

The Tradition against Rediscounting.

"It is a generally recognized principle that reserve bank credit should not be used for profit, and that continuous indebtedness at the reserve banks, except under unusual circumstances, is an abuse of reserve bank facilities. In cases where individual banks have been guilty of such abuse, the Federal reserve authorities have taken up the matter with officers of the offending banks and have made clear to them that their reserve position should be adjusted by liquidating a part of their loan or investment account rather than through borrowing. Abuses of the privileges of the Federal reserve system, however, have not been general among member banks. The tradition against continuous borrowing is well established, and it is the policy of the Federal reserve banks to maintain^{1.} it." In these words the Federal Reserve Board described the tradition against rediscounting.

The tradition against rediscounting is a new name for an old practice of commercial banks. Long before the establishment of the reserve system, commercial bankers, striving to accomplish their two-fold objective of liquidity and profits, developed certain principles and rules of thumb. Among these the most familiar probably is that certain ratios should be maintained between various assets on the one hand and deposit liabilities on the other. Another old rule which many bankers follow is that their institutions should not normally be in debt to other banks on loan account.^{2.} With the establishment of the Federal

reserve system, banks simply extended this practice and strive normally to be "even" with the reserve banks, that is to have neither excess reserves at nor indebtedness to the reserve banks. Most writers agree that the tradition is an extension of pre-federal reserve practice.^{3.} Periodically, as during, roughly, the decade of the 20's, reserve authorities have encouraged member banks to follow the tradition.^{4.} During the war of 1914-1918 and again in the 1930's, however, the pressure of the reserve authorities on the member banks was all the other way, i.e., encouraging them to borrow.^{5.}

The effects of the tradition are clearly reflected in the money markets. Mr. Riefler has shown that whereas "market rates on acceptances have never varied greatly from the buying rates established by the reserve banks....other open-market rates...have frequently ruled at levels sufficiently far above discount rates to have permitted a wide margin of profit to member banks if reserve funds had been borrowed for the purpose of lending in these markets, while at other times they have fallen well below discount rates. It is obvious that these rates in the short-term open markets could not have remained so far above discount rates for such long periods, if member banks had borrowed freely from the reserve banks whenever the operation was profitable."^{6.}

Just because the tradition aids to an understanding of market rates, it does not follow that the reserve banks may rely upon it as an adequate instrument to restrict the volume

of reserve bank credit extended to the market. The fallacy of such a conclusion may be illustrated with an analogy from English banking. English member banks customarily do not borrow from the Bank of England. Instead, they call loans which they have extended to the bill brokers. The Bank of England does not rely upon the custom of the English banks of not borrowing to control the volume of reserve resources or the volume of credit which it extends to the market, because it knows that the bill brokers follow no such custom. They borrow from the Bank when borrowing is profitable; and they are discouraged by the Bank through increases in the rate. The basic instruments which the Bank uses to control the volume of reserve resources and the volume of credit which it extends to the market are the rate and open-market operations, not the tradition of the banks. The tradition merely influences who shall borrow, not how much will be borrowed. Yet it is the volume which is of greatest importance.

If one examines the reliability of the tradition as an instrument of central banking control rather than as a concept to explain money market rates, he notes a number of important restrictions in it. In the first place it is not uniformly effective against all banks. That it is effective against many banks, no one will deny. Some bankers, whose institutions are members of the reserve system, take pride in being able to say that they have never borrowed from the reserve bank and insist that they will never do so short of a catastrophe. But this is not true of all bankers. Evidence

