CHAPTER II

INSTRUMENTS OF CREDIT CONTROL
INSTRUMENTS OF CREDIT CONTROL

Problem of credit control all over the world has gained paramount importance. Effectiveness of credit control policy of a country goes to define the solidarity and organisational pattern of the money market of that country. Truly speaking, credit control is the regulatory lever in the hands of financial authorities in any country which enables the mobilisation of credit into the desired pools. Credit control policy is nothing but an organisation of various instruments of credit control.
The methods of credit control are many and varied and have been adopted by different countries according to economic situations and particular circumstances prevailing. However, there has not been a change in the fundamental facts and all methods, for the sake of convenience can be divided into two broad groups:

(1) General or Quantitative Credit Control Measures.

(2) Selective or Qualitative Credit Control Measures.

General credit control aims at regulating the total flow of credit into the money market leaving the internal adjustment between different uses to take care of itself. It is mainly done by restricting the powers of the credit creating agencies to create more credit or making the credit costlier and thus producing a dampening effect upon those who want to borrow. It also works via shaking of confidence through a fall in the prices of long term securities, curtailment of investment and thus reduction in the money income of the people leading to a fall in the effective demand.

Selective credit control are more of an administrative nature and aim at restricting the over flow of credit in the particular sector alone. These do not aim at overall curtailment of credit but only its readjustment for particular purposes. It is thus a discriminating short-term device and more akin to an administrative measure aimed at removing the disequilibrium in the particular field than a monetary measure in the pure sense of the term.
Instrument of Bank Rate

Bank rate in a country is the rate which is minimum and at which the central bank of that country undertakes to discount for the scheduled banks' bills of certain defined qualities. Fluctuations in this rate affect the credit in any market.

In the money market of a country joint stock banks play a vital role in providing funds to businessmen, speculators and even to the producers. Short term lendings by the banks may be well controlled by increasing or decreasing the bank rate. Joint stock banks provide short term finance by discounting the bills of the parties concerned and to recoup the money, the banks rediscount such bills with the central bank. The rate of rediscount of the central bank affects the rate of discount by the commercial banks.

Now we shall see how the credit is controlled by variations in Bank Rate. When bank rate is high the rate of discount of the bills by commercial banks will naturally be high, because if the banks discount the bills on low rate and get them rediscounted at high rate they shall be losing in terms of money. If they raise their rates less people will come forward for discounting their bills. This bank rate also affects the interest rate of the banks. When interest rate is high people will not be taking loans liberally and they will be restricting themselves in various spheres. Businessmen will not like to draw money on high interest and to employ such money in their business, the speculators will not be liberal in transacting large business. Thus
issue of credit by the banks will if-so-facto be lowered.

In contradiction to the above if the bank rate is low more bills will be discounted through banks. Businessmen will employ more capital by drawing funds on low rate of interest and the speculators will be speculating in large amounts. Thus there will be huge credit in the money market. When the bank rate is low and it lowers the interest rate the credit procured on such a rate is known as 'cheapmoney'. High bank rate makes money dear.

Bank rate affects the cost of borrowing for business and consumer spending and therefore tends to control activities based on borrowed funds. Rediscount rates are directly related to the bank rate. The supposed sequence is high bank rate, less member bank borrowing to meet the demands for loans, less credit for customers and less inflationary pressure or less expansion of credit. The antiexpansion effect of higher bank rate may be illustrated by a simple example. Suppose that member bank takes commercial paper (e.g. 90 day maturity) at par of Rs. 1000 to the central bank to get additional reserves. If the rediscount rate or the bank rate is 2% the member bank will get Rs.995. If the bank rate is raised to 3%, the member bank will get Rs.992.50 instead of Rs.995 for the same paper. When we multiply this example by hundreds of rediscounts we make an appreciable decrease in the amount of additional reserves which member banks may get for potential credit expansion. In the same way if the bank rate is brought to 1% the member bank will get Rs.997.50 and when hundreds of rediscount are there, there will be an appreciable.
increase in the amounts of additional reserves which the member banks may get for potential credit expansion. It is in this way, that credit is controlled through bank rate.

The presumption is that banks' rates (interest rates on loans charged by commercial banks) will rise parripassu with higher bank rates to discourage business borrowings for excessive spending and vice versa. The effectiveness of bank rate in contraction of credit, however, turns on whether commercial banks have an easy access to additional reserves. If they have, then high bank rate is largely insignificant for credit control during inflation. The effects of bank rate are offset in the following circumstances:

