

THE DISCOUNT AND DISCOUNT RATE MECHANISM

STATEMENTS OF ASSOCIATE ECONOMISTS OF
THE FEDERAL OPEN MARKET COMMITTEE
BEFORE THE CONFERENCE OF PRESIDENTS
OF THE FEDERAL RESERVE BANKS
JUNE 21, 1954

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A. EVOLUTION OF DISCOUNTING FUNCTIONS

It is with considerable diffidence that I am undertaking to open this discussion of a matter that has been the subject of so excellent a report as that of the System Committee on the Discount and Discount Rate Mechanism--a Report that burgeoned into a revision of Regulation A. Among the many excellences of this Report, not the least is the clear-cut and provocative way in which it has raised the question of the role which the discount function ought to play in the over-all central banking management of the nation's credit supply. Until we have settled this question one way or another in our minds, we are in no position to have very firm opinions on the many related questions of administration, supervision, et cetera. All of these are necessarily colored by whatever position is taken on the more fundamental issue.

I am addressing myself, quite briefly, to a consideration of the evolution of the discount function. It is not my intention to rehearse in detail the historical facts of that evolution for they are well known to all of us. I wish, rather, to deal with some aspects of the evolution of prevailing attitudes toward the discount function. The fact that the revision of Regulation A that emerged from the Report has already undergone a further revision--one that seems to me, at least, to breathe a totally different spirit than did the first--indicates just how fast evolution can really proceed in this field.

One could only admire the cogency with which the first revision of Regulation A followed logically from the principles, to say nothing of

the philosophy, that was expounded in the body of the Report. This latest revision, however, although practically free from the objectionable features of the first, seems less well articulated than the first with the logical foundation as laid out in the Report. One may be forgiven for wondering, therefore, which attitude toward the discount function is to be taken more seriously--the one enunciated in the Report, or the one that is given practical expression in the latest revision of Regulation A.

There was, of course, no mistaking the position assigned to the discount function in the original Report. Discounting was a facility to which commercial banks should have recourse only occasionally, and then only under the most pressing circumstances and for brief periods, all the while being subject to the most meticulous scrutiny by the Federal Reserve Banks with respect not only to the quality of the paper being pledged as collateral, but also with respect to the use to which the borrowed funds were to be put. Whether the Committee intended it or not, a definite stigma was thus placed upon a bank's borrowing from the Federal Reserve. It appeared to be a shady kind of deal that a bank had better steer clear of if at all possible. In short, the discount function was, in effect, being relegated to a status that President Cleveland would have described as one of "innocuous desuetude."

In some respects this position is passing strange, since the preamble to the Federal Reserve Act names the provision of means for discounting commercial paper as one of the chief purposes for which the System was to be established. We have apparently come a long way down the evolutionary road when the very function that the System was set up to perform cannot now be used by banks except under most discouraging conditions. It would seem

that we have almost reversed the intention of the framers of both the original Federal Reserve Act and of the Banking Act of 1935, which aimed to make Federal Reserve credit via the rediscount window more accessible to commercial banks than it had previously been.

This altered opinion of the proper role of the discount function that grew up in the years between the establishment of the System and today is pretty largely the result of historical accident.

As we all know, the thinking that lay behind the original Federal Reserve Act was dominated by the so-called "real bills" doctrine which said, in effect, that under all ordinary circumstances reserve bank credit should flow into the market via the rediscounting of short-term commercial paper with the Federal Reserve Banks by commercial banks. In this way the nation would be provided with a circulating medium, consisting largely of bank credit, that would expand when business was expanding, and which would contract when business contracted.

This doctrine, along with many other things, foundered in the economic and banking debacle of the early nineteen thirties. It was mainly then that what we have come to call the "traditional reluctance of banks to borrow from the Federal Reserve" had its inception. Already in debt to the Federal Reserve, and with the volume of eligible paper rapidly shrinking, the banks found themselves unable to increase their indebtedness at the Fed. The Federal Reserve Banks, in turn, were unable to make advances or loans to the banks on the security of their other assets because of a narrow definition of eligibility. Frustrated and bitter, banks ceased to look upon the Federal Reserve as a bulwark of defense in such times of economic stress. I have

myself heard many a country banker in areas where the banks were making no pretense of really serving their farm customers say quite frankly: "We were burned once with farm loans, but never again. I would not touch them with a ten-foot pole. From now on I am going to keep my bank as liquid as possible, and under no circumstances am I ever going to get into debt to the Fed again!"

This reluctance to be in debt to the Fed may be considered a healthy development by some, but to me it seems highly questionable whether it is desirable for commercial banks to refuse to satisfy the legitimate needs of their communities in order to keep a disproportionate volume of their resources in short-term government securities just to avoid the necessity of borrowing from the Fed--a policy in which they would be confirmed if they were expected to make most of the adjustments in their reserve positions by way of changes in their investment portfolios. It is a question, indeed, of how healthy it is for the Federal Reserve Banks to be confronted with such an attitude on the part of the commercial banks, members and nonmembers alike. Perhaps we should explore the advantages that might accrue to ourselves as well as to the banking system if this reluctance of banks to borrow could be done away with rather than be hardened into a fixed attitude.

There is no gainsaying the fact that the discount mechanism broke down as a device useful for rescuing banks in a time of trouble. I think it very doubtful, however, that heavy borrowing from the Fed can be considered the major cause of the banks' troubles in the nineteen twenties and nineteen thirties. It was more likely the kind of loans and investments that the banks had in their portfolios that caused them trouble,

rather than the fact that they had built up their reserve positions via the rediscount window of the Fed. When one sees a gentlemen on a binge, doing damage to himself and to those around him, there are two ways in which you can prevent him from repeating the performance: One is to shut off his supply of firewater. Another is to prevent him from getting the funds with which he has bought the stuff. A third way of dealing with the situation might be to prevent the gentleman from taking the initiative in getting the money, but to slip it to him without cost or effort on his part, admonishing him, however, that he should not use it for such low purposes.

The approved method of handling this matter now seems to be a combination of the second and third. A bank, if not prevented, is at least discouraged from getting reserve funds at its own initiative via the discount window at the Fed. It must rather trust to luck and to the operations of the economy to bring it a proper share of whatever reserves the Open Market Committee sees fit to put into the money market via its dealings in government securities.

This ability to put the banking system in possession of reserves or to deprive it of reserves in massive amounts is certainly powerful medicine. The System, however, came into possession of such a power pretty largely because of another historical accident--the tremendous increase in the public debt just before, during, and since World War II. This war and its aftermath flooded the securities market with government obligations. The existence of the huge national debt made it possible for the System to force liquidity upon the banking system, or, conversely, to tighten credit by buying and selling such securities in the open market. One would be some-

thing less than human if he were not enamored of the possibility of controlling the supply, cost, and availability of credit by the use of this one comparatively simple instrument. In comparison with it, the discount function was a mighty weak reed to lean on when one wanted to produce massive effects in the economy.

