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NEW PROPOSALS ON SWEDISH INTEREST RATE POLICY PAUL GEKKER

Following the abandonment of subsidies and the expiration of the wage agreement at the end of 1950, a readjustment to higher levels of prices and wages has taken place in Sweden in the first half of this year. 1/ Expansion of bank credit also continued during this period, aided by easier liquidity conditions resulting from the influx of foreign exchange and to some extent from the resumption of central bank purchases of Government securities. Upward price movements seem to have halted at the present time, and in July and August the first declines in total commercial bank loans were registered. There is no assurance, however, that the full impact of increased defense expenditures in Sweden will not revive inflationary impulses in the economy. In that context, it becomes interesting to ascertain the role assigned by the authorities to measures of credit restraint.

Background

In July 1950, the Swedish Riksbank -- exercising its authority to do so for the first time -- imposed higher commercial bank reserve requirements, which became effective on October 1st. At the same time, in a more significant departure in postwar monetary policy, the central bank withdrew from the government bond market. In the half-year following this suspension of purchase operations, bond prices declined slightly and yields rose from 3 to approximately 3 1/3 per cent. In the same period, the commercial banks entered into a voluntary agreement to restrict credit. On December 1, 1950, the Riksbank raised its discount rate from 2 1/2 to 3 per cent, and this move was followed by corresponding changes in other interest rates.

In mid-December, however, price-support purchases of bonds were resumed by the Riksbank, assisted by the government-owned commercial bank. Since then the new interest rate level has been maintained. In recent months, moreover, bond prices have moved upward under the influence of easier liquidity conditions attributable chiefly to the improved balance of payments position and the consequent Riksbank purchases of foreign exchange. As a result, the yield on long-term government bonds has declined slightly and at the latest available date (September 1951) was 3.2 per cent.

Interest rate policy

In retrospect, it appears that while the central bank was anxious to check credit expansion the Swedish authorities were apparently reluctant to permit full use of traditional instruments of credit control.

1/ See a previous article, "Recent Monetary Developments in Sweden", in the Review of Foreign Developments, February 27, 1951, which described the revival of traditional credit control instruments in the second half of 1950.

For most of the postwar period, official Swedish thinking embraced a defense of the low interest policy, partly because low interest rates are a matter of doctrine for the ruling Social Democratic Party. Maintenance of low interest rates has also been officially supported on the grounds that it is necessary to the continuation of the housing program, and that increases in interest rates would result in higher rents and would endanger economic stability because of the ensuing wage-price spiral.

The resumption of flexibility in the market for long-term securities apparently did not denote a change of heart on the part of the monetary authorities. This is evident from the following quotation from a Riksbank memorandum of April 28, 1951:

> "In regard to the monetary policy of the immediate future, the Directors wish to state their expressed opinion that in the current situation there must be no recurrence of any such movement in interest rates as occured in the summer of 1950 to November 1950. If any speculation occurs which anticipates such a development...the Riksbank intends to break this, even if it should involve a temporary deflection from endeavors to keep the money market tight. In the opinion of the Directors changes in the rates of interest should result from the decision of the responsible authorities, after a proper examination of the situation, and of the probable influence of interest rates on over-all economic developments, but such changes should not occur because of temporary speculative factors on the market." 1/

The statement contained in the last sentence of this passage is no doubt unexceptionable and has indeed long been an important rationale for central bank open market operations. But this policy of maintaining orderly conditions in the market for government securities does not necessarily imply a policy of supporting an unchanged interest rate level. The implication of the Riksbank statement, namely, that the moderate increase in interest rates in the last half of 1950 did not result from a "decision by the proper authorities," and was caused by "temporary speculative factors" is hard to understand. However, a certain evolution in Riksbank thinking is undeniable. Whereas in an earlier period (1946-48) the central bank seemed unconcerned at the continued expansion of the money supply that was necessary to keep interest rates down, it now appears to be convinced of the necessity of tightening credit in an inflationary situation. In such a situation the Riksbank now intends to use its existing powers to restrict credit expansion, but it seeks in addition some means of preventing a restrictive credit policy from leading to an "uncontrolled rise in interest rates." 2/

1/ Riksbank Memorandum to the Banking Committee of the Riksdag, April 28, 1951 (translation by U. S. Embassy, Stockholm).

