

FUNDAMENTAL REAPPRAISAL OF THE DISCOUNT MECHANISM

**THE REDESIGNED
DISCOUNT MECHANISM AND
THE MONEY MARKET**

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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.

REAPPRAISAL OF THE FEDERAL RESERVE DISCOUNT MECHANISM

THE REDESIGNED DISCOUNT MECHANISM
AND THE MONEY MARKET

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THE REDESIGNED DISCOUNT MECHANISM
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Introduction

The purpose of this paper is to explore, insofar as a priori knowledge permits, the kind of interaction that might be expected between the national money market and a redesigned discount mechanism as proposed in the Final Report of the Steering Committee and to outline the kind of adaptations that the Federal Reserve would probably be required to make in the conduct of its open market operations.

This paper thus differs in concept and orientation from other studies that have been prepared in connection with the reappraisal of the Federal Reserve discount mechanism. Generally speaking, the other papers endeavored to analyze past, present, or prospective conditions and to draw from such analyses inferences as to the circumstances in which the current discount mechanism proved to be inadequate and in what respects it might be improved. This paper takes the proposed new discount mechanism as given, and tries to evaluate how such a mechanism might interact, in practice, with likely money market conditions and open market policy.

The purpose of the proposed redesign of the discount window is to make better use of monetary tools to achieve System objectives and to improve the functioning of the banking system in general.

More liberal access to Federal Reserve credit at the discount window does not imply easier monetary policy. Rather such access would redistribute responsibilities for facilitating adjustments to the posture of credit policy. The proposed design of the window should enhance the ability of member banks to meet the needs of their customers, without reducing the effectiveness and precision of open market operations.

Our growing economy has required a continuous broadening over the years of the banking system's reserve base. And over the long run, the Federal Reserve System will still have to provide substantial amounts of bank reserves, even if its efforts to achieve greater price stability are successful and its additions to reserves are held to a rate commensurate with noninflationary growth of the economy. Thus, the impact of the shift to the proposed new system on the money market and on open market operations must be viewed against the background of a long-run process of net reserve injection, the precise time profile of which is subject to seasonal factors as well as changes in System policy objectives related to cyclical developments.

Under the present Regulation A, the discount mechanism contributes little to an appropriate growth in aggregate reserves of banks or to accommodating recurrent seasonal swings in the reserve base. Because of the reluctance-to-borrow convention, a large part of the needs of member banks for adjusting reserves from one reserve

period to another are accommodated through System open market operations. Thus, over the year, open market transactions show a large volume of purchases followed by sales (and vice versa) to accommodate the fluctuating reserve needs of the banking system. As a result, in any given year open market transactions (disregarding exchanges) are several times as large as the net addition to the reserve base.

Restoration of the discount mechanism to the role of a buffer willingly used by member banks to make initial adjustments to fluctuations in their loans and deposits and to meet part of regular seasonal bulges in demand for loans will result in a change in the composition of reserve injection. Such injection will be more immediately guided by the needs of individual banks. A somewhat larger proportion of the provision of reserves will occur at the window rather than at the initiative of the Trading Desk. But since the Desk will continue to be in charge of implementing the over-all objectives of credit policy, as defined periodically by the Federal Open Market Committee, it will need to adjust the actual conduct of its operations to the new role that the Report of the Steering Committee assigns to discounting. If the amount of reserves created at the initiative of member banks is at times excessive in the light of current targets of Federal Reserve policy, the Trading Desk will need to offset such excesses by appropriate operations. Normally, part of the reserves that banks lose and seek to replenish by borrowing at the window will find their way to

banks that are anxious to reduce their borrowings from the Federal Reserve, and the net injection through the window will tend to be smaller--and at times considerably smaller--than the gross flow. This should be kept in mind in interpreting the rough estimates of gross potential borrowing cited in the Report.

The greater initiative that member banks will be able to exercise in the initial distribution of reserves to support long-term growth and to accommodate seasonal and cyclical swings in bank credit, as well as in the levels and composition of deposits, will have significant effects on the money market. The Trading Desk will need to make certain adjustments corresponding in its operating procedures and projection techniques. The redistribution of the responsibility for flexibility in the provision of reserves to member banks will, on balance, reduce the volume of open market transactions without diminishing the Desk's central role in implementing Federal Reserve policy.

