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THE TREASURY-CENTRAL BANK RELATIONSHIP IN FOREIGN COUNTRIES -

PROCEDURES AND TECHNIQUES

- -

The following report was prepared by the Staff of the Board of Governors of the Federal Reserve System. It does not necessarily represent the views of the Board. It is based on available information obtained in part from published documents and in part from personal contacts with foreign central banks developed over a period of years. The accuracy of the information has not been checked by the officials of the foreign countries concerned and is not guaranteed by the Board.

November 1950

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GENERAL INTRODUCTION

This report is prepared in response to a letter from the Chairman of the Joint Committee on the Economic Report requesting a survey of foreign experience in the field of Treasury-Central Bank relationships.

Almost all countries have central banks, and in all cases these institutions are separate and distinct from the Treasury Departments of their governments. The function performed by central banks in all countries is to regulate the supply of money in such a way as to serve national interests. Activities of central banks, designed to influence or control the availability of loan funds, necessarily affect interest rates paid by private and governmental borrowers. Conversely, actions designed to affect interest rates have repercussions upon the supply of credit. Because of the great importance of public debts in the financial structure of most countries, the need for coordination between monetary and credit policies on the one hand, and public debt management and fiscal policies on the other, has been recognized in almost all countries. Methods of working out a harmoniously functioning relationship between Treasury and Central Bank have varied widely. There is wide diversity also in the devices adopted in foreign countries to restrict the over-all supply of credit within the framework of policies which take account of large-scale financing needs of treasuries.

This survey of foreign experience is designed to provide background material for the study of problems of monetary policy in the United States. It will be immediately apparent, however, that devices which may have worked well in foreign countries may not be suitable here. Differences in political, economic, and financial structure between the United States and foreign countries as well as among the foreign countries

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themselves are so profound that a comparison of national monetary policies serves primarily to bring into sharper focus the peculiarities of national problems.

To illustrate this point, it may be well to review briefly some of the principal differences in underlying conditions among the countries whose experiences will be described below and between them and the United States.

Differences in economic structure and development are possibly most important in accounting for the lack of comparability of Treasury-Central Bank relationships among various countries. Thus, in countries where there are highly developed money and capital markets, issues concerning monetary and debt management policies tend to revolve around questions of the interest rate structure, since the rate structure affects on the one hand demand and supply factors in the money market and on the other the rates at which the Treasury can place its obligations with investors other than the Central Bank. But in countries where the central bank is the principal source of funds for financing government deficits, market rates of interest are of less importance for debt management; in these countries agreement must be reached as to the amounts that can be advanced by the Central Bank to the Treasury in view of the unstabilizing effect of these advances on the economy. Again, in a country where hyperinflation or currency reform has virtually wiped out the public debt monetary problems are of a different nature from those characteristic of a country where the public debt is large in relation to national income and is widely dispersed among both bank and non-bank holders.

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Wide differences among the various types of banking systems must also be recognized. Credit control techniques that are adequate in a country with a highly-centralized multiple-branch banking system, in which bank policies can be influenced by direct contact and suasion, may be of little help in a country whose banks are numbered in the thousands. Also, differences in banking traditions and attitudes, such as the extent to which banks are willing or reluctant to hold long-term government securities, or to borrow from the central bank, may mean that policies that are effective in some countries will not work elsewhere.

There are also important differences between countries in the political relationship between Legislature, Treasury, and Central Bank. The great size and diversity of the United States and of its economy has led to the establishment of twelve separate Federal Reserve Banks, which are partly autonomous but are placed under the general supervision of the Board of Governors, appointed by the President and responsible to Congress. The Federal Reserve Banks carry on the operations ordinarily performed by central banks while general policy decisions, which in most countries are also made by central banks, are vested largely with the Board of Governors and with the Federal Open Market Committee, which is also established by statute. Thus the central banking system in this country receives its mandate directly from the Congress and is directly responsible to it. It does not operate under or report to a member of the Cabinet. The Treasury, on the other hand, performs its function of debt management as a part of the Executive branch, which, under our form of government, is separate from the Legislative authority.

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Foreign central banks have varying degrees of autonomy or independence from the Government, but the tendency in recent years has been to bring them into the orbit of governmental responsibility. Effective coordination of Treasury and Central Bank policies affecting the supply, availability and cost of money is simplified in European and some other countries by the existence of a parliamentary form of government. Under that form, the Government in office is directly responsible to the Parliament. Actions and policies of the Government (Cabinet) are subject to constant review by the Parliament. In turn, the Minister of Finance, a member of the Cabinet who generally exercises not only the debt management function but also budgetary and other broad economic powers, has in some countries been given a degree of authority with respect to the Central Bank. Thus the central banks in these countries have been made indirectly responsible to Parliament through the Minister and Cabinet.

These differences in political, economic, and banking structure make clear the need for caution in drawing conclusions for any one country from policies and techniques which may have proved effective in other countries. Nevertheless, a review of foreign experience can be valuable in placing national problems in proper perspective. For instance, one fact brought out by the survey is that, while some twenty years ago the American banking system was considered as among the most formalized by rules and regulations, this is no longer the case today. Under the most diverse political regimes, democratic countries have adopted measures such as cash and supplementary reserve requirements, selective or qualitative credit controls, differential interest or discount rates, bond limitation plans, etc. While this experience

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does not yield any specific lesson as to the controls that ought or ought not to be adopted in the United States, it suggests that monetary controls compatible with democratic institutions may take a variety of forms.

Procedures adopted by foreign countries to coordinate Central Bank and Treasury (or governmental) policies are summarized in the following paragraphs. Subsequent sections briefly survey the main issues faced by postwar monetary policies and the various means recently employed abroad to deal with the specific problem of restricting the over-all supply of credit under conditions of large-scale financing needs of treasuries and of large holdings of government securities by different economic groups.

The Treasury-Central Bank relationship

At one time, most central banks were chartered by the legislature to operate independently, within certain limits, not only of the treasury, but of the highest executive and legislative authority of the nation. As the ultimate guardian of the value of the nation's currency, the central bank was bound by the strict rules of the gold standard. Its assets were confined largely to commercial paper, and its holdings of government securities were limited either in practice or by law. At that time, it was felt that the high public interest served by the central bank required that it operate free from government intervention and that this freedom was best safeguarded by the establishment of the central bank formally as a specially chartered private institution under the gold standard.

Today, in practically all countries, as in the United States, it is felt that the public functions performed by central banks require that they be established frankly and formally as public institutions. Many countries have worked out techniques which recognize the separate responsibilities of central banks and treasuries in their respective fields

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and at the same time facititate the development of coordinated fiscal and monetary policies.

While central banks are practically everywhere considered a part of the governmental structure, the position of the central bank within this structure is a special one. Although ordinarily governmental appointees, present-day central bank officials are often appointed for relatively long terms of office. It is generally recognized that the men to be appointed to these posts should be willing to take a strong position for the maintenance of monetary stability and that the institutions which they direct must have a measure of independence within the governmental structure. Distinction is also generally maintained between the functions and responsibilities of the Treasury as budget maker and borrower and those of the Central Bank as regulator of the supply of credit.

There is a wide range of variation in types of legislative framework governing the relation of central banks to their governments. The actual nature of the relationship depends, in addition to provisions of law, on many factors of custom, tradition, and personalities.

In a few countries, including the United Kingdom, Australia, and India, the statutes give the Ministers of Finance the ultimate power to direct the policy decisions of the Central Bank. Similar legislation was formerly in effect in New Zealand. Even where the Central Bank in its policy-making functions is subordinate to the Minister of Finance, the Central Bank is not considered as a bureau or office in the Ministry. According to the statutes of these countries, instructions from the Minister of Finance must be preceded by full consultation with the Central Bank, whose policy-making officials are expected to have independent views.

