FUNDAMENTAL REAPPRAISAL OF THE DISCOUNT MECHANISM

RATIONALE AND OBJECTIVES OF THE 1955 REVISION OF REGULATION A

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Prepared for the Steering Committee for the Fundamental Reappraisal of the Discount Mechanism Appointed by the Board of Governors of the Federal Reserve System

The following paper is one of a series prepared by the research staffs of the Board of Governors of the Federal Reserve System and of the Federal Reserve Banks and by academic economists in connection with the Fundamental Reappraisal of the Discount Mechanism.

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.

REAPPRAISAL OF THE DISCOUNT MECHANISM

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by

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June 1966

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I. Introduction

The 1955 revision of the Federal Reserve System's Regulation A governing discounts and advances developed out of a study by a Federal Reserve System Committee in 1953 and 1954. The report issued by the Committee recommended the principal change adopted, a set of General Principles to guide borrowing and lending at the discount window.[1/] Its recommendations were deeply rooted in the development of the discount mechanism during the 1920's, and also in the System decision to rely principally on open market operations in the conduct of monetary policy once flexibility was re-established after the Treasury-Federal Reserve Accord.

This paper reviews and evaluates the rationale and objectives of the 1955 revision of Regulation A -- in particular as they relate to the mechanisms for rationing credit established by the "General Principles." The analysis is based principally on the 1954 System Committee report on the discount mechanism and is supplemented by responses to a questionnaire on discount operations sent to each Reserve Bank in 1965. The historical development of the discount mechanism in the 1920's and the principal changes represented by the 1955 revision are discussed elsewhere.[2/]

1/ System Committee on the Discount and Discount Rate Mechanism, "Report on the Discount Mechanism," March 12, 1954, unpublished document. (Hereafter referred to as "Report on the Discount Mechanism," 1954.)

2/ See Bernard Shull, Report on Research Undertaken in Connection with a System Study, Board of Governors, Federal Reserve System, August 1968.

II. The Current Regulation: Objectives and Techniques

The 1953-54 study of discounting was instituted as a result of concern about the possible "over-extension" of Federal Reserve credit through the discount window. In mid-1952 discounts and advances had increased to over $1.6 billion; while declining somewhat through the first half of 1953, they still exceeded $1 billion in each of the first months of the year.[1/]

1/ According to the "Report on the Discount Mechanism, 1954," p. 22: "In part the rapid rise in borrowing during 1952 was a direct effect of restrictive credit influence exerted by the System. But it also represented borrowing by some member banks to avoid excess profit taxes, by others to profit from differentials between prevailing discount rates and market yields that developed under the tightening credit market conditions, and by still others to supplement operating resources in order to accommodate the active credit demands being generated by inflationary trends. These developments in particular brought under discussion within the System the whole question of the philosophy and effectiveness of its existing discount mechanism." The circumstances leading to a revision in Regulation A were also described in the Annual Report of the Board of Governors of the Federal Reserve System, 1957, p. 9: "In 1952-53 as credit demands expanded and Federal Reserve policy limited the amount of reserves made available through open market operations, pressure on bank reserves increased, and member bank borrowing from the Reserve Banks rose rapidly. During this initial revival of the discount mechanism after a generation of disuse numerous problems arose, including uncertainty among many member banks about what was an appropriate use of the discount privilege... . As a result of these developments, the System re-examined historical experience, notably in the 1920's.... In the light of practices shown by experience to be appropriate and sound and also in the light of statutory provisions ..., the Board of Governors revised its Regulation A."

This upsurge in the volume of funds borrowed from the discount window developed after almost 20 years of low levels of activity. Between 1934 and 1943, discounts and advances averaged $11.8 million per year; between 1944 and 1951 they averaged $253 million. Only in the early post-World War I period (1918-21) and in the late 1920's (1928 and 29) did discounts and advances approximate, in dollar amount, the levels reached in 1952 and early 1953.1/

A. Objectives in revising Regulation A

In developing and recommending a reformulation of Regulation A, in these circumstances, the System Committee emphasized several objectives. These may be summarized as follows:

1/ In the 1918-21 period, they averaged $1,840 million; in the 1928-29 period they averaged $886 million. However, it should be noted that, in the 1918-21 period discounts and advances averaged close to 70 per cent of total Federal Reserve credit outstanding. In 1928-29, they represented about 60 per cent of such credit. At the peak of discount activity in December 1952, discount credit represented only 6 per cent of Federal Reserve credit outstanding. "Member Bank Reserves and Related Item," Supplement to Banking and Monetary Statistics, Section 10, 1962, pp. 14-19.