The primary purpose of this paper is to explore the probable impact of the proposed changes on money market processes. There is no intention to minimize either the challenge to the Trading Desk or the magnitude of its task. Yet, the proposed changes in discount philosophy and procedures affect the Trading Desk in a quantitative rather than in a qualitative way. The required adjustments involve, in the main, a restructuring of the patterns of reserve flows with which the Desk

is confronted in its day-to-day operations; it is believed that these problems can be solved by gradual adjustment, as the impact of the new policies progressively affects credit conditions.

In the first section below, attention will be directed to the likely operation of short-term adjustment credit at the discount window in conjunction with ordinary money market conditions, as they may be moderated by the recent adoption of changes in reserve regulations. Succeeding sections will describe how such short-term adjustment credit might interact with money market developments as credit demands change cyclically, and as the general Federal Reserve instruments--open market operations, reserve requirements, and changes in the discount rate--are employed to implement changes in monetary policy. Another section will discuss how these relationships might be affected by the operation of seasonal credit assistance and emergency credit assistance. The concluding section will explore briefly some of the implications of the redesigned discount window for open market operations.

The Money Market Environment

The national money market is the arena in which excesses and deficiencies in supplies of, or demands for, liquid funds by a variety of participants are balanced out, insofar as those participants have the means, directly or indirectly, for reaching this market. Some of these excesses and deficiencies are highly transitory--that is, of a few days' duration; others are expected to continue for longer periods--

that is, several weeks, a season, a cycle, or indefinitely. In some instances those that supply funds and those seeking funds, as well as market intermediaries, are likely to be uncertain as to the duration or prospective dimension of the excesses or deficiencies accruing to them.

The response to such liquidity surpluses or deficits is conditioned largely by expectations as to their size and duration. In addition, responses of those with surpluses and those with deficits are affected by their basic portfolio positions, by their view of the current and prospective conditions in the money market, and anticipated future trends in basic economic and financial conditions. Guided by these considerations, including estimates of the alternative costs involved, participants in the money market choose among the alternatives open to them for adjusting excess or deficient liquidity. For member banks--the only category to be discussed in this paper--the Federal Reserve discount window is one of the alternatives, albeit one with unique terms and conditions attached.^{1/} Among member banks, needs for liquidity vary widely as do swings in their cash positions and in demands made on them and their ability to make short-run adjustments in their assets and liabilities.

^{1/} For a fuller discussion of present money market performance, bank adjustments through the money market, and the market interaction of existing monetary instruments, see Paul Meek, "Discount Policy and Open Market Operations," a research paper prepared for this study.

Modified Market Performance as a Result of Amendments to Regulation D

A special influence on the responses of member banks to variations in liquidity is their need to satisfy specified reserve requirements, on average, within each designated reserve period, in accordance with the existing provisions of Regulation D. The Board of Governors adopted certain changes in Regulation D; the revisions, which become effective in September 1968, are expected to alter bank use of the discount window somewhat and therefore should be taken into account here.

Briefly, the new reserve regulations (1) shorten the reserve periods for country banks to the same 1-week duration already applicable to reserve city banks; (2) base requirements on deposits 2 weeks earlier; (3) allow holdings of vault cash 2 weeks earlier to be used (along with the current week's reserve balance at the Reserve Bank) to satisfy reserve requirements; and (4) provide for the carry-over of either deficiencies or excesses in average reserves of up to 2 per cent of requirements from one reserve period to the next (but no further).

Banks will thus be able to operate with certain knowledge of their reserve requirements and of their vault cash credit with respect thereto at the beginning of each reserve period. On the other hand, banks will remain as uncertain as ever about the flow of their deposits during the current week and effect of this flow upon their reserve and

"due from" balances. The cost of this uncertainty in terms of actual reserves is fractionally larger because the fractional offsetting effect of any deposit movement on current required reserves under the previous regulation has been eliminated.

