CHAPTER V

MONETARY POLICY OF THE UNITED STATES.

Post-War monetary and credit conditions:

During the World War II, the United States government raised funds amounting to $380 billions. Of this amount, about 40 per cent was raised by taxes, about 35 per cent by borrowing from non-bank sources and about a quarter amounting to about $100 billions by borrowing from the banking system; growth of credit and money during the war will be evident from the following figures.1

<table>
<thead>
<tr>
<th>In billions</th>
<th>December '39</th>
<th>December '45</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve Bank credit</td>
<td>2.6</td>
<td>25.1</td>
</tr>
<tr>
<td>Member and non-member bank credit</td>
<td>50.3</td>
<td>140.2</td>
</tr>
<tr>
<td>Bank deposits (Excluding United States Govt. deposits) and currency outside banks</td>
<td>63.9</td>
<td>120.3</td>
</tr>
</tbody>
</table>

At the end of the World War, the public debt had increased from $43 billions to $279 billions. The price level rose from 20 in 1939 (base - 1937-100) to 123 in 1945, 1%

Immediately after the War, the expectation that the economic activity would slacken rapidly proved to be erroneous. The pent up demand for goods was such that the adjustment from government to private purchases and from war to civilian production was much faster than what had been believed possible. Gross National product which was at

1. Goldemberger - American Monetary policy, 1951, p.185
2. International Financial Statistics I.M.F.
the rate of $220 billions at the end of the war, fell to $190 billions by the early part of 1946, but again it rose to $260 billions in 1948.

Monetary policy in the post-war period.

With this background, the monetary authorities in the United States formulated monetary policy and adopted monetary measures. After the end of the war, while anti-inflationary economic controls were abandoned quickly, inflationary monetary policies, developed to facilitate war financing were abandoned slowly and only to a limited extent. Policies adopted for the war, however, continued for some time. Only after the summer of 1946, the preferential rate of $ per cent was for discounts secured by short term government was discontinued. The Federal Reserve authorities, since early 1946, prevented the commercial banks from purchases of long term bonds from the market and from sales to the Federal Reserve Banks of short dated bonds whose interest rates were pegged low, as this action of the commercial banks had an inflationary effect in as much as they could extend credit six times the reserves they acquired from the Reserve Banks. In order to check this, in July, 1947, the Federal Reserve authorities discontinued to buy treasury bills at 3/8 per cent and the rate was raised to 1 per cent by the end of the year. Consequently, Federal Reserve holdings of bills went down by $3 billions. The Treasury also increased rates on certificates offered in exchange for maturities, the rate of 7/8 per cent on one year certificates was gradually allowed to rise to
The above measures had tightening effect on the money market, the short term rates going up from 1/8 per cent to ¼ per cent.

Inspite of these measures, inflationary forces continued to dominate in the U.S.A. Wholesale prices and the cost of living index rose faster than before, the rise being 173 and 155 respectively in 1947. The money supply increased from 102.3 billion dollars in 1945 to 113.5 billion dollars.¹

Although holdings of government securities by the banks declined, but the decline was offset to a substantial degree by a rapid growth of loans. The expansion of bank loans prevented a decline in the money supply.

The most important factor, limiting controls of credit expansion was the obligation of the Federal Reserve System to support the market for government securities at par or above. It became clear from the statement made by the Board of Governors of the Federal Reserve System. "The powers of the Federal Reserve to exert effective restraint on credit expansion are limited by the obligation to support the market for government securities. Consequently, if credit expansion is to be restrained by Federal Reserve action, the bond support policy must be subordinated to the monetary policy."

The policy of supporting government securities became most clear cut in 1948. Heavy purchases of government 3 bonds were made by the Federal Reserve Banks. Holdings of bonds held by them rose from 1½ billion dollars to 11 billion dollars. Although a part of these purchases was offset by liquidation of treasury bills, total holdings

¹ International Financial statistics, I.M.F.
of United States securities and total Federal Reserve credit increased in 1948. Reserve balances of member-banks also increased by about 3 billion dollars. This expansion, however, was prevented by increase in reserve requirements which were raised twice in 1948. Demand-deposits of Central Reserve City Banks were raised from 20 to 22 percent which were again raised to 24 per cent in June 1948. But as excess balances of member-banks continued fairly high, the Board, in September, further raised demand-deposits to 26 per cent for the Central Reserve City Banks and 22 and 16 percent for Reserve City Banks and Country Banks respectively. Reserves against time-deposits were raised to 7½ per cent for all the three classes of member-banks.

The monetary authorities in the United States, followed cautious policies in 1947 and 1948 in the direction of restraining credit, because the authorities had to face a new situation in which government securities constituted by far the dominant factor in the financial mechanism. It was apprehended that sale of securities might have bad effects upon the whole financial structure, capital formation and capital expansion.

But, towards the end of 1948, a downward turn in the economic trend became apparent and became more pronounced in 1949. Prices declined, business loans were being liquidated, business activity slowed down and unemployment increased. Consequently, the monetary authorities adopted various measures to counteract the recession. Margin requirements on security loans were reduced from 75 to 50 per cent, consumer credit regulation was relaxed and the reduction of reserve
requirements was taken up. Late in 1948, Federal Reserve banks began to sell government bonds in the open market and by 1949, total holdings of government bonds declined from 23 billion dollars to 19 billion dollars. Sales of securities by the Federal Reserve Banks were reducing the member banks reserve at a time when bank credit was contracting in a recession.

Monetary policy after the Korean War.

