PUBLIC AS OF JANUARY 1, 2009

L.5.2

RFD 450

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

November 5, 1963

The Selective or Direct Control of Credit

17 pages

Reed J. Irvine and Yves Maroni

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Reed J. Irvine and
Yves Maroni

The Selective or Direct Control of Credit 1/

In the postwar period, many countries have made extensive use of selective and/or direct controls over credit. In so doing, they have written a record from which valuable lessons may be gleaned concerning the validity of the arguments usually advanced in support of such policies. This paper will attempt to evaluate these arguments in the light of this experience.

Two main arguments have been used to justify the use of selective or direct credit controls. It is said (1) that such controls can be advantageously used to channel credit into essential and away from nonessential uses, and (2) that such controls are necessary to prevent excessive credit expansion in certain key areas of the economy in the interest of general economic stability.

A third justification which will not be dealt with here (because it is more closely related to political strategy than to economic theory) rests on the finding in some cases that selective controls are more palatable politically than more stringent general controls might be.

Background Perspective

The view that selective controls can properly be used to channel credit into what are thought to be more desirable uses has probably underlain most of the experiments with selective controls in countries other than the United States. It might even be said that the idea of influencing the use of credit for specific purposes played some role in Federal Reserve policy in the early years of the System's history. One of the basic aims of Federal Reserve policy was to direct credit into "productive" uses, and this was one of the reasons which led to considerable attention being given to the definition of paper eligible for rediscount. The Federal Reserve System gradually abandoned this approach to monetary policy, however, since it found that banking processes did not in practice function to confine bank lending to productive uses, strictly defined, and that banks were quite content to limit their eligible paper holdings to some modest ratio of deposits considered safe for operating purposes. Moreover, since member bank borrowings from the Federal Reserve tended to be much less than the amounts of eligible paper which they wished to hold in any event, the policy did not affect the pattern of credit extended by banks.

In the early years after the end of World War II, the credit channeling concept was influential in the thinking of the monetary authorities in a number of European countries. For example, in the United Kingdom, commercial banks were asked to make their lending policies conform to the principles followed by the Capital Issues Committee in its review of applications for stock and bond flotations. Moreover, all bank credits in excess of 50,000 not made in the ordinary course of business of the borrower had to be cleared by the banks with the Capital Issues Committee.

1/ This paper was prepared for the Seventh Meeting of the Central Bank Technicians of the American Continent, Rio de Janeiro, Brazil, October 1963.

France and the Netherlands attempted to make the granting of all large bank credits subject to the approval of the central bank. It was believed that the postwar reconstruction requirements ruled out exclusive reliance on general measures of control and that the authorities would have to exercise their power to see that credit went for the uses most beneficial to recovery. The results were far from satisfactory. Under conditions of heavy inflationary pressure such as prevailed in France up to 1948, it seemed that every loan applied for was justified, and thus this kind of credit control turned out to be the absence of control. Moreover, the administrative burdens involved in this kind of credit screening by the central bank were very considerable.

The unsatisfactory experience that various European countries had with the effort to restrain the expansion of credit and channel its use by administrative screening, contributed in the early 1950's, to the revival of general monetary policy, relying on the use of the general instruments of credit regulation.

This does not mean that the use of special or selective controls to try to channel credit into particular uses was completely discredited and universally abandoned as a result of the early postwar European experience. Many countries remained interested in influencing the allocation of credit to various sectors of the economy, but they resorted to a variety of new techniques for the purpose. Screening of bank loans by the central bank generally fell by the wayside. In its place, measures of a more impersonal nature were tried. These include differential discount rates, portfolio ceilings, techniques associated with reserve requirements, and advance import deposits. The ensuing pages will discuss each of these in turn. This will be followed by a review of United States experience in the last thirty years and the paper will end with some comments on two techniques for direct control which are non-selective in nature, namely rediscount quotas and overall ceilings on credit.

Differential Discount Rates

Perhaps the most widely employed technique to influence the channeling of bank credit has been the provision of differential central bank lending and discount rates which vary depending on the type of paper offered for discount or as collateral. Such rates are often set up with the intention of inducing the commercial banks to favor certain types of activities with more abundant or cheaper credit.

Extent of experiment with differential rates

This particular technique has been most widely used in Latin America. Argentina, Bolivia, Brazil, Colombia, Costa Rica, the Dominican Republic, Ecuador, Peru and Venezuela all employ multiple discount or advance rates to some extent. Generally, these countries give preferential rates on discounts of, or advances against, agricultural or industrial paper, or both. In some cases, preferential rates are also accorded to advances secured by government securities.

Colombia goes further than most Latin American countries in the use of this particular device. The central bank there charges 8 per cent for paper covering ordinary commercial credits and short term industrial or agricultural paper, 5 or 8 per cent for loans and discounts secured by warehouse receipts (depending on the products involved), 5, 6, or 7 per cent for operations secured by agricultural bonds (depending on their purpose and terms), and a rate 2 percentage points lower than that stipulated in the collateral (a) for operations secured by paper representing industrial loans up to five years maturity, (b) for paper representing certain small loans, or loans to certain small businesses or to cooperatives, (c) for specified obligations of certain local government and public enterprises, and (d) for operations with financial corporations. In each case, eligible paper must conform to certain requirements with respect to maximum rates of interest. Most of the other countries in Latin America with a multiple rate structure have only two or three rates.