The provision for an automatic 2 per cent carry-forward should moderate bank efforts to dispose of any end-of-period reserve excesses or to meet moderate deficiencies, because it provides a limited alternative to forcing such adjustment through the market near the end of reserve periods when supply and demand schedules have been most inelastic.

Shortening of the reserve period for country banks to 1 week will increase reserve adjustment activities for those country banks that tend to experience offsetting deposit or loan movements in successive weeks, but that choose not to carry enough excess reserves to meet peak needs. On the other hand, numerous country banks for precautionary reasons up to this time have tended to accumulate excess reserves throughout most of their 2-week reserve periods and then near the end of those periods have dumped such accumulated credit into the Federal funds market or into their balances with correspondent banks; with only 1 week in which to cumulate reserves, such dumping by country banks should less often bulk large enough to swamp the absorptive capacity of the rest of the money market.

It is believed that these changes in reserve regulations will tend, on balance, to moderate the reserve adjustment activities of most of the banks, and hence to reduce somewhat their demand for end-of-period accommodation at the discount window. However, for a minority of country banks that are subject to swings in deposits or loans that are largely reversed from one week to the next, requests for intermittent assistance at the discount window may expand considerably. But on balance, the new method of reserve computation is likely to reduce both the recourse of country banks to the discount window for adjustment purposes and the periodic bulge in excess reserves supplied by these banks to the Federal funds market.

Market Influence of Short-Term Adjustment Credit under Generally Stable Money Market Conditions

For purposes of this section, generally stable market conditions are taken to include (and in part depend upon) a stable pattern of use of the discount window for obtaining short-term adjustment credit. This implies that, as a rule, member banks are making only moderate use of System discount facilities but that they are willing to increase their use of the window should their flows of funds turn adverse.^{1/} A minority of banks are assumed to be using only a small

^{1/} In most instances, it is expected that bank use of the discount window in response to changing circumstances would be substantially symmetrical; that is, what a bank would be inclined to do if an influence changed in one direction would be about the inverse of what that bank would do if the same influence changed in the opposite direction. For purposes of simplicity and clarity, influences and responses are described in a consistent direction in the text, however.

fraction of their basic borrowing privilege, another minority are assumed to be using most of their basic borrowing privilege, and only a few banks are assumed to be borrowing in excess of their basic borrowing privilege in either amount or duration and thus to be subject to administrative review.

Under the circumstances indicated, it is believed that interest rates on most of the alternative types of instruments readily available for adjusting liquidity--the markets for which are dominated by banks--would be separated from the discount rate by margins no more than equal to the costs of the attendant transactions, credit risk, market or liquidity risk, customer-relation effects, and the like.

In this environment, banks experiencing what they think will be quickly reversible drains of funds should be inclined to offset such drains by borrowing at the discount window. Their ability to do so will depend to a large extent upon whether they had previously used little or most of their borrowing leeway under the basic borrowing privilege. The longer-lived such drains of funds are expected to be, the more inclined banks would be, at the outset, to initiate correspondingly long-term adjustments in their portfolios, except insofar as they would need some transitional time to become reasonably certain of trends or to arrange orderly adjustments.

If a drain of funds should hit a sizable proportion of banks simultaneously, there could be a considerable rise in the nationwide total of borrowing. If this occurred, and if the cause of the drain

was of a reserve-absorbing nature (e.g., an outflow of currency or gold), the aggregate reserve base of the banking system would remain little changed. If, on the other hand, the drain consisted of a deposit shift from one group of banks to another, the step-up in borrowing by the deposit-losing group would enlarge the national total of reserves. The deposit-receiving banks could be expected to dispose of some of their resultant reserve excesses through the money market, and to that degree the supply of Federal funds (and similar money market instruments such as dealer loans) would be expanded. In most circumstances, the interest rates on Federal funds and money market instruments would tend to decline, and banks in debt to the Federal Reserve could be expected to try to refinance such debt by borrowing in the now-cheaper funds market, absorbing redundant reserves in the process. However, if the outstanding amount of adjustment borrowing at the discount window were too small or the time remaining in the reserve period too short to permit full absorption of the redundant reserves, day-to-day rates in the money market would drop still lower, unless some buying to build up carry-overs developed, or banks receiving part of the newly created funds used them to repay their debts at the window. If the decline in such rates seemed too great to be compatible with the currently desired money market atmosphere, the Trading Desk would need to sell securities (outright or through reverse repurchase agreements) to absorb the redundant reserves.