Discounting, indeed, came to be looked upon as something worse than this. It came to be considered a positive handicap to reserve bank operations. For, when the System might want to follow a restrictive policy, the very tightness enforced by this action would drive the banks to borrow and thus, by increasing their reserves, thwart to that extent the over-all credit policy. We would seem to be undoing with one hand what we were doing with the other. In the interest of the successful manipulation of the over-all credit situation via open market operations, therefore, it seemed only right and proper that the discounting function should be severely limited in its use. Any particular area of freedom of action is always a danger to the success of any over-all scheme of control. Smaller particular freedoms, therefore, usually come to be sacrificed on the altar of the Grand Design.

The predominant position that open market operations have come to have in the arsenal of powers at the System's command is thus the result of two historical accidents--the depression and the war. It did not come about by reason of any analysis of necessary relationships that might be presumed to exist between banking and the general economy, or between the central bank and the rest of the banking system, or of the comparative roles that the various policy instruments should play in the control of credit. It came about as purely ad hoc phenomenon. If the depression had not occurred

with the violence it did, the discount mechanism might not have broken down. Even so, if the war had not thrust the open market instrument into our hands, we might still be struggling along with some less powerful tools to work with. My only point in bringing this up is to suggest that since our current tendency to rely almost exclusively upon the open market instrument to accomplish our purposes is only a historical accident, we should, I think, beware of ascribing to it an intrinsic permanence that it does not have. We should not be too hasty, therefore, in relegating the discount function to the scrap heap of obsolete machinery. The whole question should not be treated as one of "off with the old love, on with the new."

Even granting the arguments in favor of open market operations as the preferred way of putting the banking system in possession of reserves under present conditions, there still seems to be an important role that can be played best by the discount mechanism. I think we should remember that the banking system is itself an abstraction. When we say that we are putting reserves into the banking system, we are really putting them into certain particular banks, hoping that through the buying and selling, the borrowing and lending, that is constantly going on throughout the economy, these reserve funds will eventually find their way to the places where there is a demand for them.

I think we must agree that there is more than an even chance that this may not happen. For one thing, we should be somewhat modest about our ability to determine with precision the over-all credit requirements of the economy. In the second place, we should remember that no economic process ever works quite as smoothly as we assume. All such processes involve

manifold frictions and lags of many kinds. It may well happen, therefore, that particular regions, or particular banks, may find themselves short of reserves even when there is an over-all redundancy of reserves in the banking system as a whole. Such individual banks, or banks in such regions, should be encouraged to look upon their Federal Reserve Bank as a reservoir upon which they can draw with dignity in time of need, and should not be discouraged by having first to take a pauper's oath or passing some sort of means test, and by suffering a penalty rate. The discount function, after all, is the one device by which the impact of over-all credit policy can be tempered to the differential circumstances of particular banks and regions. Banks should be encouraged to use it freely, without penalty and without stigma.

In case of fire, it is good to know that we have an efficient fire department on which we can call to fight the fire. It is also a good idea to have a fire extinguisher in good working order handy to apply the juice just where and when it is needed. Occasionally, the timely use of the extinguisher may make unnecessary the more elaborate operation of the whole fire department. Similarly, if banks could again be induced to use the discount function with greater freedom, the managers of the open market instrument might find their burden of decision eased to some extent. They might even find in the ebb and flow of discounts a diagnostic device that would prove useful in determining the timing and the scope of other measures that might have to be taken.

The conclusion to which these remarks lead is simple: As the Federal Reserve System evolves, it should not abandon any of its functions or tools en route. It should rather hold on to them, keeping them all in working order by using them itself and encouraging their use by the banks.

Earle L. Rauber, Vice President
Federal Reserve Bank of Atlanta

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B. DISCOUNTING AND THE MONEY MARKET

The existence or absence of problems in dealing with member bank borrowing is, of course, closely related to money market conditions which, in turn, are largely determined by the general direction of Federal Reserve policy. Easy money conditions imply a situation in which the banking system generally is well supplied with reserves and most banks have little difficulty in meeting their requirements without recourse to borrowing from the Reserve Banks. In such circumstances borrowing is limited to the relatively few banks which, for one reason or another, are not reached by the prevailing ease in reserve positions, and the administration of discount operations involves few problems. Demands for credit ordinarily are less active at such times, and member banks are less tempted to use the discount facilities of the Reserve Banks for inappropriate purposes.

Tight money market conditions, on the other hand, indicate pressure on the banks' reserve positions--either "natural" or induced by System action--, greater difficulty in maintaining reserves at the required levels, and consequently more frequent and larger needs for recourse to Reserve Bank "discount windows." Tight money conditions imply active demands for credit and restrictive Federal Reserve policies to restrain inflationary or unsound credit developments. Many banks are effectively restrained by their reluctance to be in debt, but some may not be deterred by the tradition against indebtedness, or by discount rate changes, and may be quite willing to use Reserve Bank discount facilities freely in order to make profitable additions to their loans and investments. This gives rise to the problem, for those

responsible for the administration of discount operations, of distinguishing between the legitimate use and the abuse of our discount facilities.

While such problems may arise in dealing with any member bank, they are likely to be especially frequent and difficult in the case of the so-called "money market banks." Those banks are among the first to feel the pressures of a restrictive monetary policy and are subject to recurrent pressures as long as the restrictive policy is continued. In fact, money conditions seldom, if ever, are really tight so long as the money market banks are able to maintain their required reserves readily without recourse to the Reserve Bank for more than occasional borrowings of moderate amount.

When those banks are under sufficient pressure to be borrowing frequently and for substantial amounts, their indebtedness may be a direct result of System open market operations or may reflect the normal functioning of the money market, practically all transactions in which have an impact on the reserves of the large city banks. Although the effects of System open market operations usually spread out to other areas quite rapidly in one way or another, they have their most immediate effect on the reserves of the New York City banks. Furthermore, the New York City banks are subject not only to the demands of their own business and individual customers for credit and currency, but also to the effects of actions taken by banks in other parts of the country to adjust their reserve positions. When those banks are in need of additional reserve funds, they are likely at first to withdraw excess balances from their accounts with city correspondents and to sell short-term securities; they may also seek assistance from their city correspondents in the form of participations in large loans or in the form of interbank loans.

In addition, the larger banks in other areas may discontinue any sales of Federal funds which they have made previously to money market banks, or withdraw from the financing of Government security dealers and throw more of the load of such financing on the New York banks. For all these reasons, reserve pressures tend to converge on the money market banks, and are likely to be repetitive, so that the results of efforts of those banks to adjust their positions without borrowing, or to repay borrowings, are likely to prove short-lived.