2/ While a majority of the Riksbank Directors appear to endorse this view, a few accept the necessity of some rise in interest rates as the consequence of a tight credit policy. Among this minority, however, opinions differ with regard to the permissible extent of the rise in interest rates.

Legislation to control interest rates

To this end, the Riksbank has suggested draft legislation which would give it authority to control interest rates. In a message dated August 23, 1951, the Board of Directors of the Riksbank give the following explanation of the proposed measure:

> "...it is possible, on the basis of the existing law regarding certain provisions about the cash reserves of commercial banks, considerably to tighten the provisions about the commercial banks' obligation to hold cash reserves. There are on the other hand only very limited possibilities of preventing a contraction on the money market from leading to a continuous rise in interest rates. Against this background there have been worked out, within the Riksbank, the requisite conditions for introducing a regulation governing interest rates, based on particular legislation." 1/

The draft legislation, which at this writing is under consideration by the Swedish Parliament, makes it obligatory for lending institutions to report in advance any intended change in either deposit or loan rates of interest. The Riksbank will have authority to freeze the existing pattern of rates and may also establish a minimum rate on deposits and a maximum rate on loans. In addition, central bank permission will be required before any new private capital issues can be undertaken. 2/

The idea which supports the present proposal is that "it is not possible to...permit a rise in the price of credit...to determine the distribution of the amount of credit". The assumptions, therefore, are that a shortage of funds will be induced by measures within the present powers of of the Riksbank, 3/ and that the scarcity so created is not to be reflected in higher interest rates but that credit will be rationed in accordance with some set of pre-determined criteria. 4/

1/ Message to the King from the Board of Directors of the Riksbank, August 23, 1951 (English translation) p.7

2/ This provision incorporates one of the guides to lending policy contained in the voluntary credit restriction agreement of August 1950.

3/ Under existing legislation, the Riksbank can recommend an increase in reserve requirements of from 10 per cent (in the case of the largest bank) to 25 per cent of demand and term liabilities.

4/ The proposal can also be interpreted in the light of a different set of considerations. A large differential between yields on government securities and private loans is undesirable in inflationary periods because it encourages a tendency on the part of investors, to liquidate these securities and employ the funds for private loans. Usually this tendency is counteracted by letting the yields on government securities rise. The Riksbank proposal can be interpreted as attacking the differential from the other end. However, this possible rationale has not been important in the preparation of the measure.

Request for authority to engage in direct lending

The Riksbank document contains some discussion of the problem of distribution (credit rationing), which will arise when a general contraction of credit is coupled with regulation of interest rates. Reliance has heretofore been placed on voluntary agreements between the commercial banks and the Riksbank but these are considered to be only moderately effective. On the other hand, the Board of Directors reject a direct system of rationing, for the present at least, because of the extensive apparatus of administration and control which would be required. The Riksbank, therefore, prefers to rely on further agreements with the private banks; but in view of the likelihood that even so "demands for credit of kinds which are of vital importance from the point of view of general economic and social policy might not be satisfied," it would be desirable that "a lender with adequate resources could correct the distribution of credit produced by the lending policy of the banks." The natural lender of this character would seem to be the Riksbank," which "already has the opportunities and the will to undertake such action, and this ought to some extent be sufficient to ensure distribution in the desired direction."

The Riksbank apparently does not fear that by extending loans it would be working against a tight credit policy, but rather seems to believe that its lending activities would only offset to some extent the decline in the overall volume of credit which would be aimed at by a restrictive policy. In addition, assurances are given that Riksbank lending would be conducted cautiously, be of relatively modest dimensions and, to the greatest possible extent, be of a merely occasional kind.

