ment process tends to express itself in a persistent deficit in the balance of payments. This, in its turn, cannot but give rise, even if only in the long run, to devaluation of the currency.

What these limits are in so far as they are connected with the problem of liquidity, we have already indicated. We have pointed out that, on the one hand, in the case of the creation of immediate liquid funds, lending by the banking system as a whole must keep pace with the rate of savings, and with the rate at which the public lends to the banks. On the other hand, in the case of a lengthening of the investment process, long-term investments must also be contained within limits which allow the normal maturing of the flow of production to keep pace with the consumption rate. These limitations are, in effect, merely two aspects of one and the same necessity; the rate of investment must not exceed the rate of saving. This is a necessity which must always be respected if the economic system as a whole is to be assured of an adequate degree of liquidity and is to avoid having to «liquidate» in advance excessive investments, and having to meet the consequent cost.

This explains why the liquidity position of the economic system, and still more of the banking system, varies greatly as between various countries, in accordance with the flow of income and savings in relation to the growth of population and the increase in capital per head. That is to say, it explains why it is that in countries that can normally count only on a comparatively small volume of savings, the liquidity problem is more keenly felt. And this is, we think, reflected also in the way in which the problem itself is understood, and in the greater attention paid to the limits of an economic nature within which each country may create for itself the liquidity margins that it needs.

Credit Control in the Netherlands

by

F. W. C. BLOM

As is known, Holland's banking system consists of: (a) the Bank of issue, the Netherlands Bank, since 1948 a state-owned corporation; (b) deposit banks (limited companies operating in the field of short term loans to business and investments in the money market); (c) cooperative agricultural banks (united in two important groups, accepting sight and savings deposits and supplying both short and longer term credit, investing the remainder of their assets partly in the money market, partly in the capital market); (d) institutional investors (savings banks, mortgage banks, life insurance companies, pension funds, and the large semi-Government Netherlands Reconstruction Bank) which operate in the capital market and also supply important long term loans to industry and housing.

Relations between the Netherlands Bank and the banking system.

Before the war the Netherlands Bank, then a private bank of issue, exercised indirect control on the monetary situation in the orthodox way, i.e. by its position as leader of last resort through discount policy, open market operations, and «moral suasion». The Bank had no legal ascendancy over the banking system.

Since the thirties — during which critical period no banking crisis occurred in the Netherlands — regular contact between the Central Bank and the banking system became closer. In 1955 the larger banks agreed to supply quarterly statements of their balance sheets to the Netherlands Bank.

A. In 1945 the relations between the Netherlands Bank and the banking system entered a new phase, as in the course of the money purge the Bank was charged with temporary credit control. This control was concentrated on qualitative lines until the end of 1950, when quantitative restrictions were dropped and replaced by more effective quantitative ones. To these controls the deposit banks and the agricultural banks, the so-called «money-creating institutions», have only been subjected. The institutional investors have not been interfered with, and until recently they have been encouraged to extend more direct loans to business.

In 1945 the granting of bank advances was licensed under the following provisions:

(a) no advances were allowed if the prospective borrower owned readily marketable securities;

(b) stock exchange advances and loans for speculative purposes or for consumption were prohibited;

(c) short term advances for trade and production were allowed without special license up to fls. 50,000 per debtor;

(d) advances of fls. 50,000 and over were subject to approval by the Netherlands Bank; approval was to be withheld in the case of advances for investment in equipment;

(e) banks were requested to restrict credit for unessential purposes.

The qualitative credit restrictions of 1945 have had some psychological effect, but in practice the Netherlands Bank has hardly ever refused approval for advances the banks were prepared to grant (for reasons to which we shall return). The restrictions therefore were not stringent, with the exception perhaps of the ban on stock exchange credit.
B) The system of control was extended and improved in 1946, when a Gentleman’s Agreement was stipulated between the Netherlands Bank and the important banks, under which:

(a) banks agreed to supply the Netherlands Bank with all particular it needs for supervising the banking system (and to permit the banks on necessary investigations), as well as with monthly statements of their situation and annual balance sheets and profit and loss accounts;

(b) banks undertook to inform the Netherlands Bank of credits opened of Rs. 1,000,000 (1) or exceeding 5% of their capital (2);

(c) the Netherlands Bank was authorized to contact individual banks should it notice developments it deems undesirable.