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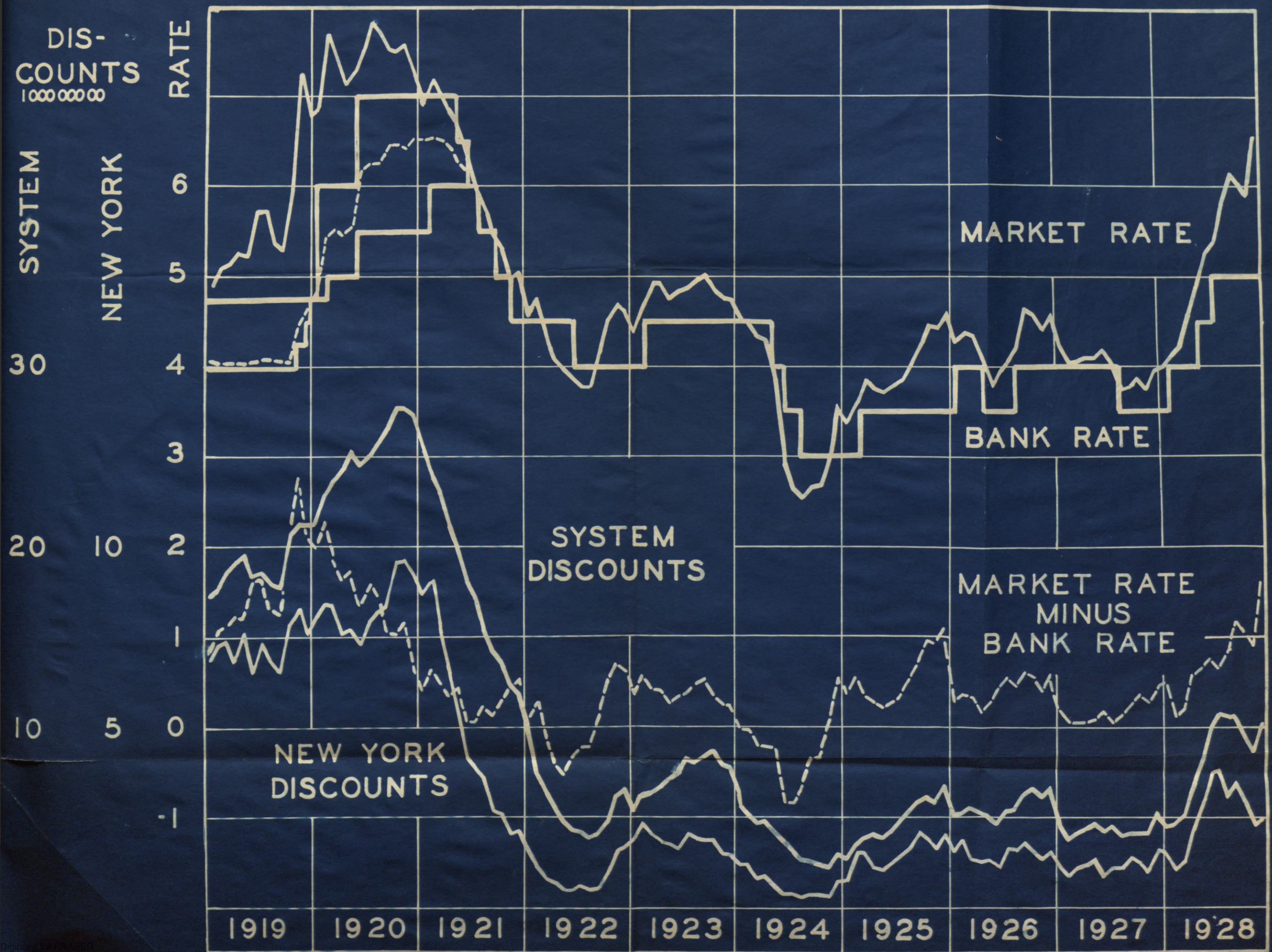


Diagram to be inserted at page 8

may be cited to show that some banks violate the tradition - especially when it is profitable to do so. The Federal Reserve Board reported that some member banks borrowed continuously in excess of three times their basic lines of credit for several years after the war of 1914-1918.⁷ In other words, some member banks have not always availed themselves of the opportunity to reduce borrowings instead of expanding loans. Sometimes⁸ When the latter is more profitable than repayment, some banks expand. Tersely stated, some bankers will violate the tradition when borrowing is sufficiently profitable. The concentration of borrowings even in a few banks, however, is a serious shortcoming of the tradition as an instrument of control over the total volume of credit. The following analysis will make this clear. If Bank A violates the tradition and borrows at the reserve bank to expand, it will presumably suffer adverse clearing balances. The bank or banks to which it loses funds, however, will receive them as new deposits and new reserves in due course. These banks may now expand without recourse to the reserve bank. The expansion of these banks, in turn, will permit other banks to expand without recourse to the reserve bank. Thus the violation of the tradition by some banks makes possible a manifold expansion of loans and deposits throughout the banking system. All the banks save those which violate the tradition and borrow may say that they never have recourse to the reserve bank; but their expansion is based upon reserve bank credit none the less because it is indirect.