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There are also many countries where the Minister of Finance is the Chairman or is one of the members of the Central Bank's Board of Directors. This arrangement has been advocated on the ground that it would provide to the Minister of Finance and to the Central Bank an opportunity for a full and mutual presentation of their views. However, it has been opposed on the ground that it might lead to undue influence of the Treasury on Central Bank policies.

A number of countries have adopted the device of a national council which is charged with the formulation of national monetary and credit policy and includes, among others, the Minister of Finance and the head of the Central Bank. Examples are the National Credit Council in France which has advisory functions and the Interministerial Committee in Italy which is a policy-making body.

A few countries have specific machinery for appeals to an arbiter in order to resolve Treasury-Central Bank differences. In the Netherlands, while the Minister of Finance has authority to give directions to the Central Bank, the Governing Board of the Bank has the right of appeal to the Crown in case of disagreement. In New Zealand, while the Central Bank is no longer subject to direct Treasury instructions, it is specifically subject to directions by resolution of Parliament. One of the proposals made in 1950 in Germany would provide for a Federal Committee to resolve conflicts.

In the many countries where there is no statutory provisions for resolving differences in viewpoint between fiscal and monetary authorities, it would appear that in practice disagreements are referred, as a last resort, to the head of the government. As a matter of fact,

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even where some governmental agency is designated by statute as the final authority on monetary policy, the head of the government of the country can, in practice, assume this authority, particularly when he hold broad powers of appointment and removal. The Finance Minister, by virtue of his closer political and personal ties with the head of the Government and of his attendance at Cabinet sessions, may be in a favorable position to obtain a settlement in favor of the Treasury view. But, as previously explained, in most democratic countries Cabinet decisions are subject to parliamentary control.

Determination of monetary policy is bound to be greatly influenced by the personalities of the officials concerned--as well as by the state of public opinion. The fact that the head of the Central Bank is not a member of the Cabinet gives him a certain degree of independence from political pressure and hence a special position in the eyes of the public, and where the Governor is a man of outstanding personality the Central Bank may acquire an influence far beyond the actual powers given to the Bank by legislative provisions. Also, in many countries the public standing of Central Banks derives largely from the prestige that they may have acquired over a long period and from their ability to attract qualified personnel. Therefore, the government currently in power would ordinarily be anxious to avoid the shock to public confidence which might result from public conflict between it and the Central Bank authority.

Besides formal provisions for coordination of fiscal and monetary policies, various informal techniques have been developed to ensure a cooperative relationship between the agencies involved. One technique which has been employed in a number of countries is that of frequent

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meetings of technicians from the Treasury and the Central Bank. Another is that of interchange of technical personnel. Such practices have contributed to a better understanding of common objectives, and hence to the development of complementary rather than conflicting measures.

Monetary policies in the postwar period

The problem facing most foreign countries in the postwar period was, in its most general form, that of reconciling monetary stability with the requirements of reconstruction and development. This problem often led Ministers of Finance and Central Banks to adopt similar positions toward programs of the so-called spending ministries. At the same time, the existence of large public debts and liquid assets at the end of the war gave rise to a special problem of restoring effectiveness to traditional instruments of monetary control. The problem of coordination of debt management policy and credit policy took various forms, depending on the distribution of ownership of long-term and short-term debt among the banks and other holders, and depending on the rate of expansion or contraction of the government debt.

An important new factor in the postwar monetary situation of many countries was the existence of large public debts which had their origin in war and occupation expenditures. In many countries a large portion of the debt was held by the Central Bank and had therefore already become monetized by the end of the war. In these countries effectiveness of credit restrictions was likely to be limited by the abundance of liquid funds in the hands of individuals and businesses. Where direct controls had prevented these funds from exerting their full effect on prices and incomes, attempts were made to absorb these

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funds before they would result in open inflation. This was done in some cases through currency reforms which involved reducing the value of holdings. Import and budget surpluses also had important anti-inflationary impacts.

In countries where the liquid funds had "broken out" and had started open inflations, instruments of credit control had greater applicability, since in those countries private credit expansion played an increasingly important role in stimulating and supporting the inflationary process fed by budgetary deficits. The French and Italian postwar inflations were stopped in part by recourse to cash and supplementary reserve requirements which placed limitations on the availability of bank credit and thereby reinforced the effect of market interest rates as credit control instruments. Under the conditions prevailing in these countries, reserve requirements had a dual purpose of channeling to the Treasury a portion of the commercial banks' funds so that direct financing by the Central Bank could be minimized, and of preventing private credit expansion which might have resulted from the sale of bank-held securities to the Central Bank.

In countries where, at the end of the war, the public debt was not primarily held by the central banks, but was widely diffused among the public and the banks, there arose the problem of preventing its monetization. Many countries attempted to deal with this problem in an indirect way, using price controls and investment controls to make it difficult for banks and individuals to use the funds they might have obtained by encashing government securities. Under these conditions, the incentives to liquidate securities were considerably

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weakened. In addition, through statutory provisions, or by informal agreements, some countries froze a portion of the short-term government securities held by the commercial banks. Moreover, while many countries endeavored to stabilize short-term interest rates, only a few countries actually increased the money supply through active support operations in the long-term market. Sweden, one of the few important countries where long-term rates were pegged until very recently, has now adopted a policy permitting greater flexibility in the market for long-term securities.

With the new inflationary pressures caused by the Korean developments, many countries have adopted positive monetary policy measures as their first line of defense in the new circumstances. In recent months discount rates have been raised in various countries, frequently for the first time in several years. At the same time, more countries have adopted reserve requirements, both primary and supplementary, as a means of combating inflationary credit expansion.

This current reliance on monetary policy is primarily explained by the hostility of public opinion in most countries against a return to direct controls of raw material allocations, prices, wages, and of consumer rations. These controls were a universal legacy from World War II and many countries are still in the process of dismantling them. Moreover, it is now widely believed that fiscal and monetary controls are superior to direct controls in dealing with the dangers of inflation in the present situation, particularly since the rearmament effort does not at present involve total mobilization and since it is likely to extend over a protracted period.

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Special monetary techniques

A technique of monetary control which has been applied in a number of countries has consisted in requiring banks to hold cash and/or government securities in amounts related to their deposit liabilities. These measures were not substitutes for the action of interest rates in influencing the supply of and demand for funds, but actually served to reinforce this action.

In some cases the permission to count government securities as legal reserves applies to the standard reserve requirement and in other cases it applies to a special additional requirement. The purposes and functions of these regulations have varied from country to country and within any given country their effect may change over time. In some cases this technique has been used to place a barrier in the way of banks' increasing their loanable funds by selling securities to the Central Bank. This was in part the immediate purpose of the reserve requirements introduced in the postwar years in Belgium, Italy, France, and Sweden. These requirements, however, could also be called upon to serve the quite different purpose of facilitating deficit financing through automatic absorption by the banks of government securities. Other uses of this general advice have occurred in the Philippines (to promote development of a local investment market), in India (as a cushion for a large increase in reserve requirements) and in Mexico.

In Mexico a system of secondary reserve requirements has been employed for the purpose of exercising influence over the kinds as well as the aggregate of bank lending; besides government securities, other types of loans which the authorities wish to promote are included among assets fulfilling these reserve requirements. The percentage of deposits required to be held in these forms is fairly large.

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A related device that has been used in a number of countries is that of imposing differential reserve requirements which require commercial banks to hold especially large reserves against increases in deposits. This device permits the imposition of high reserve requirements on expanding deposits while at the same time allowing for the fact that individual banks may vary greatly in their holdings of cash or acceptable assets at the time when the requirements are introduced. The Australian "special accounts" procedure is an outstanding example of this. Among other countries making use of this principle have been France, Italy, and Mexico.

