

RECORDS SECTION

NOV 17 1961

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE  
TO THE BOARD

November 17, 1961.



Dear Sir:

For your information, there is enclosed a copy of a memorandum on the "Use of the Discount Rate", dated October 20, 1961, and prepared by Mr. Knipe.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Merritt Sherman".

Merritt Sherman,  
Secretary.

Sent 2 copies to each President  
5 to New York

1 each to all Board Members

Mr. Thomas	Mr. Fauver
Mr. Noyes	Mr. Shay
Mr. Molony	Mr. F. Solomon
Mr. Hackley	Mr. Sammons

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS

Mr. Koch	Mr. Farrell
Mr. Holland	Files
Mr. Yager	
Mr. Young	
Mr. Sherman	
Mr. Kenyon	

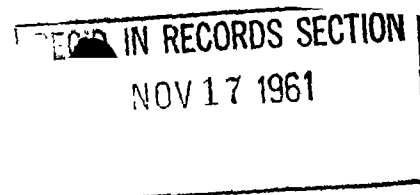
RECORDS IN RECORDS SECTION  
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USE  
OF THE  
DISCOUNT RATE

October 20, 1961

J.L.K.



USE OF THE DISCOUNT RATE

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THE TRADITIONAL VIEW

Up until the beginning of the Great Depression, the discounting process--the making of loans by the Federal Reserve Banks to member banks--often involved monetary magnitudes of a size to justify the significance which was attached in those days to the discount rate and to the discount process. Since the Great Depression, the relative importance of discounting has greatly declined in the United States and open market operations carry most of the burden of monetary policy. Apparently this is also true, but to a lesser degree, in other advanced countries.

There is always a tendency, though, for some analysts to look backward in history and to view present-day phenomena with eyes adjusted to the way things looked in earlier years. Whether the astigmatism is based on nostalgia, or on wishful thinking, it produces an image not quite in accord with actuality. The descriptions of the discount mechanism which are found in textbooks are ordinarily based on that kind of viewing, so that the reader is presented a picture which, while not exactly false, is not exactly true, either. The passage quoted below from the latest edition of the Federal Reserve's "Purposes and Functions", illustrates the point:

"The financial community thinks of Reserve Bank discount rates as pivotal rates in the credit market...it is only natural that the business and financial community should commonly interpret a change in the level of Reserve Bank discount rates as an important indication of the trend in Federal Reserve policy."<sup>1/</sup>

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As will be seen in the chronological account which follows later, it seems doubtful that the discount rate could generally be regarded as "pivotal" except on very rare occasions, and if it is considered to be an "indicator" or "announcer" of Federal Reserve policy it is usually a tardy one. As to whether the passage quoted above is, therefore, misleading, is for each observer to judge for himself as the sequence of events in connection with the discount rate changes of the last twelve years is surveyed. This will be done, after some comments as to the way in which the discount rate is now set in the Federal Reserve System.

SETTING THE RATE

From time to time one hears the criticism that the Federal Open Market Committee is not fast enough, or efficient enough, in its functioning with respect to open market operations. There may or may not be something to the criticism, but one thing is certain and that is that the setting of the discount rate is a much more cumbersome process and that by comparison the open market operations are a miracle of streamlined efficiency.

Each Federal Reserve Bank is empowered to decide on the discount rates to be charged, subject to review and determination by the Board of Governors:

"Every Federal Reserve Bank shall have power:...(d) to establish from time to time, subject to review and determination of the Board of Governors of the Federal Reserve System, rates of discount to be charged by the Federal Reserve Bank for each class of paper, which shall be fixed with a view of accommodating commerce and business; but each such bank shall

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establish such rates every fourteen days, or oftener if deemed necessary by the Board;...<sup>2/</sup>

When changes in the rate are contemplated, things are seldom as simple as one might infer from reading the law. In order to appreciate the complexities, some of which seem trivial and self-induced but which still must be considered, it is necessary to note several aspects of the way the machinery works.

First is the matter of timing of meetings. The Federal Open Market Committee meets with considerable regularity on a schedule of every third Tuesday. In this forum the national discount rate problem is discussed and the debates which take place at these meetings often play an almost crucial role in actions later taken by the Boards of Directors of the Reserve Banks.

The Boards of the twelve Banks meet on schedules which are so diverse that special meetings must always be called by some of them if any kind of national concurrence is ever to be attained. Here is the 1961 schedule:

Boston	- Alternate Mondays.
New York and Philadelphia	- First and third Thursdays.
Cleveland, Richmond, St. Louis, Minneapolis, Kansas City, and Dallas	- Second Thursdays.
Chicago	- Alternate Thursdays.

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Atlanta - Second Fridays.

San Francisco - First Thursdays.

Second, the president of each Bank will presumably tend to think in national terms, in line with his work on the Federal Open Market Committee, however conscientiously he may try to see the regional viewpoint. The directors of each Bank will presumably tend, on the other hand, to think in regional terms, however assiduously they may endeavor to give adequate recognition to national economic and financial events. Among the nine directors of each Bank, the six businessmen ("B" and "C" class directors) may be presumed to regard all economic problems somewhat differently from the way the bankers ("A" class directors) regard them. Since most of these one hundred and twenty-seven men (108 directors, 12 presidents, and 7 Board members) are likely to be intelligent, independent, forceful, individuals, it is obvious that a large job of reconciliation of viewpoints must be accomplished before a uniform, nationwide change in discount rate is possible. It is not the kind of thing that one might expect to be carried out in a short period of time.

There is a third timing difficulty to be taken into consideration. The Treasury is in the market for either new financing or refunding a large percentage of the fifty-two weeks of the year. Even though the discount rate changes might nearly always be so late as to represent nothing more than an adjustment to conditions which have been shaped, at least in part, by earlier and really important open market policy moves, the folklore of the financial district causes nearly everyone to frown on a discount rate change during Treasury financing. Even though the System publicizes

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the action as an "adjustment to market conditions," of little significance, there is still enough of the old concern with discount rate changes to create a worry about consequences. When this reluctance is added to the other possibilities of operational delays, already mentioned, it is not surprising that discount rate changes are not famed either for skillful timing or for meaningfulness.

RATE CHANGES, 1950-1956

Change #1 of the 1950-54 business cycle began on August 18, 1950, with Board approval of the New York Bank's 1/4 per cent raise from 1-1/2 per cent to 1-3/4 per cent. The other Banks trailed along over the next six days. The country was in the eighth month of a THRUST, the Korean War was in its second month, the Federal Reserve was starting an eight-month program of flooding the member banks with NONBORROWED RESERVES at the rate of nearly \$400 million per month, and the dollar was steadily losing its purchasing power. Borrowings of the member banks were on a minimal level, under \$200 million. The Federal Reserve System was still operating as an adjunct to the Treasury and so could do nothing but issue pathetically brave statements which were contradictory within a single sentence.

