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THE DISCOUNT AND DISCOUNT RATE MECHANISM

A Group of Special Studies Prepared by
Selected Board and Reserve Bank Research Personnel

May 29, 1953

PREFACE

The studies submitted herein have the single purpose of providing background information that may be helpful in finding solutions to present-day issues of discount policy. By assembling relevant materials on past and current problems of discounting and of determining discount rates these studies may help to develop a framework of principles for guiding System discount operations in the financial setting which now prevails. While the objectives of the studies are primarily analytical and educational, two of them (Nos. VI and VII) are concerned with specific approaches to current operational matters.

Early in April 1953, the Board directed its senior staff to undertake, with the cooperative help of the staffs of the Reserve Banks, a comprehensive reexamination of the System's discount and discount rate mechanism. Each of the studies has had the benefit of extensive critical discussion and comment by the System working group participating in their preparation as well as by the Subcommittee on Banking and Credit Policy of the System Research Advisory Committee. They have all been substantially revised in the light of suggestions developed in the course of this review. In view of the complexities of the subject matter under study, the authors naturally recognize that substantive gaps in information and theory may remain in present drafts and that further revision of individual studies may be needed.

The studies are being circulated at this time for such help as they may provide in discussions of System discount operations at the forthcoming joint meeting of the Board and the Presidents Conference to be held in Washington, D.C., on June 10.

Wm McC. Martin, Jr.

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I. DEVELOPMENT OF FEDERAL RESERVE DISCOUNT POLICY, 1919-23

Summary and Conclusions

In general, the years 1919-23 constituted the formative period in Federal Reserve policy. During this period considerable progress was made in the development of a mechanism for influencing credit and monetary developments. The mechanism in use during this period included qualitative discount policy as well as discount rate action and also the beginning of open market operations. By the end of the period these instruments were employed in much the same way as throughout the later twenties and early thirties.

Prior to 1917 the problem of organizing the System, together with the liquidity of the money market resulting in part from a gold inflow, had prevented the taking of much positive action designed to influence credit conditions. Thereafter, all other aims had been subordinated to the financing of the war.

During the period 1919-23, however, action began to be taken to influence the level of economic activity and prices. The particular form of action was influenced by the peculiar conditions of the period, as well as by prevailing theories of central banking. The experiments which had limited success, or which were manifestly appropriate only to special circumstances, were discarded, and from the experience of the period developed a considerable part of the philosophy of reserve banking action which was to prevail during the 1920's.

Special Circumstances of Period

The following special features which characterized the condition of the banking system and of the economy in general during the period were significant for the credit and monetary actions which were taken:

(1) The condition of the banking system and of the economy in general in 1919 was strongly influenced by the war which had just ended. In particular, commercial bank portfolios contained large quantities of loans made to enable customers to purchase Government securities, as well as Government securities purchased for their own accounts, and the banks had become heavily indebted to the Federal Reserve Banks in obtaining the reserve funds needed to meet the currency outflow and to support the increase in deposits resulting from the credit expansion. Treasury financing operations throughout 1919 hampered the application of measures designed to curb inflation.

(2) There were special difficulties in agricultural areas in the period 1920-21. Loans to farmers proved impossible to liquidate, and many banks in agricultural areas were highly illiquid.

(3) Many individual banks had unsound assets and inadequate capital; hence in supplying credit the Federal Reserve Banks considered the solvency of borrowing banks as well as the need of the economy for credit.

(4) The reserves of the Federal Reserve Banks were subject to extreme influences over the period. Throughout 1920 the reserves of all Reserve Banks combined were only slightly above legal requirements, and during the period 1919-21 individual Reserve Banks had to borrow heavily from other Reserve Banks at various times in order to maintain their required reserves. After 1921 there was such a high combined reserve ratio as the result of the gold inflow, together with the decrease in Federal Reserve liabilities resulting from the return of currency from circulation, that the expansion possible on the basis of these reserves would have been strongly inflationary.

Ideas Concerning Reserve Banking Action

The measures taken during the period were influenced by the following ideas concerning credit regulation which were reflected in the Federal Reserve Act or which were held widely enough to have some influence on measures taken:

(1) It was believed in some quarters that a considerable liquidation of commercial bank and Federal Reserve Bank credit and a decline in prices were necessary.

(2) A philosophy which had been written into the Federal Reserve Act, and which was widely accepted, was that the regulation of credit should be concerned to a large extent with its qualitative rather than its quantitative aspect, and hence that a major task of the Federal Reserve was to see that borrowing commercial banks used its credit for "productive" rather than "speculative" purposes.

(3) Closely related was the philosophy that the amount of Federal Reserve credit to which individual banks were entitled was related to their contribution to Federal Reserve lending power, and hence that Federal Reserve action should be concerned with the distribution of indebtedness among member banks.

(4) It was widely believed that the discount rate should be above some other rates, either market or customer rates, on the identity of which there was not agreememt, and that the discount rate should not be lowered as long as these other rates were above it.

(5) There was widespread belief, on the basis of gold standard theory, that discount rates and credit policy in general should be influenced by the reserve ratios of the Reserve Banks.

(6) It was widely believed that the development of a bankers' acceptance market should be fostered for the purpose of increasing the importance of the United States in the financing of international trade and also developing a liquid asset considered suitable for bank reserve adjustment.

Action Taken During Period

The following special features characterized Federal Reserve action during this period:

(1) There was a complicated structure of discount rates on different types of paper at the beginning of the period.

(2) Basic discount rates were raised only after inflation was well under way and market rates had risen, and lowered only after deflation had been in progress for almost a year and market rates had begun to decline.

(3) For a limited period of time four Federal Reserve Banks imposed progressive rates on borrowings in excess of a member bank's basic line of credit, which was generally defined in terms of its legal reserves and ownership of Federal Reserve stock.

(4) The use of moral suasion was relied on heavily.

(5) The Federal Reserve buying rate on bankers' acceptances was relatively low during most of the period.

(6) Individual Reserve Banks nought Government securities in 1922 for the purpose of improving their earning positions and without regard to the influence of their actions on general credit conditions.

Development of Theory Concerning Federal Reserve Action

The following points summarize the effects which the experience during this early period had on Federal Reserve philosophy and action in the latter 1920's:

(1) It was explicitly recognized that the quantitative aspect of credit regulation is important. Attention was still paid to the importance of qualitative influence, however; and this aspect was to assume special importance again in 1928-29.

(2) It was clearly recognized that there is not necessarily a close relationship between the paper offered for discount and the use made of the proceeds of discounting. This recognition led to a discontinuation of differential rates, which were not used again until 1942 and then only for Government securities.

(3) Somewhat more emphasis began to be placed on the choice of a discount rate that would be appropriate in view of existing conditions in the economy, and somewhat less emphasis to be placed on rationing or moral suasion. This shift was evidenced in part by the abandonment of progressive discount rates. Surveillance of borrowing member banks by Reserve Banks was continued, however, and moral suasion again assumed special importance in 1928-29.

(4) It was believed that the Reserve Banks should supply credit freely in a period of depression. Only in the next decade was it recognized that banks should be freed from debt in a period of deep depression and of strong pressure for liquidity.

(5) It was concluded that the reserve ratio of the Federal Reserve Banks should not determine credit and monetary policy under conditions such as faced the United States during 1922-23.

(6) The idea that Federal Reserve credit should be made available to banks according to their contribution to Federal Reserve lending power was abandoned.

(7) It was explicitly recognized not only that open market operations affect reserves, but also that they are likely to be followed by a movement in the opposite direction in the level of discounts.

(8) It was apparently recognized that some tightening or easing action should be taken earlier in an upswing or downswing than was characteristic in the period 1919-1921. The sequence among open market operations, changes of market interest rates, and changes in the discount rate had not been worked out, however.

(9) Approximately the pattern of regional discount rate relations which was to prevail until 1928 had been established. Differentials in rates among districts were small, however, and there was not general agreement as to the extent to which such differentials should prevail.

(10) The desire to foster the growth of a bankers' acceptance market resulted in the maintenance of relatively low buying rates on acceptance paper throughout the 1920's. After the middle of the decade, however, the buying rates were set with a view also to the seasonal reserve needs of the banks.

Developments in Inflation, 1919-20

Commercial banks were heavily in debt to the Federal Reserve Banks when inflationary developments resumed in 1919. During the war investors had been encouraged to purchase Liberty bonds and to finance their purchases by borrowing from commercial banks. Commercial banks in turn had been encouraged to make such loans to their customers and to obtain needed reserve funds by borrowing from the Reserve Banks. Discounting was made attractive by preferential rates on the discount of the so-called "war paper" -- that is, on the rediscount of customer paper secured by Government obligations and on advances on the member banks' own notes secured either by this type of paper or by their own holdings of Government obligations. Throughout the war these rates had been closely tied to the rates at which such securities were currently issued.

In order to obtain the reserves necessary to meet the currency outflow and the requirements behind the deposit increase accompanying credit expansion, commercial banks had increased their discounts with the Federal Reserve Banks from a negligible level before the war to 1.8 billion dollars on June 30, 1919. As a result of the preferential discount rates on war paper, over 85 per cent of the 1.8 billion was obtained through the discount of such paper. At this time there were also differential discount rates for the various types and maturities of commercial and agricultural paper. These rates, however, were all largely ineffective.

Banking Developments

During the inflationary upsurge beginning about the middle of 1919, bank credit increased further, as loans for commercial, industrial, and agricultural purposes and for purchasing and carrying stocks more than offset the decline in loans on Government securities. Many of the loans were made for speculative purposes or, particularly in agricultural areas, to provide what was really long-term credit, and many banks were seriously overextended in relation to their capital. The continued increase in currency in circulation and the reversal of the gold inflow depleted bank reserves, while legal reserve requirements continued to increase as the result of the credit and deposit expansion. Discounts reached 2.5 billion dollars by the middle of 1920. In addition, early in 1920 Reserve Bank holdings of bankers' acceptances reached almost 600 million dollars, the highest they were to reach prior to 1931; these holdings were still 400 million at the end of June.

The increase in Federal Reserve deposit and note liabilities, as well as the gold outflow beginning in 1919, was reflected in a relatively low reserve ratio for the Federal Reserve Banks themselves. The combined reserve ratio of all Reserve Banks averaged 45.7 per cent in December 1919 and fell to 42.4 per cent in March 1920. Legal reserve requirements for the Federal Reserve Banks were about 38 per cent at this time.[1/] Individual Reserve Banks had had to rediscount paper with other Reserve Banks or sell acceptances to them in order to keep their reserves from falling below requirements in periods of seasonal or special needs. Thus the Richmond, Dallas, and Atlanta Reserve Banks had rediscounted with other Banks during the summer of 1919, when they experienced a seasonal loss of funds. Late in the year the New York, Boston, and Philadelphia Banks had been forced to obtain accommodation from other Banks on a considerable scale as a result of both normal seasonal losses and the purchase of bankers' acceptances at favorable rates. Through the purchase of bankers' acceptances, these Reserve Banks utlimately supplied funds to other Districts.[2/]

1/ The requirements were 35 per cent in gold or lawful money behind deposit liabilities and 40 per cent in gold behind note liabilities.

2/ There was considerable controversy among the Reserve Banks concerning the provision of accommodation for other Reserve Banks, which was done primarily at Board direction. Lending Reserve Banks objected when the discount rates of borrowing Reserve Banks were lower than their own. Reserve Banks in the West and South objected to taking over acceptances purchased at the initiative of the Eastern Reserve Banks, while the latter objected to having to buy and hold the preponderance of acceptances when most of them originated elsewhere.

Federal Reserve Action

The effective rate on discounts was generally 4 per cent early in 1919. With minor exceptions there were no changes in Reserve Bank discount rates until November 1919. Prior to this date there had been an increase in rates on brokers' loans, which had been freed in January from the control formerly exercised by the Subcommittee on Money of the Liberty Loan Committee; the average call loan renewal rate was 7-1/2 per cent in October, compared with slightly over 4-1/2 per cent in January. The lag in the rise in the discount rate during this period was inconsistent with the prevalent philosophy which considered the discount rate a penalty rate.

That the discount rate was not raised was due largely to the demands of Treasury financing. The Victory loan was floated in May 1919, and the amount of certificates outstanding was not reduced significantly until the end of the year. Therefore, the Treasury requested that there be no increase in discount rates until the beginning of 1920.

Discount rates were raised somewhat in November 1919 and more beginning early in 1920. One effect of the rate increases late in 1919 was to eliminate most of the rate differentials and give a high degree of uniformity to the rate structure. The differentials according to class of paper were restored under the rate increases in 1920, however, although the differentials for a given class of paper according to its maturity were not restored. During 1920 discount rates on paper secured by Treasury certificates were generally kept in line with the rising rates on certificates being issued. According to the Annual Report of the

Federal Reserve Board for 1920, these changes were in keeping with the policy of "enabling the banks to carry the certificates without loss pending their distribution to customers, but offering them no inducement through a spread in rates to retain the certificates as an investment instead of passing them on to the public."3/ Rates were higher on rediscounts of and advances secured by paper other than certificates. At the middle of 1920 the discount rate at the New York Federal Reserve Bank on paper secured by certificates of indebtedness was 5-1/2 per cent; on paper secured by Liberty bonds and Victory notes, 6 per cent; and on commercial paper, 7 per cent. Despite the favorable rates on paper secured by Government obligations, particularly certificates, the proportion of discounts thus secured declined as some borrowing banks presumably exhausted their holdings of such paper.

In the spring of 1920 four of the Federal Reserve Banks adopted progressive rates for borrowing by individual banks. Such rates had been authorized by an amendment to Section 14 of the Federal Reserve Act, approved April 13, 1920. As administered by three of the Reserve Banks, the marginal rate was based on the relation of borrowing to the member bank's basic line of credit, defined as 2-1/2 times the sum of the bank's paid-in subscription to the capital of the Federal Reserve Bank plus 65 per cent of its total reserves. This figure was chosen as representing the contribution of the bank to the lending power of the Federal Reserve Bank. In the Atlanta, Kansas City, and St. Louis Federal Reserve Districts, the basic discount rate applied to all borrowing up to the basic line of credit; and the rate progressed by 1/2 per cent for each 25 per cent by

3/ Seventh Annual Report of the Federal Reserve Board, 1920, p. 58.

which the borrowing exceeded the basic line of credit. Advances secured by United States Government securities owned by the borrowing bank were generally exempted from the application of the progressive rate and were also excluded from the computation of the amount of discounting. In the Atlanta District loans on agricultural paper up to 100 per cent of the member bank's capital and surplus were also exempt from the progressive rate. The Dallas Federal Reserve Bank applied progressive rates to borrowings in excess of the member bank's capital and surplus.

It should be noted that the progressive rates were directed to a considerable extent at the distribution of borrowing as well as the total amount. The progressive rates were adopted to some extent as an alternative to the 7 per cent basic rates which were being applied in some districts. As noted, reserves of the Reserve Banks were low at this time, and there was concern that the available credit be equitably distributed. In its Annual Report for 1920, the Kansas City Reserve Bank pointed to the redistribution of indebtedness among member banks as an evidence of the success of the progressive rate.4/

During this period the buying rate on bankers' acceptances was kept at a low level relative to market rates, although it was generally

4/ Annual Report of the Federal Reserve Agent of the Tenth Federal Reserve District to the Federal Reserve Board, 1920, p. 11. To the extent that the shift of indebtedness reflected forced liquidations of customer loans by borrowing banks, which resulted in adverse clearing balances for other banks, it would be a factor increasing pressure for liquidation. It is known, however, that a part of the shift in the Kansas City District was the result of the withdrawal of credit to country banks by city correspondents and the consequent direct resort of the former to the Federal Reserve Banks.

somewhat above the discount rate on advances secured by Treasury certificates of indebtedness. The low level of the buying rate, which reflected the desire to foster the development of the market, resulted in the concentration of a large proportion of total acceptances in the Federal Reserve Banks.

During this period the increase in discount rates was preceded and accompanied by the use of moral suasion. In public speeches and published reports, in meetings with bankers and contact with borrowing banks, Federal Reserve officials reiterated the statement that banks should discriminate between essential and nonessential loans and between productive and speculative loans. All Federal Reserve Banks, including the eight not applying progressive discount rates, paid considerable attention to the relation of individual bank borrowings to their basic lines of credit, and statistics were published on the number of banks borrowing in excess of basic lines and the relationship of total bank borrowing to these lines.

Developments during Deflation, 1920-21

Because of the economic and banking developments in the preceding inflation, many banks were already in illiquid and overextended positions when deflation began about the middle of 1920. In many cases their positions deteriorated further in succeeding months.

Banking Developments

Discounts continued to increase until late 1920, at which time they reached 2.7 billion dollars. Total bank loans and investments showed little change in this period, and deposits and legal reserve requirements declined slightly. There was also a gold inflow on a small scale beginning in the spring. A further increase in currency in circulation and a decline in Federal Reserve holdings of bankers' acceptances and of United States Government securities, however, necessitated an increase in discounting. During 1921 a liquidation of commercial bank assets resulted in a decline in deposits and reserve requirements, the gold inflow was accelerated, and currency in circulation began to decline. Discounts of all member banks combined declined to 1.8 billion dollars on June 29, 1921, and 1.1 billion at the end of the year.

The decrease in discounts was heavily concentrated in banks in industrial and financial areas. The liquidity of commercial banks in these areas had generally increased by the middle of 1920, although the New York banks suffered end-of-year diffulcities as a result in part of loans outside the area and the withdrawal of balances by outside banks. The agricultural sector of the economy was hardest hit by the decline in general economic activity and took longest to recover. Banks in agricultural areas lost reserves and at the same time found their loans frozen. Many of these banks were faced with solvency as well as liquidity problems. Discounts generally reached their peaks in agricultural districts in the late summer of 1920, when they are at a seasonal high. For example, the discounts of member banks with the Federal Reserve Banks of Dallas, Atlanta, Minneapolis, and Richmond combined reached 524 million dollars on September 24, 1920, compared with 342 million a year earlier. Many banks in agricultural areas, however, were not members of the Federal Reserve System and thus had access to Federal Reserve credit only indirectly.

Others exhausted their supply of eligible paper and hence were unable to obtain credit. In some cases banks permitted reserves to remain below legal requirements for considerable periods of time.

The outflow of funds from primarily agricultural districts depleted the reserves of Federal Reserve Banks as well as commercial banks in these areas. On September 24, 1920, the total reserves of the Dallas, Atlanta, Minneapolis, and Richmond Federal Reserve Banks, after adjustment for the rediscount of paper with other Reserve Banks, were only 127 million dollars, compared with 203 million a year earlier. The adjusted reserve ratios of the Dallas, Atlanta, Minneapolis, and Richmond Reserve Banks on this date were 10, 17, 22, and 29 per cent, respectively.

The agricultural districts experienced a seasonal improvement in their financial position relative to other areas of the country after September. Beginning in April, however, the reserve position of the Federal Reserve Banks in agricultural districts, especially Richmond, Atlanta, Minneapolis, and Dallas, again deteriorated rapidly.[5] At the end of August adjusted reserves of these four Reserve Banks had reached 137 million dollars, and their adjusted reserve ratios ranged from 9 to 36 per cent. Discounts, which had declined to 383 million dollars at the end of March, were stabilized at about this level, as the effects of a currency inflow largely offset the effects on bank reserves of the further flow of funds to other districts.

[5] The Kansas City, St. Louis, and Chicago Reserve Banks, which had followed approximately the same pattern of developments as the Richmond, Atlanta, Minneapolis, and Dallas Banks in 1920, were in considerably better condition in 1921.

Late in 1921 the condition of banks in agricultural as well as industrial areas began to improve. Discounts at the Richmond, Atlanta, Minneapolis, and Dallas Reserve Banks declined to 130 million dollars at the end of June 1922. The decline reflected in part a regular seasonal movement of funds, in part an increase in demand for agricultural products resulting from the revival of business activity in industrial areas, and in part an inflow of funds resulting from loans by the War Finance Corporation. The Agricultural Credits Act of August 24, 1921, had given the War Finance Corporation authority to make loans to banks or cooperative associations which had made advances for agricultural purposes. These loans were made on liberal terms. In the seven months September 1921 - March 1922, advances made under the terms of this Act totaled 204 million dollars, and the balance outstanding at the end of March was 186 million dollars. The inflow of funds resulting from War Finance Corporation loans provided banks in agricultural areas as a group with reserve funds which were used to a large extent to reduce indebtedness to the Federal Reserve Banks.[6]

Federal Reserve Action

During this period the Federal Reserve System was often criticized for pursuing too restrictive policies even after deflation was under way and banking difficulties were common.

6/ In some cases individual member banks may have reduced their discounts with their Federal Reserve Banks through the proceeds of loans received from the War Finance Corporation. In other cases, member banks gained funds as the result of the transfer of frozen loans to other banks or to marketing associations receiving War Finance Corporation aid or as the result of the liquidation of loans to correspondent banks with the proceeds of such aid. In yet other cases, banks were able to liquidate indebtedness to the Federal Reserve because of the receipt of deposits resulting from the expenditure of the proceeds of new loans made by the War Finance Corporation.

Discount rates on paper secured by Government obligations were raised in the second half of 1920, and early in 1921 they were generally brought into equality with the discount rate applicable to commercial paper. Progressive rates were abolished by the Atlanta Reserve Bank in November 1920 and by the Dallas Bank in February 1921, but in each case the basic rate was raised from 6 to 7 per cent. Progressive rates remained in effect in the Kansas City and St. Louis Districts until mid-1921, although the Kansas City Reserve Bank set a maximum marginal rate of 12 per cent in January and both Reserve Banks considerably simplified the progressive rate schedule before eliminating it.