The pattern of the developments in banking in the United Stares was set by the events of the last half of 1950 when, following the outbreak of hostilities in Korea, the country experienced the worst form of inflation in the post-war period. The prospect that a full scale war might be threatening affected judgments of the government, business men and consumers alike. The private sector of the economy was influenced partly by memories of scarcity and high prices during World War II, and partly by the very fact that the government was insisting on the need for restraint in spending - thereby intensifying the fears of shortage and inflation. So there was unprecedented consumers buying of "soft" goods and of "hard" goods, such as cars, refrigerators, washing machines and furniture. At the same time stockpiling activities increased sharply. The government and business both turned to buy all available and prospective supplies of materials that were likely to become scarce. Business also embarked on a broad expansion programme that raised the rate of expenditures for new plants and equipment by more than half in the last quarter of 1950, as compared with the first quarter. A flight from fixed interest investment was accompanied by a rise in prices and by increased activity on the stock markets, and a decline in savings bond sales, and some liquidation of savings deposits.
and bond holdings. These factors resulted in a record expansion of bank credit in the United States. Its expansion to the private economy was the largest on record. The volume of credit increased from 26 billion in the 1st half of the year 1950 to 32 billion in the second half of the same year. It continued to expand substantially in the aggregate in 1951 due to heavy inventory accumulation and the pressure of buying materials by the government for military purposes. These symptoms of inflationary psychology called for determined banking policies. The monetary measures that were, in fact, adopted for combating inflation fell into three groups: voluntary credit restraint, selective credit controls and quantitative control over credit.

**Voluntary Credit Restraint:**

The Defence Production Act was passed on September 8, 1950, soon after the beginning of the war in Korea. The purpose of the Act was to intensify the militarization of the national economy, for which under the provisions of the Defence Production Act, governmental measures combined with credit and monetary controls were introduced. Price control in the form of "price ceilings" i.e., fixing of maximum price under the supervision of the price stabilisation office was introduced in the U.S.A. on January 21, 1951. But it was admitted by the American Press that far from reducing prices, government "price control" increased them.
The Defence Production Act of 1950 gave authority to the Federal Reserve system to arrange a voluntary credit restraint programme in order to divert credit from "non essential" i.e. civilian to "defence" and "defence-supporting uses". Section 708 of the Defence Production Act authorised the President of the United States to encourage financing institutions to enter into voluntary agreements and programmes to further the objectives of the Act by restraining unnecessary credit expansion. The Board of government of the Federal Reserve system, to whom the President's authority over financing was delegated, established a Voluntary Credit Restraint Committee in cooperation with representatives of financing institutions such as, commercial and mutual savings banks, life-insurance companies, savings and loan associations. One of the primary responsibilities of this Committee was the formulation of criteria for distinguishing between essential and non-essential credit. The functions of the committee included the formulation of appropriate general lending standards that might be applied throughout the country and the coordination of the work of numerous regional Committees. The committee's task was also to guide regional committees and individual financial institutions in considering requests for loans.

The Voluntary Credit Restraint Committee, at the outset, issued three bulletins stating the principles relating to business capital and credit, the first dealing with the means of restraining inventory financing, the second dealing with the principles to be followed in financing capital expansion programme and the third with the state and

local government financing. The committee distributed these bulletins, together with the statement of principles of the Programme to all financing institutions participating in the programme to provide common guiding principles for fighting inflationary loan expansion in their respective fields. As the Programme developed, more specific standards were formulated to guide restraints in particular areas. The areas selected by the committee were those in which actual or anticipated expansion of credit was substantial and statutory selective restraints were not applicable. As the Programme progressed, from March, 1951 to September, 1951, the committee issued altogether six bulletins stating the general principle for the guidance of voluntary credit restraint. In its recommendation the Voluntary Credit Restraint Committee always gave priority to war production for granting credit and continued the financial institutions against granting inventory loans. In the sphere of financing capital expenditure programme, it recommended for giving credit but with restraint to the war-industries for their plant and equipment financing while the committee recommended for the postponement of the long term financing of production of goods not related to the defence effort. It also recommended the postponement of public loans not related to defence.

The voluntary Credit Restraint Programme simply attempted to do what the American Bankers Association did in its anti-inflation program in 1945, namely to use moral persuasion, instead of government direction, to distribute credit to the essential industries related to War-production and to discourage it to 'nonessential' industries related to civilian production. According to the programme bank lending and

investing operations were not the sole source of potential credit inflation. It recognised the fact that the tremendous growth of liquid assets resulting from deficit financing during World-War II had expanded the resources of other financial institutions, such as life insurance companies. It gave them greatly enlarged lending power, which could have neutralised the effects of restraint exercised by the banks. Accordingly, these institutions were brought into the programme. There were some grumblings that the programme could not work. Nevertheless, the facts are that credit expansion declined considerably in 1951 compared with the last half of 1950. In the first Seveneek weeks after the midyear of 1951, business loans of reporting Federal Reserve member-banks (holding about fourfifths of the nation's total) advanced seasonally only $1300 million, or less than half the amount recorded in the same period of 1950 when demand for credit had been exceptionally high. An easing of prices and the decline in the accumulation of inventories undoubtedly were factors tending to lessen demand for accommodation, but the Voluntary Credit Restraint Programme undoubtedly played an important role to act as an anti-inflationary measure.

Another achievement of the programme was the gathering of data from over 200 largest banks about the purposes for which advances were being made. These data indicated not only the divergent trends of the components of the total loan, but also showed the pressure that the "defence" effort was exerting on loan demand. Since the programme
began in March 1951, the detailed figures indicated a rise in accommodation for military contracts and war-supporting activities. The half year through September showed about a million dollar increase in the 200 banks for "defence" purposes. 1

Although the Voluntary Credit Restraint Programme acted successfully as one of the anti-inflationary measures, it was, undoubtedly, responsible for the decline in the production of civilian goods in the U.S.A. In the first half of 1952, for instance, the index of production of durable consumer goods (passenger cars, television sets, refrigerators etc.) was 28 per cent lower than in the first half of 1951 and 37 per cent lower than in the second half of 1950. 2

This is a type of credit restraint measure on which economists have not been inclined to put much faith. In the final analysis, the impact of any type of credit restraint depends upon the actions of lenders, who have the responsibility of deciding who and what shall be financed. They are more inclined to be restrictive if their lending resources are limited than if they have funds available and so must be rationed among borrowers. But at any rate, they can choose, if they like to finance more or less inflationary or essential activities. Max-Neonne had a combination of general credit-restrictions, which limit the over-all supply of credit can be most effective with a voluntary restraint programme which provides standards of selectivity.