1. **LARGE AMOUNT OF SHORT-TERM GOVERNMENT SECURITIES HELD BY COMMERCIAL BANKS.**

If the commercial banks hold huge amount of short-term government securities, as in post-war years, they can increase or replenish their reserves either by disposing of those securities. Banks needing additional reserves are usually willing to sacrifice the yield on short-term securities for the sake of liquidity, as the cost of borrowing from the Central Bank is likely to be higher than that of getting the same amounts of reserve funds by disposing off low yield securities during inflation. What is more, commercial banks can get additional reserves by selling government securities at their option; the initiative lies with commercial banks, not with Central Bank - as long as Central Bank stands ready to purchase all the government securities offered
at any time. But this inflationary effect is subject to the constraint that there are no such offsetting forces in operation a Treasury "budgetary surplus" (excess of revenue over expenditure) and a large number of non-bank buyers. The Treasury could use all or part of a budgetary surplus to retire government securities held by the Central bank by drawing down its balances at commercial banks - i.e. the budgetary surplus kept in the form of deposits - and thus reduce bank reserves. But this is unlikely that the actual surplus to be so used will exceed the amount of securities sold by bank holders or the volume of securities maturing within a short period, say, one year. Thus banks do not have to depend on sales of securities to the Central Bank for additional reserves; they simply let them mature without replacement. It is also unlikely that there will be a large number of non bank buyers of government securities, in-as-much as fixed income-yielding assets are emattractive during the period of credit expansion. This means that Central bank would buy much more bank held securities than they could sell to non-bank investors, thus expanding bank reserves unwillingly. Under these circumstances the existence of large bank held securities is a strong presumption for monetary expansion despite high bank rate and discount rate.

2. NON BANK HOLDINGS OF SHORT-TERM OR REDEEMABLE GOVERNMENT SECURITIES.

Higher bank rate may also fail to check expansion of credit, if non bank holders (e.g. insurance companies, dealers and other institutional and individual investors) of Government
Securities were gradually inclined to convert their holding into cash. In the same way expansion of credit is rather difficult if non bank holders of government securities are determined to hold them, and not to convert them into cash. Such holders are expected to convert their holdings into cash because fixed-income yielding assets lose much of their appeal when prices are rising and vice versa. Conversion of non bank holdings into cash have the effect of (a) increasing the velocity of money incident to increased cash balances and of (b) increasing the volume of bank held government securities due to further sales of the banking system by the government for purposes of "refunding" operations (i.e. further government borrowing to pay off existing debt obligations with the proceeds so obtained). The first consequence means an immediate increase in aggregate effective demand, that is, total expenditure or consumption and investment, while the second means a potential increase in bank reserves and therefore in the total money supply.

It is, of course, worth noting that non-bank holders convert their holdings into cash merely to hold the proceeds idle. If so, an increase in the money supply due to above conversion would not increase total spending. But there is no good reason to suppose that non-bank holders would hold the proceeds idle. The contrary is more likely, since there is a strong tendency to get out of money and into goods when prices are rising. Even if the holders in question failed to spend the cash proceeds, there would still remain the inflationary implication of the "refunding" by the sale of additional issues to the banks. But it is will to recall
that there is no simple mechanical connection between monetary expansion and price increases. The main point here is merely that the very possession of large liquid assets like short-term or redeemable bonds implies potential monetary expansion and, more often than not, greater spending, and therefore, it means a possible offset to high interest rates or higher bank rate action.

(3) CENTRAL BANK'S SUPPORT OR OTHERWISE TO GOVT. SECURITIES.

The controlling effect of higher bank rate or discount rates is set off by inflationary effects of increased bank reserves, if the latter effects were sustained by a support policy of the Central Bank. The Central Bank may maintain a policy of keeping up the price of government securities for two reasons: namely, (a) to keep interest charges on the public debt as low as possible, and (b) to prevent the "demoralisation" of the capital market, that is, to protect the financial position of financial institutions holding government bonds. Quite apart from such a policy, it is necessary to understand first with the help of an illustration why the high selling price of government securities has the above-mentioned effects?

It is well to recall the role of interest as a got between relating income and capital. Thus we know that if the interest rate is known, annual income -- which is unknown -- can be found by multiplying interest rate by capital value (e.g. 0.20 x Rs. 10,000 = Rs. 2,000) and the known capital value by
dividing annual income by interest rate (e.g. Rs.2000/- 0.20 = Rs.10,000). But the interest rate that may be earned on a capital asset, that is annual yield on an "investment", in turn is given by annual income divided by capital value (e.g.: Rs. 2000/-/Rs.10,000/- = 0.20). All these relations of course logically adhere to one another.

Now, coming to our original point, it is easy to see why the high price of government bonds has the effect of keeping down the interest cost of public debt. In our example the capital value of an investment is Rs.10,000/- which is equal to the selling price of so many government securities. If, therefore, the price of government securities should be allowed to fall from Rs.10,000/- to say Rs.5000/-, the interest rate or the yield would rise to 0.40 (40 per cent per annum). Such a doubling of the interest rate on long-term government bonds would have a serious effect on the annual interest charges on the public debt. If the public debt outstanding totalled Rs 250 million and the interest charges averaged Rs.5 crores at the current market interest rate of 20 per cent, the cost of servicing the public debt would increase to Rs. 10 crores with a doubling of the interest rate, that is, at 40 per cent. Since such a rise in the average rate of interest on the public debt means more taxes or more borrowing, it is not strange that Central Bank authorities should be interested in maintaining the high price of government securities, what is the same thing, in keeping the interest low and stable. This is done by the Central Bank by purchasing such
securities and creating artificial demand for them in the market when their prices are coming down.

In the same way, though less convincing, the Central banking authorities might be interested in not "demoralising" the capital market. And why should the capital market be dishonoured in the absence of the Central Bank support policy? The mechanical answer lies in the fact that a rise in the interest rate gives rise to capital losses. In our example a doubling of the interest rate from 20% to 40% leads to a halving of the capital value of government bonds, or from Rs 10,000/- to Rs. 5000/- and therefore the capital losses amounting to Rs. 5000/-. This shakes the public faith in long term investments in government securities. It is partly therefore for the purpose of protecting the "public faith" and the "capital position" of the public that the Central Bank authorities may maintain a policy of keeping interest rates low and stable.