The failure to lower discount rates earlier in the course of the deflation was largely due to consideration of the following factors: First, the reserve ratios of the Federal Reserve Banks themselves remained relatively low until early 1921. It was apparently thought that lowering the rates would reduce the reserve ratios of the Federal Reserve Banks still further by encouraging more discounting, thus increasing deposit liabilities, and possibly also by reversing the gold inflow.[7] Second, market rates had declined little prior to the spring of 1921 and remained high relative to discount rates. It was believed by many that discount rates should not be reduced until market rates had begun to decline. Open market operations had not been developed, and in any case they could not have been used to ease commercial bank reserve positions without

7/ The Reserve Banks can carry deficiencies in reserves against either their note or deposit liabilities upon the payment of a tax. In the case of a deficiency against note liabilities, the tax has to be passed on to borrowing banks in the form of higher interest charges. Actually, no tax has ever been passed on, because deficiencies have always been considered as being in reserves against deposits.

risking a further reduction in the reserve ratios of the Reserve Banks; therefore, the market could ease only to the extent that the demand for loans declined or banks received excess funds as the result of the gold inflow or the reduction of currency in circulation. Third, it was believed by many that liquidation of commercial and Federal Reserve Bank credit should take place to offset the wartime expansion of such credit.

By the spring of 1921 the increase in the gold stock, the decline in money in circulation, and the decrease in member bank reserve requirements accompanying the liquidation of loans and deposits in industrial, commercial, and financial areas had resulted both in an improvement in the reserve ratio of all Reserve Banks combined and in a reduction in interest rates in the money market. The Federal Reserve Bank of Boston lowered its discount rate in mid-April, and other Reserve Banks soon followed suit. Discount rates at the various Reserve Banks, which had ranged from 6 to 7 per cent at the beginning of the year, were 4-1/2 to 5-1/2 per cent at the end of 1921.

It was claimed also that the Reserve Banks were unduly restrictive in their lending policies on the basis of the quoted discount rates. Such charges are always difficult to evaluate, particularly many years after the event. It was undoubtedly true that pressure was put on some individual banks to repay indebtedness, either because of the belief that individual banks were abusing borrowing privileges, because of a fear that the borrowing banks were in weak financial condition, or because of concern about the reserve position of the Reserve Banks. Moreover, in some cases the Reserve Banks demanded collateral for loans, especially on agricultural paper, which the borrowing banks considered excessive.

Furthermore, many banks in difficulty had exhausted their legally eligible collateral, and others were nonmember banks which could not borrow directly from the Reserve Banks and which until July 1921 could have their notes rediscounted through member banks only with explicit permission of the Federal Reserve Board, except for notes secured by Government obligations.

In July 1921 a conference was held between the members of the Federal Reserve Board and the Governors of the Federal Reserve Banks of Richmond, Atlanta, Dallas, and St. Louis which resulted in the issuance of a statement affirming the willingness to discount paper arising in connection with the harvesting and marketing of the cotton crop and also in a specific ruling to the effect that paper originating in nonmember banks would be accepted when endorsed by a member bank. The statement concluded as follows:

> "In order, however, that these rediscount facilities of the Federal Reserve Banks may be made fully effective, it will be necessary that member banks in the cotton States place their loaning facilities freely at the disposal of cotton producers and dealers in their respective localities with the knowledge and assurance that the Federal Reserve Board and the Federal Reserve Banks recognize the urgency of rendering all proper assistance to these important interests during such abnormal times."

Developments in Prosperity, 1922-23

The developments of interest in the period 1922-23 were primarily developments in the use of Federal Reserve instruments other than the discount mechanism and in the formulation of theories of central banking.

By 1922 considerably less reliance was being placed on moral suasion than earlier, and considerably less attention was being paid to the distribution of indebtedness among member banks. During this period the importance of a discount rate appropriate to the general credit and monetary situation was emphasized.[8] Moreover, a single rate was generally applied to discounts of all classes of paper. These developments were all related to a shift from emphasis on the qualitative elements of credit regulation to greater emphasis on the quantitative elements. This shift was made clear in the Annual Report of the Federal Reserve Board for 1923.[9] Attention was still paid to the qualitative aspect in this Annual Report, however, and it was stated that "it is the belief of the Board that there will be little danger that the credit created and contributed by the Federal Reserve Banks will be in excessive volume if restricted to productive uses."[10] Nevertheless, the increasing reliance on the quantitative aspect was made clear both in this report and in action taken at the time. The uniformity of discount rates for all classes of paper also reflected the recognition that there is not necessarily any direct relationship between the paper which is offered for discount and the purpose of the borrowing.[11]

The regional pattern of rates was similar in the period 1922-23 to the pattern which was to prevail until 1928. The differentials in rates among districts, however, were small and were probably considerably less than had been envisaged at the time that the Federal Reserve Act was passed. There was not general agreement at this time as to the degree to which uniformity among districts was desirable because of national

8/ See Annual Report of the Federal Reserve Board, 1923, p. 9.
9/ Ibid., pp. 33-35.
10/ Ibid., p. 34.
11/ Ibid., p. 35.

money market characteristics or the degree to which discount rates in the various districts should reflect regional differences in market and customer interest rates.[12/]

Developments in System open market policy in the period 1922-23 were closely related to the increasing emphasis on the quantitative aspects of credit regulation. Individual Reserve Banks began to purchase Government securities in order to maintain their earnings early in 1922, when there was a low level of discounts as the result of the gold inflow in conjunction with the decreases in currency in circulation and in requirements for reserves resulting from credit and deposit contraction. It soon became clear both that such purchases may have disrupting effects on the securities market, which could be partly avoided by joint Federal Reserve Bank action, and also that open market transactions have an important effect on the level of reserves and the discounting operations of member banks. At a meeting of the Governors of the Federal Reserve Banks in May 1922, a Committee on Centralized Execution of Purchases and Sales of Government Securities, consisting of the Governors of four Federal Reserve Banks, was organized to execute investment orders for all of the Reserve Banks. In October the Committee was enlarged to five members, and its duties were extended to include the making of recommendations from time to time concerning the advisability of purchasing or selling securities. On March 22, 1923, the Federal Reserve Board passed a resolution creating the Federal Open Market Committee and requiring that the Committee give primary consideration to the accommodation of commerce and business and the effect of purchases or sales of securities on the general credit situation.

12/ *Ibid.*, pp. 2 and 9.

The Annual Report for 1923 emphasized the importance of open market operations in influencing the level of discounts and in the functioning of the discount mechanism.[13] The explanation of the distinction between borrowed and unborrowed reserves from the standpoint of the functioning of credit policy had not yet been clearly stated, however; nor had any theory been stated concerning the sequence of open market operations and changes in discount rates.[14]

The level of business activity increased during 1922 and most of 1923. During this period the gold inflow continued, supplying banks with reserve funds without resort to the use of Federal Reserve credit. The Federal Reserve sold United States Government securities in the market in late 1922 and 1923, and in 1923 discount rates were raised at the three Reserve Banks which had reduced rates to 4 per cent in 1922. It was explicitly recognized at this time that the reserve ratio of the Federal Reserve Banks could not be permitted to determine credit policy, at least with the international situation then prevailing.[15] It was apparently recognized also that Federal Reserve tightening or easing action should be prompter in relation to changes in business activity than it had been in 1919-21.[16]

Despite the change in emphasis in discount and open market policy, the desire to encourage the growth of the acceptance market remained a dominant factor in the establishment of buying rates. Acceptance

13/ Ibid., pp. 11 and 13-14.
14/ For the discussion in the Annual Report for 1923 concerning the relationship between reserves supplied by commercial bank borrowing and those supplied by open market operations, see pp. 13-15 of that report.
15/ Ibid., pp. 30-31.
16/ Ibid., p. 10

holdings of Federal Reserve Banks had been almost entirely liquidated in 1921 as the result of a decline in the amount outstanding and the increasing liquidity of money market banks. Beginning late in 1921 the Reserve Banks purchased acceptances at rates which were favorable relative to market rates and to the discount rate, and acceptances again began to be concentrated in the Reserve Banks. By the end of 1923, Federal Reserve holdings of acceptances exceeded 350 million dollars.

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II. CRITERIA FOR CHANGES IN THE DISCOUNT RATE

The basic purpose of the Federal Reserve System is to exert monetary discipline on the economy. It can exert this discipline only with "the consent of the governed." In the long run, such consent should be based on understanding and should be earned through merit in operations. If the principles of monetary policy are understood, every action--or in-action--by the System should be consistent with them and, except when based on information available only to Reserve authorities, should seldom come as a complete surprise to informed observers. Thus, as stated by Dr. Goldenweiser:

> Monetary action should be simple, direct, nonsubtle, and easily understandable. It depends for its effects not only on the actual measures taken but also on the fact that these actions are meant to indicate attitudes.[1]

If this premise is correct, the question arises as to whether Reserve authorities should establish fairly definite criteria for specific actions--criteria which in turn would become known to the market so that the informed observer could anticipate and better understand major policy moves. With the re-emergence of member bank borrowing as a primary method of obtaining reserves, guides to changes in the discount rate are again of interest. The purpose of this memorandum is (1) to explore the possibility of devising some specific criteria for changes in the discount rate, and (2) to discuss the advisability of divulging this information to the market along with either an implied or expressed promise that the announced criteria will be followed in shaping policy.

1/ E. A. Goldenweiser: American Monetary Policy, p. 233.

I. Preliminary Considerations

These purposes can be achieved only if the broader aspects of the discount mechanism are understood. It is therefore appropriate to preface the analysis with a discussion of several basic questions relating to discount policy. These questions are:

A. In what ways does discount policy exert influence as a device of credit control?

B. What is the proper role of discount policy in the overall complex of monetary action?

C. What, if any, is the "normal" relationship between discount rates and market rates?

A. Influence of Discount Policy

The discount mechanism influences the flow of expenditures in four ways:

1. Through the effects exerted by the discount rate as a price.

2. Through the effects on expectations of a change in the discount rate.

3. Through the effects resulting from the reluctance of member banks to borrow from and remain in debt to the Reserve Banks.

4. Through the selective effects of the "policing" action which accompanies Reserve Bank lending.

It may seem that only the first two influences are significant to the problem of devising specific criteria for changes in the discount rate. But the fact is that all four are interrelated. For example, as market rates move up relative to the discount rate the reluctance of member banks to borrow tends to be overcome and the problem of policing grows in difficulty and extent. In other words, the reluctance to borrow on the part of member banks reduces the effectiveness of the discount rate as a price when expansion is desired, and reinforces it when a restrictive program is pursued. As will be shown later, the asymmetrical character of the mechanism is of importance in the timing of changes in the discount rate in different stages of the business cycle.

The effects on expectations of a change in the discount rate are not always predictable. Analysis is complicated by the fact that reactions to a given increase or decrease are influenced by such things as the business outlook, the level of the new discount rate relative to market rates, the nature of past Federal Reserve policy, market judgment as to the reason underlying the rate change, and so on. For example, an increase designed to bring the discount rate in line with existing market rates (this was the interpretation on the part of the market of the most recent increase) might have only minor effects on expectations because the increase would be viewed as a confirmation of past events rather than a forerunner of future movements.

Some changes in the discount rate, on the other hand, are interpreted by the market as presaging either higher or lower market rates. Unpredictability may still be present, however, because such changes tend to affect borrowers and lenders in opposite ways. In the case of an increase, borrowers, in anticipation of higher rates in general, may try to borrow more and lenders may attempt to curtail their extensions. The net result will probably be a speedier increase in market rates than would otherwise be the case, thus accentuating tightness in the credit market but with uncertain effects on the total volume of credit.

Hence, the effects of changes in the discount rate on expectations--sometimes referred to as the psychological influence--vary with circumstances and are not always predictable. This does not mean, however, that such effects should be ignored in the formulation of credit policy. Whenever possible, policy should be designed to make profitable use of the effects on expectations. If nothing more, the possibility of perverse reactions should be taken into consideration.

For purposes of this memorandum, the most important conclusion to be drawn from this brief discussion of the different types of influences exerted through the discount mechanism is that the influence of the discount rate as a price, although important, is by no means the only route through which the supply, availability, and cost of credit are affected. As a consequence, decisions concerning changes in the discount rate should be based on much broader considerations of the over-all credit situation than would otherwise be the case.

B. The Proper Role of Discount Policy

Discount policy cannot be considered in isolation. It is but one of three major techniques for influencing the supply, availability, and cost of credit. Thus any discussion of guides to rate changes should be based on an understanding of the role of discount policy in the over-all complex of monetary action.

So long as the tradition among member banks against borrowing from Reserve Banks exists, discount policy is likely to be of secondary importance to other instruments when economic events move so as to require a strongly expansionary policy. When the trend of economic forces calls for a restrictive monetary policy, however, discount policy has an important role to play and may become the most important instrument of the three. When inflationary forces are present and credit demands are strong, the discount mechanism provides an excellent device for supplying reserves to meet temporary and unusual needs. The reluctance of member banks to remain in debt to Reserve Banks means that the new reserves have a "string" on them, and they are more likely to be returned when the temporary or unusual need has passed. At the same time, open market purchases and/or reductions in reserve requirements can be used to supply the funds needed to support secular growth of the economy.

Discount policy, therefore, may be considered as a leading instrument of Federal Reserve policy when it is desirable to exert restraint or possibly when recessionary forces are mild. Throughout all stages of the cycle, however, discount policy and open market operations can and should be used as complementary instruments. In this respect, the instruments might be used in a manner similar to that developed in the 1920's. When contraction is desired, open market policy can be directed so as to force member banks to discount, which in turn would make them less willing to expand credit; and the discount rate could be moved up relative to market rates. When expansion is desired, the opposite technique would be used: securities could be bought in order to get member banks out of debt to the Reserve Banks, which in turn would promote more liberal lending policies. The advocacy of this technique is based on the generally accepted premise that member banks are more hesitant to expand loans and investments while in debt to the Federal Reserve. At the same time, the discount rate might be moved lower in relation to market rates. If market rates, in turn, moved lower still, a further reduction of the discount rate might be called for if business showed no signs of improvement.

The assumption that discount policy and open market operations are to be used as coordinated instruments implies that no separate set of criteria can be set up for changes in the discount rate alone. To be workable, any set of criteria must apply to monetary policy as a whole rather than the individual instruments of policy.

C. The Discount Rate and Market Rates

Two basic difficulties are confronted in any attempt to postulate a "normal" relationship between the discount rate and the market rates. The first refers to definition. What rate should be taken to represent market rates? The second difficulty arises from the fact that the "normal" relationship will vary with such things as business conditions, monetary policy, the relative supply of and demand for short- versus long-term funds, and so on.

The first difficulty we shall dispose of by selecting the yield on Treasury bills as the representative market rate. Although it is by no means a "representative" rate, the bill rate does possess the advantage of applying to short-term, open market paper on which there is no credit risk, and the Treasury bill is currently the most widely held money-market instrument. Furthermore, it is a sensitive rate and its level is closely related to tightness or ease in the money market. But, at the same time, this very sensitiveness gives rise to erratic fluctuations that limit its usefulness as a short-run guide to changes in discount rates, which ordinarily should not be changed with every temporary stringency or ease in the market.

The second difficulty is not so easily overcome. If the over-all forces of demand and supply are fairly well balanced so that no pressure toward tightening or loosening is being exerted by the market itself, and if Reserve policy is neutral in the strict sense of the term, one might anticipate that the bill rate would be closely related to the discount rate. If the market suddenly received funds (e.g., from an increase in float, net Treasury disbursements, etc.), the bill rate might fall below the discount rate; if the market were suddenly deprived of funds, the bill rate might rise above the discount rate.

If, however, the over-all demand for funds should increase, it would tend both to force up the bill rate and to increase the volume of discounting. The System must decide whether to supply additional funds on its own initiative or to permit the tightening to occur and, if so, how. Its decisions on these points will influence both the volume of discounting and the bill rate. In other words, neither market rates nor the volume of discounting--nor both--is an adequate independent guide to changes in the discount rate.

II. Can We Devise Specific Criteria for Changes in Discount Rates?

At the outset, it should be made clear that no one rule-of-thumb can serve as a guide to rate policy. The operational advantages of rules-of-thumb are tempting. It would be convenient if some simple, easy-to-follow guide--such as the reserve ratio, the volume of discounting, or the level of market rates--were available. But, as is so often the case, adoption of an automatic operating technique in one area merely transfers the basic necessity of using judgment to some other aspect of policy.

A. Criteria in the 1920's

In retrospect, it appears superficially that during most of the 1920's the rates on 90-day bankers' acceptances and four- to six-month open market commercial paper were the most important criteria of the level and changes in the discount rate. When these market rates moved sufficiently in either direction to touch the discount rate, the rate was changed to restore its position between the two market rates. Specifically, as the money market eased, the discount rate (Federal Reserve Bank of New York) was reduced when the commercial paper rate fell to the discount rate; and as the market tightened, the discount rate was increased when the bankers' acceptance rate rose to the discount rate. The rule worked so well that Reserve officials encouraged the market to place this interpretation on rate changes.[2/]

Once the market becomes habituated to following such objective criteria, deviations in practice will become the subject of widespread interest and concern. For example, the discount rate was not increased in the spring of 1929, when the rate on bankers' acceptances rose above it. The market soon interpreted this as a change in the rules and possibly as an indication--later confirmed--of disagreement within the System as to appropriate policy under the circumstances. Inability to anticipate all possible developments is, of course, one of the dangers of following mechanically any objective guides.

The fact that typically the discount rate was adjusted to market rates does not mean that System policy as a whole was directed by a rule-

2/ See, for example, W. R. Burgess: The Reserve Banks and the Money Market, 1927 edition, pp. 291-293.

of-thumb; nor does it imply that the System was passive in the money market. It meant merely that the change in the rate simply became, in a sense, the last link in a chain of actions. The sequence of actions is clearest if we lay aside at the outset such independent factors as gold and currency movements. If the System felt that expansion was proceeding too rapidly, it would "probe" the market through sales of Government securities. The withdrawal of funds would tend to tighten the market. Member banks would tend to become short of reserves and would borrow to replenish them. This shift in the source of funds would also tighten the market because of the tradition against rediscounting--a tradition that was fostered by the Reserve officials. The added pressure would be reflected in rising market rates. If in the process the rate on bankers' acceptances rose to the discount rate, the latter would be increased.[3] This process implies, in turn, that willingness to change the rate, when and if indicated, was reached some time before the change--namely, when the sale of securities was initiated.

An advantage of this process was that the System could experiment or probe with open market operations. Then, depending on subsequent business developments, it could renew the operation or reverse it, without "upsetting" the market. The change in rate as the last link in the process became, in a sense, a formal confirmation of a judgment expressed tentatively in the open market.

3/ The fact that the System's buying rate was the major determinant of the level of the market rate on acceptances supports the contention that the System was not passive in the money market. In raising its buying rate on acceptances, the System was in fact indicating a willingness subsequently to raise the discount rate.

In practice, of course, the mechanism was much more complicated primarily because discounts and Government securities are only two of several ways in which member banks may acquire reserves. Other means are changes in the other accounts of the Reserve Banks, such as Federal Reserve notes, gold holdings, nonreserve deposits, and float. Open market operations were adjusted to changes in these independent accounts in such a way as to increase the pressure or ease on the money market as a whole. For example, an opportune loss of gold could be utilized instead of sales of securities to probe the market; on the other hand, an inopportune receipt of gold would require larger sales of securities to put pressure on the market.

Experience in the 1920's holds important lessons for the 1950's. As recommended below, the coordinated use of open market operations and discount policy--the former being used to probe the market in advance of changes in the discount rate--would be a suitable procedure under present conditions. The specific guides to changes in the discount rate which proved so helpful in the 1920's can no longer be used, however. Open market commercial paper and bankers' acceptances are no longer as significant as formerly as money-market instruments, and no other instruments have entirely replaced them. For reasons noted in Section I. C, the rate on Treasury bills is not an appropriate criterion on a day-by-day basis. Compared with the 1920's, the Treasury bill resembles in a measure the call loan as an instrument utilized in adjusting bank reserves. Although not so erratic as the old call loan rate, which often varied several points in one day, the bill rate is still too unstable to use as a literal guide for day-by-day policy. It seems clear, on the other hand, that a tendency for the bill rate to remain above or below the discount rate for an extended period of time might indicate that a change in the discount rate is desirable. As was shown in Section I. C, however, the rate schedule existing in the market at any given time is itself partially a product of Federal Reserve policy, including open market policy, and therefore cannot serve as an independent guide for setting the discount rate.

B. Recommended Procedures

The fact that market rates do not provide specific criteria for discount action does not mean that we cannot make some generalizations concerning the timing of changes in the discount rate. This is most easily accomplished by discussing the use of the discount mechanism when Federal Reserve policy in general is designed to be (1) moderately expansionary, (2) strongly expansionary, (3) moderately restrictive, (4) heavily restrictive.

1. A moderately expansionary policy. In practice, decisions of Reserve authorities to reverse or to strengthen policies come gradually. Thus the inauguration of a policy of mild expansion is likely to be merely the reflection of a tentative judgment which may be confirmed later. As a consequence, it might be appropriate to probe the market initially with open market purchases before relaxing discount rate. Then, if the judgment proves to be erroneous, policy can be reversed before a change in the rate--which is always somewhat dramatic--is ordered. Furthermore, open market policy may be successful in correcting the situation without reliance on discount policy. If the judgment proves correct, on the other hand, the discount rate can be lowered as the final step in the chain of events.