1. Ibid p.1154
Selective Credit Control

The second line of attack on the problem of inflation was the use of selective or qualitative credit controls. Unlike discount rate changes, open market operations and reserve requirements, which affect the cost and availability of bank-credit in general, selective credit controls seek to influence particular types of credit irrespective of their sources. Selective instruments do not approach the problem through influencing bank-reserves. Instead they prescribe the terms on which certain kinds of loans may be made or credits granted, regardless of whether the banks have sufficient or insufficient reserves. Their merit is that they make it possible to restrain the flow of money into certain fields at times when conditions in the economy as a whole are such as to make general restraints on the growth in the volume of money undesirable.

Margin requirements

In the United States, this technique was employed to a minor extent even before World-War II. The Securities Exchange Act of 1934 authorised the Board of Governors of the Federal Reserve System to prescribe the maximum amount of credit that could be granted by banks or securities brokers and dealers for the purpose of purchasing or carrying securities registered on national Stock Exchanges. Such margin-requirements were primarily intended to control speculative purchases of securities with the help of borrowed money, and did not
apply, therefore, to ordinary loans for commercial purposes even though such loans might be secured by securities. Extensive use of this technique had been made both during and since World-War II. Prior to the war, the Board’s regulations required margins of 40 per cent but during the war requirements were raised first to 50 per cent, then to 75 per cent and in January, 1946 to 100 per cent. To require a margin of 100 per cent was in effect to forbid loans for the purpose in question. The reason for so drastic a requirement was that inflationary pressures were very strong and any growth whatever in stock market credit would increase them. The 100 per cent requirement was in effect up to February, 1947, when it was reduced to 75 per cent and to 50 per cent in 1949. In January, 1951, the margin requirements were raised once again to 75 per cent as a part of the general post-Korean anti-inflationary drive and they remained unchanged until February, 1953 when they were lowered to 50 per cent.

By the control of margin requirements excessive use of credit in the stock market, which caused serious disturbances to the economy in the past, has been placed under control. The danger of a stock-market boom financed by credit and followed inevitably by a disastrous collapse has been largely eliminated. A boom and collapse in the stock-market is still possible, but without the use of credit it is not likely to assume the proportions it had in the past.

For example, credit in the stock exchange market had increased to 10 billion dollars, a peak from which it fell to three quarters of a billion by the middle of 1935. This rise and fall in stock exchange
loans was accompanied by an advance in prices of common stock to an index number of 238 in the autumn of 1932. This boom and bust in the stock market caused a great damage and led to depression in the thirties. As a result of the regulation of credit in the stock market, the possibility of an episode like the one that culminated in 1929 has become very remote.

Regulation of consumer credit was instituted as an anti-inflationary emergency measure on three separate occasions. Control over consumer credit was introduced for the first time in 1941 by the exercise of the president's emergency powers. The control was administered under regulation W of the Board of Governors. Under the provisions of the Defence Production Act of 1950 consumer instalment credit was again placed under control to check inflationary forces immediately after the outbreak of the war in Korea.

Consumer credit forms an important part of the total credit in the U.S. economy and nearly two-thirds of it take the form of instalment credit on durable consumer's goods like automobiles, refrigerators, radios, washing machines etc. The purpose of control of consumer credit was to curb the use of credit for the purchase of consumers' goods and services, because, the equipment, materials and labour required for their production were being transferred to the war efforts. At the same time since employment was general and pay rolls were large, the purchasing power of consumers was increasing. Thus with decreased supply and increased demand prices were rising exorbitantly.

1. The Federal Reserve System - its purpose and functions:
   Published by the Board of Governors of the Federal Reserve System, page 42.
The President, accordingly, under the authority of his emergency powers, instructed the Federal Reserve authorities to regulate the consumer's credit.

Regulation W limited the expansion of consumer purchasing power in the form of credit dollars by establishing minimum down payments requirements and maximum periods for repayments of consumer instalment debt effectively.

During World War II, instalment credit, charge accounts and single payment loans were controlled, thus extending the regulatory powers of the Board of Governors far beyond the banking system. Since the control was exercised by virtue of the emergency powers of the President, the regulation of consumer credit by the Federal Reserve authorities was purely temporary and came to an end in November, 1947.

After the outbreak of the Korean War, The Defence Production Act of 1950 authorized the reinstatement of Regulation W. But this time only instalment credit was controlled, by prescribing minimum down payments and maximum maturities for listed articles. For example, the regulation provided that in buying an automobile on instalment, a buyer would be required to pay one third down and repay the balance in a period not exceeding 15 months; for other durables such as washing machines and television sets etc. the minimum down payment requirement was 25 per cent and the maximum time allowed was also 15 months. In this way the inflationary expansion of outstanding instalment credit was prevented to a great extent, within six months, from
October 1950 to May 1951, instalment credit outstanding declined by 400 million dollars. This contrasted with a rise of 1.8 billion dollars in the corresponding period a year earlier. The regulation of consumer-credit was not only introduced in the U.S.A to combat inflationary forces but it was also in force in Canada.

Regulation W has inherent limitations and defects as a means of credit restraint. It affects only one segment of the credit structure unlike broad general credit measures (open market operations, discount rates and reserve requirements). Regulation W imposes specified terms upon individual transactions in the regulated area. It was estimated that it had its limited applications to roughly about half of the current outstanding total of 19 billion dollars of consumer-credit in 1951. Moreover, owing to rigidity of the terms of the regulation there were accumulations of inventories which threatened to impede production with resulting unemployment in the industry affected. Therefore, it aroused widespread opposition against the regulation from dealers in automobiles and in other major durable goods and from some financial institutions and other lenders. The Banking and Currency Committee of the House of People, which was appointed to consider bills to amend and extend the Defence Production Act of 1950, criticised the regulation as "intractable" and as "unduly harsh" and "unyielding" in administering consumer-credit-control. The senate-committee recommended the flexibility of its terms with a view to facilitating easy disposal of stocks of goods.

2. Ibid. P.748.
The committees of both the Houses proposed the relaxation of the terms of the regulation, by reducing the minimum down payment and easing the maturity for repayment by three months.