The quantitative controls outlined above have, in general, been applied by means of general regulations (in terms of ratios) for all banks or groups of banks to follow. There have been a few cases, however, where the authorities have placed absolute limits on the reserves available to individual banks for the purpose of private lending. In the United Kingdom, the Treasury determines every week the total sum (if any) which the banks are called upon to invest in a non-negotiable, non-transferable Treasury obligation called "Treasury Deposit Receipt." In France, the Central Bank controls the reserves of the banks not only through reserve requirements, but in addition by imposing individual ceilings on the amounts of commercial paper which each bank can rediscount.

In addition to these various types of quantitative restrictions, a wide variety of qualitative measures have been tried in different countries. The system of reserve requirements in use in Mexico, referred to above, has qualitative as well as quantitative aspects. Various countries

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including France and the Netherlands have tried procedures whereby the making of each loan (above a certain minimum size) would be subject to the specific approval of the central bank. It was found, however, especially in France, that it is very difficult to determine and apply the criteria for the selection of individual loans by a central bank. Thus, although such a control could theoretically be extremely effective in limiting private loans, both France and the Netherlands eventually turned to systems making greater use of quantitative controls.

A special device consisting of a quantitative limitation on the amount of long-term government bonds that a bank may hold, with special provisions as to the maturity distribution that may be permitted, was introduced in Canada. This was used to prevent banks from taking undue advantage of the pegged rate on long-term government bonds.

Finally, moral suasion is an instrument to which all central banks resort at times. In some countries where acceptance of financial leadership of the central bank has become tradition, the instrument of moral suasion has been an important one; in particular, it has been an instrument well suited to the set of institutions and circumstances existing in the United Kingdom. In Canada, it may be noted, the limitation on bond portfolios was contained in agreements with the commercial banks which resulted from suasion rather than from legal backing.

As has already been indicated and as will be shown in greater detail in the individual country studies, success of the various monetary control techniques described above has varied among different countries.

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For instance, the combined cash and security reserve requirements appear to have fulfilled their purposes in a number of European countries but the essentially similar "Special Accounts" procedure adopted in Australia has been unable to stem serious inflationary developments in that country. Similarly, qualitative control of bank credit does not seem to have been an effective tool in countries like France and the Netherlands whereas it has given satisfactory results in the United Kingdom and Canada. This difference in effectiveness of similar measures has resulted from differences in accompanying circumstances and in basic characteristics of the countries involved; it thus illustrates the importance of careful consideration of differences in tradition and environment before transposing any specific technique from one country to another.

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COUNTRY STUDIES

In the following, no attempt is made at an exhaustive description of monetary policy or of monetary policy formation in all foreign countries. Attention has been focused on those instances where either institutional devices concerning monetary policy or the policies themselves appeared to be of general interest. As a result, for some countries only the institutional relationships are covered, while for others only the monetary policies and techniques are reviewed.

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UNITED KINGDOM AND COMMONWEALTH COUNTRIES

Institutional arrangements

Statutory arrangements for the coordination of monetary policies between the central banks and the government have recently been put into effect in several countries in the Commonwealth, in most instances by Labor governments which wished to ensure that the powers of the central bank be so used as to support the full employment policies of the government.

United Kingdom. - The Nationalization Act of 1946 formalizes for the first time in history the relations between the Bank of England and the Treasury. The statute now provides that "the Treasury may from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest." The significance of the qualifying clause "after consultation with the Governor of the Bank" has been emphasized by commentators, especially after the Governor stated in the House of Lords that the words "were inserted at my request and received cordial agreement from the Treasury." This clause, therefore, is designed to ensure that the Governor would participate in policy discussions with the Treasury or, at least, have the right to be heard before a decision to issue directions to the Bank will have been reached.

The new legislation in reality brought about no fundamental change in the relations between the Bank of England and the Treasury. The Treasury's power to give direction to the Bank has not yet been exercised so far as is known. Rather, a high degree of voluntary cooperation and informal consultation continues to characterize the relationship among the various segments of the British financial organization.

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United Kingdom and Commonwealth Countries

India. - Amendments to the Reserve Bank of India Act in 1948 included a provision almost identical to the one, quoted above, which formalizes the relation between the Bank of England and the United Kingdom Treasury. The Indian Government's power to give direction to the Reserve Bank has not been exercised so far as is known. There is some evidence that in 1946-1950 the Reserve Bank favored an increase in interest rates from the low levels previously reached. Actually a very gradual rise in long-term rates did occur during these years. Whether or not there were differences on policy between the Reserve Bank and the Government, the close consultative relationship between them was unimpaired.

New Zealand. - The Labor Government of New Zealand in 1936 amended the Reserve Act to provide that "it shall be the general function of the Reserve Bank ... to give effect as far as may be to the monetary policy of the government." Reserve Bank subordination to the Government was made absolute in an amendment in 1939 which required the Bank "to give effect to any decision of the Government conveyed to the Governor in writing by the Minister of Finance." Amendments introduced in July 1950 by the recently elected Conservative Government, however, restored a substantial measure of autonomy to the Reserve Bank. The Bank is now "responsible for taking such steps within the limit of its powers as the Bank deems necessary or desirable" to promote internal price stability and the highest degree of economic activity that can be achieved by monetary action. More significant, the Bank is no longer required to carry out written Treasury instructions; the amended act provides instead that "the Bank shall give effect to any resolution of the House of Representatives in relation to the Bank's functions or business."

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United Kingdom and Commonwealth Countries

Australia. - The Australian Labor Government in 1945 set up elaborate machinery to resolve differences of opinion on policy questions. The subordination of the Commonwealth Bank to the Treasury Department provided for in the Commonwealth Banking Act of 1945 was the product of the Prime Minister's expressed view that, during the depression of 1929-33, "the Bank was used by reactionary interests for a purpose directly opposed to the welfare of the Australian people and in opposition to the will of the government of the day." Under this Act the Bank is to inform the Treasurer from time to time of its monetary and banking policy; where disagreements develop which cannot be resolved by direct conversation, the Treasurer may "inform the Bank that the Government accepts responsibility for the adoption by the Bank" of a Government-approved policy. The Bank must then give effect to that policy.

Consideration is now being given in Australia to new legislation which would eliminate the subordination of the Commonwealth Bank to the Treasury. Under the terms of the proposed amendments, the management of the Bank would be restored to a Board in place of a single Governor and Parliament would become the final arbiter of any unresolved differences between the Bank and the Treasurer.

South Africa. - The Reserve Bank Act of South Africa makes no formal provision for consultations on questions of monetary policy between the Bank and the Treasury. It appears that the Bank enjoys a considerable degree of autonomy in its operations.

Canada. - Arrangements between the Bank of Canada, which was established in 1935, and the Department of Finance are not formalized in the pattern found in New Zealand, Australia, and Great Britain. While the

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Bank of Canada is Government-owned and under a board of directors which is entirely Government-appointed, it is not subordinated to the Treasury; it appears to occupy a role within Canada similar to the role of the Reserve Bank within South Africa. The relations between the Bank and Treasury appear to be marked by informality in the British tradition and by cooperation in the formulation of monetary policy.

Monetary policies and techniques

United Kingdom. - The Treasury Deposit Receipt System, introduced during the war as an emergency financial instrument, has been the principal means used in the postwar period to supplement more traditional central banking techniques in bringing about monetary stabilization in Britain. Under this system, the Treasury borrows directly from the commercial banks; the latter receive a Deposit Receipt as evidence of a Treasury obligation which is neither negotiable nor transferable. The effect, therefore, is similar to that of an extra reserve requirement which is subject to weekly adjustment. Each Friday the Treasury announces the total sum (if any) that is to be called from the banks against Deposit Receipts, leaving to the clearing and Scottish banks responsibility for establishing quotas for individual banks. The commercial banks meet their weekly quotas; the only discretion left to them is to choose the day during the following week on which the funds are to be passed over to the Treasury.

The Deposit Receipt System has also facilitated the maintenance of very low interest rates for short-term Treasury borrowing; a freeze on short-term rates has been effectively maintained since 1946 despite the appreciable rise in long-term rates during this period.