(1) The discount mechanism should not serve to relieve for long or indefinite periods the pressure of monetary restraint upon the banking system and its customers.[1/]

(2) Individual banks should not be permitted to depend on the discount window as a normal source of funds for investments and loans. Such dependence on borrowing unduly raises the risk of their insolvency and/or illiquidity.[2/]

1/ "(T)he borrowing facility should not provide a channel through which member banks generally or an important segment of them may be able to avert the over-all credit and monetary policies of the System ... (T)he discount facility [can] serve as a safety valve, easing temporarily the special reserve pressures on individual banks. At the same time, [the facility need not become] a gaping hole through which are released all the pressures on bank reserves built up within the banking system as a whole." "Report on the Discount Mechanism, 1954," pp. 9 and 12.

2/ "A major lesson brought out by the bank credit liquidation [in the early 1920's] ... was that it was unsound for any member bank to use continous indebtedness to its Reserve Bank as a resource for conducting regular banking operations.... In the severe banking crises and liquidation in the early thirties, adjustment problems of the aggressive, continuous borrowing banks made evident the hazards to safety of depositor funds and the dangers to bank solvency resulting from the injections between bank capital and deposits of borrowed funds having creditor status ahead of deposit liabilities." Ibid., pp. 10, 11.

Furthermore, increases in the risk of insolvency and illiquidity for individual banks, aside from being undesirable per se, endanger the stability of the financial system and militate against the effective operations of monetary policy. 1/

(3) That member banks are generally reluctant to borrow is, for the reasons above stated, in the public interest. In order to prevent a weakening of this

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1/ "Chronically indebted banks risk depositor pressure in the event that economic conditions turn adverse and the fact of their difficulties in a closely inter-dependent banking community can make other banks, even those in a strong position, highly sensitive about their own liquidity needs. This kind of banking climate can set the stage for a period of irrational bank credit liquidation. As Federal Reserve experience in at least one important period illustrates, constructive credit and monetary policy to cushion economic recession and foster revival can be rendered substantially ineffectual by persistent dependence on the discount facility developed by some banks in a prior phase of economic boom." Ibid., pp. 12, 13.

attitude, it is necessary that Regulation A be formulated so as to give support to the extant "tradition against borrowing."[1/]

With the achievement of these objectives, the Committee believed the discount mechanism could and should serve to meet the "needs" of individual member banks for credit accommodation to facilitate short-run adjustments in response to changes in the degree of monetary restraint and to meet "unexpected" changes in deposit flows or loan demand, and to ameliorate emergency situations.[2/] In this role, discounting would complement open market purchases and sales in achieving the desired degree of monetary restraint.

1/ "Because of this costly lesson [during the 1930's], it was possible by the mid-thirties to speak of an established tradition against member bank reliance on the discount facility as a supplement to its resources.... In a banking organization made up of thousands of member banks engaged in widely differing kinds of banking business, a well entrenched tradition against commercial bank reliance on borrowed funds is an important aid to reserve banking ... (S)uch a tradition permits the discount facility to serve as a safety valve.... From the standpoint of strong and responsive banking conditions, the tradition against borrowing in long periods of economic prosperity helps to prevent the more aggressive member banks from building up undue dependence on discount credit.... The Committee believes that the tradition against continous member bank dependence on the discount facility is sound in principle.... Future discount policy, in its opinion, should build on the tradition as a keystone.... (Italics added.) [However] (t)he tradition against large and continuous borrowing, being without adequate regulative support, is subject to the risk of weakening in periods of credit tightness.... Ibid., pp. 11-13, 22, 23.

2/ "It is desirable ... to keep open the privilege of individual member banks to borrow at the Reserve Banks to meet essential temporary or emergency needs." Ibid., p.9.

The Committee also expressed the belief that formulation of Regulation A to meet the objectives cited would serve to eliminate "incompatible inter-district differences in discount methods" among the Reserve Banks.[1/]

B. "General Principles"

To achieve these objectives, the "Report on the Discount Mechanism" recommended a set of "General Principles" to be incorporated into Regulation A.[2/] These were designed "... to guide Reserve Banks in lending and member banks in Reserve Bank borrowing," and "... to give clear and full expression to the discount obligations of the Reserve Banks as they are stated in, or implied by, present law."[3/]

The Committee indicated that "(a) key premise underlying the ... suggested revision of Regulation A is that explicit standards for use of the discount facility would reinforce the member bank tradition against borrowing by providing a frame of reference for

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1/ The "lack of a modernized System discount philosophy ... is a factor fostering undesirable regional differences in discount practices .... While some incompatible inter-district differences in discount methods may now exist, the committee is persuaded that the differences not supported by variations in regional conditions and needs would be largely eliminated by a Regulation A re-oriented along the lines suggested." Ibid. pp. 23 , 24.
2/ "Report on the Discount Mechanism," 1954, Appendix D.
3/ Ibid. pp. 23 , 24.

evaluating undue reliance on discounting by aggressive member banks ...."[1/] The majority of banks who were viewed as "reluctant to borrow" would, presumably, receive support from the position taken by the Federal Reserve and the observed change in behavior on the part of the "aggressive" few.[2/] The relatively few "aggressive" borrowers, it was expected, could be persuaded to shape their demands for credit to the standards of reluctance established by the Regulation.