The rather inflationary effect of this policy can be seen clearly in the light of what actually happens to bank reserves. In order to implement such a policy the Central Banks must buy as large amounts of government securities as bank and non-bank holders may elect to sell, that is, at par or better. This means that the banks have ready access to additional reserves, while non-bank holders can convert their holdings without capital loss. In either case bank reserves would increase by the amount by which Central Bank holdings of government securities are increased. Such an increase in the bank reserves would of
course offset the anti-inflationary effect of any adhoc rise in rediscount rates or the bank rate. As because a period of rising prices is also a period of a strong demand for credit, the banks will probably be able to expand credit on the basis of such additional reserves as they may get such reserves through sales of securities to Central Bank and the effects of higher bank rate may be circumvented. In the same manner, if the case is opposit lower bank rate may fail to expand credit due to offsetting effects of purchases by the banks at low prices. There may be other impediments to the control of credit through bank rate, but the abovementioned factors seem to be crucial. The main significance of bank rate is that this may serve as very useful barometer for business expectations of "tight" or "loose" money and a lower or higher rate of profit. For a rise in Bank Rate from, say, 1 per cent to 2 percent i.e. equivalent to announcing that credit credit conditions are firmer and that the current rate of profit (percentage return or a capital outlay). Similarly, a decrease in the bank rate by 1 per cent means cheap conditions in the credit market. Experience, however, has exhibited that bank rate in itself has not been powerfulleness depends on its level and liberality or otherwise with which the bills to which the bank rate applies are defined. Of course, the working of bank rate may prove useful if the conditions prevailing in the country concerned, are in support of it.

**METHOD OF OPEN MARKET OPERATIONS.**

Open market operations constitute an important weapon
of credit control in the armoury of Central Banks and another conventional device to check credit expansion. Broadly speaking, open market operations may be said to cover purchases and sales by the Central Bank of not only government securities but equities as well as gold and foreign exchange, but in most countries, the operations are conducted only in Government Securities. The theory underlying these operations is that when a Central Bank disposes off Government securities to banks and other investors, the supply of cash in the market is cutshort and this results in the restricted and controlled supply of credit and hardening of interest rates. On the contrary when the Central Bank purchases such securities in the money market, the supply of money therein is enhanced which means increased availability of credit and a decline in the rates of interest. In this way, theoretically speaking, open market operations are intended to effect desired changes in the supply of credit and the pattern of interest rates, which in turn affect the general level of economic activity.

Thus, briefly stated, the theory of open market operations, as a special form of creation or cancellation of Central Bank credit, is that purchase or sales of securities by the Central tend directly and immediately to increase or decrease the quantity of money in circulation and the cash reserves decrease in the supply of bank cash and, therefore, in the credit creating capacity of the commercial banks, tend still further to increase or decrease the quantity of money; and that
changes in the quantity of money tend to bring about relative changes in money rates and credit conditions, which in turn tend to bring about the desired adjustments in the domestic levels of prices, costs, production and trade.

During the early dawn of central banking the main, or more correctly, the only way sought to the control of credit was that of the bank rate, but this principal way began to be dim in the 'thirties', with a drastic falling off in the demand for capital and accumulation of excess reserves with banks which reduced the need for them to borrow from the Central Banks. And by and by the open market operations opened upon the scene and overshadowed the bank rate as a way to the control of credit. In recent years, however, the bank rate has again come into its own, and besides a number of new monetary devices have also been developed, but never-the-less open market operations still continue to play a dominant and heroic role in the drama of credit control. The general practice of today has been not to use a single but to employ various methods for controlling the credit all over the world. Thus, it is common for Central Banks to use open market operations in conjunction with their bank rate policy, with a view to reinforcing the effects of the bank rate change.

It will not be irrelevant, in this place, to study briefly the controversy which has been going on for some years now as to whether a Central Bank in its open market operations should concentrate on short-term securities only and rely on market forces to transmit the changes in the short-term rate in the long-term sector, or whether it should also intervene in the
The traditional view is that the Central Banks should deal only in short-term securities - either the commercial bills of exchange or the treasury bills. This view is based on the reasoning that Central Bank credit which is inherently inflationary should not be used in the market for long-term funds. Beyond any doubt, there is broad support for this view, but in practice it is not adhered to rigidly and Central Banks in some countries, such as Scandinavian countries, do undertake open market operations in long-term securities from time to time.

OBJECTIVES:

The open market operations have usually been undertaken in a few countries with well-developed and closely integrated financial markets, with following purposes: (i) to ensure seasonal movements in the economy, (ii) to neutralize the affects of Government finance upon the economy, (iii) to neutralize or postpone the effects of gold movements or the movements in the balance of payments (iv) to assist the Government in their financing and to that end to maintain an orderly market for and to avert undue fluctuations in their prices of government securities (v) to create and maintain conditions of cheap money in the market (vi) to hold down particular interest rates (vii) to make the bank rate more effective and (viii) to make the government securities market broad so as to create an institutional framework appropriate for a flexible monetary policy and treasury debt management. In other words open market operations
support government credit or prepare the market in connection
with the issue of new loans or conversion of old loans.