This Agreement still exists and is working smoothly. Personal contact is easy as most large banks are situated within walking distance of the office of the Netherlands Bank. It should be remarked that the smallest banks have not signed the Agreement; their quantitative importance is not large, but from the point of view of quality some of them are much wealthier than the banks which joined the Agreement.

In 1948 the shares of the Netherlands Bank were vested in the Government (3), and


\[ 	ext{Rs. 5,000,000 to Rs. 10,000,000.} \]
\[ 	ext{Rs. 2,500,000 to Rs. 5,000,000.} \]
\[ 	ext{Rs. 500,000 to Rs. 1,000,000.} \]

- At first sight this may seem unnecessary, as under the 1945 arrangements advances of Rs. 50,000 and over were almost always subject to the approval of the Netherlands Bank. But in practice it worked out differently. The Gentleman’s Agreement of 1948 is a permanent agreement between banks and the Netherlands Bank (in its capacity of Central Bank) enabling the Bank to secure information about the position and policy of each individual bank. The controls were temporary and would lose their validity with the liquidation of the Money Purses. Furthermore, credits over Rs. 50,000 were sufficient to permit of a speedy investigation of the Netherlands Bank (in its capacity as agent for the Government); and banks prefer giving the proper function of the Central Bank and the function of the Government Agent well separated from each other.

The Bank remains a limited company, managed by a Board of Governors under the superintendence of a Board of Control, consisting of a Royal Commissioner and a Royal Commissioner and a Royal Commissioner and a Royal Bank Council. The main functions of the Governor and the Royal Governor are to act as agents under the control of the Board of Control. The Finance Minister is authorized to issue such directions to the Governor as may be necessary to operate on the monetary and financial policy of the Governor and the Governor of the Bank. If the Governor of the Bank should object to follow these directions the Governor will decide whether he has to be followed, and if the Governor confirms the direction, its effect in its chapter was reconstructed upon more ambitious lines.

The tasks of the Bank are included in art. 9 of its charter (Bank Act, 1948), quoted in the footnote (4), where a supervision over the credit system is emphasized (par. 3 and 4).

Lastly, in conformity with par. 4 of said article, a bill of a full-fledged banking legislation was submitted to Parliament, containing both control on individual banks for the protection of depositors and various kinds of general monetary controls for coordinating the credit policy of the banks with the monetary and financial policy of the Government. In practice, however, up to now everything has remained as it was. The further legislation participated for detailed supervision of the banking system has yet to be approved, and emergency decrees, as provided for cases of undesirable developments harming either the soundness of the banking system or the interests of the customers of individual banks (see footnote 4, par. 4), have not been found necessary.

Broadly speaking the monetary influence of the Netherlands Bank is mainly restricted to the money market. The capital market is hardly interfered with, with the exception of a mild control over the issue of shares and bonds (5). Of course the debt policy of the Treasury is to be published together with the objections raised by the Governing Board. If then the Governing Board still refuses to comply they can be removed from office.

In consequence the domestic bank balances of consumers and the business world contracted, whilst at the same time increased use was made of credit facilities granted by banks. In other words, the fact that money was not scarce enabled the domestic community to spend beyond its current income and thus enlarge the deficit on foreign payments. Indeed this deficit exceeded Rs. 1,000,000 for 1950. It was covered by the available E.C.A. grants and other reserves, but a repetition of the same performance in 1951 had to be prevented. Not only would American aid be sharply reduced in 1951, but a greater part of available resources had to be reserved for rearmament; and so spending by the private sector of the economy had to be curtailed.