Another more serious practical difficulty is that it is possible for banks to follow the letter of the tradition (if one may so speak of it) without abiding by its purpose. Certain types of short time borrowing which are not included in the tradition but are of real importance in the control of credit are of this character.^{9.} To illustrate: If bank A, after being indebted to the Reserve bank for several days, calls loans to repay the Reserve bank and thus forces bank B to discount; and bank B, in turn, calls loans after the lapse of a few more days, only to force bank C into the Reserve bank, no single bank will have violated the tradition against continuous borrowing; nevertheless, the total volume of discounting may be continuously large. The same consequences follow if the action is not deliberate. Indeed, it is just such circumstances which constitute a so-called legitimate "emergency" which warrants a bank in rediscounting at the Reserve bank. It has been said that one of the basic occasions for so-called legitimate borrowing at the Reserve bank is the necessity of member banks to restore impaired reserves. Except in unusual circumstances a bank which borrows to expand its earning assets will not remain in good favor at the Reserve bank. Mr. Keynes says "...pressure is put on the member banks to restrain their use of rediscounting facilities with the Federal reserve banks by enticising them, asking them inconvenient questions, and creating a public opinion to the effect that it is not quite respectable for a member bank

or good for its credit, to be using the resources of the Reserve bank more than its neighbors." ^{10.} Borrowing to restore a reserve, on the other hand, is acceptable to the officials. Yet the latter permits member banks as a whole to maintain an extended condition. The tradition against rediscounting does not meet the problem. It is also true that discounts and open-market purchases do not exhaust the avenues of access to the Reserve banks. Purchased bills constitute another avenue. The funds which the Reserve bank withdraws from the market through a sale of securities may be **returned** to the market by such purchases of bills at the initiative of the member banks. Again, the tradition is not even designed to operate against such transactions.

The tradition would seem to be effective against bankers in proportion to their temerity and scrupulousness. Without the use of other instruments (eg. rationing or threats to ration) it would appear ineffective against the boldly unscrupulous. If this be true, however, it tends to penalize those banks which follow it for the benefit of those which do not follow. The followers do not borrow and make less necessary increases in the rate; but the advantages of the lower rate accrue to the borrowers, **who** do not follow the tradition.

A third serious limitation to the tradition is that it is not uniformly effective in time. As one analysis reserve policy in the 1920's it becomes clear that open market operations, the tradition, and the rate are intimately related,

Indeed, the theory of the tradition was developed to explain the effectiveness of open market operations. At first some people assumed that a sale of securities by the reserve banks would reduce member banks' reserves by a corresponding amount. It was soon discovered, however, that frequently the actual result was a corresponding increase in rediscounts. In effect, the Reserve banks would have to lend the funds which were used to buy the securities. Under these circumstances, how could the policy of contraction be served? Mr. Burgess answers the question as follows:

The importance of the purchase or sale of securities "lies usually in their effect upon the amount of indebtedness of member banks to the Reserve Banks. By increasing their holdings of government securities the Reserve Banks lighten the indebtedness of the member banks, and by selling securities they increase this indebtedness. The significance of this operation arises from the unwillingness of the member banks to remain continuously in debt at the Reserve Banks. Their lending and investing policy is very closely related indeed to the amount of such indebtedness.

"The principle of open-market operations may be summarized by saying that purchases of securities by Reserve Banks tend to relieve member banks from debt to the Reserve Banks, and lead them to adopt a more liberal lending and investing policy. Money rates become easier; bank deposits increase. Such purchases tend to create a borrower's market. Conversely, sales of securities by the Reserve Banks increase member bank borrowing and lead the banks to adopt a somewhat less liberal policy. Money rates grow firmer; bank deposits tend to decline. Sales of securities tend to create a lender's market." (11)

If one compares the reserve system's holdings of government securities with the rate of discount, however, he notes that all appreciable changes in the system's holdings

In other words, when the system wished to tighten the market, it "supports" the tradition by an increase in the rate. It is also significant that "Reserve credit is more costly to member banks when Reserve banks substitute rediscounts for other earning assets."¹²

Diagram 2 relates for the decade 1919-1928 profitableness of discounting and volume of discounting for the system and for the New York member banks where profitableness is measured by the difference between the market rate as compiled by Riefler¹³ and the New York Bank rate.¹⁴ General conditions in the market may be described as follows: first, there was a large supply of short term paper in the market in which investments could be made by banks; second there was a cluster of money rates around the bank rate; third, the discount window was active. At that time it amounted to around \$500,000,000 plus at least \$100,000,000 of reserve bank investment in bills. These facts were related not only to the tradition but also to the rate. Had the rate been higher, the volume of discounting would doubtless have been less; had it been lower, the volume of discounting would doubtless have been greater. The general conclusion is clear and significant. In general the volume of discounts varied with the profitableness of discounting. Attention may be called to a few strategic periods. Practically throughout both periods (1922 and 1924) when borrowing was unprofitable, the volume of discounts fell appreciably and continuously. The period of greatest increase in discounts (1919-1920) was also the period in which

discounting was most profitable. None of the conditions of the 20's obtained ~~intthe~~ 30's.