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United Kingdom and Commonwealth Countries

In unofficial quarters, a proposal has been made which would permit a return to flexibility in the short-term market without an undesirable rise in the interest charges on the large floating debt. 1/ Under this proposal, the bulk of existing Treasury bills would continue to be held at the present low rates while rates on net new Treasury borrowing and on all commercial paper could be allowed to fluctuate and to rise. There has been no indication, however, that official support has been forthcoming for this proposal.

Neither during the cheaper money drive between 1945 and 1947 nor during the period of disinflation from 1947 to date has the maintenance of monetary control by the Bank of England been threatened by monetization of the debt through commercial bank sales of marketable debt to replenish reserve funds. Until the middle of 1949, the bulk of the clearing banks' holdings of floating debt was held as Deposit Receipts which are not marketable.

The commercial banks were restrained from switching into long-term bonds both by strong tradition against long-term holdings and, after 1947, by the possibility of fluctuations in money rates and bond prices. The risk factors inherent in holding long-term securities were clearly demonstrated by the decline in bond prices during the second half of 1949 during which yields rose by over one-half per cent. In addition, moral suasion has been a peculiarly effective central banking technique in Britain, due to the combination of the traditional prestige of the Bank of England, the concentration of resources in the British banking system, and the desire on all sides to avoid more stringent control measure.

1/ F. W. Paish, "Prospects for Interest Rates," London and Cambridge Economic Service, February 1950, p. 14.

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Through the Treasury Deposit Receipt System, open market operations, and through moral suasion the British monetary authorities have been able to retain the initiative in controlling the credit base of the clearing banks throughout the postwar period.

Although Britain underwent a sharp expansion in credit between 1945 and 1947, this was attributable directly to the budget deficit and to the monetary policy pursued by the authorities in support of the cheaper money drive, and not to the lack of appropriate instruments of monetary control. From the middle of 1947, there has been fundamental agreement between the Treasury and the Bank of England on the desirability of avoiding either expansion or contraction of bank credit, and this policy has been effectively implemented by a close coordination of Treasury and Bank of England operations in the money market.

A further technique for control of bank lending has been the use of qualitative standards to ensure that banking resources are used only for appropriate purposes. The Capital Issues Committee, established during the war and continued during the postwar period, had responsibility for approving flotations of new issues for industrial expansion. The criteria enunciated for guidance of this group are communicated to the commercial banks for guidance in approving new business loans. In addition, an amendment introduced in 1946 provided specifically that all bank loans in excess of £50,000 must be approved by the Capital Issues Committee.

Australia. - The Commonwealth Bank has used both quantitative and qualitative controls in carrying out the responsibility to determine the lending policies of the commercial banks delegated to it under the Banking Act of 1945. The Special Accounts procedure, introduced as a wartime

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expedient in 1941 and incorporated into permanent legislation in 1945, has been the principal quantitative technique used by the Australian authorities to replace the more traditional central banking devices of monetary control. Under this arrangement, the commercial banks are required to maintain in Special Accounts at the Commonwealth Bank the proportion of new assets in Australia stipulated by the Bank. During the war, virtually all increases in deposits of each commercial bank in excess of deposits in August 1939 were impounded in these accounts. From mid-1945 to mid-1948, only 45 per cent of new funds was called up by the authorities; the proportion was increased somewhat after July 1948, however, as the large balance-of-payments surpluses in 1948-49 and 1949-50 intensified internal inflationary pressures.

The Commonwealth Bank stated that the growth requirements of the economy would be financed by releases from the Special Accounts and that the authorized volume of such releases would be such as to support a level of bank lending deemed appropriate by the authorities. It was also made clear that the banks were expected to adjust their operations so as to conform to this general level, although short-term loans from the Commonwealth Bank could be obtained by those commercial banks urgently requiring cash.

The Commonwealth Bank has also established qualitative criteria to govern commercial bank lending. These criteria, which are issued in the form of enforceable directives to the banks from time to time, are generally designed to ensure that available bank lending will be used for essential purposes and that bank lending will not add unnecessarily to the existing inflationary pressures on resources. In addition, the banks have been requested to refrain from financing capital expansion.

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Neither the radical character of the Special Accounts procedure nor the qualitative control over types of bank lending has been able to prevent the appreciable monetary expansion and sustained inflation of prices and incomes which Australia has undergone in the postwar period; these developments, however, should not be traced to domestic private credit expansion, but to the large-scale immigration and investment programs, to the booming world prices for certain major export commodities, and to the massive inflow of foreign funds for both investment and speculation which have characterized the Australian economy over the past few years.

Canada. - In 1945-46, the Canadian monetary authorities continued their wartime policy of supporting the prices of long-term government bonds. Although the price of government bonds was not rigidly pegged, commercial banks moved into long-term government securities in an attempt to expand earnings; however, as a result of the government's debt retirement operations, the Bank of Canada apparently has not been compelled to acquire government securities on a significant scale. A novel system to restrict the demands of the commercial banks for long-term bonds was introduced through an agreement between the banks and the Minister of Finance in March 1946. Under its terms, the commercial banks limited their holdings of government obligations (other than very short-term issues) to a maximum of 90 per cent of savings deposits. To supplement this limitation, it was stipulated that the maturity distribution of the long-term portfolio was to be such that income from it would not be more than the interest payable on the corresponding savings deposits, other expenses connected with these deposits, and a moderate profit.

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It is difficult to assess the effectiveness of the scheme, because lending to the private sector revived and tended to reduce the proportion of assets invested in government issues. To moderate credit expansion, the Bank of Canada then suggested to the commercial banks that it would be preferable for borrowers to obtain funds for capital expenditure by the sale of securities to the public, and that the banks should stop expanding their holdings of private long-term obligations. In compliance with this suggestion, which was made early in 1948, the banks slowed down their purchases. In 1949, with a reduction in the volume of capital investment in prospect, the suggestion was withdrawn.

The reliance on informal understandings and other forms of moral suasion as a method of credit control in Canada is in part the result of the concentration of banking--four banks hold three-quarters of the assets of the banking system--and in part a reflection of the general desire of the banking community to maintain, in the British banking tradition, a system with a minimum of statutory controls.

These special measures reduced the need for resort to traditional credit control instruments which have only recently been brought into play. The rediscount rate, which was reduced from 2½ per cent to 1½ per cent in 1944, was increased to 2 per cent in October 1950 to supplement fiscal measures designed to curb inflationary tendencies. Since the law does not provide for variation in cash reserve requirements, which are set at the low ratio of 5 per cent, it has not been possible to use this method of credit control.

India. - By 1948, prices in India had risen to four times their prewar level. After the war, there was relatively little monetary expansion,

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occurring chiefly in 1948. Government expenditures, including outlays for economic development, were in excess of revenues in 1946-50, but the additions to the money supply and to bank reserves from this source were to a great extent absorbed by the deficit in the external balance of payments, which was particularly large in the first half of 1949.

By the end of the war, interest rates on high-grade loans or investments had been brought down to unusually low levels. A very gradual rise of long-term rates occurred in 1946-50. A major feature of monetary policy in this period was the financing of excess government expenditures mainly from large cash balances which the Government had built up through wartime borrowing. The Government thus avoided heavy new borrowings which would have involved a choice between an active policy of credit expansion or a substantial rise in interest rates.

Continuing concern in India over the problem of maintaining monetary stability led to the passage of new banking legislation in 1949 which gave the Reserve Bank of India broad powers of qualitative and direct quantitative control over the lending operations of banks. These powers have not been exercised to date. The same legislation raised the requirement for reserves against demand liabilities, effective March 1951, from 5 per cent to 20 per cent. Reserve requirements had previously applied only to the larger ("scheduled") banks, but will now apply to all banks in India. The banks were given two years in which to adjust their position to the new requirement. Further to ease the adjustment, banks will be permitted to satisfy the new requirement with government securities and other trustee investments as well as with cash or balances at the Reserve Bank.