Tables I and II show the expansion of credit in 1950 and the contraction of the money circulation. As can be seen, 'cash' and other liquid assets of the commercial banks shrank by 679 million during 1950 (—127.5%; from 3030 to 2348 millions of guilders), while 'credits to clients' rose by 197 millions (12.8% ; from 5197 to 5394 millions of guilders). On the other hand 'cash' and other liquid assets of agricultural credit banks shrank in the same year by 233 millions (—30.1% ; from 747 to 518 millions of guilders), while 'credits to clients' and securities rose, as a whole, by 213 millions (+21.2% ; from 1194 to 1407 millions of guilders).

Taken together, the Tables roughly explain how the deficit on the balance of payments was reflected in the domestic monetary situation.


\[ \text{Total} \]

| Credit balances with Netherlands Bank, etc. | 203 | 315 | 207 | 224 | 214 |
| Cash balances, etc. | 62 | 57 | 58 | 59 | 63 |
| Netherlands Trade Pay. | 5.27 | 5.75 | 5.99 | 6.93 | 7.64 |
| Other short-term Government Pay. | 12 | 11 | 12 | 11 | 10 |
| Cash and Treasury, etc. | 1.55 | 1.61 | 1.61 | 1.61 | 1.61 |
| Advances to banks, etc. | 350 | 370 | 370 | 370 | 370 |
| Total | 203 | 315 | 207 | 224 | 214 |

Thus the Treasury maintained its low interest policy in the post-war years where there was an excess of competing demand for fixed incomes and ad\-vances, as long as the large volume of business remained below the pre-war level. The Treasury borrowed at a very low rate for long-term bonds and also financed to a large extent by 5-year Treasury notes at 2.5%. Even the 5-year Treasury notes had a slightly higher interest rate. These short-term Treasury securities were sold on tap, mostly in the London market.

In conclusion the interest rate for bills remained at 2.5% until December 1950.
A very interesting complete explanation of domestic money creation and cancellation during 1950 is to be found in the 1950 Reports of the Netherlands Bank (7).

Given the existing liquidity of the banking system, there was no actual check on credit expansion; at the end of 1950, about 68% of total assets of all commercial and agricultural banks consisted of cash and practically liquid assets, mainly short term Treasury securities.

Under these circumstances, in the fall of 1950 the Netherlands Bank decided on measures to curb a possible further outburst of credit. The Bank pointed out that a reasonable credit expansion was warranted by the increase of production, but that such expansion would have to be orderly and kept within bounds. On the other hand, a continuous expansion of credit with the same speed as in 1949 was not expected, so that the first expansion was for a substantial part explained by rebuilding of stocks, a process that would come to an end and perhaps be reversed later on. A mild restriction of bank credit was deemed sufficient for the moment.

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<table>
<thead>
<tr>
<th>Year</th>
<th>Cash, cheques with Netherlands Bank, etc.</th>
<th>Deposits with Treasuries and Other Government Paper</th>
<th>Cash and Treasury etc.</th>
<th>Cash and cheques</th>
<th>Deposits, loan, bills, etc.</th>
<th>Assets in gilders</th>
<th>Savings deposits</th>
<th>Current account deposits</th>
<th>Credit balances in gilders</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>4136</td>
<td>9524</td>
<td>741</td>
<td>395</td>
<td>999</td>
<td>1,035</td>
<td>1,375</td>
<td>1,325</td>
<td>1,331</td>
</tr>
<tr>
<td>1959</td>
<td>454</td>
<td>935</td>
<td>751</td>
<td>402</td>
<td>1,004</td>
<td>1,365</td>
<td>1,392</td>
<td>1,295</td>
<td>1,345</td>
</tr>
</tbody>
</table>

Table II

EXTRACT FROM COMBINED FIGURES OF AGRICULTURAL CREDIT BANKS
(in millions of gilders, as for December 31st)

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Individual qualitative restrictions replaced by a more severe policy of aggregate quantitative control.

Qualitative restrictions were quietly dropped, and the emphasis was shifted to the selective influence of a rise in interest rates and to a complex system of legal «ratios». The fundamental weakness of qualitative restrictions appears to be that at unreasonably high interest rates there may be an excessive demand for advances, each of which is above reproach as to quality; in this case qualitative selection is impossible and does not produce the required curb on credit.

