FUNDAMENTAL REAPPRAISAL OF THE DISCOUNT MECHANISM

SELECTIVE CREDIT CONTROL

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The analyses and conclusions set forth are those of the author and do not necessarily indicate concurrence by other members of the research staffs, by the Board of Governors, or by the Federal Reserve Banks.

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A. Federal Reserve Discount Policy as an Instrument for Selective Credit Control

One strand of thought in the Federal Reserve Act and in the statements and actions of Federal Reserve officials through the years is that discount policy should be used, at least on occasion, to influence the uses to which credit will be put - that it should be an important instrument, if not the principal instrument, for selective credit control.

This entire idea requires rethinking. For purposes of argument, I shall concede that on occasion the Federal Reserve may wish to exercise some degree of selective control over the uses of credit, by types of borrower and/or by types of use to which the credit is put. Selective control may be attempted over (1) credit from all sources, (2) credit from all commercial banks, (3) credit from all member banks, or (4) credit from banks that are currently borrowing from the Federal Reserve. My thesis is that primary reliance on discount policy to achieve such results is likely to prove ineffective, or to have undesirable side effects, or both. I believe Federal Reserve history bears me out. If the Federal Reserve wishes to exercise selective credit controls it should rely primarily on other more comprehensive controls.

To analyze this, consider some methods that have been used.

1. Attempts to encourage certain types of paper and to hold down interest costs on it by giving it privileged access to the Federal Reserve Banks. This can, of course, be successful if the Reserve Banks stand passively ready to buy all of the paper presented at the posted buying rate with no onus on the sellers. For example, this worked in the late 1920's when the Fed was the willing residual buyer of acceptances. It would also work if the Fed stood ready to discount or lend on the paper with no quantitative limit and no onus on the borrower. The rate on the paper could be held low relative to other market rates. Note, however: (a) the Fed loses control over the volume of its holdings of the paper; it has to buy all of the supply that others are unwilling to hold at the Fed rate; (b) it has no control over the types of credit created on the basis of the newly-issued reserves.

Now alter the situation by imposing some sort of quantitative control over the volume of borrowing by individual banks. This might be a "tradition against continuous or excessive borrowing" or anything else that made it impossible or disadvantageous to borrow fully on the basis of the "favored" type of paper. In this case it no longer follows that the favored type of paper will enjoy a lower market yield relative to other yields or that there will necessarily be a net increase in total demands for the paper.

To attract the marginal holder necessary to make demands equal to supply, the rate may have to be fully competitive with other market rates. And it still remains true that the Fed cannot control the types of credit created on the basis of the new reserves.

2. Make "undesirable" types of paper ineligible as a basis for borrowing at the Fed. This might indeed reduce the banks' demand for this type of paper if they did not hold "eligible" paper of other types sufficient to cover likely needs for borrowing at the Fed or the quantities the Fed would be willing to lend, whichever is smaller. But if banks have plenty of eligible paper, their willingness to acquire ineligible paper will be little reduced by its ineligibility.

3. Deny the discounting privilege to banks which hold "undesirable types of paper", or too much of it. The classic case occurred in 1929, when the Fed wished simultaneously to curb "speculative security loans" and to maintain reasonable rates for "legitimate business." The technique attempted was to deny, or at least limit, Fed loans to banks with speculative security loans. Note that this did not affect at all broad classes of lenders: all nonbank lenders, nonmember banks, and member banks who were not in debt to the Fed and expected that they would not need to borrow. This narrow coverage was enough to doom the experiment. It probably

did restrict somewhat such loans by member banks who were borrowing at the Fed or who feared they might have to do so. But the restrictive effects on such banks were not nearly so selective as the Fed hoped. Such banks had several ways of getting out of debt to the Fed, or of avoiding borrowing there, while maintaining speculative loans on securities. (a) Federal funds. They bid this rate considerably above the discount rate. (b) Sales of acceptances, Government securities, and other open-market assets. They did this extensively. (c) Sell mortgages, or refrain from buying them. (d) Even go so far as to limit loans to business customers.

In short, the whole attempt was a failure. Loans on securities continued to rise up to the eve of the crash and the restrictive effects were not selective; credit of all kinds to all kinds of users was restricted. Governor Harrison later claimed that this whole "moral suasion" effort aimed only at borrowing members made banks less willing to borrow at the Fed in the early 1930's. Whether or not this is true, it is plausible.

Not only this case but also other evidence and a priori reasoning lead me to the conclusion that it is unwise to rely primarily, or even heavily, on discounting policy as an instrument for selective credit control. When this is done the offense is not that of making "undesirable" types of loans; it is that of making or holding such types of loans by banks in debt to the Fed. Banks and others not in debt to the Fed can make such loans without restriction or onus. Moral: stay out of debt to the Fed and thus maintain freedom of action. I believe that the effects of such policies, if resorted to frequently, would be to:

1. Inhibit use of the Fed discount window and militate against the development of discounting. Reluctance to borrow would be augmented by "reluctance to become subject to Fed selective controls." Banks, especially the larger ones, would develop even further their capacity to "stay out of the Fed" through Federal funds, CD's, repurchase agreements, etc.