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FRANCE

The Bank of France and the State. - The nationalization of the Bank of France on January 1, 1946, completed a process begun ten years earlier but already foreshadowed by Napoleon shortly after the creation of the Bank in 1800, when he said, "I wish that the Bank be sufficiently under the control of the Government, but not too much."

From 1806 the governor and two vice-governors were appointed by the Government. Nevertheless a majority of the fifteen members of the Bank's Council were for many years representatives of "high finance" who at times disagreed sharply with the fiscal and monetary policies of the Government. On more than one occasion the Bank's refusal of credit to the Treasury led to the Government's downfall. Public resentment at this power and at the consistently deflationary policies pursued by the Bank during the early thirties was largely responsible for the reorganization of the Bank of France in 1936. By this reorganization the membership of the Council was changed and henceforth it consisted almost entirely of public officials or of representatives of various economic interests appointed by the Minister of Finance.

The act of nationalization did little to change the relationship of the Bank to the Government from what it had been since 1936. The governor and the two vice-governors are appointed by the Prime Minister and seven of the twelve Counselors are appointed by the Minister of Finance; one of the Counselors is elected by the Bank employees and the other four hold office by virtue of their positions as heads of public credit institutions.

The National Credit Council. - From the viewpoint of monetary policy, the creation of a National Credit Council was perhaps more important than the nationalization of the Bank of France. This Council, which was

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established by the same law which nationalized the central bank and the four largest commercial banks, is charged with general advisory responsibility for credit control; furthermore, it is authorized to study and advise the Government on matters pertaining to its financial transactions and monetary policy.

The Council is presided over by a Cabinet Minister, with the governor of the Bank of France acting as vice-president, ex officio. In addition, there are 38 members representing various government departments, public and private financial institutions, and business, agricultural, labor, and consumer groups.

The monthly meetings of the Council provide a forum for discussion and resolution of issues in the field of monetary policy. Indeed, with its responsibility for formulating a consistent and general monetary policy, the Council, whether its role is active or passive, provides an arena for the coordination of the views and objectives of the monetary and fiscal authorities. The Council also furnishes one kind of answer to the need for some method of bringing together the many diverse agencies engaged in granting credit or in exercising control over some segment of the credit granting process.

The large and varied membership of the Council necessarily places much power in the hands of its secretariat, which is supplied by the Bank of France. In fact, it has been said that the Council serves mainly to enhance the prestige of the Bank of France and is of great value to the Bank in gaining acceptance for new measures of banking and monetary control which, in general, originate within the Bank. On the other hand, the necessity of going through the Council with its representation of all economic interests has certainly influenced the formulation of central bank policy.

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Monetary policy. - During the early postwar period, the National Credit Council attempted to reconcile the needs for rapid reconstruction with the avoidance of inflationary credit expansion by a policy of qualitative credit controls. Thus the banks were directed to scrutinize credit requests for urgency and lack of alternative sources of financing. In addition Bank of France approval was required for credits above 30 million francs (later 50 million francs, equivalent to around $150,000).

These measures, however, proved generally inadequate to curb credit expansion, first because of the exemption of commercial bills from the supervision and secondly because of the intrinsic difficulties facing qualitative controls unaided by quantitative devices.

In the fall of 1948, with reconstruction largely accomplished, a comprehensive anti-inflation program was adopted cooperatively and simultaneously by both the monetary authorities represented by the Council, and the fiscal authorities. This program involved, on the fiscal side, increased taxes and ceilings on government expenditures. On the monetary side, it involved the systematic application of quantitative credit controls.

In the first place, rediscount ceilings were established at the Bank of France for each commercial bank at a level slightly higher than that prevailing as of October 1. The effect of these ceilings was to limit access by the commercial banks to the central bank in order to obtain reserves with which to expand lending to the private economy. This measure was of considerable real and psychological importance because of the widespread use of the commercial bill and of its traditional reputation as a near-liquid asset.

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In addition, a form of supplementary reserve requirement was established. Each bank was required to continue to hold the volume of government securities it held on October 1, 1948, and to invest 20 per cent of any increase in deposits in government securities. It was decided to freeze the existing holdings of such securities rather than to apply a uniform percentage to deposits as the required holding because of the great differences among banks in asset structure. For any increases in deposits, however, a uniform fraction (20 per cent) must be put into government securities. In part this requirement merely formalized prior "gentlemen's agreements" between the Bank of France and the principal commercial banks whereby the latter undertook not to reduce their holdings of government securities unless they suffered a net reduction in deposits. Thus, the commercial banks have been prevented from selling government securities to increase private lending. In addition, of course, these measures prevented any financial embarrassment to the Treasury which might have resulted from the failure of banks to renew their holdings of securities at maturity.

The end of 1948 marked the end of the French postwar inflation which had repeatedly and seriously threatened French political and social stability. Since the end of 1948, French price levels have been largely stabilized and there has been a remarkable improvement in the French balance-of-payments position. The measures of credit control which were adopted in October 1948 and were vigorously resisted in some quarters can no doubt claim a share in the credit for these developments. It should also be noted that credit policy since 1948 has shown a high degree of flexibility. Several restrictions have been eased when it appeared that changes in the general monetary situation made such action advisable.

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BELGIUM

Monetary policy. - Monetary policy has played a more important role in economic developments in postwar Belgium than in most other European countries. Any explanation for this fact must take into account two crucial decisions taken by the monetary authorities after the war. The first was the famous Monetary Reform carried out by Finance Minister Gutt upon liberation under which the excess liquid assets of the public were drastically reduced by a system of blocking of deposits and their partial transformation into long-term obligations of the State. As a result of this action, economic activity became strongly dependent on the availability of bank credit.

Given this dependence, the monetary authorities strengthened the credit control functions of the central bank by instituting, early in 1946, a system of supplementary reserve requirements under which the commercial banks are required to maintain, in addition to cash reserves, a reserve of government securities equal to 50 to 65 per cent (depending on the size of the bank) of their deposit liabilities. This requirement limited severely the ability of the commercial banks to sell government securities in order to increase private credit. This left rediscount of commercial paper at the National Bank of Belgium as the principal means by which the banks could expand credit, and, as a result, rendered the rediscount policy of the central bank an effective method of credit control. Thus supplementary reserve requirements have been a principal means of restraining excessive lending by the banks to the private sector of the economy.

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The National Bank of Belgium and the State. - The National Bank was "semi-nationalized" in July 1948 when its capital stock was doubled and 50 per cent was acquired by the State. In addition the powers of the private shareholders to choose the directors and regents were narrowly limited. Speaking broadly, this change in the status of the Bank does not appear to have greatly affected the position of the Bank or the relationship of monetary to fiscal policy in Belgium. The Bank, even when it was a private institution, was not completely independent of the Government. The Governor has always been chosen by the Government, and a Government commissioner supervised the operations of the Bank to insure that they were conducted in the public interest.

The extent to which the Bank maintains its independent viewpoint is perhaps best illustrated by the open controversy, during the spring and summer of 1950, between the Governor of the Bank and the Minister of Finance concerning the use of the "profit" on the revaluation of the gold reserve. The Bank argued that the State, to whom the "profit" would accrue, should use it to reduce its consolidated debt to the Bank. The Government, on the other hand, wanted to utilize the sum to finance extraordinary public works expenditures. The significance of the Bank's willingness to take a public stand against the Government is in no way weakened by the fact that the issue was finally decided in favor of the Government's view, since this decision was taken at a time of political and economic crisis when the Treasury's receipts were temporarily reduced sharply.

In appraising the position of the Belgian National Bank with respect to the Government, one must take account of the strong and respected

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position of its Governor, M. Frère. Moreover, despite the public controversy described above, it should be stressed that, on the whole, Belgian monetary policy in the postwar period has not only been fully approved by the Government, but fitted well into the Government's general economic policy which aimed at maintaining stability with a minimum of direct controls.