The only remaining official qualitative restriction was the ban on stock exchange advances; restrictions on consumer credit, advances for investment in equipment and mortgage credit being superfluous as banks in the Netherlands have always refrained from such doubtful advances. This point we would like to stress; if a banking system traditionally restricts itself to short term advances for financing stocks and debtors (working capital) there is no practical scope for effective quantitative control.

As there was no scope for qualitative selection there was no room for credit-rating either; any fair system of rationing assumes a standard of priorities which the Bank was unable to provide. The only remaining solution was chosen by the Netherlands Bank: an induced rise of interest rates which it was hoped would check the rising demand for advances.

In fact, the restriction policy started by raising the discount rate of the Netherlands Bank from 2½% to 3% in September 1950, followed by another increase to 4% in April 1951 (9).

Of course the discount rate was ineffective as long as banks were so liquid that they did not need to borrow from the Netherlands Bank. The figures of the Table I show that at the end of 1950 no less than 70% of the assets of the commercial banks consisted of liquid and near liquid assets. The large holdings of one year Treasury Notes were such as to enable banks to finance a large credit expansion simply by not reinvesting in Treasury Notes on redemption dates.

In order to make the discount policy of the Netherlands Banks effective, and to force banks to raise their rates on credits, a complex scheme was devised for more or less freezing the existing holdings of Treasury paper of the banking system.

Credit restriction mechanism effective as of January 1951.

The system chosen (9) does not imply a real rationing of credit, but it makes credit dearer and ties bank interest rates to the discount policy of the Netherlands Bank. Its essential features are: banks are compelled to hold large amounts of liquid assets, in effect primarily Treasury Notes. If banks want to expand credit they will have to borrow additional funds from the Netherlands Bank, as their liquid assets are more or less frozen. This has the double effect that the cost of granting credit becomes higher for banks (for instead of foregoing 1½% interest on Treasury Notes sold, they will have to borrow money from the Central Bank at 4 or 4½% percent) and that banks are subjected to the psychologically disagreeable experience of becoming dependent on advances from the Netherlands Bank.

A) Commercial banks.

The new and complicated system prescribes — as a fundamental rule — that the banks are to hold an amount of cover in perfectly or highly liquid or «Treasury» assets (10) equal to at least 40% of the credit-balances (11) in their books. If a bank does not meet this requirement it is put under detailed control by the Netherlands Bank. As a matter of fact, only small banks fall under the latter category, and the result will probably be that they will either reduce their business or sell out to larger and stronger banks (12).

This requirement, which would have had no effect upon banks in a highly liquid position (13), was supplemented with an alternative obligation. The banks not only have to observe the requirement of a minimum cover of 40%, but they must also comply with at least one of the two following standards:

1) The first is a special form of a «historical cover». For each bank a «historical» basis is found in the average of its actual balance-sheet figures on June 30th and December 31st, 1950. New, against the «basic» amount of credit-balances (average for 1950) at least 30% of the «base» amount of cover is to be held if actual credit-balances are higher or lower than in 1950 the prescribed amount of cover is increased or decreased by 2½ of the difference. Therefore if the deposits with a bank increase by £ 3,000,000, after, 3,000,000 have to be added to the «base» amount of cover.

2) The Cover consists of:

- cash and notes;
- balances with the Netherlands Bank, postal and municipal cheques, domestic and foreign banks, money left on call (net of that taken on call);
- Netherlands Treasury Notes and Bonds (5, 5 and 5 year remainder);
- short term securities of other Public Authorities;
- credit balances as the total sum:
- time and sight deposits;
- balances with other banks (with out)
- money taken on call (net of that lent on call);
- defers to overseas offices;
- other credit-balances.

At the end of each month a detailed monthly statement is drawn up by each bank, being an extract of its balance sheet containing guilder-accounts and liabilities and a few weeks later that statement is handed in to the Netherlands Bank.

All regulations are based upon this statement.