2. Penalize the wrong thing, i.e., borrowing at the Fed rather than the making of "undesirable loans." Presumably the prime purpose of selective controls is to regulate the latter. The former is a clumsy, ineffective, and inequitable way of trying to achieve the latter.

3. Lead to an inefficient allocation of credit. Consider, for example, an attempt to limit business loans by controlling access to the discount window. Is there any reason to believe that the most efficient allocation of credit would require the smallest expansion by those banks which for one reason or another, such as deposit drains or inability to attract CD money, were borrowing at the Fed or feared they would have to?

B. Other Bases for Selective Credit Controls

As indicated above, I believe that selective credit controls, if they are to be used, should be based upon Fed powers broader than the power to discount and applied more widely than to member banks who are in debt to the Fed or fear that they soon may be. Ideally, such controls should have at least the following characteristics:

1. They should apply to all lenders, or at least to all potentially important lenders, in the market involved. They should not discriminate against banks borrowing at the Fed, or member banks, or commercial banks.

In some cases it may be enough for the regulations to cover only commercial banks; in other cases they should apply more widely.

2. They should be based upon the social desirability of controlling selectively the type of credit involved, and justified on the basis of Fed responsibility to exercise such controls, rather than on its power to discount.

3. They should be implemented with measures appropriate to the selective ends being sought. I do not pretend to know what these measures should be. However, some possibilities may be suggested; at least some of these would require permissive legislation. (Some readers may be shocked by the degree of selective intervention implied. But can selective controls be expected to work otherwise?)

a) Margin or downpayment requirements. (Implies knowledge of true values.)

b) Maximum periods of repayment.

c) Differential reserve requirements against various types of assets, or differential marginal reserve requirements against increases in various types of assets above some base.

d) Quantitative limitations on increases of selected types of assets above some base date. E.g., not more than 5% above level at end of 1966.

e) Limitations on selected types of assets as a percentage of total assets, or total deposits, or net worth, or some other base.

f) Limitations of changes of selected types of assets as a percentage of changes in total assets, or total deposits, etc.

g) Methods of encouraging banks to hold or even to increase their holdings of selected types of assets:

i) Secondary reserve requirements in the form of the favored types of assets equal to at least a stated percentage of deposits or of assets other than cash.

ii) Marginal secondary reserve requirements requiring increase of favored assets equal to at least some percentage of increase of other earning assets. This, and variations of it, offer interesting possibilities and problems.

iii) Permit banks, in computing required reserves, to deduct from their deposits (demand or time) all or a fraction of their holdings of the favored assets. (This percentage need not be the same as the percentage reserve requirement for the bank.)

Those who are more ingenious can think of other possibilities. The types of measures suggested above, and modifications of them, could be used in various combinations. Just one imaginary example. Consider the case in 1966 when the Fed wished to discourage both the expansion of business loans and bank liquidation of certain favored assets. It might have proclaimed the following (given the legal power): "until further notice, the required reserves of any bank will be equal to its regular required reserves against deposits plus an amount equal to 10 per cent of (the change of its business loans over a specified base date minus the change of its holdings of favored assets over the same specified base date.)" Consider three cases in which a bank increases its business loans by $100.

1. It increases its holdings of favored assets by the same amount. It has no required reserves against assets.

2. It holds constant its holdings of favored assets. It has required reserves against assets of $10.

3. It decreases by $100 its holdings of favored assets. It has required reserves against assets of $20.

Of course, this would encourage banks to try to borrow rather than sell favored assets. So, if you wish, you can slap a reserve requirement on all bank liabilities, including outstanding repurchase agreements.

This is one principle; you work out the details!

C. Some Further Observations on Discounting

Here are a few brief comments on lessons from the 1920's and early 1930's.

1. As I have indicated earlier, I believe bank willingness to borrow from the Fed and to remain in debt to it, as well bank demands for excess reserves, fluctuate in a procyclical manner, even when cycles are mild. One reason is the wide fluctuations of customer demands for loans. Another is that banks share the euphoria of boom and the hesitancy of recession. A third is that banks want to retire debt and build up liquid assets in depression because they fear less liquidity will be provided by net flows of funds to them. The moral of this, as many have pointed out, is that outstanding discounts should be liquidated through open-market purchases at the onset of recession. This should be obvious, but was not to most Federal Reserve officials in 1930-31.

2. Discounting does not appear to be a very effective device for supplying additional funds to credit-scarce areas over a prolonged period. In the 1920's this was tried; country banks were in some cases encouraged

to borrow, agricultural paper of longer maturity was made eligible for rediscount, and the Federal Intermediate Credit System was created. But the results seem to have been rather limited. The reasons for this were probably numerous, but important were the facts that banks had to endorse the paper and bear the risk, that they had in many cases too little capital to make this a sound practice, and that many lacked the inclination to extend themselves.

As I read the lesson, success in remedying credit scarcity over a prolonged period requires credit institutions that can bypass the banks and put credit in the hands of ultimate users. Admittedly, however, "success" is a relative term.