Conclusion

At this distance, the proposal to control interest rates appears to indicate that the Riksbank feels uneasy about some reactions to the monetary policies followed after July 1950. It now wishes to reassure the public and the Government that it will not let interest rates rise much further and that essential credit needs, particularly for housing, will continue to be satisfied. In doing so, the Riksbank proposes two measures -- ceilings on interest rates and direct central bank lending -- which are meant to take the sting out of any future anti-inflationary monetary policy.

According to reports from Sweden, the present proposal has met with considerable criticism, not only from private interests, but to some extent within Government circles as well. At the same time, it appears that the composition of the present coalition Government virtually assures passage of the bill into law.

November 6, 1951

GOVERNMENT AND BANKING IN THE SOVIET UNION

Edward Ames

The Soviet economy is socialized; there is no private ownership of productive enterprise. In agriculture, trade and services, there is extensive cooperative organization, but elsewhere economic activity is carried on by state-owned enterprises. The coordination of these enterprises is effected by means of an economic plan, prepared directly by the cabinet. For many reasons, however, it has been found desirable to continue the use of money as a means of payment. Thus the various state-owned enterprises buy and sell to each other; in a limited sense they use a profit standard. Individuals likewise receive money incomes, and spend these incomes to purchase goods and services. Finally the State has an annual budget, with which it finances its administrative and other expenditures from revenue obtained from taxation or from borrowing. There is a State Bank which lends money to state enterprises in somewhat the same way that commercial banks in this country lend money to private firms. In other words, the Soviet economy is a monetary system, although the operations of the monetary mechanism differ from those in private enterprise economies by virtue of the fact that in general either one or -- more frequently -- both parties to any given transaction are state-owned enterprises.

The Soviet Union is not only a socialist, but also a totalitarian state. Its leaders are simultaneously Government and Communist Party officials; their policy decisions are issued sometimes in the form of Government decrees, sometimes in the form of Party programs or directives. The Party insists on its competence in all fields of policy; but it tries to keep its organs from directly participating in the administration of economic agencies. The State Bank, although depending fundamentally upon the Communist Party's attitude toward banking problems in general and towards the bank management in particular, therefore is not directly subordinate to, nor a part of, the Party apparatus.

In a totalitarian economy such as the Soviet Union, a central bank cannot function as a truly independent institution; its activities, like those of all individuals and institutions, are controlled by the economic plan, in which the policy of the State and the directives of the Communist Party are expressed. In an administrative sense, however, the central bank is autonomous: its local offices are responsible to its Board of Governors rather than to local offices of the Treasury or of the Party; and this Board has legally defined responsibilities and functions which differ from those of the Treasury and other Government or Party agencies. In an economic sense, the relations existing in other economies between Treasury and Central Bank and the role of the central bank in the short-term and long-term credit markets find their counterpart in the Soviet monetary system, although the institutional setting differs basically from our own. The following paper will describe briefly how the Soviet Union copes with these problems.

Financial Institutions in Soviet Credit Markets.

The participants in Soviet credit markets are the following:

1. The Ministry of Finances, a cabinet agency, which includes the following operating agencies:

   a. The tax collection and disbursement agencies, i.e. the apparatus comparable to that in Ministries of Finance generally.

   b. The State Bank, which is an autonomous system "within the system of the Ministry of Finances". All transactions other than wage payments and retail transactions pass through accounts in the State Bank; all public funds are kept on deposit in the Bank. The Bank is the only legal source of short-term credit, the only agency empowered to hold foreign exchange, and has the power of note emission and control over note circulation. It has a Board of Governors, appointed by the cabinet upon the nomination of the Minister of Finances.

   c. Four "banks for long-term investments", the Industrial Bank, the Agricultural Bank, the Bank of Trade and the Central Communal Bank. The last is a sort of holding company, controlling a number of local banks. Each of these banks disburses budgetary appropriations for construction in its respective field, and each makes loans to cooperatives and to state enterprises under the jurisdiction of local authorities.

   d. A system of savings institutions, which receive deposits from individuals, and invest the proceeds in state bonds.

   e. A system of insurance.