This technique has also been used in a number of Asian countries, notably Burma, Japan, Korea, Indonesia, the Philippines, Taiwan, and Thailand. The Japanese rate structure is even more complicated than the Colombian, in that the Bank of Japan has four different loan rates depending on the type of collateral offered in addition to different rates for discounts, overdrafts, and loans in excess of quotas. The Indonesian rate structure is also very complicated, but the other Asian countries limit themselves to two or three rates.

In Europe, such countries as France and Belgium have used the technique, giving preferential treatment to rediscounts of and advances against export paper. The Bank of France also provides special rediscounting facilities for medium term credits granted with the prior approval of the authorities, and applies a special rediscount rate in such cases. In addition, the French rediscount rate structure involves a basic rate for rediscounts of short-term paper up to specified quotas and two higher rates for rediscounts of such paper in excess of quotas.

Effectiveness of differential rates

In spite of the fairly wide use of multiple discount rates, there is little information available concerning the effectiveness of this device. Hence, this is a field that seems to merit fresh research. It is rendered difficult because too often the central banks do not publish the composition of their assets or the assets of the commercial banks in sufficient detail to enable an outside observer to see what, if any, impact differential discount rates may have had. It would be most useful if each central bank that has had experience with this device could analyze and publish the results that it has observed.

However, some general observations are possible about the results which such a system might produce under certain circumstances. It is apparent that the impact of multiple discount rates upon the pattern of credit extension in a country will depend to some extent upon the degree of dependence of the commercial banks upon central bank credit. In a country where the commercial banks normally do not resort to central bank credit, or do so infrequently and on a small scale, a multiple discount rate structure will not influence the lending pattern.

Commercial bankers could normally be expected to rediscount or submit as collateral paper that would qualify for the lowest rate offered by the central bank. If their borrowing requirements were small, it is unlikely that they would have to make any drastic changes in their portfolio to acquire sufficient paper of the favored types to satisfy their needs since they probably would hold enough in the natural course of events. If borrowing from the central bank tended to be on a heavier scale, on the other hand, it is possible that bankers might be tempted to acquire more of the favored paper, especially if it were a type that the banks had not been holding previously, in order to take advantage of the preferential rates.

The discount rate, however, would not be the only influence bearing on the decision of the bankers in a case of this type, and even under the most favorable assumptions, it seems unlikely that discount rate policy alone would bring about very drastic changes in the credit pattern. In countries characterized by limited borrowing from the central bank, it is difficult to see how multiple discount rates could serve any useful purpose.

Disadvantage of multiple rates

Leaving aside for the moment theoretical considerations regarding the desirability of official intervention to encourage particular lines of economic activity as opposed to others, it is possible to cite some possible disadvantages of multiple discount rate systems. One is that they may frustrate efforts to enforce restrictive credit policies at times when such policies are needed to promote a stable economic development. If the preferential rediscount rates are lower than what market forces would call for, as they must necessarily be if they are to achieve their purpose, they will constitute a potentially serious loophole which may make it difficult, if not impossible, to secure the degree of credit restriction that may at times be necessary.

Another danger to be guarded against is the possibility that the rediscounting mechanism may be used merely as a channel for directing central bank credit into certain sectors of the economy. The aim is presumably to encourage commercial banks to employ their own funds in the chosen sectors. However, if the central bank's preferential discount rates are far out of line with the market, the commercial banks may be tempted to operate in the favored sectors almost entirely on funds provided by the central bank through the discount window. The central bank should be regarded as an instrument that permits a certain amount of flexibility in the monetary system, but it cannot generally be used as a source of investment funds substituting for savings without engendering serious consequences. This danger would appear to be increased somewhat when the central bank establishes a discount rate structure for the specific purposes of promoting certain types of investment.

Other Credit Channeling Instruments

Some countries have found the multiple discount rate system inadequate to accomplish the type of changes in the credit pattern they desire and have resorted to other devices, either as a substitute or supplement.

Portfolio Ceilings

One instrument used has been portfolio ceilings. The Philippines, for example, began in April 1957 to use the power conferred on the Monetary Board by the Central Bank Act to apply limits to the volume of loans that commercial banks could make in certain specified categories. Limits were placed on the amount by which banks could increase their loans to finance certain activities, e.g., real estate investment, domestic trade, and consumption. No ceilings, however, were placed on credit to finance agriculture, industry, public utilities, and imports of highly essential commodities.

