RFD 668

L.5.2

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

May 4, 1971

Rodney H. Mills, Jr.
Martin Kohn
Jan Karcz
Ilse Higgins

A Critique of the Report on Foreign Central Banks Prepared for the House Committee on Banking and Currency — 18 Pages

This paper reflects the personal opinions of the authors and must not be interpreted as representing the opinion of the Board of Governors.

A Critique of the Report on Foreign Central Banks Prepared for the House Committee on Banking and Currency

A Staff Report prepared for the House of Representatives Committee on Banking and Currency entitled Activities by Various Central Banks to Promote Economic and Social Welfare Programs, published in December 1970, compares the Federal Reserve with the other central banks in the industrialized nations of the Western World. The Report calls these other central banks "basic mechanisms to promote the social and economic goals of the nation," and its comparison with the more passive attitude of Federal Reserve seems designed to show that the System is not such a mechanism. Considering the goals to which the Federal Reserve's activities are directed, that conclusion would be incorrect. The Report also refers to these other central banks as "active participants in the allocation of credit to various sectors of the economy." And it lists many specific activities which those central banks perform and which the Federal Reserve System does not, the implication being that the Federal Reserve ought to perform all or many of those activities itself.

General Appraisal of the Report[1/]

The Report errs in two major respects. First, the characterization of the central banks of the other main industrial countries as "active participants in the allocation of credit to various sectors of the economy" gives an exaggerated impression of the extent to which

1/ Prepared by Rodney H. Mills, Jr.

those banks direct the allocation of credit to individual sectors. Secondly, in implying that the Federal Reserve should adopt credit allocation procedures used by central banks in other industrial countries, the Report overlooks the fact that the trend abroad in the past 10 years or more has been away from direct controls, away from practices that discriminate in favor of some sectors and against others, and toward policy instruments that have broader application and more generalized effects.

Central banks in other industrial countries participate in the allocation of credit to individual sectors of the economy on a much smaller scale than one would infer from reading the initial pages of the Report. The allocation of credit for exports provides an example. The Bank of England does favor export credit in several ways. It exempts a major part of all export credits from the "ceilings" which it has imposed from time to time on loans to customers by British commercial banks; it sets interest rates on such credits at levels lower than market forces would determine; and it allows some export loans by clearing banks to qualify as a liquid asset for reserve requirement purposes. But preferential rediscount rates for export paper have recently been largely or wholly eliminated by the central banks of France and Belgium, and have not been used by central banks in other major Western European countries for many years. The Netherlands Bank does rediscount export paper of longer maturity than other types of paper, but such rediscounts are practically nonexistent, partly because rediscounting as such is so small in that country. Finally, contrary to the statement in the Report, the German Federal Bank does not provide export credits, while its special rediscount privilege for export paper is limited to allowing a longer than normal maturity in the case of paper arising from exports to underdeveloped countries.

The Report also incorrectly generalizes about the preferential treatment that is extended by foreign central banks in the allocation of credit for agriculture, State and local governments and public agencies, and housing. Concerning credit for agriculture, now that the Bank of France's preferential rediscount rate for grain stockpile bills has been abolished, not a single central bank in the industrial countries of Western Europe follows policies that could be construed as directing credit into agriculture. As regards credit for State and local governments and public agencies, no central bank among the main industrial countries lends to State and local governments except the German Federal Bank, and its loans are subject to stringent statutory ceilings. The Bank of France and the Bank of Italy do lend to public agencies, as the Report says. But in the case of Italy, the volume of such lending is negligible, and the institutions involved obtain their funds principally from the bond market, time deposits, commercial bank loans, and external sources.

With respect to housing, some central banks -- including those of France, Italy, and the Scandinavian countries -- favor credit for housing in one way or another, such measures being particularly important in Scandinavia. But the majority of central banks to not direct funds into this sector. Similarly, to say -- as the Report does -- that the central banks of France and Sweden have channelled bank credit into industrial investment in an effort to maximize economic growth, is a long way from saying that the central banks of most industrial countries do this sort of thing. The Report is also wrong in saying that the Bank of France invests in French industry; and the Bank of France's direct loans to business and individuals, which the Report implies are of some importance, in fact equalled less than one-twentieth of one per cent of total outstanding credit to such borrowers at the end of 1969.