2. The Social Insurance system, which is administered by the trade unions, and which invests free funds in state bonds.

3. Producing enterprises, both cooperatives and state-owned. These enterprises have their own balance sheets and income statements, and are thus in some degree financially autonomous. Their needs for short-term credit are supplied by the State Bank,and their needs for long-term credit are supplies by the Investment Banks.

The relations between the Cabinet, the Ministry of Finances, and the State Bank have varied from time to time. Prior to 1936, the State Bank was a part of the Ministry of Finances. According to the 1936 Constitution, the State Bank, although a part of the Ministry of Finances, was represented at cabinet meetings; in 1938 it was removed from the Ministry of Finances, and in effect given cabinet status as a special agency responsible directly to the cabinet. In 1946, the State Bank was reduced in status, being made once again a part of the Ministry of Finances, and this time deprived of representation at the cabinet level. At the present time, the Chairman of the Board of the State Bank is a Deputy Minister of Finances. As such, however, he has equal status with the chief of the treasury apparatus proper (i.e. the chief of the budgetary mechanism), and the heads of the other financial institutions mentioned above. The operations of the State Bank have been, and continue to be independent of the operations of the tax collection and disbursement agencies. It is not possible to state with any certainty the reasons for the separation of the State Bank from the Ministry of Finances in 1938 or for its return in 1946. There is no indication that any major changes in economic policy or in internal political balances of power were involved. Rather the problem seems to have been purely technical: granted the need for coordinating and unifying the activities of the economic agencies dealing with budget and credit matters, is it most expedient to resolve differences in budget and credit policies at the Cabinet level, or at the staff level within a Ministry of Finances responsible for both?

The activities of all these institutions are coordinated by an economic plan, which must be approved by the cabinet. It consists of the following elements:

1. A plan for production, costs, employment, and wages, prepared by the ministries on general directives issued by the State Planning Committee, a cabinet agency.

2. A plan for capital investments, prepared by the ministries, on general directives issued by the State Committee on Construction, a cabinet agency.

3. A state budget, prepared by the Ministry of Finances.

4. A credit plan, prepared by the State Bank.

5. A cash plan dealing with note circulation, prepared by the State Bank.

Each of these documents contains not merely national forecasts, but detailed instructions to each Ministry, regional offices of the Ministry of Finances, regional offices of the State Bank, and each producing unit. The Budget is ordinarily submitted to the Supreme Soviet (legislature) which discusses it for two or three days, and ratifies it unanimously, after making minor changes to satisfy local interests. The other documents are approved by the Council of Ministers, and are ordinarily not made public at all. Even the budget is published only in its general outline.

The detail with which Soviet economic activity is planned, the degree of coordination which in theory must exist between all agencies at every level, and the importance of policitical orthodoxy all indicate that while the State Bank is not in any real sense an independent agency, it is no less autonomous than other agencies, including the fiscal branches of the Ministry of Finances. Whereas the State Bank is technically subordinate to the Minister of Finances, it is operationally separate, and would seem to have, in its own sphere of short-term credit management, a fairly large degree of autonomy. Moreover, since Soviet economic planning is conceived largely in non-financial terms, the Ministry of Finances would appear to have only a limited degree of autonomy itself. Its function is, in brief, to provide the means whereby the government can carry out its objectives. It is the cabinet, including the special committees on planning, construction, and allocations, which actually determine economic policies. The economic policies, however, are determined by political considerations prepared by the leaders of the regime (who act sometimes as governmental, and sometimes as Communist Party officials), and which must be accepted by the cabinet as data. In this system, both Treasury and Central Bank are relatively minor agencies as makers of policy, although the success of implementation of policy depends in large part upon the results of their efforts.