The explanation of this action was that it was intended to direct expansion of bank credit into the "more essential and productive sectors of the economy" and thus accelerate economic development. Actually, at that time the Philippines was confronted with a serious problem of domestic inflation and deterioration in the international balance of payments, and there is reason to believe that the imposition of portfolio ceilings, which was coupled with an increase in the discount rate from 1-1/2 to 2 per cent, was intended to contribute to a much needed tightening of credit. There is some evidence that the pattern of credit in the Philippines was affected by this measure, but the measure did not succeed in producing the degree of monetary tightness needed to solve the problems that the Philippines was facing at that time, and more restrictive measures had to be taken a few months later.

In Costa Rica, where portfolio ceilings have been the principal instrument of monetary policy since 1948, there are general ceilings relating to the needs of the economy as a whole and special ceilings for specific purposes. The number of specific ceilings tended to increase until, in June 1962, the central bank decided to simplify the system and cut their number from 21 to 9. In general, the banks have tended to expand credit up to the level of most of the ceilings. However, some of the special ceilings have been inoperative, either because they were set too high or because they were allowed to be breached.

Colombia for a time used a system which might be called "portfolio controls" to determine what proportion of increases in bank credit would flow into specified sectors of the economy. When first introduced, in May 1960, the Colombian system provided an overall ceiling for bank credit expansion and stipulated that the increase should be distributed among several sectors of the economy in accordance with prescribed percentages. The overall ceiling, however, proved to be more an instrument of credit expansion than one of credit restraint, encouraging the banks to increase their borrowings from the central bank so as to expand their loans up to the ceiling. This led in March 1961 to the withdrawal of the overall ceiling.

When the overall ceiling was abolished, the prescription of percentages, according to which increases in bank credit were to be allocated among important sectors of the economy, was continued. The prescribed percentages were verified quarterly as to compliance, and deviations from the prescribed pattern were subject to a fine payable to the central bank. Alternatively, deviating banks were authorized to purchase from the Central Bank agricultural and commercial warrants in an amount equal to the deviation.

This portfolio control scheme was probably more effective in bringing about a credit pattern which the central bank deemed appropriate for the country than the multiple discount rate system also used by Colombia. In its most recent form, however, it was not intended to restrain credit and, as such, it did not contribute at all to the monetary stabilization of the Colombian economy. The system has now been abandoned.

A similar system has also been used in some other countries, notably Switzerland where separate ceilings apply to the expansion of mortgage credit and of other credit.

Techniques associated with reserve requirements

Mexico has had for some years a system of selective control, similar in effect to the portfolio ceiling mechanism but operated through the use of reserve requirements. The system relies on the principle that the commercial banks will be exempted from holding the minimum cash reserves required by existing regulations, provided that prescribed percentages of their portfolios consist of specified types of loans or investments. The prescribed percentages may be changed from time to time as the central bank shifts emphasis from one field to another. The percentages vary with the location of the banks, the currency in which the deposits are denominated (pesos or foreign currency), and with the nature of the deposits (demand, time or savings). Under existing rules, banks retain their freedom to use resources in excess of the prescribed percentages as they see fit, provided that their total portfolio conforms to an overall requirement as to its composition (at least 70 per cent must be in loans to agriculture and industry and at most 30 per cent in loans to commerce).

Argentina, Brazil, Chile, Colombia, the Dominican Republic, Egypt, Israel, and Peru, have employed measures which, like Mexico, make some use of reserve requirements in influencing portfolio composition, but none has had quite as elaborate an arrangement as Mexico. The Peruvian regulation merely provided that part of the reserve requirement might be met by deposits held with the State Agricultural Bank.

In Colombia, the system has been combined with a secondary reserve requirement under which the banks must invest a prescribed percentage of their deposit liabilities in specified bonds of the State Agricultural Industrial and Mining Bank. This requirement is in addition to the cash reserve requirement. Reserve requirements of this kind are also used in a number of other countries. In many cases, the purpose is to restrict the liquidity of the banks by preventing them from selling securities from their portfolio, rather than to promote favored investments (hence the name liquidity reserve requirement often used to describe them). However, both objectives may be combined. The type of paper most frequently required to be held consists of government securities, but other instruments are often specified as well. In France, for example, banks must hold specified proportions of their deposits in the form of Treasury bills, export paper and medium term paper.

Evaluation of techniques for channeling bank credit

The principal problems that these techniques raise are those of compliance and equity. Compliance is enforced through the periodic bank examinations which the authorities conduct. To the extent that the regulations prescribe that specific documents shall be held in the portfolio, the task of verification by the examiners is easy. However, it is less easy to ascertain whether or not the loans have been made for the purpose stated or have been used for the purpose that the bank intended.

Considerations of equity enter into most kinds of selective bank credit controls, but they become more serious when compliance problems are great. It is obviously not possible to set up categories with such precision that everyone would agree that every activity covered by the definition of category "A" is more meritorious and deserving of credit than some activities that fall into category "B". Inequities are inevitable. Whenever possibilities of evasion and non-compliance become considerable, inequity arises from this source. It must be said, however, that Mexico has maintained its rather complex system for a number of years and appears to be satisfied with the way it has functioned.

