate expenditure and to that expenditure and to that extent C.C.E. will be pro-inflationary.

The customer might borrow against permissible securities and use them for controlled sectors. If in that case, the volume of bank loans in the controlled sectors may decline but there would be no reduction in expenditure in the controlled sectors and no anti-inflationary effect.

2.5.2 Ceiling :-

Ceiling techniques in their present form are rather new concepts in the field of credit controls. The ceiling techniques in credit policy may be defined as the fixing of a maximum or upper limit of either rediscounting facilities of the commercial banks at the central bank or of the commercial bank loans and advances to the private sectors of the economy\(^{(35)}\).
Though used during the war, the purpose during the post war years of this tool is, "The prevention of a general expansion in bank credits" (36). In most cases ceilings have been adopted as anti-inflationary measure in order to reinforce and supplement the traditional or existing weapons of credit control (37).

According to Nallar, the ceiling techniques are direct quantitative methods of credit control which seek to regulate the availability of bank credit relative to demand and the general liquidity of the economy without working through the market (36). It is a qualitative tool used to influence the flow of credit to a particular sector.

Credibly three types can be classified.

1. **Rediscouing ceiling or ceiling over central bank facility to member banks**:

Here central bank fixes a maximum limit over which it will not provide rediscounting facility or will not provide loans to member banks. It may be applied against a part of the banking system or to the entire system. Banks' previous rediscounting or loan level or capital or capital structure may be kept as a criterion for fixing ceiling. A certain percentage of this level is fixed as ceiling for the ensuing period. Certain exceptions may be provided. This will impart selectivity to the tool as it was done in India. This
technique leaves freedom to banks in both the ways; viz. (1) banks are free to distribute credit amongst different channels within the ceiling (2) they are also free to distribute between different borrowers.

Those banks which need not approach to central bank will not be affected. In a way it will favour big banks having sufficient resources.

This type of ceiling aims at general price level by reducing credit level. It may affect profitability of the bank also. To protect the level of profits banks might raise interest rates. Ceiling will have anti-inflationary effect depending upon the level fixed. Another factor influencing the anti-inflationary effect is the reaction of borrowers. Those borrowers who are denied credit may either drop their plan or carry through. If they drop their plan, the part of the expenditure which they are financing will not be released. This may be kept idle or employed in other directions. If it is kept idle it will have maximum anti-inflationary impact. If it is employed in some other direction (with or without assistance from non-bank sources), the anti-inflationary effect of ceiling must be compared with inflationary effect of this venture. Borrowers might switch to other channels which might be costlier. In case when the
borrowers carry their plan through, it will have inflationary effect. But if ceiling is sufficiently low, all the needs of borrowers might not be satisfied by alternative channels. On balance this type of ceiling will have anti-inflationary effect, nominal effect depending upon the above factors.

(2) Ceiling over a particular channel:

Here a ceiling is fixed for advance by commercial banks against a particular type of security e.g. cotton groundnuts etc. in India. This is a classic case of 'C.C.' Here the bank's degree of freedom in the number of distribution of credit is reduced by the number of channels against which ceilings are imposed. The objective here is to influence relative prices. However what is lost in the controlled sector might be made good in the non-controlled sectors by banks. Hence the anti-inflationary effect is likely to be less than that of earlier type. Bank's profitability might not be affected. Administrative cost of this type is likely to be higher than that of earlier type.

Borrowers in the controlled channel might switch over to alternative channels or may reduce their fixed balances and if this can be done, controlling the channel by central bank will not guarantee reduction of expenditure in the specific sector and no effect on order level.
Something like this, it seems, has happened in India.
However in the short run it can be a useful device. In the long run borrowers might adjust to the control and continue the desired level of expenditure by channeling in idle balances or switching to alternative channels.

If borrowers can borrow against the permitted type and use the account for controlled channels the purpose of the control will not be served.