From the statement of Mr. Moe. O. Thomas Martin Jr., Chairman of the Board of Governors of the Federal Reserve System, on July 9, 1951, it has been crystal clear that the Board of Governors did not hold views of the Banking and currency committees of both the Senate and the House of People. The views of the Board will be evident from the following lines:

"In striving to weigh all of the facts and factors involved in this controversial but comparatively subordinate means of affecting the credit supply, we have been unable to come to any other conclusion than that, judged by the yardstick of the supply of credit requisite for the defence effort and the civilian economy, we could not justify liberalising the terms of this regulation at a time when pressures on prices, even though abated at present, threatened to re-emerge irrespective of Korean developments. Judging by the present size of the money supply and its potential expansion in volume or velocity or both, we do not feel that we could justify an action, even on the subordinate front of consumer installment credit, that would announce in effect, that we believe the inflationary danger is no longer existing. We do not believe that we should, by such an action, encourage the general public to incur more consumer installment debt which would be financed ultimately by further expansion of Bank credit. This is not the type..."

---

1. Thid p. 749-50
of credit which is directly essential for national defense."

"Our conclusion to the contrary seems to be borne out by both the Senate and House Committee reports which make it clear that a program of general credit relaxation at this time would not be in the public interest."

The Board of governors of the Federal Reserve System expressed its desire that it would apply the regulation W as a means of anti-inflationary measure to curb consumers' credit so long as the Congress would allow the Board to pursue that policy. After various revisions, the Board of Governors dropped this regulation in May 1952, and in June 1952 its authority over the field expired.

The economic impact of the control of consumer credit was far-reaching during the war-period, higher down payments and a shortening of repayment periods under Regulation W had the effect of reducing consumer purchases of durable goods and the conservation of scarce materials was possible as a result of the tightening of credit terms on consumer spending. The series on installment sales credit outstanding and more particularly, the series on installment sales credit granted show that both of these fell with the initiation of Regulation W in September, 1941, and continued to decline as the Regulation was amended from time to time for tightening the terms of consumer credit.

During the years 1942-45 the use of installment sales credit was reduced by about 20 per cent over what it might have been on the basis of increased income levels. After September, 1950, when Regulation W was again imposed, the picture of consumer installment credit...

An Appraisal of selective credit controls by R.J.Saulnier.
changed markedly; the total outstanding for the country as a whole showed a net decline of $300 million during the first nine months of 1951. This contrasts greatly with a rise of $2500 million in the similar period of 1950.

Regulation of Real Estate Credit:

In the sphere of real estate credit several important steps were taken to check inflationary developments and to conserve materials and other resources. Under the authority of the Defence Production Act, in October 1950, Regulation X was issued and the credit for constructing, purchasing and financing new houses was brought under control for the first time in U.S. history. Before the passing of the Defence Production Act, in July 1950, under the provisions of the Federal Housing Administration and the Veterans Administration, the terms under which they would insure or guarantee mortgage loans, both on new and existing properties, were tightened. Since the passage of the Defence Production Act, further action was taken to regulate real estate-construction credit, on October 12, 1950, and January 12, 1951, the Federal Housing Administration and the Veterans Administration further modified their regulations to conform to the terms of Regulation X with the consent of the Housing and Home Finance Administrator. These regulations restricted the terms of borrowing in connection with the purchase of new and old houses and apartments financed with federally unwritten mortgages and new houses and apartments financed with other kinds of mortgages.

1. The Economist, Nov. 10, 1951, p. 1154
In general, they required buyers to make larger down payments and to pay off their mortgage debt more quickly than before. Under the terms of Regulation X and E.H.A regulations, mortgage loans on houses were limited to various percentages from 90 per cent for houses valued at $4,000 or less to 50 per cent for houses valued at over $24,250. With respect to loans guaranteed by the Veterans Administration, 5 to 10 percentage points higher loan ratios was authorized by the Housing Administrator to preserve the relative credit preference granted to veterans. These terms were widely regarded as being strict and likely to reduce drastically the volume of residential houses. But in February, 1951, Regulation X was broadened to cover certain non-residential construction. On March 5, it was amended to permit relaxations by the Board of Governors of the Federal Reserve System and the Housing Administrator of financing terms in areas which are designated as critical defence areas. On August 3, 1951, forty-two areas were declared defence-areas by the Inter-agency-Critical-Areas-Committee of the Defense Production Administration. Liberal financing terms were announced for the purpose of the construction of buildings in these areas. The purpose of this measure was to divert real estate credit to essential constructions for defence purposes from nonessential uses.

The full effect of the real estate-credit-regulations was not felt immediately because Regulation X could not be put into effect immediately as inequities would have resulted if the regulation was

1. Federal Reserve Bulletin May 1951, p. 492
imposed without granting relief to those already committed. When Regulation X was issued, the Chairman of the Board of Governors of the Federal Reserve System and the Administrator of the Housing and Home Finance Agency stated that the goal was to reduce building constructions from their current rate of about 1,400,000 to around 850,000, or about 40 p.c. But the reduction was considerably less than the goal, because real estate credit regulations did not apply to credit on a large number of houses already under construction and to credit already committed. It was not until measures for general credit restraint were adopted in early 1951 as a result of the Federal Reserve Treasury accord, which reduced the availability of mortgage credit that much restraint was evident in that area. The combination of selective action in the mortgage credit area and general credit restraints helped to reduce housing constructions and lowered borrowing demands more nearly to the level of the supply of savings available for investment in that area.

Regulation X and the associated regulations of the P.H.A and V.A were relaxed for lower cost houses from time to time. With many earlier loan commitments met and with an increased flow of savings to financial institutions, funds became somewhat more readily available in the mortgage market. Gross new mortgage lending on 1 to 4-family houses in the 1st half of 1952, totaled about 8 billion dollars, the same amount as in each half of 1951. The volume of lending shown in the table below, resulted from the large, though reduced number of new houses purchased.

Mortgage loans made to 1 to 4 family houses.*
(In billions of dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>1st half</th>
<th>2nd half</th>
<th>1st half</th>
<th>2nd half</th>
</tr>
</thead>
<tbody>
<tr>
<td>1949</td>
<td>5.0</td>
<td>4.0</td>
<td>7.3</td>
<td>2.9</td>
</tr>
<tr>
<td>1950</td>
<td>7.2</td>
<td>8.8</td>
<td>7.7</td>
<td>2.5</td>
</tr>
<tr>
<td>1951</td>
<td>7.9</td>
<td>8.0</td>
<td>5.4</td>
<td>5.0</td>
</tr>
</tbody>
</table>

The average mortgage loan made on both old and new houses rose also considerably in 1952 reflecting some change in the areas of high market-activity and some shift to the purchase of higher priced properties. After various revisions, Regulation X was suspended on September 16, 1952, by Board of Governors of the Federal Reserve System in accordance with the 1952 "Amendments" to the Defence Production. These Amendments had required that relaxation of residential credit-control should be announced at a time when estimated residential construc-

tions for three consecutive months were below a seasonally adjusted annual rate of 1,200,000 units. Information was received from the Secretary of Labour that the seasonally adjusted annual rate of housing construction was less than 1,200,000 units in each of the months of June, July, and August, 1962.