For example, at the end of February 1951 the holdings of short term Treasury securities of the largest commercial banks amounted to 65% of their total assets.
to its cover and 1,000,000,000 remain available for advances (14).

a) The alternative standard is debt-accounts: the total of debt-accounts may at most exceed by 5%, the figures of September 30th, 1930. This relates to the total of: bills and promissory notes (exclusive of those grouped as cover); loans and advances (inclusive of those to participants and overseas offices).

If a bank falls short of both these standards it is required to borrow the amount of the smaller of the two shortfalls from the Netherlands Bank, for the duration of the month following that in which the statement has been handed in, debited to a special account. The borrowed amount is deducted from the amount of cover held. The possibility of appealing to the Central Bank for investments in excess of the prescribed limits, is excluded when the liquidity cover falls down to the minimum percentage of 40.

Thus, generally speaking, banks remain free to grant as many advances as they want, provided they pay the 'penalty' of borrowing from the Central Bank and the amount of the cover in liquid assets is not less than 40% of the deposits. Except by complying with the above mentioned rules, commercial banks can only grant credits or authorize dispositions over outstanding credits after a license has been granted by the Netherlands Bank (15).

b) Cooperative agricultural banks.

These banks, established on the Raiffeisen-system, are federated in two groups, each with a central bank, with which the member banks deposit their uninvested funds. The same regulations as those for commercial banks hold good for these central banks with the exception that they are exempted from the minimum requirements of 40% cover. That is, presumably, because a substantial part of their assets is invested in government bonds and fixed term loans to public authorities and the larger part of their credit-balances are savings deposits.

The member banks of both groups (the more than 1300 local cooperative agricultural banks) are subject to quite simple regulations. Their 'debts-accounts' may exceed those of September 30th, 1930, by 5%, or if the credit-balances on their books have risen since that date, their debt-accounts may rise by 1/3 of that increase. If their actual accounts are higher (which will generally mean that they have made more advances), they must borrow the amount of the excess from the Netherlands Bank, through the intermediary of the central bank of their system.

Developments since the introduction of the new measures and present prospects.

As already mentioned, the new measures made credit clearer, but not scarcer, as banks could borrow the necessary funds from the Netherlands Bank, available cover being available as collateral. The increase of interest charges from about 5 to about 6 percent did not do much to deter the customers’ demand for credit; and indeed interest charges do not matter much on a profitable deal since taxes on profits absorb half the net returns of the businessmen.

The still increasing demand for credit — during a period of rising prices and stockpiling — was easily met by bankers, as the figures in Table III show.

As can be seen, there is not much difference between the slightly rising tendency before and after the new regulations.

(14) This facility is likely to affect the bank policy for deposits rates of interest to order to increase time amounts. At the end of 1930 firms and institutions outside the building would hold less than 40% of the total volume of short term Treasury securities. The credits on advances enable the banks to offer an interest rate one mark above the 1/4% fixed for Treasury Notes. In so far as a higher interest rate accounts in inducing non-bank holders of Treasury Notes to convert such investments into time deposits with banks, the latter can at the same time enlarge their cover and extend more advances, while complying with restriction regulations.


Of course, in the long run, simple and definite cover ratios for banks of the same category would be preferable, but the emergency required that all banks should feel the restriction more or less immediately; therefore the restriction was based on the banks’ deficiencies in 1929. On the other hand, the new measures may be considered as transitional regulations.

As soon as the draft bill which is now being prepared for the further regulation of the credit system, has become law, they will be given a more durable character, whereby the experiences gained during the operation of the present regulations will be taken into account (Report by the Netherlands Bank, etc., p. 30).

Local public authorities however were hit hard. For one thing, bankers had to raise their interest charges to them previously near the discount rate of 3 percent to 5 percent and over, and even then were reluctant to renew such advances. Local public authorities again tried to cover their financial needs on the capital market, but without any success as they were tied to the interest policy of the Treasury which did not allow borrowing at more than 3 1/2 percent, although market rates were approaching 4 percent. In consequence the Treasury was obliged to extend further advances to local authorities.

But the restriction policy announced had very important indirect results also on the capital market.