3) Individual ceiling (extending ceiling):

When the ceiling is applied to the borrower of a particular channel it is called individual ceiling. Generally a certain percentage of past level of credit is fixed as ceiling. Different individuals are not treated differently. Ceiling applies to all the existing borrowers equally. When the ceiling is applied to a particular type of security, it is possible that some might favour their big borrowers and small borrowers might suffer. To protect the interests of small borrowers such individual ceiling is necessary. Big borrowers might hoard with the help of core credit. To prevent this, individual ceiling is necessary. For a long time in India this type of ceiling existed with ceiling over type of security. To ensure was ceiling over lending to an individual as well as ceiling over
lending to a particular channel e.g. against wheat etc.
Ceiling over lending to individual was dropped for
some time. But after '71 it is in operation. Ceiling
over advances against a particular type of security is
automatically achieved by ceiling over individual
credit, which is called partywise ceiling.

Administrative cost of this type is likely to
be higher as more monitoring is to be done. Rent of
freedom even in the field of borrowers is removed.
Banks profitability might not be affected as it can
lend to other channels. Its anti-inflationary effects
is likely to be small and for short term. Individuals
might draw on other sources and accommodate in due course.

On the whole ceiling is a useful technique in
the short run and is likely to be more successful if
employed with other tools and/or sufficient tightening.
Further selectivity to ceiling may be imparted by
insulating certain type of activity from the ceiling
regulation e.g. advances to F.I.I. are exempted from
ceiling in India.

2.5.3 Liquidity ratio -

Commercial banks liquidity ratio is another tool
considered very useful from a number of points of view.
Essentially the ratios are a means of ensuring that the
banks holdings of treasury bills or of other government securities should remain at not less than a prescribed minimum. It is a proportional relationship between a class of liquid assets and other aggregates such as total liabilities, deposits or other obligations or specific type of earning assets.

The purpose of liquidity ratio is (1) to hold excessive expansion of bank credit and (2) channeling bank funds into the financing of budget deficits. It is also useful as a S.C.C. tool. It is a useful supplement to other quantitative credit control instrument. In addition to being used for quantitative credit control, liquidity ratios have also been established primarily for S.C.C. purposes - in order to direct credit into desired channels generally in countries with less developed financial system.

Some types of liquid asset ratios:

(A) Cash on Legal Reserve Ratio:

If higher than banks would voluntarily adopt, the legal reserve ratio reduces profits. Thus this ratio increases cost of banks intermediation by neutralising the legal reserve portion of their borrowed money. Accordingly application of minimum reserve required to banks only should have a differential effect on the
channels of credit intermediation.

Applied against a particular type of earning asset, say commercial and industrial loans, a cash or legal reserve requirement would reduce the relative profitability of such a loan to the bank, compared to alternative earnings assets free of reserve requirements. If evasion can be prevented, this tool can be effective for such loans. But at some higher regulation level it will cause diversion of industrial and commercial loan demand to other credit markets. The restrictive effect on business spending will depend on the alternative credit channels open to specific business borrowers. The effect of the measure on credit channels is reasonably clear but the ultimate effects on real resource allocation, are less predictable.

(iii) Second form of Liquid Asset Ratio

A second form of liquid asset ratio is that requiring a reserve in the form of one or several specific forms of earning assets. These may be required against deposits, total liabilities or assets, or against other specific earning assets such as commercial and industrial loans. If the requirement increases bank holding of the reserve assets above the level that would have been held on a voluntary basis, it will
tend to increase the market demand for the asset and support its price. For example, a reserve in the form of government security against deposits will increase the demand for these securities as a proportion of bank assets and help to restrain a rise in their market yields in a period of increasing monetary stringency. If such a asset yield is less than alternative, it will reduce profitability and may diminish the relative importance of banks as intermediaries serving private borrowers. This depends again on the case with which disadvantaged bank borrowers are able to shift their demand for credit to other credit institutions and markets and on the interest elasticity of their demand for credit from whatever sources. If there is a great shift of credit demand to other institutions etc., both the upward pressure on interest rates and downward pressure on government security holding and prices may be transferred to these markets. Then it is possible that the major effect of requiring banks to meet minimum reserve requirements in the form of government securities may be to alter the distribution of public and private debt among banks and other lenders with little effect on interest rates or the volume of private debt issued.

This represents the general rather than the partial (i.e. bank only) equilibrium aspect of the problem.

(C) Third form of Liquid Asset Ratio
Another variation in liquidity ratio is that of requiring a liquidity reserve in the form of private rather than public debt, e.g. residential mortgages. Here also disadvantaged borrowers might shift. There is no guarantee that the pattern of accommodation for ultimate borrowers or the general level of interest rates would be substantially modified by the liquidity ratio measures (49).