An appraisal of selective credit controls

Although selective credit-controls have assumed greater importance in recent years, they are still regarded as essentially emergency measures. Except the control of margin requirements on stock market credit, none of the selective controls have a permanent statutory basis. But still opinion is divided on this question, that is, whether selective credit control-measures should be regarded as permanent implements of the central bank or only as temporary devices. Now let us consider this question. It will be wrong to regard selective credit control-measures as substitutes for general credit control-devices owing to two main reasons. First, they cannot cover large segments of the private credit-market. Secondly, they operate successfully in the area they cover 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 changing investment forces. The effectiveness of Regulation X was felt when mortgage lenders were less willing than before to obtain funds for mortgage investment and business financing by selling government securities in the market owing to actions taken


by the Board of Governors of the Federal Reserve System to raise reserve requirements of member-banks and to reduce monetization of the public debt through Federal Reserve support of the Government securities.

Further: Selective credit Controls can not be regarded as substitutes for quantitative controls, because, Commercial bank portfolios cannot by themselves restrict expansion of bank deposits bank so long as any eligible and attractive types of loans and investments remain available and the commercial banks possess or can obtain the necessary reserves. In a period either inflationary or of sudden transition they can be used effectively to prevent bank credit and other loanable funds from being used for purposes deemed essential in the national interest as supplement to the older and more general instruments such as, discount rates, open market operations and reserve requirements. In the United States, Regulations W and X, in the post-Korean period, were widely used in the allocation of resources from civilian to military uses without requiring a net increase in the total amount of bank credit.

Unlike traditional credit control instruments, selective credit regulations are direct, immediate and personal in their effect on the individual and the business concerns. The effect is felt, not by a relatively few financial institutions, but by a very large number of manufacturers, dealers, merchants, salesmen, and lastly, the consumers. It is interesting to note that there were about 180,000 registrants under regulation W.1

---

1. Ibid P.22 264
Again selective instruments of credit are flexible in themselves and can help to make credit policy in general more flexible. Their remarkable characteristics are that they are applicable to the limited segments of the economy instead of being applicable to the economy as a whole and that they can be used to restrain the demand for credit without operating, as general instruments of credit control do, through, the stiffening of money rates.

At present, in the United States, the degree of direct interference involved in the administration of such controls is such that selective controls are not regarded as a part of the normal machinery of monetary control. It should also be noted that selective controls employed so far in the United States are not so comprehensive as in some other countries. The whole area of ordinary business loans for increasing inventories has not yet been brought under control, quantitative or qualitative, except on the basis of voluntary co-operation among banks.

Quantitative Credit Controls.

The third line of the attack on inflation through monetary policy is quantitative restraint on the total volume of credit. The instruments used in this field are (1) discount rate, (2) open market operations and (3) variations in reserve requirements. Though they operate somewhat differently, yet each influences bank reserves position and hence affects the ability and willingness of commercial banks to lend by affecting the cost and availability of bank credit.
Since the end of World War II U.S. monetary policy was conditioned largely by the enormous growth of the federal debt and money supply during the war. In the war period, both the money supply and total liquid assets held by the public increased faster than gross national income product, and government securities occupied an important position in the total assets of the commercial banks. At the end of 1945, U.S. government securities held by commercial banks amounted to about 60 per cent of their deposits, against approximately 30 per cent at the end of 1941. While these structural changes had tended to prevent the use of monetary policy in the post-war years, U.S. monetary policy was not altogether inactive. Some steps were taken in the early part of the period to restore flexibility to short-term rates, both discount rate changes and changes in reserve requirements were used judiciously in 1948. Monetary policy was changed three times between 1948 and 1950 twice to strengthen the resistance to inflationary tendencies and once as an antidote to the recession. In 1948 both tendencies became more pronounced in the U.S. economy, the Board of Governors of the Federal Reserve System raised reserve requirements of the member banks three times during the year. While, by March 1949, industrial production fell by 6 p.c., and unemployment rose to over 4 million in May 1949.

Various monetary measures, such as the relaxation of consumer-credit regulations, lowering of the margin requirements from 75 to 50 p.c. and reduction of reserve requirements were taken.

The cheap money policy was followed in one respect, however, until after the outbreak of the Korean war. The Federal Reserve authorities supported the market for securities to prevent prices of securities from falling and did not allow the bond rate to rise above 2½ per cent until March, 1951. In practice prices of securities fluctuated above par for most of the time between December 1945 and June 1950. It would be wrong to assume that open market operation of the Federal Reserve Banks in support of the bond market led to any steady monetization of the public debt. During the first two post-war years, security prices remained generally above par. But in the autumn of 1947, when prices for securities had begun to fall owing to the liquidation of large-scale securities by industrial investors who found more attractive investment opportunities in corporate securities and real estate mortgages, the Federal Reserve Banks purchased Government securities on a large scale to prevent prices from falling below par. Holdings of government securities by the Federal Reserve Banks in the post-war years will be evident from the following table.

U.S. Government Securities held by Federal Reserve Banks.

---

In millions of U.S. dollars.