The Report noted that "(i)f the discount standards advanced should ... be applied too inflexibly by Reserve Banks ... then the regulation could tend increasingly to supplant tradition."[3/] The principles advanced, the Committee stated, were "...intended to be general guides and standards and not precise administrative instructions inflexibly applicable to all cases."[4/] Nevertheless, the principles were not intended to vary with cyclical changes in monetary policy, though the amount of credit flowing through the discount window would.[5/]

1/ Since relatively few banks ever borrowed at all, it was inferred that the majority were "reluctant to borrow." The System Committee indicated that a possible objection to its suggested revision was that the System's discount mechanism problem was mainly one of relatively few insistent borrowers. "Report on the Discount Mechanism," 1954, pp. 36, 37. The Committee stated: "the majority of member banks are now administering their affairs in line with the philosophy of the suggested revision," Ibid., p. 40. A more recent expression of the view is contained in The Federal Reserve and the Treasury Answers to Questions from the Commission on Money and Credit, 1953, p. 139.
2/ "The majority of member banks ... now administering their affairs in line with the philosophy of the suggested revision ... might feel kindly rather than antagonistic to a revision of the regulation that would help bring less conservative banks into conformity." Ibid.
3/ Ibid., p. 36
4/ Ibid., pp. 24, 25.
5/ The Report indicated that "(w)hile the Committee contemplates a System discount activity varying in accordance with general credit policy, it wishes to stress particularly that it is not recommending a set of discount principles that would in themselves flex with such policy by administrative discretion," Ibid., p. 32.

The "General Principles" as finally embodied in a new Foreword to Regulation A show minor alterations in emphasis and considerable editorial revision; but they show relatively little in the way of substantive change.[1/] The "General Principles" of

1/ The revision suggested by the System Committee Report incorporated the suggested "General Principles" in Section 1 of the Regulation. An introduction indicated the basic objectives underlying Federal Reserve credit policy, the methods utilized to achieve these objectives, the effect of borrowing on the supply of reserves, and, consequently, the need for "guiding principles" in extending credit by discounting. It indicated also that "(a)ccess to the credit facilities of the Federal Reserve Banks is a privilege of membership ... which must be considered in the light of these principles." Eight "Principles" were stated. These were, in abreviated form, as follows: "(1) Due regard must be given to the effect of any extension of credit upon the maintenance of sound credit conditions.... (2) Federal Reserve credit should normally be extended for short periods to meet temporary credit needs of member banks. (For example ... in order to enable a member bank to adjust its asset position because of such developments as a temporary loss of deposits or to assist a member bank in meeting requirements for seasonal credit which cannot reasonably be anticipated and met by use of the member bank's own resources). (3) In order to enable member banks to meet unusual and exigent situations, Federal Reserve credit should be extended for as long a period as may be deemed necessary.... (4) (U)nder ordinary conditions continuous use of Federal Reserve credit... would not be appropriate.... (5) In determining whether to grant or refuse credit ... Federal Reserve Banks are required ... to consider the general character and amount of the loans and investments of the member bank and whether the bank is extending an undue amount of credit for speculative purposes.... (6) Federal Reserve credit should not be extended where it appears that the member bank's principal purpose is to profit from rate differentials or to obtain a tax advantage. (7) The law permits only such extensions ... as may be 'reasonably and safely made'; and the acceptance of paper offered for rediscount or as collateral ... must be determined in the best judgement of the Federal Reserve Bank.... (8) The board of directors of each Federal Reserve Bank is required by law to administer the affairs of such Bank fairly and impartially and without discrimination."

Section 1 of the suggested revision closed with a statement that "(i)n passing upon requests for credit accommodation ... the Federal Reserve Bank should give consideration to all of the principles ... together with any other factors which may be pertinent." _Ibid_., Appendix D, pp. 1-5.

With the exceptions of (7) and (8), the "Principles" suggested by the System Committee were incorporated in the Foreword to the Regulation, as revised in 1955, rather than in Section 1. The actual revision did not list the principles by number, and some minor changes in language were made. But there seemed to be little in the way of changes in substance. The "Principles" numbered (7) and (8) in the System Committee Report were not explicitly incorporated in the "General Principles" in their final form; but the portion of the Federal Reserve Act from which they derive (Section 4, paragraph 8) is referred to in a footnote. See Howard H. Hackley, "A History of the Lending Functions of the Federal Reserve Banks," p. 432.

the current Regulation may be viewed as the device designed to achieve the objectives developed in the System Committee Report.

The credit-restrictive portions of the "General Principles" can be divided into three types: (1) descriptive statements about the "type" of credit available at the discount window; (2) statements about the "purposes" for which the type of credit described may and may not be appropriately extended; and (3) statements reserving the right to restrict credit on the basis of bank supervisory considerations in general.