Thus, when a restrictive monetary policy has been in effect for some time, borrowings by the money market banks are likely to be larger proportionately and more frequent than borrowings of member banks generally, even though they make a conscientious effort to adjust their reserve positions in other ways to avoid continuous indebtedness. Such borrowing cannot be taken as prima facie evidence that those banks are disregarding the System's policy of credit restraint and are extending credit more liberally than other banks. For example, in a study made in the spring of 1953 of banks in the Second District that had been borrowing most heavily in proportion to their required reserves during the preceding six months, several of the big New York City banks stood out conspicuously. We found that all of the New York City banks that were among the heavier borrowers had reduced their holdings of Government securities, especially short-term securities, more severely than reporting member banks generally, and that their loan increases in most cases were little, if any, larger. Nevertheless, there were a few banks that would, if permitted, have taken the easy course and borrowed substantial amounts of reserves continuously, rather than sell securities and curtail

their lending activities. Consequently, continuous review of the borrowings of those banks, and recurrent restraining action, were found necessary.

Such problems, of course, are not limited to the big city banks. Usually there is only scattered borrowing among the smaller banks in the early stages of a tightening money market situation. Such borrowing is likely to reflect largely seasonal and local situations where individual banks do not have the liquid assets needed to meet all the demands upon them, and are consequently unable readily to adjust their positions through such means as withdrawals of excess balances with city correspondents, or money market transactions such as sales of short "Governments." But the number of borrowing banks and the duration of borrowings tend to increase the longer a restrictive Federal Reserve policy is applied, as more and more banks exhaust the possibilities of relatively easy adjustments in their reserve positions. The city banks tend to impose stricter standards for the maintenance of balances in compensation for services rendered their country bank correspondents, and liquid assets of increasing numbers of the latter may become depleted to the point where the banks are reluctant to reduce them further.

Thus not only the money market banks, but a number of other banks, are likely to reach the position where their needs for reserves cannot adequately be met by occasional borrowings for short periods from their respective Reserve Banks, but may induce borrowing that is closely intermittent, or even continuous over rather extended periods. If they are not permitted to engage in such borrowings when their secondary reserves are depleted, such banks may be forced to sell longer-term securities under unfavorable market conditions--perhaps at substantial losses--or to curtail their ex-

tensions of credit to the point where the reasonable credit needs of their customers are not being met adequately. The situation that developed in the spring of 1953 is illustrative. At that time, the difficulty in maintaining required reserves, and the fear that the Federal Reserve credit needed to meet anticipated seasonal and Treasury requirements would not be forthcoming, led to severe unsettlement in the market for Government securities and to some complaints of unavailability of credit for normal business purposes.

What, then, is the solution? One suggestion in the report of the Committee is that since, under the suggested discount policies, restrictive effects would be felt at a lower volume of discounts, a larger part of the reserves needed by the banking system would have to be supplied in other ways--presumably open market operations. Security purchases by the System would, of course, relieve the situation of the money market banks and enable them more readily to meet the needs of the correspondent banks throughout the country. But if the banks were provided with reserves in that manner, which would relieve them of the necessity of borrowing except for occasional short periods, what would become of the restrictive monetary policy? As was pointed out earlier, money conditions are seldom, if ever, really tight so long as the big New York City banks are able to meet their reserve requirements readily without substantial or frequent borrowing. And not only the money market banks, but also their correspondent banks would be able to obtain reserve funds without the restraining influence of the tradition against borrowing if most of the banks' needs for reserves were supplied by means other than discounting. The impact of discount rate changes would then be correspondingly reduced, and there would be less opportunity for the Reserve Banks to exert an effective influence upon the credit policies of individual member banks.

Another suggestion in the Committee report is that, if more restrictive discount policies were followed by the Reserve Banks, the banks outside the principal financial centers might be forced to depend more heavily upon their city correspondents for assistance. But that raises the question of how the city banks are to meet the needs of their correspondent banks at a time when they also are under pressure. As was pointed out earlier, the big city banks, through the functioning of the money market, are likely to be among the first to feel the effects of a restrictive Federal Reserve policy and to find it necessary to have recourse to the "discount window." A possible answer would be to treat the money market banks more leniently than other banks, so that they could more readily assist their correspondent banks in meeting the demands of their customers. Justification for such a policy might be found not only in the responsibility of the large city banks for assisting their correspondent banks, but also in their responsibility for facilitating the functioning of the Government security market and the money market generally. But such a policy would be open to the charge of favoritism if discount facilities were provided more freely to the city banks than to the "country" banks, and for that reason could hardly be given serious consideration.

Perhaps the most feasible solution may be found in treating all member banks alike, not by forcing all member banks to make their borrowings fit a certain pattern or "norm," but rather by taking into account the needs in individual situations so as to enable the banks to meet their responsibilities to their customers and communities (and, in the case of the large city banks, their responsibility for the proper functioning of the national financial markets and of the banking system), while at the same time repressing any

tendency toward abuse of the discount privilege. Treating all banks alike would not preclude the officers responsible to administering discount operations from taking into account the degree of pressure on the reserves of individual banks, and the reasons for such pressures. It might be found that in some cases the pressures were of the banks' own making, while in others they were caused by external influences over which the banks had no control--quite possibly including the effects of actions taken by the Federal Reserve System. In other words, discretion and judgment are needed in dealing with borrowing by member banks--money market banks and country banks alike.

This discussion also suggests that the concept of appropriate borrowing can hardly be an unchanging one under all circumstances. The Committee report recognizes that in emergencies--general or local--discount policies should be liberal. But short of emergencies or other unusual situations, an amount and frequency or continuity of borrowing by individual banks may be appropriate in some circumstances that would be quite inappropriate in other circumstances. It may be concluded, therefore, that if discount operations are to serve most usefully the general objectives of monetary policy, the concept of appropriate borrowing must be flexibly adapted to changing conditions and to changes in Federal Reserve policy.

Harold V. Roelse, Vice President
Federal Reserve Bank of New York

C. ADMINISTRATION OF DISCOUNT POLICY

Central Bank traditions in the United States are founded on a minimum of administrative control and a preference for and dependence upon impersonal, market forces as the means of relaying central bank policy through the credit system. Nevertheless, the Federal Reserve System is faced with the fact that some degree of administrative discretion and action is necessarily involved in the process of making discounts and advances even though the maximum use feasible is made of general credit measures, including the discount rate.

The developments of recent years have given prominence to the lack of adequate guides with respect to the discount operation. The rise in the importance of advances, based upon Treasury securities as collateral, has widened the area of administrative judgment. The rules of eligibility contained in the existing regulation have not afforded sufficient guidance to the administrator either in extending advances or in making discounts, but, on the other hand, appear to have fostered the view of many bankers that no restraint should be applied so long as adequate collateral is offered.