"... the Board of Governors of the Federal Reserve System and the Federal Open Market Committee are prepared to use all the means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market."<sup>3/</sup>

In other words, the one-quarter point lift in the discount rate was without any practical significance.

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Nearly two and one-half years went by (to January 1953) before the System screwed up its courage to make another gesture of this kind. By that time, the nation was in the sixth month of THRUST #2 of the 1950-54 cycle, and the dollar's value had declined quite a bit further. Since April 1952 a policy of restraint had been imposed by the Federal Reserve-- its first postwar show of strength and of concern for the value of the dollar.

During the last three quarters of 1952 there had been a classic situation as shown in the table below, calling for a boost in the discount rate. Member banks were borrowing only \$307 million in March 1952 before the restraining policy took hold in April. Their discounting rose precipitately.

MEMBER BANK BORROWINGS<sup>1/</sup>  
(In billions of dollars)  
(Monthly averages)

	<u>Level</u>	<u>Change</u>	<u>Cumulative Change</u>
March 1952	307		
April 1952	367	+ 60	
May 1952	563	+196	+ 256
June 1952	579	+ 16	+ 272
July 1952	1,077	+498	+ 770
August 1952	1,032	- 45	+ 725
September 1952	683	-349	+ 376
October 1952	1,048	+365	+ 741
November 1952	1,532	+484	+1,225
December 1952	1,593	+ 61	+1,286

By August 1952 the 91-day bill rate had risen to 1.83 per cent. If there was ever a time when the discount rate was needed to bring home to the borrowing banks that the Federal Reserve meant business, the summer



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and autumn of 1952 was that time. Yet nothing was done, and the borrowing got more and more out of hand. Lacking any information as to political work backstage, it must be guessed that, despite the Accord of March 1951, the Truman Administration was bringing heavy pressure to keep the Federal Reserve from acting the way any central bank would naturally act in such circumstances, and that only after the Republican inauguration in January 1953 did the System feel free to act normally.

This Change #2 started on January 15, 1953, with the Board approving eight Banks' increase of  $1/4$  per cent, from  $1-3/4$  per cent to 2 per cent. The other four followed within a week. The raise was, in itself, so late and so little as to have practically no meaning as a control measure. However, it was accompanied, many bankers felt, by a much stricter attitude toward member bank borrowing on the part of the Federal Reserve loan officers. Those stricter attitudes undoubtedly brought about some reduction in borrowing, even if the discount rate raise, in itself, had no effect at all.

Just a little more than a year later, February 4-11, 1954, Change #3 was approved--reducing the rate by  $1/4$  per cent, from 2 per cent to  $1-3/4$  per cent. Only two months later, in Change #4, the rate was reduced by another  $1/4$  per cent, from  $1-3/4$  per cent to  $1-1/2$  per cent. The first approval was on April 13, the last on May 20. Since System policy had been extremely easy ever since May 1953, nearly a year before these discount rate reductions were put into effect, it is impossible to attribute any significance to the reductions. The economy was (in February 1954) in the sixth month of a DOWNSWING, and bill rates had gotten down to 1.18 per cent

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by January 1954. Borrowings by member banks had dropped from \$1,593 million in December 1952 to \$100 million by January 1954.

Change #5, a  $1/4$  per cent raise from  $1-1/2$  per cent to  $1-3/4$  per cent, was put through in the two weeks from April 13 to April 29, 1955. The national economy was in the eighth month of a THRUST, and System policy had been greatly restraining throughout the eight months, so that the discount rate raising could scarcely be regarded as a signal. Bill rates had risen to a little above the discount rate--1.59 per cent average in April, compared with the  $1-1/2$  per cent discount rate--before the move to  $1-3/4$  per cent was made by the Federal Reserve Banks.

As the THRUST continued during the last half of 1955, the Federal Reserve, from August onward, applied restrictive policies more firmly. FREE RESERVES had been lowered steadily from \$724 million in August 1954 to \$92 million in July 1955, and then were dropped another \$583 million from positive \$92 million to negative \$491 million by November 1955. Bill rates rose further from the April 1955 level of 1.59 per cent to 2.25 per cent in November. Member bank borrowings had come up to \$495 million by April 1955, to \$765 million by August 1955, and to \$1,016 million by November 1955. Some upward movement in the discount rate from the  $1-3/4$  per cent figure of April 1955 was to be expected, and so the next raises came to the market neither as surprises nor as "announcements" of a policy change. Changes #6 ( $1/4$  per cent, from  $1-3/4$  per cent to 2 per cent), #7 ( $1/4$  per cent, from 2 per cent to  $2-1/4$  per cent), and #8 ( $1/4$  per cent, from  $2-1/4$  per cent to  $2-1/2$  per cent) were approved in August, September, and November 1955.

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Insofar as these raises might have had any value in confirming a System restrictive policy of long standing, this value was somewhat dissipated by the confusion introduced in Changes #6 and #7. The Cleveland Bank went from 1-3/4 per cent to 2-1/4 per cent in August, while the others went only to 2 per cent. In September, the eleven other Banks caught up with Cleveland. Since it is doubtful that there was very much difference between the boom conditions in the Cleveland District and in the rest of the country, one might regard as unfortunate and unnecessary the seeming disunity of discount rate policy at a time when the economic situation was unusually clear, and when the System was in a long-established posture of restraint. The discount rate actions would seem to have been worse than useless, they were actually disruptive of public understanding as so-called "announcements."

Change #9, initiated on April 12, 1956, was a famous one and an odd one. It led to about as much public fuss and uncertainty as can be imagined with regard to any central bank. As of March 1956, the economy was in the third month of a PLATEAU, following a sixteen-month THRUST. System policy had been gently restraining during the first eleven months of the THRUST (through July 1955). Since then--except for a little easing in connection with a bondmarket disturbance near the end of 1955--the policy had been one of heavy restraint, from August 1955 through March 1956. FREE RESERVES were at negative \$408 million in March. Member bank borrowing was very high, at \$993 million. The bill rate in March averaged 2.25 per cent, compared with a discount rate of 2-1/2 per cent. While a discount rate raise was in order, it could certainly add little to the market's

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awareness of a severely restrictive policy on the part of the Federal Reserve, a policy which had been perfectly clear, at increasing levels of severity, over a period of more than a year and a half. Up to this point, the restrictive policy had not provoked any public, open opposition.

What then happened was that the Board, on April 12, 1956, approved a  $1/4$  per cent raise, from  $2-1/2$  per cent to  $2-3/4$  per cent, for nine Reserve Banks, and a  $1/2$  per cent raise, to 3 per cent, for the San Francisco and Minneapolis Banks. On April 19, the Chicago Bank's move up to  $2-3/4$  per cent was also approved.