The Report is incorrect in its conclusions about the role of the Bank of Japan. The Report notes that Japanese commercial banks are heavily dependent upon the Bank of Japan for funds, and that the Bank of Japan can closely control the volume of commercial bank loans and investments. But the allocation of bank credit among individual borrowers is left entirely to the banks. It is not true that the Bank of Japan, in the words of the Report, "becomes the *de facto* planning agency through its decisions to make or refuse loans."

Although these other central banks tend to allocate credit to specific sectors far less than the Report would suggest, it is certainly true that they do so more than does the Federal Reserve. But in the 1960's and currently, a number of European central banks have modified their arsenal of credit control weapons to eliminate certain cases of discrimination or favoritism in the sectoral allocation of credit. There is a general move away from direct and selective instruments to generalized market-oriented instruments. Mention has been made of lessening reliance on preferential rediscount rates for export paper by Continental European central banks. The Council of Ministers of the European Common Market has registered its opposition to this form of preferential treatment. The National Bank of Belgium no longer has such a preferential rate, while that of the Bank of France is now confined to medium-term paper arising from exports to countries outside the Common Market. Several central banks also have done away with regulations that placed the national treasury in a favored position to raise funds. Thus, in the early or mid-1960's, both the National Bank of Belgium and the Bank of France abolished regulations requiring commercial banks to keep a minimum portfolio of Treasury bills, while the Bank of Italy changed the composition of banks' required reserves in order to reduce the actual or potential flow of bank funds into Treasury bills.

The operations of the Bank of France probably have had as much incidence on the sectoral allocation of credit as those of any central bank in Western Europe. It seems appropriate to point out that Bank of France officials have been dissatisfied with a number of the credit-allocating ramifications of the Bank's activities, and this has led to a variety of reforms in favor of less discriminating practices. In addition to the simplification of its rate structure and the abolition of compulsory holding of Treasury bills by the banks, mentioned earlier, the Bank of France a few years ago instituted a system of compulsory cash reserves. This was done in conjunction with the phasing out of the so-called liquidity coefficient, an instrument of control which, by requiring the banks to hold a minimum amount of certain types of earning assets, discriminated in favor of medium-term bank credits (as opposed to short-term), export bills, Treasury bills, and grain stockpile bills, at the expense of other demands for bank credit. In addition, in controlling the volume of commercial bank recourse to it, the Bank of France is now greatly reducing its reliance on direct controls in the form of individual bank rediscount ceilings, and increasing the credit it extends through the money market. The latter is a more impersonal method, whereby market forces determine how much credit a bank obtains rather than the bank's size, or some other arbitrary criterion, as is the case with the rediscount quotas.

The Bank of France instituted a new credit control technique in April 1971, when it imposed a reserve requirement against loans granted by banks and certain other financial institutions. Although the Bank has the power to set differential reserve ratios against different categories of loans, it has not done so, and has stated publicly that the primary purpose of the new requirement is to reinforce the effects of the reserve requirement against deposits.

Evaluations of Description of Activities of Certain Central Banks

In addition to the introductory sections in which the main findings are summarized, the Report contains detailed descriptions of the activities of central banks in a number of countries. Evaluations of the Report's descriptions of the activities of the Bank of England, the Bank of France, the Bank of Italy, and the German Federal Bank follow.

Bank of England[2/]

The Report is broadly correct in its overall assessment of the role of the Bank of England in the formulation of monetary policy and in its discussion of the methods by which the Bank implements policy. On the first point, it is generally agreed, as the Report says, that the Bank of England, while free to express its views and attempt to influence policy, does not independently determine monetary policy. On the second point, the Report rightly stresses the great reliance placed on administratively imposed ceilings on bank lending in carrying out the restrictive monetary policy of recent years.

It should also be noted that in the detailed discussion of Bank of England operations no claim is made that the Bank assists social welfare programs, as the introduction to the Report implies foreign central banks typically do.

2/ Prepared by Martin Kohn.

On some matters of emphasis or detail, however, the Report is at least unclear and seems to be in error.

1. Though it is true that the Bank of England now emphasizes monetary aggregates more than earlier, the Bank is still much concerned with maintaining "orderly markets" -- that is, with preventing fluctuations in interest rates that might make the marketing of the public debt difficult.