If certain types of credits are to be encouraged, then they are included as part of their reserve requirement against deposits. The reserve requirements may be modified in one of the two ways (1) some countries have included among reserve eligible assets, bank loans for specified preferred purposes thus encouraging or actually requiring the bank to extend this type of loan (2) some countries have granted exceptions from the reserve requirements to the extent that banks have granted the preferred type of credit. In India both the things are done. As Reserve Bank of India wants banks to finance government expenditure, government securities are a part of reserve requirement, while it wants to encourage certain sectors, advances to these are exempted from reserve requirements.

2.5.4 Selective use of general measures

There can be selective use of general measures
favouring certain types of credit instruments for rediscounting purposes etc. Sometimes rate charged is lower than bank rate to encourage financing a particular sector e.g. for agricultural purposes in India.

Sometimes a structure of interest rates is established on the basis of the different kinds of paper. This is called differential discount rates. This device provides for a general or basic discount rate and various other rates applicable to different categories of paper such as agricultural or export bills, the basic rate may often remain fixed - while changes are made in the others according to requirement.

Even time and savings deposit rates might be varied. This will change the channel of intermediation. Ceiling might be fixed for interest rates but, "on the technical level these ceilings are probably inferior to liquidity ratios or reserve requirements as a device to alter the channels through which intermediation occurs" (41). Also if a few interest rates are regulated then the rise in the general interest rate level cannot be controlled. The primary effect of interest rate regulation might be to modify the relative importance of different credit channels and borrowing instruments (42).
2.5.5 Moral suasion

Under moral suasion the central bank may ask the lending institution to desist from financing for certain purposes. Here the action on the part of the central bank has ranged all the way from expressions of concern over credit developments and mild admonitions that credit trends to be watched, to full-fledged agreements with or outright request to the bank either to avoid an increase in or to reduce the existing level of loans. Moral suasion is a selective weapon if applied to a particular sector and becomes comprehensive, if aggregate volume of bank loans are supposed to be controlled.

Besides the above, selectivity can take the extreme form also. The central bank may require that every loan should be given only after its prior approval or central bank may insist that every increase in the credit facility should have its approval.

2.5.6 Consumer instalment credit

This is more relevant for the developed economy like U.S.* The purpose of consumer credit control is to curb the use of credit for the purchase of durable

* For details of experience of this tool please see Appendix I.
consumer goods like automobiles, refrigerators etc. to control inflation. Consumer credit control is done by changing margin or time period of repayment and the amount of instalment.

2.5.7 Advance deposit on imports:

This is a type of credit that the central bank would like to control when faced with balance of payment problem. Here the central bank would require those having a licence for imports to deposit with it a certain percentage of the value of licence in advance of the actual time of making of payment. This will raise importers' cost of financing a given volume of imports. Secondly as the advance deposits are required to be kept with the central bank, the commercial banks' reserves would have been reduced to the extent of the volume of such deposits. Therefore capacity of the commercial banks to create credit will be reduced which will affect the money supply. With a reduction in money supply, price level and demand for imports will be reduced; and there will be improvement in balance of payments.

2.6 Effectiveness of qualitative credit controls:

How to measure the net impact of these measures on the economy is a great problem. This is because the
real world situation is the outcome of a number of
factors operating simultaneously. That is why Couliner
writes, "Much more serious is the fact that there is
virtually no possibility of demonstrating, in any
statistically verifiable manner, what has been the
net impact on the economy of selective credit
controls." [43]. "To be able to trace with precision
the effects of S.C.C., we must await the development
of more disaggregative models of the economy incorporat-
ing a degree of institutional detail from which we
presently abstract" [44].

2.6.4 Criteria of effectiveness:

In the meantime a few working guidelines are
provided. Criteria for judging the success or otherwise
of the controls will depend upon the objective to be
served.

(A) One simple criterion will be to see whether the
use of a particular type of credit was actually reduced
subsequent to the imposition of a given regulation,
regardless of what caused this reduction. Other
factors might have influenced also. But the question is, did
the use of credit decline and by how much? If there is
only one channel then there will be definite reduction.
In the Indian context "the effectiveness of the disciplines
can be judged from the decline of bank advances, not
from their impact on prices. But normally other channels are there which might come in, if not in the short run then in the long run.