> (1) Type of credit available. Credit available at the discount window is normally short-term, and maturities are generally limited to 15 days. This "short-term" credit is not to be extended on a "continuous basis. (Longer-term credit is available, but only in exigent situations; i.e. for certain "purposes.")
>
> (2) Appropriate and inappropriate purposes. The appropriateness of any given request for short-term credit is dependent on the purposes for which the credit is requested. Short-term credit may be appropriately extended to meet a "sudden withdrawal of deposits or seasonal requirements beyond those which can reasonably be met by use of the bank's own resources."

A credit request is not appropriate if the funds are to be used to obtain "a tax advantage," to profit "from interest rate differentials," or for the "undue" extension of credit for speculative purposes. Long-term credit, as mentioned, is available for certain "purposes."[1/]

(3) General supervisory considerations. A Reserve Bank will, in extending credit, give "due regard ... to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally. It keeps informed of and takes into account the general character and amount of loans and investments of the member banks."

It is stated in the Regulation that "access to the ... discount facilities ... is granted as a privilege of membership ... in the light of the ... general principles." This statement

1/ "Federal Reserve credit is also available for longer periods when necessary in order to assist member banks in meeting unusual situations, such as may result from national, regional or local difficulties or from exceptional circumstances involving only particular member banks." Regulation A, 12 CRF 201.

was interpreted at the time and in the ensuing years as meaning that "Reserve Banks do not discount eligible paper or make advances to member banks automatically,"1/ as they presumably would if access to the discount window were granted as a "right."

C. Contemplated Administration of Regulation A

The 1954 "Report on the Discount Mechanism" discussed how Regulation A, if revised as recommended, would be administered. It also suggested how the restrictions on credit (in the "General Principles") would operate.

It was evidently expected that an "initial" request for credit by a member bank would normally be granted. The Report notes that "... promptness of discount action would require reliance in the first instance on a member bank's own statement of purpose;"2/ and the question of continuous borrowing "... would arise first at the time of the first renewal."3/ In determining the appropriateness of borrowing thereafter, the restrictions on continuity and purpose would, presumably, operate in a coordinated fashion, since all the "principles ... are closely interrelated."4/

1/ The Federal Reserve System: Purpose and Functions, Board of Governors, Washington, D. C., 1963, p. 42.
2/ "Report on the Discount Mechanism, 1954," p. 34.
3/ Ibid., Appendix C, p. 7.
4/ Ibid., p. 24.

The intended relationship between the "purpose" and "continuous borrowing" restrictions,however, is not obvious; nor for that matter are the relationships among the "purpose" restrictions themselves. The two major types of restrictions and the intended relationships require some consideration.

(1) Restriction on "continuous" borrowing

It might seem, at first, that the restriction on "continuous" borrowing was intended to be sufficient, in and of itself, to limit the supply of credit. While it is possible to interpret the restriction in this fashion, there is good reason to believe that such was not intended. It seems more likely that the intent was to use duration--or more exactly, frequency of borrowing over some duration--to establish no more than a rebuttable presumption of "inappropriate purpose." The Report explicitly indicates that the continuation of borrowing, with some degree of frequency, is to be taken as progressively more persuasive *prima facie* evidence that the credit extension is not for an appropriate purpose.

> "With each successive period in which borrowing occurs ... the probability that the borrowing stems from inadvertent causes obviously decreases .... Consequently, if a bank borrows at least once in each of a number of consecutive reserve periods, there exists

> a presumption that it is using this means deliberately to avoid more basic adjustments in its position and hence that the borrowing is continuous in the sense indicated here." 1/

Consistent with this view of the restriction, the "Report on the Discount Mechanism" refrains from a specific definition of "continuous" borrowing, though the Committee went into some detail on the issue.[2/] It noted that it is "... necessary [to develop] some reasonable empirical standard for judging the number of reserve periods that a bank may borrow successively before it is to be considered a continuous borrower."[3/] But the Report states, "(t)he specific guideposts for identifying such borrowing can be established only on the basis of broad discount experience of individual Reserve Banks and discussion among the Reserve Banks." [4/]

1/ *Ibid*., p. 10. It is conceivable that some specific duration of indebtedness (in terms of number of periods or frequency over a period of time) might have been chosen as establishing a conclusive presumption that the borrowing is for an "inappropriate purpose." Continuous borrowing would then be sufficient to restrict credit, but still only as a proxy for "purpose." However, the author has been informed by one reviewer, intimately familiar with the deliberations during the period, that there was a System-wide consensus that the definition of continuous borrowing should not be pushed further.

2/ The Report does indicate that both "extended-repetitive" borrowing i.e., cases in which banks are in and out of debt "over nearly successive reserve periods," and "extended-uninterrupted" borrowing, i.e., borrowing over successive periods, should be included under the definition of "continuous borrowing."

3/ *Ibid*., Appendix C, p. 9.

4/ *Ibid*., p. 11.