<table>
<thead>
<tr>
<th>Period</th>
<th>Bonds</th>
<th>Bills, certificates and notes</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 30, 1933</td>
<td>1,351</td>
<td>1,133</td>
<td>2,484</td>
</tr>
<tr>
<td>&quot; 31, 1945</td>
<td>927</td>
<td>23,315</td>
<td>24,262</td>
</tr>
<tr>
<td>&quot; 31, 1946</td>
<td>763</td>
<td>22,937</td>
<td>23,700</td>
</tr>
<tr>
<td>&quot; 31, 1947</td>
<td>2,653</td>
<td>19,706</td>
<td>22,360</td>
</tr>
<tr>
<td>&quot; 31, 1948</td>
<td>10,977</td>
<td>12,356</td>
<td>23,333</td>
</tr>
<tr>
<td>Daily average for December 1948</td>
<td>11,065</td>
<td>11,017</td>
<td>22,082</td>
</tr>
<tr>
<td>December 31, 1949</td>
<td>7,218</td>
<td>11,667</td>
<td>18,885</td>
</tr>
<tr>
<td>June&quot; 30, 1950</td>
<td>5,618</td>
<td>12,713</td>
<td>18,331</td>
</tr>
</tbody>
</table>

As a result of this buying of government securities by the Federal Reserve Bank, after the autumn of 1947, holdings of securities by the Banks rose from $1.6 billion to $11 billion in one year. But since they disposed of large amounts of short-term securities, the net increase of short-term government securities was about $1 billion. With the advent of recessionary tendencies in 1949 when, for the first time in the post-war period, the market prices for government securities had tended to rise above the support prices, the Federal Reserve Banks sold both bonds and bills in order to allow bond rates to decline freely. Sales of bonds during 1949 and the first half of 1950 amounted to more than $6 billion.
Not purchases and sales of securities by the Federal Reserve

Banks tend to increase or decrease the reserves of commercial banks, which in their turn determine the loan and investment of these banks. As commercial banks tend to maintain a ratio of 6 to 1 between deposits and reserves, changes in reserves are, therefore, liable to lead to proportionately greater changes in their deposits. In the post war period, the Federal Reserve Banks tended to prevent this multiplying effect by altering the banks reserve requirements. In 1948 when the Federal Reserve System bought $770 millions of government securities, it raised reserve requirements by $2570 million. In 1949 it lowered reserve requirements by $3,800 millions by its sale of securities amounting to $4,450 millions. As a result of these open market policies and of variations in reserves requirements together with the Federal budget-surplus during 1947-48, the volume of money could not increase appreciably since 1946, in spite of a fairly large expansion of business credits.
Post-Korean quantitative measures of credit control.

After the outbreak of the Korean War, the nature of the inflationary pressures that resulted in the United States from the rapid increase of expenditure for military purposes and the types of measures needed to fight it were wellknown to the monetary authorities. Besides limiting the demand for certain kinds of credit for non-defense purposes and directing such available credit into essential areas, action was taken to restrict the total volume of credit.

The use of quantitative measures, depends upon the availability of credit. In the latter part of 1950 and early part of 1951 in the United States, very large war-time increases in holdings of money and other liquid assets by business, individuals, banks and other lending institutions provided a tremendous potential for increase in credit-supply. Holdings of government-securities by the public was another source of credit-expansion, because those securities possessed unusual liquidity due to the policy followed by the Federal Reserve Banks of supporting prices and yields of government-securities. The Federal Reserve Bank's purchase of government-securities provided additions not only to money supply but also to the volume of bank reserves, - "high powered dollars" which served as a basis for further credit-expansion by banks.

Inflation could hardly be checked so long as expansion in the supply and use of money was possible. Another essential factor for fighting inflation is to encourage new savings among individuals.
and for retention of past savings by them. "A high level of current saving and retention of past savings by individuals, together with careful conservation of these funds for essential uses, are as necessary in an adequate programme of inflation restraint as anti-inflationary Government fiscal, credit and other policies." Antinflationary value of savings depends upon their forms and uses. Savings held in capital assets, either directly in housing or personal business enterprise, or indirectly through the market for corporate securities may have little antinflationary value and may actually contribute to inflationary pressures, but if they are held in the form of demand deposits and currency, such funds may become highly inflationary when attractive spending opportunities arise.

When they are invested in Government securities and are retained in that form, savings may have a special antinflationary value. If defence expenditure could have been met from income from taxation, such funds invested in government bonds would be available to the treasury for making payment for short term debt held by the banking system and particularly by the Federal Reserve Banks. Such replacement of short term debt by long term savings bonds is an antinflationary debt management because it operates to contract the money supply and to restrict lending by commercial banks.

Investments of savings in government bonds might be encouraged if investors are assured of their securities being liquidated into cash without a serious loss in value. Ever since the war, to give such

1. Reserve Bank Bulletin September, 1951, P.1053
assurance to investors about the liquidity of their securities and at the same time to discourage them from doing so presented a dilemma to the Federal Reserve Banks and the treasury. Therefore, the problem of restraining expansion of credit in order to prevent inflation in conformity with the successful financing of the government-requirements also presented a dilemma in the post-Korean period. A solution of that dilemma was possible in the United States when the Treasury and the Federal Reserve Banks acted in unison for the management of the public debt and open market operations.

Discount rate increase and changed open market policy.

In August, 1950, the Federal Reserve authorities expressed their intentions to use all available powers to check inflationary credit-expansion consistent with the policy of maintaining "orderly conditions" in the market for government-securities. In this context it should be noted that discount rates were changed from 1½ to 1⅔ per cent and open market operations were changed so as to reduce the Federal Reserve Banks' purchase of Government-Securities and thus curtail the availability of bank reserves. During the early months of the Korean War, open market operations were conducted to support treasury refunding operations and the long term-government-security-market and in carrying out these policies, the Federal Reserve Banks purchased substantial amounts of government-securities. As a result of this policy, the Banks' holdings of government bonds increased by approximately $4,3 billion during the
nine months ended March 1951, holdings of government bonds by the Federal Reserve Banks in the years of the Korean hostilities will be evident from the table given below.

U.S. Government securities held by the Federal Reserve Banks.

