

DRAFT DIGEST OF COMMENTS ON THE DISCOUNT RATE

The discount rate, with which this memorandum is primarily concerned, cannot be separated from the tradition against borrowing and the rules of borrowing any more than the discount mechanism as a whole can be separated from open market operations and changes in reserve requirements as an independent instrument of Federal Reserve policy.

Money market developments from April 1952 to June 1953 accelerated reconsideration by the System of the appropriate relationships among the three facets of the discount mechanism. The background briefly is as follows:

For a considerable period before the summer of 1952, transactions for the System Open Market Account were conducted "with a view to exercising restraint upon inflationary developments". This restraint was reflected in rising yields on securities but not in any persistent increase in the volume of borrowing from the Federal Reserve Banks. Occasional rapid increases in borrowings were of short duration - for example, advances increased from \$227 million on November 21, 1951 to \$959 million on December 5, 1951, but by January 2, 1952 they were down to \$105 million.

In the middle of April 1952, however, the volume of discounts rose rapidly and remained high for more than a year with only temporary interruptions. Since this was a period in which the System was "exercising restraint", question was raised as to whether member banks were escaping - or might be able at some future time to escape - the restraint that the System wished to exert. Question was raised as to whether the tradition against borrowing was being impaired and whether it should be reenforced or replaced by more rigid enforcement of rather restrictive rules for borrowing.

In this memorandum primary attention will be directed to the relationship between profit and the volume of borrowing. It should not be

inferred, however, that profitability of borrowing is the only factor involved. For example, if the System were now to reduce the discount rate to a level below the yield on short Treasury bills and were to make discounts freely available at that low rate, it would not follow that member banks would immediately borrow huge amounts or that the System could replace a large fraction of its Government security portfolio with loans and discounts. Furthermore, an attempt by the System to liquidate a large amount of Government securities, even though discounts were readily available at the low rate indicated, would result in severe pressure on the money market.

The "tone" of the money market is greatly influenced by the attempt of banks to adjust their asset structures to desired relationships. Banks generally do not like to borrow money (except, of course, in the form of deposits). Some never borrow and others borrow only temporarily to meet reserve deficiencies (that cannot be met by borrowing Federal funds) until they can readjust their position in other ways. The market tightens as more banks try in larger amounts to adjust their positions in these other ways.

Such considerations lead to the question: What conditions in the money market influence the volume of borrowing? Three charts have been appended to show the relationships between certain relevant factors in the period 1952-1954 and during the 1920's.

The close positive relationship between the historical level of rates and the volume of borrowing - which has frequently been pointed out for the 1920's - is apparent also in the more recent period. Banks borrow more when rates are high than when rates are low. This relationship has sometimes been interpreted to mean that banks do not borrow for profit.

The historical level of rates, however, does not measure the profitability of borrowing. Profitability is determined by comparison between market rates and the discount rate at a given time. There will always be differences of opinion as to which market rate or rates should be compared with the discount rate to determine profitability. In the attached charts the rate in the largest short term market has been used. In the 1920's this was the call loan rate. In the recent period it has been the Treasury bill rate.

The relationships between profitability as thus measured and the volume of borrowing is sufficiently close to warrant the conclusion that banks do borrow more when market rates are above, than when they are below the discount rate. This does not mean that member banks do not have a strong feeling against large and continuous borrowing from their Reserve Banks. Rather the interpretation would seem to have the following complexion. When a bank finds itself deficient in reserves, its immediate action is to restore its position in the "best" way possible. Each bank has its own ideas as to the best way but one aspect is cost. When borrowing from the Reserve Bank is the cheapest source of funds, some banks will resort to it temporarily. But typically, because of the tradition against borrowing, they will begin to readjust their position to repay. In doing so, however, they may shove other banks into borrowing. To illustrate: If Bank A, after being indebted to the Reserve Bank for several days, calls loans or sells securities to repay the Reserve Bank, it may receive funds through the clearings from, say, Bank B. Bank B in turn becomes deficient, and discounts to restore its reserves. As it attempts to adjust its position to repay the loan to the Reserve Bank, it may force Bank C into the Reserve Bank. Thus, although no single bank would have violated the tradition against continuous borrowing, the total volume of

discounting may remain at a significant level. From the point of view of total borrowing of all banks, frequency as well as length and amount of borrowing by individual member banks becomes important.

At times the volume of borrowing is large even though bank rate is above the market rate. But borrowings do not, typically, remain large very long under these circumstances. Part of the explanation may be that a few banks experience reserve deficiencies when they do not have adequate money market securities to liquidate - hence they borrow. As they readjust their positions to repay, they shift the pressure to other banks which do have an adequate supply of money market securities which can be liquidated at the lower market rate to absorb the pressure without borrowing.

