

Eligibility for Discount.

Not all of the infinite variety of paper which circulates in the financial world is eligible for rediscount at central banks. To be eligible, the paper must satisfy certain conditions. The functions of eligibility rules vary. One function is to prevent the bank from taking in paper upon which it may incur losses. Another is to restrict the "competition" of central banks with other financial institutions. Unquestionably the most important function is that which is based on the supposition that properly drawn, eligibility rules will solve the whole problem of credit control. Shorn of details the most common theory of eligibility is that if central banks confine rediscounting to paper which "represents" goods already in existence and moving toward a market, they will automatically extend precisely the proper amount of credit.

The automatic elasticity theorists wrote their ideas into the original Federal Reserve Act. Section 13 of that Act provided positively "...any Federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, and commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible, within the meaning of this Act." The same paragraph provided negatively "... such definition shall not include

notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities..."

Generally speaking, it was thought that these provisions would make the reserve banks largely passive. Any increase in the volume of "actual commercial transactions" would presumably result in a corresponding increase in notes, drafts, and bills of exchange, in short, in eligible paper. The eligible paper presumably would find its way to the reserve banks via the member banks. Since this paper (together with gold) formed the legal backing for notes, the process of discounting the the reserve banks would automatically create the added currency and deposits which were needed to transact the increased volume of "actual commercial transactions." One significant exception was made at the outset, namely, "bonds and notes of the Government of the United States" were eligible; but this was clearly viewed as an exception.

The automaticity of the system was clearly conditioned by the definition of eligible paper. In granting the right of definition to the Board, the House Committee on Banking and Currency stated: "In view of the great difficulty of defining 'commercial paper' the actual definition of the same has been left to the Federal reserve board in order that it may adjust the definition to the practices prevailing in different parts of the country in regard to the transaction of business and the making of paper." ^{2.} Yet, even this Committee believed the matter of definition to be ~~merely~~ technical and again asserted: "For obvious

reasons it is forbidden that any such paper shall be admitted to rediscount if made for the purpose of carrying stocks or bonds." ^{3.} In reality, this meant that the "automatic" system required management in the form of definition of eligibility.

The Board soon discovered an established American inter-bank loan practice which favored the loan over the discount. ^{4.} It accordingly recommended that the Act be modified "...to enable member banks to obtain prompt and economical accommodations for periods not to exceed fifteen days..." ^{5.} On September 7, 1916, the Act was amended to provide, among other things, that "Any Federal reserve bank may make advances to its member banks on their promissory notes for a period not exceeding fifteen days..provided such promissory notes are secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal reserve banks under the provisions of this Act, or by the deposit or pledge of bonds or notes of the United States." Quantitatively this new avenue, the advance secured by government securities, became by all odds the most important access to reserve bank credit.

Concerning the older device, the discount, however, the Federal Reserve Board persisted in the theory of the original Act. In June, 1920, it reported: "The Board, ever since the establishment of the Federal Reserve System, has consistently adhered to the principle that the question whether or not the

proceeds of a particular obligation are used for one of the purposes defined in the law must be determined by the use to which those proceeds are put by the maker of the note. In accordance with this principle the Board has frequently ruled that the note of a bank, a factor, a credit company, or any other such institution is not eligible for rediscount if the proceeds are used to lend to some third party. The fact that the proceeds may ultimately be used by that third party for a commercial, industrial, or agricultural purpose can not affect the character of the original obligation so far as the provisions of the Federal Reserve Act are concerned.^{6.}

Although the "principle" was supposedly clear, the Board encountered administrative difficulties in ascertaining eligible uses of proceeds of discounted paper. For example, in Regulation A, issued on September 15, 1916, it was ruled that "A Federal Reserve Bank must be satisfied by reference to the note or otherwise that it is eligible for rediscount. Compliance of a note...may be evidenced by a statement of the borrower showing a reasonable excess of quick assets over current liabilities."^{7.} Other financial ratios of the borrower have also been used to determine eligibility.^{8.}

Eligible uses of proceeds did not include fixed or permanent capital or working capital.^{9.} Nevertheless, some hairs were split in favor of agriculture.^{10.}
^{11.}

A significant departure from "the principle consistently adhered to ever since the establishment of the Federal Reserve System" was made in the regulation announced by the Board on

December 19, 1922. Governor Harding wrote; "In a conversation with Senator McKellar, of Tenn., whose home is in Memphis, I suggested that, in order to meet the wishes of the Memphis cotton factors that their notes be declared eligible for rediscount, it would be necessary to amend the law; and at his request I drafted for him a bill which provides that 'notes, drafts, and bills of exchange of factors issued as such making advances exclusively to producers of staple agricultural products in their raw state shall be eligible for such discount.'^{12.}" The bill became law. The regulation of December 19, was "issued for the purpose of permitting Federal reserve banks to purchase in the open market...bankers' acceptances...drawn by growers, or by cooperative marketing associations composed exclusively of growers, of nonperishable, readily marketable, staple agricultural products, to finance the orderly marketing of such products grown by such growers and secured at the time by warehouse, terminal, or other similar receipts issued by parties independent of the borrowers and conveying security title to such products."^{13.} The Agricultural Credits Act of March 4, 1923, further extended the principle of indirect financing by granting cooperative associations the power to borrow in order to make advances to their members.

These efforts of the Board apparently were designed to adapt the automatic self-liquidating eligibility system to American conditions, including political conditions. Meanwhile, the possibility of such an adaptation to American Commercial practices received a body blow in the extremely large advances

of reserve bank credit through the instrumentality of government securities floated to finance the war.

