SELECTIVE CREDIT CONTROLS: UNITED KINGDOM, UNITED STATES AND INDIAN EXPERIENCE

By

SHARMISHTHA A. BHIMNATHWALA

Bachelor of Arts
Gujarat University
Ahmedabad, India
1956

Master of Arts
M. S. University of Baroda
Baroda, India
1958

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the Oklahoma State University
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Thesis Approved:

Frank S. Steindl
Thesis Adviser

A T Tranton

J. Boggs
Dean of the Graduate School

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CHAPTER I

INTRODUCTION

A. Revival of Monetary Policy

Since the Second World War a number of countries have returned to an active use of monetary policy. The revival of general credit controls as policy instruments has assumed forms somewhat different from the ones familiar in pre-war days. Restrictive monetary policy instead of an "easy money" policy has become the general trend. In addition to simple, classical techniques of discount rate changes and open market operations, central banks have added a variety of new and complex weapons to their arsenal, i.e. selective credit controls. The economic policy and underlying financial background has changed greatly in many countries. The goals of maintaining a high level of employment and economic growth without incurring inflation provide a motive force in the formation of various policies. Monetary policy has been adapted, therefore, to the present needs of the economy in different countries. The emphasis throughout this study is on the analysis of different techniques used in applying selective credit controls.

The revival of monetary policy and increased use of selective credit controls is based on enlarging the definition and scope of monetary policy. There are three aspects of this evolution.

1. According to traditional monetary doctrine, the central bank should concern itself with maintaining the value of money by controlling its volume. On the other hand, the credit control doctrine refers to the effects of actions of the monetary authorities on conditions in the credit market, that is, on the cost and the availability aspects of credit and terms of lending, etc. This does not necessarily deny that the central bank's actions bring about changes in the size of the stock of money. Actually, central banks everywhere have concentrated on credit control as the basic pattern of their monetary policy. Until the beginning of the 20th century the "real bills" ideology was most persistent; it asserted that as a regulator of the volume of money and credit, the central bank should rediscount only "real bills" so that the commercial banks would observe sound banking principles in making loans and therefore provide finance only for short term bonafide transactions. Consequently, ". . . the expansion of bank money will be in proportion to any extension in trade that may take place, or to the 'needs of trade' . . ."[1] According to the modern credit view, the banking system is not a monetary agency but a source of loanable funds. In most discussions major emphasis is given to the role of the central bank as the determiner and controller of the volume, cost, and availability of loanable funds. The control of liquidity, therefore, should be the main task of the central bank. ". . . the factor which monetary policy should seek to influence or control . . . is nothing less than

[1] L. W. Mints, A History of Banking Theory (University of Chicago Press, Chicago, 1945), p. 9.

the state of liquidity of the whole economy."[2] With the advance of the selective credit controls, the central bank's control goes one step further in determining the distribution and allocation of loanable funds.

2. The second aspect of the evolution was concerned with the application of various instruments of monetary policy. During the twenties, the focus was on the cost of credit. The success of monetary policy was judged mainly by the effects of the changes in the rate of interest. It was expected that by changing the cost of credit, the demand for credit can be expanded or contracted in the interest of the economy. But the experience after the recovery from the depression, and especially after 1939, implied that the availability aspect of credit in practice is as important as its cost. Because of this, the importance of the use of other instruments, like open market operations and flexible reserve ratios, was realized. It also became increasingly realized that the monetary authorities should be able to locate and control the particular source of instability or speculation in the credit mechanism, if the need arose. This realization showed the importance of the selective credit controls.

3. During the post-war years, non-bank financial intermediaries were getting more important in the financial structure of the economy. They participated with the commercial banks in the expansion of credit and the provision of liquidity to the economy which the central banks intended to control. But no powers were authorized for the central

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[2] Committee on the Working of the Monetary System-Report (London, H.M.S.O., 1959), p. 337.

banks to control directly the operations of these institutions. From the view-point of monetary management, this has become a disturbing factor. When a restrictive monetary policy is applied with the ultimate view to restrict the general spending in the economy, these institutions lessen the impact of the actions of the central bank, by making the liquidity at their disposal available to the spenders. Many central banks have found it necessary to influence and control these specialized institutions. In other words, the need is felt that the control of the central bank should be extended to the non-bank financial institutions, too. A few central banks, such as the Bank of England and the Bank of Canada, have already tried, by way of moral suasion, to influence the lending activities of some such non-bank financial institutions with a view to making monetary policy more effective. This aspect, though not discussed in this thesis, is a very important and interesting part of the evolutionary nature and extending scope of the monetary policy.

B. Purpose and Plan of Study

The purpose of this study is to analyze the application of selective credit controls in the United Kingdom, the United States, and India. The reason for selecting these three countries is that each of them has a different financial structure. The financial structure of the United Kingdom is highly centralized, while that of the United States is highly decentralized and diversified. India has a peculiar financial structure, with the existence of a non-monetised sector on the one end and indigenous banks on the other. Both the United Kingdom and the United States are experiencing balance-of-payments difficulties.

Both nations are interested in shaping monetary policy in such a way that a high level of employment and output is maintained without incurring inflation. India has somewhat different objectives. She wants to devise monetary policy as a means of allocating the available funds to planned priorities and to control speculative tendencies so as to relieve inflationary pressures.

The prevailing socio-political outlook has its impact on the economic ideology, too. It is more so reflected in the application of the various instruments of credit control. In Great Britian and other European countries, as well as in India and many other developing economies, selective credit controls are used quite extensively along with general instruments. In the United States, general credit controls are preferred to selective controls; the latter are acceptable only as emergency measures. It is intended to make explicit the impact of socio-economic ideology in the application of selective credit controls in respective countries.

Whether selective credit controls should be included as one of the permanent techniques of monetary management is a controversial issue. Whether it should be given a complementary or substitute role to the other instruments is also a highly discussed topic. No attempt is made here to pass judgement on these issues.

Selective credit controls are a new addition to the existing instruments of monetary policy. This study implies that they can be used along with other instruments to increase the scope and effectiveness of monetary management in general. They can also be used to some extent to solve the problems of inflation and credit allocation in the economy according to priorities.

The next chapter discusses selective credit controls in general. The need for the application of the selective credit controls is explained by hinting at the limitations of the general monetary controls. In the last two sections of the chapter selective controls are analyzed in their various aspects such as historical development, different objectives, and types and techniques.

Chapters on the United Kingdom, the United States, and India begin with a brief survey of the financial structure of the respective country. A short analysis has also been made in each chapter regarding the effectiveness of the general instruments of credit control. Selective credit controls are then discussed, in view of the financial structure, the needs of the economy which monetary policy is expected to achieve.

CHAPTER II

SELECTIVE CREDIT CONTROLS IN THE CREDIT CONTROL MECHANISM

A. General Credit Controls

Control of the capacity of commercial banks to create credit is the most important function of the central bank. Traditionally, bank-rate, open market operations, and minimum reserve requirements are the three instruments used for affecting the reserves of commercial banks, on the basis of which the credit is created. A brief analysis of each would be appropriate at this point.

1. Bank-Rate

Bank-rate influences the cost of credit, i.e., the rate of interest. As the lender of the last resort, the central bank rediscounts eligible paper and makes advances to the commercial banks, charging the bank-rate for each loan. A rise in bank-rate is expected to be followed by a corresponding rise in short-term market rates. The cost of borrowing in general increases. This in turn decreases the demand for credit and consequently the total flow of spending. Thus credit creating capacity of the banks is not directly affected. However, because of the decrease in the demand for credit, less credit will be created which is exactly the purpose of the central bank in raising the bank-rate. Primary effects on short-term rates affect the long-term rates. A fall in the bank-rate similarly makes money conditions easy and increases the demand for credit. In the context of inflation, bank-rate is sometimes made a penalty rate by keeping it at a level higher than that received by the commercial banks on their loans and investments. Changes in bank-rate are generally considered as a signal or an "important index" of the Central bank's policy.[1] The success of bank-rate policy depends upon the elasticity of the demand for credit, for its cost as well as the need of the commercial banks for rediscounts at the central bank

2. Open Market Operations

Open market operations affect the cost and availability of credit by influencing the reserve position of the commercial banks. When the central bank sells securities, the cash reserves of the commercial banks are decreased and their credit creating capacity is reduced. When the central bank purchases securities, the cash reserves of the commercial banks increase, which in turn makes money conditions easy. Open market operations are quite flexible with respect to timing and magnitude. They can be simultaneously conducted in long-term as well as short-term securities to influence both long-term and short-term rates. Open market operations can be used for purposes such as to off-set the disturbing effects of gold movements or of government loans for preparing background for bank-rate changes and for maintaining or-derly conditions in the money market. The success of the open market operations will depend upon the response of the banks. Co-ordination with other instruments of credit control is also essential.

3. Reserve Requirement Policy

Changes in the reserve requirement ratio, i.e. ratio of required reserves to deposits, affect the availability of credit by influencing

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[1] R. A. Young, "Tools and Processes of Monetary Policy," United States Monetary Policy (American Assembly, Columbia University, 1958), p. 25.

the size of the reserves necessary to support a given volume of lending. In other words, by changing the base for credit expansion, changes in the reserve requirement aim to control the credit expanding capacity of the banks. Before World War II fixed reserve requirements were used for maintaining necessary liquidity and solvency of the banking system. These requirements consisted of cash and deposits with the central bank in a certain proportion to their deposit liabilities.