The Board thus took overt action--action which could add little or nothing to the financial district's understanding of System policy but which would call widespread public attention to the policy--at a time when the business situation had been developing a few signs of weakness and the production total had leveled off for several months. It was a time when one would expect a central bank to be keeping very quiet, trying to assess the situation and to decide whether or not it had gone too far, or not far enough, in its long period of restraint. Instead, it took the overt action, and in a way which suggested that all twelve Banks felt that more restraint was needed and two of them felt that much more restraint was called for.

To the press the System said nothing, just announced the actions. In its own record<sup>5/</sup>, the comment was made: "It also served as a signal to those businesses planning to finance plant and equipment expansion through the capital markets that higher borrowing costs might be anticipated if the supply of savings was taxed further by demands for capital."

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The furor which broke out during the next few weeks was a classic in the System's history. Treasury Secretary Humphrey, Labor Secretary Mitchell, General Motors' President Harlow Curtice, and many others came out in the open with opposition to Federal Reserve policy.

The System immediately reversed itself and instituted an easing policy which lasted from May 1956 through January 1957. Nonborrowed reserves were furnished in a generous way, so that by January 1957 the member banks even had positive FREE RESERVES (\$117 million for the month).

The real discount rate puzzler came in August 1956, Change #10. Between August 23 and August 30 the Board approved raises of 1/4 per cent by the ten Banks which were not already at 3 per cent, so that all of them were at the 3 per cent figure by the end of the month. This discount rate action was taken in face of the fact that through May, June, July, August (and later on through January 1957) the System was easing conditions with its open market policy. It is difficult to reconcile the May 1956-January 1957 easing with the last portion of the Board's comments quoted below, which were made in connection with the August 23 lift in the discount rate: "The current discount rate increases...recognized the continued upward trend in money market rates and served to indicate to the financial and business community, and the public generally, the need for credit restraint and for resistance to inflationary developments."<sup>6/</sup>

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The purpose of this review of the course of discount rates over the years since 1949 is to see if one can find much evidence of their being "pivotal rates" or of serving as "announcements" of a changed general monetary

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policy. No such evidence is clearly visible through the first ten changes. The discount rate seems to have been moved after the policies had been perfectly apparent to the market for a long period of time. Sometimes the discount rate moves seem not so much to have confirmed earlier policy shifts as to have confused them. In the case of this Change #10, just cited, apparently made to put the discount rate back into its more normal relationship to market rates, the Federal Reserve Board's explanation seems to be at variance with the Federal Open Market Committee's easing policy.

The August 1956 discount rate boost, together with the failure to boost the rate again until a year later, make one almost feel that discount rate policy was not being used as a supplementary tool to open market policy but was being used in opposition to the open market programs. It has just been seen how the two policies appeared to be moving in opposite directions in August 1956. The same appearance of contrary direction appeared from February 1957 onward until August 1957, except that in this case the open market moves were toward much greater restraint, while no more discount rate raises were made until August. Through the first and second quarters of 1957 member bank borrowings rose steadily from \$406 million in January to \$917 million in July. Bill rates, which were at 2.60 per cent in August 1956, rose to 3.16 per cent in July 1957, compared with a discount rate held right at 3 per cent. It is impossible to follow the Federal Reserve's reasoning, even with the benefit of hindsight.

Until some key Federal Reserve official publishes an autobiography, the 1956-57 discount rate incidents will remain one of the unsolved mysteries of postwar Federal Reserve policy. Did the System approve the raised rates

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of ten Reserve Banks to 3 per cent in August 1956 just to take the San Francisco and Minneapolis Banks "off the hook"? Or was the System using the August raise to try to make the public think that the Federal Reserve had maintained its firm policy, undaunted by the storm of criticism in May, despite the fact that it was actually easing steadily and substantially? As to 1957, was the discount rate left alone when it should have been moved upward in line with the heavily restraining policy, because the System was resolved to avoid, if possible, a repetition of the attacks of May 1956? Or were these two sets of inconsistencies, in the second half of 1956 and the first half of 1957, merely examples of the extreme cumbersomeness of the discount rate mechanism and of the impossibility of using the rate in the complementary fashion prescribed by theory?

RATE CHANGES, 1957-1960

Change #11, a one-half per cent raise from 3 per cent to 3-1/2 per cent in August 1957, was one of those unfortunate moves which, in retrospect, turns out to have been a timing error of a conspicuous type.

By August 1957, the economy had been in an upswing for thirty-six months, sixteen in a THRUST and twenty-one on a PLATEAU. Typical of the remarks which appear often in the record of the Federal Open Market Committee throughout the last months of the upswing were these for the August 20 meeting: <sup>2/</sup> "It was recognized that business activity was continuing to move sidewise and that the business outlook seemed to be a little less buoyant than a few weeks earlier." The economy looked tired, imbalances in inventories and in plant and equipment were evident. The bill rate had been above 3 per

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cent (i.e., above the discount rate) ever since December 1956, member bank borrowings had climbed steadily, and yet no discount rate move had been made.

Then on August 8 the Board approved raises from 3 per cent to 3-1/2 per cent by four Reserve Banks and, by August 23, had approved the same boost by the remaining eight Banks. The Board<sup>8</sup> employed almost the same phraseology as the Committee in writing that "For a period of several months the economy had exhibited in general a sidewise movement at a high level of activity." However, as a result of the failure to raise the discount rate earlier in 1957, the Board<sup>2</sup> found itself in an embarrassing position with a 3 per cent discount rate when the commercial bank prime rate was raised to 4-1/2 per cent: "With the upward movement of interest rates, the discount rate of the Federal Reserve Banks, which had stood at 3 per cent since the Fall of 1956, fell further behind the rate structure generally. The disparity became even more pronounced in early August when the commercial banks increased from 4 to 4-1/2 per cent the rate charged on loans to prime business borrowers."

Inasmuch as the economy turned downward immediately after the August rate boost, the action is often cited by critics as a horrible example of Federal Reserve general monetary policy at its most inept. This is not entirely fair. It may be another sad instance which proves that the System cannot use the discount rate either as an economic or a public relations tool, but the general monetary policy cannot be similarly condemned. The 1957 situation, both in the United States and abroad, was one packed with inflationary dynamite and, to this observer, the Federal Reserve showed



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considerable intelligence and courage in its open market policy--even when surveyed in the cold light of the morning after.

Apparently the Board was aware that it was not handling the discount rate with any special dexterity, and went out of its way to minimize the meaning of this and other changes--a reticence not fully in tune with the general views on discount rate philosophy quoted earlier from official writings of the Board.<sup>10/</sup> An article from the New York Times on August 11, 1957, said:

"Federal Reserve Board officials in Washington took pains to term the subsequent advance in the discount rate as routine and largely meaningless, a symbolic evidence of continued steady restraint. In recent years, they were careful to point out, changes in the discount rate more often have followed changes in other market rates than led them."