Substantially the reverse of the process outlined above should take place if the initiating factor were an inflow rather than a drain of funds at the banks in question.

As a result of greater reserve-adjustment activity stemming from more general use of the discount window, the national total of adjustment borrowing (within and outside the basic borrowing privilege) would probably fluctuate over a wider range from day to day and from week to week than occurs under the present system, but it would still oscillate around a generally level longer-run trend. Open market operations, on the other hand, would probably tend to undergo smaller, and perhaps also less frequent, day-to-day and week-to-week fluctuations; it is difficult to document this probability, however, because such operations are undertaken in relation to the total of all influences affecting member bank reserves and not borrowing alone. Open market operations to supplement rather than offset swings in borrowing would be called for whenever data on the composition of borrowing suggested a cumulative build-up of adjustment pressure at the discount window. Such situations would notably arise when a greater share of adjustment borrowing was tending to take place outside the basic borrowing privilege and was therefore under administrative review, and/or when the preponderance of banks was moving toward the upper threshold of use of the basic borrowing privilege.

Interest rates on those instruments of liquidity adjustment for which banks are by far the main suppliers and purchasers would tend

to fluctuate less widely than under the present system so long as underlying conditions remained stable. On the other hand, interest rates on instruments ordinarily utilized by the System in its open market operations would tend to be influenced less by System operations undertaken to even out reserve positions in the short run and more by the ebb and flow of private investor interest. This would mean that at times such rates might be subject to wider swings than under the present system and at other times to smaller swings, depending upon the extent to which changes in investor interest and in the volume of Trading Desk operations undertaken to meet banks' adjustment needs would have been mutually offsetting or reinforcing.

Interaction of Short-Term Adjustment Credit with Changing Money Market Conditions

When underlying money market conditions begin to undergo a basic change--either because of shifts in credit demands or because of a change in Federal Reserve policy--the proposed short-term adjustment credit facilities should work to spread the influence of such a change somewhat more gradually, but also more broadly, throughout the banking system. Recourse to the discount window may be expected to make reserves available sooner at the point of need than they would be if they were redistributed through bank portfolio adjustments, after having been injected through open market operations.

A cyclical expansion in demands for bank credit could be expected in the first instance to elicit an accommodative response

from the bank subject to such demands. As the consequent rise in deposits, and perhaps also an expansion in currency, effectively absorbed reserves, member banks would be inclined to undertake sufficient borrowing to offset such absorption at least temporarily.

As the credit expansion and resultant reserve absorption spread and cumulated, progressively more and larger borrowing by banks would be induced. The borrowing banks, in turn, would gradually reach thresholds at which they were moved to rely more heavily on alternative methods of adjustment. For some banks, this might happen as they drew close to their own desired maximum use of the basic borrowing privilege; for others, it might occur only after they had exhausted their basic borrowing privilege, had moved on into other adjustment borrowing, and had finally encountered Reserve Bank pressure to repay. The speed with which the banks reached these stages would depend, of course, on the combined effects of the reserve absorption and of bank willingness to use the discount window up to the limits outlined above. It would also depend on the degree to which reserves originally lost by the borrowing banks would be used by the receiving banks to reduce their indebtedness rather than to expand credit. There would undoubtedly be differences in behavior as between specific periods of expansion and as among different economic areas and groups of banks.