(D) Another approach to the problem of determining how effective are controls is by estimating how much credit would have been extended if there had been no reduction in credit terms i.e., no control, and by comparing these estimates with how much credit was actually extended. One can make these estimates on a number of basis. One means is simply to project credit estimated for the period on the basis of pertinent historical relationship during the earlier period. In case of U.S. two such relationships are the ratios of instalment sales credit granted to personal disposable income and to expenditure on consumer durable good.

(C) Sometimes the ultimate objective of the policy of C.C. might be to encourage investment in one form of real capital (say houses) relative to other form of capital. D.C. See (45) holds the view that the policy is successful if the required rates of return in the new equilibrium are reduced for houses and increased for other form of capital. Effects of C.C. on the required rates of return can be predicted from a comparison of pairs of partial derivatives of the respective demand functions. The required rate of return on housing will
foil (that is, investment in house, will rise) if household demand for houses is more sensitive to the mortgage rate than to the rate on corporate bonds. Return over other capital will fall.

Out of the three possible criteria listed above, this study approaches via first criteria. Each regulation on advances (against the commodities included in this study and for the time duration covered by this study) is examined to find whether it could influence the credit level or not. It is also enquired whether it could influence price level or not. As the objectives in India are to restrain speculative hoarding and to encourage genuine trading activity, branch expansion, warehousing, help FCI etc, an attempt is made whether both restraint as well as encouragement could be done simultaneously with one tool or not.

In India the objective of S.C.I. in its restrictive aspect is mainly to prevent price rise of a sensitive commodity. Realising that the price of a commodity depends on demand and supply, SCI scaled down the objective to that of preventing bank advances for a particular commodity from rising beyond a certain essential level. Or in other words to prevent hoarding with the help of bank finance. This means a control over the demand of the commodity to the extent of credit
denied. It is maintained that but for these controls, the price rise of the commodity would have been great. As the controls are employed with a view to prevent a speculative build-up of agricultural commodities with the help of bank finance. However it is difficult to say whether actual speculative build-up was significantly controlled or not. That is why Prof. McMillan writes, “The efficacy of bank action in relation to control of speculation must be considered highly doubtful."

This is because bank credit is not the only source of finance. And if traders anticipate a price rise than raising the cost of credit marginally will be ineffective. As a general and mild measure of restraint and specially for giving a warning, S.C.E. may have relevance, but for the major preventive or corrective measures against speculation, government must act through its economic or fiscal policy or through the direct powers to regulate the stock and commodity markets.

Lohanra N.C. and Ginoche A.R. are of the opinion that the criteria for judging the effectiveness of S.C.E. in India must be their impact on the pressure of demand originating from bank credit. "... it is of the view that their success is not to be judged..."
in terms of the effect they exercise on the prices of the goods concerned.(49).

2.6.2 Conditions for greater effectiveness:—

Whatever might be the objective of C.C.C., it is clear that their effectiveness increases as the limitations of C.C.C. as pointed out in section 2.7 are removed. Thus if problems of definition, administration etc. are solved the C.C.C. would be more effective. Secondly, in general, the controls are likely to be more effective in its restrictive aspect rather than in its positive aspect. Thirdly it least in its restrictive aspect the C.C.C. are likely to be more successful in short run than over a longer period of time.

However a few conditions might be laid down which if present or observed would enhance the effectiveness of controls.

(1) If the purpose of the loan is identified than the success of C.C.C. increases. "The effectiveness of such C.C.C. depends primarily on whether the purpose of the loan can be identified accurately by the collateral offered as security or by other means." (38).
(2) If the borrowers are prevented from borrowing from other accounts than S.C.C. will be more effective. This is why in India where S.C.C. against a particular commodity are levied, banks are asked not to accommodate the affected parties by giving them clean advances.

(3) According to Hodgeson⁵¹ the ability of borrowers to switch channels from one source to another adds control of use for more uncertain than control of channel. Therefore the less effective the alternative channels the more effective will be S.C.C.