At times the need for prompt expansionary action may be clear-cut. If so, a good case can be made for lowering the discount rate concurrently with open market purchases. Simultaneous action is recommended because of the member bank tradition against discounting. It was observed earlier that this tradition, although useful when restrictive policies are in order, reduces the effectiveness of discount policy when expansion is desired. When recessionary forces are dominant, a prompt lowering of the discount rate may tend to offset the tradition against discounting to a certain extent.[4/]

2. A strongly expansionary policy. When economic events call for strong measures to promote expansion, the problem of specific criteria for rate changes should be negligible. Swift and decisive relaxation of all controls will be justified. Reductions in reserve requirements and purchases of securities in the open market might serve to ease conditions, and a sharp downward movement in the discount rate would tend to reduce the reluctance of member banks to borrow.

In short, strong measures will be necessary to prevent banks from dumping assets in their efforts to obtain liquidity. Since the Federal Reserve Banks have sufficient power to supply the liquidity, the problem

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4/ This discussion raises the question as to whether it is to the long-run interests of the System to foster the tradition. Many students of central banking believe that the System has greater power to curtail than to promote expansion. Accepting this belief for purposes of discussion, it would appear that the tradition adds to the System's power to restrict but subtracts from its power to expand. It, therefore, adds to the System's powers when they are already strong and subtracts from them when they are already weak. In addition, the policing activities carried on to limit expansion are likely to be remembered most vividly, particularly by smaller banks, when expansion is desired. There is always the discount rate as a price to fall back on when use of the privilege becomes excessive. If the discount mechanism is to be a two-way street, thought should be given to the long-run effects of unduly discouraging its use through direct action during periods of expansion.

is primarily one of getting the funds to the places where they are needed as soon as possible. The discount mechanism, if properly handled, can be very useful in this respect--provided that the tradition against borrowing can be overcome.

It is clear that under conditions such as these the volume of discounting as such will be an unsatisfactory guide to rate changes. Because of the tradition against borrowing, a major purpose of heavy open market purchases is to reduce member bank indebtedness to the Reserve Banks. The volume of discounting may fall so low that further changes will be insignificant, but further lowering of rates may well be in order if the forces of deflation continue.

3. A moderately restrictive policy. The problem of setting up criteria for discount policy becomes most interesting--and most perplexing--when restrictive policies are called for. Here, however, the tradition against discounting--so long as it lasts--will facilitate control and can be utilized effectively in preventing excessive expansion of member bank credit.

When contemporary events require a slightly restrictive policy, open market operations should first be used to probe the market. Initial action of this type may be sufficient and thereby avert the need for a change in the discount rate. If demand for reserves is very strong, however, member banks are likely to come to the discount window for accommodation. At the same time, market rates on short-term Government securities are likely to rise. Under these circumstances, Reserve authorities should especially watch the volume of discounting. A rapidly rising volume, accompanied by increasing market rates, would seem to be sufficient indication for an increase in the discount rate.

This is not meant to imply, however, that the volume of discounting is itself the basic criterion for changes in the discount rate. The increase in the volume of member bank borrowing, in the situation just described, is merely the confirmation of a decision made earlier to restrict credit expansion, provided that the judgment leading to the decision is confirmed in the market.[5/] The point should be re-emphasized that the basic criteria are the economic events which lead to the adoption of a restrictive policy in the first place. The volume of discounting serves only as a procedural device--something which aids in decisions concerning the timing and extent of rate increases after the authorities have decided that increases may be in order.

Since there is nothing inviolate about the procedure of first probing the market before changing the discount rate, it would be unwise to lead the market to believe that Reserve authorities will always use this procedure. This is especially important because an increase in the discount rate may be wise policy at times when the volume of discounting is stationary or even falling.

4. <u>A heavily restrictive policy</u>. During a period of high-level business activity when inflationary forces are very strong, a heavily restrictive program may be in order. If a situation of this type follows a

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5/ Still a further indication that a rise in discount rate might be advisable would be the growing complexity of the policing problem. It was pointed out earlier that the lower the discount rate relative to market rates, the more difficult the policing problem becomes.

period of mild restriction, the proper policy might involve a tightening of controls all along the line. Open market policy might be more aggressive and the discount rate might be raised, both at the same time. If the economic situation shows signs of turning into a runaway, however, a sudden and relatively large increase in discount rates may serve a useful purpose.

Many more situations could be analyzed. Enough has been said, however, to indicate that ultimately discount policy must be empirical and based on the judgment of responsible and intelligent men rather than on a widely recognized rule-of-thumb. The extent and timing of each action--whether in regard to the discount rate, open market policy, or reserve requirements--should be guided not so much by the behavior of individual indicators as by an appraisal of the over-all economic situation.

III. Should Criteria for Changes in the Discount Rate Be Known By the Market?

Even if criteria for rate changes could be enumerated precisely, there is a serious question as to whether the market should be informed of the guides and the intention of Reserve authorities to follow them. Of course, one advantage of public disclosure of broad criteria to be followed would be a reduction of uncertainty in the market concerning movements in interest rates, bank credit, and possibly other economic quantities. This reduction of uncertainty might in turn be conducive to greater economic stability. In addition, disclosure of criteria for policy actions might be justified on the grounds that it would indicate a desire on the part of Reserve authorities to "play fair" with the market.

But the disadvantages are even more compelling. In the first place, it should be clear from the discussion presented above that any set of criteria will have to be in rather general terms if it is to be universally applicable throughout the stages of the business cycle. This necessary generality would no doubt reduce the effectiveness of public knowledge of the criteria, and there is some question as to whether information so general in nature would reduce uncertainty.

In the second place, and much more important, is the fact that once the criteria have been disclosed the authorities will always run the risk of becoming caught in a situation where they will have to break faith with the market. Once this happens, the difficulties of administration of effective monetary policy will be multiplied. This risk outweighs the advantages which might accrue from disclosure of the criteria.

On the other hand, it is clear that the market should not be wholly uninformed concerning the objectives--both short- and long-run--of contemporary Federal Reserve policy. The long-run purpose of the System, as stated by Chairman Martin in his reply to the Patman Questionnaire, is "to minimize economic fluctuations caused by irregularities in the flow of money and credit, foster more stable values, and thus make possible the smooth functioning of monetary machinery so necessary to growth of the country and to improve standards of living."

Simply stated, the short-run objective of the Federal Reserve System is to further the attainment of the long-run purpose by exerting varying degrees of pressure on the credit market. As was pointed out earlier, the degree of restraint or ease that is exercised will vary with economic conditions. The public should be informed of the short-run objective--i.e., whether the System is attempting to tighten, ease, or remain neutral. But the procedures that will be used are solely a matter of circumstance and will vary as the situation changes, and can be fully rationalized after the event has taken place. There is danger that a promise to follow a given procedure will by inference elevate that procedure into the objective.

It would seem to follow that public information concerning criteria for changes in the discount rate should be in terms of objectives rather than procedures.

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III. COMPARISON OF HISTORICAL CHANGES IN THE DISCOUNT RATE WITH CHANGES IN MARKET INTEREST RATES

This memorandum presents statistics relating to (1) the timing and (2) the degree of past changes in the discount rate in relation to changes in market interest rates.

Timing of Changes in the Discount and Selected Money Market Rates

Changes in the most sensitive money market rate have with only two exceptions preceded changes in the discount rate, as shown on Table 1, which compares changes in the discount rate with similar movements in the prevailing rate on 90-day bankers' acceptances prior to 1934 and the rate on three-month Treasury bills thereafter. The money market rate change has generally occurred from 1 to 8 months prior to the discount rate change; this period was somewhat shorter in periods when the discount rate was lowered rather than when it was raised. The only cases in which a change in the discount rate led a change in money market rates occurred in 1942 and 1946 when a preferential discount rate on advances secured by short-term Government securities was first adopted early in World War II and then removed after the War.

Following a discount rate change, short-term as well as long-term market rates have generally moved somewhat further in the same direction. This does not imply, of course, that a change in the discount rate caused a change in other interest rates. All rates may have moved in response to independent forces.

Table 2 shows that during the past 30 years both the commercial paper rate and the yield on Moody's Aaa corporate bonds have moved after the discount rate change with considerable regularity upward or downward with the discount rate. The similarity of movement is particularly striking in the case of the commercial paper rate; in no case did this rate move in the opposite direction and in only three instances did it remain unchanged when there was a change in the discount rate. The yield on corporate Aaa bonds also followed the discount rate whenever the rate declined and in most of the cases in which it increased. The divergencies in movement between the discount rate and the bond yield occurred for the most part in the period 1925-28, when long-term interest rates were tending downward.

As was pointed out earlier, a change in market short-term rates has generally preceded a change in the discount rate. Since changes in market short-term and long-term rates are quite closely correlated, this means that some change in long-term rates also usually preceded a change in the discount rate.

Degree of Change in the Discount Rate and Market Interest Rates

Generally speaking, the relative changes in the discount rate have been greater than the relative changes in market rates. Each discount rate action has usually increased or decreased the rate by from 10-25 per cent. Commercial paper rate changes following the discount rate change have usually been somewhat smaller than the discount rate change but more nearly comparable to it than changes in the yield on Aaa bonds. For the latter, the relative changes either upward or downward have been small--usually less than 5 per cent. This is to be expected in view of the smaller range of fluctuation of long-term as contrasted to short-term rates. Moreover, in view of the differing maturities of long-term and short-term securities, a specific percentage change in the yield of a long-term security means a much greater percentage change in its price than the same percentage change in the yield of a short-term security.

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Table 1

Comparison of the Timing of Changes in the Discount and Money Market Rates

(The money market rate prior to 1934 is the bankers' acceptance rate and thereafter the Treasury bill rate.)

A. Cases in which discount rate was raised

Date of change in F. R. discount rate (N. Y.)	Cases in which discount rate change:	
	Led money market rate by:	Lagged money market rate by:
1919 - Nov. 3) 1920 - Jan. 23) June 1)		1 month
1923 - Feb. 23		5 months
1925 - Feb. 27		7 months
1926 - Jan. 8		8 months
1926 - Aug. 13		3 months
1928 - Feb. 3) May 18) July 13) 1929 - Aug. 9)		4 months
1931 - Oct. 9) Oct. 16)		Less than 1 month
1933 - Mar. 3		Less than 1 month
1946 - Apr. 25	Less than 1 month 1/	Less than 1 month
1948 - Jan. 12) Aug. 13)		6 months
1950 - Aug. 21		7 months
1953 - Jan. 16		3 months

1/ Preferential discount rate on advances secured by short-term Government securities.

Note. Successive discount rate changes in the same direction within a relatively short period of time have been grouped, and the lead or lag shown in the table computed from the date of the first discount rate change in the group.

Table 1 - Continued

Comparison of the Timing of Changes in the Discount and Money Market Rates

(The money market rate prior to 1934 is the bankers' acceptance rate and thereafter the Treasury bill rate.)

B. Cases in which discount rate was lowered

Date of change in F. R. discount rate (N. Y.)	Cases in which discount rate change:	
	Led money market rate by:	Lagged money market rate by:
1921 - May 5) June 16) July 21) Sept. 22) Nov. 3) 1922 - June 22)		4 months
1924 - May 1) June 12) Aug. 8)		2 months
1926 - Apr. 23		3 months
1927 - Aug. 5		1 month
1929 - Nov. 1) Nov. 15) 1930 - Feb. 7) Mar. 14) May 2) June 20) Dec. 24) 1931 - May 8)		4 months
1932 - Feb. 26) June 24)		2 months
1933 - Apr. 7) May 26) Oct. 20)		1 month
1934 - Feb. 2		Less than 1 month
1937 - Aug. 27		4 months
1942 - Oct. 30	Less than 1 month[1]	

For footnote see preceding page.

Table 2

Comparison of Relative Changes in the Discount Rate with Similar Changes in the Commercial Paper Rate and Moody's Aaa Bond Yields

A. Cases in which discount rate was raised

Federal Reserve discount rate		Percentage change (within period of approximately 3 months after discount rate change) in--	
Date of change	Percentage change	Commercial paper rate	Moody's Corporate Aaa bond yield
1919 - Nov. 3	+ 19	+ 14	+ 4
1920 - Jan. 23	+ 26	+ 15	+ 5
June 1	+ 17	+ 10	+ 1
1923 - Feb. 23	+ 13	+ 20	+ 4
1925 - Feb. 27	+ 17	+ 10	- 2
1926 - Jan. 8	+ 14	0	- 2
Aug. 13	+ 14	+ 16	0
1928 - Feb. 3	+ 14	+ 10	0
May 18	+ 13	+ 8	+ 3
July 13	+ 11	+ 19	2/ + 1
1929 - Aug. 9	+ 20	+ 11	2/ + *
1931 - Oct. 9, 16	1/ +133	2/ + 100	+ 17
1933 - Mar. 3	+ 40	2/ + 117	2/ + 7
1946 - Apr. 25	+100	+ 3	+ 1
1948 - Jan. 12	+ 25	+ 16	- 1
Aug. 13	+ 20	+ 13	+ 1
1950 - Aug. 21	+ 17	+ 32	+ 2
1953 - Jan. 16	+ 14	+ 3	+ 5

* Change amounted to less than 0.5 of 1 per cent.

1/ Covers several successive discount rate changes, as indicated. The total change in the rate is expressed as a percentage of the discount rate prior to the first change.

2/ Change within period of approximately one month after the last discount rate change.

Table 2 - Continued

Comparison of Relative Changes in the Discount Rate with Similar Changes in the Commercial Paper Rate and Moody's Aaa Bond Yields

B. Cases in which discount rate was lowered

Federal Reserve discount rate		Percentage change (within period of approximately 3 months after discount rate change) in--	
Date of change	Percentage change	Commercial paper rate	Moody's Corporate Aaa bond yield
1921 - May 5) June 16) July 21)	1/ - 21	2/ - 20	2/ - 1
Sept. 22	- 9	- 10	- 7
Nov. 3	- 10	- 11	- 6
1922 - June 22	- 11	- 6	- 3
1924 - May 1) June 12)	1/ - 22	2/ - 24	2/ - 3
Aug. 8	- 14	- 4	- 1
1926 - Apr. 23	- 13	- 9	- 1
1927 - Aug. 5	- 13	- 6	- 2
1929 - Nov. 1) Nov. 15)	1/ - 25	- 22	- 2
1930 - Feb. 7) Mar. 14)	1/ - 22	- 23	- 1
May 2) June 20)	1/ - 29	- 20	- 4
Dec. 24	- 20	- 13	- 3
1931 - May 8	- 25	- 16	- 1
1932 - Feb. 26	- 14	- 10	- 1
June 24	- 17	- 28	- 8
1933 - Apr. 7) May 26)	1/ - 17	- 46	- 7
Oct. 20	- 20	2/ - 9	- *
1934 - Feb. 2	- 25	- 33	- 6
1937 - Aug. 27	- 33	0	- *
1942 - Oct. 30	- 50	0	- *

For footnotes see preceding page.

IV. DIFFERENTIALS IN DISCOUNT RATES AMONG FEDERAL RESERVE DISTRICTS[1]

For more than a decade there have been no differences of more than a few days duration among the discount rates established (under sections 13 and 13a of the Federal Reserve Act) by the various Federal Reserve Banks. The differences which persisted through the decade of the 'thirties appear to have mainly reflected inertia at a time when general cheap money conditions had rendered the discount mechanism largely dormant. It has thus been a long time since the System has had to face the question of developing purposeful criteria for establishing differentials among the discount rates of the various Federal Reserve Banks. Moreover, much that has happened in the development of wartime and postwar financing methods has appreciably furthered the integration of various regional credit markets into a functioning nationwide credit system. The changes have been so profound, both in narrowing regional differences in credit conditions and in discrediting the early reliance upon qualitative differences in types of discounted paper, that few analogies remain to suggest bases on which differentials in discount rates might again emerge.

Nonetheless, at a time when the System is again exploring possibilities for strengthening the use of the discount mechanism as an instrument of credit control, it is important to examine the possible contribution that differences in discount rates could make toward

1/ This memorandum represents the writer's attempt to reflect a wide variety of views expressed by various members of the research committee engaged in studying the discount mechanism. It is not intended to present the writer's personal views.

improving the sensitiveness of credit control to varying economic and credit conditions. It must be recognized from the beginning that the discount mechanism is itself one of the most important tools of national monetary and credit control. Consequently, the underlying principles of discount rate action are likely to be broadly similar in all of the Federal Reserve districts. However, the Federal Reserve Act does contemplate the independent setting of discount rates for each Federal Reserve Bank, subject to the over-all review and determination of the Board of Governors; that leaves open the possibility that differences may exist, and persist, among the discount rates of the various Federal Reserve Banks. While such differences, if they should develop, would have to be conditioned by the over-all considerations growing out of the national monetary policy, there may be room within the over-all framework of System discount policy for differentials that could give credit control a closer and more direct effectiveness within the circumstances characteristic of individual Reserve districts.

So long as many questions of national policy concerning the discount rate mechanism remain undecided, the scope for differentials among the discount rates of various Federal Reserve districts cannot be marked out with assurance. Without attempting to suggest firm conclusions, however, three broad grounds for possible differentials seem likely to deserve consideration in the future. One would be to provide for a step-by-step approach toward a nationwide change in the discount rate, with initial exploratory rate increases undertaken by those districts in which the Reserve Bank directors are most firmly convinced, in the light of their own local conditions, that some change in the discount rate is necessary. A second ground for differentials would arise when a district or districts encountered special problems, perhaps reflected in the difficulty of "policing" member bank borrowing requests, that justified temporary deviations from the national policy. A third basis for differentials might be found in regional balance of payments problems, either of a short-run or longer-run nature, which a higher or lower discount rate in a given district might help to correct.

Proceeding by Stages toward a Nationwide Change in the Discount Rate

As a further refinement of the probing through open market operations that often precedes a change in the discount rate, it might be possible to raise the rate experimentally in one or two districts in advance of a Systemwide increase in the rate. Such an approach might be considered at a time when some further warning of a need for caution seemed desirable, but when the over-all credit situation had not yet fully crystallized to show a clear basis for a nationwide advance in the discount rate. Perhaps an experimental increase might be made in one or two districts where inflationary pressures seemed considerably stronger, and where the Reserve Bank directors were more firmly convinced of the need for immediate action. Should such warning steps prove sufficient, and should no need for further action appear, the discount rates of these districts might subsequently be lowered.

The direct effects of a local tightening through an increase in the discount rate would come about partly through increasing the actual cost of member bank borrowing in the affected districts, but it would also be reinforced as the relatively high discount rate led local banks to rely to a greater extent upon borrowing from banks in other districts, or upon sales of short-term securities in the national money market. These direct effects would be greater, of course, if the member banks in the districts with higher discount rates were already heavily in debt, and if their portfolios of marketable short-term Government securities had already been drawn down close to the prudent minimum. Raising the discount rate in one or two districts would also exert a further effect, however, upon all banks throughout the country by creating an expectation that the discount rates of other Reserve Banks might soon follow.

It is possible, too, though perhaps less likely, that nationwide reductions in the discount rate might at times be desirably initiated in this step-by-step manner. If disturbing economic developments were localized within one or a few Federal Reserve districts, the encouragement given to member bank borrowing by a decisive reduction in the discount rate of the districts involved might help to prevent a spreading of the initial disturbing influences throughout the remainder of the economy. Or there might be occasions when, without the occurrence of dramatic episodes, the System wished to move cautiously in the direction of a slight easing in the national monetary policy. An exploratory reduction in discount rates by those districts whose Reserve Bank directors felt most inclined to move in the direction of ease might serve some purpose under such circumstances.

The judgment rendered in specific instances must find a balance between the considerations favoring use of the step-by-step approach, and a recognition of the inherent implications of the existence of a national credit market, such as has been developing over the lifetime of the Federal Reserve System. In so far as discount rate action is taken in stages with a view to exerting a nationwide influence upon the psychology of the banks, the existence of the nationwide credit market presents no barrier. But in so far as the direct effects of a higher discount rate upon the affected banks are concerned, they might under some circumstances be largely negatived if these banks were, as a matter of course, accomplishing needed reserve adjustments through transactions in the short-term Government security market. Of course, some banks might have relatively small portfolios of short-term Government securities; other banks might reach such a position if they unloaded short-term Governments over a long period in order to avoid borrowing from their own Reserve Bank at the higher discount rate. In effect, then, the measure of local tightness likely to be directly achieved through a higher district discount rate will be conditioned by the portfolio positions of the banks in that district.

The existence of a nationwide market in short-term Government securities thus serves to limit, to the extent that banks customarily rely upon it for reserve adjustments, the local impact of a regional change in discount rate. Unless a higher discount rate in one district could be expected to produce a corresponding increase in shorter-term interest rates in the national money market, the effect of a higher regional discount rate would be confined to those banks which were marginally dependent upon borrowing, and had not adjusted their affairs sufficiently to enable them to meet their expected reserve adjustment needs through transactions in the national market for Treasury bills or related instruments. For the banks equipped to meet their needs through the national market in Treasury bills, a rise in the discount rate of their own Federal Reserve Bank would be limited to its symbolic significance -- any effective marginal restraining influence for these banks would be that exerted through increases in Treasury bill (or related) yields in the national market. Thus, if market conditions are such that the banks rely upon adjustments through Treasury bills and related instruments, and so have little occasion for dependence upon borrowing, the scope for local effectiveness of regional discount rates would seem, by implication, to be narrowed.