One may summarize experience with the tradition as an instrument of policy. It appears most effective at the very times that the reserve banks are reducing rates and are otherwise interested in expanding credit; and it appears to be least effective precisely when the other actions of the Reserve officials indicate they wish it were most effective. This conclusion is warranted from the fact that the volume of discounts, the number of banks borrowing, and the rate roughly paralleled each other.

Therein lies the most telling criticism against the tradition. It is not sufficiently effective to curb a persistent demand for credit when profitable investments are available. If rediscounting is sufficiently profitable, some banks will indulge regardless of the tradition. Reliance upon it permits a situation to develop in which it is necessary to adopt more vigorous measures to a greater extent than might have been necessary had they been used originally. Mr. Keynes has expressed the matter as follows: "...measures of cajolery and mild discipline might prove inadequate against a widespread movement of expansion ascribable to the so-called 'legitimate' demands of trade - which are just as inflationary as the so-called 'illegitimate' demands of finance, and may be more so."¹⁵

In periods of depression, on the other hand, when bankers are not anxious for examinations, all the inconvenient questions

which the Reserve bankers asked to discourage borrowing at other times will be recalled; and the member banks will be less willing than ever to borrow. At such times, one may say, perhaps, that the tradition is effective; but that is precisely when the public interest might be served better if the tradition were violated. At such times the Reserve banks reduce their rates, yet such efforts to stimulate borrowing by direct appeal to profits could hardly be expected to be successful - if the tradition is effective. In short, the tradition has a reverse effectiveness.

Mr. Burgess seems to recognize this. At any rate, in 1927 he said that the feeling against borrowing was encouraged by the officers of the reserve system (p. 182). In 1936, he added the significant qualifying phrase "at times" (p. 220).

These factors indicate the wisdom of Mr. Harris's suggestion:

"Reserve policy should allow for the inability of the member banks in the larger city, subject to multiplex incomings and outgoings, always to balance their books. But when the banks find themselves in debt for long periods of time and when the number of banks in debt is abnormally large, there is something wrong fundamentally; the difficulty is no longer temporary disequilibrium of the balance of payments. The New York Bank is willing to discuss matters with the member banks out of line; but when all banks are borrowing excessively, the situation is to be met not by refusals but by a higher rate."(16)

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1. Annual Report of the Federal Reserve Board, 1928, p. 8.
2. Although similar in important ways, inter-bank loans are to be sharply distinguished from inter-bank deposits in the present discussion.
3. W. W. Riefler, Money Rates and Money Markets in the United States, New York, 1930, pp. 29-32; W. R. Burgess, The Reserve Banks and the Money Market, New York, 1936, p. 219. Mr. Harrod, however, in Economic Journal, Vol. 37, p. 285, attributes the origin of the tradition to "an initial distrust of the new system and the desire of member banks not to become indebted to it."
4. See the opening quotation of this section. See also W. R. Burgess, Op. cit., p. 220; Benjamin Strong in 67th Congress, 1st session, Agricultural Inquiry, Hearings on Sen. Conc. Res. 4, Washington, 1921, part 13, pp. 506-507; J. M. Keynes, A Treatise on Money, New York, 1930, Vol. 2, p. 240.
5. Cf. New York Times, August 21, 1937, August 22, 1937 (Article by Elliott V. Bell), August 27, 1937.
6. W. W. Riefler, Op. cit., pp. 22-23.
7. Annual Report of the Federal Reserve Board for 1922, p. 3.
8. W. W. Riefler, Op. cit., p. 161; S. E. Harris, Op. cit., p. 15; 69th Congress, 1st session, Stabilization, Hearings on H. R. 7895, Washington, 1927, pp. 665, 972-973.
9. 69th Congress, 1st session, Op. cit., p. 150, testimony of Professor Sprague.
10. J. M. Keynes, A Treatise on Money, New York, 1930, Vol. 2, 240.
11. Op. cit., pp. 238-239.
12. S. E. Harris, Twenty Years of Federal Reserve Policy, Cambridge, 1933, p. 66.
13. W. W. Riefler, Money Rates and Money Markets in the United States, New York, 1930, pp. 232-236.
14. This method knowingly ignores the fact that even a single bank may be able to expand its loans by a greater amount than its borrowings from the reserve bank. See C. A. Phillips, Bank Credit, New York, 1924, pp. 32-120; J. E. Rogers, Speculation and the Money Market, Columbia, Mo. 1927.
15. 1. J. M. Keynes, Op. cit., Vol. 2, p. 243.
16. S. E. Harris, Op. cit., pp. 18-19.