B. Selective Credit Controls

1. The Role of Selective Credit Controls

Bank-rate, open market operations, and changes in the reserve requirement ratio are the "general" instruments of monetary control which influence the cost, volume, and availability of credit in general. These instruments are indirect instruments because they influence the volume of credit by changing the amount of reserves on the basis of which the banks create credit. All these instruments can be used in complementary manner to increase the mutual effectiveness of the instruments and of the monetary policy itself. General controls aim to control the total supply of money and credit in the economy by affecting all banks equally. They are, therefore, considered impersonal and nondiscriminatory in nature. In reality, however, general controls do not affect all sectors equally. General controls have different effects on different classes of borrowers, depending on (a) the extent to which borrowers rely on bank funds, (b) the existence of non-bank financial intermediaries, and (c) bargaining power of the borrowers.[2] Uniform

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[2]W. L. Smith, "The Effects of Monetary Policy on the Major Sectors of the Economy," Money and Economic Activity, ed. L. S. Ritter (Houghton Miffin Co., Boston, 1961), p. 179.

effects need not, however, be desired on all the sectors of the economy all the time. A need may arise in the context of inflation to control the amount of credit emanating from a particular sector generating inflationary tendency. Or, in an underdeveloped economy, a need may arise to devise monetary policy in such a way that it allocates available funds in channels thought desirable by the monetary authorities. Selective credit controls along with the appropriate general quantitative controls may be more effective here. Selective controls are designed to encourage or discourage specific types of investment and expenditure "by differentiating between the cost and availability of credit to different sectors."[3] Consequently, selective controls allocate funds "without directly affecting the total supply available."[4] It is worthwhile, therefore, to explore what selective credit controls could achieve in the central bank's credit control mechanism. Whether selective credit controls should be included in the armory of credit control operations as one of the instruments, and if included what importance should be given to them in practice, is a highly controversial issue. Throughout the nineteenth century, selective credit controls tended to remain in the background with little or no emphasis directly. It is essential, therefore, to explain the historical development and philosophy underlying the selective credit controls.

2. Historical Development and Recent Experience

The Real Bills doctrine for central banking can be considered as a first historical glimpse of the selective approach in the central

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[3] I. G. Patel, "Selective Credit Controls in Underdeveloped Economies," I.M.F. Staff Papers, IV (Washington, D. C., 1954-1955), p. 76.

[4] W. L. Smith, "The Effects of Monetary Policy on the Major Sectors of the Economy," Money and Economic Activity, ed. L. S. Ritter (Houghton Miffin Co., Boston, 1961), p. 179.

bank's function as a lender of the last resort. It became the practice for the central bank to make rules and to decide the quality of the commercial paper which it would rediscount. Paper used to provide fixed capital or finance for stock market operations was not eligible for rediscounting at the central bank. The time of maturity for the paper to be eligible for rediscounting was determined to be a three months maximum. Thus, the selective approach was the basis on which central banking concepts were built. But selective credit controls as such were not used throughout the nineteenth century. The active use of selective credit controls in the twentieth century began during the Second World War only. During the war these controls were employed as one means whereby the available resources could be diverted to defense purposes. During the post-war years selective credit controls were used to offset inflationary pressures. Margin requirements and hire-purchase control in the United Kingdom and consumer credit control in the United States were widely used for this purpose. In developing economies, selective credit controls were tried as policy measures to diversify the economic structure. Efforts were made by applying various selective controls such as margin requirements to discourage the flow of funds in certain sectors. It was expected that those funds would then flow automatically to the desired channels. Discussions were also held as to the extent to which selective credit controls could be used in maintaining an over all stability of the monetary credit system.[5] With the revival of the monetary policy in the fifties, selective credit

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[5] I. G. Patel, "Selective Credit Controls in Underdeveloped Economies," I.M.F. Staff Papers, IV (Washington, D. C., 1954-1955), p. 73-84.

controls were increasingly used as a complement to the general controls. For example, when bank-rate was increased the application of margin requirements in speculative directions or ceiling on particular types of loans or additional directives to the banks may make the bank-rate more effective.

3. Types and Techniques of Selective Credit Controls

Selective credit controls are of two types: (a) quantitative and (b) qualitative.[6] Quantitative controls limit the amount of credit that can be granted for a particular loan or investment. This can be achieved by ceilings on certain types of loans, or by prior approval from the central bank authorities, such as in France, or by capital issue control, such as in England. In some cases, such as in India, the central bank has asked the banks to limit the amount of credit in absolute terms.

Qualitative controls are designed to regulate the distribution of credit among different sectors of the economy. This may be achieved by fixing maximum amounts and maturities for specific loans. Hire-purchase control in the United Kingdom and consumer credit control in the United States may be included in this category.

The methods of applying qualitative controls are different in different cases. Sometimes the central bank issues directives to the commercial banks asking them to follow a particular policy. The central bank is usually backed by legal powers. In some cases the arrangement is done on an informal basis. "moral suasion" which is widely used in

[6] F. B. Tamagna, "Process and Instrument of Monetary Policy: A Comparative Analysis," Monetary Management (Prentice-Hall, New Jersey, 1963), p. 132-158.

the United Kingdom is a case of such informal arrangements. "In a broad sense, moral suasion may be defined as the day-to-day influence that the central bank exercises to induce market institutions to conduct their operations in accordance with its general views and policies."[7] Voluntary credit restraint programs in the United States was an informal arrangement for credit restraint. It was relatively less selective in nature. This was for the first time that non-banking financial institutions were brought under some sort of credit control.

4. Selective Use of General Credit Controls

General instruments of credit control can also be used in a "selective" manner. Rediscount rate can be different for different types of bills, eligible for rediscount. In India, as for example, agricultural bills are rediscounted at one half percent less than the quoted bank-rate. These preferential rates are changed sometimes without any change in the "general" bank-rate. By this device, the central bank may be able to influence, to some extent, the sectoral distribution of loans. Similarly, a penalty rate on excess borrowing by the commercial banks above the predetermined quota may exert quantitative limiting influence upon the loan potential of the banking system.

Reserve requirements can also be used in a selective way. Banks might be permitted to include certain types of assets such as government securities as a part of the legal reserve requirements. This policy may induce the banks to invest more funds in government securities as an alternative for cash reserves. Interest bearing government securities

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[7] Ibid., p. 135.

in the form of reserves are obviously preferable to interest-free deposits at the central bank. In other words, this system may be used to shift the interest and business of the commercial banks towards government securities or whatever the case may be.

The best example of the selective use of the instrument of open market operations is "the bills only" doctrine. The doctrine was applied in the United States during 1953-1960. The essence of "the bills only" policy was that it affected short-term borrowers more relative to long-term borrowers.[8]

By regulating the amount, as well as the terms of lending, selective credit controls in general attempt to influence certain types of demand and expenditure activities qualitatively as well as quantitatively. Their effectiveness depends upon the efficient administration by the central bank and co-operation of the commercial banks in following the directives in real spirit. Technically, it depends upon the accuracy with which the purpose and use of the loan can be identified.[7]

5. Objections to Selective Credit Controls

Selective credit controls are sometimes objected to on the ground that they are difficult to administer. Inefficient administration was one of the criticisms for Capital Issue Control in the United Kingdom. The Commission on Money and Credit in the United States did not favor Consumer Credit Control for the same reason. The second argument against

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[8]Arthur Smithies, "Uses of Selective Credit Controls," United States Monetary Policy (American Assembly, Columbia University, 1958), p. 74.

[9]Commission on Money and Credit, Money and Credit, Their Influence on Jobs, Prices, and Growth (Prentice-Hall, New Jersey, 1961), p. 72-73.

Selective Credit Controls is that it is very difficult to distinguish accurately between the purpose of the loan mentioned by the borrower and actual use of the loan. In other words the controls could be evaded easily. Thirdly, selective credit controls are strongly opposed on the basis that they introduce undue interference of the government which is detrimental to the free enterprise economy. This is the main objection to Consumer Credit Control in the United States. As shall be seen later, most of the objection to Selective Credit Controls arises from ideological and environmental factors such as the financial structure of the economy.

CHAPTER III

UNITED KINGDOM

A. Financial Structure

Since credit control policy of the Bank of England is centered around the money market, the extent and efficacy of such policy depends largely on the nature of that market. It is necessary, therefore, to inquire into the characteristics of the institutional structure of the monetary system of Great Britain.

Great Britain has a very highly organized system of financial institutions. Different institutions extend different types of credit on different terms. The borrowers, therefore, have various alternatives.

1. Commercial Banks

The banking institutions are at the center of the entire network of the financial structure. They are divided into two groups: (a) clearing banks and (b) Scottish banks. These banks are connected with the Bank of England via the Discount houses.

Clearing Banks

Clearing banks are predominant in the commercial banking system of England. They deal mainly with the current accounts. Accordingly, their lending policy is confined to the acquisition of highly liquid assets--an obvious preference for self-liquidating bills. An eight percent "cash ratio"--cash against deposit liabilities--is strictly maintained at the Bank of England. Banks also maintain traditionally a thirty percent 'liquidity ratio' in the form of money at call or at short notice to the discount market, treasury bills and commercial bills as a percentage of total deposits. This is the second line of defense which is also subject to the influence of the Bank of England. Because of this systematic arrangement of the liquid assets, British banks do not hold excess reserves like American banks.