Special District Problems Justifying Temporary Deviations from National Policy

While it may be generally agreed that some surveillance of member bank borrowing will always be necessary on the part of each Federal Reserve Bank, the difficulties encountered in exercising that surveillance in an equitable and impartial manner may vary among districts depending upon the intensity of local credit demand. In keeping with the general principle that credit control should rely, so far as possible, upon the impersonal workings of the price mechanism, some districts may find at times that they could reduce the burden and difficulty of "policing" their borrowings by imposing instead a higher discount rate. Judgment of such a need would depend, of course, upon the experience of the individual Reserve Bank concerned, and upon its conviction that a change in its discount rate (within whatever range would be considered a practical possibility) could materially alter the complexity of the "policing" problem. In appraising whether or not its "policing" program is working satisfactorily, the individual Reserve Bank would probably also wish to take into account the intangible advantages of the special kind of restraining influence that is exerted upon banks when they are in debt, and subject to surveillance. Such considerations might have little weight, however, if the System should have determined that such intangible aids to the fulfillment of credit policy objectives are not worthwhile.

If a Reserve Bank should decide, on the basis of the types of "policing" difficulties being encountered, that it would like to experiment with the effectiveness of a higher discount rate, the principle of regional administration of the discount mechanism (as embedded in the Federal Reserve Act) would suggest that the individual Reserve Bank should be permitted to make the experiment. The Board of Governors, on the other hand, in deciding whether or not to approve the recommended increase, would also have to take into account the possible nationwide repercussions upon banking psychology of the change in a given district. The basis for approving the change might be relatively simple, however, if such action should also coincide with a general desire to take initial, experimental steps toward further tightening in the national discount rate, as described above.

Regional Balance of Payments Problems

An important segment of the classical theory of central bank discount rate action concerned the need to raise or lower the discount rate as a means of correcting balance of payments difficulties. A nation losing reserves was expected to raise its discount rate in order to attract funds; a nation gaining reserves was expected to lower its rate, and thus through a resulting general decline of other money market rates discouraged a further inflow of capital and help to reduce the "unbalance" in its balance of payments. While the classical theory sometimes ran aground, in attempting to reconcile these principles of international adjustment with the domestic need for economic stability (as witness the System's own experience in 1931), there were nonetheless many times when appropriate discount rate action exerted a helpful corrective influence upon balance of payments maladjustments. There may be some analogous grounds for considering discount rate differentials among the Federal Reserve Banks.

Two broad classes of possibilities exist in which there may at times be a place for differential discount rates as one of the appropriate means of helping to smooth out regional economic differences reflected in inter-regional balances of payments and the flow of funds. One would be longer-run structural differences, as between a region that has remained relatively depressed over a long period and the rest of the country. The other possibility relates to the temporary emergence in a given district of depressed, or unusually stimulated, economic activity -- which may have its counterpart in a temporary outflow of funds to the rest of the country, or a temporary inflow from the rest of the country.

Sustained Structural Differences

One district, or group of districts, might be lagging considerably behind the economic growth of the remainder of the country, and as a consequence might be steadily losing funds on capital account to the rest of the country. In such circumstances, under the classical theory of the international central bank discount mechanism, the affected district might wish to increase its discount rate in an effort to check the persistent drain on its funds. It might be objected by some within the district that such action, in so far as it tended to make money more costly within the district than elsewhere in the country, might exert unwanted effects, perhaps dampening the prospects for further local development. Such critics might suggest, instead, that a lower rather than a higher discount rate was appropriate in relation to the remainder of the country. Such conflicting judgments cannot be reconciled in any generalized theory of regional behavior, any more than they can be reconciled in the classical theory of central bank discount rate action. The reconciliation, leading to a choice of one course or the other, has always depended upon a detailed analysis of the circumstances prevailing in the individual case. However, to mention these conflicting prescriptions is not to deny that a case may at times exist for a differential discount rate in order to help correct an outward flow of funds from a relatively depressed economic area.

If in the actual circumstances of a given case there is general agreement within a district that individual action affecting its own discount rate could prove helpful, it is important to keep open the opportunity for such independent action! Because of the opportunities for conflicting interpretation of the need, however, it would seem essential that a district embarking on such action should do so only when the case is definite and clear. One further technical difficulty that would have to be considered is the fact that interest rates in a Federal Reserve district, quite unlike the interest rates in a given nation under the classical theory, do not move up and down sympathetically with independent changes in the district's discount rate. Owing partly to the pervasive influence of the existing nationwide market for short-term credit instruments, a regional discount rate may have relatively little effect in changing the interest rates at which market lending and investing decisions are taking place. Perhaps the direct path of influence in the case of a regional increase in the discount rate, for example, is likely to be through discouraging member bank borrowing, and thus encouraging member banks to obtain needed funds from others by paying slightly higher rates. How widespread and effective this influence might be in checking or offsetting an outward drain of funds would depend in part, at least, upon the extent to which member banks in that district were actively borrowing. If the district were suffering sustained depression, that volume of borrowing might be less than sufficient to produce the effects envisaged by the classical theory.

At the other extreme, a given district or region might be in the throes of a sustained developmental boom, fed in considerably part by a continuing expansion in local bank credit. If the local Reserve

Bank decided that this boom had reached, or threatened to reach, dangerous proportions, it might want to consider specific local action aimed at slackening the tempo of credit expansion by local banks. In such circumstances, a strict reading of the classical doctrine might suggest that it should raise its discount rate in order to check this expansion and force the investment boom to proceed, if at all, on the basis of savings drawn from local and outside sources.

Decision to raise the local discount rate would not necessarily reflect lack of concern over a speculative boom based on an inflow of funds from outside, but would imply somewhat greater emphasis upon the need to sound a note of caution with respect to the rate at which local bank credit was flowing into expansion projects, and to limit the direct access of local banks to Federal Reserve credit. Again in this situation, as in that of a depressed region, the impact of any independent discount rate action might be somewhat diffused because of the close interrelations between the money market instruments used in that district and those in the national money market. However, even after taking all of these factors into consideration, the directors of the given Federal Reserve Bank might find that independent action with respect to the discount rate would serve a helpful purpose. If no harmful consequences would be likely to result in terms of the national monetary and credit policy, a case would then exist for separate discount rate action in this district.

Temporary Balance of Payments Problems

In contrast with the conditions that might justify sustained differentials for balance of payments reasons over a period of many months, or perhaps years, there may also be short-run developments that give rise to particular local problems. In years past, depressed conditions in agriculture might have justified independent action to assist banks in carrying the credit needs of farmers. While such needs might still arise, the growing diversification that has taken place within all Federal Reserve districts over the past two decades makes it difficult to classify very many districts any longer as primarily agricultural in character. Nonetheless, should there be a particularly bad year for crops or livestock in one or more districts, and should the related problems become of dominant importance in the economy of the given districts, some special discount rate action might be one of the appropriate methods used to ease the strain. Conversely, in years of unusual agricultural surpluses, there might be an overriding need for special credit accommodation, provided any action taken with respect to the discount rate could be made consistent with the prevailing national policy concerning the appropriateness of facilitating borrowing by the member banks.

Agriculture offers only one illustration; there can be many others. In general, these temporary circumstances producing dangerous local booms, or local depression, could justify independent action in one or more Federal Reserve districts so long as it was clear that the restraint or inducement exerted by the discount rate action could produce tangible results in the local circumstances. The need here is not for a detailed delineation of cases, but merely for a recognition of the possibility that reasons for considering separate action might arise.

Conclusions

This memorandum has not attempted to develop a case for, nor a case against, the use of discount rate differentials by the various Federal Reserve Banks. Instead, it has proceeded from a recognition of the need to study all possibilities for further development of the discount mechanism as a flexible and adaptable instrument, in meeting not only the national needs for credit control, but also the differences among local situations that may arise from time to time. The need to rely upon the discount mechanism as an instrument of national policy will always necessarily impose some limitations upon the extent to which individual districts may experiment with differentials intended to meet unique local situations. Moreover, the further integration of various regions into a national credit market, at least for the marketable short-term instruments of credit, has greatly changed the environment within which individual Reserve Bank discount rate action can take place, in contrast with the environment of even twenty or thirty years ago. Also, the growing diversification as among industry and agriculture throughout the nation has also tended to remove the basis for differentials which existed when System policy could effectively distinguish between the predominantly agricultural and the predominantly industrial sections of the country.

These developments change the context within which differential discount rates may be developed. They also indicate a need for reliance upon somewhat different criteria in establishing differentials from those used in the 'twenties. They do not indicate, however, that the regional administration of the discount rate and the discount mechanism has become an historical anachronism. Within the three broad areas surveyed in this memorandum, the directors of individual Federal Reserve Banks may still, from time to time, find a justifiable basis for establishing different discount rates in their own districts from those prevailing elsewhere. These bases for establishing differentials are sufficiently different, and the environment within which they will work has sufficiently changed, however, to suggest that any action to be taken will have to depend upon extensive study of the new ground and the specific conditions of the given case. It will not be possible to rely upon the precedents of the 'twenties. This is now a frontier calling for cautious exploration.

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V. APPROPRIATE AND INAPPROPRIATE USES OF RESERVE BANK CREDIT

During the past 2 years member bank borrowing from Federal Reserve Banks has increased substantially, as the availability of reserves derived from open market operations has been restricted relative to the demand for reserve funds. Furthermore, as market prices of Government securities have declined, numerous member banks have been inclined to make short-term adjustments in their reserve accounts through the use of discounts and advances, rather than selling Government securities at prices involving a principal loss. In brief, since the Federal Reserve-Treasury accord, in carrying out a moderately restrictive credit policy, the System has not provided member banks with an amount of reserves through its own initiative that the market has judged as adequate to meet its requirements. This development - i.e., the revival of the use of the discount process - has raised problems which justify a re-examination of some of the basic principles underlying the use of Reserve Bank credit.

The Federal Reserve Act places upon the directors and officers of the Reserve Banks responsibility for the extension of Reserve Bank credit to member banks through discounts and advances. The Act charges the Board of Directors of each Reserve Bank to "administer the affairs of said bank fairly and impartially and without discrimination in favor of or against any member bank or banks."1/ In other words, the management of each Reserve Bank must administer its affairs, including the extension of its credit to member banks, in a consistent and impartial

1/ Federal Reserve Act, Section 4, paragraph 8.

manner with respect to all member banks that seek Reserve Bank credit under the same set of conditions or for the same general purposes. Uses of Reserve Bank credit that are considered appropriate (or inappropriate) in the case of one member bank also must be so considered in the case of any other member bank.

Fair and impartial administration of Reserve Bank credit extension requires not only that the officers and directors of the Reserve Banks be in possession of adequate quantitative and qualitative information regarding discounts and advances but also that they observe consistent policies with respect to appropriate and inappropriate uses of Reserve Bank credit. The Federal Reserve Act, recognizing the need for adequate information as an aid to policy determination, directs the management of each Reserve Bank to "keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions; and, in determining whether to grant or refuse advances, rediscounts or other credit accommodations, the Federal Reserve Bank shall give consideration to such information."2/

The mere fact that the demand for Reserve Bank credit by member banks is strong or has increased sharply may not in itself be a reflection of an excessive or improper use of Reserve Bank credit; such a development may indicate merely a credit demand that is consistent with high-level or expanding production, employment, and incomes. Moreover, it may involve uses of Reserve Bank credit that are consistent with a

2/ Federal Reserve Act, Section 4, paragraph 8.

reasonable interpretation of appropriate uses of Reserve Bank credit. There have been occasions in the past, however, when the demand for credit was strong, when member banks have sought Reserve Bank credit for purposes not consistent with the spirit of the Federal Reserve Act or with sound principles of central banking. Since such occasions undoubtedly will recur, the directors and officers of the Reserve Banks must be in a position to determine whether the purposes for which member banks seek Reserve Bank credit will be appropriate or inappropriate uses of such credit.

Neither the Federal Reserve Act nor Regulation A of the Board of Governors, relating to discounts for and advances to member banks, defines explicitly and exclusively the meaning of "appropriate uses" of Reserve Bank credit borrowed by member banks. This failure to be specific, however, is not surprising because legislation and official interpretations of legislation rarely spell out in a specific manner the full meaning, intent, and applicability of the legislation. The Federal Reserve Act, however, does set forth certain general principles as guides to the administration of Reserve Bank credit. In addition, regulations, rulings, and official statements of the Board of Governors have reiterated and clarified those principles.

The Federal Reserve Act states that the Board of Directors of each Federal Reserve Bank may "extend to each member bank such discounts, advancements, and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks, the maintenance of sound credit conditions, and the accommodation of commerce, industry, and agriculture."3/ Regulation A of the Board of

3/ Federal Reserve Act, Section 4, paragraph 8.

Governors paraphrases this general principle and adds, "The guiding principle underlying the discount policy of the Federal Reserve Banks is the advancement of the public interest."4/

In discussing guides to credit policy as early as 1923, the Board of Governors stated:

> "The Federal Reserve Act has laid down as the broad principle for the guidance of the Federal Reserve banks and of the Federal Reserve Board in the discharge of their functions with respect to the administration of the credit facilities of the Federal Reserve Banks the principle of 'accommodating commerce and business.' . . . further guides are to be found in Section 13 of the Federal Reserve Act, where the purposes for which Federal Reserve credit may be provided are described as 'agricultural, industrial, or commercial purposes.' It is clear that the accommodation of commerce and business contemplated as providing the proper occasion for the use of the credit facilities of the Federal Reserve banks means the accommodation of agriculture, industry, and trade. The extension of credit /against paper/ for purposes 'covering merely investments or issued or drawn for the purpose of carrying on trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States,' is not permitted by the Federal Reserve Act. The Federal Reserve System is a system of productive credit. It is not a system of credit for either investment or speculative purposes. Credit in the service of agriculture, industry, and trade may be described comprehensively as credit for productive use. The exclusion of the use of Federal Reserve credit for speculative and investment purposes and its limitation to agricultural, industrial, or commercial purposes thus clearly indicates the nature of the tests which are appropriate as guides in the extension of Federal Reserve credit."5/

The productive character of the intended use of Reserve Bank credit also is indicated in Regulation A, where, in discussing the eligibility of paper for rediscount, it is stated "which has been issued or drawn, or the proceeds of which have been used or are to be used, in producing, purchasing, carrying or marketing goods in one or more of the steps of the process of production, manufacture, or distribution,

4/ Regulation A, Statement of general principles, Board of Governors of the Federal Reserve System, October 1, 1937, revision.
5/ "Tenth Annual Report of the Federal Reserve Board," 1923, page 33.

or in meeting current operating expenses of a commercial, agricultural, or industrial business, or for the purpose of carrying or trading in direct obligations of the United States . . ."6/

On March 2, 1951, the Federal Open Market Committee directed its Executive Committee "to arrange for such transactions for the System Open Market Account . . . as may be necessary, in the light of current and prospective economic conditions and the general credit situation of the country, with a view to exercising restraint upon inflationary developments, to maintaining orderly conditions in the Government security market, to relating the supply of funds in the market to the needs of commerce and business . . ."7/ This directive, which was repeated during the remainder of the year and in 1952, also reflects the basic characteristic that appropriate uses of Reserve Bank credit are intimately and directly associated with the requirements of the productive economy; only the concept of maintaining orderly conditions in the Government security market is added. Later in 1953, the phrase "correcting disorderly conditions" was substituted for the phrase "maintaining orderly conditions."

The responsibility assumed by the Federal Reserve System to correct disorderly conditions in the Government security market, however, does not alter the concept of appropriate uses of Reserve Bank credit borrowed by member banks. Within the Federal Reserve the initiative and decisions with respect to correcting disorderly conditions in the Government security market rest solely in the Open Market Committee. That responsibility is not implied in any degree to the member banks; in fact, it may be

6/ Regulation A, Board of Governors of the Federal Reserve System, October 1, 1937, revision, page 1.
7/ "Thirty-Eighth Annual Report of the Board of Governors of the Federal Reserve System," 1951, page 101.

worth noting that no initiative in this respect is permitted even to the Federal Reserve Banks.

From the foregoing discussion, it seems apparent that the administration of discount policy by the Reserve Banks involves a qualitative, as well as quantitative, approach. Moreover, this position is just as valid when member banks obtain Reserve Bank credit through advances on Government securities as when they rediscount eligible paper. Furthermore, the use of eligible paper as a means of access to the discount window is not necessarily more revealing in its qualitative aspects than the use of Government securities underlying advances. It is rarely ever possible to trace the exact use of a specific borrowing.

In directing the management of each Bank to keep itself informed regarding the general character of the loans and investments of its member banks, as well as the amounts, in order to determine whether undue use is being made of bank credit for certain specific purposes, Section 4 of the Federal Reserve Act emphasizes the qualitative aspect of the use of Reserve Bank credit. Moreover, on a number of occasions System officials have ruled against the use of Reserve Bank credit for specific qualitative purposes. In brief, there is a degree of selectivity inherent in the discount process that is not present in such Federal Reserve powers as changes in reserve requirements or open market operations. Furthermore, that degree of selectivity is based on both quantitative and qualitative considerations, with the responsibility for such determinations resting with the officers and directors of the Reserve Banks.

Referring again to the Annual Report of 1923, the Board stated, "The Federal Reserve banks are the country's supplementary reservoir of credit and currency, the source to which the member banks turn when the demands of the business community have outrun their own [member bank] unaided resources. . . . It is its [Federal Reserve System's] responsibility to regulate the flow of new and additional credit from its reservoirs in accordance with solid indications of the economic needs of trade and industry."8/

In addition to the reference to the economic needs of trade and industry, the foregoing statement of the Board emphasizes two very important fundamental principles: (1) the supplementary character of Reserve Bank credit and (2) the presumption that member banks will meet the requirements of agriculture, commerce, and industry with the use of their own resources fully, before seeking Reserve Bank credit. The extension of Federal Reserve Bank credit to member banks through discounts and advances is primarily intended to assist them in meeting certain seasonal requirements and temporary or short-term emergency situations arising out of developments in commerce, industry, and agriculture. It is not intended that member banks shall borrow from the Reserve Banks to obtain reserves to meet all of their seasonal credit requirements; nor is it intended that member banks shall, in effect, increase their capital for lengthy periods through the use of Reserve Bank credit.

With respect to seasonal borrowing from Reserve Banks, individual member banks may be expected to meet those normal seasonal

8/ "Tenth Annual Report of the Federal Reserve Board," 1923, page 10.

requirements which may be anticipated, largely through adjustments in their asset positions. In other words, certain secondary reserves, such as Treasury bills and other short-term Government securities, should provide member banks with considerable flexibility in being able to meet seasonal loan requirements; moreover, such adjustments should be resorted to before Reserve Bank credit, through discounts or advances, is sought. The fact that member banks may be in a "fully invested" position with substantial holdings of high-quality, relatively liquid secondary assets at a time of strong seasonal loan demand is not in itself a justification for resort to Federal Reserve credit through borrowing; in fact, it may represent a strong case against such borrowing.

It is recognized that the Federal Reserve Banks are the principal source of new reserves to the banking system. Consequently, to the extent that an increment to reserves is necessary to meet the total credit requirements of the seasonal period, such reserves must be provided by the System. Provision of such marginal reserves to the market, however, is a different matter than providing individual member banks with reserves to meet their full seasonal loan requirements. For instance, the System, through open market operations, might provide the market with reserves to meet a substantial part of the seasonal requirements, thus making it possible for member banks to make adjustments in their asset positions through operations in the market. Member banks should attempt to obtain such funds through asset adjustments in the money market before seeking Reserve Bank credit.

Member bank borrowing from Reserve Banks for seasonal purposes is appropriate and justifiable only to the extent that the supply of reserves in the market is not adequate to permit secondary reserve adjustments or that rigidities or imperfect market situations impede such adjustments.

The short-term characteristic of Reserve Bank credit is clearly established by provisions of the Federal Reserve Act. The rediscount provisions of the Act limit the maturity of such credits to 90 days, with the exception of rediscounts of agricultural paper, which may carry a maturity of 9 months. 9/ Advances against member bank notes secured by Government securities are limited to 15 days under the section of the Act dealing specifically with this type of credit, 10/ although the Board of Governors has ruled that such advances may be made for 90 days under the section of the Act dealing with "advances to individuals, partnerships, and corporations." 11/ The rediscount period of 90 days generally permitted by the Act tends to coincide roughly with the seasonal and productive cycles in commerce and industry, while the 9-month period tends to relate more nearly to the full agricultural cycle. Fifteen-day advances to member banks against the security of Government securities were designed to enable member banks to obtain Reserve Bank credit quickly and economically to meet very short-run unanticipated situations.

Official statements made at different times during the history of the System also tend to support the short-term character of Reserve Bank credit. For instance, when the Federal Reserve Act was amended to

9/ Federal Reserve Act, Sections 13 and 13a.
10/ Federal Reserve Act, Section 13, paragraph 8.
11/ Federal Reserve Act, Section 13, paragraph 13.

permit 15-day advances to member banks against Government securities, the Board in its recommendation to the Congress stated that such advances should be permitted "in order to enable member banks to obtain prompt and economical accommodations for periods not to exceed 15 days."12/ Later, referring to the same privilege, the Board stated that the amendment promised to be very helpful, "as it affords them [Reserve banks] the means of supplying more economically the requirements of member banks for short-time accommodation."13/ Finally, in 1917, still on the same subject, the Board stated, "It seems that in some districts Federal Reserve banks have been encouraging renewals of paper of this kind. While the Board does not wish to prohibit the renewal of a 15-day note, it feels that the renewal should be an exception, rather than the rule."14/

Although the short-term characteristic of Reserve Bank credit is recognized, there remains the problem that may arise out of very frequent or continuous borrowing. As previously noted, it is not within the spirit or intent of the Federal Reserve Act that member banks shall, in effect, increase their capital for lengthy periods through the use of Reserve Bank credit. The Board of Governors has spoken on this question on a number of occasions.

