

Economics-1
BALLB-207

Unit 4:
Credit control

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What is credit control?

- Since uncontrolled money supply can lead to instability in the economic system, the central bank controls the money supply through control over the supply of credit.
- The monetary management of the central bank plays a crucial role in regulating money supply in the economy.
- The role of central bank is to prevent any excess demand or supply of money, and to equate them through credit control.

Methods of credit control

- **Quantitative methods**: They control the quantity or volume of credit created by banks. These are traditional methods used for decades.
- **Qualitative/selective methods**: These are used to regulate the flow of credit to specific uses. E.g. reducing the supply of credit to speculators to control speculative activities.

Objectives of credit control

- The traditional objective of credit control has been to stabilize the exchange rates, but with the adoption of flexible exchange rates, this has become less important.
- Maintenance of fixed exchange rate through credit control could place the country at the mercy of monetary policy of other countries.
- Over time, it was realized that stabilization of national prices is conducive to economic welfare. The main objective of credit control now is to prevent extreme fluctuations in prices and output during the business cycle.

QUANTITAIVE METHODS OF CREDIT CONTROL

Bank rate policy

- Bank rate is the minimum rate at which commercial banks rediscount its eligible securities or borrow from the central bank.
- Through the bank rate policy, the central bank gives financial accommodation to commercial banks against approved government securities.
- Initially the bank rate was kept much higher to prevent frequent borrowings by banks.
- However, the bank rate has been reduced to meet the genuine needs of banks. The central banks keep a strict watch over banks that borrow too much, and they advise them to contract advances or sell securities.

Assumptions of bank rate policy

- Interrelation of bank rate and interest rate
- Possession of eligible securities
- Psychology of investors
- Flexible economy: Prices, wages, rent, employment, and production is responsive to changes in borrowing or investment.
- For cash requirements above normal, commercial banks should not be prejudiced against rediscounting with the central bank.

Working of bank rate policy

- The central bank adjusts the bank rate in order to control the money supply (through credit) in the economy.
- If the central bank feels that the bank credit is excessive and is creating inflationary pressure, it increases the bank rate.
  - The high bank rate, makes it costlier for the commercial banks to borrow, and they also increase their interest rates.
  - As people have to pay a higher interest rate, they reduce their borrowings and save more.
  - Due to less money held by people, the aggregate demand in the economy reduces, which would relieve the economy from inflationary pressures.
- In a similar way, the central bank tackles a deflationary situation by reducing the bank rate.

Limitations of the bank rate policy

- The success of the bank rate policy depends on the existence of a developed money market, and certain other conditions which may not be fulfilled in developing countries. These limitations include:
  - **Existence of eligible bills**: In underdeveloped countries, the rediscount policy may not work since much of the credit is given through the unorganized sector of the economy.
  - **Possession of excess reserves by commercial banks**:
    - In developing countries, deficit financing is practiced by banks, and the commercial banks have excess reserves.
    - So, they rely on their own resources and abstain from borrowing from the central bank.
    - This makes it difficult for the central bank to control the credit practices of the commercial banks.
    - However, eventually, the developing country banks are becoming aware of the existence of the central bank as a source of liquidity.
  - **No direct relation between interest and investment:**
    - The central bank can only influence the interest rate, but cannot control the investor sentiments.

Success of the Bank Rate Policy

The bank rate policy was extremely successful till First World War, when international gold standard prevailed. However, after 1918, particularly after the Great Depression of 1929-33, the importance of this policy to control credit declined both in absolute terms as well as in comparison to other methods of credit control. Several factors were responsible for decline in the significance of bank rate.

(i) Since 1920s, the place of bills of exchange was taken over by treasury bills or other short-term government securities, due to contraction of international trade. This implied that the treasury's influence has increased and that of central bank had declined.

(ii) Economic rigidities after 1918, like stabilisation of prices, wages, interest, *etc.*, have reduced the importance of bank rate.

(iii) During the Second World War, the deposits and resources of banks increased on account of inflationary conditions. As a result, banks rarely approached the central bank for rediscounting or advances.

(iv) The bank rate policy has been revived after 1945. This policy has proved to be successful to curb inflationary forces by restricting the availability and supply of credit. However, its effectiveness as an instrument to lift the economy out of the morass of depression is open to question.