The Banking Commission. - Matters of general monetary policy are decided directly between the National Bank and the Government without specific machinery for coordination of policies. The Banking Commission, which in 1946 issued regulations concerning secondary reserve requirements, is primarily a technical regulatory rather than a policy-making agency. Its power to impose reserve requirements was originally intended essentially as a means of insuring liquidity of banks rather than as a credit control mechanism.

The Commission was created by royal decree and the Commissioners are appointed on the nomination of the Ministers of Justice, of Finance, and of Economic Affairs. It consists of a chairman and six members, two of whom are nominated from a list submitted by the central bank and two others from a list submitted by the commercial banks.

In general the Commission works in close cooperation with the central bank; the latter supplies its secretariat and performs other services for it. An illustration of the coordination between the Commission and the Bank is provided by the Commission's decision in October 1949 to ease slightly the secondary reserve requirements simultaneously with the Bank's decision to lower the rediscount rate.

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THE NETHERLANDS

The nationalization of the Netherlands Bank in 1948 appears so far to have had little effect on its functions or on the independence of monetary policy in the Netherlands. As will be shown below, traditional monetary policy has played a very small role in the Dutch economy during the whole postwar period and, in fact, began only quite recently to assume a more prominent place among economic policies in the Netherlands.

The Netherlands Bank and the State. - Perhaps the most significant change brought about by the banking legislation of 1948 was a provision that the Minister of Finance is empowered to give directions, whenever necessary, to the Governing Board of the Bank in order to coordinate the Government's monetary and financial policies and those of the Bank. On the other hand, the Governing Board is entitled to appeal to the Crown in case of disagreement with these directions. Such an appeal would lead to further careful consideration of the issue by the Government. In addition, the members of the Governing Board are now appointed by the Crown rather than elected by the shareholders; however, the President of the Bank was so appointed even before nationalization. In the words of the Bank in its Report for the year 1948: "Only practice will prove how the relation between the Bank and Government may develop under the new status. We feel it is a task of great responsibility to cooperate in forming a tradition which, next to the legal provisions, will in the long run be decisive in determining this relationship."

Postwar policies. - Traditional monetary and credit controls have, until very recently, played practically no part in the postwar policies of the Government. Immediately after the war a thorough currency reform,

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similar to that of Belgium, was undertaken in the Netherlands. While its immediate effect was to decrease drastically the liquidity of consumers and producers in the Netherlands, subsequent policies led again to relatively large cash holdings by the public, especially business firms. This situation compelled the extensive use of price controls, rationing, and subsidies to repress the inflationary tendencies arising from the high level of investment.

During the postwar period the only measure of credit control was a qualitative one: all bank credits exceeding 50,000 guilders required the approval of the central bank. It is difficult to appraise the effects of this measure. Except for a sizeable increase in 1946, private credit has expanded relatively slowly. But it is quite possible that direct controls on various types of investment expenditure may have weeded out most of the potential requests for bank credit. Furthermore, many business firms were enabled by their liquidity to expand production without recourse to bank credit.

As recovery proceeded, the Government undertook to eliminate direct controls on consumers, to reduce subsidies, and to liberalize import restrictions. By September 1949 when the currency was devalued by 30 per cent, most price and rationing controls had been eliminated.

Recent changes in monetary policy. - With the outbreak of hostilities in Korea and the rising world price level, Dutch prices began to rise again. In order to combat inflationary pressures and to discourage speculative accumulation of inventories the Dutch authorities now turned to traditional monetary policies. The Netherlands Bank raised its rediscount rate from 2½ per cent to 3 per cent, this being the first change in the rate since

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1941. At the same time it was announced that, for the first time in Dutch history, a system of cash reserve requirements would be instituted for the commercial banks.

The reserve requirements will compel each bank to maintain the same ratio of cash reserves to deposit liabilities as existed in some base period. Because of the wide differences in customary reserve ratios among the banks, it was apparently decided to "freeze in" existing reserve ratios rather than to impose uniform percentage requirements for all banks, or all banks in a given size class.

The Netherlands thus provides an especially direct example of the adaptation of monetary policy to a changing economic pattern. In the earlier postwar period, while an extremely high rate of investment was being encouraged, open inflation was prevented by rationing and other direct controls; relatively little use was made of monetary and credit controls. Subsequently, however, with the resurgence of inflationary pressures in 1950 after the direct controls had largely been abolished, the authorities have decided to attack this situation by traditional monetary means, and are therefore adopting monetary measures more vigorous than any that were used in the 1946-49 period.

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SWEDEN

Postwar monetary policy. - Differences of opinion as to the appropriate monetary policy led in December 1948 to the resignation of Ivar Rooth who had been Governor of Sweden's central bank (the Riksbank) for 19 years. Mr. Rooth resigned in protest against the Government's policy of pegging the long-term interest rate at 3 per cent, a policy that led between 1946 and 1948 to large bond purchases by the central bank. At a time of general inflationary developments, Mr. Rooth favored greater flexibility in interest rates and, in general, greater reliance on monetary policy in combating inflation.

Mr. Rooth's views were opposed not only by the Cabinet, but also by a majority of the Riksbank's directors, who are elected by the Swedish Parliament for three-year terms. The Swedish Government's position was that a stable interest rate was essential to the general policy of stabilizing prices and wages through a series of direct controls and subsidies. As an alternative to limiting Riksbank purchases of government securities and to permitting a rise in the rate of interest, it was felt that excessive investment should be checked by physical controls such as building permits. Higher interest rates were thought to be undesirable because they would eventually lead to higher rents and thereby to demands for higher wages. Mr. Rooth believed, on the contrary, that the creation of new bank reserves necessitated by the Government's policy led in itself to inflationary pressures which direct controls would be more and more unable to check.

Mr. Rooth's resignation, after a long period of smoldering conflict, came at a time when the first postwar inflationary process had largely run its course. In early 1949 investment pressures relaxed, and the banks found

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it no longer necessary to continue their sales of government securities to the Riksbank.

Recent changes in monetary policy. - Renewed inflationary pressures made themselves felt in the Swedish economy early in 1950, and were then intensified by the repercussions of the Korean conflict. In this situation the Riksbank, in full agreement with the Government, has acted quickly to utilize the previously neglected instruments of monetary policy for anti-inflationary purposes. The Bank in July 1950 withdrew its support from the bond market for the first time since the war, permitting bond prices to fall slightly below par. It also obtained Government approval for the imposition of an entirely new set of reserve requirements which combine the cash and the supplementary reserve principle in the following way:

(a) Cash and supplementary reserve assets (primarily government securities) are set for the five big banks at 10 per cent of total liabilities exclusive of savings deposits and contingent liabilities. Lower percentages apply to the smaller banks.

(b) Forty per cent of these reserves must be held in cash (till money and sight deposits with the Riksbank) and 25 out of this 40 per cent must be held on deposit with the Riksbank.

These reserve requirements which were applied as of October 1, 1950, will not require any considerable reshuffling of assets on the part of the banks, but they will tie down assets that might otherwise have been used for further credit expansion. Moreover, the authorities hold the power to increase reserve requirements up to 25 per cent of liabilities and to vary the proportion of these reserves to be held in cash.

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Finally, the Riksbank has conducted active negotiations with the various credit institutions with the aim of inducing a more cautious attitude to lending in general and of discouraging in particular credits for non-essential production, for speculative purposes, or for consumption.

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GERMANY

The Bank deutscher Laender and the Government. - Under the military law establishing the postwar German central banking system, the government of each Land (state) appoints the president of its Land Central Bank; the presidents of the eleven banks are the members of the Board of Directors of the Bank deutscher Laender--which coordinates central banking for the whole territory of the Federal Republic of Germany--and appoint the management of that Bank. The Federal Government has no legal connection with the Bank whatsoever. The occupation authorities supervise the Bank through the Allied Bank Commission; however, since the promulgation of the Occupation Statute of 1949 the powers of the Allied authorities have been virtually restricted to matters directly or indirectly pertaining to Germany's international economic relations.