The question of whether or not the effort to direct the flow of credit into particular channels through selective credit controls is economically justifiable is one that can be answered only in general terms. Countries that have experimented with the various techniques have obviously not had uniform results. Since there is some uncertainty as to the degree to which the pattern of credit has actually been modified by the techniques employed, there is even more uncertainty as to whether they have greatly influenced economic growth. About all that can be said with certainty is that the allocation of resources through the use of a selective credit control cannot guarantee the achievement of a rapid rate of economic growth, nor is it a necessary condition of growth. Whether or not it makes any contribution will depend on the wisdom with which it is used in the given situation and on the strength of the other variables that are shaping it.

But it is surely self-evident that a country cannot maximize growth by flouting the law of comparative advantage. If credit controls or other policy instruments are relied on to divert investment into uneconomic activities, a country will suffer a loss. There is always the danger that a selective credit control, if effective, may result in a serious diversion of resources away from activities that would have produced greater gains for the economy into less beneficial activities. This is not the kind of question that can be settled simply by a priori determination that all investments of a certain type are preferable to all investments of some other type. Economic decision making is a much more complex process than this, and regulations which require that decisions be made on the basis of oversimplified guidelines without careful consideration of all the facts bearing on each case are likely to result in a great many bad decisions.

It seems likely that the best justification for selective controls that aim at influencing resource allocation is that they may help achieve a desirable change that had been impeded by institutional factors. For example, where commercial banks have largely confined themselves to a field such as foreign trade financing, it may be desirable to spur them to take an interest in other fields.

It may be that nothing more than custom or inertia has kept them from making agricultural or industrial loans. Once they have been prodded into acquiring the experience and skills necessary to function successfully in new fields, they might be expected to continue their interest in these areas without special inducements to do so. This would suggest that selective credit controls to influence reserve use might best be used as short-term measures to stimulate change. If prolonged application proves necessary, it would suggest that it was something more than habit or inertia that had previously inhibited the change. In this case, the wisdom of extending reliance on the particular control ought to be carefully examined. This observation does not necessarily apply, of course, if the motivation for attempting to alter the pattern of resource allocation is clearly non-economic--such as a desire to preserve uneconomic agricultural operations for political or social reasons.

The use of selective instruments to channel bank credit to the Government is worthy of special comment. If the purpose is to accustom the banks gradually to hold government securities as part of an effort to develop a money market, the extent to which success is achieved will depend on the government's ability to avo inflation which would make fixed interest securities unattractive. The securities must also offer a realistic interest rate, one which is competitive with the rates for similar risks in the open market. If the purpose is to lock in the security holdings of the banks so as to limit their ability to liquidate their investments to finance an expansion of their loans to the private sector, success will depend on the extent to which bank liquidity is not being increased by other factors. In this respect, the post war experience of the countries of Western Europe supports the view that liquidity ratios can be most effective in reinforcing a generally restrictive credit policy.

The main danger of devices to channel credit to the Government is that they will become a tool to finance budgetary deficits. In such a case, they are likely in the short run to produce a squeeze on the private sector, by diverting resources which might otherwise have been available to it, and in the long run to lose their restrictive effect, as the deficit becomes chronic and comes to be financed in part by the central bank.

Advance Deposits Against Imports

There is another type of selective credit control that has been widely used in Latin America and Asia with rather different objectives than those underlying the controls discussed above. This is the advance deposit requirement for imports.

Mechanism of the technique

An advance deposit against imports may be tied to the margin banks normally seek to obtain with import letters of credit or it may be an obligatory cash deposit that has to be made when importers apply for an import license. In the latter case, the deposit requirement itself is not, strictly speaking, a credit measure, but it becomes one if supplemented by restrictions on the amount that banks

can lend to provide funds to meet the deposit requirement. Generally, the advance import deposit requirement provides that assigned deposits be held at the central bank for stated periods, sometimes extending well beyond the date when the imports clear customs. This device has been used in such countries as Argentina, Brazil, Chile, Colombia, Ecuador, Paraguay, Uruguay, Indonesia, Iran, Japan, Pakistan and the Philippines, not to mention some European countries, among them France, Greece, and Finland.

The selective effect of advance import deposits arises from the additional cost which they impose on importers, who must tie up their funds for longer periods than would otherwise be necessary. This tends to raise the cost of imports and is likely in the long run to reduce import demand. Moreover, the amount of deposit required may vary widely depending on the commodity, and there is therefore a selective impact not only as between imports and other goods but also between different types of imports.

Advance import deposits also have a general contractionary effect on credit in so far as the funds involved are transferred from commercial banks to the central bank. This is necessarily a transitory effect, since the release of funds eventually more or less balances the receipt of advance deposits. Of course, when the requirements are eased or eliminated, the release of funds will produce an expansionary impact on the economy.