2. The implication that forcing the discount houses to borrow at Bank rate can force up short-term interest rates is misleading in that the effect of such a move is to push rates up only slightly. Changes in Bank rate have a substantial impact on some short-term yields -- those, for example, which by convention are rigidly linked to the discount rate. However, even a change in Bank rate need not have much effect on rates -- those on local authority and hire purchase deposits, for instance -- that are allowed to rise and fall independently of Bank rate.

Bank rate lending is not mainly intended directly to affect interest rates, but rather is used as a strong signal indicating a course of action to be taken (or desisted from). For instance, Bank rate lending was recently used to indicate that interest rates would be kept high and that the banking system should not engage in speculative purchases of government securities in anticipation of a decrease in the discount rate.

3. So-called open market operations in Treasury bills are not used, as is implied on p. 17 of the Report, to encourage "expansion" by the discount houses. They are designed only to permit the discount houses to "balance their books" at the end of the day. For example, purchases of Treasury bills by the Bank permit the discount houses to eliminate a cash deficit in a nonpunitive way (in contrast to requiring them to borrow at Bank rate). The open market operations that affect the ability of the banking system to expand lending are those in long-term securities. This the Report recognizes on p. 18, where it notes that these are the operations that actively affect bank liquidity.

4. The discussion of the banks' observance of the loan ceilings imposed in November 1968 is somewhat inaccurate. The ceiling on clearing bank lending had not been met by March 1969, as the Report says. In fact, the ceiling was never met. By October 1969 it had become apparent that the ceiling had been unrealistic and that even without its being met, money was sufficiently tight. Therefore, the Bank of England made it known that it would be satisfied if there was no further expansion of clearing bank loans, which were then 4 per cent above the ceiling.

Bank of France[3/]

The Report correctly states that the Bank of France directs the flow of credit to desired end uses by means of direct controls;

3/ Prepared by Jan Karcz.

the techniques used by the Bank are adequately described but no attempt is made to evaluate the effectiveness of the system. The Report incorrectly implies that the Bank of France plays a major role in the decision-making process in allocating credits and setting credit expansion limits. It also fails to point out that about two-fifths of French credits are granted by institutions that are beyond the Bank of France's supervision. Finally, the Report fails to mention that French officials have on many occasions expressed dissatisfaction with the effectiveness of quantitative credit ceilings and that France is slowly moving away from direct controls and towards a market-oriented system more like that in the United States.

In fact, the role played by the Bank of France in French money and capital markets differs markedly from that described in the Report.

1. Generally speaking, the Bank of France is responsible for controlling the money supply and short-term credit expansion. Primary authority in the allocation and expansion of medium- and long-term credit rests with the Ministry of Finance and Economic Affairs and the Bank only implements the decisions taken by the Ministry. In recent years, nearly one-half of all credits to the economy have been granted by nonbank institutions, mostly in the so-called "Circuit de Trésor" which is outside the Bank of France's supervision. This group of institutions includes the Treasury and several public and semi-public institutions, e.g., the well-developed French postal

giro system. Credits granted by these institutions by-pass the commercial banking system and are given in accordance with national economic policies established by the government in accord with the five year economic plan. The Bank of France's control over credit extends to only a little more than one-half of the credits granted to the French economy.

2. Contrary to what is stated several times in the Report, the Bank of France does not currently invest in equities of commercial firms. Although it still grants direct loans to enterprises, its activities in this field are no longer of significant magnitude. Direct loans by the Bank of France to business and individuals amounted to less than a twentieth of one per cent of all loans outstanding to such borrowers as of the end of 1969.

3. Perhaps the most important comment to make is that officials of the Bank of France have been very dissatisfied with the effectiveness of quantitative credit ceilings and considered them a necessary, though not very effective, weapon in times of crisis. Generally, the Bank has been moving towards simplifying the structure of French money and credit markets and the 7 discount rates mentioned in the Report are now only four. Two of these are of marginal importance. The only preferential discount rate still extant today is the rate for rediscounting of medium-term export paper drawn on countries outside the European Common Market. In practice, this means that some 95 per cent of all paper discounted by the Bank is discounted at the Bank's main discount rate.,

Individual rediscount ceilings for commercial banks are losing their importance. Recently, the Bank of France allowed its money market intervention rate to descend well below the official discount rate. As a result, commercial banks have to a large degree substituted Bank of France open market accommodation for rediscounts. Officials also hope that, as a result, the Paris money market will become more efficient in bringing borrowers and lenders together, and that the banks' reliance on the Bank of France will consequently be reduced. Setting the Bank of France's open market intervention rate below the discount rate was one of the policy recommendations made several years ago by a commission on money and credit market reform chaired by Mr. Wormser, the present Governor of the Bank of France.