Scottish Banks

The Scottish banks differ from the clearing banks in the following respects. (1) They have the right of note-issue; (2) they have relatively higher proportion of time deposits to total deposits; (3) rules for cash reserves do not apply to the Scottish banks.

The domestic banking business of Scotland is handled by the Scottish banks. Their day-to-day management is completely independent of the English banks, eventhough they are under the same central bank, i.e. the Bank of England. The most interesting point about the Scottish banks is that they have the right of note-issue, which clearing banks do not have. Fixed fiduciary system is adopted as the basis of note-issue, the limit being fixed at £.2.7 million. The issue over the limit of £ 2.7 million is permitted against holding of one hundred percent of Bank of England notes.[1] So, the Bank of England has adequate control over the Scottish banks. Scottish banks have a relatively higher

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[1]Committee on the Working of the Monetary System, Report (London, H.M.S.O., 1959), p. 54.

proportion of time deposits to total deposits and consequently, a higher proportion of investment to total deposits. In 1958, the ratio of time deposits to total deposits was 53 percent and that of investment to total deposits was 45 percent. The respective ratios in English banks were 39 percent and 30 percent.[2]

Rules for cash reserves which apply to English banks, do not apply to Scottish banks. They do not publish any statement concerning the policy or methods. One gets the impression from this analysis that the Scottish banks are a weak link of the financial structure of the United Kingdom which is very difficult to manage by the Bank of England. The business of the Scottish banks is relatively small. The Radcliffe Report has concluded that these banks have comparatively small weight in the total credit structure of the United Kingdom. Moreover, they follow cautious banking policies in their lending operations.[3]

Discount Market

The discount market is the distinct feature of the United Kindom's financial structure. It deals with the purchase and sale of treasury bills and bills of exchange, guaranteed by the acceptance houses, and provides liquidity to the creditors of the bills. The discount houses borrow funds from the clearing banks. These loans constitute very important liquid assets for the banks. When the banks call their loans, the discount houses can use their privilege of rediscounting with the Bank of England. It is worth noting that this facility of rediscounting at the Bank is not granted to any other financial institution.

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[2]Ibid., p. 55.

[3]Ibid., p. 54.

Through its relation with the discount market, the Bank of England has effective control over discount rates, i.e., the cost of credit. The discount market stands as a buffer between the commercial banks and the Bank of England.

2. Non-bank Financial Institutions

Acceptance houses act as intermediary institutions between lenders and borrowers in the private sector. The bills guaranteed by them are highly liquid and eligible for rediscounting at the Bank of England. Issuing houses play the same role for public companies in raising long-term capital. Hire-purchase and financial houses are the source of consumer credit. Most of them are closely linked with the commercial banks in the sense that they borrow their funds from these financial houses. Insurance companies as well as super-annuation and pension funds have vast resources at their disposal which they invest for various business projects. On the whole these non-bank financial institutions add to the liquidity of the economy to a great extent. But they are not under the direct control of the Bank of England. Indirect effects of any measure are proved to be too small to serve any purpose. Consequently, when the Bank pursues a restrictive policy for the commercial banks, they approach the other institutions, and ultimately it becomes difficult to control the supply of money and credit.[4]

B. General Credit Controls

1. Bank-Rate

In the credit control operations of the Bank of England, the discount rate has been the main instrument. By changing the bank-rate

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[4]Ibid., p. 107-109.

the Bank of England can affect the entire structure of interest rates. Open market operations, too, are used to facilitate and make effective bank-rate policy. However, according to the Radcliffe Committee, the experience of the United Kingdom during and after the Second World War was that neither borrowers nor lenders seemed to be considerably influenced by the changes in interest rates. The Radcliffe Committee Report analyzed both the interest incentive and liquidity incentive effects of changes in the rate of interest and came to that conclusion.[5] In the words of Sir Oliver Franks, "While the pressure of interest rates, particularly if spread through the whole structure from short-term to long-term rates, was real, it was also gradual and not very large."[6]

2. Open Market Operations

The function of open market operations in the United Kingdom is regulating the securities market rather than monetary management. As mentioned before in this chapter, they are used to facilitate changes in the interest rate structure by influencing the yields and prices in the gilt-edged market as well as the money supply.

Traditionally the bank-rate has been the most used instrument of credit control in Britain. And that, too, has become less effective in the present complex financial structure.

It is obvious that to make monetary policy more effective, apart from considering the aspects of the quantity and cost of money and credit in aggregate (demand aspects), emphasis has to be laid on its

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[5] Ibid., p. 129-134.

[6] Sir Oliver Franks, Some Reflections on Monetary Policy (Asia Publishing House, 1960), p. 34-35.

availability (on the supply side) and distributive aspects simultaneously, hence, the significance of the direct instruments of credit control in the United Kingdom.

C. Selective Credit Controls

In making a systematic review of the experience in the use of the selective credit controls, this study has been confined to the experience after the Second World War. Capital Issues Control, Moral Suasion, and Hire-purchase Control were widely used selective credit controls in the United Kingdom.

1. Control of Capital Issues

During the war, the government issued regulations for new capital issues, bank advances, and other forms of borrowing. A Capital Issue Committee (CIC) was created to advise the treasury on the task of approving or rejecting applications for borrowing. The treasury via the Bank of England then passed its judgement to the banks. These wartime regulations were continued in the Borrowing (control and guarantees) Act of 1946. All requests for bank borrowing in excess of £ 50,000 (£ 10,000 during March-July 1958) were referred to the CIC. The purpose was to check speculative tendencies as well as to allocate the available bank funds in conformity with existing priorities. Defense and export considerations were given foremost priorities. In the United Kingdom banks traditionally respect the wishes of the Bank of England. So the existence of this control itself served to eliminate some applications, e.g., the banks did not foreward those applications to the CIC for further scrutiny which they did not consider to be in conformity with the established instructions from the Bank of England.

In practice, therefore, "it has never been a control of investment, but purely a control of the raising of larger sums."[7] However, CIC's operations in particular and capital issues control in general were criticized severely.

Capital issues control was the control over the issues for fixed capital purposes. There was no control on internally financed investment. There was also no control on borrowing for working capital. These exemptions were quite important as pretexts to raise the necessary capital and to circumvent the spirit of capital issue control. "Further, until about 1955 private firms were unusually liquid and quite able to finance considerable investment internally without recourse to the new-issues market."[8] Moreover, the control did not apply to the public sector's borrowing program which was quite substantial. Thus capital issue control was half-hearted and loose.

The CIC acted only in an advisory capacity to the treasury, i.e., it evaluated the applications for new issues and recommended approval or rejection to the treasury. But sometimes the recommendations of the CIC were not approved by the treasury. This created anomaly and raised the question whether the Commission should be dissolved.[9]

The CIC was also criticized for red-tapism and delay in considering the applications. "While in a number of cases the Committee

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[7] Committee on the Working of the Monetary System, Report (London, H.M.S.O., 1959), p. 150.

[8] H. J. Plous, "Control of Capital Issues in the United Kingdom," Journal of Finance, XIII (1958), p. 357.

[9] Committee on the Working of the Monetary System, Minutes of Evidence London, H.M.S.O., 1960), p. 80.

refused permission for issues, in others similar ones were sanctioned. The working of the Capital Issues Committee, therefore, gave rise to numerous complaints and tended to discredit the idea of controlling investment altogether."[10]

Looking at all this criticism it seems that the major objection was against the administration of the CIC rather than against the principles behind the Capital Issue Control. The underlying theoretical ground for the control was that savings of the economy were not sufficient to finance at the existing rates of interest the desired volume of investment. And so the CIC should "filter" the applications for new capital issues to channel the capital resources in established priorities. The Capital Issue Committee was terminated in 1959. After that, informal and voluntary consultation with the Bank of England continued in the case of large domestic issues. With respect to issues by foreign borrowers, stricter restrictions still operate. Similar control of capital issues was applied during the immediate post-war years in Australia, Norway, France, and Belgium for similar purposes. The general impression is that it has proved helpful.[11]

2. Moral Suasion

Another attempt in the application of the Selective Credit Control was in the form of directives and requests from the Bank of England to the commercial banks (clearing banks) for specific actions. The focal

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[10]Thomas Balogh, The Principal Memoranda of Evidence, The Committee on the Working of the Monetary System (London, H.M.S.O. 1960), Volume III, p. 38.

[11]F. B. Tamgna, "Process and Instrument of Monetary Policy: A Comparative Analysis," Monetary Management (Commission on Money and Credit, Prentice Hall, New Jersey, 1963) p. 147-150

point of these directives was the bank advances. The banks were instructed not to grant advances for speculative purposes but to give priority for the purpose of improving productive efficiency in general. It is of interest to note here the experience of the "forced fundings" of 1951-1952. The immediate purpose was to reduce the banks' liquidity ratio to the traditional level of 30 percent (it was 39 percent at that time). The higher ratio was due to the glut of treasury bills. The Bank of England requested the banks and other institutions to convert some of their treasury bills into non-liquid gilt-edged assets which matured after one, two, or three years. Treasury bills worth £1,000 million were converted by this "forced funding". When the first series was ready for maturity in October, 1952, the Bank of England again employed Moral Suasion and came out with another "forced funding" operation. After that, "forced funding" was not used. "Forced funding" was forceful and effective in controlling the excessive liquidity at that time.

The second experience of the use of this instrument was in February, 1952, when the Bank of England called upon the banks and acceptance houses to reduce the maximum credit period from 120 days to 90 days for commercial bills financing internal trade. From time to time such directives and requests were co-ordinated with discount rate changes. The balance-of-payments situation as well as the domestic economic climate were taken into account in determining the degree of "credit squeeze" requested of the banks.