Advantages and limitations

This control technique is specially designed to cope with inflationary credit conditions in countries suffering balance-of-payments difficulties. Since it tends to have a strong impact on import demand as well as a powerful, though temporary, overall contractionary effect, it can be useful in meeting an acute payments imbalance. It is preferable to the imposition of quantitative restrictions on imports or the use of direct exchange controls, since it continues reliance on the price mechanism as the main means of allocating resources. For this reason, advance deposit requirements are sometimes advocated as an intermediate step for countries wishing to get rid of quantitive import restrictions and exchange controls.

It is important to emphasize that no import deposit requirement can provide a long-run solution for balance of payments disequilibrium. One of their drawbacks is the danger that they will be used to cover up a bad situation and delay action that will attack the causes, not just the symptoms, of the disequilibrium.

A number of important points must be borne in mind with respect to this device. If the aim is to contract the supply of credit available to finance imports as well as to increase the cost to the importers, either the deposits must be held by the central bank or the commercial banks must be required to hold with the central bank reserves equal to the deposits. If the desired effects are to be achieved, it may be necessary to devise ways of limiting the amount of credit which banks may make available to importers to meet the deposit requirements. These limitations may be difficult to enforce uniformly and evasion is likely to be a problem.

If the enforcement is effective, the authorities are likely to be faced with complaints that the system is discriminatory. The importer may well ask why he is the primary target of the credit tightening measures when the cause of the payments imbalance may lie in the fact that everyone else has had and continues to have access to credit on excessively easy terms. The larger firm with ample resources, or with assets which may be offered as security for loans, or foreign connections which enable it to borrow abroad, or even good connections domestically, may find its import operations little hindered by the deposit requirements, while smaller houses may be hard pressed to stay in business. Measures which have such discriminatory effects may be hard to justify politically.

It is almost invariably the practice to require smaller deposits against some imports than against others. This is done to moderate the impact on what are considered more "essential" imports. But essentially is a quality very difficult to fit into broad categories. An article with a generally low priority may have some high priority uses, while another article with a generally high priority may be put to some low priority uses. Attempts to modify the regulations to ease unjustifiable discrimination and avoid economic waste could produce major administrative headaches and open the door to corrupt practices.

Eventually, the pressure for relaxation may cause the easing or elimination of the deposit requirements. This too brings problems, since the funds that have been tied up will contribute to inflationary pressure when released. If the country has not taken more fundamental measures to solve its payments problem, it may find the situation badly worsened by the release of these funds.

As experience with their use has been gained, the shortcomings of import deposit requirements have been increasingly recognized. This has resulted in some tendency to replace them with exchange taxes or higher import duties.

U.S. Experience with Selective Credit Controls

The approach to selective credit controls by the Federal Reserve System over the past three decades has been fundamentally different from that of other countries. In contrast with the more comprehensive approach found in many other countries, selective credit regulation in the United States has been limited to three areas. In only one of these, has regulation been in effect continuously for a long time. In the other two, regulation has been used as a temporary measure in periods of emergency.

As was mentioned earlier, there was a time when the Federal Reserve was concerned with channeling credit into "productive" uses through the discount mechanism, but this came to be recognized as an unfruitful approach to the problem of credit regulation.

As time passed, however, interest developed in the use of selective regulation as an instrument of credit policy under certain circumstances. The rationale given by advocates of such regulation was that selective regulation of certain "strategic" areas in the economy could play a key role in supplementing

general credit controls to help achieve general economic stability. The reasoning was that certain special credit sectors were not sufficiently responsive to general credit controls and that, therefore, they could not be materially affected unless money were tightened excessively. It was argued that some of these special sectors were capable of exerting a potent destabilizing influence and that selective regulation of them was accordingly justified. During World War II, when selective control over consumer credit was first introduced, there was also considerable emphasis on the role that this could perform in helping to transfer resources from non-essential industries.

The areas in which controls of a selective nature have been applied are stock market credit, consumer credit and real estate credit.

Stock market credit regulation

Regulation of stock market credit dates from the passage of the Securities Exchange Act of 1934, which provided that the Board of Governors of the Federal Reserve System should place limits on borrowing for the purchase or carrying of "listed" securities in order to prevent the excessive use of credit for this purpose.

This, of course, was a product of the very unhappy experience of the late 1920's when credit expansion played a very important role in the stock market boom and the subsequent contraction of credit aggravated the great crash. Those events made it clear that stock market credit does not respond well to the traditional instruments of monetary policy. In particular, in a boom, when capital values are rising rapidly, investors may not find high rates of interest a very strong deterrent to borrowing to finance speculative purchases of stocks, and from the lenders viewpoint, a loan on actively traded marketable securities is a prime loan which they may prefer over a business loan, even if the general level of stock prices is high. The important role played by the stock market in the American economy made it essential to provide a tool to which stock market credit might be more responsive. In addition it was recognized that stock market credit might need restraining at times when restraint would not be desirable for the economy as a whole.

The margin requirements imposed by the Federal Reserve, i.e., the percentage difference between the market value and the maximum loan value of a security, have long been thought to be generally effective in preventing excessive use of stock market credit. However some doubt has been cast upon this by some very recent studies by the Securities and Exchange Commission and the question is currently being reassessed. The requirement has varied from a minimum of 25 per cent when it was first imposed in 1934 to 100 per cent in 1946. In recent years, it has fluctuated from 50 to 90 per cent. This is the only selective control that is still in effect in the United States.