The downswing which began in September 1957 was not immediately apparent either to the Federal Reserve or to anyone else. Cyclical beginnings nearly always remain fairly well concealed in the statistics for at least a couple of months. Possibly the System was a bit slower than some others in recognizing the turn, or perhaps officials of the System were so worried about the deterioration of the dollar's purchasing power that they deliberately delayed action even though their economic witching-stick had turned downward as definitely as anyone else's.

Open market policy was not reversed until the third week of October and, by that time, there was a lot of criticism around the country with respect to the Federal Reserve's alleged lethargy in recognizing a downswing. No concerted series of criticisms in print had been initiated and no political campaign had been mounted, but critical conversation was heard in many places.

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As a result of this charge of lethargy, or procrastination, Change #12 may be the first example of a postwar discount rate move which really "said something" to the world. Perhaps the message could have been conveyed just as effectively through use of the English language, but at least there was a message. Between November 14 and November 29, 1957, the Board approved one-half per cent reductions in the rates of all 12 Banks, from 3-1/2 per cent to 3 per cent. Here was a textbook example of how the discount rate could be employed as a supplement to open market policy and as an effective "announcement" of an altered credit posture.

There are those who would disparage this single example of how skillfully the discount rate can be used, implying that the Board was more or less booted into taking the timely step. The quotation below is from an article in the Wall Street Journal on November 15, 1957, the day after the Board approval of the rate reduction:

"For some time the Eisenhower Administration has shown signs of growing impatient with the F.R.B. for clinging to its restrictive credit policies, in the light of signs of recessionary tendencies. Even yesterday, just before the F.R.B. action, a high Administration official sized up the feeling as a fear that the Reserve Board would wait 'too long' before taking action.

"As described by this official, both the F.R.B. and the Administration agree that, over the long run, inflation remains the big economic problem facing the country. But, until yesterday, the Administration had seemed more concerned with the threat of business downturn, while the F.R.B. continued to emphasize inflationary dangers."

To take away even a portion of the credit for this one well-executed discount rate move seems unkind. Insofar as outsiders know the facts, it remains a model operation.

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Change #13 was the reduction of  $1/4$  per cent, from 3 per cent to  $2-3/4$  per cent, which was approved between January 21 and February 13, 1958. For the month of January, the bill rate averaged 2.44 per cent, down from 3.04 per cent in December. It seems fair to say that this drop in the discount rate was sufficiently early to be regarded as timely and as a component of an extremely easy monetary policy. However, its usefulness must have been somewhat impaired by the fact that the San Francisco Bank did not join the eleven others in the lowered rate. While it was probably true that the West Coast business situation was substantially more favorable than that of the rest of the country, those who were taking for granted a strongly stimulative System policy must have been at least slightly bewildered.

Changes #14 and #15, in March and April 1958, were reductions of  $1/2$  per cent each, bringing the rate at all Banks down first to  $2-1/4$  per cent, from  $2-3/4$  per cent, and then on down to  $1-3/4$  per cent. The changes lagged well behind the very easy open market policy, and behind the bill rate, which was at 1.13 per cent by April.

The THRUST of the 1958-61 cycle began in May 1958. By August, it was in its fourth month. Monetary policy was firmed up through open market operations, beginning in August. Change #16, a  $1/4$  per cent hike from  $1-3/4$  per cent to 2 per cent, was approved between August 14 and September 22. It was timed so that it was more or less in tune with general policy, as well as with the climbing bill rate, although it lagged behind the bill rate, which stood at 1.69 per cent in August and at 2.44 per cent in September. While the change could hardly be regarded as a signal or as an

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announcement of a new policy, neither could one say that it lagged as far behind policy as in the past. The same comment applies to Change #17, a 1/2 per cent raise, from 2 per cent to 2-1/2 per cent, starting on October 23. By October the bill rate was up to an average of 2.63 per cent for the month.

Five months later, Change #18 occurred, a 1/2 per cent boost, from 2-1/2 per cent to 3 per cent. Approval was extended by the Board between March 5 and March 13, 1959. This third rate jump in the THRUST, approved in its eleventh month, was like the earlier two in that it was at least close to being on time. The bill rate had hovered around the 2.80 per cent area ever since the preceding December, and open market policy had been strongly restraining since December. Lifting the discount rate in March was, therefore, no news to anybody but it represented a delay of only one to three months beyond what one would expect under a more flexible type of rate determination. Change #19, taking the rate up 1/2 per cent, from 3 per cent to 3-1/2 per cent, approved between May 28 and June 11, 1959, falls in the same category. In June, the bill rate averaged 3.21 per cent.

These four raises (#16-#19, inclusive) in the fourteen-month THRUST, occurred in the fourth, sixth, eleventh, and thirteenth months. They aggregated 1-3/4 per cent, from 1-3/4 per cent to 3-1/2 per cent. They came much nearer to being on time, and looked more like a truly complementary tool of monetary policy than had most of the preceding fifteen actions. Considering all of the timing problems built into the rate-setting process, the performance looks fairly good even at a distance.

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The THRUST ended in July 1959, and a PLATEAU began. The country stayed on the plateau for thirteen months, through July 1960. The System carried on with its policy of heavy restraint through February 1960, the eighth month of the PLATEAU.

Change #20 was a raise of 1/2 per cent, from 3-1/2 per cent to 4 per cent, in the middle of September 1959. At the time, it was too early to identify the plateau. The economy seemed to be strong, the bill rate had moved on up to 4.04 per cent by September, and member bank borrowing remained high, around the \$1 billion mark. In these circumstances, the raise, in retrospect, looks like the four preceding ones--not too badly timed, considering the nature of the process which had to be employed.

The System did a splendid job of anticipating a downturn in the nation's economy by switching to an easing policy with open market purchases in March 1960, ninth month of the plateau and four months before the beginning of the DOWNSWING. Aided by this shift in policy, the bill rate dropped from its cyclical high of 4.49 per cent in December 1959 to 2.46 per cent by June--more than 1-1/2 per cent under the discount rate of 4 per cent. Member bank borrowings dropped rapidly and by June were down to \$425 million.

At any time in March, April, or May 1960 it would have seemed like a good idea to drop the discount rate from the 4 per cent to which it had been boosted in the previous September. A lot of analysts felt that a reduction in the Spring of 1960, to go along with the sharply easier open market policy, would have encouraged member banks to reduce their borrowings more slowly, thereby supporting the levels of total reserves and perhaps of the money supply.