As economic growth proceeds, it results in a decrease in the cash deposit ratio as well as the liquidity ratio of commercial banks. As a result, the demand for bank credit increases, and bank rate emerges as the major tool for credit policy.

Open market operations

- Open market operations refer to the sale or purchase of government or other eligible securities by the central bank.
- It is a direct method of credit control, unlike the bank rate policy where the commercial banks approach to buy or sell securities with the central bank.
- Since the breakdown of the gold standard, open market operations evolved as a

Assumptions of Open Market Operations

The success of the open market operations depends upon the fulfilment of the following conditions:

(i) Existence of well developed and well organised securities market.

(ii) Adequate holdings of securities with the central bank for operating purposes to influence the cash reserves of the commercial banks.

(iii) No material change in the lending policy of the commercial banks.

(iv) No frequent flunctuation in the value of the government securities.

Open market operations and credit control

- The central bank can influence the supply of money in the economy through open market operations.
- When there are inflationary pressures in the economy, the central bank will sell government bonds to the public (including commercial banks), who will pay for the bonds to the central bank. This will reduce the purchasing power in the economy, thereby controlling inflation.
- When there is a recession, the central bank can purchase government bonds, thereby increasing the money supply in

Limitations of open market operations

- **Underdeveloped securities market:** Open market operations have limited effect in developing countries due to the existence of an informal credit market.
- **Demand and supply of securities**: When the stock of securities is limited, the central bank is unable to produce enough securities for sale. Also, there may not be adequate demand for these securities, which makes it difficult to sell securities during a recession.
- **Economic and political conditions:** If the investors have very low confidence in the market during an economic depression, they may not accept credit even if it is offered cheap. The commercial banks will also be more concerned about maintaining their liquidity position. Similarly, during a boom, investors get do not purchase government bonds even if they are offered cheap due to high optimistic market sentiments.

Superiority of open market policies over bank rate policy

- It involves the direct initiative of the central banks, and does not require the participation of commercial banks, unlike the bank rate policy.
- Open market operations may be used alongside the bank rate policy to make it more effective.
- They influence the balance of payments by affecting the internal prices and wages.
- The central bank supports the government securities by stabilizing their prices,
- They offset the seasonal movements in the economy. While excess liquidity in the economy is overcome through sales of government securities, monetary deficit is overcome through purchase of securities by the central

Variable reserve requirements

- The requirement of commercial banks to maintain a certain percentage of their time and deposit liabilities with the central bank is called the **required cash reserve**, and this practice began in the USA in 1935.
- Any amount of reserves above this minimum requirement is known as **excess reserves**.
- This requirement ensures liquidity and solvency of banks, and provides central bank with supply of deposits for local operations.
- The central bank can control liquidity in the economy through a change in the cash reserve requirement.
- The central bank may also control the credit by assigning a minimum reserve of commercial banks in marketable securities to prevent sales of short term securities by banks. This technique is called **Statutory liquidity requirement (STR).**

Variable reserve requirements and credit control

- Through the variable reserve requirement, the central bank can directly control the credit creation by banks.
- When there are inflationary pressures, the central bank can reduce lending/investment activities by increasing the **cash reserve ratio (CRR)** of the commercial banks.
- Similarly, the central bank may increase the expansion of credit during depression by reducing the CRR. This will increase the excess reserves held by banks, thereby increasing the ability of banks to raise money supply.
- Therefore, the credit creation varies inversely with the reserve requirements, given other factors.
- Unlike open market sales of securities, a rise SLR reduces the lending capacity of banks, and forces them to sell their securities.
- Variations in reserve ratio also does not involve any losses to the bank, unlike open market operations.

Limitations of the variable reserve requirements

- During periods of depression, the banks are afraid of running out of liquidity, and do not increase lending even when the reserve requirements are low. Similarly, during extreme inflation, banks will keep lending high by keeping low cash balances due to optimistic sentiments.
- It’s a bit harsh measure as it requires complicated book keeping adjustments, and may require distress sales of securities by the banks to meet their reserve requirements. It is preferred for correcting major economic fluctuations, rather than short-term monetary changes.
- The banks may charge a very high interest rate on their loans, as the required reserves of the banks do not earn any interest.