The Soviet Short-term Credit Market.

The State Bank of the USSR is not only a central bank, but also a commercial bank, the only commercial bank in the USSR. 1/ It therefore has among its depositors not only the State (in its budget accounts), but also all producing enterprises. As the bank of issue, it controls note circulation, and thus exercises direct control over the entire money supply of the country.

By increasing its loans to producing enterprises, the State Bank may increase the size of their deposits, and hence the volume of their current assets. The Bank, however, is authorized to grant loans only on the basis of the economic plan. Thus an enterprise wishing to borrow money

1/ The banks for long-term investment issue short-term credit to construction agencies to supplement their working capital, but such credit is quantitatively insignificant.

from the Bank must show that the loan will be used to finance its current production plan, and not for purposes of capital expansion. It must show, moreover, that its inventories are not excessive, in terms of that production plan. The Bank will not lend money to finance purchases of raw materials in excess of a supply as measured in days of requirements; it will not lend money to finance stocks of finished goods beyond a certain limit; and if the plant's loan requirements arise from the accumulation of unfinished goods (which is ordinarily interpreted as an indication of managerial inefficiency), the Bank will require the plant (or will intervene with the Ministry to which the plant is directly responsible) to make sure that these inventories are reduced to normal size. Thus the Bank exercises an extremely selective control over the uses to which its credits may be put. Since the individual producing unit is not ordinarily allowed to accumulate enough working capital to be free of the need to approach the Bank for credit to finance its current operations, the Bank is able to exert a considerable influence both on current inventories and on managerial efficiency.

The Bank controls inventories not merely by controlling the volume of outstanding credit, but also by controlling the velocity of turnover of deposits. The Bank may lengthen or shorten the length of credits, increase or decrease the speed with which payments documents are accepted and paid. In this manner, the Bank is able to vary the number of transactions, and hence the total flow of goods which will take place for any given amount of credit outstanding. The quicker the turnover of deposits, the larger the flow of goods per unit of time which can be financed out of any given volume of credit, and the greater the amount of production which can be supported by any given volume of inventories. Each enterprise must conduct its transactions through the State Bank, and must borrow money from the Bank to maintain the level of current output: the Bank is therefore able, by speeding up its payments mechanism and by shortening the lengths of its credits, to force enterprises to cut costs, adjust inventories, make prompt payments, and so forth.

The Bank, however, is concerned not only with this set of selective controls, which function at the level of the individual enterprise. It must also be concerned with the total amount of credit outstanding in the economy. The Bank organization includes not merely Divisions concerned with issuing credit to particular industries, on the basis of their production plans, but also Divisions concerned with note issue, wage payments, and economic planning, which cut across all industrial categories. In issuing credit to an industry, the responsible Bank division is limited by the share allotted to it in the general Credit Plan; this Plan is based upon an integration of the budget mechanism, the financial and cost plans of the producing enterprises, and finally the credit operations of the Bank.

If the Bank grants more credits than the general ceiling would permit, it makes it possible for enterprises to accumulate excess inventories. This accumulation leads in turn to shortages of primary and semi-fabricated producers' goods and thus ultimately to disruptions of production. Moreover, an increase in credits tend to increase payrolls and hence to expand the note issue. At the same time, the increase in inventories tends to reduce the amount available for sale at the retail level and hence to retard the return of notes to the banking system, an excess of credit will lead to currency inflation, and a disorder in the retail markets.

In maintaining the "orderly" flow of materials in the economy, the Bank must therefore issue credit with regard both to the requirements of the enterprises and the economic plan as a whole. In this connection, it must coordinate its activities with those of the Treasury proper. Treasury policy tends to reduce the deposits of producing enterprises in the State Bank and to increase the deposits of the Treasury. Moreover, to the extent that the Treasury shows a budgetary surplus, its deposits increase, and the Bank is able to use directly the assets corresponding to these deposits. The Bank cannot prepare its "credit plan" without taking into account the expected volume of Treasury revenue and expenditures, as well as the expected production of the individual producing enterprises.