In its Annual Report issued in 1926 the Board stated:

> "Even where the paper is unexceptionable in every respect, the Reserve bank must be fully assured in addition that further credit may be granted to this member, not only 'safely and reasonably,' but also 'with due regard for the claims and demands of other member banks.' This question arises not infrequently in cases where a member bank remains

12/ "Second Annual Report of the Federal Reserve Board," 1915, page 22.
13/ "Third Annual Report of the Federal Reserve Board," 1916, page 5.
14/ "Federal Reserve Bulletin," 1917, page 879.

> continuously in debt to a Reserve bank for a considerable length of time. In such cases, inquiry may fairly be made as to whether the member bank's use of Reserve bank credit does not in effect amount to increasing its own capital out of Reserve bank funds. Such use of funds . . . would not be in accordance with the spirit of the Federal Reserve Act and would not be fair to the other member banks which may be active competitors of the borrowing bank. . . . Though there are circumstances that may explain and justify continuous borrowing by a member bank over a considerable period of time, particularly if the need for the borrowing arises from general economic conditions in the borrowing bank's locality, the funds of the Federal Reserve banks are primarily intended to be used in meeting the seasonal and temporary requirements of members, and continuous borrowing by a member bank as a general practice would not be consistent with the intent of the Federal Reserve Act. In most cases the member bank can make adjustments of different kinds in its own affairs . . ."15/

Again, in 1928 the Board stated: "It is a generally recognized principle that . . . continuous indebtedness at the Reserve banks, except under unusual circumstances, is an abuse of Reserve bank facilities. In cases where individual banks have been guilty of such abuse, the Federal Reserve authorities have taken up the matter with officers of the offending banks and have made clear to them that their reserve position should be adjusted by liquidating a part of their loan or investment account, rather than through borrowing. . . . The tradition against continuous borrowing is well established, and it is the policy of the Federal Reserve banks to maintain it."16/

The meaning of continuous borrowing is not explicitly defined in the statements of the Board of Governors, but the implications of such statements are sufficiently clear to indicate, in general, the broad meaning of the term. For instance, frequent references to "seasonal borrowing" or "temporary borrowing" or "short-term borrowing" are

15/ "Thirteenth Annual Report of the Federal Reserve Board," 1926, page 4.
16/ "Fifteenth Annual Report of the Federal Reserve Board," 1928, page 8.

associated with appropriate uses of Reserve Bank credit. On the other hand, such phrases as "considerable period of time" or "continuous use" or "continuously for a month or more" are used to indicate in a general way improper uses of Reserve Bank credit.

The administrative difficulty inherent in the problem of so-called continuous borrowing is not as marked in the case of those member banks which attempt to borrow for prolonged, unbroken periods as it is in the case of those member banks which attempt to borrow for very frequent, intermittent periods of from several to, say, 15 days per borrowing. In the latter case, over a period of a year the intermittently borrowing member bank may be increasing its capital through the use of Reserve Bank credit just as surely and just as substantially as the "long-term" borrowing member bank. Yet, it does not seem practical or sound to establish an arbitrary "debt-free" period - e.g., perhaps 15 days - for there may be cases in which closely intermittent but very occasional borrowing might be appropriate and justified. To illustrate, a bank might have a justifiable reason for borrowing two or three times in the course of a year, but those occasions might be closely intermittent, although borrowing on each occasion might cover only a period of a few days. Such a bank would not be increasing its capital appreciably through the use of Reserve Bank credit and, thus, should not be penalized by the insistence upon a "debt-free" period of some more or less arbitrary length.

In essence, therefore, it seems that the managements of the Reserve Banks must be guided in their decisions by (1) a clear understanding of the intent and spirit of the Act with respect to continuous borrowing,

(2) a recognition that an attempt by a member bank to maintain a "fully invested" position undisturbed is not in itself justification for borrowing, (3) an acceptance of the principle that a member bank should adjust or strengthen its asset position so as to meet normal situations or those which the bank might be expected to anticipate through the use of its own funds rather than Reserve Bank credit, and (4) the rule of reason or judgment administered by well-informed reasonable men.

It should be emphasized, however, that administration of discount policy, in accordance with such principles as those outlined in the preceding pages of this memorandum, does not require a continuous restrictiveness. Federal Reserve credit policy, including policy with respect to discounts and advances, must be and is intended to be flexible. It must be adaptable to the type of economic situation that prevails. At times when economic activity is declining or when emergency situations of an economic character prevail or threaten, expansive or "easy" monetary and credit policies are appropriate. The Federal Reserve Act recognizes the importance of placing with the System the power and authority to be expansive, as well as restrictive or contractive in its credit policies. For instance, such sections as Section 13, paragraph 3; Section 13, paragraph 13; and Section 10b are designed to provide the System with means of helping to relieve certain emergency economic situations.

This recognition of a flexible, "two-way" power and intent with respect to credit policy does not void the principles previously discussed. It simply recognizes that the discount policy of the System should be administered in accordance with the demands of the economic situation at the moment. In fact, running through the various statements of System authorities that have been quoted in the preceding pages is the strong emphasis that discount policy should be considered in the light of assisting member banks to meet the needs of commerce, industry, and agriculture. Those needs will be different under conditions of inflation and expansion from those which might prevail under conditions of deflation and declining business activity.

Other statements of the Board or officials of the System also tend to indicate the position of the System with regard to other uses of Reserve Bank credit.

In 1925 an official of the Federal Reserve System, in a private publication, made the following statement with respect to borrowing for profit:

> "Since member banks can borrow at the Reserve banks at a lower rate than they receive from their customers, the question arises why member banks do not borrow as much as possible on the basis of available eligible paper and United States securities in order to profit by the margin between the discount rate and their own rate to customers. This is due in part to a banking tradition . . . that a bank must not borrow, except in emergencies . . . It is also due to the fact that Federal Reserve banks disapprove the practice of borrowing Reserve bank funds . . . for the purpose of increasing the earnings of an individual bank. When a Reserve bank finds that a member bank is borrowing for such a purpose it uses its influence against the continuance of such borrowing."17/

Later, in its Annual Report for 1928, the Board of Governors stated, "It is a generally recognized principle that Reserve bank credit should not be used for profit, . . ."18/

17/ "Federal Reserve System in Operation," E. A. Goldenweiser, 1925, page 48.
18/ "Fifteenth Annual Report of the Federal Reserve Board," 1928, page 8.

On certain occasions, the question of borrowing by member banks from their Reserve Banks for the purpose of increasing borrowed capital in order to lessen or avoid excess profits taxes has arisen. The position of the System with regard to this practice is clearly outlined in a confidential letter addressed to the presidents of all Federal Reserve Banks by the Secretary of the Board of Governors in April 1945.

> "Illustrations of the kind of transaction that raised the question [borrowing against Government securities to increase borrowed capital] have been presented by reports that member banks had discounted with Reserve banks their notes for very large amounts secured by short-term Government obligations currently purchased in the open market. Aside from any profit due to the difference between the discount rate and the yield upon the securities used as collateral, it was apparently thought that the amounts borrowed would enable the borrowing banks in their income tax returns to set up average indebtedness that would be sufficient to produce some savings in, or to eliminate entirely, excess profits taxes which otherwise would be applicable.
>
> "While the practice mentioned above appears to be in its infancy, it has the possibility of further growth as member banks approach from an earning standpoint the exposure to the excess profits tax. The Board of Governors, in bringing this matter to your attention, suggests that you arrange to review any unusual application for discount facilities and ascertain before granting the discount whether the reasons for such application are consistent with the proper needs of the bank for replenishing reserves. The application may come after the applicant bank has purchased or committed itself to purchase new securities. Under such circumstances, you may feel that it is advisable to grant the accommodation temporarily, in order to avoid undue embarrassment to the applicant bank. If so, a maturity date should be fixed which will allow the applicant only sufficient time to liquidate the purchases in an orderly manner."[19]

[19] "Federal Reserve Loose-Leaf Service," Volume II, #5129.

The several quotations from the Federal Reserve Act and from other official Federal Reserve sources that are presented in the preceding pages of this memorandum should provide for the directors and officers of the Reserve Banks adequate tests as to "appropriate" and "inappropriate" uses of Reserve Bank credit borrowed by member banks. As indicated previously, such a determination by Reserve Bank officials must be reached to a large extent on the basis of rule of reason or judgment and not by a legalistic or mathematical formula; however, certain broad conclusions can be drawn regarding proper and improper uses of Reserve Bank credit.

Member bank borrowing from Reserve Banks for the purpose of adjusting reserves may be considered as involving an appropriate use of Reserve Bank credit when such borrowing is for one or another of the following purposes:

a. To assist member banks in their responsibility of providing productive short-term and - to a limited extent - seasonal credit to business, industry, and agriculture to facilitate the movement of goods through the productive process from the raw material producer to the ultimate consumer.

b. To assist member banks to make such occasional, <u>very short-term</u> adjustments in their accounts as may be required by such adverse developments as, for example, a temporary loss of deposits resulting from shifts of funds or a temporary impairment in the liquidity of assets.

c. To assist member banks to meet <u>more or less temporary</u> situations arising out of adverse economic conditions which appear to threaten the maintenance of sound banking and credit policies, the achievement of economic stability, or the public interest.

d. To assist member banks through periods of money panic or other economic crisis, regardless of the length of the periods.

On the other hand, member bank borrowing from Reserve Banks should be considered as involving an inappropriate use of Reserve Bank credit if such borrowing is for such purposes as the following:

a. To facilitate or support speculative or unproductive economic transactions.

b. To borrow primarily for "profit" - i.e., to take advantage of the arbitrage possibilities in the differential between the rate charged the member bank for Reserve Bank credit and rates obtainable by member banks in the open market, or to use Reserve Bank credit for the primary purpose of obtaining tax avoidance gains, or for any other such direct and primary "profit" motive.

c. To borrow "continuously" - i.e., to the extent that the use of Reserve Bank credit, in effect, tends to represent essentially an increase in the member bank's capital, rather than merely a temporary or seasonal supplement to the member bank's funds.

d. To expand the investment account of the member bank, either through the purchase of Government securities (other than such purchases as are related to a secondary distribution of new Treasury issues or which are in support of Treasury deficit financing during an emergency, such as a general war) or other securities beyond that point justified by the inherent continuing carrying ability of the member bank's own asset structure.

e. To expand loans beyond the member bank's inherent continuing carrying ability as reflected by its asset structure. This limitation should be considered as including the use of Reserve Bank credit to provide member banks with funds for normal seasonal requirements which should have been anticipated and provided for by adjustment of the member banks' asset accounts.

f. To engage in any transactions that are either inconsistent with the objectives of sound credit policy as measured in terms of the economic situation or inconsistent with the public interest.

Watrous H. Irons, Vice President
Federal Reserve Bank of Dallas

VI. A PREFERENTIAL RATE ON NONCONTINUOUS MEMBER BANK BORROWING

Summary

A preferential discount rate, in addition to the basic rate, has been suggested to bolster the tradition against borrowing and thereby strengthen the System's discount and discount rate mechanism.

One plan - for illustrative purposes - would fix a lower preferential discount rate for borrowing on Government obligations for 15 days or less following at least a 15-day free-of-debt period. Thus a spread would be created between the cost of noncontinuous and other types of reserve accommodation.

The preferential and basic rate plan would have certain advantages. It would (1) make noncontinuous borrowing less costly and, in effect, penalize abuse, not use of Reserve Bank credit; (2) be flexible; (3) temporarily provide greater freedom to adjust the operative discount rate; (4) serve as another guide for a change in System action; (5) bring the self-interest of borrowers into play to assist Reserve Banks in policing use of the discount mechanism, and (6) tend to increase liquidity of borrowing banks. On the other hand, the plan would have certain disadvantages. It might (1) discriminate in practice against banks with heavy seasonal loan demands, (2) add - in another respect - to Reserve Bank policing chores, (3) be exploited to impair some Reserve Banks' relations with their member banks. Further, partial alternatives (more frequent flexing of the basic rate and closer supervision of borrowing by Reserve Banks) are presently available without the disadvantages noted.

It has been suggested that a preferential discount rate, in addition to the basic discount rate, be brought into play to improve the working of the discount and discount rate mechanism in Reserve banking. This memorandum describes the plan in some detail and notes the purposes, advantages, and disadvantages of a two-rate device.

Purpose

To put the proposal in proper perspective, it should be noted that nothing new is proposed in Reserve banking tools. A preferential rate on certain member bank borrowing should not be viewed as a new control gadget. It is to do nothing more than sharpen the discount and discount rate mechanism and, like that mechanism, would have its principal effectiveness in a period of restrictive credit policy.

The return of borrowing as an important means of adjusting member bank reserve positions has been accompanied by some weakening of the tradition against being in debt to Reserve Banks (or, for that matter, to correspondent banks). This wearing thin of the tradition against borrowing appears to be the result of many things, but, particularly, of the example of more and more banks borrowing safely and profitably. Furthermore, for the most effective System resistance to total bank credit expansion, each borrowing member bank should be under pressure to repay funds borrowed from a Reserve Bank. Continuous borrowing would hamper credit regulation.

The preferential rate device is designed to implement a sagging tradition against being in debt, thereby strengthening the System's discount and discount rate mechanism - nothing more.

Operation

The essence of the suggested two-rate plan is a spread between the basic discount rate and a lower preferential rate which would apply only when certain standards of "noncontinuous" borrowing were met. Assume, for illustrative purposes, that "noncontinuous" borrowing is defined as borrowing for 15 or less days following at least a 15-day free-of-debt period.[1]

Under such a plan, each Reserve Bank would fix a preferential rate, subject to review and determination by the Board of Governors, that would apply to all 15-day or less borrowing by member banks, under Section 13 and collateraled by short-term United States Government securities, when the borrowing bank had been out of debt to its Reserve Bank for at least 15 days. Thus a spread would be created between the

1/ Two points should be emphasized here: (1) no attempt is made to treat the legal aspects of the proposed preferential rate and (2) no final determination is made as to the basis of the preferential rate. With reference to point one, classification of Reserve Bank credit and fixing discount rates on the basis of the length of time in the past during which a borrowing member bank has been out of debt to its Reserve Bank has been questioned. And possible discrimination against certain seasonal borrowers has been noted. In connection with point two, several variations as to the basis for the preferential rate are available. A different out-of-debt and borrowing period might be selected for each reserve-class of member banks. Access to a preferential rate could be determined by the ratio of borrowings to reserves. For example, the preferential rate could apply when daily average borrowings in a given reserve computation period amounted to (say) 5 per cent or less of daily average required reserves in the current or preceding period. Preferential accommodation could be supplied by means of re-purchase agreements in connection with short-term United States Government securities, if this means of establishing a spread between the basic discount rate and the preferential rate appeared more practicable. A final choice is not made in this memorandum as to the basis for a preferential rate. The discussion is grounded on the 15-day or less borrowing following at least a 15-day out-of-debt period for convenience.

cost of obtaining reserves by other types of discount and rediscount accommodations and the noncontinuous accommodation.

The preferential rate could be varied from time to time and from district to district by action of the Boards of Directors of the Reserve Banks, subject to review and determination by the Board of Governors. Presumably the spread between the preferential and the basic discount rates would be sufficient whenever the plan was inaugurated to effectively promote noncontinuous use of Reserve Bank credit.

Advantages

In performing its limited function, a two-rate or preferential-basic rate device directed against continuous borrowing would have certain advantages.

(1) By means of a spread, borrowing by member banks on Government securities could be made less costly to those who borrowed irregularly and infrequently and more expensive to those who borrowed continuously. In the sense that continuous borrowing is unsound, the device would penalize abuse rather than use of Reserve Bank credit.

(2) A two-rate device has the flexibility to adjust to particular situations. The spread between preferential and basic discount rates could be varied one time as against the next and also by districts. At a given time an advantage of (say) 1/4 percentage point might be effective enough to restrain continuous borrowings; at another, the spread might have to be 1/2 percentage point. Or at any given time 1/4 percentage point might do an effective job in one district while 1/2 might be necessary in another.

(3) A preferential rate might be flexed without the full psychological repercussions in the business community that attend a change in the basic discount rate inasmuch as announcements of preferential-rate changes could point out (if such emphasis were desirable) that no change was being made in the basic discount rate. (To the extent, however, that banks tended to resort to the discount window soley by way of the preferential rate, in other words, as this rate became the operative rate and the basic rate became just another rate posted by the System, changes in the preferential rate would tend to acquire the psychological significance that basic rate changes now have for nonborrowers. Thus this advantage, which would exist in the early stages, might tend to diminish over time.)

(4) With both rates in effect, increasing use of the higher, basic rate would serve, along with the aggregate level of borrowing, as an indicator of the degree of pressure on member banks for reserves. In addition to serving as another guide for System action, greater member bank use of the higher basic rate would tend to tighten the money market without any further steps by the System, the degree of tightening generated being a function of the spread between preferential and basic rates and of the extent of use of the basic rate.

(5) The existence of a lower rate for noncontinuous borrowing would bring the self-interest of the borrowers into play and to that extent assist Reserve Banks in their "policing" chores. (Objection has been raised that with a two-rate technique banks which borrowed continuously could counter policing objections to such continuous borrowing by noting that they were paying the Reserve Bank's prescribed penalty in the form of the higher rate.

It might be pointed out, however, that the spread is a flexible one and might be widened sharply on a regional basis - by raising the basic rate - for short periods to reinforce the Reserve Bank's position and, further, that policing of the use of its credit cannot be avoided by a Reserve Bank at any time. In other words, having the self-interest of the borrowers, generally, as an aid in preventing continuous use does not absolve a Reserve Bank from policing the use of its credit in all cases and taking the drastic step of refusing to grant credit in those instances where certain situations make continuous use profitable even at the higher rate.)

(6) Readjustment of earning assets by borrowing banks to take advantage of the preferential rate might tend to increase the over-all liquidity of these banks.

Disadvantages

On the other hand certain disadvantages would attach to a preferential rate for noncontinuous borrowing.

(1) Certain member banks with heavy seasonal loan demands might tend to be discriminated against.

There are two points of view on the question of discrimination against certain seasonal borrowers. One holds that a preferential rate for noncontinuous borrowing would not result in discrimination. Seasonal Reserve credit demands are supplied for the banking system as a whole (when and to the extent such provision is appropriate) and no individual bank is discriminated against by being forced to rely on the national pool of excess reserves or on the national market for United States Government obligations for all but short-term (15 day)

Reserve assistance through the discount window. Reserve credit, to the extent it should be provided seasonally, cannot be made available to a few member banks to the amount of the entire seasonal bulge in needed reserves for the full season, even at a rate above the suggested preferential rate. Each bank getting into debt to its Reserve Bank should adjust its assets to repay, even though in the process of such adjustment the borrowing burden is merely shifted to another bank and the aggregate level of member bank borrowing is left unchanged. In fact to provide a member bank's entire seasonally required reserve needs for the full season would in effect be favoring this particular bank over other members and would run counter to the requirements of Section 4 as to fair and impartial treatment of all member banks by their Reserve Banks.

The contrary position is that discrimination may exist when non-continuous borrowing is defined in such a manner as to preclude certain seasonal borrowers from access to the cheaper rate. For example, it would be difficult to justify no-discrimination in the case of a borrower needing Reserve assistance for three or four successive reserve computation periods when the borrower had substantially reduced its holdings of Government securities and had made an effort to locate idle reserves elsewhere in the banking system (either buying Federal funds or laying-off part of its seasonal paper to other banks). If some part of a member bank's seasonally needed reserves may appropriately be supplied via the discount window, why may not this portion be made available at the preferential rate (that is, without penalty), particularly if eligible paper is offered for rediscount on a 90-day basis? In other words, while it is correct, as pointed out above, that Reserve credit should not be made available to a member bank to the extent of the entire seasonal swing in its needed reserves, this is not to say that the minimum seasonal accommodation which is appropriate must be fitted into a non-continuous pattern or else bear a higher rate. The contention that there will always be an appropriate volume of reserves somewhere in the banking system to accommodate an individual member bank's needs assumes a free flow of excess funds to the point of need. In practice, on the contrary, the process is sticky and otherwise imperfect.

In practice, the proposed preferential rate based on a 15-day out-of-debt period would appear to discriminate against certain seasonal member bank borrowers - especially those in the rural areas and those financing the movement of some crops.

(2) While the Reserve Banks might find their policing burden lightened in most cases with respect to continuous borrowing, they could find it extended in another. Reserve Banks might feel obliged, on occasion, to police the use of their credit to prevent excessive borrowing by one member bank at the preferential rate to lend to a bank which had access to Reserve credit only at the higher, basic rate. (In this connection it should be noted, however, that even with some leakage through mis-use of Reserve credit in this manner, continuous borrowing would probably be penalized to some extent by higher costs, although by less than the full spread between preferential and basic rates.)

(3) A preferential-basic rate spread might be exploited, bank-relationswise, by field representatives of large, city banks with adverse effects on relations between Reserve Banks and smaller member banks. Such a development

would be of particular importance in those districts with relatively small proportions of banks in membership.

In addition to these disadvantages, it might be pointed out as an argument against a two-rate plan that it is possible to gain much of the broad objective (sharpening the discount tool through restraining continuous borrowing and strengthening the tradition against borrowing) in alternative ways without incurring the disadvantages noted.

First, reluctance to borrow, and thus the tradition against borrowing, can be bolstered by more frequent changes in the existing basic discount rate.