Limitations of the variable reserve requirements

- While banks with large excess reserves will not be affected by the reserve requirement, those with less reserves will be affected. It also does not affect the reserves of non banking financial institutions, and may be discriminatory.
- The policy is inflexible since it is applied uniformly across regions, while it is possible that some regions require more credit than others.
- Although the policy is not very suitable for short term adjustments, it may be used in conjunction with open market operations, to regulate credit supply across regions.

Qualitative methods of credit control

- Qualitative methods of credit control are concerned with directing credit towards certain priority sectors.
- It helps in channelizing credit towards socially desirable purposes, and away from speculative and other unnecessary activities.
- These methods were first implemented during second world war to control credit for inflation sensitive industries, to keep the prices of necessary goods affordable.

Qualitative methods of credit control

- **Margin requirements:**
  - These refer to the value of the collateral securities over and above the loans extended by commercial banks in order to cover the interest and possible risks.
  - The central banks can direct the banks to change their margins to increase/contract lending, according to the state of the economy.
  - It may be applicable in lending against securities as well as in the commodity market.
  - Unlike quantitative methods, it is not applicable for the economy as a whole, and may be used to control credit in particular sectors.

Qualitative methods of credit control

- **Rationing of credit:** The central bank can ration the availability of credit to certain sectors by:
  - fixing the ceiling of loans or advances by banks known as **variable portfolio ceiling**
  - Fixing the ratio of the capital of commercial banks to their total assets called **variable capital assets ratio.**
  - In rare cases, it may involve restricting of credit to commercial banks through rediscount

Qualitative methods of credit control

- **Regulation of consumer credit:**
  - The consumer credit directed to a particular good may be restricted by the central banks during a boom through ceilings on loans or reducing the time for repayment. It may also increase the amount of down payment on loans to that sector.
  - Similarly, it can increase credit to a sector by reducing down payments or increasing the period for repayment.
  - Such regulation may divert investment from

Qualitative methods of credit control

- **Control through directives:** Directives refer to expression of concern regarding the current credit situation. The central bank may persuade the commercial banks to reduce or increase credit in form of oral or written statements, appeals and warnings.
- **Moral suasion:** Through this method, the central bank influences the lending activities of the commercial banks on a voluntary basis. Effectiveness of moral suasion depends on:
  - Prestige of the central bank
  - Country's banking and credit structure
  - Degree of cooperation between central and commercial

Qualitative methods of credit control

- **Publicity:** by sharing statistical data on money supply, prices, production, employment, etc. the central bank can make the general public aware about the credit situation in the country, which will exert pressure on the commercial banks to formulate their policies accordingly. But this may not be effective in developing countries with massive illiteracy.
- **Direct action**: When the central bank finds that the commercial banks are violating the principles of credit regulation, it may exert direct control on them. Direct control involves coercive measures like restrictions on rediscount facilities, charging of penal interest rates, fixation of quantitative credit ceiling etc. However, direct control may lead to non cooperation or evasion by some banks.

Limitations of qualitative control measures

- The presence of informal lending and banking facilities that are outside the control of central banks.
- Commercial banks may enter into unproductive or speculative lending activities under headings that may be misleading. So, the central bank can not know what is the exact purpose of lending.
- The commercial banks themselves may not be able to verify the purpose for which the loans were actually used.

Comparison between qualitative and quantitative controls

Table 22.1 : Comparison between Quantitative and Qualitative Methods

Quantitative Methods	Qualitative Methods
1. These methods influence the total volume of credit indiscriminately without differentiating between essential and non-essential uses of credit.	1. These methods influence the direction of credit and are discriminatory in nature in the sense that they differentiate between essential and non-essential uses of the credit.
2. These methods are mostly indirect and impersonal. The monetary authority has to wait and watch after bringing about the change.	2. These methods are more direct and entail more responsibility on the commercial banks as well as central bank to keep a constant check on the working of the former.
3. These methods affect the lenders. the borrowers need not necessarily be affected.	3. These methods necessarily affect both the lenders as well as borrowers.

Although both quantitative as well as qualitative methods of credit control have failed to regulate credit effectively, especially during a depression, it has been found that qualitative methods have been more effective in developing countries.