In September, 1957, Bank-rate was raised from five percent to seven percent. At the same time, banks were requested to maintain the level of advances at the average level for the preceeding twelve months. It seems that the banks were quite loyal in following the instructions from the Bank of England, and this was really an important factor in holding down bank advances during early post-war years.

3. Hire-Purchase Credit Control

As a source of consumer credit, hire-purchase occupies a much more prominent position than the other sources, such as credit account, bank overdrafts, etc.

The significance of hire-purchase finance in the financial structure of the United Kingdom is that it is a convenient source of medium-term credit on fixed terms for the purchase of equipment. Here the equipment itself provides the security for the loan, which can be paid off by regular installments.

The direct regulation over hire-purchase credit terms was first introduced in 1941 with other price control regulations. The purpose was to depress the sales of particular goods required for defence or for export. The banks were asked to restrict their lending to finance houses and other institutions active in hire-purchase financing. Limits were also determined for minimum down payments and maximum periods of repayment. In 1952, the Board of Trade was authorized to administer the hire-purchase controls. This attempt to utilize the authority of the Board of Trade to restrict credit is comparable to the Regulation "W" of the Federal Reserve System in the United States. During 1952-1954, the purpose was to control the pressure of internal demand on production capacity and to spare it for export. Later on, hire-purchase controls were extended to cover a wide variety of capital goods also.

The Radcliffe Committee Report has observed that the changes in interest rates and restriction on the amount of lending to the hire-purchase finance houses by the banks did not prove very fruitful in controlling total pressure of demand for goods. Because of the existence of alternative institutions, the pressure of demand for durable consumer goods was diverted from the banks to these institutions and the purpose of the controls was not served fully.

Changes in the terms of hire-purchase controls have proved more effective than the absolute restrictions on the amount of hire-purchase finance. The reason, according to the Radcliffe Report, is that consumers react by decreasing their purchases when any disturbance in their steady weekly or monthly installments is caused by the change in the terms of hire-purchase. The assumption underlying is that the consumers habitually keep aside a certain part of their fixed income for hire-purchases.

Very strong opinion was expressed by some of the witnesses before the Radcliffe Committee that the effects of the change in the terms of the hire-purchase controls are not permanent. If there is an increase in the minimum down payments consumers have to save more in order to pay for it. Consequently, purchases decline for a while. But gradually people accumulate deposits and get accustomed to the new state of affairs, then the temporary decline in purchases is nullified.[12] If the time of the repayment is shortened, i.e., if the installment payments are made higher, the declining effect might be permanent according to those witnesses.

During 1956, total hire-purchase debt was decreased from £495 to £405 million. In February, 1956, hire-purchase controls were extended to industrial and farm equipment and such debt fell from £70 million to

[12] Committee on the Working of the Monetary System: Minutes of Evidence (London, H.M.S.O., 1960), p. 242

£ 50 million during the year.[13] During the latter part of 1958, the controls on some of the items were removed. The rise in the sale of those items was marked immediately.

So far as the growth of the hire-purchase companies during this period is concerned, the results are not very commendable. CIC had to scrutinize the applications from hire-purchase companies. Since there was no control over reserves, finance companies could manage to expand their size and scope of business by ploughing back their profits. The other noticable factor was the emergence of many small companies as there was no control over the issues of less than £ 50,000. Moreover, hire-purchase companies could successfully manage to get the needed finance from non-bank financial institutions which were not directly affected by the controls.

Apart from the criticism of the hire-purchase controls from various angles, the general conclusion is that they were considerably effective. "A restriction of consumer credit, ... has importance as imposing an immediate reduction in the sales receipts of manufactures, just at a time when they would be encountering acute difficulty in borrowing. It is a once-for-all effect, but this is appropriate to our present purpose."[14] Controls were removed completely in 1958 as inflationary pressures subsided.

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[13]Committee on the Working of the Monetary System: Report (London, H.M.S.O., 1959), p. 165.

[14]Ibid, p. 188.

In 1961, the controls were again applied more on a general request base rather than on a specific regulations base. This time the Bank of England extended the same requests to the Insurance Companies Association and Finance Houses.[15] This is the first effort to extend the monetary policy to the financial institutions other than the banks. In France such controls were extended to the dealers and distributors that were not refinanced by the banks.

4. General Remarks

Selective Credit Controls were used quite extensively and for a long time in the United Kingdom. Unlike the United States there is no objection to selective credit controls on the ground of undue interference in the mechanism of free-enterprise economy. Probably this is the reflection of the strong influence of a socialistic ideology prevailing in the United Kingdom. Another factor responsible for the extensive use of selective credit controls is the nature of the post-war problems which the United Kingdom had to face. With the increasing strain of inflationary pressures and the balance-of-payments difficulties during post-war years, the Bank of England became firm in checking those tendencies by any means. Selective credit controls were an example of this determination. Lastly, because of the peculiar banking structure of the United Kingdom, where "Big Five"[16] were dominant, it was comparatively easy for the Bank of England to direct the banks to follow particular policy in bank advances and to administer the selective credit controls, whereas it is very difficult for the Federal Reserve System in the United States to do so because there are thousands of banks quite independent of each other.

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[15]F. B. Tamagna, "Process and Instrument of Monetary Policy: A Comparative Analysis", Monetary Management (Commission on Money and Credit, Prentice-Hall, New Jersey, 1963), p. 152-153.

[16]"Big Five" are the dominent clearing banks of Barclays, Lioyds, the Midland, the National Provincial and the Westminister

CHAPTER IV

UNITED STATES OF AMERICA

A. Financial Structure

1. Commercial Banks

The financial structure of the United States, like England, is composed of the banking system as well as specialized non-bank financial intermediaries. As Sayers has remarked, the banking system of the United States is the same as that of the United Kingdom, so far as the basic principles are concerned, but it is very different in form.[1] Instead of branch banking as in the United Kingdom, the United States has a "unit" type of banking system. There are more than 14,000 commercial banks.

The commercial banks hold demand and time deposits. Compared to the United Kingdom, the "savings" aspect of deposits is considered more important here. Apart from medium-term and mortgage loans, consumer credit business is very important. Sizable investment in short-term and medium-term government securities as in the United Kingdom is the characteristic of the banks' balance-sheet. In 1959 government securities comprised 31 percent of the assets of commercial banks.[2]

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[1] R. S. Sayers, American Banking System-A Sketch (Claredon Press, Oxford, 1949), p. iii.

[2] Commission on Money and Credit, The Commercial Banking Industry (Prentice-Hall, New Jersey, 1962), p. 135.

More than 50 percent of the commercial banks in the United States are not members of the Federal Reserve System. These non-member banks are regulated by state legislation. They hold a very small portion of the total assets and liabilities of all commercial banks. Their importance, therefore, for monetary management is very negligible.[3]

Inter-bank deposit business is a striking peculiarity of the United States' banking structure. This correspondent relationship is used to facilitate clearing of checks and remittance business. In a way, this is a substitute for branch banking where the funds could be pooled together. ". . . it is a network linking practically all banks in the country directly or indirectly to the great New York banks."[4]

Both in the United Kingdom and the United States, the commercial banks have shown an obvious preference for short-term lending, i.e., they appear to be influenced by the commercial loan theory. But banks have suffered inadequacy of markets on that base and consequently they have broadened their lending perspectives.[5] Term loans and consumer credit loans are important developments in their lending policy. Consumer credit, as in the United Kingdom, is granted directly to the consumer or through financing for specialized finance companies and sales organizations which do the final lending to the consumers. Thus, the banking system is closely linked with the non-bank financial intermediaries.

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[3]Clark Warburton, "Non-member Banks and the Effectiveness of Monetary Policy," Monetary Management (Commission on Money and Credit, Prentice-Hall, New Jersey, 1963), p. 329-331.

[4]R. S. Sayers, American Banking System-A Sketch (Claredon Press, Oxford, 1949), p. 5.

[5]R. S. Sayers, Modern Banking (Claredon Press, Oxford, Fourth Edition, 1958), p. 262.

"American banking institutions serve a wide variety of credit needs and have shown remarkable ingenuity in designing new financing techniques for the effective use of credit."[6]

2. Non-bank Financial Institutions

A part of the demand for credit in the economy has also been met by specialized financial institutions. Their significance in the monetary system lies in the provision of "near moneys," bearing liquidity of different degrees. That is, the assets of these institutions can be easily converted in money.

Mutual savings banks do not have capital. They lend only from their deposit funds and follow very cautious lending policy. Savings and loan associations lend also on real estate loans. Ten percent of their assets are held in government securities. Their liquidity is increased by the secondary market for mortgages.

On the other hand, investment banks receive no deposits. They underwrite the issues of the firms and sell the securities or stocks to provide long-term capital for these firms. Commercial paperhouses sell short-term obligations of large businesses. The borrowers find this type of borrowing more convenient because they can raise the required capital by a single line of credit which is not possible by borrowing from banks. Life insurance companies are the largest single class of savings depositories. They invest in mortgages, corporation bonds, and government securities. Credit unions and consumers' finance companies operate in the field of consumer finance. Quite a few institutions work in the field of providing finance for housing and construction

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[6]F. Brooke Willis, "United States," Banking Systems, ed. B. H. Beckhart (Columbia University Press, New York, 1954), p. 909.

and agriculture. Some of them provide a national market for mortgages and add to the liquidity of the system. In both the fields of agriculture and housing, government credit plays an important role either through subsidy or guarantee. Stocks and security exchanges facilitate trading in issues and thereby add liquidity to the system. The funds can be raised easily in the continuous market for securities.