In this connection it should be remembered that the restrictions until last year are limited to the banking sphere. The increase of bank rates made long term loans from institutional investors relatively more attractive to business. Moreover many business firms, foreseeing a gradual tightening of bank credit, hurried to obtain long term advances from institutional investors and mortgage banks. The pressure of the demand for credit was therefore shifted to the capital market.

This process by which the institutional investors took over from the credit banks of the banking system was already the main structural development in the financial system before restrictions were introduced. To some extent long term loans fill the needs of over expanding industry better than short term bank loans.

The institutional investors are gradually learning the tricks of financing business, and there is nothing to prevent them from passing from long-term to variable loans, akin to current account advances, the holding of bills and perhaps short term promissory notes (16). There is a wide field in which banks and institutional investors can compete, and in which the competition between bank rates and capital market rates decides which institutions will be applied to for advances.

In fact, the institutional investors were those who experienced the highest increased demand for credit, even before and especially after restrictions. In order to meet this demand they had to reduce their holdings of Treasury securities, and these could not be absorbed by the banking system. So, in a roundabout way, the credit demands of business were met by, and the pressure was passed on to, the Treasury.

Especially in the second quarter of 1931 the institutional investors ran out of funds available for investment. Consequently, a small Treasury funding operation at 3 1/2 percent interest in the spring of 1931 failed, and interest rates in the capital market rose to 4 percent for gilts.

The Treasury did not repeat its funding effort at a higher rate of interest, and consequently had to borrow from the Netherlands Bank. The circle is now complete; at the end, the pressure placed on the banking system reacts on the Netherlands Bank itself.

One of the aspects of the restriction scheme is that it appears like an attempt to create a dual money market: a privileged and cheap one for the Treasury and a hampered and dear one for business. But we may say that a dual-interest policy, low interest for the Treasury and high interest for business, is incompatible with stringent credit restriction, as there are too many connections between the money and the capital market. Unless, indeed, the capital market too were subjected to appropriate regulations.

In any case, in our opinion, the most valuable result of credit restriction is that it has cured investment in durable goods. At present

(16) Life-insurance companies are subject to no other controls than the supervision of the Chamber of Insurance, which looks after the protection of the interests of policy holders. No objections would be raised against ways of investment that are commercially sound, even if they are not orthodox.
The Sterling Area

by

DAVID WIGHTMAN

PART II - WORLD WAR II REGULATIONS AND CONVERTIBILITY CRISIS

The Sterling Area During World War II.

The outbreak of war immediately set the British Government a formidable problem of mobilizing all available external finance to pay for vital need imports in the face of a rapidly diminishing power to export. Before America entered the war, the United Kingdom's capacity to wage war on the scale necessary to ensure victory was dangerously constrained to the limits imposed upon her capacity to pay for overseas supplies (1). To tackle the problem involved, in the first place, the imposition of exchange control and six months before the outbreak of war the Treasury had already prepared the following draft regulations, to be put into immediate operation on the outbreak of hostilities.

1) A regulation making dealings in gold and foreign exchange a monopoly of the Treasury and its authorized agencies and giving power to the Treasury to limit sales to current requirements.

2) A regulation requiring that all gold and all holdings of designated foreign currencies be offered for sale to the Treasury.

3) A regulation prohibiting all payments to residents outside the United Kingdom except with Treasury permission.

4) A regulation empowering the Treasury to exercise control over all securities marketable abroad and to call for their registration with a view to their ultimate acquisition by the Treasury.

These regulations came into force under the Defence (Finance) Regulations of 3rd September 1939, and by them the sterling area acquired its wartime definition. The Treasury was empowered to grant exemption from the prohibitions against making payment to residents outside the United Kingdom, in respect of those countries who held their principal monetary reserves in sterling at London and imposed exchange controls similar to the United Kingdom. The granting of this important exemption meant giving statutory definition to what were in fact sterling area countries (2). At one stage in the war the sterling area became co-terminus with all those fighting on the side of the allied countries. They remained free from exchange control in their dealings with one another, but maintained a united front in all their external transactions (3). Each member of the sterling area was left to operate its own exchange regulations.