The above mentioned objectives of open market opera-
tions occasionally come into conflict with the use of open market
operations as an instrument of credit control. Despite the absence
of a broad and active security or bill market, and maintenance
of fixed cash reserve ratios by banks in undeveloped money markets,
many of these aims can be achieved through open market operations.

In view of the huge increase in the public debt in most countries
during and since World War II, a small rise in interest rates
leads to a sizeable increase in the cost of servicing the debt,
and it may be that in the interest of debt management, the Govern-
ment would be inclined to relax or even abandon a policy of credit
control which the Central Bank would otherwise like to follow.
But, in practice, such conflicts are rarely prolonged, as, in
the long run, there cannot be any conflict between the Government
and the Central bank in the matter of basic objectives of econo-
mic policy for which the Government has the ultimate responsi-
bility.

Open market operations may be used either as a subsi-
diary instrument with the object of making Bank rate effective,
or independently of the bank rate for effecting changes in the
supply of money with a view to bring about changes in credit
conditions and money rates. Such operations sometimes comprise
of the operations undertaken by the Central bank in management
of the public debt. Debt operation of the Government is to be
included as it can cause the following immediate effects in the
market viz., shifts of cash reserves between the banks, and the Central monetary authority, changes in banks' holidays of Government obligations which increase or decrease their deposit liabilities by equivalent amounts, and changes in the holidays of non-bank investors which affect their cash reserves. The essence of these operations is that the Central Bank goes into the market on its own initiative and buys or sells its assets. A purchase or sale of assets by the Central Bank changes the supply of funds in the market and brings about desired changes in the money rates and credit conditions in the money market.

**FACTORS DETERMINING EFFECTIVENESS.**

Effectiveness of open market operations is determined by three important factors. In the first place, there should be broad and active money market for government securities and well-knit capital market. This will enable a Central Bank to be in a position to buy or sell securities on a considerable scale in order to affect the cash reserves of the banks without causing serious fluctuations in security prices. If the Central Bank fails to affect the cash reserves of the banks, they will have surplus funds and the very aim of open market operations will be forfeited. Secondly, banks should follow the policy of maintaining more or less a fixed ratio between their cash reserves and their deposit liabilities; lending liberally when their actual balances rise above the ratio and contracting when they are falling short of such ratio. Lastly banks should refrain from discounting bills
or taking loans from the Central Bank and so replenish their cash balances depleted by the Central Bank action either due to existence of a convention to that effect or due to their unwillingness to remain indebted to the Central Bank for any length of time. Also, open market operations cannot be undertaken on an adequate scale, if the Central Bank does not have in its portfolio a sufficient volume of securities or if the markets holdings or securities eligible for purchase by the Central Bank are meagre. It may so happen that even in absence of these conditions open market operations work out successfully if the security market is active, provided the fluctuations in the ratios between banks' cash reserves and deposits are not very large. Summing up, the ideal conditions for the success of open market operations are three, viz., the existence of a broad and active security market (or a bill market), the maintenance of fixed cash reserve ratios by banks, and the absence of rediscounting or borrowing from the Central Bank.

In this way the open market operation assume the role of a full-fledged credit instrument for influencing the availability and cost of credit. We may now conclude this brief theoretical discussion on open market operations by quoting the Report of the Ad-hoc Sub-Committee on the Government Security Market (November 1952) on the importance of open market policy in the U.S.A.

"open market operations are not simply another instrument of Federal Reserve Policy equivalent or alternative to changes in discount rates or in reserve requirements. They provide a continuously available and flexible instrument of monetary policy for which there is no substitute, an instrument which affects the
liquidity of the whole economy. They permit the Federal Reserve System to maintain continuously a tone of restraint in the market when financial and economic conditions call for restraint or a tone of ease when that is appropriate. They constitute the only effective means by which the elasticity that was built into our monetary system and credit structure by the Federal Reserve Act can be made to serve constructively the needs of the economy. Without them, the elasticity would often operate capriciously and even perversely to the detriment of the economy."

**VARIATION IN 'RESERVE RATIO'**

Traditional instruments for fighting uncontrolled expansion or contraction of credit - discount rate policy and open market operations became thick-edged and outmoded by the change in the money market conditions and credit formation. It was suggested that the banks should keep with the Central Bank a certain minimum percentage of deposits so that a pool of funds could be constituted to provide a basis of larger and more elastic credit structure than if the same amounts were scattered among the individual banks. However, the ease with which the Central Bank could affect the money market situation at any moment varies with the reserve requirements which are imposed by law upon others banks. Keynes was attracted by the possibility of varying cash ratio as a method more direct than open market operations. He observed one more important use of this method in absorbing the surplus funds of the banks in case the Central Bank cannot do so though open market sales due to meagre securities at its disposal.
To quote W.R. Burgess, "it is not simply a change in physical location, but it makes a change in character and effectiveness of the reserves and enables them to serve more adequately than original purposes. They serve to increase the capacity of the Central Bank to rediscount or otherwise create credit for the purpose of meeting the cash requirements of the commercial banks or of the money market generally."