As borrowing banks shifted to adjustment outside the discount window, interest rates on the alternative adjustment instruments utilized would rise, both absolutely and relative to the discount

rate. Most directly affected would probably be the Federal funds rate, since it is dominated by bank reserve adjustment actions. The results--higher money market rates, a tighter borrowing posture at the discount window, and the contracted supply of total reserves--if unalleviated, would presumably tighten the availability of credit on a broader scale, thus deterring some borrowers. This shift, by itself, would operate in the direction of general monetary restraint. Monetary policy-makers would then have to decide whether the tauter trends emerging in reserves, credit, and interest rates were desirable in the changing economic environment, or whether they wished to moderate such trends by buying enough securities in the open market to offset at least in part the curtailed availability of reserves at the window.

Conceivably, of course, the requirements of policy might lead the Federal Open Market Committee to accelerate rather than moderate the financial system's adjustment to the changing supply of reserves. In those instances, even though borrowing at the discount window was becoming larger and more widespread, parallel sales for the Open Market Account might be desirable. As an alternative, an increase in reserve requirements might be used to speed the adjustment and to elicit greater attention thereto.

Interaction of Short-Term Adjustment Credit with Changes in Discount Rates

The influence of a change in the discount rate on the money market and on borrowings of short-term adjustment credit sought at the

discount window will differ considerably, depending upon whether the change in the discount rate is leading market rates or is simply following a change in general money market rates and conditions.

Let us consider first a situation in which a combination of expanding demands for credit and of less expansive System open market operations has increased the reserve pressures on banks. As pointed out in the preceding section, this process, if carried on long enough, will impel more and more banks to undertake their reserve adjustments outside the discount window, and the pressure of such added demand for available reserves will tend to raise interest rates on Federal funds and various money market instruments correspondingly. By the same token, reserves borrowed at the discount window at the existing discount rate will appear relatively cheaper.

This relative cheapness of discounting might entice some additional borrowing by banks that still had not used all of their basic borrowing privileges to make their first adjustments in reserves in this way. On the other hand, a sizable and growing proportion of banks would have used all of their basic borrowing privileges and have come under administrative review; the banks in this second group would seek to effect their reserve adjustments outside the discount window--not for reasons of comparative cost but in order to comply with the standards for repayment of adjustment credit, and to be able to proceed to orderly portfolio adjustments when and as needed.

In these circumstances an increase in the discount rate following recent increases in other money market rates would not appreciably alter the pattern of adjustment of the second group of banks and would therefore not engender through them any significant additional upward pressure on market rates and would not reduce the incentive for them to delay the required adjustments. However, such an increase in the discount rate would narrow the rate incentive for the first group of banks to borrow at the discount window. To the extent that the first group rechanneled its reserve adjustment activities away from the discount window and into the market, upward pressures on market rates would increase. Generally speaking, the more the discount rate lagged behind market rate increases the larger the second group of banks should be relative to the first, and the less likely it would be for the eventual "following" increase in the discount rate to trigger much additional upward pressure on market rates.

A somewhat different pattern would tend to emerge, however, if the discount rate were to be leapfrogged ahead of the rates on the most closely related instrument of reserve adjustment. First, such a "leading" increase in the discount rate would increase the relative cost of borrowing as compared with alternative reserve adjustment instruments. All member banks that had been borrowing, but not in a large enough amount or for a long enough duration to bring them

under pressure to repay, would then find it advantageous to seek less expensive means of financing their reserve deficits. Their added financing efforts in the money market should quickly bring upward rate pressures to bear on other money market instruments. To the extent that these banks were successful in this endeavor, and thus were enabled to retire debt at the Federal Reserve, the aggregate supply of reserves would be curtailed. In consequence of all these actions, a correspondingly tauter atmosphere should soon come to prevail in the central money market.

The effects of decreases in discount rates, under the redesigned discount mechanism, are likely to be generally the reverse of those outlined in the preceding paragraphs but not precisely symmetrical. So long as the borrowing pressure on the banking system is sufficient to keep a large number of banks borrowing over and above their basic borrowing privilege, reductions in the discount rate should have only modest, easing effects on other money market rates. The fact that the bulk of the banks were still under pressure to repay their indebtedness to the Reserve Banks should tend to keep the rates on Federal funds and similar private instruments of reserve adjustment relatively high.