(In millions of U.S. dollars)

<table>
<thead>
<tr>
<th>Date or period</th>
<th>Bonds</th>
<th>Bills, certificates &amp; notes</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 1950</td>
<td>5,618</td>
<td>12,713</td>
<td>18,331</td>
</tr>
<tr>
<td>March 28, 1951</td>
<td>6,032</td>
<td>16,574</td>
<td>22,606</td>
</tr>
<tr>
<td>&quot; 26, 1952</td>
<td>5,636</td>
<td>16,892</td>
<td>22,528</td>
</tr>
<tr>
<td>Sept. 24, 1952</td>
<td>5,236</td>
<td>18,479</td>
<td>23,715</td>
</tr>
</tbody>
</table>

Although the expansionary effect of these purchases of securities was to a large extent offset by an outflow of gold and an increase in reserve requirements, there was a net increase of $1.1 billion in the reserves available for expansion of bank-credit. Nevertheless, an attempt was made by the Federal Reserve System to offset the expansionary effect of these purchases by selling other securities in the market. But, in view of the great demand for items then developing, it was difficult to achieve this effect. As a result, banks obtained additional reserves which provided the basis for a large expansion of bank-credit.

While insurance companies and other investors became large sellers of government securities, particularly long term bonds, for

obtaining funds to acquire mortgages and business securities, the treasury and the Federal Reserve banks reached an agreement with respect to debt management and monetary policies to be pursued in furthering their common purposes to minimise monetisation of the public debt and at the same to assure successful financing of the government-requirements.1 With the announcement of this agreement-developments that took place were as follows. First 2½ p.c. bonds (1967-72), offers which had been pressing heavily on the market, were offered for conversion into 2½ per cent bonds with limited redeemability. This issue had a considerable success. Out of $19.7 billions of 2½ per cent bonds outstanding $13.6 billions were converted.2

This exchange achieved success in inducing long term investors to retain their holdings of government-bonds. Secondly, while the treasury acted to immobilize a part of the public debt held by the public the Federal Reserve Banks made limited purchases of government securities and subsequently discontinued their support for them except for occasional but very small transactions to help in maintaining orderly conditions in the security-market. Thirdly, the Federal Reserve Banks discontinued the purchase of short term securities in order to allow short term rates to move up with the discount rate. The main effects of this change in policy were to reduce the creation of reserves by holders of short term securities and to induce banks to borrow from the Federal Reserve Banks. Another result of the change was the restoration of flexibility in the short-term money-market with

money rates being determined by market forces and related more to the Federal Reserve discount rate which remained unchanged at 1/2 per cent during 1951. The open market operations of the Federal Reserve System assured success of treasury financing and reasonable degree of stability in the Government security market, particularly around refunding periods. Naturally, the Treasury undertook its refunding operations at suitably higher rates.

Increase in reserve requirements.

Variations in bank reserve requirements have been a part of the U.S. monetary policy with a view to controlling the availability of bank credit. Its frequent use was made in post-war years. After the beginning of the Korean war, when reserves of banks began to increase on a large scale as a result of the monetization of the public debt, reserve requirements of all banks outside New York and Chicago were raised in January and early February, 1951, by two per cent against demand deposits and by one per cent against time deposits. This increased by about $2 billion the amount reserves that member banks were required to keep with Federal Reserve Banks and thereby reduced the expansion of bank credit. 1

1, Ibid, p. 742.
Results of monetary policy in the United States.

It is always difficult to measure the effectiveness of any economic policy. Any kind of economic development is generally the result of various factors and it is not possible to measure the varying degrees of influence of each one of them. The facts are that in the first few months after the outbreak of the Korean War, inflationary developments were high; private expenditure increased, credit expanded rapidly and prices rose. So monetary and other anti-inflationary measures were adopted to check inflationary pressures. Specific developments in the money and security-markets indicated that monetary measures adopted in the post-Korean period exerted an anti-inflationary pressure on the U.S. economy.

Resumption of member-banks’ borrowing

Since the treasury Federal Reserve Accord, the volume of member-bank reserves began to dwindle and member-banks worked under high pressure to maintain their reserve positions as a result of the withdrawal of Federal Reserve Support from the Government-security-market. It was, therefore, frequently found necessary for member-banks to resort to borrowing from the Federal Reserve Banks to maintain their reserve positions. By the end of May, 1951, member-bank excess reserves were at very low levels and banks borrowed heavily from the Federal Reserve Banks as is evident from the following figures. 1

1. Compiled from Federal Reserve Bulletins, 1951.
Member-bank reserves and borrowing
Average of daily figures.
(In millions of dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total reserves held</td>
<td>19324</td>
<td>19392</td>
<td>19392</td>
<td>19229</td>
<td>19174</td>
<td>19336</td>
<td>19268</td>
</tr>
<tr>
<td>Excess reserves</td>
<td>233</td>
<td>500</td>
<td>834</td>
<td>756</td>
<td>704</td>
<td>721</td>
<td>924</td>
</tr>
<tr>
<td>Borrowing at Federal Reserve Banks</td>
<td>131</td>
<td>438</td>
<td>170</td>
<td>194</td>
<td>292</td>
<td>338</td>
<td>95</td>
</tr>
</tbody>
</table>

This was the most significant development as it meant the restoration of member bank borrowing as an instrument of monetary policy which had become popular also in the twenties. By means of its open market operations, the Federal Reserve Banks can bring about whatever volume of borrowing it likes to see, within the limits of the reserves required by the market. It can thus control the pressure that the market imposes upon itself through its desire to pay off. This can also be an effective and flexible instrument of monetary policy, because when member banks are heavily in debt, they are not only less inclined to make additional loans but will probably like to use any funds obtained from other sources to reduce their debt before seeking new loans and investments. The Federal Reserve is also in a position to encourage this process by raising the discount rate. Thus the charged open market policy may be said to have restored member banks' borrowing and the discount as effective instruments of monetary policy.  

Effect on short term market

The Federal Reserve Banks' purchases of short term securities were

1. "Recent Monetary policies in the United States" by Henry C. Wallis American Economic Review, Vol. XLIII May, 1953, Number 2 P. 33  
reduced to a minimum and the Banks' activities in respect of open
market purchases were largely confined to periods of treasury
financing. In June and September the Federal Reserve Banks purchased
substantial amounts of maturing issues to assist the treasury in its
refunding operations. There were also seasonal money market pressures
at that time. Most of those purchases were offset by subsequent sales
or redemptions. Following this change in the open market operation
rates on short term securities rose irregularly. Further yields on
short term-government-securities increased by one third per cent in
1961 and showed wider fluctuations than in previous years. Fluctua-
tions in rates on short term securities and yields on treasury bills
will be evident from the following figures.