The proposed Regulation A is designed to set forth for member banks the conditions which govern the administration of discounts and advances. Administration is established broadly on the maintenance of sound credit conditions and more specifically on principles setting forth the appropriate occasions for borrowing. Latitude is provided to meet local conditions either that cannot be reached by more general measures or that should be exempt from the stringency that would otherwise be imposed by general credit controls. These concessions to local requirements enable the Reserve System to accommodate credit needs that may run counter to the dictates of general credit

policy as a result of developments that are not themselves a result of credit policy. Restrictive general credit policies are not considered to be contravened by the accommodation of member banks which encounter difficulty owing to unusual flows of deposits or exceptional local requirements for credit. Indeed, it is possible that general credit policy may enjoy a freer hand in applying restrictive measures as a result of the knowledge that situations requiring relief can obtain it through local discount activity.

Experience over a period of time may be required to determine whether the Regulation as now conceived will give discounting a place in the operations of the Federal Reserve System that will prove satisfactory over the long run. The fact that, in the current year, discounting has continued in moderate amount in the face of a policy of active credit ease, of generally declining loan demand, and of short-term money rates that have been well below the discount rate is evidence that ease in the central money markets may not provide a solution to the adjustment problems of all banks.

The part that administrative decisions will be forced to play in the application of credit regulation through the discount mechanism will depend in part upon the manner in which the other credit instruments are applied. If the discount rate is maintained at a level that makes it profitable to borrow to purchase Treasury bills, a much closer scrutiny must be given requests for advances than if the discount rate represents a penalty rate. Furthermore, the discount rate can involve a penalty compared with certain open-market rates and not with others. It can levy a penalty on banks with shorter-term investments and not on others with longer-term investments.

A similar relationship exists between open-market operations and the administration of discounting. Whenever open-market purchases of securities are insufficient to accommodate fully the requirement for reserves to meet seasonal needs, for example, discounting probably will be used more widely and administrative problems will be increased. The individual bank might not experience a perceptibly different loan demand or deposit flow than would have occurred if the System had made available all the reserves necessary to finance seasonal needs. The deficiency in aggregate reserves in relation to loan requirements would be registered only in the open market by a rise in rates which would affect the desirability of selling securities to make possible the extension of credit to the local community. Thus, it is well to recognize that what may, in some future period, seem to be an undue willingness of administrators of discount facilities to flex with the demands of member banks may instead be a reflection of the added strain on their judgment and analytical tools placed there by the manner in which other instruments of credit control have been applied.

Moreover, one of the policy decisions that will need to be made is whether the rigor of the administration of discounting should vary with credit policy, or whether it should be carried through with the same exacting application of principles regardless of changes in System credit policy. While the job of discount administration is a constant one, there are good grounds for arguing that it should be adaptable to the economic conditions prevailing and the credit policy being pursued. For instance, it is questionable whether it is necessary or in order to follow the same administrative policy in a period of low economic activity as in a period of "over-employment" and

price inflationary pressures. The principles of appropriate borrowing as now written would appear to be adaptable to such varied circumstances.

It may be useful in this consideration of the features of the proposed Regulation A to try to visualize as concretely as possible some of the types of problems that will be faced by those who will be charged with its administration. The following is not a plea for greater precision in the terms of the Regulation, but instead is an attempt to explore the meaning of some of its terms and to indicate the substantial area of administrative judgment that will be required.

The Regulation provides the member banks with certain principles for guidance in submitting requests for discounts and advances and the Reserve Bank administrator the same principles for judging the legitimacy of the request. Among these principles are one that allows the accommodation of seasonal requirements that cannot reasonably be met by use of the member bank's own resources and another principle that forbids credit when the bank's principal purpose is to profit from rate differentials. In the light of these principles, suppose a request is received which states: "We are having the greatest demand for Government-guaranteed loans on wheat that we have ever experienced and, since the money managers have forced bond prices down so far, we prefer to borrow on our bonds rather than to sell them to restore our reserves."

The administrator knows several pertinent facts concerning this transaction. First, guaranteed loans on wheat can be turned over to the Commodity Credit Corporation on demand and funds obtained, but the processing of these loans at harvest requires time. Second, these loans have a yield that is

higher than either Treasury bills or the discount rate. Third, loans on wheat increase rapidly in the summer, reach their normal peak about January 31, and are redeemed by the Commodity Credit Corporation on April 30. And, fourth, the money market has been tightened by the Reserve System as a restraint on inflationary trends and bonds have fallen in price. Since the member bank cannot obtain funds immediately by redemption of the loans, the alternatives are to obtain the advance, sell the bonds, borrow from a correspondent bank, or refuse to carry the loans on wheat.

In judging the request, the administrator conceivably could take the view that the bonds should be sold since the bank is gaining an interest advantage if an advance is made. Or, more probably, he may consider the need for credit to result from an exceptional seasonal condition which credit policy allows him to accommodate and grant a credit that gives time for a part of the loans to be redeemed. In doing this, he assumes that it is unreasonable to expect the bank to accommodate the demand from its own resources, since a capital loss would be involved, unless the bank was encouraged to turn to its correspondent bank. Administrators might differ in the amount and the term of the advance they would make under these circumstances where a number of principles are involved. But the case illustrates that the fact that situations will arise in which two or more, possibly conflicting, principles of appropriate borrowing are involved.

A simpler case occurs where advances are desired, not to acquire additional earning assets, but to prevent deposit drains and loan requirements from forcing the sale of such earning assets previously acquired. Illustrating this is the following case: "We are having a reduction of deposits and we believe it is better to borrow than to sell bonds. We don't want to sell bonds as we believe loans will decline and we will need the bonds." If a member bank encounters such conditions very frequently, it would be evident that the bank had not provided sufficient liquidity, and the administrator might judge each situation in terms of its own history.

Suppose that the request for an advance stated that it was for the purpose of enabling farmers to carry part of an unusually large crop into a succeeding fiscal year in order to reduce the farmers' tax liability. Is the request to be granted or denied?

A different type of situation arises if the accommodation of emergency requirements conflicts with the maintenance of sound credit conditions. An area may experience a drought that is prolonged, leading to the withdrawal of deposits from the community and later to the sale of assets. Advances to member banks under such conditions are clearly justified in the proposed Regulation A, yet the condition may show no improvement and it may become desirable to urge the member bank to dispose of securities when favorable market conditions develop, on the ground that the situation involves a structural readjustment.

Among the situations requiring a substantial degree of administrative judgment probably will be those involving seasonal borrowing. The first

principle of appropriate borrowing in the proposed Regulation A indicates that Federal Reserve credit is available to assist the member bank "in meeting requirements for seasonal credit which cannot reasonably be met by use of the member bank's own resources" and further indicates that "maturities of such borrowing normally are short." The wording of the principle gives much latitude to the administrator--a concession that appears quite desirable in the light of the difficulty of defining more precise guides for the treatment of highly variable situations.