Second, member banks abusing their use of the discount mechanism can be disciplined and that discipline can be tailored to fit individual cases (something that cannot be done with a two-rate device applying uniformly to all member banks in a district) by shortening the term of the loan requested or by denying the borrowing privilege completely in extreme cases.

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VII. TECHNIQUES FOR APPRAISING INDIVIDUAL BANK USE OF FEDERAL RESERVE CREDIT

The existence of standards of accommodation governing Federal Reserve loans, discounts and advances requires the use of administrative techniques to differentiate between borrowers which do and do not meet such standards. When "eligibility" was the chief standard of accommodation, analysis concentrated on the determination of the "eligible" status of paper presented for discount. Currently, accommodation standards embody increasing emphasis upon the frequency and magnitude of borrowing and the use to which borrowed funds are put. Judging the conformity of applicants to these latter standards involves detailed appraisals of individual bank operations. The purpose of this paper is to describe techniques which may simplify and sharpen such appraisals.

Appraising the Extent of Borrowing

Accommodation standards governing the extent of individual bank borrowing may be set in terms of one or both of two measures: (1) frequency of borrowings; and (2) relative magnitudes of borrowings. The method of measurement in either case should be fair and equitable from the point of view of all member banks which may come under consideration.

Since the primary aim of any borrowing by a member bank is the acquisition of reserve credit, equal proportions of reserve credit supplied by a Federal Reserve Bank should appear identical in administrative appraisals. A complication is introduced by the fact that member bank required reserves are specified in terms of cumulative totals over varying periods of time (seven days for central reserve and reserve city banks, from fourteen to sixteen days for country banks). As a result, all borrowings by a bank in any one reserve period are in reality parts of a single operation. Thus, among four banks with a $500 million reserve requirement in a single reserve period--one reserve city bank obtaining a one-day loan of $60 million; another with a six-day loan of $10 million, and a third with two two-day loans of $15 million, and a country bank with a twelve-day loan of $10 million[1/]--all obtain an equal degree of assistance from the lending Federal Reserve Bank in meeting their reserve requirement. The most convenient statistic for showing this equality is "average daily borrowing within each reserve period." This statistic also pinpoints the contrast between a reserve city bank which borrows $10 million for four days during one reserve week, and another which borrows $10 million for one day in each of four consecutive reserve weeks. It emphasizes the fact that the former bank, while more heavily dependent upon Federal Reserve credit in one week, is nevertheless willing and able to adjust its own assets so as to dispense with Federal Reserve assistance in three of the four reserve accounting periods.

To be sure, the figure "average daily reserve period borrowings" will obscure some secondary differences in borrowing operations. For example, a bank which habitually confines its borrowing to the last day of its reserve period is undoubtedly more precise in its reserve adjustment than one that does not. More importantly, country banks have at least twice as long a reserve period in which to adjust to reserve needs by shifts in their own assets as do reserve city and central reserve city banks. For this reason perhaps no figures on borrowings can be strictly comparable between country banks and other members. Such shortcomings,

1/ During a fourteen-day half month reserve period.

however, can be offset in marginal cases by supplemental analysis of figures. As a general measure, "average daily reserve period borrowings" is an equitable and realistic basis upon which to analyze bank borrowing patterns.

With bank borrowing figures presented on this basis, continuity of borrowing would be determined by the sequence of reserve periods during which daily average indebtedness to a Reserve Bank appeared.

If accommodation standards require consideration of the relative magnitude of borrowing, further refinements in the data become necessary. Raw data on average dollar indebtedness in each reserve period would need to be put in relative terms. For this purpose deposit figures are of little use because of varying reserve requirements among banks and types of deposits. Total capital accounts may be a pertinent measure, but primarily when questions of solvency and funds at risk are important. For general purposes, the most logical comparison is between the amount of funds provided for reserve credit by the Reserve Bank and the amount provided by the borrowing bank out of its own resources. Such a computation can be made for each reserve period by dividing average daily borrowings by either average reserve balances or average required reserves. The difference is usually not significant. Use of required reserves as a divisor would avoid variations as banks utilized the privilege of carrying up to a two per cent deficiency over from one reserve period to the next; while the use of reserve balances would give borrowers credit for any average excess reserves which they might accumulate over the period.

Appraising Borrower use of Funds

Accommodation standards may also be set in terms of "acceptable" uses of funds by banks borrowing from the Federal Reserve. For example, current policy might dictate the discouragement of borrowing by banks which are voluntarily draining their reserve position by expanding certain types of earning assets. Pertinent questions might be: "Has the bank been financing an unseasonal loan expansion? Has it recently been purchasing short-term Governments? Does it now hold Treasury bills which it can or will sell to replenish reserves? Upon acquiring excess reserves subsequent to borrowing, has the bank invested these funds in securities rather than repaying indebtedness?" Or, in a different vein: "Has the bank experienced a deposit drain? For how long? To what extent has it been able and willing to meet the drain out of its own resources?" To test borrower qualification under standards such as these, discount administrators need to make objective evaluation of changes in bank assets and liabilities.

A device which can be useful as a starting point in this analysis is the requirement that borrowers state a reason for their need of credit. The proximate reason in almost all cases, of course, will be a prospective reserve deficiency; but a potential borrower can be asked to describe the chief cause or causes of the deficiency (e.g., "loan increase," "deposit decline," "securities purchases"). Such a procedure would (1) serve notice on borrowers that use of reserve funds is a consideration in granting advances; (2) give administrative officials a basis for preliminary judgment of appropriateness of borrowing; and (3) make easier any administrative action if quantitative figures subsequently indicate that the actual use of funds was different from the purpose originally stated.

Nevertheless, to permit the formation of independent judgment on borrowing purposes, administrative appraisals must rely primarily upon analyses of quantitative changes in bank balance sheet items. The best measure of the effects on reserves of changes in bank assets and deposits would be changes in average reserve period holdings. The calculation of such changes should be based upon daily data for fluctuating items, and at least end-of-reserve-period data for all others. Such information will not be uniformly available within a Reserve Bank, however, unless special reports of this nature are required of borrowers by the Discount Department.

On the basis of typical Reserve Bank records, reserve period daily averages of required reserves, excess reserves, and deposits can be obtained by the discount officer from the Member Bank Accounts Department. Daily average reserve period figures on purchases of "Federal funds" can be inferred from records in the Wire Transfer Department. Short-term movements in some other bank asset items, on the other hand, can be measured only from one Wednesday close to the next (in the case of weekly reporting member banks) or from the last Wednesday close of one month to the last Wesnesday close of the next (in the case of all other member banks). This estimation of reserve period averages of asset holdings by averaging reported Wednesday figures is not always reliable. Changes in bank assets are reasonably controllable by bank management, and a number of institutional factors suggest that many management decisions are not spread randomly over the period between Wednesdays (e.g., purchases of new Treasury bills each Thursday; final adjustments of reserve positions for central reserve and reserve city banks each

Wednesday). On balance, any adjustment of asset figures (except reserve balances) based upon an assumption of random changes seems as likely to introduce new distortions as to remove existing ones. The expedient solution is the measuring of asset changes by the simple difference between reported Wednesday totals; and this has the advantage of conforming exactly with the duration of the reserve period for the bulk of large borrowers.

Further refinement of the measure of deposit changes can be carried out if so desired. Since the concern of the appraiser is primarily with the reserve effect of a condition item change, a given dollar change in average reserve period deposits could be adjusted to account for the partially offsetting change in the dollar reserve requirement which would automatically result.

Given the mechanics of measurement outlined above, the number of items to be so measured depends upon the degree of comprehensiveness required. Since a change in every bank condition item either increases reserves, decreases reserves, or offsets a change elsewhere in the balance sheet, all items have to be considered if a perfect balance of sources and uses of reserve funds is to be obtained. For most purposes, however, such all-inclusiveness is not required. As a minimum, those items or groups of items should be isolated which are directly considered in established accommodation standards. Items of first importance and most likely significance are total loans, total securities, total deposits, and borrowings from the Reserve Bank. Added detail is often desirable to segregate those particular assets and liabilities which typically show the effects of a bank adjusting its reserve position without recourse to the Federal Reserve (i.e., Treasury bills, excess reserves, purchases of Federal funds). Experimentation indicates, however, that a comparison of changes in deposits (change in reserve period average), loans (difference between Wednesday close figures), Treasury bills (difference between Wednesday close figures) and all other securities (difference between Wednesday close figures) usually accounts for the bulk of changes in average daily reserve period borrowings.

Such comparison can be made on a reserve week basis for central reserve and reserve city banks which are also weekly reporting member banks; but only on a monthly basis (without the Treasury bill segregation) for most other member banks. On occasion when apparent inconsistencies are significant for administrative decisions, the reserve effects of additional items for which data is available can be calculated as a supplementary operation.

These figures lend themselves to presentation in a traditional sources and uses of funds table. For rapid perusal of a bank's position over time, cumulated changes in earning asset and deposit figures can be charted, by reserve periods, against daily reserve period averages of borrowings. (Daily reserve period averages of excess reserves or Federal funds purchases could also be included if warranted, as in the expectation that a bank is borrowing for EPT purposes and allowing the funds so obtained to lie unused in its account.) A cumulative presentation has the advantage of indicating any persistent leads and lags in timing.

Once bank balance sheet figures are set up in this fashion, each drop in deposits or increase in loans or securities can be regarded as a drain of reserves; and each rise in deposits or decline in loans or securities as a source of reserves.[2/] The interpretation of these reserve-affecting changes as causes of borrowing changes can then be framed in terms of the accommodation standards governing the use of Reserve Bank credit. As an illustration, if it is determined that borrowing from a Reserve Bank should not be used to sustain purchases of Treasury securities, a rise in borrowings and securities holdings in one reserve period which was not reversed in succeeding reserve periods would be prima facie evidence of unqualified use of Reserve Bank credit. Similar generalizations could be made concerning any other asset or deposit change which is not considered appropriate for financing by Reserve Bank credit. The technique should be equally useful whether standards of accommodation are phrased in terms of the type of reserve-affecting drain or in terms of the time lapse between a drain financed by borrowing and the ultimate reduction in bank liquid assets to repay such borrowing.

It should be stressed, of course, that no single reserve period summary of this type can be utilized as conclusive evidence of the use to which borrowed funds were put. The methods of computing condition item

2/ The fact that some of these changes may be merely bookkeeping offsets does not detract importantly from the analysis. A loan may be repaid by check drawn on a deposit in the bank, thus reducing both loans and deposits without producing any change in total reserve balances; but the analysis indicated above would assume reserve receipts from the loan decline equivalent to the reserve drain from the deposit decline, with no net change in total reserves.

changes will not clearly distinguish, in one reserve period, between a bank which borrowed funds early in the period specifically to buy bills, and one which bought bills early in the period expecting to be in surplus funds only to find that an unexpected last-day deposit drain forced it to borrow to avoid a deficiency. But such a distinction would not be called for unless the latter bank liquidated its bill purchases in succeeding reserve periods to pay off indebtedness; and this operation would usually be reflected in the analysis of the following periods.

Nevertheless, this method of appraisal of the use of Reserve Bank credit becomes more definitive the larger the number of reserve periods which are considered. Thus it can be of greatest assistance in testing conformity with accommodation standards which are set in terms of protracted or repeated uses of Reserve Bank credit for specific purposes.

As an illustration of how changes in bank assets and liabilities can be organized for appraisal purposes, a sample bank chart covering the year 1952 is attached. Significant interrelationships between borrowings and other balance sheet changes at this bank might be summarized as follows:

This bank underwent a sharp January drop in deposits which was not recouped until June. The broad outline of the deposit drain was financed by the bank without recourse to increased borrowings, although smaller deposit fluctuations around this trend were often compensated for by borrowing changes. While it is a Chicago bank, its deposits did not drop sharply around the April 1 tax date in 1952; the bank apparently serviced its customers by borrowing to buy short bills at the end of March for quick sale and repurchase with depositors. In the first half of 1952, the bank occasionally reduced indebtedness by selling bills.

After June, however, the bill portfolio was held fairly stable. A substantial total of long Governments were purchased in late June and early July, and this total was later raised on three occasions. Beginning at midyear, very few reserve adjustments were made through sales of Governments; borrowings were relied upon to bear the brunt of any net differences between loan and deposit changes. Deposit swings were quite large, with short-term movements continuing to be closely matched by offsetting changes in borrowing. On the whole, borrowing levels averaged higher in the second half than in the first half, despite a considerably higher average level of deposits. Increases in holdings of loans and longer-term Governments more than absorbed the excess reserves acquired in deposit growth after June.

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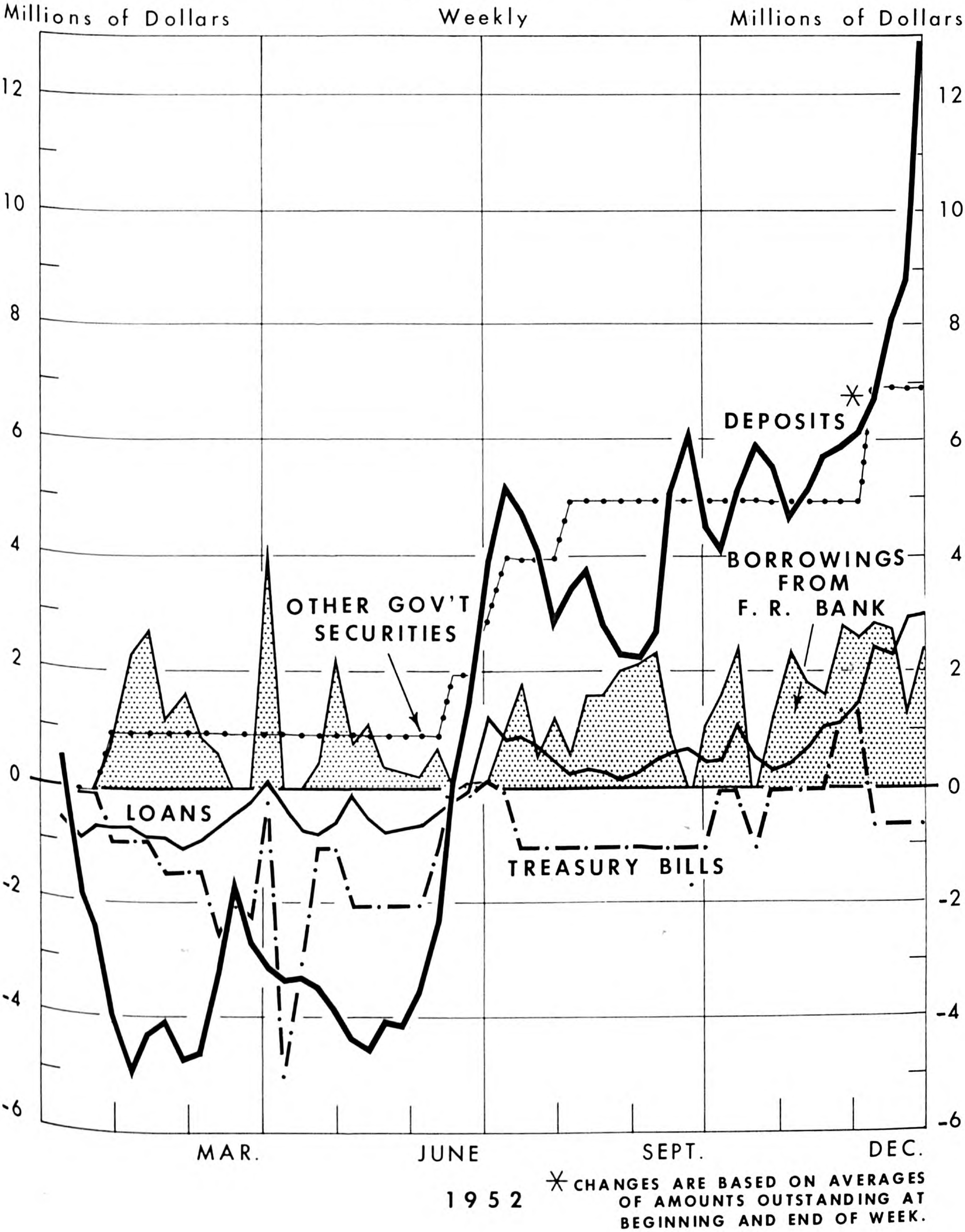
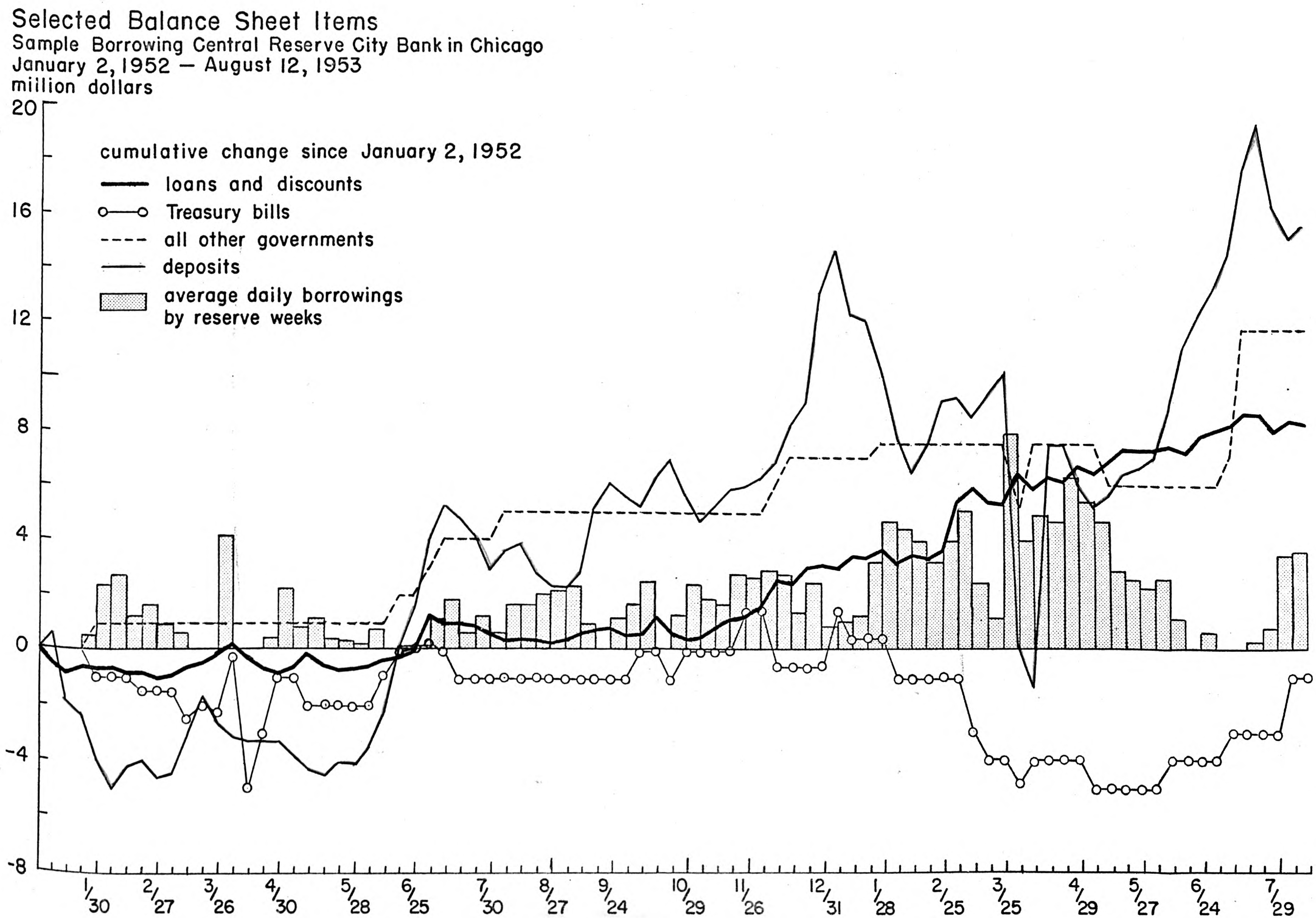
BORROWINGS FROM FEDERAL RESERVE BANK COMPARED WITH CHANGES IN PRINCIPAL BALANCE SHEET ITEMS FOR A SELECTED BANK

Cumulative Changes From January 2, 1952, Except For Borrowings Which Are Weekly Averages Of Daily Figures



* CHANGES ARE BASED ON AVERAGES OF AMOUNTS OUTSTANDING AT BEGINNING AND END OF WEEK.


Selected Balance Sheet Items
Sample Borrowing Central Reserve City Bank in Chicago
January 2, 1952 — August 12, 1953
million dollars
cumulative change since January 2, 1952
loans and discounts
Treasury bills
all other governments
deposits
average daily borrowings
by reserve weeks
20
16
12
8
4
0
-4
-8
1/30
2/27
3/26
4/30
5/28
6/25
7/30
8/27
9/24
10/29
11/26
12/31
1/28
2/25
3/25
4/29
5/27
6/24
7/29

RESERVE ITEMS, BY DAY OF RESERVE PERIOD

(In millions of dollars)

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	Cumulated totals	Daily average	Per cent of total reserves required	Number of days in debt
RESERVE CITY BANK A:																			
Reserve requirement........	10	10	10	10	10	10	10	(reserve period of seven days)								70	10	100%	
Reserves provided:																			
From own resources......	8	8	8	8	8	8	8									56	8	80%	
From discounting......	2	2	2	2	2	2	2									14	2	20%	7
RESERVE CITY BANK B:																			
Reserve requirement........	10	10	10	10	10	10	10	(reserve period of seven days)								70	10	100%	
Reserves provided:																			
From own resources......	8	8	8	8	8	8	8									56	8	80%	
From discounting......							14									14	2	20%	1
COUNTRY BANK C:								(reserve period of fifteen days)											
Reserve requirement........	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	150	10	100%	
Reserves provided:																			
From own resources......	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	120	8	80%	
From discounting......	2	2	2	2	2										20	30	2	20%	6

VIII. SUMMARY AND HISTORY OF BOARD'S REGULATION A REGARDING DISCOUNTS AND ADVANCES BY FEDERAL RESERVE BANKS

It is the purpose of this memorandum to summarize the contents of the Board's present Regulation A, relating to discounts and advances by the Federal Reserve Banks, and to review the historical development of the regulation, not with the thought that such a memorandum will necessarily suggest the need for any changes or modification, but with the thought that it may provide background material which will be helpful in connection with the current study of the discount mechanism of the Federal Reserve System. Regulation A was last revised in 1937 and has been amended since that time in only a few relatively minor respects.