The Federal Reserve System has no direct control over the lending operations of these institutions, though the indirect effect of any policy measure does exist to a certain extent. The experience of the post-war years indicates that the increase in money-substitutes by these institutions has decreased the aggregate demand for money balances and hence increased the velocity of money. There is disagreement as to how far the relative importance of the velocity goes and whether any direct control is needed or not.[7]

The Commission of Money and Credit concludes that the case for direct control over these non-bank institutions is not strong. "Their contribution to cyclical changes in velocity appears to be too small to warrent such an extension."[8] The Radcliffe Report has different observations in this case. Their conclusion is that non-bank financial intermediaries do set the limitations in the effectiveness of the monetary policy. Anyway, as Goldenweiser has remarked, the problem of coordination of their policies with the policy of the Federal Reserve System has been important.[9]

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[7]Commission on Money and Credit, Money and Credit, Their Influence on Jobs, Prices, and Growth (Prentice-Hall, New Jersey, 1961), p. 80.

[8]Ibid., p. 80.

[9]E. A. Goldenweiser, Monetary Management (McGraw Hill Book Co., New York, 1949), p. 40.

B. General Credit Controls

In contrast to the single central banking institution, like Britain and many other countries, there is a peculiar structure of Federal Reserve Banks under the Board of Governors. However, credit control operations are highly centralized.

1. Bank-Rate

The bank-rate is less effective in America because member banks generally do not prefer to borrow from the Federal Reserve System. Borrowing from the Federal Reserve System is direct--not through the discount market as in England--but it is regarded as a privilege rather than a right. Continuous and substantial borrowing by the banks in normal conditions is always discouraged by the Federal Reserve System. So, the banks have formed the habit of maintaining excess reserves.

2. Open Market Operations

The buying and selling of government securities by the Federal Reserve System affects the reserves of the commercial banks and therefore, the money supply. When the Federal Reserve banks buy securities, reserves of the member banks are increased by the amount of the purchase. The increased reserves increase the lending capacity of the banks and also leads to the expansion in money supply. The sale of government securities similarly will reduce the lending capacity of the banks. Open market operations, thus, finally affect the capacity of the banks to increase their earning assets and demand deposits. "Open market operations constitute the primary instrument of monetary control."[10] From 1953 to 1960 the policy of "bills only" was followed. The key feature

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[10] Commission on Money and Credit, Money and Credit, Their Influence on Jobs, Prices, and Growth (Prentice-Hall, New Jersey, 1961), p. 62.

was that open market operations for the purpose of stabilization were confined to short-term securities--chiefly treasury bills. It was expected that the bill market operations would initiate changes in the interest rate levels of the short-term market without creating disturbing shocks to the long-term bond market. Actually, "bills only" policy could not bring the gain in "depth, breadth and resiliency" of the long-term market. In early 1961, this policy was altered to a more flexible one which permitted operations in all maturity ranges of the United States government securities market. The reason for this change was the emergence of serious balance of payments deficits. The Commission on Money and Credit, as well as the Radcliffe Commission, had recommended that open market operations should deal in securities with all maturities.

3. Changes in Reserve Requirements

By the Banking Act of 1935 the Federal Reserve System has the powers to vary the reserve requirements of the member banks. By the Act of 1959 the country banks are required to keep the reserves between 7 percent and 14 percent on net demand deposits. The limits between 10 percent and 22 percent are fixed up for all other banks. On time deposits the limits for all member banks are between 3 and 6 percent.

A change in the reserve requirements influences the lending capacity of the banks by changing the reserves of the banks. In other words, the rise in the legal reserves ratio will increase the amount of required reserves which banks must maintain. This will result in the shrinking of legal excess reserves. Consequently, the credit creating capacity of the banks will be reduced. The fall in the legal reserves ratio, similarly, will increase the excess reserves of the banks, thereby increasing their credit creating capacity.

In the United States the discount rate and open market operations were used quite extensively in the past, whereas reserve requirement changes have been used sparingly. Frequent use of the changes in the reserve requirements as an instrument of credit control is not favored by the Commission on Money and Credit, on the ground that this instrument is "awkward and cumbersome" and "less finely adjustable" in comparison with open market operations.[11]

C. Selective Credit Controls

The use of selective credit controls has been confined to regulating margins required for dealings in registered securities and consumer credit.

1. Margin Requirements

The instrument of margin requirements known as Regulation "T" was introduced by the Securities and Exchange Act of 1934. The Federal Reserve System was supposed to administer the regulation. The Act was aimed at regulating credit used for excessive stock speculation, which was thought to be a destabilizing influence in the economy. In other words, margin requirements limit the amount which banks may lend and customers may borrow in order to purchase or carry securities. Technically, margin is that part of the price of a security which the purchaser is called upon to provide in cash. The amount that can be borrowed is, therefore, limited by the difference between the price and

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[11] Commission on Money and Credit, Money and Credit, Their Influence on Jobs, Prices, and Growth (Prentice-Hall, New Jersey, 1961), p. 67.

the prescribed margin. The greater the margin requirements, the more restrictive the borrowing will be.

Excessive stock speculation bids up stock market prices and leads to the relative overflow of money and credit in the stock market. This may become dangerous to the economic stability. It might be recalled that the Great Depression was marked and accentuated with the sudden stock market crash. It is necessary, therefore, to control the violent fluctuations in the stock market credit advances of the banks. Margin requirements, by varying the margins required against the securities, aim to regulate the bank credit used for stock market transactions. General credit situation of the economy and the direction or level of stock prices are taken into account when making changes in margin requirements.

Margin requirements have been varied from time to time over a range from 25 percent to 100 percent. It was not necessary to use this instrument extensively before the Second World War. However, "during 1945, the Board made considerable use of this new weapon with impressive results."[12] In 1946 the margins were raised to 100 percent to prevent excessive speculation in the stock market. "To require a margin of 100 percent was in effect to forbid loans for the purpose in question."[13] In 1951 the margins were determined at 75 percent in view of the general inflationary situation. In February 1953 they were reduced to 50 percent. With the revival of the inflationary pressures, margin

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[12]R. S. Sayers, American Banking System-A Sketch (Claredon Press, Oxford, 1949), p. 99.

[13]Board of the Govenors of the Federal Reserve System, The Federal Reserve System-Its Purposes and Functions (Washington, D.C., 1947), p. 40.

requirements were raised to 70 percent in April, 1955. With persistent inflationary tendencies and a stock market boom, margin requirements were maintained at a high level. 1958 was the period of depression. The Federal Reserve System adopted an easy money policy. Along with several other measures margin requirements were reduced to 50 percent in January, 1958. These deflationary tendencies disappeared within a short time. The Federal Reserve System revived the tight money policy. Margin requirements were raised to 70 percent in August, 1958, and to 90 percent in October, 1958. With little monetary ease in July, 1960, margin requirements were reduced to 70 percent. Since then margin requirements are maintained within the range of 50 percent to 70 percent.

This brief account of the changes in the margin requirements during the post-war years indicates that the fluctuations in the general price level along with the fluctuations in the stock market prices necessitate changes in the margin requirements in the same direction. In times of price-rise margin requirements are raised. It is claimed that the margin requirements successfully restrict the pyramiding of loans that takes place without adequate securities during boom conditions.[14] "Pyramid" refers to the bank holdings of the traders dealing in securities. During boom conditions, they go on adding their balances by borrowing against the additional market value of securities already held in their account without additional securities.

"By the control of margin requirements excessive use of credit in the stock market, which has caused serious disturbances to the economy

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[14]R. A. Young, "Tools and Process of Monetary Policy," United States Monetary Policy (American Assembly, Columbia University, 1958), p. 30.

in the past, has been placed under control."[15] This was written by the Board of Governors in 1947 and it is equally true today.

2. Real Estate Credit Control

Real estate credit control was introduced in 1950 in the form of Regulation "X". It applied to persons who were engaged in the business of extending real estate credit for residential purposes. The control prescribed maximum loan values, maximum maturities, and minimum amortization terms.

The basis of the real estate credit control and consumer credit control was the same--to check inflationary tendencies in those fields. The arguments for and against both of the controls are similar in nature. Detailed discussion of these arguments is done in the section of consumer credit control.

3. Consumer Credit Control

The expansion of consumer credit has made a major contribution to the national economic development. It has enabled the growth of the automobile industry and other industries making durable goods. It has also enabled the consumers to buy and own costly durable goods with their limited income by the schemes of minimum down payment and long drawn out periods of repayment. But a group of economists have always doubted about "the ethics of granting loans" to consumers by banks on the ground that these are the loans for non-productive purposes and are

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[15] Board of the Governors of the Federal Reserve System, The Federal Reserve System-Its Purposes and Functions (Washington, D.C., Second Edition, 1947), p. 42.

not sound commercial banking practices.[16] During the Great Depression and thereafter, the focus of the criticism against consumer credit loans has shifted to their unstabilizing characteristics.

Empirical observation is that the output and purchases of consumer durable goods fluctuate widely.[17] Consequently, this leads to the expansion and contraction of consumer credit and accentuates unstability. Thus, as a source of unstability, the fluctuations in consumer credit may be reflected in the violent disturbances in the volume of total credit, savings, investment, and growth. On this ground consumer credit controls are advocated.