In practice, it may be rather difficult to distinguish seasonal needs from other demands for credit from the individual member bank and to estimate with any exactitude the amount of a bank's seasonal need for reserves that it is appropriate to accommodate. Even if refined methods of estimation could be employed, seasonal variations in many communities, and particularly in agricultural districts, have widely varying amplitudes from year to year. The importance of weather in affecting the volume of agricultural production is well known. Also important are the desires of farmers, at times, to carry larger or smaller inventories of their own products, depending upon the relation of market and support prices, tax considerations, and other factors. The discount administrator will necessarily have to judge each case as best he can upon the basis of all the facts that he has available. In addition to such individual case data, however, his decision will necessarily be conditioned by the prevailing System discount policy.

The proposed Regulation does not appear to present any important obstacles from an administrative viewpoint, since its terms are general, allowing interpretation in the light of local conditions. Publication

of the Regulation should dispose of many of the cases that might have become problems, and the institution of review procedures in accord with the stated principles of appropriate borrowing should help to make clear to borrowing members the manner in which the principles are to be interpreted and applied. The extent of the administrative burden and the difficulties of administration, however, will depend upon the discount philosophy that the System places behind the Regulation and the role that discounting is intended to have among the System's instruments of credit regulation.

Clarence W. Tow, Vice President
Federal Reserve Bank of Kansas City

D. SYSTEM GAINS FROM DISCOUNTING

Perhaps the most useful role for me at this state of the discussion is to examine in greater detail some of the provocative questions which Earle Rauber raised in his opening remarks. The flurry of discounting activity in the last two years witnessed a number of specific problems of over-use. Tax avoidance considerations were often the dominant and obvious motive leading to the over-use. In other instances, lesser incentives profitwise operated. The concentration of our attention on excesses in what we may properly hope to be a nonrecurring environment naturally left some longer-run issues largely unexplored. Yet such issues deserve to be laid upon the table, if only to provide balance in the background for long-run policy.

Longer-run
issues at
stake.

The suggested foreword to the regulation on discounts and advances implies a minimum role for discounting. Member banks should only borrow for temporary or unusual needs. The implication is that total borrowings from the System will be insignificant except in periods of credit stringency, when the Federal Reserve is tightening the money markets to fight inflation. The System would, in effect, turn its back on discount policy as a continuous tool of credit control. Is it possible that by so restricting borrowing we are immobilizing a potent weapon that could be used to fight deflation as well as inflation?

Even with few misgivings about the proposed foreword, it still may be worth-while for us to take the next few minutes to

explore some of the possible gains, and, of course, the potential risks of encouraging more or less continual use of the Federal Reserve's discount facilities.

Discounting
compared
with open
market
operations

Member bank borrowing has unique potentialities and peculiar hazards not found in open market operations. For one thing, discounting places greater initiating power with the member banks.

Beyond that, however, the chief differences are confined to the point at which the funds enter the banking system. As the new reserves move through the banking structure in the normal course of business, reserves acquired from open market transactions are indistinguishable from reserves arising out of member bank borrowing.

Effects
much the
same for
"down the
line" banks

The banks to which the new reserves subsequently move may use these funds to support appropriate or inappropriate credit extensions, may let them lie idle or funnel them back into the money market, depending upon their alternative profit opportunities and management policies.

Which of these alternatives the banks "down the line" choose will not depend upon the original means of reserve injection, so long as discounting and open market operations do not have substantially different effect on market interest rates. The likelihood of significantly different repercussions on interest rates is not great, since discounting normally operates in the short end of the market, just as do open market transactions.

Advantage 1:
Better
distri-
bution
from dis-
counting

The differing effects of discounting and open market operations, therefore, are concentrated in the bank that initially borrows from its Federal Reserve Bank, sells its Governments, or

receives the proceeds from its depositors' security sales. In the latter case the bank itself may well have no immediate needs for the funds. Needs may exist elsewhere, but whether the funds are subsequently transferred to those needy spots will depend in part upon the recipient bank's own policies.

In the bank that sells securities or borrows, the reserves will be going directly to a bank seeking funds; the proof of that particular bank's needs is its willingness to pay the price of discounting or to give up an earning asset. But even for such a reserve-seeking bank, discounts and Government security sales do not produce identical reactions. Discounting increases a bank's short-term liabilities by the amount of the borrowing, and adds a like amount to its most liquid assets. Unloading Governments, on the other hand, merely results in an asset exchange--securities for cash--which produces a higher order of asset liquidity but no change in asset totals.

Advantage 2:
Borrowing
bank
faces
repayment

These differing effects on liquidity position may modify bank policy, but the influence is almost impossible to quantify. This much can be said, however; the bank that is in debt to the Fed is alert to the fact that the borrowings will have to be repaid, and its reserves subsequently reduced. When reserves for seasonal and similar needs are supplied through open market operations, no member within the banking system is anticipating or preparing to give up reserves. Discounting has a built-in automatic mechanism for facilitating the return of outstanding Federal Reserve credit.

Advantage 3:
Action
initiated
by member
banks

From a Federal Reserve Bank point of view, an obvious distinction between reserve sources rests upon the way in which the reserve change is initiated. In one case the Federal Reserve System assumes the initiative, in the other it is taken by the borrowing bank. This latter technique could become an adroit weapon of the monetary authorities. With the Federal Reserve System in the limelight of public and financial attention, it may often be desirable for reserve changes to appear to be initiated by the community rather than by direct Federal Reserve action. At the same time, the System does retain control of the volume of reserves available.

in envi-
ronment
set by
System

The job is primarily one of establishing the "proper" environment and conditions to call forth the "appropriate" level of borrowing. By making the discount rate--the price of admission to the discount window--sensitive to changes in the business climate, and by playing upon the bank liquidity effects, the flow of reserves may be kept in line with the System's over-all credit policy.

Within this framework, the Fed has something else to gain by allowing a measure of initiative to rest with the member banks. As has been mentioned in the discussions earlier this afternoon, at present we know relatively little about the actual flows of reserves from money market banks through the banking structure. Despite the many methods of reserve balance adjustments, it was sometimes evident, as it was last month, that having an adequate level of free reserves does not insure their proper distribution.

A wise use of discounting would mitigate the distorting effects of local or regional pockets of reserve scarcity.

Advantage 4: Likewise, open market operations may be imperfect with Better handling of anticipated reserve pressures respect to the exact timing of the reserve injection. The staff of the Open Market Committee has done an excellent job in forecasting reserve needs. But there are a number of factors that would defy predictive abilities of a staff of Delphic oracles. If member banks are accustomed to borrowing, discounts will act as a safety valve to relieve unexpected reserve pressure that otherwise might have needlessly disrupted the money market.