Given that the "continuous borrowing" restriction was intended to represent evidence that would help illuminate the "purpose" of borrowing, it follows that borrowing for an "appropriate purpose" (e.g., "the result of chance factors," or to meet extraordinarily large deviations from usual seasonal developments, or for "emergency" reasons) would not, in principle, be limited in duration by the restriction on continuity. Rather, most "appropriate" purposes would be such as to involve only short-term borrowing.[1/]

(2) "Purpose" restrictions

The "purpose" restrictions may, then, be considered the basic restrictions on the supply of discount credit. Presumably it would be on the basis of "purpose," as perceived by the Reserve Banks, that a determination would be made as to whether or not an extension of credit was "appropriate." It was contemplated, under the revised Regulation A, that the Reserve Bank would give "... more attention to the purpose of member bank borrowing." And that certain "... objective procedures ... would facilitate administration where findings indicated developments other than those stated [by the member bank] were responsible ..." [2/]

1/ So, for example, the provision of Regulation A permitting long-term credit in emergency situations could be thought of as establishing not a separate category of "emergency" loans, but rather a separate "purpose" for which extended credit is "appropriate."

2/ "Report on the Discount Mechanism, 1954," p. 34. The "Report" also stated that a Reserve Bank would "... engage in analyses of changes in the balance sheet items of its member banks and of the seasonal changes in their loans and deposits so that it would be in a position to make an independent, objective judgment of the factors giving rise to borrowing. The methods applicable would not present too difficult technical problems."

The Report, however, does not provide specific definitions of the three "appropriate" purposes cited in the "General Principles" (borrowing to meet "sudden" withdrawals, seasonal requirements beyond those that can "reasonably" be met, and emergency needs resulting from "unusual situations" or "exceptional circumstances"); nor does it provide definitions of the three "inappropriate" purposes cited (borrowing "principally" to profit from rate differentials, to obtain a tax advantage, or to extend an "undue" amount of credit for speculative purposes). In consequence, the purposes cited did not, on their face, establish mutually exclusive categories of "appropriate" and "inappropriate" borrowing.

As will be discussed below it is not believed that the establishment of mutually exclusive categories was intended. Moreover, the "purpose" terms themselves are closely inter-related. So, for example, in defining a word such as "reasonably" in the phrase that limits the extension of credit for seasonal purposes, the definitions of the three "inappropriate" purposes cited in the Regulation are, of necessity, qualified. The "General

Principles" can be confusing because, taken literally, borrowing could seem to be simultaneously for both an "appropriate" and "inappropriate" purpose.

The closely related nature of the credit-restrictive terms of the "General Principles" warrants further analysis. An attempt will be made below to provide an explanation of this "relatedness." It will be helpful, however, to consider first some aspects of the way in which the Regulation is administered.

III. Administration of Regulation A

Information on the manner in which the standards incorporated in the "General Principles" of Regulation A are being administered was obtained through a questionnaire sent to the Reserve Banks.[1/] It would appear that "initial" requests for credit are invariably accommodated promptly, with little if any discussion and with little inconvenience to the borrower.[2/] The information requested by the Reserve Banks

1/ "Questionnaire to Federal Reserve Banks Regarding Discount Operations," October 1965, (hereafter referred to as "Reserve Bank Questionnaire, 1965").
2/ By "initial" is meant the first request of a bank that is not currently subject to surveillance at the discount window for reason of previous borrowing.

on application for credit suggests that in most circumstances no substantial effort is made to ascertain the "purpose" of such an initial borrowing.

Beyond this initial accommodation, the administrative process can, for purposes of analysis, be broken down into at least three stages: (1) surveillance of the borrowing bank; (2) a decision on the appropriateness of the borrowing; and, (3) in cases in which the borrowing is judged "inappropriate," the undertaking of "administrative counseling" or "discipline" aimed at securing re-payment and "educating" the borrower in the appropriate use of the discount window. These stages may be viewed as elements in the process of nonprice rationing and moral suasion at the discount window.

The "counseling" and "discipline" procedures. are quite similar at each Reserve Bank. They typically involve contact with the borrowing bank, generally first by telephone, to inquire about the "purpose" of borrowing and about the presumed plans of the bank to "work out of" its debt. If a definitive judgment is reached that the borrowing is inappropriate, the effort is escalated. Such "escalation" involves contacts between Reserve Bank and borrowing bank officials at increasingly higher levels, meetings with Bank officials to "explain" the standards established by Regulation A, requests for the presentation of a repayment program, and, as a final measure, an indication that the bank's continued request for credit will not be honored.