However, once credit contraction or expansive open market operations have made enough nonborrowed reserves available for such "over-privilege" borrowing to be substantially repaid, most banks

should again be importantly influenced in their choice of reserve adjustment media by the relative costs thereof. Thereafter, reductions in the discount rate should be followed promptly by enough rechanneling of reserve adjustment pressures to the discount window and away from other avenues to cause sympathetic rate declines on such other media.

If monetary policy should ease sufficiently, however, to encourage the retirement of virtually all adjustment borrowing from the Federal Reserve, then money market rates would tend to become unhinged from the discount rate and to drop to levels that would equilibrate the demand for and supply of nonborrowed reserves.

Consideration of typical interactions and sequences suggests a very close association between the discount rate and rates on alternative instruments of reserve adjustment so long as member bank adjustment borrowing is large enough to affect market rates but not so large as to bring a significant proportion of the banking system under pressure to repay. As credit demands and monetary policy shift over the cycle, discount rates would presumably be raised or lowered more or less commensurately so as to achieve the System's objectives. However, there would be a tendency for rates on alternative instruments of reserve adjustment to rise even higher relative to the increased discount rate near peaks of strong cyclical borrowing pressure and to drop even lower relative to the lowered discount rate during cyclical troughs, when borrowing was very slack.

All the above discussion has abstracted from the special question of the "announcement effect" of any changes in the discount rate on interest rates and availability of funds in the money market. Such effects are conditioned so much by the attitudes prevailing at the time of a given rate change that any generalization is very risky. Nonetheless, it appears that such effects would be most marked when no action on the discount rate was expected. This would probably occur when the discount rate was used to lead rather than follow movements in market rates.

Additional Effect of Seasonal Credit on the Money Market

The seasonal borrowing privilege provided in the proposed redesign of the discount mechanism should work to moderate the effect on the money market of the reserves supplied or absorbed in response to changing seasonal demands. But since banks would be required to meet the first portion of their seasonal drains of funds (up to an amount equal to 5 to 10 per cent of their average deposits) out of their own resources, it is likely--judging from inadequate empirical evidence--that the great bulk of seasonal oscillations in fund flows within the banking system would continue to be met by resorting to the usual reserve adjustment techniques. To the extent that seasonal adjustments are met at the window, however, the need for seasonal open market operations of the conventional sort would be reduced. Furthermore, banks' resort to borrowing under their basic borrowing privileges to

deal with short-term seasonal oscillations should also reduce the over-all amount of open market operations required to cover seasonal needs.

The typical user of the seasonal borrowing privilege is expected to be a relatively small bank experiencing a large seasonal swing in relation to its available funds. Given the diversity of seasonal needs and their patterns, it is likely that the total amount of reserves advanced to such banks should rise and fall more or less gradually. Since the banks will be expected to negotiate their seasonal borrowing needs with their Reserve Banks over their full seasonal period insofar as feasible, the general timing and amount of reserve injections from this source should be fairly well defined in advance. In addition, the discouragement of temporary repayment of such credits with funds obtained from the money market when it turns easy for a day or two will tend to minimize abrupt changes in the level of borrowing under the seasonal arrangement.

Inasmuch as the volume of seasonal borrowing should change gradually and more or less predictably, it should be possible to insulate most of this borrowing from day-to-day changes in money market atmosphere. Seasonal borrowing, therefore, would have little more policy significance than float. This means that it should be possible to project the aggregate flow of reserves from use of the seasonal borrowing privilege with about the same degree of accuracy

as for other market factors affecting reserves--including the component of seasonal credit that will remain hidden in borrowing under the short-term adjustment provisions. If it appeared that the total of seasonal borrowing and other factors would supply too many reserves in any period, open market sales would be employed in the usual way to maintain the desired conditions in the money market.

Undoubtedly there will be a tendency for use of the seasonal borrowing privilege to rise as banks and their customers become familiar with this special facility. And it is probable that requests for seasonal credit assistance will tend to grow in periods of tight money or relatively low discount rates, and contrariwise to shrink when credit conditions are easy or when the discount rate is unusually high compared with rates on alternative instruments. But so long as the business of the nation's largest banks is such that these banks are unlikely to meet the terms of the Regulation and therefore are prevented from suddenly becoming seasonal borrowers, the total dimensions and variability of seasonal credit assistance at the discount window should be well within a scope that can be handled by present methods of open market operations.