Further light on the ramifications of borrowings can be gained from a consideration of the type of banks appearing before the discount window. For brevity's sake we might group banks into two classes--timid borrowers and aggressive borrowers. The timid borrowers make use of the discount facilities only in cases of unexpectedly large reserve drains, of either a temporary or emergency nature.

Using the aggressive banks

The aggressive borrowers, on the other hand, are alert to any potential profit opportunity and will vary their borrowings with changes in market conditions. But they will be inclined to come to the Fed for resources only when the anticipated net cost of alternative methods of obtaining liquidity is greater than the discount rate. There always are alternatives. Discounting usually competes with adjustments in a bank's most liquid and lowest-earning assets--correspondent balances and Treasury bills--and with the purchase of Fed funds. Although

computing the cost of the various methods of reserve acquisition can be complex, the final choice is simple; it will be based on the relative "prices."

The aggressive banks are sensitive to changing conditions in the markets in which they deal, whether they be national, regional or local. They are the institutions most inclined to sense and respond to shifting money and credit pressures. As a result, with reasonably free discounting, movements in the level of borrowing by these banks can serve as a barometer of changing credit climates, and can be valuable as a guide for all phases of System credit policy. Moreover, such changes in discounting permit a prompt and partial accommodation to the varying intensity of marginal credit demands.

The importance of these banks in our national credit structure should not be underestimated. They are the first to plumb areas of unserved credit needs. In periods of depressed activity, they can lead in encouraging expansion via credit extensions. Operating in the multiple segments of the financial structure into which bank credit extends, they provide an important linkage between the various sections. Without their existence, the Reserve System could not nearly be so confident that the financial structure is sufficiently fluid to adapt to the legitimate needs of a dynamic economy.

Anticipated hazards of discounting

The utilization of borrowing is not without its anticipated hazards. The total of reserves released to meet a given volume of credit demands may be either greater or smaller

through discounting than through open market operations. This will depend upon the relative leakages of funds which occur in the reserve flows which stem from each operation. But since banks can exercise initiative in draining funds through the discount window, there is the possibility that they may borrow reserves in volume sufficient to support excessive credit expansion, thereby compounding inflationary pressures in time of boom. Any overabundance of reserves funneled through discounting, of course, could be offset in total by open market sales. In this way, the over-all picture can be kept under control, while still allowing for efficient regional and local allocations.

Hazard 1:
Overexpansion of reserves

can be offset by open market operations

and controlled by rate changes

The System has other means of control in its hands to influence banks. Karl Bopp will be describing the workings of the discount rate as a means of regulating the amount of discounts. By widening or narrowing the cost differential of discounts versus other means of reserve adjustments, the System can make borrowing more or less attractive. If the System modified the environment to achieve an approximate level of borrowing, the member banks would then react in accordance with these policy objectives.

Moreover, the potency of the discount rate changes is proportional to the volume of discounts. The higher the level of borrowing the more leverage the System has in controlling member bank actions, for the harder the banks are hit by a small change in the discount rate. In order to be able to

both tighten and ease credit by varying the volume of discounts, the total of member bank borrowing should fluctuate around a level considerably greater than zero. This will not only permit flexibility of control through changes in rate differentials and liquidity positions, but will also allow substantial changes in the level of borrowing to indicate an easing as well as tightening of credit conditions.

Hazard 2:
Operating
on Federal
Reserve
resources

One other aspect of the control of borrowing merits attention. While the above-mentioned devices can regulate discount totals, there is the danger that an individual bank may continually utilize its potential borrowing position to supplement its own resources. As a last resort, administrative procedures can be developed to spot and stop such abuses. Yet I think we go too far in assuming that such an earnings increment is peculiar to discounting, and that earnings are only incidental to the credit influences we wish to exert.

Profits
dominant
banker
motive

After all, reducing bank reserve requirements enhances bank earning ability just as surely, and more permanently than does borrowing. And any System monetary action depends for its effect largely upon bank awareness of, and response to, profit opportunities. Sometimes it is true, banks act irrationally under Federal Reserve pressures. For the most part, however, the System can induce bank credit changes because it can create conditions which offer its members a chance to increase profits or reduce losses. So long as profit-making is the

dominant goal of business, the Federal Reserve must expect to see rewards conferred upon those banks which conform to its objectives.

This profit motive of enterprising bankers can be a positive aid in promoting longer-run economic stability. While the major economic problems of our future may be associated with inflation, the dangers of deflation cannot be ignored. This is doubly true for the Reserve System, for our major monetary weapons lose effectiveness in a depressed environment.

Discounting
and economic
growth in
a predom-
inantly
private
economy

During the past 15 years our economy has been bolstered by huge Government expenditure, and debt expansion. Now, Federal expenditures are being scaled down and probably will continue to be pared, barring, of course, an increase in international tensions. That means that consumer and business expenditure must not only fill the gap left by lower Government spending, but must be prepared to increase in accordance with the needs of a growing nation. In our system, rising private expenditure has usually necessitated growing private debt. The question then arises as to the ability and willingness of the financial system to accommodate such debt. This will depend, in time, partly on Federal Reserve willingness to monetize these instruments. If the Reserve System discourages borrowing, it will place a liquidity penalty upon private debt; while its sole reliance upon open market operations would attach a distinct liquidity premium to short-term Government securities.

In this situation, any sound banker would have to hold short Governments in proportion to his expected peak liquidity needs. Having exported funds to acquire such a volume of securities, he may eventually not be able adequately to take care of the growing legitimate credit demands of persons and businesses in his locality. This is most evident in capital-deficient areas, where community saving is not sufficient to provide funds for the investment opportunities. It may apply in other local areas as well, however, since many borrowers have few alternatives to choose from. Farmers, smaller businesses, and individuals, especially are directly or indirectly dependent upon bank financing, and to a great extent upon the banks in their own communities.

Reasonable availability of discounting could help to redress this possible lack of balance between bank liquidity needs and community credit demands. Were member banks to know that, if when desirous of liquidity, they could readily discount their private debt instruments at their Federal Reserve Bank, they would be willing to release some of the funds tied up in secondary reserves to their community.

In the longer run, some such general bank shift from public to private instruments may be advisable, if the future debt growth in the economy is largely in the private sector. This would permit the banking structure to accommodate the basic forces of economic growth, rather than tying it to sterile competition for a relatively contracting Federal debt

segment. The fact that discounting can contribute in a modest way to this economic dynamism, is I think reason enough to keep the discount window open.

George W. Mitchell, Vice President
Federal Reserve Bank of Chicago

E. ROLE OF THE DISCOUNT RATE

The discount rate, with which this memorandum is primarily concerned, cannot be separated from the tradition against borrowing and the rules of borrowing any more than the discount mechanism as a whole can be separated from open market operations and changes in reserve requirements as an independent instrument of Federal Reserve policy.