The procedure described appears to reflect an attempt to persuade borrowers that further borrowing is not in their own best interest. 1/ If a mutual understanding cannot be reached, the Reserve Banks are in a position to deny credit and to curtail the borrowing privilege in the future. Replies to the 1965 Questionnaire provided evidence, however, that there were important differences in understanding among Districts as to the significance of the restrictive terms of the "General Principles." In consequence, it appeared that the Regulation could be and was administered in substantially different ways. 2/

IV. Restrictive Impact of Regulation A

The principal intention of the 1955 revision of Regulation A was to limit the flow of credit through the discount window, particularly during periods of monetary restraint, and to develop an acceptable rationale for doing so. However, the Regulation itself does not, of course, spell out in detail under what economic conditions credit limitations would be imposed. Conceivably, the restrictive effects could stem from constraints on the supply of credit, from persuasive efforts aimed at limiting the demand for credit, and/or from adjustments of the discount rate relative to market rates. An evaluation of the current discount mechanism requires consideration of the kind of restrictive impact intended and realized.

1/ For further discussion of this point, with reference to experience in the 1920's, see Report on Research Undertaken in Connection with a System Study, op. cit.

2/ For a statement as to the kinds of differences found, see Ibid., pp. 14, 15.

A. "General Principles" and demand for credit

It may be recalled that the System Committee Report in 1954 stressed the fact that the key to the revision it was suggesting was the intent to give regulatory support to the "tradition against borrowing." This explicit intention implies an effort to limit the flow of credit by influencing bank attitudes toward borrowing. There is much in the Report, in the "General Principles" and in the way the Regulation operates to suggest that the principal restriction on credit was intended to operate on the demand for Reserve Bank credit--through a form of "moral suasion."

When the purpose and continuous borrowing restrictions of the "General Principles" are considered as reflecting an effort to restrict the demand for Reserve Bank credit, and not as independent constraints on the supply of such credit, the lack of preciseness in the individual restrictions is somewhat clarified. The stated restrictions on borrowing--for purposes such as profiting from interest rate differentials, accommodating seasonal demands for commercial or agricultrual credit, and compensating for expected withdrawals of deposits--may be thought of as reflecting a somewhat impressionistic regulatory image of the behavior that could be expected of a bank that, to some degree, was "reluctant to borrow." For such a bank, being in debt would entail some nonmonetary "cost." Consequently, the bank would not borrow simply because borrowing was profitable in money terms. At equal, and perhaps even at higher costs, it would prefer to obtain reserves in other ways. If the "reluctance to borrow" were very strong, the bank might borrow only small amounts "occasionally" on a "short-term, noncontinuous" basis. In this way, the duration of borrowing, in conjunction with other information, would represent evidence of the "purpose" of borrowing, or, more exactly, the degree of reluctance of the borrower.

In actual operation the restriction on "extended" borrowing provides the vehicle for discussion between the Reserve Bank and the member bank about the purpose of borrowing; i.e., about the "reluctance" of the borrower. "Surveillance" of borrowing banks and periodic conversations on the "purpose" of borrowing presumably provide the Federal Reserve with an opportunity to influence bank behavior and, by persuasion, bank attitudes. Such persuasion, of course, is backed by the mutual understanding that credit can be curtailed and that further borrowing capacity at the Federal Reserve can be impaired. Presumably these member bank-Reserve Bank discussions would, at a minimum, provide an incentive for banks to conduct their business as "reluctant borrowers" would.

It is not easy to draw an exact line between the influence of administration on bank attitudes, and therefore on the demand for credit, and nonprice rationing of the supply of credit. It seems clear, however, that a principal intent was to provide a mechanism whereby member banks would be persuaded on their own to limit their demands for Reserve Bank credit. To summarize the evidence provided thus far: (1) the 1954 "Report on the Discount Mechanism" indicated that one of the principal purposes of revising Regulation A was to give regulatory support to the "tradition against borrowing;" (2) the "General Principles" can be reasonably thought of as an attempt to influence bank attitudes by establishing a model of "appropriate" behavior. The restrictive terms of the "General Principles" could not and do not represent a very efficacious constraint on supply because they do not establish mutually exclusive categories of "appropriate" and "inappropriate" borrowing; and (3) the administrative procedure associated with the current Regulation is consistent with this interpretation and is difficult to understand otherwise. The decision to retire an outstanding debt is generally intended to reflect agreement between the

Reserve Bank and, however reluctantly, the borrowing bank. Such an agreement, reached after considerable persuasive discourse, strongly suggests a process designed to influence bank attitudes and future bank behavior.

B. "General Principles" and the discount rate

Flexible use of the discount rate, as a principal device to ration credit, was rejected by the System Committee in 1954. However, the Committee did consider briefly the role of the rate under its proposed revision. Its view tends to confirm the conclusion stated above that the intention was to restrict borrowing by building on the general "reluctance" of banks to borrow. The Committee noted:

> "If member banks generally felt free to borrow and remain in debt when borrowing was profitable, the discount rate would need to be adjusted frequently to keep it at a level equal to or not far below short-term market rates in order to function as a primary deterrent to discounting when the demand for credit is higher. If member banks limit their

> ordinary discounting to meeting temporary needs pending other adjustments, however, the sensitiveness of their borrowing to the spread between the discount rate and market rates would be less marked. The need for frequent change in the discount rate to keep borrowing from appearing profitable, therefore, would be diminished ... 1/