Proposed central banking act. - Under the proposed German central banking act, the Federal Government will appoint two delegates to attend the meetings of the Board of Directors in an advisory capacity and these delegates will have the right to protest decisions of the Board which they consider illegal or against the best interests of the country. As to the effect of such a protest, there is some difference between the drafts submitted to the German legislature by the German Cabinet and by the Bank management. According to the Cabinet draft, a conflict between the directors and the delegates would be decided by a Federal Committee, the composition of which would make it likely that the Cabinet point of view would as a rule be sustained; according to the Bank draft, a veto would merely force the Board of Directors, enlarged by a number of Government-appointed experts, to reconsider the question at its next meeting.

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In practice, there has been steady and intimate consultation between the Bank management and the Federal Government on all questions of Bank policy, and this situation is not likely to be substantially affected by the proposed changes.

Monetary policy and debt management. - In contrast to the experience of many other countries, German postwar monetary policy has not been concerned with the problem of managing a large public debt. The domestic debt of the former Reich government has, for practical purposes, been wiped out by the currency reform of 1948; the debt of the new Federal and Land governments consists almost exclusively of practically non-marketable "equalization claims" allocated to the central banking system and to private credit institutions under the currency reform legislation and of a much smaller amount of short-term advances, mainly by the central banking system.

The central banking system may purchase or discount equalization claims held by private credit institutions insofar as necessary to assure the liqudity of these institutions. The Land Central Banks may also grant credits to their respective Land Governments for the purpose of covering temporary cash deficits, up to one-fifth of their total deposits; and the Bank deutscher Laender may grant short-term advances to the Federal Government within a statutory limit.

Monetary policy has relied mainly on changes in the discount rate and in cash reserve requirements. In addition, the central banking system has issued directives to the private credit institutions setting limits for the aggregate amount of bank lending as well as for special types of credit. In spite of the absence of government bonds from the market, the central banking system has also conducted some open market operations affecting mainly

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municipal and mortgage bonds. The purpose of these operations is to maintain the price of these bonds so as to prevent their yield from rising substantially above 5 per cent. In this way the central bank hopes to lay the foundation for a revival of a capital market and, in particular, for the flotation of bond issues by the Federal Government.

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ITALY

The Interministerial Committee and the Bank of Italy. - The formulation of Italian monetary and banking policy was the object of detailed legislation adopted during the Fascist period (1936). An interministerial committee presided over by Mussolini was to determine credit policy and a specially constituted "supervisory agency (Ispettorato) for the defense of savings and for the exercise of credit" was to carry it out. The Bank of Italy provided the technical organization for both the committee and the "Ispettorato" and carried out their functions through its regional branches. Nevertheless, the system was criticized because of some duplications to which it gave rise, especially because of the newly-created Ispettorato. In 1944, a decree of Italy's new provisional government abolished the Ispettorato and the interministerial committee and transferred the policy-making functions to the Minister of the Treasury and the executive functions to the Bank of Italy. The very simplicity of this arrangement recommended it in a period of complete economic disruption. It was replaced in 1947 by a new decree which is currently in force.

This decree reestablished an Interministerial Committee for Credit and Savings composed of the Minister of the Treasury as chairman, and of the Ministers of Finance, of Agriculture, of Industry, and of Foreign Trade. The Governor of the Bank of Italy, although not a formal member, attends the sessions of the Committee, and perhaps more important, the Bank is entrusted with carrying out the decisions of the Committee as well as with the analysis of the problems which are within the Committee's competence. This covers not only broad problems of

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monetary policy but also a great number of purely banking matters such as the chartering of new banks or branches, the fixing of charges for banking services, the publication of periodic statements by banks. etc.

The influence of the Bank of Italy on the actions of the Interministerial Committee appears to be substantial. Thus, to give but one example, the first session of the newly created Committee in August 1947 decided upon the now famous Einaudi credit restrictions which were to break the backbone of the Italian inflation; but the Bank of Italy, in its annual report for 1946 issued in March 1947, had discussed and advocated measures very similar to the ones that were adopted by the Committee.

The Bank's influence is in fact much greater than could be deduced from a mere knowledge of the institutional framework. This arises in part from the exceptional qualities of its two post-war Governors, Einaudi and Menichella, and in part from the high caliber of its operational and research staff. The fact that Einaudi was appointed as Minister of the Treasury at the moment of greatest danger for the lira in 1947, was of course in large measure responsible for the adoption by the Interministerial Committee of credit policies which had long been advocated by the Bank of Italy. The success of Einaudi's credit policies in saving the lira contributed powerfully to his elevation to the Presidency of the Italian Republic in 1948.

Monetary policy. - Italy provided an outstanding postwar example of the effective use of monetary-banking policy in the fight against inflation. In the summer of 1947 inflation seemed triumphant: prices had risen to 60 times their prewar level and had doubled within a year. Then

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in October, prices suddenly started falling and leveled off in March 1948 at 15 to 20 per cent below their peak levels. Although a number of other factors favored this drastic reversal, it is commonly agreed that the major credit for having saved the Italian currency from ruin is due to the measures which were decided upon by the Interministerial Credit Committee in August 1947 and which became effective in October.

These measures required all banks to set aside an amount equal to 20 per cent of their deposits in excess of ten times their capital or an amount equal to 15 per cent of their total deposits, whichever was smaller. These amounts were either to be invested in government or government-guaranteed securities for deposit at the Bank of Italy, or to be held in an interest-bearing blocked account at the Bank of Italy or the Treasury. Furthermore, 40 per cent of any increase in a bank's deposits after October 1 was to be set aside in a similar fashion until the bank's total reserves reached 25 per cent of its total deposits. At the same time the discount rate of the Bank of Italy was raised from 4 to 5 1/2 per cent.

These new reserve requirements had been advocated by the Bank of Italy on the ground that it needed "a more efficient instrument of maneuver than that provided by the mere variation of the official discount rate which today has lost almost all of its influence on the market."[1] The new regulations did not necessitate any massive calling in of loans; nevertheless,

1/ Banca d'Italia, Adunanza Generale Ordinaria (Annual Report for 1946), Rome 1947, p. 169.

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the change in atmosphere was complete. Whereas previously the banks had not hesitated to draw on funds held in interest-bearing accounts with the Bank of Italy or the Treasury so as to expand their loans, they now became reluctant to increase lending since additional lending would have involved borrowing from the Bank of Italy.

Since a good deal of economic activity, particularly in reconstruction and investment, was premised on further credit expansion, a general shortage of funds was felt in the months following the adoption of the credit restrictions. After so violent an inflation as had been experienced in Italy, it was impossible to stop the inflation without incurring some deflationary developments. From the middle of 1948 on, however, Italian monetary policy has been attacked from various quarters on the ground that a more active policy of encouraging investment would be desirable and would not be incompatible with monetary stability.

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LATIN AMERICAN COUNTRIES

In Latin American countries, the central bank has been virtually the only source of domestic finance for government deficits since the public and the commercial banks have not generally held any sizable portion of their assets in the form of government securities. The interest rate charged the government is usually negotiated directly by the Treasury and central bank, with little reference to the supply and demand forces and terms existing in the private credit market. The Treasury therefore has more concern over direct access to central bank credit than over general credit conditions. On the other hand, the existence of government deficits requiring financing by the central bank has often been a source of concern to the latter.

Given increasing governmental responsibilities for developmental investments and for the extension of social services, coupled with problems in raising taxes, it is often difficult to accommodate the government's need for credit without endangering the country's economic stability. In the last analysis, the central bank cannot deny any insistent request for credit by the Treasury if the Treasury has the support of the highest executive authority. The central bank can attempt to impress upon the Treasury, as well as upon high authorities and even the public, the monetary implications of proposed fiscal policies. After a decision is taken, all that it can do is to minimize any undesirable repercussions of the Treasury's operations by regulating the availability and cost of credit to the private sectors of the economy.