Money market developments from April 1952 to June 1953 accelerated reconsideration by the System of the appropriate relationships among the three facets of the discount mechanism. The background briefly is as follows:

For a considerable period before the summer of 1952, transactions for the System Open Market Account were conducted "with a view to exercising restraint upon inflationary developments." This restraint was reflected in rising yields on securities but not in any persistent increase in the volume of borrowing from the Federal Reserve Banks. Occasional rapid increases in borrowings were of short duration--for example, advances increased from \$227 million on November 21, 1951 to \$959 million on December 5, 1951, but by January 2, 1952 they were down to \$105 million.

In the middle of April 1952, however, the volume of discounts rose rapidly and remained high for more than a year with only temporary interruptions. Since this was a period in which the System was "exercising restraint," question was raised as to whether member banks were escaping--or might be able at some future time to escape--the restraint that the System wished to exert. Question was raised as to whether the tradition against borrowing was being impaired and whether it should be reinforced or re-

placed by more rigid enforcement of rather restrictive rules for borrowing.

In this memorandum primary attention will be directed to the relationship between profit and the volume of borrowing. It should not be inferred, however, that profitability of borrowing is the only factor involved. For example, if the System were now to reduce the discount rate to a level below the yield on short Treasury bills and were to make discounts freely available at that low rate, it would not follow that member banks would immediately borrow huge amounts or that the System could replace a large fraction of its Government security portfolio with loans and discounts. Furthermore, an attempt by the System to liquidate a large amount of Government securities, even though discounts were readily available at the low rate indicated, would result in severe pressure on the money market.

The "tone" of the money market is greatly influenced by the attempt of banks to adjust their asset structures to desired relationships. Banks generally do not like to borrow money (except, of course, in the form of deposits). Some never borrow and others borrow only temporarily to meet reserve deficiencies (that cannot be met by borrowing Federal funds) until they can readjust their position in other ways. The market tightens as more banks try in larger amounts to adjust their positions in these other ways.

Such considerations lead to the question: What conditions in the money market influence the volume of borrowing? Three charts have been appended to show the relationships between certain relevant factors in the period 1952-1954 and during the 1920's.

The close positive relationship between the historical level of rates and the volume of borrowing--which has frequently been pointed out for the 1920's--is apparent also in the more recent period. Banks borrow more when rates are high than when rates are low. This relationship has sometimes been interpreted to mean that banks do not borrow for profit.

The historical level of rates, however, does not measure the profitability of borrowing. Profitability is determined by comparison between market rates and the discount rate at a given time. There will always be differences of opinion as to which market rate or rates should be compared with the discount rate to determine profitability. In the attached charts the rate in the largest short term market has been used. In the 1920's this was the call loan rate. In the recent period it has been the Treasury bill rate.

The relationships between profitability as thus measured and the volume of borrowing is sufficiently close to warrant the conclusion that banks do borrow more when market rates are above, than when they are below the discount rate. This does not mean that member banks do not have a strong feeling against large and continuous borrowing from their Reserve Banks. Rather the interpretation would seem to have the following complexion. When a bank finds itself deficient in reserves, its immediate action is to restore its position in the "best" way possible. Each bank has its own ideas as to the best way but one aspect is cost. When borrowing from the Reserve Bank is the cheapest source of funds, some banks will resort to it temporarily. But typically, because of the tradition against borrowing, they will begin to readjust their position to repay. In doing

so, however, they may shove other banks into borrowing. To illustrate: If Bank A, after being indebted to the Reserve Bank for several days, calls loans or sells securities to repay the Reserve Bank, it may receive funds through the clearings from, say, Bank B. Bank B in turn becomes deficient, and discounts to restore its reserves. As it attempts to adjust its position to repay the loan to the Reserve Bank, it may force Bank C into the Reserve Bank. Thus, although no single bank would have violated the tradition against continuous borrowing, the total volume of discounting may remain at a significant level. From the point of view of total borrowing of all banks, frequency as well as length and amount of borrowing by individual member banks becomes important.

At times the volume of borrowing is large even though bank rate is above the market rate. But borrowings do not, typically, remain large very long under these circumstances. Part of the explanation may be that a few banks experience reserve deficiencies when they do not have adequate money market securities to liquidate--hence they borrow. As they readjust their positions to repay, they shift the pressure to other banks which do have an adequate supply of money market securities which can be liquidated at the lower market rate to absorb the pressure without borrowing.

Although the volume of borrowing is closely related to profitability, it is significant that market rates rise above--at times significantly above--the discount rate. The surprising thing, perhaps, is not that the volume of discounting remained large--in comparison with earlier periods--from April 1952 to June 1953, but that it did not reach much higher levels. To be sure moral pressure was exerted at times; but the question remains.

The reason may be that when the volume of discounting approaches, say \$1-3/4 to \$2 billion, borrowing for individual banks ceases to be intermittent. Many borrowing banks are trying to shift the pressure to others, but these other banks are already borrowing, so that some liquidate market-able securities even at rates above the discount rate to repay their borrowings.