I. STATUTORY BASIS

For an understanding of the nature of Regulation A, and particularly the extent to which it is purely regulatory, it is desirable to have in mind the various provisions of the law upon which the regulation is based. While the basic authority for discounts and advances is contained in section 13 of the Federal Reserve Act, other provisions relating to this subject are to be found in sections 4, 10(a), 10(b), 13a, 14(d), 19, and 24 of the Act. Briefly, and without reference to details, these provisions may be summarized as follows:

1. Discounts for member banks. - The primary authority for extension of Federal Reserve credit is contained in the second paragraph of section 13 of the Federal Reserve Act which authorizes the Federal Reserve Banks to discount for their member banks paper drawn for

agricultural, industrial or commercial paper, i.e., "eligible paper". Such paper must have a maturity at the time of discount of not more than 90 days, except that, by virtue of other provisions of the Act, agricultural paper (including paper of cooperative marketing associations) having a maturity of not more than nine months is made eligible for discount. (sec. 13a) By special provisions, the Reserve Banks are also authorized to discount factors' paper drawn to finance producers of agricultural staples (sec. 13, par. 2); sight drafts growing out of the domestic shipment or the exportation of readily marketable staples (sec. 13, par. 4); and bankers' acceptances which arise out of the importation or exportation of goods, domestic shipments of goods, or storage of readily marketable staples, or which are drawn to create dollar exchange (sec. 13, pars. 7 and 12). Notes representing loans to finance residential or farm construction with maturities of not more than six months are expressly declared eligible for discount as "commercial paper" (sec. 24). No paper may be discounted if it is drawn merely for investments or for the purpose of carrying or trading in securities other than United States obligations. (sec. 13, par. 2)

2. Advances to member banks. - The Federal Reserve Banks are authorized to make advances to member banks for periods not exceeding 90 days on their notes secured by paper which is eligible under the law for discount or purchase by the Reserve Banks, and to make advances with maturities not exceeding 15 days on notes secured by obligations of the United States and obligations of the Federal Intermediate Credit Banks,

the Federal Farm Mortgage Corporation, and the Home Owners' Loan Corporation. (sec. 13, par. 8) However, advances with maturities up to 90 days may be made to member banks on direct obligations of the United States by reason of the specific authority given the Reserve Banks to make 90-day advances on such obligations to individuals, partnerships, and corporations. (sec. 13, par. 13) In addition, advances for periods up to four months may be made to member banks on any security satisfactory to the Federal Reserve Bank but at a rate of interest not less than one-half of one per cent higher than the highest discount rate in effect at the lending Federal Reserve Bank. (sec. 10(b)) The law also contains authority for emergency advances to groups of not less than five member banks under certain conditions, but this authority has never been utilized. (sec. 10(a))

3. Discounts for Federal intermediate credit banks. - The Reserve Banks may discount agricultural paper for Federal intermediate credit banks and also notes payable to intermediate credit banks which cover loans made by such banks under the Federal Farm Loan Act and which have maturities of not more than nine months and are secured by eligible paper. (sec. 13a)

4. Discounts and advances for individuals, partnerships, and corporations. - Advances may be made by the Reserve Banks for periods of not more than 90 days to individuals, partnerships, or corporations on their notes secured by direct obligations of the United States. (sec. 13, par. 13) In unusual and exigent circumstances, the Board of Governors

may authorize a Federal Reserve Bank to discount eligible paper for individuals, partnerships, and corporations, but this authority has been exercised only on a few occasions. (sec. 13, par. 3)

5. Paper endorsed by nonmember banks. - A member bank may not act as the medium or agent of a nonmember bank in obtaining discounts from a Federal Reserve Bank except with the permission of the Board of Governors. (sec. 19, par. 8) No paper may be rediscounted for a Federal intermediate credit bank if it bears the endorsement of a nonmember State bank which is eligible for membership in the System. (sec. 13a)

6. Limitation on discount of paper of one borrower. - The aggregate of the paper of any one borrower which may be rediscounted for a member bank may not exceed the amount for which such borrower could lawfully become liable to a national bank under section 5200 of the Revised Statutes. (sec. 13, par. 5) A certificate to the effect that the borrower's liability does not exceed this amount must be furnished by every State member bank applying for discounts. (sec. 9, par. 13)

7. Discount rates. - Each Federal Reserve Bank is required to establish from time to time, subject to review and determination by the Board of Governors, rates of discount to be charged for each class of paper, and such rates must be fixed with a view of accommodating commerce and business. (sec. 14(d))

8. Responsibility of Federal Reserve Banks in extending credit accommodations. - The board of directors of each Federal Reserve Bank is required to administer the affairs of such bank fairly and impartially and without discrimination in favor of or against any member bank or banks. Such credit accommodations may be granted member banks as may be safely and reasonably made with due regard for the claims and demands of other member banks, the maintenance of sound credit conditions, and the accommodation of commerce, industry, and agriculture. Each Reserve Bank is required to keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of, or trading in, securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions; and the Reserve Bank must give consideration to such information in determining whether to grant or refuse credit accommodations. (sec. 4, par. 8)

9. Regulatory authority of Board of Governors. - Many of the provisions above mentioned authorizing discounts and advances expressly provide that they shall be subject to such limitations and regulations as the Board of Governors may prescribe. In addition, the Board is generally authorized to define the character of paper eligible for discount (sec. 13, par. 2); to regulate the discount and rediscount of bills receivable, domestic and foreign bills of exchange, and

acceptances (sec. 13, par. 10); and to define the conditions under which discounts, advances, and accommodations may be extended to member banks. (sec. 4, par. 8)

II. PRESENT REGULATION A

Regulation A includes a restatement, in identical or similar language, of most of the provisions of law summarized above. In addition, it contains certain provisions of an explanatory or interpretative nature, some which relate to procedural matters, and a few which can be regarded as strictly and purely regulatory. These distinctions will appear from a general summary of the more important provisions of the regulation. In this summary no attempt will be made to explain why and when particular provisions became a part of the regulation; that will be the purpose of the following historical section of this memorandum.

The regulation consists of an introductory statement of general principles; six sections relating respectively to (1) discounts for member banks (2) advances to member banks, (3) general requirements as to discounts and advances, (4) paper acquired from nonmember banks, (5) discounts for Federal intermediate credit banks, and (6) bankers' acceptances; and an Appendix setting forth certain recommendations of the Board of Governors as to the minimum standards which should be observed by member banks with respect to real estate loans and with respect to installment paper offered as collateral for advances.

General Principles

The regulation begins with a brief statement of general principles which justifies quotation in full:

"The guiding principle underlying the discount policy of the Federal Reserve banks is the advancement of the public interest. Accordingly, the effect that the granting or withholding of credit accommodation by a Federal Reserve bank may have on a member bank, on its depositors and on the community is of primary importance.

"In extending accommodation to any member bank, the Federal Reserve banks are required to have due regard to the demands of other member banks, as well as to the maintenance of sound credit conditions and the accommodation of commerce, industry, and agriculture, and to consider not only the nature of the paper offered, but also the general character and amount of the loans and investments of the member bank, and whether the bank has been extending an undue amount of credit for speculative purposes in securities, real estate, or commodities, or in any other way has conducted its operations in a manner inconsistent with the maintenance of sound credit conditions."

It should be noted that the second paragraph of this statement of principles is almost a literal restatement of provisions contained in the eighth paragraph of section 4 of the Federal Reserve Act.

Section 1. Discounts for Member Banks

The first section of the regulation follows closely those provisions of section 13 and 13a of the Federal Reserve Act which authorize the discounting for member banks of paper drawn for commercial, agricultural, or industrial purposes ("eligible paper") and of sight drafts growing out of domestic shipments or exportation of readily marketable staples. It includes the statutory requirements as to maturity (90 days as to nonagricultural paper and nine months as to agricultural paper); the statutory prohibition against discounting paper drawn merely for investments or trading in securities (other than United States obligations); the statutory authority for discounting six-months residential or farm construction loans, paper of cooperative marketing associations, and factors' paper drawn to finance producers of agricultural products; and the statutory limitation on the aggregate amount of the paper of one borrower which may be discounted.

The section also includes the following provisions which appear to be intended to explain, clarify, or interpret the provisions of the law:

1. In describing "eligible paper" the regulation spells out the statutory description of such paper as meaning paper issued or drawn, or the proceeds of which have been or are to be used, "in producing, purchasing, carrying or marketing goods in one or more of the steps of the process of production, manufacture, or distribution, or in meeting current operating expenses of a commercial, agricultural, or industrial business."

2. With respect to the prohibition against discounting paper drawn for investments, the regulation makes it clear that this covers paper the proceeds of which are to be used for permanent or fixed investments of any kind "such as land, buildings, or machinery, or for any other fixed capital purpose."

3. In keeping with the intent evidenced by section 4 of the Federal Reserve Act, the regulation forbids the discounting of any paper of a "purely speculative character".

4. In connection with the discount of sight drafts growing out of the exportation of readily marketable staples, the regulation defines the term "readily marketable staple" as meaning an article of such uses as to make it subject to constant dealings in ready markets with such frequent quotations of price as to make the price easily and definitely ascertainable and the staple itself easy to realize upon by sale at any time.

5. The section defines "agricultural paper" as including paper drawn, not only for the production of agricultural products, but also for the marketing of such products, the carrying of such products by growers pending marketing, and the breeding, raising, fattening or marketing of livestock.

6. It is made clear that paper of cooperative marketing associations is not eligible for discount if the proceeds are to be used to defray organization expenses of such associations or for the purpose of acquiring warehouses, real estate, or other permanent or fixed investments.

Procedural in nature is a provision of section 1 which requires a Federal Reserve Bank to take necessary steps to satisfy itself as to the eligibility of paper offered for discount. In this connection, the regulation states that compliance with the requirement that paper shall not be drawn for fixed investment purposes may be evidenced by a statement reflecting the borrower's financial worth and a reasonable excess of quick assets over current liabilities.

The only provisions of the section which are of a purely regulatory nature are those which require all paper offered for discount to be negotiable. Negotiability is not expressly required by the statute. In this connection, however, the regulation waives the requirement of negotiability in the case of notes evidencing loans made under programs of the Commodity Credit Corporation, and notes evidencing loans guaranteed under the V-loan program pursuant to the Defense Production Act of 1950.

Section 2. Advances to Member Banks

In general, this section paraphrases the provisions of section 13 of the Act which authorize advances to member banks on eligible paper and on Government obligations, and the provisions of section 10(b) authorizing advances on any satisfactory collateral. It contains no additional provisions except some of an explanatory or interpretative nature. Briefly, these are the following:

1. It is made clear that, nothwithstanding the provisions of the eighth paragraph of section 13 limiting advances on United States obligations to periods of 15 days, a Federal Reserve Bank may make such advances with maturities up to 90 days because of the authority contained in the last paragraph of section 13.

2. Section 10(b) provides that advances under that section shall bear interest at a rate not less than one-half of one per cent higher than the highest discount rate

in effect at the lending Federal Reserve Bank. The regulation interprets this requirement as referring to the highest discount rate applicable to discounts for member banks under the provisions of sections 13 and 13a.

3. The regulation sets forth illustrative classes of assets which may be used as collateral security for advances under section 10(b). These include not only eligible paper and Government obligations, but such assets as investment securities, obligations insured under the National Housing Act, obligations of Federal Home Loan Banks, revenue bonds of States and political subdivisions, and paper representing real estate loans and installment loans which complies with the standards set forth in the Appendix to the regulation.

Section 3. General Requirements as to Discounts and Advances

This section of the regulation is largely procedural in nature. It restates the statutory requirement that every application for discount must be accompanied by a certificate to the effect that the borrower is not liable to the member bank in an amount greater than that which could be borrowed from a national bank. It repeats also the provisions of section 4 of the Act and the language contained in the "General Principles" at the beginning of the regulation regarding the duty of the Federal Reserve Banks to keep themselves informed as to the character and amount of the loans and investments of member banks with a view to determining whether undue use is being made of Federal Reserve credit.

In addition, section 3 requires that every application for a discount or advance must contain a certificate to the effect that the paper offered has not been acquired from a nonmember bank or, if so acquired, that appropriate permission has been obtained from the Board of Governors. It is also provided that a Federal Reserve Bank may require a member bank to file financial statements with respect to any of the parties to the paper offered for discount and with respect to any corporations or firms affiliated with such parties.

Certain provisions of the section, while procedural in character, have a bearing upon the effect of particular advances and discounts upon general credit conditions. It is provided that a Federal Reserve Bank may require such additional or marginal collateral as it may deem advisable or necessary for its protection; but, in determining the amount of any such additional collateral, the Reserve Bank is expected to give due regard to the public welfare and the general effects that such requirement may have on the position of the member bank, its depositors, and the community. It is stated that in general a Reserve Bank should limit the amount of such additional collateral to the minimum consistent with safety. If the value of the collateral required exceeds 25 per cent of the amount of the paper discounted, or 125 per cent of the amount of the advance, as the case may be, the Reserve Bank is required to include an explanation of the facts and circumstances of the case in its loan schedule submitted to the Board of Governors.

Somewhat similar is a provision which requires that if the amount of any advance made to a member bank on its note secured by direct or guaranteed obligations of the United States is less than the face amount of such obligations, the Reserve Bank shall likewise include an explanation of the facts and circumstances of the case in its loan schedule.

Section 4. Paper Acquired from Nonmember Banks

Based upon the provisions of section 19 of the Federal Reserve Act which prohibit a member bank from acting as the medium or agent of a nonmember bank in obtaining discounts, this section of the regulation provides that, without the Board's permission, no Federal Reserve Bank shall discount or accept as security for an advance any assets acquired by a member bank from a nonmember bank or which bear the endorsement of a nonmember bank, unless the assets were purchased by the member bank in the open market or otherwise acquired in good faith and not for the purpose of obtaining credit for the nonmember bank. The regulation prescribes the manner in which any application for permission to discount paper acquired from nonmember banks must be submitted to the Board of Governors. Express permission is granted by the regulation for the discount of paper bearing the endorsement of or acquired from Federal intermediate credit banks.

Section 5. Discounts for Federal Intermediate Credit Banks

This section restates the provisions of section 13a of the Federal Reserve Act as to the kinds and maturity of paper which may be discounted for Federal intermediate credit banks. In addition, the section requires any Federal Reserve Bank receiving a discount application from a Federal intermediate credit bank to give preference to the demands of its own member banks and due regard to the probable future needs of its member banks. A requirement made by the regulation but not by the law is that, except with the Board's permission, no Federal Reserve Bank shall discount paper for a Federal intermediate credit bank when its own reserves are less than 50 per cent of its own aggregate liabilities for deposits and Federal Reserve notes in actual circulation.

Section 6. Bankers' Acceptances

The final section of the regulation, relating to the discounting of bankers' acceptances, is again mostly a restatement of the provisions of section 13 regarding the discounting of bankers' acceptances, the kinds of acceptances which may be made by member banks, and limitations upon the amounts of such acceptances. However, the section includes a number of explanatory or interpretive provisions based largely on rulings made by the Board during the early years of the System. The following examples may be mentioned:

1. The term "bankers' acceptance" is defined as a draft or bill accepted by a bank or trust company or a firm, person, company, or corporation engaged generally in the business of granting bankers' acceptance credits.

2. The descriptions of the three types of acceptances set forth in the seventh paragraph of section 13 are somewhat elaborated in the regulation. Thus, the statutory reference to "domestic shipments" is described as meaning

shipments of goods within the United States. Also, the statutory requirement that acceptances covering the storage of staples must be secured by a warehouse receipt or other document conveying or securing title is interpreted as meaning that such a receipt must be issued by a party independent of the customer or by a duly licensed warehouse company; and the regulation specifies certain conditions which must be observed if trust receipts or similar documents are substituted in lieu of the original documents.

3. In connection with the statutory requirement that acceptances for any one customer in excess of 10 per cent of the capital and surplus of the accepting bank must be secured by attached documents or other actual security, the regulation enumerates various types of documents which will meet this requirement and specifically provides that trust receipts will not be considered as "actual security" if they permit the customer to have access to, or control over, the goods.

4. With respect to the maturity of bankers' acceptances, the regulation provides that, in addition to the statutory requirement that the acceptance must have a maturity of not more than 90 days at the time of discount, any acceptance discounted should not have a maturity in excess of the usual or customary period of credit required to finance the underlying transaction or in excess of the period reasonably necessary to finance such transaction.

5. As a procedural matter, the regulation states that a Federal Reserve Bank must be satisfied that the acceptance is eligible for discount and that the bill itself must be drawn so as to evidence the character of the underlying transaction, although, if it is not so drawn, evidence of eligibility may be provided by a stamp or certificate affixed by the acceptor.

Appendix

While not a part of the regulation, and while recognizing the fact that requirements of individual banks in making loans will vary according to the circumstances of particular transactions, an Appendix to the regulation sets forth certain minimum standards which the Board of Governors believes should be observed as a matter of sound banking practice in connection with loans on real estate and loans made on an installment basis. The Appendix states that these standards should be taken into consideration by examiners in reviewing loans of member banks and by the Federal Reserve Banks in passing upon applications of member banks for credit accommodations supported by real estate loans or by obligations drawn to finance the sale of goods on an installment basis.

With respect to real estate loans, the standards recommended include those prescribed as a matter of law by section 24 of the Federal Reserve Act with respect to real estate loans by national banks, i.e., that the loan should be secured by a first lien on improved real estate, and that the amount of the loan should not exceed 50 per cent of the appraised value of the real estate or have a maturity of more than five years, except where the loan is to be amortized, in which event the amount should not exceed 60 per cent of the appraised value of the real estate, and maturity should not be greater than ten years. In addition, the recommended standards call for the maintenance by the member bank of certain documents, including a recent appraisal of the real estate, an adequate description of the real estate, evidence of title, and evidence that there are no delinquent taxes and that the insurance carried is adequate.

With respect to installment paper, the Appendix recommends that such paper be secured by a first lien or retention of title to goods; that the goods be of such nature as to assure that upon resale the sum realized will be sufficient to liquidate the loan; and that reasonable steps will be taken by the member bank to satisfy itself that payments will be made in accordance with the terms of the obligation.

Summary of Principal Regulatory Provisions

From the foregoing discussion of the contents of the regulation, it is evident that the purely regulatory aspects of the regulation are few. Most of the nonstatutory provisions merely reflect past rulings of the Board interpreting the provisions of the law, such as those relating to permanent or fixed capital investments, the meaning of readily marketable staples, the necessity for an independent warehouseman in the case of bankers' acceptances covering storage of readily marketable staples, and the insufficiency of a trust receipt as "actual security" where it permits the customer to have access to the goods.

There are, however, a few provisions of the regulation which go beyond the requirements of the law. Of particular importance are those which require a Federal Reserve Bank to furnish an explanation of the circumstances of any case in which marginal or additional security is required by the Reserve Bank beyond a certain percentage and in which the amount of any advance on Government obligations is less than the face amount of such obligations. Additional provisions not required by the statute are those which require paper offered for discount to be negotiable and which prohibit discounts for Federal intermediate credit banks when the reserves of the discounting Federal Reserve Bank fall below a specified amount.

III. HISTORICAL DEVELOPMENT OF REGULATION A

Having in mind the nature and scope of the provisions of Regulation A as it exists today, it may be of interest and of some assistance in connection with the current study of the discount mechanism to review the history of the regulation since 1913 with some indication of the reasons for the various changes which have led to the development of the regulation into its present form. Such a review will show the extent to which the regulation reflects changes from time to time in the past in the discount policies of Congress and of the System - different views at different times as to the extent to which Federal Reserve credit should be made available and as to the proper uses of such credit.

Certain of the older provisions of the regulation reflect the emphasis placed on the granting of discounts for "productive" purposes during the very early years of the System. Other provisions date from the early 1920's when it was the policy of Congress and the System to encourage the development of an acceptance market. Still others bear witness to the stimulus given by the Agricultural Credits Act of 1923 to the use of Federal Reserve credit as a means of financing agriculture. Finally, many of the provisions of the present regulation grew out of the economic depression of the early 1930's when a policy of making Federal Reserve credit more freely available, without regard to formal requirements as to eligibility of paper, was coupled with a new emphasis upon the public duty of the System to see that such credit was not used for purposes inconsistent with sound credit conditions.

For convenience, and with the realization that such a division is arbitrary, a review of the history of Regulation A may be divided into four periods: (1) the formative years between 1914 and 1916, when the regulation was relatively brief and when emphasis was placed on the use of discounts for productive purposes; (2) the period between 1916 and 1923 when the regulation was concerned largely with bankers' acceptances; (3) the period from 1923 to 1937, during the first part of which emphasis shifted to agricultural credits; and (4) the period since 1937, characterized chiefly by the major revision of Regulation A in that year to reflect important changes made in the law by the Banking Acts of 1933 and 1935.