(4) Effectiveness of S.C.C. increases if used with general tools. "One of the main pre-conditions for successful working of S.C.C. is that there should be an appropriate framework of general credit regulation."⁵² Not only does a general tightening of the money market make it easier for regulation of the selective type to force a reallocation of investible funds, but they serve to hold back increases in credit extension in those areas that cannot be reached by selective measures and in which there is a tendency for credit to increase when it is suppressed elsewhere. M.I. is also of the opinion that, "From the available experience, it appears that their effectiveness is greatly
enhanced when they are used together with general credit controls\(^{(93)}\). Fowket is of the opinion that, "BROADLY SPEAKING, FOREIGN CONTROL BANKS DO NOT APPEAR TO HAVE OBTAINED SATISFACTORY RESULTS WITH S.C. POLICIES EXCEPT WHEN THE CONTROLS OVER THE DISTRIBUTION OF CREDIT WERE BUTTRESSED BY EFFECTIVE, GENERAL QUANTITATIVE CONTROLS OVER THE AGGREGATE VALUE, AVAILABILITY AND COST OF CREDIT\(^{(94)}\).

(5) S.C.C. WILL BE MORE EFFECTIVE IF THE GENERAL RELATIONSHIPS AMONG EXPENDITURES, TAXATION AND CREDIT AVAILABILITIES ARE SUCH AS TO KEEP THE ECONOMY ON A COURSE OF STEADY GROWTH. "TO BE EFFECTIVE IN CONTROLLING EXCESS AGGREGATE DEMAND, S.C.C. MUST BE PART OF A COMPREHENSIVE SET OF ADMINISTRATIVE CONTROLS INCLUDING PRICE AND WAGE CONTROLS AND RATIONING\(^{(55)}\).

(6) WHEN AN ECONOMY WHICH IS NOT SUFFERING FROM INFLATIONARY PRESSURES, SHOES THE CHARACTERISTICS OF AN EXCESSIVE CONCENTRATION OF CREDIT IN CERTAIN WELL DEFINED SECTORS, WHICH CANNOT BE REACHED, EFFECTIVELY BY THE TRADITIONAL CONTROL MEASURES, S.C.C. MAY BE EFFECTIVE.

(7) S.C.C. CAN BE USEFUL IN THE ALLOCATION OF REAL
resources, if (a) effective demand depends significantly upon credit in the real resources market from which resources are to be withdrawn, (b) real resources are mobile and will shift to alternative and favoured uses if effective demand is reduced and (c) credit can in fact be effectively reduced for such uses by non interest rationing devices.

(8) Effectiveness will be increased if the following factors are properly attended to. In India agricultural commodities have shown a distinct seasonal pattern; both in their harvest arrival and in advances against them. Wheat crop harvesting and marketing period is from November-December, while onion crop from April-July. Bank advances against particular commodities tend to rise during their marketing period; reflecting the financial needs of normal transport and trading operations. After the harvesting is over, finance is required for normal stock operations to keep the supply line in operation in the lean season. As the stocks get depleted, bank advances tend to come down to the minimum levels. The credit control scheme should take into account these factors so that the normal trading and marketing functions are not affected.

(9) The effectiveness of qualitative credit control
will increase if the objective to be realised by such control is just one or number of objectives is kept to a minimum. If regulation is imposed to restrain price rise, it is likely that it will be more effective if there is no execution from the regulation. As the number of exceptions increases the effectiveness of the control is reduced.

Whether C.E.G. measures should operate in respect of primary commodities, durable consumer goods, finished products and stocks and shares depends upon the existing situations. They should be applied if they are thought to be effective. In his reply to one of the questions posed by a congressional committee in 1952, the chairman of the Federal Reserve Board made the following statement which describes the conditions prerequisite to effective C.E.G. "To be effective, selective regulations of credit must relate to an area which is reasonably definable in terms of such things as the purpose of credit, the collateral for it, or the nature of the credit contact. Trade practices should be standardized and sufficiently standardized so that the regulation can be applied in terms of a continuation or extension of these procedures rather than a drastic disruption of them.

Furthermore, the credit area subject to regulation
must be important enough in terms of size and volatility so that its regulation can help to reinforce general credit necessary, and the flow of credit should be responsive to practicable adjustments in the borrower's equity or loan maturity. The selective credit regulation must not unduly impede permitted credit transactions and there must be a minimum possibility of successful evasion in case of other transactions.