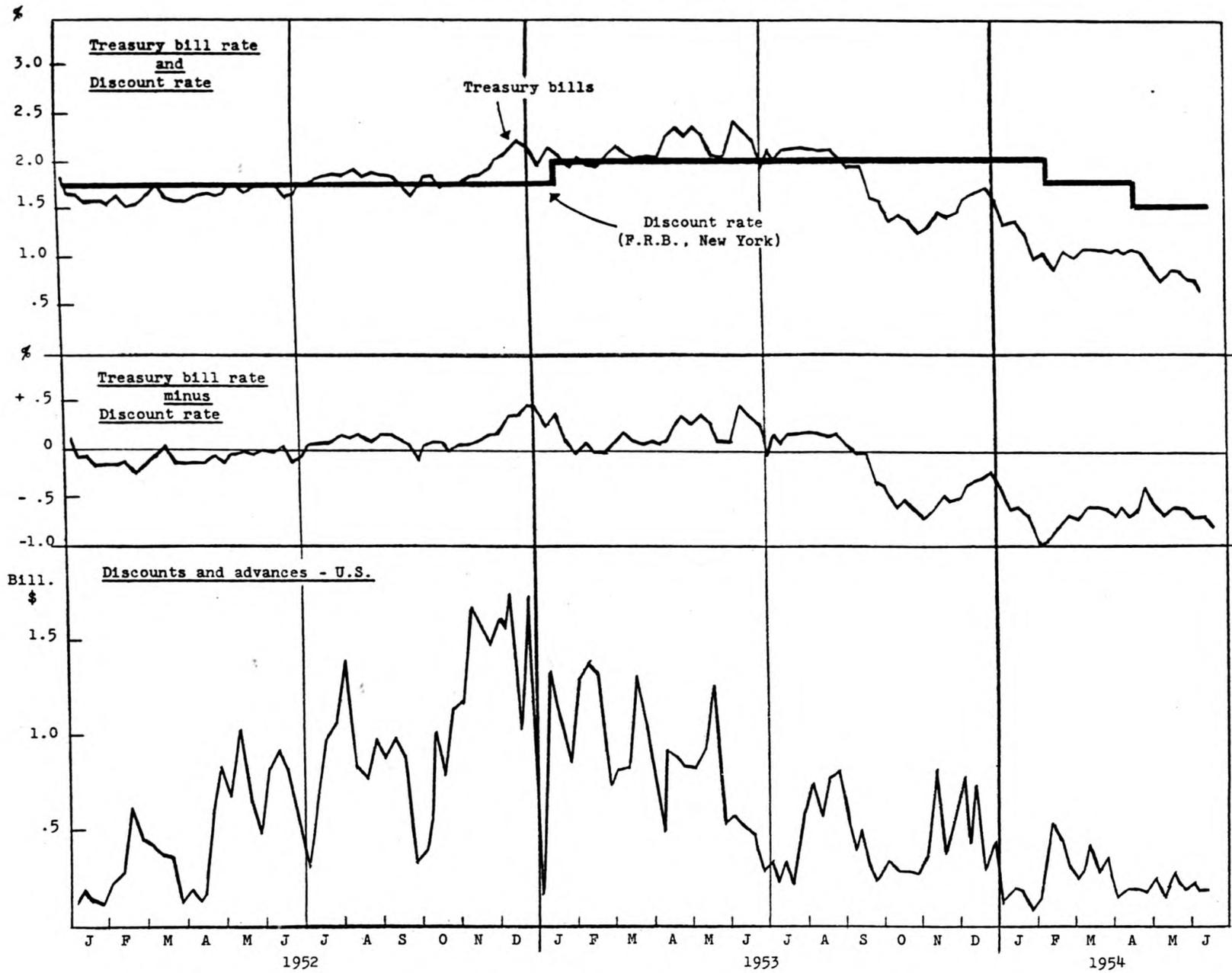
Most banks borrow as a convenience to restore reserve deficiencies rather than to expand their earnings by scalping a rate differential. It is unlikely that the volume of discounting would become large relative to the System's portfolio of Government securities even though the discount rate were kept relatively low in the short term structure of market rates. Within that limit of perhaps several billion dollars, however, the general level of borrowing is closely related to the spreads between the discount rate and market rates. This is the experience of the 1920's; it was confirmed in 1952-1953. Borrowing increased when the discount rates is relatively low and decreases when it is relatively high in the structure of rates.

It would appear, therefore, that the rate is an effective means of regulating total volume of borrowing.

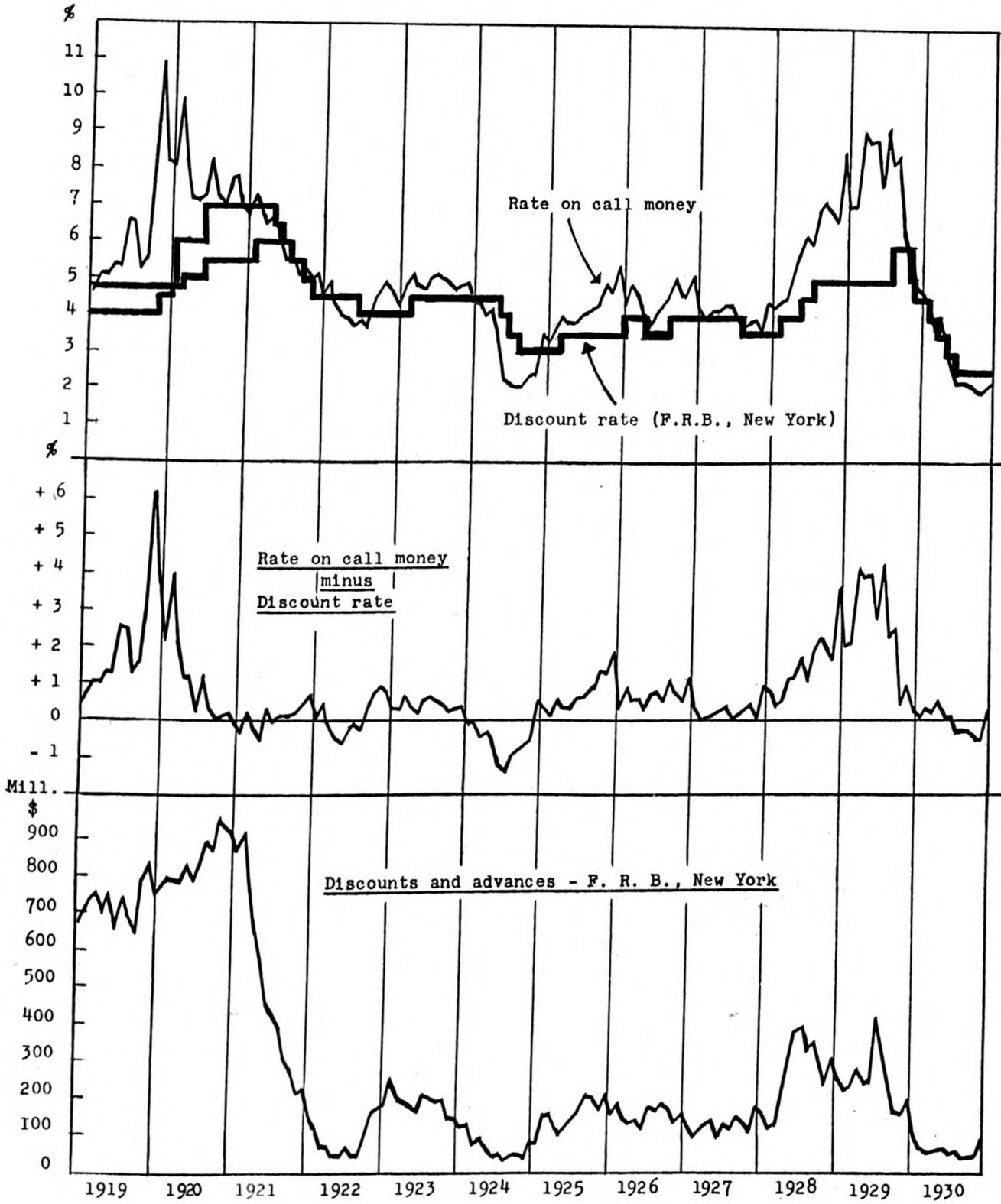
Karl R. Bopp, Vice President
Federal Reserve Bank of Philadelphia

DISCOUNTING AND PROFITABILITY: 1952-1954

E-6



DISCOUNTING AND PROFITABILITY: 1920's



DISCOUNTING AND PROFITABILITY: 1920's

E-8