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It is interesting to ponder as to how the Board could hold the discount rate at 4 per cent in April, for example, in the second month of open market easing, when the Federal Open Market Committee<sup>11</sup> wrote as follows on the 12th of the month: "...developments in the three-week period since the preceding meeting were somewhat mixed and did not serve to dispel the atmosphere of uncertainty with respect to the business outlook that had prevailed since shortly after the turn of the current year... Less favorable factors included a contraseasonal rise in unemployment in March, a declining trend in the rate of steel production, and a persistent downward movement in construction activity."

Finally, on June 2, 1960, the Board approved a reduction of 1/2 per cent from 4 per cent to 3-1/2 per cent, Change #21. There is not much one can say about this long-overdue action, except to ask how one can reconcile this sort of discount rate operation with official descriptions of how the process is supposed to work. The Federal Open Market Committee had, in this case, done an outstanding job of anticipating an economic downturn, but the Board had not fared so well in its use of the discount rate.

Change #22, a 1/2 per cent reduction from 3-1/2 per cent to 3 per cent involved approvals from August 11 through September 8, 1960. This was more nearly on time, and more nearly in line with the general policy of ease.

FAILURE TO CHANGE THE RATE, 1960-61

A chronological account of the twenty-two discount rate changes in the years since 1949 is not complete without a look at the fourteen months

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(as of October 1961) of no-change after August 1960. These fourteen months involved seven more months of DOWNSWING after the August 1960 rate cut, followed by seven months of THRUST. Throughout the entire time, System policy was very easy. Free reserves ranged between \$500 and \$600 million, and member bank borrowing was at a minimal level.

It was no secret that throughout the year and one-sixth, especially in the Autumn of 1960, the System was worried about the international financial position of the United States. Apparently it was felt that the normal sloshing back and forth of mobile international money, seeking highest available yields, would, if it shifted heavily out of low-yielding U. S. bills at that particular moment, contribute to general uneasiness about the dollar and so accelerate a "real" gold outflow, based on confidence factors. Without debating the question of whether or not there was much substance to the argument, the fact was that the Federal Reserve made it clear to the world that it did not want the bill rate to move as low as it had in earlier years during periods of extreme monetary ease.

The bill rate drop did hold at a floor of around 2.25 per cent to 2.50 per cent, an unexpected stability at least so far as the September 1960-March 1961 time span was concerned. After the THRUST began in April 1961, it was to be expected that it would hold up, or even move higher.

Although no careful analysis has been made of the bill rate during those last seven months of the DOWNSWING, either inside or outside the System, so far as is known, opinions have been expressed by competent observers. The consensus would seem to be that the Treasury, by offering new bills in such quantities and at such times as would be the most effective,

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was the principal factor in holding up the bill rate. It is also usually suggested (1) that the loan demands on commercial banks did not fall as much as in most downturns, (2) that foreign investors carried out some liquidation, and (3) that the Federal Reserve's purchasing of a wide range of Government securities in the course of its open market operations, all may have contributed to maintenance of the bill rate in the 2.25-2.50 per cent range.

The discount rate, held at 3 per cent, is given a certain amount of credit for this bill rate support by some people. Two things are usually mentioned in this connection. One is that by holding the discount rate at about a  $3/4$  per cent differential above the bill rate, contrasted with the more conventional  $1/4$  per cent, the commercial banks were encouraged to sell bills rather than to borrow at the discount window whenever they needed funds. This version is not convincing because, at a time when the Federal Reserve's policy was one of great ease, commercial banks did not need either to sell bills or borrow, in order to take care of loan demands. They were not faced with the alternative. They added approximately \$3.0 billion of Government securities to their portfolios, along with \$1.7 billion of other securities, during the seven months in question.

The other way in which the discount rate is mentioned is that it was a signal to the financial world that the Federal Reserve was eager to turn to a firmer policy as soon as possible and so, by influencing expectations of higher yields, discouraged purchase of bills. This theory seems logical, although the market influence which may have been expected in this way surely must have been very small. It seems more plausible to



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make the conventional assumption that the bill rate was determined in the period, September 1960-March 1961 in the usual-way--with the great flows of supply and demand for loanable funds exercising the main influences, Federal Reserve open market policies exercising significant marginal influences, and the discount rate exercising practically no influence at all.

If this reasoning makes sense, the failure to change the discount rate after August 1960 does not add much to the story of the twenty-two changes, except in one sense. It underlines the question of whether or not the discount rate is, because of its past importance here and its continuing importance in foreign central banks, a useful signalling device. Or perhaps it is a meaningful symbol abroad, but not at home?

No one can ever substantiate one thesis or the other, but the odds seem to be with those who believe that, once in a great while, a discount rate change is an effective way to send a message even to the financial district in the United States, and most emphatically an effective way to communicate with central banks and commercial banks in other lands. In such case, the Federal Reserve ought never to plan to relinquish the discretionary discount rate change one hundred per cent of the time. Relinquishing it voluntarily for ninety-five per cent of the time is another matter.

ONE "SOLUTION"--THE CANADIAN PROCEDURE

The experience from 1950 to date suggests that the discretionary discount rate may occasionally be useful but is ordinarily a great nuisance for the Federal Reserve System.

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One change in rate, the  $1/2$  per cent reduction from  $3-1/2$  per cent to 3 per cent in November 1957 served as an announcement of an altered policy. Since it lagged only about three weeks behind the actual reversal of policy, it was chronologically close enough to contribute to the task of convincing the financial community, as well as the Administration in Washington, that the System was aware of the recession and was undertaking to do something about it. One would think that exactly the same purpose could have been achieved with a short statement to the press, but perhaps the traditional rate move was more satisfying to those in the financial world who have an instinctive repugnance for the clearly written word, along with an inbred delight in the symbols of their business.

Of the other twenty-one changes, seven were more or less "on time," so as to have some limited meaning as a complementary tool of monetary policy, while fourteen were so late as to be meaningless. Of the late ones, the January 1953 raise of  $1/4$  per cent, from  $1-3/4$  per cent to 2 per cent, was a definite aid in setting off a campaign of criticism in Congress and elsewhere; the April 1956 raise of  $1/4$  per cent from  $2-1/2$  per cent to  $2-3/4$  per cent, was the spark which touched off the great national uproar; the August 1957 raise of  $1/2$  per cent, from 3 per cent to  $3-1/2$  per cent, has become a classic example of unlucky timing.

Since there has to be a discount rate, and since it has to be at different levels from time to time--so as to encourage (or at least not discourage) borrowing in recessions and so as to discourage borrowings near the tops of cycles--the problem cannot be swept under the rug. What is called for is a way to change the rate as often and as promptly as needed

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without drawing any more attention to the changes than is absolutely necessary. At the same time, it might be prudent to retain a way to dramatize a change on those rare occasions when it appears to be the most effective way to announce a new policy tack.

The United States has available for study an attempted solution to the problem in the so-called "tied" rate which has been used by the Bank of Canada for the last five years. While the Canadian economy is much smaller than that of the United States, and the Canadian financial institutions are quite different in many ways from those of their large neighbor, it is still interesting to see what can be learned from their imaginative approach to the subject.