Changes in Reserve Ratios affect the lending capacity of scheduled banks. If the Central Bank wants to expand credit in market it reduces the reserve ratios of the member-banks on their deposits (otherwise called demand or time liabilities). When banks are allowed to have less reserves, they may lend all the money they possess over and above this limit. Contrary to this when the Central Bank wants to restrict credit it enhances the reserve ratios, whereby the bank have to transfer amounts to cash reserves which they would otherwise lend to the traders, industrialists, speculators etc. Thus an increase or decrease in reserve requirements brings about an adverse effect on the free reserves of the banks, and therefore, on their power of credit expansion.

Instrument of variable reserve ratio was not so common twenty years back as it is today, because only a very few countries had legislation requiring the commercial banks to maintain minimum balances with the Central Bank. Elsewhere the balances of this type were frequently maintained by the commercial banks. During the early stages such reserve requirements were deemed to be almost an exclusive means of ensuring that funds would be
available, when needed; they were thus primarily to safeguard the liquidity of commercial banking system. It was not until the mid' thirties that these reserves began to be regarded as an instrument of monetary policy to influence the availability of money supply in U.S.A. A clear indication to this new concept was the grant of power to vary the requirements for such reserve by law to the Central Bank.

Since early forties statutory authority for Central Banks to establish and vary cash reserve requirements has become a common feature of central banking legislation. In 1955 variable cash reserve requirements were in force in 27 countries, either by statute or by agreement between the monetary authorities and the commercial banks. However, in the U.K. there are no requirements established by law or by formal agreement. In the U.K. custom regarding minimum ratio is the main guiding factor for commercial banks.

Generally, in a number of countries a single reserve ratio exists for all types of deposits, and in the countries having such provision after 1954, in particular. While in a few countries there is no limitation on the range within which reserve requirements may be varied, in most of the countries the range is limited. Legislation in the several countries provides that changes in the reserve requirements must be gradual, and be effected after giving a prior notice.

LIMITATIONS:

Statutory reserve requirements as a means to credit-
control are subject to certain limitations. First, if member banks happen to have large excess reserves, the basic legal requirements may have to be changed. Whether the maximum limit under the law can be raised is a question of political decision. Secondly, ready access to reserve funds, as under the Federal Reserve support policy, frees member banks' lending operations from the restraining influence of reserve requirements. Thirdly, a large net inflow of gold, owing to, say, a persistent export surplus, would increase member banks' reserves to offset the effects of variation in reserve requirements. Lastly, the policy of keeping interest rates low and stable, may favour large member bank reserves and thus discourage too drastic increases in reserve requirements.

In this respect an American example will not be irrelevant. Former chairman Reserve System proposed that the legal requirements raised from 20% to 25% against demand deposits and from 6% to 10% against time or savings deposits for member banks (to be carried in cash or short-term government securities). He further proposed that the Federal Reserve Banks be authorised to impose "special reserves" in addition to the existing legal requirements, for non-member as well as member banks (to be carried in short-term Government securities as cash in banks' own vaults, or on deposits with correspondent banks). The immediate object of special reserve requirements is to free large amounts of government securities in the hands of the banks and thus prevent them from being sold to meet the demand for bank loans. The first of these proposals - to raise basic reserve
requirements of all commercial banks - is considered as possible offset to gold acquisition and purchases of government securities by the Federal Reserve Banks. The second proposal with respect to "special Reserves" is in the nature of an emergency anti-inflation measure. Whatever objections may be raised against the plan, drastic increases (i.e. beyond the upper limit in legal reserve requirements are consistent with the general anti-inflation programme as well as with the general principle that credit policy should be determined by reference to its own standards rather than to fiscal considerations.

GENERAL CREDIT CONTROL MEASURES --

A Comparative Study

Undoubtedly, all the three measures of general credit control affect the level of bank reserves but differ on various grounds. In the first place, whereas Bank Rate produces its impact indirectly through variations in the cost of acquiring the reserves through borrowing from the Central Bank, open market operations (like changes in reserve requirements of banks) affect the reserve base directly. Secondly, while bank rate changes are made occasionally and variations in reserve requirements much less frequently, open market operations are a continuous process carried on unobtrusively, by the Central Bank on a day-to-day and

0 Testimony before a Joint Congressional Committee, April 13, * e.g. The Fed. Adv. Council, an advisory group of leading bankers from each of the Fed. Res. Banks, opposed the Eccles plan on the grounds that it might cause such credit deflation as to check production, that it would be "a step towards socialisation of banking" and that present powers of the Fed. Res. System and the Treasury are adequate if fully used.
week-to-week basis on even the smallest scale. Thirdly, there
is an element of compulsion in the conduct of open market ope-

trations by the Central Bank in the sense that the bank only
varies the price (i.e. the yield) of securities so as to induce
holders to buy or sell and does not compel the holders to buy
or sell. Fourthly, while open market operations can have a direct
and immediate effect on the volume of credit and interest rates
generally, the bank rate action depends only on its indirect
effects on money supply and credit through primary changes in
short-term money rates. Lastly, the effects of bank rate action
on the long-term rates of interest are of a secondary nature,
unlike open market operations which can produce a direct influ-
ence on the long-term rate through operations in long-term secu-

rities.