French monetary policy is moving towards a system based more on the use of general reserve requirements and less on quantitative credit ceilings. But French economic planning continues to emphasize specific direction of credit for desired uses. We can expect that in the so-called "Circuit de Trésor" group of institutions, credits will continue to be directed to economic and social welfare ends.

The new reserve requirement against loans granted by banks and certain other financial institutions, effective April 1, 1971, was initially set at 0.25 per cent and was applied only to loans exceeding 80 per cent of loans outstanding on January 5, 1971. In its annual report for 1970 the Bank of France stated that the new requirement would be a more direct and more rapid deterrent to credit expansion than reserves against deposits, and the Bank voiced the hope that this new instrument would make it unnecessary to reimpose quantitative credit ceilings in the future.

Bank of Italy[4/]

Activities of the Bank of Italy which the Report says are undertaken "to promote economic and social welfare programs" (pp. 1-6), or which the Report calls "actions undertaken to promote social welfare that are not undertaken by the U.S. Federal Reserve Board" (p. 8) in a number of cases either are misinterpreted by the Report or are of a trifling nature. The Report also contains some errors in its general description of Bank of Italy operations (pp. 27-32, 117-141).

Among the activities "to promote economic and social welfare programs," including those not performed by the Federal Reserve System, it is erroneous to say the Bank of Italy "acts as a treasury for the provinces" (pp. 2, 8). There are no provincial governments in Italy. The confusion undoubtedly arises because the Bank operates the provincial offices of the Italian Treasury. It is also inaccurate to say (pp. 27, 132) that by its automatic discounting of agricultural stockpiling bills the Bank of Italy "is effectively financing the government's agricultural price support system." Agricultural stockpiling bills that are automatically eligible for rediscount (almost entirely arising from grain stockpiling) in fact no longer relate to current

4/ Prepared by Rodney H. Mills, Jr.

agricultural operations. Bills of this type now in existence were all originally drawn to finance agricultural purchases made prior to the 1964-65 crop year, and have been rolled over on maturity.

That the Bank of Italy "stores items of value" (p. 8) scarcely seems worthy of mention. The fact that the Bank "accepts deposits from the public" (p. 8) is stated without the further information that such deposits are minuscule in number, cannot be freely opened by the public, and by statute pay no interest, whereas commercial banks in Italy pay interest even on demand deposits (at very high rates on large accounts). In any event the connection between the acceptance by central banks of deposits from the public and the promotion of welfare is not clear.

The Report mistakenly asserts that in Italy rediscounting is of negligible importance except for the previously-mentioned compulsory grain stockpile bills (pp. 27, 132). It also seems to imply that Bank of Italy advances to banks (against government securities) are also unimportant since there is no discussion of them. In fact, since 1963 rediscounts other than of stockpile bills -- together with secured advances -- have become an important source of funds for the Italian banking system. Furthermore, the regulation of the availability of this source of funds has become a tool of credit control, and the Bank of Italy is now using the discount rate as an instrument of policy. Ordinary rediscounts (i.e., excluding compulsory stockpile bills) and outstanding advances to banks rose from 283 billion lire at the end of 1962 to 2,371 billion lire ($3.8 billion equivalent) at the end of 1969, of which 747 billion lire ($1.2 billion) were rediscounts. On the latter date, ordinary rediscounts and advances to banks equalled 4.4 per cent of the total assets of the Italian banking system.

In the discussions of the regulations affecting the banks' net foreign position (pp. 29, 136) it is incorrectly stated that in 1966 "policy was reversed, and banks were encouraged to lend abroad in order to export excess domestic liquidity." In fact, at the end of 1965, the Bank of Italy did just the opposite -- it restricted the availability and raised the cost of the lira-dollar swaps it offered to the banks, in order to keep funds in Italy and speed the slow recovery from the 1964 recession.