The lack of significance attached to the discount rate in Canada over the years, is emphasized in a passage from the Bank of Canada's Annual Report for 1955:<sup>12/</sup> "In earlier years, the Bank Rate, i.e., the posted minimum rate at which the central bank will make temporary loans or advances, had had no direct function to perform in Canada and was changed only when it was desired to mark a major development in economic conditions. From 1944 to 1954 only one change was made, in October 1950 when the rate was raised from 1-1/2 per cent to 2 per cent. Banks rarely had recourse to the Bank of Canada for advances, and the Bank Rate continued at the 2 per cent level while appreciable changes in market rates of interest were taking place."

An attempt to introduce some meaning to the Rate was made in 1955, as outlined in the same Annual Report<sup>13/</sup>quoted just above: "When 1955 opened the Bank Rate was far out of touch with short-term interest

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rates, which had been declining for more than a year. By this time, the system of day-to-day loans inaugurated by the chartered banks in June 1954 was well established. After mid-1954, under conditions of falling yields and monetary ease, banks had not required advances and money-market dealers had had little occasion to finance bills or short bonds temporarily with the Bank of Canada through the medium of purchase and resale agreements. Both forms of financing might be expected to arise if and when monetary conditions should tighten, and to prepare for such an eventuality a more flexible Bank Rate policy became desirable. The necessary preliminary step of bringing the Bank Rate into close alignment with short-term market rates and, so to speak, putting it into commission for active service, was taken on February 14, when the Rate was reduced to 1-1/2 per cent..."

In order to maintain this new alignment with short-term market rates, the Bank Rate was upped to 2 per cent in August 1955, to 2-1/2 per cent in October, and to 2-3/4 per cent in November. After the turn of the year, the Rate was moved to 3 per cent in April 1956, to 3-1/4 per cent in August, and to 3-1/2 per cent in October.

At this point, the operation began to encounter the customary problems arising from an uninformed, or misinformed, financial public's reading too much meaning into the rather frequent changes in the Bank Rate which were occurring in 1955-56, after the ten-year period of immobility. As was stated in the Annual Report<sup>14</sup> for 1956: "This procedure gave rise to some misunderstanding; in some quarters it was apparently thought that the central bank was setting or fixing or controlling interest rates of all kinds by its action in changing and publishing its own minimum lending

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rate." Three pages later, the Report clarifies the Bank's attitude toward the relationship which exists between Bank Rate and market rates: "Basically, interest rates are determined by the strength of demand for borrowed funds and the availability of the funds from willing lenders. The influence of the central bank...does not arise from changes in the Bank Rate which, as already indicated, tend to follow market changes, but rather from the operations which the Bank undertakes in order to affect the money supply and from the effect of the resulting changes in the supply of money."

The Bank of Canada decided that the best way to clarify the situation would be to do the obvious--attach the Bank Rate to the market rate in order to be sure (1) that it moved appropriately and (2) at the same time did not move conspicuously. In the Annual Report for 1956 the decision was described:<sup>15/</sup> "The simplest method of ensuring that the Bank Rate will always be higher than the Treasury bill rate is to keep it at some specified and published margin above the Treasury bill rate, whatever the latter may be. This method was adopted on November 1st when the Bank announced that it would thereafter until further notice adjust its lending rate once a week in order to maintain it at a level of 1/4 of 1 per cent above the average rate on Treasury bills at the most recent tender or auction of Treasury bills...

"Another reason for adopting the new method of determining the Bank Rate was that weekly changes in the Treasury bill rate are relatively small in either direction and the fact that such changes occur weekly has become well understood. On the other hand, unexpected, unpredictable, infrequent and relatively large changes in the Bank's lending rate under the

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previous system were known to have a distorting effect on business in general and on all persons who might be contemplating the making of investments or entering into business arrangements involving credit and rates of interest. No difficulties of this sort have been reported since the adoption of the new system.

"If, with changing circumstances, the new system of determining the Bank Rate were to be found to be undesirable for any reason, the Bank could, of course, again change the basis on which it sets its rate."

This simple plan--which can be suspended, or superseded, or reversed at any time the Bank of Canada sees fit--has been in effect for nearly five years, since November 1956. It would appear that the officials of the Bank like it. Certainly Governor Coyne spoke very highly of it in late 1960. The new Governor has not, so far as is known, shown any disposition to go back to the old discretionary rate. Incidentally, there is apparently no connection at all between the Canadian discount rate procedure and Governor Coyne's political troubles. (Some people, who do not approve of a "tied" rate, either say or imply that the discount rate operation is related to Coyne's political battles and subsequent resignation.)

No matter how successfully or how long a new plan may be functioning, there are always those who dislike it simply because of its newness, because of its break with tradition. In Canada, one of the arguments heard in the money markets, so it is reported by a very competent observer, is that the Bank of Canada abdicated its leadership role when it instituted the new method of rate-setting. This is a line of thought that is hard to follow. As pointed out in Governor Coyne's testimony before a Committee

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of the Canadian House of Commons<sup>16/</sup> in 1956: "...the Bank of Canada bank rate...had been changed only two or three times in 20 years, prior to the year 1955." Even if the financial institutions had come to place an extraordinarily high value on the series of discount rate raises which were put into effect in 1955-56--an assumption that seems absurd--they can follow the open market operations as a guide to the Bank's attitudes and the Bank is not debarred in any way from speaking out on any financial subject. In short, the "we look up to our leader and we want him to lead us" ideas reportedly expressed by some of the financial entrepreneurs are not convincing. They sound like a rationalization for an objection which is probably based on some sort of personal annoyance with the rate-setting method.

Then there is said to be a group of financial people who do not like the thought of the Bank Rate following market rates down to quite low levels in times of recession. They fear that this tends to embarrass the commercial banks, in that it exposes the "stickiness" of their rates on commercial and other loans. This sort of an argument does not deserve a comment.

Some financial writers<sup>17/</sup> develop the thesis that the procedure tends to conceal the true policy and it seems to be implied that the Bank of Canada approves of this concealment. It is hard to see how policy can be concealed, with or without a discretionary discount rate. Further, if skullduggery of any kind is to be hinted at, this is an allegation that goes far beyond the way in which the Bank Rate is determined.

All in all, the opposition, insofar as it is known to this writer, seems to put forward a very poor case. If the new method were one which had

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been imposed by statute--so that the Bank of Canada could not return to a discretionary discount rate without involved and lengthy proceedings--or if the Bank were forbidden to make statements to the public, then there might be something to the objections. Since, on the contrary, the Bank has complete freedom to do anything it pleases along either of these lines, the case of the critics appears to be based largely on personal preferences.