Lastly, the constructive results of regulation must be great enough to outweigh the burdens associated with it - both on those subject to it and on those administering it.

### 2.7 Limitations of Qualitative Tools

Limitations of quantitative tools are the main justification for advocating qualitative tools, however these tools also have their own limitations.

#### 2.7.1 Problem of Defining the Area

The most serious obstacle to the development of the qualitative instruments consists in the difficulty of defining in precise terms the field to which the given instruments are to be employed. The task of distinguishing between essential and non-essential sequence and that between speculative and productive investment
in precise operational terms over a continuous period is itself a formidable one for the monetary authorities (57).

2.7.2 Administrative problem

This is considered to be most powerful limitation of S.C.C. Central Bank has to involve itself in greater detail and supervisory machinery will be needed. S.C.C. are aimed at particular type of loan and on such central bank must go into greater details than in the case with the general quantitative measures. Each loan market has different features and hence regulations will have to take these into consideration. But as the central bank goes into greater detail the problem of enforcement will also be greater.

More supervisory staff will be needed not only at the central bank level but the commercial banks will also have to keep more staff. More supervision by central bank might create a feeling of interference on the part of commercial banks. The desire to plug all loopholes to prevent inequities between different banks may result in further incursions into the banking system in the shape of more detailed regulations. It is maintained that, "The difficulty of effective administration of S.C.C. over consumer credit is a major argument against them (58)."
2.7.3 Freedom and interference:

Some argue that these controls will reduce the freedom of banks. Such controls are interference with individual freedom of choice and with an allocation of productive resources compatible with the criteria of a private enterprise. But it may be pointed out that this argument can be put against any regulation.

2.7.4 Equity:

Borrowers of industry that do not get credit will feel, they are discriminated against. Those units which borrow less will be less affected. Certain types of regulations will not affect those bank which do not approach control bank.

2.7.5 Evading:

It is possible that borrowers might borrow for the permitted purpose and use the funds for the purpose which is not permitted. Or he may use his own funds for non permitted area and borrow for the permitted one. Alternative channels of lending might be there which will nullify the effect of control.

2.7.6 E.C.E. and money supply:

E.C.E. alone may not control the total volume of
money supply and hence inflation. If banks are prevented in one line they will give in other lines and total credit level will not fall.

3.7.7 Encouragement difficult

For positive aspects qualitative controls are not much useful as investment depends upon a host of factors besides credit. However removing one obstacle is a good thing in itself.

Because of above factors it is maintained that, "As monetary control devices, S.D.C. have many cross-
bases"[59]. Even if assuming that controls are success-
ful, it will not transfer resources to the desired channel automatically. In inflation, production expend-
iture is not undertaken. Therefore it is maintained that, "It is difficult to see how S.D.C. can offer any
justification for pursuing a deliberately inflationary
policy"[60].

In India, implementation and enforcement may be
a problem as number of bank offices is very large. It
takes time before the directive is implemented. "Gener-
ally the restrictions are implemented long after the need
is over"[61]. This might not be true for all the
regulations. But the time in getting data, taking the
decision and its effect poses a serious problem. Further,
customers might be obliged by overvaluing the stock.
Sometimes control may be bypassed by making clean advances. In India the alternative sources of credit such as non-bank financial intermediaries, own funds, and unaccounted money are there. The existence of large non-monitored sectors further narrows the dimensions of the influence of credit control.

2.6 Qualitative and quantitative tools

As was seen earlier the dissatisfaction with quantitative tools is one of the points on which the qualitative controls are advocated. Policy of maintaining a low rate of interest eases for coming out of depression or for financing plans as in the case of India prevented frequent use of bank rate as a tool. Money supply was also increased which generated inflation. Expansion of certain undesirable sectors was to be controlled, while that of others was to be encouraged. R.C.C. can play a role here as they regulate the credit flow to specific sectors of the economy.

Question now arises is whether the R.C.C. be used as supplement to general controls or as substitute to general controls.