The German Federal Bank[5/]

The Report's section on Germany focuses on a number of credit policy measures with the intent of indicating the degree of preferential treatment which the Bundesbank accords to certain sectors of the economy -- thereby promoting social and economic welfare.

The Report describes the major credit policy functions of the German Federal Bank (Bundesbank), i.e., rediscounting, minimum reserves, and open market operations. It stresses correctly that the Bundesbank is autonomous in its monetary policy decisions and independent from government instruction. However, the Bank is obliged to support the

5/ Prepared by Ilse Higgins.

general economic policy of the federal government "to the extent that its monetary function remains intact."

But the examples in the Report of the preferential use of Bundesbank policy are in some cases over-generalized or even incorrect. Some functions ascribed to the Bundesbank are actually those of fiscal authorities or public agencies. Furthermore, the report contains no account of the kind of economic and social results achieved through selective and preferential credit policy measures.

The following specific comments apply.

1. The Report states that the Bundesbank provides special rediscounting privileges for prime commercial export bills with a maturity of up to 5 years. This is not quite accurate; only export bills (*) with a maturity of not less than 1 and not more than 4 years that originate from medium- and long-term exports to developing countries are exceptions to the limit that bills -- submitted for rediscounting -- must be payable within three months. This rediscount line cannot be used to provide funds for capital investment or working capital for general export purposes of the exporting firms. No special discount rate applies to these export bills.

2. Contrary to what is stated in the Report, the Bundesbank does not provide export credits. The Reconstruction Loan Corporation

(*) Promissory notes of German exporters - endorsed by the exporter's Bank and the Export Credit Company (Ausfuhrkredit Gesellschaft m.b.H.).

(Kreditanstalt fuer Wiederaufbau), which is funded by the federal and Laender governments, extends export credits and loans to finance development projects abroad.

3. The Report states accurately that the Bundesbank extends credits directly to the Laender and federal authorities and to certain special funds of the federal government. These credits are subject to stringent statutory ceilings (paragraph 20 of the Bundesbank Law), and the credits are granted at an interest rate equal to the discount rate. This might be considered as a preferential rate, but only to the extent that state and federal agencies do not have to borrow at higher interest rates in the money or capital markets.

4. Similarly, the Bundesbank uses so-called "storage agency" bills (Vorratsstellenwechsel) -- paper arising from stockpiling transactions of certain agricultural commodities -- in its open market transactions. By buying these bills, the Bundesbank facilitates the financing of agricultural and import inventories of certain public agencies (Oeffentliche Einfuhrund Vorratsstellen; paragraph 21 of the Bundesbank Law). As "storage agency" bills account for only a fraction of the volume of open market transactions, the preferential use of this instrument is marginal.

5. The Bundesbank has indeed used -- and is still using -- various monetary policy measures in order to stem excessive foreign exchange inflows. One of the earlier -- now discontinued -- measures prohibited interest payments on nonresident deposits as well as the

sale of German money market paper to nonresidents. The Bundesbank has intermittently engaged in swaps of dollars for marks at favorable rates for the same reason. It currently imposes marginal reserve requirements on banks' foreign liabilities but this has not deterred German businesses from borrowing abroad with bank guarantees. Thus, the Bundesbank continues to be actively engaged in influencing credit developments across its borders. Contrary to a statement in the Report (page 4) the Bundesbank has not used foreign exchange controls; Germany has no legal restrictions on foreign exchange trading.

6. The Report states that housing and agriculture typically receive favorable treatment in the form of selective credit policies. Most of the housing in Germany is financed through mortgage banks, savings banks, building and loan associations (Bausparkassen), and insurance companies. None of these credit institutions receive preferential credit treatment from the Bundesbank, except that the savings banks have a slightly lower minimum reserve ratio. Fiscal incentives and institutional arrangements for the provision of mortgage credit largely insulate the housing sector from changes in credit policy.

Similarly, there are no preferential central bank arrangements for credit cooperatives for farmers (Raiffeisen) and small trade and industry (Schulze-Delitzch), or for the Industrial Credit Bank that makes loans to firms too small to tap credit markets.

Thus, except for the specific cases mentioned in (3) and (4) above, the Bundesbank does not actively participate in allocating credits to various sectors of the economy.