

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 29, 1942To Board of GovernorsSubject: Lowering Discount RatesFrom Gov. Szymczak


I am sure you will find the attached memorandum of interest. It relates to the subject we discussed yesterday with the Presidents at the Open Market Committee meeting.

I am quite aware of the fact that there will not be much borrowing and we should not encourage Banks to go into debt over a long period of time. However, having so realistic a presentation of the long range program by Drs. Goldenweiser and Williams, we must be aware of the fact that we shall be compelled to rely more and more upon Open Market operations and less and less on reduction of reserve requirements.

The job ahead of us is tremendous. It is only common sense, therefore, that urges us to provide rediscount facilities for member Banks at a rate which will make it possible for them to borrow, if and when reserve conditions in individual member Banks are such as to make this advisable and part of our long range program on the subject of reserves and Government deficit financing.

I don't think, ~~in fact, I am convinced,~~ that rediscounting can be expected, nor should be expected, to provide any major share of the new reserves needed. However, lowering the general rediscount rate is highly advantageous for member Banks, which may find themselves in a tight reserve position, to avail themselves of the rediscount facilities for which the Federal Reserve Banks were created.

The attached memo concentrates on the subject discussed yesterday, namely, general versus preferential rediscounting.



Attachment

September 24, 1942

Governor Szymczak

Lowering Discount Rates

G. L. Bach

(1) The lower the interest rate anyone has to pay, the more likely he is to borrow. This is the main argument for lowering rediscount rates further. The System is now presumably exerting every effort to get banks to buy Government securities. One major argument used is that Governments are excellent secondary reserves. While this is clearly so with a supported security market, to assure the banks that even low rate Governments could at any time be rediscounted at a very low rate (so no loss would be possible) would substantially ease the fears and lessen the hesitancy of bankers to buy Governments.

(2) With the present repurchase arrangement on bills, banks are in effect invited to borrow on bills at $3/8\%$. With this standing invitation, the present 1% discount rates are largely meaningless, except for those smaller banks which have no bills. Banks would be foolish to borrow on other paper at 1% if they can get reserves on bills at $3/8\%$. To provide access to reserve funds equally to all banks and to make all good assets equally acceptable for rediscount, all regular Federal Reserve discount rates should be lowered to $3/8\%$ if the present bill rate is to be maintained, to $1/2\%$ if the bill rate is to rise to $1/2\%$.

(3) Apparently the major objection advanced to lowering rediscount rates on anything except bills is that this would permit "profiteering" at the expense of the Government by borrowing at $3/8\%$ on securities yielding up to 2% or more. This reasoning stems from a heavy fallacy, well exposed by President Ben Strong of the New York Bank in his criticism of preferential discount rates in the 1920's. It was also ably exposed by Chairman Eccles, particularly during the hearings in Congress on the Banking Act of 1935. There are two main points, one generally applicable and the other particularly applicable to the present war period.

(a) The argument for preferential rates misses the point that once reserves are provided by the Reserve through rediscounting special paper at a low rate (say bills at $3/8\%$), there is nothing to keep the reserves from being used in purchase of higher yield securities or for loans as they circulate through the Banking System and the creation of about \$6 of deposits for each \$1 of reserves occurs. To look at a single bank here is very misleading; the major part of the use made of new reserves is when they go outside the borrowing bank through deposit shifts and become the basis for deposit expansion, where \$1 of reserves (borrowed at $3/8\%$ or whatnot) underlies \$6 of new security purchases. If purchase of Governments on new reserves is to be considered "profiteering", then there will, for the Banking System as a whole, be large profiteering on borrowing whether the discount rate is $3/8\%$ or 1% or even 2% or 5% .

(b) The whole argument is now meaningless anyhow since, by open market purchases or lowering requirements, the Reserve will provide many billions of reserves to member banks "free" of all costs through the war period—hence why worry so much about 1/2 of 1% on a relatively small volume of discounts which represent use of a thoroughly desirable banking mechanism.

Put in positive terms, since it makes no sense to have a 3/8% discount rate (in effect) on bills and a higher rate on other rediscountable paper, and since every effort should be made to encourage borrowing, other discount rates should be lowered to the bill level (either 3/8% or 1/2%, depending on the expected bill rate).