CANADIAN PROCEDURE SUITABLE FOR U.S.?

A number of financial analysts in the United States have pondered the possibility that the Federal Reserve would do well to adapt the Canadian procedure to serve as a replacement for the rate-determination method now in use. Such an adaptation would be easy, would require no unusual actions of any kind, and would not involve any legislative changes.

If it were to be done, it could take the form of joint actions by the twelve Banks and the Board in announcing that, until further notice, twelve identical discount rates would be set weekly (semi-monthly or monthly) in accordance with some formula, based on some market rate or complex of market rates. The announcement would make clear that the twelve Banks and the Board were surrendering no rights or privileges while the arrangement was in effect. The arrangement could be altered, or suspended, or terminated at any time by any Bank, with approval of the Board--exactly as in the past.

In arriving at a decision as to whether or not it would be wise to go to such a method, the first question to which System officials would need to give attention would be that of temporarily replacing regional rates with a national rate. The division of the central bank in the United States into twelve district banks has been admired by many financial thinkers,



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in many countries, over a period of many years. It is, therefore, pertinent to raise the question as to whether or not the temporary national consolidation of one operation, the discount rate-setting process, would be a good thing to do.

The rate has essentially been national rather than regional nearly all of the time in recent years. Even when one or more districts have been out of line for a few weeks or a few months, the fluidity of credit is such--especially as seen in the Federal funds market--that borrowers and lenders in the out-of-line districts were probably almost unaware of their isolation. It is hard to imagine a reason for trying to hold long-continued district differentials, even if it were possible to do so, because the districts are economically neither homogeneous nor discrete, and, generally speaking, a district's problems are the nation's problems.

(A footnote to this portion of the discussion might point out that in the last twelve years the far West and, to a lesser degree, the middle West, appear to have been somewhat quicker to raise rates than the Northeast, whereas the Northeast seems to have been a touch faster in lowering rates. This is not quite in line with the well-rooted presumptions about the hard-money leanings of the financial interests along the Eastern seaboard.)

The four examples of split rates in the postwar years occurred in 1955, 1956, and 1958 (2). All were of short duration. In the first one, the Cleveland Bank raised its rate on August 3, 1955, by 1/2 per cent, from 1-3/4 per cent to 2-1/4 per cent, while the eleven other Banks went up only 1/4 per cent, to 2 per cent. Within four or five weeks, the other eleven

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Banks caught up with Cleveland. Second, and best remembered of the splits, happened nearly a year later. On April 12, 1956, San Francisco and Minneapolis moved up  $1/2$  per cent, from  $2-1/2$  per cent to 3 per cent, while the other ten Banks raised only to  $2-3/4$  per cent. Four months later, in August, the other ten Banks joined them at the 3 per cent level.

In January 1958, the third split saw San Francisco once more in a prominent place. The other eleven Banks lowered their rates by  $1/4$  per cent, from 3 per cent to  $2-3/4$  per cent, while San Francisco stayed on at 3 per cent. On March 13, the San Francisco Bank came down by  $3/4$  per cent, when the others were dropping only  $1/2$  per cent, so that all twelve were back together again at  $2-1/4$  per cent. The fourth episode took place in the summer of 1958, with San Francisco once more leading the way by moving up  $1/4$  per cent, from  $1-3/4$  per cent to 2 per cent. The rest of the Banks eventually came up to the same level, but New York took twenty-nine days to do it, Philadelphia required thirty-six days, and Boston took forty days to come to the same decision.

No one of these split-rate incidents has contributed much, so far as is known publicly, to the theory or practice of discount rate use in the United States. Neither is it known that they did any harm, except in that they may have introduced at least some little confusion as to the direction and timing of Federal Reserve policy. They certainly do not suggest that there is any great need to worry about the use of a national rate, so long as any District Bank can, whenever it wishes, propose to the Board that it go back to whatever rate-setting procedure it wishes. If the question of regionality is judged to be no obstacle to serious

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consideration of a national, automatic discount rate, the main issue of automaticity can be debated.

The principal reason for adopting an automatic rate procedure would be to keep the discount rate in proper alignment with market rates as inconspicuously as possible--on the grounds that it is an unimportant tool which should look unimportant except on the rare occasions when the System feels that it should be employed as an "announcement."

Achievement of this de-emphasis would be possible through adoption of the Canadian method, setting the rate weekly at  $1/4$  of 1 per cent above the Treasury bill rate as revealed at the latest auction. Any one of many other formulae might be equally satisfactory, or more satisfactory. The timing might be different, with bi-monthly or monthly or even less frequent changes. Limits could be placed on the rate.

A typical formula would be: take the last three months' average of the market yield on 91-day bills, compare it with last months' yield, choose the lower of the two, and add  $1/4$  per cent as the monthly rate. Put a top-side limit of  $4-1/2$  per cent and a bottom limit of 2 per cent. Put a limit of  $1/4$  per cent on the change in any one month, and disregard accumulated shortfalls, so that the latest figure would be the only one used.

Following such a plan, it would be possible for everyone to calculate the month's discount rate as soon as the preceding month's average rate were known. Rough calculations could be made a week or so in advance of the ending of the preceding month. The actual rate might be set on the third or fourth day of every month.

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What disadvantages can be visualized in such a plan? Only one comes to mind, but it is one which deserves careful thought. It has to do with the nine directors of each Bank, one hundred and eight men in all. These men are, generally speaking, outstanding figures in their communities-- leaders in their businesses and professions, competent, self-confident, eager to be of public service. It is generally agreed that the System should always take care to let these men know that their services are appreciated and that their indispensability as liaison officers with everyone outside the System is fully recognized.

In the course of expressing this appreciation and recognition is it or is it not necessary for their happiness and pleasure in their work that the directors actually recommend to the Board a different discount rate about twice a year, on the average? Would they not feel equally useful in that phase of their responsibilities if they knew that they were going to make a recommendation only once every two years, for example? Their economic discussions would surely be just as stimulating, and their cogitations just as demanding, in the latter case. Further, they would know that instead of coming up with a fairly frequent recommendation which might very well be tardy, almost meaningless, and needlessly productive of a lot of public criticism, they would produce every once in a while a really significant economic decision.

It seems logical to believe that practically all of the directors are men who regard their elections as an honor and as a recognition of their accomplishments, so that they would not mind having a slight change made in this one portion of their function. If this reasoning is well based, the

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only prospective disadvantage of a Canadian-type discount rate procedure is not really a disadvantage at all.

ADVANTAGES FOR THE FEDERAL RESERVE

There are, at a minimum, six real advantages for the Federal Reserve System in adapting a Canadian-type procedure to the financial needs of the United States.