Effects of Extension of Emergency Credit on the Money Market

The very nature of emergencies makes it hard to predict the consequences of any efforts to deal with them.

For the most part, it can be assumed that the occasional needs of individual member banks for emergency credit assistance at

the discount window will be small and infrequent enough to have no significant effect (in quantitative terms) on the over-all flows of reserves through the money market.

When the emergency assumes the aspect of a large-scale regional, sectoral, or even national liquidity squeeze, however, the probable effects of discount window assistance on the money market cannot be disregarded. In any crisis of such proportions, System open market operations would have been undertaken to bring about approximately the desired degree of over-all credit availability. Undesirably tight conditions in any specific group of institutions, therefore, would be related to the inability of such institutions to command a suitable redistribution of the national total of liquidity, unless the emergency were of national scope. Extension of emergency credit to such groups of institutions by the Reserve Banks would thus be not so much a substitute for money market activities that they might otherwise undertake as it would be an independent and complementary source of alleviation of undue pressures.

If the funds drained from the institutions experiencing the emergency accrued to others in the financial system, and if this development led to an undue easing of reserve availability in the money market, the System would need to undertake open market sales of short-term securities to absorb such reserve excesses. In such an environment, investor demands would be shifted toward liquid assets in general, and Treasury bills in particular--creating a ready market for such sales by the Trading Desk.

Provision is made in the Final Report for another kind of emergency credit assistance. This assistance would apply not to institutions in trouble, but rather to markets for the most important types of securities, should such markets become so disorderly that open market operations in the kinds of assets purchasable by the Trading Desk would not calm them. In such circumstances it is possible that the Reserve Banks could extend emergency credit to institutions as at least a partial substitute for further substantial efforts on their part to dump such securities into disrupted markets.

The reserve effects of such lending could be sizable, and it is possible that such loans could bulk so large as to tax the ability of the Trading Desk to offset quickly any undue creation of reserves. Here again, market demand for Treasury bills would probably become strong, thus facilitating the offsetting open market operations. But in certain circumstances, emergency assistance through the window might be the only feasible means for averting dangerous or even disastrous developments and such assistance would be justified even if the simultaneous or subsequent absorption of excess liquidity should prove to pose difficult problems for the Trading Desk.

Indeed it is quite conceivable that as much or more importance would attach to the psychological effects of emergency credit actions at the window than to their reserve effects. Markets plagued by fears of a liquidity crisis seek reassurance more than anything else. The knowledge that the Reserve Banks were lending to alleviate a widespread

emergency--or even that they were prepared to do so--might well do more to promote an orderly functioning of the market than the actual reserve funds so injected.

Conclusion

Each of the major types of credit assistance envisioned under the redesigned discount mechanism is likely to have a different effect on the money market and on the kind of complementary open market operations needed. However, these influences are not expected to exceed the ability of the market and the Trading Desk to deal with them. Many of them should serve to reduce on balance over the year demands on the money market and the Desk by providing an alternative for adjustments that in the past have required alternating purchases and sales of securities, at times in markets quite unreceptive to such operations.

The estimates of the potential maximum extension of credit for reserve period adjustment (under the basic borrowing privilege) and for seasonal needs that are given in the Steering Committee's Final Report are large in comparison with the net amounts added to bank reserves in recent years (including those required to offset gold losses and currency outflows). However, it is unrealistic to assume that such totals will ever be reached, even for short periods, because the conditions laid down for borrowing under the basic borrowing privilege would require all banks to be out of debt simultaneously during a fairly protracted period prior to any rapid build-up of indebtedness to the System. Furthermore, the estimated upper limit would be

reached only if all member banks borrowed maximum amounts, irrespective of their actual needs (and in spite of the rule against reselling of borrowed funds). It is much more likely that in a period of growing restraint some banks will enlarge their borrowings fairly early and thus will be subject to strong administrative pressure to adjust their assets by the time aggregate borrowings rise toward a statistical maximum as monetary conditions tighten further. One cannot guess how far below the potential maximum total bank borrowing will tend to remain in a time of extreme restraint. Only experience will show what typical profile short-term adjustment borrowing will assume in response to extreme tightening, but it is unlikely that the estimates in the Report will even be approached. And in any case the shift to the new policy could be made gradually.