It should be noted that in the following historical account of the manner in which various provisions came to be a part of Regulation A, there is necessarily considerable duplication of the material contained in the preceding section of this memorandum describing the provisions of the present regulation.

A. THE FORMATIVE YEARS (1914-1916)

The original Federal Reserve Act contained relatively few provisions regarding the discount operations of the Federal Reserve Act. Section 13 provided, as it does today, for the discounting of 90-day "eligible paper" drawn for agricultural, industrial, or commercial purposes, with the prohibition against the discount of paper drawn merely for investment or for the purpose of carrying or trading in securities other than obligations of the United States. Agricultural paper with maturities up to six months was eligible for discount, but only in an aggregate amount not exceeding a specified percentage of the capital of the Federal Reserve Bank to be fixed by the Federal Reserve Board. Bankers' acceptances were also eligible for discount, but were limited to acceptances covering the importation or exportation of goods. These were the only provisions on the subject, except for a limitation on the discounting of paper of one borrower.

On November 10, 1914, before the Federal Reserve Banks had opened for business, the Federal Reserve Board issued several circulars and regulations relating to discounts by the Federal Reserve Banks. In a general statement the Board expressed the view that the functions of the Reserve Banks were two-fold: (1) to grant credit facilities, particularly when abnormal conditions create emergencies demanding prompt relief, and, on the other hand, (2) to protect the gold holdings of the country so that they may remain adequate to meet all demands. The Board felt that credit facilities should be liberally extended in some parts of the country, but believed it advisable to proceed with caution in districts not in need of immediate relief. It stated that, while a narrow interpretation should not be placed upon the meaning of paper eligible for discount, there should be certain basic principles to guide the Federal Reserve Banks and member banks. These principles were:

(1) Paper to finance permanent investments should not be admitted for rediscount.

(2) Only short-term paper with maturities of not more than 90 days should be discounted; and maturities should be so well distributed as to enable the Reserve Banks to be in a position to liquidate, whenever such a course should become necessary, substantially one-third of all their investments within a period of 30 days.

(3) Since single-name paper, unlike double-name paper does not show on its face the character of the underlying transaction, each Federal Reserve Bank should insist that member banks carefully examine the character of the business and the general status of the concern furnishing single-name paper in order to be certain that it was not issued for purposes of an investment or speculative nature. To this end, the Board prescribed a general rule that no paper should be rediscounted which did not bear on its face evidence of its eligibility for rediscount. This evidence could be supplied by a rubber stamp placed on the paper by the member bank stating that the paper was eligible for discount and citing the number of the credit file of the borrower.

The actual discount regulations issued by the Board in November 1914 did little more than restate the applicable provisions of the law. They did, however, specifically provide that paper whose proceeds were to be used for permanent or fixed investments and paper drawn for merely speculative purposes would not be eligible for discount.

In January 1915, the Board issued a regulation on the subject of "commercial paper" which, after stating the statutory provisions regarding discounts, provided that in order for a bill to be eligible for discount, its proceeds must be used in producing, purchasing, carrying, or marketing goods in one or more of the steps of the process of production, manufacture, or distribution; that it must not be for permanent or fixed investments; and that it must not be for investments of a merely speculative character.

Bankers' acceptances were separately treated in a regulation issued in February 1915. In issuing this regulation, the Board expressed the view that, while the acceptance business was still in its infancy, its development was certain and, accordingly, the Board had determined to allow the Reserve Banks latitude in fixing rates for acceptances within maximum and minimum limits. It was also stated at that time that, in accordance with the spirit of the Federal Reserve Act, preferential treatment should be given to acceptances bearing the endorsement of member banks even to the point of allowing lower discount rates for such acceptances.

Separate treatment was also given to trade acceptances and commodity paper in brief regulations issued in July and September 1915;

and it was indicated that discount rates for such paper could be expected to be lower than the rates established for ordinary commercial paper.

B. THE BANKERS' ACCEPTANCES PERIOD (1916-1923)

Certain changes were made in the discount provisions of the Federal Reserve Act by the Act of September 7, 1916, especially with reference to bankers' acceptances. Whereas acceptances previously had been limited to those growing out of the importation or exportation of goods, the amendments made by this Act for the first time authorized the discount of acceptances growing out of domestic shipments of goods and the storage of readily marketable staples and acceptances drawn to create dollar exchange. In addition, the 1916 amendments for the first time authorized the Reserve Banks to make advances to member banks as distinguished from discounts, but such advances were limited to 15-day advances secured by "eligible paper" or by bonds or notes of the United States.

In the light of these amendments to the law, the Board on September 15, 1916, issued a regulation which for the first time was called Regulation A, and which included with slight changes, the provisions regarding the discounting of the various types of paper which had formerly been covered by separate regulations, i.e., commercial paper, trade acceptances, agricultural paper, commodity paper, and bankers' acceptances. The principal changes in the new regulation were changes necessary to conform to the recent amendments to the law regarding bankers' acceptances and advances on eligible paper.

With interest still focused on bankers' acceptances, Regulation A was revised in 1920 to incorporate certain rulings and interpretations of the Board as to the eligibility of acceptances for discount. Thus, the regulation for the first time interpreted "domestic shipments" as meaning shipments "within the United States"; provided that an acceptance covering domestic shipment of goods must be supported by shipping documents attached at the time the draft is presented for acceptance; and provided that the maturity of an acceptance at the time of rediscount should not be in excess of the customary period of credit required to finance the underlying transaction.

In 1922, the regulation was again revised and again the changes related almost entirely to the subject of bankers' acceptances, chiefly changes which eliminated some of the detailed interpretations included in the previous draft. In issuing the revised regulation, the Board stated, however, that it was not in any way modifying its former rulings on the subject, and that the intent of the changes was merely to "allow greater latitude to Federal Reserve Banks for the exercise, each in its own way, of their discretion and judgment". The Board stated also that it would watch carefully the development of the acceptance business under the simplified regulation and would call to the attention of the Federal Reserve Banks any apparent "abuse of the acceptance privilege".

C. THE PERIOD FROM 1923 TO 1937

Emphasis was shifted from bankers' acceptances to discounts for agricultural purposes by the Agricultural Credits Act of March 4, 1923. That Act made the following changes in the discount provisions of the Federal Reserve Act, most of which were for the purpose of making Federal Reserve credit more available for agricultural purposes:

1. Factors' paper to finance producers of staple agricultural products in their raw state was made eligible for discount;

2. Reserve Banks were authorized to discount for member banks sight drafts drawn to finance the domestic shipment of agricultural products;

3. As an exception to the requirement that bankers' acceptances offered for discount must have a maturity of not more than 90 days at the time of discount, it was provided that acceptances drawn for agricultural purposes could be discounted with maturities of not more than six months at the time of discount;

4. By a new section 13a, the Federal Reserve Banks were authorized to discount agricultural paper having maturities of not more than nine months, including paper drawn by cooperative marketing associations, and also to rediscount paper for the Federal intermediate credit banks.

These changes in the law were incorporated in a revision of Regulation A issued in July 1923, and only in a few respects did the revised regulation go beyond the language of the law. One purely regulatory provision, however, required the Reserve Banks, in passing on paper of Federal intermediate credit banks, to give preference to the demands of their own member banks and to have due regard to the future needs of their member banks. It was also provided that no Reserve Bank should discount such paper if its own reserves were less than 50 per cent of its aggregate liabilities for deposits and Federal Reserve notes in actual circulation, and that the aggregate amount of paper discounted by all Reserve Banks for any one intermediate credit bank should not exceed the capital and surplus of such intermediate credit bank. Later, by an amendment to the regulation in 1928, these restrictions with respect to the discounting of paper for Federal intermediate credit banks were amended so as to authorize exceptions with the permission of the Federal Reserve Board. It may be questionable whether some of these restrictions are necessary under present conditions.

In 1924, Regulation A was amended so as to require that, whenever the makers of notes offered for rediscount had closely affiliated or subsidiary corporations, separate financial statements of such affiliated corporations should accompany the financial statement of the borrower. This requirement, however, was modified in 1927, and was further liberalized in 1937 so as merely to authorize a Federal

Reserve Bank to require the filing of statements reflecting the financial worth of parties to the paper offered for discount or of any corporations or firms affiliated with such parties.

In a revision of Regulation A effective January 3, 1928, the principal change was the insertion of a new section regarding the discount of paper acquired by member banks from nonmember banks. In 1921, the Board had granted general authority to member banks to apply to their respective Reserve Banks for the discount of paper acquired from nonmember banks, but that authority had been revoked in 1923. In 1926, the Board granted general permission for the rediscount of paper endorsed by Federal intermediate credit banks. This general permission was incorporated in the 1928 regulation, together with a provision permitting the discount of bankers' acceptances and other eligible paper endorsed by a nonmember bank, if the paper was purchased by the member bank in good faith on the open market from a party other than the nonmember bank. These provisions are still in Regulation A, although in 1937 the provision authorizing the discount of paper acquired in the open market was broadened to permit the discount of nonmember bank paper acquired either in the open market or otherwise acquired in good faith and not for the purpose of obtaining credit for a nonmember bank.

In 1930, certain minor changes were made in the regulation, mostly for the purpose of conforming to technical changes in the law. The most important was an amendment to the provisions regarding the discounting of sight drafts in order to cover the discount of drafts drawn for nonagricultural, as well as agricultural purposes, and to finance the domestic shipment of goods, as well as the exportation of goods. These changes were in accordance with changes made in the law by an Act of May 29, 1928.

D. FROM 1937 TO THE PRESENT TIME

No changes were made in Regulation A between 1930 and 1937. It was during that period, however, that the economic depression of the early 1930's directed new attention to the credit accommodations available through the Federal Reserve Banks; and in various statutes enacted between 1932 and 1935, the authority of the Reserve Banks to make discounts and advances was broadened in a number of respects. The maturity of advances to member banks on notes secured by eligible paper was increased from 15 to 90 days; and the collateral eligible for 15-day advances to member banks was broadened to include obligations of Federal intermediate credit banks, bonds of the Federal Farm Mortgage Corporation, and bonds issued under the Home Owners' Loan Act. The Reserve Banks were authorized to make advances to any individuals, partnerships, or corporations on the security of direct obligations of the United States for periods up to 90 days; to make emergency advances to groups of five or more member banks; and to discount paper, in unusual and exigent circumstances, for individuals, partnerships, and corporations. Most important of all, the Federal Reserve Banks were empowered to make advances to member banks on the security of any assets satisfactory to the Federal Reserve Banks.

Along with these measures expanding the discount authority of the Reserve Banks, there was also a new emphasis placed upon the responsibility of the Reserve Banks to see to it that Federal Reserve credit was not being used for speculative purposes or for any purposes inconsistent with the maintenance of sound credit conditions. By an amendment to section 4 of the Federal Reserve Act, the Banking Act of 1933 expressly required each Federal Reserve Bank to extend credit accommodations with due regard to the maintenance of sound credit conditions and to keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether any undue use is being made of bank credit for the speculative carrying of, or trading in, securities, real estate, commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions.

In the light of these changes in the law, the Board of Governors, after many months of consideration, revised its Regulation A effective October 1, 1937. The more important changes dealt with (1) the responsibility of the Reserve Banks to see that Federal Reserve credit was not used for purposes inconsistent with sound credit conditions; (2) the eligibility of finance paper for discount; (3) construction loan paper; (4) the maturity of advances on eligible paper and

Government obligations; (5) marginal collateral; (6) extension of credit on Government obligations at par; (7) advances on the security of any sound assets; and (8) standards to be observed by member banks in making loans on real estate or installment loan paper.

(1) Improper Use of Federal Reserve Credit

The revised regulation was prefaced by a statement of "General Principles", which briefly restated the provisions of section 4 of the Federal Reserve Act referred to above regarding the responsibility of the Reserve Banks to see that credit was not used for speculative purposes or purposes inconsistent with the maintenance of sound credit conditions. It was also stated that the guiding principle underlying the discount policy of the Federal Reserve Banks is the advancement of the public interest.

In the regulation itself it was expressly provided that, as stated in section 4 of the Act, each Reserve Bank should keep itself informed of the general character and amount of the loans and investments of its member banks in order to ascertain whether undue use is being made of credit for speculative credit purposes and that each Reserve Bank should require such information from its member banks as it might deem necessary in order to determine whether any such undue use of bank credit is being made.

This responsibility of the Reserve Banks was emphasized in the Board's annual report to Congress for 1937, in which it was stated:

"Federal Reserve Banks differ from commercial banks in that they are not organized for the purpose of making profits but for the purpose of being of public service. Accordingly, in a preface to the new regulation it is stated that the guiding principle underlying the discount policy of the Federal Reserve Banks is the advancement of the public interest and that the effect that the granting or withholding of credit accommodation by a Federal Reserve Bank may have on a member bank, on its depositors, and on the community is of primary importance".

(2) Eligibility of Finance Paper for Discount

As early as 1919, the Board had ruled that paper the proceeds of which were to be used to lend to some third party was finance paper rather than commercial paper and was therefore not eligible for discount by a Federal Reserve Bank, even though the third party involved might use the proceeds for a commercial purpose. This ruling had been incorporated in Regulation A in 1920.

This prohibition was eliminated in the 1937 revision of the regulation. In its annual report for that year the Board stated:

"* * * The elimination of this provision rendered eligible for discount a large amount of paper of commission merchants and finance companies, including paper drawn to finance installment sales of a commercial character."

(3) Construction Loans

In connection with certain amendments to the National Housing Act, the Act of June 27, 1934 added to section 24 of the Federal Reserve

Act a paragraph stating in effect that loans made to finance the construction of residential or farm buildings and having maturities of not more than six months should not be considered as real estate loans within the meaning of that section but should be classed as "ordinary commercial loans". Notes representing any such loans were made eligible for discount as commercial paper if accompanied by a binding agreement to advance the full amount of the loan upon completion of the building entered into by a party acceptable to the discounting Federal Reserve Bank. This provision was incorporated in the 1937 revision of Regulation A.

(4) Maturity of Advances on Eligible Paper and Government Obligations

The Banking Act of 1933 had amended the eighth paragraph of section 13 so as to permit maturities of not more than 90 days, instead of 15 days, on advances made to member banks on their promissory notes secured by paper eligible for rediscount or for purchase by the Federal Reserve Banks. The 1937 revision of Regulation A incorporated this amendment.

The Emergency Banking Act of March 9, 1933, had added a paragraph to section 13 of the Federal Reserve Act authorizing the Federal Reserve Banks to make advances for not more than 90 days to any individual, partnership, or corporation on their notes secured by direct obligations of the United States. The Board of Governors had interpreted the term "corporation" in this provision to include any incorporated bank, including a member bank. This meant that, despite the 15-day limitation on the maturity of advances to member banks on Government obligations contained in the eighth paragraph of section 13, the Reserve Banks could now extend credit to member banks on their notes secured by Government obligations with maturities up to 90 days.

The revised Regulation A retained in the text the requirement for a maximum 15-day maturity on advances to member banks secured by Government obligations; but there was added a footnote to this provision explaining that under the last paragraph of section 13 any Reserve Bank might make advances for periods not exceeding 90 days to individuals, partnerships, or corporations (including banks) on their promissory notes secured by direct obligations of the United States.

Notwithstanding this footnote, questions arose as to the permissible maturity on advances secured by Government obligations; and in order to clarify the matter the regulation was amended in 1942 so as to provide expressly that advances to member banks on their notes secured by direct obligations of the United States might have maturities up to 90 days. The footnote to the provision was also revised in order to explain why 90-day maturities were permitted with respect to such advances notwithstanding the 15-day limitation on maturities prescribed by the eighth paragraph of section 13.

(5) Marginal Collateral

New provisions of the 1937 revision of the regulation which were not merely restatements of the law were those relating to marginal collateral for discounts and advances. It was stated that a Reserve Bank could require such marginal or additional collateral as it might deem necessary for its protection and that the requirements as to eligibility of collateral would not apply to any such additional or marginal collateral. However, in keeping with the concept that the Reserve Banks have a public responsibility in extending credit accommodations, the regulation also provided that, in determining the amount of any such additional collateral, the Reserve Bank would be expected to give due regard "to the public welfare and the general effects that its action might have on the position of the member bank, on its depositors and on the community". It was stated that a Reserve Bank would in general be expected to limit the amount of additional collateral to a minimum consistent with safety. If the amount of the required collateral should exceed 25 per cent of the amount of the paper discounted or 125 per cent of the amount of the advance, the Reserve Bank is required by the regulation to include an explanation of the facts and circumstances of the case in its loan schedule to be submitted to the Board of Governors.

(6) Advances at Par on Government Obligations

Another new provision of the regulation not required by changes in the statute was that which required a Reserve Bank to explain in its loan schedule the facts and circumstances of any case in which the amount of an advance to a member bank secured by direct or guaranteed obligations of the United States is less than the face amount of such obligations. Apparently the principal purpose of this provision was to encourage the use of Government obligations as collateral for obtaining credit from the Reserve Banks and to discourage advances on such obligations at less than par. However, the provision was less emphatic in this respect than one which had been considered during the drafting of the revised regulation which would have expressly stated that a member bank "may obtain credit in an amount equal to the face amount" of direct or guaranteed obligations of the United States.

In this connection, it may be noted that in 1939 it was announced that the Federal Reserve Banks were prepared to make advances on Government securities at par to all banks. This policy was reaffirmed in 1941 and has never been expressly rescinded.

(7) Advances to Member Banks on Any Sound Assets

In February 1932, when most commercial banks had very little paper eligible for discount with the Reserve Banks, Congress had added to the Federal Reserve Act a new section 10(b) which gave the Federal Reserve Banks temporary authority to make advances in exceptional and exigent circumstances to any member bank having no assets eligible for rediscount on the security of the note of such member bank "secured to the satisfaction" of the Reserve Bank. It was provided, however, that any such advance should bear interest at a rate not less than one per cent higher than the highest discount rate in effect at the Reserve Bank, and that the Federal Reserve Board might by regulation limit and define the classes of assets which could be accepted as security for such advances.

This authority was extended in 1933, and made permanent by the Banking Act of 1935. The 1933 amendment eliminated the authority of the Federal Reserve Board to limit and define the classes of assets eligible as security but gave the Board general authority to prescribe rules and regulations with respect to such advances. The amendment made by the Banking Act of 1935 not only placed the authority on a permanent basis but broadened the authority by eliminating the requirement that advances should be made only in exceptional and exigent circumstances and only to member banks which did not have paper eligible for discount. It also lowered the premium rate of interest on such advances from one per cent to one-half of one per cent above the regular discount rate. On the other hand, the 1935 amendment limited to four months the maturities of advances made under this section.

The authority thus given the Reserve Banks to make advances on any sound assets was something of a departure from prior concepts of the discounting authority of the Reserve Banks which had been based largely upon the form of the paper offered for discount. In its annual report for 1937, the Board stated:

> "* * * These changes in the law, culminating in the Banking Act of 1935, reflected a definite change in the intention of Congress as to the character of assets which may be used as a basis for credit accommodations at a Federal Reserve Bank. Under the original Federal Reserve Act the concept of the rediscount function of the Reserve Banks was limited to providing member banks with credit on short-term paper arising out of specific commercial,

industrial and agricultural transactions, particularly to meet seasonal requirements; whereas under the more recent amendments to the law it is provided that any assets of a member bank which are satisfactory to a Reserve Bank may be used as a basis for obtaining credit.

"* * * Experience has demonstrated that the solvency of banks is better safeguarded by careful regard to the quality of the paper that they acquire than by strict observance of the form that this paper takes, and that greater emphasis on soundness and less emphasis on form is a sound banking principle. * * *"

Although the Board was authorized by section 10(b) to prescribe rules and regulations with respect to advances under that section, the revised regulation went no further than to paraphrase the statute and to set forth certain enumerated classes of assets which would be considered as satisfactory security for advances under this section. The regulation stated, however, that whenever circumstances make it advisable to do so, a Federal Reserve Bank might accept as security for a section 10(b) advance assets other than those listed in the regulation which were satisfactory to the Federal Reserve Bank. Nevertheless, although the regulation does not so state, the Board's annual report for 1937 indicated that the enumerated classes of assets were regarded as "preferred classes of assets which cover the principal fields of financing".

(8) Standards regarding Real Estate Loans and Installment Loan Paper

Under section 10(b) of the Federal Reserve Act, it had become permissible for the Reserve Banks to make advances to member banks on the security of any assets satisfactory to the Reserve Bank. Also, the lifting of the regulatory prohibition against the discounting of finance paper had made it possible for the Reserve Banks to discount paper drawn to finance installment sales.

In order to encourage member banks to have their real estate loans and installment paper in a form which would make them acceptable as a basis for advances by the Reserve Banks, the Board set forth in an appendix to the revised Regulation A certain recommended minimum standards which should be observed by member banks in making such loans. These standards have been summarized earlier in this memorandum. (see page 17)

IV. CONCLUSION

It is recognized that the foregoing review of the history of Regulation A may not necessarily be helpful in determining whether any changes should be made in the regulation, since it is most likely that any need for changes would arise out of present-day conditions. This review, however, may be of some assistance as background in considering whether any changes in the regulation are desirable at this time. One conclusion seems clear: Regulation A is largely a restatement of the law and only to a limited extent regulatory in nature.

Despite the Board's broad authority to prescribe regulations and limitations with respect to discounts and advances, to define the character of paper eligible for discount, and to define the conditions under which credit accommodations may be extended to member banks, the regulation indicates that this authority has not been extensively exercised.

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