Open market money rates in New York city

Per cent per annum.


<table>
<thead>
<tr>
<th>Year or month</th>
<th>3 months</th>
<th>9 to 12 months</th>
<th>3 to 5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>bills</td>
<td>issues</td>
<td>issues</td>
</tr>
<tr>
<td>1948</td>
<td>1.040</td>
<td>1.14</td>
<td>1.32</td>
</tr>
<tr>
<td>1950</td>
<td>1.218</td>
<td>1.26</td>
<td>1.50</td>
</tr>
<tr>
<td>1951 January</td>
<td>1.337</td>
<td>1.27</td>
<td>1.66</td>
</tr>
<tr>
<td>&quot; February</td>
<td>1.391</td>
<td>1.60</td>
<td>1.37</td>
</tr>
<tr>
<td>&quot; March</td>
<td>1.422</td>
<td>1.79</td>
<td>1.33</td>
</tr>
<tr>
<td>&quot; April</td>
<td>1.520</td>
<td>1.89</td>
<td>2.03</td>
</tr>
<tr>
<td>&quot; May</td>
<td>1.578</td>
<td>1.85</td>
<td>2.04</td>
</tr>
<tr>
<td>&quot; June</td>
<td>1.489</td>
<td>1.79</td>
<td>2.00</td>
</tr>
<tr>
<td>&quot; July</td>
<td>1.583</td>
<td>1.74</td>
<td>1.34</td>
</tr>
<tr>
<td>&quot; August</td>
<td>1.644</td>
<td>1.70</td>
<td>1.39</td>
</tr>
<tr>
<td>&quot; September</td>
<td>1.646</td>
<td>1.71</td>
<td>1.33</td>
</tr>
<tr>
<td>&quot; October</td>
<td>1.608</td>
<td>1.74</td>
<td>2.00</td>
</tr>
</tbody>
</table>
As a result of the variations in market rates it was generally more profitable for banks to borrow from the Federal Reserve Banks to make temporary adjustments in reserve positions than to sell bills in the market at a low price and to purchase them back later at a higher price. These developments are in great contrast to the situation in which short-term securities could be readily liquidated at established prices.

**Effect on government security market.**

And as a result of the withdrawal of support from the government security market, prices of securities declined "to as much as three points below par" in the spring of 1951, subsequently "rose as much as two points". Yields on the longest term government bonds "rose about one third of a point to approximately the levels of 1939." 1

---

1. Federal Reserve Bulletin, February 1951, P.119
2. Ibid. P.115
Lastly, as a result of the withdrawal of rigid support from the bond market, large scale monetization of bonds also by institutional investors ceased.

Probable reasons for not selling bonds by these holders, might be that they could find no longer ready buyers or if buyers were available prices offered by them were not favourable. Unwillingness to sell at losses was also an important consideration. Any way, the fact was that in general, investor buying was on a small scale.

The cessation of the monetization of government securities had a number of restraining effect. First, its restraining effect was on investment, because banks and non-bank lenders were unable to obtain funds by selling short-term securities to the Federal Reserve Banks. Secondly, on account of the discontinuance of widespread purchases of government securities by the Federal Reserve Banks, additional reserve funds for banks were not easily available.

**Effect on credit-expansion**

In spite of monetary measures, the total outstanding loans and investments of all commercial banks increased to $6.7 billion in 1951 as compared with $6.5 billion during 1950. But it should be noted that private credit expansion was taking place at a considerably slower rate in 1951 than in 1950. Bank loan expansion was not large. It amounted to $6.1 billion or 11 per cent in 1951 compared with $9.3 billion or 22 per cent in 1950. The increase in bank loans that had

1 and 2 Ibid P.116
occurred, was due to the high demand by defence industries and to meet certain seasonal demands. Other types of loans either decreased or showed no greater than usual seasonal increases. To some extent the decrease in private credit-expansion no doubt, reflected in part a fall in demands as well as limitations on the available supply of credit. The inability to sell government-securities freely which resulted in reduction in bank-reserves was also a restraining factor to check the supply of credit. There was also a substantial growth in bank deposits and currency, reflecting increases in bank loans and holdings of securities and also an inflow of gold. Thus, inspite of reduced private credit-expansion, this growth in deposits reflects the effect of treasury-deficit in 1951 as against a surplus in 1950.1

1. Ibid P.120
Bank credit expanded substantially in 1952, the increase in the last quarter being especially large, accounting for almost 60 per cent of the year's expansion of $9 billion dollars. In this respect the changes in total bank credit in 1952 followed a familiar postwar pattern. Credit expansion in the second-half of the year resulted from a strong demand from consumers, businesses and the Federal government. The increase in consumer credit and real estate credit was due to the suspension of Regulations X and W dealing with consumer installment credit and real estate credit respectively. Total loans and investments of all commercial banks ending on 31st December 1952 increased to $141.4 billions from $133.4 billions in December 1951. With the open market operations of the Federal Reserve Banks being on a moderate scale, the large rise in bank credit put reserve positions of member banks under severe pressure for a greater part of 1952. Consequently, member banks were forced to resume borrowing from the Federal Reserve Banks and during the year the volume of borrowing from the Federal Reserve System averaged as much as $780 millions; borrowing in December, 1952, being $1.6 billion, the largest since 1921. Such a high level of member bank borrowing was responsible for restoring initiative to the Federal Reserve for influencing the cost, availability, and supply of credit through the discount mechanism. It was in these circumstances that the Federal Reserve Banks raised the discount rates from 1\% to 2 per cent in the middle of January, 1953.

1. Ibid P.92  
2. Ibid P.97
During the years of the Korean hostilities the monetary policy of the Federal Reserve Bank was formulated to attain two important aims. First, the Banks' aim was to check inflationary pressures arising out of a scramble for goods by consumers and businesses, financed in large part through credit-expansion. Therefore the Federal Reserve Banks used qualitative and quantitative monetary measures to shift the use of credit from non-essential purposes to essential purposes. Secondly the aim of the Federal Reserve System was to assist the treasury in its financing operations. Since the "Accord" the Banks employed a variety of techniques to minimise the monetary effects while such operations were going on and to get the money back out of the market as soon as they were over. This seemed to have been attained by undertaking open market purchases.