C. "General Principles" and the supply of credit

Consistent with the intention to restrict the demand for Federal Reserve credit by supporting the "tradition against borrowing," the "General Principles' of Regulation A also appear to represent an attempt to facilitate the distinction between borrowing that is in accordance with the "tradition" (sufficiently reluctant) and borrowing that is not (insufficiently reluctant). But, as indicated, the distinctions that the Reserve Banks have drawn in practice are not, and cannot be, clear-cut, Typically, an "initial" borrowing request is assumed to be "appropriate," (i.e., sufficiently reluctant) and is accommodated at the going discount rate.2/ Through "surveillance" that takes place over time, a judgment is reached as to whether the borrowing (or the pattern of borrowing that has developed) is, in fact, "appropriate." When a judgment is reached that the borrowing is "inappropriate," counseling or disciplinary action is undertaken. The ultimate

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1/ Ibid., p. 43.
2/ No doubt, there is some limit on the amount that a Reserve Bank would lend to an individual institution. However, there is no explicit limit (either in absolute or relative terms) in Regulation A or in the Federal Reserve Act.

step in this "disciplinary" procedure would be a Reserve Bank indication to the borrowing bank that the bank's note, if presented again, would not be honored. But some time would go by before such a step were taken; and in fact, the final recourse to credit rationing in this strict sense is apparently rarely reached.

Short of explicitly denying the continued extension of credit, the "disciplinary" procedure is perhpas best viewed as imposing an additional "cost" on the borrowing bank above the discount rate. The additional "cost" may be thought of as reflecting a threat to future borrowing capacity at the Federal Reserve and the "inconvenience" of having to negotiate with Federal Reserve officials. This "surcharge" is not easily translated into specific money terms.

Since the threat to future borrowing and the "inconvenience" imposed by negotiations increase progressively once a judgment is reached that the borrowing is for an "inappropriate purpose," the actual "cost" of credit to the bank would rise over time.[1/] Since

1/ Since the amount of a loan (relative to bank size) is taken as one indication of "purpose," the cost of borrowing over an extended period of time would be positively related to its amount, *ceteris paribus*. The System Committee "Report" stated: "The amount borrowed is one piece of evidence to be taken into account in judging whether the borrowing is intended or complacent. The larger the amount of borrowing in relation to required reserves and capital ... the greater the presumption that borrowing is planned or complacent and not the result of a succession of chance developments." *Ibid*., Appendix C, p. 11. The amount borrowed currently appears to be treated in this way by the Reserve Banks.

the Federal Reserve has almost complete discretion in making and renewing loans, the true "cost" could rise very rapidly and at some point credit could be cut off completely.

Given the Reserve Bank's interpretation of the Regulation, the duration over which a particular loan (or pattern of borrowing behavior) is considered "appropriate" would depend on a variety of factors. These include some that are "known" at the time credit is extended (such as the amount of the borrowing, the previous borrowing record of the bank and, if available, its statement of purpose); some that vary while the credit is outstanding (such as the borrowing bank's portfolio and liability management); and "time" itself, since the duration over which the credit is outstanding is presumed to provide evidence of "purpose."1/ These factors may be conceived of as interacting in influencing the "appropriate - inappropriate" decision.2/

1/ Even a loan to meet a sudden deposit withdrawal that was initially "appropriate" would not be "appropriate" indefinitely since the bank is expected to adjust its portfolio within a reasonably brief period of time if the funds do not return. Moreover, a succession of "sudden" deposit withdrawals would not be "sudden" under the terms of the Regulation over any extended period of time. And extended borrowing to meet these withdrawals would presumably not be "appropriate."

2/ They may be thought of as independent variables in a joint functional relationship with the "appropriate-inappropriate" decision. The value of the independent variable "time," at the point at which the decision is reached that the loan is not for an appropriate purpose would give the duration over which the "cost" of credit would equal the discount rate.

From the member bank's point of view, a considerable degree of uncertainty must attach to the use of a discount mechanism operating in this way. There would be uncertainty about (1) the duration over which an initial request for credit for a particular purpose is considered appropriate; (2) the rate at which the cost of credit rises once it is decided that the borrowing is for an "inappropriate purpose"; and (3) the effect of the past record of borrowing and disciplinary conflict, if any, on (1) and (2).