SELECTIVE MEASURES OF CREDIT CONTROL

The end of the Second War brought of the scene the
measures of Selective Credit Controls, measures so adopted in
the various countries being different from general or quantita-
tive monetary controls, exercised through the bank rate, open
market operations, flexible reserve requirements and which have
been just pointed out, through their direct impact upon the cash
resources of the bank and consequently on the volume of credit
bring the banks to adopt a cautious advances policy. " Selective
Credit Controls, on the other hand, envisage direct restrict the
ability of borrowers to borrow for particular purposes or against
designated security without affecting the lending capacity of.
banks." Their timing and nature have varied according to different circumstances in different countries. In the U.S.A. the fields in which selective control has been experimented viz., stock market, consumer and real estate credit, were under particular circumstances specially volatile and constituted of source of instability in the economy. The requisites of development in the postwar years with an emphasis on low interest rates have in most countries predicated correspondingly greater accent on other techniques of credit control; specially selective ones. Again, apart from the desire to limit expansion in sectors considered undesirable or less essential there has been a positive effort pool the credit into desired uses. This fits in not only in the case of the countries relatively more developed like U.K., U.S.A. and France, but also in the case of less developed countries which are seeking after development through various programmes. Really speaking, in the under-developed countries faith had been pinned more with newer techniques because of their inherent limitations on the use of quantitative controls by the central bank arising out of the relative immaturity of money market institutions. The out break of korean War led to a sewing back to monetary policy as an instrument of ensuring economic stability, as nations were reluctant to reimpose physical or price controls reminiscent of war time suffering. The new monetary policy was characterised not only by return to traditional techniques but also by the newly evolved measures of selective controls, flexible reserve requirements, etc.
It may be pointed out here that while selective credit controls are usually constructed as a form of direct check bank advances, an element of selection could also be introduced into a quantitative measures of control. Thus in Japan and Belgium, preferential rates of rediscount are applied by the central bank to bills covering exports. Or as in Australia the central bank may require scheduled commercial banks to apply lower rates of interest on certain types of loans. Exemption of certain types of deposits or assets, were the reserve requirements are linked to assets, from the maintenance of compulsory reserves as in some Latin American countries, could also be regarded as a positive mode of exercising selective control. In the same way open market operations could be aimed of stabilising the prices either of short-term or long-term bonds or securities. We may now turn to a brief review of various ways of selective credit control.

MARGIN REQUIREMENTS:

One of the selective weapons for control of credit in the hands of a Central Bank is "margin requirements" regulations. Like consumer credit control in America, this weapon is selective one with respect to the field of application and countercyclical in effect (i.e. to fight both inflation and deflation). The weapon is designed to prevent the typical "boom bust" pattern as happen in the end of 1929 attributing to a collapse of stock market in England. The "get-rich-quick" speculative mania of the 1920's would have been probaly absent in the world history
of credit and banking had there been provision of margin requirement regulations.

MECHANISM INVOLVED:

The mechanism involved is fairly simple. The demand for speculative credit is to be controlled by regulating the volume of credit which one may secure to fulfil the ends that are not in general interest. The "margin" denotes the amount of cash one must put up over and above one may borrow on his stock from a bank, a broker or a dealer. Thus if a loan of Rs.9,000/- is secured by stock worth Rs.10,000/-, the margin is said to be Rs.1,000/- for 10 per cent of the value of stock. With a 10 % margin therefore, one can borrow 90 per cent of the value of his collateral security. With a margin ratio of 100 per cent, one can borrow nothing as was actually the case during 1946-47 in America. We may generalise the rule of margin requirements by stating that 'the higher the margin required, the more cash one would have to put up or the less credit one could obtain for fulfilling his purpose and vice-versa. To see the effects of margin requirements, we shall probe into the following three cases, viz., margin requirements of 10 per cent, 75 per cent and 100 per cent.

If margin requirements are 10 per cent, a speculator could buy 100 shares of stock at Rs.100 each, and make Rs.500/- profit on the Rs.9,000/- borrowed, given a rise of 5 points (Rs.5/- per share). With a 75 per cent ratio, a cash payment of Rs.1,000/- could buy about 13 shares at Rs.100 each, and net about Rs 65/- profit on the borrowed amount of Rs 325/- (25 per cent of Rs.1300/- which is the market price of the shares), given
a rise of 5 points. With a 100 per cent ratio, a speculator with Rs.1000/- cash to invest could buy 10 shares at Rs.100/- each and make only Rs 50/- given a rise of 5 points. Apparently it is clear that no credit involved in the last case. In this manner margin requirements when raised, reduce the demand for speculative credit.

EFFECTS OF MARGIN REQUIREMENTS:

Effects of changes in the margin requirements on the credit are vital and to understand them clearly the effects of margin requirements have been discussed below.

The ratio of margin requirements are, to a large extent, responsible for mobilising the funds to certain channels. Higher margin requirements during the period of rising prices direct investible funds from speculative to productive channels. This is important, since the use of credit for expansion of plant and equipment or for carrying larger inventories would make more goods and services available relative to effective demand and thus help minimise inflationary pressure. It is, therefore, not surprising that margin ratio was raised to 100 per cent in America during 1946-47 when there was postwar booming conditions. High margin requirements reduce the volume of credit and therefore that credit is used rationally for productive purposes. On the contrary, if margin requirements are low, the size of credit available is higher and the financial institutions begin to provide credit facilities liberally for speculative purposes also.
High margin requirements have the effect of checking undue monetary expansion. With high margin requirements in effect, commercial banks would be prevented from creating large volume of speculative "bank-money" on a fractional reserve basis as to increase the total money supply significantly. Otherwise the money supply would increase relative to real income (production or output ) to increase an upward pressure on general prices. It is so because in conditions of full employment real income can increase only by a little degree. In other words in case of low margin requirements there is likely to be more purchasing power to bid up the prices of scarce goods and services than can be offset by available production. Although there is no direct or simple connection between the money supply and expenditure, a period of rising prices is highly conductive to a flight of money into goods. Thus when the purchasing power of money is deteriorating rapidly, there is a strong presumption in favour of the view that an increase in the money supply would increase effective demand or expenditure much more than if the value of money remained stable.

