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Draft of policy record regarding
elimination of preferential discount rate

The preferential discount rate of 1/2 per cent was established at all of the Federal Reserve Banks in October 1942. It was recognized at that time that the war financing program would require substantial purchases of Government securities by member banks, and it was the belief of the Board of Governors that the existence of a preferential rate would encourage member banks, particularly those outside of the financial centers, to invest in short-term Government securities more of their excess reserves, which at that time were 3 billion dollars. The Board also felt that such a rate should not be established in ordinary circumstances and should be eliminated when the need for it had passed.

Shortly before the elimination of the preferential rate, the Board had considered this question informally and had discussed it with the Presidents of the Federal Reserve Banks. The Board felt that the reason for establishing this rate no longer existed, that its elimination would not interfere with the war financing program, that the continuance of the rate would encourage a further unnecessary and dangerous expansion of bank credit, and that the privilege was becoming increasingly subject to abuse.

There was no longer the same need for encouraging banks to increase their holdings of Government securities that existed at the time of the establishment of the preferential rate. Both Treasury financing practices and Federal Reserve policies have been directed toward selling as large a proportion of Government securities as possible to investors other than banks and to keep bank purchases to the minimum necessary to assure the success of Treasury financing. Bank holdings of Government securities had increased

by larger amounts than were needed. The tremendous investment of nonbank funds in Government securities in the drives, the large remaining uninvested nonbank funds, and the sharply declining level of Treasury cash requirements, with the reduction in the scale of war expenditures, indicated that bank investment in Government securities in an amount even approaching the previous scale no longer was necessary. It was, therefore, necessary no longer to give banks any special encouragement, but rather to discourage them, in adding to their holdings.

Not only were banks increasing their total holdings of Government securities by larger amounts than necessary, they were purchasing more longer-term, higher-rate issues and fewer short-term low-rate issues than they had previously. The lower preferential discount rates on advances secured by short-term obligations was, therefore, not having the intended effect of encouraging purchases of short-term issues. There were, in fact, evidences that some banks were borrowing at the preferential rate for the purpose of increasing their holdings of securities bearing higher rates. Member bank borrowings had reached a high level in June and at the same time banks were increasing their holdings of Government securities, particularly their holdings of medium-term bonds. They were encouraged to do this by the fact that the rate of $1/2$ per cent was considerably below the rate that could be earned on most issues of Government securities. The only rate that it exceeded was the rate of Treasury bills, and member banks since 1942 had reduced their holdings of bills and had increased enormously their holdings of longer-term higher-yielding securities. The preferential rate, moreover, by encouraging a low rate on loans on Government securities that banks make

to dealers and to others, had encouraged speculative buying of Government securities on bank credit, which had reached a large amount in the immediately preceding drive. There was evidence also that some banks borrowed in order to reduce their excess profits tax liabilities.

The purpose of the lower discount rate was not to encourage banks to borrow in order to purchase securities but to assure them that if they used available excess reserves to purchase securities they could borrow at low rates in case they should later need additional reserves for temporary periods. Under the circumstances that developed, it was felt that the continuance of the preferential rate would encourage a further unnecessary and dangerous expansion of bank credit at a time when inflationary pressures were increasing.

The time chosen for the elimination of the preferential rate was one when it would cause no disturbance to the banking system and to Treasury financing. Member bank borrowings were small and excess reserves large, and the Treasury needed to borrow no additional funds for several months.