Although the volume of borrowing is closely related to profitability, it is significant that market rates rise above - at times significantly above - the discount rate. The surprising thing, perhaps, is not that the volume of discounting remained large - in comparison with earlier periods - from April 1952 to June 1953, but that it did not reach much higher levels. To be sure moral pressure was exerted at times; but the question remains. The reason may be that when the volume of discounting approaches, say \$1 3/4 to \$2 billion, borrowing for individual banks ceases to be intermittent. Many borrowing banks are trying to shift the pressure to others, but these other banks are already borrowing, so that some liquidate marketable securities even at rates above the discount rate to repay their borrowings.

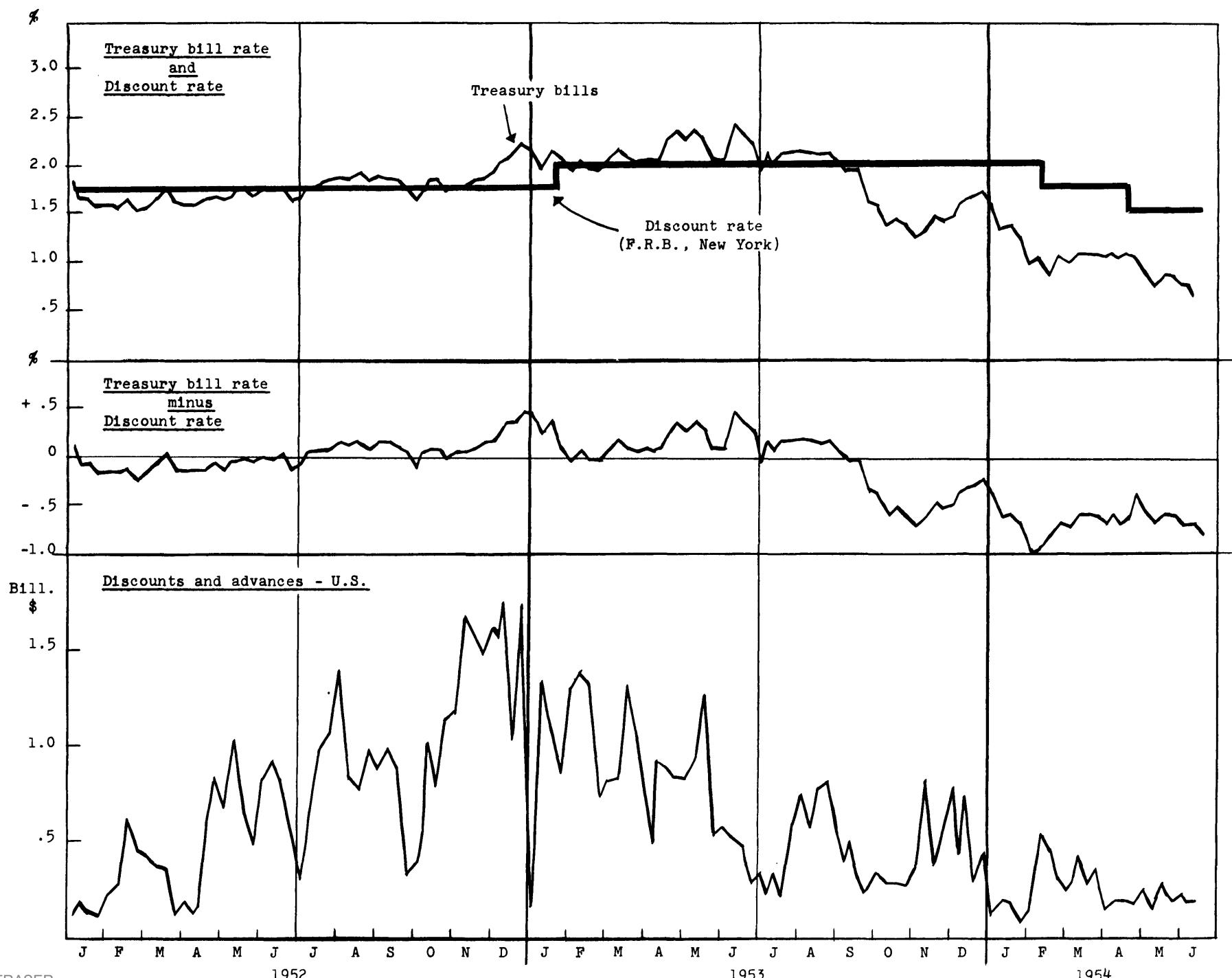
Most banks borrow as a convenience to restore reserve deficiencies rather than to expand their earnings by scalping a rate differential. It is unlikely that the volume of discounting would become large relative

to the System's portfolio of Government securities even though the discount rate were kept relatively low in the short term structure of market rates. Within that limit of perhaps several billion dollars, however, the general level of borrowing is closely related to the spreads between the discount rate and market rates. This is the experience of the 1920's; it was confirmed in 1952-1953. Borrowing increases when the discount rate is relatively low and decreases when it is relatively high in the structure of rates.

It would appear, therefore, that the rate is an effective means of regulating total volume of borrowing.

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DISCOUNTING AND LIQUIDITY: 1952-1954



DISCOUNTING AND PROFITABILITY: 1920's