It is a truism that "easy money" is easy to spend, and therefore aggregate spending is bound to increase under cheap money conditions. To see the income effect of higher margin requirements, we may resort to the supposition that speculators could make high profits on "borrowed money". The "get-rich-quick" psychology of stock market speculators might lead to reckless spending and to a mania for "easy money". Such spending would
have secondary effects on the incomes and expenditures of other recipients, thus increasing effective demand relative to effective supply. High requirements of margin would reduce inflationary effect of speculative profits upon the income-expenditure structure of the economy, and would thus contribute to the prevention of "boom bust" development. On the other hand low reserve requirements shall bring somewhat inflationary conditions.

High margin requirements go a long way towards eliminating the threat of speculative activity to the stability of the economy. The risk and uncertainties attending the corporate form of business organisation would be greatly minimised, under margin requirement regulations, so that the economy could enjoy the advantage of "venture capital" without the disadvantage of volatile fluctuations in aggregate demand. This is not to say, of course, that margin requirements alone stabilize activity, but it does emphasize the usefulness of the weapon in minimising cyclical disturbances. Needless to say, margin requirements should be lowered to enhance "bullish sentiment in times of low activity."

MORAL SUASION BY CENTRAL BANK

The measure of moral suasion has got the advantage of creating a less unfavourable psychological reaction, because it is not accompanied by statutory or administrative compulsion or threats of punitive action. If any sign of compulsion or of a threat can be detected therein, it should be regarded as a friendly and well-meant warning or as strongly worded advice
rather than as indirect compulsion. Really speaking, the theory of moral suasion implies, the use of moral force or advice by a central bank to lead the commercial banks in matters of their credit creation. The moral suasion, wherever possible, makes it easier for a Central Bank to secure the willing and active cooperation of the commercial banks in the spirit as well as the latter; and without such cooperation the Central Banks cannot hope to achieve tangible results in the long run in the direction of qualitative control of credit. Moreover, moral suasion can be adopted by the Central Banks for the purpose of trying to exert an appropriate influence also on the non-borrowing commercial banks and the other kinds of credit and financial institutions, acquired in recent times a relatively important place in the credit and financial structure of most countries, and whose operations can, therefore, seriously frustrate the credit policy of the Central Bank.

Moral suasion can be undertaken with a view to ensuring that credit be directed into those lines which have priority in the programme of development. It has also the objective of ensuring that the resources of banks are not utilized for purely speculative purposes, which may endanger the interest of the depositors. This weapon has taken the form of consultations and agreements with commercial banks for exercising voluntary restraint in Australia, Sweden, Ceylon and Switzerland. The bank of Japan warned the City Banks against extending loans for speculative purposes. In Belgium the banks were recommended to restrict accommodation on instalment sales. The Bank of England
commended a unique position in this respect. At the celebration of 250th anniversary of the Bank of England in July, 1949, the Chancellor of Exchequer said, "the position of the bank today was not, however, entirely due to the excellence of its technique or to the sheer strength of its financial position. It was due to its great moral influence in the world of finance."

In this manner moral suasion has implied any type of advice or warning in respect of commercial banks' lendings in selected spheres of credit activities.

**DIRECT ACTION**

In case of the countries where Central Banks do not enjoy special powers in this respect, the direct action may take form either of a refusal on the part of the Central Bank to rediscount for banks whose credit policy is deemed as being detrimental to the sound credit conditions, or a refusal to grant further rediscounts to banks whose borrowings from the Central Bank are considered to be overwhelming in relation to their capital and resource or to their proportionate share of the resources of the Central Bank. This decision, whether the share of resources of a bank is excessive or not is taken by comparing it with that of other commercial banks. Where the Central Bank want to avert having to detract from its position as the lender of the last resort, it need not refuse to rediscount, but may charge such banks different penalty rates in addition to the official rate of discount.
Direct action has been resorted to from time to time either as an alternative to discount rate policy or to open-market operations or in conjunction with them. In broad sense direct action may be taken to include moral suasion; i.e. moral suasion may be regarded as one of the forms of direct action and has been treated in this manner by way a writer. Direct action has derived its designation from the fact that it implies direct dealing with individual banks, whereas discount rate policy is applied generally and objectively to all institutions which have to borrow from the Central Bank, and whereas open market operations are characterised by their impersonal application as well as by their repercussions on banks and the money markets in general.