At the time the initial credit request (assumed "appropriate") is granted, the Reserve Bank is generally not in a position to indicate to the borrowing bank how often or how long borrowing will be considered appropriate. The rise in the "cost" of credit, once an inappropriate decision is reached is, by its nature, a matter of much uncertainty also. The effect of "inappropriate" borrowing behavior in the past on the availability and "cost" of credit currently cannot be indicated except in a very general manner. To take the extreme question: if, after an extended period of borrowing, credit to a bank is denied, how long would the discount privilege be withheld?[1/] As previously mentioned, such cases are rare. But the "threat" to

1/ One Reserve Bank indicated that after the ultimate step in disciplinary procedure is reached, the borrowing bank receives reassurance about the availability of credit for initial requests. "In no event would a banker be told that the borrowing privilege was being permanently curtailed but only for the relatively short run; it would be made plain that truly emergency needs of the member bank would always receive appropriate consideration."

future borrowing capacity is, of necessity, implicit at all stages in the disciplinary procedure, not simply the final stage of credit rationing. Consequently, similar questions arise in all such cases. Specifically, these are: (1) how soon will a credit request be honored after repayment; (2) to what extent will the previous borrowing record shorten the period over which the loan is "assumed" and/or "judged" appropriate. There is no information available to suggest that credit will be denied for any lengthy period of time after repayment brought about by "disciplinary action." However, as is well understood, the duration over which a loan is considered appropriate is influenced by the previous borrowing record of the bank.1/

D. Demand and Supply Relationships

It has been suggested that the 1955 revision of Regulation A was intended to influence the demand for Federal Reserve credit by supporting the "tradition against borrowing." The intention was to keep demand for Federal Reserve credit relatively low,and inelastic

1/ At some Reserve Banks, the previous borrowing record would include borrowing from other sources as well as the Federal Reserve. In either case, the previous record would suggest the degree to which the borrowing bank was "reluctant to borrow."

with respect to the differentials between market rates and the discount rate. The administrative procedures designed to facilitate this intention imply, however, a rising supply schedule for credit. This would, in and of itself, serve to limit the flow of discount credit.

A rising supply schedule is implicit in the limitations on future borrowing capacity incorporated in disciplinary procedures and, to some degree, in the physical inconvenience of negotiations instituted while credit is outstanding. Such conditions impose real costs on the borrowing bank. However, uncertainty surrounding the threat to future borrowing capacity and the troublesomeness of negotiations would also work, through bank preferences, to limit the demand for Reserve Bank credit. It is quite conceivable that many banks would have a strong preference to avert the risk of incurring "disciplinary action." The administrative procedures under Regulation A would, for such banks, imply an even greater limitation on their demand for Federal Reserve credit than is suggested by a rising supply schedule, or by the intent to support or alter bank attitudes toward borrowing.

It might be argued that uncertainties with respect to the duration over which no questions are asked, the vigor of "disciplinary action" once questions are raised, and the effects of "disciplinary action" on subsequent borrowing exist, for the most part, in those relatively rare cases of "extended borrowing;" and that most banks, applying reasonable caution, would not normally encounter a situation in which their borrowing behavior became suspect. This argument begs an important issue in that it assumes that banks are, for the most part, sufficiently "reluctant to borrow" so as to generally conform to the rough regulatory image described in the purpose restrictions of Regulation A as administered. If such is not the case: i.e., to the extent banks are less reluctant to borrow than deemed appropriate, there would be more certainty in the extreme than in the normal run of cases. For example, banks that borrow heavily to sell Federal funds at rates above the discount rate would be fairly certain of quick and vigorous "disciplinary action." Banks that borrow to avoid or postpone the sale of investments (also to earn a profit) would have to determine in each instance the duration over which the holding of such investments would be considered appropriate and the "costs" incurred in exceeding this duration.

V. Summary and Conclusions

The intention of the 1955 revision of Regulation A was to limit the amount of credit available at the discount window, particularly during periods of monetary restraint. Both demand and supply limitations were envisioned. The "General Principles" in the Foreword to the revised Regulation appear to describe roughly the kind of borrowing behavior expected of a bank that was reluctant to borrow. They were principally intended to support the attitudes of the large majority of banks considered to be reluctant borrowers. In this sense, they represented a form of moral suasion designed to limit the demand for credit.

The "General Principles" also seem intended to facilitate a distinction that discount officers and committees would, from time to time, be required to make between borrowing behavior that was sufficiently reluctant ("appropriate") and borrowing behavior that was insufficiently reluctant ("inappropriate"). However, it was not thought that it would be necessary to make this distinction often. In those instances where such nonprice rationing proved necessary, it was believed there would be a remedial effect.

The current mechanism clearly provides for adequate control over the volume of credit available at the discount window. In fact, it apparently creates a degree of uncertainty about the terms and conditions of credit that would tend to limit borrowing more than intended. This is particularly true in a financial environment in which large numbers of banks are not reluctant to borrow in accordance with the regulatory image implicit in the "General Principles." Nonreluctant attitudes on the part of banks would tend to place a heavy burden on the administrative machinery of Regulation A principally because the General Principles were not designed and are not well-suited for large-scale rationing of credit from the supply side. The distinction between sufficiently reluctant and insufficiently reluctant borrowing is not easily drawn in practice. The restrictions, both individually and collectively, are not easily understood or communicated. Differences in administration among Federal Reserve districts may be viewed as a reflection of difficulties involved in implementing the current regulation.