Direct control of consumer credit in the United Kingdom and the United States is advocated on the ground that the general credit control has proved less effective in controlling the consumer credit. This is evidenced from time to time in the United States. 1953-1956 was the period of general credit restraint and even then consumer credit loans from the banks expanded sharply,[18] as shown in the table on the following page. Easy shiftability of increased cost provides the explanation for the lack of effectiveness of general credit controls in controlling the consumer credit.

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[16] Consumer Installment Credit: Conference on Regulation, Part II, Volume I (National Bureau of Economic Research, Washington, D.C., 1957), p. XVII.

[17] Milton Friedman, "Consumer Credit Control As An Instrument of Stabilization Policy," Money and Economic Activity, ed. L. S. Ritter (Houghton Miffin Company, Boston, 1961), p. 198.

[18] Consumer Installment Credit-Conference on Regulation, Part II, Volume 2 (National Bureau of Economic Research, Washington, D.C., 1957), p. 4.

TABLE I

CONSUMER CREDIT FROM COMMERCIAL BANKS, IN U.S.A. 1952-1956

(Short-intermediate Term)

End of the Year	Installment Credit from Commercial Banks (in millions of dollars)
1952	$ 7,524
1953	8,998
1954	8,796
1955	10,601
1956	11,777

Source: Business Statistics, 1963 Biennial Edition United States Department Of Commerce, Office of Business Economies, p. 91.

Consumer credit control, known as Regulation "W", was introduced in the United States during 1941 as a war time measure. With few intervals of termination, it was continued up to 1952. It has been suspended since then.

Three characteristics could be mentioned for the consumer credit controls as they were applied in the United States. (1) Control over the volume of consumer credit was exercised by establishing minimum down payments and maximum periods of repayment. When the authorities wanted to tighten up the control, the amount of minimum down payments was increased and the number of installments for repayment was decreased. (2) The provisions varied for different types of goods and were subject to modifications. (3) Both sellers of consumer goods and lenders of cash to consumers were subject to regulation.

Consumer credit controls are probably the most controversial selective credit control applied in the United States. Many economists do agree that consumer credit is a source of instability. But, they do not agree that stand-by controls would serve the purpose. Such controls may suppress the inflation for a while but they can not cure it by removing its causes. On this line of reasoning stand-by controls will increase the difficulty of attaining and maintaining economic stability. The Commission on Money and Credit was not in favor of advocating stand-by controls because of the probable administrative difficulties.

Friedman has analyzed consumer credit control and concluded that it is a "technically defective stabilization device."[19] He compared the effects of consumer credit controls with those of a uniform excise tax and considered consumer credit controls as a heavier tax which is regressive in effects. Lower income people are mainly the credit purchasers on whom consumer credit control hits hard, while those higher income people who prefer to be cash purchasers are not affected by the controls. Consumer credit control is, therefore, a discriminatory tax. His ultimate conclusion is that the uniform excise tax is technically preferable to the consumer credit control for stabilization purposes. Moreover, these controls are undue government interference on the freedom of consumers. "As I evaluate the balance sheet, the advantages of either consumer credit controls itself . . . seem dubious and minor; the disadvantages, clear and significant."[20]

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[19] Milton Friedman, "Consumer Credit Control As An Instrument of Stabilization Policy," Money and Economic Activity, ed. L. S. Ritter (Houghton Miffin Company, Boston, 1961), p. 195-216.

[20] Ibid., p. 216.

A second argument against the consumer credit controls is that they restrict expenditure by dampening demand for credit for a particular purpose rather than by decreasing the supply of credit. Consequently, the supply of credit available will probably depress interest rates and this may stimulate non-consumption expenditure again aggrevating instability.

The third important criticism is that consumer credit control affects the growth of the industry in question and hence interferes with the pattern of resource allocation against them. "The existence and use of . . . consumer credit controls tends in the long run to make industries affected by such controls less attractive to producers and thus to reduce the fraction of resources devoted to them."[21] From Table II, on the following page, it is seen that over the last 25 years the price rise in the durable consumer goods is relatively less. It may be considered as a sign of relative progressiveness of these industries. Consumer credit controls therefore are an unjustified punishment for these industries. Really speaking, it is very difficult to prove the relative progressiveness of the industries affected by the consumer credit controls. It is equally difficult to prove that the controls interfere with the pattern of resource allocation. The essence of all these criticisms is the positive tendency towards the faith in free market mechanism without any sort of direct interference.

It is interesting to note some contrary remarks in this connection. The Federal Reserve System had submitted a statement before the House Banking and Currency Committee in May 1951, wherein it urged continuance

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[21] Ibid., p. 209.

TABLE II

ALL COMMODITIES-RETAIL PRICE INDEX
IN U.S.A. 1940-1960

(1957-59 = 100)

Year	Durables	Nondurables
1940	51.3	44.3
1950	94.2	85.9
1960	100.7	101.9

Source: Business Statistics, 1963 Biennial Edition (United States Department of Commerce, Washington, D.C., 1963), p. 38.

of Regulation "W". "While consumer credit regulation alone cannot solve the problem of inflation, nevertheless, Regulation "W," by establishing minimum down payment requirements and maximum periods for repayment of consumer installment debt, has effectively limited the expansion of consumer purchasing power in the form of credit dollars and is an essential part of any continuing comprehensive anti-inflationary program."[22] Again in a letter submitted to the Senate Banking and Currency Committee, as well as to the House Banking and Currency Committee, the Chairman of the Board of Governors of the Federal Reserve System wrote, "We have said, and we believe, that it is a desirable, supplementary measure of credit restraint in a time of inflationary danger."[23] Thus, it seems that official monetary authorities favored the continuation of the consumer credit controls during the prevailing inflationary situation.

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[22] Federal Reserve Bulletin (Washington, D.C.), May, 1951, p. 491.

[23] Federal Reserve Bulletin (Washington, D.C.), July, 1951, p. 750.

It is apparent from the pros and cons for consumer credit controls discussed here that different criteria are applied for judging these controls. Consequently, opinions vary widely.

4. General Remarks

Consumer credit controls, in particular, and selective credit controls, in general, are resented in the United States on the ground that they are not equitible and consistent with the basic principles of the free enterprise economy. The cry for maintaining a free enterprise economy in the United States is so strong that any effort of direct regulation is suspected to be an interference in the free socio-economic life of the nation. "The continuance at all of the qualitative controls is a source of extreme disappointment to one who believes the market is a superior device for the organization of economic affairs."[24] At the same time it seems that the United States has a deep faith in the efficacy of the general credit control. This is reflected in the survey of consumer installment credit conducted by the Federal Reserve System. "There is a general feeling that present monetary measures do have an effect on installment credit . . . The combination of general monetary measures and these self-regulating factors permits adequate protection against excessive and dangerous movements in installment credit."[25] Lastly, probable administrative problems are pinpointed in the United States against the selective credit controls over almost 14,000 banks

[24] L. W. Mints, "Discussion on Monetary Policy," American Economic Review, May, 1953, Volume 43, Number 2, p. 54.

[25] Consumer Installment Credit, Part III (United States Printing Office, Washington, D.C., 1957), p. 5.

quite independent of each other. The Commission on Money and Credit has not favored "stand-by" controls on this ground.

CHAPTER V

INDIA

A. Financial Structure

1. Unorganized Money Market

The financial structure of India is quite different from that of the United Kingdom and the United States. Currency is the major component of the money supply. At the end of March, 1951, currency composed 67.2 percent of the money supply. At the end of March, 1961, it was 69 percent.[1] "This sets limitations on the extent to which monetary policy of the central banking authority can make itself felt."[2] The reason for this is that monetary policy works within a relatively small area of the economy where the banking sector operates. Barter still exists to some extent in some rural areas. Another characteristic of the money market in India is the existence of organized and unorganized sectors. The unorganized sector is not under the direct control of the Reserve Bank. Widely used credit instruments in the unorganized money market are different types of "hundis", these being equivalent to internal bills of exchange. Village money lenders form the base of the unorganized structure. Like investment banks of the United States, they

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[1] Bhabatosh Datta, Essays in Plan Economics (World Press, Calcutta, 1963), p. 177.

[2] H. R. Iengar, Monetary Policy and Economic Growth (Vora and Company, Bombay, 1962), p. 5.

make loans for various purposes but do not receive deposits. Lending is based on mutual trust and transactions are seldom written or witnessed. Collateral is mostly land, houses, standing crops, or ornaments of gold and silver. The rate of interest charged is high and varies considerably according to time and place. Money lenders operate mostly in rural areas where modern financial institutions are not developed. They work on their own capital. Consequently, the Reserve Bank has not been able to control their credit operations. With the spread of banking facilities in rural areas, lending activities of the money lenders are diminishing rapidly.