MORAL SUASION V/S DIRECT ACTION:

In this connection it appear rather necessary to make a clear distinction between moral suasion and direct action. 'Direct action' covers only those cases where the Central Bank decides to take coercive measures against an offending commercial or other financial institution as it can within the limits of its powers and functions, or to issue directives to banks generally concerning their lending and investment operations under special statutory authority, while 'moral suasion' refers to those case where the Central Bank endeavours to achieve its object by making suitable representations to the institutions concerned and relying its power of persuasion and moral influence. In this way, 'Direct action' and 'moral suasion' are two distinct ideas and have their respective places in the field of credit control.
RATIONING OF CREDIT

Rationing of credit by the Central Bank is also quoted as a decisive method of selective credit control used in several countries. This manifests itself either in limiting the amount made available to each member bank or in shortening of the currency of bills eligible for rediscount. "Rationing of Credit" as observed by a celebrated Central Banker, "is a logical concomitant of the intensive and extensive planning adopted by authoritarian states." Expressing his views on the adoption of this measure in U.S.S.R. Katzenellenbaum points out, "the discount rate of the Central Bank is neither an index of the supply and demand of loan funds nor a regulator of such supply," but "the State Bank is guided by another principle...i.e. allocation of funds among financially sound credit aspirants in accordance with a definite plan."

The method of rationing of credit may prove to be a great significance only when the commercial banks in the money market are large borrowers of credit from the Central Bank. In countries where the democracy is the watchward of life, not excluding financial matters, rationing of credit without legal backing may not be conceived of as a popular instrument of credit policy.

1. Since 1936, the Bank of Mexico has fixed the credit limits based on the amount of the resources of each member bank. From October 1, 1948, the Bank of France laid down a rediscount ceiling for each commercial bank based on the level prevailing at that time.

Efficacy of Selective Controls

The assessment of the relative efficacy of the various measures of selective controls is rather difficult, because by and large, they have not functioned in isolation. Really speaking, in the broad sense selective controls have had a greater measure of success when the inflationary pressure have been contained by other measures such as discount rates, reserve requirements and open market operations or through disinflationary fiscal policy. Where inflationary pressures have been of serious proportions and where quantitative credit controls or fiscal restraint have been more or less held in abeyance, selective controls, by themselves, have generally been a failure. This has held truth in the countries like U.S.A., France, Sweden, Australia and others. Some of the limitations of the selective control measures during highly inflationary periods have stemmed from those of monetary policy itself, which tends to be powerless in the face of rising budget-deficits and even rising wage demands. Selective credit controls have, however, proved to be useful adjuncts to quantitative control measures during the periods of mild-inflation.

The size of the lending sector to which the selective credit controls apply, is one of the determinants of success or failure of such controls. If the central banks have the authority to regulate only the advances policy of the 'banks' when there one other lenders outside its control, there is likelihood of control being evaded through resort to other lenders who are
outside the control of the central banks. This happened in Australia where the insurance companies and private lenders nullified the central bank policy in respect of the financing of Hire Purchase. In United States of America, Federal Reserve Bank has got the power not only to control the credit extended by the banking system to the stock market, but also those extended by brokers and all other lenders in that field. Its power to control instalment credit covers lenders other than banks and the makers of bills for instalment financing.

The institutional set up in the country concerned, is also relevant in assessing the efficacy of selective controls. Thus, a high degree of concentration and responsibility in banking circles, as in the United Kingdom, have smoothened the task of the authorities in the application of qualitative controls in that country. In the countries with a wide spread network of small banks, all of which may not be fully aware of their responsibility, there emerges the problem of enforcement. Again, where traders and dealers operate in more than one commodity, or command sufficient credit-worthiness to obtain clean loans (likely enough in underdeveloped countries) the risk of circumvention of selective controls, would be greater.

In the countries where the objective has been to channel credit into particular sectors through a system of priorities such as that obtaining in the U.K. under the control of capital issues or through a system of preferred treatment accorded to bills of industrial equipment as in France, some degree of success has been attained in the operation of selective controls. The
practice of offering direct inducement to banks through a system of preferred re-discounts in respect of particular types of bills, such as for example, those relating to export bills in Belgium and Japan, has generally assisted the flow of credit through the desired channels. In Australia, the Commonwealth Bank lends through its specialized departments directly to primary producers and industrial undertakings, and has thus contributed to the development of these sectors, particularly in the early stages. In United States, on the other hand, the power of Federal Reserve Banks to provide direct loans granted during the depression of 1929 has not since been utilised appreciably as in the rapidly expanding economy, the need for it had practically disappeared. As a matter of fact, the retention of this provision is no longer considered necessary by the Federal Reserve Board.

Despite some of their limitations, selective credit controls have proved a success in general sense. They have generally tended to keep down demand arising through expansion of the volume of bank credit and to that extent the pressure on prices. In most of the spheres where they have operated the lendings have been brought down or at least their growth restrained. Where there has been no scope for evasion through recourse to other lenders or against other securities, their success has been more pronounced. The success of selective credit control measures either in arresting upward trend or inducing a downward trend in the prices of items to which they have been applied, depends upon so many factors, some of which have been referred to above. The most important factor, however, is the basic demand and supply
position of the relevant item or commodity. If the supply is anticipated to be short relatively to demand and the part played by bank credit in the finance of marketing and distribution is small, the role of monetary policy itself is limited and a rise in prices cannot usually be checked without recourse to price control, rationing or other physical control. Nevertheless, it is clear that in the absence of selective credit controls, the rise in prices would be greater. The selective credit controls would be greater. The selective credit controls would thus exercise a moderating influence on the course of prices. Again selective credit control has proved to be a readily usable and flexible instrument in certain sectors.