It may be pointed out that general controls have general effects. In terms of economic impact, general selective, while qualitative control can have general effects.
credit controls are less general and selective credit controls are less selective than they commonly are considered to be. General credit controls affect banks but do not affect other credit institutions. These institutions expand credit in case of tighter monetary policy.

General credit controls also tend to affect long term borrowers more than short term borrowers, because higher interest rates have a proportionately greater effect on the size of monthly interest payments of long term borrowers than of short term borrowers and are more important in the cost profit calculus of the long term borrowers. Moreover in a period of tight monetary policy, because of pressure on liquidity, banks also curb their long term lending to a greater extent than short term lending.

Selective credit controls are less selective because of three aspects: (1) the impact of a selective credit control to some extent may fall on the form of borrowing rather than on the pattern of expenditure. (2) The impact which a selective credit control has on the pattern of spending ordinarily is not entirely restricted to the specific spending area at which the control is aimed. (3) O.E.E. have a general credit control effect because one of their consequences is
tendency to restrict the total demand for credit thereby easing the pressure on the total available supply of the loanable funds.

It might be held that as S.C.C. are advocated because of inadequacy of quantitative tools to handle specific situations, they (S.C.C.) can be substituted for quantitative tools. Thus a very different overall strategy of control may be contemplated. Boeltner points out, "This is, in my opinion, a false hope."(3) Such measures are not adequate to take place of general measures. This is because of two reasons: (1) They probably cannot cover certain large segments of the private credit market. (2) In the same they cover they operate best when general credit conditions have been tightened by the absorption of excess reserves and where the money market is free to react in an orderly manner to shifting investment forces.

It is also pointed out that S.C.C. pertain to boom phase and thus the role of S.C.C. is a special and one sided one, unlike the continued role of general credit controls which have important responsibility for stimulating demand in periods of recession and depression as well as for restraining it in periods of boom. This means S.C.C. cannot be substituted for general controls. "No instruments to regulate aggregate demand
in lieu of general monetary policy, S.C.C. are temporary expedients whose effectiveness is sharply limited both in scale and duration (64).

Most of the writers are of the opinion that S.C.C. and general monetary policy tools should be used as complements to each other. Their effectiveness will increase if they are used simultaneously.

"Obviously a strict general monetary policy will ease the burden put upon the selective measures and vice versa" (65).

Sayaro examines the methods of central banking in stabilizing economic activity and views the selective (or qualitative) and the general methods of control as but two aspects of the same process of, "squeezing the financial structure at sensitive critical points" (66). He maintains that the appropriate means of control depends upon the particular historical and institutional context within which the method of control is applied, and in this way reconciles opposing views regarding the proper tools of central bank policy. "Selective credit controls are considered as a useful supplement to general credit regulations" (67).

"The vital point is not the question of general vs selective credit control - the assessment of the pros and cons as between the two methods, but that of
integrating them."(68). The coordination of selective and general controls appears to have been more effective than the use of any one of them singly and by itself.

"It is concluded here that while measures of general credit control remain indispensable, the selective instruments should logically be employed to an even increasing degree."(69). Monetary policy has to control monetary demand both at aggregate level as well as sectoral level. Whereas cost and quantity of credit can be influenced through quantitative methods of credit control, the uses and purposes to which credit can be put are to be influenced though the manipulation of S.I.E. And in the policy six whether greater emphasis should be placed on one type or the other will depend on the type of the economy, institutional set up, objectives of policy etc.

In India during most of the period between 1951-71, RBI has deployed quantitative tools as well as qualitative tools. RBI has used quantitative tools with qualitative elements and has also used qualitative tools with greater selectivity. Next chapter attempts to review briefly monetary policy of RBI highlighting its qualitative base aspect.

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7. For excellent discussion of this point, see Sinto L.V., "History of banking theory", Chicago, 1945, Ch 1.

8. Ibid, pp. 259-60.


17. Mayer has however opposed this view on the ground of neutrality of monetary policy to which Rao does not agree on the ground that in real world, perfect competition is not there, hence allocation may not be desirable, different policies will have different impact sectorally, even thought same effect on the aggregate. Rao comes to the conclusion that there is no reasonable a priori case against direct intervention. See Rao D.R. "Selective credit policy: In it justified and can it work?" Journal of Finance, May 1972, pp. 473-474.

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