Indigenous bankers are the other important component in the unorganized sector. They are prominent families who receive deposits and make loans. The reputation of the family name and the integrity associated with the name is the reason underlying their ability to undertake the business of receiving deposits and making loans. They are not, however, commercial bankers. Like money lenders, they also do non-banking business like trading. Like money lenders, they also charge different rates of interest over time and places and customers. There is hardly a clear cut distinction between short-term and long-term finance. These weaknesses of the indigenous bankers are to some extent responsible for the lack of integrity and homogeneity in the money market which is a "hindrance to the effective control policy of the Central Bank."[3]

The Reserve Bank of India put foreward several schemes to bring the indigenous bankers under its control and to link them with the

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[3]H. N. Roy, The Role of Monetary Policy in Economic Development (World Press, Calcutta, 1962), p. 76.

orgainzed sector. None of these schemes was successful, mainly because the indigenous bankers were never willing to give up their non-banking business and also to submit their accounts to the Reserve Bank. It is obvious that the only hope lies in the development of alternative financial institutions in the rural areas; and these have been developing rapidly since 1955.[4]

2. Organized Money Market

Commercial Banks

The organized sector of the money market consists of commercial banks, the State Bank of India, co-operative banks, other financial institutions, and the Reserve Bank of India.

The commercial banks in India are modeled after the British banks. They are divided into Indian scheduled banks, non-scheduled banks, and foreign scheduled banks.[5] The division between scheduled and non-scheduled banks is similar to that between member and non-member banks of the United States. According to the Banking Companies Act of 1949, a scheduled bank must have paid-up capital and reserves of not less than Rs. 500,000. At present, there are 89 scheduled banks and 256 non-scheduled banks.[6] Non-scheduled banks are those which are not included in the Second Schedule of the Reserve Bank of India Act, because of the limitations of the size of capital and resources. They are the largest

[4]As mentioned later in this chapter the State Bank of India has been assigned to develop banks in rural areas by the State Bank of India Act, 1955.

[5]After passing of the Banking Companies Act of 1949, Foreign Scheduled banks are treated on a par with the Indian Scheduled banks. They do not have any distinguishable significance now.

[6]Bhabatosh Datta, Essays in Plan Economics (World Press, Calcutta, 1963), p. 152-179.

in number but are the least important from the view point of deposits and assets as shown in the table below.

TABLE III

TOTAL DEPOSITS OF SCHEDULED AND NON-SCHEDULED BANKS IN INDIA, MARCH, 1961

	Number of Banks	Rupees in Millions
Scheduled	89	17361
Non-scheduled	256	480

Source: Bhabatosh Datta, Essays in Plan Economics (World Press, Calcutta, 1963), p. 179-180.

Unlike scheduled banks, non-scheduled banks are not forced by law to keep their reserves with the Reserve Bank. They are not entitled to get credit accomodation from the Reserve Bank. After the Banking Companies Act of 1949 was passed, the number of non-scheduled banks steadily declined from 437 in 1953 to 256 in 1961.[7] The Reserve Bank encouraged their merger with the scheduled banks. Seven major commercial banks dominate the banking field by having a large number of offices all over the country.

Government Securities form 30 percent of the total assets of the commercial banks and they are the most important items in their asset structure.

The discount market as it is developed in the United Kingdom and the United States is not developed in India. Only in 1954 did the Reserve Bank of India introduce a systematic scheme to develop the

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[7]Ibid., p. 180; and K. C. Chacko, The Monetary and Fiscal Policy for India (Vora and Company, Bombay, 1957), p. 66.

bill market. There is no strong case for the establishment of discount houses on the London model, because borrowing by overdraft or against government securities or cash credit is more commonly used. The increasing portion of government securities in the portfolios of the commercial banks has greatly added to the liquidity and elasticity of funds in the money market. On this ground, even in the United Kingdom and the United States, the importance of discount bills is declining.[8]

The State Bank of India was formed in 1955 by nationalizing the Imperial Bank of India which had 444 offices in India. Essentially it is a commercial bank with 55 percent of government capital and special status. It has been entrusted with the special task of developing banking facilities in the rural areas. It is the biggest commercial bank in the country, operating through more than 1,000 branches and with total deposits amounting to nearly one-third of the net aggregate deposits of all scheduled banks in India.[9]

Co-operative banks are the peculiar feature of the financial structure, not from the view point of monetary management but from the view point of the economic development. They receive deposits and make loans and thereby mobilize scattered savings. The co-operative banks operate in the rural areas and are designed mainly to privide finance at reasonable low rates to agriculturalists. They also borrow funds from the State Bank and the Reserve Bank. They are given special concessions in their borrowings.

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[8]K. C. Chacko, The Monetary and Fiscal Policy for India (Vora and Company, Bombay, 1957), p. 13.

[9]Ibid., p. 78-80. See also "Banks Are Not for Banging," Eastern Economist, Volume 42 (January 24, 1964), p. 125.

Non-bank Financial Institutions

Quasi-government bodies and large sized joint stock companies also participate in the operations of the money market as lenders. The Industrial Financial Corporation provides long and medium-term finance to industries in the private sector. The National Industrial Development Corporation works for both the public and the private sectors. Ninety percent of its capital is subscribed by the government. The Industrial Credit and Investment Corporation is an experiment in international investment for private industries. The State Finance Corporations provide finance to medium and small scale industries. All these institutions have greatly widened the range of the capital market in India. They are intended not only to extend credit but to underwrite the securities of the industrial concerns. They supplement bank finance for industries to a certain extent by granting medium and long-term loans. The Reserve Bank's policies do have an indirect effect on the lending policies of these institutions. However, as in Western countries the existence of the non-bank financial institutions is a factor limiting effective monetary policy. "However, since credit can also be obtained from other financial institutions, the number of which in India is large and whose activities are not subject to quantitative control by the central bank, the efficacy of a restrictive monetary policy is seriously reduced."[10]

The Reserve Bank of India as the central bank occupies the most important place in the financial structure of the country. In addition to acting as a banker to the government and the commercial banks,

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[10] H. M. Roy, The Role of Monetary Policy in Economic Development (World Press, Calcutta, 1962), p. 213.

it has contributed to the provision of the cheap agricultural credit on co-operative basis. It has also helped to establish the specialized institutions for providing the long-term finance. "Perhaps in no other country has a central bank taken such an active role in the economic development of the country as in India."[11]

B. General Credit Controls

1. Bank-Rate

The credit control mechanism is a somewhat complicated and difficult task for the Reserve Bank of India because of the existence of an unorganized and less monetized sector as well as the absence of a well developed bill market. Bank-rate has no significance as a discount rate. The large portfolios of government securities enables the banks to acquire needed cash through the sale of the securities rather than through rediscounts with the Reserve Bank. An expanding public sector also reduces the feasibility of using the bank-rate on a considerable scale. A rise in the bank-rate would increase the cost of government borrowing for the public sector. ". . . In a planned economy which has a large public sector of investment and where government has a battery of powers of direct regulation of investment, the efficacy of bank-rate changes is far less clear than it is in industrially advanced countries with a 'free' economy."[12] After 16 years of its operation, the Reserve Bank raised the bank-rate from three percent to three and one-half percent for the first time in November, 1951. After that, it has been

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[11] K. C. Chacko, The Monetary and Fiscal Policy of India (Vora and Company, Bombay, 1957), p. 300.

[12] H. V. R. Iengar, Monetary Policy and Economic Growth (Vora and Company, Bombay, 1962), p. 139.

used several times along with the other measures to check the growing inflationary pressures. Bank-rate was raised to five percent in September, 1964, to make credit costlier.

2. Changes in Reserve Requirements

The Reserve Bank has the power to vary the reserve-ratio of the commercial banks between five percent to 20 percent of the demand deposits and two percent to eight percent of the time deposits. As a measure of general credit control, a variable reserve-ratio has not been used extensively.

3. Open Market Operations

Open market operations are largely used to facilitate the government borrowing program. They are also used to help commercial banks tide over the seasonal monetary stringency in the busy season and to invest their surplus reserves in the slack season. "Broadly speaking, in India, open market operations have not assumed the role of a full-fledged instrument of credit policy."[13]

C. Selective Credit Controls

This brief account of the financial structure and credit control mechanism with the above mentioned indirect instruments does not tell the complete story. The large holdings of government securities by commercial banks and the policy of price support and a fixed pattern of interest rates followed by the monetary authorities have made the general instruments less effective unless supported by direct or selective controls, simultaneously. In fact, after the Second World War in

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[13]Ibid., p. 199.

almost all countries, the central banks had to resort to the direct control to fight against inflation.

During the Second World War, efforts were made to control bank advances against specified commodities, including bullion, through an ordinance issued under the Defence Regulation. After the war the Reserve Bank tried to influence the banks' policies with regard to their advances and investments through advice, requests, etc., with only limited success. So the Reserve Bank equipped itself under Section 21 of the Indian Banking Companies Act, 1949, to introduce selective credit controls on an obligatory basis. With the beginning of the economic planning (by a series of Five Year Plans) in India, the Reserve Bank of India had a special responsibility. It has had to shape its monetary policy in such a way that rising prices are kept in check without retarding production.[14] "The solution to such a situation is not a general tightening of credit or a general relaxation; it is selective control."[15]

1. Moral Suasion

Especially during the Second Five Year Plan, because of the heavy deficit financing and inflationary dangers, the Reserve Bank had to use selective credit controls quite extensively. During the June 1955 to May 1956 period, food prices rose by 15 percent and bank advances against food-grains were 11.5 percent higher compared with the previous year. So in May, 1956, the Reserve Bank directed all the scheduled banks to ban fresh advances of more than Rs. 50,000 against paddy and

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[14] I. G. Patel, "Monetary Policy in Post-war Years," I.M.F. Staff Papers, Volume 3 (1953), p. 72.

[15] H. V. R. Iengar, Monetary Policy and Economic Development (Vora and Company, Bombay, 1962), p. 7.

rice. They were also asked not to increase their total advances by more than 25 percent over those in the corresponding month of the last year.