First, the timing problem would be eliminated completely except on the infrequent occasions when the System might feel obliged to hoist a discount rate signal in connection with a truly major switch in policy. These occasions should come along less often, now that the System has experienced four postwar business cycles and has gotten the feel of how the American economy, entirely different in so many ways from the prewar economy, operates under conditions of cold war and influenced by the bargaining power of labor, the pricing power of industry, and the political power of agriculture. One can picture the Federal Reserve settling down to operation of its financial machine with a steadier hand at the levers from this point onward. It is also conceivable that the System may learn to use, for these occasions, the English language to much better effect than in the past--as a way of communicating its views at the major turning points of policy. It seems far-fetched to contend that a mute symbol, like the discount rate, is the best way to send out the message that monetary policy is being altered. Tradition may be a wonderful thing, but a modern Indian would surely consider the telephone or telegraph more accurate and reliable than a smoke signal for telling his friends that a storm is blowing up in his section of the country.

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With the practical elimination of the timing problem, Federal Reserve officials would no longer have to worry about the severe limitations placed on their actions by Treasury financing plans. The discount rate, changing monthly in a predictable way, would be no more subject to interference by the Treasury than would the real central mechanism, open market operations. While the System has never publicly defined "even keel" policy--which it normally tries to follow during Treasury financing periods--there is not much question as to what the term means. What it means is, in this writer's opinion, "policy proceeding steadily in the direction in which it was previously going, but so slowly as to bring about no substantial change in interest rates, or even in market psychology, while the financing is being offered." Since the Federal Reserve has probably never actually formulated such a general definition for its own guidance, to say nothing of defining a word like "substantial," it would be a waste of time to labor the matter here. The point is that the discount rate would no longer be a separate little lever which has to be jerked quite often but would, instead, be attached, as it were, to the big, smoothly-moved lever of open market operations. Discount rate changes could take place automatically each month without needing to be slowed up, or speeded up, to accommodate the debt managers in the Treasury.

As a second advantage, there would probably be no split rates among the districts, with the confusion which ensues. Under an automatic discount rate procedure whereby the national rate moved steadily to maintain a known relationship to market rates, the directors of the Bank in the most booming of the districts, for example, would not feel as "different" as they have felt under the present method of slow, jerky rate adjustments.

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As an example, take the famous four-month split of April-August 1956. Using the formula suggested just above, the national discount rate in April would have been approximately  $2\frac{3}{4}$  per cent instead of the actual  $2\frac{1}{2}$  per cent. Instead of ten Banks raising to  $2\frac{3}{4}$  per cent, and two to 3 per cent, as actually happened, it would seem likely that all would have been content with the  $2\frac{3}{4}$  per cent rate, coupled with the obvious likelihood of the rate being at 3 per cent within the next couple of months, under the formula.

Third, the problem of the "unnecessary overt act" would be either eliminated or greatly lessened. An example of the sort of thing that would have been avoided is the unfortunately-timed  $\frac{1}{2}$  per cent raise of the discount rate, from 3 per cent to  $3\frac{1}{2}$  per cent, of August 1957. If the automatic procedure had been in effect, the discount rate would have been going up during late 1956 and early 1957, so that by, say, April 1957, it would have risen to around  $3\frac{1}{2}$  per cent instead of the actual 3 per cent. It would have risen a bit more by July, so that there would have been no reason for the System to make itself look thoroughly inept by lifting the rate from 3 per cent to  $3\frac{1}{2}$  per cent in August.

Fourth, the likelihood of perverse effects from rate moves would be reduced. It is never possible to be certain that such effects have occurred, or to measure them, but it is almost inevitable that they will occur when a monetary tool is handled by the authorities with such awkwardness. A rate reduction at the top of a boom, or well along on a plateau, runs the risk of being regarded not as a signal of encouragement by the economy but, rather, as a Federal Reserve forecast of economic trouble ahead. Potential borrowers might decide to postpone some plans and wait

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for clearing weather, precisely the opposite of what the monetary authorities wanted them to do. At the bottom of the cycle, the first rate boost after a recession is customarily only a light Federal Reserve warning to borrow wisely--not an admonition to stop borrowing--and yet it may sometimes convey a sense of extravagant optimism to the business community. The possibility of such perverse effects could, of course, be avoided if the System would communicate with the economy in the way other organizations communicate, through the written or spoken word, but cannot be avoided if the fully discretionary discount rate is the only channel of message transmission.

Fifth on the list of advantages is the probability that some inroads might be made on elimination of the idea that the Federal Reserve sets interest rates in the market. One of the most difficult of all public relations jobs is to explain, with candor and honesty, that the System exercises a marginal influence on rates--sometimes of considerable strength and sometimes not. Too many people believe something quite different, and quite extreme. Some consider that the Federal Reserve has very little effect on markets, while others are certain that the authorities are sitting around a table and fixing interest rates for the whole economy. A shocking example of this was encountered by this writer at a luncheon not long ago. Sitting next to a very distinguished business leader, immediately after a meeting of a Bank board of directors, the subject of factors bearing on interest rates in the market was brought up by another guest at the luncheon. The distinguished executive leaned over and whispered, "Isn't it naive for him



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to talk about market factors affecting interest rates? You fellows just set the rates in that room over there, about an hour ago."

Completing the list of advantages, an automatic rate might reduce somewhat the way in which commercial bankers often now use the discretionary discount rate--as an explanation for their own boosting of rates on loans to whatever level they think the market will bear. Apparently it is a standard practice in many commercial banks to cite the well-publicized changes in discount rates in such a manner as to place the responsibility for the boost on the Federal Reserve. Considering the enormous number of letters which may go out bearing the message to borrowers, the public relations damage to the Federal Reserve must be very great.

FOOTNOTES

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- 1/ "Purposes and Functions," Board of Governors of the Federal Reserve System, Washington, D. C., 1961, 238 pages, p.46.
- 2/ The Federal Reserve Act, Section 14, paragraph "d."
- 3/ Statement for the Press, Board of Governors, August 18, 1950.
- 4/ Federal Reserve Bulletin.
- 5/ Annual Report of the Board of Governors of the Federal Reserve System for 1956, p. 49.
- 6/ Ibid, pp. 51 and 52.
- 7/ Annual Report, 1957, p. 50.
- 8/ Ibid, p. 68.
- 9/ Ibid.
- 10/ See the contrasting quotation from "Purposes and Functions," referred to in note #1 above.
- 11/ Annual Report, 1960, p. 49.
- 12/ Bank of Canada, Annual Report for 1955, p. 4.
- 13/ Ibid, p. 7.
- 14/ Bank of Canada, Annual Report for 1956, p. 45.
- 15/ Ibid, p. 46.
- 16/ Standing Committee on Banking and Commerce, Third Session, 22nd Parliament, 1956, p. 352.
- 17/ See Neufeld, E. P., "The Bank of Canada's Approach to Central Banking," Canadian Journal of Economics and Political Science, August 1958.