Consumer credit regulation

Consumer credit control was first instituted in 1941, during the period of national emergency arising from the war. The Federal Reserve Board's Regulation W, which governed the control of consumer credit, was in effect during three periods--September 1, 1941, to November 1, 1947, September 20, 1948 to June 30, 1949, and September 18, 1950 to May 7, 1952.

Consumer credit was a logical candidate for selective control for a number of reasons. These included (a) the fact that its volume is very large in the United States, (b) its tendency to rise rapidly in boom periods and level off during recessions, thus intensifying cyclical movements, (c) its tendency to respond sluggishly to the traditional instruments of monetary policy, and (d) the fact that loan terms did not vary as much as those of business loans, and could therefore be more easily regulated. The control was accomplished by prescribing the minimum down payments to be required of purchasers of the categories of goods covered and limiting the period during which they would be required to complete payment for the goods. Both the down payment and the maturity requirements varied somewhat depending upon the type of goods. For example, at the time the regulation was suspended in May 1952, the down payment required for automobiles was one-third, for appliances and furniture 15 per cent, and for home improvements zero. Maximum maturities for loans against automobiles, appliances and furniture were 18 months, while 36 months were allowed for home improvements.

The volume of consumer credit fell sharply during the war years, mainly because of the shortages of consumer goods, the impact of rationing and the large amount of liquidity being built up by potential buyers. In the postwar years, consumer credit rose sharply in spite of controls, as consumers satisfied their pent-up demand for goods. It was not until 1950-51 that the steady upward trend was temporarily halted. It appears that the reimposition of Regulation W in September 1950 helped to bring about a pause in the upward trend, though other factors also had an influence.

It should be noted that consumer credit regulations have been adopted in a number of other countries in the postwar period, particularly (but not exclusively) in the more industrialized countries. A partial list of countries which have used this technique includes Canada, Denmark, France, the Netherlands, New Zealand, Norway, South Africa, and the United Kingdom, as well as Chile, Peru, and the Federation of Rhodesia and Nyasaland.

Real Estate Credit Regulation

The third area in which the U. S. has had experience with selective credit control is that of real estate credit. The volume of credit used to finance the construction and purchase of residential housing in the United States is very large, and in the Defense Production Act of 1950, the Federal Reserve Board was empowered to regulate this type of credit for the purpose of preventing "undue strains and dislocations upon wages, prices, and production or distribution of materials for civilian use."

The need for regulating this type of credit was heightened by the fact that, in 1950, long-term interest rates were still pegged under the policy originally adopted during World War II. Hence, it was not possible to depend on the restraining influence of higher interest rates to limit the expansion of this type of credit. Given the emergency conditions created by the Korean War, it was felt that the country's resources could be put to more important uses.

Accordingly, in October 1950, the Board issued Regulation X prescribing maximum loan values, maximum maturities, and minimum amortization terms for credit extended in connection with certain residential dwellings. This was soon after broadened to cover all residential property and certain non-residential buildings.

The effectiveness of this regulation was greatly delayed by the fact that it exempted commitments to finance entered into prior to the time the regulation became effective. Later on, its effectiveness was greatly reduced by amendments to the Defense Production Act which forced relaxation of the restrictive terms imposed by the regulation, and the Board suspended it in September 1952.

These special circumstances make it difficult to evaluate the control of real estate credit on the basis of U.S. experience. The difficulty is increased by the fact that in March 1951, the Treasury and the Federal Reserve reached an accord which led to the resumption of open market operations as an influence on overall credit conditions. This restored the flexibility of interest rates and the ensuing rise in such rates had a restraining effect on the expansion of real estate credit in 1951.

General evaluation of U.S. experience

The task of assessing U.S. experience with selective credit controls is complicated by two considerations. One is that the purpose of the regulation was not the same for stock market credit as it was for the other two areas regulated, in that the allocation of real resources in the economy, which was important in regulating consumer and real estate credit, was not at issue in regulating stock market credit. The other is that evaluation may be made, not only from the standpoint of the success in attaining the objective desired, but also from the standpoint of the ease of enforcement, considerations of equity, and others. In the words of a multi-volume study of consumer installment credit prepared by the Board of Governors of the Federal Reserve System in 1957, "The degree of success that was attained in enforcing postwar regulation is a matter on which there is considerable difference of opinion" (Part I, Vol. I, p. 314).

While the regulation of stock market credit is currently being reassessed, it would seem to have had some effect in reducing the danger that another speculative boom in the stock market would culminate in a crash aggravated by a credit contraction.