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Central banks and the State

The central bank's place in the government's organizational structure, and its relationship with the Treasury, vary widely from one Latin American country to another. A summary classification might separate those countries which have made formal statutory provision for the co-ordination of Treasury and central bank policies from those which have not done so. In those countries where such provision has been made, legislative regulations provide (1) that the central bank has the power to make final decisions affecting monetary policy, or (2) that the Treasury hold this power, (3) that a third agency resolve any conflict that may arise between the two agencies.

Recent legislation in a few countries (e.g., Dominican Republic, Guatemala, Honduras) explicitly grants to the central banks responsibility to make final decisions in the field of monetary policy. Whether the central banks would, in fact, exercise such responsibility in the face of conflict with the Treasury in these countries has not been tested as yet. The legislative grant of authority goes even further in Costa Rica, where other government institutions are obliged to cooperate with the central bank officials in making the central bank's policies effective. On the other hand, legislation in Bolivia, Colombia, and Mexico requires that certain specified central bank monetary policies and actions be submitted to the Minister of Finance for his approval or prior review. In eight Latin American countries, the Minister of Finance is a member of the board of directors of the central bank. In general, the prestige of the position of the Minister of Finance may give him an influence on monetary decisions far beyond the formal powers of approval or veto with which he may be endowed.

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A few countries have statutory limitations on central bank operations, particularly on the bank's ability to extend credit to the government. These limitations have taken the form of absolute ceilings upon government borrowing from the central bank (Peru), of ratios between central bank holdings of government securities and average fiscal revenues of the government over a number of preceding years (Cuba, Paraguay), or of ratios between the central bank's credit to the government and the bank's capital and reserves (Chile, Colombia). When further credit to the Treasury would result in exceeding certain established limitations,the potential conflict between the Treasury and the central bank is sometimes resolved either by the Cabinet (Paraguay) or by the legislature (Chile, Colombia). In effect, the responsibility for reconciling a Treasury-Central Bank conflict is shifted to a higher governmental authority.

Monetary policies

Given the dependence of the government on central bank credit, the control of private credit expansion is made difficult. Government borrowing from the central bank leads to an increase in the free reserves of the commercial banks and, under the system of fractional reserve requirements existing in Latin America, makes possible a multiple expansion of bank credit. Because of the absence of active security markets, open-market operations by central banks are generally not feasible.

Various special measures have therefore been devised by Latin American central banks to restrict the over-all volume of bank credit expansion. In a few instances, selective controls have been applied to obtain some channeling of credit into officially desired fields.

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Mexico. - Mexico serves as the best example in Latin America of a country which has employed both traditional and novel techniques of quantitative and selective credit controls. With respect to reserve requirements, banks in Mexico are divided into three classes, the classification being somewhat analogous to that in the United States. Required reserves in Mexico City banks against peso demand liabilities were raised from 7 per cent in the prewar years to 50 per cent in 1944 and later years.

During the war years, there had been an intermittent "gentlemen's agreement" by the larger commercial banks with the Bank of Mexico to maintain portfolio ceilings. This informal arrangement was dropped in December 1946. Thereafter, a shift was made to force formal controls and increasing emphasis was placed upon influencing the composition of commercial banks' credit portfolios. In September 1948 the Bank of Mexico abandoned its uniform rediscount rate of 4 1/2 per cent and established multiple rediscount rates. These rates range from a low of 3 1/2 per cent for credit documents representing loans to increase agricultural production to a high of 8 per cent for so-called commercial or "non-productive" loan paper. At the same time, the Bank of Mexico adopted a severely selective rediscount policy; outside of hardship cases rediscount privileges are restricted to private commercial banks which maintain at least 60 per cent of their credit portfolio in "productive loans".

The regulation of commercial bank credit portfolios became much more formal in September 1949 when a new and elaborate system of reserve requirements was established. Banks are now required to hold an additional reserve of 100 per cent against peso demand liabilities in excess of the level existing on September 30, 1949; the basic 50 per cent reserve applies only to the peso demand liabilities up to this level.

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Both the basic and the additional requirements may be satisfied in part by holdings of government or government-guaranteed securities. In addition, as much as one-half of the additional 100 per cent reserve may be in the form of private paper described under six categories which set forth the various types, terms, purposes, and amounts of loans which may serve as reserves.

Although no comprehensive appraisal of the effectiveness of these various techniques is yet available, the Mexican authorities are reported to have confidence in the new structure of credit controls.

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FAR EASTERN COUNTRIES

In most of the countries of the Far East, commercial banks hold relatively little government debt. In those countries, therefore, as in most Latin American countries, the Treasury has relatively little direct concern over the general structure of interest rates or availability of commercial bank credit. The most important exception has been Japan, where there is a substantial market for government securities among the commercial banks and other financial institutions.

Japan.- The Bank of Japan and the Japanese Ministry of Finance have a long history of close collaboration, in which the Bank of Japan has had the responsibility for the underwriting and distribution of government debt. Decisions of credit policy during the prewar and war periods were made in the light of the Government's financial requirements and with a view to minimizing their inflationary impact.

Under conditions of occupation it is more difficult than usual to judge the relative weight of the two institutions in policy making. It was not until 1949 that inflation was halted in Japan by bringing government revenues in line with expenditures. It is not clear to what extent the Bank of Japan effectively restrained the expansion of private credit which occurred while the inflation was continuing nor to what extent its policies have shifted since the rise in prices and monetary circulation was halted.

New legislation in 1949 set up a Policy Board of the Bank of Japan, including as voting members the Governor of the Bank and four members appointed by the Cabinet with approval of the legislature. Representatives of the Ministry of Finance and of the Economic Stabilization

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Board sit on the Policy Board without voting powers. It is generally considered in Japan that the Governor continues to provide active leadership in formulating Bank of Japan policy, although the Minister of Finance still has legal power to "order the Bank to undertake any necessary business."

Philippines.- In the Philippines where the central bank came into existence at the beginning of 1949, most of the commercial banks hold relatively little government paper. Moreover, the power of the central bank to make direct budgetary advances to the Treasury is rigidly circumscribed, but the central bank has been called on to extend credit to the Philippine National Bank, a government-owned commercial bank, which has become heavily involved in financing the Treasury. Thus, as a result of the Government's failure to maintain a balance of revenues and expenditures, difficulties have been created for the achievement of the central bank's objectives.

The Philippine Monetary Board, the directing board of the central bank, includes the Secretary of Finance, the Governor of the Bank, the President of the Philippine National Bank, the chairman of the governing board of the Rehabilitation Finance Corporation, and three appointed members. This arrangement was intended to be of assistance in obtaining coordination of policy among the various agencies and institutions.

The powers of the central bank include the power to change the reserve requirements within specified limits and "to permit the maintenance of part of the required reserves in the form of assets other than peso deposits with the Central Bank." At present the commercial banks are permitted to hold government securities as reserves up to 5 per cent of their demand deposits, the total requirement being 18 per cent, unchanged from

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before the establishment of the central bank. The central bank also has authority to fix limits on the expansion of total loans and investments of each commercial bank or of loans and investments of particular classes. This authority has not been used.

Indonesia.- The Bank of Java, which also does a large commercial banking business, functions as the central bank of Indonesia. During 1949 it pursued a policy of contracting private credit to offset in part the inflationary consequences of its large advances to the Government. To ensure that the bank of issue will continue to have a degree of independence, the Economic Agreement between Indonesia and the Netherlands of November 2, 1949 provided that Indonesia will consult the Netherlands regarding proposed changes in the monetary laws, the appointment or discharge of directors, and credits to be provided to the Government by the bank of issue.

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