On the other hand, provision of a sizable part of the seasonal needs of the banking system through the proposed seasonal credit accommodation is expected to result fairly soon in the emergence of a different pattern of residual seasonal demands for reserves to be met through open market operations. Given the fact that few money market banks, if any, are likely to become eligible for the proposed accommodation, it is unlikely that the shift envisaged will require more than routine adjustments in projections and operations. Indeed, because the new types of assistance available at the Federal Reserve discount window will interact with existing processes and institutions in new ways, adjustments

to the new types will take some time, and they may not progress smoothly. Some transitional uncertainties are inevitable.

Interpretation of money market conditions by analysts--and more importantly, by the Trading Desk--leans heavily on magnitudes that have come to be regarded as having special relevance in reflecting current and prospective conditions. It is obvious that any change in procedures, including those flowing from the quite far-reaching recommendations of the Steering Committee, will result in changes in the level and pattern of several such variables, particularly member bank borrowing. It may be some time before representative or stable patterns emerge and before analysts acquire sufficient confidence in interpreting and projecting changes in the magnitudes of these variables that are essential for interpreting money market conditions and the posture of System policy. But all these magnitudes are affected from time to time by innovations, modifications in procedures, shifts in preferred adjustment processes, and changing bankers' attitudes and by other reasons, as well as by changes that reflect the more fundamental structural shifts that are continuously taking place in our economy and in the financial system.

A specific level of borrowing (and of net borrowed reserves) acquires its meaning from the cumulative experience of market participants who come to associate it with a certain average bank attitude and a certain market atmosphere. The relationship between given conditions is not fixed and mechanical, but is subject to change as a function of variations in market pressures, in bankers' attitudes and

policies, and in other factors (as the experience of recent years amply demonstrates). A range of net borrowed reserves of \$200 million to \$300 million has a specific meaning when related to levels in recent periods, but may have been associated with significantly different credit conditions 10 years ago.

Given the fact that specific levels (or ranges) of net borrowed (or free) reserves acquire their analytical and policy significance as a result of collective rationalization of the way in which they are associated with specific kinds of market and credit conditions, it is reasonable to assume that similar associations will become just as firmly established once Federal Reserve standards and their administration, as well as bank attitudes, have been modified by the adoption of the window design proposed by the Steering Committee. A degree of tightness that recently has come to be associated with, say, borrowings of \$600 million and net borrowed reserves of \$300 million may then be identified with, say, borrowings of \$1 billion and net borrowed reserves of \$900 million. Both the new and the old levels will synthesize essentially the same combination of conditions and attitudes and will convey substantially the same message to market participants.

It should become clear to the market fairly soon that temporary bulges in borrowing around holidays are merely a technical alternative to providing and then absorbing equivalent amounts of reserves through open market operations, and that such temporary borrowing under the

basic borrowing privilege affects over-all credit conditions no more than corresponding "defensive" operations by the Desk.

It is expected that market participants and analysts, as well as all those within the System who are connected with formation and execution of policy, will learn--as they have in the past--to live with the new levels and relationships and to interpret these levels and relationships with no less insight and imagination than they have in the past.

Uncertainties and frictions might be reduced by a campaign to acquaint all participants with the objectives and expected modus operandi of the new system, or by introducing the new system in tranches over time. The amount and frequency targets recommended in the Report could be announced as ultimate goals, but initial levels could be set lower and raised gradually in the light of cumulative experience.

Finally, both during the transition and thereafter, a considerably more sophisticated monitoring system may well be required to keep the policy makers and the operational staffs concerned with discounting and open market operations fully aware of the changing interaction between member bank borrowing and the money market and the import of this interaction for monetary policy.