As to consumer and real estate credit, it is difficult to assess the effect which selective regulation in these areas has had in the past in controlling the aggregate volume of credit and expenditures in the United States and even more difficult to evaluate the role which it might have played under differing supply conditions and differing general monetary policy. A considerable part of the experience with consumer and real estate credit regulation has been in periods when over-all demand was heightened by war or defense emergencies and when effective use of general monetary measures was either limited or altogether frustrated. Certainly this experience suggests that selective regulation cannot be a substitute for vigorous action on a broader front. The absence of such broader action heightens enforcement problems in regulated areas as well as leaving other areas free from restriction. On the other hand, there can be no doubt that effectively

increasing down payment requirements and cutting back on maturities can have a substantial effect on credit flows to the regulated areas both through the one-time effect of increasing repayments relative to extensions, and also by excluding some potential purchasers from the market. Such action may be particularly desirable in periods of war or defense emergency, when shortages make it desirable in any case to channel credit and real resources to other areas. In other circumstances, the extent of desirable changes in terms would probably be more limited because of questions of equity, problems of market adjustments, and enforcement problems, and as a result the effects on credit flows would be more marginal.

Non-Selective Direct Controls

A number of countries have used direct controls of a non-selective nature to deal with strong inflationary pressures. Two techniques of this type may be mentioned, rediscount quotas, and overall ceilings on commercial bank credit.

Rediscount Quotas or Ceilings

Rediscount quotas are ceilings placed on the amount of rediscounts and advances which the central bank is willing to grant to the commercial banks. They may be stated as an absolute amount in the country's currency or as a percentage of some suitable item on the commercial banks' balance sheets. In Colombia, for example, the ordinary rediscount quotas are stated as a percentage of the banks' capital and reserves; special quotas expressed as a fixed sum in pesos are also provided for specific types of operations (a feature which, of course, imparts a selective character to the technique).

A serious drawback of rediscount quotas, at least those which are stated as a percentage of the banks' capital and reserves, is that the banks themselves can influence the amount of their quota by recapitalizing themselves or by putting some of their profits in reserves. Under inflationary conditions, the banks may increase their capitalization by periodically revaluing their assets. If revaluation of assets is unrestricted, the rediscount quotas will automatically increase at the banks' own initiative. On the other hand, if revaluation of assets requires the permission of the authorities, the door is open to administrative inequities, and the danger arises that the stronger banks will receive unfair advantage over their weaker competitors.

Another drawback is that under this technique it is not possible to accommodate new banks without in effect allowing a larger credit expansion than may have been envisaged when existing banks were allocated their own quotas. Yet, new banks may have to be accommodated so that the banking structure does not remain frozen, and for other reasons.

Still another drawback of rediscount quotas is that they tend to give the banks access to central bank credit as a matter of right. The banks come to consider that they are entitled to these resources on a permanent basis as a normal supplement to their own capital and deposits. This makes it difficult for the central bank to use changes in rediscount quotas effectively in fighting inflationary pressures, all the more so since the technique is often coupled with an unrealistically low rediscount rate which acts to stimulate demand for central bank credit.

Changes in rediscount quotas have the same bluntness as changes in reserve requirements since they cannot be made frequently and necessarily involve the freezing (or the release) of larger amounts of bank reserves than the short-term needs of the economy require. In Colombia, changes in rediscount quotas have often been combined with other changes in monetary policy. However, while some of the accompanying measures have tended to offset the change in rediscount quotas, others have reinforced it. For example, the latest reduction in rediscount quotas, in May 1963, was accompanied by a lowering of reserve requirements, a rise in the rediscount rates, the introduction of special rediscount quotas for specific operations, and the suspension of most central bank lending to the general public. Whether the net effect of all of these steps is to ease or to tighten credit is rather difficult to judge for an outsider.

It does not appear that Colombia's experience with this technique has been such as to suggest that it is preferable to the more indirect instruments of credit regulation. Indeed, the measures taken last May would appear to indicate that the Colombian authorities themselves may not have been entirely satisfied with it. The principal effect of these measures seems to be to increase the reliance being placed on the discount mechanism, as the spread between the rediscount rates and the interest rates allowable on eligible paper has been substantially narrowed.

More to the point, perhaps, is the French experience. France introduced rediscount ceilings in 1948 but found that they were ineffective in restraining credit expansion. The ceilings had to be raised repeatedly under a variety of pressures, as demand for credit was swollen by reconstruction needs and other factors. In the end, in October 1951, the French authorities modified the system by allowing access to central bank credit beyond the rediscount ceilings, but charging penalty interest rates. In this form, the system is no longer one of direct control over credit since there is no ceiling on rediscounts at the highest penalty rate.

Overall Ceilings on Bank Credit

Overall ceilings on commercial bank credit, which are non-selective in nature, have come to be used in the postwar period as a means of treating acute inflationary conditions. Where such controls are applied, commercial banks are assigned credit quotas which they may not exceed, or they are instructed to limit credit expansion to a certain rate. Combining this kind of restriction with selective measures is, of course, not precluded. To the extent that they are not selective in nature, the object of the ceilings is, of course, to limit the expansion of inflationary pressure. Selective characteristics may be added in order to moderate the impact of the restrictive measures on certain favored sectors of the economy.