It follows, then, that there must be a close coordination of the operations of the State Bank with those of the Treasury on the one hand, and the producing enterprises on the other. The State Bank, unless coordinated at every step in the economic planning system, would be in a position to nullify the attempts of the State either by issuing too much or too little credit, or simply by allocating credit in areas not approved of by the state. For this reason, the Bank is subordinated to the cabinet and the economic planning system.

The Soviet Long-term Credit Market.

In the USSR, the use of credit in capital investment is limited. State owned enterprise may not borrow for expansion purposes (except in the case of very small enterprises operated by local authorities), but must use either earned profits or appropriations from the state budget. Cooperative organizations, collective farms, small, locally controlled state enterprises, and individual home-builders may borrow money from so-called "long-term investment banks", but the funds loaned by these banks, to the extent that they involve a net increase in credit outstanding, are financed from budgetary funds. Thus there is normally no credit creation in the field of capital investment. Loans do not amount to more than a few percent of all funds available for capital investment. There is no "market" for the loans, in that all projects,however financed, must be approved by administrative authorities; once approval has been secured, the credit is automatically opened by the bank, whose interest consists merely in supervising the efficiency of the construction operations and in making sure that the loan is spent for the purposes for which it was granted.

A second form of long-term credit is borrowing by the Government. This borrowing may be either in the form of loans for popular subscription, or of loans from financial agencies, including savings banks, insurance, and the State Bank.

The loans issued to individuals are non-negotiable and non-transferable. They have sometimes been redeemable prior to their maturity date, and sometimes not. They are typically issued once a year, for a 20-year period. Three refunding operations have taken place, in 1930, in 1936, and in 1947. On the last occasion, the face value of the outstanding debt was cut by 2/3, as part of a general currency reform aimed at eliminating excess purchasing power arising under inflationary wartime conditions. "Returns" on the bonds are in the form of rights to drawings in state lotteries. Thus an individual may receive no interest, or an enormous interest, although the state pays out in prizes the equivalent of 3 or 4 percent interest. (The rate has varied.)

Loans are issued once a year, in a major publicity campaign. In the country, subscriptions are typically in cash; in towns they are typically paid by a payroll deduction plan. The main appeal is patriotic, and subscriptions are "expected" to represent a certain number of days' pay.

Thus there is no real market for these securities, since the political mechanism of the state is such that the individual comes under strong suspicion if he does not subscribe to bonds at the going rate. At the same time, the Government is limited in its borrowing activity by the volume of wages paid, by its income tax policy, and by the quantities and prices of goods which it sells the population.

Loans are issued by the Government to savings banks and the insurance system, which otherwise would have no earnings on their funds, and which are barred from making loans or investments directly to producing enterprises. The size of these loan issues depends upon the inflow of resources to these agencies, and thus will vary somewhat from time to time.

Finally, the Government can borrow from the State Bank, where it keeps its funds on deposit. This type of borrowing is similar in nature to government borrowing from banking systems in private enterprise systems, and has the same inflationary effects. For this reason the Soviet

Government has been reluctant to borrow directly from the State Bank and has done so only in times of crisis (as in 1942 and 1943) when consumer goods production was so small (because of military demands) that normal budgetary revenues, which are based in large part upon a sales tax, were insufficient to cover budgetary expenditures. This connection between Government borrowing from the State Bank and a budget deficit indicates once again the interrelation of monetary, fiscal, and general economic policy. Given the amount of budgetary expenditures, and the amount of purchasing power in the hands of the public, the lending activities of the State Bank must be carefully integrated with the remainder of the planning mechanism, in order that the planned flow of goods may not be disrupted by a flow of money operating at cross-purposes with the objectives of State policy.