2. Margin Requirements

Existing margins were raised by 10 percent of the value of the security offered. In February, 1957, margin limits were raised to 35 percent. The Bank imposed similar restrictions on advances against other food grains to curb the inflation.[16] In June, 1957, margin requirements were raised to 40 percent. Fresh advances exceeding Rs. 50,000 were totally banned. Advances against paddy and rice were restricted to 66.7 percent and those against other food grains to 75 percent of their respective amounts as in the corresponding week of 1956.

In December, 1957, measures were tightened up. Restrictions on advances against cotton manufacturers and sugar were imposed. The banks were required to freeze the credit limits at the existing level. The margin for sugar was raised to 45 percent in July, 1958. Groundnuts were brought under selective control in February, 1959, with a margin requirement of at least 45 percent. In May, 1960, selective controls were extended to all kinds of oilseeds. At the same time the degree of control was relaxed for rice and paddy in certain states. In April, 1961, margin requirements in regard to sugar were withdrawn. All restrictions relating to advances against wheat were removed in May, 1961. In 1963 selective credit controls were extended to advances against

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[16] O. P. Jain, "Evaluation of Selective Credit Controls in India," Indian Journal of Economics, Volume 41 (1960-1961), p. 173-175.

warehouse receipts covering food grains (excluding wheat). Margin of 25 percent was applied to such advances.

All throughout the Second Five Year Plan, various directives as mentioned above were issued requiring the banks to restrict and limit advances against food-grains and other agricultural articles. And whenever the situation permitted, the degree of restraint was decreased. However, it was indicated that these agricultural commodities were the chief inflation breeding spots for the economy which required continuous watch by the authorities. During each phase of the price-rise, the prices of agricultural commodities went up more than the prices of manufactured articles. This can be seen from the table on the next page. Upward trend of prices had been greatly accentuated by bank financed speculative hoarding of food-grains. That is why the selective credit controls are applied mostly to the bank advances against food-grains and oilseeds. The general pattern of the controls is to raise the margins and set limits to the advances in a particular direction. To make them more perfect and effective, schemes have been devised to fix up the margins and limits of the advances before the agricultural season starts. It is expected that this would prevent speculative tendencies growing up from the very beginning. However, it is very difficult to know about the prospects of the coming crops and determine the degree of control required for the next season.

3. Consumer Credit Control

Unlike the Unites States and the United Kingdom, consumer credit is not a very important component of total advances of commercial banks, as seen from Table V. As a result there did not arise any need to apply consumer credit controls to the commercial banks in India.

TABLE IV

WHOLESALE PRICE TRENDS, 1955-1963
(1952-1953 = 100)

Item	June 1955	June 1956	June 1957	June 1958	June 1959	June 1960	June 1961	June 1962	June 1963
All commodities	90	102	111	112	116	123	126	127	134
Food, articles	84	99	109	113	119	120	121	125	143.8
Industrial raw materials	93	113	121	115	120	140	149	136	138.7
Manufactured articles	98	104	109	108	109	120	126	129	129.1

Source: Eastern Economist, Volume 39 (August 10, 1962), p. 268-270.

Eastern Economist, Volume 42 (June 12, 1964), p. 1383-1384.

TABLE V

PERSONAL AND PROFESSIONAL LOANS OF SCHEDULED BANKS

Year	Amount (Rs. in million)	Percentage of total advances
1949	382	8.7
1952	396	7.8
1954	476	3.5
1963	1,117	6.9

Source: K. C. Chacko, The Monetary and Fiscal Policy of India (Vora and Company, Bombay, 1957), p. 102; and Eastern Economist, Volume 42 (January 24, 1964), p. 126.

4. General Remarks

It is impossible to segregate the effects of the selective credit controls and evaluate them when other instruments of credit control are also used simultaneously. All that can be said with regard to the effectiveness of selective credit controls is that if these controls had not been introduced, speculative operations would have been larger and more damaging than they actually were. This was the observation of the Governor of the Reserve Bank of India.[17] The reports also indicated that as a result of the selective credit controls, the advances of the commercial banks against food-grains and sugar declined to a considerable extent. The decline in bank credit for these items was essential to bring down speculative and hoarding tendencies of the traders.

There were some weak spots in the application of selective credit controls which probably helped evasion to some extent. Until 1963

[17]H. V. R. Iengar, Monetary Policy and Economic Growth (Vora and Company, Bombay, 1962), p. 203.

the control did not apply to the advances against warehouse receipts, with a view to encourage the development of warehouses and use of warehouse receipts as a security for bank advances. Similarly, advances granted to co-operative marketing societies still continue to be exempt from the scope of the directives.

In Western countries, the aim of the selective credit controls is to control demand for durable consumer goods to check inflation. In India the objective is to prevent speculative hoarding of commodities so as to prevent an undue rise in their prices (thereby controlling inflation breeding spots in the economy) and to channel bank funds into desired channels. The background of a loosely organized money market, with the existence of an indigenous banking sector is entirely different from the background of financial structure in Western countries. The active participation of the Reserve Bank of India in providing and extending credit facilities to different sectors of the developing economy is peculiar.

The officially accepted objective of a "socialistic pattern of society" and the consequent expansion of the public sector in the planned economy of India gives a glimpse into the prevailing socio-political ideology which is different from that of the United States. Successful nationalization of the Imperial Bank of India and Life Insurance, a highly progressive taxation and similar developments reflect that India is not a doctrinaire against the state initiative, direction and participation in the economy. Successful implementation of a series of Five Year Plans and consequent changes in the monetary-fiscal policies reflect the determination of the government of India to achieve the goal of rapid economic development. As a result unlike the United

States, there does not exist public resentment against selective credit controls on the ground of undue interference of the state in the economic life of the nation. Probably this is an important factor causing extensive use of the selective credit controls along with other instruments. Here it is interesting to refer to the case of Norway. "The Bank of Norway considers that since it has no organized money market and its banking system is highly decentralized, it must practice direct and selective credit policies . . ."[17]

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[17]F. M. Tamagna, "Process and Instrument of Monetary Policy: A Comparative Analysis," Monetary Management (Commission on Money and Credit, Prentice-Hall, New Jersey, 1963), p. 146.

CHAPTER VI

CONCLUSIONS

The need has arisen in view of the post-war economic problems to increase the effectiveness and promptness of monetary policy. As one of the means to achieve this objective, the central bank requires use of both the general and selective credit controls. The question does not arise about the substitution of one for the other. "The desirable solution in the eyes of this observer requires the co-ordination of the general and selective credit control instruments in a manner making possible a stronger role for monetary policy in the future . . ."[1] Though it is very difficult to separate the effects and evaluate the role of the selective credit controls, it can be said that the experience in the countries studied here indicate usefulness of the selective credit controls.

Advantages and disadvantages of selective credit controls are discussed widely and opinions vary greatly. Along with the severe criticism of the selective credit controls some constructive thinking is also done in the direction as to how the selective credit controls can be used purposefully. "In view of the pervasiveness of selective controls in one form or another, they are not something that one can be unequivocally for or against. The issue is not whether, but how, they shall

[1] R. F. Shay, "Justification for Direct Regulation of Consumer Credit Reappraised," Journal of Finance, Volume 8 (1953), p. 276.

be used."[2] A similar remark has been made by R. S. Sayers in milder tone. "More generally, we can say that when an unusually difficult situation calls for sharp effects, direct control of bank advances can be justified; its disadvantages are of the kind that point to early relaxation rather than complete avoidance."[3] In developing economies, selective credit controls are given a permanent place in the armory of the instruments of credit control.

The experience with selective credit controls in the United Kingdom, the United States, and India differs greatly. The selective controls in the United Kingdom are less compulsory in nature because of more reliance on moral suasion. In India selective credit controls are more compulsory in nature, margin requirements being used predominantly. Both in the United Kingdom and India, selective credit controls are used quite extensively without any ideological objection to them. In the United States popular objection to the selective credit controls is too strong to allow the Federal Reserve System to re-introduce consumer credit control. Different types and techniques of selective credit controls are adopted in different countries to suit their needs.

In India selective credit control is viewed as a tool for economic growth, while in the United States it is considered as a policy measure for stabilization purposes.

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[2]Arthur Smithies, "Uses of Selective Credit Controls," United States Monetary Policy (American Assembly, Columbia University, 1958), p. 74.

[3]R. S. Sayers, Modern Banking (Clarendon Press, Oxford, fourth edition, 1958), p. 255.

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VITA

Sharmishtha A. Bhimnathwala

Candidate for the Degree of

Master of Science

Thesis: SELECTIVE CREDIT CONTROLS: UNITED KINGDOM, UNITED STATES AND INDIAN EXPERIENCE

Major Field: Economics

Biographical

Personal Data: Born in Dhandhuka, Gujarat, India, October 10, 1933.

Education: Graduated from Navanagar High School, Jamnagar, in 1951; received the Bachelor of Arts degree from Gujarat University, India, with a major in Economics, in 1956; received the Master of Arts degree from M. S. University of Baroda, India, with a major in Economics, in 1958; joined Oklahoma State University in the fall of 1963, completed requirements for the Master of Science degree in May, 1965.

Professional experience: Served as a lecturer in Economics at H. K. Arts College, Ahmedabad, India, during 1959-1963; served as a graduate assistant in Economics at Oklahoma State University during September, 1964 to May, 1965.