Gradually the reserve officials began to lose faith in the self-liquidating theory of control over the volume of credit even for regular discounts.

By August, 1921, reserve officials admitted that some reserve banks required additional collateral as a condition for rediscounting paper.^{14.} This was a recognition that in practice the reserve officials could not predict with certainty whether "self-liquidating" paper would in fact be liquidated.

Governor Strong indicated at the same time that his bank did not proceed upon any theory of automatic eligibility rules.

He testified: "...it would be a mistake to apply severe and technical rules in determining what paper was eligible upon the basis of goodness...the rules which we would apply and the tests which we would apply in determining the goodness of commercial paper which were justified in a period of high prices would no longer be justified in a period of low prices."^{15.}

Instead of a mechanical application of eligibility rules, the New York bank investigated the general policy of the applicant member bank, especially recent changes in loans to the stock exchange and clearing house balances.^{16.} Basically, in other words, tests were applied to the member bank not to the maker of the note.

Two significant admissions of inadequacy of eligibility requirements based on the origin of paper were made by the Board in 1924. It stated: "The Board is fully aware of the fact

that the problem of credit extension involves the question of amount or volume as well as the question of kind or character; otherwise stated, involves a quantitative as well as a qualitative determination." ^{17.} At the same time it admitted:

"There are no automatic devices or detectors for determining, when credit is granted by a Federal reserve bank in response to a rediscount demand, whether the occasion of the rediscount was an extension of credit by the member bank for non-

productive use." ^{18.} The arguments of the Board and of Governor ^{19.} Strong were repeated on later occasions.

The gist of the preceding discussion is that the viewpoint of the reserve officials changed gradually with the passage of time. At the outset they attempted to administer the Act in accordance with the philosophy behind it. Occasionally an administrative ruling was issued with primary attention directed toward the particular circumstances (including the political factor) rather than toward the philosophy of the Act. Gradually the Board lost confidence in the philosophy itself, especially in view of the important position of government securities. As confidence waned, the eligibility rules were made more lenient. Meanwhile, writers demonstrated the unsoundness of the general theory that proper eligibility ^{20.} rules would solve the problem of credit control. To be consistent, this theory would assume that each good would have outstanding and drawn against it at all times during its life a bill (or bills) equal to the value of the good. This

assumption was contrary to fact, in that some goods had no bills whereas others had several bills against them at the same time. In other words, the actual system of marketing and of financing purchases did not satisfy the assumptions made of it by the eligibility theorists. Nor was it true, as these theorists assumed, that all or ^{even} at least a constant proportion of all bills were held by the central bank.

The depression gave a dramatic coup de grace to eligibility as a control device. On October 7, 1931, President Hoover proposed the establishment of a national institution "...the purpose...to be the rediscount of banking assets not now eligible for rediscount at the Federal reserve banks in order to assure our banks, being sound, that they may attain liquidity in case of necessity." ²¹ Furthermore, point 4 of his program was: "I shall propose to the Congress that the eligibility provisions of the Federal reserve act should be broadened in order to give greater liquidity to the assets of the banks, and thus a greater assurance to the bankers in the granting of credits by enabling them to obtain legitimate accommodation on sound security in times of stress." ²²

On February 27, 1932, the Glass-Steagall Act was passed. The first two sections of this Act empowered the reserve banks in unusual, exigent, or exceptional circumstances to extend credit accommodations to member banks which did not have adequate eligible and acceptable paper to secure accommodation in the usual ways.

Senator Glass attempted to reestablish the old principles

and introduced a bill containing a section to that effect in March. The Board opposed this section of the Glass Bill and informed Senator Norbeck, "Experience shows that the particular instrument on which Federal Reserve credit is obtained is not an adequate test of the use to be made by the member bank of the proceeds of the credit...."^{23.}

Eligibility provisions were further relaxed by the Acts of February 3, March 9, March 24, and May 12, 1933.

The Banking Act of 1933 empowered the reserve banks to refuse to grant credit to a member bank even though it offered good eligible paper by changing the mandatory "shall extend" credit to banks to the permissive "may extend" credit.

Equally significant was the added requirement that the reserve banks and Board, in extending credit to member banks, have due regard to "the maintenance of sound credit conditions," Additional amendments further extended the list of eligible paper and securities especially in the directions of extensions of credit to institutions and individuals which were not member banks and in the direction of including public and publicly guaranteed securities.

Construction loans were made eligible by the amendment of June 27, 1934. The amendment of June 19, 1934, specifically empowered the reserve banks under exceptional circumstances to make loans to provide business with working capital.

A significant feature of these amendments is that they were modifications of the original theory of the Act adopted in each case to meet particular conditions. The Banking Act of 1935,

on the other hand, contained a provision which abandoned the old theory in principle. It provided: "Any Federal Reserve bank... may make advances to any member bank on its time or demand notes which are secured to the satisfaction of such Federal Reserve bank." The provision applied only to advances yet the change is fundamental. The Board, in keeping with the changes which had been made in the Act, issued a new Regulation^A on Discounts for and Advances to member banks by Federal reserve banks. These rules in effect made "all sound assets of member banks a potential basis of advances by the Federal Reserve banks."^{24.} On the other hand, the Board stated that "under the law a bank is not entitled to credit from a Federal Reserve bank merely because it has eligible and acceptable paper."^{25.} The Board said ^{that it's} ~~of its~~ new principles ~~that they~~ "mark a definite recognition of the fact that the lending function of the Federal Reserve banks is not automatic but is an instrumentality of the System's^{26.} general credit policy."