A principal drawback of the general ceiling on bank credit is its lack of flexibility. For example, it is difficult to allow for the establishment of new banking institutions. Unless the creation of new banks is totally prohibited, there is often no practical way of preventing slippage in the limitations imposed by the ceilings. It would seem undesirable to bar completely the creation of new banks in a growing economy, and at the same time there are inequities and perhaps diseconomies in restricting the growth of existing sound and well-managed banks while permitting the establishment of competiting institutions.

Chile has made extensive use of credit ceilings, and experience there seems to point to the conclusion that the device is not a highly effective one. From 1953 to 1958 credit ceilings were intended to play the most important role in the efforts of the Chilean government to combat inflation. During these years, Chilean commercial banks expanded credit to the private sector by an average of 40 per cent a year. The limitations fixed by the authorities turned out to be consistently exceeded by wide margins. The system was finally abandoned in April 1959 in favor of more indirect and traditional instruments of monetary policy.

Experience in Colombia, Korea, and Israel also indicates that the credit ceilings have not been effective in curbing credit expansion. In Colombia the ceilings were set too high and the expansion of credit proved excessive. The system was abandoned after about a year. Israel gave the ceilings a longer test, beginning in 1953. They were finally dropped in 1961, but their ineffectiveness had been recognized for several years. In Korea also the ceilings have tended to be set too high to be really effective, but their use has been continued up to the present time. France adopted an overall ceiling on credit expansion in February 1963, but experience has not been long enough to permit a fair evaluation.

On the other hand, the United Kingdom provides an example of a relatively successful use of overall ceilings on bank lending. Such success as was achieved in this case stems from the banking arrangements peculiar to the country and from the British tradition relying mainly on direct suasion upon the banks. The small number of British banks with multiple branches and their close contacts with the Bank of England made it possible, in the 1950's, for the authorities to set these ceilings informally and to ensure their enforcement. However, the banks complained that this technique hampered the efficacious working of the banking system and was dangerous to the banks and to the public interest if carried on for too long or too frequently renewed. It's use was suspended in July 1958. To take its place, the authorities devised the special deposit scheme, a form of variable reserve requirements, and began using it in 1960.

Concluding comments on non-selective direct controls

There would be no need to resort to direct non-selective controls over bank lending if the authorities were willing and able to use the more indirect instruments of credit policy. In countries where the law does not provide for the use of variable reserve requirements, the use of direct controls is perhaps justifiable, at least until action can be taken to secure the necessary legal authority to set and vary reserve requirements. In countries where full legal authority to use indirect instruments already exists, direct controls are not likely to be more than a poor substitute for these instruments.

In any event, ultimate success in fighting inflation depends on the willingness and ability of the authorities to attack the root causes of excessive inflation, i.e., the factors which lead to excessive infusion of money into the economy and thereby swell bank reserves. If the basic source of the inflationary pressure lies outside of the banking system, i.e., in government expenditures

financed through the banking system, efforts to curtail the expansion of commercial bank credit are likely to founder on the undeniable needs of business and agriculture for increased credit that are bound to arise in an inflationary situation. In other words, if nothing is done to reduce the demand for credit in these circumstances the pressure on the authorities to make the supply available is likely to be irresistible.

Summary and Conclusions

Experience with direct and selective credit controls in the postwar period has not supported the thesis that such controls are capable of playing a major role in monetary stabilization, eliminating or reducing the need to rely upon the use of general quantitative controls. In the United States and Western Europe, such reliance on selective controls as did occur in the early postwar years gave way during the 1950's to a more vigorous use of the indirect weapons of monetary policy--the discount rate, open market operations, and reserve requirements. Even in the United Kingdom, where some success was achieved with overall ceilings informally set and enforced through direct suasion, the authorities eventually came to use a form of variable reserve requirements.

In a number of Latin American and Asian countries, employment of selective controls has persisted longer. The motivation has generally been the desire to use control of credit as a means of influencing the pattern of economic development. It is not possible to evaluate the results of these efforts on the basis of the evidence now available, and further research would be desirable. From a theoretical standpoint, however, it would not appear that the use of selective controls to channel credit into certain areas would result in a pattern of resource allocation superior to that which market forces would achieve, except in cases where they were used to effect changes in irrational patterns preserved by custom and inertia. This would suggest that the use of these measures might best be limited to relatively short periods of time, except where non-economic objectives may be involved.

The persistent use of selective controls by countries such as Mexico appears to indicate satisfaction on the part of the authorities with the results being achieved, but in some other countries the results do not appear to have justified the administrative difficulties. The problems of administration vary greatly from country to country, but where well-trained personnel are not abundant and standards of honesty are not high, the administrative difficulties are likely to be great. Where these difficulties exist, the effectiveness of the controls will be reduced and serious problems of equity are likely to arise. Since injustice can bring even a well-intentioned regulation into disrepute very rapidly, any central bank wishing to experiment with selective or direct controls, which also involve difficult administrative problems, must weigh the risks against the possible gains with the greatest of care.